

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

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

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## **LIST OF ABBREVIATIONS**

**AKI** – Association of Kenya Insurers

**CIR** – Cost Income Ratio

**GDP** – Gross Domestic Product

**ICEA** – Insurance Company of East Africa

**IRA** – Insurance Regulatory Authority

**LOK** – Lion of Kenya Insurance Company Limited

**M&A** – Mergers and Acquisitions

**NOI** – Net Operating Income

**ROA** – Return on Assets

**ROE** – Return on Equity

**U.S** – United States



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## **ABSTRACT**

Mergers & Acquisition are arguably the most popular strategy among firms who seek to establish a competitive advantage over their rivals due to forces of globalization and fast technological changes coupled by market dynamics as well as changes in the regulatory environment. The objective of this research project is to establish the effects of mergers and acquisitions on the financial performance of insurance firms in Kenya. The research is based on the background that there has been a mixed and inconsistent result in the previous researches conducted in this area and scanty information linking M&A to financial performance has been presented in previous studies. The research employed event study approach as research design and descriptive statistics was used to analyze the data. The study utilized secondary data on financial statements of the merged/acquired insurance firms three years before and three years after the merger/acquisition. Panel data was collected on net profit, net premium, operating cost, current asset, current liability, total asset, total debt and revenue, this data was used to compute ratios and evaluate financial performance. The population of the study was made up of seven insurance companies that had merged/acquired over the sample duration period of 2000 and 2015. The study established that following merger and acquisition of insurance firms, ROA significantly increased from 27 percent to 50 percent after merging/acquisition of the insurance firms. This significant improvement shows that there is an increase in management efficiency in employing available assets to generate earnings. The importance of ROA means that any decrease in the management efficiency use of assets leads to a significant decline in profitability. Nevertheless, in this study ROA is the standard and proficient measure of financial performance, therefore merging/acquisition can be said to have significant positive effect on financial performance of insurance firms in Kenya. The study concludes that merging/acquisitions on its own cannot achieve strong, efficient and competitive insurance systems because performance is dependent on several other factors which need to be brought on board while evaluating M&A transaction.

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

In a globalized business environment, business units have been striving to come up with ways of increasing their value and sustenance in such competitive business environment that has resulted. It has been argued over time that one of the ways in which the firm's value and synergies can be improved is through adoption of such drivers as mergers and acquisitions (Betton, Eckbo, and Thorburn, 2008). They note that in a fiercely competitive industry that has mature firms in operations, such strategies as M&A can be attractive because of the growth they offer. For example, Cummins and Xie (2006) find that M&A provide an opportunity to expand market presence into another region, or new line of business and that the same time, purchasing similar lines of business from a competitor can also be an attractive way of adding new customers thereby improving margins and the bottom-line.

In the recent past, Kenyan firms, especially in the insurance and insuranceing sector have sought expansion and solidify existing business line through waves of mergers and acquisitions (M&A). This can partly be attributed to the need to conform to regulatory directives as well as increase the firm's profitability. The justification behind any corporate merger is the resultant synergistic effect whereby firms believe that by either merging or acquiring another company, the performance would be better than a single entity. In addition, the other benefits attributed to M&A in Kenya include; increased

market share and power, economies of scale, taxation, widen geographical areas, new market entry, elimination of inefficient management and among others (Mboroto, 2013). However, some other studies conclude that approximately half of M&A fail to meet their set objectives (Hubbard 2011) and attributes M&A failures to reasons such as mismatches between target and acquirer companies in terms of size, diversification into unrelated industries or cultural barriers where employees find themselves working under new work legislations, different working practices or company procedures.

Consequently, Eccles et al. (2009) opine that the success of M&A depends on factors like the industry or management preferences. Hence some companies prefer to build internally rather than buying or acquiring especially in cases where management realizes that they have the needed product or process knowledge and can easily capitalize on an opportunity without going through a buying process. Despite the downside of this merging process, M&A have occurred in many different forms and industries but this study seeks to figure out mergers and acquisition in the Kenyan insurance industry. In order to achieve this effectively, the study also seeks to determine whether mergers and acquisition have effect on the financial performance of the merged firms.

### **1.1.1 Mergers and Acquisitions**

A Merger is a combination of two or more companies in which the assets and liabilities of selling firms are absorbed by the buying firm. Although the buying firm may be a considerably different organization after the merger it retains its original identity. An acquisition on the other hand is the purchase of an asset such as a plant, a division or even an entire company (Sherman, 2011) which can be either full or partial depending on the level of control.

Pandey (2008) points out that there are three types of mergers: horizontal mergers, vertical mergers and conglomerate. A horizontal merger is an amalgamation between two firms potentially active in the same market at the same level of activity e.g. between two insurance companies while a vertical merger involves firms operating at different levels of the supply chain e.g. an insurance company acquiring a brokerage firm. On the other hand, a conglomerate is a merger between firms that are involved in totally unrelated business activities.

Ryan (2007) argues that mergers and acquisition occur when two firms decide to combine their businesses either by both business combining to create a new entity (merger) or by one purchasing a controlling stake in another business (acquisition). The opposite can also occur when a part of a business is 'spun off' or 'demerged'. In today's globalize economy, mergers and acquisitions are being increasingly used world over for improving competitiveness of companies through gaining greater market share, broadening the portfolio to reduce business risk, for entering new markets and geographies, and capitalizing on economies of scale among other.

The fundamental motives of M&A in insurance firms will therefore aim to achieve strategic benefits, enlargement of size and enhancing the customer base. Vertical M&A's in insurance firms helps to broaden the product portfolio thereby leading to cross-selling or up-selling with the core product. It is therefore hoped that the growth of insurance firms due to M&A leads to the concept of inorganic growth, which is often achieved through domestic or cross border M&A's. Mergers and acquisitions in the insurance

sector have the capacity to increase efficiency, profitability and synergy. They also help to form and grow shareholders value (Ma, Whidbee and Zhang, 2011).

### **1.1.2 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 which involves measuring the results and efficiency of a firm's policies, procedures and operations in monetary terms as reflected in the firm's return on investment, return on assets, return on equity, and operating income among others (Sufian and Chong, 2009). In insurance, performance is normally expressed in net premiums earned, profitability from underwriting activities, annual turnover, returns on investment and return on equity. In this study, various insurance ratios and profitability ratios obtained from audited financial statements of merged insurance companies in Kenya will be used to analyze pre and post mergers and acquisition effect on financial performance of insurance firms by way of performing analytical reviews. Pandey (2008) defines financial performance as a subjective measure of how well a firm uses assets from its primary mode of business to generate revenues. He further says that the term can also be used as a general measure of a firm's overall financial health position 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.

There is general agreement that insurance firm profitability is a function of internal and external factors. Koch (2005) observed that the performance differences between insurance firms indicate differences in management philosophy as well as differences in the market served. Profitability is a function of internal factors that are principally

influenced by the insurer's management decisions and policy objectives such as the level of liquidity, provisioning policy, capital adequacy, expense management and firm size, and the external factors related to industrial structural factors such as ownership, market concentration and stock market development and other macroeconomic factors (Athanasoglou *et al*, 2006). Though most of the studies on insurance profitability are based on developed countries especially the USA and Europe, a couple of studies focusing on developing countries Flamini et al (2009), Sufian and Chong (2009), and Naceur (2003) have also used similarly the same variables to study the determinants of insurance profitably.

### **1.1.3 Effect of Mergers and Acquisition on the Financial Performance**

Previous studies that sought to establish the effect of merging and acquisition on financial performance of companies have investigated the effect of M&A on performance by comparing pre- and post-M&A performance using financial and accounting data or using the event-study type methodology. In such a case the changes in the prices of specific financial market assets around the time of the announcement of the merger are analyzed. Lev (2003) finds that financial synergy can be realised in short term and long term goals. The short term financial synergies are, for example, price-earning effects, improved liquidity, and tax effects while the long term financial synergies include increased debt capacity, improved capital redeployment, and stabilized earnings. Lev (2003) highlight out that the motives for mergers are not only based on financial purposes, but also on such non-financial aspects of a firm as executive compensation, power needs and growth, human capital and risk diversification. On his part, Ryan (2007) assert that mergers can



generate an operating synergy which will result in improved managerial efficiency, economies of scale during production as well as improved production techniques.

Financial performance of a firm involves measuring the results and efficiency of a firm's policies, procedures and operations in monetary terms as reflected in the firm's return on investment, return on assets, return on equity, and operating income among others. In insurance, performance is normally expressed in net premiums earned, profitability from underwriting activities, annual turnover, returns on investment and return on equity. In this study, various insurance ratios and profitability ratios obtained from audited financial statements of merged insurance companies in Kenya will be used to analyze pre and post mergers and acquisition effect on financial performance of insurance firms by way of performing analytical reviews.

#### **1.1.4 Insurance Industry in Kenya**

The insurance industry in Kenya comprise of insurance companies, reinsurance companies, insurance and reinsurance brokers, loss adjusters, motor assessors, insurance investigators, insurance agents, medical insurance providers, claims settling agents and risk managers. These organizations are registered and licensed by the Insurance Regulatory Authority (IRA) in accordance with the provisions of the Insurance Act, Chapter 487 of the laws of Kenya. According to IRA's annual report (2013), the licensed insurers were forty seven (47), three (3) reinsurance companies, one hundred and seventy (179) insurance brokers, twenty four (24) medical insurance providers, and four thousand eight hundred and sixty two (4862) insurance agents. The industry's performance has registered improvement in which for example it recorded gross

premium of KShs. 130.65 billion in 2014 compared to Ksh 108.54 billion in 2013, representing an increase of 20.40%. Over the same time, the profits before tax increased to Ksh 18.17 billion from Ksh 14.637. The overall insurance penetration grew to 3.44% in 2014 compared to 3.16% in 2012. The improved was also evidenced in 2014 whereby, the registered insurance penetration rate grew to 4.12%.

Despite, the improved performance of the industry over the last decade, the industry is facing a number of challenges that must be addressed jointly with its stakeholders. Among the challenges include the threat of terrorism and sabotage and insufficient capacity to underwrite major infrastructure projects such as the Standard Gauge Railway, Oil & Gas and LAPSET which are currently being insured outside the country (IRA Annual Report 2014). In addition, the insurance firms are exposed to different forms of risks by nature of their activities and consequently, they need to pursue a more robust risk management process such that they will have to introduce policies, procedures, and technologies to protect the firm's business line from theft, fraudulent claims, and reinsurance risks. A process should therefore be in place to identify, mitigate and manage risk for insurance firms at the underwriting stage and at the same time introduce a process of quickly settling genuine claims made. At the same time, the insurance players have a role to play that includes introduction of proper self-regulation, corporate governance and making sure that the companies have the capacity to meet claims by rating risks properly, avoiding under-cutting and ensuring that their solvency margins are sufficient.

## **1.2 Research Problem**

In a firm, mergers and acquisitions decisions are critical to the success of corporations and this requires that such decision should not be hurried by the management. In an environment where different players offer the same services, firms find that the best way to get ahead is to expand ownership boundaries through mergers and acquisitions. This is because separating the public ownership of a subsidiary or business segment offers more advantages to such a firm (Eccles et al. 2009). For the existing shareholders of a firm and management the resultant synergies from the M&A strategy create economies of scale, expand operations and cut costs while for the investors mergers are expected to deliver enhanced market power. Mergers and acquisition in insurance industry respond to both structural and cyclical factors. Changes in regulation, technology and distribution can all be catalysts given that they affect competitive conditions, but their impact is gradual. Developments in the business cycle, associated moves in financial markets and underwriting market conditions are also important influences on firms' M&A decisions (AKI Annual Report 2014).

The insurance industry in Kenya has undergone fundamental transformations over the past 20 years. These changes are found both in the regulatory structure in which insurance firms operate as well as the business environments that the industry players have found themselves in. During this period, insurance firms in Kenya have had to contend with rampant economic transformations, including increased foreign competition and the requirement to increase their capital bases. These changes in the market necessitated the insurance firms to merge their operations. Presently in Kenya, notable

mergers and acquisitions include the merger of Lion of Kenya Insurance Company and Insurance Company of East Africa to form ICEA LION Group (2012), the merger of Apollo Insurance Company Ltd, and Pan Africa Insurance Company to form APA Insurance (2003). The acquisition of Mercantile Insurance Company Ltd by Colina Holdings to form Sacham Insurance Company Ltd (2012) and the ongoing acquisition of Real Insurance Company Ltd by Britam Ltd (2014). There is need to therefore establish how these companies have performed after their acquisition so as to augment the positions taken so far as relating the effect of mergers and acquisition on the financial performance of the insurance firms.

A number of studies have been undertaken to establish effect of M&A on the various performance measures of the merged firms. More recent studies have analyzed insurance and insurance firms M&A in Europe especially after the consolidation of the European economies and the unification of their currency (Yener et al., 2009). However, the results of these studies have been varied just like the methodologies that were adopted in carrying out the results. Some studies show that there is improved post-merger financial performance for acquiring firms (Azhagaiah and Kumar 2011: Ramaswany and Waegelein, 2003: Kithinji, 2007: Korir, 2006). However, other studies show that M&A have no financial benefits for the merged firms (Selcuk and Yilmaz, 2011: Yeh and Hoshino: Ndura, 2010). The conflicting findings have made it difficult for players in the insurance industry to say with certainty whether merging two insurance firms is a worthwhile undertaking making it difficult to make a concrete conclusions. For this reason, it has become important to analyze the performance of insurance firms in Kenya

after M&A. These inconclusive results relating to mergers and acquisition leads to the following research question: what is the effect of mergers and acquisition on the financial performance of insurance firms in Kenya?

### **1.3 Research Objective**

To establish the effects of mergers and acquisitions on the financial performance of Insurance firms in Kenya.

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

Few studies have been conducted on the effects of mergers and acquisition on the post-merger financial performance and specifically on the insurance industry in Kenya. Additionally, the few which have been done in this context give inconsistent results as earlier discussed. This study would be of great value and interest to policy makers, investors, customers, researchers, scholars and among others.

To policy makers, Insurance Regulatory Authority, this study would help in devising standards and procedures on establishing appropriate level of mergers and acquisition transactions as well as developing laws and regulations to guide the practice.

To investor, this study would be of value as it will help in making sound investment decision regarding mergers and acquisition transaction. It will also widen their knowledge when faced with decision on mergers and acquisition and how a merger will boost their overall wealth.

To scholars, this study will help build the knowledge in the discipline by adding on the existing literature on mergers and acquisition in relation to financial performance. The study will be used as a source of reference material and provide a ground for further research by the scholar.

To management, this study would inform them on the effect of mergers and acquisition on financial performance of their institutions. Through the findings of this study, the management will be able to strategize on how to realize maximum benefits from M & A transaction.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter reviews literature relating to M&A and its influence on financial performance by analyzing secondary materials drawn from previous research studies. The theories related to M&A are discussed. Then determinants of financial performance, empirical studies and conceptual framework are presented. A summary of the chapter and subsequent research gap is then outlined.

#### **2.2 Theoretical Framework**

The major objective of an insurance firm is to be able to register improved performance from one year to another. There are several theories competing on the area of M&A and their effect on the performance of a firm. Mergers and Acquisition theories encompass discussion on its overall effect on the firm performance and where specifically it is felt in the ensuring synergy from the firms. These competing theories include: Resource dependence theory, Efficiency theory and Organizational ecology theory.

##### **2.2.1 Resource Dependence Theory**

Resource dependence theory was most fully developed by Jeffrey Pfeffer and Gerald Salancik in 1978. It refers to the study of how the external resources of organizations affect the behavior of the organization based on the relationship between organizations as a specific conception of social action. The theory suggests that environments of organizations are important and conceptualizes the environment by focusing on groups

and organizations that supply resources to the organization. The Resource dependence theory contends that survival is the ultimate goal of the organization and identifies lack of autonomy and uncertainty in firms' business operations as important factors that will affect the sustainability of an organization. In addition, the relationship among organizations is determined by the degree of concentration of authority in the environment, the available resources between the firms and the interrelations of organizations in the environment.

The theory assumes that organizations are controlled by environment and depend on resources which originate from an organization's environment. Changes in the political-economic environment of organizations produce changing patterns of interdependence and conflict among organizations within a resource network. The desire of the insurance regulator, for example, to raise the capital base of insurance firms in Kenya to Ksh 3billion by end of 2016, is a source of uncertainty and to resolve such uncertainty, organizations merge, change the environment, or combine those three approaches (Stearns and Mizruchi, 2003). Through merging of the company's operations, there is going to be an increased size of the firms which make the organization's interaction with its environment more stable and predictable. In addition, a merger of organizations would make the resulting organization more powerful in its relationships with competitors (Mitchell and Mulherin, 2006).

Changes in regulation alter the social structure of insurance firms and such policy issues as deregulation makes the environment less certain, while regulation makes it more certain. Therefore, the resource dependence theory suggests that the condition in insurance's economic environment has an effect on its behavior. These changes in



operating environment include the health of the economy, the competitiveness of the economy, and the interest rate. Seballos and Thomson (2000), for example, suggest that regional economic conditions, in Europe contributed heavily to the failure of many insurance during the 1980s. The same can be said of Kenyan insurers and smaller insurances in the 1990s. Pfeffer and Leblebici (2003) suggest that the level of competition is an external pressure that constrains organizations. Competition has increased dramatically for insurances over the last 20 years. Domestic competition always has two effects that include the fact that deregulation made it easier for insurance or insurance holding companies to acquire insurances in other countries or within the same country and in the process increasing interstate competition (Litan and Rauch, 2008).

### **2.2.2 Efficiency Theory**

Efficiency theory was advanced by Copeland and Weston in 1988. This theory views mergers as being planned and executed by managers to achieve synergies. These synergies can either be financial, operational and managerial. Financial synergies result in lower costs of capital and this is achieved by lowering the systematic risk of a company's investment portfolio by investing in unrelated businesses. In addition, through mergers, the firm's size increases, which may give it access to cheaper capital as well as developing an internal market which operates on superior information and therefore allocate capital more efficiently (Jensen and Murphy, 1988). Operational synergies can arise from combining operations which had been separate such as the combined sales force or from knowledge transfers (Porter, 1985). Such kinds of operational synergies may lower the cost of the involved business units or may enable the company to offer

unique products and services. Managerial synergies in a merger are realized when the bidder's managers possess superior planning and monitoring abilities that benefit the target's performance. (Porter, 1985).

The theory assumes that, mergers will only occur when they are expected to generate enough realisable synergies to make the deal beneficial to both parties; it is the symmetric expectations of gains which results in a 'friendly' merger being proposed and accepted. If the gain in value to the target was not positive, it is suggested, the target firm's owners would not sell or submit to the acquisition, and if the gains were negative to the bidders' owners, the bidder would not complete the deal. Hence, if we observe a merger deal, efficiency theory predicts value creation with positive returns to both the acquirer and the target. Banerjee and Eckard (1998) and Klein (2001) evidence this suggestion.

However, several studies have discounted on the managerial, operational and financial benefits resulting from the merger. Rumelt (2001) show that indeed there is no evidence for a lower systematic risk or a superior internal capital market though they also found that there exist size advantages in the capital market. Managerial and operational synergies, on the other hand, have been criticized as evasive concepts that are often claimed for mergers but seldom realized (Porter, 1987). The differing perception of close observers (Rothman, 1988; Smith and Sandler, 1988) is the best indicator that direct evidence can produce unreliable results. On the other hand, his study showed related acquisitions to turn out better than unrelated ones, where three in four failed. Ravenscraft

and Scherer (1987) estimated a divestiture rate of one in three, and found the most active acquirers in their sample to be less profitable than the U.S. industry average.

### **2.2.3 Organizational Ecology Theory**

Organization ecology theory was developed by American organization theorists namely Michael Hannan, John Freeman and Howard Aldrich among others in 1997. The basic objective of this theory is to explain why certain organizations survive and multiply whereas others languish and disappear in the same environment. The theory assumes that, organizations depend on their environments for the resources they need to operate which gives environment considerable power over the organization. What interests the organization ecologist is not one particular organization seeking its own survival via competition for scarce and critical resources (the resource dependence view) but rather the patterns of success and failure among all the organizations that compete within a given resource pool.

The organizational ecology theory conceptualizes business entities as embedded in an environment that choose for survival the organizations that are best fitted to it. The theory posits that there are different types of organizations because of the different types of environments that exist to support such business units. This theory therefore means that the process of selecting a firm is important in determining survival than the adaptive processes that organizations use. According to this theory, factors both internal and external to the organization cause the organization to resist adaptation (Hannan and Freeman, 1997). They point that inertia or the unwillingness to embrace changes in the business environment would block structural change completely in a firm.

Organizational ecology theorists explain the failure and survival of business units by assessing specifically at the economic stability of the environment within which a firm operates. This explanation, termed niche theory, suggests that different types of organizations are likely to survive in different environments, with each population occupying a specific niche (Hannan and Freeman, 1997) and this position can be enhanced through merging of business firms with the same interest. A niche is considered as that business line in constraint space in which the population out-competes all other local populations.

A firm business niche is considered as two dimensions that are defined by whether the environment is stable or dynamic and whether changes in the environment are fine-grained (closed together) or coarse-grained (large and far apart) (Carrol, 2001). Therefore, it is taken that generalist organization, which has slack, is likely to survive change in coarse-grained environments, as they will be able to adapt to the changes. However, specialist organizations out-compete generalists during change in fine-grained environments, since generalists will not have time to make the appropriate adjustments. The reason could be that specialist's organizations out-compete generalists in stable environments since they are more efficient because of their lack of slack (Hannan and Freeman, 1997).

The idea of population niches can be used to predict which insurance firms will survive in which type of environment. Because the political-economic and regulatory environment in which insurance firms operate has been changing over time, it is expected that the firms will be affected by the evolving conditions set by the regulators. In Kenya,

the bill passed by IRA, designed to raise capital standards in the industry and improve solvency of insurers, may have forced some relatively weak insurers to find a way out of financial distress by merging with other insurance companies to avoid incurring regulatory costs. Though no evidence is available to support this, we believe further rises in capital may result in increase of mergers.

## **2.3 Determinants of Financial Performance**

In accordance with the above theories discussed, many studies have introduced some variables in the profit function of firms to shed light on key factors that make a difference in profits. From the review of the literature, there is a consensus that a firm profitability is a function of internal and external factors. Koch (1995) point out that the performance differences between firms indicate differences in management philosophy as well as differences in the market served. Athanasoglou *et al*, (2006) concurred and argued that profitability is a function of internal factors that are mainly influenced by the organizations management decisions and policy objectives such as the level of liquidity, provisioning policy, capital adequacy, expense management and size, and the external factors related to industrial structural factors such as ownership, market concentration and stock market development and other macroeconomic factors.

### **2.3.1 Capital Adequacy**

Capital adequacy refers to the sufficiency of the amount of equity to absorb any shocks that the insurance firm may experience (Kosmidou, 2009). In most of the countries, the capital structure of insurance firms is highly regulated because capital plays a crucial role in reducing the number of insurance failures and losses to the insured when an insurance

firm fails as highly leveraged firms are likely to take excessive risk in order to maximize shareholder value at the expense of finance providers (Kamau, 2009). Although there is general agreement that statutory capital requirements are necessary to reduce moral hazard, the debate is on how much capital is enough.

Regulators would like to have higher minimum requirements to reduce cases of insurance failures, whilst insurers in contrast argue that it is expensive and difficult to obtain additional equity and higher requirements restrict their competitiveness (Koch, 1995). Beckmann (2007) argue that high capital lead to low profits since insurances with a high capital ratio are risk-averse, they ignore potential investment opportunities and, as a result, investors demand a lower return on their capital in exchange for lower risk. The quality of assets held by an insurance depends on exposure to specific risks, trends in non-performing loans, and the health and profitability of insurance firms (Baral, 2005). Aburime (2008) asserts that the profitability of an insurance firm depends on its ability to foresee, avoid and monitor risks, possibly to cover losses brought about by their nature of business.

### **2.3.2 Asset Quality**

Poor asset quality and low levels of liquidity are the two major causes of insurance firms' failures. According to Waweru and Kalani (2009) many of the financial institutions that collapsed in 1986 failed due to non-performing loans (NPLs) and that most of the larger insurance-failures, involved their inability to pay on time the claims lodged. The IRA measures asset quality by the ratio of net non-performing loans to gross loans. However Koch (1995) argues that a good measure of credit risk or asset quality is the ratio of loan

loss reserve to gross loans because it captures the expectation of management with regard to the performance of loans.

### **2.3.3 Management Efficiency**

Another important decision that the managers of insurance firms take refers to the liquidity management and specifically to the measurement of their ability to pay their claimants on time. The importance of liquidity goes beyond the individual insurance as a liquidity shortfall at individual insurance firms can have systemic repercussions (IRA, 2012). It is argued that when insurers hold high liquidity, they do so at the opportunity cost of some investment, which could generate high returns (Kamau, 2009). The trade-offs that generally exist between return and liquidity risk are demonstrated by observing that a shift from short term securities to long term securities or loans raises an insurance's return but also increases its liquidity risks and the inverse is true. Thus a high liquidity ratio indicates a less risky and less profitable insurance firm (Hempel et al, 1994). Thus management is faced with the dilemma of liquidity and profitability. Myers and Rajan (1998) emphasized the adverse effect of increased liquidity for financial institutions stating that, "although more liquid assets increase the ability to raise cash on short-notice, they also reduce management's ability to commit credibly to an investment strategy that protects investors" which, finally, can result in reduction of the "firm's capacity to raise external finance" in some cases (Uzhegova, 2010).

Poor expense management is the main contributor to poor profitability (Sufian and Chong 2008). In the literature on insurance performance, operational expense efficiency is usually used to assess managerial efficiency in insurance. Mathuva (2009) observed that the CIR of local insurance firms is high when compared to other countries and thus

there is need for local insurance firms to reduce their operational costs to be competitive globally. Beck and Fuchs (2004) examined the various factors that contribute to high interests spread in Kenyan insurance firms. Overheads were found to be one of the most important components of the high expense ratio. An analysis of the overheads showed that they were driven by staff wage costs which were comparatively higher than other insurance firms in the developed world.

### **2.3.4 Market Power**

The market power theory posits that, the more concentrated the market, the less the degree of competition (Tregenna, 2009). According to Nzongang and Atemnkeng (2006) high degrees of market share concentration are inextricably associated with high levels of profits at the detriment of efficiency and effectiveness of the financial system due to decreased competition. Secondly, since commercial banks are the primary suppliers of funds to business firm, the availability of insurance credit at affordable rates is of crucial importance for the level of investments of the firms, and consequently, for the health of the economy. In situation of increased concentration, the possibility of rising costs of credits is reflected by a reduction of the demand for insurance loans and the level of business investments. The effect multiplies many folds in as much as insurance management capitalizes on the market share concentration factor.

### **2.3.5 Insurance Size**

Large insurance firms with market power have typically been viewed as having incentives that minimize their risk-taking behavior and improve the quality of their assets. Keeley (1990) as cited by Northoctt (2004) argues that the rise in insurance failures in the United States during the 1980s was due in part to an increase in



competition in the insurance industry. Flamini *et al* (2009) noted that if high returns are the consequence of market power, this implies some degree of inefficiency in the provision of insurance services. In this case it should prompt policymakers to introduce measures to lower risk, remove insurance entry barriers if they exist, as well as other obstacles to competition, and reexamine regulatory costs. But insurance profits are also an important source for equity. If insurance profits are reinvested, this should lead to safer insurance firms, and, consequently high profits could promote financial stability.

### **2.3.6 Macro-Economic Factors**

The macroeconomic policy stability, Gross Domestic Product, Inflation, Interest Rate and Political instability are also other macroeconomic variables that affect the performances of insurance firms. For instance, the trend of GDP affects the demand for insurance asset. During the declining GDP growth the demand for credit falls which in turn negatively affect the profitability of insurance firm. On the contrary, in a growing economy as expressed by positive GDP growth, the demand for credit is high due to the nature of business cycle. During boom the demand for credit is high compared to recession (Athanasoglou et al., 2005). The same authors state in relation to the Greek situation that the relationship between inflation level and bank profitability is remained to be debatable. The direction of the relationship is not clear (Vong and Chan, 2009).

From the above determinants of the insurance firm's performance, it came out that there is a multiplicity of factors that influences the performance of an insurance performance. There is need therefore of an insurance firm to consider the several determinants and not only depend on one factor. As much as external factors outside the purview of the

insurance management could influence its performance, there is need to consider also the internal factors that are also important. Such factors as insurance size, investment portfolio and management efficiency came out as equally important factors that will need to be managed effectively.

## **2.4 Empirical Literature Review**

Different types of studies have been undertaken on the area of M&A in different countries, having different levels of economic development and also using different methodologies, both at the international arena as well as in Kenya.

### **2.4.1 International Evidence**

On his part, Yook (2004) determined the impact of acquisition on the acquiring firm's financial performance by comparing pre and post-acquisition Economic Value Added (EVA) in comparison to the industry average. The study used a cross-sectional variation in EVA performance according to the types of acquisition, methods of payment, and business similarity. Using a sample of 75 of the largest acquisitions occurring during 1989 to 1994 in the United States, the results concluded that acquiring firms experience significantly reduction in their financial performance after the acquisitions process. In addition, when they calculated industry-adjusted EVA where upon they found that the difference is indiscernible and this decline in raw EVA is grounded by industry effects. Tender offers consistently earn larger EVA than do mergers. However, they found that there is no difference if EVA is calculated without adjusting the premium.

Yuce and Ng (2005) sort to establish the effect of merger announcements of Canadian firms on the abnormal returns. The sample consists of all Canadian mergers that occurred between

1994 and 2000 making up 1361 acquirer companies and 242 target companies representing industrial product companies, oil and gas companies, consumer product sectors and the rest of the sample is scattered over 38 industries. The results indicated negative results in contrast to U.S. studies. They argued that both the target and the acquiring company shareholders earn significant positive abnormal returns, but it is lower than what had reported in previous study of Megginson et al. (2004) on Canadian companies. These results mean that abnormal returns appear to be decreasing through time. The results of Yuce and Ng (2005) suggest therefore that there exist a significant and positive cumulative abnormal returns to acquirers buying private firms with stock rather than public ones and also that no significant difference is found between public and private targets when paid in cash.

Kling (2006) undertook a research on the successfulness of the mergers wave in Germany and to analyze the effect of mergers on the macro level taking into consideration variables that might drive mergers such as: economics of scale, macro-economic conditions, success of former mergers and market structure. The study used a sample of 35 leading German companies that merged over the period from the early 1870s to the beginning of the First World War in 1914 covering a period of 44 years. The results reveal that the first German wave of merger started around 1898 accompanied by the introduction of the new exchange law in 1896. The vector regression model used was unable to find out that mergers were not successful through the whole period albeit periods of successful mergers, hence, this issue has been identified using rolling regressions. From 1898 to 1904, mergers affected total stock returns positively in all industries except for insurances.

Lau et al. (2008) examined the operating performance of merged firms, compared to the performance of the pre-merger targets and acquirers, for a sample of 72 Australian mergers between 1999 and 2004. Performance measures used in the study were profitability, cash flow, efficiency, leverage and growth. The measures were used to proxy for the success of the merger, which is defined in terms of an improvement in each merged firm's industry-adjusted operating performance between the pre and post-merger period. The results provide some evidence that mergers improve the post-merger operating performance.

Kumar (2009) examined the post-merger operating performance of a sample of 30 acquiring companies involved in merger activities during the period 1999-2002 in India. The study attempts to identify synergies, if any, resulting from mergers. The study uses accounting data to examine merger related gains to the acquiring firms. It was found that the post-merger profitability, assets turnover and solvency of the acquiring companies, on average, show no improvement when compared with premerger values.

Guest et al. (2010) examined the financial impact of 303 acquisitions of UK public companies, completed between January 1985 and December 1996. They wanted to address whether takeovers yield a positive net present value for the acquiring company. They analyzed the sample using two methodologies- accounting returns and residual income approach. Their findings showed that while the accounting returns showed significant improvement in performance, the residual income approach finding was that acquisitions had a small and insignificant effect on fundamental value, relative to control firms. In general, mergers occur when the managers of an acquiring firm perceive that the value of the

combined firm is greater than the sum of the values of the separate firms (Netter, Stegemoller, and Wintoki, 2011). This change in value can occur due to the reason that the contracting costs can be lower within than across firms, creating production efficiencies in combining firms.

Hoberg and Phillips (2011) used a text-based analysis of firms' product descriptions in their 10-K reports and showed that, *ceteris paribus*, firms with broad product market similarities to all firms in the economy are more likely to merge, while firms with highly similar rivals in the product space are less likely to do so. Their results suggest that, when close rivals compete for growth opportunities and market share, such competition lessens the likelihood of a merger pair formation. Moreover, when firms are too similar, antitrust concerns might come into play, further reducing this likelihood. Similar rivals in their product market space may pursue related innovation activities. R&D efforts of rival firms may lead to the introduction of new products or services, further intensifying product market competition (Bloom, Schankerman, and Van Reenen (2013)).

Maksimovic, Phillips, and Prabhala (2013) find that productivity of acquired assets increases in industries in which the acquirer operates. They show that mergers between firms with product market similarities achieve bigger product range expansions, and higher operating profitability and sales growth. They find that vertical mergers are associated with positive wealth effects significantly larger than those for diversifying mergers.

### **2.4.2 Local Evidence**

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. The information for five years before and after the merger was compared and the results tabulated. The findings indicated an 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.

Lole (2012) set out to investigate the effects of the merger of Apollo Insurance Company Ltd, and Pan Africa Insurance Company to form APA Insurance in 2004. Lole used accounting analysis regression models and found that the merger was effective on the financial performance of the insurance company. Lole (2012) further recommended that insurance companies should opt for mergers and acquisitions to enable the insurer to alleviate the challenges that face the Kenyan insurance industry.

Marembo (2012) researched on the impact of mergers and acquisition on the financial performance of commercial banks in Kenya over the period 1994 to 2010. Marembo used accounting analysis regression models and found that the new financial institution formed after the merger was more financially sound. He further recommended that commercial

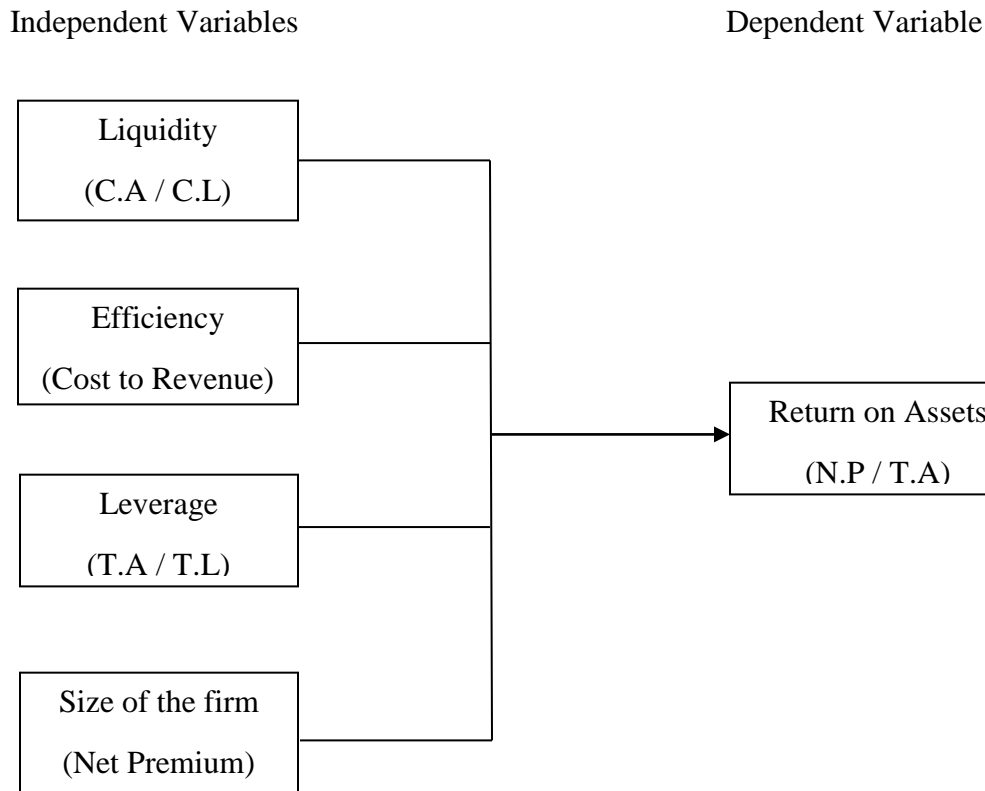
insurances with a weak and unstable capital base should seek to consolidate their establishments through mergers and acquisitions.

Mitema (2014) researched on the effect of mergers and acquisition on value creation of insurance companies in Kenya. Using descriptive design and basing the findings on all insurance companies that had merged between 2000 and 2013, the results established that following the merger and acquisition, the fundamental value of the combined entity improved as the book value of the new entity increased. These differences were significant. Dividends were also higher for the merged entity whereas the residual income and terminal value decreased. These differences were not significant. The research results were similar to the results of Lole (2012) who adopted a different approach with a different sample size. There were seven M&A and merger notifications since 2000 related to the insurance industry in Kenya

## **2.5 Conceptual Framework**

Return on assets as a measure of financial performance is identified as the dependent variable being influenced by liquidity position, efficiency of management, leverage position and size of the firm. Changes in the four independent variables are likely to affect the profitability levels of the firm as shown in fig 2.1 below.

**Fig 2.1 Conceptual framework model**



## 2.6 Summary of Literature Review

On the basis of the studies reviewed in the literature that discusses the effects of M&A on the financial performance of companies, the studies show that there has been a lack of consensus on the effect of mergers and acquisitions on returns for both the acquiring and the acquired firms; in which some studies reported insignificant improved abnormal returns (Megginson et al., 2004) while Yuce & Ng (2005) while others reported significant positive abnormal returns in Canada. On the other hand, some studies reported positive returns in high merger activity era and negative returns in low merger activity era (Tse and Soufani, 2001).



Consequently, it is the intention of this study that the results of the research will contribute to understanding of M&A and ultimately help in understanding how mergers and acquisitions can be more successful. This is because there has been a mixed and inconsistent result on the effect of M&A on the performance of the firm and studies in this area have scanty information linking M&A to financial performance. This study will therefore, seek to fill the gap by adding more knowledge on the effect of M&A on financial performance based on various financial ratios.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter sets to explain the research design, the population of interest, the basis of sample selection, the type of secondary data to be used, the sources of data, the techniques of analysis and the data analysis to be undertaken.

#### **3.2 Research Design**

This research will employ event study research design. Event study is a statistical method designed to assess the impact of an event on the value of a firm at a particular point in time (MacKinlay 1997), by describing the characteristics of a population or phenomenon and presenting a picture of the specific details of a situation, social setting, or relationship. Event study research is quantitative in nature and requires more structured design than exploratory research. The study will be cross-sectional and this will allow the researcher to make statistical inference on the broader population and generalize the findings to real life situations and thereby increase the external validity of the study.

#### **3.3 Population and Sampling of the Study**

The population of the study will be made up of all the insurance companies that had merged over the sample duration period of 2000 and 2015. There were seven M&A and merger notifications since 2000 related to the insurance industry in Kenya and this study seeks to research on all of them. These will form the researcher's population (Appendix

1) out of which two acquisitions will be excluded from the study since they do not meet the set post-merger financial data requirements of three years as at the time of this study. Since a takeover should involve a change in the ownership of the firm, the research will exclude any pending or non-binding, vertical mergers that do not have competitive effects. Firms that were registered as insurance brokerages and acquisitions of lines of business that do not involve a change in the ownership of firms will also be excluded. Since the number of the respondents is limited, then the study will be a census survey.

### **3.4 Data Collection**

The study will use secondary data on financial statements of the merged company before and after the merger. The fundamental or intrinsic value will then be compared before and after the merger. Secondary data will be obtained from the IRA annual reports as well as from the company's official websites through data collection form instrument (Appendix II). From the financial statements, the researcher will collect panel data; a combination of time series and cross sectional data. This information will include net profit, net premium, operating cost, current asset, current liability, total asset, total debt and revenue. In getting the same information, only insurance firms that will have continuously operated over the period 2000 to 2015 will be considered in the study.

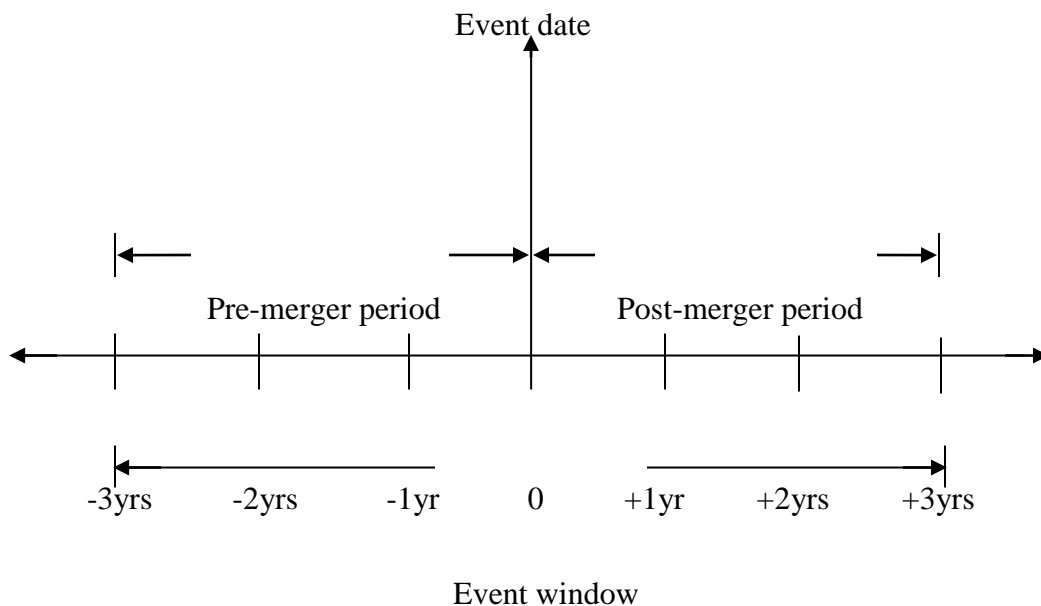
### **3.5 Data Analysis**

Since the research employs an event study approach and in order to analyze the financial performance of the insurance firms, three years pre-merger and three years' post-merger financial data analysis will be conducted in which case, the financial figures in the financial statements of two independent insurance will be consolidated and evaluated

three years before the merger / acquisition and compared three years later after the merger (when the two insurance companies are operating as one) as illustrated in fig 3.1 below. The resulting ratios once calculated, analyzed and evaluated enabled the researcher to assess the effects of mergers and acquisitions on the financial performance of insurance firms.

Descriptive statistics like mean, median, mode, skewness and kurtosis will be used to test the normality of the data. For inferential statistics the study will adopt similar test as that applied by Trivedi (2014) where upon he used Kolmogorov Smirnov Test (KS test) and Shapiro Wilk test will be applied for analysis. Frequency table will also be used for conducting analysis.

**Fig 3.1 Event study graph**



From the graph above, the event date represents the occurrence of M&A transaction while the event window represents the period within which the study will be analyzed to

establish the effect of M&A on financial performance of insurance firms in Kenya; in this case, the event window is six years.

The statement of financial position as well as the statement of financial performance and their notes will be studied to get the data for the variables mentioned in the regression model below. The model will be conducted to assess the strength of relationship between dependent and independent variable and also confirm relationship between mergers and financial performance. Specifically, the model will take the form;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon$$

Where;

- Y - ROA = Net Profit / Total Asset
- X<sub>1</sub> - Current Ratio = Current Asset / Current Liability; this is a liquidity ratio which measures the ability of a firm to meet its short term obligation.
- X<sub>2</sub> - Cost to Revenue Ratio = Cost / Revenue; this is an efficiency ratio which compares operating cost to revenue (net premium).
- X<sub>3</sub> - Leverage = Total Debt / Total Assets; this is a gearing ratio used to determine the firm's debt levels and its ability to meet financial obligation.
- X<sub>4</sub> - Log (Net Premium); this is a measure used to determine the size of a firm.
- X<sub>3</sub>, X<sub>4</sub> - Control variables of the regression equation.
- $\beta_0$  - Regression constant of the equation.
- $\beta_1, \beta_2, \beta_3, \beta_4$  - Coefficient of independent variables.
- $\epsilon$  - Error term of equation

### **3.6 Test of Significance**

The F- test will be used to determine the significance of the regression while the coefficient of determination,  $R^2$ , will be used to determine how much variation in Y is explained by X. This will be done at 95% confidence level and correlation analysis will be carried out to find the direction of the relationship between ROA and the independent variables. The Statistical Package for Social Sciences (SPSS) will be used to analyze the data.

## **CHAPTER FOUR**

### **DATA ANALYSIS, FINDINGS AND INTERPRETATION**

#### **4.1 Introduction**

This chapter presents analysis, findings and interpretation of the research. The objective of this study was to assess the effects of mergers and acquisitions on the financial performance of insurance firms in Kenya. The study period was based on firm's operational period three years before and after merger and acquisition.

#### **4.2 Data Analysis**

Being an event study approach, financial figures in the financial statements of two independent insurance firms will be consolidated and the resulting ratios evaluated three years before the merger / acquisition and compared three years later after the merger (when the two insurance companies are operating as one). Descriptive statistics will be used to describe, show or summarize data in a meaningful way and explain patterns which might emerge from the data. This study investigated the descriptive statistics on current ratio, cost to revenue ratio, leverage and net premium of insurance companies three years before and after merger and acquisition.

### 4.2.1 Three years of operational period before merger and acquisition

**Table 4.1 Ratio results of insurance companies three years before merger**

	<b>Median</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std deviation</b>
Current Ratio	1.311	1.362	1.924	1.810	.3621
Cost to Revenue Ratio	.611	.622	.871	.861	.015
Leverage Ratio	.313	.232	.911	.832	.361
Log (Net Premium)	.047	.056	.051	.054	.087
Return on Asset	.0558	-.0108	.2717	1.192	.4612

**Source: Research findings**

Results obtained various aggregated ratios three years before merger showed a mean average current ratio of 1.810. This implies that before mergers and acquisition most of the insurance companies could only put 1.810 of its current liabilities using company's current assets.

The findings also showed an aggregated cost to revenue ratio mean of 0.861 implying that before mergers and acquisition most of the insurance companies were operating on average cost of 0.861 which depicts a high the cost-to-revenue ratio and low the operating efficiency.

Results assessing the leverage ratio in three years before merger of insurance companies recorded a mean average of 0.832; this showed that 83.2% of the total company equity was financed through debts (borrowing).



Results assessing the Net premium in three years before merger of insurance companies recorded a mean average of 0.054. This shows weak strength in most of insurance companies before merger.

#### 4.2.2 Three years of operational period after merger and acquisition

**Table 4.2: Ratio results of insurance companies three years after merger**

	<b>Median</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std deviation</b>
Current Ratio	1.903	1.691	2.231	2.711	0.012
Cost to Revenue Ratio	.611	.622	.871	.361	.056
Leverage	.411	.334	.552	.432	.011
Log (Net Premium)	.0853	.0863	.0868	.0857	.1181
Return on Asset	.0321	.0221	.5041	2.373	.9347

**Source: Research findings**

Results obtained various aggregated ratios three years after merger showed a mean average current ratio of 2.711. This implies that after mergers and acquisition most of the insurance companies could put its current liabilities using company's current assets freely.

The findings also showed an aggregated cost to revenue ratio of 0.361 implying that after mergers and acquisition most of the insurance companies were operating on average cost of 0.361 which depicts a low cost-to-revenue ratio and high the operating efficiency.

Results assessing the leverage ratio in three years after merger of insurance companies recorded a mean average of 0.432; this showed that 43.2% of the total company equity was financed through debts (borrowing).

Results assessing the Net Premium in three years after merger of insurance companies recorded a mean average of 0.857 this show the high of strength in most of insurance companies after merger.

### **4.2.3 Comparison of the two operational periods**

Assessing the current ratio in the two operational periods, the results depict that after merger; most of the merged insurance companies were in a position to offset their current liabilities using company's current assets. The cost to revenue ratio dropped from 0.861 to 0.361 implying that fewer investments could yield more returns after merger with operating efficiency. The leverage ratio in three years after merger dropped from 83.2 percent to 43.2 percent which implies that owner's equity superseded the borrowing. Net Premium in three years after merger of insurance companies grew from 0.054 to 0.857 this show the high of strength in most of insurance companies after merger.

## **4.3 Relationship among Study Variables**

### **4.3.1 Correlations Analysis**

After the descriptive analysis, the study conducted Pearson correlation analysis to indicate a linear association between the predicted and explanatory variables or among the latter. It, thus, help in determining the strengths of association in the model, that is, which variable best explained the relationship between study variables.

**Table 4.3: Correlations of variables**

		Return On Assets	Current Ratio	Cost To Revenue Ratio	Leverage	Net Premium
Return On Assets	Pearson Correlation	1				
	Sig. (2-tailed)					
Current Ratio	Pearson Correlation	.841	1			
	Sig. (2-tailed)	.000				
Cost To Revenue Ratio	Pearson Correlation	.751	.042	1		
	Sig. (2-tailed)	.000	.002			
Leverage	Pearson Correlation	.783	.132	.912	1	
	Sig. (2-tailed)	.000	.045	.000		
Net Premium	Pearson Correlation	.773	.786	.151	.223	1
	Sig. (2-tailed)	.000	.000	.002	.001	

**Source: Research findings**

On the correlation of the study variable, the researcher conducted a Pearson moment correlation. From the finding in the table above, the study found that current asset was strong correlation coefficient between return on assets and current ratio as shown by correlation factor of 0.841, this strong relationship was found to be statistically significant as the significant value was 0.000 which is less than 0.005, the study found strong positive correlation between return on assets and organizational cost to revenue ratio as shown by correlation coefficient of 0.751, this too was also found to be

significant at 0.000 level of confidence, the study also found strong positive correlation between return on assets and leverage as shown by correlation coefficient of 0.783 at 0.000 levels of confidence. Finally the study found a strong positive correlation between return on assets and net premium as shown by correlation coefficient of 0.773 at 0.000 levels of confidence. The findings are in line with the research by Ambrosini, (2003) who found a strong positive correlation between leverage and Return on Assets adding that leverage can provide opportunities for achieving substantial savings, significant improvements in performance.

### 4.3.2 Regression Analysis

In this study, a multiple regression analysis was conducted to test the influence among predictor variables. The research used statistical package for social sciences (SPSS V 21.0) to code, enter and compute the measurements of the multiple regressions. The model summary is presented in the table below;

**Table 4.4: Regression statistics table**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.836 <sup>a</sup>	.745	.642	.37290

**Source: Research findings**

The study used coefficient of determination to evaluate the model fit. The adjusted  $R^2$ , also called the coefficient of multiple determinations, is the percent of the variance in the dependent variable explained uniquely or jointly by the independent variables. The model had an average adjusted coefficient of determination ( $R^2$ ) of 0.642 and which implied that

64.2% of the variations in Return on Assets are explained by the independent variables understudy (current ratio, cost to revenue ratio, leverage and net premium).

The study further tested the significance of the model by use of ANOVA technique. The findings are tabulated in table below.

**Table 4.5: Summary of One-Way ANOVA results**

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	25.904	4	6.476	5.291	.000 <sup>b</sup>
Residual	1.224	1	1.224		
Total	27.128	5			

**Source: Research findings**

Critical value =3.84

From the ANOVA statics, the study established the regression model had a significance level of 0.0% which is an indication that the data was ideal for making a conclusion on the population parameters as the value of significance (p-value) was less than 5%. The calculated value was greater than the critical value ( $5.291 > 3.84$ ) an indication that current ratio, cost to revenue ratio, leverage and net premium all have a significant effects on return on assets. The significance value was less than 0.05 indicating that the model was significant.

#### **4.3.2.1 Regression Coefficients**

In addition, the study used the regression coefficient table to determine the study model.

The findings are presented in the table below.

**Table 4.6: Regression Coefficients**

Model	Unstandardized		Standardized	t	Sig.
	Coefficients		Coefficients		
	B	Std. Error	Beta		
(Constant)	-5.283	1.454		-3.633	.002
Current Ratio	.362	.093	.284	3.892	.016
Cost To Revenue Ratio	.334	.086	.299	3.884	.005
Leverage	.329	.071	.297	4.634	.000
Net Premium	.337	.098	.282	3.439	.001

**Source: Research findings**

As per the SPSS generated output as presented in table above, the equation ( $Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \varepsilon$ ) becomes:  $Y = -5.283 + 0.362 X_1 + 0.334X_2 + 0.329 + 0.337X_4$

From the regression model obtained above, a unit change in current ratio holding the other factors constant would lead to increase in return on assets by a factor of 0.362, a unit change in cost to revenue ratio while holding the other factors constant would lead to increase in return on assets by a factor of 0.334, a unit change in leverage while holding the other factors constant would lead to an increase in return on assets by a factor of 0.329, and that a unit change in net premium while holding the other factors constant would lead to an increase in return on assets by a factor of 0.337. The findings above conform to the findings by franks and Curswoth (2003) who found out that firms

leverage is positively related to return on assets. The analysis was undertaken at 5% significance level. The criteria for comparing whether the predictor variables were significant in the model was through comparing the obtained probability value and  $\alpha=0.05$ . If the probability value was less than  $\alpha$ , then the predictor variable was significant otherwise it wasn't. All the predictor variables were significant in the model as their probability values were less than  $\alpha=0.05$ .

### **4.3.3 Multi Collinearity Test**

Problem may arise when two or more predictor variables are correlated. Heteroscedasticity means that previous error terms are influencing other error terms and this violates the statistical assumption that the error terms have a constant variance. Greene (2003) argues that the prediction is not affected, but interpretation of, and conclusions based on, the size of the regression coefficients, their standard errors, or the associated z-tests, may be misleading because of the potentially confounding effects of multi collinearity. In the presence of multi collinearity, Mason and Perreault (2011) demonstrate that the coefficient estimates may change erratically in response to small changes in the model or the data. However, the decision to finally drop an item also depends on a second step, where the variance inflation factor (VIF) is applied according to Greene (2013) and Baum (2006). The VIF detects multi collinearity by measuring the degree to which the variance has been inflated. A VIF greater than 10 is thought to signal harmful multi collinearity as suggested by Baum (2006).

**Table 4.7: Summary of Collinearity Statistics**

<b>Model</b>	<b>Collinearity Statistics</b>	
	<b>Tolerance</b>	<b>VIF</b>
Current Ratio	0.924	2.728
Cost To Revenue Ratio	0.786	1.423
Leverage	0.634	1.352
Net Premium	0.780	3.427

**Source: Research findings**

The Variance inflation factor (VIF) was checked in all the analysis which is not a cause of concern according to Baum (2006) who indicated that a VIF greater than 10 is a cause of concern. The basic assumption is that the error terms for different observations are uncorrelated (lack of autocorrelation).

#### **4.3.4 Normality test**

Normality of the variables was examined using the skewness and kurtosis. According to Kline (2011) the univariate normality of variables can be assumed if the skewness statistic is within the interval (-3.0, 3.0) and the kurtosis statistic lying in the interval (-10.0, 10.0).



**Table 4.8: Tests of Normality**

	Kolmogorov-Smirnov <sup>a</sup>			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
Current Ratio	0.127	230	0.039	0.887	230	0.012
Cost To Revenue Ratio	0.153	230	0.004	0.834	230	0
Leverage	0.126	230	0.041	0.924	230	0.397
Net Premium	0.153	230	0.004	0.808	230	0

**Source: Research findings**

From the finding on the Kolmogorov-Smirnov and Shapiro-Wilk test on normality, the study found that significance in both tests were less than 0.05 which leads to the rejection of the null hypothesis that that data on the dynamic capabilities strategies we're not normally distributed this is an indication that data on the variables were normally distributed.

## **4.4 Interpretation of the Findings**

### **4.4.1 Current ratio**

The study found a strong positive correlation between current ratio and financial performance of merged or acquired Insurance firms in Kenya (Pearson correlation factor = 0.841, P value 0.000) prediction results obtained from the regression model showed that a unit increase in current ratio would increase financial performance of merged or

acquired insurance firms (Beta coefficient value = 0.362) the findings concur with the study of Hempel *et al*, (2014) who established a positive relationship between optimal level of current ratio and financial performance of merged or acquired Insurance firms.

Descriptive results showed that after merger most of the merged insurance companies were in a position to offset their current liabilities using company's current assets. Financial managers should ensure that a company's current assets can cover its current liabilities; current ratio gives a sense of the efficiency of a company's operating cycle or its ability to turn its product into cash. Merged insurance companies that have trouble getting paid on their receivables or have long inventory turnover can run into liquidity problems because they are unable to alleviate their obligations. If the current assets of a merged insurance company are more than twice the current liabilities, then that company would have good short-term financial strength whereas if current liabilities exceed current assets, then the company may have problems meeting its short-term obligations. The findings are in support of the research by Kumar (2009) that current ratio is a test of quantity, therefore should not be used as a test for quality, current ratio is not an exact science to test liquidity of a company because the quality of each individual asset is not taken into account while computing this ratio, current ratio should be used in conjunction with other ratios like inventory turnover ratio, debt to equity ratio and quick ratio etc. to provide precise quality of current assets and a better idea of solvency

#### **4.4.2 Cost to revenue ratio**

The study found a positive correlation between cost to revenue ratio and financial performance of merged or acquired Insurance firms in Kenya and (Persons correlation factor = 0.751, P value 0.000) prediction results obtained from the regression model

showed that a unit increase in cost to revenue ratio would increase financial performance of merged or acquired Insurance firms (Beta coefficient value = 0.334) the findings concur with the study by Uzhegova, (2010) who established a positive relationship between cost to revenue ratio and financial performance of organizations.

Descriptive results showed that the cost to revenue ratio dropped from 0.832 to 0.361 implying that less investments could yield more returns after merger with operating efficiency, the study further revealed that to bring in higher revenue, merged insurance in Kenya may have to commit more cost resources, which sometimes may not have an immediate effect on the improvement of operation efficiency. In general, the cost-to-revenue ratio provides the guidance on controlling and better usage of expenses depending on a firms operating activity mix, the cost-to-revenue ratio may not accurately reflect operating efficiency at the time and is subject to further interpretation. As an efficiency measurement, the lower the cost-to-revenue ratio, the higher the operating efficiency, sometimes high number of cost-to-revenue ratios does not necessarily mean low operating efficiency over time. The findings are in support of the research by Uzhegova, (2010), that when a merged insurance has a larger percentage of its operation in fee-based and scale-driven business, the upfront cost inputs often are higher too, resulting in a higher cost-to-revenue ratio and suggesting a lower operating efficiency at the time, but as the fee income grows over time from increased business transactions, it lowers the cost-to-revenue ratio and gradually improves the operating efficiency of merged insurance companies.

### **4.4.3 Leverage ratio**

The study found a positive correlation between leverage and financial performance of merged or acquired Insurance firms in Kenya and (Persons correlation factor = 0.783, P value 0.000) prediction results obtained from the regression model showed that a unit increase in leverage would increase financial performance of merged or acquired Insurance firms (Beta coefficient value = 0.329) the findings concur with the study by Mathuva (2009) who found a positive relationship between optimal level of borrowing and positive financial performance of firms.

Descriptive results showed that the leverage ratio in three years after merger dropped from 83.2 percent to 43.2 percent which implies that owner's equity superseded the borrowing. The research also noted that too much debt can be dangerous for a merged insurance and its investors. Uncontrolled debt levels can lead to credit downgrades or worse. When the debt ratio is low, principal and interest payments don't command such a large portion of the company's cash flow and both firms is not as sensitive to changes in business or interest rates from this perspective. Low debt ratio may also indicate that both firms have an opportunity to use leverage as a means of responsibly growing the business. In general, a high debt-to-equity ratio indicates that a company may not be able to generate enough cash to satisfy its debt obligations. However, low debt-to-equity ratios may also indicate that a company is not taking advantage of the increased profits that financial leverage may bring. The findings are in support of the research by Lau et al. (2008) that a reluctance or inability to borrow may be a sign that operating margins are simply too tight.

#### **4.4.5 Net Premium**

The study found a positive correlation between net premiums and financial performance of merged or acquired Insurance firms in Kenya and (Persons correlation factor = 0.773, P value 0.000) prediction results obtained from the regression model showed that a unit increase in net premiums would increase financial performance of merged or acquired Insurance firms (Beta coefficient value = 0.337) the findings concur with the study by Chong (2008) who found a positive relationship between optimal level of net premiums and positive financial performance of firms.

Descriptive results showed that the Net Premium in three years after merger of insurance companies grew from 0.054 to 0.857 this show the high of strength in most of insurance companies after merger. The study further found that the net premium is the primary method of quickly measuring insurance company strength. The net premium written by all merged insurance companies, as depicted on descriptive analysis, has shown fairly stable growth, not patently dependent on short term economic conditions but generally following long term economic growth. The findings are in support of the research by Kamau, (2009) since the net premium calculation does not take into account expenses, companies must determine the amount of expenses that can be added without causing a loss.

#### **4.4.6 Return on Asset**

The return on assets significantly increased from 27.17 percent to 50.41 percent after merging/acquisition of the insurance firms. This significant improvement shows that there is an increase in management efficiency in employing available assets to generate

earnings. The importance of ROA means that any decrease in the management efficiency use of assets leads to a significant decline in profitability. Nevertheless, in this study ROA is the standard and proficient measure of financial performance, therefore merging/acquisition can be said to have significant positive effect on financial performance of insurance firms in Kenya.

## **CHAPTER FIVE**

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

#### **5.1 Introduction**

This chapter presented the discussion of key data findings, conclusion drawn from the findings highlighted and recommendation made there-to. The conclusions and recommendations drawn were focused on addressing the general objective of the study which was to assess the effects of mergers and acquisitions on the financial performance of insurance firms in Kenya.

#### **5.2 Summary of the findings**

The study aimed at establishing the effects of mergers and acquisition on financial performance of insurance firms in Kenya. The objective of the study was achieved by employing event study design through analyzing financial statements of insurance firms which merged or acquired between 2000 and 2015.

From the financial statistics discussed in chapter four above, the study found a positive correlation between current ratio and financial performance of merged or acquired Insurance firms in Kenya and prediction results obtained from the regression model showed that a unit increase in current ratio would increase financial performance of merged or acquired Insurance. Descriptive results show that after merger most of the merged insurance companies were in a position to offset their current liabilities using company's current assets.

Cost to revenue ratio and leverage ratio were found to be positively correlated with financial performance an indication that post-merger financial performance of insurance firms improved after merger as compared to pre-merger financial performance. This further indicates 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 effect on ROA which is the overall standard measure of financial performance.

### **5.3 Conclusions**

Mergers and acquisitions in the insurance sector are aimed at achieving operational efficiency, profitability, synergy, enlargement of size and enhancing the customer base. The study concludes based on the data presentations in chapter four and the summary of findings above that insurance firm financial performance improved following a merger/acquisition as evidenced by improved ROA from 27.17 percent before M&A to 50.41 percent after M&A. Mergers and acquisition are therefore helpful to insurance firms and can be used as a strategy to improve profitability of firms.

The study also concludes that merging/acquisitions on its own cannot achieve strong, efficient and competitive insurance systems because performance is dependent on several factors and as such, mergers/acquisition need to be supplemented by other measures such as enhancing the expertise and professionalism of the insurance personnel and embracing corporate governance practices in the context of the challenges of a globalized and dynamic business environment.



## **5.4 Recommendations**

Based on the study findings, the research recommends mergers and acquisition as this was found to promote the financial performance of insurance firms. To promoted short-term financial strength greater caution should be exercised to ensure that current assets of both companies are in a position to put out their current liabilities effortlessly.

The financial managers of merged insurance companies should work to keep cost-to-revenue ratio as low as possible this will gradually improve the operating efficiency thus promoting financial performance.

Merged insurance companies should maintain leverage ratio at a standard level. This is based on revelation that too much debt can be dangerous for a merged insurance and its investors as uncontrolled debt levels can lead to credit downgrades while at the same time low debt-to-equity ratios may also indicate that a company is not taking advantage of the increased profits that financial leverage may bring.

The study recommends for merger policies that promote Net Premium as this was found to be positively related to firm's terminal financial strength.

## **5.5 Study Limitations**

The research encountered several limitations. The descriptive and correlation study relied on secondary data which had already been compiled by insurance companies. Secondary data used was obtained from the sources and the researcher had no means of verifying for the validity of the data which were assumed to be accurate for the purpose of this study. The study results are therefore subject to validity of the data used. The study used the

ordinary least square regression method of analysis which may have its own weaknesses compared to other methods which may limit the general applicability of the study results.

## **5.6 Recommendations for Further Research**

The study sought to assess the effects of mergers and acquisitions on the financial performance of insurance firms in Kenya. The study recommends that a similar research should be conducted to assess the effect of government regulatory policy on growth and development of insurance sector in Kenya.

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## APPENDICES

### APPENDIX I: LIST OF M&A IN INSURANCE INDUSTRY BETWEEN 2000 AND 2015

	<b>Institution</b>	<b>Merged with/ Acquired by</b>	<b>Current Name</b>	<b>Nature</b>	<b>Stake</b>	<b>Period</b>
1	Apollo Insurance Co. Ltd	Pan Africa Insurance Co. Ltd	APA Insurance Co. Ltd	Merger		2003
2	ICEA Co. Ltd	Lion of Kenya	ICEA Lion Group	Merger		2012
3	Pan Africa Holdings	Hubris Holdings Ltd	Pan Africa Holdings	Acquisition	10%	2012
4	Alexander Forbes Health Care	Zanele Investments	Alexander Forbes Health Care	Acquisition	100%	2012
5	Mercantile Insurance	Colina Holdings Ltd	Sacham Insurance Ltd	Acquisition	66.67%	2012
6	Tanzania Century Insurance Co. Ltd	UAP Insurance Group	UAP Insurance Group	Acquisition	60%	2013
7	Real Insurance Co. Ltd	Britam	Britam General Insurance Co. Ltd	Acquisition	99%	2014

Source: Competition Authority of Kenya Annual Reports

## APPENDIX II: SECONDARY DATA COLLECTION SHEETS

### Merger Between Apollo Insurance & Pan Africa Insurance

*All figures in Shs millions*

	2000	2001	2002	Total
<b>Apollo Insurance (Before M&amp;A)</b>				
Net Premium	301	374	405	1,080
Operating Cost	105	135	220	460
Current Asset	372	462	263	1,097
Current Liability	148	233	410	791
Total Debt	27	32	42	101
Total Asset	1,467	2,378	1,356	5,201
Net Profit	39	14	8	61

#### **Pan Africa Insurance (Before M&A)**

Net Premium	363	383	292	1,038
Operating Cost	110	134	213	457
Current Asset	421	660	765	1,847
Current Liability	91	215	287	592
Total Debt	15	42	60	116
Total Asset	3,175	2,804	3,014	8,993
Net Profit	-65	-152	2	(215)

#### **Apollo Insurance & Pan Africa Insurance Consolidated (Before M&A)**

Net Premium	665	756	697	2,118
Operating Cost	215	269	433	917
Current Asset	793	1,122	1,029	2,944
Current Liability	238	448	697	1,383
Total Debt	42	74	101	217
Total Asset	4,642	5,183	4,369	14,194
Net Profit	(26)	(138)	10	(154)

*All figures in Shs millions*

	2004	2005	2006	Total
<b>APA Insurance Co. Limited (After M&amp;A)</b>				
Net Premium	1,164	1,265	1,439	3,867
Operating Cost	221	236	292	748
Current Asset	720	1,024	941	2,685
Current Liability	132	222	132	486
Total Debt	229	-	-	229
Total Asset	2,096	3,025	3,740	8,861
Net Profit	63	61	161	285

## Merger Between ICEA & Lion of Kenya

*All figures in Shs millions*

	2009	2010	2011	Total
<b>ICEA (Before M&amp;A)</b>				
Net Premium	1,116	1,417	1,447	3,981
Operating Cost	315	607	656	1,578
Current Asset	6,175	1,592	1,785	9,552
Current Liability	159	242	645	1,046
Total Debt	-	179	122	302
Total Asset	20	3,494	4,247	7,761
Net Profit	236	201	138	576

### **Lion of Kenya (Before M&A)**

Net Premium	938	897	908	2,743
Operating Cost	133	396	427	956
Current Asset	3,009	3,015	2,532	8,556
Current Liability	289	381	435	1,106
Total Debt	172	175	266	613
Total Asset	5,123	5,881	6,296	17,300
Net Profit	255	338	231	824

### **ICEA & Lion Consolidated (Before M&A)**

Net Premium	2,055	2,315	2,355	6,724
Operating Cost	448	1,003	1,083	2,534
Current Asset	9,183	4,607	4,318	18,108
Current Liability	448	623	1,080	2,152
Total Debt	172	354	389	915
Total Asset	5,143	9,375	10,543	25,061
Net Profit	491	539	369	1,399

*All figures in Shs millions*

	2013	2014	2015	Total
<b>ICEA Lion Group (After M&amp;A)</b>				
Net Premium	2,523	3,088	3,161	8,772
Operating Cost	929	1,186	1,291	3,406
Current Asset	1,918	1,685	1,592	5,195
Current Liability	642	800	696	2,138
Total Debt	426	479	540	1,445
Total Asset	7,786	8,724	8,850	25,359
Net Profit	640	583	392	1,615

**Acquisition of 66% of Mercantile Insurance by Saham Assurance through its Subsidiary' Colina Holdings Ltd**

*All figures in Shs millions*

	2009	2010	2011	Total
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**Mercantile Insurance (Before M&A)**

Net Premium	145	184	208	536
Operating Cost	135	142	168	445
Current Asset	245	424	287	956
Current Liability	11	31	89	130
Total Debt	5	31	41	77
Total Asset	442	666	708	1,816
Net Profit	43	49	57	149

**Saham Assurance (Before M&A)**

Net Premium	-	-	-	-
Operating Cost	-	-	-	-
Current Asset	-	-	-	-
Current Liability	-	-	-	-
Total Debt	-	-	-	-
Total Asset	-	-	-	-
Net Profit	-	-	-	-

**Mercantile & Saham Consolidated (Before M&A)**

Net Premium	145	184	208	536
Operating Cost	135	142	168	445
Current Asset	245	424	287	956
Current Liability	11	31	89	130
Total Debt	5	31	41	77
Total Asset	442	666	708	1,816
Net Profit	43	49	57	149


*All figures in Shs millions*

	2013	2014	2015	Total
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**Saham Assurance (After M&A)**

Net Premium	283	348	470	1,100
Operating Cost	158	242	256	655
Current Asset	349	432	585	1,366
Current Liability	20	121	202	342
Total Debt	-	-	-	-
Total Asset	736	831	1,048	2,615
Net Profit	12	19	27	58

Key

 Data not necessary for ascertaining financial performance of an Acquisition

### Acquisition of 10% of Pan Africa Insurance Holdings Ltd by Hubris Holdings Ltd

All figures in Shs millions

	2009	2010	2011	Total
<b>Pan Africa Insurance (Before M&amp;A)</b>				
Net Premium	2,821	3,543	3,300	9,664
Operating Cost	1,038	1,493	1,423	3,954
Current Asset	1,054	2,104	3,629	6,787
Current Liability	610	846	778	2,234
Total Debt	5,020	7,201	7,860	20,080
Total Asset	7,564	10,672	11,499	29,735
Net Profit	139	589	443	1,172

### Hubris (Before M&A)

Net Premium	-	-	-	-
Operating Cost	-	-	-	-
Current Asset	-	-	-	-
Current Liability	-	-	-	-
Total Debt	-	-	-	-
Total Asset	-	-	-	-
Net Profit	-	-	-	-


### Pan Africa & Hubris Consolidated (Before M&A)

Net Premium	2,821	3,543	3,300	9,664
Operating Cost	1,038	1,493	1,423	3,954
Current Asset	1,054	2,104	3,629	6,787
Current Liability	610	846	778	2,234
Total Debt	5,020	7,201	7,860	20,080
Total Asset	7,564	10,672	11,499	29,735
Net Profit	139	589	443	1,172

All figures in Shs millions

	2013	2014	2015	Total
<b>Pan Africa Holdings Ltd (After M&amp;A)</b>				
Net Premium	5,102	4,991	4,797	14,890
Operating Cost	1,754	1,771	2,365	5,890
Current Asset	4,981	4,453	4,420	13,854
Current Liability	1,086	1,184	1,224	3,495
Total Debt	8,070	8,934	8,270	25,273
Total Asset	21,158	24,599	27,109	72,866
Net Profit	1,250	871	27	2,149

Key

 Data not necessary for ascertaining financial performance of an Acquisition

**Acquisition of 100% of Alexander Forbes Health Care by Zanele Investments**

*All figures in Shs millions*

	2009	2010	2011	Total
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**Alexander Forbes (Before M&A)**

Net Premium	89	120	162	370
Operating Cost	80	108	146	335
Current Asset	85	115	156	356
Current Liability	61	82	111	255
Total Debt	7	9	13	29
Total Asset	5	6	9	20
Net Profit	6	8	10	24

**Zanele Investments (Before M&A)**

Net Premium	-	-	-	-
Operating Cost	-	-	-	-
Current Asset	-	-	-	-
Current Liability	-	-	-	-
Total Debt	-	-	-	-
Total Asset	-	-	-	-
Net Profit	-	-	-	-

**Alexander Forbes & Zanele Consolidated (Before M&A)**

Net Premium	89	120	162	370
Operating Cost	80	108	146	335
Current Asset	85	115	156	356
Current Liability	61	82	111	255
Total Debt	7	9	13	29
Total Asset	5	6	9	20
Net Profit	6	8	10	24


*All figures in Shs millions*

	2013	2014	2015	Total
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**Alexander Forbes Health Care (After M&A)**

Net Premium	206	286	324	815
Operating Cost	162	222	238	622
Current Asset	181	354	358	893
Current Liability	113	253	276	642
Total Debt	10	3	-	13
Total Asset	13	20	26	58
Net Profit	30	47	60	137

Key

 Data not necessary for ascertaining financial performance of an Acquisition