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

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D61/68507/2013

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION (MBA), SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

OCTOBER, 2016

DECLARATION

I declare that this research Project is my original work and has not been presented for a degree in any other university.

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DEDICATION

To my son Colin Ngahu, knowledge liberates. Indeed knowledge is power.

“Education is the great engine of personal development. It is through education that the daughter of a peasant can become a doctor, that the son of a mineworker can become the head of the mine that a child of farmworkers can become the president of a great nation. It is what we make out of what we have, not what we are given, that separates one person from another, Nelson Mandela, Long Walk to Freedom.”

ACKNOWLEDGEMENT

Through the gift of life from the almighty God, this research is a masterpiece from great thoughts and ideas inspired by years of study and passion in finance field.

First this study would not have been possible without the unyielding support from my mentors in academic world all the way from my primary school through secondary, under graduate and now graduate studies. May the almighty God bless our parents, lectures, teachers, government, donors and all other stake holders who make knowledge dissemination possible.

Special thanks go to my supervisor at the University of Nairobi Dr. Sifunjo E. Kisaka, who spent his precious time to review the research at every stage, making sure that all set standards are met.

To my dear wife, son, parents, family members, work colleagues and friends, thank you very much for your encouragement and moral support.

To all the staff at Jomo Kenyatta Memorial Library, thank you very much for the support and guidance throughout this journey. Never before had I come to rely on the library like I did during this project. Not to mention that the newspapers which formed a big part of my source of data were neatly kept, easily accessible and well arranged.

Lastly but not the least, my colleagues at University of Nairobi, whom we shared academic thoughts and ideas encouraging one another in class and outside class, in group discussions, whatsapp groups and other forums that made this study possible, thank you very much.

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LIST OF ABBREVIATIONS AND ACRONYMS

AKI-Association of Kenya Insurers

BCG-Boston Consulting Group

CAK -Competition Authority of Kenya

CBK-Central Bank of Kenya

CEO-Chief Executive Officer

CMA-Capital markets Authority

EAC-East Africa Community

EPS-Earning per Share

ICEA-Insurance Company of East Africa

IRA-Insurance Regulatory Authority

M&A-Mergers & Acquisition

ROA-Return on Assets

ROE-Return on Equity

S&P-Standard and Poor

ABSTRACT

The market has become very dynamic, influenced by a myriad of factors; wars, immigration, economic booms, recessions, globalization and technological advancement. Due to these global trends, Nations and organizations are continuously adopting new ways of doing business to counter threats as well as exploit new opportunities. Among those corporate strategic approaches taken by firms are mergers and acquisition. A merger is said to occur when two or more corporations come together to form one entity. On the other hand acquisition refers to the process in which a business entity purchases a majority or a minority stake in another firm. In either of the cases the outcome is rapid expansion in proportion of the new firm. Studies by various scholars have given diverse results for post-merger performance of acquiring firms. Among the reasons why corporations seek inorganic growth through mergers and acquisition are; to attain reduced risk, improve entry within the markets as a result of enhanced size, or make use of tax carried forward as a gain, enjoy economy of scale through cost reduction, enjoy market power through bigger market share. Corporations may also engage in mergers and acquisition as defensive mechanisms to avoid being acquired or for managers to attract takeover premia after acquisition.

The key objective of this study was to examine the influence of mergers and acquisitions on financial results in insurance firms in Kenya between 2000 and 2015. The study took a causal research design and covered three years premerger and three years' post-merger. The researcher used financial ratios ROA and ROE as well as industry specific ratios such as claims ratio and management expense ratio. Both trend and cross sectional analysis were carried out. Pre-merger results of the merged firms were compared with post-merger results to determine if there was any change and in which direction. In addition the results of the merged firms were compared with the whole industry to determine if merged firms performed better or worse than the industry average. The results indicated a marginal drop in the short run in ROA and ROE for the merged firms. Further there was an increase in industry specific ratios; claims ratio and management expenses ratio. Based on the research findings there was increased market share for the post-merger period. The research recommends careful planning and implementation of mergers and acquisition so as to attain full benefits on all fronts.

CHAPTER ONE

INTRODUCTION

1.1. Background of the Study

A merger refers to the combination of at least two firms whereby the new company takes the status of the acquiring firm. A merger enables the acquiring company to benefit from a possible attractive portfolio outcome by attaining reduced exposure to risk while still retaining the organization's rate of return. Through mergers an organization with stake in various business environments' can benefit from some reduced risk exposure that emanate from foreign exchange translation, government politics, military takeovers, and localized recessions, (Block et al, 2009). Mergers and acquisitions happen when two companies make a decision to merge their entities which may involve both firms joining to form a new business or where the bigger firm acquires the smaller firm.

Organizations pursues inorganic expansion from mergers and acquisitions so as to attain reduced exposure to variability of returns, enhance their posture in the primary and secondary market markets as well as the credit market through increased size, or get tax savings from previous accumulated losses. Mergers and acquisitions may also extend the company skills by bringing new talent to the management that enhances the capabilities of the company and allow for new product development (Poposki, 2007). One case for the popularity of mergers and acquisition is the idea that there is an active market for corporate control. This theory presupposes that mergers and acquisitions are influenced by managers' desire for prestige, power, or the gratification of personal zeal (Ryan, 2007).

Agency theorist assumes that management will delve to enhance benefits that are skewed to the management only and will act opportunistically to attain this. Given the circumstances and resources available, agency theorists argue that unless there are considerable checks put management may well engage in irrelevant ventures; projects that make managers seem better without increasing shareholder wealth or worth. There is evidence that mergers and acquisitions activity comes in waves. There is enough case of high correlation of the share (stocks) market booms and high levels of M&A activities. Abrupt technological and industrial changes may lead to uncertainty in specific economic sectors, if a number of firms are stimulated it may induce an M&A activity. M&A activities are prevalence and are highly correlated with market booms. The managerial hubris hypothesizes that M&A wave activity is caused by managements believe that organizations are systematically mis-valued. Astute management team, spotting the likely benefits, seeks to make acquisitions in order to take advantage of the mis-valuation (Ryan, 2007).

The size of the acquisitions and their importance to the purchasers' future financial performance make merger analysis a crucial capital budgeting topic. Poorly thought-out acquisitions can plague a firm for many years to come, while successful acquisitions can bring in significant returns to the acquiring company's stockholders (Lawrence et al, 1985). Ryan (2007) noted that a significant knowledge from the study of mergers and acquisitions is that majority of them do not better stockholder worth of the acquiring company. Instead for a good number of cases, it actually diminish the value the stockholders' of the acquiring company. Different studies have produced mixed results for mergers and acquisitions. Some studies have put the failure rate of mergers and acquisitions as high as 90%.This study argues that the financial position of the

merged company is by far and large affected by M&A activity. According to BCG annual report (2007), there have been six merger waves in the US market since early 1900's each with identifiable features and outcomes. Their report was founded on an elaborate study of more than 4,000 completed deals between 1992 and 2006 in United States of America.

1.1.1 Mergers and Acquisitions

A business amalgamation can occur in two forms as either as an acquisition or as a merger. According to Gill (2007) M&A involves shareholding deals among firms. It may either take the form of two or more companies consolidating to form a new single entity often referred to as a merger. On the other hand if one firm known as the acquiring company acquires a controlling stake in the target company, then an acquisition is said to take effect. This is motivated by the need to derive synergistic benefits which means that the shareholders of the original entities are better off after the acquisition or the merger.

Organizations may pursue inorganic expansion from mergers so as to attain reduced variability in returns exposure, enhance their standing in the markets due to enhanced size, or enjoy tax benefits from losses carried forward from previous years. A merger may also lead to the improvement of the marketing and management capabilities of the firm and allow for innovation that will deliver new range of products to the firm (Poposki, 2007). Another financial goal is the enhanced financial posture that a merger can foster as a consequence of expansion. Bigger companies benefits from enhanced access and acceptance to markets and thus are in a better state to raise equity and debt capital (Block et al, 2009).

A merger can be defined as amalgamation of entities after which the arising company preserves the title of the acquiring firm. Mergers enable acquiring organization to benefit from a potential

desirable portfolio effect by attaining reduction in variability of returns while still preserving a company's rate of return. Through mergers a company that has stake in diversified political and economic environments' can enjoy some reduced variations in returns that come from foreign exchange translation, government politics, military takeovers, and localized recessions (Block et al, 2009).

A merger means the absorption of one company by another. The acquiring entity preserves its status and its identity, and it assumes all the assets and liabilities of the acquired organization. The acquired firm ceases to exist as a separate business entity after the merger (Ross et al, 2010). Mergers and acquisitions achieve a critical role in corporate finance in enabling firms achieve various objectives and financial strategies (Gwaya and Mungai, 2015).

An organization/company/corporation that aims at acquiring another one is referred to as the acquiring company and one that it aims to acquire is referred to as the target firm. In many acquisitions, one company (usually the bigger of the two) simply makes a decision to acquire another firm, negotiates a price with the management of the target business unit, and then acquires the target firm .Various causes have been put forward by financial experts and theorists to explain for the large number of merger activities in the United States of America (Brigham and Ehrhardt, 2005).

The foremost motivation for a sizeable number of mergers and acquisitions is to enhance the worth of the combined business. If two businesses say, Alpha and Beta merge, and form company C, and if C's worth is more than that of Alpha and Beta taken individually then there is

said to be synergy in existence. When the resultant firms value is greater than the individual companies, the synergy exist. The apportionment of synergistic benefits between Alpha's and Betas's shareholders is achieved through negotiations of both management teams (Brigham and Houston, 2004).

After an acquiring company has located a potential target, it must as a matter of priority estimate an appropriate value or a variety of prices and then proceed to make a decision on the terms of settlement e.g. shares, cash, bonds or a combination. The next step is for the acquiring firm's management to determine how to approach the target farms' management. Incase acquiring company management team believes that the target's managers will okay the deal, then acquiring management team leader will call the other and propose to enter into a merger, and determine acceptable terms. If the two teams reach an agreement, they will issue statements to their shareholders to show that the merger is authorized or approved, and the target company's team proceeds to recommend to its shareholders their concurrence with the proposed merger. The target company's shareholders then receives the determined settlement, either as common shares of the acquiring firm (in which instant the target company's shareholders becomes shareholders in the acquiring firm), pure cash payment, bonds or some hybrid of cash and stocks. A friendly merger usually takes this process and form. The target firms' management can however resist the merger by rejecting the offer. May be they may consider the price on offer as inadequate or perhaps driven by opportunistic need to retain their jobs; they reject the offer as a defensive mechanism. The acquiring firm's request in either case is defined as hostile rather than friendly (Brigham and Ehrhardt, 2005)

Economists classify mergers and acquisitions in to four types; vertical, horizontal, congeneric and conglomerate. Horizontal mergers and acquisitions relates to a company that merges with or acquires another one within the same line of business. Vertical mergers and acquisitions on the other side relates to the vertical integration of two companies, which are operating within the same production line. Conglomerate mergers and acquisitions refer to a combination of two or more business entities in diverse business enviroments, example General Electric.

Mergers and acquisitions have become a common occurrence in our markets today. The deals done through mergers and acquisition are of significant amount. According to Delloitte M&A Trends annual report 2016, 2015 marked the busiest year for M&A with US companies announcing $2.1 trillion while the global volume is at $4.7 trillion. This was an increase from 2014 $3.4 trillion. This is made possible by increased investment opportunities and business environment. In well developed economies and markets like United States of America and United Kingdom, mergers have become very popular. One of the most notable mergers in recent past is that of Microsoft where it acquired Linkedin for $196 per share in an all cash transaction worth $26.2 billion. Linkendin is one of the most valued professional networks. Locally Barclays bank Africa acquired 63.3% stake in First Assurance for a cost of 2.2 billion shillings. Pharmaceutical drug maker Glaxo welcome merged with Smithkline Beecham to form Glaxosmithkline. Locally CFC bank merged with Stanbic bank to form CFCStanbic. Britam Insurance Limited acquired Real insurance company. The company has since changed its name to Britam General Insurance Company Limited.

According to Bloomberg, April 5, 2016, over two thirds of M&A deals since 2000 in the insurance industry in the USA failed to improve financial strength enough to lead standard and poor to upgrade the buyer. Bloomberg, June 27, 2016, Kenya Treasury Secretary Henry Rotich is pushing proposals to force takeovers and combinations in the banking sector to weed out the weakest lenders and create larger institutions able to wield their size to offer lower interest rates on loans.

1.1.2 Financial Performance

This is the overall performance of a business entity. It refers to how the company is utilizing its scarce resources in a productive way in order to maximize profits. The comprehensive revenue statement measures performance over a specified time say a year. According to Pandey (2010) in accounting terms income is defined as; Revenue – Expenses. Usually the second part of the income statement reports as a separate entry the amount of taxes charged on income. The bottom line the income statement is the net income. Often it is expressed per share of common equity that is earning per share (EPS). Through financial ratio analysis, financial performance can be used to compare firms that operate in the same industry.

The income statement is fragmented into different sections. The firm's revenues and expenses from principal operations are shown on the operations' section. One number of high significance is earning before interest and taxes (EBIT). All the financing costs such as interest expense are covered on the non-operating section of the profit and loss account section.

1.1.3 Mergers and Acquisitions and Financial Performance

Mergers that provide financial benefits must result in a combined firm with a higher valuation than the simple sums of the respective premerger market values of the firms (Lawrence et al, 1985). Poposki (2007) argues that its the prevalence of synergies that are financial in nature as the main drive for merger and acquisition activities in the insurance sector in the European Union. Nouwen, (2012) presupposes that there are different methods to assess the success of M&A; there are accounting studies, surveys of executives, event studies, etc. Accounting studies look at the reported financial statements and they test the success of M&A's by looking for example at net profit, return on common equity and earnings per common stock.

Saboo et al, (2009) conducted studies on the effect that mergers and acquisitions have on the operating performance of acquiring companies by evaluating some pre-merger and post-merger financial ratios of these companies and to see the variation in the pre-merger and post-merger ratios of the companies that were involved in local acquisitions and the firms that go for the international/cross-border mergers and acquisitions. The study concluded that there are differences in terms of effect on performance following mergers, depending on the kind of company acquired – local or cross-border. In particular, mergers have had a positive effect on key financial ratios of firms acquiring domestic firms while a slightly negative impact on the firms acquiring cross-border firms.

Mergers and acquisitions are most likely one of the most important investment decisions that any business will be required to make. Acquiring another firm is probably the quickest way for any firm to grow, and if it is done correctly, increase the shareholder value (Ryan, 2007).Farah (2015), in his study on the influence of mergers on the financial performance of financial firms

in Kenya, concluded that mergers and acquisition events resulted into an enhancement in financial performance of the companies.

1.1.4 The Insurance Firms in Kenya

In Kenya the insurance market is regulated by the Insurance regulatory authority (IRA). The global insurance industry gained momentum in 2014, with increasing premiums and reducing cost. According to IRA annual report 2014, Kenya remains the largest insurance market within the East Africa Community, a number of locally registered insurance companies continue to establish subsidiaries and associate companies within the EAC partner states. Whereas the domino effect of this branch network growth is deepening of insurance in the region, differences in intensity and scope of regulatory landscapes in each of the EAC partner states has had the effect of slowing down anticipated gains from integration.

The report further notes, the Kenyan insurance market as one of the fastest growing insurance market in Africa (Sigma 4/2015). However, 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 below capacity to underwrite big infrastructure undertakings such as Oil & Gas and LAPSET which are currently being insured outside the country. As a response to these challenges, the Authority has continued to focus on putting in place measures that aim at strengthening underwriting capacity locally. Several measures have been taken to spur growth which includes removal of the one third rule limit on ownership for East Africans. This is expected to attract investments within the region to improve the capacity of local investors.

There has also been a huge growth in the number of foreign and domestic players seeking to invest in the domestic market. As a result, major investors such as Liberty Life Assurance, Prudential Life Assurance, Saham Group from Morocco, Barclays Group, Leapfrog and Allianz Group entered the market. Their entry is expected to not only enhance industry stability through injection of core capital but also technical expertise, innovation in product development and distribution as well as increase global networks.

The IRA annual report 2014, noted that the insurance industry has also witnessed increased activities in mergers, acquisitions and other restructuring with Britam Holdings acquiring Real Insurance, Metropolitan Group acquiring Cannon Assurance, Old Mutual Group acquiring UAP Holdings and Pan Africa Holdings acquiring Gateway Insurance. It further states that the acquisitions signify a chance to create synergy and leverage on innovations to improve long term income development and profitability for the insurance sector. With proposals in the 2015/2016 National Budget Statement to increase the paid-up capital to KES 400 million for long term insurers, KES 600 million for general insurers and KES 1 billion for reinsurers, it is expected that this will further enhance industry stability especially as the Authority implements risk based supervision.(IRA Annual report 2015)

According to Dhahabu Kenya, 02nd September 2015, in 2014 alone, the Kenya insurance market experienced 6 transactions relating mergers and acquisition as below; Saham Group of Morocco bought a major share of 66.7% in Mercantile Insurance Company Ltd in April 2014, Union Insurance from Mauritius bought a major share of 66% in Phoenix insurance of East Africa Company Ltd in May 2014, Prudential Plc, UK acquired all the stake in Shield Assurance Company Ltd in September 2014, Metropolitan Insurance Group from S. Africa bought a major stake in Cannon Assurance Ltd in November 2014, 60% stake in Resolution Insurance

Company Ltd was acquired by Private equity firm Leap Frog Investments in November 2014 while 99% of Real Insurance Company Ltd was acquired by Britam Investment Group in December 2014.

According to Oxford group report 2015, strong M&A is expected in the insurance industry in Kenya which will see a round of consolidation in the year, as operators in the fast-growing sector look to not only increase market share but meet higher capital requirements. The sector has witnessed rapid growth over the past decade, with written premiums reaching compound annual growth rates (CAGR) of 15.1% between 2004 and 2014. Some in-house estimates put growth in the non-life segment at 20% per annum, while the health insurance component is leading the expansion with a 38% growth a year. Despite this fast growth insurance penetration remain relatively low at 3.4%.

1.2 Research Problem

Worldwide there have been extensive researches on mergers and acquisitions with divergent results and conclusions. Besides the business environment is rapidly changing and necessitating at times sovereign nations and individual firms to undertake mergers and acquisitions as the only strategy to save a firm with dwindling incomes. Moreover, the lure of entering a new market and reaping benefits immediately makes mergers and acquisitions very popular among other corporate finance growth strategies.

In a study about the influence of mergers and acquisition on APA insurance, Lole (2012) adopted a survey research design. The study adopted secondary data on net income and total assets of the company before and after the merger. The performance was then compared before and after the

merger. He used regression analysis to examine the effects of M&A on the financial performance of merged firms in insurance industry; he found out that financial performance of merged firms is influenced by M&A only by a margin of 33% compared to other factors 67%. Ireri (2011) concluded that M&A was positively correlated with financial performance after merger. A unit increase in mergers and acquisition would lead to increase in application of financial performance by factor of 0.166.

Onikoyi and Awolusi (2014) observed that mergers in Nigerian Bank sector in 2005 were meant to create wealth for the stockholders, foster sound and reliable banking organization's that can favorably play with international financial firms. Their study used exploratory and correlation research designs. The study population was twenty five amalgamated banks. They adopted Stratified Sampling technique to reach at fifteen merged banking institutions. Employees were supplied with questionnaires of the consolidated banks. Their research noted that among the challenges confronting merged banking institutions were depressed market prices of their stocks on the share exchange market, erosion of stockholders wealth as a result of high losses reported by the merged banking institutions and absence of dividend distribution to the stockholders. They further noted that, shareholders wealth for the consolidated banking institutions had been depleted and in some instances completely ruined.

Sidharth Saboo and Sunil Gopi (2009) conducted a research study in India that purposed to examine the influence of mergers on the operating performance of acquiring company by analyzing/comparing the pre-merger and post-merger financial ratios of the firms. The variations for pre-merger and post-merger financial ratios for the companies that engage in local and foreign/international/ over the border acquisitions were evaluated. The study concluded that there

are variations in the effect of performance after mergers and acquisition which depended on the type of deal whether a local firm was acquired or an international one was involved. Specifically there was positive impact in financial ratios of companies engaged in domestic deals/acquisitions while those engaged in foreign deals had a slightly negative performance.

Rosen (2006) posits that merger decisions could be affected if the market reaction to merger announcement is not based on fundamentals. Ngare (2013) observed that mergers and acquisitions are more prevalent in the western world hence a local aspect research is desirable. It is in light of this and our desire to contribute to the bank of knowledge that this study is undertaken.

Mergers that provide financial benefits must result in a combined firm with a higher valuation than the simple sums of the respective premerger market values of the firms (Lawrence et al, 1985). Joash and Njangiru (2015) on their study examined the banking institutions that had merged or had been acquired in Kenyan market for the time between 2000 and 2014, found out those mergers and acquisitions increased the stockholders' wealth of the merged/acquiring banking institutions in Kenya. A similar study by Farah (2015) on commercial banks in Kenya between 2000 and 2014 concluded that merger and acquisition event results into an increase in financial performance of the companies. His study further recommends that management teams need to take advantage of the benefits of mergers and acquisitions.

Different studies have produced mixed results about M&A making it one of the corporate finance conundrums. Some Studies have put the failure rate of M&A at between 70% and 90%.

Nevertheless mergers and acquisitions have become a common occurrence in our markets today. The deals done through mergers and acquisition are of significant amount. According to Delloitte M&A Trends annual report 2016, 2015 marked the busiest year for M&A with US companies announcing $2.1 trillion while the global volume is at $4.7 trillion. This was an increase from 2014 $3.4 trillion. It's therefore important to critically evaluate its effects on the financial performance of the firm so that management and various stakeholders can approach it from a point of knowledge.

The research problem that this study seeks to answer is: What is the effect of mergers and acquisitions on the financial performance of insurance institutions in the Kenyan market.

1.3 Research Objective

The objective of this study is to examine the influence of mergers and acquisitions on the financial performance of insurance institutions in the Kenyan market.

1.4 Value of the Study

To the academic world, this study seeks to add to the bank of knowledge that already exists in this field so as to refine and shape better thoughts into the future about this topic and more so in a localized context.

The portfolio benefit of mergers and acquisitions to the stockholders of the merged companies come with themselves some costs. It's therefore imperative to understand the net present value of a merger and acquisition project to guide every stakeholder in a direction of knowledge.

To the government regulators like the insurance regulatory authority (IRA), capital markets authority (CMA), the Central Bank of Kenya (CBK), and Competition Authority of Kenya

(CAK), mergers and acquisitions tends to create monopolies or firms with near monopoly power. These big firms can cause catastrophic problems that endanger their customers' welfare, their very own survival and even the entire economy. In the wake of 2008 global financial crisis in United States of America, firms that were viewed as "too big to fail" were the primary cause of the financial crisis. This study therefore is useful to the regulators to understand the consequences of their approval of certain deals that involve mergers and acquisitions.

The primary objective of management of a firm is to create wealth for its stockholders. Mergers and acquisitions have been pursued to arrive at other benefits like increasing management power by creating an empire and management pay where pay is pegged on turnover, decisions of which may not necessarily amount to increasing shareholders wealth. This study seeks to investigate value adding mergers and acquisitions and those that destroyed shareholders wealth. The government of Kenya is currently in the process of merging some state corporations this research would be very helpful in making such decisions. To the creditors they would know the safety of their loans in case of a merger.

This study has provided the evidence that mergers and acquisitions influence the financial performance of a company and therefore manager's careful focus on their planning and execution can enhance financial performance, which will ultimately result in wealth creation for the stockholders.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter is divided into four sections. Section 2.2 discusses the theoretical literature. Section 2.3 presents the empirical literature, section 2.4 presents review of local research on mergers and acquisitions and section 2.5 presents the research gap.

2.2 Theoretical Literature Review

This section will feature the theories that underpin the motivation behind mergers and acquisition which include the theory of efficiency, managers' personal incentive, tax preference theory, eat or be eaten theory and diversification.

Further the various types of mergers and merger waves that have taken place will also be featured in the study.

2.2.1 The Theory of Efficiency

When the sum of the separate firms before merger are less than the total value of the new firm after the merger then synergy has occurred (Brigham et al, 2004). Lawrence et al, (1985) observed that mergers that provide financial benefits must result in a combined firm with a higher valuation than the simple sums of the respective premerger market values of the firms. Efficiency theory presupposes that mergers are voluntary and result from the mutual benefit derived by the shareholders of the entities that engage in M&A. This theory argues that business consolidation will only occur when there synergies to be realized enough for both shareholders of each company in the deal. Synergy is said to be present when the resultant company value is

higher than the sum of individual/separate companies before the merger. In a synergistic merger the post-merger value is far much higher than the separate worth of the premerger firms.

Poposki (2007) posit that managerial motivation and preference for M&A is as a result of the benefits related to synergies that are likely to be realized after M&A. When the whole is greater than the sum of its individual components, then synergy is said to take effect. Thus two plus two is said to be equal to five and not four i.e. 2+2>4 or 5=2+2.This is made possible only when overlapping processes in production are eliminated while pooling together the new talents and skills from the enlarged pool of the new firm.

In terms of finance function, this theory presupposes that with uneven information in the capital markets an entity with inadequate cashflow or one experiencing financing gaps will not be in a position to commence all viable opportunities to invest. It therefore suggests that companies experiencing financial difficulties but with viable investment prospects have a higher possibility of engaging in M&A activities either as acquirers or at times as targets. Poposki (2007) studied the insurance industry in European Union and concluded that one key driver for mergers and an acquisition was the existence of financial synergies.

The foremost motivation for a sizeable number of mergers and acquisitions is to enhance the worth of the combined business. If two businesses say, Alpha and Beta merge, and form company C, and if C’s worth is more than that of Alpha and Beta taken individually then there is said to be synergy in existence. Synergy is possible only if the sum of individual parts is less than the whole i.e. the value of the firm after the merger is higher than the value of the individual

companies before merger. The apportionment of synergistic benefits between Alpha's and Betas's shareholders is achieved through negotiations of both management teams (Brigham and Houston, 2004).

. Mathematically this can be expressed as;

$Alpha+Beta<C$

Where $Alpha, Beta>0$

Using discounted cash flow method, the merger would only be viable if the net present value of the future cash flows is positive i.e.

$\Delta CFt > CFZt - [CFXt + CFYt]$.

In this case if $\Delta CFt>0$ then the project/ merger is beneficial to both stockholders of X and Y, and synergies will be realized when the two are combined. Synergies can be realized from financial economies, operating economies, increased market power and differential efficiency.

Economies of scale in management bring about operating economies, marketing production or distribution. Financial economies result from lower transaction costs. Higher market power is as a result of shrinking competition while differential efficiency is due to more efficient management of the acquired firm's assets by the more competent managers. More so differential management is also as a result of the bigger size after the merger that enables specialization.

If $X+Y>Z$

Where $x, y>0$

Then this would be a value destroying merger and it would not be advisable to undertake. In other words if $X+Y>Z$, then the stockholders of the separate entities X and Y are better off

without the merger. However this kind of merger and acquisition can take place due to other managerial motivations as discussed below.

2.2.2 Managers Personal Motivations (The Corporate Control Theory)

This theory is founded on the premise that mergers and acquisitions are triggered by managerial self-interest. Weston et al (2004) argues that there is optimal supply of managerial talent in the market. And that while a firm is underperforming in the market there is always another manager/management/ firm that is willing to acquire it and take advantage of economies of scale and create synergy while removing the underperforming managers. This they argue would improve the performance of its assets. The agency theory presupposes that the relationship between managers of a firm and its stock holders is that of agent and principle in nature. Thus management of a firm is expected to only undertake decisions that will maximize the value of the firm and thus maximize the value of its stockholders.

Active market for corporate control is one of the catalysts for the occurrence of mergers and acquisitions. This theory posits that mergers and acquisitions are influenced by manager's desire for prestige, power, or the gratification of personal zeal (Ryan, 2007). Agency theorist assumes that management left unchecked will maximize their own personal benefits at the detriment of the stockholders wealth maximization. Without adequate internal controls in place management will engage in cosmetic project that which do not necessarily add value to the firm (Ryan, 2007).

When management prime motivation is personal interest that drives them to engage in M&A activity and not maximization of the value of the firm, then there is agency cost associated with

the merger. (Poposki, 2007).Brigham et al (2004), notes that managers have a preference for power, and in deed a bigger corporation is associated with more power. Therefore managers may be driven by ego to engage in projects that do not necessarily add any value to the firm. He further notes that no manager is likely to accept that selfish interest and not firm's interest were the key motivation for the mergers and or acquisition. This can also be studied in behavioral finance where the gambling nature of managers may explain some of the mergers.

Where executive benefits perks are attached to the corporation size example commissions on gross turnover, the bigger the company the higher the turnover and consequently the higher the salaries and other benefits of the top executives. This is likely to influence corporate acquisition programs to favor top management with huge perks. In this case it is the top managers' desire for power, huger perks and benefits and not the primary objective to maximize the shareholders wealth that will motivate such a merger. In other cases defensive mergers can be used by the managers to block an eminent acquisition. This is mainly due to the loss of autonomy or loss of a job altogether by the managers of the acquired company once the merger is completed. In this case merger will be used to feed off a probable acquisition. The executives will say that it's the desire to create firms value and not self-interest to safeguard their jobs that inspired the mergers (Ryan, 2007).

Gorton et al (2006) noted that not all mergers are driven by the need to create value for the firm. Sometimes firms that risk to be acquired will engage in worthless merger activity such that it becomes bigger and thus avoid being acquired in what is known as defensive mergers. When companies engage in merger it automatically becomes larger than some competitors and will

avoid being acquired. This process may be self-reinforcing and could trigger merger waves. One company move makes another one in the same industry more susceptible or vulnerable as a target and because managers want to keep their jobs then they will also engage in some merger to improve their firms standing in the market and avoid being acquired.

2.2.3 Tax Preference Theory

There are mergers and acquisitions that are motivated by tax concerns. High net worth investors will prefer a low payout dividend firm since their wealth is not exposed to taxation. Alternatively a highly profitable firm in the upper taxation bands is exposed to high tax rates. The management may consider acquiring a loss making firm so that it can benefit from the accumulated losses. The accumulated losses can be utilized immediately to save the company from paying tax instead of carrying forward in to the future, (Brigham et al, 2004).

Taxes on capital gains are paid at a lower rate and thus high net worth investors would prefer a firm that has a low dividend payout. Furthermore from time value of money concept a dollar of tax paid today has a higher effect than a dollar of tax paid in the future. As such the tax paid on the capital gains which is sometimes in to the future has a low impact on the investors. Therefore such firms whose investors have a low preference for dividend payout would end up having a lot of cash to spend that they can use to acquire other firms in the market.

Where a firm has few opportunities to implement organic with the excess cash clout at hand its management may decide to pay to the stock holders an additional dividend, buy marketable instruments such as treasury bills, purchase its own shares or buy another firms portion of

shareholding. In case management decides to pay an additional dividend, the stock holders will be subjected to outright tax payment since withholding tax on dividends is deducted at source. Marketable instruments on the other hand usually offer a safe storage for excess cash though there is no guaranteed offer for high returns as required by stock holders. If the excess cash is used to purchase another firm stock, the management will save the stock holders from all the above challenges (Brigham et al, 2004).

2.2.4 The Market Power Theory

The proponent of this theory is Sayan Chatterjee (1991). His study was to study the factors that can show the benefits arising when firms engage in vertical mergers. The study concluded that maximum benefits arise when acquiring entities are from highly concentrated marketplaces while the 'target' firm is within a disjointed marketplace. In addition the study concluded that the companies under investigation experienced higher market power which was occasioned by mergers.

2.2.5 The 'Eat or be Eaten' Phenomenon

Gorton et al (2006) proposed a theory that brings together management merger motivations and regime change within an industry which may result to merger that enhance the value of an organization. Further they noted that expectation of these merger prospects can trigger defensive purchases, in which management purchases other companies to circumvent loss of paybacks when businesses are bought, or "positioning" purchases, in which companies' posture as good-looking buyout in order to get some buyout premium. This model suggests that expectation of possible mergers after change of regime generates motivations to participate in extra mergers.

They suggest further that, a competition to expand a business magnitude can arise due either 'positioning' or 'defensive' causes. One main cause for defensive purchase is management selfish interest to keep their jobs. Since if a company is acquired managers will lose their jobs, if they retain their jobs they are likely to lose previous autonomy and span of control. As such they will instead purchase another business to avoid being bought. When a business grows in magnitude by purchasing others it feeds off the prospect of being bought as its gets stronger standing in the market than its competitors. The defense merger motivation becomes self reinforcement and subsequently bringing about a wave. One businesses defensive purchase raises the prospects of a competitor becoming a target for acquisition that in turn prompts them to engage in a defense purchase. Eventually firms have to acquire or be acquired 'eat or be eaten' situation; an unprofitable defense purchase repulse some or every gainful acquisitions.

If management is rational and aim at increasing the value of the firm they would target a well performing firm as an acquiree. Synergistic acquisitions makes a firm enjoy economies of scale and will improve the firm's performance by reducing the cost of production. Thus efficient consolidations will result in synergies and thus a firm will become a pretty buyout target by becoming bigger. Gorton et al (2006) demonstrated that in industries where established or predominant firms exist such positioning acquisitions are prevalent. In such markets no buyout or acquisitions makes a company big enough to ward off acquisitions by the leading company in the industry. Instead purchasing another company inadvertedly makes the acquirer more attractive as acquire. When management sufficiently mind in maintaining their firms independence they shy off from mergers. However if management mind about the value of the firm they could indulge in buyouts with the sole reason of positioning their businesses as more

attractive target to attract an acquirer; being acquired will generate a takeover premium for the acquire and hence its managers.

2.2.6 Diversification

Mergers enable the acquirer to benefit from the effect of portfolio achieved through reduction in variability of returns while still perhaps retaining the acquirer rate of return. A firm with business interest in different economic and political environments will benefit from risk reduction that comes from foreign exchange translation, different governments with localized incentives and recessions that are particular to the local markets (Block et al, 2009).In most cases management will use diversification as the main motive to engage in merger activities. They argue that it enables stabilization of a company's income and hence profits its shareholders (Brigham et al, 2004).

2.2.7 The Managerial Hubris Hypothesis

There is a firm belief of merger wave activities being started by managers assumption that firms are usually systematically understated in value. Shrewd management will target the prospective benefit by acquiring the undervalued firm. The managerial hubris hypothesis for merger wave relies upon the existence of systematic misevaluation of companies within the capital markets, or at least the belief by managers that equity values are generally too low (Ryan, 2007).This belief negates the efficient market hypothesis which presupposes that the market price of the stocks reflects all information available pertaining to that stock.

2.2.8 Merger Waves

Back in 1900, six distinct merger waves have been identified, with every wave having distinctive features and outcome. (Boston Consulting Group (BCG) July 2007)

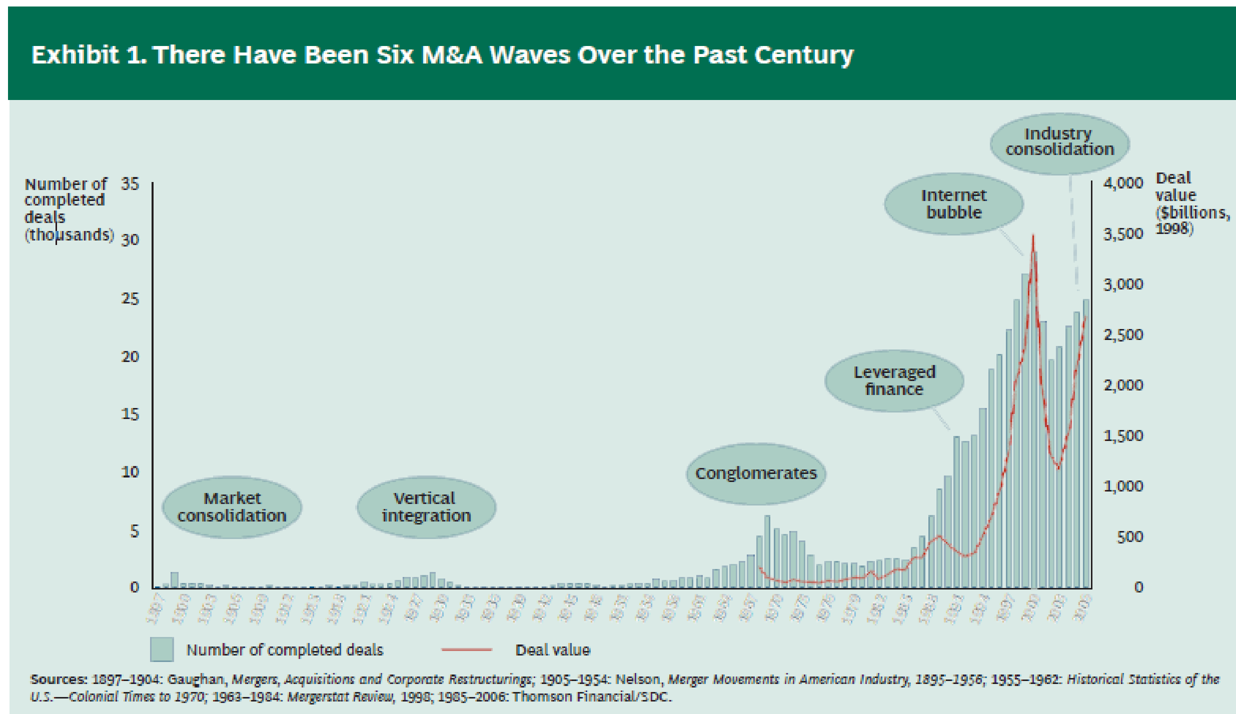

Figure 2.1: Merger Waves

There is evidence that merger activity comes in waves. There is good evidence of high correlation between stock market booms and high levels of merger activity. Abrupt technical or industrialized fluctuations can cause shockwaves inside certain industries and when a bunch of businesses are involved in this way a merger movement will seem to be greatly connected with market blasts.

Table 1.1: Summary Table of the merger waves in US history

	Wave # 1	Wave # 2	Wave # 3	Wave # 4	Wave # 5
Period	1893-1904	1910s-1929	1955-1975	1984-1989	1993-2000
Predominant means of payment	Cash	Equity	Equity	Cash / Debt	Equity
M&A outcome	creation of monopolies	creation of oligopolies	Diversification / conglomerate building	'bust-up' takeovers; LBO	Globalization
Predominant nature of M&A	Friendly	Friendly	Friendly	Hostile	Friendly
Beginning of wave	Economic expansion; new laws on incorporations; technological innovation.	Economic recovery; better enforcement of antitrust laws.	Strengthening laws on anti-competitive M&A's; Economic recovery after WW 2.	Deregulation of financial sector; Economic recovery.	Strong economic growth; Deregulation and privatization.
End of wave	Stock market crash; First World War.	The Great Depression.	Market crash due to an oil crisis.	Stock market crash.	Burst of the internet bubble; 9/11 terrorist attack.

Source: T.J.A. Nouwen–Master Thesis (2012)

2.3 Empirical Literature Review

Agrawal et al (1992) studied the performance of acquirer firms after merger. Their study derived that stock holders of acquirers incur a major loss of up to 10 per cent in a period of five years after the merger. Lous (2004) conducted a study on the impact of defensive bank consolidations against imminent buyouts threats. His study concluded that banks which had been spotted to be acquired, who later becomes acquirer to avoid a takeover ended paying a higher price for their acquisition. The study demonstrates that bank consolidations are effective tools to avoid takeovers. Banks targeted for acquisition are likely to repulse the acquisition if they themselves becomes acquirer i.e. acquires some other banks. This kind of strategy is quite expensive.

Poposki (2007) conducted a research on merger activity in the insurance industry in European Union and US markets and concluded insurance industry consolidations were largely motivated by economic viability of the projects and mainly resulted in a higher efficient industry. The BCG consulting group conducted a research on over 4000 firms that had merged in 2007 across North America, Europe and Asia pacific and found out that although M&A destroy value on average they can also generate substantial value. They further notes that industries are consolidating more rapidly making even the biggest players prey and private equity becoming more aggressive.

Anand M. Vijh and Ke Yang (2007) on a study between1980-2004 compared the performance of S&P 500 and non S&P 500 companies. They found that the stock holders of the targeted company associated an acquisition by an S&P 500 company with additional value and accepted a cheaper price for their stocks.The S&P acquiring firms were identified with high performance in operations before the merger and also target non-S&P companies with strong performance before

acquisition. These types of consolidations were found to realize strong gains in post consolidation performance. Their study concluded that the combined proof was in tandem with the efficiency hypothesis, which advocates that S&P 500 businesses are better managed companies and mark superior purchasers.

Sidharth Saboo and Sunil Gopi (2009) conducted a research study in India that aimed to investigate the influence of business consolidations on the operating performance of purchasing company by analyzing/comparing the pre-consolidation and post-consolidation financial ratios of the firms. The variations for pre-consolidation and post-consolidation financial ratios for the companies that engage in local and foreign/international/ over the border acquisitions were evaluated. The study concluded that there are variations in the effect of performance after mergers and acquisition which depended on the type of deal whether a local firm was acquired or an international one was involved. Specifically there was a better impact for ratios of companies engaged in localized deals/acquisitions while those engaged in foreign deals had a slightly negative performance.

Nouwen 2012 studied a sample of 492 friendly mergers using Capital Asset Pricing Model (CAPM) for the calculation of the abnormal stock performance of acquiring shareholders. His study showed a significant abnormal 3-year performance of 9.85% of the entire sample, indicating the presence of over-performance in the long run for acquiring shareholders. He argued that this could also indicate that share prices are on average undervalued around the merger announcement. He however cautions on interpretation of the results as previous studies suggested otherwise.

Ndura (2010) research was to investigate the influence of business consolidation on the financial performance of insurance firms in the Kenyan market that had amalgamated between 1995 and 2005. He conducted comparative analysis of the six insurance companies' financial performance for the pre-consolidation and post- consolidation phases to determine if the amalgamations had led in improved performance after the deals/acquisitions/mergers using secondary data from the financial statements. This study found that the deals had mixed effect on the effectiveness of insurance firms in the Kenyan market and that the productivity either continued to be the same as before the union or declined within a period of four years after the acquisition.

Ireri (2011) took on a causal research design studied the effects of mergers and acquisition on financial performance of oil industry in Kenya. In his study the target population was the oil companies in Kenya with keen interest on those that have gone through mergers and acquisition. The process of data collection involved self-administered drop and pick questionnaires distributed to management and employees of the oil industries involved. His study concluded that merger and acquisition would lead to a high positive performance.

Kithitu et al (2012) on their study to determine business consolidations influence on financial performance of banking firms in the Kenyan market researched 20 banks that had merged or been acquired between 1997 and 2010. Their source of data was secondary mainly from published and audited accounting records, central bank of Kenya supervision reports as well as the capital markets authority and Nairobi stock exchange reports. This study concluded that consolidation within Kenyan banking industry for the period under review resulted in a positive impact for the three ratios ROA, ROE and EPS.

Ngare (2013) conducted a research to determine the effect of business consolidations on the financial performance of commercial banks in Kenyan market. His research undertook a census study on the 16 banking institutions that have merged for the period between the 2000 and 2012. Using secondary data in financial statements of the commercial banks and the Central Bank of Kenya (CBK) reports and then conducting a relative examination on the bank's performance before and after the merger to evaluate if there was change in financial performance. He concluded that the banks that had been involved in consolidations performed better after the mergers.

Inoti et al (2014) did a case study on acquirers listed at the NSE to examine the influence of business amalgamations of the financial of acquirers in Kenyan market. They sought to determine if acquisitions enhance financial performance of a firm. The study used purposive sampling to determine a sample of all business combinations involving firms listed at the NSE. They examined the performance for three years before and three years after the merger. Their study concluded that mergers and acquisitions had no impact on the financial performance of the acquirer firm.

The IRA annual report 2014, noted that the insurance industry has also witnessed increased activities in mergers, acquisitions and other restructuring with Britam Holdings acquiring Real Insurance, Metropolitan Group acquiring Cannon Assurance, Old Mutual Group acquiring UAP Holdings and Pan Africa Holdings acquiring Gateway Insurance. It further states that the acquisitions signify a chance for generating synergies and leveraging on invention all of which if managed properly could boost long-standing income growing and efficiency for the segment. These findings were supported by Miyienda (2015) on his study of the effect of mergers and

acquisitions on the financial performance of insurance companies in Kenyan market. His study took a causal research design limited to a sample of pair that merged/acquired between the years 2002-2012. He concluded that there is enhancement in the companies' performance after the consolidation.

Joash and Njangiru (2015) conducted a survey of commercial banks in Kenya. The study tested the banking institutions that have combined in Kenyan market for the years 2000 to 2014 to determine the effect of business consolidations on financial performance of the banks. The study was a census of all the 14 banks that had merged or acquired others during the stated period. Questionnaires were used to collect data with both open and closed ended questions and analyzed using SPSS. This study concluded that the mergers and acquisitions enhanced the owners' worth of the amalgamated/acquiring banking institutions in the Kenyan market.

Farah (2015), in his study on the consequence of merger and acquisition on the fiscal performance of banking institutions in Kenyan market, concluded that merger and acquisition event results into an increase in financial performance of the companies. He further advises that management should take advantage of the positive benefits of mergers and acquisitions albeit with a caution that proper analysis needs to be done on the target firm in order to ensure value adding after the merger and/or acquisition.

In his study about factors contributing to mergers and acquisition, Afande (2015) undertook a descriptive survey. The population was all the companies listed in the Nairobi stock exchange that had partaken in merger and acquisition which numbered 5 as at June 2011. A census of all

the firms was undertaken. Primary data was collected through self-administered drop and pick of semi structured questionnaires to financial heads of the merged firms. Using descriptive statistics the data was analyzed for study objective. The study further concluded that the factors influencing mergers and acquisition were acquisition of specific asset, economies of scale, management motives, reduction of risk, decrease in cost of capital and economies of scale. Other factors were financial synergy; diversification; operation synergy; human capital; customer capital; and good growth prospects.

Ayako et al (2015) in their study on the post- Merger and Acquisitions performance of commercial banks listed at the Nairobi securities exchange used both trend and 'paired t' t test analysis to access the financial performance of merged banks between 2001 and 2014. The study used secondary data to conduct a trend analysis. The result on trend analysis showed both the return on assets (ROA) and return on equity (ROE) had dropped below the industry average in the first three years, after which they rose above it. Subsequently they concluded that merged firms outperform the industry with a time lag of about three years in terms of both ROA and ROE.

2.4 Conceptual Framework

Figure 2.2: Conceptual Framework

2.6 Summary

After extensive research, several scholars have put forward various theories that explain mergers and acquisition. According to synergy theory, mergers are motivated by the desire of a firm management to realize economies of scale derived from low production cost, specialization et cetera. Brigham et al (2004) noted that synergy is the condition wherein the whole is greater than the sum of its parts; in a synergistic merger, the post-merger value exceeds the sum of the separate companies' premerger values. He further argues that business leaders like power, and more power is attached to running a larger corporation than a smaller one and that no executive would admit that his or her ego was the primary reason behind a merger even though egos do play a major role in many mergers. He concluded that manager's personal motivations subordinates stock holders interest to play a role in mergers and acquisitions.

The "eat or be eaten" phenomenon has also contributed to mergers and acquisition. Gorton et al (2006) proposed a theory that brings together management merger motivations and an industry level regime shift which may lead to value increasing merger prospects. They further noted that expectation of these merger prospects can lead to defensive purchases, where management purchase other companies to circumvent losing paybacks if their businesses are bought, or "positioning" purchases, where companies position themselves as good-looking buyout targets to earn buyout premia. This model suggests that expectation of possible mergers after regime shift generates motivations to participate in extra mergers. They suggest further that, a competition to expand a business magnitude can arise due either 'positioning' or 'defensive' causes. One main

cause for defensive purchase is management selfish interest to keep their jobs. Since if a company is acquired managers will lose their jobs, if they retain their jobs they are likely to lose previous autonomy and span of control. A s such they will instead purchase another business to avoid being bought. When a business grows in magnitude by purchasing others it feeds off the prospect of being acquired as it becomes stronger than competitors. This defense merger motivation is self reinforcing subsequently bringing about a wave. One businesses defensive purchase raises the prospects of a competitor becoming a target for acquisition that in turn prompts them to engage in a defense purchase. Eventually firms have to acquire or be acquired 'eat or be eaten' situation; an unprofitable defense purchase repulse some or every gainful acquisitions.

If management is rational and aim at increasing the value of the firm they would target a well performing firm as an acquiree. Synergistic acquisitions makes a firm enjoy economies of scale and will improve the firm's performance by reducing the cost of production. Thus efficient consolidations will result in synergies and thus a firm will become a pretty buyout target by becoming bigger. Gorton et al (2006) demonstrated that in industries where established or predominant firms exist such positioning acquisitions are prevalent. In such markets no buyout or acquisitions makes a company big enough to ward off acquisitions by the leading company in the industry. Instead purchasing another company inadvertedly makes the acquirer more attractive as acquire. When management sufficiently mind in maintaining their firms independence they shy off from mergers. However if management mind about the value of the firm they could indulge in buyouts with the sole reason of positioning their businesses as more attractive target to attract an acquirer; being acquired will generate a takeover premium for the acquire and hence its managers.

Mergers enable the acquirer to benefit from the effect of portfolio achieved through reduction in variability of returns while still perhaps retaining the acquirer rate of return. A firm with business interest in different economic and political environments will benefit from risk reduction that comes from foreign exchange translation, different governments with localized incentives and recessions that are particular to the local markets (Block et al, 2009)

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter is divided into four sections. Section 3.2 discusses the research design. Section 3.3 discusses the population and sample while section 3.4 is about data collection instruments. Data analysis is covered in section 3.5 with section 3.5.1 presenting the conceptual model while 3.5.2 presents the analytical model. Finally section 3.5.3 presents the diagnostic tests.

3.2 Research Design

This study is a causal research that is trying to find the effect of M & A on the financial performance of merged firms in the insurance industry in Kenya. Mugenda and mugenda (2003) asserts that relationships and predictions among variables are best determined using correlation and regression techniques. Correlation technique is used to determine the degree of relationship between two variables.

This study has adopted a descriptive research design to ascertain the measures of central tendency, measures of variability et cetera in order to carry out a comparative analysis and determine the relationship between mergers and acquisitions and the financial performance of insurance firms in Kenya. The study has covered all insurance companies that have merged from the year 2000 to 2015.

3.3 Population and Sample

According to Mugenda and Mugenda (2003) a population refers to an entire group of individuals, events or objects having a common observable characteristic. Population is the group of items about which we want to obtain information from. A sample is a group of items

taken from the population for examination (Harper, 1991).A sample is a representative group from the population (Kothari, 2006).

The population for this study is all the 53 insurance companies (IRA Annual report 2015) operating in Kenya. The sample of this study is the insurance companies that have merged and acquired a controlling stake within 2000 and 2015(See Appendix 1). This represents a timeline of 15 years wide enough to cover different economic trends.

3.4 Data and Data Collection Instruments

Harper (1991) asserts that a conclusion can never be better than the original figures on which it is based. Unless the original figures are collected properly, any subsequent analysis is at best a waste of time and possibly even disastrous since it may mislead with serious consequences. This study has used secondary data collected from Insurance regulatory authority (IRA), Association of Kenya Insurers (AKI), Competition Authority of Kenya (CAK), Capital markets authority (CMA) as well as individual companies' published audited financial statements on the newspapers. Data pertaining to the following ratios has be collected pertaining to the merged firms, EPS, ROA, ROE, management expense ratio and claims ratio.

3.5 Data Analysis

According to mugenda and mugenda (2003) the first step in data analysis is to describe or summarize the data using descriptive statistics to enable the researcher to meaningfully describe a distribution of scores or measurements using a few indices or statistics. One of the most frequently used measure of central tendency is the mean with a unique characteristic that it's the only measure that takes into account each score in the distribution.

According to IRA annual report 2014 the key financial performances are: Incurred claims ratio, Net commission ratio, Management expense ratio, combined ratio, Investment income ratio and Operating ratio. Profitability ratios indicate whether the company is performing satisfactorily. They are used among other things to measure the performance of the management, to identify whether a company may be a worthwhile investment opportunity and to determine a company's performance relative to its competitors.

Financial ratios, ROA, ROE and EPS of each firm will be collected three years pre – and three years' post-M&A. Industry specific ratios such as claims Ratio, Expense Ratio will also be used to enhance the study. This research will adopt both cross sectional and trend analysis. The ratios will be computed for a period of three years to perceive trends; this is time series or trend analysis. The ratios will also be computed at the same time for several firms in the same industry, this is cross sectional analysis.

3.5.1 Conceptual Model

This study has used the following ratios to determine the financial performance, Return on Equity, Return on Assets, Earning per share, management expense ratio, commission and claims ratio. The result for the merged firms has also been compared with the industry performance to evaluate if they are doing better or worse than the industry after the merger.

Net profit= Revenues – cost

$$\text{Net profit margin} = \frac{\text{Profit after taxes}}{\text{Sales}}$$

$$\text{Return on Assets/investments} = \frac{\text{Profit after taxes}}{\text{Total Assets}}$$

$$\text{Return on Equity} = \frac{\text{Profit after taxes}}{\text{Shareholders' equity}}$$

$$\text{Earnings per share} = \frac{\text{Profit after taxes}}{\text{No. of ordinary stocks}}$$

$$\text{Incurred Claims Ratio} = \frac{\text{Total claims Incurred}}{\text{Net Earned Premiums}}$$

$$\text{Net Commission Ratio} = \frac{\text{Net Commissions}}{\text{Net Earned Premiums}}$$

$$\text{Management Expense Ratio} = \frac{\text{Underwriting Management Expenses}}{\text{Net Earned Premiums}}$$

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The objective of this study was to determine the effects of mergers and acquisition on the financial performance of insurance firms in Kenya. In this chapter data of the various ratios used have been analysed. The various results have been displayed and a summary discussion of the findings for each of the companies. Various accounting ratios for the sampled companies have been analysed in this section which include ROA, ROE, EPS, claims Ratio and expense ratio.

4.2 Summary Statistics

Descriptive statistics were used to describe the pre-merger and post-merger values. Then the results were compared to determine the difference if any which will signify if there was any change financially and to which direction.

4.2.1 Saham Insurance Company

Saham insurance company was the new adopted name after acquisition of 66% shareholding of Mercantile insurance by Moroccan investors in the year 2014. The results show that the company financial performance decreased marginally in the short term after acquisition. The claims ratio increased from 42.67% before acquisition to 57.32% after acquisition while the expense ratio increased from 32.33% before acquisition to 41.92% after the acquisition. The EPS fell from 2.03 before acquisition to 0.82 after the acquisition while ROA was down to 1.03 after the acquisition from a high of 3.53 before acquisition. ROE followed a similar trend dropping from a high of 9.67 before acquisition to a low of 4.12 after the acquisition.

Table 4.1: Change in ROA, ROE, EPS, Claims Ratio and Expense Ratio for Saham Insurance Company

	YEAR	Claims Ratio	Expense Ratio	EPS	ROA	ROE
Pre-merger	2011	36%	36%	1.16	2.17	5.65
	2012	29%	34%	4.07	6.44	16.62
	2013	65%	27%	0.87	2	6.74
	Mean	**42.67%**	**32.33%**	**2.03**	**3.53**	**9.67**
	2014	51%	34%	0.75	1.03	3.81
	2015	64%	49.84%	0.88	1.0308	4.43
Post-merger	**Mean**	**57.32%**	**41.92%**	**0.814262**	**1.029831**	**4.12**

4.2.2 ICEALION General Insurance company

ICEALION general insurance company was formed after the merger of ICEA Company Ltd, and Lion of Kenya in the year 2012. The results show that the company financial performance decreased marginally in the short term after the merger. The claims ratio increased from 40 per cent before the merger to 50 per cent after the merger while expense ratio fell marginally from 26 per cent to 25 per cent. ROA and ROE were down to 5.1 and 16.4 respectively after the merger from high of 7.5 and 26.8 before the merger.

Table 4.2: Change in ROA, ROE, EPS, Claims Ratio and Expense Ratio for ICEALION General Insurance Company

		Claims Ratio	Expense Ratio	EPS	ROA	ROE
Pre-merger	2010	54%	22%		7.9	29.4
	2011	37%	23%		6.8	23
	2012	29%	33%		7.8	28
	mean	**40%**	**26%**		**7.5**	**26.8**
	2013	47%	39%		6.7	22
post-merger	2014	51%	17%		6.4	20.2
	2015	53%	19%		2.3	7.3
	mean	**50%**	**25%**		**5.1**	**16.4**

4.2.3 Britam General Insurance Company

Britam general insurance company was formed after acquisition of 99 per cent shareholding of real insurance by Britam in 2013. The research findings indicate that the company financial performance deteriorated marginally after the acquisition in the short run. The claims ratio and expense ratio increased from 51 per cent and 26 per cent respectively to a high of 64 per cent and 31 per cent respectively after the acquisition. ROA and ROE followed a similar trend with 3 and 7 after the acquisition from a high of 8.3 and 22 respectively before the acquisition.

Table 4.3: Change in ROA, ROE, EPS, Claims Ratio and Expense Ratio for Britam General Insurance Company

		Claims Ratio	Expense Ratio	EPS	ROA	ROE
Pre-merger	2011	48%	20%		3.2	4.7
	2012	51%	25%		9.8	40
	2013	52%	35%	12	12	24
	mean	**51%**	**26%**		**8.3**	**22**
	2014	60%	30%		7.7	22.4
	2015	67%	32.00%	-0.5	-2	-8.4
post-merger	2016			0.92	4.6	19.8
	mean	**64%**	**31%**		**3**	**7**

4.3 Descriptive Statistics

Descriptive statistics are computed as below for the merged insurance firms before and after the merger.

Pre-merger	**Variables**	**N**	**Mean**	**median**	**std dev**	**var**	**min**	**max**
	Expense ratio	3	0.28	0.26	0.04	0.13	0.26	0.32
	claims ratio	3	0.45	0.43	0.06	0.33	0.40	0.51
	ROA	3	0.06	0.08	0.03	0.07	3.54	0.08
	ROE	3	0.19	0.22	0.09	0.78	0.10	0.27
Post-merger	**Variables**	**N**	**Mean**	**median**	**std dev**	**var**	**min**	**max**
	Expense ratio	3	0.33	0.25	0.09	0.74	0.25	0.42
	claims ratio	3	0.57	0.57	0.07	0.49	0.50	0.64
	ROA	3	0.03	0.03	0.02	0.04	0.01	0.05
	ROE	3	0.09	0.07	0.06	0.41	0.04	0.16

4.4 Discussion and Research Findings

The research study shows an increase of claims ratio and expense ratio for all the companies in the short term. On the other hand the research shows a decrease of ROA and ROE for all the firms researched after the merger/acquisition.The companies involved in mergers and acquisition gained more market power i.e they controlled more market after merger and acquisition. This study therefore concludes that, in the short run, there was a negative impact on the financial performance of insurance firms that were involved in mergers and acquisition. The research also concluded that the merged firms on average performed better than industry average while controlling higher market share than before the merger.

Table 4.4: Claims Ratio Comparisons

	2011	2012	2013	2014	2015
ICEALION General	37	29	47	51	53
Britam General	48	51	52	60	67
Saham	36	29	65	51	64
Mean of merged firms	**40.33**	**36.33**	**54.67**	**54**	**61.33**
Industry	**37.69**	**56.03**	**63.35**	**81.29**	**80.78**

Table 4.5: Expense Ratio Comparisons

	2011	2012	2013	2014	2015
ICEALION General	23	33	39	17	19
Britam General	20	25	35	30	32
Saham	36	34	27	34	50
Mean of merged firms	**26.3**	**30.67**	**33.67**	**27**	**33.67**
Industry	**27.29**	**36.79**	**42.52**	**51.95**	**58.7**

Table 4.6: Market Power/ Market Share

	2011	2012	2013	2014	2015
ICEALION General Insurance	3.2	**5.62**	5.27	5.24	5.03
Saham	0.9	0.86	0.98	**1.04**	1.09
Britam General Insurance	4.0	4.4	2.93	**3.21**	8.37
Mean	**2.7**				**4.83**

Source: IRA Annual reports

CHAPTER FIVE

SUMMARY AND CONCLUSION

5.1 Introduction

This chapter is divided into four sections. Section 5.2 discusses the summary of the study. Section 5.3 presents the conclusion drawn from the study findings, section 5.4 presents the limitations of the study while 5.5 cover the recommendations for further research.

5.2 Summary of the Study

This study sought to establish the relationship between mergers and acquisition and the financial performance. Secondary data relating to the merged/acquired firms were collected three years prior to M&A and three years after M&A. Key ratios within the insurance industry were used to evaluate the impact of M&A. The ratios used were; claims ratio, management expenses ratio, return on equity ratio, earning per share and return on assets ratio.

The research study findings indicate that M&A had a negative effect for the merged insurance firms in the short run on the claims ratio, ROE, ROA and expense ratio. However M&A lead to increased market power of the merged firms. In addition merged firms performed well above industry average.

5.3 Conclusion

This study concludes that M&A lead to an increase of claims ratio and expense ratio for all the companies in the short term. This resulted in negative impact on the financial performance. On the other hand the study shows a decrease of ROA and ROE for all the firms researched after the

merger/acquisition. This study therefore concludes that, in the short run, there was a negative impact on the financial performance of insurance firms that were involved in mergers and acquisition.

5.4 Limitations of the Study

This study solely depended on secondary data. One major drawback of this study was the assumption that mergers and acquisition is a mutually exclusive event in the sense that firms engaged in M&A could only record change in financial performance solely due to M&A. In reality different events may be mutually inclusive and may play complementary roles.

The research spanned across a time line of 15 years through which there were various changes in ratios used, example claim ratio and expense ratio were previously being calculated using gross premiums instead of net premium. Furthermore no adjustment for inflation was done while comparing the various ratios.

The study involved insurance firms in different categories; some newly listed and therefore enjoyed a lower tax rate example Britam. The firms involved also had different levels of leverage.

Another key challenge related to data collection. To get data spanning 15 years was a daunting task. The researcher depended on diverse sources of information to derive at these conclusions.

5.5 Recommendations for Further Research

Behavioral finance has gained momentum in 21st century. There is need to study the gambling aspect of corporate managers who engage in mergers and acquisition.

This study was centered on the short term effect of mergers and acquisition. There is need to examine the long term effect of mergers and acquisition.

This study majored in trend analysis of firms engaged in mergers and acquisition. The research recommends a comparison of merged firms against unmerged firms of the same capital structure or to remove the tax element to eliminate distortion due to interest savings.

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APPENDICES

APPENDIX I: LIST OF MERGERS ACQUISITION BETWEEN 2000 AND 2016 WITH CONTROLLING INTEREST

Institution Name	**Merged with**	**Current name**	**Date of Merger or Acquisition**
Pioneer Assurance	Fidelity Assurance	Pioneer Assurance	2002
Pan Africa Insurance	Apollo	APA INSURANCE	2004
ICEA INSURANCE	LION ASSURANCE	ICEALION	2012
Saham Group	Mercantile insurance	Saham	2013
Britam Insurance	Real Insurance	Britam General	2013
UAP (K) Ltd	Century insurance (TZ)	UAP	2013
UAP Ltd	Old mutual ltd	UAPOLDMUTUAL	2014
Metropolitan life insurance	Canon life Assurance	Metropolitan life insurance	2015
First Assurance	Barclays Africa	First Assurance	2015