MERGER STRATEGY AND ITS EFFECTS ON PROFITABILITY FOR COMMERCIAL BANKS LISTED IN THE NSE IN KENYA

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ABSTRACT

For some of the commercial banks that are listed in the NSE in Kenya, merger strategy has been previously used, more-so to grow their profit margins. But for the past two decades, these commercial banks have been experiencing a lot of economic turbulence. The business environment has changed, which has led to an influx of banks in the country, the result of which is increased competition. This has not been made any simpler by the introduction of lowered interest rates in terms of loan-rates (a result of the government introducing the Capping Bill). Therefore, as an alternative strategy to closing down of branches and retrenching employees, this study seeks to find out if the re-use of merger strategy by these commercial banks will lead to a growth in profitability once again. The main objective of the study is therefore to analyze the effect of merger strategies on profitability of commercial banks listed in the NSE in Kenya. The research methodology used in the study was mixed research design methodology. The primary data was collected using questionnaires; while secondary data was collected from the audited financial statements. The researcher used purposive sampling in the study. The study was guided by the synergy-gains theory. In regard to correlation analysis being, it was observed that, merger strategy

and ROA (after merger) had a positive and significant relationship. In regard to the regression analysis, the calculated p-value was 0.018, which was lower than the critical p-value of 0.05 for the study. This led to the researcher rejecting the null hypothesis that there was no significant relationship between merger strategy and profitability for commercial banks listed in the NSE. For primary data, using the five-point Likert scale, the responses average mean was found to be 3.75. This meant that, majority of the respondents agreed with the questions that were asked in the questionnaire for the study, which led to the conclusion that, merger strategies had significant effect on the profitability of commercial banks listed in the NSE. Therefore, a conclusion that the use of merger strategies by commercial banks listed in the NSE led to a growth in their profitability was drawn.

Keywords: Merger Strategy; Profitability; Nairobi Securities Exchange (NSE); Commercial Banks in Kenya

INTRODUCTION

In the recent past in Kenya, the banking sector had recorded a slow-down in growth in the assets, profit-margins, deposits as well as products they were offering to their clients. This slow-down in growth as well as fluctuating financial performances had been mainly attributed to factors such as increased competition as well as introduction of certain government policies such as the Capping bill (which enabled the government to regulate interest-rates offered by the banks). According to the CBK, players in the banking industry had been experiencing tough times of late. This had been attributed to a growth in competition for clients over the years, and this was due to greater innovations by players in the industry as well as more competitors into the banking market. The increased competition and introduction of the Capping Bill by the government were some of the major reasons that had caused the commercial banks listed in the NSE and had undertaken merger strategies not to attain their pre-set profit targets (that is, the expected profit margins). Despite the banks under study having undertaken an already proven growth strategy (that is, merger strategy), they had not been able to attain the expected profit margins after merging, a very worrying trend for the Kenyan banking sector. This economic hardship that the banks were experiencing had forced many banks to close some branches, and at the same time, drastically reduce their work-force as a way of ensuring their survival (through not hiring new staff as well as laying-off the

already existing ones). This they had undertaken with the hope of increasing their profit margins. With this in mind, though the merger strategies may not have been the best option for the banks, more specifically for these banks which had tried it before, it looked like the better strategy to undertake compared to downsizing and closure strategies. The study therefore sought to find out what effects that undertaking merger strategy had on the profitability of these commercial banks that had previously undertaken the strategy before and were listed in the NSE in Kenya.

RESEARCH OBJECTIVE

The main objective of the study was to establish the effect of merger strategies on profitability of commercial banks listed in the NSE in Kenya.

RESEARCH HYPOTHESIS

To proffer useful answers to the study, the following research hypotheses were formulated for the study:

> **H_0**: There is no significant relationship between merger strategies and profitability of merged commercial banks listed in the NSE
>
> **H_1**: There is a significant relationship between merger strategies and profitability of merged commercial banks listed in the NSE

SCOPE OF THE STUDY

The scope of the study was further sub-divided onto two major categories, that is: content scope and geographical scope.

(i) CONTENT SCOPE

The content scope of the study was on commercial banks that were listed in the NSE and had undertaken merger strategy before. In the current study, five commercial banks listed in the NSE which had undertaken merger strategies, that is: CFC Stanbic Bank Ltd and I&M Holdings Ltd (Consolidation merger strategy), and Barclays Bank of Kenya Ltd, KCB Ltd, and Co-operative Bank Ltd (Downstream merger strategy).

(ii) GEOGRAPHICAL SCOPE

The geographical scope of the study was Nairobi; and more specifically, the C.B.D. This was because, all the banks under study had several branches in the capital city of Kenya, a factor that further strengthened the reason for choosing the banks as well as the area of study.

OPERATIONAL DEFINITION OF TERMS

The operational definition of terms were as follows:

(i) **Listed commercial banks** are banks whose shares are available for trading to the public through the NSE in Kenya (Ireri, 2011)

(ii) **Merger** is a restructuring technique used by companies whereby two or more companies comes together, have an agreement, and either move together jointly or individually for their own individual benefit (Akinsulire, 2006).

(iii) **Merger strategy** is a restructuring technique undertaken by a company's management meant to expand the operations of the company, mainly through increasing the long-term profits of the company. It can further be broken-down to specific strategies such as Consolidation merger strategy (Ireri, 2011).

(iv) **Profitability** is the financial benefit that a bank enjoys when the incomes that are generated surpass (that is, are more than) the expenses and costs they incur, as well as the taxes they pay so as to sustain their normal day-to-day activities (Sivathaasan, Tharanika, Sinthuja & Hanitha, 2013).

LITERATURE REVIEW

The Literature review for the study was divided into two major sections, that is: theoretical review and empirical review, which were discussed as follows:

THEORETICAL REVIEW

The theory that was used for the current study was synergy-gains theory. This theory is based on the principle that, an organization will use all its available resources for purposes of increasing

its value in the market, and therefore, increasing its profits. Synergy-gains theorists believe that, for an organization to know whether it has created value or not, there needs to be a comparison between the total resources held by the organization and the total held in the economy; while at the same time, look at the opportunities with which the said resources are utilized for purposes of making profits. The term ‘resources’ in this instance could be used to mean: (i) inputs to the process of production; and (ii) factors owned and controlled by the organization.

This theory explains more about merger transaction whereby, a merger is undertaken for purposes of realizing synergies, and in the process, increase cash-flows in the firm, which results to the overall increase in profits for the firms.

EMPIRICAL REVIEW

The empirical review for the study was as follows:

EFFECT OF MERGER STRATEGIES ON PROFITABILITY

The profitability of organizations has over the years been calculated using measures such as: Return on Equity (ROE), Return of Assets (ROA), Earnings before Tax (EBT), as well as Gross Profit Margin (GPM) (Black, Wright & Davis, 2011). These ratios combined are what are referred to as ‘Financial Performance Approach’ of measuring how a merger is doing in terms of profit-margins. In the current study, profitability was meant to show how efficient a company has been in terms of using its resources over a certain period of time. The ratio that was used to measure profitability for commercial banks in the study was ROA.

Findings from various researchers have yielded varying results on how undertaking the strategies affects their profitability, for example: (Boot, 2003; Campa & Hernando, 2006; Amel, Barnes, Panetta & Salleo, 2004) are researchers who have carried out researches and have produced varying results. Further researches are analyzed as shown below.

Research by Mishra and Chandra (2010) sought to find out the effect of merger strategy on the profitability of companies in India, focusing on companies that had undertaken the strategy between 2000 and 2008. The researchers used panel-data estimation technique, and their findings revealed that, the profitability of the companies dependent on their size, the amount of effort put into selling, the amount of exports as well as imports (which went on to affect their market share

as well as demand). The conclusion of the study was that, there was no direct relationship between companies in India undertaking the merger strategies and effect on their profitability thereafter.

Previously, Saboo and Gopi (2009) undertook a study on Indian companies, seeking to find the relationship that existed between companies undertaking merger strategies, and the effect it had on their profitability. However, the researchers compared the findings of the companies that had undertaken local mergers and compared the profits with those of companies that had undertaken international mergers. In both instances, the researchers compared the profit margins before and after merging. The findings of the study revealed that, for both local and international mergers, the companies posted higher profit margins post-merging as compared to pre-merging. However, the companies that undertook international mergers posted higher profit margins than those that undertook local mergers.

Achua and Ola (2013) sought to find out the relationship that existed between commercial banks in Indonesia undertaking merger strategies, and the impact it had on their profitability thereafter. They made a seven-year comparative study (before and after the merger strategy) and found out that, commercial banks in Indonesia gained from undertaking merger strategies, as their profitability increased after undertaking the strategy. This they were able to conclude by the increased values of ROA, ROE, EBT and GPM. However, the research also revealed that, post-merging, the ‘loan-to-deposit’ ratios went down for the commercial banks, and this was attributed to slower business after merging.

In contrast, Kemal (2011) carried out research primarily on how undertaking merger strategies in Scotland by commercial banks affected their profit-ratios, and focus was laid on the Royal Bank of Scotland. The researcher used twenty (20) ratios, and of these, only six had better values after merging than before merging. The researcher concluded that, the strategy had failed for that particular bank (in terms of increasing its profitability). This therefore resulted to a conclusion being made that, undertaking merger strategy was a total let-down for Royal Bank of Scotland.

Hackbarth and Morellec (2008) carried out research to find-out the impact that merger strategies had on various operational aspects for publicly-listed banks in China. The main variables used as operational variables in the study were the profit-margin ratios (that is, ROA, ROE, EBT and GPM). The researchers carried out various tests to find the kind of relationship that existed between the two variables, and their findings revealed that, there was a significant improvement in the

profit-ratios after undertaking the merger strategies by the commercial banks. The researchers' findings also revealed that, the markets highly anticipated future merger deals due to the high profits that were being witnessed by the publicly-listed commercial banks.

Pazarskis, Vogiatzogloy, Christdoulou and Drogalas (2006) carried out research on how undertaking various merger strategies by publicly-listed commercial banks in Greece affected on their profitability. The researchers undertook the study on a sample of 50 banks that were listed in the Athens Stock Exchange (ASE), and had undertaken at-least one merger deal between the years 1999 and 2003. They focused on three financial ratios that depict profitability, that is, ROA, ROE and GPM. The researchers compared the ratios before and after merging. The findings of the study were that, banks listed in the ASE and had undertaken merger strategies recorded higher profit-ratios after undertaking the strategies as compared to before. However, this was only noted in the short-run, as in the long-run, the profitability decreased.

Mantravadi and Reddy (2008) carried out an analysis on the banks in India, seeking to find-out the effect that merger strategies had on the profit-ratios for commercial banks in the country. The researchers compared the ratios with those of banks that had not undertaken the strategy. The study was based on publicly-listed commercial banks, and was based between the years 1990 and 2004. The findings of the study revealed that, the banks that undertook merger strategies had an insignificantly higher profit-margin than those that had not merged. This led to the conclusion that, undertaking merger strategies led to publicly-listed commercial banks in India slightly increasing their profit margins.

From the studies above, it could be observed that, various researchers had tried to find the impact that undertaking merger strategies by commercial banks had on their respective profitability. However, other researchers seemed to note a positive impact where as others record negative impact; this inconclusiveness in the various findings left a research gap that clearly needed to be addressed. The study distinctively differed from previous studies undertaken in that, the researchers had been too general in their findings, with none being specific as to what was expected by the banks when a strict government policy such as the Capping-bill was introduced. Furthermore, the lack of specific studies on how merger strategies being used by commercial banks listed in the NSE in Kenya left a conceptual gap (which made this study unique from other studies previously undertaken) as well as a knowledge gap that would be addressed by the current study.

RESEARCH METHODOLOGY

RESEARCH DESIGN

Under the current study, the research methodology that was viewed to be highly appropriate was mixed research design methodology. This was for purposes of avoiding biasness when using any of the research designs.

LOCATION OF THE STUDY

The study was based in the Central Business District (CBD) of Nairobi County in Kenya. To collect primary data, it entailed administering questionnaires to management of the branches of each of the listed commercial banks, all of which had branches in the Nairobi CBD (totaling to 120 managers, that is: 54 branch managers, 54 operations managers and 12 section managers).

DATA COLLECTION METHODS

In the current study, data was collected through primary as well as secondary sources. Primary sources of information were obtained by the researcher administering questionnaires to the respondents. Secondary information was obtained from the audited financial statements of the commercial banks that were available online.

DATA ANALYSIS, PRESENTATION AND DISCUSSION

FINANCIAL PERFORMANCE TRENDS

RETURN ON ASSETS (R.O.A)

The figure 1 that follows indicated the trend of the R.O.A for the banks from the years before merger, year of merger, and years after merger. The tend indicated a drop from the period t-3 to t-2, and then a rise from t-2 to t+2, which was then followed by a slight drop from t+2 to t+3. This generally indicated that, from secondary data, the profitability (in terms of R.O.A) increased over the years.

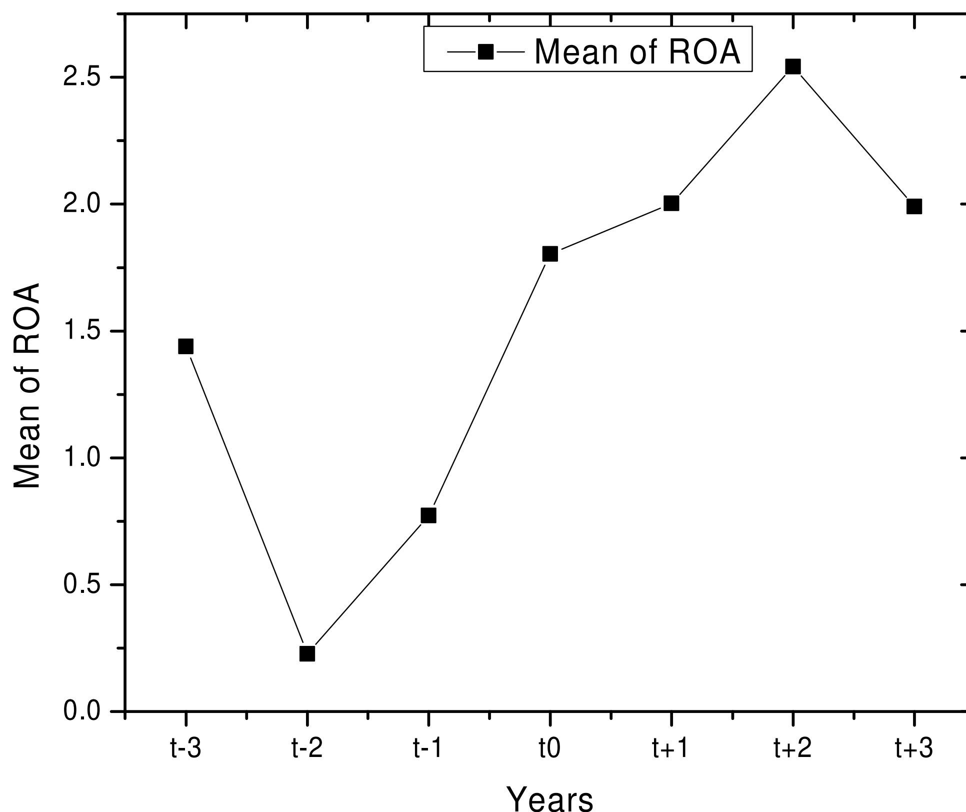

Figure 1: ***ROA Trend***

Source: Researcher, 2019

RESULTS OF CORRELATION ANALYSIS UNDERTAKEN ON EFFECT OF MERGER STRATEGY ON PROFITABILITY (SECONDARY DATA)

Table 1 that follows showed the relationship that existed between merger strategy, ROA (before merger), and ROA (after merger). From the findings, it was observed that merger strategy and ROA (after merger) were positively and significantly correlated (r=0.354, p=0.0376). This was after comparing the calculated p-value of 0.0376 with the critical p-value of 0.05.

Table 1: ***Correlation Analysis (From Secondary Data)***

		ROA (Before Merger)	**ROA (After Merger)**	**Merger Strategy**
ROA (Before Merger)	Pearson Correlation	1	0.025**	0.063*
	Sig. (2 tailed)		0.000	0.034
ROA (After Merger)	Pearson Correlation	0.025**	1	0.354
	Sig. (2 tailed)	0.000		0.0376
Merger Strategy	Pearson Correlation	0.063*	0.354	1
	Sig. (2 tailed)	0.034	0.0376	

** Correlation is significant at the 0.01 level (2-tailed).

* Correlation is significant at the 0.05 level (2-tailed).

HYPOTHESIS TESTING

Using the regression analysis results shown in table 9 below, the hypothesis (I) was tested and was as shown below:

H_0: There is no significant relationship between merger strategy and profitability of merged commercial banks listed in the NSE

H_1: There is a significant relationship between merger strategy and profitability of merged commercial banks listed in the NSE

Rule: Accept Null Hypothesis if the calculated p-value is greater than the critical p-value of 0.05

From the findings in table 2, it showed that the study rejected the null hypothesis and accepted the alternative hypothesis. This was because, the calculated p-value (0.018) was lower than the critical p-value (0.05). This showed that there was a significant relationship between merger strategy and profitability.

From the findings, the following equation was derived:

$$\text{ROA (After Merger)} = (0.798) + (0.779)\ \text{Merger Strategy}$$

This meant that, a unitary change in Merger Strategy (that is, number of branches opened) led to 0.779 change in ROA.

Table 2: ***Regression Analysis (Profitability)***

Parameter Estimate	**ROA (After Merger)** **Coefficient (p-value)**
Constant	0.798 (0.004)
Merger Strategy	0.779(0.018)
R Squared	0.25
F-Statistics (ANOVA)	7.138(0.018)

The findings of the study revealed that, for the regression model, the goodness of fit between merger strategy and ROA (after merger) (obtained from R-squared value) was 0.25. This meant that, 25% of any changes in the ROA (after merger) were explained by the company undertaking merger strategy.

RESULTS OF EFFECTS OF MERGER STRATEGY ON PROFITABILITY (FROM PRIMARY DATA)

Table 3 that follows showed the findings from primary data on the effects of merger strategy on the profitability of the banks.

Table 3: ***Effects of merger strategy on profitability***

	Strongly Disagree	**Disagree**	**Neutral**	**Agree**	**Strongly Agree**	**Std. Dev.**	**Mean**
1.Banks are getting higher profits after merger that before	8	15	12	25	33	1.1	3.8
2.Banks are getting higher profits than their projected values	5	21	13	30	24	1.2	3.7
3.Profits have risen post-merging	10	20	13	22	28	1.3	3.7
4.Profits would rise further if merger strategy was to be undertaken again	9	25	12	19	28	1.2	3.8
Average						1.2	3.75

Primary data was also used to explain the effect that merger strategy had on the profitability of banks. From the findings on primary data (using the Likert Scale), it could be seen that, 58 respondents (62.4%) agreed that the banks made higher profits after merger than before merger; 29 respondents disagreed (24.7%), while 12 respondents were neutral in their answering (12.9%).in regard to the question of whether the banks were making higher profits (post-merging) than their initial projected values, 54 respondents agreed (58.1%), 26 respondents disagreed (27.9%), while 13 respondents remained neutral (14.0%). In regard to whether profits had risen post-merging, 50 respondents agreed (53.8%), 30 respondents disagreed (32.2%), while 13 respondents remained neutral (14.0%). On whether profits would rise if the banks were to undertake the merger strategy again, 47 respondents agreed (50.5%), 34 respondents disagreed (36.6%), while 12 respondents remained neutral (12.9%).

In regard to the five-point Likert Scale, the responses' average mean was found to be 3.75, and this meant that, most of the respondents in the study were in agreement with the questions that were being asked in the study; however, there was a variation in regard to the answers, and this was shown by an average standard deviation value of 1.2(that is, answers gotten from respondents mostly ranged from 3 to 5).

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSION

The main objective of the study was to find out the effect of merger strategy on the profitability of commercial banks listed in the NSE. The findings of the study revealed that, there was a positive and significant relationship between merger strategies and the profitability there after. The general implication was that, the undertaking of merger strategies by banks generally led to improved financial performance in terms of raising profitability levels. Therefore, from the findings, a conclusion that the use of merger strategies by commercial banks listed in the NSE led to a growth in their profitability was drawn.

RECOMMENDATIONS FOR IMPROVEMENT

From the findings of the study, in regard to the effect of merger strategy on profitability, the study recommended that, the commercial banks listed in the NSE that opted to undertake merger strategy (for whatever reason) should be more vibrant in marketing their products, plan adequately on how to diversify their products, improve on their efficiency level, and also improve on their staff productivity levels. With this, would ensure that the banks got higher profits after merger as compared to before merging.

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