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MODERATING EFFECT OF ECONOMIC GROWTH ON FINANCIAL PERFORMANCE OF MERGED INSTITUTIONS

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Abstract

Purpose: The purpose of the study was to determine the moderating effect of economic growth on financial performance of merged institutions

Methodology: The study adopted a mixed methodology research design. The study population included all the 51 merged financial service institutions in Kenya. Purposive sampling was used. Primary data was obtained from questionnaires and a secondary data collection template was also used. The researcher used quantitative techniques in analyzing the data. Descriptive analysis for the study included the use of means, frequencies and percentages. Inferential statistics such as correlation analysis was also used. Panel data analysis was also applied. Further, a pre and post merger analysis was used.

Results: There was a significant relationship between the moderating effect of economic growth and financial performance of merged institutions.

Unique contribution to theory, practice and policy: The government and Central Bank of Kenya to come up with strategies and policies to protect the financial services sector due to its immense contribution to the economy of the country by formulating policies aimed at controlling the effects of rapid fluctuations of the macro economic factors and their effects on the sector. ***Keywords:*** *Economic growth, Financial performance, Merged institutions*

1.0 INTRODUCTION

1.1 Background of the Study

Mergers and Acquisitions is an important financial tool that enables companies to grow faster and provide returns to owners and investors (Sherman, 2011). According to Ross, Westerfield and Jordan (2003), a merger is the complete absorption of one firm by another, wherein the acquiring firm retains the identity and the acquired firm ceases to exist. Mergers and Acquisitions also refer to the change in ownership, business mix, assets mix and alliance with the view to maximizing shareholders' value and improve the firm performance (Pazarkis, Vogiatzoglo, Christodoulou, Drogalas, 2006; Gaughan,2012; Nakamura, 2015). According to (Pazarkis *et al*, 2010; Gaughan,2012; Nakamura, 2015), one of the main elements of improving company performance is the boom in mergers and acquisitions. A merger is a corporate strategy usually done between two or more companies where by the acquiring firm and the acquired firm stands on a merger agreement.

Grinblatt, Mark & Titman, Sheridan (2012) identified three different categories of M&A; strategic acquisitions, financial acquisitions and conglomerate acquisitions. Strategic mergers take place between two companies in the same line of business; thus between former competitors (Brealey, Myers, & Marcus, 2011& Grinblatt *et al*., 2012). Financial acquisitions are marked by no operating synergies; instead companies engage in financial acquisitions because the acquirer believes that the target company is undervalued relative to its assets. Another motive for engaging in financial acquisitions is the tax gain sometimes associated with the acquisition (Brealey *et al*., 2011& Grinblatt *et al*., 2012). In a conglomerate acquisition no clear potential for operating synergies exist, since the two companies operate in unrelated lines of business (Brealey et al., 2011& Grinblatt et al., 2012). This type of acquisition according (Brealey et al., 2011& Grinblatt et al., 2012) is often motivated by financial synergies, which enables a company to lower cost of capital there by creating value

Due to changes in the operating environment, several licensed institutions have had to merge or one institution takes over another's operations (Hitt, Ireland & Hoskissn, 2009; Fluck and Lynch, 2011). Some of the reasons put forward for mergers and acquisitions are: to gain greater market power, gain access to innovative capabilities thus reducing the risks associated with the development of a new product or service, maximize efficiency through economies of scale and scope and finally in some cases, reshape a firm's competitive scope (Hitt *et al*., 2009; Fluck et al,2011; Vermeulen and Bakerma, 2011; Vaara, 2012). Other reasons include short-term solution to finance problems that companies face due to information asymmetries (Fluck*et al*2011), revitalize the company by bringing in new knowledge to foster long-term survival (Vermeulen *et al* 2011) and to achieve synergy effects (Lubatkin, 2007; Vaara, 2012).

The synergistic effect of mergers and acquisitions includes economies of scale through greater output, avoidance of duplication of facilities and staff services and stronger financial base. The economic benefits as a reason for pursuing a merger or an acquisition include income enhancement, cost reduction and growth (Amedu, 2014). Some of the reasons for mergers and acquisitions are to: purchase a company having competent management; improve earnings per share, inject fresh ideas for better prospects and enhancement of shareholders' wealth, gain access to the financial market, eliminate duplicate and competing facilities, secure scarce raw materials, diversify into other products or markets or to complete a product range, greater asset backing; and enhance economy of scale and corporate growth (Akinsulire, 2012: Amedu, 2014).

Merger and Acquisition has become a corporate strategy enabling a firm to strengthen its core competencies and the factors affecting mergers change with their changing legal, political, economic and social environments (Gyanwali, 2013). Firms engage in mergers and acquisitions activity for different economic reasons. For example; synergy is commonly used in a merger and acquisitions activity. Synergy has been described as the combination of firms that have a value which is greater than the sum of the values of the separate firms (DePamphilis 2009). Hypothetically the underlying principle of synergy is 2+2=5, or 5+5=11 which is technically incorrect. However, it is believed that the net positive gain will be achieved resulting from the merger of two separate entities. Synergy can be produced as operational, managerial and financial synergies (Ross et.al 2003). Operational synergy can be explained as the combination of economies of scale, which would reduce average costs as a result of more efficient use of resources, and economies of scope, which would help companies deliver more from the same amount of inputs" (DePamphilis 2009). Financial synergy refers to the impacts of mergers and acquisitions on the cost of capital of the acquiring firm or the newly formed firm resulting from a merger or acquisition (DePamphilis 2009). The merged entity will be able to reduce the cost of capital and increase its buying power. However (DePamphilis 2015; Frankie TAN, 2009) explain that a conglomerate merger enables an individual unit under the umbrella of one centralized parent company achieve beyond what would have been achieved by each unit competing individually.

1.2 Problem Statement

The resultant benefits and costs of mergers and acquisitions is a strategic issue which may impact positively or negatively on financial performance (Healy, Palepu and Ruback 2012). Shareholders and their agents are therefore faced with a problem of trying to ascertain whether this strategic decision and activity will result in improvement of better financial performance (Katuu, 2003). Mergers and acquisitions could also concern policy makers because they may have negative consequences on the competitive environment by creating monopolies (Wang 2007). Several economic theories and M&A literature support the idea that shareholders experience positive abnormal returns arising from expected value creation post-merger (Halebian, 2009; Cartwright *et al*, 2013; Moeller et al., 2015). Thus, M&As are expected to create value as a result of firms exploiting economic resources that are both available and implementable but, the general result is that the shareholders of target firms earn positive and significant returns, whereas returns for acquiring firms are much lower and possibly negative(Cartwright *et al*, 2013). This is the practical gap that necessitates this study.

Many studies in M&As have been done in developed markets globally mainly in Asia, Europe and the USA. Healy,*et al* (1992) examined post-acquisition performance for 50 largest U.S. mergers between 1979 and 1984 by measuring cash flow performance, and concluded that performance of merging firms improved significantly following acquisitions, when compared to their respective industries. Lubatkin (1983) reviewed the findings of studies that investigated either directly or indirectly the question, "Do mergers provide real benefits to the combined firm?" The review suggested that combined firms might benefit from merging because of technical, and diversification synergies. Ghosh (2001) examined the operating cash flow performance improvement after corporate acquisitions; and the results showed that merging firms did not show evidence of improvements in the operating cash flow performance of postmerger and acquisition. Wang (2007) investigated the wealth effect of investment banks and fairness opinions they provide in corporate mergers and acquisitions. The study found that firms undertaking opinioned mergers under-perform firms with non-opinioned matching mergers in short windows around the announcement date. Lack of conclusiveness of studies linking merging activity to performance is a distinct knowledge gap.

Limited studies have been carried out on the M & As in the Kenyan market. These studies' findings have not shown that M & A activities positively affect financial performance. Some of them even give contradictory findings. Chesang (2002) carried out a studied on implications of merger restructuring on performance of commercial banks in Kenya. She used ratio analysis on this study and concluded that there was improved performance in some cases though; the extent of the contribution was not significant. Korir (2006) researched on the merger effects of companies listed in the NSE and found out that mergers improve performance of companies listed at the NSE. Ochieng (2006) did research on the merger between CBA & FABK and the results showed a decline in earnings and lower ratios arising out of the deal. Marangu (2007) studied effects of mergers on financial performance of non-listed banks in Kenya from 19942001 and using the ratio analysis, he concluded that there was significant improvement in performance for the non-listed banks that merged compared to the non-listedbanks that did not merge within the same period. The empirical studies conducted in Kenya including; (Maranga, 2010; Katuu, 2003; Muya, 2006; Kiplagat, 2006; Wesonga, 2006; Nyagah, 2007; Njoroge, 2007; Kithinji, 2007, Ndura 2010, Ndung'u 2011, and Ireri 2011) have all failed to treat mergers and acquisitions as a strategic activity.Despite these M&As activities continue to take place in the Kenyan economy; this presents a conceptual knowledge gap. In light of these inconclusiveness and conceptual gaps poised from these past studies, this study sought to establish if mergers and acquisitions strategic activities lead to improved financial performance of financial services institutions in Kenya.

1.3 Research Objective

The objective of this study was to determine the moderating effect of economic growth on financial performance of merged institutions.

2.0 LITERATURE REVIEW

2.1 Theoretical Review

2.1.1Efficiency Theory

According to this theory, there are firms that are below average efficiency and so operate below their potential. As such firms operating in similar businesses are more likely to be acquirers of such firms. These firms naturally have the capacity of detecting below average or less than full potential performance and have the managerial ability to improve the performance of such firms if they were acquired. While these are the assumptions on which an acquisition bid is based, they are always overoptimistic in most cases, and the acquirer may not succeed in improving the performance of the acquired firm. Being overoptimistic also means that such firms may pay too much when acquiring the firm since the acquisition value is based on the ability of improving its performance over time (Weston et al, 2003).Therefore, if a firm has an efficient management team in excess of the current managerial output demand, another firm can acquire it in order to utilize the extra managerial resources.

Critiques of this theory assert that theory makes the assumption that the shareholders of the inefficient firm are unable to replace their managerial team and prefer invoking costly mergers to replace their inefficient managers. This view gives rise certain problems; f*irst*, it is not very convincing that a merger activity can be invoked as a disciplinary means of last resort. *Second*, if the replacement of inefficient managers is the sole rationale of a merger, then it would be sufficient to operate the acquired firm as a subsidiary rather than merging it with the acquirer firm. *Third*, if a firm is acquired on the basis of inefficient managers then it means that the acquiring firm is more likely to replace the inefficient managers after the merger (Weston, et al, 2003). This has the potential of creating new problems. These criticisms of the theory suggest that it is difficult to accept inefficient management as a strong explanation for mergers.

Disciplinary and synergistic merger motives are the two leading M&A efficiency theories Disciplinary mergers theory suggests that M&As are used to discipline target firms' managers who pursue other objectives than profit maximization. Managers not maximizing profits are assumed to focus their attention on other goals than profitability. This difference in focus comes at the expense of operating efficiency therefore negatively affects the firm's performance. Opportunistic buyers always notice poorly performing plants that are accompanied by good assets and so would discipline these plant managers by acquiring them. Hence, the disciplinary theory suggests that acquiring firms merge with poorly performing targets to improve their performance by helping them realize the target assets' full potential. Synergistic mergers theory on the other hand holds that firm managers achieve efficiency gains by combining an efficient target with their business to improve the target's performance. The managers of the bidder firm recognize specific complementarities between their business and that of the target firm such that, even though the target is already performing well, it should perform even better when it is combined with its complementary counterpart. The theory implies that target firms (or plants) perform well both before and after merger.

2.2 Empirical Review

Sufian and Kamarudin (2012) identified bank specific characteristics and macroeconomic determinants of profitability in the Bangladesh's banking sector over the years 2000 to 2010 using a sample of 31 commercial banks in Bangladesh. The determinants were identified using multiple regression analysis. The results revealed that macroeconomic determinants significantly influenced profitability. The relationship between economic growth and bank performance is negative and significant.

Rao and Lakew (2012) explored the key determinants of profitability of commercial banks operating in Ethiopia using panel data set of banks over the period 1999/00-2008/09. The external factors were related to the industry and the macroeconomic scenarios within which the banks operate. Real GDP growth rate effect was found to be statistically insignificant though with a positive sign.

Dietrich and Wanzenried (2009) analyzed the profitability of commercial banks in Switzerland over the time period from 1999 to 2006. Their sample included 1919 observations from 453 banks. Besides bank specific characteristics, they included a set of macroeconomic and industry specific variables into their regression analyses. Their results showed that the GDP growth rate affects bank profitability in Switzerland positively, with the coefficients being significant at the 5% level.

Ongore (2013) studied moderating effect of ownership structure on bank performance by use of linear multiple regression model and generalized least square on panel data of commercial banks in Kenya to estimate the parameters. The findings showed that GDP had an insignificant correlation coefficient with ROA.

Constantinos and Sofoklis (2009) investigated the effects of bank specific and macroeconomic determinants of bank profitability, using a panel data approach of six Greek banks. The inflation rate appeared to have a positive but slight effect on bank profitability. Other macroeconomic variables investigated, such as GDP, were found to be highly insignificant.

Li (2009) investigated the impact of bank's specific factors and macroeconomic factors on banks profitability, which is measured by return on average assets (ROAA) in the UK banking industry over the period 1999-2006. The results indicated that macroeconomic variables real GDP and inflation had insignificant effect which indicated that macroeconomic factors have little impact on profitability of banks.

Similarly, Fadare (2010) investigated the effects of banking reforms on economic growth in Nigeria over the period 1999-2009. Using the ordinary least squares regression technique, the study established that interest rate margins, parallel market premiums, total banking sector credit to the private sector, inflation rate, inflation rate lagged by one year, size of banking sector capital and cash reserve ratios accounted for a very high proportion of the variation in economic growth in Nigeria. The findings of the study showed that, although there was a strong and positive relationship between economic growth and the total banking sector capital, the relationship between economic growth and other exogenous variables of interest rate margins, parallel market premiums, total banking sector credit to the private sector, inflation rate and cash reserve ratio revealed the wrong signs.

In conclusion, the major purpose of the various financial sector reforms was to strengthen the banking industry and position it to meet world standards, Oladejo and Oladipupo (2011), Bank supervision entails not only the enforcement of rules and regulations, but also judgment concerning the soundness of banks' capital adequacy, assets, management, earnings and liquidity. Kouser and Saba (2012) postulated that Capital, Assets, Management, Earnings and Liquidity(CAMEL) is an appropriate and simple model for the evaluating the financial and managerial performance of institutions. They argue that the CAMEL is commonly used for the evaluation of performance and ranking. The study made comparison between the performance of pure Islamic banks, conventional and mixed banks in Pakistan. The ratios of the banks' performance defined by the CAMEL model were analyzed using ANOVA to investigate any significant difference. The analysis found that, Islamic banks had developing set up. In other words, Islamic banks fare better than conventional and mixed banks in Pakistan.

3.0 RESEARCH METHODOLOGY

The study adopted a mixed methodology research design where qualitative and quantitative research approaches were used to answer the research questions. The study population included all the 51 merged financial service institutions in Kenya which had completed their merger process by 31 December 2013. Purposive sampling was used. Primary data was obtained from questionnaires and a secondary data collection template was used to collect data on Return on Assets, Return on Equity and mergers and acquisitions aspects. The researcher used quantitative techniques in analyzing the data. Descriptive analysis for the study included the use of means, frequencies and percentages to describe the primary and secondary data collected. Inferential statistics such as correlation analysis was also used to test for the relationship of the variables from the secondary data. Panel data analysis was also applied to describe change in the study variables over time and trends over a period of five years from 2009 to 2013. A pre and post merger analysis was used to test whether the merger and acquisitions had brought any significant difference in the merged firms.

4.0 RESULTS AND DISCUSSIONS

4.1 Response Rate

One hundred and twenty (120) questionnaires were administered to the respondents.

Table 1: Response Rate

Response	Frequency	Percent
Returned	83	69.2%
Unreturned	37	30.8%
Total	**120**	**100%**

Out of which 83 were properly filled and returned, representing a response rate of 69.2% as shown on table 1 According to Mugenda and Mugenda (2013) and also Kothari (2010) a response rate of 50% is adequate for a study. Babbie (2004) also asserted that return rates of 50% are acceptable to analyze and publish, 60% is good and 70% is very good.

4.2 Demographic Characteristics of Respondents who participated in the Primary Study.

Table 2 shows the results on demographic characteristics of the respondents.

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Table 2: Demographics Demography

	Category	Frequency	Percent
Gender	Female	36	43.4
	Male	47	56.6
	Total	**83**	**100**
Age	20-30	17	20.5
	31-40	22	26.5
	41-50	23	27.7
	Above 51	21	25.3
	Total	**83**	**100**
department	Accounts/Finance	25	30.1
	HR	6	7.2
	Customerservice/Business Development/Relationship Management	11	13.3
	Operations/strategy/planning	17	20.5
	Credit/risk/debt recovery	18	21.7
	Asset Finance	6	7.2
	Total	**83**	**100**
Position	Top Manager	15	18.1
	Senior Manager	25	30.1
	Middle Manager	43	51.8
	Total	**83**	**100**
Academic Qualification	College	14	16.8

	Undergraduate	37	44.6
	Masters	32	38.6
	Total	**83**	**100**
Number of Employees			
	11-50 employees	29	34.9
	over 50 employees	54	65.1
	Total	**83**	**100**

Majority of the respondents were male who represented 56.6 % of the sample while 43.4% were female. On the question of age, 20.5% the respondents were in the age bracket of between 2030years, 25.5 % were between 31-40 years, 27.7% were between 41-50 years while 25.3% were above 51 years. On the question on department, 30.1% of the respondents worked in the finance/account departments, 7.2% were from the HR department, 13.3% of were from the Customer service/Business Development/Relationship Management departments, 20.5% were from the operations, strategy and planning departments, 21.7% of the respondents were from the Credit, risk and debt recovery departments and 7.2% were from asset finance department.

The respondents were also requested to indicate their current position they held in the different departments 51.8% which was the majority indicated that they were in middle management position, 30.1% were in senior management position while 18.1% of the respondents indicated that they held top management positions.

On the question of academic qualification 44.6% had undergraduate qualification, 38.6% had masters qualification, while only16.89% had a college qualification. Lastly the respondents were requested to indicate the number of employees in their institutions, 65.1s% who were the majority indicated that their institution had over 50 employees

The respondents stated that the mergers took place through the replacement of inefficient managers of the acquired firms and amalgamations. The respondents cited gaining market share, competitive advantage, increasing revenues, risk and product diversification and improving shareholder value were stated as the most important motivating factors behind the merger and acquisition. The most obvious motive to engage in M&A was to obtain synergy effects. These were attained through cost savings gained from economies of scale and scope.

On the question of the critical strategies that the management put in place to enhance success of the merger and acquisition, respondents stated size of merging partners, number of bidders and methods of financing. Stocks were preferred as a financing method.

4.3 Description of Merged Financial Institutions

4.3.1 Economic Growth

Economic growth was measured as the annual percentage growth rate of GDP at market prices based on constant local currency. Figure 2 shows the GDP growth trend for the years 2009 to 2014.

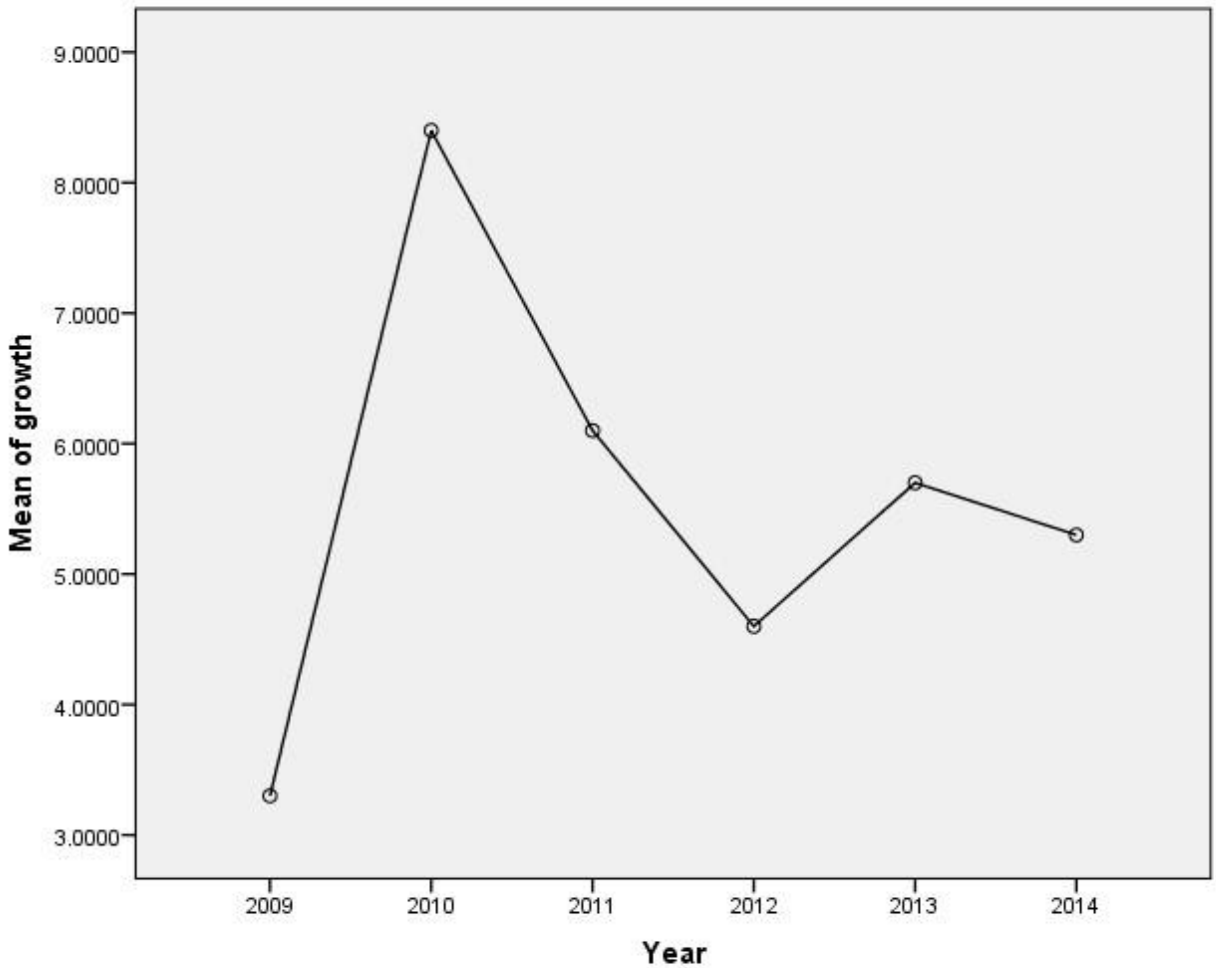

Figure 2: Economic growth Trend

The trend indicates that GDP growth had a sharp increase between 2009-2010 then declined between the years 2010-2012 which then increased in 2013 but later dropped in 2014.

4.4 Moderating Effect of Economic Growth on Financial Performance

4.4.1 Correlation Analysis

Table 3 presents the results of the correlation analysis between economic growth, ROA and ROE

Table 3: Correlation Analysis for Economic growth and Financial Performance

		ROE	ROA	Economic growth
ROE	Pearson Correlation	1	0.410	0.146
	Sig. (2-tailed)		0.000	0.034
ROA	Pearson Correlation	0.410	1	0.013
	Sig. (2-tailed)	0.000		0.854
Economic growth	Pearson Correlation	0.146	0.013	1
	Sig. (2-tailed)	0.034	0.854	

The results show that there is a positive and significant relationship between ROE and economic growth (r=.146, p=0.034).

4.4.2 Regression Analysis

Regression analysis was conducted to empirically determine whether the moderating effect of economic growth was a significant determinant of performance which is measured in ROA and ROE.

Table 4: Regression Analysis for Economic Growth and Financial Performance

	ROA	**ROE**
Parameter estimate	Coefficient(P value)	Coefficient(P value)
Constant	0.135(0.622)	0.181(0.000)
Economic Growth	0.09 ((0.854)	0.7(0.034)
R Squared	0.13	0.21
F statistic (ANOVA)	0.44(0.854)	4.555(0.034)

Regression results in Table 4 indicated the goodness of fit for the regression between board size and ROE is 0.21. An R squared of 0.21 indicates that 21% of the variations in ROE are explained by the moderating effect of economic growth. The overall model of ROE was significant with an F statistic of 4.55.

The overall model is therefore:

ROE= 0.181+ 0.7 Economic Growth

4.4.3 Hypothesis Testing

To determine whether the moderating effect of economic growth had an impact on the performance of merged financial institutions, the hypothesis that there is no significant relationship between the moderating effect of economic growth and financial performance of merged institutions was tested.

Decision rule: reject hypothesis if calculated p value is less than the critical p value of 0.05 The study used the rule of the thumb that if either the model for ROA or ROE was significant, the null hypothesis was rejected.

Regression results in Table 4 indicate that the null hypothesis is rejected since the calculated p value (0.034) for ROE is less than the critical p value (0.05). Therefore, there is a significant relationship between the moderating effect of economic growth and financial performance of merged institutions.

5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

A test was conducted on the moderating effect of economic growth on financial performance. There is significant relationship between economic growth and financial performance where growth in real GDP leads to higher profitability. This is because during periods of declining GDP growth the demand for credit falls which in turn negatively affects the profitability of a bank. On the other hand a growing economy as expressed by a positive and increasing GDP would lead to an increase in the demand for credit hence leading to growth in profitability. Hence economic growth rate positively affects profitability

5.2 Recommendations

The study recommended the government and Central Bank of Kenya to come up with strategies and policies to protect the financial services sector due to its immense contribution to the economy of the country by formulating policies aimed at controlling the effects of rapid fluctuations of the macro economic factors and their effects on the sector.

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