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The Link between Financial Synergy and Financial Performance of Commercial Banks: A Case of Kenya

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Abstract

Despite the significance of commercial banks in Kenya, their financial performance has been fluctuating over the last decade. The overall trend of financial performance (measured by Return on Equity in year 2018 to year 2022) has been inconsistent and largely erratic, with the lowest ratio recorded being 14.1% in 2018: this improved slightly in year 2019 then rose to 14.9% before dropping to 13.9% in 2020. The highest Return on Equity (at 25.6%) was recorded in the year 2022. Although the banking sector has documented growth in Assets, financial performance (in terms of Profitability) has been declining in the recent past. Empirical evidence linking financial synergy and financial performance of commercial banks documents mixed results on the nature and type of relationships. However, it remains an issue for further empirical investigation as to whether financial synergy has a significant effect on the financial performance of commercial banks in Kenya. Hence, the study sought to assess the relationship between financial synergy and financial performance of commercial banks in Kenya. The theories underpinning the study are: synergistic mergers theory and tax incentive hypothesis theory. The target population comprised 13 commercial banks which had undergone mergers and acquisitions in Kenya over the 11-year time scope (2008-2019). Positivism research philosophy and explanatory research design were adopted. The study was a census of the 13 Commercial banks. Panel data was used-the data was obtained from the audited financial statements, and Central Bank of Kenya supervisory reports. The study finds a positive and significant link between financial synergies and financial performance ($P = 0.001$). In view of the findings, the study recommends that institutions critically evaluate the overall business and operational compatibility of the merging institutions and focus on capturing long-term financial synergies, as this has a positive effect on financial performance.

Keyword: *Financial Synergy, Financial Performance, Synergistic Mergers Theory, Tax Incentive Hypothesis Theory, Return on Equity and Leverage Ratio.*

1.0 Introduction and Background

Commercial banks play an indispensable role in industry productivity and economic growth; they provide a sound medium of exchange and facilitate trading; encourage the mobilization of resources through savings and allocate resources to activities with the highest returns; monitor investments and exert corporate governance; and spread risk by offering a diversity of commercial banks (Chen & Sivakumar, 2021). Furthermore, commercial banks in Kenya provide financial assistance to fulfill the varied needs of enterprises (Lukilah & Wekesa, 2021). Generally, the financial performance of commercial banks in Kenya indicates a decline, especially bearing in mind profitability indicators (Central Bank of Kenya, 2019).

Choi (2001) contends that mergers and acquisitions are corporate strategies usually done between two or more firms whereby the acquiring firm and the acquired firm stand on a merger agreement. The changes in the business environment brought about by changes in customer preferences, globalization, and advancements in information communication and technology have called for a re-strategizing of firms if they are to remain competitive. Merger and acquisition arrangements are strategies that corporations have adopted that have seen several licensed commercial banks merge or one institution take over another's operations (Central Bank of Kenya, 2019). Some of the reasons put forward for mergers and acquisitions are to meet increased levels of share capital, expand distribution networks and market share, and benefit from best global practices, among others (Kaol, 2017). The financial sector in Kenya has experienced an unprecedented level of consolidation, especially since the 1990s (Ndungu & Muturi, 2019). Between 2005 and 2015, eleven mergers and acquisitions were witnessed in Kenya (Mshabaa & Noor, 2017). Despite the fact that mergers and acquisitions remain the most unmistakable system for accomplishing development, their achievement in building long-term investor esteem remains challenged (Mshabaa & Noor, 2017).

In view of Knoll (2008), financial synergies are performance advantages gained by controlling financial resources across firms. There are four types of financial synergies, which are: (1) Reduction of corporate risk entails increasing the risk capacity of the overall firm, which means the ability of the firm to bear more risk. Meaning that by increasing the risk capacity, the shareholders will invest more in the company and the firm will gain benefits such as coinsurance effects; establishment of an internal capital market that entails establishing internal capital gains, meaning that the firm will decrease its financing costs and increase financial flexibility, which results in the company having higher liquidity and the ability to pay its creditors easily; Tax advantages that entail reducing the tax liabilities of the firm using the losses in one business to offset profits in the other business, referred to as "profit accounting ";Financial economies of scale that entail reducing transaction costs in issuing debt and equity securities (Knoll, 2008).

The financial performance gains arising from synergies includes economies of scale that are a result of an increase in the size of operations, an increase in specialized management, and the efficient use of capital equipment, which result in a lower cost per unit. Financial synergies are created by combining the capital structures of the merged companies, resulting in higher expected cash flows or lower discount rates (Baldi & Trigeorgis, 2009). They can encompass tax benefits or enhanced debt capacity and, as a result, decrease the combined cost of capital of the company. For example, Basmah and Rahatullah (2014) show that some Saudi Arabian firms engage in M&A deals chasing financial synergy. They look forward to decreasing their overall risk by diversifying their operations and lowering the cost of capital.

Financial performance is a measure of a company's ability to create a profit or the company's ability to manage and control its resources (Fatihudin, 2018). Financial performance is used as a general measure of a firm's overall financial health over a given period (Nuber et al., 2020). Commercial banks' financial performance is considered a very important and necessary mechanism for the survival of the financial sector in any economy in the world. The soundness of a banking system is the most crucial pillar for economic development (Chen et al., 2021). Hence, banks are the most involved commercial banks in the financing of the economy. Getis (2010) contends that in measuring financial performance, several ratios are available to be used, such as return on equity, return on assets, and net interest margin, among others. In this study, return on equity (ROE) was used as a measure of bank financial performance.

Literature on mergers and acquisitions and several other economic theories support the notion that shareholders experience positive abnormal returns as a result of the anticipated value creation post-merger (Halebian, Cynthia, McNamara, Carpenter, & Davidson, 2009; Cartwright & Cooper, 1993; Moeller, Schlingemann & Stulz, 2005). Thus, M&A is expected to create value as a result of firms exploiting economic resources that are both available and implementable, leading to synergy. The primary objective for any merger or takeover would be to create value for shareholders that will exceed the cost of the acquisition; as such, synergy appears to be a tangible justification for M&A or takeovers. Once the merger process has taken place, achieving synergies is not always realized since the two companies ultimately operate as one unit to realize such synergies. There ought to be economies of scale as the entities' resources are consolidated to function as one unit (Sudarsanam, 2003; Marks & Mirvis, 2010). Financial synergy refers to the financial benefits generated by M&A transactions; it is a net cash flow on benefits that are caused by tax laws, accounting standards, and other provisions of the securities exchange (Sudarsanam, 2003; Marks & Marvis, 2010).

1.1 Statement of the Problem

Commercial banks play a crucial role in the economy of Kenya since they provide financial services to individuals, businesses, and the government (World Bank, 2019). Kenya has kept its position as the leading M&A hotspot in East Africa. Analysis predict that the banking sector currently remains the most focus for mergers and acquisitions in year 2023 since there are too many banks (39) which makes it difficult for any single lender to take on financing of large-scale projects due to capital constraints. In the last ten years, about five commercial banks have been placed under receivership because the competition in this sector has intensified. Mergers in this sector have increased over time in comparison to acquisitions, although both have recorded increasing trends.

By the year 2019, CBK reports indicated that since the year 1989, the number of mergers among the commercial banks has been 34 and acquisitions have been 10. In the last 20 years alone, a total of 23 commercial banks that are still operational have undergone mergers and acquisitions, of which 13 are mergers and 10, are acquisitions (CBK, 2019). However, over the years, despite that, the commercial banks' financial performance measured by the ROE has been on the decline; the profit before tax of commercial banks stood at 20.1 percent as of 2012, which declined to 16 percent in 2013. Furthermore, the ROE for commercial banks in Kenya fluctuated over the period (2018–2022).

Empirical evidence has produced mixed results. Ogada *et al.* (2016) investigated the effect of financial synergy on the financial performance of 40 merged institutions (having concluded their merger processes by 31 December 2013) in the financial services sector in Kenya. The results revealed that there was a positive relationship between performance and financial synergy and that there was a significant improvement in performance post-merger. Marangu (2007) examined the effects of mergers and acquisition on the financial performance of non-listed commercial banks in Kenya over the period 1994 – 2001. The results showed that there was considerable improvement in the performance of the non-listed banks which merged, unlike the non-listed banks that did not merge within the same period. This validates the theoretical assertion that firms obtain more financial synergies by merging than by operating as individual entities. Ochieng (2006) studied bank consolidations and competition the issue of Kenya's many small banks. The results indicated a decline in earnings and lower ratios when Commercial Bank of Africa merged with First American Bank Kenya Limited. The effect of financial synergy on financial performance therefore remained unclear, hence a question for further empirical investigation. The study therefore sought to fill the contextual and knowledge gaps and determined the link between financial synergies and financial performance that lead to improved financial performance of merged institutions in the Kenyan banking sector.

1.2 Objective of the Study

The study sought to determine the link between financial synergies and financial performance of commercial banks in Kenya.

1.3 Research Hypothesis

Ho: Financial synergies do not have a significant link with financial performance of commercial banks in Kenya.

1.4 Scope of the Study

The purpose of the study was to examine the effect of financial synergy on financial performance of commercial banks in Kenya. This study was guided by synergistic Mergers Theory and the tax incentive theory. The study target population comprised all the 46 commercial banks that underwent mergers or acquisitions in Kenya between the year 2008 and 2019. The study purposively selected a total of thirteen (13) commercial banks that underwent mergers and acquisitions in Kenya over eleven years (from 2008 to the year 2019) in view of the Central Bank of Kenya (2020). The choice of the study period was sufficient to capture the trend of mergers that took place in the country and the financial performance in the banking sector since Kenya and the world at large witnessed a global economic crisis, post-election violence in Kenya which disrupted business models. During this period, the country witnessed an increase in mergers and acquisitions especially in the banking industry. The inclusion or exclusion criterion was based on three three-year pre and post-merger periods by only selecting M&A that specifically met this criterion in terms of providing complete 3-year data for pre and post-merger periods.

1.5 Value of the Study

The study outcome is bound to be of value to various stakeholders. These include the management of commercial banks and other financial institutions, policymakers like the Capital Market Authority (CMA) together with the CBK. Other stakeholders to benefit from the study include owners and shareholders of all commercial banks in Kenya and future scholars and academicians. Regulators (such as Capital Markets Authority and CBK) would rely on the study findings to develop the best policies and regulations for any two or more organizations engaged in mergers and acquisitions to emerge stronger with greater financial synergies for improved performance. The policymakers in the banking industry (The Central Bank of Kenya and the Kenya Bankers Association) benefit from this study by using the conclusions drawn to make good or better regulatory frameworks related to M&As. The study also adds knowledge to the understanding of the importance of financial synergies in analyzing performance by current investors, customers of commercial banks, and other banks in this competitive industry. Finally, future researchers and academicians benefit from the findings of this study, especially those who wish to conduct further research on the same line of study. This research equips researchers with more understanding of the extent to which financial synergies influence the financial performance of banks in Kenya. This study adds value to the finance theory.

2.0 Literature Review

2.1 Theoretical Review

This study was informed by synergistic mergers theory and tax incentive hypothesis theory.

2.1.1 Synergistic Mergers Theory

Synergistic Mergers Theory was proposed by Desai and Kim (1988). The theory presents an argument on the synergies arising as a result of a merger. Specifically, the theory presents a discussion of the financial synergy as a result of a merger and acquisition. The theory posits that a firm enhances its synergy through a merger. According to Weston et al. (2003), firms are able to perform better after an M & A regardless of the type of merger. In regard to financial synergy, the theory argues that the cost of raising funds externally reduces significantly. This improves their financial position and can enable them to adjust to their environment accordingly (Weston *et al.,* 2003). Companies that have a small window for growth, may call for M & A because internal growth may be slower and take longer. The theory is important in explaining the role of M & A as a provider of synergy in firms thus being able to improve their operation as well as the financial performance.

2.1.2 Tax incentive Hypothesis Theory

According to Trautwein (1990), the tax incentive theory of mergers and acquisitions, tax provision is an important incentive for mergers since it not only affects the conclusion to merge but also the way the merger is structured. He further explains that different ways of structuring a merger will have differing tax consequences that includes an opportunity to carry over by the acquirer the net operating losses and unused tax credits, an opportunity to step up assets or use their new sales prices as a basis for depreciation, an inducement provided by a lower income tax rate on capital gains than on dividends to retain earnings to acquire other firms and finally the opportunity for a bidding firm to deduct from taxable income the interest payments incurred on acquisitions related indebtness, this theory holds up and encourages the banks financial performance.

2.2 Empirical Review

The study reviews various empirical evidence on financial synergy and financial performance.

2.2.1 Financial Synergy and financial performance

Sevvam *et al.* (2009) investigated the effect of M&As on performance of selected corporate firms in India from 2000 to 2005. A total of 356 corporate firms were chosen as the population of the study. A sample of 112 corporate firms which had undergone mergers and acquisitions was selected from 2001 to 2005. The study compared the firm's corporate results before and after the union with the help of ratio analysis using the secondary data. They concluded that M&As improved Indian firm's liquidity and profitability. However, the study did not examine performance as ROE which was the main performance measures in the current study.

Qudaiby and Khan (2013) sought to establish the relationship between financial Synergy in Mergers and Acquisitions on financial performance in Saudi Arabia. The study adopted qualitative research design and found that Mergers motivated by economies of scale were being approached with caution; firms were also found to approach vertical mergers cautiously because it was often difficult to gain synergy through a vertical merger and firms were encouraged to seek out mergers which allow the firm to acquire specialized knowledge. However, the study used structured interviews to make conclusions on financial performance. Interviews may limit the scope of coverage and take time plan and process. The study was also done in Saudi Arabia with different economic and political environments to Kenya. Therefore, the result cannot be generalized in Kenya. The current study used quantitative secondary data sauced from published and audited accounts and contextualized the study to mergers activities of selected commercial banks in Kenya.

Sevva *et al.* (2009) assessed the effect of M&A's on the performance of selected corporate firms in India from 2000 to 2005. A total of 356 corporate firms were chosen as the population of the study. A sample of 112 corporate firms which had undergone mergers and acquisitions was selected from 2001 to 2005. The study compared the firm's corporate results before and after the union with the help of ratio analysis using the secondary data. They concluded that M&As improved Indian firm's liquidity and profitability. However, the study did not measure performance in terms of ROE which was the main performance measures in the current study.

Islam (2019) conducted a survey of mergers & acquisitions experiences by financial institutions in Kenya. The analysis of the financial institutions performance for pre and post-merger periods sort to establish whether there was significant improvement of financial performance on areas of profitability, investment and liquidity. The results of the data analyzed showed that Return on Asset and Return on Investment indicate an insignificant difference while Return on Equity and Debt Equity Ratio indicate significant difference between measures of performance before and after merger. Although the study was informative, it did not focus on the M&A synergies which were the main focus of the current study.

Marshall and Meckling (2010) assessed the changes price of shares after the acquisition announcement in the New York stock exchange in America in 2010. The share price of 200 companies was under observation but they used a sample of 102 companies. They concluded from their observation that share price of the companies posted an upward trend a few days prior to the acquisition announcement. The study however focused on share price whereas current study relied on financial performance of commercial banks in Kenya.

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Junge (2014) sampled 60 commercial banks form the population of 137 commercial banks in Nigeria to study the effect of M&As on the financial performance of commercial banks from 2002 to 2006. The study also utilized a regression model to establish the relationship between mergers and acquisitions on performance. He noted that there was significant increase in the monetary performance of the firms after the amalgamation. However, the study was carried out in Nigeria while this study is Kenyan based.

Kimetto (2019) sought to examine whether the mergers of Glaxosmith and Cline merger delivered the value for the shareholders of the company. He analyzed performance 2 years before and after the merger. The analysis of financial performance involved the determination of the return on investment. The linear regression model used in the analysis confirmed the positive relationship between mergers and shareholders return. He concluded that there was better productivity after the merger in GlaxoSmithKline. The pharmaceutical firm focus made this study's findings unreliable when analyzing banks in Kenya. Although the study was relevant, it did not focus on the M&A synergies which were the main focus of the current study. In addition, the study introduced mediating and moderating effects of liquidity risk and firm size respectively.

Lazaridis (2003) assessed the influence of mergers and acquisitions on organization performance of commercial banks in Kenya. The study adopted a descriptive research design. The 14 banks that had undergone M&As between 2006 and 2017 were considered as the research population. The study adopted purposive sampling of 4 high ranking bank personnel across each of the commercial banks. A census survey of 56 bank personnel was then utilized. The study utilized mixed data with semi-structured questionnaires being applied to collect primary data while financial statements of commercial banks, and regulatory reports provided secondary data. An 88% response rate was received from the population with findings indicating that 54.5% -R 2=.545 of the variations in bank performance are determined by the mergers and acquisitions. Although the study was informative, it did not focus on the M&A synergies which were the main focus of the current study.

2.3 Conceptual Framework

A conceptual framework is as a conjectural model that defines how the predictor variables relate with the depended variable through identification of the model under the study (Mugenda & Mugenda, 2019). Financial performance was the dependent variable and the independent variable was financial synergies.

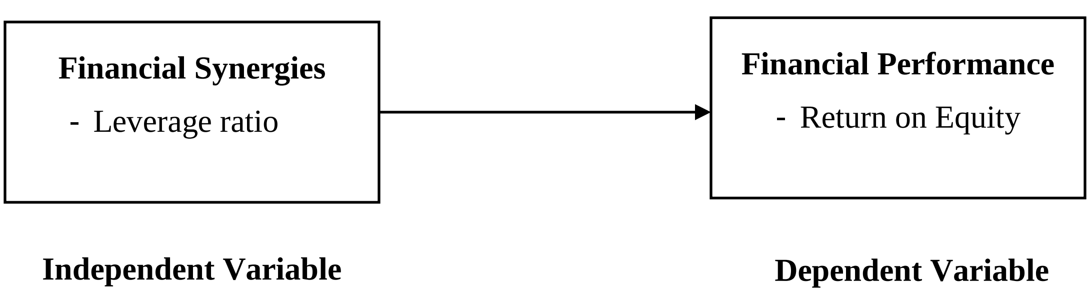

Figure 1: Conceptual Framework

Source: Author (2023)

3.0 Methodology

The study adopted positivist research philosophy. The philosophy is seen to be more objective and is based on scientific procedures for evaluating relationships in research. The philosophy has a well-defined structure that assures the study findings are objective and correct. When employing observable social reality, Creswell (2006) believes that positivist philosophy is used and that the results are not dependent of the researcher's viewpoints and generally generalizable.

The study adopted a causal research design. The justification of adopting causal research design is owed to the fact that the design clarifies a perceived problem at any given time appropriately (Vieira *et al.*, 2019). In support of Lazaridis (2003), the causal research design was best suited for this study since panel data was used and the study was bound to keep the relevant variables unchanged throughout the experiment by carefully choosing subjects according to a rigorous sampling process and statistical control of the findings (Blumberg *et al.*, 2014).

Empirical Model

A balanced panel regression analysis was used to analyze data to test the study hypothesis. Panel regression analysis entails the evaluation of the effect of one or more independent variables and a dependent variable whose measures are continuous (Brooks, 2008). Panel data was preferred to time series and cross-sectional as it allows accountability of unobservable heterogeneity in a panel set. It also yields a larger sample with more variability and efficiency as compared to time series. The empirical model was based on direct effect.

Direct Effect Model

The general empirical model to be used in this study was adopted from (Al-Khouri, 2012) as follows:

$$Y_{it}=\alpha+\beta X'_{it}+\varepsilon_{it} \quad \textbf{3.1}$$

Where

$\mathbf{Y_{it}}$ - denoted financial performance of firm i at time t

$\mathbf{X_{it}}$ - denoted a vector of independent variables (Financial synergies)

i = denoted the selected commercial banks (1; 2…………………………n)

$\boldsymbol{\beta}$ - Was coefficients to be estimated

$\boldsymbol{\alpha}$ –was the constant term and

$\boldsymbol{\varepsilon_{it}}$ was the error term.

Equation 3.1 was expanded further to yield equation 3.2 which was used for estimation.

$$FP_{it} = \alpha + \beta_1 FS_{1it} + \varepsilon_{it} \quad \textbf{3.2}$$

Where:

$\mathbf{FP_{it}}$ = Financial Performance (Return on Equity) of commercial banks i at time t.

α = Constant term.

$\mathbf{FS_{it}}$ = Financial synergy at time t.

$\mathbf{B_i}$ = Coefficients of the explanatory variables.

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εit = Error term.

The target population for this study comprised all 13 commercial banks operating in Kenya between the year 2008 and the year 2019. The study used judgmental sampling to select thirteen (13) commercial banks that had undergone mergers and acquisitions in Kenya over eleven years (from 2008 to the year 2019) in view of the Central Bank of Kenya (2020). The choice of this window period was sufficient to capture the trend of mergers and acquisitions that have taken place in the country and the financial performance of the selected commercial banks that witnessed M&As.

4.0 Results and Findings

This section presents descriptive statistics in the form of tables and figures; together with their respective interpretations and discussion. The second subsection presents inferential statistics comprising correlation analysis and panel regression analysis results.

4.1 Descriptive Statistics

This section presents data on descriptive statistics and subsequent interpretation. It describes the numerical information in the form of tables, and figures. Table 1 contains descriptive statistics for data used in the analysis.

Table 1: Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Min	Max
ROE	572	.1879131	.1116196	.107	0.236
Financial Synergy	561	338.05	.0434573	.229	.454

As indicated in Table 1, the mean value of return on equity for 572 observations was 0.1879131 with a standard deviation of 0.1116196 and minimum and maximum values of 0.107 and 0.236 respectively. The positive minimum and maximum values indicate that the commercial banks were profitable. Financial synergy had a mean of Ksh 338 billion with minimum and maximum values were 229 billion and 454 billion respectively. The positive observation implies improved financial activities to a level greater than when the banks were operating as separate entities.

4.2 Correlation Analysis

Pairwise correlation coefficient was utilized to examine the relationship between financial synergy and financial performance of commercial banks in Kenya.

Table 2: Financial synergy and financial performance

	Profitability
Financial synergy	0.4520
Sig	0.0013
N	572

Source: Research Data (2023)

The results indicated that there was a positive and significant relationship between financial synergy and financial performance. This implies that during the study period 2008 and 2019 an increase in financial synergy led to an increase in the financial performance.

4.3 Panel Regression Analysis

The study employed a panel regression model to analyze the financial synergies linked with the financial performance of commercial banks in Kenya. Creswell (2014) stated that panel data regression analysis is premised on the fact that it is suitable for both balanced and unbalanced data and can be used for such complex behavioral characteristics as financial performance. Panel data analysis is more advantageous than time-series or cross-sectional alone since it allows the researcher to account for unobservable heterogeneity (Cooper & Schindler 2014).

The study sought to test the following hypothesis:

Ho: Financial synergies do not have a significant link with financial performance of commercial banks in Kenya.

The results are presented in Table 3.

Table 3: Financial Synergy and Financial Performance-Random Effects Models

	Coefficient	Std. Err.	z	P>|z|	Model
Financial Synergy	.4066	.1621	2.51	0.012	Random Effect
Constant	.1743	.0528	3.30	0.001	
Statistics					
Wald chi2(1)	6.29				
Prob> chi2	0.0121				
R-Squared	0.5285				

From the findings in Table 3 the following model was presented.

$$FP = 0.1743 + 0.4066X_1$$

Where **FP** = Financial Performance

X_1 = Financial Synergies

The results in Table 2, R-squared were 0.5285 indicating that financial synergy explained 52.85 percent of variation in financial performance of commercial banks in Kenya. The p-value of 0.0121 indicated that the model was fit in predicting the dependent variable since the p-value was less than 0.05. Also the Wald chi2 value was greater than 0.05 indicating that the coefficient in the model was different than zero.

The results further specified that while holding other factors constant, a unit increase in financial synergy led to 0.4066 units increase in financial performance. The P-value was less than the level of significance of 0.05 indicating that financial synergies have a statistically significant link with financial performance. Hence, the study therefore reflects the null hypotheses and confirmed that financial synergy has a significant effect on the financial performance of commercial banks in Kenya. The finding is consistent with Ogada et al. (2016), Yazdanfar and Ohman (2015), Mwangi *et al*. (2014) and Marangu (2007) who established a positive relationship between financial synergies and financial performance. However, the finding contradicts Chardha and Sharma (2015), Adesina *et al*. (2015), and Abor (2005), whose studies documented a negative link between financial synergies and the financial performance of commercial banks using return on assets, return on equity, and gross profit margins as proxies for performance.

5.0 Conclusion

After analyzing the effect of financial synergies on the financial performance of commercial banks in Kenya, the findings indicated that financial synergies have a statistically significant effect on financial performance. Hence, the study concludes that variations in financial synergies significantly affected financial performance, and an increase in financial synergies led to an increase in the financial performance of commercial banks in Kenya.

6.0 Recommendation

Firms should undergo mergers and acquisitions to improve their financial activities to a level that is greater than when they were operating as separate entities. Usually, financial synergies result in a larger company, which has a higher bargaining power to get a lower cost of capital, which leads to increased benefits in terms of tax, profitability, and debt capacity. When firms attain financial synergies, they gain a wider customer base, which can result in lower competition. The expanded customer base can also result in increased revenue, market share, and cash flows. The study therefore recommends that firms critically evaluate the overall business and operational compatibility of the merging institutions and focus on capturing long-term financial synergies, as this has a positive effect on the overall financial performance.

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