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THE EFFECT OF MERGERS AND ACQUISITIONS ON THE FINANCIAL PERFORMANCE OF PETROLEUM FIRMS IN KENYA

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Abstract

Mergers and acquisitions are common features with quoted companies on the Nairobi Stock Exchange. These mergers and acquisitions are motivated by the desire to increase the value of the firms or increase their profitability. As major players in the economy of Kenya, petroleum firms have also been actively merging and acquiring each other. This study aims at establishing the effects that mergers have on the operational and financial performance of the various petroleum industry players in Kenya. There have been several of these acquisitions and mergers in the Kenyan petroleum sector. These include the acquisition of Chevron Kenya by Total oil, the takeover of Oilibya by Mobil oil, the buying of BP Kenya by Shell Kenya and the merger of Kobil and Kenya Oil to form KenolKobil. These mergers and acquisitions occur under different terms and conditions and as such affect the individual firms differently. This study employs three theoretical frameworks to explain the phenomena pertaining to mergers and acquisitions of Petroleum firms. These three frameworks are; the Theory Resource based firm theory, the transaction cost theory and the free cash flow theory. The research design employed in this study is descriptive research with the aim of understanding the intricate details that surround the financial acquisition of petroleum firms in Kenya and mergers. Primary data for the research was obtained from the financial statements of the affected firms while secondary data was collected chiefly from the Nairobi Securities Exchange, the Capital Markets Authority and the Companies own websites and publicity efforts. The analysis of data was done using the Statistical Package for Social Sciences and involved analyzing both inferential statistics and descriptive statistics. This analysis was split into two different periods, pre-merger/acquisition and post-merger/acquisition.

Keywords: *Acquisition, Merger, Financial Performance*

Introduction

Mergers and acquisitions have seen a positive growth trend on a global scale with various factors motivation firms to take over other firms or to join forces with other firms and entities. The growth in business confidence, the rise in consumer demand and improving economic conditions and investment environment all make mergers and acquisitions an attractive expansion option for Business executives. Mergers and acquisitions are adopted because they grow a company's competitive ability by expanding the market share. Mergers and Acquisitions also diversify the portfolios of the merging companies thus reducing risks. Mergers and acquisitions also help the companies to enter new markets, both demographically and geographically by assuming the identity of both the merging companies and by combining the respective customer bases (Kemal, 2011). Corporate mergers are justified by the benefits of synergy, the combining of forces and resources towards one common goal. Also, mergers effectively increase the shareholder value of the merging firms respective shareholders (Sharma, 2010). Increased market share and revenue, the benefits of synergy, taxation, wider reach and influence and economies of scale are some of the reasons that mergers and acquisitions are undertaken by companies.

In an effort to improve financial performance, corporations undertake different strategies and approaches. Financial performance is one of the vital indicators of the success of any organization as it is a reflection of the financial health of the entity and offers a useful tool for benchmarking performance as compared to other players in the market. Acquisitions and mergers are therefore undertaken because of the perceived benefits these have to financial and therefore organizational performance.

Mergers and Acquisitions

Mergers and acquisitions are changes in business structure which entail ownership change, business mix, assets mix, and alliance. These changes are affected with the view to improving for performance and optimizing shareholder value. The boom in mergers and acquisitions is one of the key elements of improved company performance. By definition, a merger is the process by which two or more firms are joined and in which only one entity continues to exist while the other(s) is submerged (Gaughan, 2002). When an entity acquires all or part of the target company's assets and the target survives as a legal entity after the transaction, this is known as an acquisition (Nakamura, 2005). More specifically, if a company only buys a specific amount of stock with a view to influencing the management of the target company, this is then known as a share acquisition.

Both mergers and acquisitions are important economically because they enable entities to combine resources leading to a relative competitive advantage. A merger is considered a win for all the merging entities as they both or all become a bigger version of themselves with wider access to resources and markets than the individual unmerged firms. The improved financial position for the different entities after a merger is a competitive advantage too for the merging entities. Mergers and acquisitions help companies who aim to reposition or reinvent themselves in the market, first by providing a new identity and secondly by making it easier to avail the resources needed for such a repositioning. Companies can, therefore, expand their market coverage rapidly and suitably modify their market position and identity.

Financial Performance

Financial performance measures the ability of an entity to use the assets available to its primary

business to realize revenues. In a merger or acquisition scenario, it is important to consider certain parameters that indicate the financial performance of firms. These parameters include profitability, liquidity, and solvency. Profitability indicates the firm's operating success over a given period. Solvency is a company's ability to satisfy its long term obligations when those obligations fall due. Liquidity refers to the capacity of the firm to meet its short term financial obligations. Put together, these three parameters show the company's financial performance in the past, and the expected or projected performance in the future. It is important to evaluate these three perspectives in evaluating impacts on financial performance.

Effects of Mergers and Acquisitions on Financial Performance

Mergers and acquisitions are intended to improve a company's competitiveness and to gain a competitive edge over other entities in the same field by acquiring a greater market share and more resource muscle to serve that expanded market. Firms also merge to expand portfolio with the aim of diversifying the risks they accrue as a business, entering new markets and geographies and to fully take advantage of economies of scale. Furthermore, significant overhead costs associated with the running of the companies are reduced or merged when the companies merge thus saving on costs. While mergers are often taken from a position of weakness and may signify a lack of corporate strength, mergers are not necessarily a sign of weakness but rather a search for synergy, sometimes combining strengths and not weaknesses. Mergers and acquisitions are an efficient way to expand ownership and get a competitive edge coupled with a larger market share. When the ownership structure of a business is changed the control structure of the firm is also affected. Changing the control structure of the business helps the company to refocus business strategy and to change previously erroneous decisions. This change in control has the maximum impact when it results in the redeployment of assets, the provision of new operational paradigms and a redesign of faulty business strategies. Mergers and acquisitions are perceived as an ideal way of improving corporate performance because of the advantages that accrue to the merging companies after the merger or acquisition. Mergers are motivated by improvements in revenue and profitability and faster growth in sales and a more convenient and wider reach to market and faster acquisition of the latest technology for improving business efficiency. Mergers also enable the merged companies to have a better access to competence and better talent. Mergers are therefore designed and projected to improve the financial performance of a company.

Research Problem

Mergers and acquisitions are a common feature among companies that are quoted on the Nairobi Securities Exchange. These mergers are intended to improve the value of the firm and its profitability. The petroleum sector, driven by these same motives, is not exempt from this trend and recent years have seen several significant mergers and acquisitions in the sector. It is critical to evaluate the impact of these mergers and acquisitions on the financial performance of these firms. Though empirical studies provide evidence of the positive impact of mergers on the individual companies (Selvam et al., 2009) (Kling, 2006), mergers and acquisitions can have adverse and detrimental effects on the firms as shown by other studies (Yook, 2004). While other studies in Kenya have concentrated on the effect of mergers and acquisitions on the financial sector, mostly banks and insurance companies, (Kithitu et al., 2012), there is insufficient research on the impact of

mergers and acquisitions in the petroleum industry. This study is aimed at investigating whether corporate mergers and acquisitions affect the fiscal objectives which the individual firms aspire to. This study is aimed at attempting to plug the academic gap by investigating how mergers and acquisitions affect the profitability, safety and liquidity of corporate firms in the petroleum industry in Kenya.

Research Objective

To evaluate the impact of mergers and acquisitions on the financial performance of Petroleum firms in Kenya.

Value of the Study

In theory, mergers and acquisitions are perceived as opportunities to explore new knowledge (Vermeulen and Barkema, 2001). Most existing research involves using or exploring knowledge in the mergers and acquisitions especially with regards to gaining new markets, expanding into new territory or gaining access to better technology and innovative capabilities by the use of explorative mergers. This study aims to focus on the impacts of these mergers on financial performance without special regard to the other benefits that accrue from merging.

This study contributes to organizational research by studying the impact of gaining access to knowledge without the relevant experience. In the context of this study, this means the effects of engaging in merging and acquisition deals for the companies that are willing to shoulder the risk and the subsequent impact on the fiscal performance of such companies.

Scope of the study

In Kenya, there are over 70 companies that are engaged in the petroleum and oil industries. The major firms in this sector in the country today include, Oilibya Kenya Limited, Shell Kenya, KenolKobil Kenya, Total Kenya, Haas Petroleum and the National Oil Corporation among others.

There have been several mergers in the petroleum sector involving some of these major players including KenolKobil, Shell BP, Oilibya and Total Kenya. These mergers have had an impact on the landscape of the industry in Kenya and provide sufficient material to study the effects of mergers and acquisitions on the financial performance.

Theoretical Review

Corporate mergers and acquisitions are useful tools crucial for survival in a cutthroat business world which rewards strength and preys on the weak. For companies to remain relevant, they have to seek to create strategic alliances and partnerships. These alliances and associations often take the form of mergers and acquisitions. Several theories seek to explain mergers and acquisitions and the nuances that make each possible. These theories mainly revolve around the free cash flow theory, the oligopolistic reaction theory and the return to scale theory. Each of the theories pertinent to the study and that form the theoretical framework for the study is discussed here below.

Free Cash Flow Theory

The conflict between shareholders and managers over the distribution of free cash gives rise to agency costs which are one of the major motivators for takeover activity. (Jensen, 1988). Though the shareholders own the firm, the managers act as agents, and they both have different interests and a different view as to the best corporate tactics for achieving the long term strategy.

Resource Based Firm Theory

Under this theory, the effectiveness of a firm is determined by the performance of the resources owned and employed by the firm. These resources

need to have certain characteristics to generate sustainable competitive advantage. According to Beena (2011), the resource based firm theory is the most important theory in this study as it seeks to explain why firms opt to engage in a merger or to orchestrate an acquisition.

Transaction Cost Theory

The transaction cost theory applies to vertical mergers and acquisitions aimed at the reduction of uncertainty and reduction in the cost of procuring the relevant factor of production. According to Coase (1937), firms evaluate the relative costs of alternatives for managing transactions. The transaction cost theory, therefore, informs why most mergers are done especially those done intending to harnessing economies of scale to reduce overhead costs.

Classification of Mergers & Acquisitions

Mergers and acquisitions can be classified into three categories which are portfolio mergers and acquisitions, financial mergers and organizational mergers (Bowman and Singh, 1999). Portfolio mergers and acquisitions involve substantial transformations in a firm's asset holdings and the main business in which it is engaged. This includes but is not limited to liquidation, divestiture sale of assets and spin offs. Financial mergers and acquisitions involve change the capital structure of a firm to reflect the new ownership structures. Organizational mergers entail changing the organizational structure of the firm and sometimes leads to the complete reorganization of the firm.

Horizontal Merger

When two firms in the same sector which are sharing the same products and markets merge, the ensuing merger is a horizontal merger. These types of mergers often happen in industries with fewer players and competitors as the competition tends to be stiffer in such sectors.

Vertical Merger

A vertical merger is the merger of two companies that are involved in producing different goods services which ultimately become one finished product. The merger is therefore between entities operating at different levels in the same industry.

Conglomerate

A conglomerate is a merger between firms engaged in unrelated businesses and which have no common business areas between them. There can either be pure or mixed conglomerates. Pure conglomerates merge companies that have nothing in common entirely. Mixed conglomerates involve firms that may have some things in common for example mergers of firms seeking product r market extensions.

Market-Extension Merger

Market extension mergers occur when two or more firms trading in similar products but in different markets merge. This ensures that the new merged entity has access to a bigger market and client base than any of the individual firms.

Product-Extension Merger

This type of merger allows companies that deal in products related to each other to merge and group their products together to facilitate access to a wider customer base.

Motivations for Mergers and Acquisitions

Kishore (2004), lists the objectives behind mergers and acquisitions especially in the twenty-first century where information technology makes it necessary for companies to institute a paradigm shift in communication and reporting technology to improve their corporate performance. The

following are some of the major motivations for mergers and acquisitions today.

Synergy

Synergy is the positive increment in coordinated energy that is associated with the joining of two entities through a merger or acquisition.

Financial Strength

Mergers and firms enhance liquidity have more reliable and unhampered access to cash resources after the merger.

Market Expansion and Strategy

Mergers and acquisitions neutralize competition amicably and protect the existing markets while acquiring more resources to pursue new markets.

Revamping of Production Facilities

Acquisitions and mergers enable companies to harness economies of scale by combining production facilities and through more intensive use of resources. Besides, mergers and

acquisitions undertake to standardize product specifications and to improve the quality of output.

Cost Reductions

A firm amalgamated through a merger or acquisition has the potential to operate more efficiently than two individual firms. Harnessing economies of scale further reduce operational costs as a benefit of mergers and acquisitions.

Acquiring New Technology

By acquiring smaller companies with novel technologies, larger firms can stay ahead of the technology curve and maintain competitiveness.

Determinants of Financial Performance

The chief determinant of financial performance in most firms is profit. However, profitability is a singular determinant and there are other parameters from which to gauge financial performance. The following are some of the measures by which a firm can determine its financial health.

Management Efficiency

The ability of the management to efficiently deploy resources to get optimum returns is what constitutes managerial efficiency. It is expressed in various ratios that compare input resources to the output realized.

Liquidity Management

Liquidity refers to the ability of the organization to sufficiently meet its obligations, especially to creditors.

External Factors/ Macroeconomic Factors

These are factors around a firm that the firm usually has little or no control of but which usually have an impact on the business of the firm. These include economic factors, politics, inflation and boom and recession cycles in economics.

Empirical Review

(Mantravadi and Reddy, 2008) investigated the effect of merging on the stability of the acquiring entities in various sectors, by examining some pre-post-merger fiscal performance, by sampling randomly picked firms that were involved in mergers involving public limited and quoted companies in India in the period from 1991 and 2003. There are minute variations in terms of effect on performance after mergers, in different Indian sectors. Mergers appear to have had a positive impact, albeit slight, on the profitability of firms in the financial sector. Other industries in the study manifested marginal negative impact in profitability and returns on investment such as the pharmaceuticals sector, the textile sector and the electrical equipment industry. These results imply that the impact of mergers on financial performance and stability is reliant on the industry under study.

Research Design

A descriptive research design was used in this research in attempting to establish how mergers and acquisitions affect the financial performance of petroleum firms in Kenya, by using the secondary data from financial statements to make a comparison and completely describe the phenomenon.

Population of the Study

The population of this study consisted all the petroleum firms in Kenya. Currently there are 70 registered petroleum companies in Kenya. However only a few participated in mergers and acquisitions in efforts to improve financial performance and maximize shareholder value. Some of the oil companies are included in the Nairobi securities exchange. This study mainly focused on firms that had engaged in mergers and acquisitions in this sector whether stated or not between the years 2007-2016. These included; takeover of Mobil Oil by Oil Libya Kenya, Total Kenya acquisition of Chevron Kenya, Kenya oil and Kobil Kenya merged to form KenolKobil and the acquisition of BP Kenya by Shell Kenya.

Data Collection

This study used secondary data on financial statements of the merged company before and after the merger. The intrinsic value was then compared before and after the merger. Secondary data was obtained from the Nairobi securities exchange and the Capital Markets authority annual reports as well as from the companies' official websites. Data from the company's books of account was included; current assets, current liabilities, net worth and total equity. Data from securities exchange was included net revenue of oil firms listed in the Nairobi Securities Exchange and had engaged in mergers and acquisitions.

Data analysis was put into pre-merger/acquisition period and post merger/acquisition period. This aided in comparison of financial performance before and after merger/acquisition. The study also apply a regression analysis to establish the relationship between the dependent and the independent variables. The regression model is as follows:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where:

Where;

X= 1, 2, 3, .k are the number of observations of the firms from the sample before and after mergers;

Y= represent observation of the dependent variable; i.e. Financial Performance in the study,

ε= error term of equation

Research Findings And Discussion

Descriptive statistics was applied to analyzed mean and the standard deviation of the variables while inferential statistics looked at the regression analysis, model summary and the analysis of variance. Correlation analysis was also conducted to assess the strength of the relationship between the dependent and each of the independent variable.

Correlation Analysis

A Pearson correlation analysis was conducted on the Expense ratio, underwriting profit (loss) ratio, return on assets ratio and liquidity ration indicators to establish the relationship among the different variables in the study, M&A's demonstrate a statistically significant relationship to ratio at the 95% confidence interval.

Table 1 Correlation Matrix

	Financial leverage	Liquidity	Size	ROE
Financial leverage	1			
Liquidity	0.244	1		
Size	0.213	-0.275	1	
ROE	0.750	0.609	0.412	1

A figure that is less than 0 indicates a negative association, that is, as the value of one variable increases the value of the other variable decreases. Table 1 above gives a summary of the correlation between the dependent variables and the explanatory variables. Financial leverage has a strong positive association with the ROA of the firm (R = 0.750). Liquidity management also shows strong positive relationship with ROA (R=0.609). While firm size affecting the firms show weak but positive relationship with ROA (R=0.412), of the firms that merged or acquired.

Regression Analysis

Table 2 Regression Results Table

Variables	Beta	Standard error	t-statistic	p-value
(Intercept)	1.467	0.043	3.416	0.000
Financial leverage	0.239	0.059	2.377	0.000
Liquidity	0.318	0.055	1.761	0.000
Firm size	0.347	0.056	0.232	0.000
Adjusted R-squared 0.472,		F-Statistic=> 157.968		p-value=>0.000

Determination coefficient (R2) was carried out to determine the proportion of the variation in dependent variable that is attributed to the changes in the explanatory variables. Established R2 of 0.472 implies that 47.7% of the variation in ROE of the firms that merged/acquired is due to the changes in explanatory variables (liquidity, financial leverage, capital adequacy, size (natural log of total assets). This also implies that 52.3% of the variances in financial performance cannot be explained by the independent variables and is actually attributed to variables not included in the model.

The regression above shows that when all other variables have a value of zero financial performance of the M&A oil company in Kenya is 1.467. This shows that mergers and acquisitions have a positive impact on the financial performance Unit increase of financial leverage, financial leverage and size of firm had a positive impact on financial performance by 0.239 and 0.347 respectively while unit increase of liquidity increases financial performance by 0.318 respectively. The critical values attained are not statistically significant at 5% hence M&A is not associated with increase in financial performance.

Summary

The objective of the study was to establish the effect of merger and acquisition on the financial performance of oil companies in Kenya. The research design adopted was descriptive research design. The study focused on the mergers and acquisitions that have occurred between year 2000 and 2014 within the industry. The study finding revealed that there was relationship between the variables. That is financial leverage, liquidity and firms' size affected financial performance of the firms by 47.7%.

Conclusion

From the findings of the study, the merger/ acquisition have a positive impact on the financial performance of the oil companies which is statistically significant at 5% level. The study therefore concludes that mergers and acquisitions

have a statistically significant relationship with ROA. The study further concludes that financial leverage, liquidity, and firm size impact on ROE and are statistically significant

Recommendation

Companies with plans on mergers/acquisitions, the study recommends that they prepare on terms of the labour forces required to retain the customers after the merger/acquisition process. Management should not only undertake mergers and acquisitions in order to improve operation and sustain failing businesses but also improve their competitiveness and financial standing. The company's management should come up with a sound strategy towards management of current asset that is liquidity and on equity management. The management of the merged companies should put into consideration the degree of transferability and marketability of assets invested in so that these assets can provide liquidity to the firm effectively.

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