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Influence of Product Diversification on Financial Performance of Commercial Banks Involved in Mergers and Acquisitions from the Year 2010 in Kenya

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Abstract:
Problem Statement: Interest rate capping has been seen as a threat to the improved profitability of the banks in Kenya and hence the need for banks to diversify their income sources. However, the ratio of gross non-performing loans to gross loans deteriorated from 12.7 percent in December 2018 to 12.5 percent in December 2019 and to 14.5 percent in December 2020.
Purpose: This study sought to establish the influence of product diversification, functional diversification and mergers on financial performance of Commercial banks involved in mergers and acquisitions from the year 2010 in Kenya.
Design/Research Method: The study utilized the descriptive research design and targeted eleven (11) commercial banks involved in mergers and acquisitions from the year 2010 in Kenya.
Finding: The correlation analysis results revealed that there was a positive and a strong significant association between product diversification and financial performance (r=0.657, p=0.000). The hypothesis test results show that product diversification statistically influences financial performance (β = 0.520, ρ = 0.000< 0.05).
Implication: Product diversification improves financial performance.
Recommendation: The study recommends that commercial banks involved in mergers and acquisitions since 2010 in Kenya make only minor adjustments to their existing operations as the current diversification measures have been successful.

Keywords: *Product diversification, financial performance, mergers and acquisitions*

1. Introduction

With the fast-changing business environment and increasing significance of long-term financial viability, an increasing number of firms today have diversified their business into new product segments or global markets to gain a competitive advantage over rival firms. The strategic importance and financial implications of corporate diversification have been widely studied in the strategic management literature. As a firm-level strategy, corporate diversification is expected to exert a universal influence on many aspects of operations (Qian, 2018).

Diversification is the entry of a corporation into new lines of action through a process of internal development or through acquiring, which entails changes in its system, administrative structure or other management procedures (Sissy, 2015). As a corporate strategy, diversification has been a vital growth tool for corporations. Furthermore, strategic management research acknowledges diversification effects on firm performance as one of the primary topics. Diversification seeks to increase profitability through higher sales volume obtained from new products and new markets. It involves venturing out into a new business, new products, or new markets to increase profits. It is a form of growth strategy involving a significant increase in the performance objectives beyond past performance records (Andreas, 2009) as cited by Alengo *et al*, (2019).

Product diversification refers to the expanding strategy into new product markets. From the Resource-Based View (RBV) point, product diversification provides a firm with an opportunity to deploy its core resources and competencies in new areas. Additionally, by expanding into new product segments, a firm may be able to develop new resources and capabilities, which can facilitate subsequent expansion. Other researchers propose that poor prospects in extant markets also stimulate a firm to exploit growth potential in a new market. The potential benefits from product diversification have been widely discussed in the strategic management literature. Prior research conjectures that product diversification strategy may improve firm performance by taking advantage of scale and economies of scope, risk reduction, increased market power, learning effects and reduced transaction costs (Qian, 2018).

The banking industry all around the world acts as the life of economic growth and is a main source of financing to the economy. Commercial banks provide advice to both individuals and corporate and financial services (Tsuma & Gichinga, 2016). According to Central Bank of Kenya (2020), the sector's asset base, which was 10.1 percent in 2019, grew by 12.4 percent in 2020 and attributed in the large part to growth in investment in government securities and loans and advances. The sector's capital adequacy ratio which was registered 18.8 percent in 2019, stood at 19.0 percent in 2020. However, the sector recorded a 29.5 percent decline in profitability attributed mainly to a higher increase in expenses. While the overall average decline for the banks involved in mergers and acquisitions was similar to the all bank average at 29.07 percent, peer bank analysis showed a disproportionate change in decline. CBK continues to encourage consolidation in the banking sector through M & A in order to create bigger and more resilient institutions that can weather shocks, fund large infrastructure projects and charge affordable rates of interest (Mōri & Tomotsune, 2021).

2. Literature Review and Hypotheses Development

2.1. Product Diversification

According to Wanjiru (2016), product diversification, as a strategy, is used by organizations to move them into new products or into new markets. Besides, product diversity referred to the degree of relatedness among various product segments. Product diversification is a growth strategy that firms apply to extend their market dominance by opening new frontiers in business. Product diversification strategies can differ in nature, depending on market and resource factors. Dasi, Iborra, and Safon (2015) discussed how a strategy is dependent on an exploration or exploitative orientation, both of which consume resources in differing amounts. Explorative orientation is the process of businesses looking for new avenues for growth or revenue. Exploitative orientation is the process of businesses focusing on what they are already good at (such as a niche market). Though product diversification is a broad, strategic term, there are different forms in which it can manifest, namely - related and unrelated diversification.

Pratyaksa, Sayoc, Koga, and Siy (2015) found that firms diversify into other industries due to limited or declining opportunities in their current industry. This implies that amidst the complications that unrelated product diversification can bring, it has value if implemented thoughtfully and purposefully. Su and Tsang (2015) described related diversification as diversifying within an industry, while unrelated diversification involved cross-industry diversification. Related diversification strategies are generally regarded as easier and less risky to implement.

2.2. Financial Performance

The organizational performance comprises the actual output or results of an organization as measured against its intended outputs. Organizations are constantly trying to adapt, survive, perform, and influence. However, they are not always successful. To better understand what they can or should change to improve their ability to perform, organizations conduct organizational assessments. This diagnostic tool can help organizations obtain useful data on their performance, identify important factors that aid or impede their achievement of results and situate themselves with respect to competitors. Organizational performance encompasses three specific areas of firm outcomes: financial performance for instant profits, return on assets, return on investment; product market performance for instant sales, market share, and shareholder return that may include total shareholder return, economic value added. Specialists in many fields are concerned with organizational performance including strategic planners, operations, finance, legal, and organizational development (Kagendo, 2015).

In recent years, many organizations have attempted to manage organizational performance using the balanced scorecard methodology where performance is tracked and measured in multiple dimensions such as financial performance like shareholder return, customer service, social responsibility for instance corporate citizenship, community outreach, employee stewardship. There is little dispute that one of the core purposes of both entrepreneurship and strategic management theory and research is the improvement of organizational performance. Many consultants maintain that various initiatives and programs improve the performance of organizations (Abishua, 2010).

2.3. Relation between Product Diversification and Financial Performance

Mwatsuma, Ali, and Ibua (2020) examined the effect of Merger on the financial performance of listed commercial banks at Nairobi Security Exchange Kenya focusing on 13 merged commercial banks from year 2010 to 2017. The study found that there was improvement in financial performance after commercial banks merger. The study also found that there was general increase in the financial performance of the listed commercial banks after merger and also improvement on the Liquidity management policies, Asset Quality and merger capital adequacy.

Njuguna (2019) conducted a study on the effect of diversification approaches on the quality of non-financial firms listed on the Nairobi Stock Exchange in Kenya. The development of the descriptive correlation survey showed that the goods diversification, geographical diversification, vertical integration, horizontal integration, and quality of listed non-financial firms in Kenya are significantly beneficial. Regression analysis found that combined use of diversification techniques contributed to 56.3 percent of improvements in the company's performance. In this report, diversification approaches are found to be important techniques for businesses to use to increase their level of profit.

3. Research Methods

3.1. Research Design

This study utilized the descriptive research design.

3.2 Target Population

This study targeted eleven (11) commercial banks in Kenya that have been involved in mergers and acquisitions since the year 2010.

3.3. Census Technique

The study used census technique due to the size of the population. According to Okuom (2013), a census is an investigation of each unit in a population. The major focus for this study was 11 corporate officers and 77 middle level managers (director governance, director strategy and branding, director Strategic execution and innovation, director culture and human resource, director strategic partnership, director finance and director marketing) giving a total of 88 Respondents which were drawn from the targeted 11 commercial banks.

3.4. Validity and Reliability

To ascertain content and face validity of the questionnaires, they were presented to Jomo Kenyatta University of Agriculture and technology assigned supervisor who has the authorities in the area for scrutiny and advice. The contents of the instruments were improved based on the advice and comments of the supervisors. The Cronbach Alpha Test was conducted on all the independent and dependent variables which gave a threshold which was greater than 0.7. The Cronbach alpha coefficients of product diversification and organizational performance were 0.716 and 0.778 respectively. According to Devellis (2017), reliability is the extent to which the measurement is random error-free and produces the same results on repeated trials.

4. Results and Discussions

4.1. Descriptive Statistics

Product Diversification	N	Min	Max	Mean	Std. Dev.	CV (%)
Related diversification only requires us to make only minor adjustments to our existing operations	68	2	5	3.37	.913	27.09
We always consider secondary stakeholders and build relationships to navigate challenges in unrelated diversification such as different regulatory laws, industry specific challenges, and geographic concerns	68	2	5	3.44	.870	25.29
Through backward integration we have a tendency to diversify into banking –related business to take advantage of the lack of resources during periods of low demand	68	2	5	4.03	.937	23.25
Our geographic and sector diversification allow for a significant reduction in the risk exposure	68	1	5	3.56	1.056	29.66
We ensure that there is control of supply or linked activities in order to reduce delays in the supply chain	68	1	5	3.22	.895	27.80
Using book values of debt instead of market values of debt for calculating excess value undervalues our firm	68	2	5	3.24	1.067	32.93
Valid N (list wise)	68					

Table 1: Descriptive Statistics

The findings of the study established that the participants strongly agreed that related diversification only requires them to make only minor adjustments to their existing operations, with a mean of 3.37 and standard deviation of 0.913 and coefficient of variation (CV) of 27.09. Dasi, Iborra and Safon (2015) discussed how a strategy is dependent on an exploration or exploitative orientation, both of which consume resources in differing amounts. Explorative orientation is the process of businesses looking for new avenues for growth or revenue. Exploitative orientation is the process of businesses focusing on what they are already good at (such as a niche market). Also in agreement is Kistruck *et al*. (2013) who found that related product diversification led to increased efficiency while unrelated product diversification led to decreased inefficiency.

The findings established that the Commercial banks involved in mergers and acquisitions from the year 2010 in Kenya always consider secondary stakeholders and build relationships to navigate challenges in unrelated diversification such as different regulatory laws, industry specific challenges, and geographic concerns, with a mean of 3.44, a standard deviation of 0.870 and CV of 25.29. Pratyaksa, Sayoc, Koga and Siy (2015) found that firms diversify into other industries due to limited or declining opportunities in their current industry. This implies that amidst the complications that unrelated product diversification can bring, it has value if implemented thoughtfully and purposefully.

It was also established that through backward integration we have a tendency to diversify into banking–related business to take advantage of the lack of resources during periods of low demand with a mean of 4.03, a standard deviation of 0.937 and CV of 23.75. Adamu *et al*, (2011) sought to evaluate the impact of product diversification on financial performance. The findings indicated that most of the construction firms that were studied diversified into construction-related businesses, such as construction plant hire, property development, and sales of construction-related materials. This tendency to diversify into construction-related business could be attributed to the desire of some firms to take advantage of the lack of resources during periods of low demand and the desire to achieve economies of scale and scope.

It was also established that the geographic and sector diversification allow for a significant reduction in the risk exposure with a mean of 3.56 within a standard deviation of 1.056 and CV of 29.60. Giannotti, *et al* (2011) sought to establish the role of portfolio diversification in the hotel industry. Specifically, the study sought to find out whether geographic and sector diversification allows for a significant reduction in the risk exposure of a portfolio of hotel investments in one of the major tourist markets, the Italian market. The results demonstrate that while standard geographic and sector diversification allows for good results, the more efficient portfolios are more concentrated. The trade-off is worse if some concentration constraints are established, but the portfolios identified are characterized by higher performance persistence.

Further the respondents concurred with a mean of 3.22 within standard deviation of 0.895 and CV of 27.80 that the commercial banks involved in mergers and acquisitions since 2010 in Kenya ensure that there is control of supply or linked activities in order to reduce delays in the supply chain. In Europe, Oh, *et al*, (2014) sought to establish the effect of regional and product diversification and the performance of the study stated that despite the importance of geographic expansion in the services sector, a few studies have analyzed the relationships between regional diversification, product diversification, and performance for services firms. Here, we focus on experiential learning benefits and managerial complexity to investigate whether and how firms in the retail sector may benefit by expanding their activities within and across regional boundaries.

It was also established that the commercial banks involved in mergers and acquisitions since 2010 in Kenya using book values of debt instead of market values of debt for calculating excess value undervalue the commercial banks involved in mergers and acquisitions since 2010 in Kenya with a mean of 3.24 within a standard deviation of 1.067 and CV of 32.93. This concurred with Mansi and Reeb (2002) as cited by Raei, *et al*, (2015). They argue in their empirical paper that diversification discount arises due to the risk-reducing tendencies of the conglomerates. They further argue that diversification reduces shareholder value on the one hand but increases the bondholder value due to the reduction in risk. As a result, it may be expected that more diversification discount exists in firms with debt as compared to all equity firms.

4.2. Correlation between Product Diversification and Financial Performance

		Product Diversification	Financial Performance
Product Diversification	Pearson Correlation	1	.657**
	Sig. (2-tailed)		.000
	N	68	68
**. Correlation is significant at the 0.01 level (2-tailed).			

Table 2: Correlation between Product Diversification and Financial Performance

The correlation analysis revealed that there was a positive and a strong significant association between product diversification and organizational performance as supported by (r=0.657, p=0.000). This implied that both product diversification and financial performance change in the same direction. According to Kistruck *et al*. (2013) research diversification strategies in charitable organizations found that related product diversification led to increased efficiency while unrelated product diversification led to a decrease in efficiency. Coad & Guenther (2013) posited that firms more often diversify into related business activities rather than unrelated ventures. Unrelated diversification may be a more complicated strategy in some cases.

4.3. Regression

4.3.1. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.657[a]	.432	.424	.30773
a. Predictor: (Constant), Product Diversification				
b. Dependent Variable: Financial Performance				

Table 3: Model Summary

The model summary shows a multiple linear correlation coefficient R of 0.657 which indicated that the independent variables (product diversification) had a positive correlation with the dependent variable. The coefficient of determination (R Square) of 0.432 indicated that the independent variable constituted 43.2% of the variance in the dependent variable.

4.3.2. ANOVA[a]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	4.759	1	4.759	50.253	.000[b]
	Residual	6.250	66	.095		
	Total	11.009	67			
a. Dependent Variable: Financial Performance						
b. Predictors: (Constant), Product Diversification						

Table 4: ANOVA[a]

The observed p value was 0.000 which was less that α = 0.05 (5%); it, therefore, implied that the regression model was good fit for data.

4.4. Model Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.880	.250		7.521	.000
	Product Diversification	.520	.073	.657	7.089	.000
a. Dependent Variable: Financial Performance						

Table 5: Model Coefficients

The model generated from the study is: Financial Performance = 1.880 + 0.520 Product Diversification. The regression coefficient of 0.520 for the product diversification implied that a unit increase in product diversification with the other variables left constant would lead to a 0.520 increase in financial performance of Commercial banks involved in mergers and acquisitions from the year 2010 in Kenya. Both the constant and the coefficient are significant given the p values are 0.000.

5. Conclusions and Recommendation

5.1. Conclusion

Commercial banks should increase their efficiency through product diversification. The respondents further concurred that the Commercial banks involved in mergers and acquisitions from the year 2010 in Kenya always consider secondary stakeholders and build relationships to navigate challenges in unrelated diversification such as different regulatory laws, industry specific challenges, and geographic concerns. This implies that amidst the complications that unrelated product diversification can bring, it has value if implemented thoughtfully and purposefully as shown by the correlation and regression analysis which portrayed a positive correlation between product diversification and organizational performance. Besides the hypotheses test supported the same as the results indicated that there exists a statistically significant correlation between product diversification and organizational performance.

5.2. Recommendation

The study recommends that the commercial banks involved in mergers and acquisitions since 2010 in Kenya should increase their efficiency through product diversification while unrelated product diversification. They should also consider secondary stakeholders and build relationships to navigate challenges in unrelated diversification such as different regulatory laws, industry specific challenges, and geographic concerns.

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