

Ownership Structure and Firm Performance of Listed Companies in Kenya's Nairobi Securities Exchange

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Abstract

The purpose of this research was to find out the relationship between ownership structure and firm performance on firms listed in the Nairobi Securities Exchange for the period year 2007 to 2010. The research examined six variables which are ownership concentration, government ownership, foreign ownership, institutional ownership, individual ownership, managerial ownership and the control variables leverage and firm size. The research used both agency and stakeholder theory as the main theoretical framework to describe ownership structure. The study used descriptive research design and quantitative data was tabulated along a continuum in numerical form. Secondary data was collected from the financial statements of the companies quoted in the Nairobi Securities Exchange. Ownership structure was operationalized in terms of ownership concentration (percentage of shares owned by the top five shareholders) and ownership identity (actual identity of shareholders). Measures of performance were return on assets and return on Equity. Thirty three companies were studied using secondary data. Tolerance factor were used to test multicollinearity. The key findings were that in the Kenyan context ownership concentration had negative relationship with firm performance while managerial ownership, individual ownership had positive relationship with firm performance. The control variable firm size had significant positive relationship with firm performance. The findings of the study have shed light on the continuous relationship between managerial ownership and firm performance. Due to low rate of tolerance the study found that there was no significant relationship between institutional ownership, foreign ownership, government ownership and the control variable leverage.

Keywords: *Ownership Structure, Firm Performance, Ownership Concentration, Individual Ownership, Firm Size*

Introduction

The relationship of ownership structure and firm performance is an important area of study in the broader field of Corporate Governance from last two decades. Researchers have focused mainly on managers and major shareholders interests on firm ownership. These researchers explored the relationship of ownership structure and firm performance keeping in view the conflict of interests of managers and owners of the firm. Research revealed that firm's market value is based not on its investment projects only but other factors such as financial structure, dividend policy and its governance and ownership structure also add value to the firms.

A great deal of attention has been given to understanding how corporate governance and ownership structures affect firm performance. Corporate governance can influence a firm's performance whenever a conflict of interest arises between management and shareholders and/or between controlling and minority shareholders. In the controlling-minority shareholder conflict, controlling shareholders use their power to benefit themselves at the expense of the minority shareholders, in what is called expropriation or private benefits of control. The root of both conflicts is the fact that the managers in the first case, and the controlling shareholders in the second case, receive only a portion of the firm's net revenue, while they fully appropriate the resources diverted. Thus, it is conceivable that, in light of this incentive structure, insiders will maximize their utility even when the firms as a whole will not (Bebczuk, 2005).

A lot of attention has focused on the relationship between ownership structure and corporation performance for instance a rich research agenda on the implications of ownership structure on corporate governance by (La Porta *et al.*, 2001) affirm that when the legal structure does not offer sufficient protection for outside investors and entrepreneurs; original owners are forced to maintain large positions in their companies which result in a concentrated form of ownership thus having implications on ownership structure. On the other hand, bulk of the evidence according to (Shirley & Walsh, 2001) indicates that privately held firms are more efficient and more profitable than publicly held ones although the evidence differs on the relative merit of the identity of each private owner.

Most of the research has focused on firms from the leading developed countries and evidence on this relationship is scanty in developing countries. These latter countries have a significant potential and

therefore it would be interesting to analyze the relationship of ownership structure and firm performance in developing countries. Therefore, this study seeks to address whether there is any relationship between ownership structure and firm performance in Kenya.

This research study is a moderate attempt to address whether there is relationship between ownership structure of the firm and its performance in Kenya.

Research Objectives

General Objective

To analyze the relationship between ownership structure and firm performance of firms listed in Nairobi Securities Exchange.

Specific Objective

More specifically the research addressed the following objectives:

1. To evaluate the association between ownership concentration and firm performance
2. To assess the relationship between foreign ownership and firm performance
3. To examine the link between institutional ownership and firm performance
4. To evaluate the relationship between managerial ownership and firm performance
5. To establish the association between government ownership and firm performance
6. To establish the relationship between individual ownership and firm performance

Theoretical Background and Informing Literature

There is no well-established tradition of selecting specific measures for the analysis of ownership structure performance relationship. In each case, the choice of these measures depends on availability of information and their appropriateness for specific research questions. For example, studies focusing on the impact of ownership concentration tend to employ the Herfindahl index or the equity stake of several largest investors, typically the top five shareholders (Demsetz & Lehn, 2001).

An agency relationship is a contract under which one or more persons (the principal) (s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. The problem is that the interest of the managers and shareholders is not always the same and in this case, the manager who is responsible for running the firm tends to achieve his personal goals rather than maximizing returns to the shareholder. This means that the manager will use the excess free cash flow available to fulfill his personal interests instead of increasing returns of shareholder.

Stakeholder theory posits a model of the enterprise in which "all persons or groups with legitimate interests participating in an enterprise do so to obtain benefits, and there is no prima facie priority of one set of interests and benefits over another" (Hill and Jones, 2005). The model rejects the idea that the enterprise exists to serve the interest of its owners being that maximizing their wealth or some other reason for being in business. Rather, the model is based on the idea that the enterprise exists to serve the many stakeholders who have an interest in it or who in some way may be harmed or benefitted by it.

Demsetz and Lehn (2001) uses stakeholder theory to develop an instrumental approach to managerial especially strategic and practice. The researcher however make a persuasive case that Stakeholder Theory is essentially normative: Stakeholder Theory cannot be supported on descriptive and instrumental grounds alone. It goes beyond the simple (and obvious idea) that organizations have stakeholders to the more fundamental question of what interests should drive the enterprise, and in whose interests the enterprise should operate.

Foreign ownership refers to the percentage of reserved stock by foreigners of the whole stocks of the company which consist of the foreign partners, foreign financial entities, and foreign nationalities. The effect of foreign ownership on firm performance has been an issue of interest to academics and policy makers. According to Gorg and Greenaway (2004), the main challenging question in the international business strategy is the outcome gained from foreign ownership of firms. It is mainly accepted that foreign ownership plays a crucial role in firm performance, particularly in developing and transitional economies. Researchers have concluded that, on average, multi-national enterprises have performed better than the domestically owned firms.

Institutional ownership refers to the percentage of reserved stock by governmental and public companies of the whole stock of the company. These companies include insurance companies, financial entities, banks, governmental companies and other parts of the government. Public companies, on the other hand, can support further indebtedness, if it promises to improve the financial position of the firm and shareholder value in the long-run.

Managerial ownership refers to the Percentage of reserved stock by family members of the board of directors. A similar trade off is implied for corporate owners such as multi-national parent companies that

may want to sacrifice local profit maximization for global interest of the organization. Among the different ownership forms, managerial ownership seems to be the most controversial as it has ambivalent effects on firm performance. On one hand, it is considered as a tool for alignment of managerial interests with those of shareholders, while on the other hand, it promotes entrenchment of managers, which is especially costly when they do not act in the interest of shareholders (Mork *et al.*, 1998).

Regarding government ownership, there is much more unanimity in the academic circles. State ownership has been regarded as inefficient and bureaucratic. A specific characteristic of these firms is that individual citizens have no direct claim on their residual income and are not able to transfer their ownership rights. Ownership rights are exercised by some level in the bureaucracy, which does not have clear incentives to improve firm performance. In their analysis of political control of state-owned firms' decision making processes (Boycko *et al.*, 1996) argue that transferring control rights from politicians to managers (that is, increasing managerial discretion) can help improve firm performance largely because managers are more concerned with firm performance than are politicians.

In the recent era various individual investors are investing in the stock exchange market. Other researchers, especially those who investigate developing economies with low availability of data, use equity stake of the largest shareholder. Accounting measures provide a historical record on the past and present situation of a firm, that is to say returns from resources employed by firm when carrying out activity.

An important and most recent study on the role of ownership structure in defining firm performance is conducted by (Aydin *et al.*, 2007), in Iranian Stock Market. They examined the role of ownership structure i.e. institutional ownership concentration, institutional ownership and ownership concentration. They have found a mix of results. At one side institutional ownership concentration showed a negative effect on firm performance and on the other side institutional ownership shown a significant negative impact on firm performance. Moreover, ownership concentration did not show any impact on the firm performance.

Control Variables

Firm Size

The size of the firm is included to account for the potential economies of scale and scope accruing to large firms since it is expected to produce a positive relationship between firm size and performance. This argument has its roots in the industrial organization literature and more recently in the empirical studies.

While a positive relationship is observed in some countries, it is not always the case and there is evidence of a negative relationship (La Porta *et al.*, 2005). It is believed that the conflicting results on the effect of firm size are the consequence of different sample features, model employed, period covered and whether it is a developed or developing country and to less extent the variables used as firm size estimators. Size can be estimated by total assets, sales and number of shareholders. According to Tandelilin *et al.* (2007), the book value of total assets may be considered to be a more robust measure of company size as it is less affected by external conditions.

Leverage

It is included in the regression models for two reasons. First there is a large body of literature that indicates that a firms leverage influence both investment decisions and firms performance. Second leverage can be a constraining force on the discretion of the managers. Since focus of this paper is on the relationship between ownership structure and firm's performance, the potential constraining influence on the leverage needs to be controlled for.

Leverage was measured using the following formula:

$$\text{Leverage} = \frac{\text{short term debt} + \text{Long term Debt}}{\text{Total Shareholders' Equity}}$$

Most of the above studies have focused on firms from leading developed countries. Evidence of this relationship is lacking in developing countries. These latter countries have a significant potential of profitability growth and therefore it would be interesting to analyze the relationship between ownership structure and firm performance. This research attempts to deepen understanding of the relationship between ownership structure and firm performance in Kenya.

Various researches have tackled variables on government ownership, foreign ownership, institutional ownership, ownership concentration and managerial ownership. However evidence focusing on Individual ownership is limited. This research fills the gap that exists and examine on the relationship between individual ownership and firm performance.

Materials and Methods

Descriptive survey design was adopted in conducting this study. This involved collection of information by looking at the financial statements of all the firms quoted in the Nairobi Securities Exchange. The study targeted all the firms listed in Nairobi Securities Exchange. These listed firms were sixty (60) in number. The researcher used purposive sampling design to narrow down to 33 companies which had data for the four consecutive years. The data was obtained from the Capital Market Authority's library and covered duration of four years, 2007-2010. This meant that the organization had to have traded in NSE actively and continuously.

Quantitative data collected was analyzed by the use of descriptive statistics using SPSS (Statistical Package for Social Sciences) to do a regression analysis and presented through percentages, means, and standard deviation. Ownership concentration was measured by the percentage of shares outstanding held by the five largest shareholders from year 2007-2010. Ownership identity was the real owners of the firm.

The general form of the model used was:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \varepsilon_{it}$$

Where,

Y is the firm performances which was measured by either return on assets and return on Equity for firm i at time t.

α is the constant term

β is a vector of regression slope

X_1 is ownership concentration (OWNCONC)

X_2 is foreign ownership (FORENOWN)

X_3 is institutional ownership (INSTOWN)

X_4 is managerial ownership (MANOWN)

X_5 is government ownership (GOVOWN)

X_6 is individual ownership (INDVOWN)

X_7 is leverage (LEV)

X_8 is firm size (FRSI)

ε_{it} is the disturbance term.

The disturbance term (ε_{it}) represented the effect of the dependent variable (firm performance) on all variables other than the once included in the study. The disturbance term was included to allow for the basic random unpredictability of human behaviour. The model was first estimated on a year to year basis and then estimated by pooling all data for all years.

Results and Discussion

Table 1. Descriptive statistics of the independent and dependent variables

	M ea n	Std. Deviation	Ownc nc	Foren own	Inso wn	Manown	Govo wn	Indvo wn	Lever age	Fir m size
ROE	.12	.200	-.026	.213	.002	.014	-.005	-.028	-.107	.415
OWNCONC	2.70	8.510		.224	.027	-.040	-.098	-.055	.390	.148
FORENOWN	.06	.065			.224	.027	-.040	-.098	-.055	.390
INSTOWN	.24	.247				-.145	-.334	.312	-.208	-.591
MANOWN	.31	1.329					-.090	-.051	-.096	-.005
GOVOWN	.08	.193						-.093	-.064	.283
INDOWN	.08	.335							-.197	-.136
LEV	2.50	2.245								.347
FRSI	9.75	.729								-

Table 2. Model summary

Model	R	R Square	Adjusted Square	R Std. Error of the Estimate
1	.658 ^a	.433	.244	.174
Predictors: (Constant), FRSI, MANOWN, INDOWN, OWNCONC, GOVOWN, FORENOWN, LEV, INSTOWN				

The model was fairly good as 43.3 % of the dependent variable firm performance were explained by the independent variables managerial ownership, individual ownership, ownership concentration, government ownership, foreign ownership and the control variables leverage and firm size. There was high degree of correlation of 65.8%. The adjusted R square indicated that 24.4% of the variance in firm performance can be predicted by the independent variables managerial ownership, individual ownership, ownership concentration, government ownership, foreign ownership and the control variables leverage and firm size.

Table 3. Coefficients after the test of multicollinearity

Model	Unstandardized Coefficients		Standardized Coefficients Beta	T	Sig.	Collinearity Statistics	
	B	Std. Error				Tolerance	VIF
(Constant)	-1.031	.468		-2.202	.036		
OWNCONC	-.002	.004	-.088	-.506	.617	.975	1.026
MANOWN	.002	.026	.014	.084	.933	.996	1.004
INDOWN	.016	.103	.027	.157	.877	.977	1.023
FRSI	.119	.048	.432	2.478	.020	.962	1.040

Dependent Variable: ROE

Ownership concentration was negatively correlated to firm performance. An increase in firm performance by 0.2% led to decline in firm performance by 0.2%. The finding of this study therefore, appeared to disagree with the position held by proponents of ownership concentration (Kuznetsov & Murvyev, 2001) who argue that ownership concentration affords the shareholders the motivation and ability to monitor and control management decisions. This posits ensures that managers make decisions that support the wealth creation motivation of the shareholders.

Managerial ownership was highly correlated to firm performance. Its level of significance was above 5%. An increase in managerial ownership by 0.2% led to increase in firm performance by 0.2%. Managerial ownership may be seen as the system of aligning interests of managers with those of the shareholders in a way that enhances corporate performance. This form of ownership can lead to entrenchment of managers which is costly when they choose to pursue their self interests (Ongore, 2011). The findings of this study agreed to a significant extent with the argument that managerial ownership enhances corporate performance.

Individual ownership had a positive correlation with firm performance. An increase in individual ownership resulted to increase in firm performance by 1.6%. Its level of significance was above 5%. Individual ownership might have had a positive relationship as most individuals are investing in Securities Exchange and are very keen on how the organizations are performing so that they earnings can increase.

The control variable firm size was significant at 2%. It was highly correlated to firm performance. An increase in firm size led to increase in firm performance by 11.9%. The results had a practical significance as the size of the firm increases its performance increases as it will be able to hire quality personnel to run the organization.

Due to low level of tolerance the variables institutional ownership, government ownership, foreign ownership and control variable leverage were eliminated. The variable firm size was the variable with the highest positive relationship on firm performance of 11.9%. This was followed by individual ownership with a percentage of 1.6%. The third was managerial ownership with 0.2% and ownership concentration of negative 0.2%. This indicates that firm size has high positive relationship on firm performance.

The variable managerial ownership before the test of multicollinearity had a high level of tolerance of 0.905. After the test of multicollinearity the tolerance level improved to 0.996. Managerial ownership ($\beta = 0.014$, $p > 0.05$) indicated that there was a high positive relationship between managerial ownership and firm performance.

The variable government ownership before the test of multicollinearity had ($\beta = 0.037$, $p > 0.05$). This indicated that there was a positive relationship between government ownership and firm performance. It had a high rate of tolerance of 0.622. In the test of multicollinearity the variable government ownership was eliminated. This led to the objective and hypothesis not being significant in the study.

Before the test of multicollinearity individual ownership ($\beta -0.109$, $p < 0.05$) indicated that there was a negative relationship between individual ownership and firm performance. After the test of multicollinearity its tolerance level improved from 0.871 to 0.977. The coefficients ($\beta = 0.157$, $p > 0.877$) indicated that there was a positive relationship between individual ownership and firm performance.

The control variable leverage had a negative relationship with firm performance before the test of multicollinearity. After the test of multicollinearity, the variable was eliminated as it had high level of tolerance. The control variable firm size after the test of multicollinearity revealed the coefficients ($\beta = 0.432$, $p > 0.02$). This indicated that there was a positive relationship between firm size and firm performance.

Conclusion

The findings of the study have shed light on the continuous relationship between managerial ownership and firm performance. It has been argued that when managers own shares in their company they become more committed to the organization since they have a stake in the residual income of the firm.

In Kenya more than 30% or more of the shares are concentrated on a few hands (that is five shareholders or less). There is a tendency for the shareholders to be less strict in their monitoring, controlling and ratification roles over the manager. This stifles manager's creativity and innovation and ultimately affects firm performance adversely. There is dire need to reasonably diversify shareholding as a way of attracting more skills and competences among the shareholders that can be tapped to improve firm performance.

There was no relationship between government ownership and firm performance. The government should infuse private sector like management systems and progress the divestiture program to attract more private individuals and institutions to co-own the state corporations. The performance contracting policy that was recently introduced by the Kenya government should be developed further and supported as a way of promoting performance based management in the public sector.

Due to low rate of tolerance the study found that there was no significant relationship between institutional ownership, foreign ownership, government ownership and the control variable leverage. There was a positive relationship between firm size and performance.

Recommendations

Recommendation for Policy and Practice

Policy makers should design a corporate governance framework that secures the benefits of large shareholders whereas preventing them from excessive private benefits. Nairobi Securities Exchange and Capital Market Authority should encourage high standards of disclosure and transparency among the market players to help ensure that the investment environment encourages all types of investors (large and small) feel comfortable to participate in the securities market. Disclosure requirements should be mandatory and enforcement should be strict. The government should encourage individuals to invest in their country their excess savings to enable the firms to invest them in order to boost their performance.

Recommendations for Further Research

Future research should be conducted in Kenya by keeping in view the capital structure, dividend policy along with the ownership structure. This will ensure more effective forecasting of firm performance in Nairobi Securities Exchange. Other researchers should try to analyze firms quoted in NSE for a longer period of time like 10 years and analyze the percentage of shares of the top 10 shareholders. This will help to analyze whether there is any effect on firm performance.

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