

**THE EFFECT OF OWNERSHIP STRUCTURE ON THE FINANCIAL PERFORMANCE OF  
FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE**

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**ABSTRACT**

*In Kenya, a number of problems relating to the way companies are controlled and directed have been identified. These problems range from errors, mistakes to outright fraud. The origins of these problems range from concentrated ownership, weak incentives, and poor protection of minority shareholders to weak information standards. Despite impressive performance at the Nairobi Securities Exchange, firm's at the Nairobi Securities Exchange are still characterized by higher ownership concentration providing the controlling shareholders with the opportunity to use their power to undertake activities intended to obtain personal gains to the detriment of minority shareholders and other stakeholders while adversely affecting the firms' performance. The study aimed at establishing the effect of ownership structure on the financial performance of firms listed at Nairobi securities exchange. The study was based on transaction cost theory, agency theory and the stewardship theory. The research design that was used in this study is both cross sectional and descriptive survey method. The target population consists of all the stocks listed at NSE as at 31st December 2014. Currently there are 63 firms who are members of the Nairobi Securities Exchange. Secondary data was used in this study. Specifically the study used financial statements. All the data was collected by review of documents, annual reports of the companies, the Nairobi Securities Exchange Handbooks and published books of accounts. Content analysis was used to determine the score for ownership structure. Regression analysis was used to test the relationship between ownership structure and financial performance of firms listed in the NSE. The study found that a strong positive correlation coefficient between financial performances of companies listed in NSE and Ownership structure, (correlation factor of 0.512, significant value 0.022) the research also revealed that Ownership structure influence the decision making segment of the firm, the degree of ownership concentration in a firm determines how power is distributed between its shareholders and managers. Study found strong positive correlation between financial performance of companies listed in NSE and Ownership concentration (correlation factor of 0.601, significant value 0.014), the research also established that ownership concentration is one of the main corporate governance mechanisms influencing the scope of a firm's agency cost. The study further found strong positive correlation between financial performance of companies listed in NSE and size of the firm as shown by correlation (coefficient factor 0.757, P- value 0.003) the research also established that The size of the company can have a positive effect on financial performance because larger firms can use this advantage to get some financial benefits in business relations. The research recommends that the management of the firms listed in NSE should therefore strike a balance between their choice of capital structure and ownership concentration as they were found to effect on its performance as it affect the shareholders risks, returns and the cost of capital.*

**<sup>1</sup>Key words: ownership structure, financial performance, firms and effect**

## 1.0 Introduction

It is generally accepted that there are distinct ownership structure differences between countries. Weimer and Pape (2009) have ranked countries in different systems (Anglo-Saxon, Germanic, Latin and Japan). The basic differences are in orientation, ownership concentration and time horizon of economic relationships (Shleifer & Vishny, 2007). Ali et al. (2007) reported that family firms of the SP 500 firms, own on average the 11% of their firms, while in Continental Europe the ownership percentage is more than 35%. Franks et al. (2008) report that in UK ownership concentration is 18%, while in Germany the percentage is 43% and in Italy 68%. Faccio and Lang (2002) pointed that shareholder structures are quite diverse across countries, with dispersed ownership being much more frequent in US and UK listed firms, compared to Continental Europe, where controlled ownership is prevalent. Faccio and Lang (2002) report in a study of 5232 publicly traded corporations in 13 Western European countries that only 36.93 % were widely held firms. In addition, cross-country studies of La Porta et al. (2009) point out that ownership of large companies in rich economies is typically concentrated; that control is often exercised through pyramidal groups with a holding company at the top controlling one or more subsidiaries; and that the controlling shareholders are often actively involved in company management and sit on the board of directors.

Although Kenya does not generally set minimums for Kenyan ownership of private firms or require companies to reduce the percentage of foreign ownership over time, a number of sectors do face restrictions. According to the World Bank's (2010) Investing across Borders Report, Kenya restricts foreign ownership in more sectors than most other economies in sub-Saharan Africa. Foreign brokerage companies and fund management firms must be locally registered and have Kenyan ownership of at least 30% and 51%, respectively. Foreign ownership of equity in insurance and telecommunications companies is restricted to 66.7% and 80% respectively, although the government allows telecommunications companies a three-year grace period to find local investors to achieve the local ownership requirements. There is discussion of scrapping the local ownership policy in telecommunications entirely. Foreign equity in companies engaged in fishing activities is restricted to 49% of the voting shares under the Fisheries Act. At least one area has seen increased restrictions on foreign ownership: as noted above, a law passed in June 2007 decreased the level of foreign ownership allowed for companies seeking a listing on the NSE from 75 to 60%. This change was not applied retroactively. Foreign investors are free to obtain financing locally or offshore. As noted above, there is no discrimination against foreign investors in access to government-financed research, and the government's export promotion programs do not distinguish between local and foreign-owned goods.

## Research Problem

Global events concerning high-profile corporate failures have put back on the policy agenda and intensified debate on the efficacy of corporate governance mechanisms as a means of increasing firm performance (Sanda et al., 2005). Since the beginning of the 21st century, serious financial scandals and many cases of corporate mismanagement brought about an increasing attention to corporate governance, in a close relation with business ethics issues. In Kenya, a number of problems relating to the way companies are controlled and directed have been identified. These problems range from errors, mistakes to outright fraud. The origins of these problems range from concentrated ownership, weak incentives, and poor protection of minority shareholders to weak information standards (Ongore &Obonyo, 2011). Despite impressive performance at the Nairobi Securities Exchange, firm's at the Nairobi Securities Exchange are still characterized by higher ownership concentration providing the controlling shareholders with the opportunity to use their power to undertake activities intended to obtain personal gains to the detriment of minority shareholders and other stakeholders while adversely affecting the firms' performance. Mbaabu (2010) who investigated the relationship between ownership, corporate governance structures and financial performance of forty one insurance companies in Kenya from 2005 to 2009, the study revealed a negative ROA when ownership was considered. The study intends to address the research gap; that is the effect of ownership structure on financial performance of firms listed in Nairobi securities exchange. What are the effects of ownership structure on financial performance of a firm?

## Value of the Study

This study will be valuable to both the existing and potential investors in these listed firms to make informed decisions by enlightening them with knowledge of how ownership structure of an institution can influence performance of their investment. The study will be so beneficial to institution managers of these firms to establish the right capital mix and adjusting it accordingly to optimize the firm returns and enhance growth and increase the competitive advantage. Findings of this study are expected to be of great importance to various researchers involved in policy making. The documented report of this study will be easily acquired in the library and it will equip the learners with more knowledge and skills on effect of ownership structure on the financial performance of firms listed at Nairobi securities exchange. The study will further make a myriad contribution to the literature on effect of ownership structure on financial performance which will be part of articles that will be useful to researchers who want to further in this study and to other wider stakeholders in academic circles.

## 2.0 Literature Review

The study was based on transaction cost theory, agency theory and the stewardship theory. The transaction cost theory is based on the work of Coase (1937) where he explains the existence of firms as an organization that is able to undertake the certain transactions at a lower cost comparing to the market until it expands to the point where 'the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organizing in another firm. According to Grossman and Hart (1986), asset specificity and ex post bargaining problems will drive the preference for integration of parties, to reduce opportunity costs. While in the process of integration, the allocation of ownership is accompanied by costs and benefits. The optimal ownership structure is thus to minimize the overall loss in surplus due to investment distortions [instead of maximizing] the total ex ante net benefits. In another word, the optimal ownership structure is in place when transaction costs are minimized in the long run.

According to the agency theory of the firm espoused by Jensen and Mekling (1976), the modern corporation is subject to agency conflicts arising from the separation of the decision-making and risk-bearing functions of the firm. In this setting, Jensen and Mekling (1976) show that managers have a tendency to engage in excessive perquisite consumption and other opportunistic behavior since they receive the full benefit of such activity but bear less than their full share of the costs. Diffuse ownership (individual owners) also makes it difficult for owners to effectively coordinate their actions. Higher levels of monitoring could encourage managers to avoid strategies decisions that harm shareholder value. In fact, research evidence shows that ownership concentration is associated with lower levels of firm product diversification. Thus, with high degree of ownership concentration, the probability is greater that managers' strategic decisions will be intended to maximize shareholder value. Much of this concentration has come from increasing equity ownership by institutional investors.

Stewardship theorists, suggest that directors frequently have interests that are consistent with those of shareholders. Donaldson and Davis (1991) suggest an alternative model of man where organizational role-holders are conceived as being motivated by a need to achieve and gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby to gain recognition from peers and bosses (Donaldson & Davis, 1991). The stewardship perspective suggests that the attainment of organizational success also satisfies the personal needs of the steward. The steward identifies greater utility accruing from satisfying organizational goals than through self-serving behaviour. Stewardship theory recognizes the importance of structures that empower the steward, offering maximum autonomy built upon trust. This minimizes the cost of mechanisms aimed at monitoring and controlling behaviours (Davis, et al. 1997). Daily et al. (2003) contend that in order

to protect their reputations as expert decision makers, executives and directors are inclined to operate the firm in a manner that maximizes financial performance indicators, including shareholder returns, on the basis that the firm's performance directly impacts perceptions of their individual performance. According to Fama (1980), in being effective stewards of their organization, executives and directors are also effectively managing their own careers. Similarly, managers return finance to investors to establish a good reputation, allowing them to re-enter the market for future finance (Shleifer & Vishny, 1997).

### **Determinants of Financial Performance of Listed Firms**

There are several determinants of financial performance of listed firms. This study focuses on seven of these determinants which are; leverage, liquidity, company size, companies' age, capital structure, risk management and market position.

#### **Leverage**

Leverage refers to the proportion of debt to equity in the capital structure of a firm. The financing or leverage decision is a significant managerial decision because it influences the shareholder's return and risk and the market value of the firm. The ratio of debt-equity has implications for the shareholders' dividends and risk, this affect the cost of capital and the market value of the firm (Pandey, 2007). Gupta et al (2010) cited some studies showing contradictory results about the relationship between increased uses of debt in capital structure and financial performance. Ghosh, Nag and Sirmans (2000), Berger and Bonaccorsi di Patti (2006) reported a positive relationship between leverage and financial performance, while Gleason et al (2000), Simerly and Li (2000) showed negative relationship between financial performance and leverage level. Similarly, Zeitun and Tian (2007) found that debt level is negatively related with financial performance.

#### **Liquidity**

The International Financial Reporting Standards (2006) define liquidity as the available cash for the near future, after taking into account the financial obligations corresponding to that period. Liargovas and Skandalis, (2008) argues that firm can use liquid assets to finance its activities and investments when external finance are not available. On the other hand, higher liquidity can allow a firm to deal with unexpected contingencies and to cope with its obligations during periods of low earnings.

#### **Company Size**

Previous studies in finance have shown that company size can predict the future stock price (Simerly & Li, 2000). For instance, Hvide and These (2007) in their study

concluded that larger firms have better performance. Flamini et.al (2009) suggested that bigger firms are more competitive than smaller firms in harnessing economies of scale in transactions and enjoy a higher level of profits. Athanasoglou et al., (2005) assert that increase in company size increases the performance of the bank. Almajali et al (2012) argued that the size of the firm can affect its financial performance.

### **Companies' Age**

Examining the relation between firm age and financial performance would seem to be relevant for both theory and practice. If performance declines as firms grow older, it could explain why most of them are eventually taken over (Loderer et al., 2009). Age could actually help firms become more efficient. However, old age may also make knowledge, abilities, and skills obsolete and induce organizational decay (Agarwal & Gort, 2002). Sorensen and Stuart (2000) argued that companies age affect the firm's performance. They further argued that organizational inertia operating in old firms tend to make them inflexible and unable to appreciate changes in the environment. Liargovas and Skandalis (2008) reported that older firms are more skilled since they have enjoyed the benefits of learning and not prone to the liabilities of newness, hence they have a superior performance. Loderer et al, (2009) found a positive and significant relationship between the age of a company and profitability.

### **Capital Structure**

Every industry requires a substantial amount of resources, whether it is land, labor or capital employment of all required finances. These finances can either be generated internally (retained earnings) or hired from outside sources (loans and bonds). The decision of selection of the source of finance is based on the cost associated with them and the capital structure of firm. Capital structure is also an important factor that determines the performance of a firm. Capital structure refers to the ratio of debt and equity financing. In case if more debt financing the company has to face certain bankruptcy risk, but there are also some tax and monitoring benefits associated with debt financing (Su & Vo, 2010).

### **Risk Management**

Risk management of a firm may also impact its performance. Risky firms tend to attract only risk taking investors. The relationship of risk and returns has to be managed so that the investors do get the return associated and expected with the risk they are bearing. Organizations have come to recognize the importance of managing all risks and their interactions, not just the familiar risks, or the ones that are easy to quantify. Even seemingly insignificant risks on their own have the potential, as they interact with other events and conditions, to cause great damage. According to Saunders and Cornett (2006)

suggested that modern institutions are in the risk management business as they undertake the functions of bearing and managing risks on behalf of their customers through the pooling of risks and the sale of their services as risk specialists.

### **Market Position**

A company's financial performance is directly influenced by its market position. Profitability can be decomposed into its main components: net turnover and net profit margin. Ross et al. (1996) argues that both can influence the profitability of a company one time. If a high turnover means better use of assets owned by the company and therefore better efficiency, a higher profit margin means that the entity has substantial market power.

### **3.0 Research Methodology**

The research design that was used in this study is both cross sectional and descriptive survey method. Cross sectional survey is a study that aims to describe the relationship between one factor and other factors of interest as they exist in a specified population at a particular time, without regard for what may have preceded or precipitated at the time of the study (Abramson & Abramson, 2000).

The target population consists of all the stocks listed at NSE as at 31st December 2014. Currently there are 63 firms who are members of the Nairobi Securities Exchange (NSE website); therefore the target population for the study is 63 firms. This is an appropriate population and therefore gave a clear picture of the situation in the market with all participants included. This was a census study where all firms listed at Nairobi Securities Exchange were included. This helped to achieve comprehensive coverage.

Secondary data was used in this study. Specifically the study used financial statements. All the data was collected by review of documents, annual reports of the companies, the Nairobi Securities Exchange Handbooks and published books of accounts.

Collected data was validated, coded and checked for any errors and omissions. Later the data was run through the statistical Package for Social Science (SPSS) Version 21. Content analysis was used to determine the score for ownership structure based on the number of sentences dedicated to each component of ownership structure in the listed firm's annual report. The financial performance was measured using return on assets. Regression analysis was used to test the relationship between ownership structure and financial performance of firms listed in the NSE.

The study used the following model;

$$FP = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + u$$

Where; FP = the measure of the financial performance of the listed firm. This will be measured by ROA of the firm. ROA = [Net Income / Average Total Assets]

$\alpha$  = A constant term which is the intercept of the regression equation

$\beta$  = Coefficient of the variables where  $\beta_1$ -  $\beta_4$  represents the sensitivity of a firm performance to changes in the movements of the various variables

$X_1$  = Ownership structure measured by shareholding percentage of (Foreign Ownership, Domestic Ownership and Government Ownership) of the firm

$X_2$  = Ownership concentration of the firm measured by shareholding above 30%

$X_3$  = the size of the firm, measured as the natural log of total assets

$X_4$  = the length of existence in years of the firm (age)

$u$  = Error Term

#### 4.0 Study Findings

This part presents analysis and findings of the research. The objective of this study was to establish the effect of ownership structure on the financial performance of firms listed at Nairobi securities exchange.

**Table 4.1: Correlations**

		Financial Performance	Ownership Structure	Ownership Concentration	Age The Firm	Size Of The Firm
Financial performance	Correlation Coefficient	1.000	.512	.601	.231	.757
	Sig. (1-tailed)	.	.425	.541	.225	.968
	N	63	63	63	63	63
Ownership Structure	Correlation Coefficient	.512	1.000	.033	.435	.001
	Sig. (1-tailed)	.022	.	.000	.003	.002
	N	63	63	63	63	63
Ownership Concentration	Correlation Coefficient	.601	.122	1.000	.026	.008
	Sig. (1-tailed)	.014	.001	.	.000	.000
	N	63	63	63	63	63
Age The Firm	Correlation Coefficient	.231	.037	.026	1.000	.124
	Sig. (1-tailed)	.012	.000	.001	.	.002
	N	63	63	63	63	63
Size Of The Firm	Correlation Coefficient	.757	.001	.008	.114	1.000
	Sig. (1-tailed)	.003	.001	.003	.000	.
	N	63	63	63	63	63

On the correlation of the study variable, the researcher conducted a Pearson moment correlation. From the finding in the table above, the study found that there was strong positive correlation coefficient between financial performance of companies listed in NSE and Ownership structure, as shown by correlation factor of 0.512, this strong relationship was found to be statistically significant as the significant value was 0.022 which is less than 0.05, the study found strong positive correlation between financial performance of companies listed in NSE and Ownership concentration as shown by correlation coefficient of 0.601, the significant value was 0.014 which is less 5% study found weak positive correlation between financial performance of companies listed in

NSE and the age of the firm as shown by correlation coefficient of 0.231, this weak relationship was found to be statistically significant as the significant value was 0.012 which is less than 0.05 and finally the study found strong positive correlation between financial performance of companies listed in NSE and the size of the firm as shown by correlation coefficient of 0.757, this strong relationship was found to be statistically significant as the significant value was 0.003 which is less than 0.05.

The findings concur with Flamini et.al (2009), who found out that strong positive correlation between the size of the firm and financial performance of companies listed in NSE, it further concurs with Radice (1971), who established a strong positive correlation between ownership structure and financial performance of companies listed in NSE.

### Regression analysis

#### Model Summary

The study used coefficient of determination to evaluate the model fit. The model summary are presented in the table below

**Table 4.2: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.876 <sup>a</sup>	.767	.734	.37290

The adjusted R<sup>2</sup>, also called the coefficient of multiple determinations, is the percent of the variance in the dependent explained uniquely or jointly by the independent variables. The model had an average coefficient of determination (R<sup>2</sup>) of 0.734 and which implied that 73.4% of the variations in financial performance of companies listed in NSE are caused by the independent variables understudy (Ownership structure, Ownership concentration, size of the firm and Age).

**Table 4.3: ANOVA**

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	14.841	3	4.947	4.291	.012 <sup>b</sup>
1 Residual	68.027	59	1.153		
Total	82.868	62			

Critical value = 2.75

From the ANOVA statics, the study established the regression model had a significance level of 1.2% which is an indication that the data was ideal for making a conclusion on

the population parameters as the value of significance (p-value) was less than 5%. The calculated value was greater than the critical value ( $4.291 > 2.75$ ) an indication that holding ownership structure, ownership concentration and size of the firm, all have a significant effects on financial performance of companies listed in NSE. The significance value was less than 0.05 indicating that the model was significant.

### Coefficients

The following tables gives the coefficients which helps in establishing the regression line

**Table 4.4: Table of Coefficients**

Model	Unstandardized Coefficients		Standardized Coefficients Beta	t	Sig.
	B	Std. Error			
1 (Constant)	1.739	.432		4.025	.000
Ownership structure	.761	.132	.231	5.765	.004
Ownership concentration	.398	.098	.243	4.061	.021
Age of the firm	.159	.032	.232	4.969	.009
Size of the firm	.459	.112	.232	4.098	.016

The established regression equation becomes

$$Y = 1.739 + 0.761X_1 + 0.398X_2 + 0.159X_3 + 0.459X_4$$

From the regression model below, it is can be deduced that, holding ownership structure, Ownership concentration and size of the firm, the financial performance of companies listed in NSE would be 1.739. it's was also established that a unit increase in ownership structure while holding other factors at constant would cause an increase in financial performance of companies listed in NSE by a factor of 0.761, a unit increase in ownership concentration, while holding other factors at constant would cause an increase in financial performance of companies listed in NSE by a factor of 0.398, unit increase in age of the firm would cause increase in financial performance of companies listed in NSE a factor of 0.159, while a unit increase in size of the firm would cause increase in financial performance of companies listed in NSE a factor of 0.459.

This Clearly shows that there is a positive relationship between financial performance of companies listed in NSE and ownership structure, ownership concentration and size of the firm. The analysis was undertaken at 5% significance level. The criteria for comparing whether the predictor variables were significant in the model was through comparing the obtained probability value and  $\alpha=0.05$ . If the probability value was less

than  $\alpha$ , then the predictor variable was significant otherwise it wasn't. All the predictor variables were significant in the model as their probability values were less than  $\alpha=0.05$ .

### **Interpretation of the Findings**

The study found that a strong positive correlation coefficient between financial performances of companies listed in NSE and Ownership structure, (correlation factor of 0.512, significant value 0.022) the research also revealed that Ownership structure influence the decision making segment of the firm, the degree of ownership concentration in a firm determines how power is distributed between its shareholders and managers. Further the research revealed that better overlap between ownership and control should indeed lead to a reduction in conflicts of interest therefore higher firm value, management owning a company can serve to better put in line managers' interests with those of the shareholders of the company, if managers and shareholders' interests are not completely aligned, higher stake in the company can give managers greater freedom to pursue their own goals without fear of reprisal.

Study found strong positive correlation between financial performance of companies listed in NSE and Ownership concentration (correlation factor of 0.601, significant value 0.014), the research also established that ownership concentration is one of the main corporate governance mechanisms influencing the scope of a firm's agency cost. Jensen and Meckling (1976) suggested that ownership concentration has a positive effect on performance because it alleviates the conflict of interest between owners and managers further it was established that the ownership concentration of the firm is an endogenous outcome of the competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium organization of the firm, concentrated ownership provides better monitoring incentives, and lead to superior performance.

The study found strong positive correlation between financial performance of companies listed in NSE and size of the firm as shown by correlation (coefficient factor 0.757, P-value 0.003) the research also established that The size of the company can have a positive effect on financial performance because larger firms can use this advantage to get some financial benefits in business relations. a large firm can get a better interest rate and also a better discount rate due to a large quantity that it buys, absolute firm size plays an important role in explaining profitability, Large companies have easier access to the most important factors of production, including human resources. Also, large organizations often get cheaper funding, The findings confirms with the findings Majumdar (1997), who investigated the impact that firm size has on profitability and productivity of a firm and found evidence that larger firms are less productive but more profitable.

The research also revealed that Profitability of firms significantly supports return on assets and market capitalization but not the return on equity, the size of the firm affects its financial performance in many ways. Large firms can exploit economies of scale and scope and thus being more efficient compared to small firms. In addition, small firms may have less power than large firms; hence they may find it difficult to compete with the large firms particularly in highly competitive markets. On the other hand, as firms become larger, they might suffer from inefficiencies, leading to inferior financial performance. Theory, therefore, is equivocal on the precise relationship between size and performance (Majumdar, 1997).

## **5.0 Conclusions and Recommendations**

The study noted that ownership structure is one of the most important factors in shaping the corporate governance system of any country and that When ownership is dispersed, shareholding control tends to be weak because of poor shareholder monitoring therefore the study concludes that strong Ownership structure had a positive impact of financial performances of companies listed in NSE. The study concludes that Ownership concentration had a positive impact of financial performances of companies listed in NSE. The study further concludes that increase in firm size had a positive impact of financial performances of companies listed in NSE. older firms are better experienced in choosing and employing information, experience and organizational competencies provided by age help firms to develop their operations in more efficient way, especially the operations relating innovation, on the other had the study also established that , older firms are prone to inertia, and the bureaucratic ossification that goes along with age and that Organizational inertia operating in old firms tend to make them inflexible and unable to appreciate changes in the environment. Bases on the revelation, the study concludes that Age may have a positive or negative impact on depending on management tactics employed.

Based on the study findings the research recommends that the management of the firms listed in NSE should therefore strike a balance between their choice of capital structure and ownership concentration as they were found to effect on its performance as it affect the shareholders risks, returns and the cost of capital. The policy makers should ensure that strategies are directed at ensuring that firms do not just grow in age but rather grow faster in size and that ownership does not grow among few owners(higher ownership concentration) but rather spread out to many owners(diffused ownership) Firms should equally watch over growth in financial leverage as this would undermine their performance, the study recommend that, firm managers should monitor the institution's growth to ensure that both size and age increase with firm performance.

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