THE EFFECT OF PRIVATIZATION ON FINANCIAL PERFORMANCE OF STATE OWNED ENTERPRISES

(A Case Study of Formerly State-owned Enterprises Listed at Nairobi Stock Exchange)

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AUGUST 2012
DECLARATION

Student’s Declaration

I do hereby declare that this project is my original work and has not been presented to any college or university for examination purpose.

Signature

Date 6/11/2012

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Declaration by Supervisors

This project has been submitted with my approval as the university supervisor

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DEDICATION

This project is dedicated to my loving wife Tina and my sons Asher and David, for their encouragement, support and continuous inspiration all through till I completed my research project.
ACKNOWLEDGEMENT

This goes to all the individuals who had significant role towards ensuring that this research project was completed. Many thanks to go my supervisors, Mr. Kaplelach and Ngugi who tirelessly worked hard without giving up till I submitted this work.

My classmates and the lecturers cannot be forgotten for their little or much help they gave me, it’s all through your challenges that I was inspired positively to work with great determination till I completed the project.

I do also appreciate the support through the resources availed by the Kenyatta University Library making my research possible.

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<td>SOEs</td>
<td>State-Owned Enterprises</td>
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<td>GDP</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>SAPs</td>
<td>Structural Adjustment Programmes</td>
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<td>GOK</td>
<td>Government of Kenya</td>
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<td>NSE</td>
<td>Nairobi Stock Exchange</td>
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<td>PE</td>
<td>Public Enterprises</td>
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<td>KPLC</td>
<td>Kenya power and Lighting Company limited</td>
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<td>PR</td>
<td>Public relations</td>
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<td>PRPC</td>
<td>Parastatal Reform Programme Committee</td>
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<td>DGIPE</td>
<td>Department of Government investment and Public Enterprises</td>
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<td>ROS</td>
<td>Return on sales</td>
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<td>NBK</td>
<td>National Bank of Kenya</td>
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<td>HFCK</td>
<td>Housing Finance Corporation</td>
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<td>ROE</td>
<td>Return on Equity</td>
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<td>SPSS</td>
<td>Statistical Package for Social Sciences</td>
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OPERATIONAL DEFINITION OF TERMS

Public enterprises - Organizations owned by the Government
Privatization - Transfer of ownership from the government to the private sector.
ABSTRACT

The analysis of the impact of privatization on financial performance of privatized enterprises in Kenya is important since there are high expectations placed upon privatization, by policy makers and the public at large, to improve enterprise performance and achieve macroeconomic stabilization. In view of this the main purpose of this study was to illustrate, using empirical evidence, the extent to which the privatization programs adopted by Government of Kenya had an impact on the financial performance of privatized enterprises as was anticipated by the policy makers. The main aim of the study was to establish the effect of privatization on financial performance of state owned enterprises. To answer the question the paper considers a large set of privatized enterprises in different sectors which experienced privatization over the period from three years. The specific objectives of the study were; to establish the effect of privatization on profitability of privatized state-owned enterprises in Kenya, to determine the effect of privatization on liquidity of privatized state-owned enterprises in Kenya and to determine the effect of privatization on working capital of privatized state-owned enterprises in Kenya. The study took the six former state owned enterprises already listed in Nairobi Stock Market. The study used the financial reports of the firms before and after privatization as the secondary data to address these objectives. The key variables of the study were the firms’ profitability, liquidity and working capital. The study established that privatization generally improved the firms’ profitability, liquidity and working capital which are the main indicators of financial performance.
CHAPTER ONE
INTRODUCTION

This chapter covers the introduction to the research. It gives the background of the study, states the problem and the objectives of the study. Finally, it outlines the significance and scope of the study.

1.1 Background Information

Since 1945, many countries in the world have attempted to use state owned enterprises (SOEs) to achieve their economic and social objectives. Developing countries typically relied on more on SOEs than industrial economies in the hope that they would balance or replace a weak ideologically unacceptable private sector. They also relied on SOEs in order to transfer technology to strategic firms in mining, telecommunications, transport and heavy industry. By early 1980s, SOEs accounted on average for 17% of Gross Domestic Product (GDP) in sub-Saharan Africa, 12% in Latin America and 3% in Asia (Peter and Ikiara, 1992).

In the 1960s and 1970s, there was a big expansion in SOEs with a key objective of achieving economic development, regional balance, local participation and control of the economy (Sunita et al., 1994). Many countries in Sub-Saharan Africa undertook far reaching economic reforms in the late 1980s and early 1990s against an unfavourable background of rapidly deteriorating economic and financial conditions. The reforms were done within the framework of the IMF and World Bank supported Structural Adjustment Programs (SAPs), these countries were to restructure their economies in order to achieve private sector led growth through a market based system (Reinhart and Tokarlidis, 2003).

Having initially been viewed as a radical, perhaps even desperate policy initiative of the most closely associated with the Thatcher government in Britain from 1979 onwards, privatization
has come to be accepted as a potential instrument of economic policy for governments of many persuasions throughout the world. Indeed, the increasing tendency towards the use of this technique shows no sign of slackening in the 21st century (D'souza and Megginson 1999; Megginson and Netter 2001).

Privatization has gradually taken global dimension originating from Chile, then the United Kingdom (UK) and New Zealand turning into a major phenomenon for both the developed and developing countries (Heracleuous, 1990). This new wave of privatization is caused by several factors. However, the most significant is the general poor performance, inefficiency and low productivity of SOEs especially in developing countries.

Privatization can take several forms, which include, complete or partial in terms of the amount of equity sold to private investors; full or selective in terms of which parts of state enterprise sold; liberalization, where a competitive climate and market forces are promoted to replace monopolistic climate; it may also involve the transfer of ownership through methods like leasing state facilities for a fee, bringing in external management, or contracting out the provision of a particular service.

Various Scholars have defined privatization. Privatization is a process that involves the transfer of ownership and or control of SOEs to private investors. The government disposes off entire or part of its shareholding in various SOEs and has no management control over them through a process of privatization (Aseto and Okelo, 1997). It has further been defined as the transfer of majority ownership of SOEs to private sector by the sale of on-going concerns or assets following liquidation (Sunita et al, 1994). The main types of enterprises that have been privatized in Kenya are in the sectors of power generation,
telecommunications, water provision and transport. Privatization is proving to be successful in developing countries suggesting that the level of development in the country could have an impact on the degree to which privatization is successful (Boubakri and Cosset, 2000).

Boubakri (1990) defines privatization as the transfer of ownership from the government to the private sector. Privatization could be partial (divestiture) or complete (100% sale of ownership). Privatization is a worldwide phenomenon. From former socialist states of Eastern Europe to Latin America, from South Asian countries to the African Continent. The world for the last two decades has been undergoing profound fundamental shifts in infrastructural development and provision of services. There has been a rush to privatize state-owned enterprises as a vehicle for development. This implies that the analysis of the privatization process and its impacts on financial performance in developing countries is important.

The reform process in privatization has been going on for the last 14 years (since 1992). The main aim of the program is to eliminate the financial burden parastatals impose the exchequer. While substantial progress has been made towards the privatization process, the government has realized that there is need to re-orient the program in order to allow wider participation and consultation with stakeholders (Report of the Working Group on Public Administration, 2001)

According to the Policy Paper on Public Enterprise Reform and Privatization (July 1992), there are 240 commercially oriented Public Enterprises in Kenya, with direct or indirect government ownership out of which 207 classified as non-strategic enterprise that were fully divested, and 33 strategic enterprises that were to be restructured but retained under public
ownership. Strategic enterprises are so defined if they either provide essential services or play a key role from the viewpoint of national security, health and environmental protection. About six strategic enterprises including Kenya Electricity Corporation, Kenya Post and Telecommunication Corporation, Kenya Railways and Kenya Ports Authority were restructured. Out of 33 strategic enterprises, two Rehabilitation Advisory Services and Nyayo Bus services were liquidated in 1997 and 1998 respectively (GOK, 2001).

In June 2000, the government passed, through the cabinet, its privatization program Strategy and Policy Framework and subsequently discussed the strategy in parliament to raise awareness and build political consensus around an extremely ambitious program focusing on privatization and private participation in all basic infrastructure services. Divestiture took the form of 11 firms on NSE, 16 firms through competitive bidding, 14 firms were liquidated, 20 firms placed under receiverships, 54 firms divested through preemptive rights and one management or employee buyout. (World Bank, 1996).

According to World Bank (2001), privatization falls under the Public Sector Reform Programs. The aim of these programs is to improve efficiency of wholly owned government institution. In 1994, Kenya started to implement the Parastatal Reform Program. The objective of this project financed by the World Bank was to support parastatal reform as a means of reducing the role of government in the economy. More specifically, there were three main components, which included enhancing the efficiency of public enterprises (PE) sector, reducing the financial burden of PE on the public budget and the need of PE to operate based on market principles, promoting operational autonomy and enhancing accountability.
The government of Kenya began privatization as part of its Structural Adjustment programs (SAPs) in 1992 (GOK, 1992). In 1996, 141 enterprises had been privatized. Privatization has been done through public share offering in the Nairobi Stock Exchange (NSE), competitive bidding conducted by the Executives Secretariat and Technical Unit (ESTU). A few companies have been privatized by public share offer on the NSE because most of the profitable companies have pre-emptive rights that were exercised to achieve privatization. The other reason is that most of the SOEs could not meet the requirements of NSE since they were not economically sound and others were too small to be offered economically on the stock exchange (The Sector Working Group Report on Public Administration, 2001)

Since 1993 the Government has been pursuing an ambitious program of macroeconomic and structural reform. The key features of this program are a reduction in the fiscal deficit and enhanced monetary discipline; liberalization of external and internal markets; initiation of parastatal reform based upon restructuring of strategic parastatals and divestiture of non-strategic enterprises; and improved government management through reduction of the size of the civil service and reorganizing key ministries. Government performance under this program had been generally good, with some key exceptions. The overall fiscal deficit had been roughly in line with the program's target. Within this target, however, the composition of expenditures had differed somewhat from the original program, as government expenditure control was not fully effective and the government was called upon to make debt service payments on behalf of parastatals (Kenya - Structural Adjustment Credit I (Vol.1), 1997/09/05, PIC1418, Project Information Document).

Evidences have shown gains from privatization even if the market structures do not change. Chile offers a striking example; infrastructure monopolies in electricity generation and
distribution and in telecommunications were efficiently run and effectively regulated as SOEs. Their privatization nonetheless produced substantial gains because private enterprises overcome a constraint on investment that the government had imposed on the SOEs and because the new private management operated the companies more efficiently (Sunita et al, 1994). The overall performance of Kenya firms is better after privatization.

1.2 Statement of the Research Problem

Privatization is rationalized by fiscal constraints and the inability of SOEs to enhance operational efficiency, improve services, curb costs escalation, attract new investment and enhance quality of service delivery. Public enterprises pursue social objectives which the market would most likely ignore (Reinhart and Tokatlidis, 2003).

The ownership debate suggests that a competitive market environment could be responsible for superior performance and not necessarily the ownership (Kay and Thompson, 1986). The problem of SOEs is not their ownership but the absence of explicit goals and objectives focusing on efficiency and lack of organization cultures and control systems to support the goals and objectives (Wortzel and Wortzel, 1989).

In Kenya in the recent years, we have noted privatized SOEs almost going under due to perpetual losses hence attracting government intervention. Uchumi Supermarkets – Kenya two years ago, due to insolvency was forced to close down which has been identified as one of the greatest corporate disasters in independent Kenya’s history (http://en.wikipedia.org). Barely two years later, another company that is Rift Valley Railways which was privatized through concession developed similar problems raising government concern and quick intervention.
Previous researches focused on profitability and efficiency. No research has focused on privatization in relation to broad financial performance measures which are more important to Kenyan government. It's therefore necessary to fill this gap by evaluating the financial performance of privatized SOEs in Kenya against the performance of SOEs which are not privatized as a way of assessing the effects of privatization on the financial performance of SOEs.

1.3 Objectives of the Study

1.3.1 General Objective

The main objective of the study was to evaluate the effects of privatization on financial performance of state owned enterprises. A case study of formerly state-owned enterprises listed at Nairobi Stock Exchange.

1.3.2 Specific Objectives

The specific objectives of the study were:

(i) To establish the effect of privatization on profitability of privatized state-owned enterprises in Kenya

(ii) To determine the effect of privatization on liquidity of privatized state-owned enterprises in Kenya

(iii) To determine the effect of privatization on working capital of privatized state-owned enterprises in Kenya
1.4 Research Hypotheses

(i) Privatization has not improved the profitability of privatized state-owned enterprises in Kenya.

(ii) Privatization has not improved the liquidity of privatized state-owned enterprises in Kenya.

(iii) Privatization has not improved the working capital of privatized state-owned enterprises in Kenya.

1.5 Justification of the Research

Privatization of state-owned enterprises is not only a complex issue but also consumes a lot of both material and non-material resources in addition to resultant far reaching social, economic and political repercussions. In particular, the immediate casualty of privatization of state-owned enterprises is usually the financial position and financial performance of the privatized organization depending on the rationale and the process of privatization. This study aimed at unearthing the privatization in Kenya with specific focus on the financial consequences of privatization. As already mentioned, the research results will hopefully assist policy makers and managers to understand better target areas of low risks, during the process of transition from public to private ownership.

1.6 Scope of the Study

The study covered a sample of the privatized state owned enterprises in Kenya from 1996 when the first state-owned enterprise was privatized to 2006. The financial performance of these privatized enterprises was the focus of the study.
CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction

This chapter reviews the literature related to the problem of the study. The chapter specifically documents previous studies related to the study problem, privatization in Kenya and the effects of its implementation of the financial performance of state owned enterprises.

2.1 Alternative View of Privatization (Ownership versus Performance)

Though privatization is seen to be beneficial to the economy, it is difficult to ascertain the real causes of improved performance because of the short-term effects of divesture on which most studies cannot give the full picture of the economic changes associated with the change in ownership. Emergence of the debate on whether ownership poses a key issue on superior performance could be attributed to their ownership. This could imply that a more competitive market climate is responsible for superior performance of private companies rather than the fact that they are privately owned (Kay and Thomson, 1986).

Still even if one accepts the view that SOEs, on average, function poorly and impede private sector development, a question remains as to whether privatization is the solution and whether the deficiencies of SOEs can be remedied without changing ownership. In theory a state-owned firm should operate as efficiently as a private firm, if both function in a competitive market setting and if their behaviour is governed by the same rules and incentives. In fact comparison of the performance of the public with the private enterprises has not consistently provided compelling evidence that ownership matters. Many analysts have concluded that competition and regulation are more important than ownership in
determining economic performance (Vickers et al, 1988), therefore policy makers should focus primarily on making markets work well.

In Sudan extensive nationalization of private industrial enterprises during the 1970s was accompanied by high public investment in projects with low returns. In 1983, the government announced a private sector action program. Some parastatals have been converted to private companies, but the policy decisions have worsened the environment for private investment. Private activities are threatened by high costs, lack of credit, rigid price regulations, disruptions in utility services and imported inputs, and uncertainty about the business climate. In 1985, the ministry of finance and economic planning and the ministry of commerce and industry directed a study of manufacturing sector in Kenya. The study focused on tariff reform and was not designed to investigate the influence of ownership on performance by comparing performance indicators, classified by industry and by type of ownership gave evidence that does not indicate the private sector performed better on average than public quasi-public sectors. Though understanding, the performance of the public firms as measured by the domestic resource cost ratio was better than the private sector (Peter and Ikiara, 1992)

Though privatization is seen to be beneficial to the economy, it is difficult to ascertain the real causes of the improved performance because short-term effects of divesture on which most studies are based on cannot give the full picture of the economic changes associated with the change in ownership. There is evidence of increasing performance before privatization takes place showing enhanced productivity even when firms are controlled by the state. This reaction could be caused by the announcement of privatization that can work as a threat to public managers and suggest that incentive mechanisms that can improve the
Since the late 1970s a substantial body of literature calling into question the performance of the government sector has developed. Though this body of work has expanded to vast proportions, some common themes visible include the complaint that the government sector suffers from unclearly defined objectives, inefficient and ineffective policy implementation processes and is excessive in size relative to its economic setting. Further criticisms typically relate to the suggested existence of costly and overly bureaucratic organizational structures, low levels of responsiveness to citizens and a consequent failure to provide either an appropriate quantity or (as the case may be) quality of goods and services to taxpayers (Osborne and Gaebler 1992).

Reformist oriented public management literature often links service and organizational sustainability deficiencies with macro level economic difficulties including persistent government sector budget deficits because of excessive costs and spending compared to poorly structured and inappropriately spread taxation bases. (Osborne and Gaebler 1992; Pollitt and Bouckaert 2004).

Many of the sentiments expressed in this body of literature were echoed in the policy settings adopted by reformist governments, most notably those in the United Kingdom, New Zealand and Australia (Carlin, 2003; Carlin 2004). Consequently substantial changes in public sector management have emerged since the 1980s with various techniques, including contracting out, commercialization, corporatization, privatization used as a basis for improving cost
effectiveness and efficiency in government. Since the late 1970s a substantial body of literature calling into question the performance of the government sector has developed.

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Both these works represented important contributions to the literature, but nonetheless left unexplored niches. For example, none of the firms included in the samples drawn upon in the Megginson et al study or the Boubakri and Cosset study were from socialist countries undergoing the transition to the embrace of market based principles. Further, while the studies used aggregate financial data to characterize the position of firms after the point of privatization, the datasets drawn upon for the basis of this earlier research were not sufficiently rich to allow detailed drilling into the causes of the phenomena these authors observed.

Partly filling this gap in knowledge, Wei, D’souza, and Hassan (2003) conducted a study on 208 privatized firms in China, a current socialist country, during the period from 1990 to 1997. The results of that study are consistent with those of the earlier studies cited above, save for their conclusions in relation to post privatisation profitability. Wei et al documented that, after being privatized, the firms in their sample did not exhibit significant change in profitability (Wei, Varela et al. 2003). Again, this research did not aim to discover the reasons for changed/unchanged profitability, for improvement in outputs, for sale efficiency and so forth, so it is not possible to determine from the results any detailed explanation for the observed phenomenon.

Another gap in the existing literature has been the failure of existing studies to document the association between privatization and a range of key business metrics such as working capital management efficiency, capital intensity, cashflow profile and the level of free cashflow generated by enterprises. Yet an understanding of factors such as these is important in the context of developing detailed insights into the journey of transition undertaken by firms as they are reconfigured from public to private ownership (Wei, Varela et al. 2003).
Understandably, given the widespread application of privatization as a tool of public policy and the high degree of materiality (in dollar and GDP proportionate terms) of many programs of privatization, the phenomenon has attracted considerable attention from researchers. Some of the work which has resulted from this attention has been empirical in its basis, with a particular focus on the performance implications of a switch from public to private ownership modes (Wei, D’souza, and Hassan 2003).

Despite considerable growth in the volume of extant scholarly literature focused on the question of the impact of management reform in the public sector, comparatively little is known about the impact of such initiatives in the developing world, particularly in instances where sweeping public financial management reform programs are of relatively recent origin (Carlin, 2003; Carlin 2004).

The privatization of Kenya Airways was the first-ever privatization of an African airline. The sale of a major state-owned asset is usually a highly charged political event, and the two-year process by which 77% of the shares of Kenya Airways were sold to a broad array of private investors was no exception. From the outset the press and public of Kenya speculated as to how and when the process would fail, and which interests would profit from that failure (The East African (Nairobi), 30 August 2000).

After the Kenya airways the privatization was carried out successfully, it opened doors to privatize other state-owned enterprises as the following media reportage suggests. To pay off debt, Kenya must sell its port authority and its railways, although there is little interest in
them. The purchaser of much of Telkom Kenya will be named. The open registry of foreign-owned ships in Kenya (Daily Mail and Guardian, 22 August 2000).

The World Bank pressured Kenya on privatization of Kenya Power and Lighting Company (KPLC) and the Kenya Electricity Generating Company, but premature privatization would have lead the country from the frying pan into the fire—as happened in the telecommunications sector, where the new ownership is based on political interests. Few past privatisations have brought tangible benefit to either consumers or the country (The East African (Nairobi), 30 August 2000).

Telkom Kenya cut 10000 jobs in a major five-year restructuring process connected with its privatization which began in April. The re-organisation was just part of an overhaul by the government of its interests, which also affected other utilities such as those in the rail and power sectors Review of Statutory Boards (1979) and Report of the Working Party on Government Expenditures (1982).

Kenya was not to receive most of an emergency energy loan nor any aid for other purposes unless the government privatized its electrical power enterprises. The deterioration of Kenya's economy had made the government increasingly dependent on aid from the World Bank and International Monetary Fund. (The East African (Nairobi), 3 November 2000)

Kenya agreed to the sell a stake in its fixed-line telecommunications monopoly to a foreign consortium. However, President Moi had said that he would not sell it to foreigners at a throwaway price given that Telkom was the biggest revenue generator of the country's state-
run companies. If the deal failed the IMF would force the government to face a shortfall of millions of dollars in this year's budget (*Business Day*, 31 January 2001).

### 2.2 Review of the Public Enterprises Performance

A comprehensive review of the public enterprises performance was carried out in the Report on the Review of Statutory Boards (1979) and Report of the Working Party on Government Expenditures (1982). The Report on Review of Statutory Boards pointed out that the growth in the parastatal sector had not been accompanied by development of efficient systems to ensure that the sector plays its role in an efficient manner; there was clear evidence of prolonged inefficiency, financial mismanagement, waste and malpractices in many parastatals; Government investments had largely been at the initiative of private promoters with government being brought in either as an indispensable partner or to undertake rescue measures; many of the parastatals had moved away from their primary functions, especially the regulatory boards most of which had translated their regulatory role into executive one, resulting in waste and confusion; and there was danger of over-politicizing production and distribution through establishment of too many parastatals.

The Report on the Working Party on Government Expenditures concluded that productivity of the state corporations was quite low while at the same time they continued to absorb an excessive portion of the budget, becoming a principal cause of long-term fiscal problem. The report observed that: -Kenyanization had remained merely presentational through government ownership; state corporations’ operations had become inefficient and unprofitable, partly due to multiplicity of objectives; existence of parastatals in commercial activities had stifled private sector initiatives; and many of the joint ventures had failed, requiring the Government to shoulder major financial burden.
The Report on the Working Party on Government Expenditures (1982) concluded that some of the resources diverted to the government to finance the state corporations' activities could have contributed more to national development if these state corporations were left in the private sector. The report recommended that the government should act as a creator of favourable setting within which people can develop themselves and the economy, divest from its investments in commercial and industrial enterprises to transfer active participation to more Kenyans through participation in shareholding, reduce exposure to risk in areas in which the Private Sector can assume risk without government intervention, dismantle some of the existing administrative hurdles which discourage private sector initiative and provide needless opportunities for corruption, and reorganize legal and institutional framework regarding monitoring and supervision of parastatals.

Following the two reviews a number of measures were put in place. One of the measures was the enactment of the State Corporations Act. However, although this was a major attempt to streamline the management of the state corporations, the performance of most of the corporations continued to deteriorate. One reason was the continued reliance on limited public sector financing. The funds were lent or channeled to them as government equity; loans borrowed by the state corporations continued relying on public sector financing which was not adequate to meet all the sector's needs. They continued to be financed from loans borrowed by the government enterprises on government guarantees which in most cases ended up being repaid by the Treasury when the corporations defaulted; funds provided directly by the Treasury as grants or equity; or through internally generated funds.
The internally generated funds were, however, inadequate due to huge debt burdens, tariffs that were below cost recovery levels, over employment, which caused most of revenue to be used in payment of salaries, non-viable ventures which siphoned away resources from the enterprises, corruption and mismanagement in general. In addition most of the parastatals were under capitalization from the time of incorporation as they were mainly financed from loans without due regard to the establishment of a strong financial base. Most of them also continued to spread their resources thinly due to multiplicity of objectives and poor accountability.

With inadequate resources the corporations were unable to reinvest to rehabilitate or modernize their operations. This led to poor service delivery and inability to extend services to new consumers including industries. The continued poor service delivery and lack of access in turn resulted in a vicious circle, which increased the country’s cost of production, thereby affecting adversely Kenya’s external competitiveness and leading to loss of jobs and of economic opportune.

Later, another category of Public Enterprises, Development Finance Institutions, (DFIs) were created to provide financing for development projects unable to obtain financing from conventional private sector sources. Similarly, investments made in enterprises by the Government, in its role as trustee for Kenyans who were not endowed with risky capital resources or the necessary entrepreneurial skills at the time of independence, became permanent holdings by the Government due to a lack of a conscious effort to divest those investments to citizens as they became wealthier and gained business skills.
During the 1970s, it became increasingly apparent that government participation in the economy had grown well beyond the Government's original intentions. Furthermore, a large debt exposure among PEs resulted in increased vulnerability. This caused PEs to be highly leveraged because of their static equity base. Operating losses and inadequate returns on investments further eroded the already weak capital bases of the PEs. The resultant administrative and regulatory interventions introduced to protect the ailing PEs resulted in a diversion of limited managerial capabilities and resources from the fundamentally more important areas of policy, infrastructural investment, development of social services and the management of the economy.

While the creation of the PEs was perhaps appropriate at independence, the changed circumstances, together with poor performance record of the PEs, have mandated the need to review continued government participation in them and/or the macroeconomic policy environment, and the sectoral policies as well as enterprise-specific policies in which the PEs operate.

2.3 Theory of Privatization

Privatization is the supply side economics based on the hypothesis that private ownership brings greater efficiency and more rapid growth. This theory is based on the fact that economic agents respond better to price incentives and signals in general.

Privatization broadens the ownership base and participation in the economy making individuals feel that they have a stake in the economic while improving efficiency, increasing output and lowering cost, privatization also controls the increase of government expenditure, values cash to reduce public internal and external debt, promotes individual initiative and
rewards entrepreneurship. The approaches that have a bearing on privatization are those of property rights, principal agent and public choice (Wortzel and Wortzel 1986)

2.4 Conditions of Privatization

The most important conditions for privatization to be successful are country conditions (Kireri, Nellis and Shirley, 1994). The country conditions are an open trade regime, a stable and predictable environment for investment and a well developed institutional and regulatory capacity. The existence of competitive markets free from any market barriers will ensure that privatizing SOEs that are tradable in a transparent process will lead to improved efficiency.

2.5 Past Efforts to Improve Performance of Public Enterprises

The Government of Kenya has made a number of attempts in the past to improve PE sector performance. In 1979, following the publication of a government report on parastatals, the Parastatal Advisory Committee was formed. At the same time the Government enlarged the role of the Inspectorate of State Corporations to serve as a troubleshooting, management audit and consulting service for parastatals.

In 1982, the Government released the findings of a Working Party on Public Expenditure, which detailed many serious deficiencies in the financial and economic performance of PEs. The report suggested a series of reforms and proposed the possibility of reducing the role of PEs and replacing it with increased private sector activity. As a result of the Working Party Report, direct budgetary transfers to the PEs were severely restricted, declining from Kshs.1.12 billion in 1982 to Ksh.0.36 billion in 1984. Ironically, the resulting gap was at first financed by flows from the banking system, which increased from Kshs. 0.16 billion in 1982 to Kshs.1.2 billion in 1984, thus neutralizing the intended effect of making capital available
for productive new investment instead of propping up ailing public sector ventures. By the
fiscal years 1989/1990 and 1990/91, however, the flow of funds from the Government to PEs
had returned to the 1982 levels (P. Ndegwa et al, Working Party on Government

Past efforts by the Government to improve the performance of PEs was coupled with reform
measures. However, these reform measures followed a firm-by-firm approach. As a result
the progress towards reform of the PE sector has been slow and uncoordinated. The need for
a comprehensive PE reform programme with well identified core elements and clear policy
guidelines has therefore become apparent. It is in the light of these experiences that the
Government of Kenya has recently come up with a comprehensive PE reform and
privatisation programme. PE reform includes all restructuring and operations rationalisation
measures aimed at making the PE sector viable while privatisation and divestiture involve the
transfer of a function, activity, organisation or investment holding from the public to private
sector.

2.6 Kenya's PE Reform and Privatization Programme

The Government of Kenya is now in the process of implementing a comprehensive PE
reform programme whose overall aims have include enhancing the role of the private sector
in the economy by shifting more of the responsibility for production and delivery of goods
and services from the public to the private sector; to create a more level playing field by
eliminating preferential treatment, including monopoly rights; and to enable the private sector
to enter the areas of activity of the PEs on an equitable basis. In addition the P.E Reform will
also reduce the demand of the PE on the Exchequer so as to improve the use of Kenya's
scarce resources, and to enhance the returns on those resources by achieving greater
efficiency in both private and public enterprises through greater responsiveness to market signals and commercial criteria.

The reform is also aim at reducing the role and rationalizing the operations of the PE sector, improving the regulatory environment by selecting more economically rational means of regulation, thereby reducing conflicts of interest between the regulatory and commercial functions of PEs that are consistent with government policy, broadening the base of ownership and enhancing capital market development.

### 2.6.1 Scope of PE Reform and Privatization

There are about 240 commercially oriented PEs with direct or indirect government ownership. Of these, the Government has designed 33 PEs as strategic enterprises and intends to retain its ownership and active Board participation in them for the time being. The remaining 207 PEs have been classified as non-strategic enterprises and constitute the Government's privatization programme. (Republic of Kenya 2003)

The Government has defined PEs as "strategic" if they provide essential services or are considered to play a key role from the viewpoint of national security, health and protection of environment. The Government has also stated its intention to divest its interest in companies where it has minority holdings. The divestiture is mainly for budgetary resource mobilization for the Government.

The process of privatization is not viewed as an end in itself but as an integral and visible element of the Government's overall PE reform programme and a progressive effort to
promote productive efficiency, to strengthen competitive forces in the economy and to support entrepreneurial development.

**Policy Guidelines for PE Reform**

The discernible primary objectives of the PE reform programme include bringing down the financial burden of the PE sector on government, to enhance the efficiency and performance of the PE sector; and to bring about financial discipline, managerial and financial autonomy, appropriate incentives and accountability, all aimed at having the PEs operating on commercial principles.

The PE reform programme has various principles which act as a guiding action toward the desired objectives.

The operations of the PE reform will include only viable commercial activities, except for certain cases where the Government directs the PE also to undertake activities for other than commercial reasons. However, such non-commercial activities will only be retained on a separate operational and accounting basis and with contractual arrangements giving the PE full compensation for the activity through transparent budgetary provisions.

Where PE operations currently include regulatory functions, these were divested and either eliminated or assigned to a separate regulatory body, PEs was to operate on a self-sustaining basis and with a hard budget constraint that will oblige them to institute and maintain adequate financial discipline. Subsidies will be phased out except for those relating to non-commercial activities as mentioned above, a major goal of PEs was profitability through efficient operations in a competitive environment. Over the longer term, a crucial reform
objective is to move to market pricing wherever competition is possible. This goal will be promoted through the break up of monopolies, reduction of trade barriers, and elimination of barriers to private entity.

In order to facilitate PE achievement of these aims, their managements was provided with the maximum autonomy over key operational variables such as prices, procurement and salary levels, when compatible with prevailing conditions.

Public Service PEs operating under monopolistic conditions will, in common with private entities of similar nature, be regulated as needed to protect the public interest, primarily through review and approval of tariffs, maintenance and replenishment of all kinds of capital resources, and cost containment. Such regulation was implemented through autonomous specialized bodies operating independently from the Government line structure, thus insulating them from political interference.

The legal and regulatory framework within which PEs are to operate was streamlined to provide a "level playing field", with the aim being to facilitate an equitable and fair basis for the efficient functioning of both public and private sector enterprises under competitive and freely market-based conditions, and to provide protection to consumers when necessary. With this objective, the legal framework applicable to the private sector, including the Companies Act, was made equally applicable to PEs.

Government's ownership functions over majority-owned PEs will include the same rights and responsibilities as the analogous functions in the private sector. In its ownership role the Government will thus: Select and appoint competent and qualified persons to PE boards according to a widely publicized and transparent process; Provide PEs' management with clear, non-conflicting objectives; gree with management on the strategy and corporate
instruments reflecting it; leave management as free as possible to achieve the objectives; oblige management to full and transparent accountability and perform "ex poste" evaluations of management performance.

All aspects of PE business will be performed in a commercial and transparent manner.

The fact of being a PE will not constitute an acceptable reason for directly or indirectly according favourable treatment to PEs, such as exemption from taxes or fiscal charges or preferential access to imported or domestic inputs. The foregoing principles are designed to secure autonomy from political interference.

Privatization and divestiture have been defined as the transfer of a function, activity, organization or investment holding from the public to the private sector. Privatization and divestiture are strategies of enhancing the role of the private sector in the economy by shifting more of the responsibility for production and delivery of goods and services from the public to the private sector.

The principles of the privatization/divestiture programme which are guiding action toward the desired objectives include; PEs was divested into competitive markets and purchasers will therefore not obtain an intact or unregulated monopoly, Purchasers will not be accorded special protection or access to credit on concessionary terms, in cases where the Government retains a minority shareholding, it will not exercise any special or extraordinary voting rights, except in limited, predetermined and well defined policy areas, there was moratorium on new Government investments in enterprises that are to be privatized, except for financial and operational restructuring that are necessary to prepare PEs for sale, all privatization sales was on a cash-only basis, with the possible exception of shares sold to the workforce of the affected firms, no specific class of potential purchasers will be excluded from participating in
the privatization/divestiture process, all transactions will be conducted in an open and transparent manner consistent with normal standards of commercial discretion. Unless justified by the existence of legal rights no predetermined direct sale or negotiations by private treaty will be entertained except after publicly solicited bids have been obtained. All aspects of the transactions will be in the public domain where appropriate. This means a prospectus or offering memorandum will be prepared and publicized for each firm to be sold, a full body of financial, management and other information will be available for disclosure to the investing public, fair and equitable bidding procedures will be established, criteria for ranking bids will be established and publicized, bids will be opened in public, the valuation of the assets and the details of all offers received will be placed in the public domain, to promote and ensure the competitiveness of the markets in which privatized companies will operate, the Government will continue to build upon existing anti-monopoly legislation and the institutional capacity to implement it in a transparent manner and no new PEs will be established in the productive sector, except for investments made purely for venture capital assistance through the Development Finance Institutions.

2.7 Privatization/Divestiture Process

The privatization/divestiture process is perceived as involving two main and distinct phases. The first phase is preparation and entails a detailed review of the PE, covering operational, financial and legal issues, in order to determine its current condition, potential strengths, weaknesses, and financial restructuring requirements, if any. This is followed by the construction of operational and financial models for the PE to project likely results under several scenarios. These steps lead to a valuation of the PE as a going concern, which forms the basis for establishing a range of values that can be used in negotiations with prospective
investors and setting the share price for a public offering. For comparative purposes, asset valuation is also conducted to ascertain the value from both a replacement and a liquidation perspective. This phase concludes with the preparation of a privatization plan of action that fully documents the results of all the analysis conducted up to this stage.

The action plan also includes a detailed set of recommendations on how to proceed to execute the transaction. The second and final phase is execution and entails the implementation of the transaction. By this stage, all key decision-makers have approved the privatization action plan. Tasks to be performed during this stage include, where necessary, the preparation of the sales documentation, (e.g. prospectus, information memorandum) completion of any financial and operational restructuring required prior to divestiture, resolution of all outstanding legal issues that affect the sale, the design and implementation of a PR campaign to inform the public of the impending sale, and finally the execution of the sale itself.

2.8 Methods of Privatization/Divestiture

According to Wortzel, H.V. and Wortzel, L.H. (1989) there are a number of alternative ways of effecting privatization/divestiture which include;

Public offering of shares on the stock exchange;
Sale of shares by private placement;
Negotiated sales;
Sales of PE assets (including liquidation);
New private investments in PEs;
Employee/management buy outs;
Leasing or award of management contracts;
Joint venture: commercial agreement between a PE and one or more business partners to operate a business;

Franchising: a fixed-term contract or license to a company to operate a service.

The choice of a privatization option is often determined according to the objectives perused by the Government for each sale, record of performance and economic prospects and size of the PE and the ability to mobilize private funds.

Institutional Arrangements

In order to achieve the Government’s objectives in the PE reform and privatization programme, the Government has created a high level policy-making body, the Parastatal Reform Programme Committee (PRPC), the functions of which include supervision and coordination of the implementation of the PE reform programme in general, prioritizing and determining the timing of the sale for each non-strategic PE, approving the operational guidelines for privatization to be followed, including the criteria and procedures to be followed in the divestiture decisions, doing final approval or rejection for the sale of public assets, monitoring and evaluating the progress of implementing the programme, providing political impetus for privatization and participation in building public awareness and the national consensus in support of the Government programme.

Another body, the Executive Secretariat and Technical Unit (ESTU) has been established to act as an autonomous execution agency and as the Secretariat of the PRPC. The ESTU is responsible for the management, co-ordination and implementation of the privatization/divestiture programme as approved by PRPC.
The Department of Government Investments and Public Enterprises (DGIPE) has been established within the Ministry of Finance and charged with specific powers and functions which are designed to render it as autonomous as possible. The DGIPE is responsible for those aspects of the reform programme that are related to parastatals which are to remain in state hands. Indeed the DGIPE is expected to carry out effective oversight and leadership of the PE reform process. This would include roles traditionally carried out by "parent" ministries. The sector ministry's functions in relation to PEs are expected to be limited to developing sector-wide policies and programmes. The PE Boards of Directors are expected to be responsible for setting corporate operational policies and to ensure that executive managements carry them out.

Critical review

This line of argument predicts that state-owned enterprises will perform less efficiently than privately owned ones. Earlier empirical studies support this argument. However, recent empirical evidence has challenged this view. Kole and Mulherin (1997) study a sample of U.S. corporations in which the federal government held 35% to 100% of the outstanding common stock for between 1 and 23 years during and following World War II. They find that the performance of the government-owned companies was not significantly different from that of private-sector firms in the same industry; they argue that the availability and implementation of monitoring devices can favorably affect the performance of any form of enterprise, public or private. Gupta (in press) examines the impact of partial privatization of Indian state-owned enterprises where the state remained the controlling owner after privatization: Gupta finds that partial privatization had a positive impact on profitability, productivity, and investment, arguing that the stock market can perform an important role in monitoring and rewarding managerial performance even when the state remains the controlling owner.
The corporatization of SOEs in China entailed restructuring the internal governance system of these firms while preserving state ownership. Such an unusual social experiment allows us to address the question whether private ownership is the only solution to agency problems in the governance system, or whether a restructured governance system can favourably affect the performance of these enterprises, even if they remain under public ownership.

Examining the impact of SOE corporatization helps not only address the question of whether governments should restructure SOEs or privatize them, but it also helps determine, if eventual privatization is warranted, the optimal pace of privatization. The Chinese SOE privatization scheme has relied mainly on share issue privatization (SIP) where some, but not all, of the government’s stake in these firms is sold to investors through a public share offering. Most of the firms that were privatized were corporatized before going into SIP. If corporatization could improve the performance and value of SOEs, then such restructuring would also enable the government to generate larger revenues from eventual SOE privatization. We find that corporatization significantly improved the performance of SOEs.
2.9 Conceptual Framework

The sketch diagram showing variables relations

Profitability

Down sizing
Customer focus
Innovation
Service quality
Effective

Privatization

Liquidity

Working Capital

Independent Variables

Intervening Variables

Dependent Variables

Source: The Researcher (2012)

The conceptual framework above depicts a relationship between privatization of state owned enterprises and the level of profitability, liquidity and working capital. The privatized SOEs used privatization strategies as; downsizing, customer focus, innovation, service quality and effective re-engineering. These strategies were meant to make the companies more appealing for the investors who could have wanted to invest through the purchase of the shares, which were the main source of capital injection into the companies to make them more competitative. The expected output were improved profitability, liquidity and working capital which were not adequate before the firms were privatized.
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Research Design

Since the objective of this study was to provide detailed evidence pertaining to the impact of the transition from state owned enterprise to private venture, the sample of organizations examined were all originally configured as SOEs but are subsequently reconfigured as private sector enterprises. Therefore, given that a key objective of this study was to track the changing fortunes of post privatized SOEs, longitudinal research design was deliberately used in order to show the financial performance of the post privatized SOEs.

3.2 Target Population

The population comprised the SOEs privatized by the end of the year 1996 for experimental group. The target population was the former SOEs which were privatised. Currently, there were six SOEs in the Nairobi Stock Market; In the commercial market segment there are; Kenya Airways and Uchumi Super Market. In the Financial and Investment segment there were Kenya Reinsurance and Housing Finance Corporation of Kenya. In the industrial and allied segment there were Mumias Sugar and Kengen.

3.3 Data Type and Sources

For inclusion in the research sample, it was necessary to consider previously state owned enterprises prior to privatization (as opposed to private businesses which had taken advantage of an initial public offering process), and that audited financial statements are available for the organization for the year immediately prior to listing and for a period of twelve years thereafter. These requirements yielded a total research sample of 6 firms. Details of the set of firms included in the research sample are set out in appendix 1.
Unlike other studies where the data relied upon for the purposes of analysis has been drawn from surveys, interviews and other similar sources, this study, focused as it did on the financial dimension of the public to private transition, which required a richer and more consistent dataset. For this reason, the study was based on disclosures contained in annual audited (and published) financial statements. In Kenya, under present regulations, these are only readily available from enterprises listed in Nairobi Stock Exchange.

3.4 Data Analysis

For inclusion in the research sample, was necessary that firms which were state owned enterprises prior to privatization (as opposed to private businesses which had taken advantage of an initial public offering process), and that audited financial statements were available for the organization for the year immediately prior to listing and for a period of three years thereafter.

Because each listing year also yields a research sample too small for meaningful analysis, this study employed a data pooling technique whereby irrespective of the actual calendar year of listing, all data pertaining to each firm’s year prior to listing, year of listing and each successive year post listing is pooled for the purposes of aggregate analysis. For each year each firm is included in the research sample, a variety of data pertaining to three key dimensions was gathered. These were; Profitability, liquidity and working capital efficiency. Correlation model was used to establish significance between the firm’s performance before and after privatization.
\[
 r = \frac{N \Sigma xy - (\Sigma x)(\Sigma y)}{\sqrt{[N \Sigma x^2 - (\Sigma x)^2][N \Sigma y^2 - (\Sigma y)^2]}}
\]

Where:
- \( N \) = number of pairs of scores
- \( \Sigma xy \) = sum of the products of paired scores
- \( \Sigma x \) = sum of \( x \) scores
- \( \Sigma y \) = sum of \( y \) scores
- \( \Sigma x^2 \) = sum of squared \( x \) scores
- \( \Sigma y^2 \) = sum of squared \( y \) scores

Table 3.1: Ratios to be used in analyzing financial performance of privatized firms

<table>
<thead>
<tr>
<th>Categories</th>
<th>Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Profitability</td>
<td>Return on Assets = OPBT/Average Total Assets</td>
</tr>
<tr>
<td></td>
<td>Return on Equity = EBIT/equity</td>
</tr>
<tr>
<td></td>
<td>Return on Sale = earning before interest and tax/sale</td>
</tr>
<tr>
<td>2 Liquidity</td>
<td>Current Ratio = Current Assets/Current Liabilities</td>
</tr>
<tr>
<td></td>
<td>Quick Ratio = Cash, Cash equivalents &amp; Receivables/Current Liabilities</td>
</tr>
<tr>
<td>3 Working capital efficiency</td>
<td>Working capital on Sales = (Current Assets- Current Liabilities)/Net Sales</td>
</tr>
</tbody>
</table>

This resulted in a dataset comprising 10 observations for the year prior to listing (t-1), the year of listing (t=0), one year post listing (t=1), two years post listing (t=2) and three years post listing (t=3). The aggregated t-1 data set comprised 5 firm year observations. Each of the other pooled datasets was constructed in the same manner.
Pooled Time series data pertaining to each of the five dimensions for each observation was analyzed using E-views which is a computer software for analyzing data.
CHAPTER FOUR
DATA ANALYSIS, PRESENTATION AND DISCUSSION

4.1 Effect of Privatization on the Firms Profitability

Profitability was measured by several proxies including return on sales (usually denoted by ROS), return on assets (ROA) and return on equity (ROE) ratios. (ROS) referred to earning before interest and tax (denoted by EBIT) divided by sales, while (ROA) referred to EBIT divided by assets; and (ROE) referred to EBIT divided by equity.

<table>
<thead>
<tr>
<th>Market Segment</th>
<th>Firms</th>
<th>Year Privatized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial</td>
<td>Kenya Airways</td>
<td>1997</td>
</tr>
<tr>
<td></td>
<td>Uchumi Supermarkets</td>
<td>1992</td>
</tr>
<tr>
<td>Financial</td>
<td>Kenya Re</td>
<td>2007</td>
</tr>
<tr>
<td></td>
<td>HFCK</td>
<td>1992</td>
</tr>
<tr>
<td>Industrial and Allied</td>
<td>Mumias Sugar</td>
<td>2006</td>
</tr>
<tr>
<td></td>
<td>EAPC</td>
<td>1992</td>
</tr>
<tr>
<td></td>
<td>Athi river Cement</td>
<td>1996</td>
</tr>
<tr>
<td></td>
<td>KenGen</td>
<td>2005</td>
</tr>
<tr>
<td></td>
<td>KPLC</td>
<td>1997</td>
</tr>
</tbody>
</table>

Source: Nairobi Stock Exchange Market Segment 2009

Table 1 was used by the study to describe the market segments where the government privatized firms fall. Majority of the firms 50% fall under industrial and allied sector, 30%
fall under financial and 20% fall under commercial segments. The earliest firm to be privatized was Kenya Airways whereas the latest firm to be privatized was Kenya Re.

![Graph](image)

**Figure 1: Return on Assets Ratio on the Commercial Sector**

Figure 1 was used to analyze the Return on Asset (ROA) ratio of the commercial sector after privatization. The study established that the ROA ratio for Kenya Airways decreased from 7.48% in FY1 to after to 5.3% in FY3 compared to Uchumi whose ROA remained almost equal at 0.11%. This finding indicated that privatization did not bring immediate positive impact in the ROA of the former government enterprises in the commercial segment in Nairobi Stock Exchange.

![Graph](image)

**Figure 2: Average ROA of the Commercial Sector after Privatization**
Averagely the study established that the commercial sector firms had their ROA reduced from 3.68% in FY1 to 2.59% in FY2. This finding indicated that privatization did not improve ROA of the firms in the commercial sector.

Figure 3: ROA Ratio of Firms in Financial and Investment Market Segment

Figure 3 was used to analyze the ROA ratio of the firms in the investment Market Segment. The study established that the ratio for NBK and KenyaRe were all the same in value but with a decreasing trend from FY1 to FY3. The ROA for HFCK was trailing behind the other two firms in the segment although it recorded an increasing trend with the best performance in FY2.

Figure 4: The ROA of the financial and investment segment
The study established that the mean ROA ratio of the firms in the financial and investment market segment tremendously declined in the third year in the stock market, although there was a high performance in the FY2. This finding indicated that the former government enterprises did not improve in profitability even after they were privatized.

![Figure 5: The ROA of the Industrial and Allied Firms](image)

The analysis of the ROA of the Industrial and Allied Group showed a declining trend continuously with Mumias Sugar having a higher ROA than KenGen. This finding showed that the privatization of the above firm by the government did not improve their profitability at all.

![Figure 6: Mean ROA in the Industrial and Allied Firms](image)
The study established that the mean ROA ratio of the firms in the Industrial and Allied market segment tremendously declined in the third year in the stock market, although there was a high performance in the FY2. This finding indicated that the former government enterprises were not profitable even after they were privatized.

Figure 7: Return on Equity (ROE) of Firms in Commercial Segment

Figure 7 shows the return on equity of Kenya Airways and Uchumi Super Market which are in the commercial segment in the stock market. The study established that the ROE of Kenya Airways was far much above the 15% benchmark ROE ratio, although the ROE was on decline especially in FY3. On the other hand, Uchumi Supermarket had a negative ROE in Fyars 1 and FY2. This was because it was around these Fys that the Supermarket had just gone through tough financial times of receivership. There was a slight improvement in FY3 when the ROE was 0.0584%
Figure 8: Return on Equity (ROE) of Firms in Financial Segment

Figure 8 shows the return on equity of Kenya Reinsurance and Housing Finance Corporation of Kenya which are in the financial segment in the stock market. The study established that the ROE of Kenya Airways was far much below the 15% benchmark ROE ratio, although the ROE was on decline especially in FY3 in both of the firms. On the other hand, HFCK had a low ROE in compared to KenyaRe.

Figure 9: Return on Equity (ROE) of Firms in Industrial and Allied Segment

Figure 9 shows that Kenya Airways had higher ROE than Mumias in the industrial and allied segment.
Figure 9 shows the return on equity of Mumias Sugar and Kengen which are in the industrial segment in the stock market. The study established that the ROE of Kengen was far much higher compared to that of Mumias Sugar and that it was above the 15% benchmark in each of the FYs. It is also important to note that the ROE tremendously increased in the FY3 of the firms trading in the stock market. This finding therefore showed that privatization of the two former government corporation improved the firms profitability based on the ROE ratio.

Figure 10: Return on Sale (ROS) of Firms in Commercial Segment

Figure 10 shows that Kenya Airways had higher Return on Sale compared to Uchumi Supermarket. It is also important to note that the ROS role in the FY2 for Kenya Airways but drastically dropped in the FY3. Based on ROS, the study established that Kenya Airways was more profitable than Uchumi Supermarket.
Figure 11: Return on Sale (ROS) of Firms in Financial Segment

Figure 11 showed that HFCK had higher Return on Sale compared to Uchumi Supermarket. It is also important to note that the ROS was high in the FY1 for HFCK but drastically dropped in the FY3. Based on ROS, the study established that HFCK was more profitable than KenyaRe.

Figure 12: Return on Sale (ROS) of Firms in Industrial and Allied Segment

The study established that the ROS was higher for Mumias Sugar compared to KenGen.
Figure 12 showed that Kengen ROS rose to 69.5% in the third year of privatization from just 22.1% in the first financial year. The ROS for Mumias Sugar remained stagnant at an average of 30%. This finding indicated that Kengen improved in its sales after privatization.

Table 4.2: The Profitability Ratios of the Firms after Privatization

<table>
<thead>
<tr>
<th>Profitability</th>
<th>FY1</th>
<th>FY2</th>
<th>FY3</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>0.3</td>
<td>0.1</td>
<td>0.2</td>
<td>Insignificant</td>
</tr>
<tr>
<td>ROE</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>Insignificant</td>
</tr>
<tr>
<td>ROS</td>
<td>0.7</td>
<td>0.7</td>
<td>0.2</td>
<td>Significant</td>
</tr>
</tbody>
</table>

Source: Firms Annual Financial Reports

Table 3 shows that there was no significant difference in the ROA and ROE ratio within the three FYs. It was ROS which had a significance improvement of 70% in the first and second year after privatization, but drastically dropped to 20% in the third year of privatization.

Figure 13: ROA of the Former State Firms before Privatization

Figure 13 was used to analyze the mean ROA of the former government firms before privatization. The study established that the mean return on asset of the firms dropped from
72% in the FY1 to 10% in the FY3. This finding showed that the firms’ assets were not able to generate the required profit, a fact which could have necessitated the privatization process.

Figure 14: ROE of the Former State Firms before Privatization

Figure 14 was used to analyze the mean ROE of the former government firms before privatization. The study established that the mean return on equity of the firms dropped from 12% in the FY1 to 2% in the FY3. This finding showed that the firms could not generate cash internally. It also implies that the firms did not use the equity efficiently to increase the firms’ profitability hence increasing the shareholders wealth.
Figure 15: ROS of the Former State Firms before Privatization

The study established that the mean return on sale of the firms dropped from 43% in the FY1 to 5% in the FY3. The firms level of sales could not generate enough income to make the firms be profitable.

4.1.1 The Relationship of privatization and firms' profitability

The study used Pearson correlation to establish whether there was a significant relationship between privatization and the firms’ profitability. The study used the mean profitability data before and after privatization.

Table 2.3: Contingency Table of Mean Profitability Before and After Privatization

<table>
<thead>
<tr>
<th>Years (after)</th>
<th>Years (Before)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.1</td>
<td>0.03</td>
</tr>
<tr>
<td>0.6</td>
<td>0.31</td>
</tr>
<tr>
<td>0.6</td>
<td>0.39</td>
</tr>
</tbody>
</table>

Source: Firms Data

The first hypothesis of the study was stated as; privatization improved the profitability of privatized state-owned enterprises in Kenya. The study summarized the mean profitability...
ratios before and after privatization. The study used SPSS to run a paired t-test to either accept or reject the hypothesis whose results are shown in the table below.

### Table 3: t-test for Firms' Profitability Before and After privatization

<table>
<thead>
<tr>
<th>Paired Differences</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Std. Error Mean</th>
<th>95% Confidence Interval of the Difference</th>
<th>t</th>
<th>Df</th>
<th>Sig. (2-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before - After</td>
<td>0.1900</td>
<td>.11136</td>
<td>.06429</td>
<td>.8662, 2.955</td>
<td>2.955</td>
<td>2</td>
<td>.09</td>
</tr>
</tbody>
</table>

The calculated paired t-value was 2.955 compared to the critical t-value of 2.080 at 2 degree of freedom and significance level of 0.1. Since the calculated t-value was higher than the calculated t-value, there was evidence to reject the hypothesis that privatization of the firms has not improved their profitability. Therefore it can be concluded that privatization improves the level of profitability.

### 4.2 The Effect of Privatization on Firms' Liquidity

The second objective of the study was to establish the effect of privatization on the firms' liquidity. Firms' liquidity is calculated by dividing the firms' liquid assets with liabilities. Liquidity ratio, expresses a company's ability to repay short-term creditors out of its total cash. The liquidity ratio is the result of dividing the total cash by short-term borrowings. It shows the number of times short-term liabilities are covered by cash. If the value is greater than 1.00, it means fully covered...
Figure 16: Liquidity Ratio of the Firms in Commercial Segment

Figure 17 shows that the liquidity ratio for Kenya Airways was greater than that for Uchumi Supermaket. It is also important to note that the liquidity ratios increased especially in the third FY upto 1.34 for Kenya Airways and 0.56 for Uchumi Supermarket. Kenya Airways was therefore able to pay its short term creditors with the cash reserve in the third FY whereas Uchumi Supermarket was not able to pay its creditors because its liquidity was far much below 100%.

Figure 17: Liquidity Ratio of the Firms in Financial and Investment Segment
Figure 17 showed that the liquidity ratio for HFCK was greater than that for KenyaRe. Both the firms in this sector were able to pay their short term creditors because of the availability of cash reserve above 100%. It is important to note that the liquidity of KenyaRe remained constant at 110% whereas that of HFCK increased to 220% in the third FY from 200% in the first FY.

![Figure 18: Liquidity Ratio of the Firms in Industrial and Allied Segment]

Figure 18 depicts that the liquidity ratio for Mumias Sugar was greater than that for Kengen during the first two FY years after their successful privatization process. Both the firms in this sector were able to pay their short term creditors because of the availability of cash reserve above 100%. It is important to note that the liquidity of KenGen (160%) went higher than that for Mumias Sugar (140%) in the third FY.
Figure 19: Comparative Liquidity Ratio of all the Segments after Privatization

Figure 19 shows that the financial segment had the highest liquidity ratio followed by the industrial and allied segment, and the commercial segment had the least liquidity performance after their privatization. It is important to note that both the commercial and financial sector had improvement in their liquidity performance compared to the industrial sector whose liquidity dropped from 190% in the first FY to 150% in the third FY.

Figure 20: Comparative Liquidity Ratio of all the Segments after Privatization
Figure 20 above showed that the financial segment had the highest liquidity ratio followed by industrial and allied segment and the industrial segment had the least liquidity performance before their privatization. It is important to note that both the industrial and financial sector had decline in their liquidity performance in the third FY compared to the industrial sector whose liquidity increased from 41% in the first FY to 56% in the third FY.

### Table 4.5: Comparative Contingency Table of Liquidity Before and After Privatization

<table>
<thead>
<tr>
<th>Fys</th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY1</td>
<td>0.80</td>
<td>1.40</td>
</tr>
<tr>
<td>FY2</td>
<td>0.68</td>
<td>1.30</td>
</tr>
<tr>
<td>FY3</td>
<td>0.56</td>
<td>1.40</td>
</tr>
</tbody>
</table>

Source: The Listed Firms Data

Table 6 above was the comparative contingency table comparing the firms’ liquidity ratio before and after privatization. The study established that there was a general improvement in the liquidity performance after the firms’ privatization.

The second hypothesis of the study was stated as Privatization improved the liquidity of privatized state-owned enterprises in Kenya. Paired sample t-test was used to establish existence of any relationship between the liquidity performance before and after privatization.

### Table 4.6: Significance Difference of Liquidity before and After Privatization

<table>
<thead>
<tr>
<th>Paired Differences</th>
<th>t</th>
<th>df</th>
<th>Sig. (2-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean Deviation</td>
<td>Std. Error Mean</td>
<td>95% Confidence Interval of the Difference</td>
<td></td>
</tr>
<tr>
<td>Lower</td>
<td>Upper</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before - After</td>
<td>-.68667</td>
<td>.13317</td>
<td>.07688</td>
</tr>
</tbody>
</table>

The calculated t-value was -8.931 compared to the absolute critical t-value at 2 degree of freedom which was 2.080 at significance level of 0.05. since the critical t-value was far much lower than the calculated t-value, the null hypothesis was rejected and the alternative hypothesis was accepted.
less than the calculated t-value, there was evidence to reject the hypothesis that privatization has not improved the firms' liquidity.

4.3 Effect of Privatization on the firms' Working Capital

The third objective of the study was to establish the effect of Privatization on the firms’ Working Capital. Working Capital is a measure of both a company's efficiency and its short-term financial health.

Positive working capital means that the company is able to pay off its short-term liabilities. Negative working capital means that a company currently is unable to meet its short-term liabilities with its current assets (cash, accounts receivable and inventory). Also known as "net working capital", or the "working capital ratio. Working Capital Ratio is calculated by subtracting current liabilities from current assets.

If a company's current assets do not exceed its current liabilities, then it may run into trouble paying back creditors in the short term. The worst-case scenario is bankruptcy. A declining working capital ratio over a longer time period could also be a red flag that warrants further analysis. For example, it could be that the company's sales volumes are decreasing and, as a result, its accounts receivables number continues to get smaller and smaller. Working capital also gives investors an idea of the company's underlying operational efficiency. Money that is tied up in inventory or money that customers still owe to the company cannot be used to pay off any of the company's obligations.

The study established that Kenya Airways had a better capitalization than Uchumi Supermarket whose working capital remained negative for the period of study. A declining
working capitalization over a longer time period in Uchumi supermarket showed an indication of bankruptcy and insolvency.

Figure 21: Working Capital of Financial Segment after Privatization

Figure 23 analyzed the working capital of the financial and investment segment. The study established that KenyaRe had higher working capital than HFCK whose working capital was continuously slightly above 1,000,000 Kenya Shillings. This finding indicated that the firms in this sector maintained a better working capital after privatization.

Figure 22: Working Capital of Industrial Segment after Privatization
Figure 24 above analyzed the working capital of the industrial and allied segment. The study established that KenGen had higher working capital than Mumias Sugar whose working capital dropped from 2.4 million in the first FY to 1.2 million in the third FY. This finding indicated that the firms in this sector maintained a better working capital (between 1.2 million to 7 million) after privatization.

Table 4.7: Contingency Table Comparing Working Capital before and after

<table>
<thead>
<tr>
<th>FY</th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY1</td>
<td>644956.7</td>
<td>1,596,432.8</td>
</tr>
<tr>
<td>FY2</td>
<td>546977.5</td>
<td>2,109,088.8</td>
</tr>
<tr>
<td>FY3</td>
<td>363713.2</td>
<td>2,057,359.8</td>
</tr>
</tbody>
</table>

Source: Firms Data

Table 8 above was the comparative contingency table comparing the firms' working capital before and after privatization. The study established that there was a general improvement in the firms' working capital performance after the firms' were privatized.

The third hypothesis of the study was stated as; Privatization improved the working of privatized state-owned enterprises in Kenya. Paired t-test was used to establish existence of any relationship between the working capital performance before and after privatization.

Table 4.8 : T-Test of the Firms' Working Capital

<table>
<thead>
<tr>
<th>Paired Differences</th>
<th>t</th>
<th>df</th>
<th>Sig. (2-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>1402411.3</td>
<td>3333</td>
<td></td>
</tr>
<tr>
<td>Std. Deviation</td>
<td>396020.60841</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Std. Error Mean</td>
<td>228642.60</td>
<td>487</td>
<td></td>
</tr>
<tr>
<td>95% Confidence Interval of the Difference</td>
<td>2386181.0</td>
<td>6131</td>
<td>418641.60</td>
</tr>
<tr>
<td>Lower</td>
<td>-6.134</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Upper</td>
<td>4.086</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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The calculated t-value was -6.134 compared to the absolute critical t-value at 2 degree of freedom which was 2.080. Since the critical t-value was less than the calculated t-value at significance level of 0.05, there was evidence to reject the hypothesis that privatization has not improved the firms' working capital performance. As such, it can be concluded that privatization is vital for enhancing the level of working capital.
CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Privatization is the process of transferring firms' ownership to the public through shares ownership in the stock exchange. The Government of Kenya through the Capital Market Authority has been in the forefront in privatizing its corporation to make them improve on their financial performance. The main aim of the study was to assess the effect of privatization on financial performance of the former government corporations. The study came up with many important findings that this section intends to present. The findings are presented in terms of the effect of privatization on the firms' profitability, liquidity and working capital.

5.1.1 Effects of Privatization on Firms Profitability

First, the study established that privatization did not bring immediate positive impact in the return on asset of the former government enterprises in the commercial segment in Nairobi Stock Exchange. Secondly, privatization the government corporation improved the profitability of the firms in the industrial and allied segment in Nairobi Stock Exchange. Thirdly, the study established that the firms' assets before privatization were not able to generate the required profit, a fact which could have necessitated the privatization process. Fourth, the study established that there was a significance relationship of the firms' profitability before and after data correlation confirming that privatization of the state corporation lead to their profitability. This meant that privatization improved firms' liquidity and profitability.
5.1.2 Effects of Privatization on Firms Liquidity

First, the study established that privatization improved the firms liquidity performance. Secondly, the study established that there was a close relationship between firms’ liquidity performance and privatization, hence making the firms improved their liquidity performance.

5.1.3 Effects of Privatization on Firms Working Capital

First, the study established that privatization did not make Uchumi Supermarket improve on its working capital compared to other firms in other segments whose working capital improved. Secondly, the study established that there was a close relationship between firms’ working capital performance and privatization, hence making the firms improved their performance.

5.2 Conclusion

The current business trend is stock trading; the government of Kenya has taken a leading role in turning its investment as stock to be traded in Nairobi Stock Exchange. The study at its conceptualization sought to assess the effect of privatization on firms’ financial performance. The study established that privatization generally improved the firms profitability, liquidity and working capital which are the main indicators of financial performance.

5.3 Recommendations

From the findings and conclusion of this study, the following recommendations will be found important in relations to the factors that affect employees’ performance. First, there is a need to undertake a serious review of the privatization policy to avoid the pitfalls of the past experience and introduce necessary modifications accordingly. Secondly, there is a need for the government to be careful in choosing the forms of privatization based on in-depth examination of the nature and history of each enterprise. Third, there is a need to encourage
private investors in the privatization process; efforts should be directed to strengthening and
developing the capital market to participating to overcome the problem of finance. In addition
to the above, privatized enterprises may wish to fulfill the following requirements to achieve
positive financial performance: emphasis on employee training and management
development through providing access to different training programs; more emphasis on cost
control; and, more effective use of relevant technology to enhance productivity.

5.4 Recommendation for further research

The following related areas can be researched on to add up to the knowledge of what this
study has achieved. First, there is a need to carry out a comparative analysis of the effect of
privatization of on financial performance of the former government corporation and private
entrance corporation like private banks and other private corporation. The finding from such
a study will be able to make some useful comparisons on how these two adverse sectors
address themselves to the issues of privatization and changes in financial performance which
in turn will make the sectors to learn from one another and to grow up the Nairobi Stock
Exchange where the firms stock are being traded.
REFERENCES


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Shirley M. Mary, Managing State-Owned Enterprises, World Bank Staff Working Paper No. 577


APPENDIX I: LIST OF STATE-OWNED ENTERPRISES

1. Kenya Airways
2. Uchumi Supermarkets
3. Kenya Re-insurance Company
4. Housing Finance Corporation of Kenya
5. Mumias Sugar Company
6. East African Portland
7. Athi River Cement
8. KENGEN
9. Kenya Power and Lighting Corporation