

**EQUITY STRUCTURE AND CORPORATE PERFORMANCE.
A CASE OF THE KENYAN OIL INDUSTRY.**

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**BY: ODHIAMBO COLLINS AGUTU
REG: D61/ 8201/04**

SUPERVISOR: MR. OTIENO LUTHER.

A RESEARCH PROJECT REPORT SUBMITTED IN PARTIAL FULFILLMENT
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DECLARATION

This research project is my original work and has not been presented for a degree or any other examination in any university.

Signed

Date

niufhk.....

Mr. Odhiambo Collins Agutu

Reg: D61/8201/04

This research project has been submitted for examination with my approval as a university supervisor.

Signed

Date

Mr . Otieno Luther

Lecturer, University of Nairobi

Department of Accounting

DEDICATION

To my dad, Mr. Maurice Agutu Giro, and my mum, Mrs. Susan Aoko Agutu for their unwavering love, commitment and support that has seen me through the long and sometimes difficult academic journey.

ACKNOWLEDGEMENTS

Glory is to Almighty God, for the grace that has made me what I am today.

My sincere gratitude goes to the University of Nairobi for granting me the opportunity to further my education. I specifically appreciate my supervisor Mr Luther Otieno for his guidance and patience that made this project a success. I am also grateful to the MBA 2004 regular class for their solidarity and academic support that helped me achieve my MBA award.

I wish to acknowledge my brothers and sisters for their moral, technical and social support for the entire period I have been undertaking my MBA, and all my family members, friends and relatives for their support in building my academic achievements.

ABSTRACT

This study examines the effects of ownership structure on corporate performance of Kenyan oil sector firms between 2001-2005. Ownership structure is defined along two dimensions: ownership concentration and ownership mix. These two categories incorporate both the influence power of shareholders as well as the identity of owners with their unique incentive mechanisms and preferences. In this study, the ownership structure is considered in terms of (i) foreign Vs Local ownership, (ii) Government Vs Non Government ownership, and (iii) Institutional Vs Individual ownership. This study uses (accounting) profitability (i.e., Return on Capital Employed (ROCE)) as measures of performance. The study adopts a multi-theoretic approach to investigate the impact of diverse shareholders on the performance of emerging economy oil firms.

Overall, the findings confirm that there is a positive association between foreign ownership and firm performance. The study shows that domestic corporations positively influence firm performance although not at the same magnitudes as for foreign corporations. Nevertheless, the result assumes significance only if domestic corporations hold large blocks of shares, which enhances their monitoring abilities and incentives. Also, it is found that firms with Institutional ownership do not perform better than those with Individual ownership in Kenya. A less significant relationship is found for Government Ownership.

The study recommends inward FDI is an essential element to introduce a new way of thinking, stimulate competition, and catalyze necessary reform. Inward FDI helps move the Kenyan economy a step towards substantial reform. Considering the possibility of market failures, there are good reasons for the government to conduct inward FDI promotion policies.

ABBREVIATIONS

NSE:	Nairobi Stock Exchange.
G.o.K:	Government of Kenya.
PIEA:	Petroleum Institute of East Africa.
IPO:	Initial Public Offering.
SOE:	State Owned Enterprise.
ROCE:	Return on Capital Employed.
FDI:	Foreign Direct Investment.
CSV:	Creating Shareholder Value.

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CHAPTER ONE. INTRODUCTION.

1.1 Background

A firm's ownership structure influences its performance for several reasons. Firstly, differences in identity, concentration and resource endowments among owners determine their relative power, incentives and ability to monitor managers. Shareholdings by corporations, individuals, banks, mutual funds and governments are well-known examples of this phenomenon. Secondly, as owners have divergent goals, they have different influences on firm performance. For example, financial investors may be interested in short-term returns on their investment, while corporate investors may be more inclined towards establishing a long-term relationship (Sytse et al, 1999).

Agency theory suggests that management control issues are important in understanding the value of the firm. It is hypothesized that the divergence of interests between the manager and the shareholders will reduce firm value, and it will be most acute when the manager owns only a small fraction of the shares. Conversely, the take-over market can function as a disciplining tool for managers, with managers being more vulnerable when they own a small percentage of the shares. In addition, it is argued that institutional investors and equity block holders have an incentive to monitor management, and they can do it more effectively and at a lower cost than atomised shareholders. (Jensen and Meckling ,1976)

The relationship between equity ownership structure and firm performance has become a key issue in understanding the effectiveness of alternative corporate governance mechanisms. In the light of massive privatization efforts in former Eastern block countries as well as experiences of developed economies of USA, Japan and Western Europe, researchers face vast amount of data to test various corporate governance issues brought out by the theory. With public offerings of equity through IPO's, direct foreign investment and a large public sector in the economy, the Kenyan market offers a very rich combination of corporate governance schemes to be compared. Moreover,

privatization of publicly owned companies is still being debated on the basis of the impact of ownership mix on performance. A related issue surfaces with respect to the method of privatization. The merits of public offering of equity which leads to a more diffuse ownership versus private placement through block sales that results in a concentrated ownership is another controversy to be resolved.

Oil is high investment, high turnover, but low margin commodity. It is a key sector in the countries' economy as it affects both its relative terms of trade and domestic prices of myriad of products. Petroleum fuels are used widely in the productive sectors of the economy. According to the Economic Survey (2001), it constitutes about 63% of the total energy consumption in the commercial sector alone. The Kenyan oil industry is segmented structurally as consisting of the Multinational Oil Companies i.e. Shell/BP, Caltex, Mobil and Total, the big local companies i.e. Kenol / Kobil and National Oil Corporation, and the "independents".

The major oil companies are consisted of the subsidiaries of the multinational oil companies and the big locals. Together the major oil companies control about 75% of the total market according to the statistics that are obtainable from the ministry of energy while the rest enjoy the balance of 25% (GOK, 2002). The multinationals own and run most of the retail and trade outlets. The independents use the low price and investment strategy to penetrate the market. In it's report on the petroleum sub - sector, The Institute of Economic Affairs (2001) states that at the time of liberalization of the petroleum industry in 1994, international oil companies with subsidiaries in Kenya largely dominated the market with a market share well above 85%. Besides, the state corporations had a market share far much lower than the major international companies.

A number of studies have been carried out on the relationship between the firm's ownership structure and firm performance. For example, theoretical postulates put forward by Jensen and Meckling (1976) and Shleifer and Vishny (1986) were empirically tested in developed capital markets by Morck, Shleifer and Vishny (1988), McConnell and Servaes (1990), Thomsen and Pedersen (2000) and Gedajlovic and Shapiro (1998,

2002), to name a few. There is also a growing body of literature examining ownership structure issues from emerging economies. Qi *et al.* (2000), Claessens *et al.* (2000), Khanna and Palepu (2000a), Khanna and Rivkin (2001), Wiwattanakantang (2001), Chang and Hong (2002), Joh (2003) and Lemmon and Lins (2003) are a representative few encompassing the literature in the strategy and finance realm.

One of the main conclusions drawn from the empirical studies done in the various countries is that ownership structure could explain the differences in the value of firms both within and across the industries. Given the significance of the oil industry in the economy, there are strong grounds justifying a separate study in this industry. This study will endeavor to establish the relationship between the distribution of equity shares among the different categories of owners and the performance of oil companies in Kenya.

1.2 The concept of Ownership Structure

Ownership structure is defined along two dimensions: ownership concentration and ownership mix. Ownership concentration refers to the percentage of shares owned by majority shareholder(s). In other words, the degree to which ownership of the firm is concentrated among the various categories of owners. Olayinka and Ayonrinde (2001) define ownership concentration as the proportion of shares held by the top 10 shareholders, percentage of dispersed shareholders, and cash flow right(s) of the ultimate owner. Ownership mix relates to the identity of the major shareholder. It refers to the composition of shareholders of the firm. Broad spectrum of owners includes foreigners, institutions, individuals, and the government.

Thuku (2003) observed that firms are different both in the terms of ownership mix and also in terms of ownership concentration. The resultant distribution of ownership among different groups can impact on managerial opportunism, which subsequently has implications for managerial behaviour and corporate performance).

1.3 Statement of the Research Problem

There is a growing consensus among academics and practitioners that both the design and the ownership patterns of financial securities have a significant impact on value creation in large corporations. Economists and legal scholars have examined the effect that large shareholders have on firm behavior. Others have analyzed the role of large lenders as well as small, dispersed owners of debt securities. Among practitioners, the Wall Street Journal (1995) has examined the role played by significant individual shareholders, while the Institutional Investor (1985) is one example of a discussion on the role of financial institutions as shareholders. Separately, there exists a long literature and debate on the optimal capital structure and its effects on corporate performance.

Investigations into the relationship between ownership structure and firm performance have produced contradictory results; for instance, Jensen and Meckling (1976) showed how the allocation of shares among insiders and outsiders could influence the value of the firm. Building on their work, Morck, Shleifer, and Vishny (1988) suggest that the relationship between inside equity ownership and firm's value is non-linear. Also in this line is the work of Stulz (1988), who finds an "optimal level" of insiders' equity ownership that maximizes the value of the firm. Demsetz (1983) and Demsetz and Lehn (1985) argue that the level of managerial ownership varies systematically as the managers try to maximize the firm value. They (1985) suggest that the forces affecting ownership structure are the optimal firm size, effective control of managers by owners, government regulation, and the firm's ability to provide amenities to owners. Thus, they assert that the level of managerial ownership does not affect firm value.

Most of the studies so far undertaken have been conducted in the developed countries. However, in emerging and transition economies external mechanisms are less developed, and therefore, governance of corporations takes place mainly through internal mechanisms. Furthermore, institutional factors like family-run business groups play a distinctive role. Government controlled financial institutions are often important shareholders and have incentives and objectives quite different from those of private

investors. Consequently, the effect of ownership on performance in emerging economies is likely to be different.

A few studies examining ownership structure issues in Kenya have been done. Thuku (2003) analysed the ownership structure and bank financial performance, Olteita (2002) analysed the ownership structure and financial performance of listed companies; thus, no such study has been carried out in the very crucial oil industry. Again, both studies have examined ownership and performance relationships using agency theory as the theoretical lens. However, for firms in emerging economies, this perspective does not fully account for the diversity in the ownership-performance linkage (Hoskisson *et al*, 2000). Eisenhardt (1989) and Oliver (1997) also argue that agency theory presents a partial view of the world and advocate merging agency and resource-based theories with institutional theory.

The oil industry plays a significant role in the economy of any country since petroleum fuel is a major source of energy; it is often described as the wheel that moves the nation. In Kenya, the industry accounts for over 20% of the GDP (GOK, 2000). The transport sector is the largest consumer at approximately 60%, followed by manufacturing at 16%, *commercial establishments at 11%, households at 9% and agriculture at 4%* (Nyoike, 1999). In its report on the petroleum sub - sector, The Institute of Economic Affairs (2001) states that since the time of liberalization of the petroleum industry in 1994, international oil companies with subsidiaries in Kenya have largely dominated the market with a market share well above 85%. Besides, the state corporations and the domestic *corporations have a market share far much lower than the major international companies.* The question then arises as to whether the persistent domination of local firms has anything to do with the ownership structure of the firms.

In view of all these, this project takes recourse to embrace a multi-theoretic approach by incorporating elements of agency theory, resource-based theory and institutional theory to yield a richer and more composite understanding of the influence of various shareholders in determining firm performance for oil companies operating in Kenya, an

emerging economy. It will utilize large-scale firm level data of Kenyan oil sector corporations to take a closer look at the performance impact of diverse shareholders with the specific aim of answering the question of whether; the financial performance of firms with a higher proportion of institutional ownership is better than those with a higher proportion of individual ownership, financial performance of firms with a higher proportion of foreign ownership is better than those with a higher proportion of indigenous ownership, and the financial performance of state owned firms better than privately owned firms.

1.4 Objectives of the Study

The main aim of this project is to;

- Determine the ownership structure of Kenyan oil sector corporations.
- Determine whether there is a significant relationship between the distribution of equity ownership and the financial performance of companies in the Kenyan oil industry.

1.5 Importance of the Study.

Ownership structure plays an important role in a firm, particularly in determining the directions and goals of the firm which influence on performance, and in turn, affect shareholders' as well as stakeholders' benefits (Porter, 1990; La Porta et al, 1998; Jensen, 2000). The study will be of importance to the following groups of users:

SoE's and private companies willing to go public will find this paper useful in the analysis of the IPO process. As pointed out by several authors, various mechanisms affect the allocation of ownership shares during the IPO process. These authors have found that there are both benefits to large owners emerging, as well as benefits to having dispersed ownership

Corporate firms especially in the oil industry will find this study useful as it will give an indication of what aspects of ownership structure would maximise on their financial performance.

Regulators and policy makers who may wish to incorporate findings of the research as they formulate legislation and policy on ownership structure for listed firms.

The findings also seek to add to the body of knowledge in the field of continuous improvement hence will be useful to scholars in areas to be identified for further research.

CHAPTER TWO - LITERATURE REVIEW

2.1 Kenyan Oil Industry

The petroleum industry, which falls under Kenya's Ministry of Energy, is a key sector in the countries' economy as it affects both its relative terms of trade and domestic prices of myriad of products. Petroleum fuels are used widely in the productive sectors of the economy. According to the Economic Survey (2001), it constitutes about 63% of the total energy consumption in the commercial sector alone. The petroleum sub-sector has been developing through a mixture of investment which involved both public and private sectors. Whereas the public sector has been involved in the development of refining and transportation facilities, the private sector has been more involved in the development of the distribution facilities such as retail service stations (Nyoike et al, 1999)

The main products distributed by oil companies include: Liquefied petroleum gas (LPG), Gasolines - Premium (Super) and Regular, dual-purpose Kerosene, Jet A1 and illuminating Kerosene, Industrial Diesel, Fuel oils, (120cs, 180cs, 280cs), Bitumen, Lubricants (gear oils, brake fluids, greases, engine oils etc), petroleum based spray oils, petroleum jelly etc. According to Nyoike et al (1999), there has been a notable shift from the traditional small sized filling stations of the seventies to large service stations with not only huge underground tanks but also incorporating a host of other non fuel services. This trend has not been in vogue within the multinational companies but it is currently observable among new entrants that are herein referred to as independents.

The government of Kenya plays a critical role in setting rules and regulations that bind the industry, particularly, the Petroleum Act contained in chapter 116 of the 'Laws of Kenya' that came into force on 31st August, 1948 was enacted by parliament to make provision for restricting and regulating the importation, transport and storage of petroleum products. Therein the Act stipulates the petroleum rules that guide the ministry of energy in as far as petroleum industry.

Before the liberalisation of the industry in October 1994, the government was heavily involved in determining both the pricing and the supply of the petroleum products. With

liberalisation, competition in the industry has resulted in lower profits reported due to downward price adjustments to match the independent dealers (Isaboke, 2002). Faced with this fierce competition and the resulting loss in profitability, the multinational companies started engaging in serious jockeying to increase market share through advertising, increased customer care and venturing by others into little known areas which may collectively called diversification.

2.2 Structure of the oil Industry in Kenya

The global oil industry can be broadly put into two categories: the upstream (exploration and production) and the downstream (refining and marketing). Kenya's is purely a downstream industry. Although there has been exploration in the northern and coastal parts of the country, no commercially viable deposit have been discovered.

According to the ministry of energy, the energy sector is divided into two sectors. The traditional sector is dependent on fuel wood and charcoal and accounts for 68% of the country's energy needs. Up to 80% of the population is dependent on this source. The modern sector depends on petroleum, fuel, solar, bio-gas, wind and electricity. Petroleum meets about 70% of the needs (Economic Survey, 2001)

The Kenyan oil industry is dominated by five major players. These are;

- Caltex, whose parent companies are Chevron & Texaco that merged recently.
- Total Kenya, a subsidiary of TotalFinaElf, whose parent companies are Total, Petrofina of Belgium and Elf of France
- Shell/BP, a joint venture between Shell (a subsidiary of Royal Dutch Company Shell) and British Petroleum (a subsidiary of British Petroleum) who also acquired Agip (K) ltd
- Mobil (K) a subsidiary of the largest oil corporation in the world, ExxonMobil both companies are incorporated in Delaware, USA.

- Kenol/Kobil who have the largest shareholders. Kenol is; managed by Kobil, is publicly quoted and Kenol/Kobil recently acquired a controlling interest in Mid-Oil Africa and later sold them back in March 2003.
- Other players in the market are Petro (K) Ltd, Engen (K) Ltd, Fuelex Oil (K) Ltd Jovenna (EA) Ltd, Galana, Mafuta Products, National Oil Corporation of Kenya (KNOCK), Petro (K) Ltd and host of other smaller companies popularly known as the "independents" within the oil industry fraternity. The total number of oil companies are currently estimated to be over two hundred (GOK, 2003)

The industry is segmented structurally as shown below:

- Multinational Oil Companies i.e. Shell/BP, Caltex, Mobil and Total.
- Big local companies i.e. Kenol / Kobil and National Oil Corporation.
- The independents.

The major oil companies are consisted of the subsidiaries of the multinational oil companies and the big locals. Together the major oil companies control about 75% of the total market according to the statistics that are obtainable from the ministry of energy while the rest enjoy the balance of 25% (GOK, 2002). The multinationals own and run most of the retail and trade outlets. The independents use the low price and investment strategy to penetrate the market.

Buyers in the oil industry can be segmented into three broad categories viz. industrial buyers, commercial buyers, and consumers. Industrial buyers use oil to run production plants, commercial use oil for public Transport, cargo transport etc. while final consumers use it to satisfy various non - commercial needs.

2.3 The Agency Theory

Agency theory concerns itself with problems that arise when the desires of the principal **and** the agent conflict with each other and when it is difficult or expensive for the principal to verify what the agent is actually doing (Eisenhardt, 1989). This feature

allows corporate managers to pursue their own interests at the expense of shareholders. Managers who disregard shareholder interests may be ousted by powerful shareholders or by a hostile takeover. This presupposes that shareholders have an interest to indulge in monitoring managerial behavior. However, shareholders differ with respect to incentives to spend resources on monitoring. Shareholders owning a miniscule proportion of shares of a firm have very little incentive to devote the necessary time and effort on voicing their view on account of free riding from other shareholders.

Dharwadkar *et al.* (2000) argue that firms in emerging economies are especially characterized by unique agency problems arising from *principal - principal* goal incongruence. This is in addition to the traditional agency problems based upon *principal - agent* goal incongruence as observed in many Anglo-Saxon economies. The *principal - principal* goal incongruence in emerging economy firms stems from expropriation within weak governance contexts when large or majority owners assume control of the firm and deprive minority owners the right to appropriate returns on their investments (Claessens *et al.*, 2000; Lemmon and Lins, 2003).

The impact on firm performance of various ownership categories taking into account both traditional) and unique agency issues is outlined by Sytse Douma, Rejie George, Rezaul Kabir (2002) in *Figure 1*. Using the twin dimensions of ownership identity and ownership magnitude as proposed by Dharwadkar *et al* (2000), they postulate the impact in four different quadrants. **Quadrant I** represents *dispersed - outside* shareholders whose impact on performance is postulated to be moderate because their ability to effectively monitor is limited by higher coordination costs and information asymmetry problems (Coffee, 1991; Black, 1998). **Quadrant II** represents *dispersed - inside* shareholders who embody the worst of both worlds. Being inside and dispersed distorts their incentive structures and compromises their ability to undertake an effective monitoring exercise (Claessens *et al.*, 2000; Sarkar and Sarkar, 2000; Khanna and Palepu, 2000b). Consequently, their impact on performance is predicted to be inferior. **Quadrant III** represents *concentrated - inside* ownership. While more concentrated holding results in a stronger incentive to efficiently manage the affairs of a firm, it provides opportunities

and the means for expropriation of minority shareholders (Bebchuk, *et al.*, 2000; Claessens *et al.*, 2000; Wiwattanakantang, 2001; Joh, 2003; Lemmon and Lins, 2003). Therefore, the impact on performance is envisaged to be moderate. Finally, **Quadrant IV** depicts *concentrated - outside* shareholdings whose impact on firm performance is postulated to be superior as these shareholders are capable of mitigating the expropriation of minority shareholders while at the same time maximizing the benefits of risk bearing, incentive alignment and monitoring (Shleifer and Vishny, 1986; Chibber and Majumdar, 1999; Dharwadkar *et al.*, 2000; Allen and Philips, 2000).

Inside	II INFERIOR PERFORMANCE	III MODERATE PERFORMANCE
	I MODERATE PERFORMANCE	IV SUPERIOR PERFORMANCE
Outside	Dispersed	Concentrated

Figure 1. Ownership - performance relationship among emerging economy firms viewed from agency theory

Source: Rejie G (2000)

2.4 Resource-based theory

According to the resource-based theory, a firm's competitive advantage is based on the possession of tangible and intangible resources, which are difficult or costly for other firms to obtain. In order to sustain the firm's competitive advantage these resources must be valuable, rare, inimitable and unsubstitutable (Barney, 1991). A major contribution of resource-based theory is that it explains long-lived differences in firm profitability that cannot be attributed to differences in industry conditions (Peteraf, 1993). It can be argued

that considerable resource heterogeneity exists among various shareholder categories. For emerging economy firms, these differences arise from shareholders being either foreign or domestic and financial or strategic. The impact on firm performance of these owners with diverse resource endowments is expected to differ as a consequence of this heterogeneity in resources and organizational capabilities.

They exemplify the impact on firm performance of various shareholders. *Financial - foreign* shareholders are endowed with good monitoring capabilities, but their financial focus and emphasis on liquidity results in them unwilling to commit to a long-term relationship with the firm and to engage in a process of restructuring in case of poor performance. These shareholders prefer strategies of exit rather than voice to monitor management (Coffee, 1991; Aguilera and Jackson, 2003). Consequently, *financial - foreign* shareholders are postulated to have a moderate impact on firm performance. *Financial - domestic* shareholders possess characteristics that represent the worst of both worlds. Their financial focus leads to short-term behavior and a preference for liquid stocks while their domestic affiliation often results in a complex web of business relationship with the firm and other domestic shareholders (Claessens *et al.*, 2000; Dharwadkar *et al.*, 2000). Therefore, these shareholders are expected to have a negative influence on firm performance. On the other hand, there are domestic and foreign shareholders who possess strategic interests because their ownership stakes are motivated by non-financial goals, such as obtaining control rights and developing sustainable competitive advantages and capabilities (Aguilera and Jackson, 2003). *Strategic - foreign* shareholders use their ownership stakes as a means to foster their strategic interests, which involve securing access to new markets, location specific resources and low cost production facilities. Their foreign affiliation also gives domestic firms relatively easy access to superior technical, managerial and financial resources (Chibber and Majumdar, 1999). Therefore, their impact on firm performance is projected to be superior. *Strategic - domestic* owners exercise property rights as a means to pursue the strategic interests of their organizations which include regulating competition between firms, underwriting relational contracts, securing new markets etc. (Aguilera and Jackson, 2003). However, their impact on firm performance is anticipated to be moderate because, in comparison to

strategic - foreign shareholders, they have relatively inferior resource endowments and capabilities.

2.5 Institutional theory

While agency theory and the resource-based theory are powerful tools and provide important insights in examining the impact of ownership on firm performance, they suffer from the serious limitation that these two perspectives do not examine the social context within which the firm's activities are embedded. Institutional theory has the potential to address this important lacuna by introducing the social and regulatory context in influencing organizational structure and firm behavior. Thomsen and Pedersen (2000) in their study on large European corporations argue that both ownership concentration and identity are embedded in national institutions and these have to be taken into account when assessing implications for corporate strategy and performance.

Institutional theory emphasizes the influence of socio-cultural norms, beliefs and values, regulatory and judicial systems on organizational structure and behavior. Institutions regulate economic activities through formal and informal rules as a basis for production, exchange and distribution (North, 1990). In addition to these features, emerging economies are characterized by greater imperfections in the markets for capital, products and managerial talent. These lead to so called 'institutional voids' - a situation when specialized intermediaries who typically provide these services in developed economies are absent (Khanna and Palepu, 2000b). It presents an opportunity for some firms, which have the necessary resources and capabilities to bridge these institutional voids. Business groups are particularly well suited to provide the necessary welfare enhancing functions to plug these institutional voids because of their superior ability to raise capital, train and rotate managerial talent among group firms, and use common brand names in marketing their products. On the downside, though, some of these institutional voids and ineffective protection of minority shareholder and creditor rights lead to greater entrenchment by controlling shareholders resulting in conditions ideally suited for expropriation of disadvantaged stakeholders.

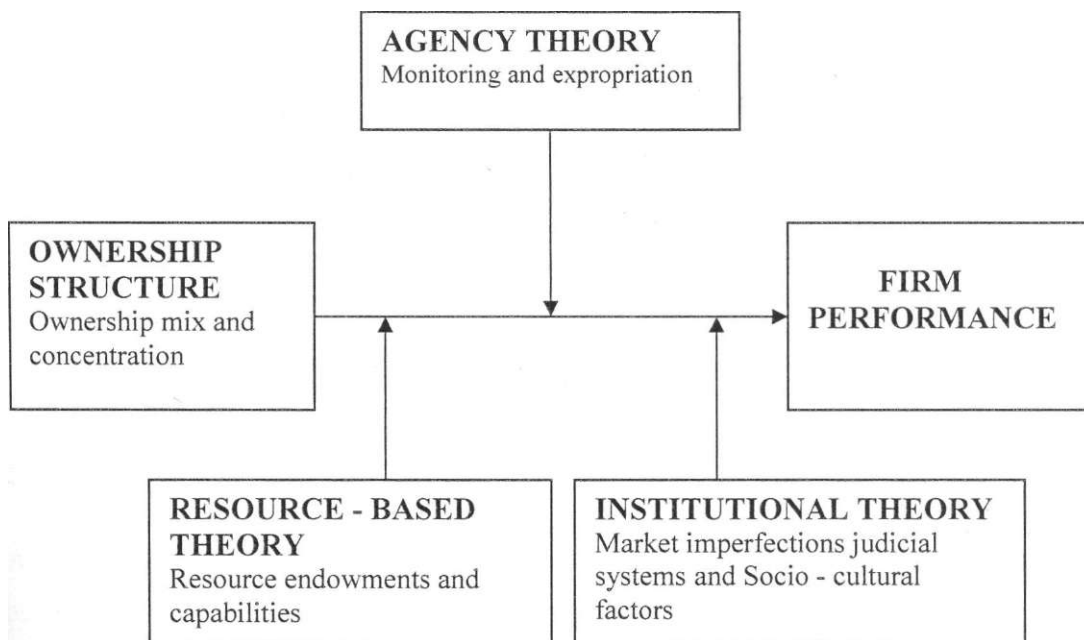


Figure 2. Multi-theoretic approach in explaining ownership - performance relationship among firms in an emerging economy context

Source: Rezaul K (2001)

2.6 Ownership structure and corporate value

2.6.1 Managerial ownership

In Jensen and Meckling (1976), the authors formalize the relationship between corporate value and managerial equity ownership by comparing firms with an owner-manager who owns 100% of stocks to a manager with an a % of stocks. The manager maximizes his utility, which depends on pecuniary returns plus non-pecuniary benefits (perquisites). The owner-manager receives 100% of the benefits of perquisites, and bears all the costs. The manager owning just a fraction of the company still receives 100% of the benefit of perquisites, but bears only an a % of the costs. So there is an incentive for the manager to increase non-pecuniary benefits by adopting investment and financing policies that benefit him, but reduce the payoff to outside stockholders. Thus, the value of the firm

depends on the fraction of shares owned by insiders, and the greater this proportion, the greater the value of the firm.

Stulz (1988) focuses on the importance of the takeover market for disciplining corporate managers. He argues that when insiders own a small fraction of the shares outstanding, a hostile takeover is more likely to succeed. As the fraction owned by corporate insiders increases, the probability of a successful takeover declines, with a probability of zero at 50% managerial ownership. This reasoning gives rise to a curvilinear relationship between managerial equity ownership and firm value. The value of the firm first increases and then decreases as managerial ownership increases.

Another interesting work is Morck, Shleifer and Vishny (1988), where the authors postulate that corporate managers respond to two opposing forces and the relationship between equity ownership and firm's value depends on which effect dominates the other. They sustain that even though managers would try to allocate firm's resources to further their own interests, as managerial equity ownership increases their interests will tend to coincide with those of the firm. Thus the relationship between corporate value and ownership structure cannot be determined a priori.

A contrary argument is proposed in Demsetz (1983), where it is argued that the ownership structure is an endogenous outcome of a competitive process in which various costs and benefits are balanced to get an equilibrium organization of the firm. In this view, there is no relationship between ownership structure and profitability. The empirical evidence in this regard is mixed. While Demsetz and Lehn (1985) find no relationship between accounting profit and different measures of ownership concentration for a sample of 511 US firms in 1980; Morck, Shleifer, and Vishny (1988) find a significant non-linear relationship between Tobin's Q and insider's equity ownership. In particular, they find that Q rises as insider ownership increases up to 5%, then falls as ownership increases to 25%, and then rises again. Similar results were obtained by Hermalin and Weisbach (1987).

2.6.2 Blockholders and Corporate Performance

Another element in the firm's equity structure likely to influence the value of the company is the presence of equity block holders. A blockholder is defined as an owner holding at least 10% of the votes. The blocks are ordered according to their voting power. The motivation for using the 10% threshold is (1) the significant control it provides (La Porta et al., 1999), and (2) the important rights against abuse by insiders given to outside shareholders holding at least 10% of all shares

The potential takeover threat that large block holders can exert, and the better position of institutional investors to monitor managers at a lower cost, may drive a firm to maximize its value regardless of manager's equity ownership. In this sense, Shleifer and Vishny (1986) predict that, all else being equal, the presence of a large-block equity holder will have a positive effect on firm's market value. However, Holderness and Sheenan (1988) analyse a sample of firms in which there is a single shareholder that owns more than 50% of the shares. When they compare the Tobin's Q and accounting profits of this sample with those of matching firms where no single shareholder owns more than 20% of the stock, they find no significant difference between the two samples.

The effect of blockholder ownership on firm value could be positive or negative (Steen Thomsen, 2003). A positive effect may come about because large shareholders have greater power and stronger incentives to ensure shareholder value maximization (Jensen and Meckling, 1976; Zeckhouser and Pound, 1990; Burkart et al., 1997, 1998). A negative effect may occur, if blockholder ownership above a certain level leads to entrenchment of owner-managers that expropriate the wealth of minority shareholders (Fama and Jensen, 1983; Morck, Shleifer and Vishny, 1988; Shleifer and Vishny, 1997). Moreover the owners' portfolio risk will increase with their exposure, which may influence risk taking and expected returns (Bolton and von Thaden, 1998). Non-linear effects are not unlikely. It may be the incentive alignment dominates for small levels of blockholder ownership, whereas entrenchment effects set in at higher levels. The effect may even become positive against very high levels: If ownership is highly concentrated - and one blockholder is firmly in control - the incentive for costly tunneling activities are more internalized by the controlling owner, the higher her share of ownership - so less

expropriation should therefore take place. Moreover, in addition to agency relations, there may be other reasons why concentrated ownership can raise or lower firm value. Concentrated ownership may for example reduce the liquidity and therefore the value of a share to minority investors.

2.6.3 Multiple blockholders and Corporate Performance

Previous research shows that the presence of large shareholders, who can monitor the actions of the manager, can benefit minority shareholders (e.g., Burkart et al., 1997; Shleifer and Vishny, 1986). Following this reasoning, other large shareholders can reduce profit diversion by monitoring the controlling shareholder in firms with multiple large shareholders (Bolton and von Thadden, 1998; Pagano and Roell, 1998). Multiple blockholders can also be beneficial if ex post bargaining problems among large shareholders limit profit diversion (Gomes and Novaes, 2001), and if the expropriation requires the consent of a coalition of shareholders, as compared to a unilateral decision by one blockholder (Bennedsen and Wolfenzon, 2000).

2.6.4 Institutional Investors and Corporate Performance.

Pound (1988) proposes three hypotheses for the relationship between institutional ownership and corporate value. According to the efficient-monitoring hypothesis, institutional investors have greater expertise and can monitor managers more effectively and at a lower cost than small shareholders. A positive relationship between institutional ownership and corporate value should therefore exist. However, the conflict-of-interest and the strategic alignment hypotheses both predict a negative relationship between institutional ownership and the value of the firm.

2.6.5 Controlling Ownership and Corporate Performance

Since Berle and Means (1932) presented the separation of ownership from control, several researchers have debated and discussed the effects of concentrated (or controlling) ownership on corporate performance. So far, there has been no conclusion as to whether or not there is the relationship between such ownership and firm performance. A number of studies find that there is a significant positive relationship between

controlling ownership and firm performance (Manse et al, 1968; Radice, 1971; Boudreaux, 1973; Stano, 1976; Steer and Cable, 1978; Kesner, 1987; Alba et al, 1998; Xu and Wang, 1999). Recently, Chen (2001) examined the relationship between ownership structure and firm value in the case of China. The results show that there is a strong positive relationship between concentrated ownership and corporate value (Tobin's Q). A positive relationship between corporate value and domestic institutional shareholders is also reported. Moreover, he mentions that managerial shareholders are positively and state shareholders are negatively related to firm value respectively (Chen, 2001).

In addition, Wiwattanakantung (2001) tests the impact of ownership structure on firm performance of Thai non-financial firms listed in the Stock Exchange of Thailand in 1996. The study argues that there is no evidence to support that controlling shareholders extract corporate assets away from the firm for their own benefits. That is, firms with controlling shareholders have higher profitability (as measured by the return on assets and sales-to-asset) than those with non-controlling shareholders. The results also report that firms with family and foreign-controlling shareholders, as well as firms with more than one controlling shareholder, have higher profitability than do firms with non-controlling shareholders.

In contrast, Holderness and Sheehan (1988) suggest that there is no difference between firms with concentrated owners and those with dispersed owners. Mulari and Welch (1989) support this notion that the performance of firms with high concentrated ownership does not differ from other firms with dispersed ownership. Also Demsetz and Lehn (1985) examine the effects of concentrated ownership on firm performance. They also classify concentrated ownership into three groups: all investors, family and individual investors, and institutional investors. The results suggest that there is no significant relationship between concentrated ownership including its three types and return to shareholders. Demsetz and Lehn (1985, p. 1176) argue "the structure of corporate ownership varies systematically in ways that are consistent with value maximization".

2.6.6 Government Ownership and Corporate Performance

The rapid rising of listed companies, in which there has been significant presence of state shareholding and government control, has spurred huge amount of academic and policy research. One of the focal points in the literature has been the effects of state shareholding on corporate performance. Theoretical perspective in the literature include the assessment of possible increase in political interference costs due to state ownership, the evaluation of possible reduction in agency costs, thanks to the monitoring of state owners, and the comparison between the interference costs and monitoring benefits (e.g., Bai *et al.*, 2000; Li, 2000; Qian, 2001; Stiglitz, 1997). Empirical findings are diverse and indicate to all possible directions. For example, Xu and Wang (1999), Qi *et al.* (2000), Sun and Tong (2003), and Bai *et al.* (2004b) all suggest a negative correlation between state ownership position and corporate performance. Chen (1998) presents a finding of positive correlation. Tian (2002) argues that there might be a U-shaped relationship between government ownership position and firm performance. Sun *et al.* (2002), however, present an inversed U-shaped relationship, exactly opposite to Tian's (2002) finding.

Laixiang SUN and Tao LI (2005) in their study of Chinas' listed firms presents their theoretical model based on the following intuition. For a listed company with significant state shareholding, the state will cover part of the losses if the company is in financial trouble. This covering can be perceived as insurance from the state to insure the company against insolvency. In fact, such insurance often extended to cover the wages and salaries of the company's employees (Green, 2003). The existence of such insolvency and salary insurance makes China's listed SOEs different from a typical limited liability company in a market economy. In the case that the company's profitability level is high, the state owner will actively engage in revenue management for profit sharing and even for resources tunneling to serve other political and social objectives (Shleifer and Vishny, 1994; Bai *et al.*, 2000; Green, 2003). Managers and employees of the company participate also in profit sharing. This profit sharing is necessary for providing them incentives to exert effort. If the state-owner holds a high proportion of total shares, the expected payoff to the managers and employees becomes smaller, unless managers

decide to take higher risks. It means that higher proportion of state shareholding would induce higher risk. With the higher proportion of state shareholding and higher risk taken, there is a wider spectrum of states of the world in which no extra payoffs can be expected except for the fixed wages and salaries. This will lower management incentives and lead to lower effort. Higher risk and lower effort will lead to lower level of performance and market valuation. This perspective indicates that while in general higher proportion of state shareholding will correspond to higher risk and lower effort, the sensitivity of the company's risk and effort choices to the level of state shareholding may differ depending on the perceived level of profitability.

Given the information advantage managers and employees, once they perceive a low level of profitability, their choices of risk and effort will become less sensitive to the shareholding position of the state owner, because profit sharing and resource taking by the state owner become less likely and the insolvency and salary insurance is guaranteed. In sharp contrast, if they perceive a high level of profitability, their risk and effort choices will become highly sensitive to the shareholding position of the state owner, because profit sharing and resource taking by the state owner become very likely and the probability to receive insolvency and salary insurance goes to zero.

Consistent with their theoretical predictions, it is found that there is an insignificant relationship between state shareholding proportion in year $t - 1$ and realized performance of listed SOEs in year t due to the insensitivity of the firms' risk and effort choices to the state shareholding proportions when the *ex ante* perceived performance level is low. A significantly negative relationship, however, exists between state ownership proportion in year $t - 1$ and realized performance in year t owing to the high sensitivity of the firms' risk and effort choices to the proportion of state shareholding when the *ex ante* perceived performance level is high. Their findings are robust to various measures of firm performance and to alternative measurements of several major control variables.

2.6.7 Foreign Ownership and Corporate Performance.

A number of studies have examined the relationship between foreign exposure and growth. Following the pioneering work by Aw and Hwang (1995), recent empirical studies have extensively examined the relationship between foreign exposure and growth at the firm- or establishment-level, confirming mostly that exporters perform better than non-exporters in the static sense. Some of these studies find that good firms tend to be exporters although the impacts of foreign exposure are not clear. For instance, Bernard and Jensen (1999) indicate that exports do not always provide positive impacts on corporate performance in the U.S. However, Kimura and Kiyota (2003) reveal that exports and FDI accelerate corporate reforms in the case of Japanese firms.

The inward direction of foreign exposure, or inward FDI, has also been examined with micro data, especially focusing on the role of foreign ownership. Globerman, Ries and Vertinsky (1994) have investigated the relationship between foreign ownership and labor productivity using plant-level data in 1986. They found that foreign affiliates have significantly higher labor productivity and pay higher wages than Canadian establishments. However, these differences do not hold if firm characteristics such as size and capital intensity are controlled. Also, there are no significant differences in the performance of Canadian establishments owned by Japanese, European or U.S. companies.

On the other hand, Doms and Jensen (1998) have found significant contrasts in performance between foreign-owned and domestically-owned plants. Based on U.S. manufacturing plant-level data for 1987, they examined differences in several plants' characteristics such as total factor productivity and labor productivity between foreign-owned and domestically-owned plants. The results indicated that foreign-owned plants are more productive, more capital intensive and pay higher wages than domestically-owned firms even after controlling for industry, size, location and plant age. They also examined differences in characteristics among foreign-owned plants, plants of U.S. multinationals, plants of large domestically-oriented firms and plants of small domestically-oriented firms, finding that the plants of U.S. multinationals are the most

ownership should be concentrated whenever bankruptcy procedures and other features of the institutional environment are creditor friendly, when effective debt covenants can be imposed, and when board representation of bankers is commonplace. On the other hand, equity should be dispersed if long-term investments are more important for firm value than short-term project selection.

Jan Mahrt-Smith concludes his study thus: because management is motivated to 'do the right thing' by the difference between the toughness of debt following poor performance and the relative weakness of equity following good performance, He concludes that the powers of debt to control management are a complement to (and not substitute for) the powers of equity to control management.

2.8.0 The concept of Shareholder Value

(Booth, 1969) says that discussion of of this concept involves both normative and positive statements, and it is important to be aware of their distinction. "Normative" statements refer to what "ought" to be and are usually derived from an assumption about how the world behaves. This is most evident in standard economics topics, where assumptions about human and corporate behaviour are made to derive supply and demand curves, which are then used to explain how prices are determined. Financial theory is an application of these standard economic models to explain how prices in the capital market are determined. As such, financial economists use essentially the same tools as their colleagues in other areas of economics to predict how, for example, equity prices "ought" to be determined, and how as a result corporate management "ought" to behave. In contrast, "positive" statements refer to "what is, was or will be," it is commonly referred to as an appeal to the facts.

2.8.1 The Normative Justification for Creating Shareholder value.

It is a normative statement that creating shareholder value (CSV) is the correct goal of the firm. Booth (1969) used Figure 3 to demonstrate the dynamics. The firm is the rectangular box with the managers "inside the box" in control of the firm's operations. The firm buys labour, capital (both debt and equity) from investors, and intermediate

goods from suppliers and uses up what we commonly refer to as "free" goods, such as the right to emit pollutants and use social services provided by the state. The firm then creates its product, which it sells to consumers and in the process creates free goods, such as, for example, by increasing the level of education in the community by retraining its workforce. All of this production, in turn, occurs under the watchful eye of governments (all levels) and subject to societal pressure from other members of the community. All of these stakeholders have some claim on the firm. How this tangle of claims on the firm subsequently gets resolved in terms of the firm's objectives depends on both the legal structure of the country and the state of the markets in which the firm operates.

He (Booth, 1969) emphasizes that finance, as understood, has largely developed in countries with a common Anglo-Saxon legal heritage that places the ownership of the firm's common equity as the primary determinant of elections to the board of directors, who then have a fiduciary responsibility to act in their interests. The corollary of this legal principal is that the stockholders are primarily interested in the maximisation of their wealth and ergo the market value of the firm's common stock price. The economic justification for creating shareholder value (CSV) as the overriding objective of the firm primarily comes from an assumption implicit in most of the finance literature that all the markets in which the firm operates are perfectly competitive. This means that if the firm's employment is increased or decreased, that the employees in figure 3 are indifferent. If they are hired, they are just getting market wages, and if they are laid, off they can immediately get equivalent jobs elsewhere. Similarly, suppliers and consumers can switch to other firms, and taxes to all layers of government will be the same regardless of the firm's operations. As a result, the welfare of all other stakeholders in the firm is unaffected by the firm's operations, so that maximizing the welfare of the stockholders causes no welfare losses to these other stakeholders.

The implicit assumption underlying most of the shareholder value literature is, therefore, that there are no other stakeholders in the firm, except the stockholders! Or put another way, the normative statement that creating shareholder value should be the objective of the firm is based on the assumption that all markets are perfectly competitive. The perfect

market assumption is valid for small businesses in practically every country around the world, since they do not affect the functioning of other markets. However, for large businesses it is more questionable. In many of the less diversified European economies, the impact of certain large firms is critical for the functioning of their economies. As result, there is "worker" representation on the board of directors and the legal responsibility of the board is to take into account factors other than the interests of the stockholders. At the other extreme, creating shareholder value has become the mantra of corporate USA, since the USA has by far and away the most diversified economy and the most competitive markets.

2.8.2 Creating Shareholder Value

There are many ways in which the overall value of the firm's operations (largely the firm's revenues) can be allocated. This means that one way to create shareholder value is simply to transfer existing value to the shareholders, at the expense of these other claimants. For example, the firm can skimp on pollution controls and increase contamination of the environment, leaving others to clean up its mess. The equity holders can also engage in activities that shift wealth from the bond holders to the equity holders, as often occurs during times of financial distress. Finally, many corporate financing strategies are tax motivated and merely transfer wealth from all tax payers to the firm's shareholders. There is no theoretical justification in economics to support creating shareholder value, when it is simply a transfer of wealth from other claimants on the firm to the common shareholders. The reason for this is simply that "society" as a whole is no better off. The economic justification for creating shareholder value is based on the efficiency gains of more productive operations and a better reallocation of resources. This result stems from having managers become "value" managers, where they treat corporate resources as they would if they were the owners. (B. Balachandran, et al 1986)

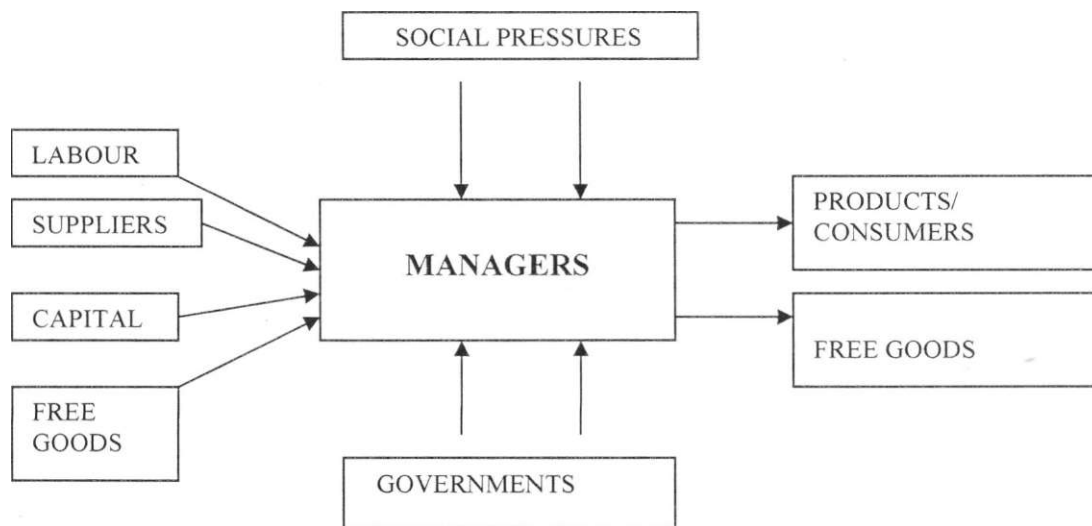


Figure 3: Creating Shareholder Value.

Source: Booth (1969)

2.9.0 Measures of Performance

Apart from controversy on the impact of ownership structure on corporate performance; questions have also been raised on the appropriate measure of performance. Financial performance has traditionally been evaluated using two approaches or methods: Accounting data based methods and Market based methods.

2.9.1 Accounting Data Based Methods

The conventional measures are accounting ratios and these include those that measure the size of the company e.g. turnover (or sales revenue), profit, or market capitalization. There are also measures of return or profitability which relate profit to sales (profit margin), capital employed (return on capital employed - ROCE) or even equity (return on equity - ROE). The third category measures growth of sales or of profit while the fourth measures corporate efficiency in terms of sales per staff or per unit of pay.

2.9.1.1 Arguments for Accounting Based Measures

Accounting numbers will reflect any actions that are taken by managers. This means wherever managers take any actions that do not work towards improving shareholders

wealth then the same will be reflected in accounting earnings figure and on any other accounting based figures or ratios.

Accounting ratios can be used to predict effects of some firm's position in future. Altman (1968) used accounting ratios to discriminate between bankrupt and non-bankrupt firms where he established that the firms could have been predicted correctly two years before bankruptcy. Similarly Wansley's (1983) showed that the price earnings ratio and other accounting ratios could be used to discriminate between firms that were takeover targets and those that were not. He concluded that a correct prediction could have been made a year before takeover. Beaver used 30 different financial ratios and he concluded that investors use the information content of ratios in predicting corporate sickness or failure and suggested that ratios can be used to predict failure five years prior to failure. These studies show that investors and other financial decision-makers can base their decision and actions on ratio analysis.

Accounting measures act as a better assessment tool on managerial performance or actions than market based measures (Kaplan, 1988). This is because market based measures are more prone to external factors that are outside managers control, for example government actions, labour shortage, general business conditions and stock price.

Accounting figures are based on the standard generally accepted rules that can be used by auditors to verify their accuracy. Thus they are better measures because both independent partners (auditors); and any users who are familiar with such rules will check them.

Accounting measures are simple to compute and the information required is always readily available. For example banks and financial institutions are legally required to publish their annual balance sheet and profit and loss at least once a year in any public daily newspaper. This means that some accounting information for the sector is readily available to any interested party through the press.

2.9.1.2 Problems with Accounting Earnings


It may surprise some, but stock market value is not created by accounting games to dress up the financial statements. This is not to deny that accounting statements are important,

they obviously are, but the fact is that the stock market looks far into the future when assessing value. A large amount of the stock price comes from future growth prospects, which are very hard to predict. It is inevitable when valuing these "growth" companies that every piece of information is scrutinized in some detail to see whether the firm's performance is still "on target." In this state of scarce and limited information, one of the most "reliable" sources is obviously the firm itself through its quarterly statements. If these results are below market expectations, without any accompanying information to explain the discrepancy, investors will extrapolate the impact into the future. The result will be an immediate impact on the stock price, with a greater effect felt for those firms with a greater "growth" component in their stock price. It is one of the ironies of finance that it is the fact that the market values operations very far into the future, that causes it to react violently to short term results. [Booth, 1969]

This result has strong implications for corporate finance. First, there is no doubt that earnings management pays off. The market does not like surprises and the management of quarterly earnings can prevent dramatic market revaluations in response to what the firm may correctly estimate to be temporary phenomena. On the other hand, it does not mean that the market is dumb and can be permanently fooled by the manipulation of financial statements. What the market is interested in is the underlying ability of the firm to generate real, not accounting earnings. This is a normative statement; however, a large amount of research over the last thirty years has gone into determining whether it is also a positive statement.

Financial statements have inherent limitations, and it follows that ratios inherit some limitations from them. Miller (1966) argued that earlier studies were theoretically and practically wrong because they emphasized individual ratios as opposed to a combination of highly reflective or multi-variate ratios that were studied by Altman.

Accounting numbers are based on ad-hoc rules specified by the accounting profession. Lack of consistency of these rules within and between firms is a problem in arriving at true *comparative analysis*. *Institutions being compared, for example, may have drawn their accounts using different accounting policies.*



When accounting numbers reflect an increased performance it is not automatic that shareholders wealth also increases correspondingly. Rappaport (1981) identified this feature in USA between 1974 and 1979 when EPS grew by 15% while in the same period return to ordinary shares was below inflation rate or negative. This means that in some situations there may be some inconsistency between accounting measures and shareholders wealth. This feature would be more significant in periods of high inflation.

Management can increase accounting earnings by using actions that do not benefit the stockholder or even decrease the firm's value. For example management may sell off assets whose market value is well in excess of book value, or change accounting policies like depreciation methods.

Window dressing of accounts is another disadvantage. This is serious in the banking sector as it is easily employed to derive some desired balance sheet appearance. It is mainly used to conceal deteriorating financial position

2.9.2 Market Based Measures

The accounting based measures of performance have been challenged as suffering from bias brought about by historical cost accounting conventions as well as inflation. Out of such challenges and the above negative arguments, other non-accounting-based methods have developed, the most prominent being the market based. Shareholders are interested in what they can fetch in case they sell their share now or in the future. This means market values would be of more relevance to them than accounting based or book values.

2.9.2.1 What Does the Market Value?

Again a discussion of what drives market values gets deep into normative and positive statements, but key insights can be gained from how professional valuers approach the problem. Most texts point out that accounting earnings are not cash, since they can't be spent. Further, since investors normally invest cash in the firm, they are interested in getting cash back. The standard finance answer to what the market values is therefore simple: future cash flows. As a result, the discounted cash flow (DCF) approach is the

recommended valuation method in every finance textbook and the basis for most "fairness opinions" in professional valuations. However, defining and calculating cash flow is somewhat controversial, since there are several definitions circulating in the investment community.

2.9.2.2 Advantages of Market Based Measures

Managers cannot easily manipulate share prices values as compared to accounting numbers that can easily be manipulated through change of accounting policies. Share prices are derived from market forces (demand and supply) by investors, or brokers who act on any information related to the firm. This process makes it a more objective measure than the accounting measures which are based on arbitrary accounting principles agreed by managers.

Measuring shareholder wealth using market based information is simple. Change in shareholders wealth is equal to change in share price over a period plus dividends over the period (that is, after making adjustments for inflation).

Market share price is seen to be a better estimate of future cashflows than book values.

2.9.2.3 Disadvantages of Market Based Measures

A share price may not really reflect the real value of the firm because it considers only that information which is available to the public and may not include any inside information, "the people within the firm do not want to tell the world about all those transactions, partly because it would be costly and partly because it would give out information the firm might regard as proprietary" (Fisher Black, 1980). This means the conditions of inadequate disclosure of information forces users of financial statements to manipulate what is reported to get out the best estimates of a firm's value.

It may be unfair to use share prices to evaluate financial performance of managers because share prices incorporate external market factors that are beyond the managers' control. If used it may cause some favorable transfer of wealth between shareholders and managers.

CHAPTER THREE - RESEARCH METHODOLOGY

3.1 Research design

The aim of this study was to explore the relationship between ownership structure and corporate performance. The population of all major oil companies operating in Kenya was considered.

3.2 Population

The population of interest for this study comprised the companies that form the Kenyan Oil industry. A census of the 13 major oil companies was taken.

3.3 Sources of Data

Secondary data was used for the study. I restricted my analysis to 13 oil firms. Financial performance data (balance sheet and income statement) for listed firms was obtained from the NSE database. The annual reports for the unlisted firms were obtained from the individual companies finance/Accounting departments and from the information filed with regulatory agencies of the respective companies. Similarly, share ownership data for listed firms was obtained from a NSE database while for the unlisted firms were obtained from file records at the registrar of companies.

3.4 Period of Study

The period of the study was the three years 2001 to 2005

3.5 Hypotheses

The study focused on testing the following hypotheses:

H₀: A firm's financial performance is a function of the distribution of equity ownership among Individual investors, institutional investors, local investors, foreigners and the government.

R\): A firm's financial performance is not a function of the distribution of equity ownership among Institutional investors, local investors, foreigners and the government.

3.6 Data Analysis.

3.6.1 Definition of Variables.

The study focused on the following variables

3.6.1.1 Performance measure.

The study employed the accounting based Return on Capital Employed (ROCE) as a measure of firm performance. In line with similar studies of this nature, ROCE is defined as the operating earnings before interest, depreciation and taxes over the capital employed. This is the return to the total capital of the firm i.e. on both equity holders as well as debt holders.

3.6.1.2 Explanatory variables

The most important explanatory variables used in the study are ownership variables. Equity ownership variables include percentage of shares owned by; Individuals, institutions, locals, Foreigners and the Government

3.6.1.3 Control Variables

The principal control variables used are Sales and Age. Sales are a proxy for the size of a firm. Size of a firm can have a significant influence on firm performance and a proxy for firm size is used in almost all studies explaining firm performance. Age is also considered to be an important determinant of firm performance. Older firms are more experienced, receive the benefits of learning and are associated with first mover advantages. However, older firms are also arguably prone to inertia and are less flexible in their ability to adapt to competitive pressures.

3.6.2 The chi - square (χ^2) test

The chi - square test of independence was used to test the hypothesis. The sample companies were ranked in ascending order of each of the ownership structure variables.

They were grouped under three categories:

- Lowest amount of foreign ownership

- Moderate amount of foreign ownership
- Highest amount of foreign ownership

Similarly, for each of the three years, the firms were ranked in ascending order of performance. Return on Capital Employed (ROCE) was adopted as the indicative measure of performance. Appendix 3 shows a summary of ROCE ratios for the various firms over the five years considered.

The data were summarized in 3X3 contingency tables as per the format shown below:

		Foreign Ownership			
Financial Performance	Low	Moderate	High	Total	
Poor					
Average					
Good					
Total					

The threshold cut-off points for both ownership structure and firm financial performance were set out as follows:

Ownership Structure (%)		Financial Performance (ROCE)	
Low	Below 40%	Poor	Below 20
Moderate	40% to 74% ,,	Average	20 to 54
High	75% plus	Good	55 plus

The level of significance was set at 5% and with 4 degrees of freedom i.e. (3-1) (3-1), $\chi^2_{0.05,4} = 9.488$. The decision rule was therefore:

Accept the null hypothesis if $\chi^2 > 9.488$;

Reject the null hypothesis if $\chi^2 < 9.488$.

The data collected was analysed using the SPSS application software to compute the value of χ^2 for each of the ownership structure parameter for each year. The value obtained was then compared with the critical value of 9.488 and the reject Vs accept decision made in each scenario.

The same procedure was repeated for other forms of ownership structure:-institutional vs. individual, non- government vs. government and local vs. foreign.

CHAPTER FOUR - DATA ANALYSIS AND INTERPRETATION OF FINDINGS

The primary objectives of this study were to determine the ownership structure of the oil companies in Kenya and establish whether there is a significant relationship between ownership structure and the financial performance of oil companies in Kenya.

4.1 Ownership structure of Kenyan oil corporations

The first objective was to answer the basic question "**who owns the oil companies operating in Kenya?**" To achieve this data on ownership structure was collected for 13 oil firms. The data collected included the category of the shareholders and number of shares held by each category. The proportionate percentage of shareholding was then computed for each shareholder category. This is detailed in appendix 4.

The data was then categorized and analysed along the three perspectives that form the framework of this study, that is, foreign vs. local, institutional vs. individual, and non-government vs. government.

4.1.1 Foreign vs. local Ownership

Analysis of the collected data shows that 54% of the oil firms in Kenya are wholly locally owned; 15% are partially locally owned and partially foreign owned while only 31% of the firms are entirely foreign owned

	No. of firms	%	Cum %
100% Foreign owned	4	31	31
100% locally owned	7	54	85
Partially Owned	2	15	100
Total	13	100	

Table 1:- Foreign vs. Local Ownership

The proportionate foreign ownership for the two firms is summarized in Table 2 below

	No. of Firms	%	Cum %
Over 75% Foreign	0	0	0
50-74% Foreign	0	0	0
25-49% Foreign	1	50	50
Under 25% Foreign	1	50	100
Total	2	100	

Table 2:- Proportionate Foreign Ownership

As indicated in table 2 above, none of the 2 firms representing 0% have more than 75% foreign ownership; while 50% of the firms have less than 25% of foreign control. On average about 0% of the partially foreign owned firms have over 50% foreign control.

Although only a small proportion of Kenyan oil firms possess foreign shareholdings, their stakes in individual firms are substantial. While their numbers and holding levels are expected to rise in the foreseeable future, in the short and medium term, domestic shareholders have to don the mantle of corporate reformers.

4.1.2 Institutional vs. Individual Ownership

	No. of Firms	%	Cum %
100% Institutionally Owned	4	31	31
100% individually Owned	3	23	54
Partially Owned	6	46	100
Total	13	100	

Table 3:- Institutional vs. Individual Ownership

Three firms were found to be fully individually owned; while four of the firms were found to be fully owned by institutional investors.

Though it was not within the objectives of the study to investigate the ultimate ownership of the institutional shareholders that are listed as being the owners, in some of the cases where this was attempted it emerged that the ultimate owners were mostly individuals. This study, however, made use of the primary shareholders without investigating the ultimate owners.

Six firms were found to be partially institutional and partially individually owned. Their proportionate institutional ownership is summarized in table 4 below.

	No. of Firms	%	Cum %
Over 75% Institutional	2	33	33
50-74%	2	33	66
25-49%	1	17	83
Under 25%	1	17	100
Total	6	100	

Table 4:- Proportionate Institutional Ownership

As indicated in Table 4 above two of the partially institutional and partially individual owned Firms representing 33% have institutional ownership of over 75%. A further 33% of the partially institutionally owned firms have more than 50% institutional ownership. This implies that a great proportion of oil firms in Kenya are owned by institutions.

13 Non-government vs. Government Ownership

	No. of firms	%	Cum %
100% non-Govt Owned	10	77	77
100% Govt. Owned	1	8	85
Partially Owned	2	15	100
Total	13	100	

Table 5:- Non-Govt vs. govt Ownership

Out of the thirteen firms examined, ten firms representing 77% are 100% non-government of Kenya, while only one firm representing 8% of the firms is 100% government owned.

Five firms are partially non-government owned in the following proportionate percentages:

	No. of firms	%	Cum %
Over 75% non-government	0	0	0
71-74%	0	0	0
41-49%	0	0	0
Under 25%	2	100	100
Total	2	100	

Table 6> Proportionate Government Ownership

As indicated in table 6 above, none out of the two partially government owned representing 0% has government control over 50%. Thus 100% of the partially government owned firms have no or limited government ownership.

4.2 Ownership Structure and the Financial Performance of oil corporations in Kenya

Financial performance of the oil sector corporations in Kenya was found to have been on a downward trend during the period under review. Return declined steadily from a peak net industry profit before tax of Kes 5.89 billion in 2001 to Kes 1.2 billion in 2005.

A close analysis of the financial result showed that while some firms were doing well, the loss making ones were indeed in bad state.

This study made use of statistical analysis to determine whether a significant relationship exists between ownership structure and the financial performance of oil corporations in Kenya. The financial performance data as represented by ROCE was available for 13 firms as summarized in appendix 3.

Co-relation of the data on ownership structure and financial performance was summarized in the 3x3 contingency tables. The Pearson's Chi square, X^2 , values were computed under each of the three perspective, compared to the critical value, as well as the decision to reject or accept the hypothesis for each of the years considered are detailed in tables 7 to 9 below.

4.2.1 Foreign and Local Ownership

Year	2001	2002	2003	2004	2005
X² value	12.546	15.328	24.852	8.490	14.479
Critical X² Value	9.488	9.488	9.488	9.488	9.488
Reject/Accept?	Accept	Accept	Accept	Reject	Accept

Table 7:- Foreign Ownership and Financial Performance

In 4 out of the 5 years the study came up with the decision **to accept** the null hypothesis that "there is significant relationship between financial performance of oil companies in Kenya and ownership structure".

The study therefore establishes that a significant relationship exists between extent of foreign ownership and financial performance of oil corporations in Kenya. Companies with a higher proportion of foreign ownership were found to perform relatively better than those with a lower proportion of foreign ownership.

Foreign owned firms also generally have a wide global representation in different parts of the world. The local management thus benefits from "migration of best practice" from other markets where the particular firms operates. The managers in these institutions also benefit from international exposure to the operations in other market where the particular firm is represented.

The study establishes that foreign-owned firms not only reflect superior static characteristics but also achieve faster growth. In addition, foreign investors appear to invest in firms that may not be profitable immediately now but will potentially have better performance in the future. The results imply that foreign investors bring useful firm-specific assets into the Kenyan market, which may work as an effective catalyst for necessary structural reform.

A strong performance culture generally tends to be evident in foreign owned companies than in locally owned ones. The foreign "head office" tends to set very stretching financial target for their management teams who are then held responsible for the achievement and are rewarded appropriately by way of bonuses pegged on performance and staff share schemes. Failure to achieve the financial target has negative consequences that include no bonus Payment, no annual salary reviews, no promotions and de-hiring on non-performance basis.

The management teams of the foreign .owned firms are therefore bound to ensure more efficient utilization of resources at their disposal and employ more prudent risk and financial management policies and processes.

Additionally, foreign firms tap into their international reputation and earn the trust and confidence of their customers and potential customers. They have a strong brand that customers are able to identify with. Total, Caltex, BP/Shell e.t.c for example, are strong internationally recognized brands that customers are able to identify with and entrust their business with. This is in contrast to local firms which do not enjoy the global reputation. This international reputation reduces the cost of funds for the international firms and increase potential for large volume business especially from multinational corporate clients.

Among the domestic shareholders, the study shows that domestic corporations positively influence firm performance although not at the same magnitudes as for foreign corporations. Nevertheless, the result assumes significance only if domestic corporations hold large blocks of shares, which enhances their monitoring abilities and incentives. Moreover, as firm managements professionalize, travel further along the learning curve and spill over effects begin to manifest themselves, the quality of the monitoring effort may increase. However, there is evidence to suggest that these benefits could be eroded if these domestic corporations belong to the same group.

4.2.2 Institutional vs. Individual ownership

Year	2001	2002	2003	2004	2005
X2 Value	3.583	2.387	5.653	0.857	9.581
Critical x2 Value	9.488	9.488	9.488	9.488	9.488
Reject/fail to reject?	Reject	Reject	Reject	Reject	Accept

Table 8:- Institutional Ownership and Financial Performance

In 4 of the 5 years the study came up with the decision to reject the null hypothesis that "there is significant relationship between firm financial performance in Kenya and ownership structure".

The analysis of institutional ownership indicates no significant relationship between Institutional ownership and the performance of the Kenyan oil firms. Only in one specification institutional ownership was found significant, eventually pointing to the conflict-of-interest and the strategic-alignment hypotheses proposed by Pound (1988).

Also, as discussed above, financial performance of the firms is dependent on the extent to which the management teams are made accountable for the performance of their institutions. Such accountability for performance does not appear to be different for institutionally vis-a-vis individually owned firms

It implies that the presence of block holders is not significant in explaining corporate performance. However, the results would be different if the institutional investors have controlling shares. Controlling ownership has a strong incentive to increase corporate performance based on both market and accounting measures. Consequently, firms with controlling ownership perform significantly higher than those with non-controlling ownership. This is consistent with Wiwattankantung (2001) who argues that controlling shareholders do not seem to expropriate firm's benefits but have high incentive to increase firm performance. Also, the firms with controlling shareholders do perform higher than those with non-controlling shareholders.

4.2.3 Non-government vs. Government Ownership

Year	2001	2002	2003	2004	2005	
X2 Value	2.754	6.231	5.178	1.687	2.435	1
\ CrvWtaX -x.l \a\we	s>.m	9.488	9.488	9.488	9.488	
Reject/Accept	Reject	Reject	Reject	Reject	Reject	

Table 9:- Government Ownership and Financial Performance

In all the 5 years the study came up with the decision to reject the null hypothesis that "there is significant relationship between firm financial performance in Kenya and ownership structure".

The study therefore established that no significant relationship exists between extent of government ownership and financial performance of Kenyan oil companies. Firms with a lower proportion of non-government ownership were not found to perform relatively any better than those with a lower proportion of government ownership.

This results therefore contradicts the study by Tao LI and Laixiang SUN (2005), who finds that the government ownership significantly influences corporate performance because the government shareholder participates actively in revenue management for profit sharing and even for resources tunneling when the company's profitability is high. And that firms with significant state shareholding have little to worry when it is in financial trouble because the state owner provides insolvency and salary insurance.

CHAPTER FIVE- SUMMARY, CONCLUSIONS & RECCOMENDATIONS.

5.1 Summary of findings

This study examined the effects of ownership structure and firm performance based on the data sample from Kenya oil sector firms between 2001-2005. The ownership structure is classified as (i) Foreign (ii) Institutional and (iii) Government ownership. Firm performance measures were represented by the profitability ratio (Return on Capital Employed). Chi-square test of independence was employed to establish independence or otherwise with the firms financial performance. Based on the analysis, the results of the relationship between ownership structure and firm performance in the case of Kenyan oil firms are presented.

54% of the oil firms in Kenya are wholly locally owned, 15% *partially foreign and partially locally owned* and 31% *are entirely foreign owned*. Foreign ownership and firm financial performance in Kenya are not independent. In other words a significant relationship was found to exist between the level of foreign ownership and the firm's financial performance. 31% of the oil firms in Kenya are wholly institutionally owned, 52% partially institutionally and partially individually owned while none are entirely individually owned. 66% of the partially institutionally owned have more than 50% institutional ownership, implying that a great proportion of the Kenyan oil firms are institutionally owned. Institutional ownership and firm financial performance in Kenya are independent. In other words no relationship was found to exist between the extent of institutional ownership and oil firm's financial performance. 77% of the oil firms in Kenya have no government ownership, 15% are partially government and partially non-government owned and only 8% are entirely government owned. Non-government ownership and firm financial performance in Kenya were found to be independent. The extent of government ownership was found to be un-related to firm financial performance.

5.2 Conclusions

Kenyan Oil companies exhibit various forms of ownership structures in relation to the extent of:-

- Foreign ownership
- Institutional ownership
- Government ownership

Only the extent of foreign ownership was found to have a significant relationship to financial performance of the oil corporations. These results imply that foreign investors bring useful firm-specific assets such as technology, managerial ability, corporate governance, and others into Kenya. The Kenyan economy now requires substantial structural reform in order to meet new challenges in the era of globalization

The external benefits from hosting FDI are potentially large. For instance, Blomstrom, Konan and Lipsey (2000) argued that inward FDI would contribute to restructure host countries' economy, bringing new firm specific skills and new industries to countries that lack them or preserve the rents on workers' skills in sectors where domestic firms have lost their firm specific advantages

In my view, inward FDI is an essential element to introduce a new way of thinking, stimulate competition, and catalyze necessary reform. Inward FDI helps move the Kenyan economy a step towards substantial reform. Substantial sunk cost for foreign firms to enter the Kenyan market still exists. Considering the possibility of market failures, there are good reasons for the government to conduct inward FDI promotion policies. Indeed, policy neutrality is not enough to attract FDI. To attract foreign investors, Kenya must prove itself to be attractive destination for FDI, compared with other competing investment locations. Policymakers must clearly advocate foreign investors where and what sort of location advantages exist in Kenya.

5.3 Limitations of the study

The results of this study are interpreted in light of the following limitations.

Secondary data was used in the study. Given that most of the firms in this industry are private limited companies, access to financial statements was limited. The data used for the analysis were in some instances provided by the corporate managers as best estimates. Empirical results must therefore be viewed in relation to the nature of the data and considerable care taken in using the information as well.

Ownership structure was held constant throughout the five-year period considered in this study. Though there may have been slight variations in ownership structure during the period, the information was not readily available. The variations however were deemed insignificant for purposes of this study.

Further, the information obtained on ownership structure may not be entirely accurate. Some firms are institutionally owned. These institutions however are themselves individually owned.

Return on Capital Employed (ROCE) was adopted as a measure of the companies' performance. Financial statements have inherent limitations and it follows that ratios inherit some limitations from them. The financial statements, for example, have been prepared under different accounting policies. The study is thus constrained by the limitation of such financial statements' preparation.

ROCE is one of the many measures that may have been adopted to gauge financial performance. It is likely that the use of other measures of performance may yield different results.

5.4 Suggestions for Further Research

Further research could be carried out using a different measure of performance and test of independence or otherwise with ownership structure. Further a weighted basket of measures may be adopted.

Research could also be carried out to establish the nature of relationship between ownership and firm financial performance. This could be extended to establish if there exists an optimal foreign-local ownership mix that would maximize firm performance in Kenya.

Further research may be carried out to establish specific factors that explain the source of differences in financial performance of the oil companies in Kenya.

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Appendix III

Companies marketing Oil products in Kenya and members of PIEA

Senior Corporates

- 1. Caltex Oil Kenya**
- 2. Kenya Shell Ltd/BP Kenya Ltd**
- 3. Total Kenya Ltd**
- 4. Kobil Petroleum/Kenya Oil Trading Company.**
- 5. Mobil Oil Kenya**

Junior Corporates

- 1. Dalbit Petroleum Ltd**
- 2. Galana Oil Kenya Ltd**
- 3. Fuelex Kenya Ltd**
- 4. Engen Kenya Ltd**
- 5. Hass Petroleum Ltd**
- 6. Petro Oil Kenya Ltd**
- 7. National Oil Corporation**
- 8. Triton Petroleum Ltd**

Appendix III

Letter of introduction

**University of Nairobi
School of business
P.o box 30197,
Nairobi, Kenya.**

**Tel: 732160
Telegram; "varsity", Nairobi
Telex: 22095 varsity**

Attention: To whom it may concern

**Sender: Agutu Collins Odhiambo
Registration: D61/8201/2004**

Is a Masters of Business Administration student at the University of Nairobi.
He is required to submit as part of the course work assessment, a research project report on **THE EQUITY STRUCTURE AND CORPORATE PERFORMANCE - A CASE OF THE KENYAN OIL INDUSTRY** and would appreciate if you help him in data collection.

Please be assured that all your responses shall be kept strictly anonymous and confidential and shall only be used for academic purposes and destroyed after data analysis is done.

A copy of the research findings will be availed to you if you so wish after the completion of the study.

Thank you in advance.

**Yours faithfully,
Collins Odhiambo Agutu**

Appendix III

A summary of ROCE ratios for the various firms over the five years considered.

		FIRM PERFORMANCE - ROCE				
FIRM		2001	2002	2003	2004	2005
1	Caltex Oil Kenva	33.9	38.46	54.99	57.85	63.46
2	Dalbit Petroleum Ltd	3.38	4.92	6.59	7.26	4.56
3	Engen Kenya Ltd	7.96	5.59	10.09	30.09	49.69
4	Fuelex Kenva Ltd	-8.73	25.33	13.6	41.97	49.71
5	Galana Oil Kenya Ltd	16.34	13.62	18.82	34.46	-6.06
6	Hass Petroleum Ltd	12.91	13.1	17.59	2.68	-1.78
7	Kenva Shell Ltd/BP Kenva Ltd	68.18	49.73	57.35	54.54	63.46
8	National Oil Corporation	10.49	10.3	10.68	15.33	25.21
9	Mobil Oil Kenya	11.38	12.47	10.1	18.92	27.88
10	Petro Oil Kenya Ltd	8.22	3.84	6.11	2.75	46.51
11	Kobil Petroleum Ltd	10.74	12.24	17.69	20.11	14.06
12	Total Kenva Ltd	17.49	15.46	24.65	29.94	22.47
13	Triton Petroleum Ltd	-4.63	4.54	17.21	19.95	27.08

Appendix IV

Summary of ownership structure for Kenyan Oil Corporations.

	FIRM	OWNERSHIP STRUCTURE					
		Local	Foreign	Institutions	Individuals	Govt.	Non Govt.
1	Caltex Oil Kenya			100			100
2	Dalbit Petroleum Ltd	100			100		100
3	Engen Kenya Ltd	93	7	28	72		100
4	Fuelex Kenya Ltd	100			100		100
5	Galana Oil Kenva Ltd	100		93	7		100
6	Hass Petroleum Ltd	100		100			100
7	Kenya Shell Ltd/BP Kenya Ltd		100	74	26		100
8	National Oil Corporation	100		90	10	100	
9	Mobil Oil Kenya		100	87	13		
10	Petro Oil Kenya Ltd	100		100		9	91
11	Kobil Petroleum Ltd	100			100		100
12	Total Kenya Ltd	20	80	88	12	2	98
13	Triton Petroleum Ltd	64	36	100			100

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