INCENTIVE AND ENTRENCHMENT EFFECTS OF A LARGE SHAREHOLDER FOR COMPANIES LISTED IN NAIROBI STOCK EXCHANGE (NSE)

BY

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DECLARATION

This management research paper is my original and has not been presented for the award of a degree in any other university.

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This management research paper has been submitted for examination with my approval as the University supervisor

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DEDICATION

I would like to dedicate this paper to my wife Ruth for being with me all the steps throughout the study process encouraging me and celebrating with me on all successes along the way. It has motivated me to see it to the end.

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ABSTRACT

This study sought to establish the extent to which the largest shareholder affects the value of the firm. The incentive effects come about when the interests of the largest shareholder and those of the firm are the same. The findings showed that at lower percentage levels of the largest shareholder the value of the firm is functionally rising reaching an optimum at within the 30 – 60 % range, after which the entrenchment effects start to set in and very steeply so, such that the value of the firm starts to decline drastically. This is typical of divergence of the largest shareholders interests and those of the firm as the largest shareholder can pursue and pass through the board practically all operational and managerial decisions without resort to the minority shareholders.

The results thus showed that there was an optimum percentage level at which the largest shareholder is recommended for firms quoted at the Nairobi Stock Exchange (NSE) which is between 30 % and 60 %. Within this range, the value of the firm with a large shareholder is highest. The study also showed that it is better for the firm to have a large shareholder at levels below 30 % than at levels higher than 70 %

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CHAPTER ONE

1.0 INTRODUCTION

1.1 Background

The effect of ownership structure on the value of the firm with an emphasis on large ownership has been extensively researched in other economies, however, the Nairobi Stock Exchange and other African stock exchanges have not received similar attention. Investors with large ownership stakes have been found to have a strong incentive to enhance firm's value, (Shleifer, Andrei, and Vishny, 1997), who stated that, large shareholders have both a general interest in profit maximization and enough control over the assets of the firm to have their interests respected. If the control ownership exceed cash-flow ownership then the principal-agent conflict of interest (Jensen and Meckline, 1976) sets in and entrenchment effects reduces the value of the firm.

The divergence between cash-flow rights and control rights occurs where a shareholder is able to exercise control of firm's operations beyond the cash-flow rights. Control is often enhanced beyond ownership stakes through pyramid structures, cross holdings among firms and also through dual class shares. Also there is a general indifference to the firms operations by small shareholders due to the onset of free rider concept. Different cultures have markedly different structures. For instance, in the U.S. a study conducted by Vishny et al (1988), found an inverse U- shaped relationship between managerial equity ownership and firm valuation. This work is complemented by Stulz, Rene, 1988. The conclusions reached in the papers were that a firm's performance improves with

managerial ownership, but after a point, managers become entrenched and pursue personal benefits at the expense of outside investors.

My concern in this paper however, is on investors generally not limiting to managerial ownership. Further, in listed companies in the Kenyan NSE, a close perusal of shareholding for companies listed therein shows that it is unlikely that an individual is directly a major shareholder so as to exercise direct control other than through a pyramid ownership structure. An exemption is Mr. Paul Wanderi who holds 13.28% of equity in CMC Holdings, making him the largest shareholder. Other companies have major shareholder being either other listed companies, private companies (the majority), GOK, Associations, Nominees etc. The 10 largest shareholders are provided in Published Financial Statements of firms listed in the NSE as a legal requirement.

Vishny et al (1997), emphasizes this relationship. They state. 'As ownership gets beyond a certain point, large owners gain nearly full control of the company and are wealthy enough to prefer to use firms to generate private benefits of control that are not shared by minority shareholders'

In U.S. firms ownership structures are widely dispersed, this dispersion does not necessarily mean there are no companies in U.S. with a concentrated shareholding, a study by Clifford Holderness and Dennis Sheehan identified over 650 such companies. It found out that it is there relative numbers to the widely dispersed ones. A large block of shares may give effective control even when there is no majority shareholder, for

instance, Bill Gates owns about 20 percent of Microsoft. This block ensures that he exercises high operational control. To be able to study the relationship between control and ownership, it is necessary to study structures with concentrated ownership as it has been done in Germany, Canadian, and East Asian firms. East Asian firms particularly show major divergence between cash-flow rights and control rights; Managers of these East Asian companies are also related to the major shareholders, making it possible to analyze the relative importance of incentive and entrenchment effects on firm value. Firm value is measured by Market-to-book ratio; this is the ratio of market value of all shares i.e. no. of shares issued multiplied by the share price at the specific time against the book value of its Debts and Preference shares whenever applicable. Book value of the firm is taken from the firm's published Financial Statements.

1.2 Ownership and Control defined

In their paper, Claessens et al (2002), eventual ownership for firms under analysis was traced. Often immediate shareholdings were corporate entities, nonprofit foundations or financial institutions. They traced their owners and owners of those owners to the individual owners, often they found family members were the eventual owners and they defined that family as a group. Separation of ownership and control required analyses of cash-flow rights and control rights. Suppose in a company, an individual owns 20% shares in company 'X'. The company in turn owns 30% in another company 'Y'. The cash-flow rights for the individual in company 'Y' are 6%, but his control rights are 20% in company 'Y'. A cut-off point has been determined beyond which the largest shareholder is deemed to have effective control, this is 10%.

Control of ownership through pyramidal shareholding of listed corporations was recognized to have some limitations. In Kenya, ownership of public corporations may be in the hands of unlisted corporations as is the case of the National Social Security Fund in Kenya, The Government of Kenya, The Agha Khan Foundation, Multinational Investor whose equity shareholding is not available locally, etc. This may result in misreporting on measures of ultimate control and ownership. In Vishny et al (1997) 'Samsung Corporation, as part of the Samsung "Chaebol", is partly owned by Samsung Life Insurance, which is not listed. But Samsung Life Insurance is controlled by the same family that has a large direct stake in Samsung Corporation, increasing the family's overall control stake in Samsung Corporation.'

Besides control and underreporting, group affiliations may also affect firm valuation because of related party transactions, which are not always done at an arms length basis. The effect could be a cost or a benefit to the company in question depending on the effect to the group activities.

Control of corporations in the East Asian Economies using the 10% cut off point indicated that the majority of the firms were family owned. This is the same throughout the 8 economies, which were studied. This ownership structure is replicated again in the 20% cut off, at the 40% cut off however, a large percentage of firms are widely dispersed and this is still closely followed by the family ownership. Contrasting this with the Kenyan economy a bigger percentage of the 53 listed companies are privately owned, while others are held by multinational companies, State owned and including state

controlled NSSF follow closely. The percentage held by the majority shareholders for 45 of the 53 companies traded in the NSE shows that 4.5% of the companies have a majority shareholding of less than 20%; indeed these are only two companies, CMC whose largest shareholder has 13.28 % and NIC bank at 15.9% respectively. At the cut off of 30%, we have 27.3% of the companies and more than 50% cut off level, 34% of the companies. This shows a very high degree of concentration it therefore renders itself in this respect to analysis of incentive and entrenchment effects more than in a widely dispersed economy.

This study takes firms analysis for the year 2006, this is because the data from all the firms will be available and will also be closest to the time of the study. In Claessens Et al (2002) the year 1996 was studied across 1,301 firms publicly traded firms across eight East Asian economies. This study wishes to replicate Claessens' study but at a smaller scale confined to the Kenyan economy.

The ownership of the majority shareholders has been found difficult in that except for government ownership, private companies' shareholding is not readily available. Similarly, tracing ownerships for the multinationals that have majority shareholding in Kenyan traded companies also poses its own difficulty. The study endeavered to trace the pyramidal ownership to the individuals or families. Some control may be exercised through common ownerships through the private holdings, which would therefore remain hidden from this study. Also some companies may be related through their common shareholders and thus effect some transactions beyond arms length. Still some family relationship could be evident on the outset; Agha Khan Foundation is a major shareholder

in four companies. NSSF and GOK are major shareholders in six out of the forty-five analyzed. Unilever Tea, which is itself a quoted company whose major shareholder is Brooke Bond Kenya (a private company), is the major shareholder of Limuru Tea, also quoted in the NSE. Also Williamson Tea is the major shareholder to Kapchorua Tea. Kapchorua Tea has its major shareholding as Ngong Tea, a private company.

These sort of underestimates were equally recognized by Claessens et al (2002), by stating 'Because we likely underestimate ownership and influence of large shareholders for group-affiliated firms, we may underestimate the effect of ownership structures on firm valuation.'

Vishny et al (1997), also encountered a similar predicament in their analysis of East Asian companies, they stated 'Complex ownership structures and group –affiliated corporations presumably increase opportunities for the entrenchment of large shareholders' they noted the possible underestimation of the effect of ownership structures on firm valuation. Thus, the inability to cover the unlisted firms in a group hampered full analyses. The same applies to the Kenya's NSE.

1.3 Hypotheses setting

The paper aimed to seek evidence that there was or otherwise effects on firm value when there is a controlling shareholder. The hypotheses being tested is two pronged, first it is premised on the thinking that the more concentrated cash-flow rights in the hands of the largest shareholder are, the stronger is that shareholder's incentive to have the firm run properly. The corporation being run properly will increase his wealth. His interests are therefore congruent to those of the firm.

On the other hand when a large shareholder has control beyond his cash-flow rights, he gets entrenched and uses his control to gain personal benefits to the detriment of other shareholders. This is a typical agency problem where the shareholders interests are divergent with the firm's.

In this study, the above two were covered by one hypothesis and it was proposed:

H_O "There is no relationship between firm's value and largest shareholders cash-flow rights"

$H_{A:}$ "There is a positive relationship between a firm's value and largest shareholders cash-flow rights

1.4 Objectives of the study

To determine to what extent the value of the firm is affected by the level of shareholding of the major shareholder.

1.5 Importance of the study

To Academicians- To add to the body of knowledge in the theory of value of the firm and corporate governance

To individual investors- When an optimum level of major shareholding is proven empirically, this information will be used in making investment decisions.

To Investment Advisers- to use the information as a guide when advising investors.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

The predominant academic view of shareholder incentives and entrenchment effect on firm value today firmly rests on the American, Asian and to a smaller extent, the European experience. In the United States, where economic analysis largely dominates the scene, most corporate analysis scholarship continues to analyze the shareholder incentives in terms of agency relationships, meaning that the interests of stakeholders other than shareholders are usually left on the sidelines.

2.2 Definitions: Ownership and Control

Shareholder incentive and entrenchment effect must not be confused with shareholder protection against outright expropriation, resulting from self-dealing, either by managers or by controlling shareholders. Shareholders (and other constituencies) can be well-protected against misappropriation of assets or stock dilution, while at the same time having little to no influence on decision making.

Whereas shareholders are left with residual cash flows, they do not have the privilege to make decisions on how the resources of the firm will be allocated, which is why their relationship to the management of the firm is said to be of primary importance. As residual risk-bearers, shareholders are said to have the best incentives to monitor other constituencies, maximize the total value of the firm and thus social welfare; thus, residual risk bearing should be aligned with residual control and the power to change the arrangement of the use of production factors. If managers are given incentives to

maximize shareholder value, it follows logically that all other constituencies, whose rights are fixed contractually, receive the full maximum value as well. From this stems the notion of shareholder primacy and the fact that shareholders are said to be the beneficiaries of managers' fiduciary duties.

Cash-flow rights and control rights diverges where a shareholder is able to exercise control of firm's operations beyond the cash-flow rights. Control is often enhanced beyond ownership stakes through pyramid structures, cross holdings among firms and also through dual class shares. In this paper, a distinction is made between cash flow rights and control rights by using information on ownership structures that that demonstrate divergence of the two.

The cut off point above which the paper assumes that the largest shareholder has effective control over the intermediate and final corporations is 10 % due to the ownership structure of most companies at the Nairobi stock exchange. Firm valuations for group-affiliated firms could be lower or higher than independent companies depending on the net gains they receive from the group.

In this study, all the firms studied have equity shares, there are no known cases of dual class shares within the NSE. Dual class shares bestows a higher control on the operations of a company to a specific shareholders often a super class shares such that a share in this class may have say 10 voting powers over the normal shares, it may also specify that some specific decisions will need to be vetted by these shareholders. Often they are

given to the founders of the organization which are inherited in the family. Empirical studies show that existent of dual class shares reduces value of the firm.

2.3 Ownership concentration and firm value

Mark j. Roe (2003), in his paper pointed out to that large shareholders may easily expropriate stakeholders. This paper has focused on the large shareholder incentives and their cash flow rights. He argued that corporate law does not even try to directly control the cost of managerial mismanagement or non-conflicted disloyalty, from managers not working hard enough for shareholders. In that sense, shareholder influence relates to institutions that determine whether managers are forced or given incentives to pursue shareholder interests within the discretion assigned to them by corporate law.

He argues that as a result of different degrees of holdup, stronger shareholder influence, in particular, the presence of concentrated ownership may mean that legal instruments that increase the bargaining power to non-shareholder constituencies may reach a local optimum.

Gomes (2000) suggests that high ownership concentration is a signal of the controlling owner's commitment to build a reputation for not expropriating minority shareholders. Therefore, the alignment effect suggests that increasing ownership concentration beyond the minimum level for effective control will reduce opportunistic behavior by controlling owners, and hence their incentive for managing earnings upward.

While it's understood that a controlling shareholder has the right to steer the company, he need not do so at the expense of minority shareholders. Sorkin et al (2000), in his

research, concluded that public investors almost always get cheated because they expect that their interests will be represented in good faith and that they will share in the risks and rewards of the business. He came up with a four-step plan to cure what are ailing shareholders.

Applying an economic perspective, Roe (2003), has suggested that shareholder primacy could be inefficient when an industry is concentrated, because the shareholders of a monopolist will gain part of the consumer surplus. The solution is of course dispersed ownership, which in turn creates collective action problems and rational apathy by shareholders.

2.4 Overview Ownership concentration features across the Globe.

Zetzsche (2004) in his paper, suggested that European corporate governance systems should be characterized as explicit systems with direct shareholder influence, whereas Anglo-Saxon systems tend to be implicit systems of corporate control.

American directors are shielded from shareholder influence for various reasons that can be found in corporate and securities law. For example, there are a number of other impediments to shareholder influence, including Section 13 (d) of the Securities Exchange Act and the regulations there-under which inhibit the coordination of shareholders when they jointly surpass the 5% threshold, and the possibility of communications between security holders triggering the (costly) duty to file a proxy statement if it is "reasonably calculated to result in the procurement, withholding or solicitation of a proxy". Other factors might create implicit shareholder influence by

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creating incentives for managers to act in the interest of shareholders, most of all hostile takeovers. Bainbridge (1993), claims that US law puts a strong shareholder wealth maximization objective without granting any significant control to shareholders. However, the concept of shareholder influence is broader than direct control and, beside explicit control, also includes a strong presence of market mechanisms that implicitly force managers to pursue shareholder interests.

Comparative corporate governance theories have always found that the UK is often a peculiar case. In spite of fully conforming neither to the US nor to the Continental model, the UK can be explained quite well as an intermediate case between the two. While ownership dispersion is the norm in the UK (as it is in the US), there appears to be some vestigial explicit shareholder influence; furthermore, there are powerful institutions that create much greater implicit shareholder influence than in the US; on the flipside of the coin, legal institutions protecting employees appear to be stronger in the UK as well. First, the empirical evidence shows that dispersion is actually less pronounced than in the US. Individual blocks are bigger, and about 70% of shares are in the hands of institutional investors (as opposed to 50% in the US).

Some researchers have expressed doubts that dispersed ownership dominates in the UK, among them the Australian scholar Geof Stapledon & Sociologist John Scott (1995). They argued that large British firms were not dominated by managers as a typical Berle-Means* firm would be, but were governed by a "constellations of controlling interest" consisting of about 20 shareholders who jointly controlled most corporations. Nevertheless, in their seminal article on the contribution of bankruptcy law on corporate

governance structures, Armour J. et al (2002), conclude that Britain should be classified as an outside corporate governance country. However, they mention a number of factors in which it differs from the US: Most to the point, they turn to the fact that British securities law, quite contrary to the situation in the US, does not impede the formation of coalitions between institutional investors regarding particular corporations. Furthermore, in alignment with a number of other commentators, they pointed out that these investors, while still showing a certain "British reserve", sometimes exercise concerted influence

** Berle-Means thesis*

Theory about governance in public corporations where the ownership and control is separated, and the owners (shareholders) rely on the board of directors to represent their interests. The theory states that over time the boards become so dominated by the management that their supervisory role becomes ineffective and the executives get to have the final say. Named after Adolf A. Berle and Gardner C. Means, the US authors of the 1932 paper 'The Modern Corporation and Private Property.'

when a firm is in difficulties, for example by requiring a restructuring of management when new shares are issued. From the legal perspective, the most conspicuous difference between the US and the UK relevant for the point here is takeover law, where these two countries are situated at two opposing ends of the regulatory spectrum.

Yuan D. et al,(1988), studied and investigated the role played by a firm's ownership structure (both ownership concentration and different ownership types) in earnings management.

They analyzed 273 privately owned and state owned Chinese companies listed in 2002 in the first study to compare earnings management practices between Chinese private-owned and state-owned listed firms.

They revealed that an inverted U-shaped relationship existed between ownership concentration and earnings management practices. From this study, it was clear that privately owned listed companies tend to maximize their accounting earnings more than state-owned listed companies. However, the entrenchment effect of ownership concentration on earnings management was found to be weaker in privately owned listed firms than in stately owned listed firms. Earnings management is always a means to an end, and uncovering the motives for earnings management is the key to explaining the issue.

In developed capital markets, with separation between ownership and management, and broad shareholder bases, it has been found that earnings management is driven by the desire to prop up the company's stock price. The stock price is often the key basis for managerial compensation, which may include stock options or other incentive plans. However, in some less developed capital markets these motives may not be relevant. In

such markets, even listed companies have a highly concentrated ownership structure and top managers are (or directly represent the interests of) the controlling shareholders. The Chinese stock market is a good example of such a context: the floating shares typically accounts for only a small proportion of listed firms' total shares, and until mid-2005, stock options were prohibited.

A similar level of concentration is found in the Kenyan NSE

Previous studies provide strong evidence that Chinese listed companies boost their earnings dramatically in order to gain authorization for an IPO, to issue new shares or to avoid being de-listed. The implicit assumption is that meeting the regulatory requirements is the companies' incentive to manage their earnings. These study added to the literature by addressing the same issue from a different perspective, namely, an agency perspective, i.e. looking at earnings management structure as a sign of the agency problem in modern corporations. They argued that the conflict of interests between controlling shareholders and minority shareholders is the root cause of earnings management in China. Since ownership structure is the primary determinant of agency cost, this study attempted to link companies' ownership structure with their earnings management behavior. The current transitional nature of the Chinese economy provides a valuable opportunity for examining the behavior of companies with different ownership types, i.e. state block-holders or private block-holders. As stated by the Chinese government, the original purpose of the stock market was to help state-owned enterprises (SOEs) raise funds and improve their operating performance. For this historical reason, the majorities of current listed Chinese companies originate from restructured SOEs and

are still controlled by the State and/or other non-listed SOEs. Yet despite this background, a distinctive group of listed companies, accounting for slightly more than 10% of all such firms, has emerged in the Chinese market: listed firms controlled by private owners.

In an empirical study of ownership structures in the German manufacturing industry, Kōke (2002) concludes that the agency problem resulting from pyramidal structures "is probably irrelevant for most German firms." But studies on separation of ownership and control in East Asian corporations, where an entity owns 20% of cash flow rights, but 40% of votes, the financial interest he holds is certainly significant and distinguishable from ownership stakes of managers of American companies.

Existing literature suggests that state ownership entails inferior governance quality compared to private ownership, due to the contracting ability problem. Alchian, (1977); Shleifer, (1998) found that Companies with private ownership will have a less serious agency problem, and hence a lower incentive for managing earnings upward. More specifically, they predicted that ownership concentration would give rise to a weaker entrenchment effect in private-owned companies than in state-owned companies. The paper provided evidence that the earnings management practices of Chinese listed firms are influenced by ownership concentration as measured by the total percentage interest in the hands of the largest shareholder. Specifically, the study showed that "the relationship between shareholding concentration and earnings management follows an inverted U-shape pattern: when the ownership concentration level is low, the agency cost is high". Initially, large shareholders tended to maximize accounting earnings in order to reap

benefits in the future (entrenchment effect). However, when the ownership concentration reaches a high level, large shareholders become the true owners of the firm, and are thus more likely to seek to preserve its future growth potential by minimizing accounting earnings (alignment effect). Their results show that in the sample of Chinese listed firms, until the top-shareholder concentration reaches the vicinity of 55%, the correlation between ownership concentration and earnings management is positive, while beyond that ownership concentration level the relationship becomes negative.

2.5 Concentration ownership and earnings management

The Yuan D. et al (1988), analysis highlighted above also showed that private-owned listed firms favor earnings boosting methods more than their state-owned counterparts. This result reflects the specificity of the Chinese capital market, where private-owned firms are still in a weaker position because of specific political and historical factors. They are thus under pressure to report a better-than-real financial performance to reassure the market. Meanwhile, the effect of ownership concentration as a factor increasing earnings maximization was seen to be less marked in private-owned firms, because their large shareholders are inclined to act as the actual owners, which means their incentives to expropriate the firm are comparatively low. All the ownership concentration and type measures hold significant coefficients of the same sign in the regressions.

A sample consisting of both private-owned listed companies and state-owned listed companies was selected for the purpose of comparison and they were able to examine whether and how ownership concentration and ownership type affect firms' earnings management practices. They put forward three hypotheses regarding the relationship

between ownership structure and earnings management. The first related to the negative effect of ownership concentration on the agency problem. Building on research by Morck, Shleifer and Vishny (1988), they argued that increased shareholding by controlling owners makes those insiders entrenched from outside monitoring. In situations where expropriation of controlling owners would result in lower actual earnings, they will manage earnings upward, to avoid any leakage of information on their misbehavior.

This is a major limitation in analysis as a perusal of the financial statements will not reveal to what extent earnings are managed upwards. In this study, an assumption is made that all transactions are at arms length basis and that all the listed Companies comply with the International Financial Reporting Standards, and other regulations and disclosure requirements.

2.6. Corporate governance and firm value

Rappaport A.(2006) has set out some basic governance principles for value creation that collectively will help any company with a sound, well-executed business model to better realize its potential for creating shareholder value. Though the principles may not be surprising, applying some of them calls for practices that run deeply counter to prevailing norms. The accountant's bottom line does not approximate a company's value nor its change in value over the reporting period. Organizations compromise value when they invest at rates below the cost of capital (overinvestment) or forgo investment in value-creating opportunities (underinvestment) in an attempt to boost short-term earnings. The practice of reporting rosy earnings via value-destroying operating decisions or by

stretching permissible accounting to the limit eventually catches up with companies. Companies should also make strategic decisions that maximize expected value, even at the expense of lowering short-term earnings. Expected value is the weighted average value for a range of possible scenarios. A sound strategic analysis by a company's operating units should produce informed approaches to the following:

2.6.1 Acquisitions

Companies typically create most of their value through day-to-day operations, but a major acquisition can create or destroy value faster than any other corporate activity. That's why companies should only make acquisitions that maximize expected value, even at the expense of lowering near-term earnings. Sound decisions about deals are based on their prospects for creating value, not on their immediate EPS impact.

2.6.2 Assets

Value-oriented companies should carry only assets that maximize value. This principle takes value creation to a new level because it guides the choice of business model that value-conscious companies will adopt. There are two parts to this principle: Value-oriented companies regularly monitor whether there are buyers willing to pay a meaningful premium over the estimated cash flow value to the company for its business units, brands, real estate, and other detachable assets. Companies can reduce the capital they employ and increase value in two ways: by focusing on high value-added activities where they enjoy a comparative advantage and by outsourcing low value-adding activities.

2.6.3. Cash Management

Even companies that base their strategic decision-making on sound value-creation principles can slip up when it comes to decisions about cash distribution. Rappaport suggested that value-oriented companies should repurchase shares only when the company's stock is trading below management's best estimate of value and no better return is available from investing in the business. When a company's shares are expensive and there's no good long-term value to be had from investing in business, paying dividends is probably the best option.

2.7 Agency Question

The situation regarding holdup risks looks very different in corporate governance system characterized by concentrated ownership. In this situation, a controlling shareholder has explicit influence, and she may have both the incentive and the opportunity to exert holdup on non-shareholder constituencies. In an idealized version of this corporate governance structure, the ultimate controller of the firm would hold voting power equivalent to cash flow rights. The typical advantage of concentrated ownership recognized by the literature is that a large or controlling shareholder with extensive cash-flow rights has a strong incentive to monitor managerial misconduct. Hence, the manager's position to extract rents from the firm's constituencies will be weak, and classic Berle-Means and Jensen-Meckling type managerial agency problem of the separation between ownership and control will be eliminated. However, as a negative side effect and another agency problem, the controlling shareholder or even another substantial large shareholder obtains the opportunity to obtain private benefits of control. Large shareholders can siphon money out of the firm by entering into non-arm's-length

deal with the firm or by exploiting corporate opportunities on their own. It follows that the most important shareholder-related policy goal.

Some shareholders may refrain from opportunism for idiosyncratic reasons. However, this is not a consequence of the ownership structure as such, but only a mitigating factor that may countervail the monetary incentive to some degree, most strongly when the owner is a governmental entity. A large shareholder attempting to show commitment to the firm's constituencies in order to foster the joint effort may occasionally have the possibility to reap the short-term monetary rewards of holdup.

Jensen and Meckling [1976] contended that more equity ownership by the manager may increase corporate performance because it means better alignment of the monetary incentives between the manager and other equity owners but Fama and Jensen [1983] argued that increased ownership concentration (any kind of owner) decreases financial performance because it raises the firm's cost of capital as a result of decreased market liquidity or decreased diversification opportunities on behalf of the investor

Shliefer and Vishny [1986, and 1997] presented a monitoring argument that large owners or block owners may be more capable of monitoring and controlling the management thereby perhaps contributing to corporate performance but Mehran [1995] argued that when managers of large firms hold significant equity stakes the question of these managers' remuneration may become less important since the majority of their income

would come from their equity stakes. Large shareholders may be represented in the board of directors or otherwise influence the firm's decision making process.

Modgillian and Miller (MM) (1958), argued that shareholders tend to have incentives to undertake riskier projects, even with the consequence of reducing the expected value of the firm. Shareholders may have incentives to under-invest (debt overhang) as the case of the conflict of interest's means that the mere threat of default can influence a firm's investment decisions in an unfavourable way. Since investors understand this risk, the market price of both the debt and the stock decline. This is another good reason for managers to operate at relatively low debt ratios.

MM contended that conflicts between managers and stockholders arise as the latter favour debt because, by forcing the managers to pay interest, force them to avoid inefficiencies, overinvestment and excessive utilization of the firm's resources to the managers' benefit. The free cash flow theory that maintains that high debt ratios increase firms' value, notwithstanding the threat of financial distress, is useful to explain the behaviour of mature (cash-cow) firms that are prone to over-invest.

Shareholders' may also have the incentive to "milk the property" at the expense of bondholders. Consider a firm at risk of default. Before the event, it might decide to pay an extra dividend or some other payments to shareholders. The value of the firm declines after the payments becomes less attractive for a takeover. However, bondholders would

as a matter of prevention require the firm to have entered into covenants against such actions.

2.8 The Role of managerial ownership concentration and firm value

Morck, Shleifer and Vishny [1988] contended that higher managerial ownership means that it is less likely that the market for management services will function. The functioning of a performance monitoring system, such as the public stock market, may depend on the ownership structure. For example, on one hand, extremely dispersed ownership may result in more speculative prices because of a lack of informed investors, but on the other hand an extremely concentrated ownership structure could also cause speculative prices because of too little market liquidity. Such distortions of market valuation may in turn result in a rise in the firm's cost of capital. Morck et al [1988] suggested that more equity ownership by the manager might decrease financial performance because managers with large ownership stakes may be so powerful that they do not have to consider other stakeholders interest. They may also be so wealthy that they no longer intend to maximize profit but get more utility from maximizing market share or technological leadership etc. They argued that the performance effect of the incentive alignment argument dominates the performance effect of the entrenchment argument for low levels of managerial ownership. For higher levels (about 5% managerial ownership) the picture is reversed and for still higher levels (about 30%) the picture is reversed back once again.

Stulz [1988] argue that more equity ownership by the manager may increase corporate performance because the managers are more capable of opposing a takeover threat from the market for corporate control and as a result, the raiders in this market will have to pay

higher takeover premiums. Stultz presented a formal model that predicts a roof-shaped relation between managerial ownership and financial performance. The model is integrating the takeover premium argument and the entrenchment argument into a single theory.

2.9 The role of Pyramid structures on shareholder entrenchment effects

One could argue that an incentive structure in concentrated ownership structures does not exist because of the often significant divergence between ownership and control, which can be created by various deviations from the one-share one-vote principle, which is normally thought to create optimal incentives for efficient shareholder decisions, such as differential voting rights, cross-ownership of shares, and most interestingly, stock pyramids. Pyramidal structures, if carried out to the extreme, may allow a controller to vote the majority of the stock of a publicly traded firm while at the same time owning only a minimum of capital and cash-flow rights. For example, if shareholder A owns 50% of the shares of company B, which in turn holds 30% of publicly traded firm C, A will effectively vote 30% of C's shares (which will in most cases be enough to control a publicly traded.

Luca Enriques and Paolo Volpin describe the case of Telecom Italia, where, in 2005, one person held 18% of TI's voting power with only 0.7% of capital by means of a chain of four intermediary firms (two of them publicly traded). This extreme type of pyramidal structure approximates a Berle-Means corporation in important respects: The manager is almost totally in control of the firm and hardly accountable to minority shareholders,

without owning a significant stake himself. There is no (other) large shareholder with incentives or even the possibility to monitor management. One might think that the Blair and Stout** theory could apply in this situation with the person controlling the firm through a pyramid functioning as a "meditating hierarch", meaning that the holdup problem incidental to concentrated ownership will be largely eliminated, because the monetary incentive to holdup non-shareholder constituencies is greatly reduced or even eliminated by the pyramid. However, a closer look reveals that even if the controller of the firm only has a nominal entitlement to the firm's cash flow, holdup may still happen on the bottom of the pyramid. First, any monetary benefit that can be squeezed out of the firm on the bottom of the pyramid by reneging on implicit deals with non-shareholder constituencies could be used for projects in another firm within the pyramid

***The "team production theory" of corporate law is articulated by Margaret Blair and Lynn Stout. The team production theory rejects the principal-agent model of the public corporation and replaces it with a "mediating hierarch" approach to corporate governance. Under a mediating hierarch model, directors of public corporations do not maximize shareholder value but instead resolve competing claims that various "stakeholders" might have to the firm's residual product. According to Blair and Stout, this "mediating hierarch" model of governance empowers public corporations to refrain from opportunistic exploitation of non-shareholder constituents and thus reduces the transaction costs associated with obtaining relationship-specific investment*

Franks & Mayer (2001), gives an example of a closely-held entity formerly holding 1.2% of cash flow rights in Daimler Benz, which apparently was not connected by exclusive control of the firm, as it was cancelled out by other firms holding similar voting rights on several levels of the pyramid). In line with the predominant agency cost analysis, it is often said that pyramidal structures eliminate the large shareholders incentive to monitor managers. At any level a pyramid, the controller can sell his share of the company. A potential buyer may find the purchase worthwhile because she considers herself able to increase the competitiveness of the firm, but it may equally hope for gains from the holdup situation discussed here. So even if there is no current holdup risk, there is always a potential one, which should equally discourage specific investment. With respect to a possible sale of control, pyramids are different from dispersed ownership, where the manager – who will have the possibility to initiate a one sided holdup of e.g. employees – cannot sell his shares to a new manager who will start a holdup, the controller of a pyramid can transfer cash flow rights to an outsider who will have a larger share in those and therefore have the incentive to do so. Given all of this, there are good reasons to believe that pyramids do not eliminate holdup risk. While the incentive to monitor managers in a pyramid may be greatly decreased, the danger of holdup remains. Finally, it should be emphasized that pyramids, where the controller actually holds a substantial chunk of equity in the bottom subsidiary, seem to be more the rule than the extreme form described by Enriques et al (2001) and Volpin & Pagano (2001). For example, in Germany, while there is little hostile takeover activity, there is a thriving market of controlling blocks.

The empirical evidence and its interpretation by Porta et al (2004), Concluded that, while pyramids are common, the magnitude of deviations from the one-share-one-vote ideal tends to be small.

A theoretical explanation of the existence of pyramids and their respective structures (which entails varying degrees of separation of ownership and control) is provided by

Almeida & Wolfenzon (May 2005), suggesting that there is an influence of the degree of investor protection and profitability of the firm.

2.10 Methods of valuation

In arriving at the values of the firms, various methods of valuations have been considered;

i) Book value per share method

Under this method, the value is a function of net assets divided by the number of common shares outstanding. This method gives the accounting book values, which are historical, and does not capture very many things that the accountant does not put a value on. The method ignores the market within which the firm operates.

This method is not considered appropriate for this study.

ii)Tobin Q

This Method involves market value of assets and their current replacement values, It is very difficult to get current replacement values. Thus though this method has merits, lack of data makes it less useful for this study.

iii) Current market value

This is the value the shares are currently trading at NSE. The shares have markedly different par values. The comparison of the trading prices on their own have information content though their relative movements do. It is therefore not considered as an appropriate method for this study.

iv) Future cashflows (residual equity) method

Under this method, we forecast future cashflows and discount them using the cost of equity to arrive at present values. From a Financial Economists point of view this is the best method, however it suffers from the need to forecast future positions, which will require the need for perfect information and appropriate tools of analysis. This is impossible in the present world. The many number of parameters required will render the method too complicated for this study and it is therefore ruled out.

v) Market to book value

The market-to-book ratio is the ratio of the market value of assets to the book value of assets. This can be interpreted as the number of times the market value of the company exceeds the book value of its assets, which can also be viewed as the incremental value of the company.

This method is considered most appropriate for this study and is therefore used.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Research Design

The study aimed at investigating the entrenchment effects of large shareholders for firms listed on the Nairobi Stock Exchange (NSE). The study focused on firms listed on the NSE for the year 2006. This paper was replicating the work of Claessens et al (2002) albeit at a lesser scale covering only one Economy, Claessens had also studied one year i.e. 1996. The focus in this study is across the firms not within firms across the years. Very little changes in shareholding is expected across firms as such a change is rare and often a major occurrence.

3.2 Population

The population is all listed companies at NSE as at 31st December 2006 who were trading except the suspended ones. This comprises of 45 companies. There will therefore be no sampling. The best performing firm in the NSE in 2006 was E A Cables, this firm is owned by Cable Holdings (Kenya) Ltd at 70.28%, This company is controlled by Transcentury, a locally owned investments group. It was however excluded from this study because its market-to-book ratio was disproportionately high, its Market capitalization increased from Kshs 300 Millions in December 2005 to Kshs. 1 Billion in December 2006 (One year hence), this was a 233% increase against the market movement from 462.52 Billions to 791.58 Billions a 71% increase in the same period.

3.3 Source of Data

The study used Primary data gathered from the company secretariat in order to gain understanding of corporate governance issues in play in the company's basic decision making and also the use of secondary data from the published audited financial statements filed by the firms with NSE for 2006. The information from the financial statements assisted in identifying the largest shareholder. Furthermore, the book value of debt, preference shares and the total assets was gotten from the individual firm's balance sheet. The study also used average prices on the last NSE trading day for the last day of the year 2006.

3.4 Data specifications

The study collected the following data from the published annual reports and NSE prices:

1. Largest shareholder details and the percentage shareholding. In line with good corporate governance practices, the information on who is the largest shareholder and the percentage shareholding is disclosed in the financial statements of listed companies, in Kenya,
2. Market value of common stocks. This is the same as market capitalisation i.e. number of shares outstanding at the end of the year (per the annual reports) multiplied by the average prices at the end of the year.
3. Book value of debt. This is the sum of short term and long-term debt as per the company's balance sheet.
4. Book value of preferred stock. This is value of preference stock as per the company's balance sheet.

5. Book value of assets. These are the total assets of the company as per the balance sheet.

3.5 Variables

This study focused on the following main variables:

i) Dependent – The value of the firm as 'Market-to-book ratio.

ii) Independent – Percentage of Largest shareholder to total shareholding.

The value of the firm as measured by the market-to-book ratio is therefore a function of the largest shareholder influence through the incentive and the entrenchment effects.

3.6 Data analysis

The assembled data is used to calculate the Market-to-Book Ratio as the valuation measure for 2006. The market-to-book ratio is the ratio of the market value of assets to the book value of assets. This can be interpreted as the number of times the market value of the company exceeds the book value of its assets, which can also be viewed as the incremental value of the company. The ratio is given as follows:

Market-to-book ratio = (MV of common stocks + BV of debt + BV of Preference shares)/

BV of Total assets

Based on the above understanding, the higher the market-to-book ratio, the higher the value of a company. The ratios are analyzed and a ranking carried out of the various

companies. Segment mean is also computed in order to compare performances within the various segments of NSE.

The share values of firms trading at the NSE are grossly overvalued whereby their trading values are beyond their economic values this is caused by demand and supply of the shares trading. The component beyond the economic value is the noise content. This however, is factored in all the shares across the counters not just one counter, thus assuming the case, we can take the market values as equally being affected and thus for comparability purposes ignore the noise content.

CHAPTER FOUR

4.0 DATA ANALYSIS AND FINDINGS OF THE STUDY

4.1 Data analysis

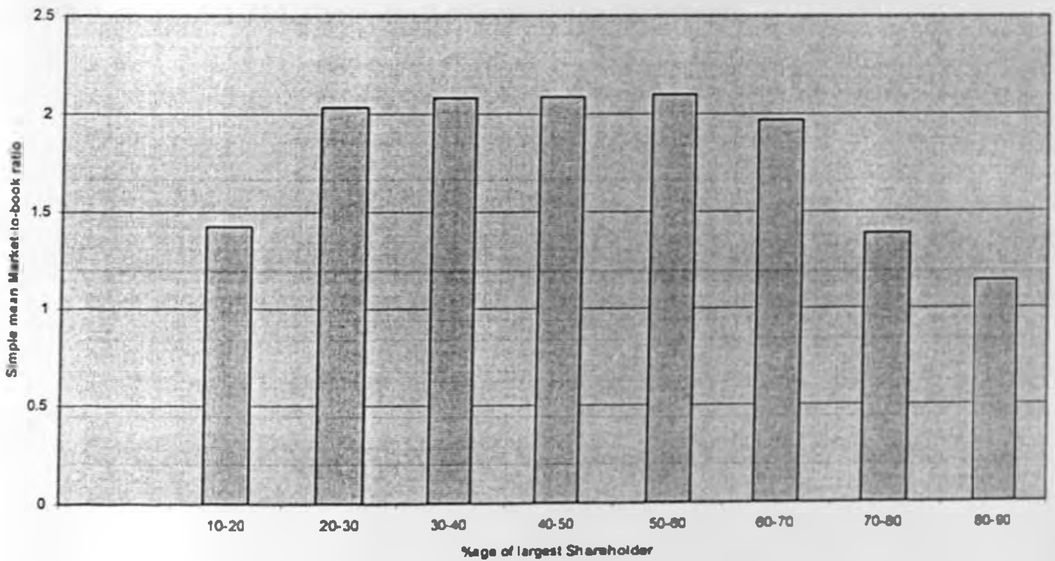
This chapter analysis the effects on value of the firm by the existence of a large shareholder who exerts significant influence on operational and administrative affairs of the firm.

Eveready, with the major shareholding being Eveready East Africa is the 2rd highest valued firm at 4.620 followed closely by Nation Media (Agha Khan Fund for Economic Development) valued at 4.557 and Bamburi Cement (Fincem Holdings Ltd) valued at 4.473. These were the only companies with market-to-book ratio of more than 4. Their percentage shareholding however was 35.12 %, 44.7 % and 29.30 %. On the lower end, Williamson Tea (Largest shareholder Ngong Tea Holdings Ltd) had a market-to-Book ratio of 0.565 followed by Unga Group (Victus Limited) at 0.704, Kapchorua Tea (Williamson Tea) at 0.705 and Kakuzi (Bordure Limited) at 0.906. These companies had a largest shareholding of 51.5 %, 50.93, 39.56 % and 26.06 % respectively.

Categorizing companies using their largest shareholding and taking up group averages, the results showed as follows:

%age largest shareholder	Simple mean-market-to-book ratio
10-20	1.423
20-30	2.033
30-40	2.082
40-50	2.084
50-60	2.097
60-70	1.968
70-80	1.387
80-90	1.143

This can be plotted in a chart as follows:



The graph shows that value increases from the 10-20 %, which has an average value of 1.423 to 2.033 in the 20-30 % range, where it remains stable for the next three ranges all past a value of 2, at the range of 60-70 %, the value starts to come down gradually in successive steps. At the 70-80 %, the value falls to below the 10-20 % at 1.387. The Highest range of largest shareholder in the NSE is 70-80 %, whose value is 1.143.

There are some variations actually within the ranges that need highlighting, these include; Within the 20-30 % age range the lowest valued company is Kakuzi at 0.906, the highest in value terms is Bamburi cement at 4.473, there are 11 companies in this range.

Within the 30-40 % age range, the lowest valued company is Kapchorua Tea at a value of 0.705, the highest valued is Eveready at 4.620, similarly a very wide range indeed, there are 6 companies in this range.

In the 40-50% range, the lowest valued is Crown Berger at 1.174, the highest is Nation Media at 4.557, and there are 11 companies in this range. In the 50-60% age range the lowest valued company is Unga group, whose value is 0.704, and the highest is Limuru Tea with a value of 3.744, there are 5 companies in this group.

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CHAPTER FIVE

5.0 SUMMARY OF FINDINGS, CONCLUSIONS, RECOMMENDATIONS, LIMITATIONS OF THE STUDY AND SUGGESTIONS FOR FURTHER RESEARCH

5.1 Summary of findings and conclusions

The objective of this study was to determine to what extent the value of the firm is affected by the level of shareholding of the major shareholder. It was found out that the level of the largest shareholder increases the value of the firm as the shareholding increases, plateauing at the 30-60 % level and steeply reduces the value of the firm once you exceed the 50-60 % value. Incentive effects were found to set in right from the 10 % level and as the shareholding of the largest shareholder progressively increases, so does the value of the firm. At the 10-20% level, the value of the firm is a mean Market-to-book value of 1.423, there are 2 firms in this category. At the 20-30%, 30-40% and 40-50% levels, the market-to-book ratio are 2.033, 2.082 and 2.084 respectively, the 50-60% being the highest. There are 11, 6 and 11 firms respectively in each of these categories. At the 60-70% level the entrenchment effects become evident, the Market-to-book ratio starts to fall at 1.968%, there are 5 firms in this category. Beyond this level of shareholding the ratio falls drastically to 1.387 and finally to 1.143 for the 70-80% and 80-90% levels, there are 3 and 1 firms en each category respectively.

The loss in the ratio at higher levels of shareholding more severe at lowest levels I.e. beyond 70 % shareholding, the value of the firm reduces to below the 10-20 % and the 20-30 % levels.

5.2 Recommendations

That the largest shareholder at the Nairobi Stock Exchange should ideally be in the level of 30 % to 60 %. This shareholding should not be exceeded and it is better for the shareholding to be widely dispersed than to be concentrated beyond the 60 %. regulatory authorities are therefore adviced to ensure this is followed for firms listed in order to maximize value of the firms.

5.3 Limitations of the study

Caution is required in interpreting the results of this study. First, getting to the eventual individual or the driver of a group or a family to know which individual make the necessary managerial and productive decisions was not always achieved.It was more difficult for the foreign companies. In Olteita J. K. (2002), he stated that the foreign owned listed companies had the highest value. In this study, the same is not so vivid since though they had high market-to-Book ratio, they equally have the lowest Market-to-Book ratio. Secondly, this study is confined to analysis of the largest shareholder. Suffice to mention that other large shareholders do exist. Their effect on firm value is expected to have an effect either on its own or in conjunction with other shareholders. In Kakuzi Ltd the largest shareholder is Bordure Ltd with 35.12 % , the second is Linktak at 33.2 %, this kind of shareholding would be complementary to form a 68.32 % shareholding which would border on the full control or create divergence in case the two shareholders are at cross purposes. This kind of relationship was not part of this study. Thirdly, some firms may be related to other firms listed in the same Bourse, with this commonality in shareholding, they may transact beyond arms length this would not be apparent. Fourthly,

there are shareholdings through nominee accounts the ownership and control of whom, is not disclosed. These could exert control without the same being apparent.

5.4 Suggestions for further Research

A more detailed study to disclose the shareholdings to the immediate shareholders would be more informative. This would reveal more on common shareholders and shareholdings.

Equally a study of privately registered companies would reveal whether a similar trend is replicated in private companies granted that the publicly traded ones are more regulated and thus reveal more information to the public and more often.

A more detailed relationship between the shareholders large and otherwise would be done to bring out salient points in the nature of their commonality of interests and also common shareholders in other listed companies.

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APPENDIX

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INCENTIVE AND ENTRENCHMENT EFFECTS OF LARGE SHAREHOLDERS FOR COMPANIES LISTED IN NAIROBI STOCK EXCHANGE (NSE)

Questionnaire

(To be filled by the respondent)

1. Name of organization: (optional) ______________________________

2. Name of respondent: (optional) ______________________________

3. Designation: ______________________________

4. Your largest shareholder is? ______________________________

5. % age of shareholding? ______________________________

6. Who are the largest shareholder's representatives in the Board of Directors

   ____
   ____
   ____
   ____
   ____
   ____
   ____

7. Is any of the above an executive Director?

8. How can he(she) be removed?

9. What Committees of the Board are there?

10. Which committees do the representatives of the largest shareholder seat and in which capacity?

Name of Board Member	Committee	Capacity

11. What influence does the major shareholder have in appointment of the senior Management (separate from the Board)

12. Does your company have dual class shares? Yes ( ) No ( )

13. What in summary are their special features separate from the ordinary shares?

14. Who holds them?

15. How are the Board decisions carried out?

17. How often does:

  i) Board of Directors meet?
  ii) Senior management meet?

18. Who determines the Agenda?

19. What tendering process is in place?

20. How are dividend decisions initiated?

21. How is the decision on the appointment of the Auditors done?

22. Who are the company's main bankers?

23. Do the Bankers have a relationship with the main shareholder?

24. How is the chairman of the Board appointed?

25. How is the CEO of the company appointed?