Implications of Shareholder Types on Financial Performance: Empirical Evidence from Listed Companies in Kenya

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Abstract: Scholarly interest in the relationship between shareholder types and firm performance has been evident since the seminal work of Berle and Means of 1932. The many researches so far conducted have, however failed to give conclusive results. The study whose results are reported in this paper therefore, sought to address the glaring knowledge gap, especially with regard to developing countries. The typical shareholder types among listed companies in Kenya are government; foreigners; institutions; managers; and diverse shareholders. Using Logistic Regression, the relationships between shareholder types and financial performance as measured by ROA, ROE and DY were tested. The results indicate a significant negative relationship between state ownership of firms and financial performance. On the other hand, foreign, insider, diverse and institutional ownership gave significant positive relationships with financial performance. Collectively, these results are consistent with pertinent literature with regard to the implications of government, foreign, manager (insider) and institutional ownership forms, but significantly differ concerning the effects of diverse ownership on financial performance.

Key Words: Shareholder Types; Firm Performance; Agency Theory; Principals; Agents.

1. Introduction

The emergence of the large corporation has occasioned separation of ownership and control of capital in publicly held companies. This has in effect precipitated conflicts of interest between the owners of capital and those who control it (Berle and Means 1932). The overriding objective of the owners of capital as entrepreneurs (referred to as principals) is to maximize their wealth. On the hand, those to who they entrust their capital (known as agents), more often than not, have divergent interests which may include enhancement of personal wealth and prestige. This divergence of interests often leads agents to engage in insider dealings where there are no mechanisms for effective monitoring, ratification and sanctioning of managerial decisions. It has been argued that agents resort to extraction of private benefits from firms that they manage if they are not shareholders, and thus neither meet the full cost of mismanagement nor share in the residual income of those firms (Jensen and Meckling 1976). To remedy managerial failings, a number of governance mechanisms aimed at aligning the interests of agents with those of principals, including equity ownership by managers, may be considered. To enhance their monitoring role, and ensure capital is applied to its intended purpose, shareholders choose from amongst their ranks, individuals to represent them on the board of directors. The Board is therefore, put in place to safeguard the interests of principals from agents who are bent on extracting private benefits from the organization (McDonald 2005). Research has however, shown that the board of directors does not always protect the interests of shareholders, and some of them, in fact, get entrenched. They thus become a threat to shareholders rather than a panacea to managerial failings. To mitigate the collective failings of both agents and board, shareholders are forced to incur agency costs by hiring independent auditors to help monitor managerial decisions that are ratified by board of directors. Managerial discretion has been a subject of academic investigation for sometime, especially after initial researches showed mixed results on its relationship with firm performance. Research has shown that most of managerial failings are largely attributable to the fact that managers, more often than not, do not meet the full costs of mismanagement. Besides, managers in many companies do not share in the residual income of the firms that they run, especially where they are not shareholders. The study, whose results are reported by this paper was thus, conceived to bridge the glaring gap in literature. Kenya has experienced turbulent times with regard to its corporate governance practices in the last two-and-a-half decades,

resulting in generally low corporate profits across the economy. Coincidentally, this picture is fairly well replicated globally in the same period.

2. Ownership Identity and Firm Performance

The pertinent literature on corporate governance pays much attention to the issue of shareholder identity (Shleifer and Vishny 1997; Welch 2000; Xu and Wang 1997). The cited authors argue that the objective functions and the costs of exercising control over managers vary substantially for different types of owners. The implication is that, it is important, not only how much equity a shareholder owns, but also who this shareholder is, that is, a private person, manager, financial institution, non-financial institution enterprise, multi-national corporation or government. Investors differ in terms of wealth, risk aversion and the priority they attach to shareholder value relative to other goals. Owner preferences and investment choices are influenced by shareholder interests that the owners may have in addition to their own interests (Cubbin and Leech 1982; Nickel 1997; Hill and Jones,1982; Hansmann 1988; 1996). To the extent that owners have their economic relations with the firm, conflicts of interest may arise. For example, banks may play a dual role as lenders and owners, government as regulators and owners (Thomsen and Pedersen 1997). For each of these stakeholders, preferences regarding company strategy will involve a trade off between the pursuit of shareholder value and other goals. A similar trade-off is implied for corporate owners such as multi-national parent companies that may want to sacrifice local profit maximization for global interest of the organization. Among the different ownership forms, managerial ownership seems to be the most controversial as it has ambivalent effects on firm performance. On one hand, it is considered as a tool for alignment of managerial interests with those of shareholders, while on the other hand, it promotes entrenchment of managers, which is especially costly when they do not act in the interest of shareholders (Mork, et. al. 1988; Stulz 1988).

Thomsen and Pedersen (2000) posit that the relationship between ownership concentration (as a proxy for shareholder control over managers) and firm performance depends on the identity of the large (controlling) shareholders. One possible interpretation of this finding is that different types of shareholders have different investment priorities, and preferences for how to deal with managers' agency problems. The overall impact of managerial ownership on corporate performance depends on the relative strengths of the incentive alignment and entrenchment effects. Regarding government (state) ownership, there is much more unanimity in the academic circles. State ownership has been regarded as inefficient and bureaucratic. De Alessi (1980, 1982) defines state-owned enterprises as "political" firms with general public as a collective owner. A specific characteristic of these firms is that individual citizens have no direct claim on their residual income and are not able to transfer their ownership rights. Ownership rights are exercised by some level in the bureaucracy, which does not have clear incentives to improve firm performance. Vickers and Yarrow (1988) consider the lack of incentives as the major argument against state ownership. Other explanations include the price policy (Shapiro and Willig 1990), political intervention and human capital problems (Shleifer and Vishny 1994). State ownership of firms is not without some benefits to the society. Traditionally, public enterprises are called upon to cure market failures. As social costs of monopoly power become significant, state control seems to be more economically desirable as a way of restoring the purchasing power of the citizenry (Atkinson and Stiglitz 1980).

Generally speaking, however, empirical evidence suggests that public firms are highly inefficient in comparison to private ones (Megginson, et. al. 1994), even in pursuing public interests. There are several reasons for such observed poor performance of state-owned firms. According to Shleifer and Vishny (1994), state-owned firms are governed by bureaucrats or politicians that have extremely concentrated control rights, but no significant cash flow rights since all the profits generated by the firms are channeled to the government exchequer to finance the national budget. This is aggravated by political goals of bureaucrats that often deviate from prudent business principles (Repei 2000). Such enormous inefficiency of state firms has precipitated a wave of governance transformations in economies around the world in the last two decades through heightened privatization of state-owned firms. In their analysis of political control of state-owned firms' decision making processes, Boycko, et. al. (1996) argue that transferring control rights from politicians to managers (i.e. increasing managerial discretion) can help improve firm performance largely because managers are more concerned with firm performance than are politicians. Banks and other financial institutions are most likely to be risk averse because of their concern with profit maximization. An organization that is heavily leveraged lacks the capacity to pursue risky investment options as these would jeopardize their chances of honoring loan repayment schedules, especially in loss making situations. Banks will also try to discourage further indebtedness as more loans might lead to liquidity problems and perhaps insolvency (Hansmann 1988). Public companies, on the other hand, can support further

indebtedness, if it promises to improve the financial position of the firm and shareholder value in the long-run.
Regarding diffuse shareholding, it is clear from the relevant literature on agency problem that this kind of ownership structure will not give adequate control to the shareholders due to lack of capacity and motivation to monitor management decisions (Jensen and Meckling 1976). Hence the control of the firm reverts to underhand dealings aimed at augmenting their income. This insider dealing might compromise company performance**.** Manager/insider ownership, on the other hand, has attracted a lot of attention and interest for a wide variety of reasons. Much of the interest has focused on the potential for better economic performance, particularly through enhanced motivation and commitment from employees who have a direct stake in the residual income of the firm. Strong majorities of the public believe that manager-owners work harder and pay meticulous attention to the quality of their work than non-owners, and are more likely than outside shareholders to influence firm performance. There have also been social arguments for manager/insider ownership of firms, based on its potential to broaden the distribution of wealth, decrease labor-management conflict, and enhance social cohesion and equality by distributing the fruits of economic success more widely and equitably (Gates 1998). The effect of foreign ownership on firm performance has been an issue of interest to academics and policy makers. According to Gorg and Greenaway (2004), the main challenging question in the international business strategy is the outcome gained from foreign ownership of firms. It is mainly accepted that foreign ownership plays a crucial role in firm performance, particularly in developing and transitional economies. Researchers (Aydin, et. al. 2007) have concluded that, on average, multi-national enterprises have performed better than the domestically owned firms. It is therefore, not surprising that the last two decades have witnessed increased levels of Foreign Direct Investments in the developing economies. Two main reasons have been put forward to explain the phenomenon of high performance associated with foreign ownership of firms. The first reason is that foreign owners are more likely to have the ability to monitor managers, and give them performance-based incentives, leading the managers to manage more seriously, and avoid behaviors and activities that undermine the wealth creation motivations of the firm owners. The second reason is the transfer of new technology and globally-tested management practices to the firm, which help to enhance efficiency by reducing operating expenses and generating savings for the firm.

3. Methodology

The relationship between shareholder types and firm performance is conceptualized based on pertinent literature on corporate governance. Shareholder types were conceptualized as comprising five categories, namely: foreign; institutional; government; insider; and diverse. Each of these shareholder types has different risk-taking orientations, which in effect impacts investment decisions and financial performance differently. Using Logistic Regression, scores of each of the shareholder types (independent variables) were regressed against observed results in terms of returns on assets (ROA), returns on equity (ROE) and dividend yield (DY).

3.1. Sampling Approach

A census approach was used, and thus the sampling frame consisted of all listed firms in Kenya. Using the Nairobi Stock Exchange Handbooks (2006, 2008), 54 firms were on the roll, out of which six had not compiled their financial reports for the relevant period of study. Another six failed to take part in the study. The final sample therefore, consisted of forty-two firms, representing about 78 percent response rate. The sample comprised four firms from the Agricultural sector (9.5%), seven from Commercial Services (16.7%), ten from Finance and Investment (23.8%), fourteen from Industrial and Allied (33.3%), and seven from Alternative Investment Market (16.7%).

3.2. Reliability Analysis

Reliability analysis was used to assess internal consistency (degree of homogeneity among the items). Cronbach's Alpha coefficients were computed for 18 items under board effectiveness and managerial discretion, and the overall assessment was 0.87. According to Nunnally (1978), a data collection instrument with a good internal consistency should have Cronbach's Alpha coefficients that are higher than 0.7. The items were therefore, found to be highly homogeneous.

4. Results

Pearson's Product Moment Correlation and Logistic Regression were conducted on SPSS. The results of ownership identity were analyzed based on five elements: government; foreign; institution; diverse; and manager (insider). On the other hand, managerial discretion has three elements:

perceived power; perceived discretion; and locus of control. The general form of the models used was:

FIRM PERFORMANCE = b_0 + b_2FORENOWN + b_3INSTOWN + b_4GOVOWN + b_5DIVOWN+ b_6 MANOWN…(1)

Where FORENOWN = foreign ownership; GOVOWN = government ownership; INSTOWN = institution ownership; DIVOWN = diverse ownership; MANOWN = manager ownership

The logistic regression results based on the model are summarized in Tables 1 and 2

Table 1: Results of Regression Analysis of the influence of Shareholder Type on Firm Performance (Mean and Median)

Variable	Foreign	Institution	Government	Diverse	F-Value
Return on Assets (ROA)					
Mean	11.3683	8.9433	5.7802	15.9147	0.705
Median	13.3438	7.9954	5.7802	15.4759	
Return on Equity (ROE)					
Mean	13.0520	12.0264	10.6902	22.1410	0.976
Median	16.49018	10.6834	10.6901	19.9699	
Divided Yield (RY)					
Mean	2.5363	1.2300	1.4300	1.9742	1.155
Median	2.1400	1.4800	1.4300	2.4900	

Table 1 shows marginal differences in firm performance by ownership category. These differences are, however, consistent with the expectation that foreign-owned firms were likely to have several advantages over their competition as they benefit from internationally sourced expertise, large capital base and internationally tested management practices. The results support a significant positive relationship (ROA: mean = 11.3883 and median = 13.3438; ROE: mean = 13.0520 and median = 16.49018; DY: mean = 2.5363 and median = 2.1400). A combination of all or some of these factors usually gives foreign multinationals an edge over competitors in the host countries. Diversely-owned firms, on the other hand, seemed to have slightly higher performance compared to institutions and government-owned firms. Government owned firms posted the lowest performance levels in terms of ROA and ROE (ROA: mean = 5.7802 and median = 5.7802; ROE: mean = 10.6902 and median = 10.6902). This finding is consistent with previous studies (see, De Alessi 1980, 1982; Yarrow 1988; Shapiro and Willig 1990; Shleifer and Vishny 1997). The relative low performance of government owned firms is in part attributable to the political interference in the management of such firms leading to whimsical appointments of boards and managers who may be under no obligation to serve the commercial interests of the firms. The relationships were also tested using r and β values, and the results are presented in Table 2.

Table 2: Logistic Regression Results for the effects of Predictor Variables on Firm Performance (Above Market Average)

Indicator Variable	**ROA Above Market Average**	**ROE Above Market Average**	**DY Above Market Average**
Predictor Variable	Parameter Estimates (β)	Parameter Estimates (β)	Parameter Estimates (β)
Foreign ownership	6.436*	3.810	6.579
Institution ownership	4.888	2.595	3.120
Government ownership	-15.794	-17.778	-17.021
Diverse ownership	6.041*	5.038	3.718
Manager/ insider ownership	5.013	4.049	5.162

*p<0.05

Hypothesis H_1: Manager (Insider) Ownership has a positive effect on firm performance. Logistic Regression results: ROA (β=5.013, p<0.05), ROE (β= 4.409, p<0.05) and DY (β = 5.162, p<0.05). The relationship was positive and significant, and hypothesis was accepted.

Hypothesis H_2: Government ownership has a negative effect on firm performance. Logistic Regression results: ROA (β=-15.794, p<0.05), ROE (β=-17.778, p<0.05) and DY (β=-17.021, p<0.05). The relationship was negative and significant, leading to acceptance of the hypothesis.

Hypothesis H_3: Ownership by Corporations has a positive effect on firm performance. Logistic Regression results: ROA (β=4.888, p<0.05), ROE (β=2.595, p<0.05) and DY (β=3.120, p<0.05).The results were positive and significant, leading to acceptance of the hypothesis.

Hypothesis H_4: Diffuse (Diverse) ownership has a negative effect on firm performance.

Regression results: ROA (β=6.041, p<0.05), and ROE (β=5.038, p<0.05); DY (β=3.718, p<0.05). The results led to a rejection of the hypothesis.

H**ypothesis H_{5e}: Foreign Ownership has a positive effect on firm performance.** Logistic Regression results: ROA (β=6.436, $p<0.05$), ROE (β=3.810, $p<0.05$; DY (β=6.579, $p<0.05$), leading to acceptance of the hypothesis.

4. Discussion and Conclusion

The study found a significant positive relationship between insider ownership and firm performance. It has been argued that when managers own shares in their company, they become more committed to the organization since they have a stake in the residual income of the firm, and are likely to bear the cost of mismanagement. This commitment translates to superior performance. In fact, the study reaffirmed this position among listed companies in Kenya. What was not established by the study however is the critical level of shareholding, beyond which there would be accelerated firm performance arising from commitment of managers. There is a significant negative relationship between government ownership and firm performance. Government ownership has been roundly criticized for contributing to generally poor performance of firms, due to excessive bureaucracy, tribalism, nepotism, poor human resource policies, political expediency in appointments and lack of respect for laws and regulations of the country. The current study has confirmed this long-held position. The implication is that government should infuse private sector-like management systems and progress the divestiture program to attract more private individuals and institutions to co-own the state corporations. Regarding the relationship between ownership by corporations and firm performance, the study found a significant positive relationship. Previous studies have found ambiguity in the relationship between ownership by corporations and firm performance, due mainly to the differences in investment preferences and shareholders' goals. So the good performance is attributable to the investment choices and orientation of the parent companies, and not necessarily the ability of managers.

The results stress that companies that are performing poorly need to carefully chose strategic partners to prop up their poor performance. A surprising finding of this study is the significant positive relationship between diverse ownership and firm performance. The global trend toward diffuse ownership has confounded many researchers, since it undermines the popular belief that managers are inherently self-seeking and can easily wreck the organization if left without close monitoring. The findings have brought a new dimension that emphasizes managerial discretion for creativity and innovation, and less monitoring by shareholders. Thus, diffuse ownership of firms provides a good environment for excellent policies to be developed and implemented by managers. The managers are therefore best informed regarding alternative uses for the investors' funds. As a result, the managers end up with substantial residual control rights and discretion to allocate funds as they choose. The downside of this argument is that it presumes that managers are honest, and always prepared to work in the interest of the shareholders, a position that is often not true. The fact that managers have most of the control rights can lead to problems of management entrenchment and rent-seeking behavior by managers. This study has shown that managers work best when they have sufficient latitude for innovation and creativity, that is, less monitoring by principals. The positive and significant relationship between foreign ownership and firm performance appears to have gained universal acceptance across the globe due to a number of factors. First, foreign owned companies have access to management systems whose efficacy has been tested in many contexts. The massive resource base and bail-out plans for fledgling affiliates are other factors that enhance performance of foreign owned firms. However, the ability of these companies to reorganize their global operations to be able to assign more costs to harsh tax regimes and profits to tax havens in a bid to reduce their overall tax liability, is the most damning feature of foreign ownership.

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