THE EFFECT OF EMPLOYEE SHARE OWNERSHIP STRUCTURE ON FINANCIAL PERFORMNACE OF FIRMS LISTED AT NAIROBI SECURITIES EXCHANGE

BY:

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DECLARATION

This project proposal is my original work and has not been presented for award of anydegree in any University.

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This project has been submitted for examination with my approval as University ofNairobi supervisor.

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DEDICATION

This research project is dedicated to wife Risper and my two lovely daughters Sally and Melisa, and friends for their support throughout our course.

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First and foremost I thank the almighty God, to whom all knowledge and wisdom has come from and for sustaining us in good health throughout the study period.

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ABSTRACT

The objective of this study was to determine the effect of employee share ownership structure on financial performance of firms listed at the Nairobi Securities Exchange in Kenya. The research used a descriptive survey research design. The descriptive survey was ideal because it ensured thorough description of the situation ensuring least possible bias in data collection. The study made use of secondary data collected from annual reports submitted to the CMA for the target population comprised of all listed companies who have adopted ESO. Summaries of data findings together with their possible interpretations were presented using tables, charts, correlations, standard deviations and regression. The study found out that mean of ESO ratio is relatively high as compared to other variables. The ESO ratio also had the highest standard deviation. The Foreign ownership had the highest correlation with the performance followed by ESO. From the regression equation the study concluded that a unit increase in ESO, Foreign ownership and firm size would lead to improvement on the financial performance of companies listed at NSE. Therefore; the study recommends that; ESO should always be taken in to account to improve the performance of listed companies as measured by return on assets. Policy makers should also undertake to understand the impact of employee and management ownership in the performance of firms listed at NSE.

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LIST OF ABBREVIATIONS

AIMS Alternative Investment Segment

CMA Capital Markets Authority

ESO Employee Share Ownership

ESOP Employee Share Ownership Plans

FIMS Fixed Income Market Segment

GDP Gross Domestic Product

MIMS Main Investment Segment

NSE Nairobi Securities Exchange

ROA Return on Assets

CHAPTER ONE

INTRODUCTION

1.1 Background ofthe study

Employee ownership structure is identified as a means of enhancing enterprise performance through promoting worker productivity. The theoretical basis for this rationale is generally located in agency theory. In the corporate governance context, agency theory has highlighted the corporate governance problem arising out of the separation between ownership and control. Shareholders and managers may have divergent interests and shareholders may find it difficult and expensive to monitor management, particularly where they hold small stakes in much different firms. Agency theory has also been used as a theoretical framework in studies of financial participation. It is argued that agency costs arise as a result of the divergent interests between employees and other stakeholders in the company (principally managers and owners). Managers may seek to ameliorate these agency costs through directly monitoring employees and/or through adopting incentive-based forms of remuneration. Employee share ownership is one such incentive mechanism by which to reduce costs to the company through more closely aligning the interests of employees with those of other stakeholders in the company (Landau and O'Connell, 2007).

According to Brown and Wah Lau (1997) there is a range of industrial relations or human resource management rationales for employee share ownership (ESO). ESO is viewed by some as a potential means of enhancing industrial democracy or of bringing the employee into corporate governance.For some, it is a means of increasing employee understanding of how the

company for which they work operates and, more broadly, of absorbing the principles on which the economy of the country is run.For others, it is seen as a means of facilitating labor-management cooperation through breaking down the 'them' and 'us' mentality. Some identify ESO as a substitute for salary or wages when business is not performing well.

In relation to corporate governance, ESOs are identified as a potential defense against hostile take-over bids or as a means of rescuing companies in financial difficulties. ESOs may also be a mechanism through which employees can 'buy out' a company or a government can privatize a government enterprise. ESO may facilitate the development of an enterprise and at the macro-economic level;ESO can be seen as a means of raising capital and of dispersing ownership within capitalist societies. ESO are also recognized as a potential means of ameliorating the shortage of long term savings.

1.1.1 Employee Share Ownership Structure

Employee share ownership (ESO) is a form of employee financial participation that confers on employees the right to share in the wealth of the company and, in theory at least, the right to exercise some degree of control over company affairs. The creation of the ESOis usually credited to Louis Kelso, a San Francisco attorney and investment banker. In 1956, Kelso implemented for a San Francisco newspaper the first ownership transfer to employees by means of what later became known as The Kelso Plan. In 1958 he collaborated with the philosopher Mortimer Adler to write The Capitalist Manifesto outlining the economic, social and political benefits that would ensue from broad based employee ownership. In the early 1970s, the concept attracted an important ally, Senator Russell Long of Louisiana, the longtime Chairman of the Senate Finance

Committee. Kelso and Long claimed that employee ownership builds commitment, which leads to productivity and profits, and argued that legislation facilitating broader-based ownership would not only increase corporate performance, but also ease workplace tensions, reduce disparities of wealth, and help build a better society.

The most widely identified cost arising from employee share ownership is the financial risk it imposes on employees. In general, employees have less discretionary income and a lower ability to diversify their risks than conventional investors. The wage system allocates the greater proportion of risk upon shareholders who are more capable of bearing the risk. Employee share ownership shifts some of this risk back on employees. Through broad-based ESOs, an 'employee is asked to make an equity investment in the same firm in which his or her labor is invested. Should the firm fail, the employee loses on both investments. The extent to which ESOs expose employees to risk will, of course, vary significantly depending on the way the ESO is structured and the regulatory framework (Gordon and Pound, 1990).

According to Bartkus (1997) ESO is a qualified retirement plan which must be accompanied by a qualified trust. He defined ESO as a defined contribution plan that is a stock bonus plan or a qualified stock bonus money purchase plan that must invest primarily in qualifying employer securities. There are two types of ESOsi.e leveraged and unleveraged. Leveraged ESO means that the employees borrows money to acquire employer shares and the stock is kept into a trust which has full control over the shares until the debt is paid while Unleveraged ESO is where employees buy shares with money from their own sources. Both leveraged and unleveraged ESOs may be initiated by employees or by management. ESO are the results of decisions

undertaken management unilaterally. ESO is a form of participation that offers employees an opportunity to participate in the ownership and also participation in decision-making as noted by Hallock et al., (2003). The ESO concept is increasingly becoming popular amongst corporations in Kenya. The reason for adoption of ESO by the Kenyan companies is largely attributed to the need to attract and retain top talent to drive the companies' long term performance and value creation. Equity based compensation is expected to reduce employee turnover and motivate workers (Odera, 2004).

1.1.2. Financial Performance

Performance can be defined in many ways. It has been defined as the amount of utility or benefits derived from the firm or the organization by its stakeholders (Rashid, Islam & Anderson 2008). The continued viability of an institution depends on its ability to earn adequate return on its assets and capital. Good earnings performance enables an institution to fund its expansion, remain competitive in the market and replenish and increase its capital evaluation of earnings. The performance relies heavily upon comparisons of key profitability measures such as return on assets and return on equity to industry benchmark and peer group norms. According to Kagalwala and Ram, (2003) many institutions throughout the world have disappeared due to weaknesses in board parameters of risk management functions. Institutions that must survive need Higher Return on Assets (ROA). This is a net after tax profit divided by total assets. It is a critical indicator of profitability. Companies, which use their assets efficiently, will tend to show a ratio higher than the industry norm.

According to Jensen and Mecklings (1976) agency theory, that financial incentives such as employee ownership may make interest of the employees align with those of the stockholders. Financial performance in this context refers to measuring the results of a firm's policies and operations in monetary terms. These results are reflected in the firms return on assets or value added. In this paper, the financial performance would be measured in terms management efficiency ratios such as assets turnover, operating profit margins and operating profits relating to assets. These efficiency ratios are indirect improvement in the firm's performance which could be attributed to the change of employee's perspective from that of being a worker to an owner, thus making them responsible and productive.

1.1.3. The Effect of Employee Stock Ownership on the Financial Performance

Some studied have indicated a positive impact while others have indicated a negative or nearly no relationship. The general conclusions however of the major empirical studies that have examined the relationship between adoption of ESOs and firm performance, firm productivity and stock performance indicates that the impact of adoption of ESOs on the firm performance appears weak, but a positive association does exist.

ESOs adoption boost employee morale and may also strengthen incentives for management to make decisions in the employee/ owners best interest, leading to improved profitability through gains in labor productivity or reduction of labor costs (Chen and Kensinger 1988).Ownership interest motivates employees by aligning their interests with those of shareholders and workers may increase measures of management efficiency such as asset turnover and profitability. Taylor (1981) also noted that ESO adoption would enhance firm performance through self and

peer monitoring and establishment ofreciprocal agency between employees and managers.Other writers have however indicated that ESOs impede the efficient transfer of corporate control leading to the shareholders loss of potential takeover premium and also excessive consumption of firm resources by entrenched managers, thus leading to less than optimal performance by the firms.

1.1.4. Companies Listed at Nairobi Securities Exchange

The Nairobi Securities Exchange is the principal stock exchange of Kenya. It began in 1954 as an overseas stock exchange while Kenya was still a British colony with permission of the London Stock Exchange. The NSE is a member of the African Stock Exchanges Association. Nairobi Securities Exchange is Africa's fourth largest stock exchange in terms of trading volumes, and fifth in terms of market capitalization as a percentage of GDP. There are more than 61 businesses and companies listed in the NSE.

NSE is categorized into three market segments; Main Investment Market Segment (MIMS), Alternative Investment Market Segment (AIMS) and Fixed Income Market Segment (FIMS) Companies listed under this segment are further categorized in ten sectors that describe the nature of their business, namely: agricultural, commercial and services, telecommunication and technology, automobiles and accessories, banking, insurance, investment, manufacturing and allied and construction and allied. Currently, there are Sixty one Companies listed in the Nairobi Stock Exchange. However, only 10 of these have registered Employee Stock Ownership Plans (Appendix I).

1.2 Research Problem

There is a range of industrial relations rationales for employee share ownership. Employee share ownership is viewed by some as a potential means of enhancing industrial democracy or of bringing the employee into corporate governance. For some, ESO is a means of increasing employee understanding of how the company for which they work operates and, more broadly, of absorbing the principles on which the economy of the country is run. ESO is seen as a means of facilitating labor-management cooperation through breaking down them and us mentality. Some identify ESOs as a substitute for salary or wages when business is not performing well. More recently, employee share ownership, as a means of financial participation, is identified byscholars as one practicethat together constitute a high performance work system. Employee share ownership also intersects with the discourse on labor-management partnerships. ESOs have also been identified as a potential defense against hostile take-over bids or as a means of rescuing companies in financial difficulties.

There are many rationales offered to support employee share ownership, informed by a variety of ideologies and intentions. Some justifications are focused on the enterprise level, whereas others see ESO as part of a broader social or macro- economic project. Employee share ownership is identified as a means of enhancing enterprise performance through promoting worker productivity. The theoretical basis for this rationale is generally located in agency theory. In the corporate governance context, agency theory has highlighted the corporate governance problem arising out of the separation between ownership and control. Shareholders and managers may have divergent interests and shareholders may find it difficult and expensive to monitor management, particularly where they hold small stakes in many different firms. Agency theory

has also been used as a theoretical framework in studies of financial the adoption of ESOs has continued to grow globally especially in the developed world. The dramatic growth has been attributed to various factors such as tax benefits, mergers, acquisitions and employee benefits (Pugh et al., 2000) and employee motivational tool (Dhiman 2008).

There is a considerable amount of empirical research that attempts to assess whether the implementation of employee share ownership leads to enhanced organizational performance. There are two commonly identified ways in which ESO schemes reduce agency costs: through increased productivity as a result of employee's feeling they have a direct interest in the performance of the enterprise (thus enhancing commitment to the objectives of the firm); and through lowering monitoring costs through aligning employee interests with those of the firm.
A number of theoretical explanations have been proffered for the precise way in which ESOs lead to increased organizational performance. First is the 'pure incentive effect of financial involvement' by employees as they receive some income (deferred or cash) which is directly linked to the performance of the enterprise. Second, ESOs cause the employee to identify with the firm, thus leading to reduced employee turnover and absenteeism. Finally, ESOPs may provide incentives for employee owners to share information at all levels, resulting in increased organizational efficiency (Landau et al.2007).

Blasi et al. (2003) claim a confluence of favorable outcomes among nearly all empirical research studies on employee ownership. Problems related to ESO adoption and suggest that ESOs have not led to significant increases in corporate performance. In Kenya, ESOs are being used as schemes to provide employee benefits and also as investment vehicles. The schemes are largely

motivational tools to attract and retain top talent. Equity based compensation locks in employees because only those who have served a company for a particular period qualifies for the incentive. This will help drive long term performance and value creation the motivational aspect is expected to augment the profitability performance of the company by reducingemployee cost, minimize wastage and improve on company's management or operating efficiency. Studies in other countries on the effect of adoption of ESO have indicated mixed results. Despite growth in the adoption of ESOs by firms in Kenya, few studies have been conducted to determine any effect(s) or relationship of adoption of the ESO on the firm performance, hence the need to carry out this research. This study wished to answer this research question: Does the adoption of ESO influence financial performance of listed companies in Kenya?

1.3 Objective of the Study

The objective of the study was to establish the effect of employee share ownership on the financial performance of firms listed at Nairobi securities exchange.

1.4 Value of the Study

This study is important to various stakeholders and market regulator namely the CMA which will gain knowledge on how to handle employee stock ownership plans in regard to the regulations and making of policies. Due to making sound regulations and policies, this would result into improved confidence in investors in investing in the stock market.

The study would give guidelines to institutional investors to enhance their understanding of the determination of the companies to invest in. This would assist the investors in making viable

decisions while investing in the stock market. This study would be helpful to investors in taking rational decision like where to invest, how to invest, and what portfolio should be made to obtain maximum profits from their investment base on whether the companies have employee stock ownership plans.

Listed companies and those companies seeking to list their shares on the NSE will be able to appreciate the effect of employee stock ownership plans, and this would assist them in making so sound decisions whether to have employee stock ownership plans. They would make viable decisions when making strategic decisions.

The study results obtained would be useful to research institutions and the Government who want to advance the knowledge and literature on employee stock ownership plans. It would also add to literature on the subject as reference material and stimulate further research in the area. The employee stock ownership plans implications are crucially important to economy policymakers of the developing markets, not only because employee stock ownership plans plays such key role in the performance but also it fuels the economic growth of these markets by feeding the great capital demand.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter seeks to explore four components of the study. It entails the theoretical framework, which contains theories in governance. It also tackles empirical review, which explores various past studies by different researchers on various aspects of employee share ownership.

2.2 Theoretical Literature Review

The following Section reviews the theoretical perspectives of employee share ownership that is relevant for this study, drawn on agency theory, stewardship theory, stakeholders' theory and institutional theory.

2.2.1 Agency Theory

Much of the research into governance derives from agency theory, which posits that accountability is necessary in order to ensure that the principal-agent problem is mitigated (Berle& Means 1932). The agency theory was established by Jensen and Meckling in 1976. The theory models the relationship between principal (government) and the agent (public sector managers) .An 'agent' is someone who performs work on behalf of another individual (i.e. the principal). The difficulty that arises from the principal-agent relationship is that it is not possible for principals to contractually define everything that the agent should do in every conceivable situation. The 'ideal' or 'complete' contract is impossible due to bounded rationality. The

problems arising from the principal-agent relationship may be exacerbated by three factors: hidden information, sunk costs and opportunism (Fama& Jensen 1983b).

Jensen and Meckling (1976) argued that the separation of ownership and control has resulted in an agency problem as the managers who act as agents might not always act in the best interests of the shareholders or owners, who are the principals of the firm. This might be due to the interests of both parties which are not aligned. Agency problem results in agency costs, which are the costs of the separation of ownership and control. Agency costs have been defined as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual costs. The agency problems arise because managers will not solely act to maximize the shareholders' wealth; they may protect their own interests or seek the goal of maximizing companies' growth instead of earnings while making decisions. Jensen and Meckling (1976) suggested that the inefficiency may be reduced as managerial incentives to take value maximizing decisions increased. Agency costs arise from divergence of interests between shareholders and company managers; it includes the monitoring costs, bonding costs, residual loss and costs of free cash flow and debt

2.2.2 Stakeholder Theory

The significance of stakeholder theory is that it recognizes that organizations are not controlled or affected purely by those that exercise ownership rights in the organization. As Freeman et al. (2004) argued: the notion that shareholders govern the corporation is largely a fiction; typically, executives have the greatest power'. In this sense the conventional model of the corporation, in both legal and managerial forms, has failed to discipline 'self-serving' managerial behavior. The

fundamental consequence of stakeholder theory for corporate governance is that it necessitates governance structures that promote alignment not just between agents and principals, but between agents, principals and parties who have broader, but reasonable, interests in the organization. It is precisely because of this multifaceted approach to understanding corporate governance: that corporate governance should be responsive to multiple, competing interests, which provide intellectual rigor to a stakeholder framework.

According to Smallman (2004), the main criticism of stakeholder theory is focusing on identifying the problem of who constitutes genuine stakeholders. Another argument is that meeting stakeholders' interests also leads to corruption, as it offers agents the opportunity to divert the wealth away from shareholders to others.

2.2.3 Stewardship Theory

Stewardship theory has its roots from psychology and sociology. A steward protects and maximizes shareholders wealth through firm performance, because by so doing, the stewards' utility functions are maximized (Davis Schoorman and Donaldson 1997). The theory stresses on the role of top management being as stewards, who integrate their goals to that of the organization and becomes a good steward of the corporate assets (Donaldson and Davis, 1991). It suggests that stewards are satisfied and motivated when organizational success is attained and views agents as stewards who manage their firms responsibly to improve its performance (Donaldson and Davis, 1991; Muth and Donaldson, 1998).Stewardship theorists argue that senior executives will not disadvantage shareholders for fear of jeopardizing their reputation (Donaldson and Davis, 1994).

The stewardship theory argues and looks at different forms of motivation for managers drawn from organizational theory. Managers are viewed as loyal to the company and interested in achieving high performance. They are motivated by their desire to perform excellently and the need to achieve gain satisfaction through successfully performing inherently challenging work recognition from peers and bosses due to exercising responsibility and authority. Therefore, there are non-financial motivators for managers (Donaldson and Kay, 1976).

It argues that managers are given the freedom to act more autonomously in running the affairs of the firm in order to maximize shareholders wealth since failure of the firm will be ascribed to failure by the managers while success of the firm will boost managers' morale and provide bonuses plus additional incentives. Managers' motivation is less problematic and the most important factor influencing firm performance and shareholders return is the design of the firm structure so that managers can take effective action (Chitayat, 1985). The key issue is thus not to raise control and monitoring of management or make them firm owners but rather to empower executives.

2.2.4 Resource Dependency Theory

According to the resource dependency theory, directors bring resources such as information, skills, key constituents (suppliers, buyers, public policy decision makers, social groups) and legitimacy that will reduce uncertainty which in turn reduces the transaction cost and the potential of linking the organization with the external networks. This provides opportunity to gather more information and even skills in various specialties. Lawrence and Lorsch (1967)

linked the resource dependency theory as an environmental influence on corporate governance and they argued that successful organizations possess internal structures that match external environmental demand. Pfeffer (1972) confirmed this argument and explained that board size and its composition is a rational organizational response to the conditions of the external environment and he further argued that external independent directors may serve to connect the external resources with the firm to overcome uncertainty, which is very important for long term sustainability. This was emphasized in the corporate governance which explains that a majority of external members could bring the most needed business skill into institutions. Further resource dependency theory was supported through appointment of external members to the board as a way of obtaining multiple skills and because of their opportunities to gather information and networking in various ways.

2.2.5 Institutional Theory

Institutional theory is a widely accepted theoretical posture that emphasizes organizations is social cultural systems and it focuses on the deeper and more resilient aspects of social structure. It considers the processes by which structures, including schemes; rules, norms, and routines as authoritative guidelines for social behavior (Scott, 2004). Different components of institutional theory explain how these elements are created and adapted over time.

The emphasis on institutional theory is normally viewed from the regulatory perspective. Better legal environment encourages the adoption of good governance due increased incentives to the firms and countries have different governance codes that serve as templates for practice in the concerned countries (Stulz et al., 2004). The main idea of institutional theory is that the

organizations are exposed and linked to external environment accordingly; governance should ensure that, there is a clear link between the organizations and environment based on organizations goals and objectives. Governance should have an effective influence and involvement in formalizing and identifying corporate goals. Cohen et al. (2007) suggested that, in order to formulate a compensation policy senior manager should understand all norms and traditions of the organization. However, those policies are resistant to change even in the face of major changes in job content and technology complexity. The adaptation and rejection of these changes should be examined and investigated based on the historical, social and political issues that are linked to recognizing organizational changes.

2.3 Determinants of financial performance

There are clear differences within countries in the promotion and incidence of share ownership plans; there are also clear differences between countries. Certain kinds of firms are far more likelyto use employee share ownership plans than others.

2.3.1 Size

Information asymmetries and monitoring are said to become more costly as firm size, and managerial hierarchies, increases. For this reason, size is widely predicted to be associated with the adoption and use of share plans, and indeed many studies find this to be the case (Landau et al. 2007). Employee share ownership appears to be a large-firm phenomenon and it seems likely that high fixed costs associated with the administration of share ownership plans may also be important in explaining the distribution of share schemes. However, the problem with this

finding is that company size is likely to be inversely related to the incentive effects of share ownership, because of the free-rider effect.

2.3.2 Risk

Agency theory predicts that optimal contracts will be a trade-off between incentives and risk.

There is substantial evidence elsewhere in the pay literature that firms facing high risk are less likely to use incentives-based pay schemes, probably due to employee risk aversion (Bloom and Milkovitch, 1998). It has been suggested that the need to pay preemie to employees to compensate them for bearing significant risk can make contingent rewards costly for firms.

However, Prendergast (2002) posits a positive relation between risk and incentives, since in more uncertain settings the principal is often better off delegating responsibility to the agent(s), and the delegation necessitates the use of incentives.

Oyer (2004) argues that when uncertainty is high, fixed wage contracts require frequent revision, but the transaction costs of rewriting the contracts become prohibitively costly. To retain the best employees, it is better to tie compensation to a measure that correlates with the business cycle, such as share price. Most studies do not measure the role of risk in the firm's operating environment (Sesil et al. 2002) but it is common for measures of competition to be used. The results, however, tend to be inconclusive.

2.3.3 Liquidity Constraints

According to Yermack (1995), firms with severe cash constraints and high capital needs maysubstitute equity compensation for cash pay. For instance, IT companies that have not

yetsecured positive income streams and are investing heavily relative to their assets may use equity-based pay (especially options) for this reason. Core and Guay (2001) found that firms use non-executive option grants as a substitute for cash compensation to a greater extent when they face

Cash flow constraints and when the costs of external capital are greater.However, Jones et al. (2006) found no support for this in a Finnish panel studyHence, the rationale for using share ownership plans is not so obvious (Prendergast 1999).

2.4 Empirical Literature Review

ESO is now a widespread form of employee participation in many industrialized nations. It is where employees acquire equity shares in their employer so that they become shareholders. In recent years governments in North America, Europe, Australasia, and Asia have promoted various forms of employee share ownership, though the incidence of schemes and the level of employee participation varies considerably between countries. In principle, employee ownership gives employees additional rights to those normally expected by employees: a right to share in the company's profits, access to information on company finances and operations, and rights to participate in the management of the company (Rousseau and Shperling 2003).

According to Gates (1998) ESO may bring about fundamental changes in employee attitudes and behavior, which may in turn be reflected in a range of company-level outcomes such as productivity and financial performance. ESO takes a variety of forms, some of which may have greater significance and effects than others. Employees may acquire large proportions of

company shares; possibly even a majority or the entire share capital, or just a small minority stake. Shares may be held individually or collectively. Participation in the share ownership plan may be limited to just a few individuals, typically senior managers, or open to the entire workforce. The extent to which employees possess profit-sharing, information, and participation rights also varies considerably (Ben-ner and Jones 1995).

Rosen and Quarrey (1987) examined employment and sales growth in a sample of 45 ESOs and a control group of 238 non-ESOs chosen to correspond to each subject firm's size and industry. The time period examined was from 5 years prior to ESO implementation to 5 years after ESO implementation. The authors found that the ESOP firms had 1.89 percent faster growth in sales and 1.21 percent faster growth in employment than the control group prior to ESO implementation, but the ESO firms outperformed the control group at the rates of 5.4 percent in sales growth and 5.05 percent in employment growth after the implementation of the ESO. Also, 73 percent of the ESO sample significantly improved performance with regard to sales and employment growth during a five-year period immediately following the ESO implementation. Similar results were found with a smaller sample of 20 ESOs and a control group of non-ESO firms (Rosen, 1991).

Gordon and Pound (2005) examined the immediate stock market reaction to the public announcement of ESO adoptions that specifically preclude their use as a takeover defense. These authors report significantly positive share-price reactions to ESOPs adopted solely for the purpose of an employee benefit or wage concession. Although studies of large public companies provide evidence that the market reacts favorably to the announcement of no defensive ESOPs,

they do not investigate whether firm performance is actually improved in the long run. The positive share-price reaction at the time of the ESOP announcement is consistent with the market's pricing the expectation of higher future cash flows. Whether these higher expected cash flows actually occur is an unanswered question.

Gamble (2003) did a study on ESOPS as financial performance and federal tax incentives. Previous research had suggested a relationship between the establishment of employee stock ownership plans (ESOPs) and past-adoption improvements in financial performance — presumably as a result of the alignment of employee and stockholder interests. I examine the role of tax incentives on the financial performance of ESOP firms. The results indicate that ESOPs farmed prior to the availability of tax incentives provided by the lax Reform Act of 1986 have experienced significantly greater improvement in financial performance than ESOPs established after passage of the Act, The results are consistent with my hypothesis and suggest that even though ESOPs can be utilized to reduce a firm's federal income tax liability, ESOPs may be more useful to management to reduce agency costs throughout the firm.

Blasi et al. (2003) claim a confluence of favorable outcomes among nearly all empirical research studies on employee ownership. ESOs have not led to significant increases in corporate performance. Although the quantity and cumulative findings of research on employee ownership may be impressive, lack of engagement with critics means that the research and the idea of employee ownership have limited impact in the larger world of knowledge and ideas, and leaves doubts about the assertions. This variety means that generalizations about employee share ownership have to be made with caution. Perspectives on the significance of employee share

ownership also vary widely. Policy-makers in some countries have identified incentive effects from aligning workers interests withthose of the firm and its shareholders. Some go further and see it as heralding a significant change in the nature of employment in advanced industrial societies by blurring traditional boundaries between workers and owners.

2.5 Summary of Literature Review

Most share ownership plans do not appear to fundamentally transform the employment relationship. This is because, in mostcases, the amount of equity passing to employees is proportionally small, and there is little expectation on the part of those involved that share ownership will transform the way the company is run. But there are exceptions, especially where there is substantial employee ownership. However, even focusing on minority ownership there is substantial evidence of attitudinal and behavioral impacts in certain circumstances. There is also enough evidence to suggest that share ownership has favorable effects on company and workplace performance. Despite consensus in the literature on these effects, it is also apparent that there is a lack ofclarity.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the methodology of the study. It outlines how the study was carried out. The chapter presents the research design, the population, sample and sampling technique, data collection method and instruments and data analysis.

3.2 Research Design

This study adopted a descriptive research design. The choice of the descriptive survey research design was made based on the fact that in the study, the research is interested on the state of affairs already existing in the field and no variable was manipulated. A descriptive study attempts to describe or define a subject, often by creating a profile of a group of problems, people, or events, through the collection of data and tabulation of the frequencies on research variables or their interaction as indicated by Cooper and Schindler (2003). Descriptive research portrays an accurate profile of persons, events, or situations (Kothari, 2000).

3.3 Target Population

Cooper and Schindler (2003) define target population as the entire group that is of interest to the researcher. The population of the study will be listed companies at the NSE which have adopted ESO (CMA 2014). The study will focus on the listed companies who have adopted ESO. The study period was from 2010 to 2014. A five year period is long enough to reveal short-term, medium-term and long-term changes and permit valid conclusions thereof. The target population

for this study was 10 companies who have adopted ESO (Appendix I) listed in the Nairobi Securities Exchange as at December 2014.

3.4 Data Collection

The study used secondary data, this is because listed companies at the Nairobi Securities Exchange are required to publish their Audited Financial Statements and Other Disclosures in a newspaper of nationwide circulation as well display them on their websites. The balance sheet will be analyzed to enable the researcher to identify liquidity components and the income statements which provided the financial performance measures for the period. Any other relevant notes to the financial statements for the period were considered.

3.6 Data Analysis Methods

Data was analyzed using Statistical Package for Social Sciences (SPSS Version 21.0) program. Being that the study was descriptive in nature, both quantitative analysis and inferential analysis was used as data analysis technique. The data collected was run through a regression model so as to clearly bring out the effects of change in ESOs on firm's financial performance. The results obtained from the models were presented in tables to aid in the analysis and ease with which the inferential statistics were drawn.

The under-mentioned model was used: $Y = \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + \varepsilon$

Where: Y = Financial performance (measured by Return on Assets)

$\beta 0$ = Constant Term; $\beta 1$, $\beta 2$, and $\beta 3$ = Beta coefficients;

X1= ESOs (measured by Number of ESO/Total number of shares)

X2= Foreign Ownership (measured by Number of Foreign Ownership share ownership /Total number of shares)

X3=Company size (measured by natural log of total assets)Control variable

ε = Error term

3.7 Test of Significance

T-tests can be used to determine whether there is a significant difference between two sets of means. Therefore t-tests using SPSS statistical program would be employed in this study. Conducting the t-tests requires that the normality of the data is not violated. The P-values of results of the multiple regression analysis shall be used to test for significance of the relationship between variables. The significance level to be used shall be 0.05 (5%) to test for significance where any P-value of less than 0.05 shall indicate a significant relationship.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The chapter presents the outcome of data analysis and findings in line with the objectives of the Study. The general objective was to assess the effect of employee share ownership structure on the financial performance of firms listed at NSE. The data were analyzed using the Statistical Program for Social Sciences (SPSS) version 20, by use of both descriptive and inferential statistics. Descriptive statistics such as minimum, maximum mean and standard deviation were used. The results are based on the analysis of financial results of 10 listed companies which have adopted the ESO plans. A discussion of findings is then made.

4.2 Findings and analysis

A cross examination of the data collected in respect of the study variables reveals various insights that are relevant to the subject of the study. This section presents the data for the variables of the study. In particular, descriptive statistics of the variables are discussed below followed by the regression analysis of the variables.

4.2.1 Financial Performance

The financial performance of listed companies at the NSE was measured as the ratio of the aggregate profit before tax in every year of the study period (2010-2014) and the aggregate value of the total assets of the companies at the end of each year. Tabulated below are the descriptive statistics of the quarterly ROA.

Table 4.1: Descriptive Statistics, Quarterly Return on Assets.

	N	Minimum	Maximum	Mean	Std. Deviation
Return on Assets	50	-0.01891	0.3012	0.20513	0.01706
Valid N (list wise)	50				

Source: Research Findings (2015)

The aggregate return on assets earned by companies listed at NSE who has adopted the ESO plans between 2010 and 2014 stood at an average of 0.20513. The minimum ROA for the years studied -0.01891while the highest was 0.3012. The standard deviation of the ROA in all the 50data points was 0.01706, suggesting a relatively low level of variability in the ROAs from the mean value.

4.2.2 Employee Stock Ownership

This was the key independent variable of the study. The ESO percentages were obtained from the annual reports issued by the CMA for the last five years starting from 2010 to 2015. The percentage was obtained by computing the amount of stock owned by the employee compared total amount of shares outstanding for the listed companies (Appendix II). The table below illustrates the descriptive statistics for theESO.

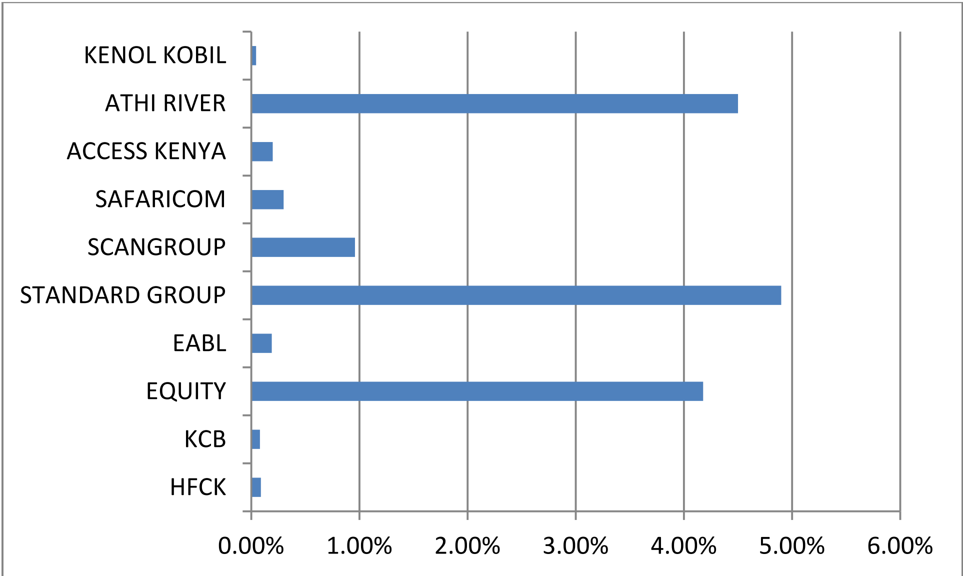
Table 4.2: Descriptive Statistics, ESO Plans

	N	Minimum	Maximum	Mean	Std. Deviation
ESO	50	0.046	4.900	1.540	0.172
Valid N (list-wise)	50				

Source: Research Findings (2015)

From the table, 4.1 there was a relatively high variation in the ESO percentage of firms listed at NSE, considering the wide range of the values observed. The minimum ESO was 0.046%, the maximum was 4.9. This could explain the wide variation observed between the minimum and maximum values observed over the entire study period. In addition, the CMA of Kenya is mandated by law to review the performance of the listed companies.

Figure 4.1. Employee Stock Ownership



Standard group of companies has the highest percentage of employee stock ownership plans at 4.9%, followed by Athi River Mining at 4.18%, Equity Bank at 4.18% and Scan group at 0.96%. The company with the least percentage of the ESO was Kenol Kobil at 0.046%.

4.2.3 Foreign Ownership

The foreign ownership of companies listed at NSE are influenced by several factors including the rules and regulations regarding the listing of companies at the exchange. The other important factor is whether the firm is a multinational or not. Apart from the ESO and the foreign

ownership other variables were taken into consideration that is the total assets to control for the size of the firms which are in different industries and were listed at different times.

Table 4.3: Descriptive Statistics, Foreign Ownership

	N	Minimum	Maximum	Mean	Std. Deviation
Foreign Ownership	50	0.0921	0.2152	.1214	.02270
Valid N (list-wise)	50				

Source: Research Findings (2015)

4.3 Regression Analysis

Researcher conducted a multiple regression analysis so as to test relationship among variables (independent) on the financial performance (Profitability). The researcher applied the statistical package for social sciences (SPSS V 20.0) to code, enter and compute the measurements of the multiple regressions for the study.

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (Financial performance (Profitability)) that is explained by all the three independent variables (ESO , Foreign Ownership and Total Assets).

4.3.1 Model Summary

The three independent variables that were studied, explain only 74.6% of the financial performance (Profitability) as represented by the R^2. This therefore means that other factors not

studied in this research contribute 25.4% of the financial performance (Profitability) of listed companies at the NSE. Therefore, further research should be conducted to investigate the other factors (25.4%) that affect financial performance (Profitability) of listed companies at NSE.

Table 4.5: **Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.841[a]	0.746	0.683	0.5271

a. Predictors: (Constant), ESO, Foreign Ownership, Total Assets

Source: Research Findings (2015)

The coefficient of correlation among the quarterly Return on Assets, ESO and Foreign Ownership variables have a high correlation. From the table, the value of the coefficient is 0.841. The proportion of variation in the ROA of the listed companies and the ESO and Foreign ownership in the study period that is explained by the variation in the study independent variables is also high. The R Square is 0.746, suggesting that approximately 74.6% of the variation in the ROA across all the listed companies most likely arose from changes in the study's independent variables. Further tests were performed in order to examine the significance of the regression model obtained. Tabulated below is the ANOVA summary obtained from the significance tests performed.

4.3 ANOVA Results

The significance value is 0.0276which is less than 0.05 thus the model is statistically significance in predicting the financial performance of listed companies which have adopted the ESO plans. The F critical at 5% level of significance was 3.23. Since F calculated is greater than the F critical (value = 9.475), this shows that the overall model was significant.

Table 4.6: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	3.532	3	1.267	8.475	.0276[a]
	Residual	7.317	37	2.421		
	Total	**10.849**	**40**			

a. Predictors: (Constant), ESO, Foreign Ownership, Total Assets

b. Dependent Variable: ROA

Source: Research Findings (2015)

4.4 Coefficient of Determination

Multiple regression analysis was conducted as to determine the relationship between financial performance (profitability) and the three variables. As per the SPSS generated table above, the equation

($\mathbf{Y} = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$) becomes:

$Y = 2.143 + 0.752X_1 + 0.487X_2 + 0.545X_3$

According to the regression equation results and taking all factors into account (ESO, Foreign Ownership and Total Assets) constant at zero, financial performance will be 2.143. The data findings analyzed also shows that taking all other independent variables at zero, a unit increase in ESO rate will lead to a 0.752 increase in financial performance in listed companies; a unit increase in foreign ownership will lead to a 0.487 increase in financial performance of listed companies, a unit increase in total assets will lead to a 0.545 increase in financial performance in commercial banks. This infers that ESO contributes most to the financial performance in listed companies followed by total assets. At 5% level of significance and 95% level of confidence, ESO had a 0.0193 level of significance;foreign ownership showed a 0.0169 level of significance and total assets showed a 0.0252 level of significance.

Table 4.7 Coefficient of determination

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	**Std. Error**	**Beta**		
1	(Constant)	2.143	1.3221		1.614	0.047
	ESO	0.752	0.1032	0.252	5.123	.0193
	Foreign Ownership	0.487	0.3425	0.014	2.724	.0169
	Total Assets	0.545	0.2178	0.126	3.736	.0252

a. Dependent Variable: Return on Assets

Source: Research Findings (2015)

4.4 Interpretation of the Findings

The test of significance of the regression model using the ANOVA technique shows that the regression model is was statistically significant.The significance value is 0.0193which is less than 0.05 thus the model is statistically significance in predicting how ESO ,foreign ownership and total assets affect return on assets of listed companies at NSE. The F critical at 5% level of significance was 2.76%. Since F calculated is greater than the F critical (value = 8.475), this shows that the overall model was significant.This implies that the changes that were observed in financial performance as the changes in the ESO, foreign ownership and total assets. This could be attributed to the stringent regulatory framework that the CMA has put in place in recent times to ensure that listed companies are adequately shielded against adverse economic events.

The significance of the model is further affirmed by the results of the significance tests for the regression coefficients. This infers that ESO contribute most to the financial performance in listed companies at NSE At 5% level of significance and 95% level of confidence, ESO had a 0.0193 level of significance, foreign ownership showed a 0.0169 level of significance and total assets showed a 0.0252 level of significance.

From the above regression models for the five years, the study found out that there were several factors influencing the financial performance of companies listed in the NSE, which are ESO, foreign ownership and total assets. They influenced it positively and the highest value was 0.752 and the lowest was 0.487. The study found out that the company size measured by total assets positively influenced the financial performance.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of the study findings, conclusions, the limitation of the study and subsequent recommendations. The conclusions provide a basis for the policy recommendations that are offered. In addition, suggestions are provided for further studies given the limitations that were encountered in the study.

5.2 Summary of the findings

From the table, 4.1 there was a relatively high variation in the return on assets as a measure of financial performance. The highest return on assets was 0.3012 and the lowest was -.001891. The average mean return on assets was 0.20513. On average it means most of the companies are able to break even on the investments they have done i.e for every asset on average they are making a return of 20.51%. The minimum return on assets was -0.01891 for the period 2010 to 2014. This could explain the wide variation observed between the minimum and maximum values observed over the entire study period.

The study investigated three dimensions of a firm's profitability, namely, financial performance, ESO, foreign ownership and firm size. The descriptive results indicated that most listed firms considered the ESO and foreign ownership had a stable asset base. However, the findings concluded that ESO did not contribute to profitability of listed firms. The financial performance of listed firms was 20.51%, which is a moderate score. This was an indication that financial ESO

did contribute to profitability of listed firms. These findings are however consistent with Odero (2012) who assert that if employees are shareholders then those firms tend to do better financially.

There are many rationales offered to support employee share ownership, 'informed by a variety of ideologies and intentions.' Some justifications are focused on the enterprise level, whereas others see ESO as part of a broader social or macro- economic project. ESO is identified as a means of enhancing enterprise performance through promoting worker productivity. The theoretical basis for this rationale is generally located in agency theory. In the corporate governance context, agency theory has highlighted the 'corporate governance problem' arising out of the separation between 'ownership' and 'control'. Shareholders and managers may have divergent interests and shareholders may find it difficult and expensive to monitor management, particularly where they hold small stakes in many different firms.

5.3 Conclusion

The conclusion that may be drawn from the study findings is that in Kenya, ESO improves firm performance. The typical agency problems that are very likely to arise in situations where professional managers control the assets of a corporation in which they are not shareholders are adverse selection and moral hazard. It has been argued that these problems often arise because managers lack the requisite motivation to ensure prudence since they do not have a stake in the residual income of the firm (Fama &Jensen, 1983). According Stulz (1988) employee ownership is the most controversial and ambivalent form of firm ownership, and has mixed effects on performance. Whereas ownership by employees may be seen as a system of aligning the interests

of managers with those of the shareholders in a way that enhances corporate performance, this form of ownership can also lead to entrenchment of managers, which is costly when they chose to pursue their self interests. It has been argued that the overall impact of employee ownership on firm performance depends on how well the entrenchment effects and incentive alignment are balanced.

The findings of this study agreed to a significant extent with the argument that ESO enhances financial performance. In Kenya, ESO have been actualized through executive share options. The findings therefore, suggest that when managers also doubleup as shareholders, they are motivated to work towards realization of the wealth creation objective of the shareholders of whom they are part. On the other hand, managers whoare not shareholders are more likely to engage in insider dealings as a way of enhancing their personal wealth and prestige.

Foreign ownership is that the shareholders have the ability to diversity into this companies thus the good performance. It is also consistent with the documented practice by firms or investors to extend their investment preferences and risk-taking behaviors to the firms they acquire. Regarding the impact of diverse ownership on firm performance, the findings of thisstudy appear to contradict those of previous researchers (Fama and Jensen, 1983) who have argued that agency problems are more severe in diffusely held firms due to lack of capacity to collectively monitor the activities of managers, a situation that gives managers unlimited leeway to run the affairs of the corporation in their own self interest. This argument, however fails to appreciatethat shareholder-managers will almost invariably demonstrate more commitment to thefirm than will their counterparts who are not shareholders since the latter have no stake in the

residual income of the firm. Although some researchers have tended to favor concentrated ownership over diverse ownership, the reality is that the agency costs incurred in monitoring managers(especially if they are not shareholders) are huge, and may undermine firm performance.

The most definitive results were on the relationship between foreign ownership and firm performance. The significant positive relationships have vindicated the long-held beliefthat on average, foreign owned companies perform better than their counterparts with dominant local ownership. Thomsen and Pedersen (1997) posit that preferences regarding company strategies will often involve a trade-off between the pursuit of shareholder values, orientation and other goals. Successful companies with an international presence tend to be large, with well-established management systems that are replicated.

5.4 Recommendations for Policy and Practice

The study established that ESO and foreign ownership have a positive a significant influence on the financial performance, CMA should concentrate on those policies which encourage the adoption of the ESOs among companies since they may be helpful in enhancing financial performance of the companies and therefore achievement of robust national economic growth.
Since the study deduced that ESO generally affects the financial performance of the companies listed in the NSE positively, the researcher recommends that the companies' management should put in place and implement corporate policies that better align the interest of employees and employers so as to promote employee engagement and productivity. This can be achieved by

encouraging employees to take up the ESOs among the companies listed in the NSE and by having a high-involvement and open culture necessary for an ESOP to thrive.

Due to strong positive relationship of ESOs and financial performance, public policy recommendation should be formulated by the Government of Kenya to promote broad based ESOP which in turn enhances national saving and facilitate as well as encouraging the development of small to medium, privately owned enterprises including startup companies.

The study also recommends that a public policy formulation encouraging investors and entrepreneurs to promote broad based ESOs in their investments and enterprises. This is because for the enterprising business owner who has toiled for years to grow their business and now dreams of retirement, ESOs allow for a transitional scale back of day- to- day involvement. The policy also should facilitate employee buyouts scheme and business succession, a successful alternatives to selling the company to an external buyer.

5.5 Limitations of the Study

There are a number of limitations inherent in the study that seeks to measure whether ESO has a positive effect on productivity and financial performance.Attempts to establish a direct relationship between ESOs and higher organizationalfinancial performance inevitably encounter difficulties in causal uncertainty.It may be, for example, that it is the most productive enterprises that are choosing to introduce ESO schemes. Secondly, the small number of shares held by employees may mean that the financial entitlement from participation in an ESO is ‘marginal, uncertain and disconnected from day-to-day working life’, rendering tenuous any perceived link between ESOs and higher productivity.

Thirdly, researchers often fail to consider why particular firms initially adopt ESO plans. Firms may implement ESO plans for a range of reasons that are not necessarily linked to a desire to improve productivity: they may be motivated by a desire to resist a take-over or to take advantage of tax concessions. The structure and performance effects of ESOs are likely to be strongly influenced by the circumstances in which employee ownership is introduced and the motives for it.

5.6 Suggestions for Further Research

Future studies may attempt to employ a wider period than that used in this study. This may be done by studying the variables over a period longer than 10 years, such as 15 or 20. This will yield a sufficiently large number of observations that also helps in eliminating random sampling error in the final results. Studies should also be conducted examining the strategies that individual companies employ in order to address any adverse outcomes that may result from agency problems.

The study has overwhelming used written surveys. Because all methodologies have their limitations, using a single method yields one-dimensional results. Complementing survey research with open ended interviews, experimental studies, action research, and case studies, including matched pairs and ethnographies could enrich the understanding dramatically. Methodological creativity is especially important in trying to document some of less tangible benefits such as improved stakeholder relations. Well-focused surveys on theoretical questions could also shed light on some of the larger questions of interest to economics, sociology and management

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Appendix I: Approved ESO at the NSE

1. East African Breweries Limited

2. Equity Bank (K) Ltd

3. Kenya Commercial Bank (K) Ltd

4. KenolKobil Ltd

5. Athi River Mining Ltd

6. Access (K) group

7. Safaricom Ltd

8. Housing finance Company of Kenya

9. Scangroup Ltd

10. Standard Group