THE EFFECTS OF INITIAL PUBLIC OFFERING ON THE FINANCIAL PERFORMANCE OF COMPANIES LISTED AT THE NAIROBI SECURITIES EXCHANGE

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DECLARATION

I declare that this research project proposal is my original work and that it has not been previously presented for a degree at the University of Nairobi or any other university.

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

Supervisor: Dr. Josiah Aduda

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THE DEAN SCHOOL OF BUSINESS,

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DEDICATION

This research project is deducted to my dear parents, siblings and my loving daughter, Catherine Njeri, for their unwavering support, prayers and encouragement throughout the study period.

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ABSTRACT

This research investigates the change in performance of firms in Kenya as they make the transition from private to public ownership through initial public offerings (IPOs). The study compares the performance of the firms before and after going public.

The performance of firms from previous study has shown a decline on the post- issue operating performance. This study confirms that the same still holds in Kenya. The study examined 6 Kenyan IPOs issued on the NSE from 2002-2012. The study compares the pre-issue financial performance against the post-issue financial performance of the 6 Kenyan IPOs. The study will adopt a descriptive research design. Descriptive analysis will use the mean and standard deviation to measure the variables. The study measures the decline on financial performance by use of ratios; it used the return on assets, return on sales, current ratio and fixed asset turnover ratio.

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LIST OF ABREVIATION

CMA   Capital Market Authority

EBITD   Earnings before Interest, Tax and Depreciation

EPS   Earning per Shares

FAT   Fixed Assets Turnover

IPO   Initial Public offerings

NSE   Nairobi Securities Exchange

PBDIT   Profit before Depreciation, interest and Tax

ROA   Return on Assets

ROE   Return on Equity

ROS   Return on Sales

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Most companies start out as family owned business or by raising equity capital from a small number of investors, with no liquid market existing if these investors wish to sell their stocks while others start as state corporations. If a company prospers and needs additional equity capital, or if the state wants to divest, the firm may find it desirable to "go public" by selling stocks to a large number of diversified investors. Once the stock is publicly traded, this enhanced liquidity allows the company to raise capital on more favourable terms than if it had to compensate investors for the lack of liquidity associated with a privately held company (Ritter 1998).

The decision of private firms to go public is one of the most fundamental decisions that the company faces in its life. It is the decision that changes the whole structure of the Company. It is not surprising then that the IPO topic has attracted the attention of scholars, investors and decision makers. A vast number of studies have been conducted on the IPO topic, and it has been growing at faster pace in recent years (Shen and Wei, 2007; Pagano et al 1998).

1.1.1 Initial Public Offering

An initial public offering (IPO) occurs when a security is sold to the general public for the first time, with the expectation that a liquid market will develop (Ritter, 1998).

Several papers have analyzed stock returns and post- operating performance after IPOs. These studies have investigated stock returns and operating performance after firms go public. Both Kinds of studies have shown that IPO firms present less profitability compared to firms that have not gone public.

Stock returns analysis according to (Ritter, 1991), has revealed that investors seem to incur losses due to holding shares in the firms that have recently carried out an IPO compared to those that have not done so. The strategy of investing in IPO at the end of the first day of public trading and holding them for three years would produce a wealth of 83% compared to that obtained by investing during the same period in a group of control firms belonging to the same sector and with a similar market value.

According to (Ritter, 1991) the long run returns of IPOs are in line with the going public of many firms coinciding with the existence of relevant interest in certain sectors which implies that investors may be periodically over – optimistic regarding the potential profit of new firms . Several studies have agreed with Ritter 1991, in that they have found the existence of negative long- run abnormal stock returns for firms at 5 years following the IPO.

There are a number of potential explanations for the decline in the post-issue operating performance of IPO firms. One explanation is related to the potential for increased agency costs when a firm makes the transition from private to public ownership. The reduction in management ownership that occurs when a firm goes public is likely to lead to the agency problem described in (Jensen and Meckling 1976). As a result of the heightened conflict of interest between initial owners and shareholders, the performance of the firm could suffer as managers have incentives to increase perquisite consumption. Using the proceeds from the IPO in non value maximizing projects is one manifestation of perquisite consumption. The second reason could be that managers attempt to window-dress their accounting numbers prior to going public. This will lead to pre-IPO performance being overstated and post-IPO performance being understated. A third explanation for the decline in operating performance is that entrepreneurs time their issues to coincide with periods of unusually good performance levels, which they know cannot be sustained in the future. The common threads running through these three explanations for the post-issue decline in operating performance are the presence of information asymmetry and/or a conflict of interest between the original entrepreneurs and the new shareholders (Jain & Kini 1994).

Jain (1994), investigated if there existed a relationship between IPO under pricing and the post-IPO operating performance of newly public firms. The results of his study found no evidence to support the implications of the signaling models. There was no positive relationship between IPO and under pricing and post-IPO operating performance. According to his study, the only explanatory variables in the determinants of post-IPO operating performance were the size of the IPO and the risk of issue.

1.1.2 Financial Performance

Financial Performance is a subjective measure on how well a firm uses its assets from its primary mode of business to generate revenue. In broader sense, financial performance refers to the degree to which financial objectives being or has been accomplished. It is the process of measuring the results of a firm's policies and operations in monetary terms. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare industries or sectors in aggregation (Trivedi, 2010).

The financial performance analysis identifies the financial strengths and weaknesses of the firm by properly establishing relationships between the items of the balance sheet and profit and loss account. The first task is to select the information relevant to the decision under consideration from the total information contained in the financial statements. The second is to arrange the information in a way to highlight significant relationships. The final is interpretation and drawing of inferences and conclusions. In short, "financial performance analysis is the process of selection, relation, and evaluation." (Trivedi, 2010)

Since their inception companies have used various yardsticks for measuring and reporting financial performance. The two main items used to measure financial performance are the firm's market share within the particular industry in which it operates and its profitability. Profitability is then used to measure the company returns on capital employed hence value to its shareholders. Accountants and economics have derived and used various financial ratios to assess company financial performance. These ratios mainly involve the company liquidity – cash flow liquidity

ratios debt management – financial leverage index, asset management – returns on total assets profitability – cash flow margin and return on investment – dividend yield (Brealy, 2003).

According to Waymond (2007), profitability is associated with the results of management performance ROE and ROA are the most commonly used ratios and the quality level of ROE is between 15% and 30%, for ROA is at least 1%. The purpose of ROE is to measure the amount of profit generated by the equity in the firm. ROE is also an indicator of the efficiency to generate profits as well.

1.1.3 IPO and Financial Performance of Firms

The reason for going public involve the trade – offs benefits of being publicly traded and the associated costs. Financial economists have proposed several benefits of going public. For the entrepreneurs, they gain from having a more diversified portfolio and with increased liquidity these could positively affect firm value Chemmanur & Fulghieri, (1999).

There are also numerous costs of going public to the original owners. They have to give up control and increase disclosure of inside information to outsiders which, in turn, can reduce the firm's competitive advantage. More importantly, there is also a cost of separating ownership and control. The agency cost of equity, along with information asymmetry, can potentially lead to a situation in which entrepreneurs may attempt to expropriate wealth from new outsiders' shareholders. This expropriation of wealth can lead to high levels of under pricing at the initial public offering and poor long – run performance, Jensen & Meckling (1976).

Financial performance is often assess firm's production and productivity performance, profitability performance, liquidity performance, working capital performance, fixed assets performance, fund flow performance and social performance.

Measures of central tendency are also known as statistical averages. It is the single value which represents the whole series and is contain its measure characteristics. The main objective is to give a brief picture of a large group, which it represents, and to give a basis of comparison with

other groups. Arithmetic mean, median, mode, geometric mean and harmonic mean are the main measures of tendency. Mean, also known as arithmetic average, is the most common measure of central tendency. It is defined as the value which obtained by dividing the total of the values of various given items in a series by the total number of items. (Trivedi 2010)

Stein (1989), using a signal-jamming model, shows that, even in efficient capital markets, myopic behavior like window-dressing may persist since it is a Nash equilibrium. In the context of IPOs, his model implies that managers may attempt to manipulate investors' beliefs by pumping up pre-IPO earnings. In equilibrium, the market is not fooled by this behavior and correctly anticipates and accounts for it in its valuation of the firm. The more intuitive equilibrium in which managers avoid window-dressing and, therefore, investors do not need to account for it, cannot be sustained as a Nash equilibrium. Stein's signal-jamming model can also be extended to show that, in equilibrium, managers may attempt to time issues and that rational investors anticipate and account for this behavior. If the market is able to account for such actions, the long-run investment performance of IPO firms should be normal. However, the long-run investment underperformance documented by Ritter (1991) and Loughran and Ritter (1995) suggests that the decline in operating performance is not anticipated and investors are constantly surprised by the poor performance of IPO firms. Previous studies have shown post-issue declines in the M/B ratio, P/E ratio, and EPS are consistent with this interpretation, suggesting that potential investors initially have high expectations of future earnings growth, which are not subsequently fulfilled.

1.1.4 Nairobi Securities Exchange

The Nairobi Securities Exchange was constituted as Nairobi Stock Exchange (NSE) in 1954 as a voluntary association of stockbrokers in the European community registered under the Societies Act. It is one of the most active capital markets in Africa. The listed companies were very few and in the recent past the NSE has undergone major changes and transformations and the level of activity has tremendously increased.

The exchange has also enabled companies to engage local participation in their equity thereby giving Kenyans a chance to own shares. Companies can also raise extra finance essential for expansion and development. To raise funds, a new issuer publishes a prospectus, which gives all pertinent particulars about the operations and future prospects and states the price of the issue. A stock market also enhances the inflow of international capital.

The Nairobi Securities Exchange comprises approximately 61 listed companies with a daily trading volume of over USD 5 million and a total market capitalization of approximately USD 15 billion. Aside from equities, Government and corporate bonds are also traded on the Nairobi Securities Exchange. This offers an opportunity to study the relationship between IPO and performance of firms. The NSE has been selected as a focus of this study given the availability of secondary data for all the firms listed on the NSE hence it will be easier to collect the data and the data will also be very reliable.

1.2 Research Problem

There is a relationship between IPOs and performance of firms that go public both locally and internationally. Previous studies have shown that most firms' performance declines after IPO and this is mainly due to increased agency costs, window- dressing of the accounting numbers prior to going public and also due to lack of timing of the market before floating the shares (Jain & Kini 1994).

Several authors have shown conflicting results both in developed and developing economies. Jain & Kini (1994), Teoh et al (1998), Wang (2005), Shiah-Hou (2005), Ahmad-Zaluki (2008) and Mittal & Mayur (2012) all showed a significant decline in operating performance after going public where as Krishnan (2011), Chancharat (2012), Kinyua et al (2013) and Bessler (2012) showed an improvement of performance after going public.

A number of studies have been carried out on IPOs in Kenya, which includes: Kinyua et al (2012), on the effects of initial public offer on performance of companies quoted at the NSE as

measured by liquidity, leverage and profitability, Karitie (2012), on the long- run performance of IPOs and Lishenga et al (2012), on analysis of the performance of IPO at the NSE.

Studies on developing economies and especially Kenya are still very few especially on the performance of firms after going public. Most studies done have concentrated on the short and long –run IPO performance and on the under pricing of share prices rather than company performance after an IPO. With the rising number of IPOs in Kenyan market in the recent past, it is important to undertake an analysis of the Post-IPO performance in Kenya. This study focused on a longer period (2002-2012). The study compared the pre- issue operating performance with the post-issue operating performance of IPO firms in Kenya.

1.3 Objective of the Study

The objective of this study was to establish the effects of IPO on the financial performance of companies listed at the NSE.

1.4 Value of the Study

This study is important to various stakeholders. The study will be useful to companies as they will be able to understand more on the IPOs and be able to know the issues that surround the issuance of IPOs. The company will be able to know on how to reduce on the agency costs and also know on the timing in which to float their shares in the market. The companies would be able to make a decision as to whether to float their shares. The study will also be useful to the government in policy formulation and the regulators such as Capital Market Authority in providing knowledge on how to handle future IPOs so as to improve confidence of the investors in the stock markets.

This study will also be a reference point for investors on the future performance of the firms which will eventually reflect on the share price after IPOs. This will assist the investors in making investment decisions in the capital markets. This study will be useful to other researchers

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as it will contribute to the literature on IPOs and the recommendations will stimulate further research in the area. This will fill the research gaps that this study may not address.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews the various theories and empirical studies that have been conducted in the area of Initial Public Offering in relation to performance of firms in order to eliminate duplication of what has been done and provide a clear understanding of existing knowledge base in the problem area. This literature review is based on recent, original and authoritative sources such as the internet, journals, books and dissertations.

2.2 Review of Theories

This study reviewed on the theoretical studies and mainly concentrated on three theories which were on the agency theory, window of opportunity hypothesis and signaling theory.

2.2.1 Agency Theory

Agency theory, as initially conceptualized by Jensen and Meckling (1976) analyzes the relationship that develops in an economic exchange when an individual (the principal) concedes authority to another (the agent) to act in his or her name, so that the wealth of the principal is benefited by the decisions adopted by the agent. According to the theory, separating ownership from control can result in costs for the principal, known as agency costs, thus requiring costly mechanisms for controlling these costs. Agency costs arise because agents are argued to pursue interests that do not necessarily coincide with those of the principal. Because the use of incentives to create alignment of interests between principal and agency is a primary mechanism proposed by the theory to reduce agency costs, the theory is without doubt one of the main (if not the main) theoretical frameworks in the area of compensation management (particularly at the top management level) (Gomez-Mejia, Berrone, & Franco-Santos, 2010).

The roots of agency theory are linked to economic utilitarianism (Ross, 1973), which suggests that rational individuals will favor alternatives that enhance their own utility.

It provides parsimonious predictions as to how rational individuals would behave in bilateral relations between self-interested individuals, where each individual is faced with information asymmetry about the other individual's effort and interests. In summary, agency theory focuses on identifying the most efficient contract for aligning the interests of an agent with those of the principal (Fama & Jensen, 1983).

2.2.2 The Window of Opportunity Hypothesis

Ritter (1991) argued that, if there are periods when investors are especially optimistic about the growth potential of companies going public, the large cycles in volume may represent a response by firms attempting to "time" their IPOs to take advantage of these swings in investor sentiment. He argued that the low returns on IPOs are consistent with issuers taking advantage of "window of opportunity" in which the market is willing to overpay for their equity. Myer (1994) viewed this framework as a dynamic financing hierarchy or window of opportunity model. External financing is sometimes the first choice for financing because sometimes firms can issue overvalued equity. The window of opportunity predicts that there will be low long – run returns of firms conducting IPOs than on firms conducting seasoned equity offerings.

2.2.3 Signaling Theory

Leland & Pyles (1977) model is one of the first signaling models which describe the issuer's function in the IPO process. Their model is a simple static equilibrium model where the ownership retention rate signals to investors the quality of the issuer. They argued that the level of retention of shares by original shareholders can be convincing signal of the firm value to the outsiders. This idea is very much tied to the principal – agent conflict which should be less of a problem when owners of a company retain large amount of shares after the IPO, thus these companies are regarded as high quality ones. Investors are expected to make their IPO purchasing decisions based upon this crucial information.

Allen and Faulhaber (1989), Grinblatt and Hwang (1989), and Welch (1989) have suggested that issuers use under pricing as a mechanism to signal their quality to the market. These models posit that high-quality firms under price their stock at the IPO and subsequently conduct a seasoned offering when market prices are established and there has been an opportunity for information revelation. The cost of under pricing and a positive probability of their type being revealed between the two offerings prevent the low-quality firms from following suit. Thus, signaling models of under pricing predict that IPO firms that under price should exhibit superior operating performance in comparison to those that do not. The absence of a positive relation between the change in operating performance and under pricing is inconsistent with the signaling explanation for under pricing.

2.3 Determinants of Financial Performance

There are different measures of a firm's performance such as financial performance, efficiency performance, productivity, growth, employment, export and market share. Financial performance measures involve analyzing the financial statements of an organization. The financial statements provides information on the resources available to the management, how these resources were financed and what the company accomplished with them.

Financial performance exists at different levels of the organization, financial performance measures are split into profitability, liquidity/ working capital, gearing, investor ratios. Financial ratios are widely used to reflect the firm's performance such as profitability measures and liquidity (Kaplan Financial Knowledge, 2014).

Miller et al. (2014) categorized financial performance determinants into profitability, liquidity and solvency measures. Profitability ratios include; Operating profit margin, ROA and ROE. Liquidity measure ratio is the current ratio which is a basic indicator of short- term debt servicing and cash flow capacity. It is the extent to which current asset ratio which measures the ability of the business to repay all financial obligations if all assets were sold.

2.4 Review of Empirical Studies

Mittal & Mayur (2012) examined ownership change and deterioration of performance in post-IPO period in Indian firms. They measured performance by comparing the post – IPO performance of Indian public firms with pre-IPO performance using percentage changes and median values of operating profit, sales to asset, RONW and PBDIT to asset. Their results showed that the overall performance of firms deteriorated significantly in the post- IPO period. The decrease was comparatively sharper for sales/ total assets, ROWN and PBDIT/ total sales. They concluded that change in ownership inversely affects the performance of firms in post-IPO performance of Indian public firms.

Alanazi et al (2011) studied a sample of 16 Saudi IPs on the financial performance of the IPOs period 2003-2009. The performance was measured by the ROA and ROS which showed deterioration after the IPO of which it intensified in magnitude in the subsequent years. The decline in performance could not be attributed to the lack of opportunities since there was a steady growth in terms of sales and capital expenditure. The decline was attributed to the agency cost and conflict impact on the performance this was due to the conflicts between the original owners and new shareholders.

Ahmad-Zaluki (2008), investigated the operating performance and the existence of earnings management for a sample of 254 Malaysian IPO companies over a period of 1990-2000. He compared the pre and post-IPO accounting – based operating performance and found that the average IPO Company under performs over the three year post-IPO period. There was also a strong decline in performance in the IPO year and up to three year following the IPO. The results confirm that the deterioration in the post-IPO operating performance is due to earnings management by IPO managers at the time of going public.

Kurtaran & Er (2008) analyzed the post-issue operating performance of initial public offerings at the Istanbul Stock Exchange (ISE) as a developing market. They documented a general decline in operating performance subsequent to the IPO. They then explored the relationship between managerial ownership and the change in the post-issue operating performance. They found a positive relation between post-issue operating performance and under pricing level. Finally, they

examined post-issue market –to-book ratio and price earnings ratios to test the market expectations and their results inducted post-issue declines in both ratios.

Shiah-Hou (2005), studied operating performance of B-shares in China where he observed a substantial decline in post-issue B-shares operating performance for issuing firms, which was significantly lower than that of other firms in the same industry. He measured the operating performance using the variables of t-test and rank test basing it on the International Accounting Rules where the results showed a decline in sales which were accompanied by increased capital expenditure for after – going public B shares.

Koech (2011), studied short-run and long-run IPO financial performance for firms quoted at NSE during the period 2000-2010. From a sample of 8 IPOs, she observed that the IPOs were under priced by an average of 57% and also there was a decline in operating performance of companies.

Njoroge (2004) analyzed initial and long-run performance of IPOs for companies listed in the NSE during the period 1984-2001 with a sample of 14 IPOs. He found that all the IPOs recorded an overall negative cumulative growth of -68.46%.

Kinyua et al (2013), investigated on the effects of initial public offer on performance of companies quoted at the NSE where they measured performance of the companies using leverage and earnings per share between 2006 and 2011. The study concluded that earnings per share which comprised of sales, assets, profit after tax, ROA and ROE increased after the IPO.

Njuki (2011) investigated the initial and aftermarket performance of IPOs: evidence from the NSE period 1996-2008, from a sample of 11 companies. He observed that IPOs were under priced by an average of 65% and the market adjusted initial returns shows that the returns for day 1 averaged at 59.69% and he concluded that on average IPOs are under priced in Kenya.

Bante (2010) studied the performance of IPOs of private and state - owned companies at the NSE, during period of 1984 – 2008. Using a sample of 17 companies, he found that most state-owned companies were underpriced more than the privately owned companies.

Jumba (2002) studied the initial public offers in Kenya for the period 1992-2008. Her sample size was 9 IPOs and she found that the average daily return is 0.06% in three years after going public, whereas a market model produced daily returns of 0.3% over the same period. She also found out that for three years buy and hold period, all IPOs produced below the market average Beta values below 1.

Ooko (2013) analyzed the effect of shares valuation method used by companies on the IPO outcome for a period 2006-2011. He studied 9 Kenyan companies and discovered that most companies used the discounted cash flow method and company comparable multiple method to arrive at the offer price. He found that of the 9 companies studied 8 of them had a positive initial return and had under priced their shares. He also found that the average initial return was 0.577 for the 9 companies which issued their shares during the period of study.

2.5 Summary

The above review has shown the theories that relate to issuance of IPO. The theories explain better why firms issue IPOs and why there has been under performance of firms after IPOs. The empirical review has shown has shown the studies done in the area as well as pointed out the gaps left for the studies. This study seeks to bridge the gap by focusing on post –IPO operating performance of companies listed at the NSE.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the method that was adopted to carry out the study. The research methodology refers to the research decisions that were taken within the framework of specific determinants unique to this study. It contains research design used in the study, the target population, sample size to sampling method, data collection and analysis methods and tools.

3.2 Research Design

This study used descriptive survey. A descriptive survey is a present- oriented research that seeks to accurately describe the situation as it is. Descriptive research is defined as a process of data collection to test the hypothesis or answer questions concerning the current status of the study Mugenda and Mugenda (2003). This method was selected because it enabled the researcher to be able to attempt to describe the relationship that exists between IPOs and operating performance of companies listed at the NSE.

3.3 Population

A population is a complete census of all items or people in a research's area of study Mugenda and Mugenda (1999). The target population of this study comprises of all IPOs carried out at the Nairobi Stock Exchange covering the period between the years 2002 to 2012. There are 61 companies currently listed at the NSE and the list is provided as appendix I. The 61 firms are the target population.

3.4 Sample

A sample is a subset of the population. The sample size was composed of 6 companies which were listed at the NSE during the period 2002 to 2012. The sample size of 6 was selected as it representative of the population to enable the researcher meet the objective of the study (appendix II).

3.4 Data Collection

The collection of data for this study was from secondary source. The nature of data collected was purely quantitative. The data was from the annual financial statements of the companies sampled. This was collected from the Nairobi Stock Exchange database, Capital Market Authority, newspapers or the respective company premises inclusive of their websites.

3.5 Data Analysis

According to Miles & Huberman (1994), data analysis consists of three concurrent flows of activity, namely data reduction, data display and conclusion drawing. The methods employed in data analysis mainly depend on the purpose of the study and the type of data collected (Cooper and Schindler, 2003).

The data analysis involved comparing the performance of the selected firms before and after IPO, descriptive statistics such as mean and standard deviation will be used. Microsoft Excel Software will be used to carry out the data.

This study was done to test the effect of initial public offering (independent variable) and on the financial performance (dependent variable) of firms. The study employed profitability, liquidity and activity ratios as measures of operating performance.

The first measure is operating return on assets which measures efficiency of asset utilization. ROA is also based on the EBITD due to its neutrality to depreciation methods, leverage and tax treatment and measures pre and post IPO efficiency of assets.

Return on Assets = <u>*Earnings before Taxes*</u> *x 100*
　　　　　　　　Total Assets

The second measure was ROS ratio which was used to measure the firm's operational efficiency. ROS is also known as a firm's "operating profit margin". ROS can be used both as a tool to analyze a single company's performance against its past performances. It is also used in sectors that require large investment in infrastructure with long gestation period. The ROS was employed in this study is calculated as follow:

Return on Sales = <u>*Earnings before Taxes*</u> *x 100*
　　　　　　　　Sales

The third measure is the current ratio, which is the most basic liquidity test. It signifies a company's ability to meet its short-term liabilities with its short-term assets. A current ratio greater than or equal to one indicates that current assets should be able to satisfy near-term obligations. A current ratio of less than one may mean the firm has liquidity issues.

Current Ratio = <u>*Current Assets*</u>
　　　　　　　Current Liabilities

The last measure is the Fixed Assets Turnover (FAT). The FAT ratio measures how intensively a firm's fixed assets are used to generate sales. A low fixed assets turnover implies that a firm has too much investment in fixed assets relative to sales; it is basically a measure of productivity. The FAT ratio was employed in this study is calculated as follows:

Fixed Asset Turnover =   Sales
                        Fixed Assets

The study further used the Wilcoxon Rank Sum test to test the pre and post IPO performance. The Wilcoxon Rank Sum test was used to test for a difference between two samples. It is the nonparametric counterpart to the two-sample Z or test. Instead of comparing two population means, we compare two population medians.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

4.1 Introduction

In this chapter, an analysis of the data is done and results presented. The analysis involves the use of secondary data obtained from the financial statements. The financials was analyzed by use of ratios and the analysis relied on the Microsoft Excel statistical package.

4.2 Descriptive Statistics

All the firms reviewed by the study are analyzed a single unit to see the effect of listing by comparing the pre and post initial public offering. There was use of ratios, four performance measures were selected. These are return on assets (ROA) based on EBT, return on sales (ROS) based on EBT, current ratio and fixed asset turnover (FAT). The mean, standard deviation and the variance of the four measures of performance are used to calculate for the period before and after IPO and are shown in Table 4.1.

Table 4.1 Descriptive Statistics

FIRM	YEAR	PRE - INITIAL	PUBLIC	OFFERING		POST – INITIAL	PUBLIC	OFFERING	
		ROA	ROS	CURRENT RATIO	FAT	ROA	ROS	CURRENT RATIO	FAT
SCAN GROUP	0	22.5	9.3	1.55	63.41	22.5	9.3	1.55	63.41
	1	19.7	8.6	1.26	59.89	20.1	6.8	1.41	33.67
	2	13.8	4.5	1.13	52.65	11.6	7.5	2.14	32.14
	3	9.7	2.7	1.04	42.27	13.8	9.2	2.07	8.23
ACCESS KENYA	0	16.7	19.4	4.02	3.42	16.7	19.4	4.02	3.42
	1	31.2	12.2	1.69	8.53	17.5	16.8	1.5	1.92
	2	8.7	3.7	0.78	6.39	7.9	8.8	1.09	1.2
	3	20.6	9.7	0.73	4.62	-0.2	-0.3	0.71	-0.003
SAFARICOM	0	26.8	32.5	0.51	0.99	26.8	32.5	0.51	0.99
	1	30.5	36.2	0.77	1.03	16.7	21.7	0.49	0.95
	2	27.8	35	0.69	0.21	20.1	25	0.67	1.03
	3	24.6	31.4	0.31	0.28	16.1	19.4	0.64	1.03
EVEREADY	0	25.5	11.5	1.89	11.57	25.5	11.5	1.89	11.57
	1	32.9	12	1.54	16.08	15.1	8	1.56	12.13
	2	38.1	13.9	1.54	15.12	3.3	1.6	1.66	8.91
	3	32.6	13.2	1.56	12.36	4.2	2.5	1.51	8.13
KENGEN	0	5.7	45.2	1.76	0.16	5.7	45.2	1.76	0.16
	1	3.4	23.7	1.15	0.2	4.6	42.4	1.45	0.12
	2	2.6	27.1	1.49	0.1	2.9	26.7	1.41	0.02
	3	7.2	48.9	1.97	0.16	4.2	36	2.17	0.13
KENYA RE-INSURANCE	0	5.6	21.2	9.31	0.52	5.6	21.2	9.31	0.52
	1	5.7	21.3	4.07	0.34	12.9	51.3	0.79	0.32
	2	9.3	36.8	4.4	0.33	9.8	38.1	2.22	0.59
	3	6.7	32.9	3.39	0.25	9.6	33.3	2.26	1.13
TOTAL		427.9	512.9	48.55	300.88	293	493.9	44.79	191.717
MEAN		17.83	21.37	2.02	12.54	12.21	20.58	1.87	7.99
STDEV		11.18	13.43	1.92	20.13	7.63	14.85	1.76	15.00

Source: Author

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The study analyzed the four performance measures to test the change in any of these before and after the IPO. From the analysis above, the study compared the financial performance of the companies for three years that is three years before and after listing. There was an overall total decrease in ROA, ROS, Current ratio and FAT in the six companies that were sampled. This shows that the companies' general performance declined after going public.

4.3 Summary of Findings and Interpretations

The four performance measures are applied to determine the operating performance pre and post IPO. To ensure the robustness of the test, the operating performance is evaluated based on four different financial performance measures. For each of the four financial measures the results of the test are presented followed by a discussion of the robustness and reliability of the results.

4.3.1 Return on Assets

The return on assets is the prevailing financial measure for comparing the financial performance of the companies over time before and after IPO, it is the starting point in this presentation and discussion results. ROA indicates the number of cents earned on each shilling of asset, it measures efficiency of the business in using its assets to generate net income thus the higher the ROA, the better the performance of the firm.

The table below shows the results of the return on assets based on EBT for three years pre and three years post IPO for six companies that were studied. Access Kenya, Safaricom and Eveready show a decline in ROA while Scan Group, KenGen and Kenya Re recorded an increase of ROA after initial public offering. The average ROA decreased from 17.76 to 12.21, this means that in general the performance of companies decline immediately after an initial public offering.

Table 4.2 Return on Assets

FIRM	PRE- INTIAL PUBLIC OFFERING	POST - INTIAL PUBLIC OFFERING	VARIANCE
SCAN GROUP	16.43	17	**-0.57**
ACCESS KENYA	18.87	10.48	**8.39**
SAFARICOM	27.43	19.93	**7.5**
EVEREADY	32.28	12.03	**20.25**
KENGEN	4.73	4.35	**0.38**
KENYA RE-INSURANCE	6.83	9.48	**-2.65**
MEAN	**17.76**	**12.21**	**5.55**
STDEV	**10.92**	**5.56**	**8.48**

Source: Author

4.3.2 Return on Sales

The ROS is the second financial performance measure which was included to overcome normal drawback normally experienced in the computation of ROA. ROS is created purely by income statement items and are thus not affected by potential problems of historical costs. ROS measures the portion of each shilling of sales that a firm is able to turn into income. A higher value of ROS is favorable which indicates that more proportion of revenue is converted to operating income.

The test shows a decline of financial performance thus in relation to ROS the companies' performance decreased in after going public in comparison to before listing. Safaricom, Eveready and KenGen shows a decrease in ROS while Scan Group, Access Kenya and Kenya Re shows a decline in the financial performance. However, the average ROS decreased from 21.37 to 20.58, this also shows that the general performance of companies declined immediately after an initial public offering.

Table 4.3 Return on Sales

FIRM	PRE- INTIAL PUBLIC OFFERING	POST - INTIAL PUBLIC OFFERING	VARIANCE
SCAN GROUP	6.28	8.2	**-1.92**
ACCESS KENYA	11.25	11.18	**0.07**
SAFARICOM	33.78	24.65	**9.13**
EVEREADY	12.65	5.9	**6.75**
KENGEN	36.23	37.58	**-1.35**
KENYA RE-INSURANCE	28.05	35.98	**-7.93**
MEAN	**21.37**	**20.58**	**0.79**
STDEV	**12.85**	**14.14**	**6.22**

Source: Author

4.3.3 Current Ratio

Current ratio is the third financial performance measure that was used in the study. It is the ratio of current assets of a business to its current liabilities. It is the mostly widely used to test of liquidity of a firm and its ability to pay its short term liabilities.

The table below shows the results of the current ratio for the six companies that were sampled. Access Kenya, Safaricom and Kenya Re insurance shows a decrease on the current ratio while Scan Group, Eveready and KenGen showed an increase on the current ratio after listing of the firms. The overall current ratio decreased on average from 2.02 to 1.87, this shows that the general performance of companies declines after an IPO.

Table 4.4 Current Ratio

FIRM	PRE- INTIAL PUBLIC OFFERING	POST - INTIAL PUBLIC OFFERING	VARIANCE
SCAN GROUP	1.25	1.79	**-0.54**
ACCESS KENYA	1.81	1.83	**-0.02**
SAFARICOM	0.57	0.58	**-0.01**
EVEREADY	1.63	1.65	**-0.02**
KENGEN	1.59	1.69	**-0.1**
KENYA RE-INSURANCE	5.29	3.65	**1.64**
MEAN	**2.02**	**1.87**	**0.16**
STDEV	**1.66**	**0.99**	**0.75**

Source: Author

4.3.4 Fixed Asset Turnover

FAT was included in the study in order to measure a company's ability to generate net sales from fixed asset investment. It is an efficiency ratio that measures a company's ability to generate sales from its assets by comparing sales with FAT. The higher the FAT the better the company is utilizing the capacity of its fixed assets.

The table below shows the results of the FAT for the companies that were sampled. Scan Group, Access Kenya, Eveready and KenGen shows a decline in the FAT while Safaricom and Kenya Re Insurance show an increase on the FAT after the IPO. The overall performance of the sampled firms shows a significant decline on the FAT from an average of 12.54 to 7.99 which portray a decline of the performance of the firms immediately after an IPO.

Table 4.5 Fixed Asset Turnover

FIRM	PRE- INTIAL PUBLIC OFFERING	POST - INTIAL PUBLIC OFFERING	VARIANCE
SCAN GROUP	54.56	34.36	**20.2**
ACCESS KENYA	5.74	1.63	**4.11**
SAFARICOM	0.63	1	**-0.37**
EVEREADY	13.78	10.19	**3.59**
KENGEN	0.16	0.11	**0.05**
KENYA RE- INSURANCE	0.36	0.64	**-0.28**
MEAN	**12.54**	**7.99**	**4.55**
STDEV	**21.25**	**13.46**	**7.92**

Source: Author

4.4 Discussion of Findings

When the firms are analyzed individually on the four measures of the performance, some of the firms show increase in performance after an IPO, Scan Group, Kenya Re and Access Kenya showed a slight increase on the financial performance after an IPO. Safaricom, Eveready and KenGen show a decline on the general financial performance after an IPO in comparison to before the IPO.

This study however has shown that the overall financial performance of firms decreases in the few years that follow after an IPO of the firms. This corroborates with earlier studies that found that the few years immediately after an initial public offerings, the general performance of the companies that have just been listed declines.

Taking into account the performance of the companies in the sample three years prior of their IPOs, it can conclusively be seen that 4 of the 5 (67%) declined on their performance for the period of three years after IPO while the remaining 33% increased on their performance after the IPO. This means that 67% of the companies that go public experience a decline on their performance after an IPO.

These study shows that Scan Group increased on the performance on the three out of the four measures. The mean ROA increased from 16% to 17%, ROS increased from 6% to 8%, current ratio from 1.2 to 1.8 where as FAT decrease from 54 to 34.

The results for Access Kenya were different in that all the four measures showed a decline in financial performance of the company after the IPO. The mean ROA decreased from 19% to 10%, ROS decreased from 11% to 10%, current ratio from 1.8 to 1.7 and FAT from 5.7 to 1.6.

Results from Safaricom also declined on average in the ROA mean decreased from 27% to 24%, ROS decreased from 12.6% to 12%, current ratio was in difference with 0.57 and FAT decreased from 1 to 0.6. Eveready declined on the ROA from 32% to 12%, ROS from 12.6% to 12%, current ratio from 1.6 to 1.5 where as FAT from 14 to 10.

This study found the results for KenGen were different in that some measures showed a decline while others showed an increase on its performance after the IPO in the mean ROA decreased

from 4.7% to 4.3%, ROS increased from 36% to 37%, current ratio increased from 1.6 to 1.7 where as FAT remained the same as 0.1. Kenya Re Insurance increased on the ROA from 6.8% to 9.4%, ROS increased 28% to 35%, current ratio declined from 5.2 to 3.6 where as FAT from 0.36 to 0.64.

These results are both in line and also in contrast to the results of other studies that have been carried out both in the international and local studies. Studies such as Kinyua (2013), shows evidence of increasing on performance after an IPO using leverage and earnings per share as measures of financial performance. There are studies however that are consistence to this study, Mulu (2006), shows that the performance of the companies declines immediately after an IPO.

The studies that have been done outside Kenya are consistent to this study even when using different methodology. Other studies used management earnings, market to book ratio, price earnings ratio which still shows a decline on the financial performance of the companies after going public.

There have however been studies where there have shown increase on the performance of companies. The reasons for this divergence among studies are probably the difference in the methodology that has been adopted in computing the financial performance of these companies during their IPOs. The other reason for divergence among studies is in companies which have gone public and the owners still maintain the management rights of the company thus the performance increases. There are companies which also increase their financial performance after an IPO due to investing on the cash received from selling the company's shares.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Summary

Based on the results of the data analysis, it can conclusively be stated that a majority (67%) of the companies in the sample had declined in performance after an IPO. This mean that companies either window dress their financial statements immediately before going public or there is an increase on the agency cost due to change of ownership after an IPO. A mean of (33%) of the companies sampled show an increase in financial performance after an IPO. This means that either the management of the company did not change after the IPO and or the company used the proceeds received from the sale of its shares to invest in viable investment that improved on the financial performance of the companies.

It was noted that all the four performance measures that is the return on assets, return on sales, current ratio and fixed asset turnover all showed a mean decline on the performance of the companies that were sampled. The companies whose performance declined the most were Access Kenya, Eveready and Safaricom. Scan Group recorded an increase in financial performance in all the measures that were used after the IPO.

The results are consistent with previous studies carried out in this particular area. The same results were concluded by Jain & Kini (1994), Ahmad –Zuluki (2008) and also Alanazi (2011). Alanazi (2011) measured the performance of 16 companies in Saudi using ROA and ROS and also found a deterioration of performance due to increased agency cost.

5.2 Conclusion

The study found that firms going public exhibit a sustainable decline in post- issue financial performance. Over the six years period extended from prior and post IPO financial performance levels have declined based on several performance measures.

Though not significantly different, liquidity was seen to improve in the post going public period. This is due to the proceeds received by companies from the sale of their shares to the public. This therefore implies that firms improve their liquidity position after going public.

Overall, the study indicates that IPO firms are unable to sustain their pre-issue financial performance levels. Although IPO firms display high post - issue growth in sales, their measures of profitability decline. Earlier studies have documented decline on the financial performance of companies after going public and the results of this study are consistent with these studies. It appears that IPO firms are priced with the expectation that profit margins will grow beyond their pre-IPO levels, while in reality they decline over time.

It should however be noted that the main aim of an IPO is for a company to raise as much capital as possible and therefore the companies that wish to go public should do so without misinforming the public on the position of their financial performance in order to sell their shares at a higher price than the shares' actual value.

5.3 Policy Recommendations

The study recommends that the government and regulatory bodies to thoroughly audit companies that wish to be listed especially the three years financials before going public in order to

discourage the management from "window dressing" of their financial statements in order to avoid miss - informing the public on the true financial position of the company been listed.

Investors should also be careful when investing in IPOs because companies time their issues to coincide with periods of unusually good performance levels, which they know cannot be sustained in the future. Thus investors should be keen on the performance trends of the companies that they wish to invest in.

I recommend that underwriters, valuers and transaction advisors refine or completely re-examine their IPO valuation techniques and methods in order to prevent the gross overvaluation of IPOs. This because over valuing IPOs may adversely affect investors once these IPO enter the market. They can accomplish this primarily through better forecasting techniques that take into account the strengths, weaknesses, opportunities and threats faced by the companies as well as their particular industry and the economy in general.

Investor protection agencies such as the Capital Market Authority should also be more vigilant in protecting would be investors who may wish to take up company shares in an IPO. While they cannot directly affect the actions of the issuing company and the underwriters when it comes to price setting they may be able to sensitize them on the importance to put investor interest at the centre of their decision making processes and to avoid miss informing them on the financial performance of the company. They should also sensitize investors on prevailing valuation trends so as equip them with all the information necessary for them to make informed investment decisions.

5.4 Limitations of the Study

The first limitation of the study was the unavailability of the data that need to be analyzed. The study had initially targeted to use a sample of 10 companies that were listed during the period 2002 to 2012. This proved to be difficult as the researcher was not able to get all the secondary data for all the 10 companies from the CMA and NSE as the data was missing or non- existent. Some of respective companies that were on my sample were also not willing to provide their financial data to be analyzed for the study. The researcher however was able to get 60% of the targeted sample which is representative of the population.

The researcher was comparing financial performance of companies from different industries and that is bound to give misleading results. This is because the researcher was not able to get listed companies in Kenya from the same industry that were listed within the same period of time to be able to compare their financial performance by use of ratios.

There was a limitation on the number of financial years that the study was carried out. The study compared data for three financial years before and after an IPO, this period could have been longer like for five or more years in order to give a better position of the sampled companies. This was not possible as some of the companies had not been listed for more than four years and thus their post issue financial data is non – existence. On the other hand, some of the companies that have been listed for more than five years, their IPO prospectus were not available with CMA and NSE to enable the researcher compare their pre- IPO financial performance. Companies which formed sample of this study did not go public at the same time.

The final limitation of the study was the use of financial ratios on the financial statements of the sampled companies. Any weaknesses of the financial statements such as "window dressing" of accounts are also captured in the financial ratios.

5.5 Suggestions for Further Research

This area of performance of companies after an IPO needs further research in order to determine several outcomes. Most of the study done only compares the results of three years prior with three years post initial public offering and using only four performance measures. This may be limiting as other performance measures may be used with a larger sample of the population in order to make a better conclusion of the study.

Most studies on the IPO have concentrated on the share price after an IPO and very few studies especially in Kenya have been done on the performance of the company after a companies at is clear from this study that there exist a relationship between an IPO and the performance of the company. Other avenues of the study therefore need to be done in order to enhance knowledge on how companies perform after an IPO and also how they affect the development of the capital market in Kenya.

The study analyzed companies from different sectors, comparing ratios across sectors may not be comparable. There is a need to study if there is any difference in the financial performance of companies after going public in each sector.

The study only compared three years prior to listing with three years after listing, a further research which covers a longer period could be done to establish the financial performance trend over a longer period

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APPENDICES

Appendix I: Listed Firms on the NSE

AGRICULTURAL
1. Eaagads Ltd Ord 1.25
2. Kapchorua Tea Co. Ltd OrdOrd 5.00
3. Kakuzi Ord.5.00
4. Limuru Tea Co. Ltd Ord 20.00
5. Rea Vipingo Plantations Ltd Ord 5.00
6. Sasini Ltd Ord 1.00
7. Williamson Tea Kenya Ltd Ord 5.00

COMMERCIAL AND SERVICES
8. Express Ltd Ord 5.00
9. Kenya Airways Ltd Ord 5.00
10. Nation Media Group Ord. 2.50
11. Standard Group Ltd Ord 5.00
12. TPS Eastern Africa (Serena) Ltd Ord 1.00
13. Scangroup Ltd Ord 1.00
14. Uchumi Supermarket Ltd Ord 5.00
15. Hutchings Biemer Ltd Ord 5.00
16. Longhorn Kenya Ltd

TELECOMMUNICATION AND TECHNOLOGY
17. Safaricom Ltd Ord 0.05

AUTOMOBILES AND ACCESSORIES
18. Car and General (K) Ltd Ord 5.00
19. CMC Holdings Ltd Ord 0.50
20. Sameer Africa Ltd Ord 5.00
21. Marshalls (E.A.) Ltd Ord 5.00

BANKING
22. Barclays Bank Ltd Ord 0.50
23. CFC Stanbic Holdings Ltd ord.5.00
24. I&M Holdings Ltd Ord 1.00
25. Diamond Trust Bank Kenya Ltd Ord 4.00
26. Housing Finance Co Ltd Ord 5.00
27. Kenya Commercial Bank Ltd Ord 1.00
28. National Bank of Kenya Ltd Ord 5.00
29. NIC Bank Ltd 0rd 5.00
30. Standard Chartered Bank Ltd Ord 5.00
31. Equity Bank Ltd Ord 0.50

32. The Co-operative Bank of Kenya Ltd Ord 1.00

INSURANCE
33. Jubilee Holdings Ltd Ord 5.00
34. Pan Africa Insurance Holdings Ltd 0rd 5.00
35. Kenya Re-Insurance Corporation Ltd Ord 2.50
36. Liberty Kenya Holdings Ltd
37. British-American Investments Company (Kenya) Ltd Ord 0.10
38. CIC Insurance Group Ltd Ord 1.00

INVESTMENT
39. Olympia Capital Holdings ltd Ord 5.00
40. Centum Investment Co Ltd Ord 0.50
41. Trans-Century Ltd

MANUFACTURING AND ALLIED
42. B.O.C Kenya Ltd Ord 5.00
43. British American Tobacco Kenya Ltd Ord 10.00
44. Carbacid Investments Ltd Ord 5.00
45. East African Breweries Ltd Ord 2.00
46. Mumias Sugar Co. Ltd Ord 2.00
47. Unga Group Ltd Ord 5.00
48. Eveready East Africa Ltd Ord.1.00
49. Kenya Orchards Ltd Ord 5.00
50. A.Baumann CO Ltd Ord 5.00

CONSTRUCTION AND ALLIED
51. Athi River Mining Ord 5.00
52. Bamburi Cement Ltd Ord 5.00
53. Crown Berger Ltd 0rd 5.00
54. E.A.Cables Ltd Ord 0.50
55. E.A.Portland Cement Ltd Ord 5.00

ENERGY AND PETROLEUM
56. KenolKobil Ltd Ord 0.05
57. Total Kenya Ltd Ord 5.00
58. KenGen Ltd Ord. 2.50
59. Kenya Power & Lighting Co Ltd
60. Umeme Ltd Ord 0.50

GROWTH ENTERPRISE MARKET SEGMENT
61. Home Afrika Ltd Ord 1.00

Appendix II: Sample to be used

1. KenGen Ltd Ord. 2.50
2. Scan group Ltd Ord 1.00
3. Kenya Re-Insurance Corporation Ltd Ord 2.50
4. Access Kenya
5. Safaricom Ltd Ord 0.05
6. Eveready East Africa Ltd Ord.1.00