

**CORPORATE FINANCIAL DISTRESS: AN ANATOMY  
OF UCHUMI SUPERMARKET STORES IN KENYA  
(2001 - 2006)**

**BY**

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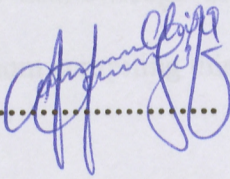


# DECLARATION

I declare that this research paper is my original work and has never been submitted to any other institution for any award.

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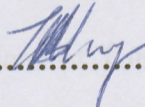
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## LIST OF ACRONYMS

|       |  |
|-------|--|
| ICDC  | - Industrial and Commercial Development Corporation            |
| ICDCI | - Industrial and Commercial Development Corporation Investment |
| KWAL  | - Kenya Wines Agencies Holding Limited                         |
| KNTC  | - Kenya National Trading Company                               |
| ERP   | - Enterprise Resource Planning                                 |
| NSE   | - Nairobi Stock Exchange                                       |
| CMA   | - Capital Market Authority                                     |
| KMC   | - Kenya Meat Commission  |
| KPCU  | - Kenya Planters Cooperative Union                             |
| AFC   | - Agricultural Finance Corporation                             |
| KCC   | - Kenya Cooperative Creameries                                 |
| MM    | - Modigliani & Miller  |
| ACCA  | - Association of Chartered Certified Accountants               |
| CEO   | - Chief Executive Office                                       |
| MDA   | - Multiple Discriminate Analyses                               |
| ANN   | - Artificial Neural Networks                                   |



## DEFINITION OF TERMS

**Financial Distress** This is a condition under which a firm is unable to meet scheduled payments or when cashflow projections indicate that it will soon be unable to do so.

**Restructuring:** Restructuring typically involves extension and or composition. In an extension, creditors postpone the dates of required interests, principal payments, or both. In a composition, creditors voluntarily reduce their fixed claims on the debtor by accepting a lower principal amount by reducing interest rates on the debts, or by some combination of changes.

**Workouts:** Voluntary reorganization plans arranged between creditors and generally sound companies experiencing temporary financial difficulties. Workouts typically require some restructuring of the firm debt.

**Chapter 11:** the business reorganizations chapter of the bankruptcy reform act. The chapter provides for reorganizations rather than the liquidation of the business.

### Hold out Problems

A problematic characteristic of informal reorganization where all of the involved parties do not agree to the voluntary plan. Holdouts are usually creditors who attempt to receive full payment on claims.



## ABSTRACT

To investigate the missing link between prudent management, bankruptcy laws, and financial distress. We find that Uchumi supermarkets became insolvent when its Board of Directors decided to embark on unplanned expansion program. The expansion program was founded on four pillars which included the deployment of retail management technology to increase efficiency; staff rationalization and renewal; Branding; and branch expansion.

The expansion programme was funded primarily with internally generated funds that involved cash inflows from operations, trade creditors and a medium term debt from commercial banks. The company had also projected a significant growth in sales from the newly created branches. Although there was an overall improvement in sales, the operational costs outperformed the sales growth by a considerable margin. The general economic performance of the country also stagnated at the time. That led to a big mismatch between assets and liabilities. The company started experiencing some cash flow difficulties a move that made the management to reverse some of the expansion goals by closing down the loss making stores. The closure of the stores further resulted to a loss of jobs. An estimated 580 employees were declared redundant and laid off their duties. The paper concludes by clearly articulating the missing link between prudent management, bankruptcy legislation and financial distress. An elaborate legal framework taking into account the interests of all the firms' stakeholders was recommended with core objectives of preventing, managing, and dispensing bankruptcy related cases.



# CHAPTER ONE

## INTRODUCTION

### 1.0

#### 1.1 Background of the Study

Rose *et al* (1996), defines financial distress as in ability to pay ones debts, lack of means of paying ones debt, such a condition of a woman's assets and liability that the former made immediately available would be insufficient to discharge the latter. Karen & Wruck (1990) defines financial distress as a situation where cashflow is insufficient to cover current obligations. They classified financial obligations into hard and soft contracts. According to them, the holders of hard contracts have both the specified and unspecified legal recourse to reinforce the contracts but for soft contracts, the discretion of discharge them rests with the management.

Altman (1983), distinguished between stock based insolvency and flow based insolvency all of which leads to financial distress. The former refers to the firm's negative net worth that causes the value of its assets to be less than the value of its debts. The latter, flow based insolvency conversely refers to a situation when a firm's cashflows are insufficient to cover contractual obligations. The US Bankruptcy code (11 USC 101, Clause 32) defines insolvency as a condition such that the sum of such entity's debt is greater than all such entity's property, at fair valuation.

#### 1.2 Background of Financial Distress

The study of financial distress fundamentally integrates the knowledge of: Capital structure and capital adequacy; operating cashflows and cost structure; earning capacity;



liquidity; and asset conversions. It also includes asset utilization efficiency and the strategic position that a firm is located. (<http://www.solvency.com/solvency.htm>).

In 1958, Franco Modigliani and Merton Miller formulated a classic capital structure irrelevance proposition. The two made a paradigm shift by defining a new role of market equilibrium an economic analysis model when they used it to articulate a positive theory of financial structure. They demonstrated that in the absence of taxes and contracting costs, the firm's investment policy is irrelevant to its valuation (Jensen & Smith 1986, Williams 1938). The dual studies concluded that the value of the firm is unaffected so long as the probability of distribution of cashflows remains unchanged. The MM proposition as popularly known contradicted the traditional theory that advocates for optimal capital structure. The disciples of traditional theory argues of how the increase in debt capital will initially reduce the cost of capital due to the effects of tax rebates and then increase with increase in cost of equity as more and more investors will demand a higher return to compensate for increased risk on return. The traditional theories however do not statistically or quantitatively define the optimal capital level. The theory remains largely descriptive making it a weak model of defining an optimal capital structure.

Although Modigliani and Miller (1958) model on capital structure irrelevance proposition won the dual a Nobel Prize, their studies failed to articulate the financial decisions observed in practice. Certainly, the probability of distribution of the firm's cashflows is



affected by market imperfections such as the present value of agency costs, bankruptcy costs/financial distress costs and tax affects (Jensen & Smith 1986).

### **1.2.1 Towards an Optimal Capital Structure**

In later studies, MM (1963) revised the capital structure irrelevance proposition to reflect the effects of market imperfections. The two argued that market imperfections will only increase stock values only on the following grounds: first, reduce taxes or transaction costs; two, provide a reliable “signal” to investors, of managements confidence in the firms earnings prospects; or three, increase the probability that management will undertake only profitable investments (Chew 1993). The market imperfections however do not provide an infinite advantage in firm valuation. Had this been the case, then it would mean that the equity capital could be substituted with debt capital to maximize the shareholders wealth. The threshold of an optimal capital structure sets in soon after the contractual costs exhausts the benefits of tax shields. Beyond the optimal capital structure, increased leverage leads to financial distress and other insolvency related problems.

### **1.3 Kenyan retail industry**

The Kenyan retail industry is largely undeveloped. It is characterized by a few supermarkets, retail shop outlets and thousands of Kiosks spread all over the country. The inadequate managerial skills and inaccessibility of capital by entrepreneurs are additional features that define the Kenyan retail market. Except for the few supermarkets in the retail industry, other retail outlets are largely owned and managed by individual



households. It is estimated that most of these retail outlets collapse at infancy stage due to poor managerial skills and lack of capital for expansion.

Most of retail outlets save for supermarkets deal with consumer goods and services. The stock levels are primarily driven by the market forces of supply and demand, and the capital employed in the business by its proprietors. Unlike other retail outlets, supermarkets dispense a certain level of managerial skills. They employ qualified professionals, keep proper books of accounts and are tax compliant. Most of the supermarkets are located within the capital city Nairobi and its environs. The location enables them to stock other household goods such as household appliances, clothing and furniture.

#### 1.4 Background of Uchumi Supermarkets

It is estimated that the Kenyan retail industry comprises of 120,000 retail outlets. 25% of them are supermarkets and 75% are individual unit retail outlets. Uchumi supermarkets owns an estimated 5% of the overall retail market and 20% of the supermarkets share (Uchumi Information Memorandum 2005). However, this position continuously keeps changing due to entrant and exit of more players in the market. With Uchumi in financial crisis, the structure of the market may have further changed. The main players in the supermarket market share are Uchumi, Nakumatt holdings, Tusker Mattresses (Tuskys), Ukwala Supermarkets and other independent supermarkets. Traditionally, Uchumi has played a dominant position with 17 stores followed closely by Nakumatt and Tusker mattresses each with 15 and 10 branches respectively.



Compared with other East African states i.e. Uganda and Tanzania, Kenya is the only country in the retail industry that do not have a single foreign investor. The shoprite and pick “N” pay both from South Africa are already in Uganda and Tanzania. The economic analysts observe the consolidation of retail supermarket in Kenya as the main challenge that has discouraged new players from rolling out their businesses in the country (Uchumi Information Memorandum 2005). However, the high cost of doing business in Kenya, the punitive tax regimes, and the numerous licenses required before a firm rolls out its business are further to blame for uncompetitive market. That shows the main competitor of Uchumi will continue to be Nakumatt, Tusker mattresses (Tuskys) and Ukwala supermarkets.

#### **1.4 Background of Uchumi Supermarkets**

Uchumi Supermarkets Ltd was established in 1975 to create retail outlets for locally manufactured goods and other essential products. The company’s founding shareholders were ICDC, ICDCI, KWAL and KNTC. During the formative stages, Uchumi engaged standa-spa of Italy in a management contract. In 1990’s, a local team of management took over the operations of the company. This development came in the backdrop of the Italian company. After two decades of business (1992), Uchumi was listed at the bourse becoming the first retail company to be listed in Nairobi stock exchange. The listing made Uchumi a major player in the market. The listing further enabled the company to consolidate its dominance in the market because it could easily get additional funding through the stock market. This development gave Uchumi a competitive edge over its competitors in the retail market.



In 2001, Uchumi Board of Directors formulated a new five years expansion strategy designed to enhance shareholders value. The strategy involved: opening new stores of various formats including supermarkets in Nairobi, Mombasa and mid size urban branches; a regional expansion program designed to transform Uchumi into an East African retail Chain through specialty shops program with companies offering complementary goods and services (e.g. Bata, Kodak, Steers restaurants, Stanbic- in-store bank, mobile phone booths etc) designed to enhance foot traffic into Uchumi; and acquisition of an ERP system to strengthen processes, control cost margins, monitor operations and enable better management control.

The expansion program saw the number of Uchumi stores grow to 28, including four supermarkets in Kenya and one in Uganda. As the implementation strategy got underway, the turnover lagged far behind the capital outlay costs. The profitability levels failed to match the development costs and the operating costs outstripped the sales growth by a considerable margin. This development unfolded against a background of increasing competition, entry of new players and a change of market structure.

Uchumi's five years strategic plan was funded by cash from operations, trade creditors and short term borrowing from commercial banks. The programme involved the purchase and development of property, plant, and equipments. This financing approach greatly undermined the working capital. The company also experienced an acute shortage of cashflow. Uchumi being a services sector, adequate cashflows were necessary to keep



the business at a sound financial position. The situation got worse when the country continued to experience a prolonged economic depression. The Interest rates on borrowing were also not favourable to the company at the time. The sales levels also went down considerably. As a result, the Board of management reversed some of the expansion goals by closing down loss making or poorly sited stores. Senior management left the company and an estimated 580 employees lost their jobs.

In 2005, Uchumi issued more equity to finance the working capital requirements and pay part of its creditors. The offer raised an estimated Kshs 1.2 billion and saw the volume of the company subscribed shares triple to 180 million. As the volume of shares increased, the share prices declined. The decline in share prices could have resulted from the increased uncertainty about the future of the company and other fundamentals related to the market.

In year 2006, Uchumi turned insolvent. The company closed all its branch net work country wide except for one in Uganda. It was later re-opened under the supervision and management of receiver managers. The government also injected Kshs. 670 million to bail out the company. Other efforts to revive the company involved a request to the creditors to stagger their due dates of payment. Banks were also asked to slow down interest rates, and convert some of their credit into a share capital. The company also issued additional debenture capital that had a superior claim over other creditors



## 1.5 Problem statement

The study of financial distress has become an issue of global significance. Much of the attention to the study is drawn from the increasing cases of business failures born out of the high incidences of financial bankruptcy and insolvency. However, to be able to attain the desired goal of sustainable development and self dependence in our Kenyan economy, the issue of corporate financial distress is critical and must be addressed at all levels of business practices. Such a development will guarantee sound business institutions that are financially healthy. It will also promote the confidence of both the lenders and investors in the business environment.

Globally, out of the studies done on financial distress, a number of them have recommended the development and enhancement of bankruptcy related legislations such as the famous US bankruptcy code Chapter 11 as the way forward towards solving the problems of financial distress. This misconception has accelerated the rate of business failures and widened the much needed link between financial distress and prudent management. Analysts have in the past raised skepticism on the efficiency of such legislations in addressing the insolvency problem. The US bankruptcy code for instance is to blame for the high cost of formal reorganizations and much time taken in the formal workouts. Besides the motivation to dissolve the firm, the only other essence of bankruptcy laws primarily addresses the differences between stakeholders than the core issue of insolvency and sustainability of the business as a going concern. Such legislations cannot therefore be credited to remedy the insolvency problems when in actual sense are increasing the high cost of formal workout.



In this paper, the researcher has critically analyzed the missing link between the prudent management, bankruptcy legislation, and financial distress with special reference to Uchumi Supermarkets in Kenya. This paper shows why it is significantly important to have bankruptcy legislations that protect the interest of corporation as a going concern and why it is also legally necessary to have an accountability charter that regulates the actions of management.

## Government

### 1.6 Objectives of the Study

#### 1.6.1 Broad Objectives

To investigate into the causes, effects, and the missing link between prudent management, bankruptcy legislations and financial distress.

#### 1.6.2 Specific Objectives

1. To establish the causes of financial distress in Uchumi Supermarkets.
2. To establish the effects of financial distress to Uchumi stakeholders and the overall retail industry in Kenya.
3. To establish the role of management in the plebiscite of financial distress in Uchumi
4. To identify the missing link between prudent management, legislation and financial distress.

### 1.7 Research Questions

1. What were the causes of financial distress in Uchumi?
2. What was the effect of Uchumi's insolvency to its stakeholders?
3. What was the role of management in the collapse of Uchumi?



4. How adequate are the Kenyan bankruptcy laws in articulating the challenges of financial distress?

## 1.8 Significance of the Study

This study was considered to be of use to the following interest groups and organizations.

### Government

The findings of this study are of significance to the government of Kenya as a regulating authority that provides an enabling and conducive business environment. The study helps the government to appreciate the essence of formulating adequate legal framework that is well blended to prevent financially distressed firms and to protect firms already in financial distress and its stakeholders.

### Corporate Managers

To the corporate managers, the study serves to enlighten them on how to detect, prevent, and manage financial distress cases.

### Industry

Given that most business entities approach the public to solicit for funds through the secondary market, the study serves to enlighten other firms in the industry on how to gauge and benchmark them while evaluating their debt levels.



## **Regulators**

To the market regulators e.g., CMA and NSE the study serves to enlighten them on barometers to use in evaluating the viability of firms seeking for funds through the secondary market in order to protect the market players and retain market confidence of investors.

## **Academicians**

The study provides a reference material for future researchers and scholars who would want to venture into this area of study.

### **1.9 The scope of Study**

The study was conducted within the capital city Nairobi. The location of the study was considered appropriate because most Uchumi stores are located in the city. The problem of the study was also identical in every aspect thus data collected from Uchumi stores in Nairobi was considered to be a representation of the entire population. The study covered a period of five years of Uchumi's operations beginning with year 2002 to year 2006. Year 2001 was also included in the study but only as a base year.

### **1.10 Limitations of the Study**

#### **Lack of Appropriate Data**

The researcher was not able to obtain a financial secondary data for both Uchumi and other firms in the industry beyond six years period. It is also worth to note that the main competitors of Uchumi in the retail industry namely Nakumatt Holdings, Tusker



Mattresses (Tuskys) and Ukwala Supermarkets are not quoted in the stock market. That made it difficult to obtain their past financial reports that would have been essential for this study.

### **Discomfort**

A number of respondents were reluctant to fill in the questionnaire for fear of loosing their jobs and the basic assumption of leaking essential information to competitors. This may have influenced the respondents to give distorted facts about the problem of study. It may also have influenced them to conceal some information necessary for the study.

### **Lack of Co-operation**

A number of respondents declined to fill and return the Questionnaire. This had the effect of reducing the sample size of the study.

### **Population of the Study**

From the study, it is clear that the researcher conducted a survey of only one company in Kenya. This obviously limits the scope of the study and it was not immediately possible to establish the cause of failure in other Kenyan firms. Establishing the future of other firms would enable the regulators to adopt a more elaborate approach in design and development of the necessary legislation.



## CHAPTER TWO

### 2.0

## LITERATURE REVIEW

### 2.1 The nature and meaning of financial distress

The US bankruptcy code (11 USC 101 clause 32) perhaps gives the most basic but legal definition of financial distress. The statute links financial distress to insolvency and defines it as a financial condition such that the sum of the entity's debt is greater than all of such entity's property at fair valuation (<http://www.solvency.com/solvency.htm> 19/07/2007). Rose *et al* (1996), too linked financial distress to insolvency and defines it as the inability to pay ones debt. Such a condition of woman's asset and liability that the former made immediately available would be insufficient to discharge the latter. Altman (1983), distinguished between stock based insolvency and flow based insolvency all of which leads to financial distress. The former depicts a condition when a firm has a negative net worth causing the value of its assets to be less than its debts. Conversely, flow based insolvency occurs when firms cashflow are insufficient to cover contractual obligations.

Karen & Wruck (1990) defines financial distress as a situation where cash flow is insufficient to cover current obligations. To them, financial obligations can be categorized to hard and soft contacts. Hard contacts are those implied or explicit which if violated, the claims holders have specified and unspecified legal recourse to reinforce the covenants. Controversy, Soft contracts are those that the claims holders have expectations of receiving current payments from the firm. Unlike for hard contracts, soft



contracts are those where payments are often policy decisions at the discretion of management.

From the above definitions, it is clear that there are a variety of definitions however, what is more fundamental is not a list of definitions but rather the application of those definitions. More important are the judicial citations and interpretations of financial distress as put forward by different judicial systems. It was also observed from the study that different countries have different interpretations and applications of bankruptcy related cases. That has a likely effect of creating inconsistencies on how best to manage financial distress. It may cause the likely effect of lacking universality necessary to guide the insolvency related problems.

As the study of financial distress continues to gain a reasonable attention in financial literature, the problem of financial bankruptcy continues to bite in both developed and developing economies. Financial distress has evolved as a problem of small firms, medium sized enterprises and large corporations. A number of studies did show how big corporations have found themselves candidates of financial distress. In United States for instance, Pan Americans Airlines, Texaco, World com Inc, Enron Corporation, Conseco Inc and financial holdings were once listed as candidates of financial distress and business failures. This trend of increased business failures has raised sharp reactions as to the effectiveness of chapter 11 in addressing the insolvency related cases. Other examples of failed corporations includes ground Inc, reliance group holdings and federal mogul corp. (Brigham and Dave's, 2004)



In Kenya, the incidences of financial distress and business failures are more pronounced. The notable examples include Uchumi Supermarkets, Safari Park Hotels, Norfolk Hotels, National Bank of Kenya, Kenya bus service and the defunct Euro and finance banks. Government corporations have also been involved in failure related cases. In late 1980's and early 90's a number of government corporations failed in the country. They include KMC, KPCU, AFC, KCC and the defunct United Insurance.

## **2.2 Background study of financial distress**

The most important financial decisions that a company makes is to determine the ideal capital structure that a firm should adopt. Capital structure involves determining the proportions of debt to equity that a firm aims to achieve. An evaluation of the capital adequacy is therefore important. Capital adequacy relates to whether a company has enough capital to finance its planned future operations. If the company's capital is inadequate, then it must either be able to issue new equity or arrange for a new debt. The amount of debt that a company can absorb or repay from its continuing operations is normally referred to as the company's debt capacity. The company needs to evaluate its operational cash flow projections and match it with its capital needs. If a company needs to undertake a major project, then it has to perform financial feasibility study to determine whether the firm has financial capacity to undertake the project and whether the company will generate adequate cash flows to repay all future debts (<http://www.solvency.com/solvency.htm>,19/07/2007)



To achieve an ideal capital structure, a number of theories have been put forward to explain how a firm could do it. These theories expound a concept of the optimal capital structure, but whether managers' aim towards it in practice is a subject of a further research. The static trade-off view develops the traditional theory and states that firms will aim for an ideal capital structure. The firm according to this theory will issue debt or equity depending on what their current position is in relation to ideal capital structure. However, pecking order theory provides an alternative approach to traditional school of thought. It states that firms will prefer retained earnings then debt and equity in that order when making financial decisions. The proponents of pecking order approach contend with the fact that the theory gives a positive signal to investors that the future cash flow of the firm looks certain and that the management will only invest in profitable investments. But critiques argue that the theory fails to demonstrate the effect of taxation, financial distress and agency costs. They also argue that the pecking order approach do not show how the investment opportunities available may influence the choice of finance (ACCA Professional education, 2006). An in-depth analysis of traditional theory, static trade off and pecking order approach derives us to a conclusion that these theories are purely descriptive. They follow a hierarchical order and provide no statistical proof of a possible optimal capital structure observed in practice. Largely, these theories explain what happens in practice as opposed to what should happen.

In 1958, Franco Modigliani and Merton Miller rubbished the whole idea of an optimal capital structure. To justify their argument, the two made a paradigm shift in defining the role of market equilibrium an economic analysis model. They used it to develop a



positive theory of financial structure. They demonstrated that in the absence of taxes and contracting costs, the firm's investment policy is irrelevant to its valuation (Williams 1938, Jensen & Smith, 1986). Their studies went a head to suggest how the value of the firm remains unchanged so long as the probability of distribution of cash flow remains unchanged (Jensen & Smith, 1986). Coase (1960) also articulated that in the absence of contracting costs and wealth affects, the assignment of property rights leaves the use of real resources unaffected.

Although the MM studies on capital structure irrelevant proposition gained a wide acceptance in finance literature, their model failed the test of the financial decisions observed in practice. Certainly the probability of distribution of the firm's cash flow is affected by contracting costs such as the present value of agency cost, financial distress and the effects of tax shield (Jensen & Smith, 1986)

### **2.2.1 Towards an optimal capital structure**

Here, MM laid a revised version of capital structure irrelevance prepositions to include the effects of contractual costs and tax shields. They argued that contractual costs will only increase the stock values of the firm on basis of the following. First, reduce tax or transaction costs; second, provide a reliable "signal" to investors of management confidence in the firms earning prospects; and third, increase the probability that management will undertake only profitable investments (Chew, 1993). After recounting the reasoning behind the capital structure irrelevance prepositions, MM (1963) considered the contribution of taxes, agency and bankruptcy costs in levered firms. They



concluded that since corporate tax allows the deduction of interest payments in calculating taxable income the more debt in capital structure, the lower the corporate tax liability, the higher the after tax cashflows and greater the market value of the firm (Jensen & Smith, 1986). However, the tax effect theorem was only a narrow consideration, Farrar Selwyn (1967), Black (1973), and Jensen Smith (1986), argues that one cannot talk of tax advantage of debt without considering personal income taxes. They suggested that corporate tax advantage of debt is offset by personal tax rate on investor debt income. Brennan & Schwartz (1978), and Jensen & Smith (1986) argues that the value of tax advantage on debt is by far an exaggeration because tax shield is lost if the firm goes through a bankruptcy and liquidation and therefore advantage of tax may not be of much significance.

To erase the significance of the tax shield, a number of studies devoted a reasonable attention to the definitions and significance of the market imperfections. Jensen & Meckling (1976) defined agency costs as the sum of structuring contract with formal and informal monitoring expenditure by the principal, bonding expenditure by the agent and the residual loss. Residual loss is the opportunity costs associated with the change in real activities that occurs because it is not worth reinforcing all the contracts with perfection. The dual argues that agency costs involve determining the optimal ownership structure of the firm including relative quantities of debt and equity held by different stakeholders. Jensen & Smith (1986) proposes that the capital structure problems involves determination of the entire set of contracts among stock and bond holders and management as well as other agents party to a contract.



Kraus & Litzenger (1973), and Jensen & Smith (1986), demonstrated how tax shield is offset by increased bankruptcy costs to produce an optimal capital structure. As more substitution of debt to equity takes effects, bankruptcy increases and so does the cost of financial distress. The increased leverage increases the present value of financial distress up to a level where the available tax shield is exhausted by the increased bankruptcy and agency costs. A further use of debt capital according to the study increases the contractual costs and exposes the firm to financial distress. The optimal capital structure therefore is the break-even point at which the benefit of tax shield is fully exhausted by the contractual costs. A further use of debt exposes the firm to financial distress.

### **2.3 Causes of financial distress.**

According to Kose John (1993), financial distress is caused by a spectrum of things namely: threatened bankruptcy; sales decline; increased competition and poor performance of the firm. After the closure of Uchumi the company's CEO was quoted in the media as saying "competition made recovery impossible, in spite of management best effort". A report by equity analysts African Alliance showed that the sales fell by 35% to 5.1 billion in 2005. The company made a loss of 1.2 billion against Ksh 699 million in the previous year Brigham & Dave's (2004) considers the causes of financial distress as economic and financial factors. To them, other factors arise out of negligence. The economic factors are diverse and include industrial weakness, poor location and the level of interest rates. The financial factors on the other hand coin the amount of debt, capital inadequacy and poor management judgments arising from poor analysis of financial ratios. Uchumi financed a long-term investment using short term funds mainly cash from



its creditors and bankers. The company was also burning cash in brick and mortar and not leasing its stores. The finance costs went up to Kshs 149m in 2006 from 25m the previous year (Daily Nation: Friday 2<sup>nd</sup> June 2006) an indication of poor management.

Uchumi financed a long-term investment using short-term funds a clear indication that the firm did not have a financial capacity to undertake the expansion programme. (Daily

### **2.3.1 Capital structure and adequacy**

Capital structure relates to proportion of debt to equity in the company. Summary measure of a company's capital structure includes the debt to equity ratio (D/E) and debt to total capital ratios (D/D+E). Capital structure theory helps evaluate whether the firm will manage to pay interest and principal as they mature in the normal course of the business. To assess the viability of interest cover, the firm has to determine the ratio of earnings to interest expense. More probable than not, when a firm has a major investment project, it is more likely to acquire more debt than defined by the market parameters and its ideal capital structure. The increased financial leverage is pegged on the assumption of increasing equity ratios. However, increasing the ratio of debt to equity in a company's capital structure implicitly makes the company relatively less solvent and more financially risky than a company without debt.

( <http://www.solvency.com/solvency.htm>19/07/2007)

Liquidity refers to how quickly an asset can be converted into cash and the certainty

The company needs to evaluate capital adequacy needed to finance planned future operations if it has to avoid ugly scenarios of increased gearing. If the company's capital is inadequate, then it must be able to issue new equity or arrange for new debt. But before a company could use either a feasibility study is important to determine whether the



company has financial capacity to undertake the project and whether the company will be able to repay all future debts. If that is not done, a capital structure that a company uses could make it financially distressed (<http://www.solvency.com/solvency.htm>19/07/2007).

Uchumi financed a long-term investment using short term funds a clear indication that the firm did not have a financial capacity to undertake the expansion programme. (Daily Nation: Friday 2<sup>nd</sup> June2006)

### **2.3.2 Operating cash flows and cost structure**

Generally companies that can consistently generate positive cash flows from operations will remain relatively more solvent than those that cannot. A company needs to generate cash flow that exceeds operating costs. When company cash flows are erratic, it stands a high chance of becoming insolvent (<http://www.solvency.com/solvency.htm>19/07/2007). Erratic cash flow however, does not always mean the firm will be insolvent. Even when erratic, huge cash flows could easily be evenly distributed to cover gaps with little or no cash flows at all. Further, erratic cash flows could more be associated with poor diversification of business portfolio than the specific project's ability to produce adequate cash flows.

### **2.3.3 Liquidity**

Liquidity refers to how quickly an asset can be converted into cash and the certainty associated with the conversion ratio or price which will be realized for the assets. Controversy, for liabilities, liquidity describes how quickly obligations will have to be paid in cash and whether the obligations can be paid at less than their full stated repayment. Measures frequently used in liquidity include a working capital, current ratios



and quickly ratios. Every asset in a company must be evaluated for liquidity. However, when a company becomes financially distressed, even assets which are normally considered liquid may become relatively illiquid. The liquidity position may further be compromised when company long-term liabilities often become immediately due and payable if the company violates contractual debt contract. A company becomes bankrupt when liquidation value is reduced to zero (<http://www.solvency.com/solvency.htm19/07/2007>). Uchumi recovery strategy failed because of its inability to sell its non core fixed assets. Most offers according to the management were not suitable. A sign of an offer that is not equal to the value of the asset disposed in the ordinary course of business.

#### **2.3.4 Asset conversions**

Companies become financially insolvent when assets are converted to less liquid forms over a sustainable period. Such developments arise when company assets grow faster than the company sales. In the event of such developments the company becomes more highly levered and long-term investment decisions do not pay off in term of planned operations.

#### **2.3.5 Assets utilization efficiency**

The main objective here is to achieve an optimal output both the human capital and assets. This would be measured by a return on investment (ROI) and higher return per employee. Companies that are successful are more likely to register higher returns than the less successful ones. In the absence of aggressive asset management, companies result to whole sale asset divestitures and are often forced to restructure to fund their



continued operations (<http://www.solvency.com/solvency.htm>). More likely than not, such programs would result in the sale of non core businesses and assets. The programs result to reduced diversification for a company and increased risk of insolvency and bankruptcy.

### **2.3.6 Strategic position**

The available literature document a high positive correlation between return on investments and such factors as, market share, product quality and lower capital intensity. Companies with strong strategic position are more likely to experience higher returns than their competitors. The high returns guarantees increased solvency for market leaders than their competitors with lower average returns to markets average.

## **2.4 Bankruptcy prediction**

Financial literature has devoted a reasonable attention to the models of failure prediction. Beaver (1967) provides some of the earliest studies of failure prediction. In his studies, Beaver used a univariate analysis of financial ratios to distinguish between failed and non failed firms for a period of five years. His studies concluded that cashflow/total debt was the single most factors to consider in failure prediction.

In 1993, Edward Altman formulated what came to be the most famous failure prediction model Altman's Z- Score. In his work, Altman appeared to build on the weakness of Beaver's (1967) work. Unlike the preceding studies, Altman based his work on multiple



discriminate analyses (MDA). His development came up with the formulation of the form.

$$E = 0.012x_1 + 0.014x_2 + 0.33x_3 + 0.006x_4 + 0.999x_5 \text{ Where}$$

$X_1$  = working capital/total assets

$X_2$  = Retained earnings/total assets

$X_3$  = Earning before interest and taxes/total assets

$X_4$  = market value of equity/book value of total liabilities

$X_5$  = Sales/total assets.

Altman studies concluded as follows  $E < 1.10$  indicates that a firm is in financial distress, zone,  $E = 1.10 - 2.6$  a firm is in grey zone, while  $E > 2.6$  a firm is in a non bankrupt zone.

Later, Altman revised his earlier Z-score model to incorporate new coefficients. In his revised studies, he dropped  $x_4$  and  $x_5$  variables and replaced them with a new variable  $x_4 = \text{net worth (book value)}/\text{total liabilities}$ . The  $x_5$  was dropped to dilute the potential industry effects related to asset turnover.

In 1977, Altman in a joint study with a private financial firm (Zeta services Inc) developed a seven variable Zeta model. The model was developed from a sample of 113 manufacturers and retailers. The zeta model was by far considered more accurate in predicting and classifying bankruptcy for periods ranging from 2 to 5 years. Zeta model is based on the following variables which are not specific.

- Return on assets
- Stability of earnings



- Debt service
- Cumulative profitability
- Liquidity/asset ratio
- Capitalization (five years average to total market value)
- Size (total tangible assets).

Another approach of failure prediction is the Gambler's Ruin model. According to this model, bankruptcy sets in when a company net liquidation value is defined as total assets liquidation value less total liabilities. The net liquidation value is increased by cash inflows and decreased by cash outflows. The difference between cash inflows and outflows gives rise to adjusted cashflows. The model goes on to suggest that failure is more probable when the net liquidation value are smaller as well as the adjusted cashflows. Recent studies of 1990's came up with another failure prediction model "Artificial Neural Networks". The model is computer generated and processes information in parallel similar to the human brain. The model stores information in patterns and are able to develop from past experience. Unlike in previous models, ANN's is credited for processing vast amount of data in a more complex relationship. However, the model is still unable to monitor independent variables independently.

## **2.5 Effects of financial distress to a firm**

Jensen (1989) believes that the costs of formal reorganizations are high enough to explain the greater incidences of workouts. The studies by Brigham & Dave's (2004), documents such costs as time taken in formal workouts; sales decline; loss of key staffs;



management time taken in responding to bankruptcy cases rather than concentrating on business and the opportunity cost of creditors. The study by Schleifer and Vishiny (1993), found that when firms are forced to sell assets, and other firms in the industry are themselves near distress, the assets may be sold at prices below their values in their best use.

## **2.6 Control of financially distressed firms**

The subject of financial distress has been investigated by various finance scholars (Kose John 1993, Brown, James and Mooradian 1991, Asquith 1991, John Lang 1990, and Karen & Wruck 1990, their studies suggest that, defaults leads to significant changes in the ownership of the firms equity and right to manage corporate resources. Their studies concludes that: Bank lenders frequently become major stakeholders or appoint new directors; only 46 percent of the incumbent directors remain when bankruptcy of debt restructuring ends; Directors who resign hold significant fewer seats on other boards following their departure; and common stock ownership become more concentrated with large block of stakeholders.

## **2.7 The Government Role**

According to Pomerleano & Shaw 2005, the government has two primary roles of dispensing insolvency. The two roles are: government monitoring and intervention. It is the duty of the government to manage and provide a regulatory framework of corporate restructuring. With adequate legal framework in place; the government does not have to deal with emergency cases.



### **2.7.1. Monitoring**

Pomerleano and Shaw (2005), goes on to suggest that the general public require adequate necessary information related to corporate debts of corporations in order for them to make timely and necessary decisions. Although, the nature and timing of such information may differ from one country to another depending on the nature of legislation and legal framework available, the composition of corporate debt; exchange rate; denomination of debt; residence of debt owners; profitability levels of the company and structures of corporate governance would be important to disclose in debt assignments. Although such information could be provided, it is difficult to tell whether the target group will have the capacity to rationally analyze the data. Instead of government venturing into such, it would sound more prudent to enact legislations that would guarantee more disclosures by such companies.

### **2.7.2. Intervention**

Intervention calls for adherence to certain minimum standards. Such standards will ensure that corporations are properly classified and those which are not viable are liquidated with utmost efficiency (Pomerleano & Shaw 2005).

## **2.8 Legal Frame Work**

The role of adequate legal environment is to reduce legal and financial uncertainty and provide equitable treatment to all stakeholders. It also involves providing efficiency when disposing off cases of financial insolvency. However, despite the target objective, most countries face a host of challenges. Such challenges include inadequate legal



uncertainties of dispensing cases of corporate restructuring due to lack of preparedness on part of judiciary (Pomerleano & Shaw 2005).

The American based law, chapter 11 is such rare example of bankruptcy related legislations. The legislations core objective was to protect, corporations from being liquidated if they are more viable retained as a going concern. The second most objective was to guarantee efficiency in disposing the assets of winding companies. However, given the problems associated with the legislation, many corporations shy away from court administered workouts. The legislation is by many aspects considered cumbersome and costly (Pomerleano & Shaw 2005). Infact, Jensen (1989), believes that the costs of formal reorganizations are high enough to explain greater incidences of work outs. The studies conducted by Gilson, John & Lang (1990), concluded that asset and financial characteristics determine between formal and informal debt restructuring. They concluded that, workout are more likely to be preferred when greater proportions of firm's assets are intangible, much of debt is from bank and when firm has fewer lenders leading to easier bargains. However, though less costly, informal workouts may suffer from lack of binding deadlines and lack reliable mechanisms to resolve difference among creditors (Pomerleano & Shaw 2005).

### **2.8.1. Legal Framework in Kenya**

In Kenya, the company's act, chapter 486 section 212 basically provides for bankruptcy process, and administration of receivership. The act provides for a basic legal framework necessary to winding up a company. The act in its provision suggests that a company can



be wound up by a court order, voluntary dissolution and voluntary but court supervised dissolution. The act further defines how the after winding up wealth should be shared out. The act is however rigid in application and lacks the flexibility required to guarantee a fair play. The Kenya judicial system further lacks the right personnel with adequate expertise to address such challenges. In Kenya lack of authentic data stands out to be the main challenge besides the necessary legislation.

### 3.2 Research Design

A descriptive survey was adopted for the purpose of data collection. The main aspect here was to identify the study location and to identify the appropriate approach of data collection. The researcher scaled down the study to the expository type of survey for easier analyses of objectives. The approach was also useful in explaining and describing the concepts of the study (Peter 1994).

### 3.3 Study population

The researcher conducted a survey of all the Uchumi outlets within the central city Nairobi. According to the company's Right Issue Memorandum (2005) Uchumi had 13



## CHAPTER THREE

### 3.0 RESEARCH METHODOLOGY

#### 3.1 Introduction

This chapter has outlined three fundamental elements of the study. First, the chapter gives the researchers approach in data collection. In this segment the researcher has defined the research design the target population, and the sampling strategy of the study. Second; the chapter describes the tools of data collection that were used in the study. The main tools of data collection were a structured questionnaire, past financial statements, and Uchumi Right Issue information memorandum (2005). Third, the chapter presents data analysis and inferences made from the findings. Altman's (1993) Z-Score model and Beavers (1967) univariate model were the main tools of data analysis.

#### 3.2 Research Design

A descriptive survey was adopted for the purpose of data collection. The main aspect here was to identify the study location and to identify the appropriate approach of data collection. The researcher scaled down the study to the expository type of survey for easier analyses of objectives. The approach was also useful in explaining and expanding the concepts of the study (Peter 1994).

#### 3.3 Study population

The researcher conducted a survey of all the Uchumi outlets within the capital city Nairobi. According to the company's Right Issue Memorandum (2005) Uchumi had 13



stores within the city. This was a 46.42% of the total population that stood at 28 stores country wide. The sample population was specifically taken because of its ideal location.

### **3.4 Sampling strategy**

A survey was carried out covering all the Uchumi branches in Nairobi. A total of 26 Questionnaires were administered to the respondents through a drop and pick approach. Two questionnaires were administered in every Uchumi retail outlet. The research specifically targeted top management whom in the researcher's view were in a better position to give more accurate information from the management's perspective. To represent non operational stores, the researcher randomly selected stores attendants to fill in the Questionnaire from the operational branches.

### **3.5 Data Collection**

A Questionnaire was administered as the main tool of data collection. The Questionnaires had both the closed and open ended Questions. To supplement Questionnaire as the main tool of data collection, the researcher used Uchumi's past financial statements obtained from NSE hand books and the company's right issue information memorandum. From the financial statements, the researcher was able to analyze a number of financial ratios necessary to ascertain the company's financial position. The statements were also useful in analyzing other variables of the study that were used in formulating Z-score results. The Uchumi's right issue information memorandum provided useful background information on what led to insolvency status of the company and how the expansion programme was to be financed.



### 3.6. Data Analyses

For the purpose of the study, Altman's Z - score model and Beaver's (1967) univariate model were used to analyze the data. The former uses weighted average discriminate functions while the latter analyses a number of financial ratios. To analyze the Questionnaire, the researcher tabulated the data and summarized the findings in percentages. The findings were then interpreted in both the descriptive form and by use of illustration tools such as pie charts, graphs and histograms.



## CHAPTER FOUR

### FINDINGS

#### 4.0.

##### 4.1. Introduction

This chapter presents the findings of the study and the inferences made from it. The chapter is ideally composed of two parts. These are findings from failure prediction models and from the questionnaires. In the failure prediction study, the researcher presents the findings both of ratio analyses model and the Altman's Z-score model. Conversely, part two of the chapter presents the findings of study as analyzed from questionnaires. Statistical illustration tools such as the graphs and diagrams were used to aid the interpretation and understanding of the data. Where possible, the researcher used both primary and secondary sources of data to enable him reach a reasonable conclusion.

##### 4.2. The Choice and Size of the Sample

The data for part one of these chapters was obtained from past audited financial statements of Uchumi and other firms in the same industry. Industry in this case refers to all the listed and publicly quoted companies in commercial and services sector of the stock exchange where Uchumi Supermarkets was a key player. The study on audited financial reports covered a period of six years between year 2001 and 2006. Year 2001 formed the base year of study. In part two of the chapter, the researcher conducted a descriptive survey on all Uchumi Supermarkets located within the capital City Nairobi. A total of 13 stores were earmarked for study. The location was ideal for study because most of Uchumi stores are located in Nairobi. To ensure a fair representation, two questionnaires were administered in every Uchumi store. However, at the time of study,



a number of stores had closed down partly due to poor business and partly because of increased financial insolvency. To ensure such stores were fairly represented, the researcher randomly issued questionnaires earmarked for such branches to stores attendants of other operational branches. The main respondents of study were top managers who in researcher's view were more informed about the topic of study. The questionnaire was the main tool of data collection. To supplement questionnaire as the main tool of data collection, other company documentaries related to the study were also used.

### **4.3. Uchumi's Capital Structure**

A survey on past financial statements of Uchumi Supermarkets shows how for a long time the company was financed. The company use to be equity financed with no debt component in its capital structure. After year 2003, the company borrowed a medium term loan to finance its expansion strategy. In the past, the company use to borrow short term funds to finance its working capital but record shows that the borrowings were easily manageable by the company. There were no long term borrowings in the capital structure of the company. The need to factor in short term borrowing in the working capital of the company was based on the nature of supermarket businesses which is cash based. The choice of the company not to use debt capital in the past means it was not enjoying the tax credit associated with debt capital. Ironically it happened to be the period when the company posted good returns. Could be the company benefited much from capital allowances that gives the same benefit. However the study could not find a company financial policy that occasioned the kind of funding that the company use to



have. Lack of such a policy negated the wisdom of optimal capital structure that most companies aim to achieve. It also shows how possible it can be to manipulate the capital structure. For instance, this could be the case when management wants to undertake risky projects which are not economically viable. Uchumi fits well in this case

#### **4.4. Approach to the Failure Prediction**

The researcher used two statistical models in the study. The models were used to show the performance trend and the actual period when Uchumi eventually failed. The two models are: Beavers (1967) ratio analyses model and Altman's Z-score model. In the ratio analyses model, a comparative study was conducted on a number of financial ratios between Uchumi and the industry's average. A similar study was also conducted between the period of study and the base year of the study. Separate analyses were carried out between Uchumi and other firms in the industry. The aim was to eliminate distortions associated with Uchumi's performance. The Z-score model on the other hand was used to show the actual period when the company became insolvent. The model was more recommended because unlike the Beaver's model that uses a unitary factor of ratio analyses, Z-score model use a multiple of factors. To analyze the data using the z-score model, the researcher first obtained the necessary variables of the model before equating them to the model. The necessary variables were computed for a period of six years and each analyzed separately before equating them into the model. The results of the model were further analyzed at three levels. The levels are: non bankruptcy zone, grey zone, and the bankruptcy zone. The grey zone was taken to mean that the company was indifference to bankruptcy.



**Table 4.1**

| <b>RATIO</b>                     | <b>UCHUMI/INDUSTRY</b> | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> | <b>2002</b> | <b>2001</b> |
|----------------------------------|------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <b>CURRENT RATIO</b>             | INDUSTRY               | 1.62        | 1.53        | 1.24        | 1.32        | 1.24        | 1.26        |
|                                  | UCHUMI                 | 0.18        | 0.36        | 0.51        | 0.58        | 0.72        | 0.98        |
| <b>EPS</b>                       | INDUSTRY               | 8.71        | 6.70        | 4.38        | 4.06        | 3.39        | -1.32       |
|                                  | UCHUMI                 | (27.38)     | (21.06)     | (11.52)     | (3.40)      | 0.83        | 1.49        |
| <b>PAY-OUT RATIO</b>             | INDUSTRY               | 16.31       | 22.20       | 28.09       | 51.68       | 20.18       | 23.47       |
|                                  | UCHUMI                 | -           | -           | -           | -           | 60.41       | 107.63      |
| <b>D. Y.</b>                     | INDUSTRY               | 3.32        | 2.57        | 3.33        | 2.97        | 3.70        | 5.85        |
|                                  | UCHUMI                 | -           | -           | -           | -           | 3.01        | 3.52        |
| <b>PE</b>                        | INDUSTRY               | -           | 9.01        | 10.37       | 17.31       | 10.65       | 1.92        |
|                                  | UCHUMI                 |             |             |             |             | 20.05       | 30.61       |
| <b>NET ASSET VALUE PER SHARE</b> | INDUSTRY               |             | 49.86       | 39.71       | 44.42       | 42.65       | 42.07       |
|                                  | UCHUMI                 |             | -1.49       | 8.77        | 11.57       | 15.54       | 15.63       |
| <b>CF/T.DEBT</b>                 | UCHUMI                 |             | -11%        | -17.17%     | -30.32%     | -14.17%     | 42%         |



#### **4.5. Analyses of Financial Ratios**

Table 1 above shows the findings of key financial ratios that were used to determine the financial performance of Uchumi. Normally the ratios are in most cases used to determine the company's level of performance. In this case they were used to determine the trend of failure. The following is the descriptive analyzes of table 4.1 above.

##### **4.5.1 Earning per Share**

Earning per share was used to evaluate the financial performance of Uchumi over a consistent period of time. The core essence of evaluating the ratio was to track the earning distributable to shareholders over a given period of time. Table 4.1 above shows a declining trend of earning distributable to shareholders. The trend was occasioned by the management decision to fund an expansion strategy using short term borrowing. The use of funds greatly undermined the working capital and that had the effect of reducing sales and overall returns. Another factor that explains the decline in the ratio was the financing cost. The increase in financing cost was as a result of the company's inability to finance the debt capital. Perhaps the management of Uchumi had not forecasted that the proposed project would take some time before it could pay off in terms of cash flows. Going by the results of this year (2001) the company earnings shows that the assets were efficiently employed as confirmed by earning per share of 1.49. The earnings further confirm that the genesis of failure was occasioned by the expansion. The management needed to evaluate the required financial resources in relation to what was



available to fund the programme without having to strain the business. A feasibility study was required not only to evaluate the traditional profitability performance of the company but also to ascertain the required financial cost and other effects of the project on the company performance. To give a good evaluation, it was good to determine the cost of the project, time required to complete the project, sources of fund, the viability of the project in terms of risk and return, the payback period and risk management.

#### **4.5.1. Cash flow to Total Debt**

Looking at the cash flows to total debt in table 4.1 above, we find a situation where Uchumi had stable cash flows to debt in 2001. The proportion of cash flows to total debt stood at 44%. That was an indication that Uchumi met its current debt obligations without much difficulty. However given that Uchumi is in retail business, adequate cash flows was necessary to finance the working capital. The proportion of cash flows to total debt above was only adequate to finance working capital and current obligations but not the future debts. This could perhaps be explained by the sharp decline of the company cash flows. In a span of one year, the company cash flows to total debt declined from 42% in 2001 to -14.17% in year 2002. Year 2003 was the worst for the company in terms of cash flows.

The drastic change of cash flows within the first three years shows that the timing of the proposed expansion strategy was poor. The proposed expansion period of 5



years was also inadequate to implement and actualize the programme that needed such huge cash flows. For such undertakings to be successful, adequate timing was very important in terms of cash flows. Majority of companies post good returns when the over all economy is performing, the interest rates on borrowings are low, and when the over all competition is manageable. If the competition is high, the company's products ought to be differentiable or dominant in a certain market niche to protect its cashflows. Even then, it is not a guarantee that the company would be in a position to finance the project using debt capital.

With cash flows such as those projected in table 4.1 above, the future of the company looked a little more uncertain. Although there was a slight improvement in cash flows between year 2004 and 2005, the over all effect remained unchanged. The company still posted negative cash flows. The insolvency status of the company still remained the same due to high financing costs. Later, the company closed down its operations after it was unable to improve its cash flows and the over all liquidity.

#### **4.5.2. Current Ratio**

Like other financial ratios, an evaluation of the current ratio in table 4.1 above was not any different from those other ratios in the same table. When compared with industry's average, Uchumi's current ratio was operating at below average in the entire period of study. There was a gradual decline of the current ratio between years 2001 to year 2006. The ratio declined from 0.98 against the



industry's average ratio of 1.26 to the lowest of 0.18 against the industry's average of 1.62. Such a decline meant the company could in future be unable to finance its short term financial obligations.

A number of factors could be used to explain the above results. First, the company was fast converting current assets into long term assets. However, the rate of conversion was not matched with those assets ability to generate cash flows. Second, the company was slowly becoming insolvent as a result of its inability to replenish the stores with essential products.

#### **4.5.3 Net Asset Value per Share**

According to the table 4.1 above, Uchumi had a relatively stable financial base within the first two years of study. Although there was relative decline in the Earning per Share, the decline was not that drastic particularly when compared with other financial ratios of the company. Between year 2002 and 2003, the company asset value per share declined from 15.54 to 11.57. The decline was occasioned by capital depreciation of assets over the years. Another possible option was the disposal of assets. What raises more concern however is the decline of the ratio between years 2004 and year 2005? The decline was too drastic. The asset value per share declined to -1.49 from a previous ratio of 8.77. The main cause of the decline was the accumulated losses that the company posted between the two years. Among the key causes of the loss was the increased financial cost.



Although the decline in asset value per share was not as drastic by Uchumi's standard, it was opposite when compared to the industry. The industry posted very stable results over the whole period of the study and when compared with Uchumi. That means Uchumi had a weaker financial adequacy as compared to the industry.

#### 4.6. The Z-Score Findings

The ratio analyses model described above presented major flaws that made it necessary to re-think the model. First, the model only analysed one factor of the study the financial ratios. Secondly, the model could not discriminate between failed and performing firms. The findings of the model could not give a break even point that separates failed and performing firms. The z-score model was able to articulate the two problems. Table 4.2 presents the variables of the model, their dates of reference and the overall z-score findings obtained by the study.

**Table 4.2**

| <b>YEAR</b>    | <b>2006</b> | <b>2005</b> | <b>2004</b> | <b>2003</b> | <b>2002</b> | <b>2001</b> |
|----------------|-------------|-------------|-------------|-------------|-------------|-------------|
| X1             | -0.73       | -0.66       | -0.41       | -0.34       | -0.17       | -0.01       |
| X2             | -0.73       | -0.44       | -0.15       | 0.05        | 0.14        | 0.17        |
| X3             | -0.77       | -0.48       | -0.19       | -0.05       | 0.03        | 0.06        |
| X4             | 0.24        | 0.33        | 0.39        | 0.49        | 0.85        | 2.29        |
| X5             | 0.90        | 1.22        | 2.44        | 2.60        | 3.12        | 3.88        |
| <b>Z-Score</b> | <b>0.63</b> | <b>1.22</b> | <b>2.44</b> | <b>2.60</b> | <b>3.12</b> | <b>3.39</b> |



#### 4.7. Interpretation of the Model

Between year 2001 and 2002, Uchumi was financially stable and free of bankruptcy. The z-score findings show the company was rated at 3.39 and 3.12 between the two years respectively. According to the standard rating of bankruptcy, a company is non bankrupt if it is rated above 2.60. Between points 1.10 and 2.60, the company is said to be in grey zone, while below 1.10 the company is bankrupt. Between year 2003, 2004, and 2005 the company was in grey zone. This was recorded by z-score ratings of 2.60, 2.44, and 1.22 respectively. In year 2006, the company turned bankrupt. The company posted a z-score of 0.63 which was way below the actual bankruptcy ratings.

A number of variables could be used to explain the above results. First, the company operated a negative working capital for the entire period of the study including the year just before the expansion strategy was rolled out. However, the situation deteriorated in the subsequent years with year 2006, registering the worst working capital to total assets. The working capital to total asset was prefixed X1 in table 4.2 above.

Second, although the company had good retained earnings to total assets between years 2001 and 2002, the situation changed in year 2003. The company recorded retained earnings to total asset ratios of 0.17, 0.14 and 0.05 in the three years respectively. The decline in retained earnings arose from the management decision to fund an expansion by use of company reserves. Between years 2004,



2005, and 2006 the company recorded negative retained earnings to total assets. The decline was as a result of reported losses by the company. The X prefix 2 & 3 were used to give the above analyses.

Third, during the project implementation period, the market value of equity to book value of total liabilities reduced significantly. The market value ratio declined from 2.29 in 2001 to 0.24 in 2006. The main cause of the decline was the mixed signals that the company was sending to the market in terms of the proposed project. Theoretically, it is argued that the use of debt capital give a positive signal of a company's ability to increase the future cash flows. It is assumed that the company will only use debt capital when it is assured of positive future cash flows hence an increase in share prices. That was not the case with Uchumi hence forcing the share prices to decline. Another reason was the management's decision to issue an additional equity to supplement the debt capital. In an efficient market, such an announcement could push down the share prices in anticipation of the likely effect of the proposed right issue. That was essentially what happened with Uchumi. The share prices went down soon after the announcement and not at the time of rolling out the right issue.

Fourth, the company sales to total assets declined considerably during the expansion programme. Although X prefix 5 in table 4.2 above explains the ratio, there was a gradual decline in the company sales to total assets. The decline became more pronounced between year 2004 and 2005. The company recorded



sales to total asset of 3.12 in 2002, and 0.90 in 2006 which was the lowest sales ratios over the period of the study. The decline could be explained by a number of factors. Key among them includes the increased competition, and the company's increased overtrading. Overtrading in this case was characterized by the sharp decline in cash flows and the increase in payables. A combination of the above factors made the company insolvent and subsequently bankrupt.

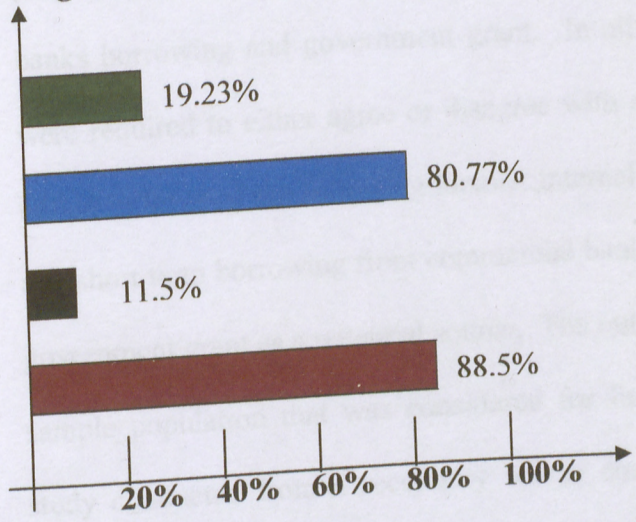
#### **4.8. Data Collection Analyses**

A total of 26 Questionnaires earmarked for study were distributed to all the 13 stores of Uchumi in Nairobi. To ensure a fair representation, a systematic sampling method was used in the distribution of questionnaires. That ensured every store got an equal and known chance of study. Each store received two questionnaires requiring two respondents of the study. The questionnaires were issued to the top management of individual branches who according to the researcher were more informed about the problem of the study. During the sampling period the researcher noted that some branches had closed down because of continued poor business and the non strategic position they were located in that made it difficult improve the performance. To ensure their representation in the study, the researcher randomly selected store attendants from the operational branches to fill in the questionnaires earlier earmarked for those branches. A drop and pick method was used during the distribution and collection of the questionnaires.



From a total of 26 respondents, 24 questionnaires were returned while 2 of them were not, representing 88.5% and 11.5% of the sample population respectively. A further analysis of the 24 questionnaires was conducted and the findings were as follows. 21 questionnaires were complete and adequate for further analyses while 3 more were incomplete and inadequate for further research representing 80.77% and 19.23% of the sample population respectively. Diagrammatically, the data collection analysis was represented as follows.

**Diagram A**



**KEY**

- Spoilt Questionnaires
- Used for further research
- Non Returned Questionnaires
- Returned Questionnaires



## **4.9. Causes of Insolvency**

In this segment the respondents were required to answer 3 questions. The first question was related to the sources of funds for expansion while the other two were related to the application and investment of funds as follows:

### **4.9.1. Sources of Funds**

Here, the respondents were required to identify from a number of limited factors the actual sources of additional finances that Uchumi used for expansion. The proposed sources were: internal cash flows, cash due to suppliers, short term banks borrowing and government grant. In all the four factors the respondents were required to either agree or disagree with a specific factor. 21 respondents tallied in favor of the following factors: internal cash flows, cash due to suppliers and short term borrowing from commercial banks. None of the respondent tallied government grant as a potential source. The outcome therefore was a 100% of the sample population that was considered for further research. A supplementary study conducted from a secondary source confirmed the above findings. The study shows the sources as having been the internal reserves, a short term borrowing and a medium term bank loan. Source: Uchumi information memorandum (2005).

### **4.9.2. Investment of Funds**

In this part the researcher sought to know how the funds that were sourced for expansion were utilized. 95 % of those interviewed said the funds went to the

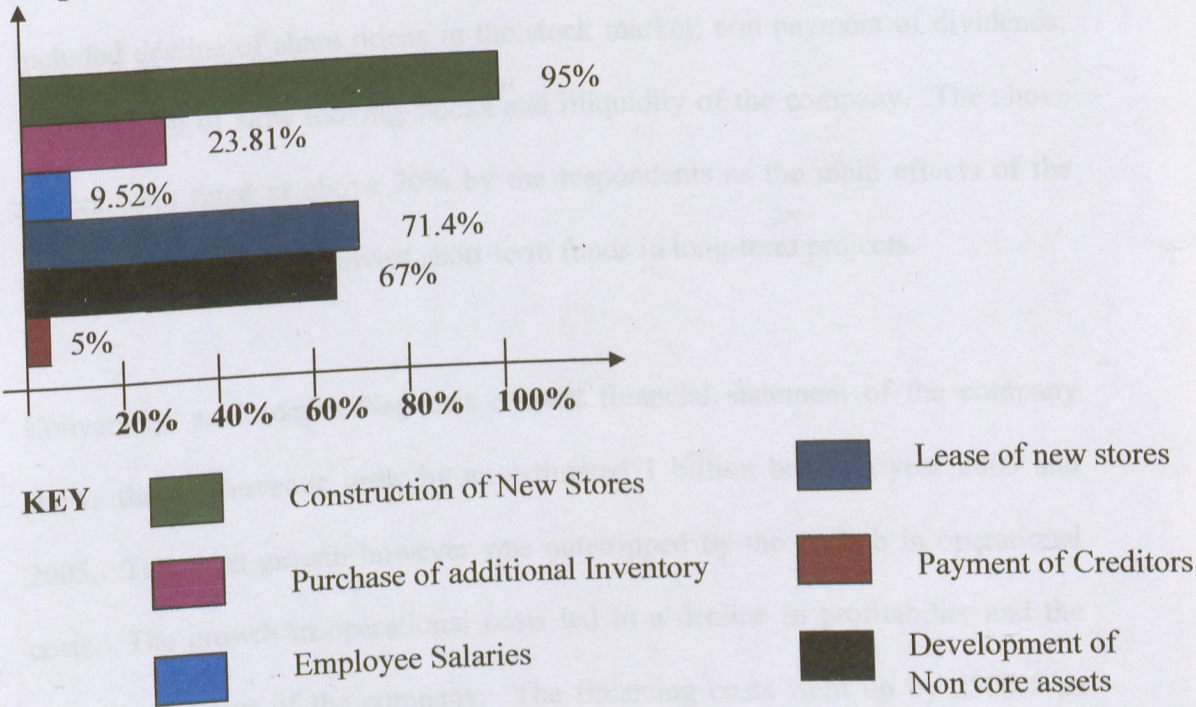


construction of new stores, 23.81% to replenish the inventories, 9.52% in settlement of staff dues; 71.4% on the lease of new stores and 67% in the development of non core assets. A similar study on secondary findings suggests that the funds were used in the development of property, plant and equipment. Although the findings of the two studies were not exactly the same, the outcome was not fundamentally different.

*“The company funded its expansion programme primarily using internally generated funds short-term borrowing and Kshs 500 million term loan. The expansion programme resulted in approximately Kshs 1.6 billion invested in construction of new building stores and associated infrastructure”.*

Source: Uchumi Right Issue Information on Memorandum)

**Diagram B**





#### **4.9.3. Induced Inference**

By taking the above two findings into perspective, we find that the problem of Uchumi originated from the management's decision to use short term funds and borrowing to fund a project of a capital nature. The above findings show how the finances were sourced and the use that they were put into.

#### **4.10. Effects of Insolvency**

The management decision to invest short-term funds in long-term projects had a very adverse effect on the company. The study on the effects of insolvency shows there was a positive correlation between the management's investment decision and the subsequent poor financial performance of the company. According to the respondents, the management's decision led to: sales decline, increased competition; redundancy of employees, and loss of jobs. Other effects included decline of share prices in the stock market; non payment of dividends; accumulation of slow moving stocks and illiquidity of the company. The above factors were rated at above 70% by the respondents as the main effects of the management decision to invest short-term funds in long-term projects.

Conversely, an in-depth diagnosis of past financial statement of the company shows that the revenue grew by an estimated 1 billion between year 2003 and 2005. The sales growth however was outstripped by the growth in operational costs. The growth in operational costs led to a decline in profitability and the overall cashflows of the company. The financing costs went up by 2500% an



indication that the company had over borrowed the funds. The over borrowing exposed the company to financial gearing and subsequent insolvency. The company also experienced increased competition from other market players namely Nakumatt, Tusker Mattresses (Tuskys) and Ukwala supermarkets. These developments led the management to lay off 580 employees, reverse some of the expansion programmes and dispose assets worth 950 million. The company further suspended the payment of dividends which it use to pay before. Source: Uchumi Information Memorandum (2005).

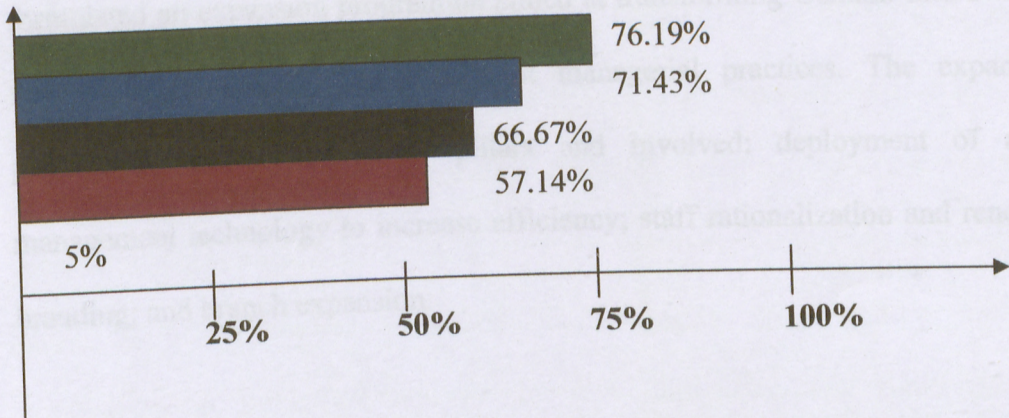
#### **4.11 Role of management**

In 2001, Uchumi Board of Directors formulated a 5 year expansion programme that consisted of the deployment of retail management technology to increase efficiency; staff rationalization and renewal; branding; and branch expansion. The company funded these expansions primarily using internally generated funds, short term borrowing and Kshs 500 million medium term debts. Source: Uchumi right issue information memorandum (2005). A survey conducted from the sample population on the role of management shows that the Board of Directors sanctioned the following decisions: construction of new stores (76.19%); development of non essential/core assets (71.43%); branding (66.67%) and branch expansion (57.14%). Although the study shows shareholders approval of expansion, it was upon the management to decide how the project was to be funded. To that extent, the management was responsible for acting imprudently.



The diagram below shows the respondents' ratings on the management's role in each of the above issues.

Diagram C



**KEY**



Construction of New Stores

Development of non core Assets



Bank Borrowing

Expansion programme



## CHAPTER FIVE

### 5.0 SUMMARY AND CONCLUSIONS

#### 5.1 Introduction

The problems of Uchumi began when the company's Board of Directors formulated an expansion programme aimed at transforming Uchumi into a world first class supermarket with the best managerial practices. The expansion programme consisted of four pillars and involved: deployment of retail management technology to increase efficiency; staff rationalization and renewal; branding; and branch expansion.

#### 5.2 Sources and Administration of Funds

The company's expansion programme was funded from internally generated funds, overdrafts and short term borrowing from commercial banks. The funds raised were used in purchase and development of property, plant and equipment. As the expansion programme got underway, the company's sales projections fell below the operating costs. The company asset portfolio also began to grow at much faster rate than the company's revenue would sustain it. That led to overtrading by the company which subsequently made the company insolvent and highly geared. The company capital structure took a new shape with both the current and long term liabilities shaping up the capital structure components in the balance sheet.



### **5.3 Effects of Financial Distress**

The company's imprudent decision on expansion was later to turn catastrophic. Besides placing the company under statutory management, the expansion programme reversed some of the earlier gains that the company had achieved over the years. The company became prone to increased competition as competitors followed closely the expansion initiative of Uchumi by widening their branch networks. An estimated 580 employees were declared redundant and lost their jobs. The company closed loss making branches and disposed off the non core assets. These assets however could not fetch the market price and most of them were sold at less than the realizable value. During the same period of study, the company share prices declined by over 50% and were later suspended from trading in the stock market.

### **5.4 The responsibility of Uchumi board of management**

The study shows that the shareholders of the company approved the expansion programme with the recommendation from the company's Board of Directors. However, the management failed to articulate how the expansion programme was to be funded. The study shows how the programme was funded from internally generated funds, bank overdrafts, and medium term borrowing. Basically, given the nature and magnitude of the expansion, a feasibility study on funding was necessary. Of course this was the duty of the management. Capital budgeting was also necessary not only to define the phases of implementation but also to project the viability of the project in terms of payback in cash flows. Still from the



studies, it was clear that there were early signs to warn the management of a possible insolvency. To that extent, it was the researcher's view, that Uchumi board of management was to blame for eventual collapse of Uchumi supermarkets.

## **5.5 Area of further research**

This was an area the researcher was unable to cover due to the scope of the study but which a further research is needed. The researcher proposes the following area for further study.

### **5.5.1 The essence of Disclosure Requirements and their Effectiveness in Enhancing Corporate Governance**

The researcher was compelled to propose this area of research for two reasons. First, less than a year prior to the closure of Uchumi, the company auditors reported that the supermarkets were viable as a going concern for at least the next financial year. Uchumi was declared insolvent nearly six months after that. It was the researcher's opinion that having witnessed the company's huge negative cashflows, and the level of uncertainty surrounding the company by then, what the company auditors needed to do was to issue a disclaimer report to provide for uncertainty. Instead the auditors gave unqualified opinion giving an assurance that the business of the company was still viable. Second; Uchumi's right issue got an approval of the capital market on the basis of the information memorandum that was provided by Uchumi. The information memorandum



provided that the company was on rebound and guaranteed of turnaround after the right issue but the company collapsed less than a year after the right issue. Therefore, the issue at hand was whether there is any value in disclosure requirements if such disclosures are self contradictory and negated the actual developments that took place in the company.

## **5.6 Conclusion**

From the above studies, it was evident that Uchumi supermarkets were a victim of imprudent management and poor financial decisions. However, despite the far reaching implications of insolvency to the company's stakeholders, there was clearly no defined way for legal redress to make those responsible accountable. The only legal redress was to place the company under statutory management. Even under statutory management, the receiver managers are more concerned the interest of appointing authority and less on the going concern nature of the company. Further more, other stakeholders according to the study were left at the mercy of the liquidators with no legal basis of raising up their concerns. This study therefore recommends an establishment of adequate legal frame work that takes into account the interest of all stakeholders. In particular, the law should provide for the going concern nature of the corporation; holding of shares in trust; transfer of insurable risks; a creation of the accountability charter to regulate the actions of management; legal ways to manage financial distress; and a legally defined optimal capital structure that companies must aim to achieve.



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# APPENDIX 1

## FINANCIAL RATIOS USED IN THE PAPER

- **Price to Book Value (Kshs.)** =  $\frac{\text{Market Price per Share}}{\text{Net Asset Value per Share}}$
- **Current Ratio** =  $\frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$
- **Earnings per Share** =  $\frac{\text{Earnings Attributable to Shareholders}}{\text{Number of Outstanding Shares}}$
- **Price-to-Earning Ratio** =  $\frac{\text{Market Price Per Share}}{\text{Earning per Share}}$
- **Dividend Yield** =  $\frac{\text{Dividend per Share}}{\text{Market Price per Share}}$
- **Pay Out-Ratio** =  $\frac{\text{Dividend (Kshs) paid}}{\text{Total Number of}}$
- **Market Price to Book Value (Kshs.)** =  $\frac{\text{Market Capitalization}}{\text{Net Assets Value}}$
- **Price-to-Earning Ratio** =  $\frac{\text{Market Capitalization}}{\text{Total Earnings}}$
- **Net Asset Value Per Share (Kshs.)** =  $\frac{\text{Total Net Assets}}{\text{Total Earnings}}$
- **Return on Equity** =  $\frac{\text{Net income (profit after tax)}}{\text{Number of Outstanding Shares}}$
- **Other formulas used**

$$\text{Mean} = \frac{\sum x}{n}$$

$$\text{Standard Division} = \sqrt{\frac{\sum dx^2}{n}}$$



## APPENDIX II

### INTRODUCTION LETTER

Mr. Charles M. Muchira  
P. O. Box 44635-00100  
Nairobi  
Email: [charleslimmugo@yahoo.com](mailto:charleslimmugo@yahoo.com)  
Cell phone: 0720-898-908/0734-653-929

Dear Respondent,

**RE: A REQUEST TO FILL THE QUESTIONNAIRE FOR RESEARCH PURPOSE**

This is to kindly request you to fill the attached questionnaire for a research purpose.

The purpose of my research is for partial requirement for the award of master of Business Administration Degree from the University of Nairobi. The Research focuses on Financial Distress with special attention to Uchumi Super Markets. The information you will provide will be treated with utmost confidentiality. A copy of this research will be provided to you upon completion for your future reference.

Thank you in advance.

Regards

Mr. Charles Mugo Muchira



# APPENDIX III

## QUESTIONNAIRE

### Causes of Uchumi's Financial Distress

1. Name the Uchumi Branch that you are working for.....  
.....

2. In 2001, Uchumi embarked on an expansion programme. How was the programme to be financed? (Tick the correct box for every factor) **1=Agree, 2=disagree.**

|                                 | 1                        | 2                        |
|---------------------------------|--------------------------|--------------------------|
| Cashflow from sales and profits | <input type="checkbox"/> | <input type="checkbox"/> |
| Cash credit from suppliers      | <input type="checkbox"/> | <input type="checkbox"/> |
| Short term Bank loan            | <input type="checkbox"/> | <input type="checkbox"/> |
| Government grant                | <input type="checkbox"/> | <input type="checkbox"/> |
| Others (specify) .....          |                          |                          |

3. To what use were the cash generated from question two above used for? **(1=Agree 2=Disagree)**

|                                  | 1                        | 2                        |
|----------------------------------|--------------------------|--------------------------|
| Construction of new stores       | <input type="checkbox"/> | <input type="checkbox"/> |
| Purchase of additional inventory | <input type="checkbox"/> | <input type="checkbox"/> |
| Payment of employees             | <input type="checkbox"/> | <input type="checkbox"/> |
| Leasing new stores               | <input type="checkbox"/> | <input type="checkbox"/> |
| Development of non core assets   | <input type="checkbox"/> | <input type="checkbox"/> |
| Payment of Creditors             | <input type="checkbox"/> | <input type="checkbox"/> |

4. How do you rate the following factors in relation to circumstance that lead to the insolvency status of Uchumi. **1=Correct, 2=Incorrect**

|                                      | 1                        | 2                        |
|--------------------------------------|--------------------------|--------------------------|
| Accumulation of dead stocks          | <input type="checkbox"/> | <input type="checkbox"/> |
| Theft of stock and other inventories | <input type="checkbox"/> | <input type="checkbox"/> |



- |                                     |                          |                          |
|-------------------------------------|--------------------------|--------------------------|
| Possibility of Ghost employees      | <input type="checkbox"/> | <input type="checkbox"/> |
| Leasing of new stores               | <input type="checkbox"/> | <input type="checkbox"/> |
| Uncompetitive prices by suppliers   | <input type="checkbox"/> | <input type="checkbox"/> |
| Turnover of top CEOs of the Company | <input type="checkbox"/> | <input type="checkbox"/> |

**Effects of Financial Distress**

5. The following factors are considered to have arisen out of the insolvency status of the company. Is it correct to say that the following factors are as a result of Uchumi's insolvency position? (1=correct, 2=incorrect).

- |  | 1                        | 2                        |
|--|--------------------------|--------------------------|
| Sales decline                                      | <input type="checkbox"/> | <input type="checkbox"/> |
| Increased competition                              | <input type="checkbox"/> | <input type="checkbox"/> |
| Accumulation of dead stocks                        | <input type="checkbox"/> | <input type="checkbox"/> |
| Redundant employees                                | <input type="checkbox"/> | <input type="checkbox"/> |
| Turnover/Resignation of to management              | <input type="checkbox"/> | <input type="checkbox"/> |
| Decline of share prices                            | <input type="checkbox"/> | <input type="checkbox"/> |
| Loss of jobs                                       | <input type="checkbox"/> | <input type="checkbox"/> |
| Inability to pay bank loans                        | <input type="checkbox"/> | <input type="checkbox"/> |
| Disposal of assets at less than their market value | <input type="checkbox"/> | <input type="checkbox"/> |
| Non payment of dividends                           | <input type="checkbox"/> | <input type="checkbox"/> |
| Non payment of taxes                               | <input type="checkbox"/> | <input type="checkbox"/> |

**Role of management in financial distress**

6. In your view who between the management and the shareholders were responsible for authorizing the following changes in Uchumi? (1=Management, 2=Shareholders)

- |                                | 1                        | 2                        |
|--------------------------------|--------------------------|--------------------------|
| Construction of new stores     | <input type="checkbox"/> | <input type="checkbox"/> |
| Development of Non core assets | <input type="checkbox"/> | <input type="checkbox"/> |
| The expansion programme        | <input type="checkbox"/> | <input type="checkbox"/> |
| Increased Bank Borrowings      | <input type="checkbox"/> | <input type="checkbox"/> |



## Management Of Financial Distress

7. Which among the following factors are the strategies put in place by management to bail out Uchumi out of its current financial problems? **1=Correct 2=Incorrect**

|  | 1                        | 2                        |
|--|--------------------------|--------------------------|
| Sales of Non Core fixed assets                                       | <input type="checkbox"/> | <input type="checkbox"/> |
| Change of Management   | <input type="checkbox"/> | <input type="checkbox"/> |
| Conversion of loans into shares                                      | <input type="checkbox"/> | <input type="checkbox"/> |
| Making the branches Independent on Profitability and operating costs | <input type="checkbox"/> | <input type="checkbox"/> |
| Closure of loss making stores  | <input type="checkbox"/> | <input type="checkbox"/> |
| Extending payment period of creditor                                 | <input type="checkbox"/> | <input type="checkbox"/> |
| Employing staff on Contracts   | <input type="checkbox"/> | <input type="checkbox"/> |
| Aggressive marketing   | <input type="checkbox"/> | <input type="checkbox"/> |
| Renegotiating agreement Contracts Union to avoid Legal suits         | <input type="checkbox"/> | <input type="checkbox"/> |
| Issuing more shares  | <input type="checkbox"/> | <input type="checkbox"/> |
| Issue of debentures  | <input type="checkbox"/> | <input type="checkbox"/> |
| Paying less salaries than the market rates                           | <input type="checkbox"/> | <input type="checkbox"/> |
| Government grants  | <input type="checkbox"/> | <input type="checkbox"/> |
| Change of Board of Directors   | <input type="checkbox"/> | <input type="checkbox"/> |
| Financing of stores  | <input type="checkbox"/> | <input type="checkbox"/> |
| Non payment of dividends   | <input type="checkbox"/> | <input type="checkbox"/> |

**Thanks for your participation**

**End**



## **APPENDIX IV**

### **LIST OF UCHUMI BRANCHES**

Uchumi Jogoo Road Branch

Uchumi Ngong Road

Uchumi Langata Hyper

Uchumi Parklands Hyper

Uchumi Sarit Centre

Uchumi Mombasa Road

Uchumi Koinange Street Branch

Uchumi Railways

Uchumi Aghakan Walk

Uchumi City Square

Uchumi Taveta Branch

Uchumi BuruBuru