



UNIVERSITY OF NAIROBI

SCHOOL OF MATHEMATICS

**THE IMPACT OF A RIGHTS ISSUE ON THE EARNINGS PER
SHARE OF A LISTED COMPANY**

A Research Project submitted to the School of Mathematics, University of Nairobi in

**Partial fulfillment of the requirement for the award of Postgraduate Diploma in Actuarial
Science.**

UNIVERSITY OF NAIROBI

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DECLARATION

This research project is my original work and has not been submitted or presented for examination in any other institution

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ABSTRACT

A rights issue is a way by which a listed company can raise additional capital. However, instead of going to the public, the company gives its existing shareholders the right to subscribe to newly issued shares in proportion to their existing and market capitalization. In case of a rights issue, since additional equity is raised, the issuing company's equity base rises to the extent of the issue. In theory, every new issue has some kind of diluting effect and hence as a result of a fall in the market price in proportion to an increase in the number of shares, the market capitalization remains unaffected.

In this paper, KQ rights issue in 2012 is considered. Consistent with empirical results for Seasoned equity offerings in developed financial markets, there is a statistically significant decline in the earnings per share (EPS) by 23% and the market share price (MPS) after the rights equity issue. In the KQ case, this decline in performance is made more severe by economic and geopolitical environment after the issue and the aggressive expansion plan that national carrier embarked on.

Further, various proxies measuring market valuation also declined during the post-issue period after a run up in the pre-issue period. The results of the study suggest that over-investment hypothesis and agency models can better explain the decline in performance as measured by the EPS compared to asymmetric information hypothesis. The results also indicate that rights equity issues are not simple de-leveraging decisions.

These findings have implications for several groups of capital market participants as follows:

- The investing public and analyst who are too optimistic about the issuers should consider deteriorating performance while arriving at the valuations.
- Investors should be vigilant about the 'empire building' implications of increased investments through rights issue.
- Optimistic managers should reassess the investment opportunities and have conservative plans before approaching the market.
- The policy makers and regulators should come out with better regulatory framework to control the use of funds acquired from the rights issue.

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KEY WORDS

Rights Equity Issue-This is the selling of ordinary shares to existing shareholders on a pro-rata basis

Earnings per Share-As per IAS 33, EPS is the profit attributable to a single share held in a company. It is used to measure the ongoing financial performance of a company from year to year.

Information Asymmetry-The gap existing between information available to a firm's management and what is actually shared with shareholders.

De-leveraging- reducing levels of debt financing in favor of equity financing.

Agency Problems-Conflicts existing between managers as decision makers of listed companies and shareholders who are the owners of the company.

Empire building-growing a company by top management without taking shareholder interests into consideration. It's normally for the glory of the CEO or the Managing Director.

Accounting rate of Return-Also known as Return on Investment (ROI) is a measure of an Investment's profitability .It is the ratio of after tax profit divided by average investment.

LIST OF ACRONYMS

EPS –Earning Per share

MPS- Market Price per Share

ARR-Accounting Rate of Return

KQ-Kenya Airways

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CHAPTER 1

INTRODUCTION

This chapter introduces rights issue, Kenyan history on stock market; Kenya Airways company profile and problem description

1.1 RIGHTS ISSUES

When a firm wishes to raise new funds, it can do so in a variety of ways. One of the most basic policy choices confronting managers is deciding on what type of security to issue. Though there is no unified theory available to explain the corporate financing decision, there have been substantial improvements in the modern theory of capital structure beginning with the celebrated paper of Modigliani and Miller (1958).

Researchers have reported a number of regularities regarding the security-price performance and earnings behavior around seasoned equity issues (see Eckbo and Masulis, 1995 and Ritter, 2003 for detailed surveys on security issue). Majority of these results are from developed countries and can be classified into three major heads, viz., announcement effects, long-run operating performance, and long-run security-price performance.

Though rights issues have an insignificant announcement effect, the negative reaction to the announcement of seasoned equity offerings (SEOs) from developed markets like the US is well documented (Asquith and Mullins, 1986; Masulis and Korwar, 1986). Recent studies show that this is generally followed by statistically and economically significant long-run underperformance (Loughran and Ritter, 1995; Spiess and Affleck-Graves, 1995). Further, the deteriorating operating performance following equity issues (Loughran and Ritter, 1997; McLaughlin, Sufied-dine and Vasudevan, 1998) and earnings management associated with SEOs (Teoh, Selch and Wong, 1998; Shivakumar, 2000) provide some explanation for this behaviour.

In many capital markets, majority of the subsequent equity issues after initial public offerings are sold through rights issue (Eckbo and Masulis, 1995). In a rights offer, current shareholders are given short-term warrants on a pro-rata basis allowing them the option to either purchase the new

shares or sell the warrants in the market before expiration. Unsubscribed shares are offered to the shareholders who wish to purchase more than their pro-rata share of the issue.

The market reaction to announcement of rights issue is mixed. Therefore, whether the empirical regularities reported from the US market for SEOs are relevant for rights equity issues in other countries is a question which needs further investigation.

Further, the institutional mechanisms in a developing country like Kenya differ widely from these well-developed markets which provide an interesting opportunity to study how firm-specific variables can explain this behavior.

In this paper, we examine the share performance of KQ following rights equity issue during the 2012/13 financial year. For this study, I have relied on accounting measures as the inefficiency of the market/frequent market scams and the 'bad model problem' (Fama, 1998) will have little impact on the expected results.

As per the results it is shown that subsequent to the rights issue, KQ's EPS performance declined compared to the control of the firm. The decline in performance is more severe for big firms, low market to-book value firms, and firms with lower directors' holdings.

This phenomenon is due to the inefficiency in utilization of assets, existing economic and political situations; but not due to decrease in profit margins. Further, various proxies measuring market valuation also declined during the post-issue period after a run up in the pre-issue period. The firms' declining performance is related to the investment opportunity and agency cost variables.

1.2 EVOLUTION OF STOCK MARKET

The evolution of stock market is dated back in 12th century France the *courretiers de change* were concerned with managing and regulating the debts of agricultural communities on behalf of the banks. Because these men also traded with debts, they could be called the first brokers. A common misbelieve is that in late 13th century Bruges commodity traders gathered inside the house of a man called *Van der Beurze*, and in 1409 they became the "Brugse Beurse", institutionalizing what had been, until then, an informal meeting, but actually, the family Van der Beurze had a building in Antwerp where those gatherings occurred; the Van der Beurze had Antwerp, as most of the merchants of that period, as their primary place for trading. The idea

quickly spread around Flanders and neighboring counties and "Beurzen" soon opened in Ghent and Rotterdam.

In the middle of the 13th century, Venetian bankers began to trade in government securities. The Venetians were the leaders in the field and the first to start trading the securities from other governments. They carried slates with information on the various issues for sale and meet with clients; much like what broker do today. In 1351 the Venetian government outlawed spreading rumors intended to lower the price of government funds. Bankers in Pisa, Verona, Genoa and Florence also began trading in government securities during the 14th century. This was only possible because these were independent city states not ruled by a duke but a council of influential citizens. Italian companies were also the first to issue shares. Companies in England and the Low Countries followed in the 16th century. The moneylenders of Europe filled important gaps left by the larger banks. Moneylenders traded debts between each other; a lender looking to unload a high-risk, high-interest loan might exchange it for a different loan with another lender. These lenders also bought government debt issues. As the natural evolution of their business continued, the lenders began to sell debt issues to customers - the first individual investors.

The Dutch East India Company (founded in 1602) was the first joint-stock company to get a fixed capital stock and as a result, continuous trade in company stock occurred on the Amsterdam Exchange. Soon thereafter, a lively trade in various derivatives, among which options and repos, emerged on the Amsterdam market. Dutch traders also pioneered short selling – a practice which was banned by the Dutch authorities as early as 1610.

There are now stock markets in virtually every developed and most developing economies, with the world's largest markets being in the United States, United Kingdom, Japan, India, China, Canada, Germany (Frankfurt Stock Exchange), France, South Korea ,Netherland and Kenya(Nairobi Securities Exchange)

1.3 KENYAN HISTORY ON STOCK MARKET

In Kenya dealing in shares and stock started in the 1920's when the country was still under the British colony. There was no formal market, no rules and no regulations to Govern stock broking activities .Trading took place on gentlemen agreement in which Standard commissions were

charged with clients being obligated to honor their Contractual commitments of making good delivery and settling relevant costs. At that time, stock broking was a sideline business conducted by accountants, auctioneers, estate time agents and lawyers who met to exchange price over a cup of coffee .Because these firms were engaged in other areas of specialization, the need for association did not rise ([www.nse .co.ke](http://www.nse.co.ke))

In 1951 an Estate Agent by the name of Francis Drummond established the first professional stock broking firm. They impressed upon Sir Ernest Vasey the idea of setting up a stock exchange in 1953 and the London Officials accepted to recognize the setting up of the Nairobi Stock Exchange as an overseas stock exchange (Muga, 1974).The Nairobi Stock Exchange was constituted as a voluntary association of stock brokers registered under the societies Act in 1954 .The dealing in shares was then confined to the resident European community ,since Africans and Asians were not permitted to trade in securities until after the attainment of independence in 1963 .At the dawn of independence ,stock market activity slumped due to uncertainty about the future of the independence Kenya. In the first three years of independence the market was once

Again rekindled and the exchange handled a number of highly oversubscribed public issues (Muga, 1974). The growth was however halted in 1972 when the oil crisis introduced inflationary pressures in the economy which depressed shares prices. A 35% capital Gains tax was introduced in 1975 (suspended since 1985) inflicting further losses to the exchange which at the same time lost its regional character following nationalizations exchange controls and other inter – territorial restriction introduced in neighboring Tanzania and Uganda In 1976 Uganda compulsorily acquired a number of companies .which were either quoted or subsidiaries of companies quoted, on the Nairobi Stock Exchange (www.nse.co.ke).

1.3.1 The Kenyan Stock Market Structural Changes

In 1980 the Kenyan Government realized the need to design and implement policy reforms to foster sustainable economic development with an efficient and stable financial system. In particular, the country set out to enhance the role of the private sector in the economy ,reduce the de-

mands of public enterprise on the exchequer ,rationalize the operations of the public enterprise sector to broaden the base ownership and enhance capital market development .The International Finance Corporation and the Central Bank of Kenya carried out a study on ,”Development of Money Markets in Kenya “.The 1984 study became a blue print for structural reforms in the financial markets which culminated in the formation of a regulatory body, The capital Markets Authority (CMA)in 1989 to assist in the creation of a conducive environment for the growth and development of the country’s capital markets (IFC /CBK 1984) In 1988 Kenya Commercial Bank became the first company to privatize through the Nairobi Stock Exchange after the Kenya Government successfully sold 20% of its holding in the Bank. In 1991 NSE was registered under the companies act and phased out the “call over “trading system in favors of the floor based open outcry system .The NSE 20 share index recorded on all -record high of 5030 points on February 1994. Extensive modernization exercise was undertaken, including a move to more spacious premise at the Nation Centre in July 1994 setting up a computerized delivery and settlement system

(DASS) and a modern information Centre. Thereafter, the number of licensed stockbrokers rose to eight (www.nse.co.ke).

The Kenyan Government relaxed restrictions on foreign ownership in locally controlled companies and foreign investor participation was introduced in 1995. The entire Exchange control act was repealed in December 1995 seeing more stock brokers licensed to bring the number of licensed brokers to twenty. In 1996 the largest share issue in the then history of NSE, the privatization of Kenya Airways, came to the market and more than 110,000 shareholders acquired a stake in the airline .The Kenya Airways privatization team was awarded the World Bank award for Excellence in 1996 for being a success story in the divestiture of state owned enterprise. In 1998 the government expanded the scope for foreign investment by introducing incentives for capital markets growth including the setting up of tax-free Venture Capital Funds, and removal of Capital Gains Tax. Subsequently, listed companies split their shares at NSE while others issued bonus shares.

Automation of the Trading System

In November 2004 the Central Depository System was introduced thus automating settlement of transactions at NSE to achieve T+5. The NSE trading hours increased from 2 to 3 hours (10.00 am- 1.00 pm) and subsequently increased to 5 hours (10.00a.m –3.00p.m). The new system offers and has led to greater transparency in the placement of bids and offers improvement in market surveillance. Transmission is almost real time and trading information relating to index movements, price and volume movements of traded securities is released on a timely basis.

Nairobi Stock Exchange Market Segments

In 2001, NSE was restructured to give rise to three market segments namely; the Main Investments Market Segment (MIMS), the Alternative Investment Markets Segment (AIMS) and the Fixed Income Securities Market Segment (FISMS) (www.nse.co.ke). The MIMS is the main quotation market, the AIMS provide an alternative method of raising capital to small, medium sized and young companies that find it difficult to meet the more stringent listing requirements of the MIMS while the FISMS provides an independent market for fixed income securities such as treasury bonds, corporate bonds, preference shares and debenture stocks, as well as short term financial instruments such as treasury bills and commercial papers (www.nse.co.ke)

1.4 KENYA AIRWAYS COMPANY

Kenya Airways traces its history back to 1946 with the formation of the East African Airways Corporation ("EAA"). Initially, EAA had a good reputation for service and reliability. With the formation of the East African Community, EAA passed into the joint ownership of the governments of Kenya, Tanzania, and Uganda. Shortly after the collapse of the East African Community in 1976, EAA was placed in liquidation. Kenya Airways was incorporated in January 1977 as a company wholly owned by the Kenyan government. It was established as the national flag carrier of Kenya and acquired certain of the assets and staff of EAA.

Kenya Airways Ltd is a Kenya-based company that operates in the aviation industry. It is engaged in international, regional and domestic carriage of passengers and cargo by air, the provi-

sion of ground handling services to other airlines and the handling of import and export cargo. The Company operates domestic flights and flies to 56 destinations in Africa, Middle East, Asia and Europe. As on March 31, 2012, the Company had 34 aircraft, either owned or on operating leases. These comprised four Boeing 777 wide body jets, five Boeing 767 wide body jets, 15 Boeing 737 narrow body jets, nine Embraer regional jets and one B747 Freighter. Kenya Airways Limited operates through several subsidiaries, including; Kenya Airfreight Handling Limited, African Cargo Handling Limited, Ken cargo Airlines International Limited and Flamingo Airlines Limited.

1.4.1 COMPANY'S VISION

"Be the Pride of Africa, by inspiring our people and delighting our guests consistently."

1.4.2 COMPANY'S MISSION

To Maximize Stakeholder Value by Consistently

- Providing the Highest level of Customer Satisfaction
- Upholding the Highest level of Safety and Security
- Maximizing Employee Satisfaction

1.4.3 COMPANY CORE VALUES

Safety

- KQ strives to meet the highest standards for safety in the workplace and operations.
- They ensure that all their employees and those with whom they work, perform their duties in a safe manner

Customer First

- Everything that KQ does begin and ends with the customer experience in mind.
- KQ listens to their customers and delivers ever-increasing value in the markets we serve

Respect

- KQ respect and value the worth of all people and this crosses the cultures, viewpoints and backgrounds.
- KQ treats each other with honesty, dignity and sensitivity.

Integrity

- All KQ actions and decisions should be bound by rock-solid integrity.
- All of us act in the best interest of the company while accepting personal responsibility.

Passion

- KQ enthusiasm and care for the business fuels our dedication for Guest service.
- What we do and how we do it, are important; it is what sets us apart.

Trust

- KQ's culture promotes trust, teamwork and dignity within our diverse workforce.
- Our words and actions are consistent.

1.5 PROBLEM DESCRIPTION

This section is divided in two parts, first dealing with the background of the problem and second with the objective of the study.

1.5.1 PROBLEM BACKGROUND.

Right issues have been the subject of much research by academics and practitioners for over two decades (Bayless & Jay, 2008). Many aspects of share price performance are commonly accepted, such as general declines in share price on the announcement date observed in many studies, from

older studies conducted in South Africa(Bhana,1999) to recent studies conducted in China (Shahid,Xinping,Mahmood &Usman,2010).

While such abroad principles around shares prices performances are accepted, we find differences across markets as well as over different time periods.

Firms need finance to work efficiently and an organization can adopt various methods for the purpose of financing its business. According to Hovakimian & Tehranian (2004), the acquiring of finance choice depends on several factors such as the firm characteristics, profitability prospects, time and existing capital structure. Firms can use equity financing, debt financing or employ a combination of both. All of them entail various costs and benefits. If the firm decides to raise extra equity the stock market can be used as a source.

According to the Kabir & Roosenboom (2003), firms listed on stock exchange generally obtain external equity finance either from existing shareholders or from new investors. They describe first one as rights issue and considers this method of raising capital as very popular in international capital markets. Miglani, (2011) define Right issues as the choice specified by the organization to its existing shareholders to buy the shares of the company. In a rights issue, corporations willing to acquire additional equity capital gives certain rights to existing shareholders on a pro rata basis.

These rights allow them to purchase a certain number of new shares proportionate to their existing shareholdings at a pre-specified price. According to the Shahid, Xia, Mahmood, & Usman (2010) new shares offered to existing shareholders at a specified subscription price that is normally less than what the offering price to the general public will be. It enables the existing shareholders to preserve their proportionate ownership in the company when the new issues are made, called preemptive right.

Rights issues give the option to the current shareholders to increase their proportion in the company. The purpose of this study is to find out if a Rights issue has any value creation effect for shareholders. The share price may increase in response to this information & affect the shareholders wealth.

The study examines whether the investors in Kenyan capital market can gain or lose abnormal returns from the announcement of right shares by companies.

1.5.2 PROBLEM STATEMENT.

To study the impact of rights issue on the EPS of a company; using Kenya Airways as the case study.

1.6 OBJECTIVE OF THE STUDY.

The objectives of this study are

- i) To exact relevant exist theory on rights issue and their impact on share price Performance.

An examination of the stock market announcement of the KQ rights issue indicated a statistically significant share price decline. Further share price decline was also observed during the subscription period.

- ii) To quantify the impacts of rights issues announcement on share price performance of Kenya Airways Company

Post-rights issue analysis of the operating performance results of the company were consistent with the announcement period decline in share price, Additional investigation of both share and operating performance decline provided full support for the information asymmetry hypothesis, partial support for the free cash flow hypothesis but no support for the window of opportunity hypothesis

CHAPTER 2

LITERATURE REVIEW

This chapter provides a conceptual framework for the purpose of this study. Work done by other researchers has also been reviewed in this study.

Eckbo and Masulis (1992) argue that issuing common stock through non-transferable rights to existing shares is a potential solution to the adverse selection problem associated with subsequent equity issue. Similarly, rights offerings have comparatively low direct costs. Unlike the situation in US markets; markets in Canada, Europe, and Pacific Basin do not show an aversion to rights issue (Eckbo and Masulis, 1992). Most firms in the US issuing new security are using the apparently more costly underwritten offer rather than the less costly rights offer which is considered as a 'paradox' in finance (Smith, 1977; Eckbo and Masulis, 1992). But, several authors including Hansen (1988) and Eckbo and Masulis (1995) have argued that there are some additional costs associated with rights issue.

Along with the indirect costs like capital gains taxes in the event of renouncement of rights, transaction costs of reselling the rights-shares, wealth transfer to convertible security holders (due to anti-dilution clause), and agency problems like pressure from investment bankers may also lead to public issue.

The theoretical models explaining the reasons for the rights issue paradox are limited in their scope. The model developed by Heinkel and Schwartz (1986) assumes asymmetric information between investors and managers. Based upon the quality of firms, they rank the three financing alternatives, that is, standby rights, uninsured rights, and underwritten issue in that order.

2.1 THEORETICAL MODELS

The major explanations to the well-documented market reactions around security issue are based on the information content of corporate financial policy. These theories can be classified under two areas; agency costs and information asymmetries.

2.2 MODELS BASED ON AGENCY COSTS

Agency cost-based models argue that changes in capital structure change the incentives of corporate managers.

The ‘free cash flow model’ of Jensen (1986) argues that managers do not like to disburse free cash to investors even when no positive net present value (NPV) project is available. Since debt commits the firm to pay out cash, it reduces the amount of free cash available to managers but, on the other hand, equity issues increase free cash flow available to managers and are, therefore, detrimental to firm performance and value.

However, Jensen and Meckling (1976) and Myers (1977) point out that the conflicts between debt-holders and equity-holders may result in stringent debt contract. So, the capital structure decisions are also based on the ‘agency costs’ of debt along with the disciplinary influence of debt. The model proposed by Stulz (1990) also points out the role of debt payments in reducing the resources under the discretion of managers who are disposed to over-invest. The agency cost of debt as per this model is that debt payments may result in underinvestment or reduce the funds available for profitable investment.

In other words, the models of Jensen (1986) and Stulz (1990) argue that leverage can reduce the agency costs arising from the conflict of interest between shareholders and managers. Another line of argument considers debt as a tool for avoiding takeover challenges (Zwiebel, 1996). Harris and Raviv (1991) argue that debt serves as a disciplining device in the sense that debt servicing allows creditors the option to force the firm into liquidation.

The major implication of these models is that changes in leverage should be accompanied by a change in stock price in the same direction.

2.3 ASYMMETRIC INFORMATION AND SIGNALING MODELS

As per the asymmetric information models, financing choices of the managers reveal some of their private information to the market. Based on the game theoretic approach, these models assume that it is prohibitively costly for low quality firms to perfectly mimic high quality firms. Some of the earliest signaling models in finance literature like that of Ross (1977) and Leland

and Pyle (1977) discuss the signaling role of debt. In Ross' Model, the proportion of debt signals the quality of the firm.

Here, the cost of the signal is the bankruptcy costs which are lower for high quality firms. Leland and Pyle (1977) agree that the retention of shares by insiders signals better future prospects for the firm. Since large debt is associated with a higher proportion of equity owned by insiders, higher debt level is associated with higher firm quality.

Miller and Rock (1985) provide an alternative explanation for the price reactions and performance changes. In their model, all firms have fixed investment opportunities with diminishing marginal returns. Since the sources of funds must equal the uses of funds, security offerings signal that the firm had an unexpected fall in earnings.

Myers and Majluf's (1984) model argues that managers will prefer debt to equity if they need external funds because, if firms are issuing equity, under pricing may lead to erosion of old shareholders' value. Therefore, managers issue equity only when it is overvalued.

So, in an efficient market, equity offerings will result in a reduction of a firm's market value.

According to them, rights issue can minimize this conflict to a certain extent. Building on Myers and Majluf (1984), Eckbo and Masulis (1992) proposed that rights issues will be used only by firms with highly concentrated ownership. Hansen, Ma and Pinkerton (1986) also argue that firms with concentrated share ownership will find rights offers less expensive. This leads to the conclusion that when a firm with diversified ownership is going for a rights issue, it signals that rights offerings are the only method available to them.

When a company announces rights equity issue, the management is conveying information both about investment and financing. The financing signal that internal funds will be insufficient to finance its activities is not good news. The investment signal is that it would like to invest aggressively. The implication of this signal depends upon the investment opportunity of the firm.

2.4 THEORETICAL APPROACH

A rights issue is an issue of new shares for cash to existing shareholders in proportion to their existing share holdings. A rights issue is, therefore, a way of raising new cash from shareholders, an important source of new equity funding for publicly quoted companies.

The major explanations to the well-documented market reactions around rights issue are based on the information content of corporate financial policy. These theories can be classified under two areas; agency costs and information asymmetry.

Legally a rights issue must be made before a new issue to the public. This is because existing shareholders have the “right of first refusal” (otherwise known as a “preemption right”) on the new shares. By taking these preemption rights up, existing shareholders can maintain their existing percentage holding in the company. However, shareholders can, and often do, waive these rights, by selling them to others. Shareholders can also vote to rescind their preemption rights. If a shareholder does not take the company up on their rights issue then they have the option to sell their rights on the stock market just as they would sell ordinary shares, however their shareholding in the company will weaken

2.5 RESULTS OF SHARE PRICES AFTER RIGHTS ISSUE

After the right issue is offered price of that particular stock falls in the stock market. It happens because the number of stock of that company increases in the market. Especially if the number of the right issue is relatively higher than the paid-up capital the price falls. Moreover the dividend yield and the PE ratio of that particular stock also falls after the right issue is offered.

Theoretically the right issue does not give significant profit to the shareholders in spite of the fact that they get the stock in lower price. But in practice the shareholders always find the right issue an attractive option to buy the shares of the company. This is because the presume that the company is going to utilize the additional fund from the right issue for further development and expansion of the company that will eventually strengthen the financial standing of the company.

To sum up;

A rights issue has the following effects on the price of a stock.

1. Share capital gets increased according to the rights issue ratio.
2. Liquidity in the stock increases.
3. Effective Earnings per share, Book Value and other per share values stand reduced.
4. Markets take the action usually as a favorable act.

5. Market price gets adjusted on issue of rights shares.
6. Company gets better cash flow which may be used to improve the business and may help increase effective Earnings per share.
7. Usually a shareholder may not back out from applying for the rights issue unless the offer is almost same as the prevailing market price. This is because if a stock is trading at 100 and a rights issue in the ratio 1:1 at a price of 40 will make the stock trade at 70 soon after the ex-rights date.

2.5.1 ADVANTAGES OF A RIGHTS ISSUE.

- The good news is that the shares will be cheaper than the current market rate. When a company offers new shares via a rights issue, it is usually at a discount to the current market rate. What this means is that if the market price of the share is Kshs 500, the company may offer the shares for Kshs 450. So you get more shares at a cheaper rate than what you would get if you buy it from the market.
- Controlling of the company is retained in the hands of the existing shareholders. Issue of right shares makes possible equitable distribution of shares without disturbing the established equilibrium of shareholdings because right shares are offered to the persons who on the date of rights issue are the holders of equity shares of the company proportionately to their equity shares on that date.
- The existing shareholders do not suffer on account of dilution in the value of their holdings if fresh shares are offered to them because value of the shares is likely to fall with fresh issue. This decrease in the value of the shares will be compensated by getting new shares at a price lower than the market price. They are likely to suffer on account of the dilution in the value of their holdings if fresh shares are offered to the general public.
- The expenses to be incurred, if shares are offered to the general public, are avoided.
- Image of the company is bettered when rights issues are made from time to time and existing shareholders remain satisfied.
- There is more certainty of getting capital when fresh issue of shares is made to the existing shareholders instead of to the general public.
- Directors cannot misuse the opportunity of issuing new shares to their friends and relatives at lower prices and at the same time retaining more control in their hands when right

shares are issued because in rights issue shares are offered proportionately to the existing shareholders according to their existing holdings.

- Generally, when a rights issue is announced, the price will go up because investors now want to buy the shares so that they can avail of the rights issue.

2.5.2 DISADVANTAGE OF A RIGHTS ISSUE

The shares do not come free of cost.

- A rights issue will need you to buy the shares. They do not come free. For shareholders – the earnings per share will reduce since there are now more shares for the same earnings, and so will the dividends. Whenever a company comes out with a rights issue you have to evaluate it to see whether it makes sense for you to subscribe to it. Subscribe to a rights issue only if you really trust in the company's performance. Don't just buy it because you are getting it cheaper than market price. Try to find out why the company is coming out with a rights issue. If the company needs this to raise money for a sound business plan that will eventually increase the profits and share price, then it is good that the company can choose to subscribe to all of the shares you are eligible for, or a part of them.
- Lengthy of time period this leads to high level of volatility and potential manipulation.
- There is dilution this happens if investors do not take all the shares or sell shares to other investors. The value of each share will be diluted as a result of the increased number of shares issued.
- It is awfully easy for investors to get tempted by the prospect of buying discounted shares with a rights issue. But it is not always a certainty that you are getting a bargain. Besides knowing the ex-rights share price, you need to know the purpose of the additional funding before accepting or rejecting a rights issue.
- A rights issue can offer a quick fix for a troubled balance sheet, but that doesn't necessarily mean management will address the underlying problems that weakened the balance sheet in the first place.

2.6 EMPERICAL LITERATURE REVIEW

Nelson, (1965) examined 380 rights offerings in the US by using monthly data for the period of 1946- 1957 and found no announcement effects. He concluded that six months prior to the rights offerings announcement and six months after rights offerings, shareholders wealth neither increased nor decreased. Smith & Jr. (1977) analyzed 38 rights offerings and 56 rights with standby underwriting offerings in the US for the period of 1971-1975. He found no significant abnormal returns for either type during the month of the rights offerings. Loderer & Zimmermann (1988) investigated 122 rights issues announced by 56 industrial corporations in Switzerland for the period of 1973-1983. They observed insignificant average abnormal returns, which was an indication of no announcement effects. Eckbo & Masulis (1992) used daily data to examine 192 rights issues in the US for the period 1963-1981. Their findings indicated a decrease of shareholders wealth of around 1%. Tsangarakis, (1996), explored 59 rights offering in Greece and reported a significant excess return of as much as 4%. However, he was not clear of the cause of these abnormal returns.

Balasingham & Sally (2001) looked at the share price reaction to announcement of bonus share issues of Australian companies. They analyzed that the magnitude of price reaction to bonus issue announcements is statistically related to the size of bonus issues and pre-announcement effect. Madhuri, Thenmozhi, and Kumar (2003) found negative reaction to the bonus issue announcement. They were of the opinion that market under reacted after the announcement of bonus issue.

Kabir & Roosenboom (2003) observed that statistically significant negative abnormal return associated with announcement effect of rights issues in Netherlands. Mishra, (2005), examined the stock price reaction to information content of bonus issue. The results indicated significant positive abnormal returns for a five day period prior to bonus announcement. The results indicated the semi- strong market efficiency of the Indian stock market.

Chen & Chen, (2007), examined 205 right issues in China and found market reacts negatively around such announcement, but positively during the post-announcement period (in +10 to +20 days expiration period). Vergos, Konstantinos, Apostolos & John, (2008) investigated the effects of political, economic, investment & analysts report announcement on share prices of Hellenic

telecommunication organization. The study found that stock prices do not react to public announcement & continue to increase or decrease until 10 days after the event.

Owen & Suchard, (2008), reported significant abnormal return of -1.83% associated with announcement of right issue of equity in Australia.

Shahid et al, (2010), observed the positive market reaction after the announcement of right issues in china. Miglani, (2011), observed positive excess returns of 32 right issues from India. They reported a gain of 1.42% in the shareholders wealth on the day of announcement of right issue.

Suresh & Naidu (2012) explored the wealth effect of Nifty stocks and found no evidence of existence of significant positive abnormal returns on event day. The event has reported negative ARR of -0.048 and it is statistically insignificant.

As can be seen from the above literature review; there is no consistency in the research findings on right issue announcement effect on shareholders wealth. There is a well-documented empirical pattern in market reactions to security issue announcements. Stock price reactions to announcements of leverage increasing transactions are favorable compared to leverage decreasing transactions (Smith, 1986; Eckbo and Masulis, 1995).

Masulis and Korwar (1986) report an average abnormal return of -3.19 per cent for industrial firms and -0.56 per cent for public utilities on a two-day interval (day 0 and +1) around offering announcements of seasoned common stock.

Eckbo and Masulis (1992) report an abnormal return of -1.0 per cent for rights offerings. These results are consistent with the signaling models as equity issues are conveying negative information to the market.

In view of the fact that the seasoned equity issues in Canada, Europe, and Pacific-Basin capital markets are predominantly through rights issue, studies from these markets will be more applicable to the Kenyan market. Studies from these markets report a positive abnormal return around rights offer announcement (Eckbo and Masulis, 1995).

There are a number of studies analyzing the performance of firms following SEOs. Loughran and Ritter's (1995) and Spiess and Affleck-Graves' (1995) are two major studies documenting the long-run underperformance of firms after SEOs. Healy and Palepu (1990) examine the changes in earnings and risk for a sample of NYSE and AMEX listed firms issuing seasoned equity. Their study finds no evidence of performance decline following equity issue. Loughran and Ritter (1997) examine the changes in operating performance for a sample of 1,338 SEOs and

document poor post-issue operating performance. Similarly, McLaughlin, Sufieddine and Vasudevan (1998) report a decline in the operating performance for a sample of 1,967 firms that issued security from 1980 to 1993. Though there is no unified theory to explain this anomaly, many explanations are available in the financial literature.

One explanation is the ‘windows of opportunity hypothesis’ offered by Loughran and Ritter (1995) which states that firms issue equity when they are overvalued irrespective of whether they need funds or not. Recently, Teoh, Welch and Wong (1998) and Rangan (1998) hypothesized that the earnings management at the time of equity offerings could well explain this anomaly. They documented negative relation between pre-issue abnormal accruals and post-issue abnormal security returns.

However, after re-examining the ‘earnings management hypothesis,’ Shivakumar (2000) argues that the earnings management at the time of equity offering is not intended to mislead investors but it merely reflects the issuers’ rational response to anticipated market behaviour after seasoned equity issue announcements.

2.6.1 Kenyan Studies

Findings of studies on the market behaviour around rights announcements in the Kenyan market are similar to those of the US. However, some differences do exist due to:

- legal and regulatory differences
- A developing stock market
- differences in corporate control mechanisms
- Institutional differences and/or market inefficiencies.

The financial sector reforms and number of policy initiatives from the capital markets Authority and the Kenyan government have resulted in exponential growth in the Nairobi securities market, making it a leader in the region.

The corporate sector is increasingly depending on external sources for meeting its funding requirements, thus more companies are listing their shares in the NSE. There appears to be growing preference for direct financing (equity and debt) to indirect financing (bank loan) within the external sources.

This study comes at a time when the Kenyan financial system is undergoing a transition from a bank-based financial system to a market-based financial system.

There is need to consider the impact of leverage while explaining the market reaction to rights issue. Raymar (1993) argues that equity issuance may be a positive event when a firm has a high debt level. He shows that in the presence of a sufficient degree of leverage and default risk, a positive market response is possible for equity issuance.

But, once the issue of agency cost is considered, this reaction cannot be expected (Jung, Kim and Stulz, 1996). Another important factor is the growth opportunities of the issuing firm. McConnel and Servaes (1995) argue that while the corporate value of the high-growth firms is negatively correlated with leverage, for the low-growth firms the correlation is positive.

Lang, Ofek and Stulz (1996) also provide similar evidence. A stock-exchange listed company in Kenya can raise equity capital through public issue, preferential allotment, and rights issue. In the Kenyan market, rights issues are normally made below market prices (may be due to the minimum subscription clause) and are similar to bonus issues/stock dividends in some respects (Barua, Raghunathan and Varma, 1994).

This observation is consistent with Kothare (1997) who examined the market micro-structure effects of the rights from the perspective that rights issues should have the effect of stock split and argued that the effect in micro-structure should be comparable to that. A rights issue at a discount from the market price can be decomposed conceptually into a bonus issue and an equity issue at market price. Bigelli and Scaravilli (1998) observed that the positive market reaction to the announcement of most of the European rights could be explained by the quasi-split effect which signals a large increase in dividends.

CHAPTER 3

METHODOLOGY

In this chapter, methods of data collection used are addressed.

3.1 METHODS OF DATA COLLECTION

In this study data was gathered in two stages:

Stage 1: Primary Data

Stage 2: Secondary data

3.1.1 Primary data

The researcher approaches various functional heads in charge of Agriculture Finance and collected related information for the study. Primary Data is the data that is not already available. The researcher collects is first-hand.

The data was collected by the researcher based on following data collection techniques;

- Observation and measurement.
- Personal interviews.
- Land Survey.
- Focus Groups.
- Questionnaires.

The researcher did physical inspection of stores and stock levels, field surveys with the help of company field agents and engaged in one to one interviews with various heads of departments in collection of data during his internship period of three months in the company.

3.1.2 Secondary data

Secondary Data is data or information that is already available. This data is collected by a person or organization other than the use of the data.

Advantages of Secondary Data

- Saves time and money
- Access to international and cross-historical data that would otherwise take several years and millions of dollars to collect
- Ideal for use in classroom examples, semester projects, masters theses, dissertations, supplemental studies
- Data may be of higher quality
- Studies funded by the government generally involve larger samples that are more representative of the target population (greater external validity!)
- Oversampling of low prevalence groups/behaviors allows for increased statistical precision
- Datasets often contain considerable breadth (thousands variables)

Disadvantages of Secondary Data

- Data may not facilitate particular research question
- Information regarding study design and data collection procedures may be scarce
- Data may *potentially* lack depth (the greater the breadth the harder it is to measure any one construct in depth)
- Constructs may be operationally defined by a single survey item or a subset of test items which can lead to reliability and validity concerns
- Post hoc attempts to construct measurement models may be unsuccessful (survey items may not hang together)
- Certain fields or departments (e.g., experimental programs) may place less value on secondary data analysis
- May require knowledge of survey statistics/methods which is not generally provided by basic graduate statistics courses

Secondary Data can be collected from various sources, which include, but are not limited to: Books, Magazines, websites, already published reports, TV, Radio, Newspapers, Films, Journals and publications, Research papers etc.

Secondary Data can be of two types. These are:

- Cross Sectional Data.
- Longitudinal Data.

i) **Cross Sectional Data:** It is the data collected at the same time from different places

ii) **Longitudinal Data:** It is the data collected at regular time intervals. Longitudinal Data can be further divided into two types:

- Data collected through Panel Study.
- Data collected through Repeated Design.

In this study, I used secondary data from Kenya Airways company website where I was lucky to gain access to some of the company financial statements from previous years and gathered the related information to facilitate my study.

This form of data will be my core source of data since most data I collected from the organization's website as much as secondary data was also of significance. I looked at the Annual financial reports of the organization as well as other reports that I were able to collect from the website.

3.2 MODEL OF THIS STUDY.

In this study I used line graphs to interpret my results since it demonstrates trend i.e. it shows change in data over time.

3.3 EARNINGS PER SHARE (EPS)

USES OF EPS

To assess the ongoing financial performance of a company

To compare the major stock market indicator of performance

$$\text{Price Earnings Ratio (P/E)} = \frac{\text{Market Price Per Share (MPS)}}{\text{Earning Per Share (EPS)}}$$

$$EPS = \frac{\text{Net Profit For The Year After Preference Dividend
But Before Ordinary Dividend}}{\text{No Of Ordinary Shares In Issue}}$$

Right issue

Normally below full market price. The steps for calculating rights issues are;

Adjust for bonus element

$$\text{capital in issue} = \frac{\text{actual cum rights price}}{\text{theoretical ex rights price}}$$

In step two you calculate weighted average capital in issue.

3.4 LIMITATIONS OF THE STUDY

The study of rights issues of Kenya Airways Company had a few constraints:

- The information collected for the study had been taken from documents which had been let out by the public documents such as the annual reports of the company.
- To the extent that the executives could spare their time, they gave the information by way of small discussions for the purpose of data collection.
- Most of the information has been kept confidential and as such was not passed on as part of the policy of the company.
- The study of information is mostly depending upon the secondary data.
- Time has been limiting factor since the duration of the study that two months were not sufficient to study and obtain detailed information

CHAPTER 4

DATA ANALYSIS & INTERPRETATION

This chapter focuses on an analysis of the data obtained from the study.

Earnings per share (EPS) are a really simple concept. Here are graphs showing how EPS works.

AFTER RIGHTS ISSUES:

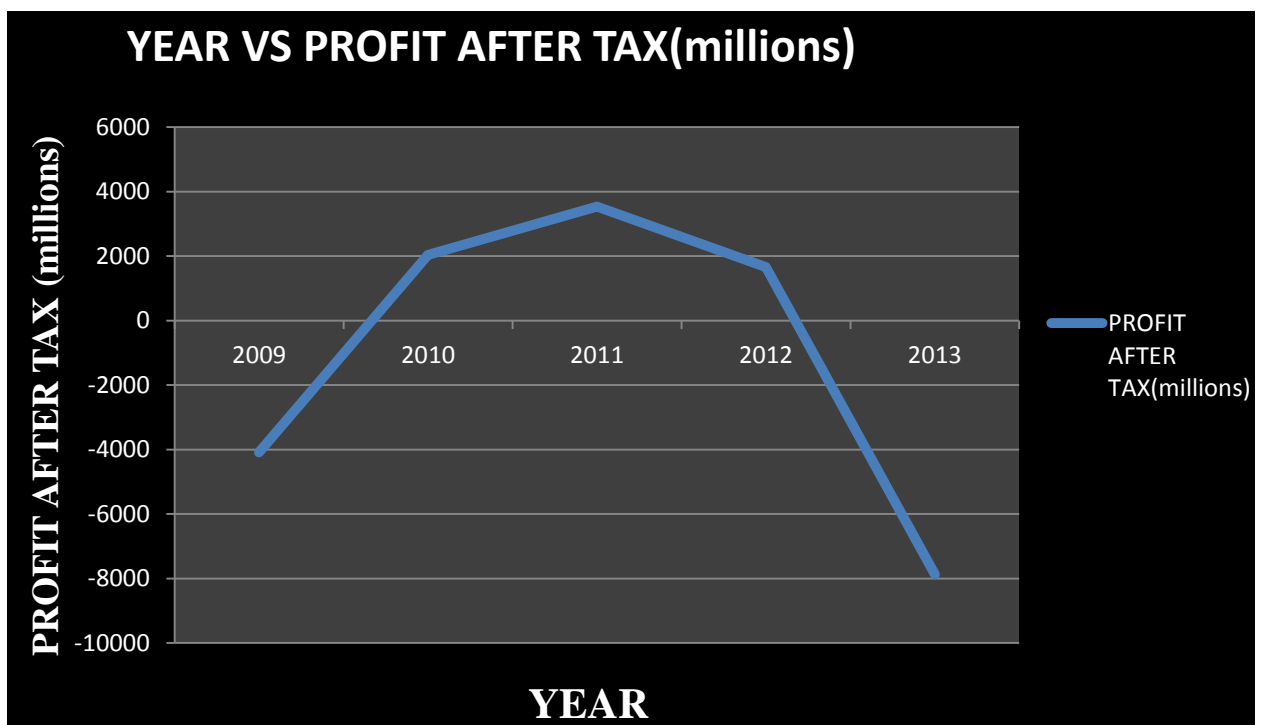


FIG 1

Source: Authors' creation

For the financial year 2009; the profit after tax decline maybe attributable to adverse economic environment during the first half of the year and a staff strike in august; the highest KQ peak period.

This condition improved from the second half of 2010 and peaked in 2011, with a profit of 3.538 billion Kenya shillings.

The drop in profitability witnessed from 2012 maybe due to negative economic and geo-political environment, in addition, travel advisories issued by western countries after the 2013 terror attack led the poor performance.

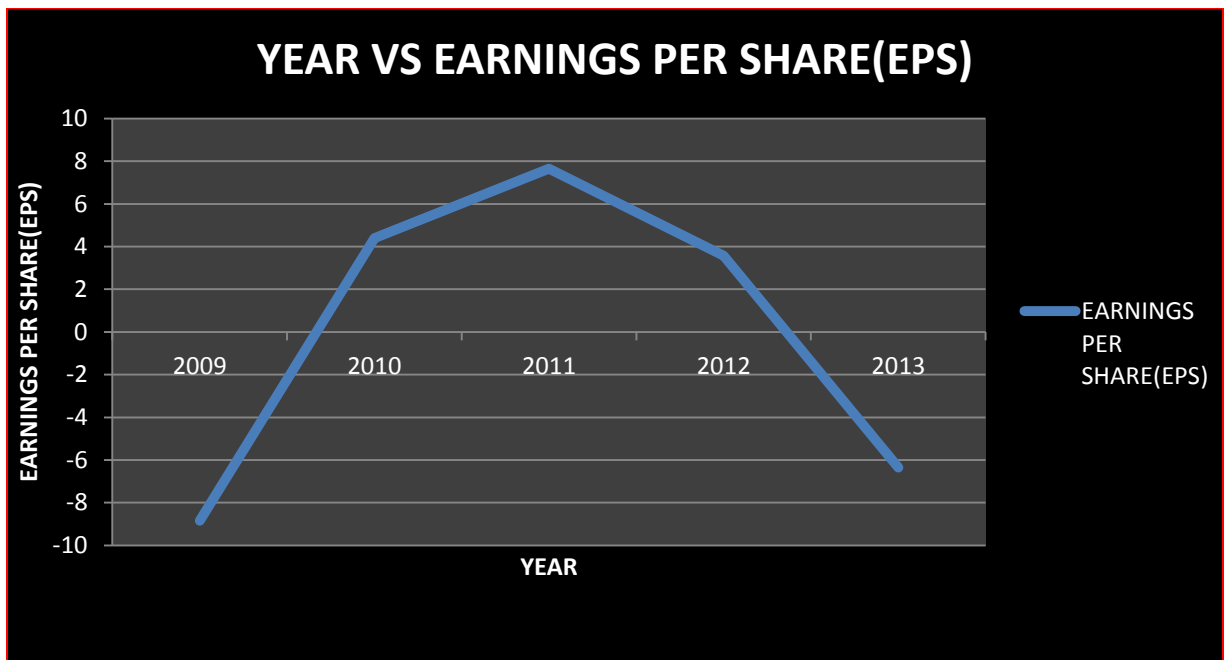


FIG 2 Source: Authors' creation

After the losses realized in 2009, Kenya Airways regained profitability and its EPS (earnings per share) increased by 149.8%; from -8.84 to 4.40.

This upward trend in EPS was maintained in 2011 with a figure of 7.65, but went down to 3.58 in 2012.

The rights issue in 2012 led to dilution of the EPS to -6.35 in march 2013. This dilution was as a result offering the rights issue at a discounted price of Ksh.14 and stock market speculation after the rights announcement pushed the MPS (market price per share) to Ksh.13.25, this is has not recovered to date.

EPS AFTER RIGHT ISSUE

YEAR	PROFIT AFTER TAX(<i>millions</i>)	ORDINARY SHARE CAPITAL	EARNINGS PER SHARE(<i>EPS</i>)
2009	-4083	461,877,829	-8.84
2010	2035	462,500,000	4.40
2011	3538	462,483,661	7.65
2012	1660	463,687,151	3.58
2013	-7864	1,238,425,197	-6.35

Table 1 Computed EPS after rights issue

EPS BEFORE RIGHT ISSUE

YEAR	PROFIT AFTER TAX(<i>millions</i>)	ORDINARY SHARE CAPITAL	EARNINGS PER SHARE(<i>EPS</i>)
2009	-4083	461,877,829	-8.84
2010	2035	462,500,000	4.40
2011	3538	462,483,661	7.65
2012	2156	463,687,151	4.65
2013	-7864	1,238,425,197	-6.35

Table 2 Computed EPS Before rights issue

From the two tables above, the profit after tax decreased from 2156 to 1660 when rights issue was introduced in March 2012

CHAPTER 5

CONCLUSION, IMPLICATIONS AND RECOMMENDATIONS

5.1 CONCLUSION

The theory says that right issue can decline EPS without having adverse effect on firm's ability to invest in profitable investment opportunities in future due to increase in number of shares. It means company's profit should raise to the greater extent in future after issue right shares to keep EPS constant. But from this study, the profit after tax decreased after the introduction of rights issue in March 2012. The earnings per share (eps) also decreased when the rights issue was introduced.

The various financial and non-financial aspects have their impact on the market price of shares. The prominent of these financial factors are reserve & surplus, the earning per share, the net profit of the company, and the dividend per share, turnover, bonus issue and right issue. In this study, I have tried to find out on empirical basis of rights issues announcement on share price performance of a Company.

5.2 IMPLICATIONS

The above findings have implications for management, investors, regulators, and other capital market participants.

5.2.1 Implications for Managers and Investors

Two major explanations can be offered for the documented deteriorating performance of rights equity issues. First, potential issuers may be actively managing their earnings for the success of their issues. Second, the issuers are timing their rights equity issue irrespective of the requirements of funds that may be leading to over-investment.

In our case, the decline in the Ex-rights share price and EPS though affected by other environmental factors may be attributed to over investment in the KQ shares. This over-investment may be because managers are over-optimistic about the investment opportunities of the firm like the investors at the time of issue. Alternatively, it may be due to the opportunistic behaviour of the managers. This means that managers are realistic but they want to exploit the prevailing positive market sentiment and go for ‘empire building.’

The investing public and analysts who are too optimistic about the issuers should consider the fact of deteriorating performance while arriving at the valuations.

In general, investors should be vigilant about the ‘empire building’ implications of increased investments through rights issue.

On the other hand, optimistic managers should reassess the investment opportunities and have conservative plans before approaching the market. Especially, large firms that are listed in developing stock markets, with lower investment opportunities should be more disciplined while approaching the capital market.

5.2.2 Implications for Policy-makers

An investment opportunity is a major determinant of the issuing company performance in the post-issue period.

Large firms like KQ are the worst performers after the rights issue. The regulators especially the Capital Markets Authority (CMA) have to look into the requirement of funds and the quality of the potential investment in the case of large companies. A major obstacle in designing a monitoring policy may be the difficulty in identifying the managers with opportunistic behaviour.

Group affiliation and managerial ownership can influence firm performance following rights equity issue in the KQ case, KLM and the Kenyan government who are major shareholders took up all their rights a move which cushioned a total failure of the rights issue.

The policy-makers and regulators should in future come out with better regulatory framework to control and punish opportunistic managers.

This can vary from stringent regulations for better reporting to monitoring of the usage of additional funds raised through rights equity.

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