THE EFFECT OF PRIVATISATION ON FINANCIAL PERFORMANCE OF FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

BY

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DECLARATION

This project is my original work and has not been presented for a degree in any other University.

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SUPERVISOR’S DECLARATION

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

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Lastly to my family who have been with me throughout this journey. God bless you all.
DEDICATION

I dedicate this work to my family and all those who supported me in the completion of this project. Thank you and May God bless you abundantly.
LIST OF ABBREVIATIONS

EBIT – Earnings before interest and tax
GDP- Gross domestic product
IMF - International monetary fund
KCB – Kenya commercial bank
NSE - Nairobi securities exchange.
SOEs - State owned enterprises
SPSS- Statistical Package for Social Sciences
IPO – Initial public offer
ROCE – Return on capital employed
ABSTRACT

Hongo (2006) while looking at the effect of privatization rate on SOE financial performance where she found that the rate has no effect also observed that no study had been undertaken in Kenya on the effect of privatization on the already privatized former state owned enterprises (SOEs) listed at the NSE. Therefore this study analysed the effects of privatization on financial performance of former state owned enterprises that are now listed at the NSE.

The study employed descriptive survey design on a population of privatized former SOEs quoted at NSE. The study used secondary data sources in collecting information; internet, periodic report and brochures for a period of five years before and five years after privatization of each SOE. The data was analyzed for variation using a regression model where the independent variable performance is regressed against dependent ratios i.e. profitability ratio, liquidity ratio, leverage ratio and activity ratios, a t-test statistic, to test the hypothesis on whether there is any significance difference in financial performance after privatization was also performed.

The study concluded that privatization had a positive impact on the financial performance of these firms as it increased their profitability and activity ratios. The results of the study also showed varied performance results from the other ratios. The recommendation of the study is that the managers of these SOEs should focus more on attracting foreign direct investments into the firm and the government should relinquishing all of their control on the privatized firms and let them operate on their own.
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CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Privatization is positively linked with hardened firm budgets and the extent of market liberalization, but its constrained by excessive debts and work redundancy. Firm efficiency and state owned enterprises; financial liabilities imposed on local governments are not factors of influence (Guo and Yao, 2005). Privatization represents a potential revolution in the role of government in promoting economic growth and development. This revolution gained force in the 1980’s and continues to gather momentum (Kikeri, Sunita, John Nellis & Mary Shirley, 1992).

The privatization movement set in motion by the Reagan administration in the 80s in the United States appears to have started a global trend of restoring the free enterprise spirit (Dhameja and Sastry, 1998). The economic benefits of privatization are now widely accepted and can include improved enterprise efficiency and financial performance, developing, competitive industry which serves consumers well, accessing the capital knowhow and markets which permit growth, achieving effective corporate governance, broadening and deepening capital markets and securing the best possible price for sale, (Kikeri et al., 1992).

The results from an empirical study sponsored by the World Bank regarding 12 cases of divestitures of government owned assets in four middle income and developed countries showed that privatization can bring substantial gains. Eleven out of the twelve cases the gains were positive amounting to an average of 2.5 percent permanent increase in GDP (World Bank, 1995a).
1.1.1 Privatization

Privatization can be defined as the process of transferring productive operations and assets from the public sector to the private sector, it is much more than selling an enterprise or corporation to the highest bidder. According to the guidelines given by the World Bank and the IMF, privatization is only deemed to have occurred when the government reduced its shareholding in the corporation to 25% or less (World Bank, 1995).

Nyong’o (2004) defined privatization as the generic term used to describe a range of positive initiatives meant to alter ownership or management away from the government in favour of the private sector. Despite modern privatization being associated with the Thatcher government in the United kingdom the first large scale sale occurred in 1961, when the Federal Republic of Germany sold a majority stake in Volkswagen in a public issue heavily tilted towards small investors.(Megginson et la,2004).

There are a number of ways to privatize state owned corporations in Kenya which included: sale of shares, where the government will sell off its shares through methods like competitive sale, public floatation and pre-emptive rights, sale of assets using ways like open tenders, public auction, direct sale and liquidation of assets, management buyouts and employee buyouts, transfer of assets and shares, equity dilutions, joint ventures, restitutions and management contracts (Oliver and Bhatia, 1998).
Boubakri and Cosset (1994) note that privatization has turned into a major phenomenon for the developed world, particularly so over the last decade, with SOEs being privatized at an increasing rate. (Ramamurti, 1991) notes that the objectives of privatization are numerous; these objectives include improving government cash flows by reducing subsidies and capital infusions to SOEs, acquiring efficiency in resource utilization, increasing profitability, promoting popular capitalism through a wider ownership of shares, restraining the power of trade unions in the public sector, redistributing incomes and rents within society, satisfying foreign donors by reducing the government's role in the economy and especially enhancing the efficiency and the performance of the SOE sector based on the rationale that the private sector outperforms the public sector.

1.1.2 Financial Performance

Estrin and Perotin (1991) argue that with the government as owner, the business will not concentrate on profit maximization since the government has both political and economic objectives that are different from those of commercial firms and that corporate performance in such firms will be inferior due to weaker governance arrangements.

Shleifer and Vishny (1998) show that private ownership is favored to government ownership because the government extorts firms to the merits of politicians and bureaucrats. (Megginson and Netter, 2005) concluded that the weight of empirical research is now decisively for the proposition that privately owned firms are more efficient and more profitable than otherwise comparable to government-owned firms.
The main assumption is that privatization generates sufficient funds and that the privatized enterprise, apart from being large, continues to operate efficiently post privatization and that the divestiture price at least equals the government’s investment in the enterprise; the proceeds are used for repaying a corresponding amount of public debt. This has led to increased interest in disassociation of the state from production of goods and services, (World Bank, 1995).

1.1.3 The Effect of Privatization on Financial Performance

Yarrow (1986) notes that as firms move from public to private ownership, their profitability should increase, first, given that shareholders wish the firm to maximize profit, newly privatized firms' managers should place greater emphasis on profit goals secondly, privatization typically transfers both control rights and cash flow rights to the managers who then show a greater interest for profits and efficiency relative to pleasing the government with higher output or employment.

Boycko et al., (1993) state that following privatization; firms should employ their human, financial and technological resources more efficiently because of a greater stress on profit goals and a reduction of government subsidies. They also predict a fall in output since the government no longer subsidizes the newly privatized firm to maintain inefficiently high output levels. (Meggison et al., 2004) note that governments expect that greater emphasis on efficiency will lead the newly privatized firm to increase its capital investment spending. Once privatized, the firm should also increase its capital expenditures because it has greater access to private debt and equity markets and it will have more incentives to invest in growth opportunities. It should also increase output because of greater competition, better incentives and more flexible financing opportunities.
Megginson et al., (2005) believe the switch from public to private ownership should lead to a decrease in the proportion of debt in the capital structure because with the end of government debt guarantees the firm’s cost of borrowing will increase and because the firm has a new access to public equity markets. The authors further note that with privatization, dividend payments should increase because unlike government’s private investors generally demand dividends and dividend payments are a classic response to the atomized ownership structure which most privatization programs led to. (Kikeri et al., 1992) assert that governments expect the level of employment to decline once the SOE which is usually overstaffed turns out private and no longer receives government subsidies. However, in growing sectors, the newly privatized firm could absorb surplus labour through new capital investment and more productive use of existing assets. Privatization as an economic development policy is currently in progress world over.

Megginson (2005) also argued that the impact of privatization is increasingly related to performance; while it did not have a significant impact on profitability it increased operating efficiency, reduced employment at firm level and decreased fixed assets (Clarke & Pitelis, 2003) also argued that based on mainstream economic theory, markets allocate resources efficiently without state intervention as long as market failure does not exist which is caused by externalities, public goods and monopolies.

1.1.4 Nairobi Securities Exchange

In 1954 the Nairobi Stock Exchange (later renamed Nairobi Securities Exchange) was constituted as a voluntary association of stockbrokers registered under the Societies Act. The year 1988 saw the first privatisation through the NSE - the successful sale of a 20% government stake in Kenya Commercial Bank. The sale left the Government of
Kenya and affiliated institutions retaining 80% ownership of the bank. (www.nse.co.ke).

In 1996, the largest share issue in the history of NSE - the privatization of Kenya Airways, came to the market. Having sold a 26% stake to KLM, the Government of Kenya proceeded to offer 235,423,896 shares (51% of the fully paid and issued shares of Kshs. 5.00 each) to the public at Kshs. 11.25 per share. More than 110,000 shareholders acquired a stake in the airline and the Government of Kenya reduced its stake from 74% to 23%. The Kenya Airways Privatization team was awarded the World Bank Award for Excellence for 1996 for being a model success story in the divestiture of state-owned enterprises. 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, removal of Capital Gains Tax on insurance companies' investments, allowance of beneficial ownership by foreigners in local stockbrokers and fund managers and the envisaged licensing of dealing. (www.nse.co.ke).

An MoU between the Nairobi Stock Exchange and Uganda Securities Exchange was signed in November 2006 on mass cross listing. The MoU allowed listed companies in both exchanges to dualist; this would facilitate growth and development of the regional securities markets. In July 2007, the NSE reviewed the Index and announced the companies that would constitute the NSE Share Index. The review of the NSE 20-share index was aimed at ensuring it is a true barometer of the market. It constituted 20 blue chip companies who qualified to trade their stocks on the NSE. (www.nse.co.ke).
In 2008, the NSE All Share Index (NASI) was introduced as an alternative index; its measure is an overall indicator of market performance and incorporates all the traded shares of the day. Its attention is therefore on the overall market capitalization rather than the price movements of select counters. In April 2008, NSE launched the NSE Smart Youth Investment Challenge to promote stock market investments among Kenyan youth. (www.nse.co.ke).

Most privatized firms which have managed to trade on NSE have been successful in their quest for high profits and capitalisation, as at 2013 over 50 firms have listed their shares on the NSE (www.nse.co.ke).

1.2 Research Problem

The performance of state owned public corporations had been less than satisfactory. This was in spite of the massive budgetary allocation to these enterprises by the government. State enterprises have proved to be wasteful and inefficient, producing low quality goods and service at a high cost. Sheltered from competition these enterprises were often overstaffed and required to set prices below costs, resulting in financial losses that amounted to as much as 5% to 6% of the country’s gross domestic product (GDP) annually (World Bank, 2004). Bailouts and fiscal strains resulted covering state enterprises losses through the fiscal transfers required the government to finance larger fiscal deficits and increase tax revenues or reduce spending in other areas or both. Financing losses through the state banking system reduced the private sectors access to credit and threatened the viability of the financial sector. Many governments became incapable of providing capital to these state enterprises (World Bank, 2004).
Research on privatization in emerging economies; see (De Castro and Uhlenbruck, 1997; Laban and Wolf, 1993; Nellis and Kikeri, 1989 and Ramamurti, 1992) has not considered post privatization management practices of SOEs, nor have researchers examined the relationship between performances of newly privatized firms. Most work on privatization either takes the macro public view, usually aiming to demonstrate benefits of privatization to the public, (De Castro and Uhlenbruck, 1997). The transition from state owned to private enterprise is a dramatic change. As Goodman and Loveman (1991) put it, like the takeovers of public corporations, the privatization of government assets is a radical change; managing such a radical change requires the presence of a catalyst having the vision and stamina to bring the transformation needed for success of the new organization.

Although a number of empirical studies have been conducted in order to measure the financial effects of privatization on the newly privatized firms throughout the world, only a limited number of empirical studies have attempted to measure the effect of privatization on the economic growth in the developing countries. Perhaps the main reason for the lack of such studies arises out of the fact that privatization has been a fairly new phenomenon, particularly in developing countries.

Otieno (1998) observes that little research has been undertaken in Kenya to compare the performance of SOEs before and after privatization. The author analysed the financial performance of newly privatized firms in Kenya, however this study covered only a period of four years after privatization and the findings only revealed the immediate benefits. Thus further research should be undertaken to determine the long term benefits. Mike (2003) analysed the privatisation of Kenya Airways and
concluded that there is no universal formula for successful privatization and there is no well thought out policy for measuring performance pre and post privatization of firms listed on the NSE. Hongo (2006) while looking at the effect of privatisation rate on SOEs financial performance observed that no study has been fully undertaken in Kenya on the effect of privatisation of firms listed on the NSE hence this study intended to answer the question, “Has privatisation had an effect on the financial performance of former state owned enterprises now listed on the NSE”? 

1.3 Objective of the study
To determine the effect of privatisation on financial performance of firms listed on the Nairobi securities exchange.

1.4 Value of the study
The findings of this study will be of benefit to:

Financial managers and directors of SOEs who will be able to convince the government to divest from state owned enterprises so that efficiency of the workforce increases and government expenditure is reduced or eliminated and replaced by revenue being generated.

Individual investors and investment firms who will be able to operate in a liberalized environment where there is information symmetry and they will strive to be competitive to ensure the listed firms yield profitable returns on their investments.

Academics who will be able to gain more knowledge on the success factors of privatization of SOEs. This will enable them to enhance their literature on the financial benefits of privatization state owned enterprises.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction
This chapter involves a review of literature related to the current study. Its purpose is to examine whether the problem in question is related to any other study or written work in the same area of research. This summarized literature review will help to compare, contrast and clarify some important issues that have been observed by others.

2.2 Theoretical review
Relevant theories on the privatization concept are: productive efficiency theories, property right theory, agency theory as well as the theory of allocative efficiency.

2.2.1 Productive Efficiency Theory
Productive efficiency focuses on a decrease in the production costs, which can be achieved by a proper management and the right incentives. In this respect, neoclassical economists argue that private ownership stimulates the implementation of efficiency-enhancing policies.

Principal-Agent relationships may be common in small firms, but in the large modern limited liability corporation the property rights are diluted. Diluted ownership reduces the control of owners over managers. As a result, managers have a considerable amount of freedom to back their own interests (Commander & Killick, 1988; Adam et al., 1992).

Moreover, the implications of ownership with respect to production and efficiency depend to a high degree on the nature of the business environment. These
environmental factors have a considerably larger impact on firm performance than ownership. Therefore, apart from ownership, these factors, including competition and regulation, have to be taken into account when assessing the privatisation process (Van Brabant, 1995).

### 2.2.2 Property Right Theory

Property rights are instrumental in achieving both allocative and productive efficiency with respect to the use of firm resources (Vickers & Yarrow, 1988). It is argued that abolishing the public sector property rights has a positive impact on the productive performance and innovation of firms (Erbeta & Fraquelli, 2002).

Property rights that are poorly defined, insufficient protection against theft and expropriation, breach of contract, these are all factors that undermine efficiency (Bocko, Shleifer and Vishny, 1995).

Barzel (1989) points out that property rights are never entirely accounted for by the law, and that issues such as expropriation, free-riding, and eluding the law are quite common. In addition, Starr (1988) argues that the property rights school fails to recognise that the separation of ownership and management alters the nature and functioning of private firms. Further, property rights theory rules out the significance of aspects such as size, centralisation, hierarchy, or leadership. Finally, it does not recognise the relationship between firm performance and the exchange of information or ambiguity about business goals. The general view of critics is that privatisation is not the answer to public sector problems.
2.2.3 Agency Theory

Agency theory states that agents act merely out of self-interest, and therefore incentives have to be offered that motivate them to adjust their aims to those of the enterprise. Agency theorists believe that privatisation stimulates the design of new macroeconomic systems, including accounting systems (Macias, 2002). Further, privately owned firms are presumed to be governed by business goals and the capital market acts as a deterrent to managerial non-profit behavior (Ott & Hartley, 1991).

Critics argue that the empirical validity of the views on which this theory is based is dubious. Full information is hard to obtain in practice and thus information processing is highly complex. Moreover, internal conflicts undermine communication between organizational members. In addition, in LDCs the competitive markets are still poorly organised, and the economic relationships and motivations are much more complex than is being portrayed by the agency theory. It is difficult to model them by means of this theory. For example, trust is not dealt with (Armstrong, 1991; Neu, 1991). Further, the relation between a manager’s efforts and the output in terms of profitability is more difficult to determine than is being suggested in this theory.

2.2.4 Allocative Efficiency Theory

According to Adam et al., (1992) competition generated by private ownership is essential in achieving allocative efficiency, as during this process crucial information is revealed, which is required for an efficient use of a firm’s input. If the level of competition is low, it will be more difficult to detect signals on the basis of which a proper input-output balance can be determined. In addition, due to managerial inefficiency or lower levels of demand, profits may decrease. Neo-classical economists claim that the allocative efficiency of public enterprises is poor because
the politicians as well as the managers and workers are motivated by goals that do not correspond with the interests of the company. They also argue that an adequate allocation of resources will be stimulated by measures such as market pricing, the removal of import restrictions or quotas, the promotion of the private sector, the curtailment of government activities by closing state enterprises, and contracting out government functions to the private sector (Toye, 1994). The view is that private rather than public ownership will produce more efficient enterprises, beneficial to consumers, the industry, and the nation as a whole (see Donald & Hutton, 1998; Flemming & Mayer, 1997; Shaoul, 1997; Ogden, 1997; Adam et al., 1992; Goodman & Loveman, 1991).

Advocates consider privatisation to be intertwined with public financing and allocative efficiency. In their view privatisation reduces net budgetary transfers, eliminates possible external debt liabilities and decreases the adverse effects of deficit financing. Critics however, argue that the actual reality differs significantly from what is being claimed in most theories on privatisation. They argue that a broader range of issues have to be incorporated to achieve the desired results. Generally, it is believed that improved performance will result in both accounting practices that are more transparent and an increase in economic performance (Vickers & Yarrow, 1988), investments, Gross Domestic Product (GDP), productivity and employment. The assumption is that these improved management control systems and accounting techniques are suitable to be introduced in any privately-owned firm. There is however, little empirical evidence to support this notion, especially with respect to LDCs (Cook and Kirkpatrick, 1995). Some studies even doubt the relevance of improved performance in the case of LDCs.
2.3 Measures of financial performance

Kathanje (2000) states the performance is defined as the predictive value for a financial institutions performance. It’s obtained by a factor of 4 ratios: gearing, liquidity, earnings and asset quality ratios.

In this study ratios were used to measure the financial performance of the privatised firms. The ratios provided an analysis of the firm’s debt burden, operating efficiency and profitability.

The four types of financial ratios used in analyzing the financial position of the firm included liquidity ratios which indicated the capacity to meet short term obligations, leverage ratios which indicated the firms capacity to meet its long term and short term debt obligations, activity ratios which indicated how effective the company was in using its assets, and profitability ratios which indicated the net return on assets.

For liquidity ratios the researcher used current assets ratio and acid test ratio. As for leverage ratio the researcher used the debt equity ratio. For activity ratio the researcher used the ROA ratio, debtors’ ratio and for profitability ratio the researcher used net profit margin ratio to arrive at the results.

2.4 Empirical studies

Since the 1980s, privatisation has been the most significant approach in global market reform. In general, privatisation is associated with economic liberalisation, free trade, competition and limited government intervention. In spite of the fact that it was introduced decades ago, there is not much documentation available about privatised firms, which is considered as a major concern (Adam et al., 1992; Cook & Kirkpatrick, 1988). Only after a considerable time after their global introduction have
researchers started to investigate the results and effects of privatisation programmes. Several studies on post-privatisation effects have been published (Cook, 1986; Cook & Kirkpatrick, 1995; Megginson & Netter, 2001; Parker & Kirkpatrick, 2005), but their findings are somewhat ambiguous and contradictory.

Comparative studies were, for example, conducted by Weiss (1995) to evaluate the performance of state-owned and privately-owned corporations, and by Karatas (1995) to compare the performance of enterprises during the pre-privatisation and the post-privatisation periods. These studies have not provided significant and conclusive data. In addition, the empirical evidence presented in the development literature does not offer significant clues to the nature of the internal changes taking place within firms during the privatisation process (Wickramasinghe, 1996).

The empirical evidence collected so far on the effects of privatisation in developed countries is inconclusive. Wright et al. (1993) show that in several cases privatisation has had a positive impact on firm performance through so-called management buy-out practices. On the other hand, other studies indicate that privatisation policies have resulted in the transfer of a large amount of public wealth into private hands. But the studies do not find much evidence that privatization itself increases firm profitability. They show that net income-based profitability measures improve after privatization, but EBIT-based profitability measures do not.

Juliet D’Souza & William Megginson (1999) compare the pre- and post-privatization financial and operating performance of 85 companies from 28 countries (15 industrialized and 13 non-industrialized) that experience full or partial privatization
through public share offerings for the period from 1990 through 1996. The study documents significant increases in profitability, output, operating efficiency, and dividend payments – and significant decreases in leverage ratios- for all the sampled firms after privatization and for most sub- samples examined. Capital expenditures increase significantly in absolute terms, but not relative to sales. Employment declines but insignificantly. By and large, findings from this study strongly suggest that privatization yields significant performance improvements.

Earle and Estrin (1996) present empirical evidence that privatization in Russia had an impact on enterprise efficiency, but domestic market structure and hardening of the budget constraints mostly had little effect. Later they found systematic effects of private ownership on several types of restructuring behaviour and on labour productivity (Earle & Estrin, 1997). A comparative analysis of economic performance of more than 2,000 Russian state-owned and privatized enterprises carried out by experts of Saint-Petersburg and Moscow showed that private enterprises were ahead of state-owned ones for basic economic indicators (Eio, et al., 1997). The difference was more significant for effectiveness of production and less for financial indicators.

Potts (1995) conducted research into denationalisation and production efficiency in Tanzania. In two states the management of organisations had improved after privatisation, whereas in others it had declined. According to Potts there is a relationship between management decline and production performance. Further, Potts concludes that apart from some macro-economic benefits, a clear disadvantage of the privatisation process is the transfer of ownership to foreign-based companies. When
using size, market structure, industry trends and ownership as variables to investigate possible changes in performance.

Weiss (1995) found no significant evidence for the assumption that public enterprises perform less good than private companies. Moreover, he has found no proof that privatisation measures increase economic efficiency. What Weiss’ study does show us is that in particular branches, foreign-owned firms outperform national firms.

Karatas (1995) compared pre- and post-privatisation firm performance in Turkey by using financial measures as point of departure. No significant differences were found. Although the theory suggests that privatisation leads to the improvement of financial practices, researchers generally show little interest in finding empirical evidence that supports this assumption. The available evidence does not convincingly show clear improvements in the performance of enterprises as a result of privatisation.

In Sri Lanka (Wickramasinghe, 1996) measured the effects of privatisation on profitability of firms in Sri Lanka and found that privatisation did not lead to higher levels of profitability or productivity after privatisation.

In Mexico, a study by (Uddin & Hopper, 2003), conducted in 13 privatised firms on the effect of privatisation on firms returns showed that returns did not increase; in fact, states revenues as well as employment decreased. In addition, transparency in external reports was not achieved, and some shareholders, creditors and tax collecting institutions were affected by wrongful transactions.
A study conducted by (Paul Cook and Yuichiro Uchida, August 2003), provides an empirical analysis of the effects of privatization on economic growth in developing countries. (Cook and Uchida, 2003) empirical analysis suggests that there is a robust negative correlation between privatization and economic growth in developing countries. Since the theory predicts a positive correlation between privatization and economic growth, something is possibly lacking from the model specifications. This can provide powerful insights in the methodology of future studies. Their study largely eliminates the possibility that the privatization variable captures other economical changes. Perhaps, as theory implies, it is possible that some of the success of privatization as a policy that promotes economic growth lays in the fact that privatization leads to other structural changes in the economy.

Jones et al., (1999) undertook an impact study applied to 81 privatizations (covering not just infrastructure firms but a range of firms already operating in competitive markets (in agriculture, agro-industries, tradable and non-tradable sectors) to determine the effect of privatisation of firms in Cote d’Ivoire and concluded that firms performed better after privatization and that they performed better than they would have had they remained under public ownership. The study also found that the set of transactions as a whole contributed positively to economic welfare, with annual net welfare benefits equivalent to about 25% of pre-divestiture sales. These results stemmed from a number of effects, including increases in output, investment, labour productivity, and intermediate-input productivity.

overtime. The authors show that privatization leads to increase in profitability, efficiency, and output in former state-owned firms from Asia. Employment increases but insignificantly. Compared to the related literature on the effects of privatization in developing countries, results from this study indicate that performance improvements in Asia where most firms are partially privatized are less significant than those documented in other studies. This study finds that higher improvements are associated with certain aspects of corporate governance and the economic environment: For example, a friendly institutional environment, lower political risk, more developed stock markets and involvement of foreign investors, are important determinants of performance improvements after privatization. Finally, the study shows that governments generally do not relinquish control and private ownership concentrates overtime, but by far less than what is observed elsewhere in developing countries.

Zuobao Wei et al., (2003) examined the pre- and post-privatization financial and operating performance of 208 firms privatized in China during the period 1990-1997. The full sample results show significant improvements in real output, and sales efficiency, and significant declines in leverage following privatization, but surprisingly, no significant change in profitability. Further analysis by the authors shows that, privatized firms experience significant improvements in profitability compared to fully state-owned enterprises during the same period. Firms in which more than 50% voting control is conveyed to private investors via privatization experience significantly greater improvements in profitability, employment and sales efficiency compared to those that remain under the state’s control. The authors conclude that, privatization works in China, especially when control is passed to private investors.
In a study on partial privatization and firm performance in India, Gupta N. (2004) uses data from Indian state owned enterprises and found that partial privatization has a positive impact on profitability, labour productivity and investment spending. On the other hand, he found no evidence that firms are chosen for privatization because of unusually bad performance in the previous year. His analysis confirms the argument that the most profitable enterprises are usually the first to be privatized as with the case in Indian oil and gas companies. He also documents that privatization and competition are not substitutes in their impacts on firm performance. His results supports the hypothesis that partial privatization address managerial rather than the political view of inefficiency in state-owned enterprises.

2.5 Summary of literature review

Most of the empirical studies done view privatization as a way of gaining profit incentives, most of the studies reviewed focus on privatisation of companies in LDCs and they also focus more on how privatisation affects other performance comparatives i.e. employment, employee and sales efficiency, economic growth and welfare. Not many researchers focused their studies on the effect of privatisation on the financial performance of former state owned enterprises.

So on the basis of these reviews the researcher identified some gaps in the theories on privatization, in particular with respect to the desired outcome of the privatization process in terms of financial performance of former SOEs.

Conclusively we could ask ourselves where privatization is leading us to and where it might lead us to, if there are any improvements in financial performance of the former SOES or not.
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction
This chapter describes the specific strategies or procedures that were used in data collection and analysis in order to answer the research question. The chapter focused on research design, target population, research instruments, data collection procedures and analysis criteria.

3.2 Research design
The researcher adopted descriptive survey design. In addition, quantitative analysis was carried out in data collection and analysis. The design was suitable because it addressed the major objective and research question in the study adequately. The method provided a framework for examining the current conditions, trends and status of events. Also, it helped in measuring and describing major variables identified in the context of privatization.

3.3 Population and Sample
Burns and Grove (2003) and Mugenda and Mugenda (2003) describe population as all the elements that meet the criteria for inclusion in a study. Population is therefore the entire group of individuals, events or objects having a common observable characteristic. The population of the study consisted of 6 listed companies which were former state owned enterprises and were within the intended time frame of the researcher’s study and no sampling was done.

3.4 Data collection
This study entailed the use of secondary data from annual reports of the sampled quoted companies and internet sources. The data was for 5 years prior to privatization.
i.e. (2003- 2007) and 5 years after privatization i.e. (2008 – 2012) of the former state owned enterprises.

Data for the financial variables was collected from the financial statements of the SOEs. The variables considered were those that quantify assets, liabilities and equity as well as profit measures such as operating profit, net profit and gross profit.

In ascertaining determinants of financial performance, profitability was employed as the measure of performance. As such, the researcher took ROA as the proxy measure to represent profitability.

In order to breakdown and understand the variation in performance, several independent variables were employed in a regression model as determinants of financial performance. While firm’s profitability and liquidity were the main focus of the study, other controlling variables like leverage, and activity level were included in the model as well.

3.5 Data analysis

After the information was collected, data was summarized and presented by the use of market ratios which included: profitability ratios, liquidity ratios, leverage ratios and activity ratios. The model used was as follows:

\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \mu \]

Where:

\( Y \) = Performance
\( X_1 \) =profitability ratio
\( X_2 \) = liquidity ratio
\( X_3 \) = leverage ratio

\( \mu \)
X4= activity ratio

In the model, β0 = the constant term while the coefficient βii= 1….4 was used to measure the sensitivity of the dependent variable (Y) to unit change in the predictor variables. μ was the error term which captured the unexplained variations in the model.

Performance was measured through profitability where the researcher used ROA. Liquidity of firm was be measured by the liquidity ratio obtained from the division of current assets to current liabilities. Leverage of the firm was measured through the ratio of equity over debt. Activity ratio was measured through the average collection days and payment period and average stock days.

The researcher used comparative statistics to compare the performance of the firm’s pre and post privatisation using the stated ratios. The data was analysed through coding in a spread sheet where the researcher used descriptive statistics to present the performance of independent variables in tables and charts based on their percentages. A regression was run to determine the coefficients of the independent variables in relation to the dependent variable. This was with the aid of the Statistical Package for Social Sciences (SPSS).

The two-tailed Wilcoxon signed-rank test was used to test for significant changes in the variables. It tested the null hypothesis of the median difference in variable values for the pre privatization and a post privatization sample was zero. We use the Z test statistic which, for samples of at least ten observations, approximates a standard normal distribution.
Besides the Wilcoxon test, a proportion test was used to determine whether the proportion $p$ of firms experiencing a change in a given direction is greater than what would be expected by chance, typically testing whether $p=0.5$.

To test the significance of the difference between the average before and the average after privatization two types of tests were carried: the parametric $t$ test in the case of means and the non-parametric $Z$ test (Wilcoxon Signed Rank Test) for the medians. Given that the sample is small, results obtained in the test of medians were considered more attentively. The results of the findings are presented in the form of table and graphs for easy interpretation and understanding.
CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter presents the findings of the study, analysis of data and presentations of major findings.

Regression analysis was undertaken by fitting an equation of financial performance ratios of privatized companies through the NSE. The researcher regressed \( Y=\text{performance} \) against independent variables profitability (\( X_1 \)), liquidity (\( X_2 \)), leverage (\( X_3 \)) and activity (\( X_4 \)). A test of significance was carried out to test the differences between the averages means and median of the data and the results were presented in quantitative form and tables and graphs where applicable. The analysis of data relied on Microsoft (MS) excel statistical package (SPSS).

Performance\% = \text{profit ratio}\% \times \text{liquidity ratio}\% \times \text{leverage ratio}\% \times \text{activity ratio}\%

Table 1 to table 6 shows the annual financial performance ratios for the 6 companies’ studied. -(See Appendix I)

4.2 Trends in financial performance ratios

The following graphs show the trends in overall financial performance of the 6 companies studied
Graph 4.1 Trends in financial performance ratios for company 1

Source: research data

Graph 1 shows the financial performance for company 1 in the pre and post privatization era. The profitability of the company was highest before privatization it later declined for some time in the post privatization era however much later it increased with the exception of the last years. Liquidity ratio declined in the first years of post privatization however it later increased, the leverage ratio showed an increase in the post privatization and this increased throughout. The activity ratio fluctuates in the post privatization era.

Graph 4.2 Trends in financial performance ratios for company 2

Source: research data
The trends in financial performance ratios of company 2 show that its only leverage ratios which show an improved performance after privatization this indicates the company will be able to meet its short term obligations and longterm because of privatisation. The company from its profitability ratios also show that the company has improved its ability to meet its short term commitments out of its liquid assets and becomes more efficient after privatization.

Graph 4.3 Trends in financial performance ratios for company

![Graph showing trends in financial performance ratios over years]

Source: research data

The trends in financial performance ratios of company 3 show that its only leverage ratios which shows a much improved performance after privatization. This indicates the company will be able to meet its short term obligations and long term because of Privatisation. The Company from its profitability ratios also show that the company has improved its ability to meet its short term commitments out of its liquid assets and becomes more efficient after privatization.
Graph 4.4 Trends in financial performance ratios for company 4

Source: research data

Graph 4 shows the financial performance ratios of company 4 where for this company the pre and post privatization performance of all ratios increased after privatization.

Graph 4.5 Trends in financial performance ratios for company 5

Source: research data

Graph 5 shows that profitability ratio for company 5 did not significantly change after privatization. Liquidity ratio also declined after privatization and eventually started to increase. Leverage ratios of the company decreased after privatization while activity significantly increased after privatization.
Graph 4.6 Trends in financial performance ratios for company 6

![Graph showing trends in financial performance ratios for company 6]

Source: research data

Graph 6 shows that profitability ratio for company 6 significantly declined after privatization. Liquidity ratio also declined after privatization and eventually started to increase. Leverage ratios of the company fluctuated on an increasing level after privatization while activity significantly increased after privatization.

4.3 Regression results for SOEs privatized through the NSE

The financial ratios profitability, liquidity, leverage, activity for the 6 companies were regressed against performance y using SPSS package.

**Company 1**

The regression results yielded the following outcome

\[ Y = 4.7722E-17 + 1.666E-8x1 - 1.088E-09x2 - 5.228E-09x3 - 5.611E-10x4 \]

\[ Y = \text{performance} \quad \text{X1=profitability ratio} \]

\[ \text{X2=liquidity ratio} \quad \text{X3=leverage ratio} \]

\[ \text{X4=activity ratio} \]
The coefficients for the model are $4.7722 \times 10^{-17}$ for intercept, $1.666 \times 10^{-8}$ for profitability, $1.088 \times 10^{-9}$ for liquidity, $5.228 \times 10^{-9}$ for leverage, $5.611 \times 10^{-10}$ for activity. The t-statistics for profitability and liquidity are more than the level of significance showing that they are important for the model. The correlation results show that profitability ratio is positively related to performance while leverage and activity ratios are negatively related to performance.

Correlation tests imply that profitability is strongly related to performance while liquidity, leverage activity are negatively related to financial performance of the company.

The ratios used to establish a model:

$$Y = 4.7722 \times 10^{-17} + 1.666 \times 10^{-8} x_1 - 1.088 \times 10^{-9} x_2 - 5.228 \times 10^{-9} x_3 - 5.611 \times 10^{-10} x_4$$

**Company 2**

The regression results for Company 2 yielded the following outcome

$$Y = 9.728 \times 10^{-18} + 2.873 \times 10^{-9} x_1 + 6.548 \times 10^{-10} x_2 - 1.386 \times 10^{-8} x_2 - 1.077 \times 10^{-10} x_4$$

The coefficients for the model are $9.728 \times 10^{-18}$ for intercept, $2.873 \times 10^{-9}$ for profitability, $6.548 \times 10^{-10}$ for liquidity, $-1.386 \times 10^{-8}$ for leverage, $-1.077 \times 10^{-10}$ for activity. The t-statistics for profitability and liquidity are more than the level of significance showing that they are important for the model. The correlation results show that profitability and liquidity ratios are positively related to performance while leverage and activity ratios are negatively related to performance.

The ratios used to establish a model:

$$Y = 9.728 \times 10^{-18} + 2.873 \times 10^{-9} x_1 + 6.548 \times 10^{-10} x_2 - 1.386 \times 10^{-8} x_2 - 1.077 \times 10^{-10} x_4$$
Company 3

The regression results for company 3 yielded the following outcome

\[ Y=5.145E-18+2.493E-08x1-5.469E-10x2-1.493E-09x3+1.324E-10x4 \]

The coefficients for the model are 5.145E-18 for intercept, 2.493E-8 for profitability,-5.469E-10 for liquidity,-1.493E-09 for leverage, 1.324E-10 for activity. The t-statistics for profitability and activity are more than the level of significance showing that they are important for the model. The correlation results show that the profitability and activity ratios are positively correlated while the liquidity and the leverage are negatively correlated to performance.

The ratios used to establish a model;
\[ Y=5.145E-18+2.493E-08x1-5.469E-10x2-1.493E-09x3+1.324E-10x4 \]

Company 4

The regression results for company 4 yielded the following outcome

\[ Y=1.698E-18+5.867E-10x-7.812E-10x2-1.867E-09x3+1.620E-09x4 \]

1.698E-18 for intercept, 5.867E-10 for profitability,-7.812E-10 for liquidity,-1.867E-09 for leverage and 1.620E-09 for activity the t-statistic for profitability and activity are above the level of significance and are implying they are important in the model while that of liquidity and leverage are below the level of significance implying that they are not significant in the model. The correlation tests show that profitability and activity are positively correlated to performance while liquidity and leverage are negatively related to performance.

The ratios used to establish a model;
The regression results for company 5 yielded the following outcome

\[ Y = 1.698 \times 10^{-18} + 5.867 \times 10^{-10}x - 7.812 \times 10^{-10}x^2 - 1.867 \times 10^{-9}x^3 + 1.620 \times 10^{-9}x^4 \]

**Company 5**

9.192E-18 for the intercept, 1.206E-09 for profitability, -2.024E-09 for liquidity, 1.705E-09 for leverage, 4.752E-09 for activity. The liquidity ratio has a t-statistic which is below the level of significance indicating that it is not important in the model. The correlation tests indicate that profitability, leverage and activity have a positive correlation to performance while liquidity has a negative correlation to financial performance.

The ratios used to establish a model;

\[ Y = 9.192 \times 10^{-18} + 1.206 \times 10^{-09}x_1 - 2.024 \times 10^{-09}x_2 + 1.705 \times 10^{-09}x_3 + 4.752 \times 10^{-09}x_4 \]

**Company 6**

The regression results for company 6 yielded the following outcome

\[ Y = 3.950 \times 10^{-18} + 1.365 \times 10^{-09}x_1 + 1.482 \times 10^{-10}x_2 - 6.879 \times 10^{-09}x_3 + 1.765 \times 10^{-10}x_4 \]

The profitability, liquidity, leverage and activity ratio fell in the acceptance region showing that we reject the null hypothesis and accept the alternative hypothesis. The performance fell in the rejection region showing that we accept the null hypothesis and reject the alternative hypothesis. The correlation results indicate that all ratios except leverage ratio are positively related to performance. The results are confirmed by the Z test yielded more than 1.96 for profitability liquidity and activity.
The ratios used to establish a model

\[ Y = 3.950 \times 10^{-18} + 1.365 \times 10^{-9}x_1 + 1.482 \times 10^{-10}x_2 - 6.879 \times 10^{-9}x_3 + 1.765 \times 10^{-10}x_4 \]

The performance ratios for each group were calculated and the formula used for arriving at the overall financial performance was.

**4.4 Interpretation of findings**

Test of significance of performance for both pre and post privatization performance were done using MS excel Z test statistic on 2 sample means for each of the periods. The analysis of the profitability ratios for the six companies studied showed that privatization did not result into the companies increasing their net return on investment.

The liquidity ratio showed improved performance in the post privatization era with the only exception being company 3 which showed a decline and company 5 where the results were almost the same.

Correlation tests that were done showed that profitability ratios are positively related to performance for all the six companies. Leverage ratios are mostly negatively related to the performance with only one company being an exception. Liquidity and activity ratios were both positively and negatively related to performance for some companies.

The positive relation of profit to performance for all the six companies studied confirms the results of the overall trends in financial performance, where by profits declined with 2 companies being an exception.
The negative relation of leverage to performance for five of the six companies studied confirmed the results of the overall trends of financial performance whereby where leverage improved in 2 companies, overall performance declined and in company where leverage was almost the same overall performance still improved. The only exception was one company where improved leverage ratio was related to improved financial performance.

Hypothesis testing results show that the pre and post privatization performance is significantly different when using the profitability and leverage ratio in four of the six companies studied. The null hypothesis is therefore rejected and the alternative is accepted.

The results further show that when using overall financial performance and activity ratios, pre and post privatization performance is not significantly different and thus the null hypothesis that pre and post financial performance is not significantly different is accepted and the alternative hypothesis that pre and post privatization performance is significantly different is accepted.

4.5 Discussions

The study has established that financial performance of privatized former SOEs listed at the NSE varies when using different financial performance ratios. In addition it has proven that profitability should not be the only criteria used to judge performance of the managers of the privatized SOEs as other criteria can also be used i.e. liquidity, leverage and activity ratios.
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction
This chapter provides the summary of the findings from chapter four, the conclusions and recommendations of the study. The objective of the study was to determine the effect of privatization on the financial performance of firms listed at the NSE.

5.2 Summary
The study had the main objectives of establishing the pre and post privatization performance of former SOEs privatized through the NSE and developing a performance predictive model for these SOEs. Secondary data was used and the data was coded and analyzed using SPSS package. The objectives were achieved by analyzing financial ratios i.e. profitability, leverage, liquidity activity. Regression analysis between performance (y) as the dependent variable and each of the financial ratios was done.

The profitability ratios results showed that all the six companies did not immediately gain from the process but that is not for assumption that the process was not successful. The liquidity ratio results showed that privatization enables some companies to be able to compare their ability to fulfill their short term commitments out of their liquid assets. This was noted in companies in the commercial, finance and industrial sector.

The leverage ratio results indicated that some companies were able to improve their ability to meet their short and long term debt commitments while for one company there was no significant change this was for companies in all the sectors apart from the industrial sector.
The activity ratio for four companies indicated that privatization resulted to the companies being able to improve their efficiency in using their assets to generate sales. The activity ratios therefore showed that privatization results to improved efficiency for the company. Generally all the sectors showed that privatisation can result to improved results and the only exception being the industrial sector.

An analysis of the overall financial performance shows that only two of the six companies studied had better overall financial performance. These companies were in the finance and commercial sector. This means that performance is relative and needs to be viewed in a broader perspective.

A decline in overall financial performance is possible even when the company is improving its ability to meet, utilize its assets to generate sales. Managers of privatized companies should therefore not be judged only by looking at overall financial performance but also at other indicators of performance.

5.3 Conclusion

An analysis of the financial performance ratios indicates that profitability ratio did not immediately increase in post privatization era, meaning that privatization should be viewed as a long term strategy. This applied to all the companies.

The liquidity ratios showed improved performance in the post privatization era, with the only exception being company 2 which showed a decline and company 5 where the results were almost the same. The activity ratios indicated that post privatization performance was much better with the only exception being company 1ad company
2. these companies are in the commercial and finance sector respectively. The other four companies had better performance in pre privatization era.

The leverage ratios showed mixed performance with three companies showing better post privatization performance and company 2 showing minimal significant changes. Company 2 is in the finance sector.

The test for significance on whether pre privatization performance is significantly different from the post privatization era was done sing the Z tests for 2 sample means showed that overall performance was not significantly different in pre and post privatization era in company 2, company 3, company 4, and company 6 while it was significantly different in company 1 and company 5 which are in the commercial and allied sectors.

5.4 Limitation of the study

The study used financial data derived from financial statements of the six companies studied collecting the data proved quite a challenge because it had to be gotten form the Nairobi securities exchange journals which proved quite expensive.

The researcher faced a challenge in determining a sample for the companies to be studied. This was brought about by the limiting time frame of the researchers study which was 5 years prior to and five years after privatization.

The study also faced difficulties in pursuit of drawing firm conclusions regarding privatization and performance of firms listed at the NSE, among them was lack of adequate time, this was because the study applied survey design which is very time consuming because of nature of financial data collected. Therefore capturing all aspects therefore was not possible due to time constraints.
The study used descriptive statistics to value performance and to obtain valid information, however reliability of this method and its validity was in questions because most companies tend to manipulate financial data to show that the company is performing well.

Lastly financial constraints were the other limiting factor for the researcher as the research became quite expensive exercise especially when gathering data.

5.4 Recommendations

The study has shown that overall financial performance in the pre and post privatization era is not significantly different. This should however not put a halt to the privatization process. There is need to look at the valuation of enterprises that are up for privatization. Future earnings flows and the firms gearing ratios are factors that are known to influence the value of IPOs.

Privatization is sometimes seen to have failed in Kenya mainly because it was done in a legal vacuum leaving it to the whims of those in power. The privatization bill limits the participation of privatization to Kenyans by reserving a specific fraction of the total value of the SOEs assets being privatized to Kenyans while the government still maintains a considerable share of the assets even though they are not a controlling majority. This provision has been an avenue whimsical management of the process.
Restriction or participation of privatization to Kenyans is a move that undermines the realization of the objectives of divestiture. An important fact is that governments usually retain significant shares in the privatized firm. The firm will not operate like a private company until the government relinquishes its control.

5.5.1 Policy Recommendations

The policy makers can also look into foreign direct investment through the privatization process for a developing country like Kenya, privatization provides an opportunity to attract foreign direct investment into Kenya sectors of the economy with the hope of making capital gains.

Methods of privatization also need to be reviewed to make the process easier for both the stakeholders and the investors. The most favored method is IPO at the Nairobi securities exchange, this method is preferred as it reduces the differences that arise over the net value of state enterprises.

5.2.2 Suggestion for further research studies

Further studies can be done to determine whether privatization that does not limit foreign participation will result to improve performance or which method of privatization will yield better results.

More research also needs to be done on the financial performance of privatized companies which were not formerly SOEs and are not also listed on the NSE this will be able to show if there are any major differences.
REFERENCES


Nairobi Securities Exchange financial journals.


(www.nse.co.ke).

## APPENDICES

Appendix I: Financial performance ratios

### Table 1: Financial performance ratios - Company 1

<table>
<thead>
<tr>
<th></th>
<th>Profitability</th>
<th>Liquidity</th>
<th>Leverage</th>
<th>Activity</th>
<th>Performance</th>
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Profitability ratio = Net profit/sales

Liquidity ratio = Current assets/Current liabilities

Leverage ratio = Debt /Equity

Activity ratio = Sales /Total assets

Pre- privatisation period – Year 1-5

Post privatisation period – Year 6-10
### Table 2: Financial performance ratio – Company 2

<table>
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<th>Year</th>
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<th>Performance</th>
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Profitability ratio = Net profit/sales

Liquidity ratio = Current assets/Current liabilities

Leverage ratio = Debt /Equity

Activity ratio = Sales /Total assets

Pre-privatisation period – Year 1-5

Post privatisation period – Year 6-10
### Table 3: Financial performance ratios - Company 3

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Profitability ratio = Net profit/sales

Liquidity ratio = Current assets/Current liabilities

Leverage ratio = Debt /Equity

Activity ratio = Sales /Total assets

Pre- privatisation period – Year 1-5

Post privatisation period – Year 6-10
### Table 4: Financial performance ratios - Company 4

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<th>Year</th>
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<th>Performance</th>
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- **Profitability ratio** = Net profit/sales
- **Liquidity ratio** = Current assets/Current liabilities
- **Leverage ratio** = Debt /Equity
- **Activity ratio** = Sales /Total assets

Pre- privatisation period – Year 1-5
Post privatisation period – Year 6-10
### Table 5: Financial performance ratios - Company 5

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Profitability ratio = Net profit/sales

Liquidity ratio = Current assets/Current liabilities

Leverage ratio =Debt /Equity

Activity ratio = Sales /Total assets

Pre- privatisation period – Year 1-5

Post privatisation period – Year 6-10
Table 6: Financial performance ratios - Company 6

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Profitability ratio = Net profit/sales
Liquidity ratio = Current assets/Current liabilities
Leverage ratio = Debt /Equity
Activity ratio = Sales /Total assets
Pre-privatisation period – Year 1-5
Post privatisation period – Year 6-10
### AGRICULTURAL

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