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## **INFLUENCE OF SHARE CAPITAL AND PREFERRED STOCK ON FINANCIAL PERFORMANCE OF BANKS LISTED IN THE NAIROBI SECURITIES EXCHANGE, KENYA**

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## INFLUENCE OF SHARE CAPITAL AND PREFERRED STOCK ON FINANCIAL PERFORMANCE OF BANKS LISTED IN THE NAIROBI SECURITIES EXCHANGE, KENYA

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### Abstract

**Purpose:** The purpose of this paper was to examine the influence of share capital and preferred stock on the financial performance of listed banks in Nairobi Securities Exchange (NSE).

**Methodology:** The study adopted a cross-sectional survey research design. It targeted all the eleven commercial banks listed at the NSE. The research used a datasheet to collect secondary data. This implies that the study entirely used secondary data, which was obtained from the financial records of the targeted banks. The study used census, meaning that all the banks listed in the NSE were included in the study. Data was analyzed using both descriptive and inferential statistics. Pearson's product moment correlation was used to indicate the hypothesized influence of share capital and preferred stock on financial performance. The findings were organized, summarized and presented using tables and charts.

**Results:** Correlation results indicated a strong positive relationship of  $r=0.873$  and  $P=0.000$  between share capital and financial performance, as well as a strong positive relationship at  $r=0.851$  and  $P=0.001$  between preferred stock and financial performance. The study concluded that the banks' financial performance was dependent on their share capital which was used as a source of equity financing. The more a bank injects share capital into its finances, the more likely it will improve its overall financial performance. The study recommended the use of share capital as source of equity financing in commercial banks as it is an efficient source of financing to such institutions.

**Contribution to theory, practice & policy:** The study contributed theory by indicating that the value or performance of firms does not solely depend on internal sources but some combination of both internal and external sources could be necessary. As such banks and their management should look for the best combination and optimal levels of internal and external financing that would steer their firms to success.

**Keywords:** *Share Capital, Preferred Stock, Leverage, Financial Performance of banks*

### INTRODUCTION

Equity capital refers to invested money that, in contrast to debt capital, is not repaid to the investors in the normal course of business. It represents the risk capital staked by the owners through purchase of a company's common stock (ordinary shares). The value of equity capital is computed

by estimating the current market value of everything owned by the company from which the total of all liabilities is subtracted. On the balance sheet of the company, equity capital is listed as stockholders' equity or owners' equity. It is also called equity financing or share capital (Bhanot & Mello, 2006). Preferred stock on the other hand refers to a share ownership in a firm where the owners of stock are given a guaranteed and pre-agreed dividend payout at regular intervals. Preferred stock is a financing option for companies that are ready to raise capital externally. Stock that entitles the holder to a fixed dividend and whose payment takes priority over that of common-stock (Bond, 2012).

In general, the concept of business performance is based upon the idea that an organization is the voluntary association of productive assets, including human, physical, and capital resources, for the purpose of achieving a shared purpose (Baker, 2011). Those providing the assets will only commit them to the organization so long as they are satisfied with the value they receive in exchange, relative to alternative uses of the assets. As a consequence, the essence of performance is the creation of value. So long as the value created by the use of the contributed assets is equal to or greater than the value expected by those contributing the assets, the assets will continue to be made available to the organization and the organization will continue to exist. Therefore, value creation, as defined by the resource provider, is the essential overall performance criteria for any organization. How that value is created is the essence of most empirical research in management (Altman, 2010).

The Nairobi Securities Exchange (NSE) is a leading African Exchange, based in Nairobi Kenya. Founded in 1954, NSE has a six decade heritage in listing equity and debt securities. It offers a world class trading facility for local and international investors looking to gain exposure to Kenya and Africa's economic growth. NSE plays a vital role in the growth of Kenya's economy by encouraging savings and investment, as well as helping local and international companies access cost-effective capital. NSE operates under the jurisdiction of the Capital Markets Authority of Kenya. It is a full member of the World Federation of Exchange, a founder member of the African Securities Exchanges Association (ASEA) and the East African Securities Exchanges Association (EASEA). The NSE is a member of the Association of Futures Market and is a partner exchange in the United Nations-led SSE initiative.

## LITERATURE REVIEW

This study was based on three theories; trade-off theory, pecking order theory and Modigliani and Millan theory. Trade of theory proposes that a companies' optimal capital structure include the tradeoff among the influences of companies and personal taxes, agency costs and bankruptcy costs. The theory is premised on management of firms having to choose between various leverage plans. The pecking order theory by Myers (1984) presupposes an existence of a preferential order in terms of debt, retained earnings, and equity. In this pecking order, firms are said to prefer internal to external financing and debt to equity in case external financing becomes the preferred mode. Donaldson (2001) carried out a study on the relationship between share capital and firm profitability in Canadian consultancy firms where a sample of 235 firms was used. The study revealed that a positive relationship is expected between share capital and firm profitability. The study, therefore, concluded that that investors will prefer to invest in profitable firms. This is

because the more profitable the firm is, the lower the likelihood of default and of having to face financial difficulties and bankruptcy. Therefore, a positive relationship is expected between profitability and share capital (Myers & Rajan, 2008).

According to a study by Qurad, (2010) on how retained earning can improve or slow the financial performance of MFIs, the findings indicated that proper management of retained earning enables firms to sort their liability in time. The study noted the balance between the capital and liabilities is crucial in ensuring that the firm is able to pay it liabilities. As such, firms should employ skilled personnel to monitor and manage the retained earning function of a firm.

Myers and Rajan (2008) carried out an exploratory research to assess the impact of preferred stock on liquidity in German banking sector. The findings revealed that there is a positive relationship when preferred stocks are used to finance the banks. Thus, a negative relationship between preferred stock and liquidity would be expected. A high financial performance may be considered to be a positive signal as preferred stock provides opportunities for its long-term investment decisions. Hence a high liquidity ratio may be considered to be a negative signal for institutional investors.

Myers and Majluf (2004) carried out a study on the impact of asymmetric information on firm's choice for share capital use the study was a descriptive one where 342 agribusiness firms in Canada were sampled, the study found that in the presence of asymmetric information, a firm would prefer share capital over other sources of funds, but would issue debt if internal finance was exhausted, the least attractive alternative for the firm would be to issue new equity, profitable firms are likely to have more retained earnings.

In a study conducted to determine the effect of working capital management on profitability of Indian firms, Sharma and Kumar (2011) used a sample of 263 non-financial firms listed on the Bombay Stock Exchange during 2002 to 2008. Data were analyzed using OLS multiple regression. The study found a positive relation between WCM and firm profitability, although the relationship between cash conversion cycle and ROA was not statistically significant. The study also found that account receivables are also positively related to ROA and that account payables are negatively related to ROA. The results assert that Indian firms can increase profitability by increasing cash collection cycle. This study contradicts other studies (Ogundipe, Idowu & Ogundipe, 2012; Mathuva, 2010). The authors attribute this difference to the fact that India is an emerging market.

Abdul (2012) has examined the relationship between capital structure decisions and the performance of firms in Pakistan. The study concluded that financial leverage has a significant negative relationship with firm performance as measured by return on assets, gross margin, and Tobin's Q. The relationship between financial leverage and firm performance as measured by the return on equity (ROE) was negative but not statistically significant. In another study, Javed and Akhtar (2012) explored the relationship between capital structure and financial performance. They concluded that there is a positive relationship between financial leverage, financial performance, and growth and size of the companies. The study, which focused on the Karachi Stock Exchange in Pakistan, used correlation and regression tests on financial data. The findings of the study are consistent with the trade-off theory which predicts existence of a positive relationship between



leverage and firm performance. Thus this study isolated other financing decisions and focused mainly on financial leverage.

Hovakimian, Opler and Titman (2004) carried out a study to investigate the effect of growth potential of dairy firms to investors in UK where 312 firms were involved, using exploratory research design he found that high growth dairy firms bring more capital gains to institutional investors than lower growth ones, agency problems are likely to be more severe for growing firms, because they are more flexible in their choice of future investments. Therefore, the expected growth rate should be negatively related to long-term leverage. Moreover, firms with high-growth opportunities provide a positive signal about the firm's future performance. As such, institutional investors prefer to invest in high-growth firms rather than lower ones. He concluded that this is because institutional investors, as taxpayers, would prefer to invest in capital-gain stocks to delay tax payments and to avoid double taxation. Thus, a firm's growth opportunities are considered to be a positive signal for institutional investors.

Rajan and Zingales (1995), in their study of firms in G-7 countries, sought to determine whether or not the use of preferred stock in business is a factor in determining its financial performance. In their study, 21 businesses in each category for small and big were used as the sample of the study. The researchers sought to compare the results from the two groups. From the findings, they observed that firms that use preferred stock over common stock are more diversified and, therefore, have higher financial performance.

Miller and Rock (2005) carried out a study to assess the role of corporate reputation in entering equity market by service industries. The study was explorative and involved 231 questionnaires with a response rate of 45%. It was found that firms with a reputation for paying a constant stream of dividends face less asymmetric information when entering the equity market. As such, if dividend payments represent a signal of sound financial health and hence of higher debtissuing capacity, one would expect a positive relationship between dividend payments and leverage. In addition, firms with a reputation for paying a stream of dividends will be monitored by the capital market. Institutional ownership may act as alternative monitoring device, and so this will reduce the need for capital markets as external monitoring system. The study concluded that there is a positive relationship between dividend payments and institutional ownership. However, the existence of institutional ownership mitigates the need for dividends to signal good performance.

Myers and Rajan (2008) carried out an exploratory research to assess the impact of preferred stock on liquidity in German banking sector. Their research revealed that there is a positive relationship when preferred stock are used to finance the banks. Therefore, a negative relationship between preferred stock and liquidity would be expected. Similarly, the effect of preferred stock is an ambiguous signal to institutional investors. A high financial performance may be considered to be a positive signal as preferred stock provide opportunities for its longterm investment decisions. Consequently, a high liquidity ratio may be considered to be a negative signal for institutional investors. However, a high liquidity ratio may be considered to be a positive signal from the firm, because it indicates that the firm can easily pay its obligations and hence faces lower risk of default. This means that high liquidity could be a positive signal for institutional investors.

Prior studies (Abeywardhana, 2016; Frdit 2014) has shown a significant positive relationship between size and leverage for firms in the USA, the UK, and Japan and an insignificant negative relationship for firms in Germany and a positive relationship for firms in France. A study by Dong and Su (2010) concluded that a firm's profitability and retained earnings are affected by working capital management. The study used pooled data for the period between 2006 and 2008 to assess the companies listed in the Vietnam Stock Exchange. The study focused on cash conversion cycle and related elements to measure working capital management. The study found that the relationships among these variables were strongly negative, suggesting that profit is negatively influenced by an increase in cash conversion cycle. The study also found that profitability increases as the debtor's collection period and inventory conversion period reduce.

According to Qurad (2010), in a study on how retained earning can improve or slow the financial performance of MFIs, proper management of retained earning enables firms to sort their liability in time. The study concluded that the balance between the capital and liabilities is crucial in ensuring that the firm is able to pay it liabilities. The research recommends that firms should employ skilled personnel to monitor and manage the retained earning function of a firm.

### **Statement of the Problem**

The financial performance of organizations is very important for the achievement of organizational goals and as a result, organizations in all sectors strive to achieve improved financial performance. The financial performance of commercial banks depends heavily on the net of income generating activities and the related activities' expense (Myers & Rajan, 2008). In the recent past, especially after interest rate capping in 2015 the banks have registered declining performance. For instance, sector valuation has dropped 0.8 times, operational costs have risen and branches closed (AIB Capital 2017). Equity financing is a method of financing in which a company issues shares of its stock and receives money in return. Depending on how a company raises equity capital, it may relinquish anywhere from 25 to 75 percent of the business. Most businesses prefer this method of raising capital in relation to debt financing. Ideally, businesses seek to raise their net worth and as a result, businesses are formed with the aim of achieving improved performance and this can be easily realized when the right sources of funds are used to raise capital (Miller & Rock, 2005).

Many studies (Abdul 2012; Mohsen & Mohammadreza 2012; Kaumbuthu 2011) have focused on performance goals leading to a partial or complete failure as a result of use of the wrong sources of finance. Much of the available and reviewed literature does not touch on the relationship between equity capital and financial performance hence the researcher seeks to fill this gap by conducting study of the relationship between equity capital and financial performance of commercial banks listed in the Nairobi Securities Exchange.

### **MATERIALS AND METHODS**

A cross-sectional survey research design was used for this study. This design enabled the researcher to effectively describe all the subjects of the study. The research targeted banks listed at the NSE. As such, the research relied on existing datasheet to collect the necessary data. This implied that the study entirely used secondary data, which was obtained from the financial records at the NSE. The datasheet covered the share capital, preferred stock, retained earnings and treasury

stock of NSE listed banks. The study used census meaning that all the banks listed in the NSE included in the study. This was informed by the small number of the targeted population. For analysis, the research used correlation analysis which was conducted on the collected information to measure relationship between equity capital and financial performance of all the 11 commercial banks listed in the Nairobi Securities Exchange in Kenya. The findings of the study were presented using tables and charts.

## RESULTS AND DISCUSSION Impact of Share Capital and Preferred Stock on Financial Performance of Banks

The study sought to establish the relationship between equity capital and financial performance of commercial banks listed in the Nairobi Securities Exchange in Kenya. The results were as shown in Table 1 below.

**Table 1: Raw data from NSE listed banks**

Banks in 2015	Millions '000	Millions '000	Millions '000
	Preferred Stock	Share Capital	Profitability
KCB	3	558	2.5
EQUITY	4.3	800	3
COOP	6.5	765	3.25
STAN-CHART	3.7	633	2
CFC	1.3	231	1.5
I&M	1.1	431	2
DIAMOD TRUST	1.7	212	1.5
HAUSING FINANCE	0.9	199	1.25
NBK	5.3	539	3
ABC	3.3	644	3
PRIME BANK	1.3	198	1.25

### Relationship between Share Capital and Financial Performance of Banks

The study further sought to establish the relationship between share capital and financial performance of banks listed at the NSE. The results on this item were as presented in Table 2 below.

**Table 2: Relationship between Share Capital and Financial Performance**

		Share Capital	Financial Performance
Share Capital	Pearson Correlation Sig. (2-tailed)	1	.873** .000
	N	11	11
Financial Performance	Pearson Correlation Sig. (2-tailed)	.873** .000	1
	N	11 -tailed).	11

\*\*. Correlation is significant at the 0.01 level

(2

Correlation results indicated a strong positive relationship at  $r=0.873$  and  $P=0.000$  between share capital and financial performance. From these findings it was evident that there was a strong positive relationship between share capital and financial performance. This finding was in agreement with those of Menkuh and Audar (2010) on share capital impact on financial performance. Menkuh and Audar found that share capital is crucial in stabilizing the financial performance of an organization as it serves as a source of equity financing in case of financial crisis. They recommend that share capital should be traded to the shareholders for cash in order to balance the nominal and premium share capital.

The findings also concurred with those of Donaldson (2001) who carried out a study on the relationship between share capital and past profitability in Canadian consultancy firms using a sample of 235 firms. The study revealed that a positive relationship is expected between share capital and past profitability. The study, therefore, concluded that that investors will prefer to invest in profitable firms. This is because the more profitable the firm is, the lower the likelihood of default and of having to face financial difficulties and bankruptcy. Therefore, a positive relationship is expected between profitability and share capital.

### **Relationship between Preferred Stock and Financial Performance of Banks**

The study also sought to establish the relationship between preferred stock and financial performance. The findings were as summarized in Table 3 below.

**Table 3: Relationship between Preferred Stock and Financial Performance**

		Preferred Stock	Financial Performance
Preferred Stock	Pearson Correlation	1	.851**
	Sig. (2-tailed)		.001
	N	11	11
Financial Performance	Pearson Correlation	.851**	1
	Sig. (2-tailed)	.001	
	N	11 -tailed).	11

\*\*. Correlation is significant at the 0.01 level

(2

Correlation results indicated a strong positive correlation at  $r=0.851$  and  $P=0.001$  between preferred stock and financial performance. These findings suggested that there is a strong positive relationship between preferred stock and financial performance. According to Naukri (2015), in a study on influence of preferred stock on financial performance of firm the findings, lack of effective plan on how to effectively utilize preferred stock over common stock by the organizations indeed does slow down their financial performance.



The findings further agreed with those of Rajan and Zingales (2005) in their study of firms in G7 countries to determine whether the use of preferred stock in business is a factor in determining the financial performance in 21 businesses. They found that firms that use preferred stock over common stock are more diversified and, therefore, have higher financial performance. The study findings similarly reiterate those of Myers and Rajan (2008) who carried out an exploratory research to assess the impact of preferred stock on liquidity in the German banking sector. Their study revealed that there is a positive relationship when preferred stocks are used to finance the banks. As such, a negative relationship between preferred stock and liquidity would be expected. Similarly, the effect of preferred stock is an ambiguous signal to institutional investors. A high financial performance may be considered to be a positive signal as preferred stock provides opportunities for its long-term investment decisions.

### CONCLUSION AND RECOMMENDATIONS

Based on the study findings, it is concluded that banks' financial performance is dependent on the share capital which was used as a source of equity financing. The more the bank inject share capital into their finances the more likely they are to improve their overall financial performance. Preferred stock has an advantage over common stock as they have ability to be redeemed before they mature opposed to the latter, the more the bank invest in preferred stock as their source of funding the more they improve in term of their general financial performance. The study also found that there is a strong positive relationship between preferred stock and financial performance. The study recommended the use of share capital as source of equity financing in commercial banks as it is efficient compared to other source of financing such as credit.

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