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## Effect of Ownership Concentration on Stock Returns of Firms Listed at the Nairobi Securities Exchange

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### Abstract

*Ownership concentration leads to entrenchment by majority owners, makes the company unsafe and unappealing investment, leading to a decline in stock demand and price. There is a dearth of research on ownership concentration and its impact on stock market returns and existing literature reported conflicting outcomes. This study examined the effect of ownership concentration on stock returns of firms listed at the Nairobi Securities Exchange from 2006 to 2019. A census survey was conducted on sixty-seven companies listed at Nairobi Securities Exchange and data was obtained from sixty firms. The study adopted a panel longitudinal research design to analyze the secondary panel data. Fixed effects model was used to conduct regression analysis for the unbalanced panel data. Hypotheses test results found a negative and significant link between ownership concentration and stock returns. The study recommends that listed companies should adopt appropriate levels of ownership concentration and caution corporate managers against high levels of ownership concentration which adversely affect stock returns.*

**Keywords:** *Ownership Concentration, Stock Returns, Fixed Effects Model, Agency Theory*

### Introduction

There is an immense interest among scholars, practitioners, regulators, and investors in how ownership concentration (OC) affects Stock returns (SR). One of the key areas of investigation, mainly in developed economies, has been the question of whether the proportion of shares held by shareholders and their relative power influence stock returns. Ownership concentration is associated with increased monitoring and reduced agency costs as majority shareholders exercise control over the management. Due to active monitoring by majority shareholders, Managers' interests are aligned with shareholders' interest in value creation; leading to better firm performance. Monitoring efficiency creates the alignment effect, which directly affects stock returns (Kamran & Shah, 2014). However, positive performance benefits may not be achieved as majority shareholders use their influence to extract personal benefits, causing prospective investors to view the company as unsafe for investment and negatively impacting on stock demand (Wang

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& Shailer, 2015). Thus, Whereas ownership concentration is largely expected to improve performance in stock markets due to its anticipated role as an internal governance mechanism, the performance benefits are not always realized (Crisóstomo et al., 2020). Instead, literature on the nexus between OC and performance shows that ownership concentration may increase, reduce, or have no effect on performance (Bathula & Singh, 2015). This study examined whether ownership concentration affects the stock returns of firms listed at the Nairobi securities exchange.

Ownership concentration is significant because it allows the majority owners control over a company's key decisions through monitoring managerial actions and interests. The constant and consistent monitoring by majority owners aligns the interests of managers with those of stockholders as managers pursue wealth maximization, leading to improved stock performance. According to Malietso (2017) ownership concentration improves monitoring and eliminates predatory firms who would wish to take over the operations of the firm through hostile takeover, leading to better performance. Nevertheless, majority owners in concentrated firms may use their voting power to entrench themselves, derive personal benefits and deny the minority owners the right to receive dividends. Entrenchment by majority owners leads to a rise in information asymmetries and a high affinity towards debt capital as concentrated owners seek to maintain their proportionate share in the firm; leading to the firm being classified as a risky investment by prospective investors and hence volatility in stock returns (Wang & Shailer, 2015).

In previous studies, the percentage share held by five large shareholders and proportion of stock held by the major shareholder have been used as indicators of ownership concentration (Sousa and Galdi, 2016; Madhani, 2016; Alzeaiden & AL-Rawash, 2014 and Narang, 2018). Furthermore, scholars applied the Herfindahl-Hirschman Index (HHI) which estimates the equity stake of the principal shareholder. Herfindahl-Hirschman Index measures concentration for the whole corporation but does not meritoriously explain the qualified control of an individual stockholder; making it inappropriate for examining the link on majority-minority stockholders conflict. Ownership concentration was operationalized through the percentage of shares owned by five largest shareholders in order to widen the Scope of concentration.

Stock returns are significant because stock price movement is closely tied to changes in macroeconomic conditions. This is due to the fact that stock markets contain important information about the macroeconomic environment, and knowing the factors that drive stock returns is critical in making company

decisions for improved performance by capturing the conflict among shareholders. Various indicators have been used to measure stock market returns. Hatem (2017) estimated stock returns as Return on assets (ROA) calculated as profit divided by total assets and return on Equity (ROE) calculated as net profit divided by equity. In this study, the stock return was operationalized by taking the difference between the closing and opening market price per share plus dividends paid in the year divided by opening market price of the stock. This metric is significant because it calculates the gain from the price movement as well as the current dividend paid by the company, yielding the total return on the shares.

The Nairobi Securities Exchange 20-Share index, which is commonly used to calculate stock returns, has seen price and trade volume swings. The stock market performance in Kenya declined significantly during the 2019–20 fiscal year, which may have been caused by the market effects of Covid–19. Market capitalization, bonds turnover and the NSE 20 Share Index, all decreased by 7.63%, 4.66% and 26.25%, correspondingly. Nevertheless, there was a rise of 8.43% in equity turnover and a 0.14% rise in share volume that could be attributed to the massive panic trading that followed the announcement of corona virus disease in 2019 (CMA, 2020). Globally, the MSCI World Index reported a 24% market gain in 2019, the strongest since the global financial crisis in 2008, mainly due to rapid technological innovations among US technology giants and a strong recovery of Eurozone and Asian stocks. The FTSE 100, a measure of the performance of British blue-chip stocks, increased by 12% to close at 7542 points in 2019 compared to 6,728 in 2018 (Brătian, Mihaiu, & Şerban, 2022).

### **Research Problem**

Designing and implementing regulations, policies, and tactics that improve stock returns is a vital function for corporate boards, investors, and regulatory authorities. This may be achieved through appropriate levels of ownership concentration where the controlling shareholder takes control of the strategic decisions, exercise management monitoring and aligns stakeholders and management interests (Crisostomo et al., 2015). However, concentrated firms experience expropriation resources by majority owners, information asymmetries and insider trading, resulting to volatility in stock prices (Demsetz & Lehn, 1985).

The stock return at the Nairobi Securities Exchange has witnessed significant price volatility despite the increase in ownership concentration. The stock market performance in Kenya declined significantly during the 2019–20 fiscal year, which may have been caused by the market effects of Covid–19. In the period

between 2008 to 2014 the Nairobi Securities exchange all share index (NSEASI) reported positive total returns when no dividends were reinvested in the index and remained positive when dividends were reinvested in the index. However, between January to December 2015, the NSEASI reported negative total returns that were attributed to the declining value of the Kenyan shilling against the dollar and rising interest rates both locally and internationally (Economic survey, 2015).

Empirical studies on the association between OC and stock returns report conflicting findings. Panda (2022), Clark & Wojcik (2005) reported a negative impact; Shumali & Abuamsha (2022), Zou & Adam (2008) and Hegde et al. (2020) observed a positive nexus while Warrad et al. (2013) and Elghouty (2017) found no association. Panda (2022) contend that Ownership concentration negatively impacted stock returns in the pre-financial crisis phase, while there was no effect in the post-financial crisis period. Panda (2022) Opined stockholding through institutions had no effect on stock market returns since profitability and firm age enhanced stock returns before the financial crisis. Alzeaiden & AL-Rawash (2014) pointed to a positive nexus between the five largest shareholders and stock price volatility when seemingly unrelated regressions (SUR) was used while no relationship was reported when Ordinary least square regression (OLS) was used.

Cross-sectional regressions have been used in empirical studies on the link between OC and stock returns. Nonetheless, Cross-sectional models are unable to take unobserved heterogeneity into account and the results may be biased due to variable misspecification, creating a methodological gap. The panel regression with fixed effects method was used in the present work to try to close the gap. Due to causal linkages, panel regression analysis enables better control of endogeneity (Cheng, 2007). Additionally, because panel data uses both time series and cross-sectional data, it is more effective, has less multicollinearity, and has more latitude and flexibility (Njuguna et al, 2022). There is a dearth of studies on the nexus between OC and stock returns. Besides, majority of studies were conducted in advanced economies with divergent cultural and economic factors from the local context. Therefore, the question is: what is the effect of ownership concentration on stock returns.

### **Research Objective**

Determine the effect of ownership concentration on stock returns of firms listed at the Nairobi Securities Exchange

## **Literature Review**

### **Theoretical Review**

The agency theory propagated by Ross and Mitnick (1973) anchors the relationship between ownership concentration and stock performance. According to Ross and Mitnick (1973), conflict of interest is unavoidable in any company with more than one stakeholder. Theoretically, a conflict of interest arises where there is a divergence of interest between the principal and the agent (Bosse & Phillips, 2016). According to Jensen and Meckling (1976), the principals who are the owners incur losses to the agency due to a lack of direct control of their firm. The shareholders hire managers to maximize their wealth; however, managers engage in self-serving behaviors through huge allowances and engaging in projects that do not provide the expected returns, leading to principal agent conflict. The agency theory highlights the significance of professionally handling the principal agency conflict to avoid its adverse effects on performance. The Principal often develops strategies, regulations, and policies aimed at minimizing conflicts between them and agents. The agency theory contends that through concentrated ownership majority shareholders can align management's interests with their interests to promote better performance (Romdhane, 2016). Furthermore, Agency theory recommends performance based contracts and disciplinary measures against errant managers to ensure they stick to the core objective of maximizing shareholders wealth (Jensen & Mechling, 1976). Shliefer (1986) contends that Ownership concentration helps in monitoring management actions leading to a reduction in agency costs. As a result, the agents make investment decisions that are likely to maximize the wealth of stockholders through increased returns (Jensen and Mecklin, 1976).

### **Empirical Review**

Contradictory findings have been reported among studies on the association between concentrated ownership and stock returns. Panda (2022) and Clark & Wojcik (2005) reported a negative link whereas others reported a positive association (Shumali and Abuamsha 2022; Alzeaideen and AL-Rawash, 2014).

Panda (2022) applied the Generalized Method of Moments (GMM) to examine the nexus between OC and stock returns among Indian firms. Pre (2000-2008 and post (2009-2016) financial crisis periods were considered with the year 2008 as the base. Ownership concentration negatively impacted stock returns in the pre-financial crisis phase, while there was no effect in the post-financial crisis period. This outcome was achieved despite the control for dividend payout, leverage, age, liquidity, size and risk. Similarly, Clark and

Wojcik (2005) found a negative relationship after controlling for size. This could be attributed to huge Funding requirements for large corporations, something that cannot be achieved, except through increase of the capital base (Demsetz, 1985). The study by Clark and Wojcik (2005) was done among firms at the Frankfurt securities exchange in German from 1997-2001. Germany is a developed economy and the findings cannot be inferred in Kenya which is an emerging economy, hence creating a contextual gap. The study by Panda (2022) used GMM which suffers from difficulties of weak and several instruments that may lead to biased estimates, hence creating a methodological gap.

Shumali and Abuamsha (2022) used OLS method to investigate the nexus between OC and stock returns of Palestinian-listed firms from 2016-2020. Foreign shareholding, management holding, large ownership and stock returns had a positive relationship. Zou & Adam (2008) confirmed a positive link between large block holders and stock returns among Chinese firms. However, these studies used OLS regression analysis which does not take care of fixed effects and may lead to distorted results. Also, the study by Zou and Adam (2008) was done in china which is an advanced economy with different cultural and economic factors from the local context, leading to a contextual gap.

Using seemingly unrelated regressions (SUR) and OLS on 51 listed Jordan firms from 2005-2009, Alzeaideen & AL-Rawash (2014) examined the effect of OC on share price volatility. The outcomes pointed to a positive nexus between the five largest shareholders and stock price volatility when SUR was used while no relationship was reported when OLS was used. The different results could be due to the fact OLS does not take care of fixed effect, hence the need to use a more robust model in this relationship. This study applied panel regression with fixed effects analysis to fill the methodological gap.

Elghouty (2017) investigated the impact of ownership structure on firm stock returns on the Egyptian stock exchange from 2005-2011.using a panel model, the research found no nexus between OC and stock returns. Panda (2022) Opined stockholding through institutions had no effect on stock market returns since profitability and firm age enhanced stock returns before the financial crisis. However, the study took a sample of 85 out of 213 firms that were listed, this could have brought selection bias between small, medium and large firms and thus the results could not be attributed to all companies. Also, the study was conducted at the heart of the global financial crisis, during the crisis there is increased volatility in stock returns, hence the need to extend the study to cover pre and post-financial crisis as envisaged in this study.

In Kenya, Ongore (2008) used Cross-sectional models to find a significant negative nexus between ownership concentration, board effectiveness, government ownership and firm performance of NSE-listed firms in 2006. However, Cross-sectional models are unable to take unobserved heterogeneity into account and the results may be biased due to variable misspecification, creating a methodological gap. The panel regression with fixed effects method was used in the present work to try to close the gap. Due to causal linkages, panel regression analysis enables better control of endogeneity (Cheng, 2007). Additionally, because panel data uses both time series and cross-sectional data, it is more effective, has less multicollinearity, and has more latitude and flexibility (Njuguna et.al, 2022).

### Conceptual Framework

This study sought to determine the effect Ownership concentration on stock returns. High ownership concentration enhances monitoring by majority shareholders, Managers' interests are aligned with shareholders' interest in value creation; leading to better firm performance. Ownership concentration is calculated by taking number of shares owned by five largest shareholders divided by the number of outstanding shares. Stock return is the response calculated as the difference between opening and closing market price of a share plus any dividends paid during the year divided by the opening market price of the share.

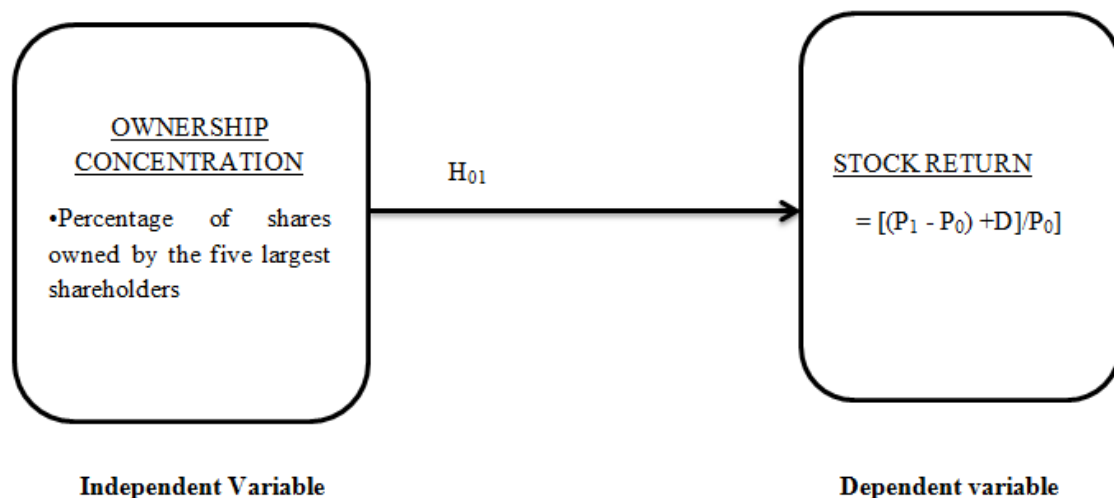


Figure 2.1 Conceptual Framework



## Research Hypothesis

H<sub>01</sub>: There is no relationship between ownership concentration and stock returns

## Methodology

The study targeted the entire population of firms that were listed at the NSE. According to NSE (2019), there were 67 listed firms as at 31 December 2019. However, after cleaning and sorting, 60 firms had the complete information that was needed for analysis. The firms that were excluded from the study were either suspended, had incomplete data, or had been delisted. Secondary panel data was used for the period 2006 to 2019. The data was collected from companies' financial statements, NSE database and licensed data vendors. The predictor variable, ownership concentration, was operationalized through proportion of shares held by five largest shareholders. The response variable, stock returns, was operationalized through change in share price during the year plus dividends paid divided by the opening market price of the share.

This study adopted a panel longitudinal design; the design was selected as the most appropriate since it permits the scholar to collect data and match diverse populations over time. This design was used to enable the researcher to make an empirical inquiry into the subject matter without control of variables as their manifestation has already occurred and cannot be manipulated (Bryman & Bell, 2015). Descriptive statistics were conducted in the form of frequencies, standard deviation percentages, and mean scores. Descriptive statistics were used in this study as they enabled the researcher to provide an expressive explanation of the distribution of scores using a few indices (Bogdan & Devault, 2015). Further, inferential data analysis such as Pearson's correlation analysis and panel regression analysis were adopted to test the statistical effect among variables. The analyzed statistics were represented in form of tables and figures. To confirm the statistical assumptions of the panel regression model, diagnostic tests such as Multicollinearity, Linearity, Heteroskedasticity, Model Specification, Stationarity, and Autocorrelation Test were done. The statistical effect of OC on stock returns was evaluated using a fixed effect model.

$$SR_{it} = \beta_0 + \beta_1 OC_{it} + \varepsilon_{it} \dots\dots\dots (1)$$

$SR_{it}$  = Stock Returns;  $OC_{it}$  = Ownership concentration;  $\beta_0$  = is the constant;  $\beta_1$  = coefficients of variables ;  $\varepsilon_{it}$  = the error term

## Findings and Results Discussions

### *Descriptive statistics*

The statistical summaries of the explanatory variable and the response variable are included in Table 4.1.

**Table 1: Panel Variables Summary Statistics**

Variable	Obs	Mean	Std. Dev.	Min	Max
Stock returns	719	.243	.44	-4.86	2.55
Ownership concentration	719	.66	.169	.11	.97

From the output in table 1 above, stock return had an average return of 24.3% with a variation of 44% implying a high variability of individual firm returns from the mean. The findings correspond to lowest stock returns of -4.86 times and highest stock returns of 2.55 times. This implied while some firms had negative stock returns due to a fall in stock prices and dilution of dividends, others recorded as high as 255% in stock returns.

The predictor variable, ownership concentration was at 66% with a variation of 16.9%, implying that there was a low variability of individual firm's OC. The findings meant that majority stake among listed firms is controlled by the five largest stockholders. However, the minimum and maximum levels of ownership concentration had a wide spread of 11% and 97% respectively. This implied that while some companies were less concentrated, others were highly concentrated.

The results of Pearson correlation analysis showed a negative correlation between OC and the stock returns while results from Diagnostic test reported a violation of the assumption of normally distributed data. The data was transformed using natural logarithms to treat the non-normality. Moreover, the model specification tests revealed the fixed effect model as the most appropriate model to examine the correlation between the variables.

### **Regression of Ownership Concentration and Stock Returns**

The objective was to determine the effect of ownership concentration on Stock returns. The statistical effect was evaluated using a fixed effect model shown in table 2 below.

**Table 2: Ownership Concentration and Stock Returns**

Stock returns	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Ownership concentration	-.107	.048	-2.23	.026	-.201	-.013	**
Constant	1.601	.023	70.00	0	1.556	1.646	***
Mean dependent var	1.650		SD dependent var		0.158		
Overall-r <sup>2</sup>	0.0019		Number of obs		719		
F-test	4.957		Prob > F		0.000		
R <sup>2</sup> – within	0.0075		R <sup>2</sup> -between		0.0027		
Adjusted -r <sup>2</sup>	0.083						

\*\*\* p<.01, \*\* p<.05, \* p<.1

The outcome of panel least square regression shown in Table 4.2 above reported a negative nexus between ownership concentration and stock returns ( $\beta_1 = -.107$ ,  $P < 0.05$ ). Signifying that 1% surge in ownership concentration results to a 10.7% decline in stock returns. The overall model was statistically significant at a 99% confidence level (P-value <0.05). The Adjusted- R squared of 0.083 implied that ownership concentration accounted for 8.3% of the changes in stock returns. The finding of an inverse relationship implies that ownership concentration could have adverse entrenchment effects as majority stockholder extract private rents to the detriment of minority shareholders. The lack of protection for minority shareholders may make investors divest from highly concentrated firms or consider such firms as high risk. Before investing in a company's stock, potential investors consider factors such as the level of ownership concentration. Concentrated corporations are associated with more information asymmetry, and the companies are negatively rewarded. The results were consistent with the findings of Clark and Wojcik (2005) and Panda (2022) who established a statistically negative association between OC and stock returns. However, the results contradicted studies that reported a positive correlation between ownership concentration and stock performance (Shumali and Abuamsha, 2022; Alzeaiden and AL-Rawash, 2014).

### Conclusions and Recommendations

The hypothesis test results provided proof of a statistically negative effect of ownership concentration on stock returns. The inverse relationship indicates that stock returns are adversely affected by the levels of OC in the ownership structure which signifies exposure to idiosyncratic risk due to the risk aversion behaviour

of large shareholders with concentrated ownership. Since large shareholders have less diversified portfolios, they tend to advocate for less risky investments that may not have high returns for all shareholders. Thus, adverse information on high levels of ownership concentration may send negative signals among minority shareholders necessitating the disposal of their stocks and a drop in the market price of stocks, hence adversely affects the stock returns.

The study recommends the need for companies to design appropriate policy frameworks that embrace the use of appropriate levels of ownership concentration to reduce its negative impact on stock returns. Suitable policies help to avoid the concentration of ownership in a few shareholders who may serve their interests at the expense of minority shareholders as well as promote good governance that enhances the performance of companies and hence increased stock returns. Appropriate degrees of ownership concentration serve as an effective way of eliminating agency conflicts and so improving stock returns. Therefore, companies must seek to balance between the levels of ownership concentration to avoid concentration of ownership in a few shareholders who may serve their interests at the expense of minority shareholders. Effective control of ownership concentration levels through policy decisions helps promote an ideal internal governance mechanism that enhances the performance of companies and hence increased stock returns.

Although restraint was taken to ensure that the limitations did not adversely affect the outcomes, the following need to be considered. First, the study assumed that the response and predictor variables are linearly related but failed to take into account that other associations, like curve linear relationships could affect the nature of this relationship. Secondly, the research relied on secondary data from the NSE database as well as audited published reports from companies. These general-purpose reports are used to track the general soundness and financial health of businesses across a range of industries. As a result, any limitation that is observed and reported within could affect the reliability and validity of the results. To address this limitations the study utilized unbalanced panel data and panel regression analysis models with fixed effects robust for standard errors.

Future research can explore whether there is a nexus between ownership concentration and performance using performance indicators other than stock returns, such as ROE, ROA and Tobin's Q. A similar study could be undertaken in other developing and industrialized countries. Given the variances in cultural, economic and regulatory dynamics among nations, identifying the nature of interaction would be intriguing.

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