THE EFFECT OF FINANCIAL INFORMATION ON SHARE PRICES:
A CASE STUDY OF THE NAIROBI STOCK EXCHANGE

A PROJECT
PRESENTED TO THE
GRADUATE FACULTY OF THE SCHOOL OF
BUSINESS AND MANAGEMENT
UNITED STATES INTERNATIONAL UNIVERSITY – AFRICA

IN PARTIAL FULFILMENT
OF THE REQUIREMENT FOR THE DEGREE OF
MASTERS IN BUSINESS ADMINISTRATION (MBA)

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JULY 2000
STUDENT'S DECLARATION

I, the undersigned declare that this is my original work and has not been submitted to any college, Institution or University, other than USIU in Nairobi for academic credit.

Signed: ___________________________ Date: 6th October, 2000

Queenville Owala

This project has been presented for examination with my approval as the appointed supervisor.

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ABSTRACT

International financial markets can develop and thrive, provided that local regulations permit the market and especially if potential users are attracted to it. Political stability and minimal government intervention are prerequisites for becoming and remaining an important international financial center. London is one of the most important financial centers. It has a lightly regulated offshore market in a world of financial rigidities. Its access to information attracts huge capital flows, its pool of financial talent, its well-developed legal system, and its telecommunications links have greatly contributed to its growth. Other emerging markets attempt to create similar operating environments.

The environment of capital markets in Kenya has been greatly affected by diverse economic and political factors. Market efficiency is important to business firms and investors since efficiency implies that the market performs its function in a less discriminatory manner. An efficient market will therefore reflect all information on its share prices.

The purpose of the study is to show the changes in share prices as a result of a Company’s financial information.

Analytical procedure was used in analysing eight companies listed in the Nairobi Stock Exchange. Random sampling was used in selecting two companies from each of the four sectors namely: Agricultural, Commercial and Services, Finance and Investments, Industrial and Allied.
The financial statements and share prices were sourced from the Nairobi Stock Exchange library.
DEDICATION

To my parents, who have faithfully supported and encouraged me.
ACKNOWLEDGEMENT

In carrying out this study, I received a lot of assistance from various people. I take this opportunity to sincerely thank them for their unrelenting support.

To my lecturer and research supervisor, Mr. Kiongo Maina, who continually gave me useful insights for my study. To Susan Kabue of the Nairobi Stock Exchange who faithfully provided me with the needed information for my study.
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Chapter 1: INTRODUCTION

1.1: An Overview of the Kenyan Economy

In the 1990’s, Kenya pursued both economic and political reforms simultaneously. Multi-party democracy was introduced in 1991. The most extensive economic reforms have been effected since early 1993. The main reforms include liberalization of interest rates, price decontrol, relaxation of import restrictions, privatizations, civil service retrenchment and floatation of the shilling including the repeal of the Exchange Control Act.

In 1994 economic recovery started and the economy went through a stable growth phase in the first half of 1995. The second half of 1995 witnessed a difficult path with the manufacturing and tourism sectors notfairing well while major export commodities prices declined. In 1995, the development of the economy fell a little short of expectation. During the year, Kenya saw some new private and foreign investment. Competition for new foreign investment is a worldwide phenomena and is consequently competed for very keenly. The Kenyan economy appears to be less competitive than some other countries who seem able to offer higher incentives and where more generous investment returns can be realised by the investor. In 1996, the economy experienced a resurgence of inflation. This rose swiftly from 1.6% at the end of 1995 to 9.0% by the end of December, 1996.

1997 started with a severe drought in the first quarter. The biggest blow to the economy was the suspension of 205 million dollars enhanced structural adjustment facility by the
IMF. This caused the Kenya shilling to depreciate by about 30% to around shillings 72. The tourism sector was affected by the violence that erupted in the coast province. Being an election year there was a tendency by investors to withhold their investment decisions pending the outcome of the elections.

In 1998, the Kenyan economic environment was a reflection of the declining trend in other global economies. The year had started on a promising note as the Government hoped to re-negotiate balance of payments support with the IMF. The World Bank had also taken the lead in raising funds to assist in the reconstruction of vital infrastructure which was destroyed in 1997 and early 1998 by the El Nino rains. Even though they had a negative impact on infrastructure, the El Nino rains improved agricultural production particularly tea output. In most of the year, there was a slump in manufacturing production and depressed investment. There was a fall in the world prices of tea, coffee and horticultural products. The scenario was further aggravated by the August 7, bomb blast in Nairobi and labour unrest in the banking and education sectors. This led to a sharp decline in the economic growth rate. A general decline in corporate profits reduced demand for shares. Also the carry-over effects of the uncertainties of the 1997 elections and the withdrawal of IMF balance of payments support significantly affected investor confidence. The banking industry witnessed a rapidly changing operating environment, characterized by stiff competition, changing customer needs, technological innovations, tight liquidity and higher financial risks. The Banks’ operations were interrupted on two occasions during the year by general strikes in February and August when unionisable staff opted for industrial action against the introduction of the Fringe Benefit Tax.
The economic decline experienced in 1998 was a continuation of the recession, which had started three years previously. The decline was worsened by weakened infrastructure, low private sector confidence, dampened growth prospects, minimal donor funding and labour unrest. The Agricultural sector grew by a mere 1% as compared to 1.2% the previous year. This was attributed to lack of credit, rising input costs, and constraints in management and marketing. Good rainfall and favourable prices led to an increase in tea production. Coffee and horticultural exports were down. Tourism earnings fell by 25% due to continuing insecurity and poor infrastructure.

1.2: An Overview of Financial Statement Analysis:

Financial statement analysis is the foundation of information efficiency of stock markets all over the world. Efficient markets are said to be those that instantaneously and without bias incorporate new information into the security prices.

Public companies are by law required to release financial statements to their shareholders and other stakeholders. The statements contain information on their past performance and future projections. One area of concern is whether such projections or forecasts are attained in the subsequent years.

1.3: Profile of the Nairobi Stock Exchange

Since its inception in 1954, the Nairobi stock Exchange has had a big impact on Kenya's
financial system. The development of the NSE is hereby outlined indicating the different periods since its inception.

- **1.3.1: The Early Years (1920s to 1954)**

According to the NSE Annual report of 1997, dealing in stocks and shares started in the 1920s when Kenya was still a British colony. It was an informal market and trading took place on gentlemen’s agreement in which standard commissions were charged with clients being obliged to honour their contractual commitments of making good delivery and setting relevant costs.

At this time stockbroking was a sideline business conducted by accountants, estate agents and lawyers who met to exchange prices over a cup of coffee.

In 1954 the NSE was constituted as a voluntary association of stockbrokers under the societies Act. This was made possible due to clearance from the London Stock Market, which recognized the NSE as an overseas Exchange. This gave the NSE more credibility. Trading at this time was restricted to Europeans only. This explains why it was later on difficult to convince locals, who had been formally banned from participation, that the institution was a vital vehicle for handing over power from foreign to local control. The NSE had 45 ordinary shares, 28 preferential and 12 municipal and government stock. There was presence of dual listing of some companies, e.g. Kakuzi due to its 'international' nature.
1.3.2: Independence period (1960 – 1971)

At the onset of independence in 1961-62, confidence in the NSE fell due to uncertainty in independent Kenya's future.

At independence the government removed restrictive regulations and there was increased pressure for the Africanization of the NSE. In 1964, Francis Thuo became the first African chairman of the NSE. After 3 years of calm and economic growth, confidence in the market was rekindled. The National Social Security Fund (NSSF) became a major investor in the NSE, paving way for other investors. The government encouraged the financial system to provide credit lines for those wishing to purchase shares in both the primary and secondary markets - thus there was over-subscription of share issues and solid performance by Kenyans.

By 1971, companies listed in the NSE were 67, the highest number recorded to date.

1.3.3: The Depression and Boom period (1972 – 1979)

The year 1973 saw the oil crisis of the Middle East being felt by the Kenyan economy and subsequently, the NSE. Increased oil prices led to increased borrowing by the government to facilitate purchase of oil, but these costs were untransferable through commodity prices due to price controls. This led to inflationary pressures that helped depress prices in the stock market.
In 1975, the capital gains tax was introduced at 35%. This further aggravated the already gloomy scenario, with individual and corporate investors holding to their shares thus affecting liquidity, this led to a loss of the market’s regional characteristic. It was also aggravated by nationalization, exchange controls (meant to check on capital flight) and other inter-territorial restrictions introduced in neighbouring countries. For example, when the East African Community collapsed in 1977, Uganda compulsorily acquired companies quoted or subsidiaries of companies listed in the NSE.

The coffee boom of 1977 due to a drop in production of coffee by competitors, Brazil and Guatemala, replenished exchange market reserves leading to economic rejuvenation, higher demand for securities and higher prices in the market.

This boom had the direct effect of increasing local awareness and saw the establishment of various indigenous financial service institutions. Initially, there only existed Insurance Company of East Africa (ICEA).

- **1.3.4: Stagnation Period (1980 – 1985)**

This was a rather stagnant period in terms of market activity because of the abortive coup de taut in 1982 and the drought of 1984, which brought about uncertainties about the economy and therefore depressed the market. There was growth of parastatals due to pressure for individual ownership; the government invested on behalf of the local people, for example, in the National Cereals and Produce Board.
Fixed interest rates during this period reduced demands for capital through securities by private companies.

This period also marked the entry of some companies in the NSE; Bamburi Portland (1980), Kenol (1982), Diamond Trust (1983) and Jubilee Insurance Company (1984). It also marked the exit of other companies due to mergers, takeovers or company acquisitions. During this period the government suspended the Capital Gains Tax and this resulted in new interest in the market.

- **1.3.5: The Reform Implementation Period (1986 – 1991)**

In 1986 the government begun to implement the 1984 International Finance Corporation (IFC)/ World Bank study findings on development of capital markets in Kenya. This was a blue print for structural reforms in the financial market.

The reforms were aimed at fostering sustainable economic development within an efficient and stable financial system. In particular to:

1) Enhance the role of the private sector in the economy;

2) Reduce the demands of public enterprises on the exchequer; and

3) Rationalize operations of the public sector or to broaden the base of ownership and enhance capital market development. The IFC/WB study findings culminated with the formation of regulatory body Capital Markets Authority, in 1989 to assist in creating a
conducive environment for growth and development of Kenya's capital market.

In 1991, the NSE was registered as a limited liability company under the companies act. Call over system was replaced by open outcry system.

- **1.3.6: Market liberalization (1992 - 1998)**

This period has seen a lot of achievement and has been marked by increased privatization, foreign investment and expansion of trading instruments.

1995 saw relaxation by the government of exchange controls. This encouraged foreign investors to participate in locally controlled quoted companies to an aggregate corporate and individual limit of 20% and 25% respectively. These were doubled to 40% and 50% respectively, in the June 1995 budget, to further encourage foreign investment. A series of other incentives were also introduced to encourage investment in the NSE. These include the lowering of commission rates from 2.5% to between 2% and 1% on a sliding scale for equities, and 0.05% for all fixed interest securities for every shilling.

In January 1996, the government allowed CMA to levy charges on Public share issues, bonuses, rights issues and Public placemements by public companies so as to become self sufficient financially thus, reducing reliance on the Treasury.

The 1996/97 budget read in June 1996 saw the introduction of the regulatory reforms. In
November of the same year bonds were introduced into the market.

December 1996 saw the launch of the 8th National Development Plan 1997-2001, with the theme "Rapid Industrialization for Sustained development". This focused on the shift from government involvement in the economy to government facilitation of the private sector to achieve economic growth.

In January 1997, the government listed Treasury bonds- issue 3/1997 valued at 2.8 billion Kenya shillings.

The first quarter of 1997 also saw a severe draught which resulted in a drop in output. Thus, the government waived VAT on wheat and maize to encourage imports to meet the shortfalls.

A big blow to the economy was in August 1997 with the suspension of the $205 million enhanced structural adjustment facility by the IMF, because of the slow pace of reforms in the infrastructure sector. The shilling therefore depreciated by 30% to approximately 72 Kenya Shillings to a dollar. The government was unable to finance its debt and therefore as a partial remedy it increased taxes and borrowed heavily from the domestic market. Interest rates on Treasury Bills rose drastically in a period of 2 weeks from 18.8% to 23.6%, reaching the peak by the end of September 1997. This drastically reduced demand for securities in the NSE. (The NSE Annual Report, 1997)
Another major impediment on economic growth was the violence that erupted in Coast Province in August 1997. What started as a simple banditry attack erupted into full-scale violence paralyzing activities in the whole of the coastal region. El Nino rains in the last quarter of 1997 destroyed infrastructure and in some areas halted economic activities. This affected volume of agricultural production although international prices of tea and coffee remained strong.

The closing of the year 1997 was marked by the election period. There was therefore a tendency by investors to withhold their investments pending the outcome of the elections.

1.4: Importance of the study:

This study seeks to analyse the effects of financial information release on share prices. It will seek to establish whether the prices of the shares of companies quoted on the Nairobi Stock Exchange are sensitive to financial information. A key area of concern in financial statement analysis is the influence financial information has on share prices and whether the release of such information influences share price movements.

This type of study is of importance to investors, investment or financial analysts and to the management of a company. Investors here include both potential investors and existing shareholders. A rational investor would normally attempt to arrive at an estimation of a company’s future earnings stream in order to attach a value to the securities being considered for purchase or liquidation. The investment analyst would
often seek information on a company’s performance record and seek to know the future expectations. The analyst would want to know the company’s record with regard to growth and stability of earnings and of cash flow from operations. He would attempt to measure the level of risk inherent in the firm’s existing capital structure and the expected returns, given the firm’s current condition and future outlook. The analyst would also want to know how successfully the firm competes in its industry, and how well positioned the company is to hold or improve its competitive position. The investment analyst often uses historical financial statement data to forecast the future. However, for the investor, the ultimate objective is to determine whether or not the objective is sound.

For the management of a company, financial statement analysis relates to all of the questions or issues raised by creditors and investors because these user groups must be satisfied in order for the firm to obtain the needed capital. Management also considers its employees, the general public, regulators, and the financial statement data to determine how well the firm has performed and why. In so doing it seeks to emphasize which operating areas have contributed to the firm’s success and which have not. Secondly it seeks to know the strengths and weaknesses of the company’s financial position and thirdly the changes to be implemented in order to improve future performance.

All these stakeholders are concerned about the future performance of the company. Financial statements provide insight into the company’s current status and lead to the development of policies and strategies for the future.
Finally, as a student of finance, I seek a better understanding in the area of financial analysis which is not spoken much of in the Kenyan investment arena. After having received an introductory study in stock market analysis, I seek to apply the various tools and approaches learnt for such analysis thereby developing the necessary or needed skills in financial analysis.

Chapter 2: LITERATURE REVIEW

2.1: Efficient Capital Markets

Capital markets refer to the aspect of financial markets that deal in financial claims
having a maturity longer than one year, usually referred to as long term claims. Such claims include stocks, bonds, and long-term loans. Capital markets provide long term capital for investment.

Capital markets enhance the mobilisation of savings into productive investment not only by providing an outlet for accumulated capital (savings) but also by allocating capital to investments that bring the most value to the economy.

Capital markets are provided by individuals or institutions who have savings or surplus income or who pool savings for investment directly or indirectly in commercial ventures as part owners (shareholders) or lenders (bond holders) of those enterprises. The capital markets provide the venture with long term funding to engage in productive economic activities which cannot be reasonably carried out through short term lending. Companies issue financial instruments or capital market securities for the purpose of raising equity or debt capital and is usually in the form of a share certificate or bond or commercial paper.

The theory of efficient capital markets is the theory of competitive equilibrium applied to asset markets. A capital market is seen to be efficient if it utilises all the available information in setting the prices of assets. Efficiency in this case implies that the price that a firm will obtain when it sells a share of its stock is a fair price in the sense that it reflects the value of that stock given the information that is available about it. Investors should therefore not worry that they are paying too much for a stock with a low dividend or some other characteristic, because the market has already incorporated it into the price.
It is sometimes said that the information has been priced out. The prices of securities are therefore determined by the conditions of equilibrium in competitive markets. Personal financial situations and available information determine the positions individual traders take. The market aggregates and reflects the available information. Therefore knowledge that earnings will rise in future does not necessarily imply that the stock should be bought now: it is only differences in information – this refers to information that is not “fully reflected” in prices – that can form the basis for profitable trading rules. The reverse is therefore true, that information that is universally available cannot provide the basis for profitable trading rules.

2.2: Efficient Market Hypothesis

An efficient market is one where at any one time asset prices fully reflect all available information. It is assumed that market participants act in an intelligent, self-motivated manner and assess and act upon available information about share prices when formulating their buy or sell decisions. As market participants act on this information the price of the share will adjust accordingly until there are no further opportunities for profit.

This is a highly restrictive definition of efficiency since it refers to information efficiency, it does not refer to the economist’s normal sense of efficiency which refers to providing services at least cost in terms of resources employed. For equity investments, the efficient market hypothesis implies that investors can forecast returns. This means that investor’s estimate each company’s profit and dividends for each year stretching into the distant future. Market efficiency becomes a complex joint hypothesis when linked to
equilibrium in financial markets.

Efficient market hypothesis asserts that asset prices reflect fundamental values of the assets.

Efficient market hypothesis has implications for both firms and investors. Since information is reflected in prices immediately, investors should only expect to obtain an equilibrium rate of return. Therefore awareness of information when it is released does an investor no good because the price adjusts before the investor has time to trade on it. It should be noted that efficient market hypothesis merely states that share prices quickly adjust to reflect publicly available information. It does not mean that everyone interprets the information in the same way.

Firms should expect to receive the fair value for securities that they sell. Fair means that the price they receive for the securities they issue is the present value. Thus, valuable financing opportunities that arise from fooling investors are unavailable in efficient capital markets.

Efficient market hypothesis therefore suggests that the information effect would be zero in a market which fully reflected the information.

Virtually all testing of the efficient market hypothesis has been based on testing for pricing efficiency.
2.3: Types of Efficiency

It is generally assumed that markets respond immediately or instantaneously to all available information. However, certain information may affect stock prices more quickly than other information. The response rates are different. The market may respond to three information sets: information on past prices, publicly available information, and all information. These three information sets have different effects on prices.

For a stock market to be efficient, at any time the share price of a company should reflect the value of that company on the basis of its expected future earnings. In an efficient market, the share price at any time will reflect its true value that is, its intrinsic value.

2.3.1: Weak-form efficiency

A capital market is said to satisfy weak-form efficiency if it fully incorporates the information in past stock prices. This is when investor’s decisions are based on information on past prices instead of information on, for example, earnings forecasts, merger announcements or money supply figures. Weak form efficiency can be represented mathematically as follows:

\[ P_t = P_{t-1} + \text{Expected return}_t + \text{Random error}_t \]
This means that the price today ($P_t$) is equal to the sum of the last observed price ($P_{t-1}$) plus the expected return on the stock plus a random component occurring over the interval. The last observed price could have occurred yesterday, last week or last month (depending on the sampling interval). The expected return is a function of a security’s risk while the random component is due to new information on the stock which could be positive, negative or zero. The random component in any one period is unrelated to the random component in any past period. This component is therefore not predictable from past prices. The prices are said to follow a random walk.

Weak form efficiency is considered to be the weakest type of efficiency that a capital market can be expected to display since historical price information is the easiest kind of information about a stock to acquire.

Technical analysis in the financial sense, among other things, is an attempt to predict the future from the patterns of the past price movements. Competition can cause shrewd investors to buy at times when prices are low, this in turn forces prices up. They would then sell at the high points, forcing prices down. Competition eliminates cyclical regularities and leaves only random fluctuations. Financial analysts believe that all relevant information on a security’s price movement is contained in the security’s past movement. Other information is considered distracting.
2.3.2: Semi-strong form efficiency

A market is semi-strong form efficient if prices reflect (incorporate) all publicly available information, including information such as published accounting statements for the firm as well as historical price information. The distinction between semi-strong form efficiency and weak form efficiency is that semi-strong form efficiency requires not only that the market be efficient with respect to historical price information, but that all of the information available to the public be reflected in the price.

2.3.3: Strong form Efficiency

The market is strong-form efficient if prices reflect all information, public or private. This form of efficiency incorporates the other two types of efficiency. This form claims that anything that is pertinent to the value of the stock and that is known to at least one investor is, in fact, fully incorporated into the stock value. It’s believed that even inside information would be recognized by the market and the price would, for example, rise before the person with the inside information could buy any of the stock.

2.4: Characteristics of an Efficient Capital Market
An efficient market is one in which security prices fully reflect all available information that bears on its expected return in the future. A market is efficient with respect to information if there is no way to make unusual or excess profits by using that information. When a market is efficient with respect to information, it is said that prices incorporate the information. This information includes both technical data, such as historical prices and volume, and fundamental data, such as past or projected earnings and balance sheet strength. We can assume that investors make decisions based on such information, and we can further assume a sufficient number of investors in the market so that no single investor can influence market price with his or her trading, then a market price is described as being in equilibrium. An investor in an efficient market expects to earn an equilibrium required return from an investment, and a company expects to pay an equilibrium cost of capital. This therefore means that it is a relatively stable price with no pressure to push it either up or down. The stability may be short-lived, because new information can arise that might change investor expectations, leading to greater buying or selling pressures that push price to a new higher or lower equilibrium.

For markets to be considered to be efficient in the financial sense, they need to have the following conditions:

- There are no trading costs in trading securities.

- All information is freely available to all market participants.
• All participants agree on the implications of current information for current and future security prices, and have the same expectations of the risk and return of each security.

• All investors are “risk averse” i.e. for a given return they minimize risk and for a given level of risk they maximize return.

• There is a large number of buyers and sellers in the market.

• A sufficient number of securities is traded to enable participants to acquire a balanced portfolio.

The efficient market hypothesis implies that share prices reflect all information as soon as it becomes available, and discounts future expectations. Therefore, it is not possible to make profits by identifying “undervalued” shares, because they do not exist. It is therefore not possible to beat the market, except by luck, above average forecasting skills or inside information. An efficient market, therefore, renders useless the services provided by investment managers and tip-sheets.

In an efficient capital market, all assets are correctly priced. This refers to both physical assets as well as to portfolio assets. Therefore capital budgeting would not be possible since assets would be worth their cost. Investment would therefore become merely a matter of selecting one’s preferred combination of risk and return.
In the real world, markets are not perfectly efficient since opportunities for profitable investments which yield excess profits do arise. Empirical work has been done to test the efficiency of capital markets. Samuels (1981) concludes that only the New York, London and Tokyo markets are reasonably efficient. However New York is considered to be the most efficient. No market is perfectly efficient and markets are therefore ranked by their degree of efficiency.

Samuels (1981) identifies five types of inefficiency in organized capital markets:

- Inefficiencies due to small size, with an inadequate number of traders to ensure competition, and insufficient securities to enable them to hold a diversified portfolio of their choosing.

- Inefficiencies due to different risk preferences and perceptions of investors. This may be a feature of new markets where participants do not have much experience or understanding of the market.

- Inefficiencies due to inadequate market regulation and standard of disclosure by companies.

- Inefficiencies due to poor communications so that some investors have an advantage over others. Moreover, the costs of obtaining the information may be significant.
- Inefficiencies due to a lack of competent analysts and professional advisors, resulting in differing expectations about the performance of securities.

- Inefficiencies due to significant transaction costs, which may deter small, private investors, thereby limiting the number of market participants, and restricting the market to relatively infrequent, large bargains.

A large number of developing countries do not have organized stock markets. Many have unorganized markets where securities are traded between institutions, between institutions and individuals, and between individuals. The major inefficiency in the capital market in most of these countries is the lack of information available in an organized market.

The few developing countries that have organized capital markets have various characteristics of inefficiencies. Many of these existing markets tend to be small with only half of the countries with stock markets having 100 companies quoted. Substantial industrial and service companies which make up the bulk of stock markets in developed countries are relatively scarce in developing countries. Developing economies are much more dependent on agriculture. Few of these agricultural enterprises are even incorporated and those which are tend to be foreign or government owned. The same is true of industrial and mining companies. Since many foreign companies do not need to raise capital locally, there is little incentive for these companies to obtain a local
quotation. Normally the main pressure to obtain a local quotation comes from the
government or from a "diplomatic" urge to encourage a certain degree of local
shareholding. Also there is a low volume of transactions, in most of the countries, the
ratio of stock transactions to GNP is usually a fraction of 1%, with the exceptions of
Taiwan, Singapore, Korea and Brazil. Since the volume of transactions is low, the
reaction of share prices to new information may not be immediate, and therefore prices
may not "fully reflect" all available information.

Other forms of inefficiency tend to reinforce the fragmentation of the capital market.
Investors with significantly different perceptions of risk and return usually have shares
demonstrating different characteristics. Inadequate market regulation and inadequate
disclosure standards by companies provides opportunities to rig the market and to make
windfall gains because access to information is uneven. Also some shares do not reflect
their risk return ratio. Poor communication restricts and slows the spread of information.
Those investors who receive information early can profit at the expense of those who
receive it later. For example, in large developing countries such as Nigeria, investors
outside the capital receive information much later than those in the capital. Poor
communication and uneven disclosure by companies causes uneven spread of
information among investors which might result in the lack of confidence in the market
by investors. Suggestions of insider dealing, even when it is nothing more than quick
reaction to slowly spreading information, may produce cynicism among other investors
which leads them to shun the market. Authorities responsible for stock market regulation
need to tread a narrow path between under-supervision and over-supervision. Investors must have confidence, but should not feel over-protected.

Analysts play an important part in identifying the risks and returns associated with individual securities and also in disseminating their views. The absence of such analysts will lead to disparate (and often incorrect) views about a share’s risk-return ratio. The absence of expert analysts will tend to prolong irrational behaviour such as a preference of one share to another. Relatively high transaction costs, especially high minimum commissions and fixed-rate taxes, will tend to deter small investors, and leave the market in the hands of a relatively small number of large operators who, acting individually, can affect market prices substantially. Numerous small transactions by small investors help to keep markets fluid, and help to maintain equilibrium.

Majority of the developing countries do not have organized capital markets and therefore the fragmentation effect is likely to be much greater. In these countries a few financial institutions, mainly dominate the market. In such countries, central banks sell government securities to commercial banks and development banks who may in turn sell some to their corporate or individual clients. The market in equities will be dominated by development banks, and other financial institutions, who take equity in companies and then hold it rather than trade in it. Under these circumstances trading will be sporadic and “lumpy” (large parcels of shares will tend to change hands), and the stock market guides to valuation (risk measures, or price – earning ratios) will be absent, as prices will not be available for comparable securities.
2.5: Determinants of Share Prices:

2.5.1: The volatility of Share Prices

There are a number of factors that determine the prices of shares. However, in general, share prices are determined by market forces, that is, the forces of demand and supply. In the short run, demand factors tend to be more important than supply factors since the supply, the flow of new issues, is small in relation to the current stock.

Demand which is a key factor in determining the price of shares may be based on a company’s earning potential and therefore the prospective yield of the investment. The value of a particular share could also reflect the underlying “economic” worth of the company. The share price may fluctuate around this value but ultimately will tend to gravitate toward it. Usually share prices do follow closely the developments in company prospects.

However investment philosophies depend on the different notions that are said to determine share prices. These investment philosophies are based on technical analysis, fundamental analysis and efficient market hypothesis.

Technical analysis takes the view that in attempting to predict the future course of share prices it is useful to focus on the past behavior of those prices. Technical analysis is also
referred to as chartism. Chartists argue that share prices move in trends and patterns which periodically repeat themselves so the key to making gains is to recognise these patterns before others. Technical analysis use charts to detect the likely movement in the prices of shares.

Fundamental analysis on the other hand examines the underlying economic factors which, they argue, ultimately determine the value of equities. Some of these factors are based on balance sheet information and others are derived from measures of income. Some examples are information relating to earnings per share, assets per share, turnover profits margins. Various financial ratios are therefore used in an attempt to assess how far a share’s market price is out of line with some notion of its intrinsic value. The intrinsic value is estimated as the discounted present value of all its expected future dividends.

2.5.2: Financial Statement Analysis: An overview of Business

Performance

Investors usually attempt to arrive at an estimation of a company’s future earning stream in order to attach a value to the securities being considered for purchase or liquidation. A company’s performance record, it’s future expectations, growth record and stability of earnings are key.

Financial statement analysis also seeks to ascertain the level of risk inherent in a company’s existing capital structure. It also seeks to estimate a company’s expected
returns, given the company’s current condition and future outlook. Financial statement analysis also compares a company with others in the industry in order to assess its success as it competes in its industry, and also how well positioned the company is to hold or improve its competitive position.

Financial statement analysis enables management to know how well the company has performed and the operating areas that contributed to this good performance. Management is also able to know the strengths and weaknesses of the company’s financial position and provides guidelines on the changes that should be implemented in order to improve future performance. Management is therefore able to get insight into a company’s current status and as a result can lead to the development of policies and strategies for the future.

Financial statement analysis is often supplemented with other sources of information such as an independent auditor’s report which expresses the fairness of the financial statement presentation.

2.5.3: Profitability Ratios:

These measure overall efficiency and performance. They include ratios such as gross profit margin, operating profit margin and net profit margin. These represent the firm’s ability to translate sales “dollars” into profits at different stages of measurement. The relationship between sales and the cost of products sold is shown by the gross profit
margin. It measures the ability of a company both to control costs of inventories or manufacturing of products and to pass along price increases through sales to customers. The operating profit margin incorporates all of the expenses associated with ordinary business activities. It’s a measure of overall operating efficiency. The net profit margin measures profitability after consideration of all revenue and expense, including interest, taxes and non-operating items.

2.5.4: Market Ratios:

There are additional financial ratios that are relevant to financial statement analysis. These assist in investment decisions and long range planning. Four market ratios that are of particular interest to investors are earnings per common share, the price-to-earnings ratio, the dividend pay out ratio, and dividend yield. Earnings per share helps in determining the market of the equity shares of the company. It estimates the company’s capacity to pay dividends to shareholders. Price–to–earnings ratio helps the investor in deciding whether to buy or not to buy shares of a company at a particular market price. The dividend-pay-out ratio is an index showing whether a company pays out most of its earnings in dividends or reinvests the earnings internally. Dividend yield helps an investor in knowing the effective return he is going to get on the proposed investment.

Financial statement analysis consists of a mixture of steps and pieces that interrelate and affect each other. No one part of the analysis should be interpreted in isolation. Short-term liquidity impacts profitability: profitability begins with sales, which relate to the
liquidity of assets. The efficiency of asset management influences the cost and availability of credit, which shapes the capital structure. Every aspect of a firm’s financial condition, performance, and outlook affects the share price. Financial statement analysis attempts to integrate the separate pieces into a whole.

Financial statement analysis is also useful in the assessment of earnings quality. Investors are less interested in total earnings than they are in earnings per share of common stock. Earnings strength is measured by examining profit margins, key earnings ratios and earnings and dividends growth rates. The price – to – earnings ratio, for example, is the function of a myriad of factors which include the quality of earnings, future earnings potential, and the performance history of the company. Financial analysis follows a three stage approach: analysis of the firm, industry and overall economy. In order to know whether a company is sick or healthy ratios are compared to industry averages or the changes in the ratios over time.
CHAPTER 3: RESEARCH DESIGN AND
METHODOLOGY

3.1: OBJECTIVE OF RESEARCH

As stated earlier in chapter 1, financial statement analysis is the foundation of information efficiency of stock markets all over the world.

The objective of the research is to analyse the effects of financial information on share prices. There are different levels of efficiency for different markets. An efficient market is known to reflect all information on its share prices. The research seeks to assess the effects of financial information on share prices.

3.2: RESEARCH DESIGN

Research design is often determined by the unit of analysis; the research time frame; the research setting; the research purpose; and the criterion used to judge the adequacy of research design.

The unit of analysis was the various companies and their reaction to financial information.
The period of analysis was five years. The selected company’s performance was analysed over a period of five years.

The research setting was natural. This is because financial performance of companies is controlled by the various forces in the environment: these could be economic, political or even climatic, as was the case of agricultural based companies, or a combination of several of these factors. Since this was an analytical study of the past financial performance, the research setting was natural and was therefore uncontrolled or uncontaminated in any way by the researcher. It is not possible to influence past data of the Nairobi Stock Exchange. Manipulation or control of variables was not possible because historical data was being analysed.

The purpose of the research was to ascertain and explain the relationship between share prices and financial information.

The analytical nature of the research meant that it was not possible to control or manipulate variables. This is because historical data was being used to analyse an already existing environment.

3.3: RESEARCH METHODS

Analytical procedure was used in analysing eight representative companies from four sectors represented in the Nairobi Stock Exchange. Two companies were selected from each sector. Data was sourced from the financial statements of these companies over a 5
year period starting from 1994 to 1998, inclusive of both years. This period was chosen in order for the performance of these companies to be studied at a time when the Kenyan economy has been liberalised and is said to be operating as a free market.

Profitability ratios were calculated for each of the companies in all of the years. A graphical representation of earnings per share and share prices of each of the companies in all the 5 years was produced in order to provide a graphical relationship between share prices and earnings per share.

The financial statements were sourced from the Nairobi Stock Exchange library.

3.4: SAMPLING TECHNIQUE

A representative sample was selected from a large population of companies, each company falling into one of the four main sectors. Both stratified and random sampling was used. Stratified sampling was used in the sense that companies were selected from the four sectors. Stratified sampling helped to reduce any bias which might possibly arise if samples were chosen completely at random.

Even though stratified sampling was used in representing the four main sectors, random sampling was effected in choosing two companies from each of the four sectors.
Chapter 4: RESEARCH DATA ANALYSIS AND INTERPRETATION OF FINDINGS

4.1: COMPARATIVE ANALYSIS OF PERFORMANCE

4.1.1: Share Prices

The highest share price recorded in all the data collected is for Brooke Bond Kenya Ltd. in 1994. This was Kenya shillings 269 per share while the nominal value is Kenya shillings 10 per share. While the lowest in the entire period was Kenya shillings 25 per share for Marshalls (East Africa) Ltd. in 1998 while the nominal value in Kenya shillings 5 per share.

4.1.2: Earnings Per Share

In most of the years, most of the companies made profits with the exception of losses incurred by Brooke bond Kenya Ltd in 1996 and 1997; George Williamson in 1995 and Unga Group in 1998.

The highest earnings were made by George Williamson in 1998 while the greatest loss per share were made by Unga Group in 1998.
4.1.3: Losses

Losses were incurred by Brooke Bond in 1996 and 1997, by George Williamson in 1995, and by Unga in 1998. The greatest loss as reflected in earnings per share was made by Unga in 1998.

4.1.4: Comparative Sectoral Performance Analysis

In the 4 sectors, the highest share prices were found in the Agricultural sector in Brooke Bond Kenya Ltd. while the lowest prices were found in Commercial and Services sector in Marshalls (East Africa) Ltd.

The highest earnings per share was found in the Agriculture sector in George Williamson while the lowest was found in the Industrial and Allied sector in Unga Group. In the Agricultural sector, Brooke Bond Kenya Limited had generally higher prices while George Williamson had the highest earnings per share.

In the commercial and Services sector, Uchumi Supermarket had both the highest share prices and the highest earnings per share. The lowest prices and earnings per share were found in Marshalls (East Africa) Limited.
The highest prices and earnings per share were found in Kenya Commercial Bank while the lowest were found in Standard Chartered bank in the Finance and Investment sector.

The Industrial and Allied sector on the other hand experienced the highest price and highest earnings per share in Unga Group and East African Breweries respectively.

4.1.5: Comparative Trend Analysis

In 1994, Brooke Bond had the highest share prices while Marshalls (East Africa) had the lowest. The highest and lowest earnings per share were those of George Williamson and Marshalls (East Africa) respectively.

In 1995, the highest prices were recorded by Brooke Bond while the lowest were recorded by Marshalls (East Africa) limited. The highest and lowest earnings per share were recorded by Kenya Commercial Bank and George Williamson respectively.

In 1996, Brooke Bond Kenya limited had the highest share price while Marshalls (East Africa) had the lowest price. The highest and lowest earnings per share were recorded by Kenya Commercial Bank and Brooke Bond respectively.

In 1997, Brooke Bond Kenya limited had the highest price while Uchumi Supermarket had the lowest price. The highest and lowest earnings per share were recorded by Kenya Commercial Bank and Brooke Bond Kenya limited respectively.
In 1998, the highest price was recorded by Brooke Bond Kenya limited and George Williamson, while the lowest share price was recorded by Marshalls East Africa. The highest earnings per share was recorded by George Williamson while the lowest was recorded by Unga Group.

4.2: ANALYSIS OF INDIVIDUAL COMPANY PERFORMANCE

4.2.1: Brooke Bond Kenya Limited

Adverse trading conditions and unfavorable external factors persisted throughout 1994 and 1995. However commodity prices were experienced in all the major areas.

The Kenya shilling remained stronger than had been anticipated resulting in lower shilling revenues at a time when labour costs continued to increase on the basis of Collective Bargaining Agreements negotiated in 1993.

High interest rates were a further negative factor in the difficult external environment.

At the end of 1994 it was the objective of the company to maintain a reasonable profit level whatever the external environment. This was not achieved in 1995, but the company
worked hard to improve those areas of business directly under their control. There was an attempt to improve product quality and the utilisation of both labour and capital.

However, profit attributable to the shareholders fell dramatically from Kenya shillings 410 million to Kenya shillings 50 million in 1995. There was a decrease in share prices from Kenya shillings 269 in 1994 to 190 in 1995. In considering its long term strategy, the company decided that coffee was no longer a core crop and in 1995, it was considered timely to sell the coffee estates and concentrate the available management, technical and financial resources on the other product areas, with special emphasis on tea.

Tea production at 31,770 tonnes was 17% above 1994 but less than the internal target. Despite improved rainfall, temperatures in Kericho were consistently lower than the 15 degree year average. A one degree reduction in average temperature can mean up to 10% reduction in production. The company extended the bulk transport of leaf to cover over half the estates in Kericho which helped to keep down transport costs. The major problem in 1995 was lower shilling revenues from tea as a result of lower world prices compounded by a lower exchange rate.

In the flower division and particularly in the case of spray carnations, it was again impossible to compensate for the reduction in market prices. The market was difficult throughout the year and became worse in October when the early entry into the market of an increased volume of Southern European flowers caused a sharp drop in prices.
Tea prices in dollar terms rose steadily throughout 1996 and the Kenya shilling was relatively stable.

During the year, part of the year weather conditions were favorable for tea production but towards the end of the year, a series of hail storms and dry conditions made what promised to be an exceptional season into a merely good one.

Flower prices were generally poor.

Increased wage cost and high interest rates continued to heavily burden the company.

The business continued to improve its efficiency, quality and added value.

Even though inflation was low and the Kenya shilling strong, high interest rates greatly constrained the profitability of the business.

Tea production volume in 1996 was a record 34,515,000 Kilograms. Better harvesting standards ensured greater consistency in the final product. Investments in productive and infrastructural assets ensured that a high standard of production was maintained throughout seasonal variations in volume and quality.

The research facility at Kericho continued to make useful contribution to the Unilever world wide beverages research programmes.
In this year the share prices decreased to Kenya shillings 157.50.

The 1997 drought had adverse effects in the cropping patterns even though the year commenced with high production levels. However the year had started with high production levels but quickly saw the onset of severe drought. This led to a shortfall of some 40% in Brooke Bond’s crop for the first half of the year. 5% of tea bushes were lost and it was only in December that a real return to normal volumes was realized.

The year ended very profitably as the shortfall in Kenya crop combined with growth in world demand for black tea generated exceptionally good prices. There was an overall good performance by the Tea Division despite the impact of the drought in the Kericho area.

The research department was re-organized to give greater focus to innovative projects for the development of both new processes and new products, in conjunction with their Unilever associates internationally.

The Flower Division experienced increasing losses. This was due to a combination of factors beyond their control, including a decline in the market for outdoor spray carnations, which comprised 65% of Brooke Bond’s portfolio and weakness of the Deutsch mark, the currency in which most of their products were sold under existing
contractual arrangements. A decision was made to undertake major restructuring, by concentrating on indoor crop production, in order to return the business to profitability prior to divestment. Restructuring was successfully achieved but the accumulated losses and associated provisions had a major impact on the 1997 results.

In 1997 the coffee division was also a candidate for divestment in order to free up financial resources for the tea business. However it had a very good start in 1997 with a good crop taking advantage of the strong market.

In 1997, the share price was Kenya shillings 145.

It achieved a marked improvement in profitability during 1998. The earnings per share was Kenya shillings 4.70, an increase from the last year's loss per share of 4.85. There was a reduction in the share price to Kenya shillings 141. There was excellent performance in the tea division during the first quarter. In this quarter good volumes coincided with very high prices. This was due to increased world demand. There was also a reduction of losses associated with the flower division.

However in the later part of the year, low tea crop volumes, declining prices and a high wage award by the industrial court contributed to a substantial reduction in profitability.
The good performance of the tea division early in the year generated a strong cash flow which enabled the group to eliminate borrowing requirements. The sale of Sulmac Company Limited, a principal flower business, further improved the cash position.

Further divestment activities for the remaining flower and coffee businesses were planned for 1999. This resulted in the sale of Kibubuti and Kentmere farms.

Research activity was also intensified to add value to the tea product base.

One issue of great concern during this period was the lack of development in the economy, prevailing high interest rates, labour cost inflation supported by the industrial court, a strong currency and a deteriorating infrastructure which greatly affected industrial growth and a competitive export sector. The bank lending interest rates were also generally high in this year. However, the reduction of government Treasury Bill rates towards the end of the year were encouraging.

Shear harvesting was to be introduced to improve labour productivity. Fully mechanised harvesting was being explored in order to enable Brooke Bond compete with their competitor tea growing countries, including Tanzania and Uganda.
4.2.2: George Williamson Kenya Limited:

In 1994, the group profit before tax was Kenya shillings 319 million as compared to Kenya shillings 97 million for the previous year. The earnings per share was Kenya shillings 21.61 while the share price was 140. This substantial increase was due to higher crops, increased selling prices and the continued devaluation of the Kenya shilling.

The company continued to reap the benefit of the accelerated development at Changoi between 1986 – 1990. Also an agreement with Nyayo Tea Zone corporation to take over the management of some of its tea planted round the South Nandi forest yielded large kilograms of green leaf.

The engineering business continued to experience difficult trading conditions.
The principal activities of the group are cultivation and manufacture of tea, investment in property and sale of tea machinery and generators.

In 1995 in spite of record crops, the group profit before tax was Kenya shillings 10 million as compared to Kenya shillings 319 million for the previous year. The loss per share was Kenya shillings 0.6 while the share price decreased to 86. This substantial decline was due principally to depressed international selling prices and the continued strength of the Kenya shilling which reduced the company’s Kenya shilling realizations without any significant reduction in the cost of inputs. During the year, the company continued investing significant sums in labour, housing and the provision of welfare amenities for its staff.

The Engineering business had a disappointing year although sales and servicing of generators continued to expand.

In 1996 following a record crop, the group profit before tax was Kenya shillings 31 million as compared to Kenya shillings 10 million for the previous year as earlier stated. The earnings per share was Kenya shillings 1.36 while the share price increased to Kenya shillings 88.13. This was mainly due to world tea prices, which improved slowly during the year, and a more advantageous Exchange rate.
While the Generator business continued to expand, the General Engineering business again produced disappointing results.

In 1997 due to the drought in January, February and March, crops were lower than in the previous year, and while the Kenya shilling continued to grow strong, there was a helpful improvement in World Tea prices. However one disadvantage was the continued increases in wages and inputs.

The profit before tax was Kenya shillings 86 million as compared to Kenya shillings 31 million the previous year. The earnings per share was Kenya shillings 6.58 while the price per share slightly increased to 88.25.

The eight floors investment in George Williamson house continued to make a valuable contribution to the Company’s profitability.

The Generator business operated from a new premises during the year. Due to power rationing and supply problems throughout the country during the year, the Engineering company achieved better results.

An increase in authorised share capital was approved.
In 1998 following the El Nino rains, excellent crops were harvested and during the year world tea prices improved substantially. However increased costs were a disadvantage.

It was an exceptional year, group profit before tax was Kenya shillings 424 million as compared to Kenya shillings 86 million the previous year. The earnings per share increased to Kenya shillings 31.79 and the share price increased to 141.

There was a severe fall in world tea prices over recent months caused by substantial increase in world tea crop compared to the last year.

The investment in Williamson house increased its contribution to the Group’s profits.

During the year, the workshop premises was finally sold and with the continuing power problems in the country, turnover and profitability increased.

![Graph showing Share Price and Earnings Per Share over years 1993 to 1999 for George Williamson Kenya Ltd.](image)

**Figure 2**

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4.2.3: Marshalls (E.A.) Limited

During 1994, the motor vehicle market continued to be affected by growing imports of secondhand passenger cars and commercial vehicles. This brought about increased competition for the company. The company therefore made an attempt to consolidate and improve its position in the passenger car and light commercial vehicle segments.

Growing demand for professionally managed vehicle fleet operations led to the launching of a marketing activity to handle this section of the market. Strong emphasis continued to be placed on staff training together with regular investment in special tools and service standards.

The profit before tax increased from just over 20 million Kenya shillings to just under 130 million Kenya shillings, and the earnings per share increased four and a half times. The earnings per share was Kenya shillings 1.67 while the share price was 41.

In the 1995/96 period there were hard hitting campaigns by the Peugeot Division particularly the very successful Peugeot 405 style campaign. The special edition of 400 units combined with an attractive part exchange programme was very well received by the market. The Lion used car scheme was launched. It provided customers with a
selection of quality used cars backed by a Marshalls six months warranty. The scheme recorded impressive sales volumes after only three months operations.

A totally integrated computerised system was fully implemented. The system linked every Marshalls branch to the central computer in Nairobi. The successful implementation of the new computer system enabled the company to restructure job responsibilities thus reducing its work force by over 20%. Subsequent months realized significant increase in productivity and efficiency in all areas of the business.

Workshop productivity and revenues notably increased due to regular staff training and refurbishment of branches by equipping workshops with special tools required for modern and more sophisticated vehicle models.

Profit before tax of Kenya shillings 144 million was up by 39%. The increase in volumes, turnover and profitability demonstrated the strength of the company in terms of its marketing initiatives. The earnings per share was Kenya shillings 7.64 and 8.30 for 1995 and 1996 respectively each reflecting an improvement from the preceding year. The share price increased to 37 in 1995 and later to 42.25 in 1996.

The year 1997, marked the fiftieth Anniversary of the incorporation of the company. The Heavy Commercial vehicles Division continued to face increasing competition, particularly from Japan following the significant depreciation of the Japanese Yen against the U. S. dollar. As a result, much of the competitive edge enjoyed by the company’s
Tata franchise was reduced. However Volvo trucks and construction equipment recorded their best ever performance in the year under review.

Refurbishment and improvement of branches continued and the company’s training school continued to recruit and train mechanics to the highest standards in the industry. The training school was selected to be the regional training centre for its distributors in East and Southern Africa.

The “Fundi of the year” competition has been of immense benefit in motivating the staff and enhancing the quality of their work.

The 1997/98 financial year was a demanding one for the motor industry. The withdrawal of foreign aid to Kenya combined with the uncertainty prior to the general elections followed by adverse weather conditions in early 1998 all had a major impact on the motor industry. The total market for new vehicles fell below 12,000 units, while the number of competing importers continued to increase. In 1997, the earnings per share decreased to Kenya shillings 5.03 while the share price increased to 61. In 1998 the earnings per share decreased to 2.60 while the share prices to 25.
4.2.4: Uchumi

The year 1994 was a very unusual year for Kenya. At the outset there was a major challenge in procuring balance of payment support from Western countries and donor agencies. Foreign exchange reserves fell sharply and the Kenya shilling dropped in value to approximately Kenya shillings 80 million to the U.S. dollar. Inflation and interest rates escalated. The prolonged drought which hit many parts of the country further added to the general economic problems. The later half of the year was the exact reverse of the earlier part. Deregulation of interest rates, liberalization of the foreign exchange regime and removal of import controls resulted in substantial changes in the economy. The shilling became progressively stronger and reached a record level; interest rates had fallen dramatically and the general liberalization of the economy has forever changed the
market place. Prices of consumer products began to fall rapidly and competition became increasingly fierce.

The net profit before tax amounted to Kenya shillings 419 million, 54% higher than the previous year. The earnings per share was Kenya shillings 6.76 while the share price was 68.

In 1995 interest rates continued falling before they stabilized and experienced an upward trend. The effects of the readjustment of the exchange rate for the Kenya shilling and the imposition of VAT at retail level on almost all non-food items resulted in a slightly upward trend in prices. Competition became even more fierce.

The company experienced impressive trading results during this financial year. The company recorded a 25.6% increase in sales while their profit before tax dropped. An attempt to bring staff emoluments in line with those of the market leaders together with other increases in operating costs greatly offset the effect of the increase in profit before tax attributable to higher turnover. The earnings per share decreased to Kenya shillings 5.27 while the share price to 40.

In 1996 trading conditions were made difficult by increased competition from both existing and new players that entered the retail market. Also the inclusion of more consumer products in the VAT bracket resulted in curtailed consumer disposable income.
The profit before tax was higher than the Kenya shillings 405.8 million recorded in the previous year. The earnings per share further decreased to Kenya shillings 4.33 while share price increased to 45.75.

In the 1997 financial year, inflation rose and this greatly reduced consumer spending and dampened demand. Difficult trading conditions were aggravated by a major fire in February 1997 which destroyed the central warehouse and all stocks contained therein. However, gross turnover registered an 11% growth on the previous year. This was not in line with the originally projected growth due to the delayed opening of the Ngong Road Hyper branch. Wage increases and inflationary rises greatly increased operating costs. The profit before tax at Kenya shillings 364.1 million was 10% lower than the previous year’s profit of Kenya shillings 405.8 million. The earnings per share decreased to Kenya shillings 3.75 while the share price increased to 49.50.

The company having withstood the impact of the warehouse fire, made a recovery during the following months and in consequence had a healthy cash flow position at the year end. This enabled the company to internally fund the full cost of the new Hyper branch on Ngong Road.
In 1998, the devastating nationwide effects of the El Nino phenomenon, a dampened demand due to a depressed economy and despite increased competitiveness in the retail sector, the company achieved record growth in its turnover and profits. Pre-tax profits for the year rose to Kenya shillings 485.3 million compared to Kenya shillings 364.1 million in 1997, an increase of 33.3%.

The effective rate of tax for the year was lower than that in the previous year following the reduction in the corporate tax rate and various tax incentives arising from the capital investment incurred during the year. Profit after tax at Kenya shillings 312.6 million thus increased by 39% (from Kenya shillings 224.9 million) resulting in earnings per share of Kenya shillings 5.21 compared to Kenya shillings 3.75 for the previous year. The share price decreased to Kenya shillings 44.

![Uchumi Supermarkets Graph](image)

Figure 4

4.2.5: Kenya Commercial Bank
The major preoccupation in 1995 was to explore and put in place strategies which would enable the Kenya Commercial Bank Group to face future challenges and in order to yield sustainable profitability, growth and efficient customer service.

In the first half of 1995, the economy went through a stable growth phase. This was a continuation of the economic recovery which started in 1994. The second half of the year witnessed a rather difficult path, production in the economy increased generally, prices of major export commodities declined in the international markets. The manufacturing and the tourism sectors did not fair well either. As a result of these unexpected developments, the published results of many companies which operate in the agricultural and tourism sectors posted lower than expected profits, some at half the levels attained in 1994. Despite these setbacks the economy in general registered improved performance, with GDP growing from 3% in 1994 to 5% in 1995. This growth was largely attributed to the economic reform measures which had been undertaken by the government.

The financial sector recorded the highest growth and to a large extent contributed to the overall performance of the economy. When the National Budget speech was read in June, 1995, inflation was down at 6.57%, the exchange rate averaged Kenya shillings 55 to the US dollar and interest rates were relatively low. The yield on the 91 day Treasury Bills was about 15% while commercial Banks base rates averaged 17%, with Kenya Commercial Bank’s base rate the lowest at 15.5%. This scenario changed drastically during the second half of 1995. In July, the Central Bank of Kenya in a bid to keep
inflation at single digit levels, became an active participant in the financial markets by offering high interest rates on Treasury Bills. As a result of escalation in the market cost of funds, commercial banks responded by hiking their base rates to around 26% initially before stabilizing at 22% by the end of the year.

The operating environment was made more competitive by the repeal in December 1995, of the Foreign Exchange Control Act, the various amendments to the Banking Act, the conversion of a number of non-bank Financial Institutions into Banks and the Licensing of a number of Forex bureaux.

There was a pre-tax profit of Kenya shillings 3.784 billion, an increase of 33.4% over Kenya shillings 2.837 billion recorded in 1994. The earnings per share in 1994 was Kenya shillings 19.96 while the share price was 90. In 1995 the earnings per share increased to Kenya shillings 21.15 while the share price decreased to 85.

The launching of two credit cards, internationally accepted KCB VISA Gold card and the locally circulating KCB VISA card enabled KCB to complement it’s vast array of products and services as well as strengthen the Bank’s position as a market leader.

The protocol of co-operation signed by the three Heads of State of the East African Region is expected to create a larger market and new business opportunities not only for financial intermediaries but also for investors in general.
The Group’s trading results during 1996 maintained the upward trend despite the prevailing stiff competition for deposits and good lending in a relatively high cost of funds environment.

Gross Domestic Product declined from 4.8% in 1995 to 4% due to less than expected performance by key sectors such as agriculture and tourism.

During the year, the economy experienced a resurgence of inflation. It rose swiftly to 9.0% by December 1996 from 1.6% at the end of 1995. Lending was adversely affected by interest rates which remained stubbornly high. The 91 day Treasury Bill yields, which acts as the financial barometer of basic cost of money in the market, rose marginally to 21.7% by the close of the year from 21.5% at the beginning of 1996.

The year witnessed the collapse of two small banks although the crash did not shake the financial sector which registered satisfactory growth for the fourth year running, increasing its contribution to GDP by over 10%. The economic tempo was subdued by lower imports while higher capital inflows strengthened the shilling despite weakening slightly against the Sterling pound but gaining against the US dollar from Kenya shillings 57 early in the year to Kenya shillings 54 at the close of 1996. Kenya’s overall balance of payments position improved from a deficit of US dollars 139 million in 1995 to a surplus of US dollars 409 million in 1996.
In this year, the group registered impressive financial results. There was a 7% increase in pre-tax profits. The earnings per share increased to Kenya shillings 22.29 while the share price decreased to 72.

In 1997 the group trading results were achieved against a marked slowdown in economic activity especially during the later half of the year. The factors that contributed to the slowdown included the effects of the lapse of Enhanced Structural Adjustment Facility (ESAF) with the International Monetary Fund, political uncertainties in an election year, the onset of the El Nino weather phenomenon, a depressed tourism sector and a rundown physical infrastructure.

In 1997, the growth in Gross Domestic Product declined to 2.9% from 4.6% in 1996. Inflation rose to double digits in 1997 closing the year at an average annual level of 11.2%. The high levels of interest rates were a direct consequence of the tight monetary policy maintained which resulted in a credit squeeze in both private and public sectors from August onwards with commercial bank overdraft rates reaching 30.3% by December. The Treasury Bill yield rate similarly rose to close to 26.4%.

There was intensified competition experienced in the Kenyan financial environment. The overall balance of payment surplus in 1997 fell to US dollars 56 million from US dollars 398 million in 1996. The tourism industry was rocked by declining visitor numbers whilst there was a decline in agricultural output due to the adverse effects of the El Nino
weather phenomenon. However international coffee and tea prices rose to record levels and provided a welcome boost to the Sector.

Yet again the KCB Group registered improved financial results attaining a 2% increase in pre-tax profit. The earnings per share increased slightly to Kenya shillings 22.87 and the share price also increased to 88.50.

In 1998 the Kenyan economy experienced one of the most difficult times in the recent past. All key macro-economic indicators showed a deteriorating trend.

Real Gross Domestic Product declined to 1.6%, Interest rates remained stubbornly high for the first nine months of the year and started to decline gradually during the last quarter. Inflation was low for most part of the year.

These developments had a negative impact on the company. The trading results are a reflection of the difficulties that the economy faced in 1998. The Group performed below expectations, recording pre-tax profits of Kenya shillings 4.1 billion in 1997, a decrease of 65.8%. The Group’s total income rose by 4.7% from Kenya shillings 17.1 billion to Kenya shillings 17.9 billion, whilst expenses grew from Kenya shillings 12.9 billion to Kenya shillings 16.5 billion over the year. It was during this year that the new chairman of the board, Mr. P. C. Nyakiamo was appointed on the 23rd of March, 1998. The earnings per share decreased to Kenya shillings 8.15 and the share price to 61.50, a decrease of Kenya shillings 27.
4.2.6: Standard Chartered Bank

1994 was a watershed year for the Company during which a fundamental review of the business and business processes was commenced. This resulted in rationalization of the Bank's structures, reduction of headcount through a voluntary early retirement scheme and substantial investment in technology to enable the Bank to meet customer needs for quality service.

As mentioned earlier the performance of the economy during 1994 was better than expected. Group financial performance improved considerably during 1994 with
operating profit increasing to Kenya shillings 1.956 million compared to Kenya shillings 787 million in 1993. This improvement arose from the successful switch to a more stable deposit base from money market deposits as interest rates came down, which had a positive impact on funding costs; improved returns on the investment portfolio whose maturity was better structured to enable the Bank take advantage of available earning opportunities; and improvement in the management of the forex position following investment in new technology and more proactive action. The earnings per share was Kenya shillings 6.39 while the share price was 75.

In 1995, the Bank sponsored two promotional investment conferences, one in Nairobi and the other in London. The objective of these conferences was to bring international awareness of the new Kenya investment climate to prospective investors.

There was an improvement in the financial results for 1995. Operating profit went up by 13% which can be attributed to increases in interest income, foreign exchange earnings and commission income. More than 50% of total costs consisted of staff related costs. The 20% plus award by the Industrial Court effective March 1995 was a major blow. After tax profit rose by 60% from Kenya shillings 700 million in 1994 to Kenya shillings 1.13 billion in 1995. The earnings per share increased slightly to Kenya shillings 6.87 while the share price decreased to 53.

The introduction of the new computerisation banking project became a reality during 1995. The branch rationalization programme was completed with the sale of seven
branches, the merger of two branches into a single branch, the relocation of another branch and the closure of two branches.

The year 1995 was characterized by increased competition between the commercial banks in both the local money and forex markets. In the forex markets, customers actively searched out the most attractive deal and the Bank reacted to this challenge with aggressive pricing. Profitability was maintained by increasing volumes.

The year 1996 was full of challenges for the Bank as it underwent the final stages of its restructuring. The significant task of updating the Bank’s computer systems (which began in 1994) was geared at integrating many features that offer simplifications of internal procedures so as to provide enhanced customer service and internal controls. The Bank recorded a Kenya shillings 2.23 billion operating profit. Profit before tax of Kenya shillings 1.76 billion and after tax of Kenya shillings 1.15 billion was a slight increase from that of 1995. The earnings per share increased slightly to Kenya shillings 6.97 while the share price decreased to 50.75.

In 1997 political and environment effects had a considerable impact on the country’s economy which, in turn affected the Bank’s performance.
In the first half of the year, Kenya experienced extreme drought thus necessitating importation of staple food. The delayed announcement of the date of the expected national elections also had an impact on the economy. Finally, the El Nino weather phenomenon devastated the country’s infrastructure in the last half of the year. There were no major investment opportunities since the economy remained stagnant throughout the year.

In 1997 there was a culmination of the internal reshaping of Standard Chartered Bank Kenya Ltd. The centralisation project was completed in May, when all branches were interconnected thus bringing to an end the ambitious project that started in 1994. The final restructuring exercise was planned to be completed in 1998. The centralization project was completed in 1997. This project had been started in 1994 to interconnect all branches. It is in 1998, that the Bank began to make better use of its advanced technology.

The strategy continued to be that of concentrating on the growth of the core banking of retail, corporate, trade and treasury. Special emphasis was being laid on trade finance and cash management. It was believed that this strategy when backed by technological advancements and the new Global networks should guarantee the bank steady growth into the next century.

The financial results of 1997 saw income from trading of Kenya shillings 7.1 billion up from Kenya shillings 6.5 billion in the previous year. This is a 9% growth. The operating
profit reflected a 9% growth. The earnings per share decreased to Kenya shillings 6.46 while the share price increased to 51.

The Bank had a strong performance in 1998. Trading profit increased by 30% to Kenya shillings 2,291 million from Kenya shillings 1,759 million. Earnings per share also increased by 34% to Kenya shillings 8.67 while the share price decreased to Kenya shillings 50.50. As much as the Bank performed well, the economic environment was not favourable.

The Bank off-loaded the business activities which were not adding value to their corporate strategy and revenue streams. This strategy enabled the Bank to not only survive but also to produce commendable results. There was a more focused growth on the core banking businesses of Consumer Banking, Corporate and Institutional Banking and Treasury. There were a few changes to the existing board of directors.
4.2.7: East African Breweries:

In 1994 as the government continued to implement the structural adjustment programmes, greater liberalisation of the economy and rising inflation, higher prices became necessary and because of opening up of the economy, increased competition from imported beer became obvious. As a result of stabilization of the exchange rates, Kenya Breweries (as it was known at this time) earnings from the export trade declined because the local currency started appreciating against the dollar.

Domestic sales suffered a great deal from taxation policy.

The very good results achieved in the year contradicted the economic conditions. Domestic and export sales of 23,834,542 metric cases were 16% below the previous year’s level. Export sales grew by 64% and were 17.7% of the total volume sales. Export sales contributed 56.3% of the total profits. Most of the company’s export market is
within the East Africa region. This region was also experiencing a time of similar liberalization of markets and economy.

The company’s pre-tax profit for the year was 83.5% higher than that of 1993. The earnings per share was Kenya shillings 10.25 while the share price was 115.

In 1995, the company made a profit before exceptional items of Kenya shillings 1,162,731,000 which was Kenya shillings 125,640,000 or 12.12% higher than the 1994 profit of Kenya shillings 1,037,091,000. The profit after tax and minority interest of Kenya shillings 178,266,000 was 66% below last year’s profits of Kenya shillings 524,045,000. This was due to the high exceptional costs of payments made to staff retiring under the voluntary retirement scheme. The earnings per share decreased to Kenya shillings 2.79 while the share price decreased to 57.50.

In 1996 liberalisation created a more competitive environment at this time especially because imported brands were readily available.

In this year, profit before tax was a record Kenya shillings 1.27 billion. This figure was slightly depressed by payments made to the last group to leave under the early retirement scheme. The results of the group were considerably enhanced by improvements in the
company’s two major subsidiaries, Central Glass Industries Limited and Uganda Breweries Limited.

The company’s on-going crop research resulted in a significant increase in average yields from 1.8 tonnes per hectare in 1990, to 2.8 tonnes per hectare in 1996.

The company’s core business is to brew and market beer. The brands of the company markets locally dominate the market and each of them is aimed at a specific segment of beer consumers. The earnings per share in 1996 increased to Kenya shillings 6.45 while share prices increased slightly to 59.50.

Some significant developments in new products, investments in new plant, cost controls and quality management were achieved at the Breweries in 1997. The plan to upgrade production facilities was completed on schedule. The company’s promise to drive through a staff improvement and multi-skilling initiative won its first ISO 9002 compliance at the company’s largest brewery – Tusker: and other brewing units are currently moving to win the same badge of excellence.

In this year, profit before tax was Kenya shillings 1.2 billion with a satisfactory result from beer sales temporarily depressed by lower returns from Central Glass Industries Limited caused by increased competition and unfavourable export exchange rates. The
earnings per share increased to Kenya shillings 13.29 while the share price decreased to Kenya shillings 54.75.

In 1998, Kenya Breweries committed itself to becoming a truly East African brewing group. Beer sales continued to accelerate in Tanzania and Uganda. Plans were made in 1998 to rename the company, East African Breweries limited. The company wants to be the dominant brewing group in East Africa in terms of sales, profitability, product and customer service.

Group turnover was Kenya shillings 25,778,213,000. It was up by 12%. Profit before tax and after exceptional items was Kenya shillings 494 million. This includes Kenya shillings 1.5 billion spent on extensive staff retrenchment.

In this year, the company marked its 75th anniversary. The market share in Uganda increased from nearly 42% to just over 51% thus achieving its objective to be the market leader in that country.

The market share in Tanzania grew by an average of over 9% annually since 1994. Six depots were opened during this financial year.

About 82% of the company's revenue is derived in Kenya inspite of many negative factors. Central Glass Industries achieved a profit of Kenya shillings 157 million. The earnings per share decreased to Kenya shillings 2.27 while the share price increased to
4.2.8: Unga Group Limited:

The results of 1994 reflect a year in which the group overcame many challenges and seized every opportunity to apply efficient methods in use of resources in a partially liberalised environment. Substantial growth was achieved in the year with turnover rising to Kenya shillings 6 billion from Kenya shillings 3.3 billion in the previous year. In constant prices, turnover rose by 40%, pre-tax profits improved to Kenya shillings 237.5 million compared to Kenya shilling 63.1 million in the previous year. Taxation rose to Kenya shillings 136.4 million from Kenya shillings 50 million. The earnings per share was Kenya shillings 2.45 while the share price was 71.
In 1995, the turnover was 7,100,668,000 while the profit before tax was 435.5 million. This was an increase from the previous year’s 237.5 million. The earnings per share increased to Kenya shillings 4.14 and the share price doubled to Kenya shillings 42.

In 1996, turnover followed the expected trend to reach peak performance at Kenya shillings 7.4 billion in product sales for 11 months. Unga Feeds Limited emerged with the fastest rate of growth and high return on capital employed. To a lesser extent Unga Maize Millers Limited broke out from the struggler’s pace to deliver it’s budgeted profits. Again the smaller companies, Elianto Kenya Limited and Proctor and Allan Limited, needed a lifeline to keep them afloat. Contrary to all expectations, the group flagship, Unga Limited, registered the most disappointing finish. The earnings per share decreased to Kenya shillings 1.07 while the share price decreased to 119.25.

Rapid expansion of national milling capacity led to under – utilisation of plants and stiff competition for survival by new – comers. In this year, the group embarked on ISO 9000 certification and aimed for an early accreditation. This was to form part of the foundation for Total Quality Management which was being undertaken to reduce operating costs. An ambitious change process was put in place to ensure that the entire group employees were re-oriented through training so as to be more responsive to the fast changing environment.
There was a great deal of development of the company's corporate strategy in 1997. The core processes of procurement, production, marketing and sales were revamped while new products were developed and marketed.

The three economic measures of exchange rate, interest rate and inflation rate made a complete U-turn scuttling many business plans into a state of confusion. The situation was further confounded by conflicting perceptions about the stage of deregulation, liberalisation and privatization underpinned by IMF structural adjustment programmes. Agriculture was the home base for past economic regime and at this time seemed to require new assurances and guidelines.

Turnover rose by 14.8% to Kenya shillings 9.3 billion. This achievement was regarded as a good start judging from the circumstances in which the group underwent functional changes at every station. The earnings per share increased to Kenya shillings 3.43 while the share price increased to 133.50.

In 1998, the company made a loss before tax of Kenya shillings 708.24 million. This disappointing performance was due to the depressed and uncertain economic conditions which had prevailed in Kenya during this period, coupled with problems related to the company's change programme. The change programme had involved radical re-engineering and restructuring all operations of the group, in order to bring them more into line with modern business practices and to focus more clearly on its core businesses.
This involved dividing the Group’s activities into four units: milling operations, under Unga Limited; animal feeds under Unga Feeds Limited; edible oils and cereals under Elianto Kenya Limited and properties under Chester House Limited. The bloated workforce was also down-sized. A further significant negative factor was the impact of the El Nino rains on stocks and grain prices. Whilst all of these factors contributed to the poor trading results, also included in the overall loss is an amount of Kenya shillings 234 million directly related to restructuring costs, particularly retirement and retrenchment of staff.

In April 1998, a decision was taken to close down Elianto Kenya Limited and dispose of most of its assets and brands. The company had consistently performed poorly in recent years and it was considered that the capital investment necessary to re-equip the plant would not produce the desired return on investment. Included in the loss for the year are expenses amounting to Kenya shillings 89.85 million relating to this closure.

On a more positive note, Unga Feeds Limited, which was not affected by the restructuring to the same extent, recorded substantially improved profits. During the year, there were also a number of other positive developments. A significant investment was made in Year 2000 compliant computer hardware and software. Additionally, it was also decided to invest in a new packaging business, which is closely allied to the company’s milling operations. A new company, Bullpak Limited was established in partnership with Nampak Holdings, South Africa’s largest packaging manufacturer. Unga invested Kenya
shillings 80 million, representing 51% of the shareholding of this company, which commenced operations in October 1998.

Figure 8
Chapter 5: SUMMARY AND CONCLUSIONS

5.1: Summary

The performance of all the 8 companies that have been analysed were greatly affected by the economic environment that prevailed in each of the periods. Many other factors apart from the economic environment in some way also affected these companies performance. However, the economic environment played an important role in their financial performance. This was either positive or negative.

The highest earnings per share was found in the Agriculture sector in George Williamson while the lowest was found in the Industrial and Allied sector in Unga Group. In the Agricultural sector, Brooke Bond Kenya Limited had generally higher prices while George Williamson had the highest earnings per share.

In the commercial and Services sector, Uchumi Supermarket had both the highest prices and the highest earnings per share. The lowest prices and earnings per share were found in Marshalls (East Africa) Limited.
The highest prices and earnings per share were found in Kenya Commercial Bank while the lowest were found in Standard Chartered Bank in the Finance and Investment sector.

The Industrial and Allied sector on the other hand experienced the highest price and highest earnings per share in Unga Group and East African Breweries respectively.

5.2: Conclusions and Implications

No very clear trend were encountered in the reaction of share prices to changes in earnings per share of the various company’s. There are cases when an increase in a company’s earnings resulted in an increase in share prices as in the case of George Williamson in 1998. An earnings per share increase from 6.58 in 1997 to 31.79 in 1998 resulted in an increase in share price from 88.25 to 141. However this trend was not always the norm, for example, an increase in Brooke Bond’s earnings per share in 1998 had an opposite effect on share prices. It resulted in a decrease in share prices from 145 to 141. Therefore it can be said that an increase in earnings per share does not necessarily result in an increase in share price. Share prices are affected by an interplay of many factors. Earnings per share is just one of the factors, but not the only one. The correlation coefficient between earnings per share and share prices is 0.091635326.

5.3: Limitations of the study
One of the disadvantages of the study was the period of analysis. The period covered was too vast. This vast period did not allow for a thorough analysis of the data. Since the reaction of the share prices was not analysed on a daily or monthly basis, the immediate reaction was not evident. Daily or monthly analysis of the share prices would have allowed for a better observation of the reaction of share prices to the various forms of information released. This would be made possible especially if financial statements would be released on a monthly basis. If data was analysed frequently this would have given a clearer picture of the nature of efficiency of the Nairobi Stock Exchange.

5.4: Recommendations for further study

A study should be done that will allow for a thorough analysis of the data over a much shorter period. This could vary for each of the company’s depending on the month the financial reports are released.
BIBIOGRAPHY


## The Nairobi Stock Exchange

### Analysis of Earnings of Selected Stocks

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### Agricultural
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#### 8. Unga Group
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