FACTORS DETERMINING RIGHTS ISSUE FOR FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

By

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D61/P/8390/2003

A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF A MASTER OF BUSINESS ADMINISTRATION , UNIVERSITY OF NAIROBI

OCTOBER 2012

DECLARATION

BY CANDIDATE

This project is my original work and to the best of my knowledge has not been submitted for examination or a degree award in any other university.

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SUPERVISOR

This project has been submitted for examination with my approval as the university supervisor.

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ACKNOWLEDGMENT

I would like to acknowledge the contribution of my family, supervisors Mirie Mwangi and Cyrus Iraya and friends for their valued contribution and input without which the study would not have been finalized within the stipulated time.

DEDICATION

I would like to dedicate this study to My family and friends who have always encouraged me to study more, for their continuous encouragement throughout the study and course.

ABSTRACT

A rights offer refers to an equity issue where all existing shareholders of the issuing company have right to sign up for new shares on a pro rata basis at a certain price and within a certain time period. Although the share rights issue is a vital process in financing of corporations, only few studies have investigated it. A company faces different alternatives when it comes to issuing equity. However, the choice between initial public offer, private placement or share rights issue remains a major problem as there is no scientific procedure that has been established through empirical research. The objective of this study was to determine the factors leading to choice of rights issue as a mode of corporate finance in Kenya.

The study adopted explanatory research design with a population that consisted of the 14 firms listed in the NSE that have used rights issues between the year 2000 and 2011. This study used time series data exclusively obtained from NSE, CMA and audited financial statements of the respective firms. The data collected was analyzed using descriptive statistics, correlations, and linear regression analysis. This was achieved through the use of Statistical Package for Social Scientists (SPSS) and Microsoft Excel. Multivariate regression analysis was utilised in fitting a regression model that describes the relationship subsisting between the dependent variables and independent variables

From the research it was determined that the financial strength of a firm determines whether a firm has a rights issue or not. Post- rights issue ownership retention during this period impacted negatively rights issue contrary to the expectation whereas the age of the rights offer impacts positively the rights issue. It can be recommended from the study that besides this significant model explaining the variation in the rights issue, this research is informative because the findings are consistent with intriguing findings of limited prior research regarding the relevance of rights issue prospectus in guiding investors in making rational investment choice. The findings help clarify preceding empirical rights issue research regarding which factors determine rights issue pricing. Securities exchange regulatory authorities need to review the disclosure requirements for firms going public

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LIST OF ABBREVIATIONS

CEO – Chief Executive Officer

CMA – Capital Markets Authority

NSE – Nairobi Securities Exchange

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The origin of securities markets goes back a couple of centuries. The roots of securities markets are to be found at the beginnings of the Industrial Revolution that began in Europe about four centuries ago. Many of the pioneer merchants of the industrial age wanted to start huge businesses with inevitably large capital outlay, which no single merchant could raise alone. It therefore became inevitable for them to come together, pool their savings and start these businesses as partners or co-owners. Initially, trading in shares began as informal "hawking" in the streets of London. As the volume of shares increased with more companies floating shares (giving people opportunities to buy their shares), the need for an organized marketplace for the exchange of these shares escalated. In the year 1773, the first securities exchange, the London Securities Exchange, was founded. Financial intermediaries (brokers, fund managers, investment advisers investment banks etc) and other instruments like bonds were then to follow suit as an inevitable consequence, (Kayhan and Titman, 2007). The Kenyan securities market; the Nairobi Securities Exchange, was formed in 1954 as a voluntary organization of securitiesbrokers, is now one of the most active markets in Africa. As a capital market institution, the Securities Exchange plays an important role in the process of economic development (www.nse.co.ke). The Nairobi Securities Exchange (NSE) is therefore a market, which deals in the exchange of shares of publicly quoted companies and government, corporate and municipal bonds among other instruments for money.

1.1.1 Rights Issue

A rights offering refers to an equity issue where all existing shareholders of the issuing company have a right to sign up for new shares on a pro rata basis at a certain price and during a certain time period. Since all existing shareholders are eligible to sign up for new shares, there is a possibility that they will all sign up for shares, in which case there will be no dilution of share value and no change in ownership

structure Such an issue can thus be regarded as more or less a reshuffling of capital from investors to the company, leaving the firm value per share exactly the same. In reality, however, the issue may be priced at a discount to current market price. Since the existing shareholders are allowed to resell their subscription rights, assuming efficient markets, no wealth transfer from existing shareholders to outside investors should take place, i.e. there would be no dilution of share value, and no securities market reactions would exist

According to Eckbo and Masulis (1992), a rights issue is when the company offers existing shareholders the right to acquire additional shares in proportion to their current holdings by subscribing to the offer. The company may want to insure itself against less than full subscription in order to obtain the needed capital and/or as a certification of quality, for example, in case the company wants to undertake an insured rights issue they can turn to a guaranteeing investor who is willing to purchase the remaining subscription rights, which has not been exercised or sold by existing shareholders, at the end of the subscription period.

A company faces different alternatives when it comes to issuing new equity. It can either go out broadly to the public with an offer like a public offering or more narrowly with an offer to a selected group of investors. This group can be new potential shareholders or already existing ones. This more selective offer is usually a private placement or a rights issue.

When a company decides to undertake a rights issue it usually first turns to large existing shareholders (Aneborn *et al*, 2006). This is generally viewed as the fairest alternative since existing shareholders should benefit from the risk already taken by investing in the company. Furthermore, if the company turns to other investors the ownership share of the old shareholders decreases relative to that of the new shareholders. If the ownership is dispersed or large shareholders do not want to give a guarantee the company turns to outside investors. These can be investment banks, institutions or wealthy private persons. This means that one or a few investors have the contractual responsibility against the issuing company. These investors in their

turn have agreements with sub-investors. A reason for this can be that the sub-investors want to be anonymous.

The intent of outside guaranteeing investors may vary (Aneborn *et al*, 2006). Either they want to gain a stake for long-term holding or they want to sell the shares directly in order to make a profit. To sell the shares directly involves a risk, since the current securities price might be lower than the issue price, but the compensation for guaranteeing the issue is a certain payoff. In most cases the guarantee will not be used, at least not to a full extent, and then the guaranteeing investor will obtain the compensation without service in return. In the last few years it has become more common that private wealthy investors take advantage of the guarantee not being fully used and make large profits from the compensation (Affärsvärlden, 2005).

The most common method of payment to investors that guarantee a rights issue is a percentage of the amount guaranteed (Aneborn et al, 2006). This percentage usually varies between 4 and 15 percent depending on the quality of the company, with a higher percentage for a company with a lower quality. Another payment method is that the guaranteeing investor gains the right to obtain more shares in the issuing company.

During the trade period for the subscription rights the price for these rights usually is rather stable around the theoretical value. This theoretical value is equal to the discount after dilution. The intensity of the trade in the subscription rights depends largely on the size and the ownership concentration of the company. If the company is large the trade is generally more intense and if the ownership concentration is high the trade is less intense. Almost no rights issues fail, meaning that there are none or very few shareholders that subscribe to the issue, however it is rather common that they are not fully subscribed (Aneborn,et al ,2006).

1.1.2 Determinants of Rights Issue

Financing of a firm is determined by a myriad of issues. These include the cost of finance, the need to maintain a controlling interest by the founders, the ability of the

source to raise the required finances and the number of procedures that a firm has to go through before it can access the finances.

Titman (1984), posit that the financial strength of a firm plays a critical role in the choice of a mode of financing. He argues that firms with a strong financial base are more likely to use rights issue than firms with a weak financial base. In addition, the perception of investors of a firm is key in the issuance of rights by a firm. According to Xiong, (2003); Baker and Stein (2004), a firm with positive investor sentiment has a higher chance of successful uptake of the rights and further boosting its share price at the securities market. He further argues that firms with negative investor sentiment may avoid issuance of rights to avoid negative effects on its securities at the market. The age of a firm influences a number of firm activities. Mature firms issue rights at the market as they have more experience of the market dynamics and have gained enough popularity to guarantee the success of the issue (An and Chan, 2008). Firms also monitor the activities to establish the appropriate timing of an issue. Most firms issue rights when the market is bullish. The movements in the securities market are therefore closely monitored by firms in order to establish the right time to issue. Securities market volatility affects any issue in the market whether initial public offering, (IPO), rights issue, or normal trading in commodities, bonds or shares in the securities market (Tang and Isaksson, 2010).

From the foregoing empirical evidence, it is important to establish the determinants of rights issue in the Kenyan environment. In particular, it is important to investigate the role of financial strength, ownership concentration and age of the firm in the issue of rights by firms in Kenya.

1.1.3 Status of Rights Issue in Kenya

The subject of rigths issue in Kenya is unexplored despite series of rights issues in the last two decades and large participation by the public in the process. As compared to developed and emerging markets, the number of companies issuing rights in Kenya is low. A study by Daily *et al,* (2005) showed that more than 773 firms issued rights in the United States between 1996 and 1997; while a study undertaken by Zhang and Li (2008) shows that between 2003 and 2007 more than 146 and 205 companies issued

rights in China and Hong Kong respectively. In Kenya a rights issue is an issue of new shares for cash to existing shareholders in proportion to their existing holdings.

A few blue chip companies such as Kenya Commercial Bank, Standard Chartered Bank and Kenya Power have used this method as way of raising new cash from shareholders - this is an important source of new equity funding for publicly quoted companies. However, in Kenya, shareholders can, and often do, waive these rights, by selling them to others. Shareholders can also vote to rescind their preemption rights. The price at which the new shares are issued in Kenya is generally much less than the prevailing market price for the shares. A discount of up to 20-30% is fairly common. The main reason is to make the offer relatively attractive to shareholders and encourage them either to take up their rights or sell them so the share issue is fully subscribed.

The price discount also acts as a safeguard should the market price of the company's shares fall before the issue is completed. Do existing shareholders have to take up their rights to buy new shares? Shareholders who do not wish to take up their rights may sell them on the stock market or via the firm making the rights issue, either to other existing shareholders or new shareholders. The buyer then has the right to take up the shares on the same basis as the seller In addition to the price at which a rights issue is offered, there are several other factors that need to be considered when undertaking rights issue in Kenya. These include issue costs, shareholder reactions and control, among others.

According to Ngugi and Njiru (2005) only three companies were listed in the NSE between 1980-1989 while between 1990 and 1999 only 9 companies were listed, four of which were part of the ongoing privatization process of government parastatals. Between 2000 and 2008 only 9 companies were listed on NSE. Further, the study by Ngugi and Njiru (2005) shows there has been a considerable number of companies trading on NSE showing interest on rights issues. As such a study on rights issues as a form of corporate finance for firms listed in the NSE in Kenya is not only relevant but also timely.

1.2 Statement of the Problem

Although the share rights issue is a vital process of financing corporations, it tends to limit the participation of the overall investments in corporations. A study on factors determining share rights issue is of great relevance in emerging markets and Kenya in particular. Daily *et al.,* (2005) argued that because of the importance of share rights issue to the firms' entrepreneurs and initial owners, a study on factors determining funds generated through share rights issue is of crucial importance. Further, it should be noted that the tideus and costly process invovled in rights issue may discourage corporations. According to Ross and Stephen, (2008) factors determining the use of rights issue as a mode of corporate finance has been the main challenge to firms because if a firm fails to identify the right indicators it can make the issue unsuccessful. It has therefore become imperative to understand the factors leading to a choice of a mode of corporate finance and rights issues in particular in the Kenyan Nairobi Securities Exchange.

Despite a growing corporate finance literature on equity offerings, there is a surprising lack of evidence on how firms choose between different modes of corporate finance in Kenya. For example, Daily *et al.,* (2005) argue that determinants of share rights issue offer remains relatively unexplored in literature. Firms have for a long time relied on the pecking order theory in choosing the mode of corporate finance where a firm prefers to finance their operations first by retained earnings; secondly where internal financial sources are not sufficient, they favour debt over equity because of the desire retain independence and control (Cosh and Hughes 1994; Chittenden *et al*. 1996). However, the choice between initial public offering, private placement or share rights issue has been a problem yet no scientific procedure has been established through empirical research. Daily *et al* (2005) argue that there is very limited knowledge on factors that investment bankers take into consideration when setting the offer price. Paleari and Vismara (2007) also agree that although choice of a mode of finance and in particular share rights issue is a vital issue, only limited extent research has addressed it. Despite its importance, determinants of share rights issue financing has remained unexplored in the Kenyan secondary market.

What then are the factors leading to rights issue for firms listed in the Nairobi Securities Exchange?

This study therefore sought to fill this gap by contributing to existing literature and establishing the key determinants of share rights offer by firms listed at the NSE.

1.3 Objectives of the Study

The general objective of this study was to investigate the factors determining rights issue as a mode of corporate finance

The specific objectives of this study was:

i. To determine whether financial strength of a company leads to a rights issue;

ii. To assess whether the age of a firm leads to rights issuance; and

iii. To determine whether ownership concentration of a firm leads to rights.

1.4 Significance of the Study

The findings of this study will be of importance to the following groups:
The findings and recommendations of this study will highlight areas for regulatory framework enhancement which will be of utmost importance to the CMA and NSE management. For investment banks that will underwrite rights issues in Kenyan securities market, it will be useful to take into consideration various factors that determine share rights issue. Identification of key determinants will help to balance divergent interests of investors and firms thus enhance investor sentiment, firm reputation and integrity of the securities market. This research project will be undertaken to contribute to existing literature on the choice of a mode of corporate finance. Therefore, analysts and researchers with an interest in the Kenyan securities market will benefit from the results this study.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter covers the theoretical literature, determinnats of rights issue,empirical literature and summary of literature

2.2 Theoretical Literature

In a rights issue, corporations wishing to raise additional equity capital distribute certain rights to existing shareholders on a pro rata basis. These rights entitle them to buy a certain number of new shares proportionate to their existing shareholdings at a pre-specified price. Shareholders unwilling to buy these new shares are free to sell their rights in the market during a pre-specified time period. Conflicting findings of preceding research on the factors determining share rights issue include those of Bayless and Chaplinsky (1996) who posit that market macroeconomic conditions affect the choice of a mode of corporate finance. In contrast,Koop and Li (2001) argue that underwriter reputation and macroeconomic factors are not related to share rights issue.

Finance journals from the late 1970s to the early 1990s contain a lively discussion of the rights issue as a mode of corporate finance. Marsh (1979), Levis (1995) and Slovin *et al* (2000) document that seasoned equity issues in the United Kingdom are predominantly rights issues. Widespread use of rights offerings in many European countries is reported in different studies by De Jong and Veld (2001) for the Netherlands; Gajewski and Ginglinger (1998) for France; Bohren, Eckbo and Michalsen (1997) for Norway and Tsangarakis (1996) for Greece. Rights offerings are also observed, although not frequently, in Japan (Kang and Stulz, 1999).

The fact that most American firms raise seasoned equity via underwritten public offerings despite the lower cost alternatives of non-underwritten or underwritten rights issues (Smith, 1977, Hansen and Pinkerton, 1982, Heinkel and Schwartz, 1986, Hansen, 1988, and Eckbo and Masulis, 1992). By the early 1990s, the literature

reaches a consensus that rights are used by firms with high ownership concentration, where high insider takeup and exercise of the rights can be expected. The negative signal that a poorly subscribed rights offering would send, which could occur in firms with widely dispersed ownership, is seen as too damaging to risk.

Rights offerings are thus expected to decrease as markets mature and come to include more large firms with widely dispersed ownership. As rights issues did decline in the US, the rights issue paradox seemed settled and research on the problem subsided. A recent study presents a different picture, however. Heron and Lie (2002) report that US rights offerings "rebounded in the 1990s." Because their study is a broad survey of virtually all types of seasoned equity offerings (including primary, secondary and mixed offerings, as well as rights and shelf issues), these authors cannot provide a complete theory of rights usage, though they do note that rights are used by firms in "tight" financial situations.

One contribution of this study is an explanation for the revival of rights offerings as a means of equity financing by firms in Kenyan. Existing finance theory suggests that offers lacking underwriter certification would face a costly negative securities price reaction due to adverse selection. For this reason, Eckbo and Masulis (1992) hypothesize that rights are used by firms with high ownership concentration and expected insider takeup, which neutralizes adverse selection and wealth transfers. This study assumes that, regardless of ownership concentration, value-maximizing managers of distressed firms are willing to accept the costs of adverse selection and proceed with non-underwritten rights issues when existing shareholders have little value to lose, even though investment banks show little interest in underwriting the offering. Thus non-underwritten rights offerings are used by firms in poor financial condition with low net worth, largely as a last resort method for raising equity capital. This can explain the revival in rights offerings in the in the US in the 1990s, given Altman's (1993) recognition that in this period corporate financial bankruptcies soared. In effect, due to innovation, the rights offering method has taken on a new role in choices of equity financing.

This study tries to address the rights issue paradoxes. If rights are used primarily by firms in poor financial condition, then managers of healthy firms would be less likely

to want their firms to be associated with rights offerings, despite out-of-pocket cost savings that might be available. Furthermore, while troubled firms have low adverse selection costs and will thus get lower benefits from underwriter certification, healthy firms face high adverse selection costs that would outweigh the cost savings of rights issues. Moreover, recognizing that the financing method choice is a mutual choice problem between issuers and underwriters (Fernando et al., 2005), investment banks are often unwilling to be lead underwriters for deeply distressed firms. There are thus no rights paradoxes in the case of distressed financing using the non-underwritten rights method.

2.2.1 Adverse Selection Model

This theory was established by Myers and Majluf (1984). This model concerns the situation where a company seeks new funds to undertake a certain project and relies on three crucial assumptions: first, that there exists asymmetric information between the management and the market, where the management knows more about the true value of the company than the market, secondly, that the CEO of the company always maximizes the return of the existing shareholders; and finally that the offer is directed both to existing and potential shareholders, thus it is a public offering.

Under these circumstances a manager who is aware that the company is undervalued will not choose to issue new equity through a public offering. If an undervalued company chooses to undertake a public offering the value of the shares for the existing shareholders will become diluted and hence the old shareholders will be worse off than before the offer. Thus all issuing companies in a public offering are overvalued.

Since all actors in the market in this model know that the CEO always maximizes the return of the existing shareholders they also know that all issuing companies must be overvalued for the reasons explained above. The new shareholders will thus demand a discount to compensate for this overvaluation. Furthermore the market reaction following a public offering is negative since the market interprets this event as a sign of overvaluation.

The manager of an overvalued company that wants to undertake a public offering has the option to choose between an insured and an uninsured issue. The benefits of an insured public offering are that the market reaction will be less negative and that the demanded discount will be lower. This is the case since a guaranteeing investor only is willing to give a guarantee after a thorough investigation because of the relatively large amount of capital set aside to be invested in the issue. This guarantee gives a signal to other potential investors that the issue price is fair and hence reduces the asymmetric information.

2.2.2 Market Timing Theory

The general market timing theories claim that the tendency to issue equity depends to a large extent on the overall market conditions, as stated in for example Baker and Wurgler (2002). Put simply, companies rather issue new equity when their shares are overvalued by an optimistic market.

The market timing theory is closely related to that of adverse selection and pecking order. Under normal market conditions, only overvalued companies with poor future prospects will choose to issue equity. This is because companies with worse future outlook will have greater difficulties in issuing debt, and will then to a greater extent have to issue equity. Furthermore, overvalued companies have greater incentives to issue equity since they have the opportunity to benefit from the unfoundedly high value. Undervalued companies with better future prospects want to diversify themselves from the companies with poorer prospects, and will thus issue debt. Hence, the market uses the companies' choice of capital as a method to separate the good companies from the bad ones.

According to the market timing theory, both companies of better and worse quality will choose to issue equity in periods when the market is booming since more companies face a securities price over the intrinsic value during this period. The problem of adverse selection is then decreased since more companies of good quality are included in the pool of issuing companies.

2.3 Determinants of Rights Issue

There are various determinants of rights issue. Those relevant to this study include the following:

2.3.1 Ownership Concentration and Rights Issue

Large shareholders have more incentives to participate in any undertaken rights issue, since they by definition have a larger interest invested in the company. Therefore large shareholders might require a smaller discount in order to subscribe to a rights issue, since they want to maintain their controlling position in the company. A contradictive reasoning to this is that majority shareholders might desire a large discount since they own a large stake and therefore will benefit the most from a large discount. In this case the majority owners will vote for a larger discount even if this is not in the best interest for the company. We believe that this last effect will be the dominating one and hence we state the hypothesis that companies with a more concentrated ownership will offer a larger discount when undertaking a rights issue.

Ownership Concentration and Agency Problem theory, predicts that investors will want to diversify their ownership as much as possible to avoid any idiosyncratic risk (Bergström and Samuelsson, 2001). However, reasons for concentrated ownership can be found; for example Bergström and Samuelsson (2001) argue that concentrated ownership can be a way to solve the agency problem. The agency problem arises as soon as the management of the company, the agent, is separated from the shareholders, the principal (Jensen and Meckling, 1976). This induces an information asymmetry between the two groups. There is a risk that the managers become reckless with the company's holdings since they are not fully affected by the financial, consequences of their actions.

The possible reduction in return on investment for the principal is a part of the agency costs. Jensen and Meckling (1976) refer to this as residual loss. Agency costs also include monitoring costs, which is borne by the principal, and costs for the agent to signal good behavior, which is called bonding costs by Jensen and Meckling (1976). The incentive of managerial misbehavior increases if the shareholders are unable to fully monitor the managers. This problem can be solved by increasing the ownership

concentration since an owner with a larger stake in the company will be more inclined to put effort into the costly monitoring. Thus companies with a higher ownership concentration can be expected to bear less agency costs than the average company.

However, the agency cost is not entirely reduced when the ownership concentration is high. To some extent the agency problem is transferred from the relationship between managers and shareholders to that between majority and minority shareholders (Bergström and Samuelsson, 2001). In terms of Jensen and Meckling (1976) the majority owner will in this case take the role of the agent and the minority owners will be the principals. Here, the minority owners might suffer from agency costs in terms of residual loss if the majority owner acts only in her own interest. The majority owner bears monetary and/or non-monetary bonding costs to signal good behavior. If the minority owners experience that the majority owner misbehaves, concentrated ownership can also help to solve what Bergström and Samuelsson (2001) refer to as the matters of incomplete contracts and collective decisions.

2.3.2 Post-rights Issue Ownership Retention

Post-rights issues ownership retention may play a role in valuation process of rights issues. Private firms are not always wholly owned by managers, and separation of ownership and management creates agency problems (Fama and Jensen, 1985; McBain and Crause, 1989).

Ofek and Richardson (2001) show a positive relationship between rights issues values and post-rights issues ownership retention using a downward sloping demand curves for rights issues shares. Thus, higher retention levels means that fewer shares will be available for trading and hence rights issues prices will increase. According to McBain and Krause (1989) higher valuations are experienced by firms whose pre-rights issues shareholders maintain relatively larger ownership positions following the offer.

Consistent with Ritter (1984), Bhagat and Ruggini (2004) document a positive relation between rights issues valuation and post-rights issues ownership retention. rights issues increases dispersion of shareholdings, leading to decline in ownership

concentration which give rise to managerial incentive and control consideration (Zingales, 1995). This managerial incentive and control consideration is linked to rights issues anomalies such as underpricing and long-run poor performance (Pham *et al*, 2003). Bhagat and Rangan (2004) argue that greater ownership concentration by pre-rights issues shareholders sends a credible signal of their confidence about the company's prospects to the investment banker and to potential investors, and thus leads to higher rights issues values.

Ljngqvist and Wilhelm (2003) posit that ownership structure and saving behaviour have an impact on the intensity of monitoring and hence the extent of realised underpricing. Ownership structure has an impact on the pricing of rights issues via the principal-agent relationship. Habib and Ljngqvist (2001) posit that where owners sell fewer shares at the time of rights issues, they are likely to be more tolerant to underpricing (and hence higher offer price) because the benefit of costly monitoring is minimal.

Baker and Wurgler (2007) argue that because executives have better information about fundamental value of their firms, their personal portfolio will reveal their views about the value of the firm. Bhagat and Rangan (2004) extending the work of Leland and Pyle (1977) argue that the entrepreneur taking the firm public retains shares only when he is optimistic regarding future cashflows of the firm. The signalling model of Leland and Pyle (1977) implies that greater ownership retention enhances rights issues values.

2.3.3 Financial Strength and Rights Issuance

Ursel (2006) makes a connection between the use of rights issues and financial strength. Companies that are financially weaker will face higher underwriting fees, since the underwriter will be less willing to give an insurance to buy remaining shares in a company that is more likely to face bankruptcy. These increased costs of insurance may be higher than the reduced costs of adverse selection, and financially distressed companies may thus not want to issue rights. Hence Ursel (2006) believes that the propensity to issue rights is positively correlated to the financial strength.

However, we question the logic of her reasoning. It is plausible that the companies that are in risk of financial distress also are the ones with highest need of capital and hence in greater need of a right issue to secure the capital needed. This is a factor that Ursel (2006) does not consider.

A number of studies have focused on explaining the negative share price response to rights issue announcements. The majority of the findings in this area have produced information models (Myers and Majluf, 1984). More recently, researchers focused on finding explanations for the variances within the negative share price responses. They focused on firm-specific factors, which included the application of funds, capital structure, issue size, information asymmetry, growth opportunities and managerial ownership (Korajczyk & Levy, 2001).

Economic factors have been found to explain some of the variance and have been linked to other issues surrounding rights issue announcements. Madura and Akhigbe (1995), in their study of the effect of economic factors on the valuation effects of convertible debt offerings, found a significant relationship between the share price response and nominal interest rates; the relative securities price level of the issuing firm, and economic growth.

Although several researchers have identified significant relationships between interest rate changes and share returns, volatility and cash flow (Nofsinger, 2001), Choe *et al.* (1993) found that neither long-term nor short-term interest rates had any significant power to explain the share price reaction to the announcement of an equity issuance. He further explains that periods of high economic growth are also periods of low asymmetric information, which accounts for the clustering of equity issues in periods of strong economic growth. Periods of low asymmetric information are associated with lower adverse selection costs, as investment opportunities are more promising and there is less uncertainty about the assets in place.

In South Africa, Home (1999) found that a three-month moving average of the five-day average cumulative residual returns subsequent to a rights issue announcement could be plotted against time to reveal hot, cold and normal periods in the market. He suggested that there could be external determinants for the above periods. Bayless and

Chaplinsky (1996) focused on finding periods in which equity could be raised at favorable terms, using the aggregate volume of equity issues as their main focal point. Their findings seemed to suggest that macroeconomic conditions are unrelated to share price responses, but they qualify their findings by stating, "However, it should be stressed that these results do not imply that macroeconomic factors are unimportant influences on investor's expectations of the motivation to a rights issue. Indeed the significant differences in economic conditions in hot and cold markets amply demonstrate the need to control for the influence of market and macroeconomic conditions on the announcement date prediction errors." (Bayless and Chaplinsky, 1996).

2.3.4 Age of the Firm

Rights issues firms are subject to uncertainties regarding quality of the firm because of missing track record and lack of public scrutiny. In order to compensate investors for value uncertainty, investment bankers discount rights issues offer prices (Beatty and Ritter, 1986; Rock, 1986). According to Carter and Manaster (1998) older firms have longer operating histories and face less uncertainty. This observation was also echoed by Ritter (1998) who argue that younger firms have shorter operating history and are subject to great deal of uncertainty. According to Daily *et al* (2005) because of greater uncertainties surrounding the prospects of younger firms, underwriters apply greater offer price spread and lower offer prices as compared to older firms with larger operating history.

According to Kim and Ritter (1999) it is difficult to forecast future cash flows of younger firms due to missing track records. Ritter (1984) observe older firms are subject to less uncertainty, and because underpricing is a compensation to uncertainty investment bankers attach higher value to rights issues of older firms. Information asymmetry theory advanced by Beatty and Ritter (1986) postulates that firms facing larger uncertainty need larger offer price discounts to compensate investors for value uncertainty. Consequently, younger firms with short operating histories are valued less because of greater uncertainty arising from missing track record.

2.4 Empirical Literature

Daily *et al.,* (2005) argued that because of the importance of share rights issue to the firms' entrepreneurs and initial owners, a study on factors determining funds generated through share rights issue is of crucial importance. Further, it should be noted that the tideus and costly process involved in rights issue may discourage corporations. According to Ross and Stephen*,* (2008) factors determining the use of rights issue as a mode of corporate finance has been the main challenge to firms because if a firm fails to identify the right indicators it can make the issue unsuccessful. It has therefore become imperative to understand the factors leading to a choice of a mode of corporate finance and rights issues in particular in the Kenyan Nairobi Securities Exchange. Derrien (2005) argued that rights issues pricing is based on intrinsic value of the company as revealed by investor sentiment. Ljngqvist, Nanda, and Singh (2003) also agree that investor sentiment affects the pricing of rights issues, but posit that since noise traders are wealth constrained, the issuer must price rights issues below the price noise traders are ready to pay to induce informed investors.

Despite a growing corporate finance literature on equity offerings, there is a surprising lack of evidence on how firms choose between different modes of corporate finance in Kenya. For example, Daily et al., (2005) argue that determinants of share rights issue offer remains relatively unexplored in literature. Firms have for a long time relied on the pecking order theory in choosing the mode of corporate finance where a firm prefers to finance their operations first by retained earnings; secondly where internal financial sources are not sufficient, they favour debt over equity because of the desire retain independence and control (Cosh and Hughes 1994; Chittenden et al. 1996). However, the choice between initial public offering, private placement or share rights issue has been a problem yet no scientific procedure has been established through empirical research. Daily et al (2005) argue that there is very limited knowledge on factors that investment bankers take into consideration when setting the offer price. Paleari and Vismara (2007) also agree that although choice of a mode of finance and in particular share rights issue is a vital issue, only limited extent research has addressed it.

Empirical research on the effects of a rights issue on the stock prices gives evidence that the market reacts favorably to a rights issue. Satyajit & Chhaochharia, (2006), for example, have documented evidence of a favorable reaction of the stock market to a rights issue in the US. Brennan and Hughes, (1991), and Obaidullah (1992) have found out similar evidences in India. Empirical research has shown that the market generally react positively to the announcement of rights issue (Mayank,2008), Numerous studies in India have dealt with the information content of various types of announcements (Singh and Mittal (2004), and Mishra (2005).

According to Ngugi and Njiru (2005) study only three companies were listed in the NSE between 1980-1989 while between 1990 and 1999 only 9 companies were listed, four of which were part of the ongoing privatization process of government parastatals. Between 2000 and 2008 only 9 companies were listed on NSE. Further, the study by Ngugi and Njiru (2005) shows there has been a considerable number of companies trading on NSE showing interest on rights issues.

2.5 Summary of Literature

Ofek and Richardson (2001) show a positive relationship between rights issues values and post-rights issues ownership retention using a downward sloping demand curves for rights issues shares. According to McBain and Krause (1989) higher valuations are experienced by firms whose pre-rights issues shareholders maintain relatively larger ownership positions following the offer.

A number of studies have focused on explaining the negative share price response to rights issue announcements. The majority of the findings in this area have produced information models (Myers and Majluf, 1984). More recently, researchers focused on finding explanations for the variances within the negative share price responses. They focused on firm-specific factors, which included the application of funds, capital structure, issue size, information asymmetry, growth opportunities and managerial ownership (Korajczyk and Levy, 2001).

Derrien (2005) argued that rights issues pricing is based on intrinsic value of the company as revealed by investor sentiment. Ljngqvist, Nanda, and Singh (2003) also

agree that investor sentiment affects the pricing of rights issues, but posit that since noise traders are wealth constrained, the issuer must price rights issues below the price noise traders are ready to pay to induce informed investors.

According to Carter and Manaster (1998) older firms have longer operating histories and face less uncertainty. This observation was also echoed by Ritter (1998) who argue that younger firms have shorter operating history and are subject to great deal of uncertainty. According to Rock (1986), to lure relatively uninformed investors, investment bankers underprice share rights issues to cushion against potential losses experienced by uniformed investors due to Winner's curse. An and Chan (2008) posit that greater uncertainty of the firm's value encourage investors to demand for lower share rights issue price as an incentive for risk. Further, Daily *et al.,* (2005), argue that outside board member is a prestigious assignment. Certo *et al* (2001) argue that rights issues firm gains legitimacy through prestigious board of directors.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter contains the research design, target population of the study, sample design and size, data collection methods, data analysis techniques and limitations of the study. This was done to make the research project a success in choosing the research design, population sample, data collection and analysis.

3.2 Research Design

A research design identifies the strategies through which a research is to be carried out. This study adopted a descriptive research design. This design was appropriate for the study as it enabled higher level analysis such as correlation and regression analysis that allowed for establishing the nature strength and extent of the associations between the variables. According to Cooper and Schindler (2009) explanatory research design is structured with clear investigative questions and can be used to discover associations among different variables. This corresponds to the aim of the study to investigate factors leading to rights issuance as a mode of corporate finance in Kenya.

3.3 Population of the Study

Cooper and Schindler (2009) describe a population as the total collection of elements whereby references have to be made. The population for this study consisted of firms listed at the NSE that have had rights issue from 2000 to 2011. According to the NSE database, 18 firms have used rights issues in the past with only 14 being between the year 2000 and 2011. See appendix I for details. Due to the small size of the Kenyan-based listed firms that have used a rights issue, a census was carried out covering all the companies that have used this mode of corporate finance since the year 2000. The most appropriate sampling design that was used is purposive sampling. According to Mugenda and Mugenda (2003) purposive sampling facilitates the use of cases that posses the required information in relation to the research objectives. This ensured

that the elements chosen are relevant for the study and was therefore important when studying a specific feature of the subjects under consideration.

3.4 Data Collection

This study used secondary data exclusively. This was suitable as the study adopted a quantitative research approach. Rights issues between the period 1 January 2000 and 31 December 2011 was identified from the NSE bulletins. Rights issue announcement date was established by inspecting the company records obtained from NSE and CMA. In particular, issue price, issue size, market value of equity, securities returns and market returns was obtained from the CMA library in Nairobi. The daily share and index closing prices were obtained from NSE and CMA. In addition, financial strength, post- rights issue ownership retention and age of the firm will be collected.

The data was obtained from NSE, CMA and audited annual financial statements submitted to the Capital Markets Authority. The data was entered into an excel sheet to facilitate further computation of the ratios required to measure the variables of the study. To ensure completeness and accuracy of data, a data collection guide, was used to capture data on all the variables of the study.

3.5 Data Analysis and Presentation

The data collected was analyzed using descriptive statistics, correlations, and linear regression analysis. This was achieved through the use of STATA software package. The analysis sought to answer research questions and explain the associations and dependencies between the variables of the study. The output was presented in form of tables and figures. Multivariate regression analysis resulted in a prediction equation that describes the relationship between the dependent variable and independent variables (Gujarati, 2000). The model is as explained below;

$$Y = \beta_0 + \beta_{ij} X_{ij} + \epsilon$$

Where

Y -dependent variable- rights issue

β_0 -is the constant (y intercept)

X_{ij} is a set of - independent variables *i* for company *j* these variables include the financial strenght of the company (X_1), age of the rights offer firm (X_2)and post-rights issue ownnership retention (X_3).

B_{ij} -regression coefficient *i* for variable *j*

ϵ -the stochastic error term

In relation to the objectives of the study the researcher used STATA to estimate the following multivariate regression analysis covering the factors determining rights issue for firms listed at the NSE as shown below:

$$R = \beta_0 + \beta_1 FINS + \beta_2 AGE + \beta_3 PRIOW + \varepsilon$$

Where R : Rights issue at time (t).

FINS: is the financial strength of the company.

AGE: Age of the Rights offer firm.

PRIOW: Post- rights issue ownership retention . β_0 is the intercept; and reflects the constant of the equation.

β_1 is the sensitive coefficient of each independent variable (i=1,2,3,4,5).

ε is the error term.

The T-test was used to test the significance of the difference in pre and post rights issue. These tests were conducted at 95% level of confidence (α=0.05).

3.5.1 Measurement of Variables

Rights issue (R): is measured in Kshs and is obtained from from the prospectus of the rights issues firms.

FINS was based on the current ratio measured in Kenya shillings made during the period prior to the rights issue offer

AGE: is number in years the rights offer firm has been in existence to the period of the rights issue.

PRIOW: Post rights issue ownership retention is a fraction of the total shares owned by the top 20 shareholders to the total issued shares of a company.

3.6 Reliability and Validity

Reliability was concerned with the consistence of measures. The level of an instruments' reliability is dependent on its ability to produce the same results when used repeatedly (Babbie & Mouton, 2001). Validity refers to whether an instrument actually measures what it is supposed to measure, given the context in which it is applied (Babbie & Mouton, 2001).

To achieve validity and reliability, data was checked for coding errors and omissions while coding into excel sheets. The database was also verified for accuracy and completeness of all the entries to ensure reliability of data is achieved.

3.7 Ethical Consideration

Data was obtained from Nairobi Securities Exchange data set, Capital Markets Authority and annual financial reports after obtaining the consent of the respective institutions. This was done by an official letter from the university and an introductory letter from the researcher. All the information obtained was kept private and treated with the confidentiality it deserves, was used for academic purposes and only findings was published and not the raw data.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter deals with data analysis and presention of the findings. It covers the financial strength ownership concentration ,the age of the firm and the firm size as they affect rights issue. Other areas capture include sectoral classification of the sample of rights issue by companies response rate,level underpricing and regression results.

4.2 Response Rate

The study utilized secondary data gathered from the firms listed in the NSE. The research studied the records of all the firms listed . The response rate was therefore 100%.

4.3 Sectoral Classification of the Sample of Rights Issue by Companies Rate

The companies listed on NSE were classified into five sectors. This classification is based on sectoral classification by the NSE. The table shows that majority of the companies listed on the NSE between 2000 to 2011 were from agricultural 8%, commercial and services sector 18%, financial and investment sector 26% and industrial and allied sector was 34%. The fact that industrial and allied, and financial and investment sector had the highest percentages of companies listed could be attributed to availability of growth opportunities for firms in these sectors.

Data was collected from NSE database; company rights issue prospectus and websites of investment banks. Company prospectuses were obtained from Capital Market Authority (CMA) of Kenya library. The sample of 14 companies that have participated in rights issue between the 2000 and 2011 that were considered in this study represents 28% of the 50 companies listed on NSE currently. Investment firms, firms with cross-listings and firms with missing information were excluded from the companies listed on NSE for the period under study. As a result, three companies

were excluded, resulting to 10 sample companies with an effective response rate of 77%.

The companies that participated in this study were, 1 or 25% was from those in the Agricultural sector, 2 or 23% were from the commercial and services sector, 3 or 23% were from those in the financial and the investment sector. On the other hand, 3 or 18% were from the industrial and allied sector while 1 or 14% were from the alternative investment market segment. Table 4.1 below best illustrates the facts above.

Table 4.1 Sectoral Classification and Sample Companies

Main investment segment	**Total Number**	**Percentage**	**Rights issued**	**Participants**	**Percentage**
Agricultural sector	4	8	2	1	25
Commercial and service sector	9	18	2	2	23
Financial sector	13	26	4	3	23
Industrial sector	17	34	5	3	18
Alternative investment market segment	7	14	1	1	14
Total	50	100	14	10	100

4.4 Financial Strength and Rights Issue

The findings indicate that subject to shareholder approval is usually the basis for capital ratios, strengthening the core equity of companies that give rights issues. Internal capital generation remains strong for firms under study who were found to be strong with a tier o 1.2 ratio of 7.4 on average when pegged on the rights issue**.** It was also found out the Rights Issue enhances firms' ability to deal with the impact of an uncertain economic environment and to respond to unforeseen events and give them options in relation to opportunities for those with superior financial strength. Analysis indicates that 90% of the firms point out that higher regulatory capital requirements

and changing market sentiment has raised expectations regarding capital levels for the rights.

At the same time the analysis is instructive that planned internal capital generation remains strong and this capital raising will enhance firms' ability to deal with the impact of an uncertain economic environment and to respond to unforeseen events. Importantly, it will also gives firms options regarding opportunities which firms believe will present themselves to those with superior financial strength. Analysis shows that firms' boards believe that the Rights Issue is in the best interests of shareholders, helping us strengthen our competitive positioning so that we can better deliver sustained value over time.

Consistent with the gradual incorporation of information, financial strength predicts both future returns and future institutional investor demand. Further consistent with the gradual incorporation of information, more sophisticated transient (high-turnover) institutions respond to financial strength signals prior to less sophisticated, nontransient institutions. A number of additional tests suggest that financial strength forecasts stock returns, at least in part, because it forecasts institutional demand, and institutional demand drives prices.

4.5 Age of the Firm

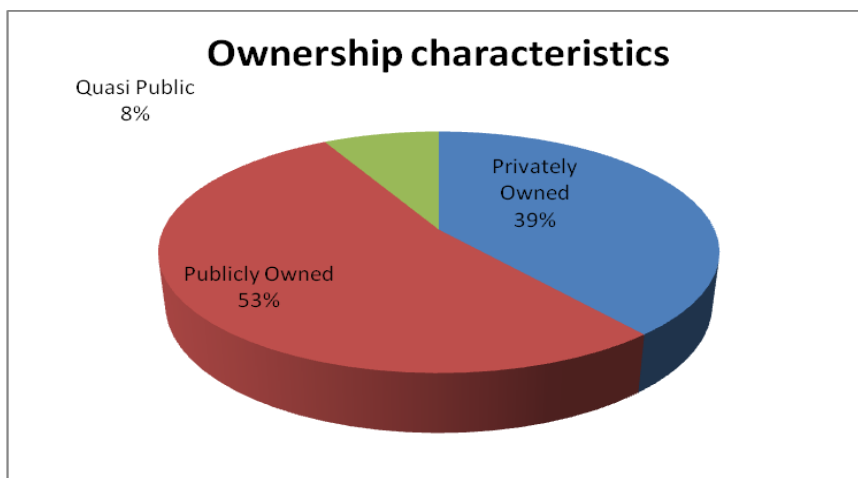
From the study findings it can be deduced that age of the firm could be a proxy for other drivers of performance, for instance, financial constraints leading to rights issue. Shumway (2001), claim that the economically most meaningful measure of age is the number of years since listing of the firm. That event is a defining moment in a company's life. Not surprisingly, rights issue listing affects ownership and capital structure multiplies growth opportunities, increases media exposure, and demands different corporate governance structures thus having an influence on the rights issues. The issuer firms` age and rights issue proceeds are not significant determinants of choice. Again it is not the case that large issues tend to be affected by rights. Relative issue size is significantly negative, consistent with the theoretical development. Consistent with prior research, there is overall negative abnormal returns for the whole sample of rights issue during the study period.

Study findings indicate that there is a statistically significant positive relationship which exists between age of the firm, the rights issue and aftermarket performance for the overall sample of all the firms in the study period. An observation from the study is that the age of the firm and the return after rights issue relationship is different for different firms. In the aggregate, the findings show a statistically significant correlation between firm age at the time of the right issue and the post rights issue excess returns. Young firms outperformed older firms, though the difference in return between the two age groups did not rise to a high level of statistical significance.

4.6 Ownership Characteristics

Figure 4.1 below provides information showing the ownership characteristics of the companies listed on the NSE between 2000 and 2010. It is clear that most of the companies at 39% listed on NSE were privately owned with few shareholders prior to any shares offer. Publicly owned companies were 53% while quasi public companies were 8%. The reason why majority of the companies listed were publicly owned by few companies and individuals prior to rights issue offers could be attributed to resource constraints of the private sector and the need to expand to take advantage of growth opportunities. The need to privatize parastatals to enhance efficiency could explain why public (government-owned) companies constituted the second largest number of companies listed.

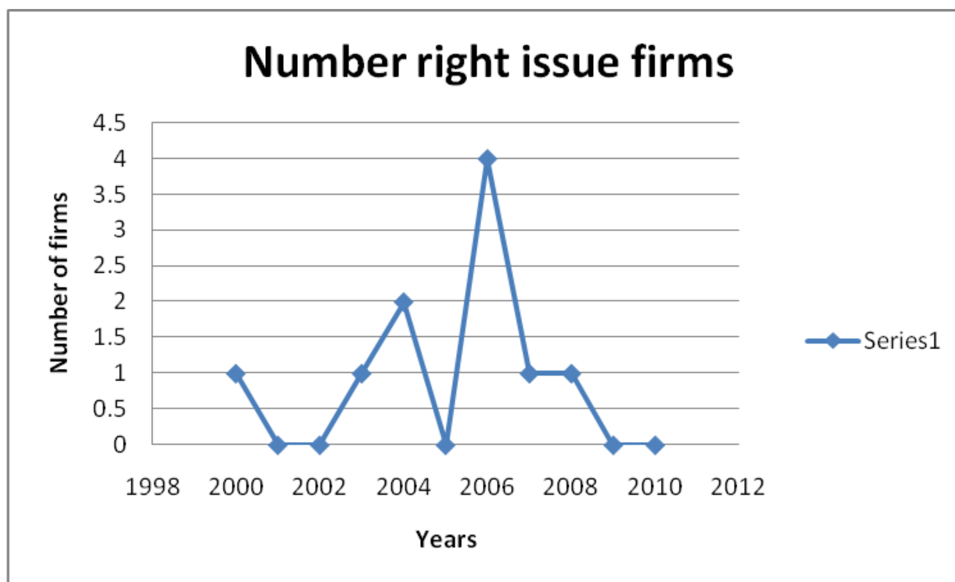
Figure 4.1 Ownership Characteristics



4.7 Variation in the Number of Companies Listed Annually

From the study findings during some years none of the companies offered rights issues on offer. The highest number of companies that offered rights issue was experienced in 2006. The number of firms issuing rights issues on the NSE fluctuated between zero and four. The observations in Figure 4.2 below were not surprising. These were consistent with previous researches for example (Pastor & Veronesi, 2005) that right issues come in waves. The fluctuations in the number of rights issue could be attributed to fluctuations in investor sentiment and companies taking advantage of windows of opportunities. According to Baker and Wurgler (2007) demand for rights issues is sensitive to investor sentiment and this explains why rights issues volume fluctuates over time.

Figure 4.2 Variation in the Number of Companies Listed Annually



4.8 Regression Results

Using STATA, following regression analysis was estimated.

$$R_0 = \beta_0 + \beta_1 FINS + \beta_2 AGE + \beta_3 PRIOW + \varepsilon$$

The fitted regression model is presented as follows:

$R_0 = 9.367331_{(0.01691)} - 1.0014685_{(0.02512)}FINS + 0.7151691_{(0.02244)}AGE - 7.009067_{(0.00321)}PRIOW$

The coefficients` *R*-values are given in the parenthesis. In all the estimated model coefficients, the R-values were less than .05 (i.e. 0.5>R) implying that the variables tested significantly influence the rights issue offer price at 5% significance level. Also since the coefficient for financial strength (FINS) and ownership concentration (PRIOW) are negative, this means that FINS and PRIOW negatively relates to the rights issue offer price i.e. the higher the FINS and PRIOW, the lower the rights issue offer and vice versa. The fitted model was diagnosed and found that the regression was statistically significant at 5% significance level (regression *R*-value= .05 >. 035515). This shows that the combination of these factors (explanatory variables) significantly affect the response variable (rights issue offer price). Further, R-square = 61.234%, implying that the explanatory variables accounted for 61.234% of the response variable.

The financial strength of a firm detrmines whether a firm has a rights issue or not. If a firm is financially capable of carrying out its obligations more especially those to do with expansion programs then there is need for it to issue rights. This being the case therefore a well performing firm will never issue rights thus financial strength negatively impacts on the rights issue. In this study period a unit change in financial strength of a firm decreased chances of a rights issue by 1.0014685 or 10.014685%.

Post- rights issue ownership retention during this period impacted negatively rights issue contrary to the expectation. In the period 2000-2011 understudy the decisions made concerning the post-rights issue ownership retention such as right to sale before period set elapses, transfer of post-rights issue to third parties decreased rights issue. In this period a decrease in post- rights issue ownership retention decreased rights issues by 7.009067 which is equivalent 70.09067% of rights issue.

The age of the rights offer impacts positively the rights issue. The number in years the rights offer of firm has been in existence relates positively to the period of the rights issue. If a firm has been in place for a long time quite some time the rights issue is

positively influenced. In the study period the age of the rights offer increased the rights issues by 0.7151691 or 7.151691%.

All together the effects of explanatory variables captured in the model are significant, and these findings are informative, as they intrigue significant questions regarding factors underwriters take into account when pricing rights issue, and the relevance of rights issue prospectus. Apart from one market factor the other four factors are firm-specific variables disclosed in prospectus. They are intended to signal the value of rights issue firm to potential investors and help mitigate uncertainties surrounding right issue firm due to missing track record as a result of limited public disclosure of the company dealings prior to going public for a rights issue.

On the basis of these findings, high value firms are unable to distinguish themselves from low value firms as far as firm-specific explanatory variables captured in the model are concerned. The regression result is consistent with the findings of preceding studies such as Daily (2005) and Ritter (2002). Daily (2005), for example, found there is a relationship between rights issue offer price and firm-specific information disclosed in prospectus, consistent with the Efficient Market Hypothesis, Signalling Theory and Resource Based View of the firm. Ritter (2002) found that rights issue price only partially incorporate publicly available information. The regression output showed R-square value of 61.234%. This implies that there could be other factors that contribute to the remaining 38.766% in explaining the variation in rights issue offer price in Kenya.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of the finding and discussions of the study. It also covers the recommendations for further studies on related issues on the study not well covered as well as recommendations on matters of factors leading to rights issue as a mode of corporate finance. The study finally addresses the limitations of the conclusions of this study.

5.2 Summary of Findings

It can be summarized from the findings that a widely used measure of investor sentiment is the performance of securities market index prior to the offering. Investor sentiment is a belief about future cash flows and investment risks that is not justified by the facts at hand. Behavioural finance literature shows that investor sentiment results from noise trader sentiment where noise traders suffer a sequence of psychological biases such that their trading behaviour cannot be explained by rational expectation theory. Behavioural biases have become popular for explaining asset pricing that are inconsistent with a rational decision-making framework. Accordingly excessive optimism drives asset values above fundamental.

Post-rights issue ownership retention may play a role in valuation process of rights issue. There is a positive relationship between rights issue values and post-rights issue ownership retention using a downward sloping demand curves for rights issue shares. Thus, a higher retention level means that fewer shares will be available for trading and hence rights issue prices will increase. Higher valuations are experienced by firms whose pre-rights issue shareholders maintain relatively larger ownership positions following the offer. Where owners sell fewer shares at the time of rights issue, they are likely to be more tolerant to under pricing (and hence higher offer price) because the benefit of costly monitoring is minimal. An entrepreneur taking the firm public retains shares only when he is optimistic regarding future cash flows of the firm.

Older firms have longer operating histories and face less uncertainty. This observation was also echoed by Ritter (2002) who argue that younger firms have shorter operating history and are subject to great deal of uncertainty. Because of greater uncertainties surrounding the prospects of younger firms, underwriters apply greater offer price spread and lower offer prices as compared to older firms with larger operating history. Investors in the capital market posses differing levels of quality information, given the missing track record of the firm. Because of information unevenness, extant research has relied on signaling theory for investigating determinants of rights issue firm performance. Signaling theory postulates that rights issue firm managers strive to reveal the firm`s value to outsiders through favourable information so as to maximize the share price. Firms reveal their value through prospectus to show their potential and growth opportunities. This study was guided by signaling theory, complemented by the resource based theory of the firm. The resource based theory of the firm postulates that a firm nurtures resources to differentiate itself from its competitors. This theory complements the signaling theory .Rights issue firms during the book building process strive to induce institutional investors and investment banks that it merits investing in its shares.

5.3 Conclusion

This study investigated the factors determining rights issue for firms listed at the Nairobi Securities Exchange. It was intended to investigate the extent to which the identified explanatory variables lead the explained variance in the dependent variable, the rights issue. The data collected was presented using descriptive statistics and analyzed using multivariate regressions. The findings show that majority of the companies listed were from industrial and allied sector 34%, followed by financial and investment at 26%, commercial and services 18%, and agriculture 8%. Of the sample companies, 39% were privately owned, while 53% were publicly owned and 8% were quasi-public.

Abnormal initial returns were also observed among the sample companies. Save for Housing finance which experienced negative initial returns of -1.41% and KPLC with initial returns of zero, the other entire sample companies' experienced positive initial

returns. The average under pricing was found out to be 49.44%. The average rights issue was Ksh. 10.97 with an average of first day trading closing price of Ksh. 16.74.

In all the estimated model coefficients, the *R*-values were less than .05 (.05>.035515), implying that the variables tested do not significantly influence the rights issue at 5% significance level. R2 was 61.234%, which means that the explanatory variables accounted for only 61.234% variation of the response variable. Consistent with the hypothesized signs, the financial strength (FINS) and post rights issue ownership concentration (PRIOW) were positively related to rights issue.

The rights issue pricing in Kenya is inconsistent with Efficient Market Hypothesis, as evidenced by under pricing phenomenon. Efficient Market Hypothesis postulates that security price reflects all publicly and privately available information. Unfortunately, investment banks in Kenya under price rights issue and investors are able to make abnormal returns on the first day of trading through flipping. Of the explanatory variables captured in the model, none is significantly related to the rights issue offer price. For all the estimated coefficients, R is less than .05. The expected positive sign for financial strength implies that the effect of financial strength on security pricing in Kenyan rights issue market can be explained by rational theory. The result was consistent with the findings of Daily (2005) and Beatty and Ritter (2002) that publicly available information disclosed in prospectus is of very little relevance. This has been evidenced by the significant coefficients of the explanatory variables and the low level of the overall goodness of fit of the model. The R2 of 61.234% implies that a major proportion of the variation in the rights issue is explained by factors outside the model.

5.4 Recommendations

It can be recommended from the study that besides this significant model explaining the variation in the rights issue, this research is informative because the findings are consistent with intriguing findings of limited prior research regarding the relevance of rights issue prospectus in guiding investors in making rational investment choice.

Although this research is to some extent Kenyan-specific, the findings help clarify preceding empirical rights issue research regarding which factors determine rights issue pricing. Since publicly available information provided in the prospectus have little relevance, then the potential for the regulatory authorities to protect potential investors is curtailed. Therefore, securities exchange regulatory authorities need to review the disclosure requirements for firms going public.

5.5 Recommendations for Further Research

From the work done further research can be considered on: Whether factors leading to rights issue as a mode of corporate finance are the same with those of initial public offer of shares, A comparative study on the determinants of initial public offer as well as rights issue pricing or The impact of financial strength and investor sentiment on the rights issue pricing.

5.6 Limitations of the Study

Time was a limiting factor for the researcher since he is in full time employment and therefore did not have adequate time especially in the collection of data. Further, data from NSE was insufficient to be used to answer the research objectives sufficiently. In addition, limited resources on the part of the researcher were another limitation. The research lacked adequate funding for conducting the research.

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APPENDIX I: LIST OF RIGHTS ISSUE FROM 2000- 2011

Company	Shares on Issue	Type of Issue	Year of Issue	Offer Price	Sum Raised	Subscription level
Kenya Orchards	7,400,000	Rights	2001	0.5	2,965,859	80%
Standard Newspapers	76,871,154	Rights	2001	5.85	305,793,451	68%
Total Kenya	70,030,000	Rights	2001	18	1,260,354,708	100%
Express Kenya	38,400,000	Rights	2003	6.5	178,002,500	71%
KCB	50,000,000	Rights	2004	49	2,750,125,000	112%
Uchumi	120,000,000	Rights	2005	10	1,269,600,000	106%
CfC Bank	12,000,000	Rights	2005	62	744,000,000	100%
DTB	15,527,343	Rights	2006	50	2,305,810,436	297%
Olympia	30,000,000	Rights	2007	14	428,400,000	102%
DTB	23,291,015	Rights	2007	70	2,902,060,469	178%
NIC Bank	16,482,910	Rights	2007	70	1,719,167,513	149%
HFCK	115,000,000	Rights	2008	20	2,369,000,000	103%
KCB	221,777,777	Rights	2008	25	8,122,024,075	146%
KCB	887,111,110	Rights	Jul-10	17	12,500,000,000	82.50%
TPS East Africa	24,701,774	Rights	Sep-10	48	1,185,685,152	135%
Standard Chartered	15,109,323	Rights	Oct-10	165.45	2,499,837,490	161%
KPLC	488,630,245	Rights	Nov-10	19.5	9,830,340,000	103%
TOTAL	**2,212,332,651**				**50,373,166,653**	

Source: Capital Markets Authority, the CMA Capital Markets Bulletin –Q4/2011, pg. 10