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Financial Distress in Commercial and Services Companies Listed at Nairobi Securities Exchange, Kenya

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Abstract

The study sought to assess financial distress amongst commercial and services companies listed at the Nairobi Securities Exchange, Kenya with an objective of determining whether the companies in this sector were prone to bankruptcy. The study utilized secondary data collected from the Nairobi Securities Exchange over a five year period (year 2009 to year 2013). Using Altman's Z score model, the study findings indicate that the companies' Z scores (on average) lay between -1.88 to 3.5. This is an indication that the companies are relatively not in danger of bankruptcy. In view of this findings, the study concludes tha. in addition, the study recommends that….

Keywords: Altman's model, financial distress, bankruptcy, Nairobi Securities Exchange

1. Introduction

Financial distress refers to firms facing financial constraints thus not being able to carry out their day to day activities smoothly. The word can refer to bankruptcy, insolvency, failure or even default. These words have been clearly defined in past researches (Altman, 1993). According to Theodossiou et al (1966), financially distressed companies are not willing to file for bankruptcy proceeding while financially healthy companies file for bankruptcy to run away from legal suites and taxes. Failure refers to situation where a company's required rate of return is not met. This means the company has not achieved the targets set at the beginning. Insolvency refers to company not being able to meet the liquidity levels required. The company is not able to meet the short term obligations as and when they fall due. This leads to default of obligations and contracts which is associated by law suits against the company.

Financial distress prediction has become an integral part of corporate governance as it helps all the stakeholders analyse the company on the direction its taking. According to Warner (1977), companies which are in financial distress tend to exhibit decline in market value over time.

Kenya has experienced its fair share of companies which are in financial distress and almost on the verge of collapsing. These include Uchumi, Kenya Airways and several financial banks which have been on the spot light in the last couple of years. The question arises on to whether these crises could have been predicted before the actual events.

The problem arises because the managers, who are agents of the companies, focus on short term profit goals rather than the long term wellbeing of the firm (Harlan and Marjorie, 2002).

Maringa and Muturi (2016), found the stock markets to be inefficient in semi-strong form. This reduces the reliability of the Nairobi Securities Exchange to detect a company on decline due to financial distress thus need to carry out the distress tests.

Many statistical models have been developed to assist in prediction of companies experiencing financial distress (Alareeni & Branson, 2013). The Altman Z score model is one of them. The model has been modified severally in the quest to improve it by different scholars.

2.0 Literature Review

There have been many models developed in order to predict business failures (Gep & kumar 2012). Many of these models involve use of ratio analysis to analyse failed companies. Altman (2000) developed a model which comprised of 22 ratios. He was able to revise the model to five ratios which he considered most important. The model is as follows:

$Z=1.2X_1+1.4X_2+3.3X_3+0.6X_4+1.0X_5$

Where:

X_1 Is the ratio of working capital to total assets

X_2 Is the ratio of retained earnings to total assets

X_3 Is the ratio of earnings before interest and tax to total assets

X_4 Is the ratio of market value of owners' equity to book value of total liabilities

X_5 Is the ratio of sales to total assets

A company is considered to be healthy if the Z score exceeds 2.99. If the score is lower than 1.81, then the company is considered to be in financial distress. If a company's Z value lies in between, then the company is referred to be on grey zone and it needs to be monitored closely.

X_1 the ratio of working capital to total assets: This ratio tests the company's falling in to financial distress. A company with less working capital is likely to experience financial distress as it cannot be able to meet short term liabilities. A company with working capital which is positive is able to meet its obligations with ease.

X_2 the ratio of retained earnings to total assets: It shows the amount of earnings or losses reinvested. It shows the firms leverage. The higher the ratio, the healthier the company is financially.

X_3 the ratio of earnings before interest and tax to total assets: The ratio measures firms' ability to make profits before interest and taxes.

X_4 the ratio of market value of owners' equity to book value of total liabilities: The ratio measures how much a company's' market value can be able to cover liabilities in case of solvency.

X_5 the ratio of sales to total assets: The ratio measures how well a company employs its assets to generate sales. The lower the ratio of X_5, the greater the chance of the company not being able to fight competition.

Altman (1968) created multivariate discriminant analysis where he constructed a graph such that if a company was on the left of the line, it was considered safe. If the company was on the right side of the line, it had high chances of becoming bankrupt.

3.0 Financial Distress

Financial distress is associated with both direct and indirect costs (O'Neill, 1986). The direct costs include legal fees, auditor expenses and other payments associated with bankruptcy proceedings. The loss of value prior to bankruptcy can be referred to as indirect costs which includes decrease in level of sales and loss of goodwill. According to Wruck (1990), there are several pointers that can be used to detect financial distress in companies. A reduction in the level of dividends issued out, or non-issue of dividends can be a good indicator of financial distress. Retrenchment of employees and resignation of top management can be a good indicator of financial distress.

According to Whitaker (1999), the process of financial distress starts with a company not being able to pay short term obligations, as and when they fall due. The main reasons behind financial distress can be attributed to inappropriate asset mix, corporate governance or financial structure (Gilbert et al, 1990).

According to Natalia (2007), factors such as large debts, uninformed expansion, competition which is intense, large legal costs are probable causes of financial distress. Adeyemi (2012) noted that lack of adequate is one of the major factors leading to financial distress as capital has the capability to absorb losses. Lack of managers with adequate management skills can also lead to corporate failures (Ooghe & Prijcker, 2008). Most managers focus and blame external factors when their business fails rather than evaluate internal factors too (Scherrer, 2003).

4. Methodology

The researcher evaluated all the companies in the commercial and services sector at Nairobi Securities Exchnage. This is because the sector has been put into spotlight when giant companies like Kenya Airways and Uchumi Ltd are reported not to be financially healthy. The government always comes to their rescue injecting more funds into

the companies. The companies were examined from 2009 to 2013. The companies were to fulfil the set criteria which included:

- Must have been in operation from 2009 to 2013
- Must be commercial and services in listing at NSE
- Must have published accounts during the period in consideration

The research used secondary data obtained from NSE handbook on company's returns. The study used descriptive analysis which employed the Altman model in the data analysis.

5. Conclusion

The following results were obtained:

				2009	2010	2011	2012	2013
EXPRESS KENYA LIMITED			Z=	-1.88663	0.663126	-0.69053	0.420141	0.975749
KENYA AIRWAYS LIMITED			Z=	1.184854	2.174676	2.080225	1.983994	0.688924
LONGHORN KENYA LTD			Z=	2.692169	2.043638	2.611839	1.701007	2.451991
NATION MEDIA GROUP LTD			Z=	3.55947	3.485732	4.104014	4.211441	4.275675
SCANGROUP LIMITED			Z=	3.530206	3.022534	3.198887	4.920683	3.486857
STANDARD GROUP LTD			Z=	2.158892	2.233504	1.840004	2.094549	2.073805
TPS EAST AFRICA SERENA HOTELS			Z=	1.894696	2.01183	1.665536	1.245864	1.5836
UCHUMI			Z=			3.091698	2.955193	2.720259

From the results in table above, the Z score for Express Kenya limited was below 1.81 which may be treated like a company in financial distress for all the years investigated. The Kenya Airways had a relatively strong Z score which reduces as time goes by. This is correct finding because the company has been making substantial losses in recent years and facing financial difficulties up to the extent of experiencing government intervention.

Longhorn Kenya limited is having a high Z score on average thus interpreted not to be in financial distress.

Nation Media Group, Scangroup Limited and TPS East Africa Serena and Uchumi have shown a relatively high Z score on average thus not considered to be on verge of financial distress.

However, interpretation of the ratios is not to be taken on the face value only. Uchumi limited has been experiencing financial difficulties and have been engaged in creative accounting where they dispose off their assets for cash which is in turn used to settle short term obligations. May be that is the reason their Z score is relatively safe and does not raise any queries.

Recommendations

There is need for further researches on this area despite the milestones which has been achieved. Studies should be carried out on how creative accounting influences the prediction power of the Altman distress model.

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Figure 1.