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Journal homepage: www.publishing.globalcsrc.org/jafee**Shareholder Engagement and Firm Value Creating Outcomes in Kenya**¹ Amos Muhinga Kimunya, ² Amos Njuguna, ³ Francis Wambalaba¹ United States International University – Africa Email: akimunya@thefoothills.co.ke² United States International University – Africa Email: amnjuguna@usiu.ac.ke³ United States International University – Africa Email: fwambalaba@usiu.ac.ke

ARTICLE DETAILS	ABSTRACT
History Revised format: May 2019 Available Online: June 2019	The objective of the study was to determine the firm value creating outcomes arising from institutional shareholder engagement in Kenya. The study used data from a sample of 117 institutional investors in the Nairobi Securities Exchange, Kenya, selected using stratified simple random sampling technique.
Keywords Shareholder Engagement, Firm Value Creation, Institutional Investor, Activism	The study established that the shareholder engagement outcome that significantly explains firm value creation is improvement of a firm's system of governance, which includes boards of directors that have independent, equitable and minority representation.
JEL Classification: G32, M40, N27	The study contributes to literature on shareholder engagement from a Kenyan perspective and adds an impetus to investors, management and policymakers to address issues that are impeding shareholder engagement given its effect on governance and value of the firm. The study recommends that firms invest in improvement in governance structures, and policymakers are advised to maintain an updated register of all the institutional investors, including their current contacts, and a Kenya-specific central depository of data on engagement actions and outcomes across listed companies.

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1. Introduction

Investors are interested in maximizing their wealth, through maximizing the value of the firms they invest in. Value is created when the synergy from managerial effort and utilisation of assets generates returns that are higher than the required rate of return for the investment class, over a long planning horizon (Arnold, 2013). Shareholders can take certain actions to achieve outcomes that would positively influence managerial effort and management decision making towards value adding initiatives. Misalignments have been noted on dividends, where management may prefer payments in the short term while shareholders may prefer reinvesting of the same to create long-term value (Derrien, Ambrus, & Thesmar, 2013). Similar disparities exist on views on long-term sustainability, strategy alignment, and concurrence on project selection.

Debate is divided on whether involvement of shareholders and their engagement with the management of their companies is beneficial to the firm (Gillan & Starks, 2007; Goranova & Ryan, 2014; Ho, 2010; Ingley et al., 2011). Proponents argue that engagement leads to a better understanding and cooperation, which adds to the firm's value; it aligns the expectations of both the board and shareholders, thereby averting unnecessary unexpected consequences such as negative votes on proposals; aligns the interests of investors with bondholders by addressing management entrenchment problems; and helps management to provide detailed information on its long-term strategy to shareholders, who may be concerned with cyclic short-term performance challenges (Ho, 2010; Kim & Schloetzer, 2013; Sunder, Sunder, & Wongsunwai, 2014).

On the other hand, Kim and Schloetzer (2013) report that engagement is a complex and risky process, that is costly and time-consuming for management; is likely to send uncoordinated and inconsistent messages and signals from several distinct engagements; is unlikely to accommodate the variety of shareholder interests and expectations causing disappointments; and may face legal challenges of unfair provision of market-sensitive information to selected engagers at the expense of other market players. Goranova and Ryan (2014) also argue that shareholder engagement may just compound managerial self-interest with shareholder self-interest. As observed by Bratton and Wachter (2010), the U.S. mortgage crisis may have been fanned by shareholders who encouraged management towards managing-to-market strategies, rewarding them with generous compensation for their high-risk, high-return strategies that gave shareholders short-term wealth. Bebchuk et al. (2015) however suggest, based on their recent work, that claims of negative effects of hedge funds activism on long-term firm value are not only not supported by empirical data, but that activism actually contributes to improved performance.

Other engagement supporters have observed that shareholders are the providers of capital, the ultimate risk takers, and as the residual claimants. Therefore, they need to be involved to reduce the residual loss (Fama & Jensen, 1983). Opponents, however, counter that investors are not the owners of companies, but mere renters, with rights to claim value based on their limited liability (McNulty & Nordberg, 2016), but not to take decisions, which are best left to professional managers (Bratton & Wachter, 2010; Donald, 2005). While this may be true of short-term investors interested in trading in shares, there are those with a long-term view of the company, seeking growth and stability, who require recognition and engagement (Clark & Hebb, 2004; Donald, 2005).

Indeed, contrary to Berle and Means (1932), with a separation of ownership and control arising from shareholder power dispersal, pension funds with their wide beneficiary base are observed to play a role in aggregating dispersed owners and being active in the management of the companies they invest in. This is meant to drive firm fundamentals and secure their long-term value (Clark & Hebb, 2004). In the U.K., Becht et al. (2009) report a positive relationship between shareholder engagement and stock returns of investee companies, but also note that doubts have been expressed on the marginal value of the much-discussed engagement by the pension fund CalPERS and others within the U.S. by several scholars.

A further challenge arises with respect to measuring value created from shareholder engagement. While value of firms has been measured variously using different accounting metrics such as Tobin's Q, Return on Assets (ROA), Return on Equity (ROE) and other such measures, scholars have however highlighted the difficulty of measuring effects of shareholder engagement on the performance of a firm, especially when part of it takes the form of behind-the-scenes negotiations, using efforts that are not publicly documented (Becht, Franks, Mayer, & Rossi, 2009; Black & Coffee Jr., 1994; Crespi & Renneboog, 2010; Goranova & Ryan, 2014; McCahery, Sautner, & Starks, 2016). It is observed, for example, that it was only in exceptional circumstances that Becht et al. (2009) studied the effects of engagement by an active fund manager with its investee companies, using its unique dataset and reported higher than market returns arising from what they described as otherwise unobservable private engagements.

This study recognises the challenge of attempting to measure value arising from such engagement, especially when studying several heterogeneous investors, with varied portfolios, and no publicly available data. Accordingly, the study attempted to find or create a measure of this influence of shareholder engagement over managerial effort, from the engagers' experience and informed perspectives.

2. Literature Review

The study was carried out against the backdrop of the Shareholder theory of the firm which defines the motivations of shareholders as being to maximize economic value (Pfarrer, 2010), and on agency theory which highlights the asymmetric relationship between shareholders and their agents ((Fama & Jensen, 1983; Jensen & Meckling, 1976).

Scholars have identified several outcomes arising engagement actions. McCahery et al. (2016) identified the main outcomes which include improved governance, appointment of effective boards, alignment of shareholders' and management objectives on dividends and long-term sustainability, strategy alignment, and concurrence on project selection. Other outcomes include change of ineffective management, improved corporate reputation, and adequacy of management compensation. These are expected to contribute to improved values of their portfolios, and reduction in waste (Bach & Metzger, 2015; Bebcuk, Brav, & Jiang, 2015; Brav, Jiang, & Kim, 2015; Ingley, Mueller, & Cocks, 2011; Isaksson & Celik, 2013; McCahery et al., 2016).

One of the outcomes that has been highlighted is the appointment of boards of directors. Gillan and Starks (2007) observe that while shareholders may appoint boards of directors with a fiduciary responsibility to hire, fire, and monitor the managers, their failure triggers shareholder activism and engagement. The board represents the interface between investors and management, and is highlighted as the most important institution in corporate governance (Capital Markets Authority, 2015). Effectiveness of the boards is dependent on having optimal board sizes, independence and non-affiliation to management (Giráldez & Hurtado, 2014; Judge, Gaur, & Muller-Kahle, 2010; Pascual-Fuster & Crespi-Cladera, 2015; Schooley, Renner, & Allen, 2010).

Giráldez and Hurtado (2014) observed that boards were appointed by shareholders to provide long-term strategic direction on companies, to oversee and monitor the executive management thereby reducing opportunism, and to act as the liaison between the owners and managers, thus enhancing communication. They have the unique responsibility of setting the tone at the top (Hunton, Hoitash, & Thibodeau, 2011). If the ethical issues of monitoring and communication are done properly, as Giráldez and Hurtado (2014) observe, the result is to increase or protect the value of the firm.

Judge et al. (2010) observed that board size and independence contribute to board effectiveness in monitoring, while La Porta et al. (2000) posit that equitable investor representation is related to the value of stocks. Jensen (1993) observed that board sizes beyond seven to eight people provide an opportunity for control by management, while Ocasio (1994) argues that larger boards generate political coalitions that are able to challenge and control management (as cited in Zona, Zattoni, & Minichilli, 2013). Furthermore, Giráldez and Hurtado (2014) advocate for an optimal board size, noting that larger board sizes while bringing in variety of experience and expertise could also stifle decision making; they suggest board size can be measured using the number of directors.

Boards represent the interests of investors, while ensuring the overall goals of the firm are not compromised by the several individual and often divergent investor interests (Celik & Isaksson, 2013). La Porta et al. (2000) reports that where investor protection includes minority representation on the boards, stock values have been noted to appreciate, but the minorities could also extract private benefits and distort long-term investment strategies to the detriment of firms (Belloc, 2013). Boards must also balance between representing their appointing investors' interests, and ensuring the overall goals of the firm are not compromised by the several individual and often divergent investor interests (Celik & Isaksson, 2013).

Literature supports the hypothesis that independence of directors is positively related to value (Giráldez & Hurtado, 2014; Judge et al., 2010; Laux & Mittendorf, 2011). In this regard, Giráldez and Hurtado (2014) report that the association between board size and firm value is improved by the moderating effect of the presence of board independence. Giráldez argued that while self-interest and a desire to demonstrate achieving shareholder expectations, and incentives for earning managerial rewards, could lead to unethical behaviour by management, this is best controlled through a combination of a limited number of independent directors in the boards and strengthening of the ethical dimensions of management.

Similarly, Judge et al. (2010) studied the antecedents of shareholder activism in target firms spread over different legal systems, and among other findings reported that prior studies had observed that independent boards that had a majority of outside directors were more effective in controlling management. This is supported by Schooley et al.

(2010) on the importance of board composition, including independent directors and leadership. Hunton et al. (2011) however argues that where chief executives have more power than board members, it can present an agency problem. Evidence also suggests that when independent board members are not appropriately qualified for the task, they have not always helped the situation (Wong, 2011).

3. Research Methodology

This adopted a descriptive correlational research design. The population of the study consisted of 166 institutional investors in listed firms at the Nairobi Securities Exchange as of September 2016, and a sample size of 117 using stratified random sampling. The study used, to the extent applicable, a modification of a recently-used questionnaire in a study involving shareholder engagement by institutional investors (McCahery et al., 2016), with the kind permission of one of the authors. The questionnaire was modified to include variables and issues not included in the McCahery et al. (2016) study. The data was then analyzed using descriptive statistics of frequency and percentage distribution, mean, mode and median and inferential data analysis methods, which included factor analysis.

4. Analysis and Findings

The firm value creating outcomes in the study were measured using four variables. The variables sought to measure the observed outcomes as a result of previous shareholder engagement, the importance of the engagement outcomes to value of the firm, board of directors as a value creating outcome, and the preferred board size. Table 1 below summarizes the outcomes that were observed as having resulted from previous shareholder engagement.

Table 1: Observed Shareholder Engagement Outcomes

Engagement Outcomes	Frequency	Percentage
Appointment of effective board of directors	58	74%
Change of ineffective management	53	68%
Change of company strategy	60	77%
Alignment of the shareholders' and management objectives on dividends	60	77%
Alignment of the shareholders' and management objectives on long-term sustainability	66	85%
Appropriate projects selection to create value	51	65%
Reduction in wasteful expenditure	61	78%
Improved governance	68	87%
Improved portfolio or firm value due to the engagement	50	64%
Improved corporate reputation	50	64%
Adequacy of management compensation	43	55%

The investors were asked to rank the outcomes in order of importance to the value of the firm, based on their experience and expertise. A summary of the importance of the engagement outcomes on the value of the firm was presented in Table 2. The question was measured on a scale of one to five, with one being not at all important and five being very important. The results indicated that all the outcomes had a modal score of 4 or 5, indicating that most respondents agree that they are important shareholder engagement outcomes to value of the firm. The mean scores indicated a wide statistical range among the responses received for these factors, necessitating further analysis.

Table 2: Importance of Shareholder Engagement Outcomes to Value of the Firm

Shareholder engagement outcomes	Mean	Median	Mode
Appointment of effective board of directors	4.19	4.00	4
Change of ineffective management	4.13	4.00	4
Change of company strategy	3.71	4.00	5

Alignment of shareholders' and management objectives on dividends	3.62	4.00	5
Alignment of shareholders' and management objectives on long-term sustainability	4.01	4.00	4
Appropriate projects selection to create value	3.90	4.00	4
Reduction in wasteful expenditure	3.72	4.00	4
Improved governance	3.80	4.00	4
Improved portfolio or firm value due to the engagement	3.86	4.00	5
Improved corporate reputation	3.33	4.00	4

The third variable sought to measure the attitudes of the respondents towards various aspects of the board of directors as a value creating outcome on a scale of one to five, with one being strongly disagree and five being strongly agree. The results in Table 3 indicate the mean score for equitable representation of all shareholders on the board and minority shareholders who should be represented in the board was 4, which means that most of the respondents agreed with the statements with relation to the board of directors as a value creating outcome. On the others, most of the respondents neither agreed nor disagreed with the statements.

Table 3: Board of Directors as a Value Creating Outcome

	Mean	Median	Mode
The size of the board of directors affects its effectiveness	3.16	3.00	3
Having independent (outsider) directors in the board improves decision making	3.51	4.00	3
Independent directors protect shareholders interests and control over management	3.34	3.00	3
There should be equitable representation of all shareholders on the board	3.58	4.00	4
Minority shareholders should be represented in the Board	3.56	4.00	4

The fourth objective sought to determine the appropriate board size as preferred by the shareholders. The summary presented in Table 4 shows that most of the respondents indicated their preferred board size would be 6 to 8 at 37.3%, while 28% of the respondents indicated a preferred board size of 8 to 10. However, 8% of the respondents noted that their preferred board size would at most be 6, while 6.7% indicated an appropriate board size of 10 to 12. Up to 20% of the respondents indicated that the board size did not matter.

Table 4: Preferred Board Size

Preferred Board Size	Frequency	Percentage
At most 6	6	8.0%
6 to 8	28	37.3%
8 to 10	21	28.0%
10 to 12	5	6.7%
Board size does not matter	15	20.0%
Total	75	100.0%

Table 5 below shows the suitability of the data for carrying out factor analysis on the importance of shareholder engagement outcomes in creating firm value using the KMO test and Bartlett's test of sphericity that tests for sampling adequacy. The KMO statistic is between 0 and 1 and the closer it is to 1, the better the data is for factor analysis. The KMO statistic of 0.88 is supported by the significant Bartlett's test statistic at 95% confidence, hence the conclusion that the data can support factor analysis.

Table 5: KMO and Bartlett's Test of Sphericity on Value Variables

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		0.88
Bartlett's Test of Sphericity	Approx. Chi-Square	601.249
	Df	45
	Sig.	0.000

The dimension reduction showed that improved governance had the highest factor loading as an engagement outcome that creates value for the firm as illustrated by the component matrix Table 6. The factor loading for the appointment of an effective board of directors as a value enhancing outcome of shareholder engagement was however 0.792 and was ranked seventh in comparison to 10 shareholder engagement outcomes.

Table 6: Factor Analysis on Value Creating Outcomes

Factor	Factor Loading
Improved governance	.912
Appropriate projects selection to create value	.896
Change of company strategy	.896
Reduction in wasteful expenditure	.847
Alignment of shareholders' and management objectives on long-term sustainability	.821
Change of ineffective management	.801
Appointment of effective board of directors	.792
Adequacy of management compensation	.744
Improved corporate reputation	.705
Alignment of shareholders' and management objectives on dividends	.426

Factor analysis was carried out on the board of directors as a value creating outcome of shareholder engagement to identify which factor of a board of directors was ranked highly in relation to the others. Table 7 below displays the KMO and Bartlett's statistic indicating the suitability of the data in carrying out factor analysis. The results indicated a KMO statistic of 0.771 supported by a significant Bartlett's test statistic at 95% confidence level.

Table 7: KMO and Bartlett's Test of Sphericity on Directors

Kaiser-Meyer-Olkin Measure of Sampling Adequacy		0.771
Bartlett's Test of Sphericity	Approx. Chi-Square	156.409
	df	10
	Sig.	0.000

An inspection of the component matrix in Table 8 showed that having independent (outsider) directors in the board improves decision making, ranked first with a factor loading of 0.912, while the second and third factor, independent directors protect shareholders' interests and minority shareholders should be represented in the board, are tied with a factor loading of 0.896. Equitable representation of all shareholders on the board has a factor loading of 0.847, while the question whether the size of the board of directors affects its effectiveness trails at 0.517, indicating it was not a major contributing factor.

Table 8: Factor Analysis on Directors

Factor	Factor Loading
Having independent directors in the board improves decision making	.912
Independent directors protect shareholders interests and control over management	.896

Minority shareholders should be represented in the board	.896
There should be equitable representation of all shareholders on the board	.847
The size of the board of directors affects its effectiveness	.517

5. Discussion of Results

The study was cognisant of the difficulty of determining an appropriate measure of value of the firm that would be attributable to shareholder engagement actions, especially when studying several heterogeneous investors, with varied portfolios, and no publicly-available data. Following McCahery et al. (2016), this study therefore measured value created from the responses by investors, as to what extent they believed their actions had resulted in value creating outcomes.

The study confirmed that the respondents had engaged and observed one or more outcomes. It identifies improved corporate governance as the most important engagement outcome that leads to enhancing the value of the firm. The findings of the study concurs with the findings of McCahery et al. (2016) who found that corporate governance affects the financial performance of a firm, and that change of company strategy is among the main factors that enhance the value of a firm. It agrees with Arnold (2013) who noted that investors are interested in maximizing their wealth, through maximizing the value of the firms they invest in. The finding on alignment of shareholders' and management objectives on long-term sustainability is also in tandem with the observation by Arnold (2013) that value is created when the synergy from managerial effort and utilisation of assets generates returns that are higher than the required rate of return for the investment class, over a long planning horizon. The study also found that respondents had observed that reduction in wasteful expenditure enhances the value of the firm, and also considered it important. The study thus agrees with the findings of Goranova and Ryan (2014), who asserted that shareholders take voice and exit actions to influence managerial effort and management decision making towards value adding initiatives.

On the matter of boards of directors, the study showed appointment of an effective board of directors was not considered a very important factor in creating value for the firm, having been ranked seventh, after improved governance. This contradicts earlier observations on the importance of the board. Giráldez and Hurtado (2014) had observed that the board represents the interface between investors and management and its members are appointed by shareholders to provide long-term strategic direction for companies, to oversee and monitor the executive management and thereby reducing opportunism, and to act as the liaison between the owners and managers and thus enhance communication. If the ethical issues of monitoring and communication are done properly, as Giráldez and Hurtado (2014) observe, the result is to increase or protect the value of the firm. Boards are also highlighted as the most important institution in corporate governance (Capital Markets Authority, 2015). The respondents chose improved governance as the most important outcome, and this may have clouded their choice on effective boards, especially given their responses on what they considered as effective boards. It appears therefore that appointment of effective boards on its own was not ranked high, but considered as an integral part of improvement in governance.

The study found having independent (outsider) directors in the board improves decision making. Other rankings included, in descending order: Independent directors protect shareholder interests, minority shareholders should be represented in the board, there is a need for equitable representation of all shareholders on the board, and lastly, the size of the board of directors affects its effectiveness. The study further reports that the appropriate board sizes are between six and 10 members. The finding of this study echoes the findings of Judge et al. (2010) who observed that the board size and its independence contribute to board effectiveness in monitoring, and with La Porta et al. (2000) who posit that equitable investor representation is related to the value of stocks. It accords with Giráldez and Hurtado (2014), who advocate for an optimal board size.

6. Conclusions

The study concludes that improvement of a firm's system of governance, which includes boards of directors that have independent, equitable and minority representation, is the outcome that significantly explains firm value creation arising from shareholder engagement.

7. Suggestions for Improvement

The study recommends that firms invest in improvement in governance structures, which includes effective boards that have independent, equitable, and minority representation, and preferably with a size of between six and ten directors. This will ensure alignment of shareholders and management objectives on long-term sustainability, reduction in wasteful expenditure, change of company strategy, and other outcomes that drive firm value creation.

8. Suggestions for Further Research

The study initially set out to investigate the effect of shareholder engagement on the value of the firm in Kenya but was limited to assessing the effects of engagement on only value creating outcomes. This was due to the challenges of determining an appropriate measure of value of the firm that would be attributable to shareholder engagement actions, especially when studying several heterogeneous investors, with varied portfolios, and no publicly available data. It is recommended that further research be carried out on specific firms to establish relationships between documented as well as behind-the-scenes engagement actions over time and changes in value of the firms using conventional value metrics. This could be done using case study approaches or experimental methods, with the treatment being the engagement actions.

The study also found there is limited, if any, publicly-available data on engagement. This study recommends research on the development of a Kenya-specific central depository of data on engagement actions and outcomes across listed companies, borrowing from best practices in the U.S. and U.K. This will facilitate efficiency and effectiveness in future research as engagement becomes embraced in the country and the region.

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