FOREIGN DIRECT INVESTMENT AND FINANCIAL PERFORMANCE OF MANUFACTURING FIRMS REGISTERED WITH KENYA ASSOCIATION OF MANUFACTURERS

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ABSTRACT

Manufacturing firms in Kenya have been marred with unprecedented losses even despite government concerted efforts to attract the inflows of foreign direct investors in the manufacturing sector. The worst-hit include: Mumias Sugar Company that recorded a net loss for the periods of 2017 and 2018, East African Portland Cement that also posted net loss for the financial year 2019, Nzoia Sugar Ltd, Sony and Chemelil both recorded losses in the financial year 2014/15. Therefore, it is on this grounds that this research sought to establish the relationship that exist between foreign technological flow and financial performance while consecrating the moderating effect of political was informed by two main theories that include resource-based theory and agency theory. It was also anchored on pragramatic philosophy. The study used both correlational cross-section survey design targeting firms in the manufacturing sector that are registered by Kenya Association of Manufacturers. This study covered the data obtained from 2017 to 2021. A census was conducted on all the 81 targeted firms. The research employed data from first hand and auxiliary sources guided by questionnaire and data collection sheet respectively. The study instrument had been pilot tested to ensure it was valid and reliable enough. A test for normality and autocorrelation was also carried out, after which the collected data was analyzed quantitatively using descriptive and inferential statistics. The data was presented in form of tables, charts and narratives. The study established that foreign technological flow were significant predictors of financial performance moderated by political risk. The study concludes that foreign direct investment is a significant enabler of financial performance moderated by political risk. The study recommended that ICT managers of the manufacturing firms in Kenya should leverage the soft and hard technological flows to support the processes and enhance financial performance of their firms.

Key Words: *Foreign Direct Investment, Market Diversification*

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INTRODUCTION

Performance has been the greatest concern among most manufacturing firms around the world. In the United States of America (USA), a report by Price Waterhouse Coopers (2016) indicates that the manufacturing sector has been characterised by falling output for quite some time. According to West and Lansang (2018), China outperforms most countries in terms of output manufactured while Poland on the other hand is said to be a country with the highest number of employees employed in the manufacturing sector. China leads in terms of manufacturing followed by Germany, Italy, Turkey and finally South Korea.

According to Dawson (2017) Foreign Direct Investment refers as any form of direct investment in a company whose main objective is to market or produce goods in a foreign state or country, with an aim of expanding or diversifying their market. The technological transfers associated with FDI have elicited strong debates in economics discourse. FDI has been attributed to the rapid transfers of technology from the country where the parent company is domiciled to the host country where the subsidiary is located. The technology transferred is either soft or hard technology. According to Portelli and Narula (2003), soft technology is that technology that includes organization systems, skills, management expertise and knowledge. On the other hand, hard technology includes machineries, fixtures and fittings, equipment and plants. The amount of technology flowing from the parent country to hosting country is measured in form of number of types of technologies passed on to the firm. Soft technology is measured by the type of management expertise, management systems, softwares and skills brought into the firm; while the hard technology on the other hand is to be measured by the number of technologies gotten from the parent to subsidiary in the host country (Skenderi, 2012).

Bremmer (2005) defines political risk as the risk that a corporation operating offshore is likely to face due to political events and situations. These political events are very disruptive as they tend to disrupt the operation of firms. Politics of a country can severely affect how a firm is run or managed. There have been various attempts to measure political risk the most notable one, being the one devised by Political Risk Service Group (PRSG) in conjunction with International Country Risk Guide (ICRG), that sought to develop an index to measure political risk by considering a wide array of indicators, that include socio-economic factors, government stability, conflict situation, level of investments, level of corruption, military involvement in political matters, religious tensions, and level of democracy (Ayhan, 2019). Osabutey and Okoro (2015) adopted all these indicators to measure political risk in Nigeria and found out that this measure is quite accurate in forecasting the political environment.

Statement of the Problem

This trend in financial performance of the manufacturing firms is not encouraging and needs policy attention. Although there have been considerable efforts by the Kenyan government to attract more FDI in the manufacturing sector to promote financial performance and realization of Big-4 agenda, more is however need to be done. This is mostly due to the idea that these FDI will be instrumental in job creation, boosting GDP, advancement in manufacturing technologies arising from spillover effects. The FDI will be beneficial to local manufacturers due to knowledge transfers and technologies from the parent company to the subsidiary and then subsequently to the manufacturing sector in the host country. This shall considerably reduce the cost of production for local manufacturing firms (Koen & Bartoldus, 2002).

The extant literature from a global scale includes Bruno and Cipollina (2014) who looked at FDI and the economic performance in Europe. The study noted the FDI influenced economic performance of the country. Locally in Kenya, Fernandez, Muhoho and Kahuthia (2019) looked at FDI and financial performance focusing on listed insurance entities and a positive relationship was identified. Amondi (2016) did a study on foreign direct investments and

financial performances of firms in the real estate sector. In this inquiry, the interplay between the study variables was strong. The aforementioned studies create gaps that the present study sought to fill by establishing whether FDI influence financial performance of companies in the manufacturing sector that are registered by Kenya Association of Manufacturers.

Research Objectives

- To establish the relationship between foreign technological flow and financial performance of manufacturing firms in Kenya
- To appraise the moderating effect of political risk in the relationship between foreign direct investment and financial performance of manufacturing firms in Kenya

Research Hypotheses

- **H01:** Foreign technological flow has no significant relationship with financial performance of manufacturing firms in Kenya
- **H02:** Political risk has no significant moderating effect in the relationship between foreign direct investment and financial performance of manufacturing firms in Kenya

LITERATURE REVIEW

Theoretical Review

The study was guided by the Endogenous Growth Theory that was proposed by Paul Romer in his research work in 1990, and purports that technological transfers from parent company to the subsidiary is important to a country long-term economic growth, especially those countries with limited resources to carry-out research and development. Endogenous growth theory further claim that foreign direct investments plays an important role in diffusion of technology from developed economies to less developed economies where the subsidiaries is located (Borenztein et al., 1998). The technological diffusion benefits African host countries with severe technological gaps, enhancing their competitive advantage both in short-run and ling-run. The spillover benefits arising from FDI are in essence beneficial to companies in the manufacturing sector that require modern technologies to enhance internal production efficiencies as well as maximizing their revenues (Jarvocik, 2014). Due to that many African governments have instituted measures to attract FDI. Some have succeeded while a significant majority have failed to allure more multinational corporations (Woo, 2009).

In their study, Crespo & Fontoura (2007) noted that there are five aspects of technological diffusion that are associated with foreign direct investments, and include: competition, mobility of labour, goods exportation, FDI spillover benefits to domestic companies. The other benefits associated with FDI are that they boost skills and expertise of employees in the host countries, as well as prices stabilization and promotion of healthy competition (Easterly & Levine, 2001). According to Caseli (2005) and Beck et al., (2000), foreign direct investments and international trade are the leading conduits of technology transfers among developed and developing countries. FDI inflows often result to flow of superior technologies from parent to subsidiary company abroad (Javorcik, 2004; Ajakaiye & Page, 2012; Koo & Perkins, 2016). This theory is useful in this study as it provides explanations on how technological flow influence foreign direct investments (FDI).

Empirical Review

Technological Flow and Financial Performance

In yet another study by Elteto (2001) who while examining competitiveness of companies that are foreign owned and domestically owned in Hungari for the period 1993-199, found out that companies that are foreign owned performed better, in terms of competitiveness, research and development, and investment, than their counterparts. This is in line with another study by Croner & Roper (1999) which while examining the association between multinational corporations and suppliers in North Ireland, and after interviewing senior executive level managers, the study found out that multinational corporations incorporate superior manufacturing techniques that enable produce high

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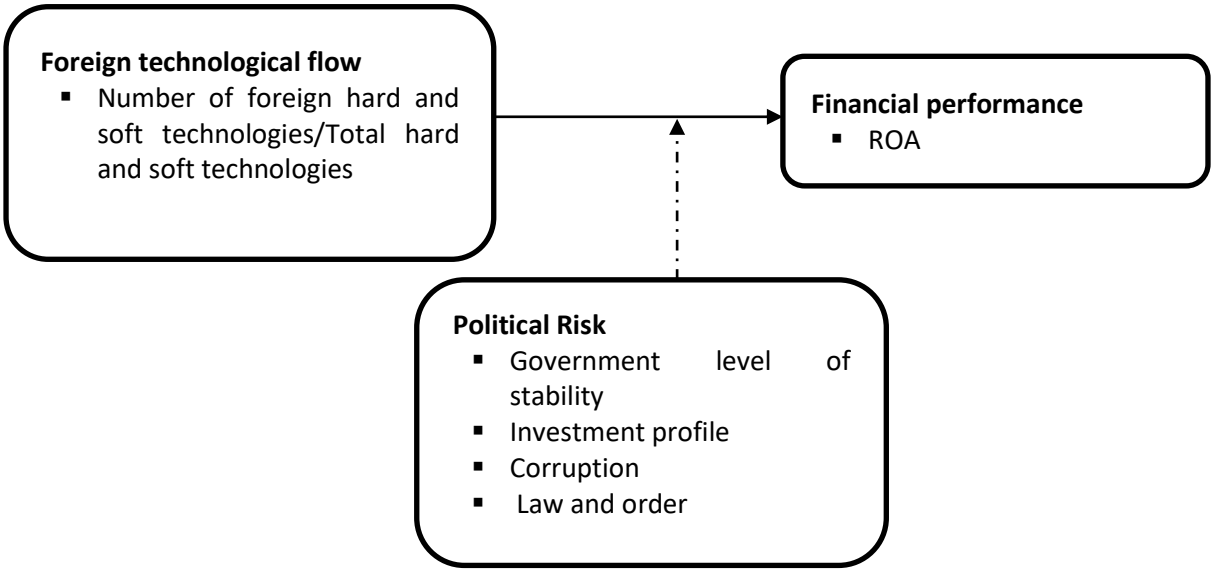
quality of goods that translated to increased sales. Knowledge and technological transfers from the parent company plays a significant role in bolstering their performance.

Political Risk, Foreign Direct Investment and Financial Performance

Khan and Akbar (2013) conducted a study on political risk and its link with FDI. The study covered 94 countries focusing on the period 1986 to 2009. The key focus of the study was on bringing out the inverse link between political risk and foreign direct investment (FDI). The study established that political risk influences the nature of the relationship that exist between FDI and financial performance. However, this study did not cover the aspect of performance which creates the gap. Another study by Baek & Qlan (2011) as they examine influence of political risk on FDI in developed and less developed countries, and upon using 12 indicators of political risk developed by ICRG. It was shown that political risk significantly influences FDI both in developed and developing economies. Nelson, Sooreea and Gokcek (2016) did a study on nexus between FDI and political risk. A total of 140 countries were covered in the study focusing on the period 1984 all through to 2012. Both panel and time series methodologies were embraced. The inquiry noted that any country having increased flow of FDI is linked with a reduced level of political risk.

Conceptual Framework



Independent Variable **Moderating Variable** **Dependent variable**

Figure 1: Conceptual Framework

METHODOLOGY

A research philosophy is quite useful in any given research as they show the assumptions upon which a specific research is based on. In essence it creates a basis of knowledge where fundamental predispositions of a specific research is founded on. In that regard the researcher used pragmatism philosophy, which according to Denscombe (2008) is a philosophical that is aimed at finding out and using method that is most relevant for research problem in question with little regard of claims on which is the best optimal method to solve the specific research problem in question. Research design according to Cooper & Schindler (2011) is an outline or plan used to structure the study such that the research process is smooth. It is a roadmap that guide the researcher in actualizing research objectives. In that regard, the research used correlational and cross-sectional research design, which provided better understanding of the

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phenomena or situation under review. On the other hand, a cross-sectional design was quite useful in this study as it was used in examination of one variable in numerous groups bearing similar characteristics.

The study focused on all the manufacturing firms registered and represented by the Kenya Association of Manufacturer (KAM), which are 81 in number as at December 2020. The study used a census that involved all manufacturing firms registered by Kenya Association of Manufacturers (KAM) with an aim of obtaining data that was used to gain deeper insights into the effect of FDI on their performance.

The data was collected from primary and secondary data sources. The secondary data was useful in substantiating and augmenting primary data collected. This study in particular used construct and content validity that was evaluated through panel assessment and by the use of judgemental discretion. The use of content validity on research instrument was to ensure that all concepts central to the research were assessed (Cooper & Schindler, 2014; Houser, 2011). To ensure validity of research instruments, a draft copy was shared with supervisors and panel of experts for viewing. The views, opinions and recommendations from the supervisors were factored into the refining of the questionnaire where necessary. The US Census Bureau (2010) defined reliability as the degree to which research instruments used in a given study will be consistent. Reliability of the questionnaire was realized through the use of Cronbach's alpha, aiming to have a minimum index of 0.7, which according to (Santos, 1999) is the most appropriate.

Data analysis according to Zikmund et al., (2012) is a process of scrutinizing the collected data with a view to draw meaningful understanding of the association, patterns and trends that exist between variables in question. The collected data obtained through the use of questionnaires was organized in a systematic manner to facilitate optimal quantitative data analysis. The moderating effect of political risk was tested using Moderate Multiple Regression (MMR) analysis that encompasses the use of estimation in evaluating the association that exist between the FDI factors (independent variables) and financial performance (dependent variable). MMR was complemented by the use of Ordinary Least of Squares (OLS) model. The researcher performed various diagnostic tests to find out whether the data set under review is agreement with the assumptions of regression analysis. More specially, the study carried out multicollinearity, autocorrelation, normality and Heteroscedasticity Test.

FINDINGS AND DISCUSSIONS

Correlation Matrix

It is from correlation analysis that the direction and strength between the study variables can be predicted with certainty. Pallant (2011) define correlation analysis as the beginning step in any statistical procedure whose essence to evaluate existance of the relationship between the study variables. In this study, the strength of the relationship was determined through Pearson Correlation. Hair et al. (2014; 2010) noted that an ideal positive interplay between the variables is supported by correlation value within the range ±1 while the value of 0 signifies absence of the relationship. Cohen (1988) provided the rule of thumb as follows: r within range 0.1 to 0.29 show weak relationship, 0.3 to 0.49 imply moderate relationship and value above 0.5 imply strong relationship. The summary of correlation matrix is as summed up in Table 1.

Table 1: Correlation Matrix

		Financial Performance	Foreign Technological Flow	Political Risk
Financial Performance	Pearson Correlation	1		
Foreign Technological Flow	Pearson Correlation	.576	1	
Political Risk	Pearson Correlation	.219	.163	1

Table 1 shows that foreign technological flow is a strong and positive correlate of financial performance of manufacturing firms in Kenya (r=0.576). The finding is in line with Gachino (2007) who found out those local companies with high technological gaps benefit significantly from the FDI technological spill overs, which bolster their performance. On the other hand, it was shown that political risk (r=0.219) has a weak but positive relationship with financial performance. The finding contradicts Kilicarslan (2016) who noted an inverse link between political risk and FDI inflow. However, the results are consistent with Dragusha (2016) who showed that political risk deters the flow of FDI investments.

Regression Results Linking Foreign Direct Investment and Financial Performance

Regression analysis was conducted to predict the effect of FDI on financial performance. Table 2 is the breakdown of the model summary.

Table 2: Beta Coefficients on Foreign Direct Investment and Financial Performance

	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	.821	.166		4.948	.000
Foreign Technological Flow	.058	.016	.376	3.584	.001
R=0.738	R^2=0.545	Adj. R^2=0.523			

The findings in Table 2 indicated the coefficient of determination R square as 0.545, this means that 54.5% change in financial performance of the manufacturing firms in Kenya is explained by FDI. It then follows that aside from FDI, there are still other factors that have not been captured by the study and can be explored by future studies. The findings were as follows: foreign technological flow (β=.058, p<0.05), an indication that it was statistically significant. Hence, the study rejects hypothesis H_{03}. This finding was consistent with Newman et al. (2015) who established that there is a significant association between FDI technology spill overs and performance companies.

Test for Moderation of Political Risk in Foreign Direct Investment and Financial Performance

The test for moderation effect of political risk uses a three-stage method that was popularized by Fairchild and McKinnon (2009), which illustrates the regression model evaluating its effects on the relationship between FDI factors and financial performance of manufacturing firms in Kenya. The model illustrating the moderating effect is as follows. Table 3 is a summary of the findings.

Table 3: Moderated Model Summary

					Change Statistics				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change
1	.626[a]	.392	.383	.16427	.392	41.316	1	64	.000
2	.637[b]	.406	.387	.16367	.014	1.466	1	63	.230
3	.736[c]	.542	.520	.14489	.136	18.395	1	62	.000

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Table 3 shows three models that were used to test for moderation. In model 1, the R square change is given as 0.392, while that for models 2 and 3 is 0.014 and 0.136. It is this change in R square that signifies the moderating effect of political risk. As observed by Fairchild and McKinnon (2009), the moderating effect in any case is represented by changes in R square once variables have been entered in the model at each step of moderation testing. Table 4 indicates the moderated beta coefficients of the regression model.

Table 4: Moderated Beta Coefficients and Significance

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	.693	.126		5.479	.000
	Foreign Direct Investment	.038	.006	.626	6.428	.000
2	(Constant)	.524	.188		2.794	.007
	Foreign Direct Investment	.042	.007	.696	6.165	.000
	Political Risk	.018	.015	.137	1.211	.230
3	(Constant)	.537	.166		3.232	.002
	Foreign Direct Investment	.008	.010	.136	.827	.411
	Political Risk	.036	.014	.282	2.676	.010
	Interaction Term	.003	.001	.744	4.289	.000

Model 1 shows that FDI is a statistically significant predictor of financial performance of the manufacturing firms in Kenya, ($p<0.05$). This means that improvement in FDI would boost financial performance of the firm. This finding is consistent with Bruno and Cipollina (2014) who looked at FDI and the economic performance in Europe where it was noted the FDI influenced economic performance of the country.

In model 2, political risk is introduced and its resultant $p>0.05$. Thus, political risk as a moderator variable was significant in the second stage of moderation testing. As noted by Mugenda (2009) as well as Fairchild and Mckinon (2009), if the beta of political risk is significant in this step 2, then the variable is deemed as explanatory. Furthermore, the beta of FDI slightly increases from $\beta=0.038$ to $\beta=0.042$ and it is also positive. Thus, the introduction of political risk under model 2 increased the beta coefficient of FDI, which provide evidence of moderation. The end result of this would be improving the financial performance of the manufacturing firms in Kenya. These findings are supported by empirical evidence of Khan and Akbar (2013) who established that political risk influences the nature of the relationship that exists between FDI and financial performance. In model 3, the p-values of political risk and the interaction term are $p<0.05$ respectively. This confirms the mediating role of political risk and thus hypothesis H_{04}. As such, the study infers that political risk significantly moderates the relationship between foreign direct investment and financial performance of manufacturing firms in Kenya. Baek and Qlan (2011) noted that political risk significantly influences FDI both in developed and developing economies.

CONCLUSIONS AND RECOMMENDATIONS

Informed by the correlation results, the study conclude that foreign technological flow is a strong and positive correlate of financial performance of manufacturing firms in Kenya. In light of the regression results, hypothesis H_{03} was rejected.

The last objective of the study sought to establish moderating effect of political risk on the relationship that exist between foreign direct investments and financial performance of

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manufacturing firms in Kenya. Guided by correlation results, the study concludes that political risk had a weak but positive relationship with financial performance. Basing on regression analysis, hypothesis H_{04} was rejected.

With regard to the third objective, the study recommends that the ICT managers of the manufacturing firms in Kenya should leverage the soft and hard technological flows to support the processes and enhance financial performance of their firms.

The government of Kenya should provide conducive environment by enacting progressive policies that support FDI. The Ethics and Anti-corruption commission together with the Director of Criminal Investigation (DCI) should work closely to counter corruption which was seen to deter the inflow of FDI in the country.

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