RELATIONSHIP BETWEEN SHARE RETURNS AND SHARE PRICES FOR STOCKS LISTED AT THE NAIROBI SECURITIES EXCHANGE

JAVEL MUTHEE MURIRA, BERNARD BAIMWERA, AGNES MUNENE

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Javel Muthee Murira[*1], Bernard Baimwera[2], Agnes Munene[3]

[*1]MBA Student, Financial Management, Kenya Methodist University [KEMU], Meru, Kenya.
[2] Lecturer, Department of Economics and Finance, Kenya Methodist University [KEMU], Nairobi, Kenya
[3] Lecturer, Department of Economics and Finance, Kenya Methodist University, [KEMU], Nairobi, Kenya

ABSTRACT

Investors expect to earn returns from their investment in shares and hence they pursue a profit maximization objective. The higher the returns the higher the demand for shares, which in turn causes share prices to rise. This study investigated the relationship between share returns, represented by; earnings per share, dividends per share and price-earnings ratio with market price of shares for companies listed at the Nairobi Securities Exchange during the period between 2010 and 2014. Secondary data was collected from the Nairobi Securities Exchange database and the audited financial statements of all the 65 companies listed at the Nairobi Securities Exchange. Data was analyzed using SPSS version 21 and   included both descriptive statistics such as the mean and the standard deviation and the inferential analysis that involved the correlation and multiple regression analysis. The study found out that both earnings per share and dividend per share have a positive significant relationship with share prices. However, price earnings ratio is positive but does not have any significant relationship with share prices. Therefore the study concluded that earning per share and dividend per share positively influence market price of shares listed on the Nairobi Securities Exchange. The study therefore recommends that companies should come up with an optimal dividend policy for dividend payment as dividends affect the market price for shares. In addition, managers of companies listed on the NSE should enhance the earning per share as they positively influence the market price for shares.

Key Words; Share Price, Earnings per Share, Dividends, Retained Earnings, Price-Earnings Ratio

INTRODUCTION

A share is a unit of ownership of a firm acquired by an investor through capital contribution, by way of buying shares. Investors buy shares with the expectation of earning returns in the form of dividends and capital gains and hence they pursue a profit maximization objective (Bohart, 2007). The value of the share is equivalent to the present value of all the future benefits associated with the share. Therefore, the greater the expected benefits associated with a share, the greater its price is (Tanveer, Mohsin, Bhattib, Hussain & Akbar, 2013). In other words, the higher the expected returns the higher the demand for shares will be, which in turn will cause share prices to rise (Levin E.J. and Wright 2006). Knowledge of the relationship between the share returns and share prices would be of benefit to the investors and the firms in two ways; first, it would help the investors to make wise investment decisions and secondly, it would enable the companies to enhance their market value by managing returns to the shareholders (Ruhani & Islam, 2014).

Past research studies have attempted to explain the factors that determine share prices using data from different stock markets. The differences in the research findings of different researchers demonstrate that, there is no single criterion for explaining share prices. However, the researchers have agreed that there are two major lines of reasoning, being used to explain companies' share prices. The first is the fundamentalists' view that, a share price is a product of the company's economic performance as reflected by the earnings, dividends and the cashflows. Fundamental analysis using companies' financial statements has been the predominant technique adopted in appraising equities by those using this approach (Wang, Haslam & Marston, 2011). The second line of reasoning is the view that it is the underlying net book value of the firm that determines the value of the shares. The two lines of reasoning are relevant in explaining the market price of shares, but their efficiency varies depending on the nature and characteristics of the company in question (Gallizo & Salvador, 2006).

A detailed review of past studies on this subject left many unanswered questions. The review demonstrates that, although there is ample research on share valuation internationally, this appears not to be the case in emerging capital markets of the third world economies (Bruner, Conroy, Estrada, Kritzman & Li, 2002. The research findings did not explain fully the nature of the relationships between share prices and share returns. The findings demonstrates that, while in equilibrium, share prices eventually reveal the total value of the firm, but, in many cases, the market cannot identify the actual source of value creation (Collins Dufresne P., Fos V., 2013). The share return variables namely; earnings per share, dividend per share, retained earnings per share and price-earnings ratio showed both positive and negative effect on share prices depending on the stock market used. The relative importance of earnings per share as determinant of share prices is not clearly defined in past research studies (Ruhani F., Islam A., 2014). The study on the effects of dividend policy on share price volatility in the Nairobi Securities Exchange found that it explains only 21.8% of the of share prices; hence there are other factors that explain the remaining 78.2% of the share price (Kenyoru N.D., Kundu S.A., Kibiwott L.P., 2013). In another study, Lewellen (2002) observed that a lot of past literature concentrates on price-earnings and price to book ratio characteristics.

In view of the shortcomings in the past research studies, it was necessary to carry out a locally based research study with a view to develop relevant information on share pricing in Kenya. This study

was to establish whether returns to shareholders represented by earnings per share, dividends per share, retained earnings per share and price-earnings ratio influenced the share prices for companies listed at the Nairobi Securities Exchange between 2010 and 2014.

Objectives of the study

- To find out how earnings per share reported by companies listed at the NSE between 2010 and 2014 affected market price of shares for those companies.

- To find out how dividends per share declared by companies in the years from 2010 to 2014 affected market price of shares.

- To find out how retained earnings per share influenced the market price of shares between 2010 and 2014.

- To establish the relationship between price-earnings ratio and market price of shares for companies listed at the Nairobi Securities Exchange between 2010 and 2014.

LITERATURE REVIEW

Theoretical framework

Empirical literature

A study by Vijayakumar A. (2010), found that book value, earnings per share, dividend cover, growth rate and dividend yield had a positive association with market price of shares. The dividend per share and price-earnings ratio had a negative association with market price of shares. Financial performance of a company, as evidenced in its record of earnings; dividend, growth and future prospects influence its share price trends. Obeidat M.I. (2009), carried out a study that investigated the effects of earnings per share (EPS), dividends per share (DPS) and book value per share (BVS) on stock

market prices in Abu Dhabi Securities market from 2002 to 2006. The study concluded that, stocks with strong fundamental values would prevail in the long-run compared to those that drift on the random walk path of the market. The market mechanism has a way of correcting any share price errors for the stocks that have diverged from their fundamental values to ensure that the market is rational and not overreacting to historical information.

A study by Riahi-Belkaoni A., Picur R.D. (2001) found that, share value is a function of earnings, dividends and book-value where the function depends on the relative level of investment opportunity set. For firms in low investment opportunity set group, both retained earnings and dividends are relevant, even though retained earnings are more relevant than dividends. Earnings per share and book value per share had a significant effect on market price while there was no significant effect from dividends per share. Chan W., Liow K.H., Sing T.F. (2002), carried out a study to establish whether property share prices reflected their fundamental values namely, earnings per share (EPS), dividends per share (DPS) and net assets value (NAV). The study found that; 9 out of 15 sampled stocks had long-run convergence relationships between share prices and the fundamental values. Ruhani F. and Islam A. (2014), wrote a paper that reviewed the previous studies on the determinants of share prices with special focus on dividends, retained earnings and earnings per share. He observed that; Dividend policy and earnings management were found to be very active contributor of share price volatility. Dividend policy, especially information content of dividend, information asymmetry, signaling theory, dividend clientele effect and dividend yield have been found to have significant effect on share prices.

Relationship between earnings per share and share prices

Johnson W.B., Zhao R., (2012), carried out study which found that; Earnings surprises matter to managers and investors. Reporting a profit figure that yield a zero or positive earnings, builds credibility with analysts and investors, and maintains or increases the share price. Negative earnings are believed to evoke a severe share price penalty because the failure to at least meet the expectation of the market raises doubt among investors about the underlying strength of the firm. Bessler W. and Thies S. (2007), carried out a study to investigate the long run performance of initial public offers (IPO) of shares in German for the period from 1977 to 1995. The study concluded that only successful firms have the opportunity to raise additional funds in the equity market through seasoned equity offering. Dechow P.M., Sloan R.G., Zha J. (2014) study used accounting earnings in form of summarized periodic corporate performance as key determinants of stock prices. The study concluded that earnings are tied to the long-run cash distribution paid on securities and that stock prices clearly respond to information in earnings announcements. However, earnings are considered to be a relatively untimely source of information, particularly for early-stage firms engaging in innovative activities..

Salvador M., Gallizo J.L.(2006), studied the effects of cashflow and book value on the share price. The study found that the firm size and speed of asset turnover are a company's most relevant features, which is indirectly consistent with the company lifecycle theory (Wang K.C, 2005). For larger firms, book value has greater influence on share prices. For smaller companies asset turnover, associated with cashflows, influences the share prices. When earnings are random walk, both the level of and changes in profits are closely correlated with the share price. According to Pindado J., Perote J., Brio E.B. D. (2013), investors are only prepared to reward firms with high free cashflows when they announce increase in capital expenditure and if their investment opportunities are profitable.

Relationship between dividend per share and market price of shares

According to Waithaka S.M., Ngugi J.K., Aiyabei J.K., Itunga J.K., Kirago P. (2012), the determination of the amount of dividends payable is an important decision that companies undertake since the objective of the firm is to maximize the shareholders wealth as measured by the price of the companies' common stock. An increase in a firm's stock trading volume affected the share price and investors who wanted current investment income owned shares in high dividend payout firms. They concluded that, companies should always strive to pay dividends consistently for their shares to perform well at the stock exchange. Dividends policy have an effect on the share prices, hence, companies should pay dividends to maintain high share prices. A study by Dawar V. (2013) concluded that; Earnings distributed as dividends have a greater impact on firm value than do earnings retained within the firm, hence confirming the signaling effect of dividends policy. For companies exhibiting extreme returns on equity, the value impact of dividends is greater than that of retained earnings.

Mgbame C.O., Aruoriwo M., Hussien K. (2011), carried out a study that examines the relationship between dividends policy and share price changes in the UK stock market using regression analysis method. The study compared specifically, share prices changes against both dividend yield and dividend payout ratio. The study found that, there was a positive relation between dividend yield and stock price changes and a negative relationship between dividend payout ratio and stock price changes. The study concluded that dividend policy is relevant in determining share price changes for a sample of firms listed in the London Stock

Exchange. Nirmala P.S., Sangu P.S., Ramachandran M. (2014), carried out a study to examine the long run causal relationship between share prices and dividends in the Indian stock market. The findings were that, there exists bi-directional long-run causality between share prices and dividends. The study concluded that, companies should consider the interplay between share price and dividends when framing their dividend policies. A change in dividend policy would have an effect on market value of the firm; hence firms need to frame dividend policy in such a way that it would enhance their market value. However, a study by Okafor C.A., Mgbane C.O., Chojoke A. (2011) based on the Nigerian stock market found that, dividend policy and dividend yield showed a general negative impact on share price. Dividend payout ratio, showed a negative influence in some years and positive influence on others though all were at low significance levels.

Kenyoru N.D., Kundu S.A., Kibiwott L.P. (2013) carried out a study that sought to determine the impact of dividend policy on share price volatility in Kenya. The study used data from the actively trading companies listed in the Nairobi Securities Exchange for a ten year period between1999 to 2008. The study found that dividends are the major determinants of share price volatility in the NSE with a beta (β) of 0.470, ≤ 0.05. Dividend yield negatively affects share price volatility at β= 0.124, ρ=0.05. Therefore, the higher the payout ratio, the less the price volatility. Hashemijoo M., Ardekani A.M., Nejat Y. (2012), study that examined the relationship between dividend policy and share price volatility with focus on consumer products companies in Malysian Stock Market. The study found that, there was a significant negative relationship between share price volatility and both dividend yield and dividend payout and a significant negative relationship between share prices and size of the firm. The study concluded that dividends

yield and size have the most impact on share prices. A study by Kyle A. and Frank W. (2013) that attempted to identify the effects of financial variables such as dividend yield, payout ratio, size, long-term debt and growth on share price volatility found that dividend yield and size of company related negatively with the share price volatility.

**Relationship between retained earnings and market price of shares**

A study by Ahmed (2000) to determine the relative importance of dividends and retained earnings in the share price determination for companies listed in Bangladesh between 1988 and 1995 found that; both dividends and retained earnings influenced share prices. The dividends had a stronger impact on share prices of non-growth industries while retained earnings had greater impact on prices of growth industries. A study by Ghausi S.K.M. (2014), found that size of the company had a positive significant relationship with the share prices. A study by Gregorian, Gupta and Healy (2015) found that, in the telecommunication sector, stock prices are influenced by non-financial factors such as market penetration, churn rates, number of subscribers and retention rates. Research and development expenditure was found to be statistically significant for the stock prices of growing and high technological telecommunication companies and appear more important for investor's decision to purchase telecom company stocks than the dynamics of earnings and cashflows.

Relationship between price-earnings ratio and the market price of shares

Nel W.S. (2009), carried out a study that investigated the accuracy in the use of price-earnings ratio and other four multiples in the valuation of equities of South African companies listed on the JSE Securities Exchange for the period, 1988 to 2007. The research results revealed that

the P/E ratio does not perform the most accurate valuations across all sectors and that different multiples should be used for different sectors. A study by Leong K., Zaima J.K. and Pagani M. (2009), found the firms with low P/E exhibit low returns while firms with high P/E ratios or growth stocks exhibit the highest returns. A study by Xiaoyan C. (2015), found that, the consistently high price-to-earnings ratios in the Chinese share market indirectly prove the scarcity of investment choices available to domestic investors. A study by Riahi-Belkaoni A., Picur R.D. (2001) found that, firms in high investment opportunity set were 'price-earnings valued' while the firms in low investment opportunity set were dividend-yield valued.

Conceptual framework
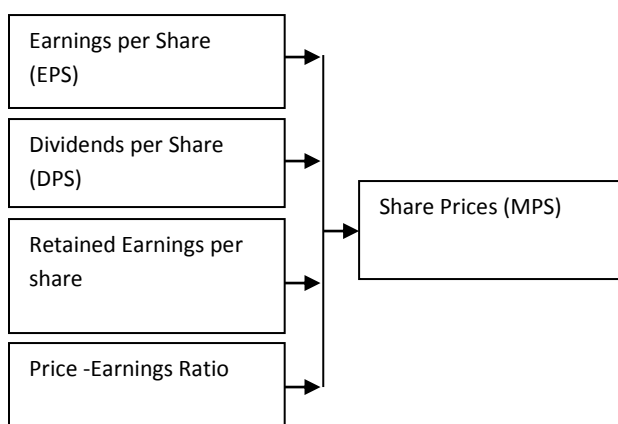
Independent variable   Dependent variable

Figure 1: Conceptual Framework

Source: Researcher, 2016

Table 1: Descriptive Statistics Results

METHODOLOGY

This research study used the descriptive research design to portray accurately the relationship between share returns and share prices. The study was based on the entire population of the sixty five companies which were listed at the Nairobi Securities Exchange between 2010 and 2014. The study used the secondary data from listed companies that had continuous data available over the entire five-year study period to eliminate companies whose share price was largely a consequence of either circumstances such as newly listed companies and companies experiencing financial distress (Dyl E.A, Elliot W.B., 2000). The data used in the study was available in the companies' published financial statements for the years 2010 to 2014 and at the Nairobi Securities Exchange database. The data used in the study was collected from the Nairobi Securities Exchange database in October, 2016. Data analysis was aided by use of SPSS version 21. Analysis involved both descriptive and inferential analysis. Confirmation of the SPSS results was done using EXCEL statistical functions as applicable.

DATA ANALYSIS

The descriptive statistics such as the mean and the standard deviation were determined in order to give a general summary of the nature of the data used. Their results were presented in table 1 below;

Variable	Observation	Mean	Maximum	Minimum	Standard Deviation
Market Price Per Share	273	73.81733	903.000	1.70000	118.0203
Earnings Per Share	273	7.460967	97.4500	-18.3400	16.37071

Dividend Per Share	273	2.890601	75.0000	0.00000	7.202295
Retained Earnings	273	4.570366	90.1700	-71.3500	14.40764
Price Earnings Ratio	273	14.35055	733.330	-318.1800	63.47040

Source: Study data (2016)

From the findings on table 1; the mean value of market price per share for the period under the study was 73.81733.The standard deviation of 118.0203 indicates a great variation in market price per share in for the period as evidenced by a maximum value of 903.000 and minimum value of 1.70000. The earnings per share had an average of 7.460967 with the highest earning of 97.4500 and lowest earning of -18.3400 for the period 2010-2014.The negative earning implied that some companies were making losses and the shareholders were not only earning nothing but also losing the value of their shares. The dividend per share had an average value of 2.890601.The maximum dividend paid for the period was 75.0000 and the minimum dividend paid was 0.0000 which

was an indication that some companies listed on the Nairobi Securities Exchange did not pay any dividends for the period 2010-2014. The price earnings ratio had a mean of 14.35055 with a maximum value of 733.30 and minimum value of -318.1800 respectively. The standard deviation of 63.47040 was an indication of a big variation in price earnings ratio during the period.

Correlation Analysis

The researcher used Pearson correlation matrix to explain the strength of the relationship between share returns and share prices for stocks listed at the Nairobi Securities Exchange for the period 2010-2014. The results are presented in the table 2 below;

Table 2: Pearson Correlation Matrix Results

	MP	EPS	DPS	REPS	PER
MP	1.000000				
EPS	0.595357	1.000000			
DPS	0.548510	0.476192	1.000000		
REPS	0.402253	0.898185	0.041134	1.000000	
PER	0.025759	-0.030795	-0.013203	-0.028390	1.000000

From the findings on table 2; Earnings per share, dividend per share, retained earnings per share and price earnings ratio had a positive correlation with market price per share. Retained earnings per share and price earnings ratio had a weak but positive correlation with market price per share with price-earnings ratio having a very weak correlation of 0.025759.

Diagnostic Test Results

Before conducting multiple regression analysis the researcher conducted diagnostic test in order to avoid non sense regression results and also to ensure that the coefficients obtained were best, linear and not biased. The tests included: multicollinearity test, test for autocorrelation and test for heteroscedacity

Multicollinearity Test Results

The presence of multicollinearity was tested using the correlation coefficient test as indicated by results on table 2. According to Gujarati (2003); Cooper and Schindler (2008) a Correlation of above 0.8 is an indication of severe multicollinearity. From the findings in table 2 earnings per share and retained earnings per share had a correlation coefficient of 0.898185 which was an indication of severe multicollinearity. Brooks (2008); asserts that the solutions to severe multicollinearity include dropping one of the collinear variables, so that the problem disappears. The study therefore dropped

retained earnings per share since it had a weak correlation with market price per share as compared to earnings per share.

Autocorrelation Test Results

In order to test for autocorrelation, the study used Breusch Godfrey Serial Correlation LM test. The null hypothesis was that, there was no serial correlation and the alternative was, there was serial correlation. The findings were presented on table 3 below;

Table 3: Serial Correlation Results

Breusch-Godfrey Serial Correlation LM Test:

F-statistic	33.33301	Prob. F(2,267)	0.4424
Obs*R-squared	52.69845	Prob. Chi-Square(2)	0.0651

Source: Study data (2016)

From the results the F statistic with which two and two hundred and sixty seven degrees of freedom had a value of 33.33301 and a P value of 0.4424. Since the P value was greater than 5% level of significance then, the F test was statistically insignificant and therefore the study failed to reject the null hypothesis and concluded that there was no problem of serial correlation.

Heteroskedacity Test

The researcher used the white test (1980) in order to detect heteroskedacity. The null hypothesis was that the error term is homoscedastic against the alternative hyphothesis that, the error term was heteroskedastic. The results are presented on table 4 below;

Table 4: White Test Results

Heteroskedasticity Test: White

F-statistic	97.4725	Prob. F(3,269)	0.0610
Obs*R-squared	142.6735	Prob. Chi-Square(3)	0.0995
Scaled explained SS	1641.509	Prob. Chi-Square(3)	0.9129

Source: Study data (2016)

The F statistic, with three and two hundred sixty nine degrees of freedom had a value of 97.4725 and a P value of 0.0610. Since the P value was greater

than 5% level of significance then, the F test was statistically insignificant and therefore the study

failed to reject the null hypothesis and concluded that there was no problem of heteroskedacity.

Regression Analysis

The regression analysis was used to determine the relationship between share returns and share prices. This includes analyzing the coefficient of determination and the multiple regression analysis using the ordinary least square method.

Coefficient of Determination

The coefficient of determination explains the extent to which the changes in market price per share is explained by the independent variables, namely; earning per share, dividend per share and price earnings ratio. The results are presented in table 5 below;

Table 5: Model Summary

Model	R	R Squared	Adjusted R Squared	Std. Error of Estimate
1	0.668711	0.447175	0.441009	88.238650

Source: Study data (2016)

From the findings in table 5; Earnings per share, dividend per share and price earnings ratio jointly explain 44.1% of the variation in market price per share as presented by the adjusted R squared. The remaining 55.9% variation in market price per share could be explained by other factors not included in this study.

Multiple Regression Analysis

In order to determine the relationship between share returns and share prices, multiple regression analysis was done using the method of Ordinary Least Squares. The results are presented on table 4.6 below;

Table 6: Multiple Regression Results

Dependent Variable: Market Price per Share

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Earnings Per Share	3.125483	0.371807	8.406189	0.0000
Dividend Per Share	5.614120	0.844708	6.646228	0.0000
Price Earnings Ratio	0.081135	0.084335	0.962047	0.3369
C	33.10569	6.113158	5.415482	0.0000

Source: Study data (2016)

From the findings on table 6 the following regression equation was obtained;

$$MP_{it} = 33.1 + 3.12EPS_{it} + 5.61DPS_{it} + 0.08PER_{it} + \varepsilon_{it}$$

According to the findings taking earnings per share, dividend per share and price earnings ratio at zero, market price per share for the stocks listed at the Nairobi Securities Exchange for the period 2010 to 2014 is Ksh.33.10. Earnings per share are positive and statistically significant at 5% level of significance. This implies that when holding all other factors constant a one unit increase in share prices led to a 3.12 units increase in share returns (earnings per share). This finding supports those of Obeidat, (2009) and Dechow, Sloan and Zha (2014) who found that earnings are important in determining the stock prices as the stock prices clearly respond to information in earnings announcements. The finding shows that, dividend per share is positive and statistically significant at 5% level of significance. This implies that a one unit increase in share prices led to a 5.61 unit increase in share returns (dividends) while holding other factors constant. This finding corroborates those of Waithaika et,al (2014) and Saravanakumar, (2011) and Dawar ,(2013) who found out market price of shares positively responds to the dividend announcement. Further, the findings supports the bird in hand theory by Gordon and Litner (1963) who posits that dividends are relevant in determining share prices because investors prefer near to future dividends. However the findings refutes dividend irrelevance theory by Modigliani and Miller (1961) who contend that a firm's dividend policy has no effect on share prices and therefore dividends are of no consequence. The price-earnings ratio is positive but not significant in determining the share prices. The findings support those of Nel (2009) who found that the P/E ratio does not perform the most accurate valuations across all sectors and that different multiples should be used for different sectors.

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The study conducted the diagnostic test and then used ordinary least square method to analyze the data. First, the study sought to find out the relationship between earning per share and market price of shares listed at the NSE. The study used OLS method for analysis and found that the coefficient for earning per share is positive and statistically significant at 5 %. Secondly, the study sought to find out the relationship between dividend per share and market price of shares listed in the NSE. Using OLS method for analysis the study found out that the coefficient for dividend per share is positive and statistically significant at 5 %. Thirdly, the study sought to find out the relationship between price-earnings ratio and market price of shares listed at the NSE. Using OLS method for analysis the study found out that the coefficient for price earnings ratio is positive but not statistically significant in determining the share prices.

Conclusions

First, with regards to the relationship between earning per share and market price of shares listed in the NSE, the study concluded that earnings per share has a positive and statistically significant relationship with market price of shares listed in the NSE for the period 2010-2014. Secondly, the study concluded that dividend per share has a positive and statistically significant relationship with market price of shares listed in the NSE for the period 2010-2014. Lastly, the study concluded that price earnings ratio has a positive but not statistically significant relationship with market price of shares listed in the NSE for the period 2010-2014.

Recommendations

The study recommended that companies should come up with an optimal dividend policy for dividend payment as dividends affect the market price for shares. It also recommends that, managers of companies listed on the NSE should enhance the earning per share as they positively influence the market price for shares.

The study recommended a further research on other factors affecting market price for shares not included in this study. Besides, a further study could be carried out to compare the relationship between share returns and market price for shares for regulated and non-regulated firms listed on the NSE.

Suggested areas for further research

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