



ECONOMIC FACTORS AND FINANCIAL PERFORMANCE OF THE PETROLEUM FIRMS IN KENYA

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ABSTRACT

This study sought to evaluate the effect of economic factors on financial performance of the petroleum firms in Kenya. The study used the causal research study design with a census of the subjects. Causal studies are concerned with learning how one variable produces changes in another. The target population was 50 petroleum firms in the industry up to the year 2018 operating along Nakuru-Nairobi. This was also the accessible population which represented 100% of all the 50 the firms targeted in this study. The study conducted a census of all the 50 petroleum firms. The researcher used close-ended questionnaires as the main primary data collection tool. The secondary data was collected from the audited financial statements of the petroleum firms selected from the period 2011 up to 2018. The collected data was coded and cleaned before inputting it into the SPSS program version 21.0 for analysis. Descriptive statistics was employed in analyzing quantitative data and qualitative data was taken through content analysis and then organized into narratives. The study found out that oil price control had significant positive relationship with financial performance of the petroleum firms in Kenya; level of inflation had significant negative relationship with financial performance of the petroleum firms in Kenya; bank interest rate had significant negative relationship with financial performance of the petroleum firms in Kenya and global oil prices had significant negative relationship with financial performance of the petroleum firms in Kenya. The study recommended that CBK should come up with policies that regulate the banks interest rates to regulate them from arbitrarily increasing their interest rates; firms need to have strategies put in place to mitigate uncertainties in the interest rates; ERC need to come up with proper policies to curb the issue of inflated fuel prices and the government of Kenya should try to control inflation to avoid extreme inflation rates which negatively impact the petroleum firms and in turn affect the country's economy. The study recommended further study to be done on other factors that affect the petroleum firms in Kenya other than economic such as government legislations and globalization. It further recommended replication of similar study in other countries to allow comparison and generalization of the study findings.

Keywords : Company Performance, Earnings per share, Energy Regulation Commission, Oil Marketing Company, Organization of the Petroleum Exporting Countries, Price Regulation, Return on Equity and Sales growth.

INTRODUCTION

As robust as the petroleum industry is, it faces as many challenges as the numerous opportunities it has for its growth prospect. One of the key issues is its financial performance. Theoretically, oil prices should be a function of supply and demand. When supply and demand increase, prices should drop and vice versa. But the reality is different. Oil which is the preferred source of energy has a complicated pricing model. Demand and supply are only part of the complex equation that has generous elements of geopolitics and environmental concerns, which is a great economic concern to financial managers (Kilian, 2006). The Petroleum products play a central role in the economic development of most countries in the world. It is also important to note that most households in developing countries rely heavily on petroleum products as sources of energy such as lighting and running of small and medium enterprises (SMEs), this is according to the Kenya Association of Manufacturers (KAM reports, 2014). In essence, petroleum products have a huge macro and microeconomic effect on the economies of most countries (Kojima, Mathews & Smith, 2010).

After the deregulation of the oil industry in Kenya in 1992 the market structures of the oil industry remains oligopolistic both in whole and retail level (Government of Kenya, 2005). About 85.3% of market share control is by major oil companies that is Shell/BP now VIVO, Total, Kenol Kobil, Caltex sold all their assets to Total K, and Mobil currently Oil Libya. The major oil companies are vertically integrated with a stake of 51.4% of the 1,153 retail outlets, the remaining are controlled by new entrants and independent owners (Government of Kenya, 2005).

The success of the petroleum firms in the industry is traced for instance from the Earnings per share, which serves as an indicator of a company's profitability. However, data sources sometimes simplify the calculation by using the number of shares outstanding at the end of the period. The term earnings per share (EPS) represents the portion of a company's earnings, net of taxes and

preferred stock dividends, that is allocated to each share of common stock. The figure can be calculated simply by dividing net income earned in a given reporting period (usually quarterly or annually) by the total number of shares outstanding during the same term. Because the number of shares outstanding can fluctuate, a weighted average is used (Marr, 2012).

To a great extent, the growing economies in Asia, South America and Africa depend heavily on petroleum and its products to run its rapidly expanding industrial base. The East African economies, in particular, depend heavily on crude oil and refined oil products mainly from the Middle East region, with few multinational firms dominating this lucrative business in the entire region. Petroleum industry thus has a great need for sound financial management to enhance profitability and stability (Roberts, 2014).

In Kenya the oil sector operates under Energy Regulation Commission where oil prices are determined. Although oil prices are generally affected by external factors, it is felt that Cartels and monopoly tendencies distort these same market forces to ensure high prices prevail. Most often due to public outcry, the government from time to time is forced to intervene through price regulatory mechanism by introducing maximum retail price to be charged by marketing firms on certain oil products. This came into effect in December 2010 to eliminate unhealthy competition and enhance quality standards in this giant industry. This effectively ushered into the sector Controlled Market System by the government (Katisya, 2011). The petroleum industry has several giant players including Total Kenya, Oilibya, Caltex, National oil, Gulf oil, Kobil and many other companies. These major firms have outlets all over the country with almost up to 70% stake of market share in the industry (ERC, 2017). The past studies, fail to clearly show how the macroeconomic factors such as price control and the rate of inflation affect financial performance of the petroleum industry. There is also little information on the intervention mechanisms to enhance better financial

performance. The previous empirical studies have not been conclusive on the question of financial performance and pricing of petroleum products in Kenya. Hence, the purpose of this study was to fill the gap in the country.

Statement of the Problem

Over the recent years Africa as a whole and Kenya in particular has had sharp increase in demand for affordable energy especially petroleum. Despite this, the industry is overwhelmed by the demand; worsened by the usually sky-rocketing prices since 2007. It is argued that oil firms take advantage of international prices to exploit the public (Arthur, 2012). Pressure from the members of public and consumer protection lobby groups has led to pump price control by government through ERC. Whether the price control has borne fruit is yet to be ascertained. Financial performances of the industry is in question as giant firms close, merge or are taken over yet new firms are entering the market since 2010. It is not clear how economic factors affect financial performance of petroleum firms (ERC, 2017). Related studies have given mixed results. Gikungu (2012) in his study of the effect of economic factors on the performance of the Nairobi Securities Exchange (NSE) concluded that there was a general rise in share prices, money supply, rate of inflation, rate of interest and exchange rate over the period under study. Muchiri (2012) in his study the influence of economic factors on the performance of the Nairobi Securities Exchange in Kenya, concluded that money supply and inflation rate had a positive nonetheless minor effects on securities exchange while interest rate had a negative nonetheless minor effect on securities prices but found out that exchange rate has a substantial impact on stock market behaviour. It is of great concern that with many firms entering the market, others are also exiting; putting spotlight on whether the industry is really performing financially or is unfeasible. It also begs the question of products quality, safety in the firms and adherence to healthy standards set by ERC and other watchdogs. This study sought to get findings in the

petroleum industry to fill the gap by examining economic factors that influence the financial performance including price control, inflation, bank interest rate and the global oil prices. The same factors can either enhance or hinder stable financial performance of the petroleum industry in Kenya and thus affect the overall well-being of the firms.

Research Objectives

The general objective of the study was to evaluate the effect of economic factors on financial performance of the petroleum firms in Kenya. The study was guided by the following specific objectives:

- To determine the influence of price control on financial performance of the petroleum firms in Kenya
- To establish the effect of inflation rate variation on the financial performance of the petroleum firms in Kenya
- To determine the effect of bank interest rate variation on the financial performance of the petroleum firms in Kenya
- To establish the influence of the fluctuations in global oil prices on the financial performance of the petroleum firms in Kenya

LITERATURE REVIEW

Theoretical Review

Public Interest Theories of Regulation

Central to this category of theories is the view that public interest is promoted whenever economic agents (such as firms) are brought under regulation. Public interest here connotes the allocation of the scarce resources in the „best possible“ way to ensure individual and collective good of the society. The assumptions of benevolent regulator, perfect enforcement and full information lie at the foundation of these theories. The market mechanism, „the invisible hand“ as Adam Smith would call it, to a large extent determines resource allocation in western countries. Arrow (1985)

observes that theoretically, it is possible to demonstrate that market mechanism allocates resources optimally.

But Bator (1958) opines that the conditions do not always hold in practice making resource allocation by market mechanism sub-optimal hence the need for improved methods of resource allocation. A competitive market assumes equilibrium in which prices (marginal returns) equals marginal cost. A firm is thus seen as capable of expanding its productive capacity up to the point at which the marginal cost of an additional unit equals marginal returns. But this is largely an ideal market. Thus a rational choice theory to economic maximization of welfare is missing. Public interest theories have also been criticized for their inability to make predictions that can be tested empirically by economic science, (Stigler, 1971). This theory explains the influence of price control on financial performance of the petroleum firms in Kenya.

Arbitrage Pricing Theory

The theory of Arbitrage Pricing Theory (APT) was first suggested in 1976 by a researcher called Stephen Ross. This is an asset assessing model which explains in depth about the expected return of an investment or a financial asset ought to be modelled accordingly in the form of a lined relationship of different macroeconomics variables or else in a situation at which correlation towards fluctuations in individual macroeconomics variable that is characterized through a constant through known as the beta coefficient.

By the fact that there exists a linear relationship that is brought about as a result between both the assets' expected returns and their covariance with other random variables Capital Asset Pricing Model (CAPM) also in Arbitrage Pricing Theory hence they both act as substitute to each other (Ross, 1976). A market portfolio's return is depicted as the covariance in CAPM model of analysis. This specific theory is appropriate for the study since there are different variables hypothesized to determine firm performance which are the GDP fluctuations, rate

of inflation, rate of exchange and interest rate. This theory explains the effect of inflation rate variation and fluctuations on the financial performance of the petroleum firms in Kenya.

The Classical Theory of Interest

The classical theory of interest also known as the demand and supply theory was propounded by the economists like (Marshall & Fisher, 1951). According to these theory interest rates are a major factor affecting the amount of investments and the willingness for investors to save as well as ensuring that equilibrium is maintained between the two. Several scholars and economist have been credited as frontiers of the theory, the likes of Marshall, Cassel and Flux. To understand the theory, one has to view investment as the demand, while the saving as the supply and the rate of interest as the "price" of the investible resources. When the demand of a resource is equal to the supply, the price becomes relatively fixed. Interest rates vary depending on the varying market conditions from time to time. A situation whereby the investment and savings are equal at a certain rate is known as an equilibrium point (Maynard, 2014). The importance of this theory in relation to our study is that it shows us how a variation in interest rates can affect the financial performance of the petroleum firms in Kenya.

Managerial Motives Theory in Financial Performance

Managerial Motives theory by Kemal (2011) states that higher financial performance can also arise because of investment and cost issues that exist between shareholders and managers, especially when the managers are more concerned with satisfying their own objectives than with increasing the investment wealth of shareholders in the industry. The relevance of this theory from this perspective is that the motives behind firms having a lot of staff incentives even amidst poor financial performance may be to increase managers' pay and power. This needs to give higher financial returns to the firm and the general industry. The Managers

may also believe that the larger their organization, the less likely it is to be taken over by another company and hence the more secure their jobs will become. This explains the basis for some takeovers in the petroleum industry. The structural changes made on these grounds may not have shareholder wealth justification since managers are likely to increase their own wealth at the expense of the shareholders. This could be the reason some well-intended structuring strategies including cost cuts, mergers and acquisitions ended up hurting than building the petroleum firms.

Conceptual Framework

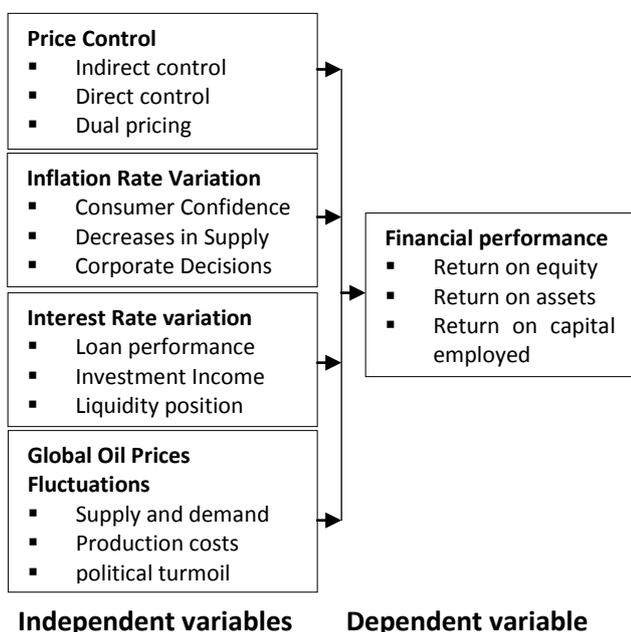


Figure 1: Conceptual Framework

Source: Author (2018)

METHODOLOGY

This study used causal research study approach. The target population was the 50 petroleum firms in the industry up to the year 2018 operating along Nakuru and Nairobi road. This was also the accessible which represented 100% of all the 50 the firms targeted in this study. The sampling frame of this study was a list of all the 50 petroleum firms operating in Nakuru and Nairobi drawn from petroleum firms in Kenya. The total sample of this study was a census study of all the 50 petroleum

firms. The researcher used close-ended questionnaires as the main primary data collection tool. A pilot test is a method that is used to test the design and/or methods and/or instrument before carrying out the research. Descriptive methods was employed in analyzing quantitative data where measures of central tendency, frequencies, regression analysis and proportions were used in interpreting collected data as per the audited financial statements. The study conducted a correlation analysis to establish the strength of the relationship between the independent and the dependent variable. Multiple regressions were done to analyze the effect of economic factors on financial performance of the petroleum firms in Kenya. In addition, a multiple regression was used to measure the quantitative data and was analyzed using SPSS version 21.0.

RESULTS AND DISCUSSION

Descriptive and inferential statistics was used to discuss the findings of the study. The study targeted 50 petroleum firms with a turnover of at least Ksh 10 million annually. 48 of them filled and returned the questionnaire, forming a response rate of 96%. A response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent (Mugenda & Mugenda (2008). Hence in our case the response rate of 48 out of 50 is excellent.

Reliability Analysis

Reliability analysis was carried out in order to determine how reliable the questionnaire was. The study applied Cronbach's Alpha. Gliem and Gliem (2003) established the Alpha value threshold at 0.7, thus forming a benchmark for the study. The Cronbach's alpha was used to determine the reliability of each objective. The findings indicate that oil price control, as an alpha of 0.811, level of inflation as an alpha of 0.821, bank interest rate as an alpha of 0.833, global oil prices an alpha of 0.847 and financial performance an alpha of 0.815. This was an indication that all the variables were reliable.

Table 1: Reliability analysis

Scale	Cronbach's Alpha	Number of Items
Oil Price Control	0.811	8
Level of Inflation	0.821	9
Bank Interest Rate	0.833	8
Global Oil Prices	0.847	7
Financial Performance	0.815	3

Correlation Analysis

The correlation analysis was used to analyze the association between independent and dependent variables. The study used the Pearson Moment

Correlation analysis to determine the association between oil price control, level of inflation, bank interest rate and global oil prices with financial performance of the petroleum firms in Kenya. The results were as shown in Table 2.

Table 2: Correlations Coefficient

		Financial performance	Oil Price Control	Level of Inflation	Bank Interest Rate	Global Oil Prices
Financial performance	Pearson Correlation	1				
	Sig. (2-tailed)					
	N	48				
Oil Price Control	Pearson Correlation	.779**	1			
	Sig. (2-tailed)	.000				
	N	48	48			
Level of Inflation	Pearson Correlation	-.784**	.771	1		
	Sig. (2-tailed)	.000	.000			
	N	48	48	48		
Bank Interest Rate	Pearson Correlation	-.718**	.712	.709	1	
	Sig. (2-tailed)	.000	.000	.000		
	N	48	48	48	48	
Global Oil Prices	Pearson Correlation	-.721**	.719	.723	.715	1
	Sig. (2-tailed)	.000	.000	.000	.000	
	N	48	48	48	48	48

The results established that there was a strong positive correlation between oil price control and financial performance of the petroleum firms in Kenya as shown by $r = 0.779$, statistically significant $p = 0.000 < 0.01$; there was a negative correlation between level of inflation and financial performance of the petroleum firms in Kenya as shown by $r = -0.784$, statistically significant $p = 0.000$; there was a negative correlation between bank interest rate and financial performance of the petroleum firms in Kenya as shown by $r = -0.718$, statistically significant $p = 0.000$; there was a negative correlation between global oil prices and

financial performance of the petroleum firms in Kenya as shown by $r = -0.721$, statistically significant $p = 0.000$. This implied that oil price control, level of inflation, bank interest rate and global oil prices have effect on financial performance of the petroleum firms in Kenya.

Multiple Regression Analysis

Model summary is used to analyze the variation of dependent variable due to the changes of independent variables. The study analyzed the variations financial performance of the petroleum firms in Kenya due to the changes of oil price

control, level of inflation, bank interest rate and global oil prices.

Table 3: Regression Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.921 ^a	0.848	.834	0.4468

Adjusted R squared was 0.834 implying that there was 83.4% variation of financial performance of the petroleum firms in Kenya due to the changes of oil price control, level of inflation, bank interest rate and global oil prices. The remaining 16.6% imply that there are other factors that affected financial performance of the petroleum firms in Kenya which were not discussed in the study. R is the correlation coefficient which shows the relationship between the study variables. From the findings, the study found out that there was a strong positive

relationship between the study variables as shown by 0.921.

Analysis of Variance

The analysis of variance ANOVA was used to determine whether the data used in the study is significant. From the ANOVA statistics, the processed data (population parameters) had a significance level of 0.001. This showed that the data was ideal for making a conclusion on the population’s parameter as the value of significance (p-value) was less than 0.05.

Table 4: Analysis Of Variance

Model		Sum of Squares	df	Mean Square	Sig.	F
1	Regression	37.237	3	12.412	62.189	.001 ^b
	Residual	8.782	44	0.200		
	Total	46.019	47			

The F calculated was greater than F critical (62.189 < 2.802). This showed that oil price control, level of inflation, bank interest rate and global oil prices significantly influenced financial performance of the petroleum firms in Kenya.

The equation above revealed that price control, level of inflation, bank interest rate and global oil prices constant variables significantly influence financial performance of the petroleum firms in Kenya as shown by constant =0.987 as shown in Table 5 below.

Beta Coefficients of the study Variables

The regression equation was

$$Y = 0.987 + 0.231X_1 - 0.213X_2 - 0.209X_3 - 0.195X_4 + \epsilon$$

Table 5: Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error			
1	(Constant)	0.987	0.098		10.071	0.000
	Oil Price Control	0.231	0.111	0.227	2.081	0.006
	Level of Inflation	-0.213	0.153	0.209	-1.392	0.005
	Bank Interest Rate	-0.209	0.187	0.204	-1.118	0.005
	Global Oil Prices	-0.195	0.160	0.191	-1.219	0.003

The study sought to determine the influence of price control on financial performance of the petroleum firms in Kenya. From the findings, oil price control is statistically significant to financial performance of the petroleum firms in Kenya as

shown by ($\beta = 0.231$, $P = 0.000$). This implied that at 95% confidence level, oil price control had significant positive relationship with financial performance of the petroleum firms in Kenya.

From the findings it was evident that, a unit increase in oil price control resulted to increase in financial performance of the petroleum firms in Kenya by 0.231. The study therefore concluded that oil price control had a positive effect on financial performance of the petroleum firms in Kenya. The findings were in agreement with the empirical findings of Shanmugam (2003) who studied the financial performance of petroleum firms in Malaysia and found out that price control on its own cannot achieve strong, efficient and competitive business however, it can be supplemented by measures such as enhancing professionalism of the personnel and bringing about more effective corporate governance to further increase the resilience and competitiveness of the firms in the petroleum industry it improves the performance of the company.

The second objective of the study was to establish the effect of inflation rate variation on the financial performance of the petroleum firms in Kenya. From the findings, level of inflation was statistically significant to financial performance of the petroleum firms in Kenya as shown by ($\beta = -0.213$, $P = 0.005$). This meant that at 95% confidence level, level of inflation has significant negative relationship with financial performance of the petroleum firms in Kenya.

From the findings it was clear that a unit decrease in level of inflation resulted to increase in financial performance of the petroleum firms in Kenya by -0.213. The conclusion of the study was that inflation rate variation had a negative effect on the financial performance of the petroleum firms in Kenya. The findings were in agreement with Viverita (2008) who conducted a study on the impact of inflation factors on the financial performance of the firms in the petroleum industry in Indonesia and found that the firms could not improve their ability to carry out their functions as intermediary institutions, indicated by declining the ratio of profits to expenditure and resulted to lower returns on investment and thus poorer financial performance in the sector.

The study sought to determine the effect of bank interest rate variation on the financial performance of the petroleum firms in Kenya. From the results, bank interest rate was statistically significant to financial performance of the petroleum firms in Kenya as shown by ($\beta = -0.209$, $P = 0.005$). This meant that at 95% confidence level bank interest rate had significant negative relationship with financial performance of the petroleum firms in Kenya.

From the findings it was evident that a unit increase in bank interest rate resulted to decrease in financial performance of the petroleum firms in Kenya by -0.209. The study therefore concluded that bank interest rate variation had a negative influence on the financial performance of the petroleum firms in Kenya. The study agreed with the findings of a study carried out by Muhammad (2011), on profitability of Royal Oil Company; the study concluded that high interest rates lowered profitability, thus affecting financial performance of the company.

The study finally sought to establish the influence of the fluctuations in global oil prices on the financial performance of the petroleum firms in Kenya. From the findings, global oil prices was statistically significant to financial performance of the petroleum firms in Kenya as shown by ($\beta = 0.195$, $P = 0.003$). This implied that at 95% confidence level, global oil prices has significant negative relationship with financial performance of the petroleum firms in Kenya.

From the findings it was clear that a unit increase in global oil prices resulted to decrease in financial performance of the petroleum firms in Kenya by -0.195. The study therefore concluded that fluctuations in global oil prices significantly and negatively affect financial performance of the petroleum firms in Kenya. The findings were in agreement with findings of Marangu (2007) who studied the effects of global oil prices of the Asian owned oil companies on their financial performance; his study concluded that there was no significant improvement in performance for the oil companies with unpractical global oil prices and

other sound fiscal policies. It was concluded that the industry can do well with practical policy framework to implement global oil prices by individual companies.

CONCLUSION

The study found price controls to be very important since if removed, prices would immediately increase, which could temporarily shock the economic system. The study also found that Oil price control is statistically significant to financial performance of the petroleum firms in Kenya. The study further established that oil price control had significant positive relationship with financial performance of the petroleum firms in Kenya. The study therefore concludes that a unit increase in oil price control will result to increase in financial performance of the petroleum firms in Kenya.

The study found out that analysing inflation is very critical in evaluating performance of firms. The study also found that level of inflation is statistically significant to financial performance of the petroleum firms in Kenya. The study also established that level of inflation had significant negative relationship with financial performance of the petroleum firms in Kenya. The study therefore concludes that a unit increase in level of inflation will result to decrease in financial performance of the petroleum firms in Kenya.

The study that bank interest rates had both negative and positive effects on financial performance of petroleum firms in Kenya. The study also found that bank interest rate is statistically significant to financial performance of the petroleum firms in Kenya. The study further established bank interest rate had significant negative relationship with financial performance of the petroleum firms in Kenya. The study thus concludes that a unit increase in bank interest rate will result to decrease in financial performance of the petroleum firms in Kenya.

The study revealed that without competitive pricing as well as able executives, the firm is likely to decline in efficiency and value, scaling down its

profit margins. The study also revealed that Global oil prices are statistically significant to financial performance of the petroleum firms in Kenya. The study further established that global oil prices had significant negative relationship with financial performance of the petroleum firms in Kenya. The study concludes that a unit increase in global oil prices will result to decrease in financial performance of the petroleum firms in Kenya.

RECOMMENDATIONS

The study concluded that oil price control had a positive effect on financial performance of the petroleum firms in Kenya. It is recommended that there is need to have effective corporate governance which will further increase the resilience and competitiveness of the firms in the petroleum industry and thus improve their general performance.

The study concluded that inflation rate variation had a negative effect on the financial performance of the petroleum firms in Kenya. This means that an increase in inflation negatively affects financial performance of petroleum firms. The study recommends that the government of Kenya should try to control inflation to avoid extreme inflation rates which will negatively impact the petroleum firms and in turn affect the country's economy.

The study concluded that bank interest rate variation significantly and negatively affected financial performance of the petroleum firms in Kenya. The study recommends that CBK should come up with policies that regulate the banks interest rates to regulate them from arbitrarily increasing their interest rates. Also firms need to have strategies put in place to mitigate uncertainties in the interest rates.

On fluctuations in global oil prices, the study concluded that fluctuations in global oil prices significantly and negatively affect financial performance of the petroleum firms in Kenya. The study therefore recommends that ERC need to come up with proper policies to curb the issue of inflated fuel prices.

Suggestions for Further Research

The objective of this study was to evaluate the effect of economic factors on financial performance of the petroleum firms in Kenya. The study recommended further study to be done on other

factors that affect the petroleum firms in Kenya other than economic such as government legislations and globalization. The study further recommended replication of similar study in other countries to allow comparison and generalization of the study.

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