

A Review of Free Cash Flow Hypothesis on the Investment Firms Listed in Kenya

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Abstract: Free cash flows refer to the amount of cash available to a firm net of expenses, including capital expenditure. It is the difference between cash flows from operating activities and cash flows from investing activities (Afrasiabishani, Amadinia, & Hesami, 2012). The quantum of free cash flows is ascertained by adding the changes in fixed assets and working capital to the comprehensive profit. The general objective of this research was to evaluate the association between free cash flows and the financial performance of listed investment firms in Kenya. Specifically, the study sought to address the effect of free cash flows on the return on assets of a firm. Descriptive and causal research design was used to assess the association between the free cash flows and the return on assets. The study population consisted of all the five investment firms listed at the Nairobi Securities Exchange as at 31st December 2017. The audited financial statements of the 5 listed investment firms in Kenya used in this study covered a seven-year period from 2011-2017. Since the number of the targeted firms was small, and secondary data used in the study was readily available from these firms' websites and the security market's research handbooks. Data used in the study was collected using a checklist. Descriptive and inferential statistics was used to analyze and present data. The results of the study showed that the relationship between free cash flows and return on assets was statistically significant at $r=0.87$ with a p -value of 0.00 compared to 0.05 level of significance.

Keywords: Free Cash Flow, Investment Firms, Return on Assets, Nairobi Securities Exchange, free cash flow hypothesis

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I. Introduction

According to Afrasiabishani, Amadinia and Hesami (2012), free cash flows refer to the amount of cash available to a business organization after the firm has paid all its expenses, including capital expenditure. Free cash flow is important because it affords the firm the opportunity to pursue other profitable ventures that have a positive effect on firm value. Without cash, it will be very difficult for a business organization to make acquisitions, develop new products, pay dividends to its shareholders or reduce debt. This theory assumes that a firm may curtail its manager's excesses and possible misuse of organization's income for personal gain by using the available free cash flow to pay interest on its long-term loans and dividends to its shareholders.

The concept of free cash flows was initiated by Jensen (1986) who argued that, having excess free cash flow creates conflict between owners and management of a firm. Consequently, this scenario will have a negative effect on the firm's financial performance. The free cash flow hypothesis states that a negative relationship exists between free cash flow and firm's financial performance under the control of managers. Servicing long-term debt or paying out dividend to shareholders reduces free cash flows.

Many empirical studies have been done in different countries around the world to test the free cash flow hypothesis. Those in support of the hypothesis argue that free cash flows has a negative relationship with firm performance include: Lachheb and Slim (2017) on French listed firms; Hau (2017), on listed Vietnamese firms with low investment opportunities; Zhou, Yang, and Zhang, (2012) on real estate listed companies in China; Kadioglu, Kilic, and Yilmaz, (2017) on 370 firms listed on the Borsa Istanbul Stock Exchange and Heydari, Mirzaeifar, and Javadghayedi, (2014) on selected firms listed at the Tehran stock exchange in Iran.

On the other hand, some studies are not in support of the free cash flows hypothesis. These studies argue that there is a positive relationship between free cash flows and firm performance. They include: Ali, Ormal, and Ahmad, (2018) on the German automobile sector; Wang (2010) on Chinese firms; Tabrizi (2016) on Iranian listed firms and Ambreen and Aftab (2016) on 580 firms listed at the Karachi Stock Exchange in Pakistan.

Empirical evidence from previous studies concerning the relationship between free cash flows and financial performance of firms in Kenya is mixed and conflicting. Banafa, Muturi and Ngugi (2015) study on 42 listed non-financial firms at the Nairobi Securities Exchange established that free cash flows had a positive

relationship with firm performance. In support, Mutende, Mwangi, Njihia and Ochieng (2017) and Wambua (2017) found positive relationship between free cash flows and firm financial performance. However, Ndungu and Oluoch (2016) in their study on public constructions firms in Kenya established that free cash flows had a negative relationship with the firms' stock performance. The contrasts in these studies presents a conceptual knowledge gap, which is worth investigating. The researchers are not aware of any existing literature that has studied free cash flows and financial performance of investment firms listed in Kenya.

II. Literature Review

This section reviewed relevant previous literature on the relationship between free cash flows and return on assets of a firm. Aliet al., (2018) investigated five dominant firms in Germany and found that the adjusted R squared to be 0.766, an indication that 76.6% of the change in the return on assets was explained by the free cash flows. Similarly, (Lachheb & Slim, 2017) using French stock exchange data found a positive relationship between the free cash flows and the return on assets. Wang (2010) researched on the effect of free cash flow on firm performance. Specifically, the study sought to re-examine the free cash flow hypothesis as applied in the Chinese economy using Taiwan publicly listed firms. Heydari, Mirzaeifar, and Javadghayedi (2014) investigated the effect of free cash flows on the financial performance of listed Iranian firms. Using a sample of 63 Iranian firms quoted at the Tehran stock exchange between 2006 and 2012, the study findings revealed that there was a significant negative relationship between free cash flows and all the firm performance measures used in the study namely: return on equity, return on assets, stock return and Tobin's Q ratio. Thus, the study findings showed that there was increased conflict of interest between firm managers and firm owners due to free cash flows, which consequently leads to decline in the firm's performance. The study affirms the free cash flows hypothesis in Iranian Stock Exchange.

In Nigeria, Liman and Mohammed (2018), examined the relationship between operating cash flows and financial performance of quoted conglomerate firms for a 10-year period 2005-2014. A sample of five out of six listed conglomerate firms were studied. Using secondary data obtained from the targeted firms' audited accounts, the study findings showed an insignificant positive relationship between free cash flows and return on assets.

III. Research Methodology

This section highlighted the methodology used in the study. The study applied a descriptive and causal design. The population used in the study comprised of all the five investment firms listed in the Nairobi Securities Exchange as at 31st December 2017. A checklist was used to gather financial statements of the population of interest. From the financial statements, the researchers extracted the free cash flows and the return on assets being independent and dependent variables, respectively. The independent variable, free cash flow was calculated adding changes of fixed assets and working capital to the comprehensive profit. Descriptive and inferential data was presented in form of tables.

IV. Results and Findings

Table 1 shows free cash flows had mean value of Kenya Shillings 1.2 Billion with a standard deviation of Kenya Shillings 3.2 Billion. The only dependent variable, return on assets, had a mean of 0.0071, which was lower than the standard deviation of 0.09134. This means that the mean values could not be construed to be reliable.

Table 1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Free Cash Flow in Kshs. '000'	35	-3016302	13,246,752	1,283,591	3,235,697
Return on Assets	35	-0.23	0.22	0.0071	0.09134

Valid N (listwise) 35

Table 2: Pearson Correlation between Free Cash Flow and Return on Assets

		Return on Assets	Free Cashflows
Return on Assets	Pearson Correlation	1	.871**
	Sig. (2-tailed)		0
	N	35	35
Free Cashflows	Pearson Correlation	.871**	1
	Sig. (2-tailed)	0	
	N	35	35

** Correlation is significant at the 0.01 level (2-tailed).

Table 2, indicates that the relationship between free cash flows and return on assets was significantly positive at 0.871. The p-values were 0.00. Thus, the association was statistically significant compared to 0.05 level of significance.

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.871a	0.759	0.751	0.04553

a Predictors: (Constant), Free Cash flows

Table 3: Free Cash Flows and Return on Assets Model Summary

The study sought to evaluate the interconnection between free cash flows and the return on assets. The resulting adjusted R square was 0.751, meaning that 75.1% change in the dependent variable can be explained by variation in the independent variable.

V. Conclusion

The study concluded that there was a statistically significant positive relationship between free cash flows and return on assets. The researchers fail to support free cash flow hypothesis, which states that free cash flows are negatively correlated with firm performance. They further assert that free cash flows have a positive relationship with the return on assets.

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