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*Improving public policy making for economic growth and poverty reduction*

# Enhancing Growth of the Nairobi Stock Exchange Primary Market

Stock market development is crucial in financing economic growth. In the financial sector reform process, the government has prioritized the reform of the stock market with the aim of enhancing its activities and making it a viable vehicle for financing development. Reforms targeting the stock market include tax incentives, review of the regulatory framework, review of the listing requirements, and segmentation of the market to accommodate different categories of membership.

The stock market in Kenya has a long history. Share trading was initiated in the 1920s and formalized in 1954 with the establishment of the Nairobi Stock Exchange (NSE). Despite this long history, the listing of firms making public offer has not picked up. Today, the market has fewer listed firms as compared to those inherited at independence.

In 1954, the stock market in Kenya had 46 listed firms. In the 1960s, the number of new listings increased to 19 but with a huge number of delistings. The total number of listed firms increased to 63 in 1969. In the 1990s, nine new public offers were made, of which four were part of the privatization process of government parastatals. The number of new listings declined in the early 2000s to two listings. Presently, the market has 50 active listed companies of which 20 percent are listed on the alternative market segment, which targets small firms. The industrial and allied sector has the highest share of listed firms (36%) while the agricultural sector has the least (14%).

The stock market hardly attracts listing of local private firms. Majority of the listed firms have foreign ownership. Since the 1980s, local public enterprises undergoing privatization have joined the market. In 2006, the market saw listing of a public enterprise that was not in the privatization process.

Because of the small number of new listings, the stock market in Kenya has not managed to contribute significantly to development. On average, the stock market has financed only about 0.18 percent of GDP. The key question then is how can the stock market be enhanced to sustain growth of new listings and therefore enable the market play its developmental role more significantly.

## Factors Affecting Growth of the Primary Market

Various factors have constrained the growth of the Nairobi Stock Exchange primary market in terms of initial public offers. They include:

### *Size of market scope*

When the NSE opened its doors, it was serving the East African region. However, the break up of the East African Community (EAC) in 1977 reduced the market scope for the NSE with the delisting of firms incorporated in Uganda and Tanzania. Further, with the regional integration on top of the EAC agenda, Tanzania and Uganda have opened their own stock exchange. The NSE needs to be very competitive to be able to capture back that market.

***This policy brief is based on KIPPRA Discussion Paper No. 47 on Growth of the Nairobi Stock Exchange Primary Market. Other related papers in this area include Discussion Paper No. 27 on the Development of the Nairobi Stock Exchange: A Historical Perspective, and Discussion Paper No. 29 on What Defines Liquidity of the Stock Market: Case of the Nairobi Stock Exchange.***

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When the NSE market was initiated, it operated like a private club and was dominated by foreign-owned firms. It was only after independence that locals got involved with the activities of the stock market. However, domestic firms have not yet been able to utilise the market significantly to raise funds. This could be explained by the weak culture of share trading due to information gap.

### *Motivation to go public*

Firms indicate the need to finance their growth as a major motivating factor to making a public offer. Performance of most of the firms in the post-listing period shows significant improvement, which implies that the listed firms tend to meet their targeted development goals. Given these remarkable results, the question then is why other firms have not be able to take advantage? It is possible that there is information gap on the benefits of going public. It is also possible that the ownership structure of most firms constrains their efforts in going public. It is important to note that most local firms are family-based and the owners are not willing to relinquish part of the ownership to outsiders.

### *Listing costs*

Firms face both direct and indirect costs of listing. Indirect costs are generally information-based costs, while direct costs include underwriting fees, registration fees and the annual layouts on auditing, certifications, dissemination of accounting information, and stock exchange fees. The government has given tax incentives to the listed firms in an effort to reduce the listing barrier. For example, in the fiscal budget for 2001/2002, corporate tax on newly listed companies approved under the Capital Markets Act was reduced to 27 percent as compared to the standard rate of 30 percent. The duration of this was to be three years following the date of listing. However, such companies should offer at least 20 percent of their share capital to the public. Further, companies that apply and are listed would get a tax amnesty on their past omitted profits subject to them making a full disclosure of their incomes and assets and liabilities during the year commencing at the date of listing and undertaking to, henceforth, pay their due taxes in full. However, these incentives have not borne fruits. Although the market has not experienced a significant level of under-subscriptions, the information costs could be higher than the benefits of such tax incentives. It is also possible that the capital structure of the firms is not responsive to the tax element.

### *Listing requirements*

There is a general feeling that the listing requirements are very prohibitive and target a cadre of firms that may not be existing in this economy. Whereas majority of private firms that have listed have foreign ownership, few locally-owned firms have entered the market. The structure of the private sector in the Kenyan economy shows that majority of private businesses are small to medium and generally family-owned. As a result, the requirements for listing (minimum capital of Ksh 20 million) could lock out many of them. Furthermore, it is observed that older or large companies have lower information asymmetry and therefore fetch better prices, such that information asymmetry costs (adverse selection) tend to be an obstacle for the listing of small and young firms.

### *Weak economic performance*

Growth of the economy and macroeconomic stability define the growth prospects of firms. In most cases, firms listing are out to take advantage of the various growth opportunities. Such prospects are halted if the economic conditions are not favourable.

## Policy Recommendations

Growth of the number of firms listing at the Nairobi Stock Exchange is important for the

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stock market to be able to play its role in financing national development. In view of the above constraints to the growth of the stock market, the following recommendations are proposed:

***a) Inculcate a culture of share trading***

There is need for intensive mass education to create awareness among investors and potential firms and enlighten them on stock market operations and the advantages of raising funds through the market. The media has been doing a lot through business-related programmes, and students are also being sensitised on the operations of the NSE. However, there is need for a more active interaction with potential firms to understand the elements of the stock market that discourage them from engaging in external equity financing, and how the market can be organized to meet their needs. To achieve this, the Capital Market Authority and the Nairobi Stock Exchange should establish a channel of relationship with private sector umbrella bodies such as the Kenya Private Sector Alliance, Kenya Association of Manufacturers, Federation of Kenya Employers and micro and small enterprise associations.

***b) Widen market scope***

Presently, attempts are being made to harmonize the regulatory system of capital markets in East Africa within the regional integration process. However, for Kenya to gain from the integration process, it must be competitive. Keeping the NSE competitive at the international level means that institutional structures must be strengthened, including the listing requirements and participation of foreign investors.

Further, the market stands to benefit from local firms participation if the Private Sector Development Strategy succeeds in growing the private sector. The stock market should seize the opportunity to operationalise the over-the-counter market for growth-oriented firms.

***c) Reduce listing costs***

There is need to address the information costs by reducing information asymmetry, tightening the regulatory framework, and conducting mass education to create awareness on share trading. However, it is not clear, at the moment, the proportionate contribution of information costs to total listing costs. There is need therefore to carry out a study to examine the structure of listing costs more thoroughly in order to establish clear areas of intervention.

***d) Understand the financing strategies***

It is important to understand factors that define the capital structure of private firms in order to make concrete and precise proposals. If the capital structure does not respond to tax incentives, then using such incentives will not help attract new firms to list in the market. Therefore, a thorough analysis of the factors defining the capital structure of non-listed firms is crucial.

***e) Operationalize an over-the-counter market***

In 2002, the stock market saw the establishment of an alternative market segment to cater for firms that cannot qualify for the main segment and serve as the over-the-counter market. However, this segment has not seen new listing so far. It is possible that few of the potential firms are aware of this market. Such a market would target growth-oriented local firms. The government can support this initiative by offering such firms an environment that will see them mature and join the main market. The government could, for example, provide such firms with a facility similar to the Export Processing Zones.

***f) Encourage listing of business groups***

One way of dealing with the problem of many small firms not qualifying for listing is to encourage listing of business groups. This will, however, require changes in the regulatory framework to accommodate the business groups.

## About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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