The Role of Kenya's Capital Market on Economic Growth, & Cytonn Weekly #01/2021

Focus of the Week

Business owners can fund their business through various means but they fall mainly into two main brackets i.e. equities or debt. There is occasional structuring that is done to get some in between the two forms of capital sources to enhance the attractiveness to potential investors. Globally, capital markets play a key role in ensuring that businesses get the requisite funding and that owners of Capital are well protected and get the return that is required. Most of the investments in the Capital Markets are long term in nature and it is therefore important that all the players actually understand the products that are offered in the markets before either issuing them to raise funds and also before buying into them. For instance, with the pandemic, there was a lot of volatility in most markets with the Kenyan equities market for example declining by 8.6% last year.

Despite the volatility, it is important to note that capital markets continue to play a key role in economic development more so as a source of funding for businesses and individuals and as such, we saw the need to revisit the topic, focusing on Kenya's Capital Markets. Below are the previously done topics where we covered;

i. The role of Capital Markets in economic development – In March 24, 2019, we wrote about the role of the capital markets in economic development and concluded that a well –developed capital markets creates a sustainable low-cost distribution mechanism for multiple financial products and services across the country, and,
ii. Capital Markets as a catalyst for economic growth – In September 18, 2019 we wrote about Capital Markets being a catalyst for economic growth and saw that a well-established capital market enables the business community to raise long term capital funds that are used to purchase capital goods, thereby propelling their growth and supporting the country's economic growth,

Given the significant role that the capital markets play, we shall then focus on Kenya's Capital Markets and the impact they have made on the economy. As such, we shall cover:

i. The role of capital markets in an economy,
ii. Developments in the Kenyan capital markets,
iii. The challenges facing the Kenyan capital market,
iv. Recommendations for the Kenyan capital markets, and,
v. Conclusion.

Section I: The Role of Capital Markets in an economy

Capital markets main role is to link suppliers of capital for example pension schemes or SACCOs with users of the capital i.e. people who are mainly in the production of goods and services across sectors. The capital markets therefore play a vital role in economic development as they promote growth in the real economy by enabling access to long-term financing for producers of goods and services, and entities tasked with infrastructure development like the government.

To be able to efficiently do this, the capital market players should ensure that:

i. **They are promoting a Saving and Investments Culture**: Given that Capital market offers a variety of financial instruments, it is important that the products offered are attractively priced and easily understood across the board. Additionally, to promote the savings and investments culture in the economy, capital markets need to ensure that the products offered meet the risk-return threshold and that the units are affordable to the larger public,
ii. **Linking Suppliers and Users of Capital**: Though the link between agents with a monetary deficit and the ones with monetary surplus can take place directly through direct financing, it can as well take place through the financial intermediaries in form of indirect financing. This is a situation whereby operators facilitate the contact between the real economy and the financial market enabling optimum use of assets and resources in monetary form which promote economic growth, and,
iii. **Facilitate Efficient and Effective Allocation of Resources**: By offering a wide range of financial instruments with different risk profiles and returns, the capital markets support efficient allocation of deficient financial resources in the financial market. The competitive pricing of securities and a large variety of financial instruments with different risk and return features allow investors to juggle around their risk profiles and return appetite.

Section II: Key developments in the Kenyan capital markets

Over time, the Kenyan capital markets has evolved achieving a number of milestones over the years and in effect catalysing economic growth. Some of the most recent developments include:

i. **The Authority holds a Capital Markets Industry Webinar to engage stakeholders in the Industry**. Some of the key bottlenecks has been lack of knowledge on how the capital markets operate and the lack of a feedback mechanism on the products already issued in the market. However, we have seen a lot of effort by the Regulator, professional association and individual firms coming forth with both training and stakeholder webinars to continue giving information and also answer questions regarding the capital markets products,
ii. **Increased product offering in the market such as;**
    a. **Approval of the issuance of Kenya's first unlisted green bond in 2019** which were received with huge appetite by both foreign and local investors and consequently led to a first time listing of the Kenyan shilling bond in the United Kingdom. The bond structured as a restricted public offer for sophisticated investors sought to raise Kshs 5.0 bn to fund sustainable and climate-resilient student accommodation. This posed to be a critical step in advancing the development of an effective ecosystem to support the establishment of green capital markets in Kenya, now that the necessary legal instruments are in place to facilitate such issuances,
    b. **Approval of the issuance of Real Estate Investment Trusts**: Following the issuance of the Fahari I-REIT in 2015, Acorn also got the approval to issue a REIT to finance their student housing in 2020. We expect more and more people to follow the same route. For more information on the same, see our Cytonn Weekly #50/2020, and,
    c. **Continued approval of the Corporate Bonds**: In 2020, we saw Centum get approval to issue a corporate bond that shall be used to invest in the real estate projects.
iii. **Developments led by the Nairobi securities exchange**: As a Self-Regulatory Organisation (SRO), the Nairobi securities exchange has come up with great initiatives to help companies that want to list in the securities exchange. Some of them include:
    a. **Establishment of the Growth Enterprise Market Segment (GEMS)** that was set up in 2013 with the intention of enabling venture companies without a profit history as well as small

and medium sized firms to list. So far, the segment has four listed companies and still attracts more, as recently, Homeboyz Entertainment was listed by way of introduction on the GEMS, and,

b. The Nairobi Securities Exchange (NSE) launched Kenya's first formal Over-the-Counter (OTC) market platform, the **Unquoted Securities Platform**, to facilitate the trading, clearing and settlement of securities of unquoted companies. The OTC will enable unlisted commercial banks, cooperative societies and private companies access the benefits of an efficient OTC market anchored on leading technology capabilities and resources. For more information on the same, see our Cytonn Weekly #51/2020.

iv. The Setting up of the **National Credit Guarantee Fund** in 2017 meant to provide support to potential NSE Growth Enterprise Market Segment (GEMS) entities and FinTech start-ups thus reducing market concentration risk. The fund has helped enterprises hedge against credit risk and thus made GEMS more attractive to companies,

v. **Gazettement and Implementation of the Capital Markets (Commodities markets) regulations 2020 and Capital Markets (Coffee Exchange) Regulations on April 2020**, which will play a vital role in promoting food security and nutrition as defined in the big four agenda outline. The authority is still engaging with stakeholders to ensure a positive transition,

vi. Increased innovation by creating a regulatory Sandbox that allows people to test their products and technology before rolling them out, and,

vii. Launch of the **NSE digital application in 2020**, which is a major milestone in the Kenyan capital markets as it will increase participation of both local and foreign investors in the market. Investors as well as other players such as the brokers and investment banks, will be able to monitor their portfolios and market trends from the comfort of their homes.

Section III: Challenges facing the Kenyan Capital Markets and the effects on the economy:

Economic growth in any economy relies on an efficient and viable financial sector that is responsible for mobilizing private capital to finance domestic development. Despite the developments in the Kenyan capital markets, there are still factors that hindered significant growth of the markets. Below are some of the challenges that Kenya faces in developing its capital markets:

i. **Overreliance on bank funding:** According to the World Bank, banks in Kenya provide 99.0% of funding, with other alternative sources such as the capital markets providing a combined less than 1.0%. This is comparison to developed markets, where banks provide only 40.0% of the capital in the economy while other sources provide 60.0%. Kenya's over-reliance in bank funding can be attributed to the lack of knowledge by both suppliers and users of capital on how best to structure and ensure there are products that meet their aspiration. The large amount of capital in the domestic market is still partially affiliated to banks,

ii. **Deepening of the capital markets:** Capital market's depth can be measured by how easy it is to get in and out of the market and this can be a product of the different types of products on offer and the volumes. Capital market deepening is guided by the below four thematic areas namely; i) Robust policy and regulatory framework for the capital markets, ii) Diversification of capital markets products and services, iii) Efficient capital markets infrastructure and institutional arrangements, and, iv) Investor education and public awareness. Kenyan capital markets have continued to make strides in introducing new products such as the New Gold Exchange Traded Funds (NSE: GLD) and NEXT derivatives which allow one to trade in equity index futures and single stock futures. This was mainly done to broaden and deepen capital markets in Kenya. Despite this, we still have some work to do in order to be at par with other markets like the South African markets, which for example, has diversified the products they offer by venturing into the Real Estate Investment Trusts (REIT). The Market Cap to GDP for Kenya is currently 0.06% of GDP in Kenya compared to 6.9% in South Africa, shows significant opportunity for REITs**.** Lack of diversity in product has forced investors to rely on banks for short to medium terms loans as they have to contend with a thin capital basket,

iii. **Facilitative regulatory framework and supervision**: To reliably extract the benefits of well-functioning markets, adequate regulation of users of funds, investors, and intermediaries in addition to robust supervisory arrangements to protect investors, promote deep and liquid markets, and manage systemic risk are critical. A lot of legislative action has been focused on banks, yet we still need legislation for other competitive products which will enable investors tap into alternative avenues that are more flexible and pocket friendly, and,
iv. **Limited supply of issuers:** Investors play a catalytic role in market development and adding liquidity to the capital markets. However, such an investor base remains limited in Kenya as the number of issuers willing and capable of accessing markets is limited considering the cost and complexity of issuing securities restraining interest. Potential issuers tend to shy away from capital markets evidenced by the fact that only 65 companies have been listed in the NSE since its official declaration. This still points to the complexities of getting into the market which results to extremely low liquidity from insufficient supply and demand. As a result, this tends to lead to extremely high volatility in the country,
v. **Past corporate Failures**: Some investors have lost money in the capital markets and this has led to some bad taste in their mouth making it difficult for them to participate in new offerings if they are to come to market, and,
vi. **Inadequate Knowledge that acts as a barrier**: The capital markets experiences less participation owing to the inadequate knowledge among some investors and the general public which would have helped to build their confidence and promote active participation in the market and consequently disseminate growth of the market

Section IV: Recommendations on enhancing the Development of Local Capital Markets to Leverage Economic Growth

In line with the challenges mentioned above, there is still much to be done with regards to deepening the Kenyan capital markets. Below are some of the steps that Kenya should take to ensure that capital markets play their role in the economy:

i. **Innovative Financial Products and Services**: In order to deepen the capital markets and provide alternative platforms for investors, it is imperative that more sophisticated products and value adding services are created. This should be in line with technology advancements, investor education and accompanied by the necessary regulatory policies and supervisory frameworks to support their growth. In addition, the capital markets should introduce more technological innovations to make it more efficient. This can be borrowed from other developed capital markets like South African Reserve Bank that has set up an electronic trading platform for primary dealers in an effort to improve liquidity and transparency in the government bond market,
ii. **Embracing Structured Products in the Kenyan Market**: The investing public should spend time and understand the structured products and participate in those that they can tolerate the risk and they understand the returns. Products which respond to falling or rising markets in periods of high or low volatility will be available as structured products are flexible and can be tailored to meet individual investment needs,
iii. **Tax Amendments and favourable regulations:** To provide an incentive to issuers so that they invest in capital markets, structured Products and non-bank funding need to be given favourable tax treatment and favourable issuing securities,
iv. **Amendments in the regulatory frameworks**: The capital markets should adopt regulations that allow market players to craft their products within the general principles, balance the cost and profit margins as well as diversify risks. In return, this will lead to innovations resulting to deepened and developed capital markets. The authority should also develop policies which will require listed firms to disclose corporate news and price sensitive information to the bourse before going to the media. This will improve market access and efficiency seeing that in order to achieve efficiency, high quality and timely information is required. This is derived from better disclosures by listed companies.

Section V: Conclusion

In conclusion, Capital markets influences economic growth by providing the capital that is required for investment in the real economy. It is also important that the issuers together with the Regulatory bodies ensures that proper products are put out in the market to ensure that all issued products get back to the investors what was truly promised. The Investing public should spend more time understanding the capital markets and how they operate and only invest where they fully understand. The government should continue putting in place regulations that support capital markets and should encourage more players in the field. Capital markets can create greater financial inclusion by introducing alternative products and services meant to suit investors' preference for risk and return.

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