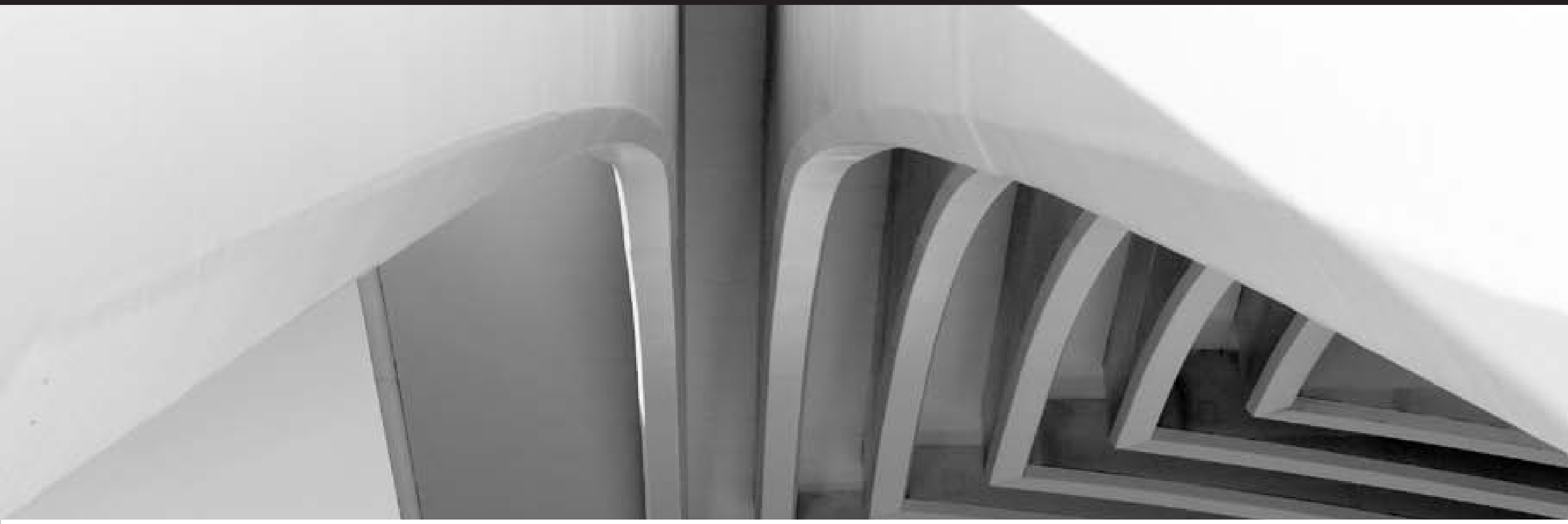
ACCOUNTANTS FOR BUSINESS

Connecting capital markets: the Nairobi securities exchange growth enterprise market segment



This report was developed in association with the Nairobi Securities Exchange

About ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 162,000 members and 428,000 students in 170 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of over 89 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

ABOUT ACCOUNTANTS FOR BUSINESS

ACCA's global programme, *Accountants for Business*, champions the role of finance professionals in all sectors as true value creators in organisations. Through people, process and professionalism, accountants are central to great performance. They shape business strategy through a deep understanding of financial drivers and seek opportunities for long-term success. By focusing on the critical role professional accountants play in economies at all stages of development around the world, and in diverse organisations, ACCA seeks to highlight and enhance the role the accountancy profession plays in supporting a healthy global economy.

www.accaglobal.com/ri

About the Nairobi Securities Exchange

Established in 1954, the Nairobi Securities Exchange (NSE) is the principal securities exchange of Kenya and the leading securities exchange in East Africa, offering platforms for the issuance and trading of equity and debt securities. The NSE is a member of the African and East African Securities Exchanges Associations, and an affiliate member of the World Federation of Exchanges.

www.nse.co.ke

This paper draws on interviews with NSE officials as well as coverage in the African and international financial press to tell the story of the Growth Enterprise Market Segment (GEMS), the Nairobi-based board targeted at small and medium-sized enterprises.

It is part of a series of ACCA case studies looking into the shared experiences of regulators, exchange operators, investors and listed firms in emerging capital markets.

FOR FURTHER INFORMATION

Emmanouil Schizas
Senior Economic Analyst, ACCA
emmanouil.schizas@accaglobal.com

Introduction

Since the global economic downturn began in 2008, it has been clear that the world must look to the emerging economies of Africa, Asia and Latin America for growth. If emerging markets are to live up to their promise, businesses in these regions will need to be able to finance themselves more efficiently, and from multiple sources, as they continue to outgrow the narrow savings bases of their home countries and their still-developing banking systems.

ACCA's research shows that the accountancy profession is instrumental in capital market development, which can be stunted or unbalanced without its support. As preparers, users and auditors of financial reports, accountants have an interest in upholding confidence in the rules, and educating firms and investors where appropriate. As global as the capital markets themselves, the profession is an established network well suited to the task of conveying good practice around the world.

As the most global of the professional accountancy bodies, ACCA is most acutely aware of these responsibilities of the profession. Nearly half the ACCA members in non-OECD countries (48%) work in regional or global financial centres, some in positions of authority that actively shape market development. Through ACCA they have access to an unparalleled network of local know-how that can guide the development and integration of capital markets and promote their healthy function.

ACCA's 'Connecting Capital Markets' series focuses on significant moments in capital market development and collects the experiences of the regulators, exchange operators and investors that made them possible. Its aim is to start a range of conversations on what different markets can learn from each other, and to prompt greater collaboration.

The first paper is a case study focusing on the birth of the Growth Enterprise Market Segment (GEMS), a segment of the Nairobi Securities Exchange (NSE) set up to serve small and medium-sized issues. The case study is based on secondary research as well as an interview with NSE officials, carried out in July 2013. The author is extremely grateful to the NSE for their insights and assistance. Apart from direct quotes, all views, including any errors and omissions, are the author's alone and should not be attributed to the interviewees or to ACCA.

Origins of the GEMS

When the Nairobi Securities Exchange (NSE) launched its Growth Enterprise Market Segment (GEMS) on 22 January 2013, the reception from policymakers and analysts in Kenya and beyond was enthusiastic, hailing the new exchange, serving primarily small and medium sized enterprises (SMEs), as an important innovation that was well timed to capitalise on investors' historically high interest in East Africa. Its origins, however, can be traced back nearly 10 years. [Figure 1 here]

The first seeds of the idea for GEMS were sown back in 2004-5. According to Donald Ouma, head of market and product development at NSE, the idea for an enterprise board came from NSE's discussions with potential issuers, most of whom were involved in family-owned businesses or closely held groups of companies. In their efforts to draw more large companies to the market, NSE officials quickly confirmed that the owners of many promising firms were unwilling to give up much control and found requirements for a stock exchange listing particularly daunting.

The NSE was sympathetic to these concerns. Companies listed on Nairobi's Main Investment Market Segment (MIMS) need to have a minimum of 1,000 shareholders, and the Alternative Investment Market Segment (AIMS) requires a minimum of 100. Even owners who did not wish to control the business closely could still find it very costly to acquire so many shareholders before listing.

Other firms were automatically disqualified by the NSE's requirements for a track record of profitability. To list on the MIMS, a company has to have five years' worth of audited accounts, and to have turned a profit in at least three of those. On AIMS, issuers need three years' audited accountants, two of which must show either a profit or that the company is 'on course' for profit. This was a crucial obstacle to firms in rapidly growing primary industries such as mining or energy, which might have clear prospects but lacked the track record demanded by the main and alternative boards while they were still in 'exploration mode.' Companies shifting their primary activity, or born from the reorganisation of older businesses, would be similarly affected.

By 2011–12, such restrictions also seemed increasingly at odds with rising international interest in the country's hydrocarbon reserves, as well as its proposed policy of reserving 35% of shares in the extractive industries for Kenyans.

Mr Donald Ouma, head of market and product development at the NSE.

The makings of a market

Bearing this feedback in mind, the NSE revisited its existing market segments and considered whether there was a gap in its offering; a service was needed that would make it easier for smaller companies and mid-caps to access public markets. The NSE's Market and Product Development Department came up with a concept for a Growth Enterprise Market Segment and, along with the Capital Markets Authority (CMA) and the Central Depository and Settlement Corporation (CDSC), they developed proposals for the regulation of the market alongside the NSE's Compliance and Legal Departments. The relevant regulations were gazetted in June 2012, and the first listing followed 13 months later.

Legislating for the GEMS market was actually very much easier than expected. According to Mr Ouma, the level of support from the CMA in particular was 'really quite amazing'. He is not alone in thinking this; during the ceremony to commemorate the first GEMS listing, the NSE chairman, Mr Eddy Njoroge, singled out the CMA for praise and thanked it for its help in developing the regulations.

Part of the ease of developing the framework for the new exchange, however, could also be attributed to a plethora of functional models. Small-business-listing exchanges are no longer as exotic as they once were. In addition to the well-established ones such as London's AIM market or the Toronto Venture Exchange, Mr Ouma and his staff were able to draw on the experience of a number of SME boards in emerging markets that share Kenya's challenges and aspirations; they singled out Egypt's NILEX, Brazil's Nova Mercado and Tanzania's Enterprise Growth Market as examples of good practice. These markets are, in one sense, complementary to their countries' fledgling venture capital sectors, and the investor community saw Kenya's GEMS as sharing this feature.

Addressing the main criticisms of existing exchanges, GEMS requires only that listed firms have acquired 25 independent shareholders within three months of listing and a 15% free float (ie, having 15% of their shares in the hands of public investors), with at least 100,000 shares in issue. GEMS issuers need only a single year's track record and do not have to have been profitable at any point, but they must be able to demonstrate that there is sufficient working capital to run the business for a minimum of 24 months after listing, in addition to the minimum KSh10m worth of paid-up capital.

Mr Ouma stresses, however, that GEMS has avoided compromising on the actual level of disclosure. Listed firms must report according to International Financial Reporting Standards (IFRS), and must submit audited annual accounts (although interim results can be presented as management accounts). Unlike the main and alternative NSE boards, GEMS will accept soft copies of their reports, providing another small but significant saving.

Finally, one noteworthy difference between GEMS and other SME boards is the former's international orientation. GEMS's mission dovetails with Kenya's Vision 2030, the master plan for transforming Kenya into a middle-income country. Along with other industry stakeholders, under Vision 2030 the NSE is tasked with the objective of making Nairobi a financial services hub for East Africa, and this is reflected in the rules for the new exchange. A company needs only a registration in Kenya to join GEMS – it does not need to be incorporated in Kenya as is the case for other exchanges. Hence the NSE's explicit aspiration is to attract listings from abroad – and not just from SMEs. Mr Ouma jokes that Barclays Bank, for instance, would be welcome on the exchange. 'Listing requirements are a floor – not a cap. Nobody is too big.'

A new set of controls

While the relaxed shareholding rules of the GEMS have been hailed as a very significant advantage, the NSE's intention was not to relax governance requirements but rather to replace one set of controls with a more appropriate and efficient one. In emerging capital markets, principal–principal conflicts are common, and NSE faced the risk that GEMS-listed shares would be too closely held, or that shareholders would seek to offload their securities to the unsuspecting public. Moreover, a lack of brand recognition could mean that securities might not be taken up and could have low liquidity – previous shareholding requirements, however onerous, offered significant protection against these risks. In GEMS, the NSE expects to replicate the effectiveness of traditional requirements through three new sets of controls.

The first set involves avoiding abuse by directors and major shareholders: controlling shareholders at listed firms are locked in for two years, and their boards and senior management must be shown to be competent directors with no recent history of bankruptcy, fraud, criminal offences or financial misconduct.

The second set of controls involves training for directors. Within six months of listing, the NSE takes at least one-third of the would-be issuer's board through a two-day tailored Directors' Induction Programme – and the rest of the board needs to follow suit within six months of listing. The programme is an introduction to capital markets, their rules and governance requirements, as well as the principles of investor relations. Directors of an NSE-listed company are additionally invited to speak to the board about their experience, further reducing the risk and uncertainty for new issuers.

The third, and arguably the most important set of controls, involves the work of 'Nominated Advisers' (Nomads). GEMS issuers are required to appoint a Nomad by written contract well ahead of listing, not only for the purposes of the transaction itself but for the entire time the issuer remains listed. Nomads are registered with NSE, with which they maintain a close relationship; their job is to assist the issuer with corporate governance matters and disclosures and they are held personally responsible (and liable) for their client's compliance.

Ms Lina Ng'inja, senior officer (corporate finance) at the NSE.

As Lina Ng'inja, senior officer (corporate finance) at the NSE explained, in addition to being guarantors of good governance and the exchange's 'first line of defence', Nomads are also in a way the GEMS' sales force. They act as agents of the NSE and educate would-be issuers on what the exchange has to offer – and in return, the exchange has an incentive to attract and develop as many Nomads as possible.

Because of this role, Nomads are expected not only to have a minimum of public markets experience and a track record of successful and recent (over three years') corporate finance transactions under their belts, but also an existing client base. This prerequisite signals their ability to provide deal flow for the GEMS market.

'The more the merrier', Ms Ng'inja explains. 'As long as we have qualified, authorised representatives going round and making these companies knowledgeable about the capital markets and investing on the GEMS market, and we keep the quality and standard of the authorised representatives at the level the exchange wants, then we don't want to put a cap on their numbers.'

Aware of their crucial importance to the GEMS board's business model, the NSE started training potential Nomads well ahead of its launch, with 32 firms attending the Nomad Training Forum on 20–21 September 2012. The exchange had lined up four Nomads by December, eight by January 2013, and 14 by June 2013, with others queuing for approval. Successful applicants can look forward to further extensive training with the exchange, including in-house training for key staff that highlights the Nomad's role in the market and their responsibilities.

Selling the GEMS

Alongside the Nomads, the NSE also maintains its own in-house business development team for GEMS, led by Ms Ng'inja's boss, Mr Terry Adembesa. The exchange makes a point of meeting potential issuers one-to-one, to sensitise them to its offering, explain what the GEMS market is about and what the value proposition is. If companies show an interest, they are invited to appoint a Nomad, and then taken through the Directors' Induction Programme.

As the GEMS matures, dealing with individual would-be issuers will be left primarily to the Nomads – the NSE business development team, on the other hand, works with industry associations, such as the Kenya Association of Manufacturers, organising major events in order to raise awareness. This link is particularly important because it makes it possible to reach companies outside Nairobi, which the NSE is under 'huge pressure' from its stakeholders to do, and make the case not only for GEMS but the capital markets in general.

Another high-profile partnership for the GEMS business development team was presented by Kenya's Top 100 Mid-sized Companies initiative, led by KPMG Kenya and Nation Media Group. The Top 100 are selected through an annual survey for revenue growth, profit growth, returns to shareholders and cash generation/liquidity. While the Top 100 are a natural audience to which to sell the GEMS, the NSE was also able to use them as a sounding board on the listing requirements for GEMS as well as its vision for the market in general; it seems that NSE found the experience enlightening.

More recently, and with much of the groundwork laid out among businesses, a public awareness campaign has been launched to inform potential retail investors about GEMS; NSE has secured high visibility in Kenya's cities, using billboards and radio ads.

NSE is learning a lot from this business development work, which Mr Ouma calls a 'very useful experience'. The lessons learnt, he explains, can be applied to the main board and AIMS in order to increase the number of listings there. 'A lot of decision makers in private companies have no idea how capital markets work', Mr Ouma explains, 'and it's the NSE's duty to inform them and talk them through what they need to consider'.

Over time, the NSE is hoping to attract both retail and institutional investors to GEMS. Nomads suggest that there is substantial interest from the latter already, but the key to attracting both, according to Mr Ouma, is liquidity.

Unlike some other exchanges aimed at SME issuers, GEMS attracts no fiscal incentives unique to itself. It does, however, benefit from all existing incentives for Kenya's capital markets in general – as do the Main and Alternative boards.

NSE does, however, have an advantage that many emerging market exchanges lack – enhanced regulatory powers. If an issuer is not actually raising any new capital – for instance if it is just introducing shares, or carrying out transactions such as share splits, bonus issues or dividend payments, the power to approve such transactions lies with the exchange as opposed to the Capital Markets Authority (CMA). Being closer to the markets, the exchange is able to carry out the approval process faster and more efficiently, and additionally has a commercial incentive to do so.

These powers are part of a raft of additional responsibilities taken up by the NSE as it worked its way through the final stages of de-mutualisation: a process by which the exchange itself would eventually become a publicly listed firm. Mutualisation will change the relationship between the CMA and the NSE, with the Authority delegating more regulatory responsibilities to the exchange.

Building expectations

The first company to list on the GEMS market (and Kenya's first listed real estate developer) was Home Afrika Ltd (HAL). Originally established as an investment club, Home Afrika had only been running for four years when it was first approached by NIC Capital in late 2012 and encouraged to list on GEMS.

The company's stated plan, under its Go Africa strategy, was to emerge as a regional champion in Africa, with plans for expansion to Tanzania, Uganda, South Sudan, Ethiopia and Rwanda, building a KSh87bn property portfolio by 2017. Drawing on the company's own communications, the financial press noted that the business expected 7 to 10 projects per year over the next five years and had projects under construction worth KSh12bn. Financing this level of growth with loans and personal funds, the company's previous method of financing itself, would be impossible.

Home Afrika's listing statement hinted at an additional motivation: the company was paying 21.5% interest on its debt – partly owing to a hike in the Central Bank rate in the last quarter of 2011 from 6.25% to 18%. Although the reference rate had fallen back to 8.5% by the time of the listing, the Bank was now actively encouraging real estate companies to seek non-bank funding in the interests of their, and the country's, financial stability.

Home Afrika was certainly doing so. The company maintained that its listing was a first step to tapping the capital markets for debt and new equity through an initial public offering (IPO). It also captured capital market analysts' attention by announcing plans to launch two real estate investment trusts (REITs): a KSh2bn-development REIT intended to fund the construction of five projects, followed by an investment REIT designed to generate regular income in five years' time. This announcement came only a month after the launch of Kenya's regulatory framework for tax-exempt REITs. In introducing this, Kenya was closely following the lead of South Africa, which had introduced its own framework in April.

> 'The GEMS listing is Home Afrika's introduction to the capital markets. We intend to be players on the REITs, Bonds and Equities markets.'
>
> DAN AWENDO, DIRECTOR, HOME AFRIKA

Home Afrika had turned a sizeable profit in 2012, but had recorded an even more substantial loss in 2011, when it increased its assets substantially and paid down a great deal of debt. This alone would have disqualified it for listing on the main exchange, even though turnover had grown 15-fold over these two years, and the company had a pipeline of new projects and a consistently good record of generating cash from operations. Ownership requirements for listing on the main exchange would have been equally daunting. Before listing, the company had 128 shareholders, only 19 of whom had individual holdings of more than 1% of its shares, adding up to 45% of the company.

In February 2013 Home Afrika formally appointed NIC Capital as its Nomad, enabling official discussions with the NSE to begin. In late May 2013, Home Afrika revealed its intention to list 'by introduction' – ie listing existing shares without issuing new ones – and declared its aspiration of carrying out an IPO 'within a year'. The introductory listing finally came on 15 July.

This nine-month interval from first contact to listing, Mr Ouma says, can be significantly shortened in future. Some issuers need less convincing than others, but once a decision has been made, the Nomad's preparation and exchange approval take three to five months at the most. On the other hand, even relatively quick procedures can still introduce uncertainty. For instance, before approval of an issue, the exchange has to give seven days' notice to the CMA for final checks. This leads to what Mr Ouma called 'a few tense days' as both the NSE and the issuer wait for the CMA to authorise the listing.

The debut and the aftermath

On 15 July, Home Afrika listed about 405m shares on the GEMS market, a free float of roughly 20%, at a reference price of KSh12 (see Figure 3 for historical share prices). The share price soared to double that (KSh25) on the first day of trading, briefly valuing the company at Ksh10bn.

By the time the company had its next annual general meeting on 27 July, authorising its transformation into a holding company for a group of more specialised property businesses, shares remained very thinly traded. Although the share price had by now subsided to 19.95, analysts saw the company as significantly overvalued and began to comment to this effect in public, casting doubts on the company's ability to issue new shares in the planned IPO. Analysts' notes pointed in particular to how Home Afrika's price to earnings (P/E) ratio of 48.66 was much higher than the bourse's average of 14.94, and even more so than the nearest comparator's ratio of 6.1.

These reactions prompted a steep decline in the company's share price, which continued until the end of September 2013 – before bottoming out at precisely half of the original reference price (KSh6). The influence of analysts' estimates was clear, as the share price stopped falling only once Home Afrika had reached a price-to-earnings ratio in line with the NSE average, bringing its valuation to Ksh2.51bn.

The replacement of Home Afrika's CEO in late August 2013 was another pivotal event. On the week of the announcement, the stock saw the biggest volume of trades in its brief history. Importantly, liquidity started flowing into the stock following the upheaval of early September and has since grown substantially. As of late September, Home Afrika continued to plan an IPO within 2013, and was getting ready to launch the first of its REITs, while still working with its original Nomad, NIC Capital. Meanwhile, the NSE has learned crucial lessons from this exercise.

According to Mr Ouma, the NSE emphasises that, from the moment they first consider pitching to a potential issuer, Nomads should be targeting an affordable relative cost of capital and a good valuation – a P/E ratio in line with comparators. Prospective issuers and their Nomads should not overpromise; if anything, they should offer a discount so that when the company finally lists, the price rises. The issuer should additionally provide substantial free float to ensure liquidity, for which investors will pay a premium.

These conditions help create a good story around the issue and encourage both investors and the issuer to return to the market. Both depend on reliable book-building, as this gives market participants an indication of what a good listing price should be. For its own part, the exchange signalled to Nomads and issuers from the start that it would not approve overpriced issues.

Figure 3: Average weekly share prices for Home Afrika – July to October 2013

Source: 'Real time market data, Home Afrika Ltd (HAFR)', http://live.mystocks.co.ke/stock=HAFR

For GEMS, on the other hand, the Home Afrika listing appears to have been a success. Even before this there was a great deal of excitement about the new exchange, and NSE was being approached by companies that wanted to know more. When the HAL listing was announced, the emphasis shifted to its Nomad, NIC Capital, which reported a lot of interest from prospective issuers. The big difference, however, came post-listing, as talk of the GEMS moved from word-of-mouth recommendations and one-to-one conversations involving the exchange or the Nomads to a big media push. Ms Ng'inja and her colleagues are keeping close tabs on the Nomads' business development activity and the signs are encouraging. At the time of the interview, two more Nomads had signed four new mandates – the exchange was expecting another listing in November and a very interesting 2014.

POL-AFB-NSEGEM

ACCA 29 Lincoln's Inn Fields London WC2A 3EE United Kingdom / +44 (0)20 7059 5000 / www.accaglobal.com