REVIEW OF GROWTH ENTERPRISE MARKET SEGMENT (GEMS) AND INCREASING ACCESS TO KENYA'S CAPITAL MARKET BY SMALL AND MEDIUM ENTERPRISES (SMES)

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CAPITAL MARKETS AUTHORITY

FSD Kenya
Financial Sector Deepening

Review of Growth Enterprise Market Segment (GEMS) and increasing access to Kenya's capital market by small and medium enterprises (SMEs)

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FSD Kenya
Financial Sector Deepening

The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). Current funders include the UK's Department for International Development (DFID), the Swedish International Development Agency (SIDA), and the Bill and Melinda Gates Foundation.

Government of Kenya

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EMBASSY OF SWEDEN Nairobi

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Abbreviations

ADB	African Development Bank
AIM	Alternative Investment Market (LSE)
AIMS	Alternative Investment Market Segment (NSE)
CDSC	Central Depository and Settlement Corporation
CFO	Chief Financial Officer
CMA	Capital Market Authority
CPC	Capital Pool Company
CVE	Canadian Venture Exchange
EIB	European Investment bank
ESM	Enterprise securities market
FSDK	Financial Sector Deepening (FSD) Kenya
GDP	Gross Domestic Product
GEMS	Growth Enterprise Market Segment
IB	Investment banking
ICDC	Industrial and Commercial Development Corporation
IFC	International Finance Corporation
IPO	Initial public offering
ISE	Irish Stock Exchange
JSE	Johannesburg Stock Exchange
KES	Kenyan Shillling
KRA	Kenya Revenue Authority
LSE	London Stock Exchange
MIMS	Main Investment Market Segment (NSE)
NEDs	Non-Executive Directors
NOMAD	Nominated Adviser
NSE	Nairobi Securities Exchange
OTC	Over-the-Counter
PE	Private equity
PR	Public relations
SC	Securities Commission
SLA	Service level agreement
SME	Small and medium enterprise
TSX	Toronto Stock Exchange
USM	Unlisted Securities Market
VC	Venture capital

Figures, tables and boxes

FOREWORD

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Through the joint participation of the Capital Markets Authority (CMA) and the Nairobi Securities Exchange (NSE), this study serves as an important benchmark for deepening access to the capital markets for SMEs. GEMS was launched in 2013 as Kenya's market segment for small and medium companies wishing to expand their businesses in East and Central Africa and to tap capital from Kenya's deepening capital markets. This segment was introduced in recognition of the role that SME's are to play as the engine for economic growth and transformation under the Vision 2030 economic blueprint.

However, as an industry, we recognise that this market segment's potential will only be fully unlocked through continuous improvement and refinement to expand its outreach and to attract even more mid-sized companies to list. Our institutions are committed to strengthening the GEMS and will leverage the lessons learned through this study in order to make it an even more attractive option for growing the SME sector in Kenya. The attention of this work has therefore been particularly aligned with the needs of those SMEs that lack access to competitive or appropriate finance and those SMEs that wish to use public capital to supplement other existing sources of capital.

The Capital Markets Master Plan (CMMP), 2014 -2023, aims to have 39 listings on GEMS by the end of 2023. At the Exchange, our target is to have at least 19 listings by 2017, thereby increasing the momentum to attain, and hopefully exceed, the CMMP target milestones.

Our institutions have already begun to implement the recommendations of the study. We believe the recommendations will enable us to provide what our clients, partners and industry want, that is, greater access to capital and liquidity for their businesses and securities, and improved profiling, while protecting the interests of investors.

We wish to especially thank Financial Sector Deepening (FSD Kenya) for funding the study, our industry partners, and the companies who participated in the study consultations. We further wish to thank the consultants – Genesis Analytics (Pty) Ltd and Bourse Consult LLP – for their efficiency in executing the study and presenting it in an easy-to-use format. We hope the readers will find it as useful as we have.

EXECUTIVE SUMMARY

Kenya has ambitious plans to become the "Heart of African Capital Markets". This is part of a broader strategy to target 10 per cent average annual economic growth by 2030. Critical to this vision is the development of a vibrant and globally competitive financial sector that will promote a high level of savings to finance Kenya's long-term investment needs. Capital markets play a key role in achieving this objective through intermediating long-term savings, mobilising and allocating capital, and providing a framework for the governance of corporations.

In recognition of the contribution the financial sector can make to toward achieving this vision, the Government of Kenya has adopted a Capital Market Master Plan anchored by three pillars: i) to support developmental and economic transformation, ii) to develop the infrastructure of financial markets, and, iii) to reform the legal and regulatory environment in Kenya.

Under the second pillar, the Master Plan has set a target for developing the Growth Emerging Market Segment (GEMS) on the Nairobi Securities Exchange (NSE). Launched in 2013, GEMS provides a platform for small and medium-sized enterprises (SMEs) to raise finance through more favourable listing requirements compared to other segments. As GEMS reflects the supply of future main board listings, the Master Plan has set a target of three to four new listings on GEMS each year – culminating in 16 listings by the end of 2016.

To support the development of the GEMS market under the Master Plan, the Financial Sector Deepening (FSD) Kenya, worked together with the Capital Market Authority (CMA) and the NSE-appointed Genesis Analytics and Bourse Consult to "review GEMS in order to identify ways to increase its listings, and explore additional or complementary capital market products for financing, with the overall aim of increasing access to finance for SMEs in Kenya".

SME NEEDS AND OPTIONS FOR FINANCE

In both developing and developed countries, SMEs play a vital role in driving economic growth. Not only are they key to creating dynamic, market-oriented growth, but they also spur innovation and help to create employment opportunities for the growing workforce.

Better knowledge of the needs of SMEs is very important if the financial services sector is to develop products that are appropriate to these businesses. SMEs have a variety of needs, including access to finance, to markets, to information, to technology, to supplies, to infrastructure, and to knowledge and expertise. Of all the constraints facing SMEs, access to finance is one of the most commonly cited barriers to their growth and competitiveness.

SMEs can raise finance in a number of ways, from the most informal (loans from family and friends, for example), to the most widespread (bank financing), to the more sophisticated capital market options (such as bond finance or public equity).

This review has confirmed that the largest funding gaps for SMEs in Kenya are long-term bank finance, equity finance, bond finance, OTC market finance, and finance from government SME finance schemes. Whilst the terms of equity and bond finance as well as longer dated bank finance may be suited to the capital needs of growing SMEs, these kinds of finance are simply out of the reach of many, for a combination of reasons, including: high disclosure requirements, lack of collateral, and limited certainty of cash flow. Meanwhile, while the term of government finance may be more suitable (shorter in duration) to the needs of SMEs, stakeholders interviewed suggested that the lack certainty and continuity associated with this type of finance made it unsustainable.

Most SMEs interviewed in Kenya indicated that informal and short-term bank finance were the most prevalent means of finance. In comparison, demand among SMEs for other alternatives such as financing through GEMS, from private equity investors or from development finance institutions was far more limited. In part this feedback reflects a lack of awareness, and understanding, among entrepreneurs of more sophisticated financing options. Though the benefits of capital markets are not well understood by SMEs, companies interviewed indicated that a key reason they would (and did) access financial markets – and a GEMS listing in particular – was to raise the profile of their business over and above raising growth capital.

Overall, GEMS fares relatively well when compared to the other financing options available to SMEs in Kenya. It is seen as a place to raise relatively cheap long-term financing, to raise the profile of the company, and as a mechanism for embedding stronger governance mechanisms in the business. At the highest level, however, what hinders GEMS from being a financing option of choice among SMEs is: awareness of the market and of the benefits of a listing among entrepreneurs, ease of access for SMEs located outside of Nairobi, and, in the case of an IPO, the cost and speed of obtaining finance through GEMS.

THE GEMS LISTING PROCESS

The analysis of the GEMS listing process considers both the decisions made by SMEs before listing as well as the overall listing process itself. The roles that various stakeholders play during the listing process is also explored in detail, as well as the total cost associated with coming to market through GEMS.

Deciding on coming to market

Interviews with GEMS-listed firms have confirmed that the decision to access financial markets is a milestone in a company's life cycle. In most cases, the decision is an organic one - borne out of a desire to grow and a need to obtain finance to fund such growth. The decision to access financial markets, however, is not exclusively financial and many companies see funding as secondary to the need to increase the sophistication of their internal governance, to raise the status of their brand or to enter new markets.

Choosing an adviser: Once a company has decided to join GEMS it needs to appoint a nominated adviser, the NOMAD. The role of the NOMAD is to guide the company through the NSE's listing requirements, ensuring that its submissions and structures are compliant. The view of some SMEs interviewed is that NOMADs are somewhat of a grudge purchase, particularly the requirement to maintain a long-term relationship after the listing process.

Deciding a route to market: Companies that do decide to list on the NSE have a number of options - MIMS, AIMS or GEMS. GEMS is seen as a more ideal route to market than AIMS or MIMS for SMEs, as the lower float requirements are in line with their reluctance not to cede control of their companies. GEMS is currently seen as a stepping stone toward a full listing but ultimately this may change as the market develops a personality of its own.

Introduction to the market

Once an SME has taken the decision to list and has appointed a NOMAD, much work needs to be done to get the company ready for listing.

Getting accounts into shape: Coming to market involves a number of challenges for SMEs. Perhaps the most important is getting their accounts into shape, the time and cost of which is not negligible. Here, the NOMAD plays a key role in ensuring that the accounts are of the required standard. The difficulty SMEs might have in getting accounts into shape should not be exaggerated – while companies may be surprised by the amount of effort required, they fully recognise the value an organised set of accounts may provide to their business as it matures.

Getting corporate governance into shape: Most SMEs have relatively informal governance structures, often with boards composed of family members who lack the required expertise to deal with the additional responsibilities that come with a listing. Thus, SMEs find it challenging to accept outside management input, to find appropriate people willing to be non-executive directors and to appoint qualified Chief Financial Officers (CFOs).

Arrange capital raising and price: SMEs can choose to access GEMS via an initial public offering (IPO) or an introduction, with the choice of raising capital immediately or simply gaining admission through introduction, and raising capital at a later stage through a rights issue. Companies tend to raise capital through private placements into small groups of investors. Institutional investors prefer this option to a public offer, where funds have to be committed for a long period of time and where there is not sufficient liquidity in the market to acquire the sort of stake they would consider worthwhile. Additionally companies find a public issue more strenuous, costly and time consuming.

The role of stakeholders in the process

In practice the NSE and the NOMADs are the main participants in the listing process, however, the CMA, as well as other professional services such as accountants, legal advisers and PR firms, are also involved.

The NSE

Regulating GEMS: The NSE takes the frontline role in regulation with the CMA having an oversight role both in the issuance of no objection notices and through licensing the NSE. The NSE engages in an iterative process with the NOMAD and the legal advisers, and through the NOMAD with the company, to ensure that the documents submitted comply with its rules (and with those of the CMA). Comments from market interviewees suggest that the NSE performs this role competently, with reasonable speed and certainty of timescale. Having said this, there appears to be a perception that there are too many not-very-competent NOMADs in the market. This is in part due to the fairly aggressive recruitment of NOMADs by the NSE when GEMS was first launched. As this perception is damaging, the NSE should take action to ensure professional standards are maintained.

Operating the market: When it comes to running the GEMS Market, the NSE needs to continually assess the market structure and infrastructure to maximise liquidity and minimise transaction costs. The challenge of sustaining liquidity among GEMS companies is much greater than for the other markets of the NSE because GEMS companies are expected to be smaller. Transaction costs are high for small cap companies because there is little two-way business. A consequence is that most significant trading is done on an arranged basis away from the market. Market makers, however, can be used to support trading in small size and ensure some measure of price continuity.

Marketing of GEMS: The NSE has recently devoted considerable effort to the marketing of GEMS. Having said this, the level of awareness and understanding among companies remains low. In this regard, the marketing done to date may have been too passive. The KPMG Top 100 SMEs event is a fine way to establish contacts, but an aggressive programme of individual follow-ups needs to be in place to sustain the momentum and interest generated by these kinds of events.

The CMA

To date the CMA has played a relatively small role in the listing process because many listings have not been IPOs. As the CMA is the lead agency for setting and changing rules for issues, however, its role in the market is still important and may even increase should IPOs become more commonplace.

Role in introductions: Applications, once approved by the NSE, are passed to the CMA for issuance of a "no objection notice". The CMA is then required to issue the notice – or to respond with requests for further information or other objections within seven days. There have been reports that this has been problematic, with the CMA raising multiple queries at different times rather than presenting a single consolidated list of issues for resolution. However, this appears to have been resolved, and the number of applications received by the regulator thus far is too small to draw strong conclusions. Ideally, applications should be managed in a single database to which all parties have access during the listing process.

Role in secondary offerings: Money-raising issues must be approved by the CMA. This includes rights issues by GEMS companies. The time for approval of rights issues appears to users to be excessively long and there is a perception that turn-around time commitments are not being adhered to. Again, it would help if there was more interaction during the approval process between the various stakeholders, including the CMA.

Rule-making amending: As the regulator for capital markets, the CMA retains ultimate control over the rules in the market. It may, however, as in the case for the GEMS market, delegate some part of its rule-making authority to the NSE within certain limits while retaining ultimate accountability. Engagement between the CMA and the market is needed in rule-making on secondary issues, which currently require rights issues in all cases.

Nominated advisers (NOMADs)

NOMADs have three primary roles – ensuring the compliance of applicant companies; marketing the GEMS market to prospective SMEs, and advising on pricing or supporting the market for the shares of the applicant.

Ensuring compliance of applicant companies: NOMADs are responsible for ensuring that applicant companies comply with the listing requirements at the time of listing and also meet continuing obligations. Market opinion is that, on the whole, NOMADs do a very acceptable job of this. Indeed the iterative interaction between company, the NSE, and legal advisers (discussed later in this section) is a good example of a process which works well, and is quick and relatively certain in outcome. Discussions with various stakeholders in the market confirm that applicant companies have very little idea of what is required of them as part of a listing and so rely heavily on NOMADs for support. When questioned, companies seemed to be mostly satisfied with the support given by their NOMADs in complying with listing requirements. What the NSE and NOMADs need to address is the issue of GEMS companies' not fully understanding the disclosure requirements, especially those relating to the continuing obligations needed to inform the market of price sensitive information.

Marketing of GEMS: The business of a NOMAD is to bring companies to GEMS and it is therefore expected that they would be actively marketing their product. However, there is variability among NOMADs in their efforts to sell a listing on the GEMS segment, with many appearing not to put much effort into marketing.

Advising on price and supporting the market for the shares: A company's relationship with the market should be seen as a continuing partnership with investors. Good advisers recognise this, and ensure that a new listing is priced in such a way that investors feel satisfied that the price is fair, and that there is upside potential and are therefore more willing to participate in future funding. The experience of the first listed GEMS company highlighted the importance of pricing new listings in such a way as to attract investors rather than to maximise proceeds. More recent listings suggest that NOMADs may have learnt this lesson and are now pricing more reasonably. The assessment criteria for registering NOMADs should recognise the importance of having the right competencies (for example in securities analysis) as well as track record to effectively guide companies on pricing. Additionally, there is room for NOMADs to potentially fulfill a market-making role and to offer a continuous price in small size.

Legal advisers

Legal advisers play an important role in the listing process because of their strong knowledge and grasp of the NSE's requirements. Though the number of legal firms with capital market experience in Kenya is said to be small, interviews with selected legal firms in Nairobi revealed a significant number of highly competent legal specialists. As the quality of NOMADs in the market increases over time, the role of legal advisers in the listing process is likely to diminish, unless complex transactions such as IPOs are involved.

Accountants

It is reported that many potential applicants for GEMS have relatively informal financial reporting processes. In this regard, accountants play a key role in upgrading the accounts of SMEs – a role which they perform successfully according to stakeholders interviewed.

Public relations (PR) advisers

Given how much value a listing is seen to bring to the profile of a company, PR firms play a key role in raising awareness of the SME among investors and the general public. In time, these companies may develop their own in-house resources – as Home Afrika has done in the creation of an investor relations department – but in the early days, external PR advisers are an important part of the listing process.

Cost of listing

The costs of the listing process are made up of both direct and indirect costs.

Direct costs: It is difficult to explore, given the small sample, the commercially sensitive nature of cost estimates, and the fact that costs are negotiated (often quite significantly) between providers and the company. The information received from two firms that did submit data suggests the combined cost of a

NOMAD and a legal firm to support a listing is between KES 2 and 4 million. Meanwhile the NSE's initial charge fees for a listing are in the region of KES 150,000. In addition to these fees, listed companies must pay the CDSC between KES 500,000 – KES 1 million for incorporating and maintaining the share register.

Indirect costs: Indirect costs include the cost of getting adequate accounts to comply with the listing requirements, the cost of complying with governance and management requirements (which include the cost of finding and remunerating non-executive directors and qualified personnel in the finance and company secretary roles, as well as remunerating investor relations and compliance personnel in time), and the cost of management time diverted from running the business toward managing the listing process. It has not proved possible to estimate the indirect costs associated with a listing but they are relatively high. Fortunately, companies interviewed acknowledged that these costs were part and parcel of a maturing organisation and hence were necessary to achieve the company's growth aspirations.

INCENTIVES OFFERED BY GEMS COMPARED TO OTHER FORMS OF FINANCE

The GEMS segment offers a wide range of incentives to attract SMEs to market. The incentives on offer for companies fall into a number of types – easier admission criteria, easier processes, tax incentives and fee incentives.

The most relevant incentive is the reduced free-float requirement (15 per cent of issued share capital), something which aligns very well to SMEs, unwillingness to cede control of their businesses.

The requirement that prospective GEMS companies do not need to have made a profit at the time of listing (unlike MIMS, which requires profitability for three years prior to listing) will become particularly important when GEMS starts to attract start-ups and mining ventures – businesses which typically take some time to generate a profit.

In theory, the reduced corporate tax rate that is offered to listed companies should attract SMEs to list. In reality, this is not a significant enough incentive for SMEs to list more than the minimum (15 per cent) amount of capital.

The requirement for GEMS companies to retain a NOMAD at all times is currently perceived by SMEs as an unnecessary expense. Though this requirement does not necessarily discourage listings, it is seen as a burden by many of the SMEs interviewed.

Though not necessarily visible to SMEs, the ability of the NSE to approve an introduction as a front line regulator, makes a considerable difference to the time, and importantly, the certainty of time taken to gain admission to the market.

LESSONS FROM INTERNATIONAL PRACTICE

Many exchanges around the world have attempted to create alternative market segments to attract smaller companies. The results have been mixed, with a few proving to be extremely successful (such as AIM and NASDAQ), and others less so. The key lessons which can be drawn from the experiences of other exchanges worldwide include:

- Markets can be slow to start, therefore, it is important to be patient and give the market time to develop.
- Exclusive sector focus has not worked in many exchanges worldwide but there is still a role for targeting a particular sector in line with local needs and circumstances in addition to having listings from SMEs across the board.
- It is essential to maintain strong disclosure and corporate governance requirements to attract investors.
- A certain timescale and a streamlined listing process are just as important as having the right size requirements to list.
- The regulatory structure needs to be flexible according to the needs of small companies.
- Marketing is essential for a small cap market – this will allow it to develop its own persona and to attract SMEs to the market.
- Advisers (the NOMADs in the GEMS case) are necessary, and are especially important in cases where companies are new to capital markets.

CENTRAL MESSAGES AND FINDINGS

Having reviewed the listing process and international approaches taken to the development of alternative market segments, and after holding numerous discussions with market stakeholders and SMEs in Kenya, the following findings have been drawn:

- Small cap markets are risky, volatile and not easy to start or sustain. Kenya has timed it well but given that the performance of SMEs reflects the broader economic outlook, both the regulator and the market need to be aware that an SME market is ultimately, a risky one.
- The regulatory standards are correct, however, regulatory processes need some streamlining. Kenya seems to have adopted the successful template of alternative exchanges; that is, not to have lower disclosure requirements than the main market. The challenge now is to simplify the process for money-raising issues, something which is currently perceived as onerous and difficult.
- The regulation of NOMADs should receive particular attention, specifically to weed out the weaker participants whose compliance capabilities may

be poor. This will enhance the capability of the stronger participants and generally boost the market's perception of NOMADs.

- Marketing is not working yet: In spite of the NSE's most recent efforts, the level of awareness of GEMS among prospective companies remains very low. Interviews suggest that companies either are not aware of GEMS, or only have a vague grasp of the costs and benefits of listing on GEMS. Increasing awareness among prospective GEMS companies will require a concerted effort by NOMADs in more actively marketing GEMS, as well as by the NSE through more proactive engagement with prospective companies.
- Liquidity in small cap markets is always a challenge, and there is no complete solution. The key incentive (minimum 15 per cent free-float) offered to attract prospective GEMS companies is part of the problem, and the small size of companies means that the level of two-way order flow is too small to support a liquid market. The current practice of private placements followed by introduction also limits liquidity, as private placements are only distributed to a handful of investors. Unfortunately, there are no easy solutions to this: market makers would not be feasible, as principals and requirements that other investors should be able to participate in block orders are only helpful to a point. For smaller retail transactions, market makers, if they can be found, may help ease liquidity. Electronic order books or bulletin boards may also help for the most illiquid stocks.

KEY RECOMMENDATIONS AND IMPLEMENTATION PLAN

At the time this research was commissioned, GEMS had attracted only one listed company. On completion of the research, this number had already increased to three; a positive indicator for the future of the market.

While this is a positive sign for the future of GEMS, patience is necessary, as international experience indicates that SME markets do take time to develop. Maintaining a high quality of listed companies and flexibility in terms of entry requirements and sector focus will be important in the early stages of developing GEMS.

More specifically, the report identifies a number of other recommendations for developing the GEMS market, which have been organised below according to the following time frames:

Short-term	
Demand side	▪ Expand marketing information to include the whole range of attractions of a listing
	▪ Improve the marketing of AIMS
	▪ Create a dedicated GEMS department and staff at NSE
	▪ De-emphasise the role of GEMS as a path to MIMS
Supply side	▪ Develop consultation procedure to get stakeholder input on new products/regulation
	▪ Encourage direct VC/PE involvement in bringing companies to market
Regulatory and policy	▪ Clarify the current situation on tax amnesty for companies joining GEMS and consider the use of tax amnesties to incentivise SMEs to list
	▪ Ensure review of GEMS applications checks for firms only interested in tax breaks
	▪ Provide better guidance on disclosure requirements
Medium-term	
Demand side	▪ Merge AIMS into GEMS
	▪ NSE develops market-making regime for GEMS
Supply side	▪ Develop single application process for regulatory submissions
	▪ Give NSE sole powers to approve capital raising by GEMS companies
	▪ Review regime for secondary issues by GEMS companies
	▪ Review options for better determining opening price of new listings
	▪ Develop simple regulatory structure for VC and PE market
	▪ Develop OTC market as stepping stone to GEMS
	▪ Consider options to attract listings from particular sectors of the economy

Medium-term	
Support for the market	▪ Review minimum standard regime for NOMADs
	▪ Create SLA for relationship between NOMADs and SMEs
Regulatory and policy	▪ Allow GEMS companies, supported by NOMADs to have less qualified company officers
	▪ Separate NSE commercial and regulatory roles
Long-term	
Supply side	▪ Review current listings and remove defunct companies
	▪ Introduce tax incentives relevant to GEMS companies
Demand side	▪ Review exchange membership requirements to only have high quality brokers
Support for the market	▪ Improve investor education to include education on risk and its mitigation
	▪ Review broker regulatory regime and range of permissible activities against conduct and activities of brokers

Chapter 1

INTRODUCTION

Kenya has ambitious plans to become the "Heart of African Capital Markets". This is part of a broader strategy to target 10 per cent average annual economic growth by 2030. Critical to this vision is the development of a vibrant and globally competitive financial sector that will promote a high level of savings to finance Kenya's long-term investment needs. Capital markets play a key role in achieving this objective through intermediating long-term savings, mobilising and allocating capital, and providing a framework for the governance of corporations.

In recognition of the contribution that the financial sector can make to toward achieving this vision, the Government of Kenya has adopted a Capital Market Master Plan (CMMP) anchored by three pillars: i) to support developmental and economic transformation, ii) to develop the infrastructure of financial markets, and, iii) to reform the legal and regulatory environment in Kenya.

Under the second pillar, the Master Plan has set a target for developing the Growth Emerging Market Segment (GEMS) on the Nairobi Securities Exchange (NSE). Launched in 2013, GEMS provides a platform for small and medium-sized enterprises (SMEs) to raise finance through more favourable listing requirements compared to other segments of the NSE. As GEMS reflects the supply of future main board listings, the Master Plan has set a target of three to four new listings on GEMS each year – culminating in 16 listings by the end of 2016.

In an ideal world the benefits of listing on GEMS should be clear to early stage companies. Equity listings provide a way for entrepreneurs to obtain long-term risk financing and to realise value from building a business. They also allow investors to benefit from the growth of the company. The introduction of GEMS means that companies can be engaged with much earlier in their development and provided with another route for obtaining necessary risk capital.

In practice, however, many factors may impede SMEs from accessing finance through capital markets and GEMS specifically. The awareness of public markets among SMEs may be limited, particularly compared to more obvious, traditional forms of finance such as bank lending. Where there is awareness, there may be misconceptions as to the value of a listing. To many entrepreneurs, the enhanced scrutiny and disclosure requirements associated with accessing a public market may also seem unattractive. Whether perceived or actual, these factors play a role in limiting the attractiveness of a listing to SMEs in Kenya.

To support the development of the GEMS market under the Master Plan, the Capital Market Authority (CMA) and the NSE commissioned this work – through Financial Sector Deepening (FSD) Kenya – to "review GEMS in order to identify ways to increase its listings, and explore additional or complementary capital market products for financing, with the overall aim of increasing access to finance for SMEs in Kenya". The work was undertaken by a consortium made up of Genesis Analytics of South Africa and Bourse Consult from the U.K.

This report provides Genesis and Bourse Consult's (together, 'the consultants') findings and recommendations for developing the GEMS market. These findings were drawn from a variety of sources: a review of documentation published by the NSE and CMA setting out the building blocks for the GEMS market, engagement with a wide variety of stakeholders interviewed in Kenya, and the consultants' knowledge of developing second-tier markets.

The report is structured as follows:

- Section 2 reviews the needs of SMEs in Kenya and what drives entrepreneurs to access financial markets in general.
- Section 3 provides a review of the listings process on GEMS by taking a step back to before the listing process and examining the decisions companies need to make before they embark on the journey to accessing the public market.
- Section 4 considers the roles of each stakeholder involved in the listing process as well as the costs, direct and indirect, associated with a listing on GEMS.
- Section 5 identifies the specific incentives available to SMEs which might list on GEMS and assesses what effect each incentive has on prospective companies.
- Section 6 considers the attractiveness of GEMS compared to other options for raising finance in Kenya against a range of criteria that are considered by SMEs when considering raising finance.
- Section 7 reviews international practice in developing second-tier markets, highlighting idiosyncrasies and commonalities in offering capital market financing to SMEs.
- Section 8 brings together the issues identified in the previous sections to provide a systematic statement of the challenges identified during the consultants' assessment.
- Sections 9, 10 and 11 provide a comprehensive list of recommendations made to develop GEMS and identify priority areas and institutions responsible for implementing each recommendation.
- The Appendix to this report contains the names and designations of all the stakeholders that were interviewed as part of this project.

CHAPTER 2

A REVIEW OF SME NEEDS

In both developing and developed countries, SMEs play a vital role in driving economic growth. Not only are they key to creating dynamic, market-oriented growth, but they also spur innovation and help create employment opportunities for the growing workforce.

The contribution of the SME sector to the Kenyan economy has been significant, both in employment generation and in the growth of the economy's gross domestic product (GDP). It is estimated that SMEs are responsible for around 80 per cent of Kenyan employment, and contribute about 40 per cent to the economy's GDP [1].

Better knowledge of the needs of SMEs is very important if the financial services sector is to develop products that are appropriate to their needs.

The needs of SMEs are wide-ranging, and include both financial and non-financial needs. The most obvious is a need for finance, an accepted barrier to the development of SMEs worldwide.

A lack of finance is a critical impediment because it hinders the ability of SMEs to reach their full potential and scale, and in the process, reduces the potential of the SME sector to contribute to the fiscus and to employment creation. SMEs also have other needs that include:

- Access to markets;
- Access to information;
- Access to technology;
- Access to supplies;
- Infrastructure;
- Linkages with large enterprises;
- Knowledge and expertise; and
- Human resource development.

The inability of these smaller firms to access such needs remains a significant constraint to SME growth and competitiveness. While a listing on an exchange may not address all their needs, it can indirectly assist by creating an environment whereby SMEs are given access to the resources needed to succeed. As Section 6 will show, raising finance in a public market such as the NSE is very different to other sources of funding available to SMEs, as it includes many benefits over and above providing finance directly. As Section 3 will indicate, listing on GEMS would fulfill many of the typical requirements of SMEs, including:

- Raising capital;
- Raising the profile of the business;
- Knowledge and expertise provided by investors and advisers;
- Geographic and industry expansion;
- Providing a means for price discovery; and
- Providing an exit opportunity for the owner or entrepreneur.

It is also important to distinguish between the different types of entrepreneurs present in the market: novice/target entrepreneurs, portfolio entrepreneurs, and serial entrepreneurs.

- ***Novice entrepreneurs*** are those that operate one business only, and are often in the early stages of development.
- ***Portfolio entrepreneurs*** are typically characterised by entrepreneurs who have multiple entrepreneurial activities on the go at the same time.
- Lastly, ***serial entrepreneurs*** are those that continuously enter and exit ventures, without being tied down to any one business.

While each of these types has different financing needs, they are all likely to access capital markets, and specifically the stock exchange, but for varying reasons. For example, the novice entrepreneur may want to list in order to raise capital to get the company started, whereas the portfolio entrepreneur may come to market to expand certain entrepreneurial activities into other territories. Alternatively, the serial entrepreneur would most likely list on the exchange as a means of exiting the business.

The purpose of this section is to review the needs of SMEs who would be specifically looking to list on the GEMS Market. The views expressed here reflect the valuable input of SMEs, NOMADs and other key stakeholders interviewed in Nairobi.

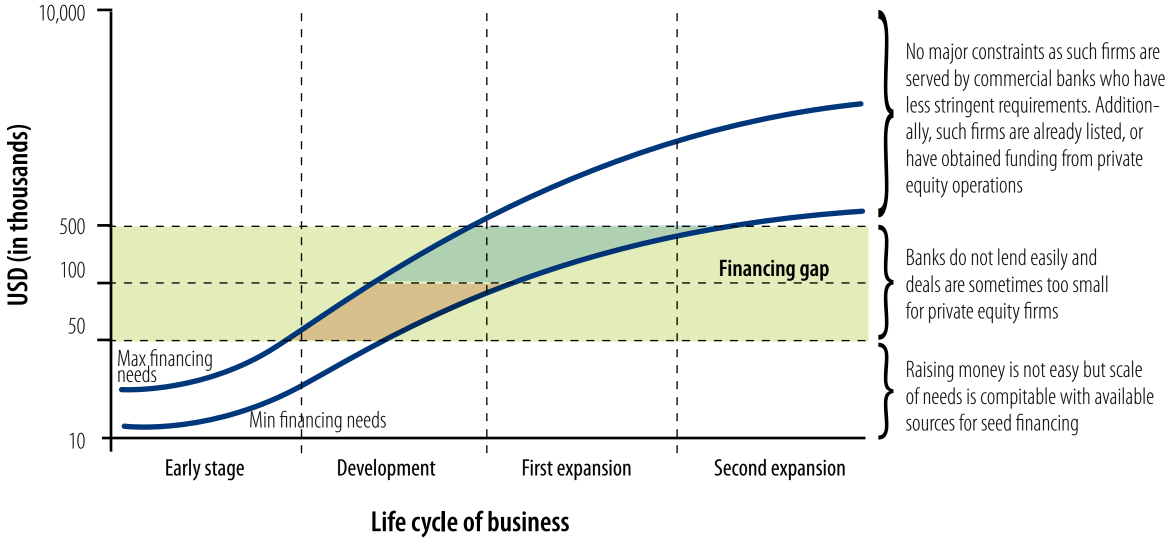
2.1 RAISING CAPITAL

Section 6 provides a more comprehensive analysis of the financing options available to SMEs in Kenya. A brief summary of these options is presented in this sub-section.

There is a large appetite among Kenyan SMEs for affordable financing that allows them to increase the scale of their operations and meet rising demand for their goods and services. The ability to raise appropriate financing is a problem experienced the world over. In Kenya, SMEs tend to predominantly fund their operations through either self-financing or bank loans. However, these two avenues are inadequate in meeting the funding needs of an SME as it matures. While self-financing (through family and friends or retained earnings) may work in the initial start-up phase, and while bank financing may be preferable for an SME's working capital needs, the long-term financing needs of SMEs are unfilled. SMEs in Kenya predominantly rely on bank finance

1 Kenya Institute of Public Policy Research and Analysis, KIPPRA (2009) Kenya Economic Review

Figure 1: Nature and severity of the financing gap



Source: Financing Technology Entrepreneurs & SMEs in Developing Countries: Challenges and Opportunities, infoDev, 2008.

to meet these longer-term requirements, however, the shorter duration and high interest rates charges on such loans makes them undesirable.

In short there is a significant financing gap for SMEs in Kenya [2]. While micro-enterprises tend to be serviced by microfinance institutions, and the larger, less risky firms by commercial banks (at favourable rates) or private equity companies, SMEs in the so-called 'missing middle' are left underserved, or in some cases, unserved altogether. It is precisely these firms that could benefit from a listing on the GEMS market. Doing so would provide them with the much needed capital to service their long-term needs, such as expanding in their own industry, into other related industries, or even geographically into new markets.

2.2 RAISING THE PROFILE OF THE BUSINESS

An important constraint faced by SMEs is finding a large market for their products and services. If an SME were to get more public exposure, its addressable market may increase. Public exposure might also attract the attention of prospective investors wishing to support the growth aspirations of the SME.

Early evidence of this desire to raise the profile of the business is even found in the GEMS market. Interviews with Home Afrika, with SMEs that are in the process of listing, and even with other SMEs that have not considered GEMS yet, indicate that the ability to raise capital upon listing is not necessarily the primary reason for doing so. Instead, many SMEs, especially those that are listed or in the process of listing, do so to raise the profile of their business. Companies interviewed confirmed this and indicated that there is a certain prestige associated with listing on an exchange. This acknowledgment of prestige is something that is reflected across the spectrum of SMEs, from newer 'startup' SMEs to those that have second or third generation owners. The same SMEs believed that a listing would enhance their credibility, something they believed was important to attract new investors to their business at a later stage, particularly those from international markets. So while some companies require capital initially, others may simply be seeking the public exposure that a listing provides.

Another factor to be considered is that by raising the profile of an SME, a listing on the GEMS market could also potentially 'open doors' or provide procurement opportunities for SMEs with larger companies, creating linkages that could prove to be extremely valuable in the longer-term. This benefit associated with a public listing was mentioned by several SMEs interviewed in Kenya and is common practice internationally.

2.3 EXIT OPPORTUNITY

A characteristic of SME ownership in many developing countries, including Kenya, is the number of different companies that a business owner or entrepreneur owns, in many cases across a wide variety of industries. It is not uncommon, for example, to find a portfolio entrepreneur that owns a packaging company together with a company that imports shoes. This view was confirmed by almost all stakeholders interviewed in Kenya.

In such a scenario, an SME owner may look toward external investors as a means to offload some of his ownership in any number of businesses and to recoup some of his wealth. While a listing may not seem as the most common avenue for this, it is nevertheless an option available to the SME owner.

2 CMA (2010) The Development of Micro-cap Securities Markets for SMEs in Kenya

2.4. GEOGRAPHIC OR INDUSTRY EXPANSION

SMEs often struggle to expand their operations into other territories and regions or to further penetrate their industry. One reason for this is the large capital outlay that such strategic moves require. Interviews with stakeholders in Kenya suggest that where SMEs have done so, it has been predominantly financed using internal funds (family, friends or retained earnings) or with repeat short-term finance obtained from banks. As indicated above, these sources of funding are often insufficient to adequately fund longer-term investments.

A listing on the GEMS market provides a way for Kenyan SMEs to fund their regional ambitions. Capital could be raised from a listing to expand organically and set up operations in the targeted markets. Alternatively, companies could use their shares as acquisition currency, and grow via acquiring existing businesses in these markets.

Several SMEs interviewed had ambitions to expand to the rest of the continent, and being able to use listed shares as a means for expansion would aid in their efforts to become regional players. This is a benefit which should be communicated more clearly to SMEs in Kenya (see Sections 9, 10 and 11).

2.5 PRICE DISCOVERY

An interesting and often overlooked need among both SME owners and investors interested in investing in companies is the ability to get an objective valuation of the business. This benefit is particularly attractive to SMEs that are jointly owned by family members or by groups of friends. For these kinds of SMEs, a listing allows each shareholder to measure the value of their holdings. On an ongoing basis, a listing also provides shareholders with a reflection of the growth in their respective indication of the growth in their respective investments.

2.6 KNOWLEDGE AND EXPERTISE

Access to information, knowledge, and contacts to key market players are seen as some of the main stumbling blocks to the survival of SMEs. Often, the skills and expertise required to grow the business are lacking in the top management of SMEs (which are often a collection of family or friends and not necessarily persons appointed for their professional skills), as well as the technical skills to support the day-to-day running of the business.

In this regard, obtaining finance from investors, such as private equity or venture capital companies, is a popular option for SMEs in other markets to access industry-specific knowledge or expertise[3]. Not only do these investors provide SMEs with valuable funding, they also provide 'hands-on' support and coaching to the management team on the running of the business.

Private equity or venture capital is not the only option open to SMEs to meet this need. A listing can also provide SMEs with access to the necessary knowledge and skills required, albeit indirectly. This is because a listing forces an SME to make certain governance changes (for example, bringing in external board members or independent directors) in order to comply with the listing process. Though many SMEs interviewed view these changes as a kind of 'grudge purchase' they can be immensely valuable to the business in the longer-term, especially in embedding greater management accountability and strategic vision into the business. Lastly, the changes also ensure that the SME complies with appropriate governance standards, which enhances the investment case for external investors interested in investing into the companies.

Interviews with SMEs confirm the above drivers, with many companies interviewed believing that such changes would help build stronger and better businesses. When questioned as to whether the greater governance requirements are indeed a 'grudge purchase', the majority of SMEs acknowledged that such changes would inevitably be required as their businesses matured. In other words, the requirements GEMS places on listed companies are part and parcel of the life cycle of a growing company.

3 CMA (2010) The Development of Micro-cap Securities Markets for SMEs in Kenya

Chapter 3

THE GEMS LISTING PROCESS

This section describes the process of acquiring a listing on GEMS. It steps back before the actual listing process to examine the decisions that the companies need to make before they even start on the process, how those decisions are made and what factors are considered. The stages in the process are discussed below.

3.1 DECIDING ON WHETHER TO COME TO MARKET

The decision to access financial markets is a milestone in a company's life cycle. In most cases, the decision is an organic one – borne out of a desire to grow and a need to obtain finance to fund such growth. The decision to access financial markets, however, is not exclusively financial and many companies see funding as secondary to the need to increase the sophistication of their internal governance, to raise the status of their brand, or to enter new markets.

These financial and non-financial motivations for coming to market are not mutually exclusive. In fact, they are complementary. Companies may access financial markets to raise finance and, in the process of doing so, may attain brand and governance value from the exposure that financial markets provide and the oversight that investors require. Conversely, companies may access financial markets to raise the status of their brand and to strengthen internal governance arrangements, only to find that better control of their business and greater demand for their products or services drives a need to access finance from the market.

Table 1: Reasons given by companies for accessing financial markets

Financial	Non-financial
▪ Raising capital to finance growth	▪ Raising brand profile
▪ Gaining acquisition capital	▪ Broadening management input
▪ Obtaining a regular valuation	▪ Establishing a presence in the country
▪ Reducing gearing levels or raising credit standing	▪ Developing employee share incentive schemes
▪ Accessing tax breaks given to listed companies	▪ Exit mechanism for investors (family, venture capital companies, private equity investors)

Source: Interviews conducted by Genesis Analytics and Bourse Consult in Nairobi, 2014

Discussions with Kenyan SMEs that have listed on GEMS, companies that were already in the process of listing on GEMS, and ones that had not done so or had considered listing, confirmed these drivers.

SMEs that had given significant thought to why they would, or did, access financial markets and GEMS in particular, suggested that the need to raise the company's profile and to obtain growth capital were the most important drivers of their decision. Raising the profile of the business was actually the most commonly reported reason for accessing GEMS and the NSE in general. Senior stakeholders of SMEs spanning a variety of sectors all indicated that listing was seen as a mark of graduation, that their company had arrived, and that by listing it was joining "the big league". Capital-raising was reported as another important reason for accessing financial markets in general (though, as described below, in the case of GEMS, usually separately from the listing).

Interestingly, other reasons for accessing financial markets seem not to feature in the decision-making of Kenyan SMEs. This may be symptomatic of limited awareness of the broader benefits of accessing financial markets as much as the sophistication and financial knowledge of SMEs that may be eligible for listing on GEMS.

In other markets, companies are influenced in their decision by the marketing efforts of the exchange and by the marketing activities of advisers, intermediaries and third parties that have an interest in developing capital markets like the regulator. None of these seemed to be of much importance in Kenya and certainly direct approaches by the exchange or intermediaries to communicate the benefits of accessing financial markets are relatively rare.

Selecting an adviser

Once a company has decided to join GEMS, it needs to appoint a nominated adviser (NOMAD). The role of the NOMAD is to guide the company through the NSE's listing requirements, ensuring that its submissions and structures are compliant. This is a significant decision as GEMS companies (unlike companies on the full list, the Main Investment Market Segment (MIMS)) are required to retain a NOMAD continuously throughout the period of being listed on GEMS. Should the company be dissatisfied with the performance of its NOMAD, it is certainly possible to change the NOMAD. This is, however, likely to raise questions in the market so it is not something a company would consider lightly.

There are currently 24 NOMADs registered with the NSE to advise GEMS companies on the listing process. According to stakeholders interviewed, the quality of NOMADs varies widely. As the number of listings on GEMS has so far been small, though it is growing and expected to grow faster, there is little track record among NOMADs in the market to confirm this view. Nonetheless, the perception of NOMADs is not very high and potential listed companies are said to see little value in their services or the requirement for long-term relationships. Accordingly, companies have a transactional approach to advisers (and this is supported by the absence of any similar requirements on MIMS companies) and price is probably the largest determinant: a tough negotiation between the adviser and the company on fees charged is the norm.

Deciding on whether to come to market

Companies that do decide to list on the NSE have a number of options – MIMS, the Alternative Investment Market Segment (AIMS) or GEMS. AIMS has not been attractive to companies and it seems to be perceived by investors as requiring less disclosure. The perception is that the disclosure requirements and the corporate governance requirements for MIMS and GEMS are practically the same (which from international experience is wise) and the decision by SMEs to rather access GEMS is largely driven by the lower free-float requirement compared to AIMS. By nature, SMEs are always cautious about ceding ownership and control to external shareholders (including venture capital and private equity investors which are often seen as more likely to intervene in management, since they hold a larger stake and usually require board representation) and so GEMS is inherently more attractive – as it is designed to be.

GEMS is currently promoted as a step towards a full listing. The current perception among investors is that GEMS companies should move to a full listing fairly quickly. It is not clear why this is so since the disclosure requirements – which are a key consideration for investors – are practically the same between the two markets and are recognised as such. This view of GEMS as a stepping stone to the main market may change in time as GEMS develops a personality and culture of its own but it remains the current view. Therefore, for the moment, a company entering GEMS will be attracted by the lower free-float requirement for GEMS, but must be aware of the expectation that it may be required at some point to increase its free-float to meet the MIMS requirement.

Deciding on raising capital

At this early stage the company needs to take a decision on capital-raising: does it want to raise capital at this stage or wait until after it has gained admission through an introduction and then have a rights issue? Companies also have the option of raising money through an over-the-counter (OTC) private placement and listing through an introduction soon after. While the placement would not be directly conditional on the listing, the investors would be given a clear commitment that the company would seek to list. The process is significantly different between an initial public offering (IPO) and an introduction. Each of the two process streams are described below.

3.2. INTRODUCTION TO THE MARKET

The following process applies irrespective of whether the company has raised money through a private placing before the listing or not. Once the company has appointed a NOMAD and made the decisions described above, the next steps are:

Getting accounts into shape

In many cases, the financial reporting of SMEs is fairly informal. This is not surprising or unique to Kenya and the lack of formal financial reporting of SMEs simply reflects their fledgling nature. SMEs are required to produce audited accounts for the Kenya Revenue Authority (KRA) but views from stakeholders interviewed suggest that the standard and quality of the accounts and the audit are nowhere near as high as those required for a listed company. This raises a number of challenges for the SME:

- The time and skill required are considerable and may not be something the company has anticipated. Intermediaries in the process suggest that the quality of SME books is very poor and that a great deal of work is required by the intermediary to get them to the appropriate standard. It should be said that intermediaries are not unbiased observers of the quality of accounts but direct reports from companies confirm that the work is considerable and may be beyond the capabilities of their existing accounting system.
- There is a view that SME accounts, since they are the basis for taxation, may not fully represent the true financial state of the company. More complete accounts, SME owners fear, would lead to a higher burden in the future and, of more concern to SMEs, a reappraisal of past tax payments by the KRA. In the literature the idea of a tax amnesty has been considered from time to time as a means of encouraging companies to list on the exchange. As this may attract the wrong kind of companies, however, no such amnesty is provided in Kenya – though there is a general provision for a waiver of penalties and/or interest on prior non-disclosures depending on the circumstances of each case.
- Companies potentially have certain transactions of an unofficial nature which may be difficult to incorporate into the more comprehensive, transparent accounts required for listed companies. Restricting such transactions would be in the national interest but for the moment, some businesses believe they are a necessary part of doing business and so will have to address them somehow.

The difficulty SMEs might have in getting accounts into shape should not be exaggerated – while companies may be surprised by the amount of effort required, they fully recognise the value that an organised set of accounts can provide to their business as it matures.

Getting corporate governance into shape

Most SMEs have relatively informal governance structures, often with boards composed of family members and with little oversight of family members in operational management roles. Often, corporate officers will have been appointed without having any formal training in finance, company secretaryship or management. The challenges for these SMEs are threefold:

- *Accepting outside management input and finding appropriate people.* Outside management input is a new experience for many SMEs (though not for all companies as some will have had venture capital or other partners). GEMS requirements include appointing non-executive directors (NEDs) which can be difficult – even in highly developed markets good NEDs are in limited supply.
- *Appointing qualified people.* GEMS requires CFOs and company secretaries to be registered with relevant professional bodies. According to stakeholders interviewed, such people are available in sufficient numbers in the market but are likely to be considerably more expensive than the current staff. They also have to finesse the appointment of new people for jobs that were held by family members or similar connected parties.
- *Training for directors.* The NSE requires GEMS directors to attend training courses to equip them for their new, wider responsibilities. This might be seen by the SME as distracting key staff from other responsibilities, unless the quality of the training was seen as high enough to bring offsetting benefits. The latter hopefully may apply, as some interviewees who had attended such courses commented how beneficial they found them. However, others who felt they did not need such training resented the cost of it and the time needed to be spent on it.

SMEs interviewed mostly seem to understand the need to improve corporate governance and the value brought by doing so. As with improved financial reporting, better corporate governance is seen as part of the development of the company and outside management input tends to be seen as a necessary part of operating on a wider national stage. Similarly, more professional management is recognised as necessary to match the growing size and complexity of the company. As an example, it is worth noting that Home Afrika has appointed an investor relations manager which goes beyond the requirements of GEMS but is in recognition of a need for the role in a more sophisticated company.

One area which has proved problematic in both disclosure and governance in other markets has been the treatment of price sensitive information. GEMS (and MIMS) companies have a continuing obligation to inform the market of developments which would be considered likely to affect the price of the company. The requirements are not intended to force companies to, for example, reveal commercial secrets (and none indicated that this was a concern), but their aim is to ensure an orderly release of information and to limit the risk of insider trading. It is always an area of concern for directors and NEDs of listed companies who could face sanctions (including imprisonment in some countries) for failing to comply. It is important that regulatory authorities give adequate guidance on what should be disclosed. However, there should not be hard and fast rules on what constitutes material information as these offer scope for evasion. In other countries a statement of principle supported by case-study type material has been found to be a good solution. The training of directors which covers price sensitive information would add real value in an area of concern. This training cannot and should not, be too specific. It is probably not possible and is risky (because it risks creating legal "safe harbours") to try and specify exactly what should be disclosed and when. This is why the rules are written in terms of an expectation that something might be material. The guidance would be better structured as case studies or Frequently Asked Questions exploring examples of situations companies may face. Such approaches have proved useful in other markets, particularly where they are issued by the regulator or by the exchange.

Produce disclosure documents and submit to the NSE

GEMS companies are required to produce regulatory documents for approval by the NSE. The NOMAD puts together a listing statement which in theory should be reviewed by the legal counsel (adviser) and then sent to the NSE for approval. In reality, the NOMAD and the legal adviser will prepare the document, often with a checklist, though this is not a legal requirement, before submitting to the NSE for initial review. Based on the amendments, if any, the NOMAD will then submit a formal application for approval to the NSE. It is relevant to note that this is an iterative process – the application has been pre-vetted by the NSE and adjusted accordingly so that success is the most likely outcome. Comments from market interviewees suggest that the NSE performs this role competently, with reasonable speed and certainty of timescale.(The time for an introduction to GEMS is mentioned to be two weeks with considerable certainty.) While it is important that applications are approved as quickly as possible, one must be careful not to advocate superficial approvals just to speed up the listing process. A more important issue, however, is the certainty of timescale. A company would prefer a certain time-scale, say three weeks, rather than an average of between two to four weeks. To build confidence in the listing process and the GEMS market, it is essential that timelines are given, adhered to, and only breached in exceptional circumstances.

Arrange capital raising and price

If the company wishes to raise capital prior to the introduction, it will be done by a private placing with a small group of investors. The NOMAD will approach a group of institutional investors and select investors from the existing brokerage and investment banks' client lists and negotiate a price. Institutional investors want exposure to newly listed companies but the lack of liquidity in the market makes it difficult for them to acquire the sort of stake they would consider worthwhile. (This is not a uniquely Kenyan problem and fund managers in other markets have set up specialist small cap funds alongside their main market funds or farmed the business out to specialists. The small cap funds are more nimble, take larger per centage but smaller value stakes, and often have close relations with the company.) Institutional investors are happy to buy into private placements – indeed they prefer this to a public offer where funds have to be committed for a long period (up to two months) while the offer process is conducted with associated costs and market risks.

The pricing of the placements is quite opaque and there is a sense that prices have been too high on occasions. Investors are suspicious of what they see as exit strategies where the price might be inflated since the owners are not looking to develop the company. Recent issues which have not done well (on MIMS and GEMS) have increased the suspicion of listings for exit. However, there is a growing feeling (especially after the recent listings) that the lesson has been learned – best-practice for companies is to "leave something on the table" so that the experience of investors is positive and they are more likely to be willing to provide further capital in the future. Recent issues seem to bear this out. On an ongoing basis however there would be value in scrutinising the competency of NOMADs to guide companies on pricing and to ensure that certain minimum standards, including standards associated with valuing companies (like securities analysis skills), are met by NOMAD staff.

Submit to CMA for no objection notice

After the NSE has approved the application, the documents are passed to the CMA (this cannot be done until the NSE has given its approval - i.e. the approval process is sequential rather than parallel). The CMA has seven days during which it can request further information and can, if it deems it necessary, prohibit the listing. After seven days the CMA, if it is willing to allow the listing, will issue a no objection notice and the listing can go ahead. Certain stakeholders were of the view that the CMA tends to ask or need too much information and when that is provided possibly raises new questions. However, the consensus seems to be that the CMA has become more willing to accept the regulatory decisions of the NSE on GEMS listings. The management of the most recent listings to GEMS confirmed this point.

Opening on the market

After the no objection notice, the stock is entered into trading on the market. While the opening price would be expected to be closely related to the price of any previous private placement, it is essentially arbitrary. There is no auction process or similar to decide an opening price and it would certainly be worth considering whether some opening auction would be feasible. In the case of Home Afrika, the price, after an initial rise, slumped soon after the opening. The NSE operates a 10 per cent circuit breaker starting from the day after admission which meant that the stock continued to decline over quite a protracted period. There is some suggestion that the NSE might have mitigated the fall by mentioning that the stock was fundamentally sound. In the consultants' view, however, this is not the role of a regulatory agency and involves serious risk – explaining the company's prospects should be the job of the company and the NOMAD.

Initial public offer (IPO)

If a company opts to raise capital at the time of the issue through a public offer the process is significantly different. For public issues the documentation requirements are much higher, including a detailed prospectus showing the uses of the funds raised. More importantly the approval process is entirely operated by the CMA (contrasting with NSE approval and CMA no objection notice for introductions). The process is also considerably longer because more documentation is required (since the public is being asked to subscribe capital) and, more importantly, the timing is uncertain. For an introduction, the estimate given is two weeks and there is considerable certainty about the timing, in large part because the NOMAD, legal counsel and the NSE work together. For an IPO there is no set time and, while the consensus is that the CMA has improved, the time taken it is still perceived as too long and too uncertain.

Chapter 4

A COST-BENEFIT ANALYSIS OF GEMS

4.1 ROLE OF EACH PARTICIPANT IN THE LISTING PROCESS

This section looks at the contribution of the participants in the listing process. The participants surveyed include:

- Nairobi Securities Exchange (NSE)
- Capital Markets Authority (CMA)
- NOMADs
- Legal advisers
- Accountants
- Public relations (PR) advisers
- Kenya Revenue Authority (KRA)

In practice the NSE and the NOMADs are the main participants in the listing process and hence most of the discussion will focus on them. It should be pointed out that with only one GEMS listing at the time of the initial field work being done – though there were several applications in the pipeline and two more successful listings occurred during the writing of the report – any conclusions on performance should be treated with caution.

The NSE

The NSE has four primary roles: regulating the GEMS primary market, monitoring continuous obligations, running/regulating the secondary market and marketing the GEMS market.

Regulating the GEMS primary market

The NSE takes the frontline role in regulation, with the CMA having an oversight role both in the issuance of no objection notices and through licensing the NSE. The NSE engages in an iterative process with the NOMAD and the legal advisers and through the NOMAD with the company to ensure that the documents submitted comply with its rules (and with those of the CMA). Comments from market interviewees, including recent listings Flame Tree and Kurwitu, suggest that the NSE performs this role competently, with reasonable speed and certainty of timescale. From the regulatory side there was a strong feeling supported by some evidence that the NOMADs and NSE were not fulfilling this role because they were letting through companies with inadequate documentation. The sense, however, is that this has improved and will continue to improve as the process becomes more familiar. The two recent successful listings confirm this impression.

In common with other small cap markets, such as London's Alternative Investment Market (AIM), much of the regulatory work for GEMS is, in effect, carried out by NOMADs. This brings flexibility and reduces costs, which is advantageous, but it does require the exchange to regulate the NOMADs. There are currently 24 NOMADs and reports suggest that the recruitment of NOMADs by the NSE was fairly aggressive and that quality may have been somewhat of an issue. The current situation is that there is clearly a wide range of competence among NOMAD, with varying degrees of quality of work and reputation. One way of addressing this would be to apply strong sanctions on NOMADs that failed in their regulatory duties, and there is no doubt that the NSE can do this. However, the perception that there are too many not-very-competent NOMADs is damaging and, as the primary market regulator, the NSE should take action to ensure professional standards are maintained. Improving standards of NOMADs at this stage, before they can cause any problems, is much more preferable to imposing sanctions later. The good news is that the new listings in 2014 were both successful. NOMADs who do continue to do a good job will be preferred in future listings.

For introductions, therefore, the process works well. For capital-raising issues, the results are less positive – companies understand that the process is slower, less certain and significantly more costly and so tend to avoid capital raising issues when the company first comes to the market, preferring (less regulated) private placements. As a consequence, capital-raising issues in the current environment may be rare. This weakness arises because the responsibility is split between the NSE and the CMA. This will be discussed further below.

Monitoring continuing obligations

Continuous obligations include the requirement to submit regular updates of financial data. The bigger challenge, however, is managing intermittent disclosures of price sensitive information. Monitoring with only one company, unsurprisingly, presents little hard evidence in this area and there has certainly been no evidence of any problems to date. However, the interviews with stakeholders revealed a lack of understanding among prospective GEMS of how to manage price sensitive information. Of course, the NOMADs are there to guide companies and this is part of the reason for requiring a continuous NOMAD relationship but it is essential that both parties are clear as to what is expected of them. The lack of clarity suggests that there may be potential problems in the future unless remedial actions – such as guidance notes, case studies and wider investor education – are forthcoming. It is not absolutely clear where the responsibility for guidance lies but it is fairly clear that the NSE is best placed to manage that responsibility.

Running/regulating the secondary market

When it comes to operating and regulating the secondary market, the NSE has two responsibilities:

- Market supervision to ensure that trading is orderly and financial crime is detected; and,
- Market structure and infrastructure to maximise liquidity and minimise transaction costs.

Market supervision is outside the scope of this project so the focus is on market structure. The secondary market for GEMS is structurally identical to the market for MIMS. However, GEMS companies are expected to be smaller than MIMS companies and therefore the challenge of sustaining liquidity is much greater for GEMS companies relative to their MIMS counterparts (however it is likely that the challenge of maintaining liquidity in some MIMS and AIMS companies is similar).

Unfortunately, there is only a limited amount an exchange can do – transaction costs are high for small cap companies because there is little two-way business. In consequence most significant trading is done on an arranged basis away from the market. However, market makers can be a useful adjunct to support trading in small size and to ensure some measure of price continuity. The feasibility of introducing market makers is discussed in Section 9.1.5.

Marketing the GEMS market

The NSE has devoted considerable effort to marketing GEMS. However, the level of awareness and understanding among companies remains low. The marketing may have been too passive – SMEs are not likely to see advertisements in the financial press for example. It is surprising that the NOMADs have not been more active in marketing GEMS but this may reflect the mixed quality of NOMADs mentioned above. In other markets, press advertising is supplemented by seminars (perhaps organised through trade associations and industry apex bodies) and by "banging on doors" marketing. The KPMG Top 100 SMEs event, for example, is a fine way to establish contacts but an aggressive programme of individual follow-ups needs to be in place to sustain the momentum and interest generated by these kinds of events. In many other markets, the small cap market is constituted as a separate department or even a separate business unit with its own CEO. This seems to add incentive and drive to the marketing effort.

In addition, once a company has come to market, the contact should continue. The first listed GEMS, Home Afrika, commented that there had been no subsequent visits or check-ups subsequent to its listing. To some extent this is the role of the NOMAD, but it is good practice internationally for an exchange to follow up with new customers to ensure they are satisfied and not experiencing problems that may be easily resolvable.

As Section 3 has shown, it is worth noting that the range of benefits from listing of which SMEs are aware is quite narrow. Most see it as a way of possibly raising capital but raising the profile is the main reason for most. Listing, however, does offer a much wider range of benefits and marketing should present the full range of benefits.

One last point to consider under marketing is the role of fees charged to companies, something which the NSE has decided to waive for new GEMS companies. This is, of course, a positive attraction but it has a cost. Charging fees might enable the NSE to mount a more assertive marketing effort and/or enforce a tougher monitoring regime on NOMADs. Compared to the other costs of joining GEMS, discussed below, the NSE fees are likely to be relatively small and are unlikely to be a make-or-break factor for companies considering joining the market.

The CMA

The CMA's role in GEMS listings is relatively small, unless the issue is an IPO, which, as the previous section has shown, is not the model preferred for GEMS, at least so far. The CMA's role in secondary issues therefore becomes much more significant. The CMA is also the lead agency in setting and changing rules for issues.

Role in introductions

Applications, once approved by the NSE, are passed to the CMA for issuance of a "no objection notice". The CMA is required to issue the notice, or respond with requests for further information or other objections within seven days. There have been odd reports that this has been problematic with the CMA raising multiple queries at different times rather than presenting a single consolidated list of issues for resolution. This appears to be resolved now, though the number of applications received by the regulator thus far is too small to draw strong conclusions. Both recent listings, Flame Tree and Kurwitu, mentioned that they were happy with supplying the additional disclosures required by the regulator.

From discussions with various stakeholders in the market, it would certainly simplify the process and prevent unpleasant surprises if the NSE and CMA could liaise during the NSE approval process (as the NSE, NOMADs and others already do) but this has not been done to date. Ideally, applications should be managed in a single database to which all parties have access during the process.

Role in secondary offerings

As already discussed, money-raising issues must be approved by the CMA. This includes rights issues by GEMS companies. The process is considerably longer and requires significantly more documentation than for an introduction – quite rightly, as the public's money is being solicited including that of retail investors. However, the problem has been that the time for approval appears to users to be excessively long – possibly two to three months – and very uncertain.

Again it would help if there was more interaction during the approval process between the various stakeholders, including the CMA. It would also reassure the market if the CMA committed to giving rulings within a specific time period. Though the regulator has published turn-around time commitments, there is still a perception in the market that these commitments are not always met. It is not uncommon for regulators to face such accusation – in fact it is almost the norm – and many regulators have responded by publishing performance data in their annual reports to show the actual picture.

Rule-making/amending

As the regulator for capital markets, the CMA retains ultimate control over the rules in the market. It may, however, as in the case for the GEMS market, delegate some part of its rule-making authority to the NSE within certain limits and whilst retaining ultimate accountability.

The CMA also has control of the rule-making process including consultation with stakeholders. Consultation is an international best practice and has the practical benefits of: a) ensuring that new rules are workable and not unnecessarily restrictive; and b) encouraging acceptance by giving objectors a fair hearing. It is not clear how well-developed the CMA's consultation processes are. Feedback during the fieldwork suggested the consultation for GEMS was not very deep and came fairly close to the end of the process (i.e. when decisions had already been taken, rather than at an early stage).

A particular issue relating to GEMS is that of the rules requiring secondary issues to be made as rights issues in all cases. Pre-emption rights are important and should not be dismissed lightly but the size of secondary issues by GEMS companies makes a full rights issue excessively expensive. The CMA may be being disproportionately strict in its insistence but it is equally possible that the market is making an unjustified criticism. This is an excellent example of an area where consultation would allow the market and regulator to express their views and arrive at a right and proportionate mix of investor protection and practicality.

NOMADs

NOMADs have three primary roles – ensuring compliance of applicant companies, marketing of GEMS, and advising on pricing/supporting the market for the shares.

Ensuring compliance of applicant companies

NOMADs are responsible for ensuring that applicant companies comply with the listing requirements at time of listing and also meet continuing obligations. Market opinion is that, on the whole, NOMADs do a very acceptable job of this. Indeed the iterative interaction between company, the NSE and legal advisers (discussed later in this section) is a good example of a process which works well, is quick, and is relatively certain in outcome. Discussions with various stakeholders in the market confirm that applicant companies have very little idea of what is required of them as part of a listing and so rely heavily on NOMADs for support. When questioned, companies seemed to be mostly satisfied with the support given by their NOMADs in complying with listing requirements.

It is too early to judge the NOMADs' success in ensuring compliance with continuing obligations but as mentioned above there are concerns over the market's understanding of price sensitive information – something which the NSE and NOMADs should address going forward.

Marketing of GEMS

The business of a NOMAD is to bring companies to GEMS and it is therefore expected that they would be actively marketing their product However, this does not seem to have been the case, as some NOMADs appear to be active (some very active) but most are not. For historical reasons, companies and other intermediaries do not have a particularly high opinion of NOMADs and regard them as a something which is required and which will provide some benefits but that the benefits will not justify the cost. This perception drives companies to negotiate NOMAD fees down to the bare minimum.

This suggests that NOMADs have, overall, not been good at convincing companies that they offer a valuable service, not only at the time of listing but continually as the financial needs of the company grow and become more complex. There is some pressure to remove the requirement for GEMS companies to have a permanent relationship with a NOMAD which obviously reflects the companies' and intermediaries' low opinion. International practice is to require a permanent relationship with an adviser. This should be retained but it will only be sustainable if the NOMADs develop and market a valued range of services which SMEs are willing to continue paying for.

That said, of the three companies currently listed on GEMS, the majority did say that the service of the NOMAD had been valuable and that it was happy to retain the NOMAD on a permanent basis (the other felt it could manage without the NOMAD). This may demonstrate that a good NOMAD can deliver real value. The problem is that not all NOMADs in the market are that good, something that the NSE needs to manage as the market develops.

Advising on price and supporting the market for the shares

A company's relationship with the market should be seen as a continuing partnership with investors. Good advisers recognise this, and ensure that a new listing is priced in such a way that investors feel satisfied that the price is fair and that there is upside potential, and so are more willing to participate in future funding. This requires that the price at which the company is brought to market is not so demanding that the only direction for the stock is to go down.

Companies have not always appreciated this point, seeing capital raising as a way of maximising proceeds rather than as part of an ongoing partnership with investors. Of course, if the aim of listing is to exit then this is rational but investors in Kenya, as elsewhere, are wary of proprietor exits. Companies and NOMADs have not always appreciated the need to leave something on the table (discussed above) and have set the initial price too high as was the case with Home Afrika – moreover other advisers have done the same with other listings on MIMS. The result is detrimental to the company future as investors are dissuaded from investing in the company's, and it can take several years to recover during which time the company is shut out from further capital rising on the market. Having said this, more recent listings suggest that NOMADs may have learnt this lesson and are now pricing more reasonably.

NOMADs should also take some responsibility for the aftermarket, at the very least acting as a trading post where investors wishing to trade can leave expressions of interest which the NOMAD will seek to match without exposing the offer to the market. In some markets they take a formal market-making role offering a continuous price in small size. Kenyan NOMADs do not seem to fulfill any of these market supporting roles.

Legal advisers

Legal advisers play an important role in listing, not least because they seem to have the strongest grasp of the requirements. Although the number of legal firms with capital market experience in Kenya is said to be small, interviews with selected firms in Nairobi revealed a significant number of highly competent specialists. It may be that over time, as the quality of NOMADs improves and participants become more experienced, that the role of legal advisers will become smaller and more routine. Where more complex transactions such as IPOs are required, the contribution of legal advisers is likely to be much more important.

Accountants

It is reported that many potential applicants for GEMS have relatively informal financial reporting processes. These need to be substantially upgraded for admission to GEMS and accountancy firms. Interviews conducted with stakeholders did not uncover any adverse reports on accounting matters, though GEMS firms often require very significant amounts of work to provide adequate accounts.

One area where advice and reassurance is needed by accountants is in dealing with the sensitivity among SMEs of possible retrospective tax liabilities being imposed (this is discussed again below). What is worrying is that this is said to be a deterrent to SMEs joining GEMS. It is not clear how far accounting firms advise firms on this but it is clearly an area where advice and reassurance is required.

PR advisers

SMEs have not generally had much need for PR support. However, gaining profile and exposure is a major incentive to join GEMS and upping the company's PR effort is a large part of that. NOMADs use PR advisers to provide this service particularly with respect to investors as well as to press and other media. In time, companies may develop in-house resources – as Home Afrika has done in investor relations – but in the early days, external advisers are an important part of the listing process.

The KRA

The KRA is not a direct participant in the listing process but its actions are important since taxation is a factor for some companies in the decision to list. As the national body charged with administering tax policy set by the National Treasury, the KRA has two roles: a) as an administrator of tax incentives (see Box 1 below) for listed companies which, as noted elsewhere, is not of much importance to GEMS companies; and, b) in the potential opening of previous years, accounts when a company lists to reclaim any underpaid tax.

Box 1: Tax incentives offered under the Income Tax Act

In the Income Tax Act, under Part IV Ascertainment of Total Income, the following expenses are deductible from the calculation of income that is subject to tax:

- Expenditure of a capital nature incurred by legal costs and other incidental expenses relating to the authorisation and issue of shares, debentures or similar securities offered for purchase by the general public.
- Expenditure of a capital nature incurred on legal costs and other incidental expenses, for the purpose of listing on any securities exchange operating in Kenya, without raising additional capital.
- Expenditure of a capital nature incurred in that year of income by a person on rating for the purposes of listing on any securities exchange operating in Kenya.

Under the Third Schedule of the Income Tax Act, listed companies also benefit from a reduced rate of corporate tax as follows:

- In the case of a company newly listed on any securities exchange approved under the CMA Act with at least 27 per cent of its issued share capital listed, 27 per cent for the period of three years commencing immediately after the year of income following the date of such listing.
- In the case of a company newly listed on any securities exchange approved under the CMA Act with at least 30 per cent of its issued share capital listed, 25 per cent for the period of five years commencing immediately after the year of income following the date of such listing.
- In the case of a company newly listed on any securities exchange approved under the CMA Act with at least 40 per cent of its issued share capital listed, 20 per cent for the period of five years commencing immediately after the year of income following the date of such listing.

Source: Interview with KRA Domestic Taxes Department – Policy Unit Technical; Income Tax Act 2010 Revision

The potential for reclaiming unclaimed revenue brings uncertainty to companies and may act as a deterrent to joining GEMS. According to discussions with the KRA, the current situation is that there is no formal amnesty on past disclosures for listed companies, with each instance being dealt with on a case-by-case basis. There is, however, "a general waiver for penalties and/or interest depending on the circumstances of each case."

While it is easy to understand the National Treasury's unwillingness to grant a general amnesty as a matter of overall tax policy, the current situation invites a company to open itself up to the possibility of a re-assessment. Such uncertainty may deter companies even if they believe they have fully met all their tax obligations. It would be better if there was certainty or limits on the amount of back tax that could be claimed.

4.2 DIRECT AND INDIRECT COSTS OF LISTING ON GEMS

This section gathers together a limited amount of data on the costs of GEMS listings. Gathering the data and drawing conclusions has been challenging for a number of reasons:

- Fees charged by service providers are negotiable and therefore actual fees are commercially sensitive. It is fairly rare in these sort of projects to be able to get precise figures for listing fees and the fact that some data has been provided is down to the goodwill of the companies involved.
- Indirect costs are not measured or captured by companies or disclosed by service providers.
- There had only been one GEMS listing and a handful were in process at the time the fieldwork was conducted.

The information presented in this section was therefore predominantly obtained in discussion with Home Afrika, the first GEMS listed company, as well as another SME which is currently in the process of listing on GEMS.

Direct costs

All direct costs are negotiable and it seems that companies negotiate quite hard. Given the small sample of data, it would be unfair to give too much detail of costs that are commercially sensitive. The two firms that supplied data incurred costs for NOMAD and legal of between KES 2 million and 4 million. The NOMAD costs are continuing because of the requirement to maintain a NOMAD at all times.

In addition, listed companies must pay the depository, CDSC, an initial and on-going fee to maintain the share register. Again, from limited data available the cost of this service ranges from KES 500,000 to KES 1 million.

The NSE, like other exchanges, charges initial fees for new companies.The initial fees for Home Afrika were KES 145,000. However, the NSE has since decided to waive such fees on GEMS admissions.

Indirect costs

Indirect costs include three main elements:

- *The cost of getting adequate accounts to comply with the listing requirements and the cost of restructuring accounting systems to ensure continued compliance.* This is a significant cost and indeed interviewees suggested that this was large; considerably larger than they had expected but largely unquantified. It mainly consisted of the additional staff time and the diversion of time from other activities.
- *The cost of complying with governance/management requirements.* These are similarly larger than expected and include the costs of finding and remunerating NEDs, and recruiting and retaining qualified personnel in the finance and company secretary roles. Over the longer-term, GEMS companies are likely to find that additional roles such as investor relations and compliance are also added to those costs.
- *The cost of management time, which is diverted during the listing process from running the business to managing the listing.* This includes the selection and management of advisers, meetings with potential investors as well as generally managing the process at the same time as running the business.

It has not proved possible to get estimates of these costs, largely because management do not know them and the costs would vary widely between companies depending, for example, on the state of the financial reporting function within the firm.

It is too early to say whether the costs of a GEMS listing are outweighed by the benefits. It is however true that companies in other markets have found that the listing has brought many benefits – not just capital raising – as described above. As the market develops, it is likely that costs will fall through competition and familiarity. It is worth noting that the costs for GEMS are actually quite low when compared to other similar markets. For example, the costs for joining London's AIM are estimated at upwards of £500,000. Firms that join the market will also very likely come to see that sustaining membership of the market is quite complex and that advisers fees are not altogether unjustified. In practice, the sense is that the entry requirements for GEMS are more important in a company's decision to list, as opposed to costs.

Chapter 5

THE GEMS OFFERING

This section considers the incentives available to companies which might list on GEMS. The incentives are additional to the benefits which come from the listing itself (e.g. the ability to raise capital, higher profile, etc, as mentioned above).

The stage at which incentives come into play will be when a company has started to consider a listing and incentives will help ease the final decision for them. It is not likely, and it is probably not desirable, to have incentives which are so powerful that they, in themselves, attract companies. As noted above, this can lead to compliance problems with companies that have no interest in the capital market other than as a way of getting the incentives. A further point is that certain kinds of incentives, such as reduced disclosure, are only useful if investors will accept the reduced disclosure – in practice, they usually do not, so the incentive becomes irrelevant as all companies comply with the minimum requirements of investors.

The incentives for companies fall into a number of types – easier admission criteria, easier processes, tax incentives and fee incentives. The tables below list incentives to join GEMS, incentives to listing in general, and disincentives that are specific to the GEMS market. The effects on companies are colour coded, with **green** indicating that the measure has a significantly positive effect and **red** for other measures that have no effect or a negative effect:

Table 2: Incentives in place to join GEMS

Incentive	Description	Effect on prospective GEMS companies
Easier free-float requirements than for MIMS	GEMS companies are required to list a minimum of 15 per cent of the issued capital and 25 shareholders. The requirement for MIMS is 25 per cent and 1,000 shareholders.	**Very significant** SMEs are always concerned about letting go of ownership so an easy initial threshold is attractive. Most prospective GEMS companies are looking to sell 15 per cent.
Lower size threshold	▪ MIMS minimum issued capital KES 50 m. GEMS minimum issued capital KES 10 m. ▪ MIMS min. net assets KES 100 m. GEMS no minimum.	**Small** The sums for MIMS are actually quite small and for GEMS very small. It would seem unlikely that a company with share capital of KES 10 m is suitable for a public market. The companies who are currently exploring a GEMS could probably meet the MIMS requirement.
Accounts	MIMS companies must have adequate, recent financial accounts. There are no such requirements on GEMS.	**Zero** The market perception is that GEMS need to have good accounts comparable with those for MIMS companies. Investors would be unlikely to buy shares without adequate accounts.
Track record	MIMS must have three profitable years in the last five. No requirement on GEMS.	**Slight for now but potentially important** The population of potential GEMS is taken as the SMEs in the top 100 SME list, pretty much all of which will have a reasonable track record. Going forward, when GEMS starts to attract start-ups and mining ventures, this will become more important.
Admission mainly decided by NSE	For introductions to GEMS the NSE is the front-line regulator with the CMA only coming in with a time-limited option to query an admission. For MIMS the admission process is mainly with the CMA.	**Very significant** The different routes make a considerable difference to the time and equally importantly the certainty of the time taken to gain admission. The time for an introduction to GEMS is reckoned to be about two weeks with considerable certainty. The time for admission to MIMS is considerably longer and far less predictable.

Incentive	Description	Effect on prospective GEMS companies
Tax incentives	The main tax incentives offered for listed companies include: ▪ Listed companies are eligible for a reduced rate of corporation tax (normally 30 per cent) for three to five years following the year of listing; the rate (20 per cent-27 per cent) and period depend on the per centage of capital issued (more than 20 per cent). ▪ There is provision for a waiver of penalties on prior non-disclosures and/or interest depending on the circumstances of each case.	**Slight** ▪ As GEMS companies coming to the market are likely to list the minimum (15 per cent) or not much more and so are not eligible. They may have further issues but that is some way off in the thinking of newly listing companies. ▪ Many SMEs are not aware that there are waivers on past non-disclosures. The fact that these waivers are considered on a case-by-case basis however is likely not to be a strong enough incentive to attract SMEs to list and 'open-up' their books to the KRA.
Reduced/ zero fees	Both NSE and CMA waive fees for GEMS companies. Companies joining MIMS pay 0.6 per cent of the value of securities to be listed – minimum KES 200,000, maximum of KES 1.5 million. CMA also levies fees.	**Unclear** Companies are certainly conscious of the direct costs of listing – e.g. NOMAD fees. However, it is not clear that the costs to the NSE are fully justified by the benefits to companies.
GEMS allows foreign companies	GEMS allows companies that are not Kenyan domiciled to list.	**Very significant for some companies** Flame Tree could not list on MIMS

Source: Genesis Analytics and Bourse Consult team analysis, 2014

Table 3: Incentives in place for all listed companies

Incentive	Description	Effect on prospective GEMS companies
Sundry tax breaks for MIMS and GEMS companies	Various exemptions from Stamp Duty for changes to share capital. Various tax deductible expenses such as costs of IPOs and legal costs associated with secondary issues.	**Slight** It is unclear how widely known these incentives are among SMEs. It is likely that they would be discovered only after a listing is being considered, and therefore, be incidental and not causal to the decision to list.

Source: Genesis Analytics and Bourse Consult team analysis, 2014

Table 4: Provisions specific to the GEMS market which act as disincentives

Incentive	Description	Effect on prospective GEMS companies
Need to have a NOMAD	GEMS companies are required to have a NOMAD at all times. There is no equivalent requirement on MIMS.	**Slight** In time the improvement in the quality of NOMADs should improve the perception of their value but for now this is not true in most cases.
Need to train directors	GEMS companies are required to send their directors on the Director Induction Programme.	**Unclear** The intention is valid but the GEMS companies are not persuaded of its value – improved marketing or refocusing the course to meet real concerns such as PSI might help.

Source: Genesis Analytics and Bourse Consult team analysis, 2014

Chapter 6

GEMS COMPARED TO OTHER MEANS OF FINANCING

Section 2 above identified access to finance as one of the foremost needs of SMEs in Kenya as in most countries worldwide. The previous section then documented what incentives have been put in place to attract SMEs to list on GEMS. This section draws on both these inputs to compare GEMS against a range of alternative financing choices available to SMEs in Kenya.

To do so, the analysis in this section is structured as follows. Several criteria have been identified that guide the choice made by SMEs, how to raise finance. These criteria are used as a basis to compare different forms of finance, spanning from the most informal (loans from family and friends, for example), to the most widespread (bank financing), and to the more sophisticated capital market options (such as bond finance or public equity). A simple qualitative rating scale is then used to determine how important each criteria is to the decision of SMEs to access any particular financing option. This rating is informed by the views of SMEs interviewed in-country. Finally, an indication of the relative supply and demand for each financing option helps to identify particular pressure points.

The criteria that have been used are as follows:

- **Ease of access** – Is the type of financing easily reachable for SMEs?
- **Speed of access** – Can SMEs attain the financing relatively quickly?
- **Cost of finance** – Is the financing relatively cheap for the SME?
- **Value added** – Does the type of financing add knowledge and expertise to the SME?
- **Disclosures required** – Are the disclosure requirements for financing favourable?
- **Length of finance** – Is the term of finance suited to the long-term needs of SMEs?
- **Information and awareness** – Are SMEs aware of the type of financing?
- **Profile** – Does the financing raise the profile of the business?
- **Sustainability** – Is the form of financing sustainable in the long-term?
- **Control** – Can the owner still maintain some ownership and control of the business?
- **Funding demand and supply gaps** – What is the demand from SMEs for the particular type of financing and are there any supply gaps present in the type of financing?

Table 5: A comparison of various types of SME financing in Kenya

Types of SME Financing			Ease of access Is the financing easily accessible?	Speed of access Can SMEs attain financing relatively quickly?	Cost of finance Is the financing relatively cheap for the SME?	Value added Does the financing add knowledge and expertise?	Disclosures required Are the disclosure requirements favourable?	Length of finance Is the term of finance suited to the L-T needs of SMEs?	Info and Awareness Are SMEs aware of the type of financing?	Profile Does the financing raise the profile of the business?	Sustainability Is the form of financing sustainable in the L-T?	Control Can the SME owner still maintain ownership and control?	Funding demand and supply gaps
Informal Financing			Yes	Yes	Yes	No	Yes	No	Yes	No	No	Yes	Significant demand/No funding gap
Commercial Banks	Long-term Financing		Yes	Yes	No	Somewhat	No	Yes	Yes	No	Somewhat	Yes	Significant demand/Major funding gap
	Short-term Financing		Yes	Yes	No	No	Yes	No	Yes	No	No	Yes	Significant demand/Small funding gap
Capital Markets	Equity: Other NSE Segments	Private Placement	No	Somewhat	Somewhat	Somewhat	No	Yes	No	Yes	Yes	Somewhat	No demand/Major funding gap
		IPO	No	No	No	Somewhat	No	Yes	No	Yes	Yes	Somewhat	No demand/Major funding gap
	Equity: The GEMS Market	Private Placement	No	Somewhat	Somewhat	Yes	Somewhat	Yes	No	Yes	Yes	Somewhat	Small demand/Small funding gap
		IPO	No	No	No	Yes	Somewhat	Yes	No	Yes	Yes	Somewhat	Small demand/Small funding gap
	Bond Market		No	No	No	No	No	Yes	No	Somewhat	Yes	Yes	No demand/Major funding gap
	OTC Market		No	No	No	No	Somewhat	Yes	No	No	Yes	Somewhat	No demand/Major funding gap
SME Development Finance Programs			Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	No	No	Yes	Small demand/Small funding gap
Government SME Finance Schemes			Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	No	Yes	Small demand/Major funding gap
Private Equity / VC			No	No	No	Yes	No	Somewhat	No	Somewhat	Somewhat	No	Small demand/Small funding gap

Legend: Yes; Somewhat; No. Significant demand/Major funding gap; Significant demand/No funding gap; No demand/Major funding gap; Small demand/Small funding gap; Significant demand/Small funding gap; Small demand/Major funding gap

Source: Genesis Analytics and Bourse Consult team analysis, 2014

Table 5, above, identifies the largest funding gaps for SMEs in Kenya as including: long-term bank finance, public finance raised on the main board of the NSE, bond finance, OTC market finance, and finance from government SME finance schemes. Whilst the term of equity and bond finance and longer dated bank finance may be well suited to the capital needs of growing SMEs, this kind of finance is simply out of the reach of SMEs for a combination of reasons, including: high disclosure requirements, lack of collateral and limited cash flow certainty. Meanwhile, while the term of government finance may be more suitable (shorter in duration) to the needs of SMEs, stakeholders interviewed suggested that the lack of certainty and continuity associated with this type of finance was a major reason why it is not sustainable for SMEs.

On the demand side, Table 1 confirms the views expressed by most SMEs interviewed in country: that informal and short-term bank finance is the most prevalent means of finance for SMEs. In comparison, demand from SMEs for other alternatives such as financing through GEMS, from private equity investors or from development finance institutions is far more limited. By and large this finding reflects a lack of awareness, and understanding, among entrepreneurs of these financing options.

Overall, GEMS fares relatively well when compared to other options for finance available to SMEs in Kenya. At the highest level, what hinders GEMS from being a financing option of choice is: awareness of the market and of the benefits of a listing among entrepreneurs, ease of access for SMEs located outside of Nairobi, and, in the case of an IPO, the cost and speed of obtaining finance through GEMS. GEMS does, however, provide SMEs with a sustainable and relatively cheap form of long-term financing and also provides additional benefits to SMEs such as the ability to raise the profile of the business, as well as stronger governance mechanisms.

6.1 INFORMAL FINANCING

Informal financing is the preferred method of obtaining finance for SMEs in Kenya. This finding is confirmed in the literature and from the interviews conducted in-country[4]. Informal financing can take many forms. The most prevalent include:

- Funds received from family and friends;
- Funds from retained earnings; and,
- Funds from other companies that the entrepreneur owns.

Among these alternatives, funding from family and friends seems to be the most common, principally because it is easy to access. In large part the reliance on family and friends tends to be a coping mechanism where bank financing is not granted. Another option for SMEs to obtain informal finance is to fund their future operations through retained earnings. This option, however, is less common as it assumes: i) that entrepreneurs hold a portfolio of businesses from which they can draw capital; and ii) they are able to build up a pool of retained earnings from these companies to fund organic growth. Interestingly, a high number of interviewees indicated that this was established practice among SMEs in Kenya. It is unclear, however, whether this particular choice of financing mechanism is deliberate or whether it is simply the result of limited alternatives.

Incentives and benefits

That informal financing is the most popular option among SMEs is not surprising as it is relatively easy to access, quick to attain and costs less than most other forms of financing available. It is usually the easiest way for an SME owner to finance the business, hence is in high demand. Crucially it does not require the submission of any documentation or the presence of any governance structures in the business. This is extremely favourable for SMEs, since most do not have sufficient record-keeping procedures, or even a business plan which they can use to justify formal financing. Informal financing also allows the owners of the company to maintain ownership and control of their businesses, something that is especially important for family-owned SMEs.

Constraints

Although widely used, informal financing was acknowledged by stakeholders interviewed as not being a suitable or sustainable type of financing for the long-term capital needs of SMEs. This is purely due to the uncertainty of the future availability of funds from friends, family or from other businesses the entrepreneur controls.

Another key finding from the interviews is that informal financing methods are mainly utilised by SMEs because of a lack of knowledge and awareness of other means of financing. Though relatively intuitive, this finding is important

Types of SME Financing	Ease of access Is the financing easily accessible?	Speed of access Can SMEs attain financing relatively quickly?	Cost of finance Is the financing relatively cheap for the SME?	Value added Does the financing add knowledge and expertise?	Disclosures required Are the disclosure requirements favourable?	Length of finance Is the term of finance suited to the L-T needs of SMEs?	Info and Awareness Are SMEs aware of the type of financing?	Profile Does the financing raise the profile of the business?	Sustainability Is the form of financing sustainable in the L-T?	Control Can the SME owner still maintain ownership and control?	Funding demand and supply gaps
Informal Financing	Yes	Yes	Yes	No	Yes	No	Yes	No	No	Yes	Significant demand/No funding gap

Yes · Somewhat · No

Significant demand/Major funding gap · Significant demand/No funding gap · No demand/Major funding gap

Small demand/Small funding gap · Significant demand/Small funding gap · Small demand/Major funding gap

4 The Development of Micro-cap Securities Markets for SMEs in Kenya, CMA, 2010

Types of SME Financing		Ease of access	Speed of access	Cost of finance	Value added	Disclosures required	Length of finance	Info and Awareness	Profile	Sustainability	Control	Funding demand and supply gaps
		Is the financing easily accessible?	Can SMEs attain financing relatively quickly?	Is the financing relatively cheap for the SME?	Does the financing add knowledge and expertise?	Are the disclosure requirements favourable?	Is the term of finance suited to the L-T needs of SMEs?	Are SMEs aware of the type of financing?	Does the financing raise the profile of the business?	Is the form of financing sustainable in the L-T?	Can the SME owner still maintain ownership and control?	
Commercial Banks	Long-term Financing	Yes	Yes	No	Somewhat	No	Yes	Yes	No	Somewhat	Yes	Significant demand/Major funding gap
	Short-term Financing	Yes	Yes	No	No	Yes	No	Yes	No	No	Yes	Significant demand/Small funding gap

Yes Somewhat No

Significant demand/Major funding gap
Small demand/Small funding gap
Significant demand/No funding gap
Significant demand/Small funding gap
No demand/Major funding gap
Small demand/Major funding gap

as it suggests there would be significant benefits from an educational campaign targeted at improving awareness of formal financing options for SMEs in Kenya.

Conclusion

As expected, informal financing methods such as family and friends, retained earnings and other companies fare well in terms of access, speed of financing and awareness of the type of financing. However, when looking at the sustainability of these types of financing for longer-term needs, they fall short. So, while they may be an important source of funding for short-term requirements, they do not sufficiently meet the longer-term capital needs of SMEs.

6.2 COMMERCIAL BANKS

Short-term bank financing is the second most prevalent form of finance for SMEs in Kenya. Practically, this takes the shape of short-term loans issued to the principal of the business or commercial overdrafts offered to the business itself. While there is significant demand for this type of financing, it is not as easy to obtain as informal financing because banks require that SMEs provide evidence of accounting records, business plans and, in some cases, even collateral before extending short-term finance. The funding gap for short-term bank finance is therefore larger than that of informal finance.

Kenyan banks interviewed note the lack of quality information as the biggest hindrance and obstacle to SME lending[5]. As a consequence, they find it difficult to evaluate and monitor even small-value loans made to SMEs. Anecdotal evidence reported by some stakeholders suggests that a lack of competition in the banking sector also deters banks from reaching down market to lend to smaller businesses. Although there are over 40 banks in Kenya, the majority of the market is controlled by only a handful of providers.

That said, interviews with market stakeholders suggest that bank lending to SMEs is on the rise in Kenya as these becomes engines of economic development. Recent statistics[6] show that around 17 per cent of total bank lending in Kenya is directed towards SMEs, higher than in Nigeria, South Africa, Tanzania and Rwanda. Banks in Kenya therefore seem more oriented toward financing the needs of SMEs than in other countries. Whilst this is only a small piece of evidence, it is supported by anecdotal accounts offered to the consultants by interviewed SMEs.

Incentives and benefits

Bank financing has proved to be a common type of financing in Kenya because it is easy and quicker to access relative to other forms of finance. More practically, it is also the easiest to understand, and the ubiquity of bank distribution makes it the most visible to SMEs. Another reason why bank financing is attractive to SMEs is that it also allows the owners to retain control of their business.

When looking at the funding granted to SMEs from commercial banks, it is important to distinguish between short-term and long-term financing. Bank financing is seen as an appropriate vehicle to fund the working and short-term capital needs of SMEs. Most Kenyan SMEs who are financed by banks have a revolving credit line/overdraft facility for such requirements. Where the shortfall lies is in financing the long-term needs of SMEs. While long-term financing granted by commercial banks would help to meet the requirements of smaller enterprises, few actually receive such funding due to the risks perceived by banks in doing so.

Constraints

The cost of bank financing is reported as a major obstacle for SMEs. Interest rates vary depending on the type/size of SME and the relationship it may have with the bank, with interviewees suggesting interest rates charged are between 14 and 30 per cent. Such rates are not sustainable for growth stage SMEs, particularly where cash flow is irregular and where future prospects are uncertain. That said some of the larger and older SMEs have managed to build strong and long-standing relationships with their banks, resulting in lower, more manageable interest charges.

SMEs are also impacted negatively by the length of loans granted by commercial lenders. Loans granted tend to be for a short period (less than three years), proving inadequate for longer-term capital requirements. As a

5 Bank Financing to SMEs in East Africa: Findings of a survey in Kenya, Tanzania, Uganda and Zambia, African Development Bank, 2012

6 Bank Financing of SMEs in Five Sub-Saharan Countries, World Bank, 2013

Types of SME Financing			Ease of access Is the financing easily accessible	Speed of access Can SMEs attain financing relatively quickly?	Cost of finance Is the financing relatively cheap for the SME?	Value added Does the financing add knowledge and expertise?	Disclosures required Are the disclosure requirements favourable?	Length of finance Is the term of finance suited to the L-T needs of SMEs?	Info and Awareness Are SMEs aware of the type of financing?	Profile Does the financing raise the profile of the business?	Sustainability Is the form of financing sustainable in the L-T?	Control Can the SME owner still maintain ownership and control?	Funding demand and supply gaps
Capital Markets	Equity: Other NSE Segments	Private Placement	No	Somewhat	Somewhat	Somewhat	No	Yes	No	Yes	Yes	Somewhat	No demand/Major funding gap
		IPO	No	No	No	Somewhat	No	Yes	No	Yes	Yes	Somewhat	No demand/Major funding gap
	Equity: The GEMS Market	Private Placement	No	Somewhat	Somewhat	Yes	Somewhat	Yes	No	Yes	Yes	Somewhat	Small demand/Small funding gap
		IPO	No	No	No	Yes	Somewhat	Yes	No	Yes	Yes	Somewhat	Small demand/Small funding gap

Yes · Somewhat · No

Significant demand/Major funding gap · Significant demand/No funding gap · No demand/Major funding gap · Small demand/Small funding gap · Significant demand/Small funding gap · Small demand/Major funding gap

result, many SMEs fund their long-term capital needs with short-term loans, which adds to the already high cost of bank financing.

Financing from commercial banks also lags behind other types of financing in terms of providing broader benefits other than raising capital, such as increasing the profile of the business and the addition of valuable knowledge and expertise.

Conclusion

The high interest rates charged by commercial banks make it difficult for SMEs to utilise bank funds as a sustainable form of long-term financing. Banks are also hesitant to extend such financing to SMEs, due to a lack of information and the uncertainty involved. Therefore, there remains a situation where the demand from SMEs for long-term financing is high, but a major funding gap exists on the supply side. As a result, many SMEs tend to finance their long-term capital needs with shorter-term loans from banks, adding to the already high cost of financing.

In this regard, a GEMS listing is better suited to the needs of SMEs, as it provides the business with a cheaper form of long-term financing. As many SMEs have reported, it also serves as a platform to raise the profile of their business to prospective buyers and to suppliers. Access to non-executive directors and ongoing support from NOMADs also provide valuable knowledge and expertise to the management team of the company. Where a GEMS listing falls short in comparison to bank financing is in the time it takes to raise financing. SMEs interviewed reported being able to access finance from their bank within a week. In comparison, accessing finance through capital markets is a much lengthier process, particularly in the case of an IPO, or debt issue.

6.3 CAPITAL MARKETS

In theory capital markets are ideally suited to the long-term needs of companies. Until the introduction of GEMS, however, capital markets were out of reach of SMEs for a variety of reasons, most importantly because of limited awareness and understanding of capital markets, the high informational and monetary cost associated with accessing capital market participants and services, and the more onerous disclosure requirements associated with raising finance from the public. As a result, the funding gap in capital markets is higher for SMEs than it is for larger corporates, for example. This finding is not unique to Kenya and holds across most markets worldwide.

To shed more light on the relative demand and supply of capital market financing for SMEs, this section reviews the following options in more detail:

- The equity market
    - The GEMS Market
    - Other NSE segments (AIMS and MIMS)
- The bond market
- The OTC market

Equity market: other NSE segments

Exchanges around the world find it difficult to cater for the specific needs of SMEs. In this regard the NSE is no different and, partly by design, the NSE's two other boards, MIMS and AIMS have not attracted SMEs to raise long-term finance. The GEMS market was created specifically to fill this gap.

Incentives and benefits

Listing on MIMS and AIMS can be done through either a private placement or IPO. Private placements seem to be the preferred choice for listing in Kenya, particularly for smaller companies, as it is seen as a faster and cheaper way to access finance than an IPO.

Listing on either board helps raise the profile of the company relative to other forms of financing. Additionally, important management knowledge and expertise are added to the business due to the structural changes made to ensure that the company complies with the corporate governance requirements of the NSE.

Constraints

SMEs, in general, have a poor understanding of capital markets, and are unaware of the ways that they can be used to raise funds. Therefore, many SMEs do not know about, or have even thought of, listing on an exchange to raise capital. Paired with this is the fact that the majority of SMEs simply would not be able to afford or qualify to list on AIMS or MIMS.

Types of SME Financing			Ease of access: Is the financing easily accessible?	Speed of access: Can SMEs attain financing relatively quickly?	Cost of finance: Is the financing relatively cheap for the SME?	Value added: Does the financing add knowledge and expertise?	Disclosures required: Are the disclosure requirements favourable?	Length of finance: Is the term of finance suited to the L-T needs of SMEs?	Info and Awareness: Are SMEs aware of the type of financing?	Profile: Does the financing raise the profile of the business?	Sustainability: Is the form of financing sustainable in the L-T?	Control: Can the SME owner still maintain ownership and control?	Funding demand and supply gaps
Capital Markets	Equity: Other NSE Segments	Private Placement	No	Somewhat	Somewhat	Somewhat	No	Yes	No	Yes	Yes	Somewhat	No demand/Major funding gap
		IPO	No	No	No	Somewhat	No	Yes	No	Yes	Yes	Somewhat	No demand/Major funding gap
	Equity: The GEMS Market	Private Placement	No	Somewhat	Somewhat	Yes	Somewhat	Yes	No	Yes	Yes	Somewhat	Small demand/Small funding gap
		IPO	No	No	No	Yes	Somewhat	Yes	No	Yes	Yes	Somewhat	Small demand/Small funding gap

Yes   Somewhat   No

Significant demand/Major funding gap   Significant demand/No funding gap   No demand/Major funding gap
Small demand/Small funding gap   Significant demand/Small funding gap   Small demand/Major funding gap

AIMS for example, which is a middle market between GEMS and MIMS, requires that companies have share capital of KES 20 million at the time of listing. This is double the share capital requirements of GEMS. It also requires four times as many shareholders as GEMS, a full year's worth of profit, and that the company's net assets immediately before the IPO be valued at no less than KES 20 million.

Equity market: the GEMS market

GEMS shares many of the benefits and constraints mentioned in the other NSE segments. There are, however, a few key differences that make it both easier and more attractive as a venue for SMEs to raise long-term finance.

As is in the case of MIMS and AIMS, private placements seem to be the preferred option for listing on GEMS with the intention of raising the profile of the business in the short-term, and, possibly at a later stage, raising additional finance. Like the other NSE boards, GEMS is not the easiest form of financing to access for SMEs compared to other alternatives. GEMS is also not the fastest, in spite of the lower requirements set for the market compared to AIMS or MIMS. Like other NSE markets, GEMS also suffers from a lack of awareness as to the real benefits of listing and raising finance on public markets.

Where the GEMS Market does differ to the other NSE segments is in the relative ease of accessing the market, the lower cost of listing, the added value provided by training programmes for directors, and the higher level of control afforded to the owner/s of the business. As confirmed in interviews with prospective GEMS companies, all of these factors contribute to making GEMS better suited to the needs of SMEs than other markets provided by the NSE.

It is also important to note that the GEMS Market is attractive and open to all types of entrepreneurs (novice/target, portfolio and serial), and caters for companies that are at varying stages of the business life cycle. It also allows foreign registered companies to list.

The companies that are currently listed on GEMS would have qualified to list on MIMS, and have most likely listed on GEMS due to the lower free-float or due to GEMS allowing international listings. Having said this, it is important to note the need for GEMS to attract smaller companies, if it is to make an impact on SME financing in Kenya.

Bigger companies initially listing on the secondary market is not uncommon, and is seen in many second-tier markets globally. However, as the market develops, and the listing costs become cheaper, more smaller companies are enticed to list on the exchange. How long this takes is uncertain, and depends on the nature of the development of the market. It is also important to attract small SMEs that are properly run and fully compliant with the listing requirements.

The GEMS market may not be able to address the needs of all small SMEs (especially those that are in stable industries and are not likely to grow fast). However, a more vibrant GEMS market will assist the VC industry, for example, which in turn would aid SME financing. Therefore, the GEMS market is a key part of the SME financing solution.

Types of SME Financing		Ease of access: Is the financing easily accessible?	Speed of access: Can SMEs attain financing relatively quickly?	Cost of finance: Is the financing relatively cheap for the SME?	Value added: Does the financing add knowledge and expertise?	Disclosures required: Are the disclosure requirements favourable?	Length of finance: Is the term of finance suited to the L-T needs of SMEs?	Info and Awareness: Are SMEs aware of the type of financing?	Profile: Does the financing raise the profile of the business?	Sustainability: Is the form of financing sustainable in the L-T?	Control: Can the SME owner still maintain ownership and control?	Funding demand and supply gaps
Capital Markets	Bond Market	No	No	No	No	No	Yes	No	Somewhat	Yes	Yes	No demand/Major funding gap
	OTC Market	No	No	Somewhat	No	Somewhat	Yes	No	No	Yes	Somewhat	No demand/Major funding gap

Yes   Somewhat   No

Significant demand/Major funding gap   Significant demand/No funding gap   No demand/Major funding gap
Small demand/Small funding gap   Significant demand/Small funding gap   Small demand/Major funding gap

Types of SME Financing	Ease of access Is the financing easily accessible?	Speed of access Can SMEs attain financing relatively quickly?	Cost of finance Is the financing relatively cheap for the SME?	Value added Does the financing add knowledge and expertise?	Disclosures required Are the disclosure requirements favourable?	Length of finance Is the term of finance suited to the L-T needs of SMEs?	Info and Awareness Are SMEs aware of the type of financing?	Profile Does the financing raise the profile of the business?	Sustainability Is the form of financing sustainable in the L-T?	Control Can the SME owner still maintain ownership and control?	Funding demand and supply gaps
SME Development Finance Programs	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	No	No	Yes	Small demand/Small funding gap
Government SME Finance Schemes	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	Somewhat	No	Yes	Small demand/Major funding gap

Yes   Somewhat   No

Significant demand/Major funding gap; Small demand/Small funding gap; Significant demand/No funding gap; Significant demand/Small funding gap; No demand/Major funding gap; Small demand/Major funding gap

Bond and OTC markets

The bond and OTC markets are two other possible mechanisms for SMEs to obtain long-term finance in capital markets.

Although in theory it is well suited to SMEs, longer-term capital needs, the corporate bond market is only a viable form of financing for larger corporates and parastatals. The level of awareness among SMEs of the existence or nature of the corporate bond market is likely to be very low. Even if SMEs knew or understood the bond market, it is still nascent and has not attracted significant issuance among these more mature types of businesses. The uncertainty of future profits is also a key barrier to SMEs accessing bond markets. The lack of detailed reporting and financial statements among SMEs would also discourage prospective investors from purchasing the debt of an SME.

The OTC market in Kenya is just as underdeveloped as the bond market. According to stakeholders interviewed, there are currently only a handful of companies that trade OTC in Kenya. By the nature of the market, information about the market and its participants is not public knowledge. SMEs are therefore highly unlikely to know about or understand the use of the OTC market to raise long-term financing.

The practice of using OTC markets to facilitate SME financing seems a generally uncommon practice in that it is genuinely small-scale and is often regulated. In many countries the preferred approach is to let these markets emerge and grow organically before putting in place a regulatory framework to govern their operation.

Introducing a simple regulatory structure – such as requiring more transparency – would assist the development of the market and so improve the trading of unlisted stocks on the Kenyan OTC market, which exists but lacks development and basic transparency. In this way, the OTC market in Kenya could potentially be developed as a stepping stone to the GEMS market.

Although the development of OTC markets specifically for SMEs would provide one additional option for SMEs looking to raise long-term finance, the merits of doing so in the current context need to be considered. In many countries, OTC markets have emerged in the absence of an alternative market segment dedicated to SMEs. In other words, international experience is that countries either have an exchange dedicated to SMEs (like GEMS), or have developed an OTC market for such companies.

Conclusion

When SMEs require long-term funding, capital markets provide them with a better and cheaper form of financing than others. The requirements needed to access capital markets, in whatever form, also help SMEs to better streamline their governance structures and accounting records; things which help build better companies.

Despite the benefits, SMEs in Kenya appear wholly unaware of the range of options available within capital markets and need to be educated on the benefits of raising financing through capital markets as well as the requirements to do so. Interviews suggest that once SMEs are aware of capital market alternatives, particularly GEMS, they would see significant value in the benefits and even requirements, associated with raising finance publicly.

6.4. SME AND GOVERNMENT FINANCE PROGRAMMES

SME finance programmes and government finance schemes are common mechanisms for extending public finance to SMEs. Typically funded and managed by public sector or donor entities, these programmes play an important role in providing credit to enterprises that have difficulties in attracting private finance. These funds can be disbursed in various ways, including:

- To financial institutions that provide long-term capital to private enterprises;
- Directly to private enterprises;
- To private sector intermediaries (such as other funds) who then invest in private enterprises involved in development projects; or
- Through risk sharing or guarantee instruments.

Examples of SME development partners include the International Finance Corporation (IFC), the European Investment Bank (EIB), and Norfund. Other examples of initiatives in Kenya include the investments made by the Industrial and Commercial Development Corporation (ICDC) and the African Development Bank (ADB).

Many of these programmes tend to channel financing to the agribusiness sector, understandably so, as it is a large part of the Kenyan economy and employs a large share of the working (formal and informal) population. However, these initiatives are somewhat constrained by the small size of funding disbursed relative to both demand and to other forms of financing.

Types of SME Financing	Ease of access	Speed of access	Cost of finance	Value added	Disclosures required	Length of finance	Info and Awareness	Profile	Sustainability	Control	Funding demand and supply gaps
	Is the financing easily accessible?	Can SMEs attain financing relatively quickly?	Is the financing relatively cheap for the SME?	Does the financing add knowledge and expertise?	Are the disclosure requirements favourable?	Is the term of finance suited to the L-T needs of SMEs?	Are SMEs aware of the type of financing?	Does the financing raise the profile of the business?	Is the form of financing sustainable in the L-T?	Can the SME owner still maintain ownership and control?	
Private Equity / VC	No	No	No	Yes	No	Somewhat	No	Somewhat	Somewhat	No	Small demand/Small funding gap

Yes / Somewhat / No

Significant demand/Major funding gap; Small demand/Small funding gap; Significant demand/No funding gap; Significant demand/Small funding gap; No demand/Major funding gap; Small demand/Major funding gap

Stakeholders interviewed also questioned the sustainability of these funding mechanisms, particularly those funded by government.

Biashara Kenya is a recent government initiative that has been undertaken to merge certain public sector development funds to better facilitate SME financing. The reason for merging is due to the fragmented nature in which these funds operate. The hope is that merging the funds into one structure will have a far greater impact on SME lending in Kenya.

Incentives and benefits

SME finance programmes can assist SMEs indirectly through a financial institution or SME fund, or directly into an underlying enterprise. How this is done affects the cost of financing, as well as the support given to SMEs. When funds are lent indirectly through banks, for example, additional costs are added on top of the initial costs faced by the SME.

Direct investments are also usually accompanied by some form of knowledge transfer, either in the form of technical assistance or training. This is not necessarily the case with indirect funding.

Another benefit of SME finance programmes is the fact that it allows SME owners to still maintain control and ownership of their businesses, and in the process makes it a more attractive form of financing.

Government funded initiatives also, to some extent, help SMEs to raise the profile of their business. The reason for this is that they may potentially assist the SME in attracting more work from government-related projects such as government procurement.

Constraints

The major constraint of these programmes is the longer-term sustainability of funding. While a few of these schemes do offer longer-term loans, the majority provide finance on a much shorter basis. Therefore, it is difficult for the majority of Kenyan SMEs to rely on such funding for their longer-term needs. Additionally, these initiatives cannot be sustained indefinitely due to constraints on government funding, and are thus better suited to helping kick-start broader SME financing.

Conclusion

On the demand side, Kenyan SMEs are in need of some form of funding from SME financing schemes. On the supply side, however, there is a difference between the funds offered by SME development finance programmes and government SME finance schemes. This is primarily due to the tight financial constraints faced by government. In this regard, it is imperative that more sustainable forms of long-term SME financing be found.

Listing on the GEMS market compares quite favourably to the funding received by SME finance programmes. While these schemes may provide access to finance cheaper than listing on an exchange, they are not seen as a sustainable form of financing for the long-term capital needs of SMEs. Additionally, a GEMS listing adds more value to the SME in terms of knowledge transfer and management expertise, and also provides a better platform for the enterprise to raise its profile.

6.5. PRIVATE EQUITY AND VENTURE CAPITAL

Private equity and venture capital are alternative forms of financing that have been prevalent in developed financial markets for some time. These investments are made at various stages of a company's life cycle, and are used to provide both seed capital as well as funds to grow existing businesses. They are made over the medium to longer-term (between five and ten years), and are usually made into companies with high growth potential.

Although private equity financing has been around for a while, it has only recently begun to make a meaningful impact in Africa. According to Deloitte[7], East Africa was the region with the most private equity activity in 2013. Kenya is actually seen as one of the most active destinations for private equity investments on the continent, with 23 per cent of all deals for 2013 taking place in the country, at a value of US$112 million. Although the majority of these investments have been made into the larger Kenyan corporates, the number of SMEs that have been able to access private equity financing has steadily increased [8].

Venture capital investments have also been shown to be successful in the Kenyan context. Research[9] indicates that venture capital investments made in Kenya have increased the profitably of the businesses' invested in, as well as helped to create additional employment.

Incentives and benefits

7 Deloitte (2014) Private Equity Confidence Survey

8 Gatawa, J (2014) A Survey of Private Equity Investments in Kenya,, European Journal of Business and Management

9 Memba et al. (2012) Venture Capital: Its impact on Growth of SMEs in Kenya, International Journal of Business and Social Science

Private equity financing provides an SME with various other benefits in addition to capital raising. Indeed, many SMEs are attracted to private equity funding due to the knowledge and expertise brought in by prospective investors.

Many SMEs in Kenya struggle due to a lack of information, knowledge, expertise and key contacts within the market they operate in. Private equity financing helps in this regard, as investors usually bring in expertise and know-how to help the business fulfill its true potential. Investors play an active part in the company, making them professional and allowing them to grow. They are able to bring in technical expertise to help with the day-to-day running of the business, as well as add input into the strategic management decisions of the company. In addition, many private equity firms have contacts within the market that the SME operates in, as well as around the world, potentially opening up new avenues for the SME's products and services.

All in all, private equity is able to provide extensive support, both financially and strategically, tailored specifically to the size and stage of an SME.

Constraints

Private equity funds have had difficulty in gaining traction among SMEs in developing countries due to ownership concerns [10]. Private equity investments usually require that the PE firm take a controlling position in the company it invests in. However, this tends to be a sticky issue among SME owners across Africa and in Kenya specifically. Many SMEs tend to be family-owned and hence are unwilling to relinquish a large share of control to external investors.

Information around the use and benefits of private equity financing is also lacking. Many SMEs do not know of, or understand, the workings of private equity as a vehicle for finance. Indeed, the lack of awareness around private equity in Kenya is seen as one of the key challenges facing private equity funding.

Private equity financing may also not provide the exposure that an SME may want to raise their profile among the general public. While private equity financing may provide contacts to key players, it does not offer the public exposure that a listing on GEMS would.

Another constraint to private equity financing is the disclosures and information required before capital is granted. Most investments require extensive financial reports and business plans, which many SMEs do not have. This makes it difficult for private equity investors to put a value on the business, and in turn reduces the chances of granting an SME financing.

Conclusion

Private equity financing provides SMEs with management knowledge and expertise, as well as possible contacts to key industry players. However, it compares less favourably to a GEMS listing, primarily because of the amount of control that owners need to relinquish to private investors. Additionally, it does not provide an SME with the exposure that it could potentially get by listing on a public market.

Having said this, private equity activity within Kenya has steadily increased, with numerous investors coming into the market over the last few years. Additionally, more of these funds are being channeled into SMEs. Due to a lack of awareness from SMEs of private equity investing, a situation exists where there is little demand for such financing. On the supply side, however, there are numerous investors looking for prospective companies, and therefore there is no funding gap seen within the market.

10 Non-traditional private equity financing can be a win-win solution for SMEs, World Bank, 2013

Chapter 7

LEARNING FROM INTERNATIONAL EXPERIENCE

Many exchanges around the world have attempted to create an alternative exchange in order to attract smaller companies. The results have been mixed, with a few proving to be extremely successful (such as AIM and NASDAQ), and others not.

This section reviews some of the experiences of other exchanges around the world in developing second-tier markets aimed at smaller enterprises. The aim, therefore, is to see if any meaningful lessons can be drawn from these markets, in order to better position the GEMS offering.

The markets that have been reviewed include:

- South Africa
- Canada
- United Kingdom
- Ireland
- Malaysia
- Brazil

7.1 SOUTH AFRICA – THE JSE ALTERNATIVE EXCHANGE (ALTX)

The AltX is the JSE's board for good quality, small and medium-sized high-growth companies. It is aimed at various companies, including: family-owned businesses, junior miners, black economic empowerment companies and startups.

Formed in 2003, the AltX recently celebrated its tenth anniversary. In that time, the exchange has had its fair share of ups and downs. Since inception, 109 companies have listed on the board, with around R35 billion in capital being raised [11]. Of these, 23 companies have graduated to the Main board. Currently, there are 60 counters listed on the board, with a total market cap of R33 billion.

Stepping stone

The JSE actively markets the AltX as a 'stepping stone' to the Main board, and in doing so provides companies with a clear and structured growth path to making the step up. The exchange has been fairly successful in this endeavour, with 23 companies having made the move to the JSE's Main board so far.

It is important to note that a high failure rate is tolerated on the AltX, with the JSE management team measuring success according to the number of companies that have grown and developed during their time on the exchange, as well as by the number of listings moving up to the Main board.

Internal JSE research[12] indicates that AltX listed executives believe that their listing has helped them meet their objectives, whether these be raising capital, improving business processes or distinguishing them from their unlisted peers. Over 92 per cent of respondents surveyed indicate that they made acquisitions post their listing, indicating that the AltX is a catalyst for growth.

Education and awareness

The JSE has placed an important emphasis on educating and promoting the benefits of the AltX market. The exchange holds various roadshows across South Africa in a bid to attract SMEs to the board. In this regard, the AltX has a dedicated business development team that visits targeted companies to market its offering.

Policy incentives

Currently there have been no policy incentives put in place by the National Treasury to either attract listings onto the AltX market, or to incentivise investors to invest in companies listed on the board.

A concern for the JSE is the lack of institutional participation on the board. The majority of investors participating in the market are retail investors, which is in stark contrast to other successful secondary markets around the world, such as LSE's AIM Market. Here, institutions form the bulk of trading participants. A prime reason for wanting to attract more institutional participation is due to them focusing more on the fundamental qualities of companies, while retail investors tend to respond more to emotion.

Lessons

- **Patience.** The AltX management team within the JSE have allowed the market to develop and mature, and in the process have been willing to tolerate a high number of failures.
- **Clarity in role of the exchange.** The market has been clearly defined as a means to develop, grow and eventually move up to the Main board. While this may not have worked in other exchanges, it seems to have been fairly successful in the JSE's case. Important here is the fact that the JSE has clearly defined the role that the AltX plays, and actively assists companies in realising the move to the Main board.
- **Marketing and communication.** AltX has a dedicated business development team that educates and trains targeted companies around the country.
- **Importance of institutional participation.** The presence of institutional investors is a key characteristic of many of the successful second-tier markets. It is therefore important to increase institutional participation within the GEMS Market.

11 AltX commemorates 10th year anniversary, https://www.jse.co.za/news/altx-commemorates-10th-year-anniversary, 2014

12 According to data received from the JSE

Table 6: A comparison of the listing requirements between JSE's Main Board and AltX

Listing Requirements	Main Board	AltX
Share Capital	R25 million	R2 million
Profit History	3 Years	None
Pre-tax Profit	R8 million	N/A
Shareholder Spread	20 per cent	10 per cent
Number of Shareholders	300	100
Sponsor/DA	Sponsor	Designated Adviser
Publication In The Press	Compulsory	Voluntary
Number Of Transaction Categories	2	2
Special Requirements	N/A	Appoint Financial Directors
Annual Listing Fee	0.04 per cent of average market capitalisation with a minimum of R26,334 and a maximum of R121,700 (including VAT)	R22,000 (including VAT)
Education Requirements	N/A	All directors to attend Director's Induction Programme

Source: JSE website

7.2 UNITED KINGDOM – ALTERNATIVE INVESTMENT MARKET

The Alternative Investment Market (AIM) is an exchange regulated market operated by the London Stock Exchange (LSE). Under EU law the full lists are governed by directives such as the Prospectus Directive and regulated by the national regulator (for the UK, the UK Listing Authority – UKLA). Trading venues, such as exchanges, are allowed to set up their own regulated sub-markets with their own rules and admit companies to trading. The trading venues have an overall responsibility to the national regulator to run orderly, fair markets.

AIM was set up in 1995 and replaced two earlier markets – the Unlisted Securities Market (USM) and the Third Market. These earlier markets were founded on limited disclosure and had not achieved great success. AIM is designed to appeal to smaller, newer companies. As described in Section 8, AIM has experienced ups and downs following the path of the national and global economies. Over its history, the type of company joining AIM has changed as investment interest has changed – for example from UK leisure stocks in the late 1990s to mineral companies in the late 2000s. At the end of October 2014 AIM had 879 UK companies and 217 non-UK companies giving a total of 1,096, with a total market value of £71.5 billion. In the first 10 months of 2014, AIM admitted 95 new companies and raised £4.8 billion.

Generally, investors including institutional investors treat Main Market and AIM companies as similar in terms of disclosure although AIM has lower free-float and minimum size requirements.

Admission and regulation

The regulations are determined and enforced by the LSE. However, as in Kenya, the regulator is involved if there is money-raising. AIM applicants are required to appoint a NOMAD who acts to ensure the company is in compliance at all times with the AIM regulations. AIM disclosure standards are regarded as essentially the same as those for the Main Market, though the details of documentation requirements are set by the LSE rather than by the national regulator. Entry requirements and continuing requirements are different to the Main Market(see Table 7):

Table 7: A comparison of the listing requirements between LSE's Main Market and AIM

AIM	Main Market
No minimum market capitalisation.	Minimum market capitalisation.
No trading record requirement.	Normally three-year trading record required.
No prescribed level of shares to be in public hands.	Minimum 25 per cent shares in public hands.
No prior shareholder approval for most transactions.	Prior shareholder approval required for substantial acquisitions and disposals.
Nominated Adviser required at all times.	Sponsors needed for certain transactions.
Admission documents not pre-vetted by the Exchange or by the UKLA in most circumstances. The UKLA will only vet an AIM admission document where it is also a Prospectus under the Prospectus Directive.	Pre-vetting of prospectus by the UKLA

Source: London Stock Exchange

The continuing disclosure obligations are the same. AIM companies can use private placements for secondary capital raising (instead of rights issues) if shareholders consent. AIM companies can engage in acquisitions and disposals without the need to gain shareholder approval.

NOMAD regulation is the responsibility of the LSE and the LSE has been totally willing to deregister NOMADs if their performance in achieving compliance is poor.

Education and awareness

AIM is marketed as a separate entity and has its own department at the LSE. There is no implication that companies should move to the Main Market. Companies can and do remain on AIM for as long as it suits them. AIM is also marketed as a distinct and separate entity and has its own operating department. It also has its own index as well as special events, such as the AIM Company of the Year.

Trading

AIM companies trade on one of several trading platforms depending on their size/trading volume. They may be purely order-driven, hybrid with continuous market maker quotes or purely market maker. For all platforms, brokers are able to negotiate trades privately and then enter them into the trading system – which is the norm for substantial transactions.

Policy incentives

Transactions in AIM shares are exempt from UK Stamp duty which is 2 per cent.

Lessons

The key lessons for Kenya which can be extracted from the UK experience include:

- **Strong disclosure requirements are essential.** in practice, investors will shun companies and markets where disclosures are perceived as partial.
- **Lead role of exchange.** the exchange has developed a model which suits the needs of the market and has outlasted other small cap markets
- **Delegation to stock exchange works,** and in turn to NOMADs, but the exchange must impose strict regulation on NOMADs to maintain quality.
- **No focus on sectors –** the type of companies joining AIM has changed over the years, as the economy and investment interest have changed. The nature of companies on the exchange has thus evolved organically as opposed to through a specific focus on certain sectors of the economy.
- **Flexibility –** in secondary issues and other transactions is acceptable to investors where costs justify.
- **Separate marketing –** encourages focus on developing the separate market.
- **Special ethos –** AIM is seen as a market for dynamic, high growth companies and companies can stay on AIM as long as it suits them.

7.3 REPUBLIC OF IRELAND – ENTERPRISE SECURITIES MARKET (ESM)

Like the LSE's AIM, the ESM is an exchange regulated market operated by the Irish Stock Exchange (ISE), and also replaced an earlier unsuccessful market. It is targeted at smaller, growth companies and is designed to meet the funding needs of companies at earlier stages in their development. In practice it mainly targets Irish companies which have joined the AIM market. It currently has 25 companies with a total market value of € 63.3 billion. Of this market value € 60 billion is represented by the residual parts of two failed banking institutions. Of the remaining 23 companies, 21 are also listed and traded on AIM (one is also listed in Toronto).

Table 8: A comparison of the listing requirements between the ESM and Main Securities Market

Enterprise Securities Market (ESM)	Main Securities Market
No specific admission criteria other than the requirement for an applicant to have a minimum market capitalisation of €5 million.	Detailed conditions for listing required.
No trading record required.	Normally, a 3 year trading record is required.
No minimum number of shares to be held in public hands.	Minimum of 25 per cent of shares to be held in public hands.
No pre-vetting of ESM admission documents by the ISE.	Pre-vetting of listing particulars by the ISE prior to circulation.
In most instances, no prior shareholder approval of substantial acquisitions and disposals.	Prior shareholder approval required for substantial acquisitions and disposals.

Source: Irish Stock Exchange

Admission and regulation

The regulations are determined and enforced by the ISE but are designed to be very close to the AIM requirements. However, as in Kenya, the national regulator is involved if there is money-raising. Companies are required to appoint and maintain a corporate finance adviser. ESM disclosure standards are regarded as essentially the same as those for the Main Securities Market though the details of documentation requirements are set by the ISE, rather than by the national regulator. Entry requirements and continuing requirements are different to the Main Securities Market:

Education and awareness

The ESM is marketed as an adjunct to listing on other markets for Irish companies. The emphasis is upon streamlining of procedures so that listing on the ESM is a very low-cost addition to listing on another market – same documentation, integrated processes.

Trading

Trading is on an electronic order-driven platform. Most of the stocks are also traded in the UK market.

Lessons

The two key lessons from Ireland's experience that are applicable to the Kenyan context are:

- **Strong disclosure requirements are essential –** In practice, investors will shun companies and markets where disclosures are perceived as partial.
- **Simple processes –** will attract businesses especially where the stocks are likely to be cross-listed.

7.4 CANADA – TSX VENTURE EXCHANGE (TSXV)

The TSXV was created in 2001 when the TMX (which owns the Toronto Stock Exchange – TSX) purchased the Canadian Venture Exchange (CVE) and rebranded it. CVE had been created in 1999 after an agreement among the various Canadian exchanges and at the encouragement of the regulators who were concerned about the chequered past of the Vancouver Stock Exchange. The listed companies were largely mineral companies but also included some hi-tech companies. TSXV retains a strong mining and minerals orientation.

Canada, being close to the US and considerably dependent upon US investors, is somewhat constrained in its regulatory stance. It examined the possibility of following the AIM model in the mid-2000s but saw it as too risky.

TSXV lists a large number of companies: – end August 2014 figures are 2,005 companies with a market value of C$35.6 billion. It is open to both Canadian and non-Canadian companies with 140 foreign listings.

Admission and regulation

The TSX has a number of tiers within each market segment depending upon size, industry sector, how close the company is to profitability, and so forth. The documentary requirements vary from tier to tier and sector to sector – for example mineral exploration companies have to make specified disclosures about reserves. For initial requirements, the parameters measured as well as the level required also vary from tier to tier and from sector to sector. Some examples are shown in the Table 9.

The requirements seem to offer a lot of fine detail but on key measures, such as those shown in the table, the differences are fairly slight.

The ongoing disclosure and reporting requirements are the same as for the TSX.

TSXV offers a unique model for listing, the Capital Pool Company (CPC). Under this model a group of investors can list a shell company and raise money through an IPO. They then have to purchase a private company using the proceeds within two years. This has the effect of transferring the listing decision and listing work to a group of investors who essentially set up a single-investment investment company and then buy a company in a way that resembles a trade purchase. Canadian markets have a history of shell

Table 9: A comparison of the listing requirements on the TSX

	TSXV tier 1 Industrial/ Technology/Life Sciences	TSXV tier 2 Industrial/ Technology/Life Sciences	TSX Industrial Cos.
Net tangible assets	C$5 million	C$750,000	C$7.5 million
Distribution/float	Public float of 1 million shares, minimum 250 shareholders	Public float of 500,000 shares, minimum 200 shareholders	Public float of 1 million shares, minimum 300 shareholders
Sponsorship	Not required	May be required	May be required

Source: TMX

companies and reverse takeovers (as does AIM in the UK) and this structure formalises that investors do not have to wait for a listed shell company to become available as they can set one up themselves.

Education and awareness

The TSXV is marketed as part of a package of markets which are presented as a progression from private finance through TSX Private Markets to TSXV, and ultimately to the TSX main market. The marketing material presents the TSX and TSXV in the same sections and headline statistics are for total TSX+TSXV.

Trading

The TSX and TSXV use the same electronic order matching system for trading.

Lessons

The Canadian experience in developing an alternative market offers some interesting lessons:

- **Strong disclosure requirements are essential** – In practice, investors will shun companies and markets where disclosures are perceived as partial.
- **Complexity may not be wise** – The TSX/TSXV has a lot of complexity in its initial requirements with the aim, presumably, of tailoring them to different needs. But it is not clear whether, a) there is much difference on the key measures; and b) whether much is gained by the fine detail and complexity.
- **Specialisation can work where it matches the structure of the underlying economy** – Over 60 per cent of TSXV companies are mining companies and a further 11 per cent are oil and gas companies, both of which are major economic sectors for Canada. TSXV has tailored its offering to the needs of those companies and their investors. TSXV is thus one of the few examples worldwide of a market with an explicitly focus on attracting extractive-based companies. Given how endowed Canada is with natural resources, this specialisation made sense for TSXV at the outset. Since then it has managed to attract extractive-based companies from across the world. This suggests that initial endowment of natural resources, and hence extractive-based companies, is a key driver of the likelihood of success of a specialised exchange.

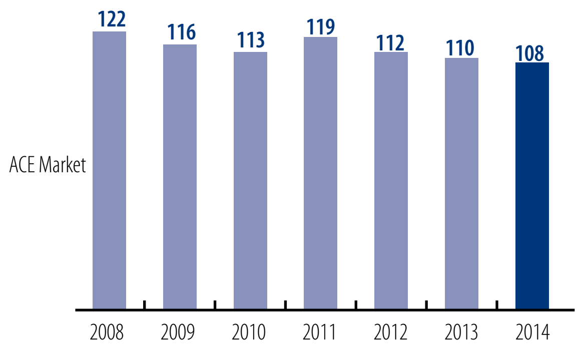
7.5 MALAYSIA – ACE MARKET

Malaysia's foray into creating an alternative exchange for smaller enterprises began with the creation of the MESDAQ in 1997, which was designed to focus on tech companies with high growth prospects. In 2009, Bursa Malaysia (the Malaysian stock exchange) replaced it with the ACE Market, which now focuses on emerging companies from all sectors of the Malaysian economy. Changes were made to the structure of the market in order to:

- Enhance the attractiveness of listing on the exchange.
- Improve efficiency and the time to market.
- Strengthen investor protection through enhanced provisions for greater clarity, integrity and credibility of the company as well as the market.

The market has struggled to grow the number of listings in recent years, with more counters leaving the board than listing. A major issue has been the quality of businesses brought to market, with many having been turned down in recent years. Currently, there are108 companies listed on the exchange.

Figure 2: Number of companies listed on the Ace Market



Source: Bursa Malaysia

Some of the differences between the Main Market and the ACE Market are presented in Table 10.

Sponsors

One of the major changes to the ACE Market has been the move to a more sponsor driven exchange. Sponsors (who are mainly investment banks) in essence fill the role of NOMADs, and are responsible for guiding a company through the listing process. Companies are required to maintain the services of a sponsor for at least three full financial years after listing.

However, this is not the only role of the sponsor. A listing on ACE can only be done through a sponsor, and in reviewing a listing application, the exchange relies on them to determine a company's suitability. Only once a sponsor determines that a company is suitable to list, will an application be sent through to Bursa Malaysia for approval. Essentially, the sponsors take over the Security Commission's (SC) function as gatekeeper, and a lot of responsibility is given to the sponsor to ensure that quality companies are brought to market.

Although there is reputational risk to being a sponsor, many have been criticised for the poor performance of companies brought to market, with some calling for the Bursa Malaysia to step in and monitor the performance of sponsors.

Table 10: A comparison of the Main Market and ACE Market

	Main Market	ACE Market
Who is the market aimed at?	For established companies with a profit record of three to five years or companies with a sizeable business.	Alternative sponsor-driven market designed for companies of all business sectors that have growth potential. No operating or profit record required.
How will a company be assessed?	A company will be assessed in terms of quality, size, operations, management experience and expertise, integrity of directors and key personnel, and public interest by the SC before approving a listing on the main market.	A listing on the ACE Market can only be done through a sponsor, and in reviewing a listing application, the exchange relies on the sponsor to determine a company's suitability.
Attributes required	▪ An identifiable core business ▪ Good corporate governance policies and practices ▪ Management with suitable experience and qualifications ▪ Positive cash flow from operating activities and sufficient working capital for at least 12 months	▪ Visible growth trajectory within the foreseeable future ▪ Sufficient systems, procedures, policies, controls and resources in place to ensure continuous compliance with relevant rules and regulations ▪ Possess internal control and risk management systems
Approval to list granted by?	The Securities Commission (SC)	Bursa Malaysia

Source: Bursa Malaysia

Education and awareness

The exchange has placed great emphasis on ensuring that prospective companies are aware of all aspects of the listing process. In this regard, it has created a comprehensive booklet which is distributed to SMEs around the country, to help guide companies through the listing process. Companies are given a clear timeline of the listing process and how long each step takes, as well as taken through the benefits of listing. Topics covered include:

- Making the decision to list – What factors companies should take into consideration
- The benefits of listing
- Assessing whether the company is ready to list
- Parties included in the listing process and their roles
- How to select a sponsor
- The listing process – A step-by-step walk through including timelines
- Life after a successful listing – What continual listing obligations are required

Lessons

- **Focusing on a particular sector** – As has happened to other exchanges worldwide, the MESDAQ's model of attempting to focus purely on a single sector proved unsuccessful, and thus the ACE Market was subsequently opened up to companies from all sectors. This suggests that in the absence of significant initial endowments of natural resources, such a focus is very difficult to achieve.
- **Sponsors** – Sponsors, or NOMADs in the case of the GEMS market, are the vital link between the SME and the exchange. In this regard, it is important that the exchange ensures that they provide a high standard of service to listed companies and to the exchange.
- **The importance of educating prospective issuers** – Bursa Malaysia has been quite good at ensuring that companies wanting to list are made aware of all aspects of the listing process. It is vitally important that companies are made aware of what a listing entails, and what is required of them, not only during the listing process but also beyond the listing.

7.6 BRAZIL – NOVO MERCADO AND BOVESPA MAIS

The Novo Mercado and Bovespa Mais make up two of the five listing segments of the BM&F Bovespa (The Sao Paulo Stock Exchange). Other segments of the exchange include the Traditional, Level 1 and Level 2 segments.

The different segments adopt progressively more stringent requirements. The Traditional Market is aligned exclusively to Brazilian legislation, whereas Level 1 goes beyond this and requires companies to adopt practices that raise the level of public disclosure to international standards. Over and above these requirements, companies listed on Level 2 are required to adhere to a broader set of corporate governance practices. The Novo Mercado maintains the highest set of corporate governance standards, and requires companies to only issue capital composed of common stock (over and above the requirements of Level 2).

Separate to these markets is Bovespa Mais, a dedicated market segment focused on SMEs but which adopts many of the same stringent requirements of the Novo Mercado.

For the purposes of this report, the key features of Novo Mercado and Bovespa Mais are presented below.

Novo Mercado

The Novo Mercado segment of the Bovespa was launched in December 2000, with the aim of expanding the Brazilian equity market. Only two firms listed on the Novo Mercado in its first three years. Despite this slow start, the market has grown from strength to strength, and between 2004 and 2010, has hosted 81 of Bovespa's 113 IPOs. The segment currently comprises of 132 of the 521 listings on the Sao Paulo Stock Exchange.

The importance of appropriate corporate governance requirements

At the time of Novo Mercado's inception, the exchange was struggling to attract new listings as well as interest in the Brazilian equity market. Between 1995 and 2000, only eight IPOs were conducted in Brazil. Reasons included poor corporate governance requirements as well as the lack of suitable protection for minority shareholders.

In a bid to revive the Brazilian equity market, the Sao Paulo Stock Exchange decided to implement its own listing and corporate governance requirements. This culminated in the creation of the Novo Mercado, a special listing segment based on corporate governance structures, over and above those established by the Brazilian corporate law and capital market regulation. The view was that good governance could reduce the cost of capital and attract investment. The new requirements were voluntary (companies could choose to list on the Novo Mercado with more stringent corporate governance requirements, or list on the Traditional Market which relied only on Brazilian legislation), and were designed to increase investors' interest and confidence in the market. These additional requirements included the adoption of a set of rules that enhanced the rights of shareholders, as well as more transparent and comprehensive disclosure policies. Table 11 summarises the additional obligations required by Novo Mercado.

Table 11: Additional obligations required by Novo Mercado

Requirements of Novo Mercado over and above those required by Brazilian Corporate Law
▪ Capital stock can only be common shares (voting shares);
▪ The maintenance of a minimum free float, equivalent to 25 per cent of total capital;
▪ Public share offerings have to use mechanisms that favour capital dispersion and broader retail access;
▪ The conditions provided to majority shareholders in the disposal of the company's control have to be extended to all shareholders, e.g. minority shareholders as well (tag along rights)
▪ The establishment of a unified two-year term for all boards of directors, which must consist of a minimum of 5 members, and of which 20 per cent need to be independent members;
▪ The disclosure of annual balance sheets according to IFRS or US GAAP standards;
▪ Improvements in quarterly reports, such as the requirement of consolidated financial statements and a Special Report Review issued by an independent auditor;
▪ Make available annually to shareholders the calendar of corporate events containing the main acts and company events, in addition to the dates of public meetings with analysts and the release of financial information of the company;
▪ Adhere exclusively to the arbitration rules of the Bovespa, pursuant to which the Bovespa, the company, the controlling shareholder, the management and the members of fiscal council, if any, agree to resolve by arbitration any dispute or controversy related to the Novo Mercado listing rules.
▪ Hold public meetings with financial analysts and any other interested third parties at least once a year to present information regarding its financial and economic position, projects and prospects; and
▪ If a decision to delist from the Novo Mercado is made, the issuer´s controlling shareholder must launch a tender offer for the acquisition of all outstanding shares at a minimum price to be established based on an independent appraisal.

Source: BM&F Bovespa

Bovespa Mais

The Bovespa Mais is a special listing segment of the Bovespa aimed at SMEs that need to raise funds to finance their projects. The segment is designed for companies that do not meet the liquidity requirements of the other Bovespa segments, but that are committed to expanding their shareholder base and adhering to corporate governance best practices. Launched in 2005, the OTC-based exchange has struggled to attract companies to the board, with only nine companies currently listed.

Bovespa Mais is designed for smaller companies seeking gradual access to the market. One of the main features of the market is that it allows companies listed in this segment up to seven years to reach the minimum required free float of 25 per cent, as opposed to on the day of listing as in the other segments. This allows companies listed on Bovespa Mais time to make the necessary corporate governance changes and to gradually adjust to having stock market investors. Investors, in turn, also have the opportunity to fully research the company before the IPO.

Companies listed on Bovespa Mais are also exempt from registration fees, and are given gradual discounts on listing maintenance fees (the discount is 100 per cent in the first year, and is gradually reduced to 25 per cent in the fourth year).

The Bovespa Mais is similar to the Novo Mercado, in that companies voluntarily adhere to practices of corporate governance and public disclosures over and above those required by Brazilian legislation. Effective December 1, 2014, the Bovespa Mais Level 2 will also be introduced, allowing for preference shareholders as well.

The key differences between the Mais and the Bovespa's other segments are shown:

Table 12: A comparison between the Mais and other Bovespa segments

<table>
<tr><th></th><th>Bovespa Mais</th><th>Bovespa Mais Level 2</th><th>Novo Mercado</th><th>Traditional</th></tr>
<tr><td>Characteristics of Shares Issued</td><td>Allows the existence of only common shares</td><td>Allows for common and preferred shares</td><td>Allows the existence of only common shares</td><td>Allows for common and pre-ferred shares (as legislation)</td></tr>
<tr><td>Free-float</td><td colspan="2">25 per cent free float up to the 7th year of listing</td><td>At least 25 per cent free float</td><td>No rule</td></tr>
<tr><td>Public offerings</td><td colspan="2">No rule</td><td>At least 25 per cent free float</td><td>No rule</td></tr>
<tr><td>Composition of board of directors</td><td colspan="2">Minimum of 3 members (as legislation), a unified term of up to 2 years</td><td>Share dilution efforts</td><td>Minimum of 3 members (as legislation)</td></tr>
<tr><td>Financial Statements</td><td colspan="2">As legislation</td><td>Minimum of 5 members, of which at least 20 per cent must be independent with unified term of up to 2 years</td><td>As legislation</td></tr>
<tr><td>Annual public meeting</td><td colspan="2">Optional</td><td>Translated into English</td><td>Optional</td></tr>
<tr><td>Calendar of corporate events</td><td colspan="3">Mandatory</td><td>Optional</td></tr>
<tr><td>Tag Along concession</td><td>100 per cent for common shares</td><td>100 per cent for common and preferred shares</td><td>100 per cent for common shares</td><td>80 per cent for common shares (as legislation)</td></tr>
<tr><td>Adherence to the Market Arbitration Chamber</td><td colspan="3">Mandatory</td><td>Optional</td></tr>
<tr><td>Additional disclosure of information</td><td colspan="2">Securities trading policy</td><td>Securities trading policy and Code of conduct</td><td>No rule</td></tr>
</table>

Source: BM&F Bovespa

Other initiatives

BM&F Bovespa is heavily committed to educating the public so as to increase the participation of individual investors in capital markets, and especially on the stock exchange. In this regard, it has a stand-alone Education Institute that offers various programmes open to the general public. The aim of these programmes is to promote financial education and create a culture of saving, planning and personal finance.

The BM&F Bovespa has also vigorously promoted the Brazilian market offshore to increase the participation of foreign investors. It currently has offices in London, New York and Shanghai to help increase foreign participation.

Lessons

Patience and appropriate corporate governance requirements are essential – Only two firms listed on the Novo Mercado in its first three years. Only after three years did the exchange gradually developed and companies started to list more frequently. Since then the Novo Mercado has been an important step forward in the improvement of corporate governance in Brazil, and the segment has now become the standard for transparency and corporate governance demanded by investors in new IPOs.

7.7 CONCLUDING LESSONS

The experience of the various markets examined in this section suggests that markets are often tailored to local circumstances so it is not necessarily wise to rigorously follow the model adopted in another country. There are, however, some key lessons which can be drawn from international experiences. These are:

- **Alternative markets can be slow to start** – AIM and TSXV, the oldest of the alternative markets reviewed, have been around for a long time and were fairly slow to start but are now very successful. A degree of patience is therefore required in getting a critical number of companies to list on the market.
- **Strong disclosure and corporate governance requirements are essential** – In practice investors will shun companies and markets where disclosures are perceived as partial, i.e. less than the main list. Alternative markets therefore should not compromise on standards for listed firms and, in some cases, should impose even stricter governance requirements on would-be issuers.
- **Size requirements for entrants are probably not very useful** – Where they exist they are too small to matter – and the costs of entry probably exclude the smallest anyway. Excessive complexity in initial requirements does not achieve much for the market and may inhibit its natural growth.
- **Streamline processes** – All the marketing material of alternative exchanges internationally stresses the ease and smoothness of the process to come to market and also the certainty of the timescale. These features are vital to issuers and help to keep down the cost of accessing capital markets compared to other sources of finance. These are aspects which should form part of the marketing collateral of the exchange.
- **Flexibility is essential** – Sticking to principles is important but in small cap markets where costs can be high, it is appropriate to adopt a pragmatic and proportional approach. For example, rights issues are expensive so maybe they are not always right for smaller companies. In some circumstances a private placement will be the cheapest and easiest option and existing shareholders may be happy to accept some dilution in the interests of an overall gain. With smaller companies, it is unwise to be too prescriptive and the regulatory structure could acknowledge this and let the shareholders decide.
- **Marketing the exchange is essential** – In order to attract listings and grow the exchange, effective marketing is essential. In this regard, many secondary exchanges around the world have dedicated marketing and business development teams which focus solely on driving the growth and development of the exchange. Closely tied to marketing is education, and the need to ensure that companies are made aware of what a listing entails, and what is required of them, not only during the listing process but also once they are listed on the exchange.
- **Sectoral specialisation is not easy and needs to be carefully managed** - All the markets discussed in this section focus on small cap and growth companies but are indifferent as to which sector of the economy they represent. Canada's market has tended toward attracting extractive-companies due to the country's endowment with natural resources but at the same time it is open to companies from all sectors of the economy. In this case, specialisation has worked for the market because it closely reflects the structure of the underlying economy. Once a market becomes known as a sector-specific market, companies from across the globe tend to gravitate toward the market. This is the case for NASDAQ for tech companies (which has attracted tech companies away from the Tel Aviv Stock Exchange) and for both TSX in Canada and ASX in Australia for mining companies. In the case of Malaysia however specialisation in technology companies did not work due to a limited supply of listings in the chosen sector.

While it may be tempting to position GEMS as a technology or extractive-focused market segment in line with anticipated economic growth areas, the market first needs to develop and mature before it is recognised as such. This is not to say that there is no value in specialisation but rather that the message a new market segment should be communicating is that it accepts all types of companies. Once the exchange starts to grow, then local needs and context can determine if it makes sense to target a particular sector, beyond listing companies across the board. Where this need has been identified, however, and where specific incentives, allowances or exceptions need to be made to accommodate companies from a particular sector, it is important that these do not compromise the integrity or identity of the market by creating a complex lattice of rules for multiple sectors. International experience suggests that this kind of complexity tends to be stifling and should be avoided.

- **Advisers are necessary for companies throughout their development –** Typically an adviser is required and is especially necessary where companies are new to capital markets and their owners are not familiar with obtaining public finance. The pattern is for this support to be ongoing, recognising that companies' capital requirements get more, and not less, complicated over time.
- **Stick to a pattern that works** – While other models should not be followed slavishly, there is no gain to a small cap market from being different from others just for the sake of it. This is especially true if a market hopes to attract cross-listings.

Chapter 8

CHALLENGES AND OPPORTUNITIES

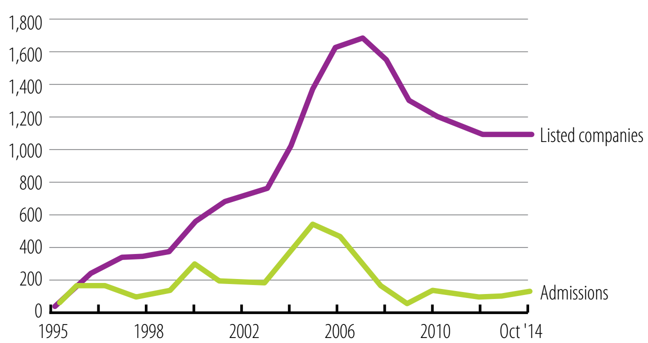
This section brings together the issues which have been discussed to provide a systematic statement of the challenges identified during the project.

8.1 SMALL CAP MARKETS ARE RISKY, VOLATILE AND NOT EASY TO START OR SUSTAIN – BUT KENYA HAS TIMED IT WELL

The first point to make is that slow starts are not unusual in small cap markets (or indeed any new markets) – as Figure 3 below shows. The LSE's AIM (AIM UK) started in 1995 with 10 companies (most of which transferred from a previous small cap market) and at its peak had about 1,700 companies. The chart also shows the susceptibility of small cap markets to economic circumstances:

- AIM UK grew rapidly in its earliest years
- Admissions tailed off in the mid-1990s as the UK suffered a recession
- Admissions boomed through to the early 2000s until the tech crisis struck
- Admissions rose rapidly in the boom of the mid-2000s
- The market fell away in the global crisis
- The slow recovery in the UK (and global economy) has kept admissions low

Figure 3: The number of companies and admissions on AIM (1995 – 2014)



Source: London Stock Exchange

This volatility also reflects the risky nature of small cap markets – these companies are more vulnerable to economic swings than main markets. Since its peak, AIM experienced a net loss of about 600 companies. During that time over 500 companies have been admitted, this implies (with some simplification) that about two-thirds of the companies that were on AIM UK at the peak in 2007 have since left. Some will have been taken over, some will have decided to go private but many will have just failed. Many others will have prospered, which explains investors' continued interest – it is risky but the returns are there for a good investor.

This raises three points for Kenya:

1. If GEMS succeeds then it will be by attracting companies which are deemed too risky for the MIMS market – too small, too tightly held and with too little a track record. There will inevitably be a significant number of failures and it is therefore essential that the regulators are comfortable with this. The path that Kenya is following is one of full disclosure so investors know what they are getting into and therefore must accept the risks. However, for this to succeed it is important that investors are sufficiently educated about risk to accept what may happen – and that not too many failures occur in the early days of the market. The poor price performance of Home Afrika is generally seen as a factor which has deterred investors and issuers and must not become the norm. Fortunately, the performance of Flame Tree Group on introduction has been reassuringly good.

2. Timing is important in starting a small cap market. AIM managed to start in a boom time and prospered – few small cap markets have survived for nearly 20 years. GEMS is starting at a time when the world economy is still in difficulties though probably in recovery. But while the world economy affects performance of Kenya's economy, given its level of exports, it is less of a factor for the SME companies. The more direct factors are Kenya's own level of economic activity and business cycle.

3. More importantly, it is starting at a time when Kenya is at the beginning of a period of rapid economic progress. So the timing for GEMS is good. The initially slow response was partly a consequence of the performance of Home Afrika but the indications are that a reasonable pipeline is now building up.

8.2 REGULATION STANDARD IS RIGHT BUT REGULATORY PROCESS NEEDS STREAMLINING

The challenge in setting up SME markets is how to have more relaxed requirements than the main list without scaring investors away. Where markets have tried to have substantially lower disclosure standards, they tend to fail – for example the Neuer Market in Germany and the Vancouver Stock Exchange in Canada. The successful template appears to have very similar disclosure requirements to those of the main market but to allow newer, smaller, more tightly held and generally more risky companies into the market. This is the model chosen by GEMS and it seems the right choice.

The outstanding challenge for the NSE and CMA, once the market is established with a reasonable number of issuers, is to simplify the process for money-raising issues. Currently the process for GEMS IPOs is seen as cumbersome, difficult, expensive and risky – all things likely to deter companies from joining. To date, this has not mattered very much as companies have chosen to list by introduction and raise money by a pre-listing private placement. This is undesirable, in itself, since it means that the money-raising is largely unregulated, that most investors are excluded from the initial money-raising and that liquidity is impaired by the limited shareholder base. More importantly, when the GEMS companies come to make a secondary issue through a rights issue they will have to use the extended process for money-raising issues. If GEMS is to take its place as a significant source of finance for SMEs it will require that the regulatory process for money-raising issues is considerably streamlined. The lack of flexibility in secondary issues may also hinder development.

Regulation of NOMADs

The regulation of NOMADs is a particular issue for the NSE. There are 24 registered NOMADs, about half of which are licensed brokers. The quality is said to be very variable and the market perception of NOMADs is not generally high. At the same time, certain NOMADs who are known to be good are judged by some to be too expensive. So far the market has not been fully persuaded of the value of NOMADs.

The regulation of NOMADs should aim to weed out the weaker participants including those whose compliance capabilities appear weak, enhance the capability of the stronger participants and generally boost the market's perception of NOMADs. There is some perception that the NSE is not very strict in its enforcement of NOMAD rules so, to counteract this, the NSE should be seen to be maintaining strong discipline and working to raise standards. There is currently pressure to relax the requirement to have a NOMAD at all times. The NSE believes that the requirement is right and that it is consistent with international practice, which it is. However, if it wants to resist the pressure to relax the NOMAD requirement it will have to be seen to be acting to drive up the standards of and the value added by NOMADs.

8.3 ENHANCING TARGETED MARKETING TO REACH THE RIGHT AUDIENCES

The NSE has put considerable effort into marketing through advertising. However, the level of awareness among prospective GEMS companies remains considerably low. Companies either are not aware of GEMS or have only a vague grasp of the costs and benefits of joining GEMS. Some had been in contact with NSE – for example at KPMG Top 100 SME receptions – but this has not been followed up aggressively. They also have little knowledge of the costs that would be incurred, what they would get in return (in the way of benefits for those costs) or how they should go about the process of getting a listing.

It is disappointing that the NOMADs have not been more active in marketing GEMS and it is not clear why they have not sought to sell the product more aggressively. It therefore falls to the NSE to lead the marketing effort. As the market grows, awareness will increase but the NSE will have to drive that process as well.

In other markets the marketing strategy has been based around the idea that the new market was exactly the place to be for SMEs and that they should not want to be anywhere else. Most SMEs see themselves as dynamic, growing companies and they want to be part of a market that recognises those features and attracts other like-minded companies, and the investors who are interested in that type of higher risk/higher return investment. The NSE could encourage such an ethos by supporting GEMS events, GEMS-focused publications and GEMS-focused press coverage.

The NSE faces three issues to think about in marketing:

- Successful SME markets (and other markets) have tended to succeed when they have a champion who is dedicated to the market and becomes known as the champion of the market - "Mr. GEMS" (or Ms. GEMS, of course). These markets had their own department specifically focused and slightly separate from the exchange and very separate from the function marketing full listings. The NSE does not have this yet, though it is understood that this is currently under consideration.
- In two of the most successful SME markets, AIM and NASDAQ, there is no sense that the market is a "junior" market or that companies will at some time be "promoted" to the main market. Companies are encouraged to feel that the market, AIM or NASDAQ is right for companies like them – dynamic, growth companies. No one wants to be in the second division or to anticipate a time when they will cease to be a dynamic, growth company. The situation in Kenya is different. In part this is because currently investors expect a rapid move to MIMS – hopefully this will change. However, the literature of the NSE also suggests that GEMS is a junior market.
- The GEMS market has waived entry fees. While this is attractive it limits the resources available for marketing GEMS. Maybe this could be reconsidered after the initial group of companies is safely on board.

8.4 LIQUIDITY IN SMALL CAP MARKETS IS ALWAYS A CHALLENGE WITH NO COMPLETE SOLUTION

Liquidity in small cap stocks is always difficult. The small size of the companies means that the level of two-way order flow is too small to support a liquid market. One contributor to the problem is that only 15 per cent free-float is required for a listing on GEMS. However, this is a major attraction for GEMS and so it would not be wise to change it. The current template of private placement followed by introduction also limits liquidity as private placements are only distributed to a handful of investors. But the much more extensive documentation, higher cost, and longer and more uncertain timeline mean that private placements will remain the norm.

So if the underlying distribution of shares cannot be changed it becomes important to look for market structure solutions which can aid liquidity. There are two types of liquidity requirements in a small cap market:

- Block transactions where investors or, indeed, directors wish to buy or sell large amounts of stock.
- Small transactions where retail investors wish to buy or sell small amounts.

Block transactions

Normally these are transacted by negotiation. There is too much risk for any counterparty to enter into a transaction without knowing quite a bit about the initiator. The risk is that the initiator, particularly if the initiator is a director, may have substantial inside information on the company. There is also the risk that, in a very illiquid market, the price will move against the initiator once the order becomes public. For both these reasons the normal process is for intermediaries to conduct negotiations. It will take some time and the negotiations will be carried out in secret. Normally brokers and/or NOMADs will lead the negotiations since they know where the stock is and where there might be interest.

Regulators and exchanges can do little to ease this process. There have been various attempts at bulletin boards to disseminate expressions of interest but these have not generally been very successful. However, overly intrusive regulation can impair the process of negotiation:

- An excessive requirement for pre-trade transparency (i.e. exposure of orders to the market) can make negotiation difficult if not impossible and should be avoided.
- Requirements that other investors should somehow be able to participate in the trade (by being able to submit orders at the negotiated price and having them filled by reducing the amounts the initiator or counterparty buy or sell) are helpful up to a point. This can be achieved by requiring such negotiated trades to be "put through" the market – essentially the broker concerned submits a buy and a sell order to the order book and any other orders on the book which can be executed at the put-through price are executed (so one party to the negotiated trade will get either buy or sell less than they anticipated). Such arrangements do improve fairness and may encourage liquidity providers to submit orders knowing they will not be bypassed by cross trades. These arrangements can make such transactions too risky or just not worthwhile for the main participants. It is important that such requirements are finely judged to balance the competing interests.

Market makers, if they exist, are unlikely to be involved in these sorts of transaction as principals (though they may be involved as brokers) since the risks of not being able to unwind a position are so great that the market maker's spread would need to be so wide as to make the trade uneconomic.

Small retail transactions

With these transactions the risks of insider information are slight and the transactions are individually too small to significantly affect the price. There are useful interventions which exchanges can introduce to facilitate these trades. Naturally, an electronic order book will be a good forum for such trading if there is some two-way flow. Bulletin boards can also help in the most illiquid counters. For the moderately illiquid ones market makers can assist.

A market maker or makers (competing quotes is obviously better but realistically, finding one market maker might be difficult enough) could commit to making continuous quotes in small size for the benefit of small investors. Small investors could then be guaranteed liquidity at a reasonable cost – as the market maker was only quoting in small size the risks are small so the spread will not be too wide. It is a common practice, to give market makers some privilege(s) to compensate them for making continuous quotes. Although not studied in Kenya, possibilities include exemption from transaction taxes/fees, access to stock borrowing facilities, access to central bank financing and special privileged access to negotiated trades (perhaps allowing market makers to execute customer orders and close positions).

NOMADs could take the role as market makers (as could any broker but NOMADs are well-placed to know the market for the company's stock). There is a potential conflict of interest, with NOMADs having inside information as already noted, but the small size of their quotes would limit the risk.

The NSE operates an order-driven system and the market-making system could be designed to integrate with this as a hybrid market mechanism. The LSE operates a system known as SETSqx. This is designed to be a predominantly market-maker quote-driven system but there are facilities to enter orders which are displayed. However, displayed orders are not matched continuously but are processed in four intra-day auctions (plus and opening and closing auction). In between the auctions the trading is solely with market makers and market makers are not obliged to interact with any displayed orders (see discussion of crosses above). Market maker trading is by telephone so market makers can, and do improve on their displayed quotes. This is controversial but is probably the price of getting market makers to participate. Other markets do it differently – for example, NASDAQ requires that orders have priority over market maker quotes. This encourages investors to submit orders but may make market making not worthwhile. The balance is quite fine and the NSE will need to consult extensively to see whether firms would want to act as market makers and what privileges and execution priorities are consistent with a sustainable market-making system.

Chapter 9

RECOMMENDATIONS

The following sections (9, 10 and 11) list all the recommendations on how to develop GEMS, grouped together into logical sections. Each of the recommendations is discussed in detail. This is then followed by a table summarising the key recommendations and indicating which organisation (between the CMA, NSE, FSD Kenya, and others) is responsible for implementing the recommendation, the priority of the recommendation and its expected ease of implementation.

GENERAL

Be patient

This is not an 'active' recommendation but a practical one. SME markets often take a while to get off the ground and attract adequate interest. Once they start to attract interest they can develop a persona of their own which makes them attractive to similar companies who see the persona as consistent with their view of themselves. In November 2014, the NSE welcomed the second company to GEMS and there is a pipeline of other companies currently going through the listing process.

Understand risk tolerance

By definition SME markets are more risky than main markets. Is the market, regulator and government willing to accept a relatively high level of failure on companies in the SME market? Probably not at the start, so do not be too fearful of making sure that the early entrants have stable businesses which they intend to grow.

Be flexible in structure and target companies

Many SME markets have failed because they were too inflexible such as, focusing excessively on a specific sector, over-regulation, insisting on progress to main markets, excessive entry requirements, and the like. Maintaining flexibility in the early stages of development is a key part of enabling organic growth and for the market to develop a persona of its own. Having said this, it is possible to target certain incentives toward particular types of companies which may be attracted or compelled to list on the exchange. These could include tax incentives aimed at specific sectors: the relaxation of paid-up capital requirements for advertising companies and minimum public ownership and/or listing obligations for companies in the extractive sector (for example, all local mineral operations need to have at least 20 per cent of equity listed on exchange)[13]. This last example is important, because GEMS could be used not only as an avenue for funding within the extractive sector, but also to help broaden local ownership in national resources. Despite the international experience against sectoral focus, this suggests that local needs and context are important in determining if a market segment can target a particular sector of the economy. As the previous section has mentioned, however, this focus needs to be carefully managed so as not to compromise the integrity and identity of the entire market.

13 Kenyans to own 20 per cent stake in mining firms, The Star, 2014, http://www.the-star.co.ke/news/kenyans-own-20-stake-mining-firms-balala.

Start at the right time

SME markets are vulnerable to cyclical effects. Kenya is at the start of an upswing in its own market, which will be affected, but not dominated by global movements, so now is a good time to develop the SME market.

It is also important to note that the GEMS segment has been developed at the same time as the demutualisation of the NSE. The perception of the NSE is improving and confidence in the exchange has been growing steadily. Stakeholders interviewed have confirmed this and have noted the improvement in the NSE's image.

9.1 SUPPLY SIDE – INCENTIVES OFFERED

9.1.1 Expansion of marketing information

Current GEMS companies and prospects know of capital raising (which is usually done after or before the listing) and increasing their profile but are unaware of other benefits, such as:

- Issuing new equity reduces gearing and so potentially increases borrowing capacity;
- Listing implies a regular market price for valuations;
- Listed companies can issue shares to fund or make takeovers of other listed and OTC companies which has been an important source of faster growth for SMEs;
- Importantly, equity financing is cheaper than many other sources of funding, especially capital raising through banks;
- The low free-float of a GEMS listing is especially attractive when compared to other types of financing such as private equity and venture capital;
- These benefits need to be communicated to prospective firms through effective and targeted marketing efforts.

Ideally NOMADs should be the primary source of providing information to SMEs and promoting the attractions of GEMS, as they are (or should be) closest to the companies. They can provide the direct sales effort. However, this needs to be supported by NSE primarily, providing the material they need but also more generic marketing.

Additionally, the NSE needs to keep up to date, and look out for, provisions in legislation that may incentivise companies to list, and actively market such provisions. Examples include tax amnesties (if any are given) and/or incentives, as well as the requirement that all local mineral operations need to have at least 20 per cent of equity listed on exchange.

The recommendation is:

> **1.1 Expand marketing information to include the whole range of attractions of a listing. This includes all the benefits of a GEMS listing, as well as provisions made in legislation to entice companies to list.**

9.1.2 Improve marketing of AIMS or merge AIMS into GEMS

There is no clarity in the market as to the differences between AIMS and GEMS and the consultant view is that having both is having too many market sectors. Therefore, a decision needs to be made to either allow AIMS to continue or roll it into GEMS If it is to continue as a separate sector – which seems one sector too many – then make clear how it differs from GEMS – which is certainly not clear at the moment. The sense is that AIMS requires less disclosure than GEMS – which is unlikely to be sustainable in the longer-term.

The recommendation is:

> **1.2 Improve marketing of AIMS, failing which merge AIMS into GEMS.**

9.1.3 Separate MIMS and GEMS departments

The MIMS and GEMS markets are essentially separate products and each should have their own marketing strategies, which is not likely to occur if they are in the same department. Separation would allow for the appointment of a "GEMS champion" to drive the market forward. Such a champion could:

- Create public awareness of GEMS
- Actively search for potential GEMS candidates
- Educate potential listings on the benefits of listings
- Continue to engage with GEMS companies after listing

The recommendation is:

> **1.3 Create a dedicated GEMS department and staff at NSE.**

9.1.4 De-emphasise the role of GEMS as a path to MIMS

There is an apparent preference among investors for GEMS companies to migrate to MIMS speedily. However, the perception of the capital market is of an intimidating institution to potential GEMS companies – GEMS is scary enough without suggesting they will be encouraged to rapidly move to MIMS. The marketing should stress that progress is at the company's chosen pace. The marketing should also stress that the quality of companies listed on the GEMS market is not necessarily inferior to the quality of companies listed on MIMS. This should also strengthen the perception of GEMS as a market segment in its own right.

The recommendation is:

> **1.4 De-emphasise the role of GEMS as a path to MIMS and manage the perception that the difference between GEMS and MIMS implies a lower quality of listed companies.**

9.1.5 Explore possibility of using market makers to add liquidity to GEMS

Liquidity in SME markets is always a challenge, and is always far less than the liquidity in the main market because the companies are smaller and shares are more tightly held. As a consequence transaction costs are high and most significant transactions are arranged privately by brokers rather than being exposed to the market. Liquidity will be higher if shares are more widely distributed and in this respect the current practice which uses private placements is a restrictor of liquidity.

Market makers can provide liquidity by using their capital to facilitate investor order i.e.: by buying on to or selling from their own inventory. Market makers will quote a spread and this spread will be wider the larger the transaction. In practice, in small cap markets, the model is for market makers to provide continuous, firm quotes in small size and for larger deals to be privately negotiated. The advantage of having market makers is that retail customers can trade easily and that there is a continuous price for valuations.

Dealers would prefer to make quotes when it suits them and to encourage them to make a continuous quote it is usually necessary to offer them an incentive – perhaps a tax break (stamp duty exemption) or preferential access to private trades or similar.

It is not obvious who would take the market-making role in the NSE. The most obvious candidates are the NOMADs (who by virtue of their relationship with the companies will probably know where buying or selling interest lies) but their involvement with the company also makes them potential insiders which would make their market maker quotes suspect. This could be addressed by requiring so-called "Chinese walls" between the corporate finance and trading parts of the firm but this is not an established practice in Kenya.

To introduce market makers would require the development of a regulatory framework for them which would need changes to rules and regulations at the CMA and NSE.

The recommendation is:

1.5 The NSE develops a market-making regime for GEMS.

9.2 DEMAND SIDE

9.2.1 Integrate the listing process to reduce delays

The current process is perceived to involve sequential rather than parallel processing of applications. This may not be entirely fair but the perception (and the process) could be improved by using a common platform for regulatory submissions which can be viewed by all regulatory participants. The CMA would view a parallel processing structure as involving it more closely in the approval process which it would not find acceptable. However, it is willing to accept a single database for information relating to listings and issues. The time for the CMA's "no action" notice is seven days and if this is adhered to then that would be acceptable. It is recommended that the NSE and the CMA consult with stakeholders as to how the process could be streamlined. Of course, if the NSE is given full power to approve capital-raising issues (see below), this recommendation falls away.

The recommendation is:

2.1 Work towards developing a single application process for regulatory submissions.

9.2.2 Give NSE power to approve capital issues including money-raising offers for GEMS companies without necessity of recourse to CMA

The current structure is seen as too rigid, slow and uncertain. Introductions can be approved by the NSE (albeit with some possibility of a late CMA intervention). Public offers require CMA approval and very much more extensive documentation. The consequence is that the normal template is for an introduction with separate capital raising – either through a private placement before listing or a secondary issue later on (though this will be subject to the same CMA rules as for an IPO – see below). Private placements lead to restricted liquidity, and while they should be an acceptable form of issue the regulatory structure should not actively encourage them over public offers. Giving the NSE the authority to approve public offers (subject to appropriate self-regulatory capacity being established at the NSE and approved by the CMA, and of course subject to overall regulatory supervision of the NSE by the CMA) would reduce the time, risk and cost of public offers and encourage their greater use. It should be pointed out that this is common practice for second-tier markets in other jurisdictions. For example, in Europe all admissions to the main list are regulated by the national regulator but all issues on second-tier markets are regulated by the exchanges themselves. The CMA is willing and able to delegate this power to the NSE subject to a consultation process in which the NSE is able to demonstrate adequate capacity to the CMA. The authority of the NSE to regulate capital issues should cover both primary issues and further issues.

The recommendation is:

2.2 The NSE should be given powers to approve capital raisings (both primary and further issues) by GEMS companies subject to apex-level oversight by the CMA as the regulator and licensing authority for the Exchange.

9.2.3 Ease regime for secondary (further) issues by GEMS companies by allowing more flexibility

The current regime is believed to require further issues to be carried out as rights issues (i.e. giving pre-emption rights to existing shareholders). Rights issues are an expensive mechanism for small issues and in other markets which have pre-emption rights, companies are given more flexibility as to the method of issuance – if shareholders give their consent. The impact of such greater flexibility should be explored though consultations with stakeholders with a view to allowing greater flexibility. The recommendation is:

2.3 Review the possibility of greater flexibility in structure of secondary (further) issues by GEMS companies.

9.2.4 Improve opening pricing of introduced companies

The first listing on GEMS suffered severe price falls which have mainly been attributed to incorrect pricing when the company was introduced to the market. Having spoken to other companies who have either just come to market or are in the process of doing so, lessons from the Home Afrika experience seem to have been learnt. Many of the SMEs interviewed have stressed the point of correctly pricing their issue, and the importance of the NOMAD in advising the company to price the issue at a discount to entice and reassure investors. The opening price on the first day of trading appears to be largely arbitrary and driven by factors other than the level of market supply and demand at the time. It would be better if the initial price were to be determined by an auction process or similar so that companies' opening prices were not to be followed by immediate declines.

The tendency to adopt a private placement followed by an introduction exacerbates the problem since the placement price strongly influences the price decided for the opening of the stock on the first day of trading. Therefore, a move towards more public offers or proper book building would also improve the quality of opening prices.

If market makers were introduced (see Recomndation 1.5 above) they would help to stabilise the price – assuming the opening price was right. Alternatively NOMADs could be given a role in stabilising the price in early trading.

The competency of NOMADs to effectively guide companies on pricing should also be evaluated. To do so, certain minimum standards (qualification in securities analysis, for example, or at least a track record of successful valuations) could be considered alongside the registration requirements for NOMADs.

The recommendation is:

> **2.4 Review options for better determining opening price of new listings.**

Options to be considered include using book building to determine a price before opening or using market makers to stabilise the price after opening. Additionally pricing could be improved and standards could be considered to guide pre-listing price setting through minimum qualification requirements for NOMADs.

9.2.5 Develop a consultation procedure to get stakeholder input on new products/regulation

Changing products and rules is complex and as the market matures that complexity increases. It becomes essential for the regulator and the exchange to consult the spectrum of interests before launching new initiatives. Consultation does not mean slavishly following the stakeholders' or markets' opinion but it does mean offering an opportunity for dialogue and attempting to minimise the negative impact of new regulations, and reduce the risk of unsuccessful products. Ideally, consultations should be public and relatively formal as such a structure encourages compliance by stakeholders even when they disagree with the final decision. Kenya's aspirations to become a regional financial hub reinforces the need to have greater flexibility in managing innovation and the need for a robust process to incorporate practitioner expertise into the regulatory response to innovation.

The recommendation is:

> **2.5 Develop consultation procedure to get stakeholder input on new products/regulation.**

9.2.6 Develop the supply chain of GEMS companies by improving the pipeline from VC and PE companies, improving the OTC market, and considering measures to attract companies from specific sectors

GEMS will provide an exit point for PE and VC investors. There is an active, though small, VC and PE market in Kenya though there is no regulatory structure supporting it and little transparency. Introducing a simple regulatory structure – such as requiring more transparency – would assist the development of the market and so improve the GEMS pipeline. Similar comments can be made about the trading of unlisted stocks on the OTC market which exists but lacks development and basic transparency. Additionally, it is important to identify opportunities specific to the local economy and assess the viability of incentives and other measures to attract companies from certain sectors. At this early stage, GEMS has the potential to be a useful tool for extraction funding and for addressing the local component aspects of companies operating in that industry.

Specific recommendations are:

> **2.6 Encourage direct VC/PE involvement in bringing companies to market**.
>
> **2.6 Develop simple regulatory structure for VC and PE market.**
>
> **2.6 Develop OTC market as stepping stone to GEMS.**
>
> **2.6 Consider options to attract listings from particular sectors of the economy.**

9.2.7 Improve image of the NSE market

NSE has recently demutualised and this will certainly improve its image with users as it becomes clear that the exchange is operating in the interests of all its stakeholders. However, there are still negative elements in the perception of the NSE, and this is a deterrent to companies joining GEMS. In particular the main list is seen as retaining a large proportion of companies that are effectively defunct and where there is next to no trading interest. Such companies, where they exist, also present compliance challenges. Similarly the broking community is seen as containing firms whose interests are not well-aligned with those of market users. The NSE could improve this perception by acting to reduce the number of effectively defunct companies and of poor-quality brokers.

Broadening the business models of stockbrokers would also aid this process. Currently most brokers focus almost exclusively on trading – as opposed to corporate finance or investment management. The growth of firms offering a wider service – investment banks – would raise the quality of broking. Firms should be encouraged to offer a wider range of products and deterrents – such as the current capital adequacy rules should be reduced.

Having said this, the perception of the NSE has steadily been improving and confidence in the exchange has grown. This improvement in the NSE's image has been confirmed by many of the stakeholders interviewed.

The recommendations are:

> **2.7 Continue to monitor listed companies to ensure that companies which bring little benefit to the market and which fail the listing requirements are delisted so as to avoid impairing the vibrant image of the market.**

2.7 Support exchange members in developing wider business models – such as corporate finance – so as to raise the overall standard and viability of broking firms and reduce dependence upon pure agency trading.

9.2.8 Introduce investor education programme to increase risk tolerance

Markets become more efficient through commercial pressure from users and the competitive interactions designed to meet user needs. The current situation with institutional investors in Kenya (and in many other countries) is one where institutional investors are not driven to seek higher returns by their customers. This is combined with a highly cautious investor mindset to produce investment portfolios which lean towards very low risk assets. The result is that investors, whose horizons would suggest they adopt more risky strategies, are managed into inappropriately safe investments and the capital of those investors is not mobilised into more risky, but high potential companies.

An investor education programme could be designed to give investors a more accurate perception of risk, the benefits of diversification and the effect of long time horizons (such as those of pension plans) in reducing risk. The resulting competition to provide investment products more suited to investor needs would increase the supply of capital for risk investment and reduce the long-term cost of pensions and other types of long-term saving.

The recommendation is:

2.8.1 Improve investor education to include education on risk and its mitigation.

9.3 SUPPORT FOR THE MARKET

9.3.1 Retain NOMAD requirement but improve quality of NOMADs and enhance their value by reducing the number and insisting on professional standards for firms wishing to be NOMADs

There is some pressure to reduce the NOMAD requirement to perhaps two years after listing (as opposed to the life of the listing), to address resentment at the cost of a lifelong commitment. The perceived low quality of some NOMADs supports this suggestion. However, the norm in other markets is to require some kind of permanent relationship with an entity skilled in finance and financial compliance – and it might not be wise to dispense with this and rely on the company's own ability to comply and to judge its own financial market needs. The current view seems to be to pay for financial services when required and not at other times. This may encourage short-termism among advisers – for instance overpricing issues rather than developing a long-term, mutually beneficial relationship with investors. The answer may lie in retaining the NOMAD requirement but:

- Broaden the assessment regime for qualification as a NOMAD to include an evaluation of track record over and above competency and qualification. The number of NOMADs seems out of proportion with the likely size of the market and many apparently have little skill. Introducing a minimum standard regime (and confirming this with certification or licensing) would result in increasing the quality of the NOMADs. It would give more confidence to the SMEs that the NOMAD has the skills and track record (in corporate finance and valuation, for example) to do the work and NOMADs keen to get business would be supportive of this regime. Any firm that could not show that its staff had the necessary competencies (in guiding companies on pricing, for example) or was not prepared to undertake the necessary training would not be allowed to operate as a NOMAD. In addition, NOMAD evaluation should involve a continuous evaluation of performance to assess whether their enthusiasm for NOMAD work and their track record of successful issues justifies their continuing registration.
- Create a template or SLA setting out minimum service requirements and contractual obligations between SMEs and NOMADs.
- Encourage brokers to develop a wider range of business approximating to investment banking (IB) – current regulations implicitly discriminate against this by allowing brokers to undertake some IB activities, such as position-taking, but imposing significantly higher capital requirements on firms that explicitly declare themselves to offer the full range of IB services.
- Possibly extending a similar obligation to MIMS companies.

Specific recommendations are:

3.1.1 Review minimum standard regime for NOMADs.

3.1.2 Create SLA for relationship between NOMADs and SMEs.

3.1.3 Review broker regulatory regime and range of permissible activities against conduct and practice of brokers.

9.4 REGULATORY AND POLICY INCENTIVES

Current requirements are recognised to be about right i.e. identical to MIMS. Anything less will scare investors and result in a non-sustainable market as international experience has shown. However there could be some small changes that will assist SMEs coming to GEMS.

9.4.1 Clarify tax amnesty for companies joining GEMS

Discussions with the KRA have confirmed that no general tax amnesty is currently in place, however, there is a waiver in place that does away with penalties and interest associated with previous non-disclosures on a case-by-case basis. The fact that this is considered by KRA on a case-by-case basis, however, is still a disincentive to listing and is probably the worst of all outcomes – companies fear opening their books since if they are unable to negotiate a deal then they are left more vulnerable than before. In this regard, clarity is probably more important than the amnesty itself. Such clarity should be provided as a matter of policy by the National Treasury as well as the KRA as the body charged with implementing tax policy. KRA could lessen the disincentive by making clear that it will not engage in speculative, aggressive "fishing" expeditions against GEMS companies – though it will not turn a blind eye to egregious examples of tax underpayment either.

The recommendation is:

> **4.1 Clarify the current situation on tax waivers for companies joining GEMS, and consider and communicate the use of tax amnesties to incentivise SMEs to list.**

The outcome of this process should be a clear policy statement of the current presence, or not, of any tax amnesty or waivers for listed companies. If no such amnesty or waiver is granted, consideration should be given to the appropriateness of introducing such fiscal tools to incentivise SMEs to list. Regardless of what position is taken, a clear statement should be communicated to the market so that there is absolute certainty on the tax implications associated with accessing public markets. The statement should be careful not to present the KRA as naturally hostile to smaller firms, but should stress that only very severe cases will be pursued strongly and there will not be speculative investigations.

9.4.2 Make taxation incentives relevant to GEMS companies

Current taxation incentives reward large free-float starting at 30 per cent. All current and pipeline companies plan to issue 15 per cent so will not gain from the tax break at the start. Suggestions of tax incentives are though consultation may reveal more effective incentives:

- Further reducing the tax threshold on issued share capital (to make it attractive for companies listing at the minimum 15 per cent level)
- Consider tailoring tax exemptions to incentivise public offers and capital raising at time of inception
- Consider exemptions from dividend withholding tax for listed GEMS
- Re-introduce the tax amnesty on listed firms (or consider exemptions for listed GEMS from penalties and/or interest arising from prior non-disclosure)

The recommendation is:

> **4.2 Consider introducing tax incentives relevant to GEMS companies following consultation with stakeholders to determine the most effective measures.**

9.4.3 Be careful of attracting firms which just want the tax break

There is a risk that the incentives or requirements to list will attract companies with poor compliance capabilities or interest in the market. Thailand offers substantial tax reductions to listed companies and has a large number of poorly compliant companies which bring little to the market and discourage compliance in others. Nepal meanwhile requires finance companies to list and has over half of its market comprised of companies which do not comply and have no intention of complying with any requirements. Egypt is another example where many companies listed to take advantage of the tax amnesty put in place, but rarely traded. Additionally, once listed, many of these companies did not adhere to the exchange's disclosure requirements. It is therefore important to ensure that listed companies are incentivised to meet the continual listing obligations.

The recommendation is therefore to:

> 4.3.1 **Ensure review of GEMS application checks for firms only interested in tax breaks, and to ensure that listed companies are incentivised to meet the continual listing obligations.**

9.4.4 Ease costs of compliance with corporate governance requirements by a more flexible approach to company officers

Improved corporate governance is critical to admission of companies to public markets, and is often seen in hindsight by public companies as a major benefit of listing (improved corporate governance gives access to wider, more experienced and more independent management input for example). However, this can be disproportionately costly for smaller companies. In particular, the requirements for financial officers and company secretaries to be fully qualified may not be completely necessary or affordable for all SMEs. Flexibility – with compliance backed up by a well-regulated NOMAD – is possible and would ease the burden on companies in the early days of listing.

The recommendation is:

> **4.4 Allow greater flexibility on requirements for qualified officers to suit individual company circumstances.**

9.4.5 Assist companies to understand disclosure requirements – especially ongoing requirements.

GEMS entrants do not fully understand disclosure, especially relating to the continuing obligation to inform the market of price sensitive information. NOMADs seem clear on initial requirements but are also vague on what constitutes price sensitive information. Stakeholders interviewed also mentioned that the CMA may say one thing and the NSE another. It is clearly unwise to be dogmatic – by, for example, too closely defining which information is price sensitive – but it would be helpful to offer guidance with examples to allay fears that companies have to disclose commercial secrets and also provide feedback when companies play safe and disclose unnecessary information.

The recommendation is:

4.5 Provide better guidance on disclosure requirements.

9.4.6 Separate regulatory and commercial roles of NSE particularly in regard to GEMS

There is a clear conflict of interest and there is a perception that NSE may be easier on GEMS companies and NOMADs since it has a commercial interest (though the fees are low/zero, the NSE has a commercial interest in growing the GEMS market). The separation of commercial and regulatory functions is international best practice for exchanges and is a necessary component to empower the NSE on capital raising approvals. Once undertaken, it will also be also important to ensure that the market is aware of the change.

The recommendation is:

4.6 Separate NSE commercial and regulatory roles.

Chapter 10

SUMMARY OF RECOMMENDATIONS AND IMPLEMENTATION FRAMEWORK

The following tables indicate the priority, phasing and implementing responsibility for each of the recommendations made in the previous section. For most of the recommendations there are no dependencies so a great deal of the work could be carried out in parallel, depending on the resources available.

In order to achieve the objectives of the project, it is suggested that a small steering committee, composed of the members of this current project steering committee, agree the list of recommendations and the priorities assigned to them. The actual work to achieve the recommendations can then be driven by a dedicated project manager from each body (FSDK, CMA and NSE). These managers should have the delegated authority to push forward to implement the recommendations and have the necessary access to their organisation's senior management and the steering committee to resolve issues that will inevitably arise. As many recommendations require tight coordination between the organisations, the project managers will need to develop good working relationships and meet regularly.

We further propose that the entire project be given a one-year time frame in order to put the necessary focus and urgency on the project, with targets agreed by the steering committee for each quarter.

Legend

The **colouring** of in the tables that follow indicates:

Actions that are very important to the realisation of the plan to improve the number and quality of listings on GEMS are highlighted in red.

Normal actions that still contribute to the achievement of the plan but that are less important are highlighted in grey.

The **time frames** mean:

Short-term – could be achieved within 3 months as relatively straight-forward recommendation

Medium-term – could be achieved within 6 months

Long-term – will take several months to achieve due to difficulty of the task

10.1 DEMAND SIDE INCENTIVES

No.	Action	Short-Term	Medium-Term	Long-Term	Responsibility
1.1	Expand marketing information to include the whole range of attractions of a listing. This includes all the benefits of a GEMS listing, as well as provisions made in legislation to entice companies to list				NSE/CMA
1.2	Improve marketing of AIMS, failing which merge AIMS into GEMS				NSE
1.3	Create dedicated GEMS department and staff at NSE				NSE
1.4	De-emphasise the role of GEMS as a path to MIMS and manage the perception that the difference between GEMS and MIMS implies a lower quality of listed companies				NSE
1.5	NSE develops market-making regime for GEMS				NSE

10.2. SUPPLY SIDE INCENTIVES

No.	Action	Short-Term	Medium-Term	Long-Term	Responsibility
2.1	Work towards developing a single application process for regulatory submissions				CMA/NSE
2.2	NSE be given powers to approve capital raisings (both primary and further issues) by GEMS companies				CMA/NSE
2.3	Review the possibility of allowing greater flexibility in the structure of secondary (further) issues by GEMS companies.				CMA/NSE

No.	Action	Short-Term	Medium-Term	Long-Term	Responsibility
2.4	Review options for better determining opening price of new listings				CMA/NSE
2.5	Develop consultation procedure to get stakeholder input on new products/ regulation				NSE/CMA
2.6.1	Encourage direct VC/PE involvement in bringing companies to market				CMA/NSE
2.6.2	Develop simple regulatory structure for VC and PE market				CMA
2.6.3	Develop OTC market as stepping stone to GEMS				CMA
2.6.4	Consider options to attract listings from particular sectors of the economy				NSE/CMA
2.7.1	Continue to monitor listed companies and enforce removal of companies which are effectively defunct				NSE/CMA
2.7.2	Raise quality and viability of broker members by encouraging the development of wider business models and reducing dependency on pure agency broking				NSE
2.8	Improve investor education to include education on risk and its mitigation				CMA/NSE

10.3 SUPPORT FOR THE MARKET

No.	Action	Short-Term	Medium-Term	Long-Term	Responsibility
3.1.1	Review minimum standard regime for NOMADs				CMA/NSE
3.1.2	Create SLA for relationship between NOMADs and SMEs				NSE/CMA
3.1.3	Review broker regulatory regime and range of permissible activities against conduct and activities of brokers				CMA/NSE/KASIB

10.4 REGULATORY AND POLICY INCENTIVES

No.	Action	Short-Term	Medium-Term	Long-Term	Responsibility
4.1	Clarify the current situation on tax amnesty for companies joining GEMS and reassure firms that they will not be subject to investigation without good cause and only for the most severe breaches.				NSE/KRA/NT
4.2	Introduce tax incentives relevant to GEMS companies after consultation				NSE/KRA
4.3	Ensure review of GEMS application checks for firms only interested in tax breaks, and to ensure that listed companies are incentivised to meet the continual listing obligations				NSE
4.4	Allow GEMS companies to have greater flexibility in meeting the requirement for qualified company officers				CME/NSE
4.5	Provide better guidance on disclosure requirements.				CME/NSE
4.6	Separate NSE commercial and regulatory roles				NSE

Chapter 11

SCHEDULE OF RECOMMENDATIONS

This section lists all the recommendations in the body of the report above and provides, for each action:

- The title of the action itself;
- More details about the action (if necessary);
- The implementation activities;
- Which organisation is ultimately responsible for delivery of the action;
- The expect result of the action;
- How the success of the action should be measured and what constitutes success; and,
- Timing, particular importance (indicated as 'Important') and any dependencies.

11.1 DEMAND SIDE

Action	**1.1 Expand marketing information to include the whole range of attractions of a listing. This includes all the benefits of a GEMS listing, as well as provisions made in legislation to entice companies to list.**
Details	▪ Develop marketing collateral that advises companies of all benefits of listing including: ▪ Issuing new equity reduces gearing and so potentially increases borrowing capacity ▪ Listing implies a regular market price for valuations ▪ Listed companies can issue shares to fund or make takeovers of other listed and OTC companies which has been an important source of faster growth for SMEs
	▪ Marketing collateral should also describe the risks and adequacy of capital market finance compared to bank finance
	▪ The most suitable medium for reaching SMEs should be reviewed (at this stage possible mediums could include booklets published jointly by NSE and CMA or even targeted TV campaigns)
Implementation	Development of marketing material and training of staff responsible
Responsibility	NSE and CMA
Result	Increase in interest in listing on GEMS
Measurement	Increase in listings
Priority / Dependencies	Short-term / None

Action	**1.2 Improve marketing of AIMS, failing which merge AIMS into GEMS**
Details	▪ Potential issuers are not aware of the differences between AIMS and GEMS – there is confusion as to the differences in requirements and the benefits associated with each market.
	▪ In the medium term, if the features and requirements are not too dissimilar and GEMS attracts the same kind of companies as AIMS then consideration should be given to merging the two markets as there is no need to have both sectors in this market
Implementation	▪ In the short-term initiate a project to review the marketing of AIMS with a view toward increasing awareness of the requirements of the AIMS market
	▪ In the medium term undertake a project to combine AIMS and GEMS into one market sector
Responsibility	NSE
Result	▪ AIMS is well known as a market in its own right and vibrant
	▪ Alternatively, that NSE has just MIMS and GEMS as market sectors
Measurement	▪ Increase in listings on AIMS if marketing is successful
	▪ AIMS is merged into GEMS
Priority / Dependencies	▪ Short-term
	▪ Medium-term / Conditional on the success of the previous project

Action	1.3 Create a dedicated GEMS department and staff at NSE
Details	Creating a dedicated GEMS department will allow the appointment of a "GEMS champion" to drive the market forward. Such a champion could: ▪ Create public awareness of GEMS ▪ Actively search for potential GEMS candidates ▪ Educate potential listings on the benefits of listings ▪ Continue to engage with GEMS companies after listing
Implementation	Separate staff into MIMS and GEMS, each with own budget and targets
Responsibility	NSE
Result	Separation of departments
Measurement	More active and focused marketing of GEMS
Priority / Dependencies	Short-term / None

Action	1.4 De-emphasise the role of GEMS as a path to MIMS and manage the perception that the difference between GEMS and MIMS implies a lower quality of listed companies
Details	Entering the capital markets is intimidating enough for SMEs without the added pressure of being expected to rapidly migrate to MIMS. GEMS should be a market segment in its own right.
Implementation	Marketing message to make clear to the market that GEMS is a segment in its own right.
Responsibility	NSE
Result	Perception of GEMS as market in its own right is established.
Measurement	More companies list on GEMS
Priority / Dependencies	Short-term / None

Action	1.5 NSE develops market-making regime for GEMS
Details	NSE actively explores possibilities to introduce market makers to the GEMS market.
Implementation	NSE to consult with its members and develop rules and regulations for market making, for approval by CMA
Responsibility	NSE with approval by CMA
Result	Market maker regime introduced for GEMS
Measurement	Active market making on GEMS
Priority / Dependencies	Medium-term / None

11.2 SUPPLY SIDE

Action	2.1 Develop a single application process for regulatory submissions
Details	A single application process involving the two regulatory bodies (CMA and NSE) is required to improve and speed up the listing process. Recommendations on how the application process can be made smoother should therefore be developed in consultation with stakeholders alongside a broader investigation of other arrangements and processes between the NSE and CMA.
Implementation	Development of new procedures
Responsibility	Capital Market Master Plan technical committee working with CMA/NSE
Result	New procedures put in place
Measurement	Faster turnaround times for listing applications
Priority / Dependencies	Medium-term / None

Action	**2.2 The NSE should be given powers to approve capital raisings by GEMS companies – both primary issues and further issues.**
Details	NSE can approve capital raisings by GEMS companies without the involvement of the CMA
Implementation	CMA, NSE and stakeholders together determine the issue
Responsibility	CMA/NSE
Result	NSE obtains sole powers
Measurement	Companies coming to GEMS to raise capital
Priority / Dependencies	Medium-term / Regulatory capacity needs to be established within the NSE to approve such capital raisings in line with the separation of commercial and regulatory functions (see Recommendation 4.6)

Action	**2.3 Review regime for secondary issues by GEMS companies**
Details	The current secondary issue regime is unattractive to GEMS companies as they have excessive disclosure requirements
Implementation	CMA, NSE and stakeholders together determine the issue
Responsibility	CMA/NSE
Result	Regime changed
Measurement	GEMS companies raise capital subsequent to listing
Priority / Dependencies	Medium-term / None

Action	**2.4 Review options for better determining opening price of new listings**
Details	There is a need to have a non-arbitrary opening price for new listings and reasonable stability thereafter. The tools available could include book-building to find an opening price or using market makers to stabilise the price. Alternatively, standards could be considered to guide pre-listing price setting or to put in place proper book building to improve the quality of opening prices. The competency of NOMAD staff to conduct securities analysis should also be assessed more formally as part of their registration (see Recommendation 3.1.1)
Implementation	CMA, NSE, NOMADs, brokers and other stakeholders together determine the issue
Responsibility	CMA/NSE
Result	New arrangements in place
Measurement	More stable prices in early days following a GEMS listing
Priority / Dependencies	Medium-term / None

Action	**2.5 Develop consultation procedure to get stakeholder input on new products/regulation**
Details	Consultation with all stakeholders makes for better products and better regulation to improve flexibility and support Kenya's development as a regional financial hub
Implementation	Set up regime for actively and positively engaging with all stakeholders when developing products, rules or regulations
Responsibility	NSE/CMA
Result	Better products and better regulatory regime
Measurement	More vibrant capital market
Priority / Dependencies	Short-term / None

Action	**2.6.1 Encourage direct VC/PE involvement in bringing companies to market**
Details	GEMS should be positioned as an ideal exit mechanism for VC/PE investments
Implementation	Engagement of all parties with VCs and PE companies on the benefits of GEMS as an exit point for their investments
Responsibility	CMA/NSE
Result	All VCs and PEs understand GEMS and how it can help them exit
Measurement	Improved GEMS pipeline
Priority / Dependencies	Short-term / None

Action	**2.6.2 Develop simple regulatory structure for VC and PE market**
Details	There is an active, though small, VC and PE market in Kenya though there is no regulatory structure supporting it and very little transparency. Introducing a simple regulatory structure would assist the development of the market and so improve the GEMS pipeline. It is important that the principle and practice of VC involvement is established as a guide to regulatory needs before any regulatory structure is drawn up.
Implementation	CMA to consult with stakeholders and develop the regulatory structure
Responsibility	CMA
Result	Regulatory structure in place
Measurement	Improvement in the GEMS pipeline
Priority / Dependencies	Medium-term / None

Action	**2.6.3 Develop OTC market as stepping stone to GEMS**
Details	An active OTC market can be instrumental in providing a stepping stone to listing
Implementation	Develop rules and regulations for the OTC market
Responsibility	CMA
Result	Rules and regulations governing OTC trading in place
Measurement	Active OTC market
Priority / Dependencies	Medium-term / None

Action	**2.6.4 Consider options to attract listings from particular sectors of the economy**
Details	Local needs and context may matter in determining if GEMS can target a particular sector beyond listing SMEs across the board. Going forward, the NSE and CMA should scope out sector-specific opportunities for GEMS and assess the viability of incentives and other measures to attract companies from certain sectors (for example the extractive sector) without compromising on the integrity of GEMS.
Implementation	CMA and NSE to consult with stakeholders and identify potential sectors that GEMS could target as well as the tools to do so.
Responsibility	NSE/CMA
Result	Incentives and other measures in place to attract companies from targeted sectors within the local economy
Measurement	Improved GEMS pipeline from targeted sectors
Priority / Dependencies	Medium-term / Establishment of a vibrant GEMS market first and foremost

Action	2.7.1 Review current listings and remove defunct companies
Details	Having effectively defunct companies who do not trade is bad for the reputation of an exchange as centre of the capital markets
Implementation	Strengthen review of quality of listed companies and enforce listing requirements to make it difficult for defunct companies to remain listed
Responsibility	NSE with CMA approval
Result	More vigorous monitoring and enforcement of listing requirements.
Measurement	Improvement in quality of listed companies
Priority / Dependencies	Long-term/None

Action	2.7.2 Support and encourage brokers to develop wider and more sustainable business models and reduce reliance on agency broking
Details	NSE brokers need to develop more sustainable business models to reduce reliance on agency broking and to support development of a sophisticated market to support Kenya's aspirations to be a regional financial hub.
Implementation	Encourage and support development of broking firms into investment banks to service a more developed regional market.
Responsibility	NSE
Result	Improvement in quality of NSE membership
Measurement	Less members of NSE but of higher quality with more diverse business models
Priority / Dependencies	Long-term / None

Action	2.8 Improve investor education to include education on risk and its mitigation
Details	A poor understanding of risk makes it difficult for an SME market to thrive and education as to the realities of risk and its mitigation could allow for a more realistic assessment of investments by investors
Implementation	All parties to review and coordinate training and education material
Responsibility	CMA/NSE
Result	New and updated publications and training on risk
Measurement	More investment in GEMS companies
Priority / Dependencies	Long-term / None

11.3. SUPPORT FOR THE MARKET

Action	3.1.1 Review minimum standard regime for NOMADs
Details	Review the minimum standards and the licensing regime for NOMADs to ensure it adequately accounts for the track record and qualifications of NOMADs as well as the necessity of certain requirements (for example continuing reporting requirements)
Implementation	Working group set up with industry to determine what these standards should be. CMA or NSE (to be determined) to develop the licensing regime
Responsibility	CMA/NSE
Result	Less suitable NOMADs are removed from the market
Measurement	Only high quality NOMADs in the market
Priority / Dependencies	Medium-term / None

Action	3.1.2 Create SLA for relationship between NOMADs and SMEs
Details	Set out minimum service standards and contractual obligations between NOMADs and SMEs
Implementation	Working group set up with industry to determine what these standards should be.
Responsibility	NSE/CMA
Result	SLA in place
Measurement	SLA used in all relations between NOMADs and SMEs coming to GEMS
Priority / Dependencies	Medium-term / partly dependent on 2.1.

Action	3.1.3 Review broker regulatory regime and range of permissible activities against conduct and practice of brokers
Details	▪ Current regulations implicitly discriminate against offering more investment banking activities by allowing brokers to undertake some activities, such as position-taking, but imposing significantly higher capital requirements on firms that explicitly declare themselves to offer the full range of IB services.
Implementation	▪ In other cases brokers are prevented from providing advisery services (whilst investment banks can) which is at odds with their role in assisting potential issuers with coming to market and raising finance
Responsibility	Undertake a full review with industry consultation on the relevant regulations
Result	CMA/NSE with input from brokers
Measurement	Review regulatory regime
Priority / Dependencies	Increase in brokers offering wider range of investment bank services Long-term / None

11.4 REGULATORY AND POLICY INITIATIVES

Action	4.1 Clarify the current situation on tax waivers for companies joining GEMS, offer reassurance to GEMS companies that the KRA will not launch speculative inspections on newly listed companies and that only very serious underpayments will invite action.
Details	There is confusion and misinformation about the tax incentives and scrutiny that are applied to listed companies that is preventing companies from applying to join GEMS
Implementation	National Treasury and KRA to make statement on the current tax impact of joining GEMS and their policy towards retrospective investigations
Responsibility	KRA and NT
Result	Clarify the presence or absence of tax incentives and expected tax authority treatment of GEMS companies
Measurement	Tax situation is not mentioned as impediment to firms joining GEMS
Priority / Dependencies	Short-term/ attitude of NT and KRA

Action	4.2 Introduce tax incentives relevant to GEMS companies
Details	Consider tax incentives relevant to GEMS that could be introduced. Possibilities include: ▪ Further reducing the tax threshold on issued share capital (to make it attractive for companies listing at the minimum 15 per cent level) ▪ Consider tailoring tax exemptions to incentivise public offers and capital raising at time of inception ▪ Consider exemptions from dividend withholding tax for listed GEMS ▪ Re-introduce the tax amnesty on listed firms (or consider exemptions for listed GEMS from penalties and/or interest arising from prior non-disclosure) though consultation would be required to identify the most effective measures

Implementation	KRA/NT to review the incentives and engage with the other stakeholders to determine appropriate incentives
Responsibility	FSDK/NSE/KRA and NT
Result	Efficient tax incentives for SMEs to join GEMS
Measurement	More GEMS listings
Priority / Dependencies	Long-term / attitude of KRA

Action	**4.3 Ensure review of GEMS application checks for firms only interested in tax breaks, and to ensure that listed companies are incentivised to meet the continual listing obligations**
Details	It is important not to attract firms to GEMS just so they can obtain the tax benefits
Implementation	Add to list of checks when reviewing GEMS listing applications
Responsibility	NSE
Result	No unsuitable companies joining GEMS
Measurement	No unsuitable companies joining GEMS
Priority / Dependencies	Short-term / None

Action	**4.4 Allow greater flexibility in the requirement for qualified company officers to correspond to the needs of specific, company circumstances**
Details	Having fully qualified company secretaries and finance officers puts an extra burden on SMEs and is considered unnecessary when the companies are supported by NOMADs
Implementation	Regulator and exchange to consult, determine policy and arrange for changes to regulations to allow some flexibility
Responsibility	CMA/NSE
Result	New regulations
Measurement	More companies attracted to GEMS
Priority / Dependencies	Medium-term / None

Action	**4. 5 Provide better guidance on disclosure requirements**
Details	SMEs are unsure of what has to be disclosed, as are the NOMADs and, reportedly, the CMA and NSE
Implementation	Development of best practice guidance
Responsibility	CMA/NSE
Result	Guidance document
Measurement	SMEs and their NOMADs clear on disclosure requirements
Priority / Dependencies	Short-term /None

Action	**4. 6 Separate NSE commercial and regulatory roles**
Details	Having regulatory and commercial roles combined is not good practice internationally and can lead to concerns that commercial interests are put before regulatory ones
Implementation	Separation of personnel into regulatory or commercial roles and the creation of the necessary governance arrangements to support this
Responsibility	NSE, with CMA approval of arrangements
Result	Separation of roles and announcement of the change
Measurement	Increased confidence in NSE processes, and ability for the NSE to approve capital raising approvals for GEMS companies (see Recommendation 2.2 above)
Priority / Dependencies	Medium-term / None

APPENDIX

STAKEHOLDERS INTERVIEWED

The findings of this report are in large part the result of extensive consultation with a variety of market participants, interviewed over two weeks in Nairobi. The contribution of each of these stakeholders to this report is acknowledged and appreciated.

Institution	Contact	Role
FSD Kenya	Gitau Mburu	Policy Specialist
	Francis Gwer	Policy Analyst
	James Kashangaki	Head of Inclusive Growth
CMA	Luke Ombara	Ag. Director, Regulatory Policy and Strategy
	Paul Muthaura	Ag. CEO
NSE	Donald Ouma	Head of Market and Product Development
	Terry Adembesa	Manager, Product Development
	Godfrey Omilly	Senior Officer, Product Development
	Andrew Wachira	Ag. Chief Executive
	Stephen Muendo	Manager, Compliance & Legal
	Tom Kimaru	Manager, Supervision
The National Treasury	Nzomo Mutuku	Senior Adviser, Financial Sector
NSSF	Richard Langat	CEO/Managing Trustee
	Gideon Kyengo	GM Finance and Investments
KRA	Maurice Okelo	Policy Unit; Domestic Taxes Department
	Gemma Gachai	Policy Unit; Domestic Taxes Department
KPMG	Mugambi Wanjiku	Senior Consultant
Chamber of Mines	Stephen Mwakesi	Ag. Chief Executive Officer
Anjarwalla & Khanna	Dominic Rebelo	Partner
Coulson Harney Advocates	Christine Mweti	Partner
Mboya Wangong'u & Waiyaki	Peter Waiyaki	Partner
	Nyambura Karita	Associate
OMK Advocates	Nicholas Gitonga	Advocate
Lingua Communications	Solomon Mahinda	Consultant, Communications & Public Affairs
BSD (EA) Ltd	Eva Muraya	CEO
Burbidge Capital	Edward Burbidge	CEO
Pinebridge Investments	Nicolas Malaki	Senior VP Chief Investment Officer
	Nicholas Ithondeka	Investment Manager
Stanlib	James Muratha	Fund Accountant
Equity Bank	Raphael Devantier	Director for Advisery Services
	Anthony	Corporate Finance
DOB Equity	Mercy Mutua	Senior Manager Business Development
IFC	Grace Ogola	Securities Market Specialist
NIC Capital	Maurice Opiyo	Managing Director

Institution	Contact	Role
Empire Microsystems	James Mworia	Managing Director
Oil and Energy Services	Mwenda Nyaga	Managing Director
	Jean Githinji	COO
Home Afrika	Njoroge Nganga	CEO
	Timothy Kamau	Head of Investor Relations
Flame Tree Group	Heril Bangera	CEO
Kurwitu Ventures Ltd	Abdirahman Abdillahi	Managing Director
Prafulchandra & Brothers Ltd	Mukesh Desai	Managing Director
East African Data Handlers	George Njoroge	Managing Director
Nairobi Enterprises Limited	Raju Dhanani	Managing Director
Cellulant	Ken Kimaita	Knowledge Management
	Jeremiah Gichonge	Competitive Intelligence Officer
Tabaki Freight Services	Reuben Ndegwa	Managing Director

The recommendations made by the consultants also benefited from an early review facilitated by FSD Kenya, the CMA and the NSE as part of the launch of the Capital Market Master Plan Working Group II on GEMS, held on 4 March 2014.

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Financial Sector Deepening

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