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Market Failure Analysis:

IPO's in selected African stock exchanges

2014 – 2019

Executive summary

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This study, tasked by FSD Africa Investments (FSDAi) and undertaken by RisCura, seeks to identify, explain and address the root causes of "market failure" relating to Initial Public Offerings ("IPOs") on African stock exchanges. The study takes a robustly comparative approach, drawing out common challenges and recommended solutions from deep individual analysis of seven stock exchanges, ranging from West Africa (Ghana and Nigeria) to East and Southern Africa (Kenya, Tanzania and Zambia) and Francophone countries (the Bourse Régionale des Valeurs Mobilières or 'BRVM', and Bourse des Valeurs Mobilières de l'Afrique Centrale or 'BVMAC').

In each of these focus markets, RisCura conducted surveys and interviews – commencing in January 2020 – with key stakeholders from across the stock market eco-system, including issuers, exchange operators, regulators (capital market authorities), private equity firms, intermediaries (brokers), and investors (retail and institutional, as well as local and international).

Challenges

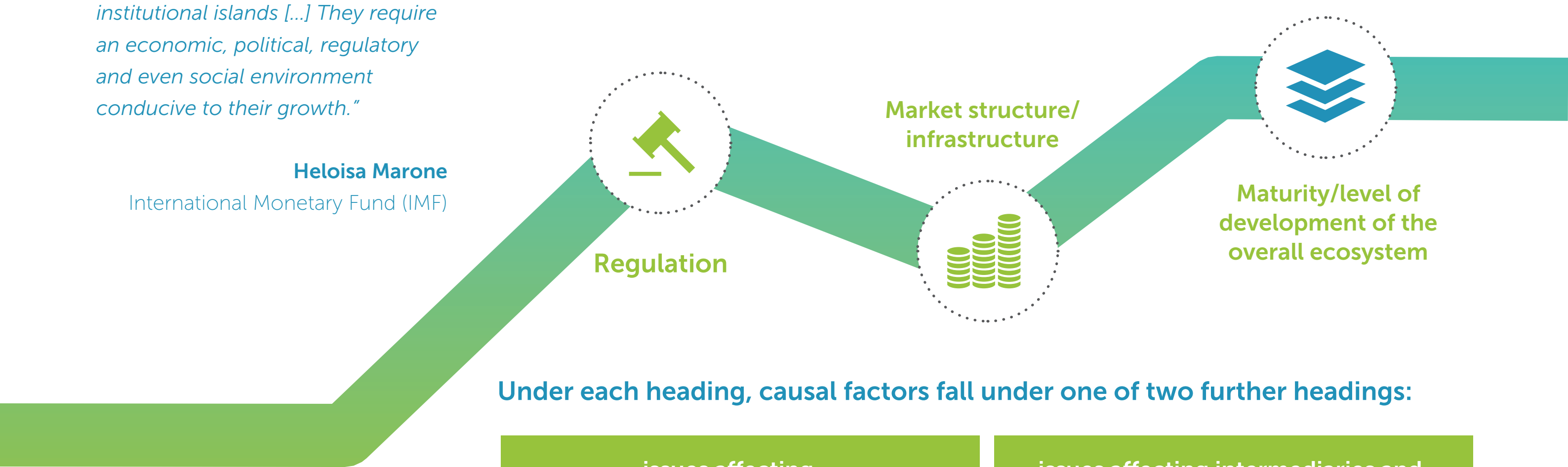
Underperformance on African stock exchanges has no single cause; instead, multiple interrelated factors are at play.

"African stock exchanges are not institutional islands [...] They require an economic, political, regulatory and even social environment conducive to their growth."

Heloisa Marone
International Monetary Fund (IMF)

The study's starting point – the widely observed historical underperformance and low volume of IPO activity on African exchanges – has complex origins and requires unpacking. Indeed, interviewees for this study identified multiple causes for the 'market failure' witnessed to date, with responses differing according to geography as well as to the respondent's role, or vantage point, within the ecosystem and wider economy.

These factors can be grouped into three broad categories:



Under each heading, causal factors fall under one of two further headings:

issues affecting suppliers of capital	issues affecting intermediaries and users of capital

For suppliers of capital, interviewees cited three key challenges in the regulatory landscape. First, crowding out of the local public equity market by high levels of government borrowing from domestic capital markets (a commonly observed theme was that local financial institutions across Africa tend to prefer short-dated treasuries due to the perceived lower cost, time/effort and risk associated with them versus locally listed stocks). A second frequently identified challenge was restrictive or outdated investment guidelines for IPOs. Thirdly, interviewees noted weak regulatory oversight and enforcement with regard to stock exchange activity as a critical barrier.

Suppliers of capital also identified two key themes in terms of market structure challenges, namely: (i) low liquidity levels (including the small average size of trades) which is due, for example, to the fact that large institutions are the main players on most African exchanges and typically adopt a 'buy-and-hold' strategy; and (ii) excessive stock concentration, which implies a limited investible universe of securities and a lack of sectoral diversification. In one notable example, the telecommunications and banking sectors account for over 80% of the Nairobi Stock Exchange (NSE) market capitalisation, with just one company – Safaricom –

alone accounting for over 50% of the NSE's market capitalisation as at the end of 2019 (more than half of all trades on the exchange in 2019 were in Safaricom shares).

Finally, from a market development perspective, suppliers of capital pinpointed two aspects of the generally under-developed research, advisory and reporting ecosystem around IPOs that represent barriers to market growth and confidence. First, interviewees noted a degree of rigidity and uniformity of pre-conceived views among market participants with respect to the quality of companies seeking to IPO. Second – and related – is the issue that too many companies have a "checkered track record" prior to listing, which creates real or perceived uncertainty over quality across the entire IPO market (in this sense, the so-called 'lemons problem' of information asymmetry – whereby sellers of shares have more and better information than buyers – looms large). Both of these thorny challenges are exacerbated, respondents noted, by insufficient and inadequate sell-side research for most African public equity markets.

Turning to the intermediary and user-of-capital perspective, concerns over the regulatory framework centred on prohibitive costs (both the compliance and governance cost burden, and on-going compliance and reporting costs).

Meanwhile, in terms of market structure, brokers and users of capital cited two broad challenges as undermining the value proposition of IPOs:

1	Fear of loss of control and ownership, in addition to other cultural attitudes that create resistance to public listings (such as a reluctance to engage in full transparency over financial results or tax positions)
2	Market illiquidity, which results in under-valuation.

Finally, regarding overall ecosystem development, interviewees referenced a general lack of appreciation of investor requirements, the overly burdensome frequency of reporting, and issues over the quality of reporting.

Total transaction costs for investing into a share

(i.e., brokerage commissions plus clearing, settlement and other fees)

exceed **3%** on at least five African stock exchanges

exceed **2%** on at least four African stock exchanges

Source: Independent research compiled by RisCura on trading costs on African stock exchanges

Solutions

The wide spectrum of challenges cited above may appear daunting, but the study's interviewees were positive and proactive in recommending cross-cutting solutions which, taken together, have the potential to transform the performance of IPOs on African exchanges.

Three high priority changes were identified as important and necessary:

Regulation needs to strike a well-considered balance of encouraging new listings whilst enforcing high compliance standards

Amortising the cost of IPO regulatory compliance over a longer period of time would reduce the up-front costs that deter some companies from listing (specifically, a clear and workable mechanism is required in order to defer and/or reduce the regulatory and tax-related costs at IPO)

Regulation must be amended to allow for greater allocation to risk assets by financial institutions (including local African banks and pension funds), and clear longer-term horizons should be put in place to measure associated financial performance

More incentives are required to allow for digital and mobile savings products that provide low-cost exposure to equity markets.

There is a need for 'softer' reforms and initiatives in the form of enhanced advocacy, awareness-raising and information-sharing.

In terms of market structure, there was a consensus among stakeholders interviewed that attracting domestic retail investors (currently under-represented on all stock exchanges in scope for this study) represents the key to achieving increased liquidity in African stock markets. More incentives are therefore required to allow for digital and mobile savings products that provide low-cost exposure to equity markets. The launch in June 2020 of a mobile share trading app by the Nairobi Securities Exchange (NSE), downloadable free of charge as the NSE App from both Google Play store and IOS, is an encouraging example of this type of initiative aimed at enhancing retail investor participation.

Connected to this theme were a collection of pragmatic recommendations from survey respondents for deepening the liquidity of African exchanges, including: introduction of scaled costing based on a combination of thresholds (time, volume, value); the introduction of derivative instruments (tied to fit-for-purpose regulation); integration of stock exchanges for increased scale and liquidity; and – along similar lines – more twinning agreements between African stock exchanges and international stock exchanges.

Beyond these structural and 'infrastructural' solutions, there is also a clear need for 'softer' reforms and initiatives in the form of enhanced advocacy, awareness-raising and information-sharing. Recommendations in this area included the potential for pro-active workshops for investors and companies highlighting the benefits of using local capital markets, and for road shows by listed African companies to showcase their growth potential to the international investment community. Additional proposals in this category focused on the need for improved information flows on listed companies and better promotion of quarterly reporting requirements, as well as the need to ensure that African Exchanges' statistics are relayed live to international data vendors like Bloomberg and Reuters.

Further 'market building' actions for consideration

Well-publicized study on the benefits of IPOs showing tangible wins (pre- and post-IPO) in terms of greater employment, tax revenue and turnover at recently listed companies.

The need for a public ownership model that is tailored to business landscapes where family ownership, and a traditional preference for debt rather than equity capital, predominates (for example, dual-class/multi-class share structures that enable continued family control but without a degradation in investor disclosures or minority protections). In other words, African stock exchanges should consider developing listing requirements that are business model-sensitive, as opposed to a one-size-fits all approach (with the additional possibility of a tiered compliance regime with 'light', 'medium' and 'full' options).

The creation of private capital placement pools under the auspices of stock exchanges was also proposed.

As the exciting range of actionable solutions summarised above suggests, the past track record for IPOs on African public equity markets may be mixed but the future potential is significant. In this sense, African stock exchanges represent a unique innovation opportunity – similar in this respect to the continent's harnessing of mobile money – to leverage both technology and tailored solutions in order to leapfrog the historic barriers to improved stock exchange liquidity, performance and scale.

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