

Challenges to the Growth of Capital Markets in Under Developed Economies: the Case for Uganda

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ICBE POLICY BRIEF



EXECUTIVE SUMMARY

Despite the universal recognition that stock markets are the most pragmatic and cost effective method to raise money for expansion and other projects, companies especially in private sector in underdeveloped economies have consistently shunned this option. As a result, most of the Initial Public Offers (IPOs) and other developments taking place at the capital markets in many developing countries have been state driven, rather than market driven. While private sector firms have shunned the markets, there is evidence that there is demand for share ownership as most of the IPOs done in many of these countries especially in the recent past have been oversubscribed.

This study used expert interviews to develop a conceptual model for examining the factors that can explain the private sector's failure to use stock markets as a financing vehicle. A hypothetical model was developed using the results of the literature review, expert interviews and focus discussion groups. Panel data across the years 2003 – 2007 was then collected regarding the study variables and used to test the hypothetical model.

Four models to examine why firms in emerging markets have failed to use stock markets to raise money were tested using static panel regression analysis. The models involved the use of different proxies for IPO readiness among private sector companies including publication of accounts, share

transferability, board control and a composite variable for IPO readiness.

The models show that age, auditor type, disclosure and size are significant pointers as to whether a company is ready to list on the market. In addition legitimacy of the board through inclusion of independent non executive shareholders, and increased market activity significantly point to improved IPO readiness or efforts for a firm to look to stock markets as a legitimate source of income and even financing.

From a policy prescription point of view, IPO readiness must be seen as a maturation process of a company and will only be achieved as firms become older and the costs of information gathering diminish. But legislation can be used to reduce the costs of information availability by compelling firms that meet the requirements to list on the stock markets to file financial statements with a central authority (probably the Uganda Securities Exchange – USE) whether they are interested in listing or not.

There is also a need to improve levels of disclosure by firms because these firms occupy an important place in the business space. As firms' disclosure improves, so will their readiness to go IPO. Lastly firms need to legitimize their business so as to increase their acceptability as investment vehicles for mobilising private savings.

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CONTEXT AND IMPORTANCE OF THE PROBLEM

Despite the universal recognition that stock markets are the most pragmatic and cost effective method to raise money for expansion and other projects, companies especially in the private sector in underdeveloped economies have consistently shunned this option. As a result, most of the Initial Public Offers (IPOs) and other developments taking place at the capital markets in many developing countries have been state driven, rather than market driven. While private sector firms have shunned the markets, there is evidence that there is demand for share ownership as most of the IPOs done in many of these countries, especially in the recent past, have been oversubscribed.

To investigate why local firms are not listing on the local stock market — the Uganda Securities Exchange (USE) — this study employs expert interviews and focus discussion groups. These tools help the study to understand reasons behind failure by the private sector to use stock markets as a financing vehicle. Using data across the years 2003 – 2007, the study empirically examines the reasons for the current state of stock markets with special emphasis to Uganda.

CRITIQUE OF POLICY OPTIONS

Why Do Firms Go Public?

There are several explanations as to why firms go public. Conventional wisdom suggests that the public offering represents a stage in the growth of a firm (Jain and Kini, 1999, Mikelson et al 1997) at which it attempts to raise cheap additional funds through the IPO. In the post IPO phase, the firm can evolve into one of three basic states. It can survive as an independent firm, fail outright or get acquired and lose its current identity.

The scarcity of empirical evidence, especially for IPOs, is primarily due to the difficulty in obtaining data on private firms. Without data on the status of a company before it become a publicly listed company, drawing conclusions about the factors that influence the going-public decision is treacherous (Rosen, Smart and Zutter, 2005). What is clear is that in more developed markets, many private firms with growth

prospects eventually go public to finance investments, all other factors being constant.

This, however, does not explain the existence of several large successful private firms with further growth prospects. Rosen et al. (2005) carried out before and after IPO comparison of banks that went public and those that remained private. A key finding was that banks that went public had been growing faster, earned higher profits and employed more leverage than banks that remained private.

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Banks that listed on stock markets were riskier and had invested more of their assets in loans. The IPO appeared to be the first stage in the sale of the firm and such banks that had gone public were more likely to be acquired or become acquirers themselves. In the post IPO period, the banks studied exhibited deteriorating performance as measured by return on equity and assets. The study also found empirical support for the notion that banks went public following a period of high stock market returns, implying that the IPO decision was also influenced by market direction. If the market was bullish, then IPO activity was more likely than when it was bearish.

Another explanation in the literature suggests that firms go public not to finance growth but rather to rebalance their accounts after a period of high investment and growth (Rydqvist and Hogholm, 1995). This finding, which is based on empirical data for Italian, Swedish and Spanish companies, is rather surprising because it is counter intuitive. Companies list to raise money and hence one would expect that a company that has already raised capital from elsewhere for growth and expansion would not need to go public. Once growth opportunities have been extinguished, the need to go public so as to raise additional capital disappears.

Going public represents the first stage in the sale of the firm (Zingales, 1995). Firms make an IPO in order to obtain a market valuation for their assets, which facilitates the sale of the firm either gradually through reduction of ownership or immediately through an acquisition.

A stock market listing enables companies to know the value of their investment at anytime and thus provides a yardstick for evaluating management efficiency. Again the evidence in support of this explanation is mixed. Brennan and Franks (1997), using a sample of UK IPOs, found that almost two thirds of shares of the IPO issuing firms were sold to outsiders within seven years of the IPO. Mikkelson et al. (1997), using a sample of US IPOs report a substantially lower 29 percent turnover in control for established firms and a 13 percent turnover in control for start-ups. Many IPO issuers however include anti takeover provisions to deter such acquisitions.

According to other authorities, the reason cited for public offering is that entrepreneurs see their growth prospects levelling off and seek to divest their holdings prior to failure. Firms in this category would experience a slowdown in activity in the post IPO years before eventually failing. This provides support to the argument that entrepreneurs with superior information divest through an IPO in anticipation of subsequent failure (Jain and Kini, 1999).

This proposition is extremely tenuous because it makes several outrageous assumptions. One, it assumes that entrepreneurs are exiting business and are not conscientious. Two it ignores the fact that regulators have a continued stake in maintaining public trust in the market and engage in a drawn out process of due diligence to establish the business prospects, risks and profitability of the company. Three, it assumes that the investing public is easily gullible, and that the market is rather inefficient, i.e. that prices do not incorporate known information about future business prospects of IPO firms.

Advantages of going public

There are several advantages that would accrue to firms that go public. First is the prestige and status gained by the firm as a result of the perception that business operations meet prudential requirements. This increased esteem in the public is based on the fact that listing requirements are quite stringent and involve adherence to the listing regulations issued by the Capital Markets' Authorities.

Secondly, the stock market provides a cheap source

of capital, compared to other known sources. Borrowed funds attract interest rates ranging from 30 to 16 percent annually. The costs of an IPO, which are a 'one off' cost, range between 14 percent to as little as five percent depending on the magnitude of the IPO. Thus for any firm wishing to raise additional capital, the stock market provides a clearly more attractive route, barring other externalities.

Experience shows that several entrepreneurs do not possess the requisite managerial skills necessary to run the business over the long haul. Entrepreneurs are 'hunters' rather than 'skinners.' Hunters lose interest in the venture once the business is up and running, but skimmers have an eye for detail and order. A company that is traded on the stock exchange, therefore, stands a better chance of attracting professional management.

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Stock markets provide entrepreneurs with capacity to explore multiple investment ventures, by increasing their potential liquidity. Since shares of public companies are freely tradeable, an entrepreneur who wishes to explore alternative investments obtains far greater latitude in raising cash from her financial asset portfolio. Quoted shares also offer the investing public an attractive and fairly safe avenue for earning a return on savings.

A number of tax incentives can be gained by a company being publicly quoted. In Uganda there is no capital gains tax and stamp duty. Dividends for listed companies are taxed at 10 percent at source compared to unlisted company dividends that are taxed at 15 percent.

Contextual Limitations of Theory and Literature

Most of the discussion of the IPO decision is premised on two fundamental issues. One is that there are no macroeconomic bottlenecks and two that there is an efficient or well developed market for trade in financial assets. Another issue on which the IPO decision is premised, although this is not so critical, is the assumption of a degree of sophistication in the firm's disclosure and governance aspects. These assumptions cannot be taken for granted when examining the case of underdeveloped markets. The consequence to this argument is that firms in a developed market have only one choice set, that is the decision to go public or not and the costs associated therewith. On the contrary, firms in underdeveloped markets have choice sets to consider, when making the decision to go public.

Stock markets in underdeveloped economies are generally creations of policy rather than natural organic growth. The origin of markets in developed economies is clearly linked to the industrial revolution and the growth of mass production. Such sophistication in production requires more specialized management, hence the separation of ownership and management which led to the evolution of financial markets. In underdeveloped countries, this is clearly not the case. Markets have been legislated into place without any relation to the level of economic sophistication. Underdeveloped economies are faced with a host of structural and political bottlenecks that constrain market development.

Market development has thus been detached from the nature and size of the economy. Poor fiscal policy management, an elementary monetary policy (no yield curve) and a restricted demand because of poor equity supply all conspire to curtail market development. There are also low levels of public trust, due to political instability and continual erosion of purchasing power resulting from excessive public expenditure deficits in developing countries.

As an example of the lack of competitiveness in financial markets, in most underdeveloped countries of sub-Saharan Africa, the pension sector is dominated by one statutory monopoly. Such monopolies hold up savings while paying returns far below market rates. In Uganda, the National Social Security Fund (NSSF) dominates the market and holds in excess of US \$ 500 million on which it pays a return of only seven percent. Compare this with a prime rate of 11 percent offered by the Central Bank. It is often argued that people in underdeveloped countries have poor savings habits. This ethnocentric view of savings habits in underdeveloped countries is untrue. Rather, savings habits are constricted due to the lack of savings opportunities in the formal market.

Formal markets are dominated by the banking sector, which dismally fails to offer the variety of financial instruments that would encourage savings in underdeveloped markets. Savers are therefore more adjusted to investment in non-financial assets such as land, farm animals and housing. All these factors have a restrictive effect on the growth of capital markets.

CONCLUSION

Policy change can result in significant improvements in market development. An increase in incentives to direct local savings away from real assets to financial assets would result in availing more funds for investment. An increase in liquidity by developing secondary market capacity would also further increase the synergies for growth. There is thus a need for a concerted effort to grow capital markets by reshaping attitudes to share capital formation and share ownership.

POLICY RECOMMENDATIONS

Based on the study findings, the following recommendations are being made to assist policy makers to grow the market and increase securitization of investments in the market

- 1.** For firms to make IPOs or to operate to a higher global business standard there is a need for legislation requiring firms of a given size to file financial statements with a designated public body. This requirement is now standard in several emerging market jurisdictions such as Taiwan. This filing requirement should not be confused with the tax authority reporting that firms are required to undertake annually but must be seen as part the market confidence building process. Such a policy requirement would make information regarding firm performance more readily available as a basis for macro-economic planning. Secondly, large firms, even though privately held are 'public-interest' companies, which enjoy common property resources and should be enjoined to show their corporate responsibility through disclosure of their performance. There is already sufficient evidence that firms that provide more disclosure enjoy a relatively lower cost of capital.
- 2.** IPO readiness is partly a maturation process. As a firms' age increases, its propensity to sell shares to non-insiders increases. Older firms are better managed and usually have a better performance as a result of their market experience and resilience. Older firms are also less likely to be controlled by the founder and their survival necessitates a higher level of transparency. Most Ugandan firms are relatively

young and should be able to go public as their ownership becomes more dispersed and they experience improved corporate governance. This should take place in tandem with the growth of the Uganda Stock Exchange. As a listing becomes more widely appreciated through educational efforts, firms are also more likely to go the IPO route.

- 3.** There is a need to improve on the disclosure regime of firms as part of the process of increasing IPO readiness. The empirical results show that adequate disclosure is a very important determinant of a firm's preparedness for an IPO. Firms need to be assisted to improve disclosure if they are interested in going IPO. There are other benefits associated with increased disclosure such as a lower cost of capital. Firms that disclose more information have lower borrowing costs. This is necessary to make Ugandan firms more competitive in a global environment.
- 4.** Firms that wish to make IPOs need to increase their legitimacy. Legitimacy refers to the extent to which the board includes independent non-executive directors. Firms have an immediate and far reaching impact on the communities in which they operate. As a result, including eminent members of their communities on their boards would be a positive indicator of their continuous commitment to those communities, the extent of their responsible business practices and good governance. Most Ugandan firms are closely controlled, meaning that their social involvement with their communities is also limited to commercial transactions. Firms need to increase their impact on the societies in which they operate.

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