CAPITAL MARKETS AUTHORITY

CAPITAL RAISING OPPORTUNITIES FOR SMEs: THE DEVELOPMENT OF MICRO-CAP SECURITIES MARKETS IN KENYA

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ABSTRACT

More than 99% of all enterprises in the world are SMEs. SMEs consist of firms varying widely in size and characteristics -- namely from very small start-up firms in an infant stage of development to established SMEs already listed on the stock market. It is agreed that most SMEs heavily depend upon bank loans and generally experience a 'financing gap,' even in developed countries. This financing gap, often defined as the difference between the demand for funds by SMEs and the supply of funds, occurs because of various reasons. Research suggests that the fundamental reasons behind SMEs' lack of access to funds can be found in their peculiar characteristics, in addition to the fact that SMEs suffer from financing gaps because of market imperfections on the supply side. In reality, SMEs face financing gaps probably because of a combination of reasons originating from both the supply and demand sides. This financing gap for SMEs is most prominent in capital market financing and most countries, including developed ones, have problems in SME financing through capital markets.

The paper is broadly structured into four parts. The first part examines the characteristics of SMEs and factors constraining them in accessing financial resources, and highlights the role of finance in SMEs development. The second part looks at specific public and private programmes to support SMEs in accessing financing including the policy development framework in Kenya. An attempt to quantify the financing gap has also been made. Section three analyses the challenges and gaps identified as well as capital markets financing initiatives in other jurisdictions. The paper concludes with synthesizing the findings and makes recommendations for capital markets policy action in the development and financing of the SME sector in Kenya.

The paper finds that the Small and Medium Enterprise (SME) Sector has continued to play an important role in the economy of this country. The sector's contribution to the Gross Domestic Product (GDP) has increased from 13.8 per cent in 1993 to about 40 per cent in 2008. The Small Enterprise Sector or Informal Sector provided approximately 80% of total employment and contributed over 92% of the new jobs created in 2008 according to the Economic Survey of 2009. In addition, the study finds that a financing gap exists with regards to access to capital for SMEs in Kenya. The main challenges facing SMEs in kenya include Overlap and Inconsistencies in Legal and Sectoral Policies; Lack of Clear Boundaries in the Institutional mandates; Lack of a suitable legal framework; Outdated council By-Laws; Unavailability of land and worksites; Exclusion of local authorities in policy development; Lack of access to credit; Lack of a central coordination mechanism; Lack of a devolved coordination and implementation mechanism. The paper also finds that the main impediments to SME securities offerings in Kenya include Company law limitations; Stringent listing requirements at the NSE; Lack of a formal OTC market; Control Concerns; and tax and disclosure concerns and makes recommendations on how to improve the current situation.

Abbreviations

CIV	-	Collective Investment Vehicle
CMA	-	Capital Markets Authority
GDP	-	Gross Domestic Product
GOK	-	Government of Kenya
IMF	-	International Monetary Fund
IPO	-	Initial Public Offer
LSE	-	London Stock Exchange
MFI	-	Micro Finance Institution
MSME	-	Micro, Small and Medium Enterprises
NESC	-	National Economic & Social Council
NGO	-	Non-governmental Organization
NSE	-	Nairobi Stock Exchange
OTC	-	Over-the-Counter
RBA	-	Retirement Benefits Authority
SRO	-	Self Regulatory Organisation
USAID	-	United States Agency for International Development
VCC	-	Venture Capital Company

EXECUTIVE SUMMARRY

Kenya's development agenda is anchored in Vision 2030 in the long term and the First Medium Term Plan in the short term. Vision 2030 is anchored on results being achieved in three areas, namely the Economic, Social and Political Pillars. The paper espouses the merits of the economic pillar which aims to attain a growth of 10% per annum and sustain it to 2030 in order to generate more resources to address the issues of wealth creation, employment generation, equitable distribution of national wealth as well as effective youth employment and engagement. The Government has identified the MSME sector as one of the key drivers of vision 2030. The sector is destined to play an effective role as an engine for economic growth, poverty eradication and unemployment creation and is crucial in meeting projected development objectives of Kenya.

1. SME Financing

Theoretically, seven modes of finance can be employed - but all have some degree of problem associated with them in providing capital to SMEs. Banks are invariably restrictive in lending to SMEs. Early stage ventures often have a low equity base and lack a visibility in cash flow, which can sustain debt finance. Further, the loans are collateralized, high cost and often are bundled with a delay in receivables. The high informational asymmetry makes it difficult for the debt finance to thrive. With the banks increasingly being in the public eye, there is an increased element of risk averseness. The course of debt financing from a development finance institution has not been a runaway success. Bond finance as an option is as good as negligible even for larger corporates in Kenya, let alone being workable for an SME. The MFI sector is growing but not rapidly enough and certainly not large and structured enough to provide the required capital. The same may be said of the Venture Capital industry, which has stagnated over time and will have to attain greater significance for Kenya to achieve breakaway growth. A large part of the capital required by SMEs still comes from lending by Non Bank Financial Institutions (NBFIs) and through informal finance – wherein the cost of borrowing is significantly high. Thus, the situation is complicated by the fact that the preferred mode of finance is self – largely due to associated high interest rates.

2. Financing Gap

SMEs consist of firms varying widely in size and characteristics -- namely from very small start-up firms in an infant stage of development to established SMEs already listed on the stock market. Of course, the major sources of financing for SMEs differ depending on their current stage of growth and development. However, it is agreed that most SMEs heavily depend upon bank loans and generally experience a 'financing gap,' even in developed countries. This financing gap, often defined as the difference between the demand for funds by SMEs and the supply of funds, occurs because of various reasons. Some fundamental reasons behind SMEs' lack of access to funds can be found in their peculiar characteristics and because of market imperfections on the supply side. In reality, SMEs face financing gaps probably because of a combination of reasons originating from both the supply and demand sides. This financing gap for SMEs is most prominent in capital market financing and most countries, including developed ones, have problems in SME financing through capital markets.

3. SMEs in Kenya

It is estimated that there are 7.5 million[1] SMEs in Kenya, providing employment and income generation opportunities to low income sectors of the economy. The Sector has continued to play an important role in the economy of this country. The sector's contribution to the Gross Domestic Product (GDP) has increased from 13.8 per cent in 1993 to about 40 per cent in 2008. The Small Enterprise Sector or Informal Sector provided approximately 80% of total employment and contributed over 92% of the new jobs created in 2008 according to the Economic Survey of 2009. The sector therefore plays a key role in employment creation, income generation and is the bedrock for industrializing the Country in the near future.

Due to their characteristics, SMEs in Kenya suffer from constraints that lower their resilience to risk and prevent them from growing and attaining economies of scale. The challenges are not only in the areas of financing investment and working capital, but also in human resource development, market access, and access to modern technology and information. Access to financial resources is constrained by both internal and external factors. Internally, most SMEs lack creditworthiness and management capacity, so they have trouble securing funds for their business activities such as procuring raw materials and products, and investing in plant and equipment. From the external perspective, SMEs are regarded as insecure and costly businesses to deal with because they lack required collateral and have the capacity to absorb only small amount of funds from financial institutions. So they are rationed out in their access to credit because of high intermediation costs, including the cost of monitoring and enforcement of loan contracts.

To overcome some of the constraints, the government and other relevant stakeholders have designed programmes and policies that are market driven and market non-distorting to support SMEs. Government has, for example, created stable macroeconomic conditions, liberalised the economy, and encouraged the growth of micro-financing business. A law has been enacted to guide the development and sustainability of micro-finance institutions[2] while at the same time allowing them to collect deposits. Nevertheless, the challenge to SMEs in accessing financial services will also depend on how they themselves increase their creditworthiness.

The following issues have been cited as major challenges and gaps to Implementation and Coordination of Policy Initiatives: Overlap and Inconsistencies in Legal and Sectoral Policies; Lack of Clear Boundaries in the Institutional mandates; Lack of a suitable legal framework; Outdated council By-Laws; Unavailability of land and worksites; Exclusion of local authorities in policy development; Lack of access to credit; Lack of a central coordination mechanism and Lack of a devolved coordination and implementation mechanism.

4. Constraints facing SMEs access to Financing in Kenya

In Kenya, strong SMEs tend to be located in urban and peri-urban centres and are usually registered. However, they face a number of constraints, which include the difficulty in employing competent people with techniques in financial management because of the salaries such people would demand, financial problems arising from late payments by debtors, and inability to raise own finance and access financial services from formal sources. This category of SMEs usually looks to the banking sector and other financial intermediaries for instruments to finance working capital and to provide credit for short-term liquidity

[1] Economic Survey 2009

[2] The Micro Finance Act 2008

management. They, however, often fail to access the financial resources in the required amounts because banks evaluate them on the basis of a checklist, including:

i. Audited financial statements for the last three years including management accounts;
ii. Project proposal highlighting the strengths, weaknesses, opportunities and threats;
iii. Financial projections;
iv. Monitoring costs;
v. Credit or default risk because of the problem of information asymmetry;
vi. Enforcement costs.

Additionally many MSMEs employ less than 5 people, mostly family members who are usually not legally registered, apply simple and relatively rudimentary technology in production and, therefore, the quality of their products is likely to be poor. They may suffer from limited market access and fierce competition from many rival producers. This category of MSMEs usually does not have proper physical structures such as premises from which to operate business, accessible roads and other essential utilities, which are major catalysts to accessing formal sector credit. In addition, there is a general lack of professionalism within this category of MSMEs in terms of strategic planning procedures, decision-making processes and business planning, and management in general.

Generally, the smaller the enterprise, the less likelihood its management will understand the need for financial management and the poorer the understanding of financial management. Likewise, the size and the distance from major cities/urban centres are negatively related to the level of awareness of financial instruments. That is, the smaller the size of the enterprise and the farther away from the city/urban centre the enterprise is, the less aware the firm is of the financial instruments available. This makes them vulnerable to shocks to revenue or costs and, therefore, and makes them unlikely to expand beyond a certain limit. This explains why the turnover of majority of SMEs in Kenya is estimated at only the Kshs.5 million (app US$63,000) a year threshold. Thus, poor returns, lack of good financial records, and lack of collateral make them not creditworthy.

5. Funding opportunities for SMEs in Kenya

The Key MSME finance providers in Kenya comprise Risk Fund Managers, Venture Capital Funds and Private Equity funds, Banks, Investment clubs, Development Finance Institutions, leasing companies and Technical Assistance funds. One private equity fund operates with a license from the Capital Markets Authority i.e. Acacia Fund (managed by the fund manager, Aureos). There are 14 and 16 registered fund managers by RBA & CMA respectively as of 2009. Of these, 11 firms are registered to manage both Pension funds and Collective Investment Schemes. The other venture capital/risk funds operating in Kenya are incorporated in their countries of origin but have a legal structure that allows them to carry on the business locally. The market for risk funds in Kenya is dominated by two main sectors: the pension fund sector and the insurance industry. Both industries are intertwined as both are involved in the investment of retirement benefit funds.

A. Supply of Funds

The Insurance Sector	By 31 December 2008, the long-term funds under management by insurance companies stood at Kshs 18.31 billion[3]. Insurance companies are allowed to invest up to 5% of these funds, i.e. the equivalent to around Kshs 0.92 billion in unlisted equities. In addition to funds directly available to insurance companies, many have funds available through shareholders funds or holding companies that could be placed in risk capital. However, it is difficult to estimate the magnitude of these funds that have recently been valued to be at least Kshs 500m[4].
The pensions sector	By June 2009, the value of private pension funds in Kenya stood at Kshs 287.7 billion[5]. The RBA Act limits the maximum funds available from pension funds for investment as long-term risk capital at 5%of the total funds under management, so, the amount of long-term capital available for risk capital investment in Kenya is approximately Kshs 14.4 billion. It should be noted that this figure includes pension funds managed by insurance companies. As at the time, only Kshs 5.9 bn (2.1%) of total funds were invested in unquoted equity.
Risk capital funds	Traditional venture capital funds, many of which are in their infancy in the Kenyan market, are an important source of capital for private equity transactions. The size of these funds in Kenya is estimated to be at least Kshs 15 bn with only Kshs 2.9 bn being invested in SMEs. Business angels also exist in Kenya and have participated in a number of private equity transactions. Data on business angel funding of early-stage venture capital are, however, difficult to obtain so, estimates are not possible
Other Potential Investors	In addition to traditional venture capital funds, an increasingly important source of capital for private equity transactions in Kenya comes from the myriad investment groups scattered across the country. There are no official data on the number of these groups, but they are estimated to be in the thousands. Although no detailed research on the sector has been done, estimates of the funds available are approximated to be Kshs 60 billion[6] as at December 2009. One in three Kenyans is thought to be a member of an investment group. It is unlikely that more than 5% to 10% of these funds are available for investment in early-stage funds/enterprises.
Collective Investment Schemes (CISs)	A recently new source of risk fund capital in Kenya consists of Collective Investment Schemes. As of September 2009, funds under management by CISs were valued at Kshs 13.4 bn. Of this amount, 5% (Kshs 670 mn) can legally be invested in unquoted equities. Current data shows that Kshs 375 mn is invested in unquoted equities making CIVs the best performer with regard to providing risk capital funds to enterprises, registering 56% of total allowable and available funds for investment in unquoted equities.

[3] According to latest statistics published by the Association of Kenya Insurers
[4] FSD Kenya; report on SME risk capital, 2008
[5] RBA newsletter, June 2009
[6] Estimates provided by the Kenya Association of Investment Groups (KAIG).

B. Demand for Funds

The market for private equity and or long-term risk investment in Kenya is in an early development stage with few players taking part in the market. The main source of financing for Kenya's SMEs is internal financing followed by bank financing which constitutes 86% of the total demand for funds. Kenyan SMEs do not use credit cards or leasing as a source of finance. Only 0.58% of SMEs surveyed used equity finance.

C. Experiences in other jurisdictions

An analysis of experiences form other jurisdictions observed the following:

i. Kenyan SMEs face similar constraints with regards to access to credit

ii. To alleviate the financing gap, either an OTC market has been developed to encourage Venture Capital development or there is an established Credit Guarantee Scheme in place for SMEs complemented by an SME Advisory/Information Bureau

iii. The introduction of SME loans securitization programmes is gaining popularity particularly in Asia

6. Obstacles to SME Financing through the Capital Markets

A move away from bank intermediation towards funding in the capital markets has long been considered a long-term objective of many countries. When companies are in the growth phase, they tend to get leveraged. Beyond a certain point, banks are reluctant to provide further credit. Equity capital is required to bring strength to the leveraged balance sheet. At this point, either the promoter will have to self provide for injecting in the requisite levels of equity or would have to do without the capital, which in turn would kill the impetus of growth. Having the option of equity financing through the equity market, allows the firm not only to raise long-term capital but also to get further credit due to additional equity cushion now being available. If successful, this approach would address the chronic lack of long-term credit available to SMEs. This promising move, however, has many hurdles until its full implementation.

The first hurdle to overcome is having an adequately developed capital market in terms of depth and liquidity. Second, SMEs, in essence, have relatively high credit risk. While SMEs have high growth potential, they are also more vulnerable to sudden changes in the economic and competitive environment. Third, there exists severe information asymmetry in this segment of enterprises. SMEs' corporate information is often nonexistent, or comes with very high access costs in many economies. Fourth, SME financing is inherently associated with a higher unit cost when compared with that of large corporations. The relatively smaller size of funding, as well as higher information and monitoring costs, leads to higher implementation costs per deal when processing finance in capital markets.

6.1 Current impediments to SME securities offerings in Kenya

Several reasons exist that preclude SME's from going into the public market to raise capital through the sale of securities. The principal reasons include:

i. Company Law Limitations

Private companies in Kenya are limited to no more than 50 shareholders, the securities are non-transferable, and they cannot offer any shares or debentures to the public except where a provision is made for the same in a company's MoU and AoA and not offered to public. More significant as impediments to capital raising are the public offering provisions of most company and securities laws. Any offering of securities, regardless of size or number of purchasers, must comply with the full registration process set forth in the Legal Framework. SME's desiring to raise a relatively small amount of capital must go through the same costly, time-consuming process of registration as if it were a multimillion offering. SME capital requirements are often too low, too sporadic, and too immediate to warrant the required registration process.

ii. The Problems of Listing on the Stock Exchange

Two serious problems exist in this area for SME's. The first is that many SME's, even after the sale of shares in a public offering, will be too small to meet exchange listing standards. The Stock exchanges listing requirements are quite stringent with regard to company assets, number of shareholders, and market capitalization. The NSE, recognizing the problem and seeking to attract smaller companies into their fold, introduced listing tiers. Tier I, MIMS, is composed of large companies that meet the regular listing requirements. Tier II, AIMS, is composed of smaller companies who qualify under modified listing standards. Although this arrangement has the merit of allowing smaller companies to be listed on the exchange, in practice the two tier system has generally not been successful. Many investors regard second tier companies with skepticism. A Tier II label is like a badge of demerit ---- a Tier II listing connotes a public company that is not "good enough" to make it to the "big board." Hence, trading in Tier II stocks tends to be sparse. This adversely affects both stock prices and liquidity (the two are linked). The potential of a Tier II listing is thus a meager inducement for SME's and potential investors.

iii. Lack of an Over-The-Counter Market

The inability to meet exchange listing requirements would not be a serious impediment to a public offering by SMEs if those companies could assure potential investors that an over-the-counter ("OTC") market would be created for secondary trading. An OTC market provides a liquidity function for shareholders similar to that of an exchange. Unfortunately, an OTC market does not exist in Kenya, nor have rules governing its operation been established.

iv. Tax and Financial Disclosure Concerns

An often stated major impediment to attracting SME's to make public offerings is the concern that the required disclosure of audited financial statements will alert government authorities to possible prior under-reporting of taxable income. The two sets of books phenomenon is frequently noted in discussions. The tax collector sees a set of books that show little if any profit, while the owners' set of books shows the true condition of the company. If the company were to make a public offering that requires audited financial statements, prior under-reported income might be disclosed. The idea of a tax amnesty has been floated from time to time as a means of encouraging companies to sell and list their shares on the exchange. Kenya offers a reduction in the corporate tax rate for companies listed on the national stock exchange. In light of the relatively low number of private companies that have chosen to list on stock exchanges, current tax inducements do not appear to be very effective. More thinking needs to be done to resolve this very practical problem.

v. Control Concerns

Owners of SMEs are understandably reluctant to sell securities to the public if the result is a diminution or loss of management control. This is a very real personal problem, especially for SME's developed and nurtured within family units. It is a problem, however, that can be addressed through education of company owners as to alternative offering techniques, and through changes to existing statutes and regulations to permit more diversified ownership interests.

7. Recommendations

i. Registration Exemption

This is the most important, although not sole, reform measure that can be taken to facilitate capital raising by SMEs. The current registration provisions are too costly, too time consuming, and contain too many technicalities for smaller companies. What is needed is some form or forms of exemption from registration that permit capital raising without going through the entire registration formalities. The CMA must consider whether and to what extent the registration of securities rules can be altered for SMEs. We will of course need to adopt provisions consistent with our circumstances. The only caveat offered is that the greater the technical requirements, the more the conditions begin to look like a registered offering, the less the exemption will be utilized and SMEs will remain frozen out of the capital market.

ii. Creation of an Over-The-Counter Market

Just as the privatization movement required the establishment of a stock exchange in Kenya, so too the loosening of strictures on SME securities offerings requires the development of an over-the-counter market. Tier II eligibility standards might be met for exchanges that create tiers, but the trading experiences for Tier II companies have not been generally successful. The better course might be to develop an OTC market. The study findings on the Viability of an OTC market in Kenya and Appropriate Capital Market Segments and Structural Arrangement in Kenya are progressed towards formal adoption with the aim of implementation. The introduction of an Over-the-Counter Market to facilitate investment through private placements with a medium to provide exit strategies, and transparent pricing is recommended.

iii. Establishment of a SME Support Bureau

In order to ensure that adequate attention, guidance, and support are provided to SMEs, a Small Business Development Agency should be established. The agency could provide any and all of the following services: Regulatory Coordination: Education and Training: Financial Assistance: Market Evaluation as well as Private Fund Development.

iv. Establishment of a Credit Guarantee Scheme

Technical credit rating deficiencies could be alleviated through the establishment of a Credit Guarantee Scheme specifically targeted at SMEs wishing to raise debt/equity capital from the capital markets. Such a scheme could be operationalized by a special entity supervised by the Ministry of Finance. The overriding issue is that without a formalized OTC market for IPOs/exit strategies and some form of credit enhancement facility for SMEs in Kenya, access to capital market finance is near impossible. *However, it would suffice to note that Government credit lines or guarantees effectively relieve the investor of any risk, and therefore the motivation to spend time and expensive efforts to appraise the companies. Also such credits or guarantees have in many cases become de- facto grants as governments rarely strongly pursue repayment or foreclose when the guarantee is exercised.*

v. Improved Tax and Other Financial Incentives

Tax or other financial incentives could be affirmatively developed that will alleviate the disclosure concerns. Moreover, a tax reduction is scarce recognition of the potentially significant economic benefits that a company can generate by being an active participant in the country's economic development. Other tax or financial incentives should also be considered. Dividend taxes might be substantially reduced or eliminated for publicly-held SME's. Licensing fees might also be modified. Priority consideration for bidding by government contracts might be given to publicly-traded SMEs.

vi. Education Program for SME Owners and Managers

Many owners and managers of SMEs do not understand that they can maintain control of the company even under materially changed circumstances, nor are they aware of the significant economic benefits (in addition to capital raising) that can result from a public market in a company's securities. An ongoing educational process is required. The educational program could be developed by the CMA and its stakeholders and implemented through the Financial Education partnership programme steered by Financial Sector Deepening – Kenya Project.

vii. Rebranding of the AIMS segment of the NSE

One of the reasons companies seek a listing on an exchange other than to provide an exist strategy to existing shareholders; a transparent method to value a company, and/or to raise capital is to raise the public image of the company. There is a high level of prestige obtained by a company when it lists on an exchange. Presently the AIMS section of the NSE does not offer this prestige. As a result, the AIMS segment of the NSE needs to be rebranded.

viii. Undertake a best-practice review of the existing regulatory and tax regime for venture capital funds:

The Capital Markets Authority should examine further the environment for the establishment of venture capital funds in Kenya. This will entail a review of the existing rules as well as a broader examination of the incentive structure for establishing funds in Kenya vis-à-vis other destinations. In addition, the CMA should undertake additional research to identify the scope and potential for establishing a structure similar to the US Small Business Administration (SBA) and their Small Business Investment Companies (SBIC) that can finance growth and development of early-stage funds for SMEs. This would entail exploring further the concept of establishing a "fund of funds".

ix. Awareness creation on Private Placements

Many Kenyan firms have not embraced private placements as a way of funding their businesses. As opposed to IPOs, private placements are not publicized. Many investors don't know how they can participate in private placements. And herein lays the problem. The solution therein lies with the implementation of a concerted and targeted public awareness and investor education campaign on this matter.

x. Formalization of the SME sector

A major challenge facing SMEs emanates from the fact that Kenya does not have an SME Act in place yet, to regulate SMEs. There is need to make this part of a policy and it will encourage SMEs to grow. This issue is important since SMEs form a huge sector of our economy and present a great potential in wealth creation and employment. They are key in spurring the economic growth while contributing to poverty alleviation and reduction. It is therefore recommended that the CMA lobby the Government, through the Treasury, to fast track Enactment of the MSME bill, 2009 which provides for regulation, promotion and development of SMEs.