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The Dearth That No One Saw Coming

In a number of developed economies (USA and Canada), the declining number of listed companies as compared to previously observed numbers has been cited by some as the quietest crisis facing the economies. With the same "crisis" taking root in the country, we delve more into the reasons behind the declining IPOs, whether we should abandon ship altogether and if not, what are the potential remedies.

Reason behind the weak pulse in IPOs

The rise and rise of private capital: Deregulation of private capital in the developed markets has seen the number of private firms and the muscle they wield surge. As such, they have met the primary need of companies going public which is to raise capital.

Ease of raising capital in private markets: Unlike public markets which have quite a number of boxes to tick, private capital require little capital raising costs with few regulatory prerequisites. In addition the capital raised is gotten more easily when compared to the expensive public marketing that's undertaken by firms going public. The fewer number of intermediaries in private capital makes the process not only friendlier but also less costly.

The relatively high costs of regulatory compliance: Unlike private placements and dealings, public firms have to grapple with high (for small cap firms) regulatory compliance costs.

Controlling the pool of shareholders: Once a company goes public, the current shareholders have little say as to the type of shareholders that the company onboards. As such, firms may attract shareholders with different objectives from the current shareholders which makes stewardship cumbersome. In addition, public companies expose themselves to shareholder activism and potential additional litigation. With the public company, short-term earnings carry more weight in the market than the long-term performance.
Private capital firms onboard shareholders with the same interests. With a majority of private capital providers demanding seats at the board, the quality of management is enriched.

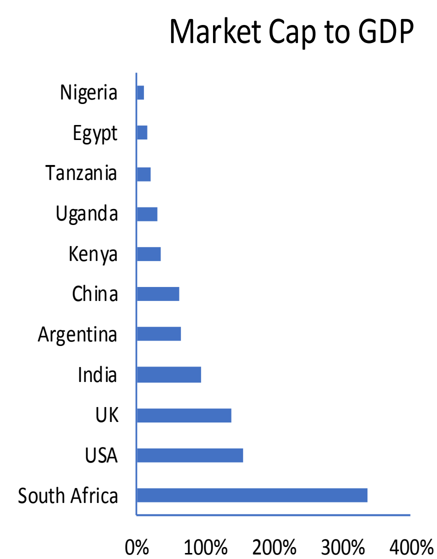
Ceding of competitive advantage to competitors: Public companies have to comply with additional compliance requirements and have to make certain public disclosures of which their private competitors don't have to contend with. This gives the competitors an upperhand. As such, potential firms may shy away from the public limelight.

Poor performance of previous companies: Small cap companies tend to hurt in the public markets with a bulk of the money coming from institutional and high net-worth investors who focus mainly on the large cap counters. In Kenya, companies that have recently gone public have slumped in market price. Nairobi Business Ventures has lost 52.0% of its listing value (KES 5.00 as at June 2016) while Deacons has lost 83.7% of its listing price of KES (15.00 as at August 2016). Such negative performances dissuade companies looking to list of which a number are small cap counters.

Kenyan IPOs in the last 10 Years

Company	Year	Offer Price KES	IPO Value KES B
KenGen	2006	11.90	26.0
ScanGroup	2006	10.45	0.7
Eveready	2006	9.50	0.6
Kenya Re	2007	9.50	2.3
Safaricom	**2008**	**5.00**	**50.0**
Coop Bank	2008	9.50	5.4
Britam	2011	9.00	5.8
NSE	2014	9.50	0.6
Fahari I-REIT	2015	20.00	3.6

Source: CMA



Source: Respective exchanges

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Discouraging prerequisite listing conditions: A major hurdle for family owned firms to list is the prerequisite condition that not more than one third of the board members should be related. In addition, corporate governance guidance dictates that the board should have a specified number of independent directors. In most privately owned companies, a huge chuck of the board members are related and may not be willing to onboard a "stranger" who could change the fabric of the firm's top leadership.

Absurdly high valuations: A number of companies that go public have the current shareholders demanding a lofty premium for ceding ownership to the public. As a result, the valuation of the new market entrants may end up ranking above its peers which discourages investors from investing in the firms. Once the firm goes public, there's usually an abrupt price correction in the market which dents the market price and paints the public markets in the wrong picture.

Alternative exit strategies: Prior to the development of private capital, IPOs were the most preferred exit strategies for private capital seeing that they promised rich valuations, compensating for the cumbersome process. However, with private deals calling for fewer regulatory requirements, private firms are selling their stake to other private firms avoiding the public route.

Additional running costs associated with listing: Before a firm goes public, it needs to onboard a certain level of management and auditors which raises the operating costs.

Silver lining

The silver lining in the dearth of IPOs is that firms intending to go public take longer to list. As such, the private companies develop more stable business models which are easier to pitch to the public markets. Consequently, the firms grow in the shadows and emerge in the limelight as large cap counters which generally do better in the market than small cap counters. This leads to fewer IPOs in number but, larger capital raised in the long-run. Though this trend has not been observed in the country, some developed markets (e.g. USA) are observing this trend which may be replicated in the country.

Mend the side-scuttle or abandon ship?

For us eking a living from the public markets, our opinion is cast in stone that the public markets should be revived. However, some circles argue that we should let "nature" take its course seeing that the private capital markets are fulfilling the primary role of going public which is raising capital in a more efficient and faster manner. However, other factors affecting this argument are explained further below.

Retirement funds and individual savings are locked in the public markets: Most pension funds and individual shareholders are heavily invested in the public markets. In Kenya, pension funds are given a bigger headroom for public equities and bonds as compared to private equity and other instruments. As such, the public markets have a lot of vested interests.

Decreased disclosures: Competitive markets work best where the information flows freely. Though purely competitive markets don't exist, public markets ensure information flows freely encouraging competition. The high regulatory and reporting conditions demanded in public markets ensure transparency.

Need for price discovery still exists: Regardless of the development of private capital, public pricing is still king. Some of the valuations of privately held companies have been questionable with the true underlying pricing to be determined in the public sphere.

The need to complement banking services: Similar to banks, public markets provide capital to entrepreneurs but at different levels. One is left to ponder, if we had a developed capital market, would the rate cap have dented lending to the private sector? With the banks contracting lending to the private sector, the capital markets could/should have stepped in and offered capital to the SME sector. As such, the public market should be revamped and more so the small cap sector which provides alternative sources of capital to the risky sector.

Cardioversion to the weak IPO pulse

We are of the opinion that the public markets are in dire need of a lifeline from any direction. Some of the remedies we envision to be effective have been outlined below.

Creating demand for small cap counters: Most of the IPOs are expected to be small cap counters which have in the recent past performed very poorly. As such, the regulator and the exchange should push for the increase in individual investors.
The two have taken commendable first steps by tapping into the growing gambling market. As Treasury seeks to introduce a 20% withholding tax on winnings, the NSE requests for preferential tax treatment to winners who direct some of the winnings to public markets. With an estimated c.5.0% of Kenyans investing in the public markets, there exists headroom for growth in the number of individual investors.

Additional incentives to listing companies: The current listing incentives (lower tax rates) have done little to lure companies to list and as such, additional ones need to be introduced. The largest hinderance to listing has been the additional legal requirements and additional public disclosures. We opine that staggered implementation of some of the prelisting requirements will encourage some of the companies to list.

Different share classes to be listed: To deal with shareholder activism, different classes of shares could be introduced and listed. The lower class shares could have little/ /no voting rights and sell at a discount to onboard quiet/dormant shareholders.

Increased activity by the largest economic player: The government is the largest employer and consumer of goods in the country. With the government showing goodwill in encouraging the number of listings, it should take the first step in divesting some of its parastatals to the public markets. We take cognizance of the intended dual listing of National Oil at the NSE & LSE early next year.

Adoption of technology in investing and analysis: Among the reasons why there has been little investment flowing to small cap counters is reduced research coverage by investment firms. The adoption of AI based analysis may broaden the coverage to cover the small cap counters and encourage investment therein.
Still borrowing from the growing gambling market, mobile based trading should be instantaneous with account settling done as soon as trading is done. This will encourage the switch from gambling to investing.

Taking advantage of the exchange status: The USA has had a stable number of cross-border listings as the foreign firms eye the most developed capital market in the world as well as the large market for their products. With the adoption of Continental African Free Trade Area agreement, the NSE and regulators should seek for the linking with other African exchanges. The NSE should also offer incentives to firms seeking exposure in the African market to list on the bourse. Lagging other developed African markets, this is a leap of faith, but the introduction of new products in the market will raise NSE's profile; encouraging cross-border listings.

Autocratic legislation: Markets should be free with little interference from the political elite. However some circles call for the compulsory listing of a number of firms in different sectors; a stance that has been adopted by Tanzania. The country has made it compulsory for all telco and mining firms to list, effectively raising the number of publicly listed firms. The Kenyan government had hinted on the possible introduction of similar regulation for mining companies but it remains to be seen what the reception would be from the affected firms. Though this route raises the number of IPOs, it's more of killing a mosquito with a sledge hammer.

The ripple effect of a resurgence in IPOs: A recovery in IPOs may convince private capital firms that IPOs are still a viable exit strategy and may start eyeing the strategy. Given richer valuations and lower hurdles to go public, the private firms may opt for the strategy further driving the number of IPOs.

Parting shot

Public and private markets are here to stay and the success of one should not be deemed as the failure of another. In addition, the two should complement each other and not cannibalize each other. The growth and development of private capital has been supported to a large extent by deregulation. As such, it's high time public capital markets are subjected to lower and friendlier forms of regulation. As the Government and the regulators are not known for their prompt action, a disruption in the sector is wanting which could force them to react faster to the issues raised.

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