ASSESSING THE ROLE OF THE CAPITAL MARKETS AS AN ENGINE FOR ECONOMIC GROWTH IN KENYA

BY

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DECLARATION

I declare that this research project is my original work and has not been submitted or published or presented in any way to any academic institution for any academic awards.

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This proposal has been submitted for examination with my approval as the University supervisor. .

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DEDICATION

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ABSTRACT

The study assesses Kenya's capital market as an engine for economic growth. Generally, capital markets facilitate mobilization of capital for development and provide savers with an alternative saving tool. Funds that would otherwise have been consumed or deposited in bank accounts are re-directed to promote growth in various sectors of the economy as people invest in securities. Economic growth is promoted through improved efficiency in mobilization of savings as capital is allocated to investments that bring the most value to the economy. Long term savings are, therefore, mobilized for financing long term ventures through competitive pricing mechanisms.

Kenya's capital market, just like any other capital market in the world, provides enterprises with a non-bank source of financing through the sale of shares to the public. It provides not only the substitution but also diversification of risk to entrepreneurs as they raise capital through equity. The Kenyan government and local authorities use the capital markets as an alternative source of funds to increase taxes in order to finance development projects. Through the issue of bonds to the public, funds are raised for different types of projects. As an instrument of privatization, the capital markets has provided an avenue of liberalization of sectors previously dominated by the government and facilitated public divestiture of its shares in public enterprises such as Kenya Commercial Bank, Kenya Airways, Mumias Sugar Company, among others.

The capital markets encourage broader ownership of firms. The general public is accorded an opportunity to have ownership rights over listed enterprises thus helps to reduce large income inequalities through the sharing of profits made by the enterprises resulting in wealth re-distribution. In addition, the capital market facilitates improved corporate governance. Public companies tend to have better management records than private companies because of the improvement of management standards and efficiency to meet the demands of shareholders and the capital markets authority (CMA) under its corporate governance rules. Investors are accorded the opportunity to buy the number of securities affordable to them, thereby facilitating the small investor's source of extra

income. This is in contrast to other means of investments that require large capital outlays that are not within the reach of small investors be they individual or institutions.
The activity in the capital market serves as a 'barometer' for the performance of the economy. The movement of shares is an indicator of the general trend in the economy because share prices tend to rise or be stable when the economy and the relevant companies are stable and growing.

The Kenyan capital market however faces impediments in its development. These include weak macro-economic environment, lack of awareness, state of market infrastructure, legal framework and limited scope of products and services. The prevalence of such impediments among others may explain why companies have continued to prefer using retained earnings, family savings and bank loans (overdrafts) to finance their operations.

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LIST OF ABBREVIATIONS

ATS	Automated Trading System
CDS	Central Depository System
CMA	Capital Markets Authority
EASRA	East African Securities Regulatory Authorities
GDP	Gross Domestic Product
ICT	Information and Communications Technology
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offer
MMOU	Multilateral Memorandum of Understanding
NBFIs	Non-Bank Financial Institutions
NASI	Nairobi All Share Index
NSE	Nairobi Stock Exchange
OTC	Over the Counter
SME	Small and Medium Enterprise

CHAPTER ONE: INTRODUCTION

1.1 Background

The existence of a link between capital markets and economic growth has long been debated by economists. In the 19th Century, economic theory held that the capital structure of an economy did not affect the real economic variables, including economic growth. More recently, leading economists came to believe that unregulated capital markets perform better than regulated capital markets. Hence, the existence of competitive capital markets should, in principle, enhance economic livelihood. Indeed, early empirical work by Goldsmith (1969), McKinnon (1973), and Shaw (1973) produced considerable evidence that liberal capital markets policies correlate positively with economic growth.

Recent theoretical literature on capital markets development and economic growth identifies three fundamental channels through which capital markets structure and economic growth are linked. These include the fact that capital markets development increases the proportion of savings that is channeled to investments. In addition, capital markets development may change the savings rate and hence affect investments. Lastly, capital markets development increases the efficiency of capital allocation. Efficient capital allocation means that funds are allocated to the investment projects or firms that bring the most value to the economy; the marginal product of capital value is the highest.

Capital markets enhance financial stability by diversifying both the avenues for investing savings and the sources of funding for investment activities beyond the banking sector. Capital markets promote economic growth through improved efficiency in savings mobilization. Capital markets with adequate depth play an essential role in economic development by mobilizing funds to finance longer-term projects. The market for long-term funds typically consists of three main components, namely long-term bank loans and deposits, the bond market and the equity market. These components serve different purposes and are, therefore, complementary to each other. In an environment where all three components of the capital market are adequately efficient, bank loans would generally provide bridging finance or be used for smaller amounts of funding.

When larger projects are to be funded and as credit ratings improve, it makes more sense to issue bonds, because of the lower and fixed funding costs. However, maintaining a good credit rating implies that an acceptable debt/equity ratio has to be maintained, which in turn requires funding in the form of equity. In this regard, the equity market plays an essential role.

In any country, government needs to make concerted efforts to build supporting infrastructures for the bond markets by developing primary dealers, improving auctioning procedures, issuance of benchmark securities, creation of sound and efficient depository organizations, enhancing clearing and settlement systems, and developing rating companies in most cases in collaboration with international rating agencies.

In the context of capital markets, liquidity is of paramount importance. A market is liquid if transactions of large size can be made instantaneously and continuously without moving the price significantly, that is, the ability to execute transactions of a representative size cheaply and rapidly without having too much of an effect on the price. A liquid government bond market improves the efficiency of the capital markets by facilitating pricing of other and riskier financial assets. This has a direct impact on the degree to which other segments of financial markets (forward and futures markets, including foreign exchange hedging) can be developed to support risk management functions.

Illiquid and increased transaction costs are the most important symptoms of inefficient stock markets. Such inefficiencies may be caused by the market power of brokers and other individuals, which increase transaction costs and by the dominance of the market by a small number of firms or individuals. The latter may result in the manipulation of stock prices, keeping them artificially low or high to suit the purposes of those in power. The net result of this is the eradication of the gains to be obtained from the stock market. Such inefficiencies can also result in the loss of public confidence, leading to reduced participation of the public investors.

There are a number of proxy measures for liquidity, such as the bid/offer spread, the turnover per year and the turnover as a ratio of market capitalization. The bid/offer spread on shares varies from company to company.

An efficient and well functioning government bond market is also essential for the conduct of open market operations by the central banks.

1.1.1 Roles of the capital market

1.1.1.1 Source of finance

Firms can finance investment through a variety of means. They can use internal funding such as retained earnings or borrow externally by raising either equity or debt. The choice of alternative channels depends on the cost factors including the interest rate and the agency costs, access and availability, and the ability to service the loan or debt. Firms often seek external funding when they face liquidity constraints, but when the capital markets is shallow and thin with few instruments and low liquidity, this not only leaves the firms with minimal financing options, but also exposes them to high bank lending rates. The private sector has had to rely mainly on the banking sector to finance both their operations and their investments. At the same time, savers have been left with a thin basket of financial assets, which has seen them with little or no bargaining power for expected returns even on their deposits. This can then be a constraint on the mobilization of adequate and appropriate resources. Further, with an illiquid and immature capital market, the cost of financing increases while the channeling of resources from savers to good investment opportunities tends to be poor.

In addition to the capital market's role as a source of finance, other important roles the capital markets can play in the growth process include:

1.1.1.2 Ability to diversify

Without efficiently run capital markets, investors have limited means to diversify their portfolios. As a result, investors may avoid equity stakes because they are too risky. Hence, corporations may find it difficult to raise equity. With the creation of capital markets, individuals can diversify firm-specific risks, thus making investment in firms more attractive.

1.1.1.3 Moral Hazard

Capital markets play a subtle but important role in mitigating the moral hazard. Moral hazard often arises because managers gain from decisions affecting firm value only to the extent of the shares they hold. Suppose a manager holds 1% of the firm's equity and his compensation (either flat rate or tied to firm earning) produces most of his income. This manager has an incentive to take actions that maximize his compensation in ways that might have little or nothing to do with maximizing the firm's value (and equity value) when his compensation is tied to the firm's profitability which can be easily manipulated.

An efficient capital market gives a good measure of a firm's performance and its long term value, thus tying the manager's compensation to stock prices reduces the incentives for imprudent actions and therefore increases the firm's value. An efficient capital market can enhance growth by mitigating moral hazard and consequently increasing productivity. The significance of this effect depends on the magnitude of the moral hazard and on the proportion of the economy that is represented in the capital market. Thus, one may expect a positive correlation between capital market coverage (total market value as a fraction of gross domestic product [GDP]) and growth from this effect. Also, the gains from efficient capital markets may be greater if disciplining managers through other means is ineffective.

1.1.1.4 Change of ownership

In addition to providing performance measures to be used in the employment contracts, the capital market disciplines managers indirectly through change of ownership. If the managers are not doing a good job, the stock prices declines below the potential value of the assets. Such firms are then takeover targets for investors, who will increase the value of the shares by replacing current managers. Managers would refrain from productivity-decreasing actions when faced with the threat of takeovers.

1.1.1.5 Innovation

Another key growth contribution of an efficient capital market is its effect on entrepreneurs. An entrepreneur considers not only the profits generated in a new venture but also the possibility of a lump-sum gain through selling the venture to the public. If capital markets are not efficient, the public offering is less feasible as a result of high transaction costs or the uncertainty of getting a fair price in the capital market. Thus, inefficient capital markets may reduce the incentive to enter new venture, reducing overall long-term productivity of the economy.

An efficient stock market reduces the transaction costs of trading the ownership of the physical assets and thereby opens the way for the emergence of an optimal ownership structure. Certain individuals possess the entrepreneurial spirit for "new start" ventures, and such entrepreneurs should be involved in the innovation phase of a firm's development. As the firm matures, they often transfer to another class of investors, one that specializes in running mature firms. The entrepreneurs can then move on to the fledgling company. This is the idea of optimal ownership. Clearly transferring the ownership of such assets would be very difficult without stock markets. The idea that stock markets contribute to the economy by providing rewards to innovators is an important one in the model studied by King and Levine (1993).

1.1.2 Kenya's market Structures: Achievements and challenges

The capital market in Kenya has taken a number of significant steps towards developing a mature and efficient market environment. A review of these is as discussed below:

1.1.2.1 Legal and regulatory framework

The Nairobi Stock exchange (NSE) and the Capital Markets Authority (CMA) have encouraged investments in securities of companies quoted at the NSE. Over the years, NSE has provided necessary information regarding stock trading and also provided the necessary legal framework for trading to take place. NSE has been in existence since July 1954, when it was established. Current number of listed companies at the NSE average 56. The Kenyan CMA was set up in 1989 as a statutory body charged with the prime responsibility of regulating the development of orderly, fair and efficient capital markets in Kenya. It licenses and supervises market intermediaries, conducts on-site and off-site market surveillance, enforces compliance, promotes market integrity and investor confidence. The principal objective of the CMA as set out in Section 11(1) of the Capital Markets Act include development of all aspects of the capital markets with particular emphasis on the removal of impediments to, and the creation of incentives for long term investments in productive activities. It also aims to protect investors' interests by operating an insurance fund to protect investors from financial loss arising from the failure of a licensed broker or dealer to meet his contractual obligations. The regulatory structure enables the building of an effective system of market oversight, including a mechanism for monitoring compliance with specific regulatory requirements. Market surveillance enhances the level of intelligence information on market operations, hence acting as an early warning system.

Like elsewhere in Africa, the Kenyan capital market remains small in size with limited number of listings, relatively low liquidity, and significant structural and regulatory weaknesses. There is however significant scope for improvement. Low liquidity and other market weaknesses mean that the market does not always price the cost of capital appropriately, leading to potential misallocation problems. In addition, there remain institutional weaknesses and gaps in the market infrastructure which risk undermining confidence and efficiency in the market. In particular, legal and regulatory factors that enhance investor confidence and develop the culture of participating in the capital market need to be developed and tax incentives appropriately aligned.

1.1.3 Modern writing on Capital Markets

Whereas previous research focused exclusively on technological progress as the main engine of economic growth, new models show that growth can be self-sustaining without technological progress; Lucas (1988). Economic growth in a modern economy hinges on efficient financial sector that pools domestic savings and mobilizes foreign capital for productive investments. In the absence of an effective capital market, productive projects may remain unexploited. Inefficient capital markets will have the effect of taxing productive investments and thus reducing scope for increasing the stock of equipment needed to compete globally. Inefficiency can substantially cut growth from the levels that might have been possible given appropriate policies and market structures.

According to a survey carried out by Pagano (1993), in many of the new models, financial development has the ability to increase economic growth through various channels. By far the primary role of financial institutions and capital markets is to allocate capital efficiently, that is, to allocate funds to the investment projects with the highest marginal product of capital.

Capital markets play a key role in an economy by providing an alternative source of long-term finance for long-term productive investments. This helps in diffusing stresses on the banking system by matching long-term investments with long-term capital.

1.2 Research Problem

Small and Medium Enterprises (SMEs) form a key part of economies throughout the world. In Kenya, SMEs have the potential to contribute significantly to economic growth and poverty reduction through increased production and employment. In most cases, SMEs rely on bank loans, overdrafts and informal sources of financing as the main source of finance even for fixed capital and long term investments. Limited access to equity financing by SMEs is stifling the growth of the enterprises.

According to a report that was commissioned by Kenya's Capital Markets Authority (CMA) to look into ways of drawing investment into the ICT sector, the huge "equity gap" that exists in the sector has to be addressed to unlock its potential. With the exception of telecommunications, the report that was recently launched in Nairobi notes, the ICT sector is dominated by SMEs that unfortunately face huge financing challenges. It indicates that the use of equity financing is limited, with SMEs depending more heavily on personal loans from friends and family or bank financing. This state of affairs is traced to shortcomings not only in the ICT sector, but also the small and medium enterprises in the emerging markets. For starters, the small and medium enterprises are fragmented; that is, spread over a wide area and without collaboration making it unattractive to the funds. Challenges range from having few financiers that target early stage and startup enterprises that make the bulk of SMEs in the sector to a shortage of professionals who can assess and identify viable investments.

SMEs face challenges in raising capital as financial institutions are unwilling to offer credit as a startup capital since they are perceived to be high risk ventures. Capital markets would thus be a better source of finance for the SMEs to spearhead their growth.

Capital markets however face many challenges in promoting more efficient allocation and mobilization of capital within emerging markets. These include poor market infrastructure which hinders efficient flow of information, lack of professionalism, ineffective corporate governance, unethical practices as seen in insider trading and inadequate legal framework to protect investors.

Long term financing remains a major drawback in companies' operations. The study intends to ascertain capital markets participation in bridging the gap in financing SMEs, other private sector companies and the public sector. Key research questions would thus be: can the capital markets bridge the gap in financing the Kenyan economy? Can the capital markets be seen as the most preferred source of finance among investors?

1.3 Research Objective

The objective of the study is to assess the role of the capital markets as an engine to economic growth.

1.4 Value of the Study

Various groups who will benefit from the study include the following:

The Government, SMEs, and the private sector: since capital markets will be viewed as a key source of finance to stimulate growth within the sectors

The public investors: since the will be sound ethical, corporate governance practices and legal & Institutional framework governing operations of the capital markets reducing cases of malpractices likely to result in the collapse of the brokerage firms hence loss to the investors

Foreign investors: since they will perceive the legal and institutional framework as a protective layer reducing the level of risk within a given economy and higher liquidity influenced by active participation of the investors given high investor confidence.

Regulators: The CMA and the NSE as self regulatory organizations in facilitating the development of capital markets can us the findings of this study as a basis of formulating policies or strengthening policies already formulated thus facilitating growth of the market.

Academicians and Scholars: The findings of this research would establish the basis for further research within the field of finance.

CHAPTER TWO: LITERATURE REVIEW

2.1 Link between capital market development and economic growth

Rao *et al.* (2008) using a panel of five Asian countries over the period 1970 - 2007, found that financial developments have a significant positive correlation with economic growth in all but one country where the relationship was weak. Similar results were found by Apergis *et al.* (2007) who investigated the casual linkage between financial development and economic growth using a panel co-integration and panel estimation on sixty-five countries over the period 1975 - 2000 and found a significant positive impact of financial development on growth. In the case of a single country, Kularatne (2001) used Johansen's VECM to investigate the financial-growth link in South Africa over the period 1954 - 1992 and found a strong feedback relationship between the two.

External equity has not been a popular source of finance in Kenya possibly because of the level of development of the capital market. In the mid-1990s, with the government policy to consolidate the banking sector, most non-bank financial institutions (NBFIs), some of which were offering specialized financing products, converted to commercial banks and thus reduced the provision of provision of the specialized asset financing products in the market. The hardest hit by these developments were the small to medium -sized enterprises (SMEs), which face collateral issues banking institutions. Ngugi (2002, 2008), studying listed firms in the NSE, showed that capital market imperfections had a direct impact on capital financing behavior through their effect on the ease of access to and availability of capital. Such uncertainty in the market created by market imperfections adversely affects investment expenditure.

2.2 Link between market integration and economic growth

According to Bekaert, Erb, Harvey and Viskanta (1996) report estimates of equity transactions costs in emerging markets; transaction costs are high for foreign investors in many emerging markets, illiquidity combined with taxes (income, withholding and transaction) and various capital market restrictions (official registration of securities transactions and exchange controls) make foreign market participation very costly to many investors.

Many emerging markets are segmented. This means that investors are local residents and foreign participation in the local market is limited. Segmentation has many causes; for example, foreigners may be prohibited from participating in the local market. The causes may be more subtle in terms of regulatory, institutional and tax barriers to investments. Nevertheless, a market dominated solely by local investors is not likely to be integrated into global capital markets.

In a segmented market, investors' portfolios are exposed to price fluctuations induced by the state of the local economy. Even though the investor might hold many stocks, this portfolio is not fully diversified, because all of the stocks are linked to the local economy. Since all the stocks originate within one country, they all are exposed to fluctuations emanating from the local economy. Logically, investors in the segmented capital markets require compensation for this risk. This compensation takes the form of higher expected rates of return which translates into higher cost of capital for corporations operating within that market.

In integrated capital markets, however, compensation is different: the investor holds securities from many countries. This is a world diversified portfolio. The diversified international portfolio provides a natural hedge for country-specific events. The investor, although still concerned about negative shocks in any one country, does not require a risk premium for the lack of country diversification. The expected rate of return on the local stock is determined by how it interacts with all of the stock in the investor's worldwide portfolio.

Research by Bekaert and Harvey (1995) suggests that the expected risk premium on equity investments in many emerging markets can be reduced by increasing their integration into worldwide capital markets. Their research proposes an econometric model that examines two possible regimes: segmented capital markets and integrated capital markets. Using historical data, the model reveals the evolution of many markets from closed markets to being integrated into world capital markets.

The expected rates of return on equity differ in segmented and integrated markets. In segmented market, the expected rate of return is linked to local market volatility. In the integrated capital market, the expected rate of return is linked to the way the security integrates with a geographically broader investment portfolio. The cost of capital would thus be lower in integrated markets because of the following reasons:

First, in emerging markets, the local market volatility is very high; Bekaert and Harvey (1997a). This high volatility leads to high expected rates of return on equity investments in segmented capital markets.

Second, emerging markets are attractive investments for world investors because these markets serve as a hedge for such investors' portfolio (the local economies are not highly correlated with developed economies). Since the industrial structure of emerging markets is often much different from that of developed markets, bad news in developed markets is often cushioned with good news in emerging markets, and vice versa. This natural hedge cause a high demand for the emerging market's securities by foreign investors - if the emerging market is integrated into world capital markets. This demand raises equity prices and eventually reduces expected rates of return. A formal model of how this desire for portfolio diversification can lead to higher economic growth for economies that integrate their capital markets with world markets is provided in Obstfeld (1994).

2.3 Corporate governance, legal structure and economic growth

As Iskander and Chamlou (2000) observe, the capital markets in developing countries provide little incentive for better corporate governance (either in the real sector or in the financial sector), primarily because of the dominance of a few large firms, low trading volumes and liquidity, absence of long-term debt instruments and inactivity of institutional shareholders.

Shleifer and Vishny (1997) argue that a firm is likely to get external finance not only because of the reputation of the capital market and excessive investor optimism, but also due to assurances provided by the corporate governance system.

Whilst firms rely on external finance (e.g. equity or debt) in meeting their investment needs, the pattern of relationship between the firm as a distinct legal entity and the shareholders or creditors, tends to be determined by a complex contractual arrangement, which in turn is influenced by the legal system within which the firm operates. Unlike developed economies, the legal protection of the firm's external financiers (shareholders or creditors) in many developing economies tends to be very low because of the differences in interpretation in the legal systems and poor legal enforcement (Shleifer and Vishny 1997).

Aside from working as a source of financing investment (Samuel 1996), a capital market tends to have both direct and indirect influence on the governance practices of the listed firms (Singh 2003). The direct governance measures include: tightening listing requirements, controlling insider dealing arrangements, imposing disclosure and accounting rules, ensuring protection of minority shareholders and attracting reputational agents (Claessens 2003; Singh et al. 2002). Conversely, a capital market can exert indirect influence through pricing mechanisms, which include both allocative and disciplinary measures and the takeover mechanisms (Singh 2003; Samuel 1996).

2.4 Factors important for capital market development

For the capital markets to play a decisive role in mobilizing and allocating resources for long term investments there has to be a critical mass of products and services, issuers of securities, market players, market infrastructure, and an enabling environment. Investor protection creates confidence in the market, enhancing liquidity. Investors need assurance that they are engaging in a fair game and that they have the ability to take advantage of market opportunities in good time. Firms, who are issuers of securities, consider ease of entry and continued control of the ownership of their companies as key considerations in participating in the market. On the other hand, diversification of products gives an opportunity to investors to diversify their portfolio while the availability of professionals in the market reduces information asymmetries and smoothes investors' participation. As such, the institutional and policy environments become major determinants in the growth of the market, creating an enabling environment for the participation of the firms/issuers, investors, and professionals. The factors are as follows:

2.4.1 Market Infrastructure

A well functioning market infrastructure reduces obstacles to trading flows, provides secure custody of claims, and safeguards against systematic risks. These factors allow for low-cost settlement of financial transactions and raise investor confidence. On the firm side, such developments also encourage greater market liquidity, which in turn enhances efficiency in the price discovery process (Amihud *et al.,* 1990; Bessembinder and Kaufman, 1997) and hence ensures that efficient stock prices act as benchmarks for evaluating the costs of capital and investment returns for investment projects (Green *et al.,* 2000). For investors, improved investor protection encourages participation in share trading, which improves liquidity. It has been shown that countries that protect shareholders have more valuable stock markets, a large number of listed securities per capita, and a high rate of IPOs, and, moreover, this protects markets against excess volatility (La Porta et al., 2000). By ensuring investors' confidence, this enhances investors' participation in market activities, encouraging savings and channeling these savings into productive real investments, thus fostering capital market accumulation and efficiency in investment and real sector development. It is, however, debatable whether investors' protection promotes market efficiency.

2.4.2 Systems of information disclosure

Systems of information disclosure are more likely to promote market efficiency by providing informed traders with low-cost information (Georgakopoulos, 1996). For example, it is observed that securities may deviate from their fundamental values because of irrationalities in the market including uninformed trading or noise trading. As this type of trading interferes with optimality of market allocation of capital among competing firms, there may be a strong argument for tightening disclosure rules. However, Yartey (2008) observes that, when exchanges are demutualized, there is a conflict of interest as exchanges tend to shy away from enforcing actions against their customers who are sources of income, and there is also commercialization of services including data and trade information, which would retract any gains in reducing information asymmetry. Similarly, listing standards and oversight can be lax.

2.4.3 Quality of overall institutional structures

In addition to the market specific regulations, Yartey (2008) finds that the quality of overall institutional structures such as law and order, democratic accountability, and bureaucratic quality are also important determinants in the development of stock markets. These factors reduce the political risk that external investors would be factoring in to their expected earnings and enhance the viability of external finance. This finding is consistent with La Porta *et al.* (1997, 1998), who show that countries with lower quality of legal rules and law enforcement have smaller and narrower capital markets and that listed firms have more concentrated ownership. Similar links between the general level of political governance and capital market development are found by Demirguc-Kunt and Maksimovic (1998) and Bekaert (1995).

2.4.4 Overall macroeconomic stability

As Gertler and Rose (1996) argue, growth and macroeconomic stability enhance the pool of net-worth borrowers, whereas high and volatile inflation, a volatile and fast depreciating exchange rate, and high interest rates destroy this pool.

2.4.5 Level of savings and technological development

Financial sector development is assumed to affect growth through the amount of savings put into investment and the technological development. Enhanced financial development reduces the transaction cost of external finance to firms, which results in increased investment and promotes growth (Rajan and Zingales, 1998). This affects the proportional share leaking out of the financial system. Further, Wurgler (2000) shows that, even if financial development does not lead to higher levels of investment, it allocates existing investment better and therefore promotes economic growth through production process.

2.4.6 Presence of foreign investors

Foreign investors may catalyze small emerging markets by bringing capital and skills to the market and, as a result, may provide depth and liquidity in the early stages of market development, thereby dampening latent volatility. But equally, large-scale foreign participation in (small) emerging markets may be de-stabilizing if they raise the risk that capital inflows are quickly reversed (the so-called 'sudden stop' problem as a result of small changes in the domestic or, indeed, international risk environment. Sellin (1996) highlighted the risks associated with large foreign participation in domestic markets.

2.5 Conceptual Framework

Institutional Framework

- Well functioning market infrastructure & systems of information disclosure
- Political stability
- Sound legal framework

Macroeconomic stability

- Low cost of equity capital
- Firm's ability to access to equity finance with ease
- Low & stable inflation rate
- Higher level of savings

Capital Market Development — **Economic Growth**

Ethics & Corporate Governance Quality

- Ethical guidelines
- Ownership structures
- Shareholder rights
- Independence and responsibilities of the board and management
- Disclosures and auditing
- Responsibility towards the stakeholders

- Increased investors' confidence & optimism of future expected cash-flow
- Increased foreign investors participation

Independent Variables

Dependent Variable

Source: Researcher's own formulation (August 2011)

2.6 Empirical studies on Capital Markets

2.6.1 Financial development and Growth

Empirically, early research by Goldsmith (1969), McKinnon (1973) and Shaw (1973) document a positive correlation between financial development and economic growth. However, questions still remain about causality: does financial development affect growth; does economic growth lead to more financial development, or both? Recent research has not completely resolved the issue but suggests strongly that financial development is an important determinant of future economic growth. The most comprehensive of this research to date is by King and Levine

(1993). King and Levine (1993) conclude, "Our findings suggest that government policies toward financial system may have an important casual effect on long-run growth" (p. 540).

2.6.2 Capital markets and Economic Growth

A number of economists have suggested that the existence of capital markets has little relevance to real economic growth; Stiglitz (1989); Mayer (1989). According to Harris and Raviv (1991), since managers typically have more information than outsiders, equity may be mispriced in the market from their point of view. Given that they have the choice of borrowing, the managers may only issue new equity if equity is overpriced. This may make investors reluctant to invest in new equity issues thus many companies may not heavily rely on new equity to finance new investments.

Atje and Jovanovic (1989) compare the impact of the level of capital market development and bank development on subsequent economic growth. Their finding were that there exists a large effect of capital market as measured by the value traded divided by GDP on subsequent development, but they failed to find a similar effect for bank lending. In their conclusion, they wrote, "It is even more surprising that more countries are not developing their capital markets as quickly as they can as a means of speeding up their economic development" (p. 636).

There exists a positive correlation between the various measures of capital market development as well as between these measures and economic growth, saving, and investment. Deep and liquid markets tend to be associated with higher growth. Granger causality tests indicate a unidirectional causality from market capitalization to savings and investment rates. Conditional on investment and measures of openness, all measures of capital market development are strongly and positively correlated with growth. This is the case whichever measure of liquidity is used in estimation; the coefficient sizes are not significantly different. The size of the market also has a positive and significant relationship with economic growth.

2.6.3 Conclusion

Economic growth can be enhanced through various channels of financial institutions and capital markets. This is through competitive pricing mechanism for better utilization of scarce resources thus efficient capital allocation.

Sound ethical guidelines are necessary to maintain higher investor confidence and increased investor participation in the capital markets. This provides a gateway to Kenya for global and foreign portfolio investors. Increased investors' participation in the capital markets ensures that capital markets play a key role of providing important alternative source of long-term finance for long-term productive investments.

CHAPTER THREE: RESEARCH METHODOLOGY

3.0 Introduction

This chapter outlines the methods and procedures that will be adopted to meet the objective of the study. It is sub-divided into research design, research population, data collection and data analysis.

3.1 Research Design

The researcher intends to use descriptive research study carried out in the form of questionnaire. Descriptive research determines and reports the way things are, it describes data and characteristics about the population and phenomenon being studied. According to Cooper *et al,* (2003), a descriptive research is concerned with explaining the: who, what, when and how of a phenomenon. Descriptive research is the investigation in which quality data is collected and analyzed in order to describe a phenomenon in its current trends, events and linkages between factors at the current time, which is the concern of the study. The study can be termed as descriptive as the researcher attempts to assess capital markets as an engine for economic growth in Kenya. Both qualitative and quantitative data will be gathered for this study. This will ensure that both non-statistical and statistical data are used in order to support the findings and result of the study.

3.2 Research population

Cooper *et al,* (2003), population is the total collection of elements about which we wish to make some inference. The target population of the study will consist of all listed companies at the NSE, the CMA, and NSE. A census study will be carried out hence no sampling will be done. The study will however exclude listed firms currently suspended from NSE, firms under statutory management or have since gone under. The firms listed at the NSE are categorized in various groups as outlined in appendix 3.

3.3 Data Collection

Primary data will be used in the study to address the research problem. Primary data will be collected using structured questionnaires (see appendix 2). A structured questionnaire will be used because it is easy to administer, analyze and economical. Each item in the questionnaire is developed to address the research problem and research objective. The questionnaire comprises both open and closed ended questions and will be administered through 'drop and later pick' technique and/or by face to face interview where appropriate. In instances where distance is prohibitive, questionnaires will be mailed with self administered and stamped envelopes to encourage them to apply.

The respondents will consist of key personnel involved in formulation and implementation of policies within the organizations selected. They will be expected to give an insight into some of the factors expected for capital markets to drive economic growth.

3.4 Data Analysis

According to Marshall and Rossman (1999), data analysis is the process of bringing order, structure and interpretation to the mass of data collected. Once data has been collected through questionnaires and secondary sources, it is systematically organized in a manner to facilitate analysis. The data collected will be analyzed using content analysis. According to Kothari (1990), analysis consists of analyzing the contents of documentary materials such as books, materials, magazines, newspapers and contents of all other verbal materials which can be either spoken or printed. It is a technique of making inferences by systematically and objectively identifying specified characteristics of messages and using the same to relate to trends. Content analysis examines the intensity with which certain words have been used. Content analysis systematically describes the form or content of spoken material (Kombo and Tromp, 2006). Descriptive statistics such as mean, percentages and tables will also be used in the data analysis. The descriptive statistics will enable the researcher to describe the key variables within the capital markets that would result in the capital market playing a key role in economic growth. The key variables include institutional framework, ethics and corporate governance, investors' confidence and cost of capital. The data will be tied to the objective of the study in order to arrive at reliable conclusions.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND *DISCUSSION*

4.1 Introduction

This chapter entails the findings of the study based on the data collected from the field. The analysis focused on the objective of the study which sought to assess the capital markets as an engine for economic growth in Kenya. The capital market in Kenya is made up of stock market, bonds, development financial institutions and pension funds.

4.2 Data Analysis

4.2.1 Scope of the study and demographic results

A census study of all companies listed at the NSE was used. This however excluded CMC Holdings Limited which is currently under statutory management. Additional data was collected from the CMA and NSE. Research questionnaires were sent to all the 56 companies listed at the stock exchange. The researcher received feedback from 20 companies from face to face interviews held at the companies' premises. Additional feedback from 10 companies was received in the form of a mail. Further, a follow up was done through phone calls for the remaining 25 companies from which data was successfully received. In general, the respondents were quite co-operative in assisting in data collection.

Categories of the sectors under which the companies fall are as per the table below:

Table 1: Categories of the sectors under which companies fall

Category	Number of companies
Agricultural	7
Commercial & Services	8
Telecommunication & Technology	2
Automobiles & Accessories	4
Banking	10
Insurance	4
Investment	3
Manufacturing & Allied	9
Construction & Allied	5
Energy & Petroleum	4

The period of existence for the companies covered under the study is as per the table below:

Table 2: Period of existence

Period incorporated / established	Existence period	Number of companies
2011 -2009	0-2 years	1
2008 - 2006	3-5 years	3
2005-2001	6-10 years	1
2000- 1996	11-15 years	2
1995- 1991	16-20 years	1
Before 1991	Over 20 years	48

Out of the 56 listed companies, 48 companies were incorporated before 1991, thus have been in existence for over 20 years.

Companies listed before 1968 include: Marshalls (1954), Limuru Tea (1967), Kenya Oil (1959), Consolidated Holdings - now listed as Standard Group - (1954), City Brewery (1950) currently listed as City Trust, A. Baumann (1948), Sasini Tea and Coffee (1965), CMC Holdings (1950), and George Williamson (1951). In 1968, Kenya Orchards, Kapchorua Tea, Kenya Power (formerly E.A Power), E.A. Portland, E.A Breweries, Car and General, Industrial Commercial and Development Corporation Investment Company (ICDC - set up by the Government of Kenya to promote the African owned business sector) were all listed. All of these companies except Kenya Orchards and Kapchorua Tea had the Government of Kenya as a shareholder. This implies that the government shareholding was either bought from the British government or from British investors who chose to leave after Kenya attained her independence in 1963.

Summary for the year of listing for the companies is as per the table below:

Table 3: Year of listing „,

Category	Number of companies
Before 1963	7
After 1963	49

A number of respondents were accountants in the various companies covered in the research. The researcher did not manage to have an interview session with any of the Chief Executive Officers or Managing Directors of the various companies.

The table below shows the respondents' position in the various companies:

Table 4: Respondents' position in the company

Category	**Number**
Managing Director	0
Finance Director	2
Chief Accountant	5
Accountant	34
Others (Financial Analysts)	5
Others (Shares Registrar)	8
Others (Assistant Shares Registrar)	1

Majority of respondents from the various companies have worked in the particular companies for a period of between 3 - 5 years. This is as shown in the table below:

Table 5: Respondents' period worked in the company

Category	**Number of companies**
0 - 2 years	6
3- 5 years	27
6 - 10 years	18
Over 10 years	4

4.2.2 Capital markets development

The trends of listing, delisting and/or suspended companies at the NSE over the years are as per the table below:

Table 6: Trends of listing, delisting and/or suspended companies at the NSE

Year	**No. of listed companies**	**No. of delisted companies**	**No. of suspended companies**
2004	48	-	-

2005	48	-	2 (BOC, Carbacid); Re-admitted 2009
2006	51		1 (Uchumi Supermarkets); Re-admitted 2011
2007	54	-	-
2008	55	1 Unilever Tea (K) Ltd	1 (A. Baumann)
2009	55	-	-
2010	55	-	-
2011*	56	-	-

*Jan 2011 - June 2011; Source: Capital Markets Authority

There has been one de-listing and four suspensions since year 2004. Three of the four suspensions have been lifted. Also, since year 2004, the number of companies listed has risen from 48 to 56.

Financing is one of the major factors companies consider in their operations. Preference on the mode of financing varies from company to company and in some case, this may be attributed to the companies' ability to negotiate for terms of finance with the parent company, related sister company, financial institution or the capital markets. The listed companies preference for the mode of financing is as shown in the table below:

Table 7: Companies preference on mode of financing

Category	**Very high**	**High**	**Moderate**	**Low**	**Very low**	**Not preferred at all**
Bond	40	10	5	Nil	Nil	Nil
Commercial Paper	32	15	8	Nil	Nil	Nil
Money Market Loan	20	19	9	7	Nil	Nil
Offshore loan	2	5	10	38	Nil	Nil
New issue of shares	36	9	7	3	Nil	Nil

From the research findings shown above, bond is the most preferred source of finance, possibly because of the interest tax savings arising whenever bond is used as a mode of financing.

In the last few years, activity in the bond market has far exceeded the primary and secondary equity markets as a result of the introduction of treasury and corporate bonds. The market statistics on the trend of the bond performance compared to equity performance in Q1/2011 and Q2/2011 are as shown in the table below:

Table 8: Market statistics on the trend of the bond performance compared to equity performance

	Q1 -2011			Q2-2011		
	Jan-2011	Feb-2011	Mar-2011	Apr-2011	May-2011	June-2011
Bond Turnover (Kshs Bn)	19.89	49.04	40.12	33.38	33.65	69.42
Equity Turnover (Kshs Bn)	9.46	6.22	7.98	7.88	8.41	7.05
Shares Volume Traded (Mn)	725.05	335.25	469.03	497.19	410.87	410.97
NSE 20-Share Index	4,465	4,240	3,887	4,029	4,078	3,968
NASI	99.02	96.66	89.50	94.18	93.21	91.36

Source: NSE, Capital Markets Authority

The bond market traded many times the value of the equity market as government securities registered growth in number, amount and length of maturity.

The government has embarked on a program to restructure its domestic debt from short-term treasury bills to long-term bonds by increasing the maturity of government bonds. Quarterly comparative of Treasury bond and corporate bond turnover for Q4/2010 and Q1 & Q2 2011 is as shown in the table below:

Month	Government Bond Turnover (Kshs bn)	Corporate Bond Turnover (Kshs bn)	Total Bond Turnover (Kshs bn)
	Q4/2010		
October	26.31	3.55	29.87
November	31.46	2.42	33.87
December	22.55	0.73	23.28
	Q1 /2011		
January	19.77	0.12	19.89
February	48.86	0.18	49.04
March	36.29	3.83	40.12
	Q2/2011		
April	32.95	0.42	33.38
May	32.11	1.53	33.65
June	29.26	0.15	69.42

Source: NSE

Data from the research reveal that only 10 companies out of the total companies listed at the stock exchange have opted to source for finance through the NSE. This is as per the table shown in the table below:

Table 10: Companies having opted to source for finance through NSE

Category	**Number of companies**
YES	10
NO	45

All the companies which have opted to source for finance through the NSE stated expansion, as the purpose of finance; which is as shown in the table below:

Table 11: Purpose of source of Financing for companies having opted to source Finance through NSE

Purpose	Number of companies
Setting up operations (Start up)	Nil
Expansion	10
Debt Repayment	Nil
Payment of suppliers	Nil
Dividend repayment	Nil
Others	Nil

Findings from the study reveal that stringent eligibility requirements is the highest factor that discourages corporations, SMEs and the private sector in general from seeking finance from the capital markets in Kenya. Summary of the deterrent factors is as per the table below:

Table 12: Likely deterrent from seeking finance from the Capital Markets in Kenya

Reason	Number of companies
Stringent eligibility requirements	32
Lack of knowledge on operations at the Capital markets	3
Less diverse types of securities to offer	16
Political uncertainty	5

The eligibility requirements outlined below have created higher barriers to potential entrants to the stock exchange.

Table 13: Eligibility criteria that must be satisfied to list securities on any of the NSE three boards, (MIMS, AIMS, and FISMS):

Requirement	Main Investment Market Segment (MIMS)	Alternative Investment Market Segment (AIMS)	Fixed Income Market Segment (FISMS)
Incorporation status	The issuer must be a public company limited by shares and registered under the Companies Act	The issuer must be a public company limited by shares and registered under	The issuer must be a public company limited by shares and registered under the Companies Act

• • • • I I Requirement	Main Investment Market Segment (MIMS) p B H H H H H ^ H I H H	Alternative Investment Market Segment (AIMS)	Fixed Income Market Segment (FISMS)
	(Cap 486)	the Companies Act (Cap 486)	(Cap 486) or any other corporate body.
Share Capital	The minimum authorized, issued and fully paid up capital must be Kshs. 50 Million.	The minimum authorized, issued and fully paid capital should be Kshs.20 Million	The minimum authorized, issued and fully paid up capital must be Kshs. 50 Million
Net Assets	The net assets should not be less than Kshs. 100 Million immediately before the public offer.	Net assets immediately before the public offer should not be less than Kshs.20 Million	The net assets should not be less than Kshs. 100 Million immediately before the offer.
Transferability of shares	The shares to be listed shall be freely transferable.	The shares to be listed shall be freely transferable.	May or may not be transferable.
Financial records.	The audited financial statements of the issuer for five preceding years be availed.	The audited financial statements of the issuer for three preceding years be availed.	The audited financial statements of the issuer for three preceding years be availed (except for the government)
Directors and Management	The directors of the issuer must be competent persons without any legal encumbrances.	The directors of the issuer must be competent persons without any legal	The directors of the issuer must be competent persons without any legal encumbrances

Requirement	Main Investment Market Segment (MIMS)	Alternative Investment Market Segment (AIMS)	Fixed Income Market Segment (FISMS)
		encumbrances.	
Track record	The issuer must have declared positive profits after tax attributable to shareholders in at least three years within five years prior to application.	The issuer must have been operating on the same line of business for at least two years one of which it must have made profit with good growth potential.	Not a requirement.
Solvency	The issuer should be sol vent and have adequate working capital.	The issuer should be solvent and have adequate working capital.	Not a requirement
Share ownership structure	At least 25% of the shares must be held by not less than 1000 shareholders excluding employees of the issuer.	At least 20% of the shares must be held by not less than 100 shareholders excluding employees of the issuer or family members of the controlling shareholders.	Not a requirement

Requirement	Main Investment Market Segment (MIMS)	Alternative Investment Market Segment (AIMS)	Fixed Income Market Segment (FISMS)
Certificate of comfort	May be required from the primary regulator of the issuer if there is one.	May be required from the primary regulator of the issuer if there is one.	May be required from the primary regulator of the issuer if there is one.
Dividend policy	The issuer must have a clear future dividend policy	The issuer must have a clear future dividend policy	Not a requirement

Source: http://www.nse.co.ke/public-educatioii/faqs.html (3rd October 2011)

The NSE is a highly concentrated market with most of its activity centered on a few listed companies. Concentration of majority shareholders is as per the table below:

Table 14: Concentration of majority shareholders

Category	Number of companies
Local pension funds	9
Retail investors	15
Private ownership / specific group Institutional investors	40
Banks	10
Insurance companies / firms	3
Fund Managers	6

Out of the 56 equities listed in NSE, about 15 companies are regularly traded. Trading on securities from the remaining companies is haphazard and irregular. The low turnover ratio, which is less than 5%, may be attributed to the limited floatation of shares as only about 35% of market capitalization is available for trading. In addition, there is a high incidence of "buy and hold" particularly among institutional investors who dominate the market.

The trend of the investor holding at the NSE as at June 2011 is as per the table below:

Table 15: Trend of investor shareholding

	Type of investor		
Year	E.A. Institutions (%)	E.A. Individuals (%)	Foreign Investors (%)
2003	44.7	21.9	33.4
2004	47.4	22.8	29.8
2005	51.2	22.5	26.3
2006	52.8	21.6	25.6
2007	54.5	26.9	18.6
2008	77.2	14.9	7.9
2009	74.2	15.7	10.1
2010	73.6	13.8	12.6
2011*	68.89	13.53	17.63

*Year to June; Source: CMA

Findings from the study reveal that most respondents have moderate knowledge on operations, services and benefits derived from the capital markets in Kenya. This is as shown below:

Table 16: Respondent's knowledge on operations, services & benefits derived from Capital Markets in Kenya

Level of Knowledge	Number of respondents
Highly knowledgeable	13
Moderate knowledge	37
Less knowledgeable	5
No Knowledge	Nil

In addition, feedback from the respondents show that they have high level of confidence in capital markets operations as shown in the table below:

Table 17: Respondents level of confidence in Capital Markets operations in Kenya

Level of confidence	Number of respondents
Very high	5
High	38
Moderate	10

Low	2
Very low	Nil
No confidence	Nil

Capital markets development is enhanced through various factors including: political stability, sound legal framework, ethical & corporate governance practice, macroeconomic stability, i.e., stable interest rates, acceptable levels of inflation and exchange rates. A stable macroeconomic environment and well developed institutional framework plays a key role in capital market development. Poor governance undermines integrity of corporations and discourages the use of capital markets as a means to intermediate savings. Particularly the areas of transparency and disclosure have been a major factor behind instability in the financial markets across the globe. Good corporate governance is an essential pre-requisite for the integrity and credibility of capital market players. Good corporate governance contributes to the development of a vibrant economy and robust capital markets.

Other factors likely to contribute to the capital markets role as an engine for economic growth include: availability of wide range of financial services, that is, many number of securities - shares, bonds, derivatives traded; adequate monitoring and supervision role of the CMA and minimal bureaucracy to encourage investors' participation in the capital markets.

Generally, policy and institutional factors play a key role in development of the capital markets. Investors require confidence, protection and information to participate in the market. Firms look for ease of entry, internal firm policy and fiscal incentives. For a bond market to contribute significantly in the development process it requires that the market caters for a diverse risk preferences, be liquid, efficient and have minimal volatility. To achieve this, there must be a sound fiscal and monetary policy, effective legal and regulatory framework, secure and efficient settlement and custodial system, effective information disclosure system, a diversified investor base, favourable tax policies, sound and prudent debt management for Treasury bonds and credible and stable government.

A summary of the respondents' view on the factors affecting operations at the capital markets in Kenya is as shown in the table below:

Table 18: Respondents view on the factors affecting operations at the Capital Markets in Kenya

Factor	Very high	High	Moderate	Low	Very low
		Num	**jer of respondents**		
Macroeconomic environment	40	13	2	Nil	Nil
Level of savings & technological development	5	38	8	4	Nil
Cost of capital	2	29	15	9	Nil
Level of transparency	30	11	10	4	Nil
Level of bureaucracy	35	14	6	Nil	Nil
Sources of financing options	30	12	9	4	Nil
Certainty on source of capital from CMA	11	18	7	9	Nil

About two-thirds of the current listed companies are categorized as local companies, with the majority of shareholders being residents of Kenya or companies incorporated in Kenya under the Companies Act, while a third of the listed companies are categorized as foreign with the majority shareholders being companies incorporated and operating in a foreign country or with shareholders resident in a foreign country. The trend of the foreign institutional and local equity investor participation at the NSE is as per the table below:

Table 19: Trend of the foreign institutional and local equity investor participation at the NSE

Quarter	Month/Year	Net Local Turnover	Net Foreign Turnover	Total Turnover	Participation of Foreign Investors
		Kshs Millions	Kshs Millions	Kshs Millions	%
Q3/2010	July	10,005	1,375	11,380	12.08%
	August	14,409	1,765	16,174	10.91%
	September	5,405	2,335	7,740	30.17%

Q4/2010	October	7,100	3,130	10,230	30.60%
	November	6,400	2,900	9,300	31.18%
	December	4,225	1,655	5,880	28.15%
Q1/2011	January	6,780	2,682	9,462	28.34%
	February	4,663	1,554	6,216	24.99%
	March	3,404	1,496	4,900	30.53%
Q2/2011	April	5,349	2,535	7,883	32.15%
	May	5,409	2,998	8,406	35.66%
	June	4,915	2,133	7,048	30.26%

Source: NSE, Capital Markets Authority

The process of structural adjustment and privatization due to fiscal deficit and government divesture programs has resulted in the entry of restructured firms in the stock market. In the 1990s, the NSE was driven to historic levels of activity when the Kenya Airways and Kenya Commercial Bank were listed in the NSE. In the new Millennium, activity levels increased with the divesture of government holding through rights issues in Mumias Sugar Company and the Kenya Commercial Bank.

Over-subscription of the government divesture of its shares at Kenya Commercial Bank in 2004 and the issue of Safaricom's corporate bond indicates the potential of the market to absorb new issues and is evidence of the existence of untapped potential in the mobilization of domestic resources.

The capital markets is however working towards reforming and deepening financial systems, through expansion of the regional markets in order to improve its ability to mobilize resources and efficiently allocate them to the most productive sectors of the East African economy. This can be seen through East African Members States Securities Regulatory Authority (EASRA); a forum for East African capital markets regulator which was established in 1997 whose member states are: Kenya, Uganda, Tanzania, Rwanda, and Burundi. The main objectives of EASRA are: Information sharing among the members; Mutual assistance and cooperation between members; and Advancing the integration of the East African capital markets. These objectives are in line with the provisions of the East African Community (EAC) Common Market Protocol that provide for the free movement of capital in the region. The free movement of capital is already boosting trade and investments, thereby making the region more productive and prosperous.

4.2.3 Assessment of capital market's role in Kenya's economic growth

The capital market has an intricate role to play in mobilizing savings and channeling them into the most efficient investments. Therefore, the capitals market becomes a fundamental component of the financial sector in achieving a robust and sustaining economic development in the following ways:

4.2.3.1 Source of Finance

The capital market provides an important alternative source of long-term finance for long-term productive investments. This helps in diffusing stresses on the banking system by matching long-term investments with long-term capital. In addition, the capital markets provides equity capital and infrastructure development capital that has strong socio-economic benefits - roads, water and sewer systems, housing, energy, telecommunications, public transport, etc. - ideal for financing through capital markets via long dated bonds and asset backed securities. Government bonds have dominated the debt market in the NSE. Until 2002, there was little trading in the bond market partly because institutional investors exhibited a "buy and hold" strategy. Since 2002 the issue of corporate bonds and the issue of longer-term government treasury bonds has increased turnover in the bond market.

4.2.3.2 Ownership of productive assets

Further, the capital market encourages broader ownership of productive assets by small savers to enable them benefit from Kenya's economic growth and wealth distribution. Equitable distribution of wealth is a key indicator of poverty reduction. The capital market promotes public-private sector partnerships to encourage participation of private sector in productive investments. This results in pursuit of economic efficiency shifting driving force of economic development from public to private sector thereby enhancing economic productivity.

4.2.3.3 Complements Government's effort in financing socioeconomic development

Capital market further assists the Government to close resource gap, and complement its effort in financing essential socioeconomic development, through raising long-term project based capital. It improves the efficiency of capital allocation through competitive pricing mechanism for better utilization of scarce resources for increased economic growth.

4.2.3.4 Avenue for investment opportunities

The capital market also provides avenues for investment opportunities that encourage a thrift culture critical in increasing domestic savings and investment ratios that are essential for rapid industrialization. The Savings and investment ratios in Kenya are too low, below 10% of GDP. The capital market provides a gateway to Kenya for global and foreign portfolio investors, which is critical in supplementing the low domestic saving ratio.

4.2.4 Impediments to capital market's role as an engine for economic growth

4.2.4.1 Macroeconomic environment

The stability of the macroeconomic environment is a critical factor in making long-term investment decisions. It significantly determines the returns on investment and opportunities for business expansion. Kenya's economy over the last two decades stagnated with a real GDP annual average growth rate of less than 4% resulting in contracting opportunities for investments. Low performance is attributable to factors such as: Level of investments, Instability in interest rates; Limited international aid flows; Poor state of infrastructure. Hence, most companies have not found it appropriate to raise funds through the capital markets. Equally, the cost of capital plays a major role in defining investment decisions. High and variable interest rates increase the cost of capital. High real short-term interest rates have reduced the demand for capital market instruments and crowded-out substantial domestic savings to short-term government securities. Interest rate spreads are high and currently standing at about 19%. Deposit rates are too low and lending rates too high thereby discouraging domestic savings and investment. The domestic savings are less than 10% of GDP and thereby insufficient to meet investment needs and generate demand for equities and debt instruments. Therefore, as part of the measures to create an enabling environment for capital markets development it is recommended that: a stable macro-economic environment is created and establishment of Memorandum of Understanding between the various regulators within the financial system to facilitate pursuit of a coordinated, sustainable and desirable policy framework.

4.2.4.2 Liquidity

NSE is considered a more liquid and active market than those of its East African counterparts (Uganda and Tanzania) and in sub-Saharan Africa in general. However, by international standards, it is small, illiquid and volatile with regard to price and returns. Low liquidity is particularly evident in the secondary bonds and equity markets. The NSE is a highly concentrated market with most of its activity centered on a few listed companies. Out of the 56 equities listed in NSE, about 15 companies are regularly traded. Trading on securities from the remaining companies is haphazard and irregular. The low turnover ratio, which is less than 5%, may be attributed to the limited floatation of shares as only about 35% of market capitalization is available for trading. In addition, there is a high incidence of "buy and hold" particularly among institutional investors who dominate the market.

4.2.4.3 Public awareness

Generally, there is lack of awareness and information on the role, functions and operations of the stock exchange and the CMA among potential investors and business entities. Many Kenyans throughout the country do not know enough about the NSE and the CMA, and the market does not seem to market itself sufficiently to potential investors or provide a variety of products to attract companies. This may be attributed to financial and human resource constraints. The lack of public awareness on NSE operations is a major hindrance to corporate participation in stock market. Some companies with the potential to list do not completely understand the benefits of listing. The process to raise funds through the capital markets is perceived to be a specialized and complex field compared for example to other traditional financing methods like retained earnings and commercial loans. Creating awareness requires an all inclusive approach by all stakeholders. Hence it is recommended that the CMA in collaboration with other market stakeholders:

Implements a compressive awareness and public education programme that targets both supply and demand of securities.

4.2.4.4 Regulatory framework

Stringent listing requirements before an entity can qualify for listing have contributed to the elimination or disqualification of many business enterprises. The regulatory framework has been viewed as being too stringent to the extent that it discourages potential issuers. Requirements like the debt ratios, minimum track history, minimum number of shareholders and capital requirements are considered limiting. It is therefore recommended that: A comprehensive review of the regulatory framework is undertaken to be in tandem with the global trends without undermining the domestic environment needs; a new regulatory framework is established for products and services that are not currently available in our market.

4.2.4.5 Disclosure requirements

Disclosure of information seems to be a major impediment to listing at NSE. The risks associated with additional disclosure are perceived to be inadequately compensated by additional returns. The need to comply with regulations may be seen as a burden and there is stronger aversion to the disclosure and reporting requirements associated with a public listing. There are cases whereby these requirements may be seen as a loss of privacy and an exposure to the public domain, which can be seen as a loss of competitive advantage. It is such information that the competing non-listed companies might access and therefore it is appropriate to device ways through which such companies are compensatecbfor the perceived loss arising from competition.

4.2.4.6 Cost of going public

Some unlisted companies consider the cost of disclosure not commensurate with benefit accrued by listing. There are direct costs of issuing shares to the public and listing at a stock exchange. This is perceived to be high especially because the companies have to pay annual listing fees. The process is subject to approval and sometimes can take too long (management time) before it is concluded which serves as a major disincentive. However, it has been established that the costs of equity and debt are comparatively lower to bank term loans.

4.2.4.7 Shallow market

Limited diversity of products at the NSE to attract eligible firms is also a major factor inhibiting listing at the NSE. Our capital market is mainly characterized mainly by two products i.e. equity and bonds. Currently, the market provides firms with the option of trading in ordinary and preference shares, commercial papers, government bonds and corporate bonds. More firms may opt to list on the NSE if other products are introduced such as futures and options market, an over-the counter (OTC) market, and trading in asset-backed securities. Lack of integration with other stock exchanges within the region also limits the extent to which potential issuers can enjoy the benefits of listing. For the capital markets to effectively mobilize adequate long-term capital there is need to create additional financial instruments and expand the mobilization base through rigorous pursuit of regional integration of capital markets. It is therefore recommended that: additional financial products are introduced; all market players are sensitized on the concept, operations and benefits of cross border listing and trading. Enhanced and harmonized capital market development policy initiatives are pursued.

4.2.4.8 Size of companies

There is dominance of small and medium scale enterprises, which are dependent on bank loans and informal sources of financing. Many of these firms rely on overdrafts as a major source of finance, even for fixed capital. Although overdrafts are theoretically payable on demand, they are usually renewed every 12 months and function as a source of permanent, long term financing as long as the borrower continues to meet the key covenants in the overdraft agreement. In order to facilitate these companies to utilize the capital markets to meet their financial needs it is recommended that: The medium sized companies be sensitized on the need to raise long term debt capital through capital markets as opposed to relying on overdrafts to finance projects. Further, during the review of the regulatory framework, it should be appreciated that majority of companies are small and medium sized therefore the legal framework should accommodate such entities.

4.2.4.9 Loss of control

There is fear of loss of control by opening up firms to public ownership particularly by family owned companies. Many firms especially family owned or closely held companies are reluctant to dilute ownership and lose voting control. They tend to rely on bank finance as well as a proven network of family and friends to raise additional capital when required. Capital market offers an opportunity not only to raise long term capital but it also ensures that the issuer benefits from good corporate practices, which all the listed companies are expected to adhere to.

4.2.4.10 Bond Market

Lack of suitable pricing benchmarks for pricing of corporate bonds and the absence of rating agencies has hampered the development of the corporate bond market.

4.2.5 Conclusion on the capital markets assessment

The findings of this study to a large extent reveal that a number of impediments to capital markets development remain unresolved. Such impediments include weak macro-economic environment, lack of awareness, state of market infrastructure, legal framework and limited scope of products and services. The prevalence of such impediments among others may explain why companies have continued to prefer using retained earnings, family savings and bank loans (overdrafts) their operations to finance operations.

CHAPTER FIVE: SUMMARY, CONCLUSION & RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary and conclusion from the research findings. It also includes suggestions for further research. The findings of the study are presented in order of the key aspects of the objectives of the study: "Assessing the role of the capital markets as an engine for economic growth in Kenya".

5.2 Summary and conclusion

When companies are considering whether to list their securities at the NSE, the factors inducing listing include: access to cheaper sources of financing, suitability of the NSE as a vehicle for trading equity, opportunity to share the risks associated with sourcing capital.

On the other hand the factors inhibiting listing include: disclosure of information which seems to be a major impediment to listing at NSE. The risks associated with additional disclosure are perceived to be inadequately compensated by additional returns. Some unlisted companies consider the cost of disclosure not commensurate with benefit accrued by listing. The dual role played by commercial banks in Kenya as investment advisors and lenders has indirectly discouraged the use of the stock exchange as a means of raising capital. Since banks do not require public disclosure of a company's affairs like the NSE does, many firms prefer to remain unlisted and source their capital from the banks. There is also fear of loss of control by opening up firms to public ownership particularly by family owned companies. Limited diversity of products at the NSE to attract eligible firms is also an inhibiting factor to companies intending to list at the NSE. Currently, the market provides firms with the option of trading in ordinary and preference shares, commercial papers, government bonds and corporate bonds. More firms may opt to list on the NSE if other products are introduced such as futures and options market, an over-the counter (OTC) market, and trading in asset-backed securities. Many firms prefer to raise start-up capital from own savings, loans from domestic commercial banks and foreign sources. Finding from this study conducted from companies listed at the NSE indicate that about 60% of the firms used private savings as start-up capital for their business, 12% obtained loans from commercial banks while about 4% obtained loans from foreign sources. Stringent listing requirements before an entity can qualify for listing have contributed to the elimination or disqualification of many business enterprises. Inadequate marketing of the NSE to eligible companies could also be cited as among the possible factors inhibiting listing at the NSE. Thus, potential in the Kenyan capital market is far from being fully utilized. There is a lot of un-invested capital that could be tapped into the capital market either by long term investors or speculators. The capital market has the potential to help create wealth and the long-term capital needed for development thereby facilitating poverty reduction and improvement of living standards. The industry has a collective responsibility of taking the capital market to the people by way of persistent informative campaigns / advertising. All media channels available need to be exhaustively utilized, and in particular the Kenya Broadcasting Corporation (KBC), the British Broadcasting Corporation (BBC), and Deutsche Welle (DW), because these are accessible to the majority of Kenyans. Other information channels include the internet and local FM radio stations which target middle income earners and the youth. There must be a concerted campaign by the CMA, the NSE, brokerage firms, and publicly listed companies, to market the capital market to a wide cross-section of Kenyans. The public needs to be made aware of the different products available in the capital market, and how suitably to invest in these products.

The majority of Kenyans who have a stake in the Kenyan capital market, are ordinary shareholders of publicly quoted companies. They play a largely dormant role, and largely appear at annual general meetings where they for the most part, play a passive role. This must change to fit in with changing global economic trends. In these competitive times the role of the shareholder must change with changing company structures, and changing market conditions. Shareholders are expected to support the company in terms of ideas, marketing, expansion and constructive criticism. It is of less importance to only interact with shareholders once a year at annual general meetings. Practically all companies quoted on the Nairobi Stock Exchange, are guilty of this. For instance, as manager / director of East African Breweries Limited, I would expect the shareholders of the firm to actively promote company objectives and products all year round to ensure the success of the corporation. To achieve these companies must move towards developing a lasting rapport with their shareholders. Instead of having just one annual general meeting, open days / seminars / informal gatherings, should be held as frequently as possible, in which management / directors, and shareholders, interact. This is certainly of mutual benefit. Shareholders can be enlightened on company objectives and sensitized on their role in meeting these objectives. Shareholding matters, and indeed the operations of the entire capital market must be geared towards dynamism and vibrancy.

The jobs, businesses, prosperity and future of the East Africa region as a whole lie in the capital markets' ability to mobilize capital for economic development and growth. The securities exchanges can be a powerful tool for growing indigenous capital that will attract international capital if they are well designed and set up, properly regulated and supported by appropriate government policies.

5.3 Policy recommendations

In order to facilitate companies to utilize capital markets to meet their financial needs, it is recommended that: the SMEs be sensitized on the need to raise long term capital through capital markets as opposed to relying on overdrafts to finance projects. For capital markets to effectively mobilize adequate long term capital there is need to create additional financial instruments, and expand mobilization base through full realization of regional integration of the capital markets.

5.4 Limitations of the study

The analysis only covered the firms listed at the NSE and this may limit the fair findings that could have been found if the non listed firms were covered.

5.5 Recommendations for further studies

This study used data from the CMA, NSE and listed companies to assess the capital markets as an engine for economic growth in Kenya. More studies should be conducted to include other unlisted companies and SMEs likelihood contribution in the capital markets and their impact in economic growth. This would help stakeholders better understand the value likely to realized when the unlisted companies and SMEs actively participate in the capital markets in Kenya. This is because SMEs form a higher percentage of the Kenyan GDP thus their active participation in the capital markets in Kenya is likely to drive economic growth.

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APPENDICES

APPENDIX 1: LETTER OF INTRODUCTION

University of Nairobi - School of Business
P.O. Box 50428 - 00200,
Nairobi - Kenya.
25th September, 2011.

Dear Sir / Madam,

RE: REQUEST FOR RESEARCH DATA

I am a post graduate student at the University of Nairobi, studying Masters in Business Administration (MBA), Finance option. In partial fulfillment of the requirements for the award of the MBA degree, I am conducting a research on: **"assessing the role of Capital markets as an engine for economic growth in Kenya".**

Given your valuable contribution towards economic growth, you have been selected to form part of this study. Therefore, I am kindly requesting for your assistance in completing the attached questionnaire. Any additional information in the form of suggestion(s) and comment(s) that you may feel may add value to the research findings particularly in this area of study will be highly appreciated.

The information provided will be used exclusively for academic purposes and will be held in strict confidence.

Thank you in advance for the valuable contribution of your time and information.

Kind regards,

Okoyo Kenneth Onyango	Otieno Luther
MBA Student,	Lecturer - Supervisor,
University of Nairobi.	University of Nairobi.

APPENDIX 2: QUESTIONNAIRE

SECTION I: GENERAL INFORMATION

1. Kindly tick the key sector under which the company falls; as per NSE categorization

Agricultural	Commercial & Services
Telecommunication & Technology	Automobiles & Accessories
Banking	Insurance
Investment	Manufacturing & Allied
Construction & Allied	Energy & Petroleum
Other (please specify)	

2. How long has the company been in existence?

0 - 2 years	3 - 5 years	6 - 10 years
11 - 15 years	16 - 20 years	over 20 years

3. Which year was the company listed at the NSE?

Before 1963 (i.e., before independence) - please specify the year:

After 1963 (i.e., after independence) - please specify the year:

4. Kindly indicate your position in the company

Managing Director	Finance Director
Chief Accountant	Accountant
Other (Please specify)	

5. How long have you worked in this company?

0 - 2 years 3 - 5 years

6 - 1 0 years Over 10 years

SECTION II: FINANCING

6. To what extent does your company prefer the following mode of financing? Please tick as applicable

	Very high	High	Moderate	Low	Very low	Not preferred at all
Bond						
Commercial Paper						
Money Market Loan from local financial institution						
Offshore loan from International financial Institution						
New issue of shares						
Others (please specify)						

7. Has the company ever opted to source for finance through NSE?

YES NO

8. If yes in 6 above, please specify the purpose of the source of finance?

Setting up operations (start up) Expansion

Debt repayment Payment of suppliers

Dividend payment Others (please specify)

SECTION III: CAPITAL MARKETS

9. What are likely to discourage corporations, SMEs and the private sector in general from seeking finance from the capital markets in Kenya?

Stringent eligibility requirements

Lack of knowledge on the operations at the capital markets

Less diverse types of securities to offer

Political uncertainty, closely linked to the performance of the markets

Others, please specify

10. What is the concentration of majority shareholders in the company?

Local pension funds   Retail investors

Private ownership / specific group of investors

Banks   Insurance companies / firms

Fund managers   Others (please specify)

11. What is your knowledge on the operations, services, benefits derived from and limitation of the Capital Markets in Kenya?

Highly knowledgeable (excellent)

Moderately Knowledgeable (Good / Average)

Less Knowledgeable (Below average)

No Knowledge

12. What is your level of confidence in Capital Markets operations in Kenya?

Very high	High	Moderate
Low	Very low	No confidence

13. Please indicate your view on the following factors affecting operations at the Capital Markets in Kenya. Please tick where appropriate.

	Very high	High	Moderate	Low	Very Low
Stable macroeconomic environment					
Higher level of savings & technological development					
Lower cost of capital					
Higher level of transparency					
Limited bureaucracy					
Many sources of financing options (other than debt, equity - i.e., alternatives like derivatives)					
Higher certainty on the sources of finance from CMA					

14. Kindly give any other comment you deem helpful in relation to the above research

THANK YOU

APPENDIX 3: LISTED COMPANIES AT THE NSE

AGRICULTURAL

1. Eaagads Ltd
2. Kakuzi
3. Kapchorua Tea Co. Ltd
4. Limuru Tea Co. Ltd
5. Rea Vipingo Plantations Ltd
6. Sasini Ltd
7. Williamson Tea Kenya Ltd

COMMERCIAL AND SERVICES

8. Express Ltd
9. Hutchings Biemer Ltd
10. Kenya Airways Ltd
11. Nation Media Group
12. Scangroup Ltd
13. Standard Group Ltd
14. TPS Eastern Africa (Serena) Ltd
15. Uchumi Supermarket Ltd

TELECOMMUNICATION & TECHNOLOGY

16. Access Kenya Group Ltd
17. Safaricom Ltd

AUTOMOBILES & ACCESSORIES

18. Car & General (K) Ltd
19. CMC Holdings Ltd
20. Marshalls (E.A.) Ltd
21. Sameer Africa Ltd

BANKING

22. Barclays Bank Ltd
23. CFC Stanbic Holdings Ltd
24. Diamond Trust Bank Kenya Ltd
25. Equity Bank Ltd
26. Kenya Commercial Bank Ltd
27. Housing Finance Co Ltd
28. National Bank of Kenya Ltd
29. NIC Bank Ltd
30. Standard Chartered Bank Ltd
31. The Co-operative Bank of Kenya Ltd

INSURANCE

32. Kenya Re-Insurance Corporation Ltd
33. CFC Insurance Holdings Ltd
34. Jubilee Holdings Ltd
35. Pan Africa Insurance Holdings Ltd

INVESTMENT

36. Centum Investment Co Ltd
37. City Trust Ltd
38. Olympia Capital Holdings Ltd

MANUFACTURING & ALLIED

39. A.Baumann & Co Ltd
40. B.O.C Kenya Ltd
41. British American Tobacco Kenya Ltd
42. Carbacid Investments Ltd
43. East African Breweries Ltd

44. Eveready East Africa Ltd
45. Kenya Orchards Ltd
46. Mumias Sugar Co. Ltd
47. Unga Group

CONSTRUCTION & ALLIED

48. Athi River Mining
49. Bamburi Cement Ltd
50. Crown Berger Ltd
51. E.A.Cables Ltd
52. E.A.Portland Cement Ltd

ENERGY& PETROLEUM

53. KenGen Ltd
54. KenolKobil Ltd
55. Kenya Power & Lighting Co Ltd
56. Total Kenya Ltd

Source: http://www.nse.co.ke/news/sector reclassification (23rd August, 2011)