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RESEARCH NOTE SERIES

THE MISSING LINK: GETTING THE GROWTH ENTERPRISE MARKET OFF THE STARTING BLOCKS

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INTRODUCTION

The capital markets have been in existence for eighteen (18) years now since the Capital Markets Authority (CMA) Act was enacted in 1996. To date only eight (8) domestic companies have been listed on the Uganda Securities Exchange (USE). All these companies have been government divestitures from previously government parastatals with the exception of one, UMEME Ltd. Capital markets are designed to provide long-term capital to facilitate business growth and development. Therefore Uganda's capital markets should be playing a major role in closing the long-term capital gap in Uganda's economy. Many Ugandan businesses have identified access to long-term finance as one of their major business growth constraints. The question then is why aren't these businesses accessing the capital markets to meet their long-term financing needs? Previous research we have done at the CMA identified the lack of awareness and poor corporate governance practices as one of the major constraints to private sector access to the capital markets in Uganda. While these are major constraints that need to be addressed, there is an area which up to now has not received much attention and yet it is very critical to unlocking the access to the capital markets dilemma in Uganda; the Growth Enterprise Market Segment (GEMS) of the USE. The GEMS was mainly designed to provide Small and Medium enterprises (SMEs) access to long-term capital. The SMEs are the backbone of the Ugandan economy and as such they should be the driver of growth in Uganda's capital markets.

According to the most recent Uganda census of business establishments carried out in 2011, there are a total of 458,106 businesses in Uganda. Seventy (70%) of these businesses are Micro enterprises while over 29% are Small and Medium enterprises (SMEs). The large businesses account for less than 1% of the

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businesses in Uganda. Based on the categorization of the Uganda census of business establishments Micro businesses have an annual turnover of less than five (5) million shillings irrespective of the number of employees, while small businesses have an annual turnover of between five (5) and ten (10) million shillings irrespective of the number of employees. Medium businesses on the other hand have an annual turnover of more than ten (10) million shillings but employing less than 50 persons while the large businesses have an annual turnover of more than ten (10) million shillings and employing at least 50 persons. A summary of this categorization is shown in Table 1.

Table 1: Categorization of Ugandan Businesses

Employment Size	**Turnover (Ushs Million)**		
	Less than 5 Million	Between 5-10 Million	More than 10 Million
1-4	Micro	Small	Medium
5-9	Micro	Small	Medium
10-19	Micro	Small	Medium
20-49		Small	Medium
More than 50			Large

Source: Uganda Census of Business Establishments 2010/11

While there is a Growth Enterprise Market Segment (GEMS) at the USE mainly targeted towards SMEs, much focus has been placed on encouraging large companies to access the capital markets. The bias towards large companies is reflected in the transaction advisory fees the market intermediaries are willing to charge for a company seeking to access capital in Uganda's capital markets. Findings from a CMA internal survey on the cost of an Initial Public Offer (IPO) put the average cost of an IPO at US$ 200,000 way beyond a typical Ugandan SME. Most of the large companies in Uganda have huge reserves and some especially the foreign owned already have access to far more liquid capital markets in their home countries. In any case with a very liquid banking sector in Uganda these large companies can access cheap credit without the public disclosures that come with a listing on the stock market. Therefore for some of these large companies it would not make economic sense to list on the USE.

Therefore the indigenous SMEs are the key to the growth of Uganda's capital markets as their best option at accessing long-term capital is the GEMS. These SMEs neither have the huge reserves nor access to cheaper credit from the banking sector. The GEMS should be the engine of Uganda's capital markets, providing a breeding ground for the Main Investment Market Segment (MIMS) which hosts the more mature and large companies.

An increased focus on attracting SMEs will require a paradigm shift in the Ugandan capital markets industry. Increasing SME access to capital markets will take more than having the GEMS in place but a change in the entire capital markets ecosystem in Uganda. The government, the regulator, the market intermediaries, and investors need to think more "SMES" than they do now. This would mean an accommodation of higher risk that comes with the SME sector. This paper provides some insights into some of the strategies that can be adopted in this paradigm shift.

STRATEGIES FOR INCREASING SME ACCESS TO THE GROWTH ENTERPRISE MARKET SEGMENT

So far the GEMS has to a great extent addressed the limitations to SME capital markets access within the USE listing rules[2]. However this is not sufficient more has to be done to make the GEMS that market it was envisaged to be. The following are some of the strategies that can be adopted to get the GEMS off the **STARTING BLOCKS**.

Provision of Risk Capital

Most of SMEs that would list on the GEMS will in most cases not have a track record or will have operated for only a few years. One thing they will have in common will be a potential for growth and high returns. However this growth potential will come with the risk of failure. The most active growth markets also usually have the highest number of delistings. Ordinarily the typical investors in Uganda's capital markets; the pension funds and retail investors would not invest in such a company because they are accustomed to investing in blue chip companies with a very small or no probability of delisting.

Therefore to attract such investors to the GEMS, the market intermediaries (which in most cases will be Broker/Dealers or Investment Banks) need to commit a substantial amount of what I have termed as "Risk Capital". This is capital they can afford to lose. The risk capital will be committed through the underwriting of the GEMS Initial Public Offers (IPOs) and playing a "market-maker" role in the secondary market. As "market-makers" the market intermediaries will be guarantying liquidity in the secondary market of the GEMS listed companies[3]. The commitment of risk capital by the market intermediaries will greatly enhance the confidence of the market in the GEMS market. Given the specialty and experience of the market intermediaries in this market, their commitment of capital would imply that sufficient due diligence will have been done on the companies intending to list on the GEMS. Otherwise they would not commit that capital. In most cases institutional investors such as pension funds and retails investors do not have the experience and capacity to undertake the extensive and intensive due diligence required before investing in the type of companies that would list on the GEMS. New Connect which requires a market-maker for all companies it admits to its list has registered

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[2] Refer to appendix 1 for a summary of the eligibility requirements for listing on GEMS.

[3] The New Connect (the Alternative Growth Market of the Warsaw Stock Exchange-Poland) requires that all listed companies have a market-maker to provide liquidity in the secondary market.

tremendous in the seven years of its operation growing from just 24 listed companies in 2007 to over 400 listed companies at the end of August 2014.

This framework would be very similar to the private equity framework with the general partner taking on more risk than the limited partners. In this case the market intermediary would be the general partner and the other investors the limited partners. The only difference would be that this time round the target company would be a public company traded on the GEMS market. The other difference would be the fee structure where the market intermediary would not charge the limited partners performance fees but would instead recover their costs from the underwriting fees, the brokerage commissions and the market maker's spreads in the secondary market.

Creation of Secondary Markets for Private Placements

The GEMS market provides for capital raising through private placements but it does not provide for the necessary infrastructure and framework to facilitate secondary trading of private placements. Private placements in Uganda law are restricted to close business associates, professional and experienced investors. Furthermore the number of investors in a private placement should not exceed one hundred (100). The private placement like in many other jurisdictions does not have to be subjected to the more detailed approval process and disclosure requirements expected of a public offer. This makes private placements less costly and onerous on the part of the issuer.

Therefore SMEs are more likely to prefer private placements than public offers. In any case there is already an informal capital market for private placements. The creation of a formal secondary market for private placements will greatly enhance the appeal of this market to the more risk averse Ugandan pension funds. The pension funds account for the biggest proportion of domestic investors. Therefore a more organized secondary market for private placements on the USE Growth Enterprise Market Segment is likely to inject the much needed liquidity on this market segment. A secondary market provides more opportunities for entry and exists of the private placement investments thereby reducing the investment risks associated with such investments. Private placement secondary markets are very different from public secondary capital markets as they are restrictive in terms of market participants and information disclosure. Not every investor will be eligible to trade on the private placement secondary market and also information about companies trading on this market will only be restricted to the market participants eligible to trade on this market.

While restrictive private placement secondary markets can provide a platform for an SME to engage and also build relationships with institutional investors who could well form part of their core investor base in their Initial Public Offer (IPO). These markets can also act as a preparation ground for better corporate and financial reporting standards without much pressure and fear of exposure to the public and the firm's competitors. In a public capital market the financial performance of the SME is available to the public including its competitors and potential competitors. While this information disclosure is good for the investing public, it could actually be detrimental to the business growth of the SME. A profitable business is more likely to attract competition which the SME may not be in position to contain at its level of development. It may not have developed sufficient entry barriers to protect itself from the onslaught of competition from the industry. Competition may actually destroy the business rather than facilitate its growth at this stage of development. Therefore a private placement market where such critical information is only restricted to those that matter to the business is very conducive for the growth of the SMEs into mature businesses that can compete favorably in the public markets. The NASDAQ Private Market, the New Connect Private Placement Market Segment and the NYSE-ACE Portal are notable examples of markets that have successfully established secondary markets for private placements.

Building the Market Research Capacity of the Capital Markets Industry

One of the major constraints to SME access to financial markets is information asymmetry. There is very little or no information at all on the performance of various business sectors and on specific companies in those sectors. The prevalence of information asymmetry in Uganda makes it very difficult to correctly assess the risks associated with a specific business as well as correctly project its future profits. Therefore given the complexity of investments in SMEs the market research function plays a very critical to increasing SME access to the capital markets. Market Research and Investment Analysts provide the information and analytical reports that investors require to make informed investment decisions. The more information investors have about SMEs and the industries in which they operate the more likely they are to invest in the SMEs.

There are three major ways in which the capacity for market research function in the Ugandan capital markets can be built; first the GEMS market needs to automate its trading and back office systems to enable real time dissemination of market data. Secondly the market intermediaries need also to invest substantial resources in market and industry research. They need to build capacity for market research and investment analysts. Much as the number of market professionals in Uganda with a Certified Financial Analyst (CFA) qualification is increasing, analyst coverage of the listed companies and the industries they operate is almost non-existent. An increase in investment in market research and analyst coverage of listed companies will greatly boost the investor confidence in the Ugandan capital markets and increase the likelihood of investors' interest in GEMS listings. Thirdly the market research and investment professionals in the Ugandan capital markets need to develop a platform that will not only regulate their activities but also facilitate and promote market research independent of the market intermediaries. This will further boost the investor confidence in the Ugandan capital markets.

Provision of SME Business Advisory Services

The listing of an SME on the stock market is a major milestone in the business growth life cycle. It will in most cases require the restructuring of the SME intending to list. The restructuring will vary from something as basic as transforming into a public company to more complex requirements such as financial reporting and corporate governance obligations.

The restructuring process is usually a long and protracted process requiring a lot of financial and human capital resources. The vast amount of resources in most cases required to successfully prepare for a listing, can be a great hindrance to SME access to capital markets. The establishment of an SME Business Advisory Fund to provide technical support to potential issuers to adequately prepare for a listing on GEMS at an affordable cost will be very critical to increasing SME access to Uganda's capital markets. Government and development partners could provide the seed capital for this fund but it should be managed and sustained by the industry, preferably the Uganda Broker/Dealers Association. This fund will not only provide a pool of potential SME GEMS listings but also reduce on the probability of failure of SME GEMS listings.