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RESEARCH NOTE SERIES

CAPITAL MARKETS DEVELOPMENT IN POLAND, SRI LANKA, KAZAKHSTAN AND VIETNAM: ARE THERE LESSONS FOR UGANDA'S CAPITAL MARKETS?

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1.1 Introduction

After 18 years of laying a firm foundation in the form of a facilitative legal regulatory framework, Uganda's capital markets are on the cusp of taking off. With the necessary sensitization, supply and demand for securities can be stoked to increase market activity in terms of fund raising aspects and trading. The projected rapid economic growth in the future, pension reforms, the expected production of crude oil and regional integration indicate that the best is yet to come for Uganda's capital markets. The capital markets in Uganda can be positioned as an alternative source of long term capital as well an alternative investment avenue for the public to take advantage of the expected structural changes in the economy.

In the bid to position the markets, lessons can be drawn from other jurisdictions that applied a host of strategies to develop their capital markets. Many jurisdictions were in a similar position as Uganda barely two decades ago and in that period, they have managed to transform their capital markets boosting their significance in economic development. The question that begs for answers is the practicability of some of the strategies applied in some jurisdictions to Uganda's case. How practical are some of the strategies and approaches to the Ugandan situation? What lessons can be drawn from some of the jurisdictions? In seeking to provide answers to these questions, the Author will look at: Sri Lanka, Poland, Kazakhstan and Vietnam. These jurisdictions have been selected owing to the fact that about 20 years ago some of their market indicators were almost similar to those of

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Uganda currently. This provides an opportunity for Ugandan capital markets to learn what was done right in transforming these markets into more vibrant capital raising platforms.

2.2 Alternative Trading Systems for SMEs': The Case of New-Connect in Poland

For small and medium-sized enterprise, alternative trading systems can provide convenient channels to raise capital for further development and expansion. They primarily provide fund raising opportunities for innovative companies with high growth potential that are not able to obtain significant funding from other sources such as banks. Sub-markets allow small organizations to raise funds with greater regulatory flexibility than applies to most main markets. Sub-markets compared to main markets are usually characterized by lower fund raising costs and fewer barriers to entry, as well as more liberal formal obligations and information requirements.

Poland is a transitional economy having adopted open market policies at the end of the cold war in the 90's. Over the years, Polish capital markets have grown by leaps and bounds with the country curving itself a niche as an attractive fundraising center in central and Eastern Europe. Poland as a leading economy in central Europe has drawn local and international investors as well as issuers of securities from far and wide owing to its low cost structure for accessing the capital markets, solid legal foundations and transparent markets.

A scrutiny of capital markets indicators in Poland shows that over the last 6 years, most of the growth has emanated from the alternative trading system. On the alternative trading system, the number of listings has jumped astronomically from 24 to 445 in a period of 6 years. In a similar period, the main board of the Warsaw Stock Exchange (WSE) recorded an increase in listings of 99. Market capitalization on the alternative trading system has also experienced a seven fold increment over the last 6 years compared to the WSE whose market capitalization has trudged downwards over the period remaining almost unchanged.

Table 1: Polish Capital Markets Indicators

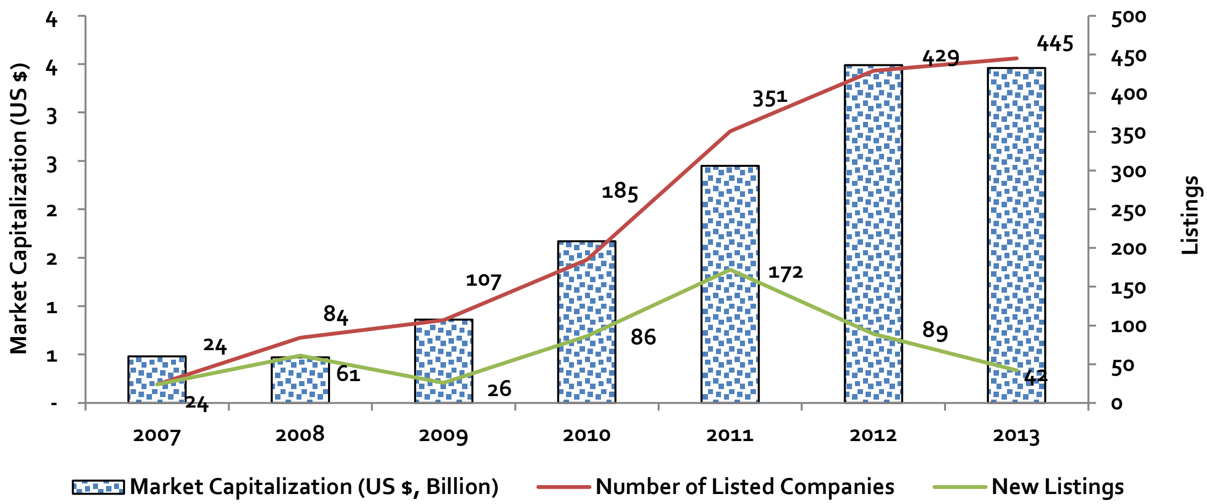
	2007	2008	2009	2010	2011	2012	2013
GDP (US $ Billion)	425.32	529.43	430.92	469.80	515.77	490.21	517.54
Market Capitalization (Main Board, US $ Billion)	178.18	172.15	93.80	142.09	158.79	144.42	173.42
Market Capitalization (Alternative Board, US $ Billion)	0.48	0.47	0.86	1.67	2.45	3.49	3.46
Market Capitalization/GDP (%)	42.01	32.61	21.97	30.60	31.26	30.17	34.18
Number of Listed companies (Main Board)	351	374	379	400	426	438	450
Number of listed company (Alternative Board)	24	84	107	185	351	429	445
Average size per company (Main Boards, US $ Million)	0.51	0.46	0.25	0.36	0.37	0.33	0.39
Average size per company (Alternative Board, US $ Million)	0.02	0.01	0.01	0.01	0.01	0.01	0.01

***Source**: Warsaw Stock Exchange & World Bank*

New-Connect, the alternative trading system of the WSE, is one of the largest markets in Europe for smaller and rapidly growing companies. It fills an important gap that had existed in the domestic market by tailoring products targeting high risk investors as well as fast growing companies. New-Connect`s success is hinged on a simplified and flexible regulatory environment which has been specifically crafted to meet the needs of smaller companies. The shape of the market has been designed in a similar format to the Alternative Investment Market (AIM) organized and regulated by the London Stock Exchange.

A key aspect of the flexible regulatory environment of the New-Connect is the opportunity for companies to raise capital through private placement which has minimal financial implications as well as a limited number of advisors vis-à-vis public offerings. Majority of the issuers on New-Connect have taken this route to bring their offers to the market. Private placements target 149 investors and are brought to the market under a simple information document. The information document is prepared by an Authorized advisor in conjunction with the issuer and approved exclusively by the Authorized Advisor. Additionally, as part of the flexible regulatory framework, the mandatory disclosures are more flexible with companies not obligated to publish quarterly reports and present audited half yearly reports. This environment has spurred growth in issues with the number of listed companies standing at 445 at the end of the year 2013 (see figure 1).

Figure 1: Trends in New-connect Market Capitalization and Listings



Source: *New-Connect*

The private placement route taken by companies has seen the average cost of issuing securities at the New-Connect being low compared to a public offering. An analysis of past issues indicates that on New-Connect, the mean IPO cost is 4.89% of the capital being raised.

2.3 Sri Lanka: Listings by Introduction as a Driver of Growth

Sri Lanka's economic growth has been generally robust even during times of adverse global and domestic macroeconomic conditions. In the 1980s and 90s, Sri Lanka's economic growth averaged about 5 %, despite a 20 year civil war with various levels of intensity. In 2000-2001, a significant slowdown in growth was associated with a widespread civil conflict. Following a ceasefire in 2002, the economy performed well with real GDP growth averaging 6.2 percent despite a number of external and domestic shocks. Since the end of the war in 2009, the Sri Lanka economy has experienced unprecedented growth, averaging 6-8.2% per annum.

Growing in tandem with the rapidly expanding economy, the capital markets have also been on an upward trajectory. As a demonstration of that, the stock market in Sri Lanka (Colombo Stock Exchange) rose euphorically through the early days of 2012, including a gain of over 90% in 2010.

Table 2: Key Metrics for Sri Lanka's Capital Markets

	2007	2008	2009	2010	2011	2012	2013
GDP (US $ Billion)	32.35	40.72	42.07	49.57	59.18	59.39	67.18
Market Capitalization (US $ Billion)	7.55	4.29	9.55	19.92	19.44	16.97	18.81
Market Capitalization/GDP	23.35	10.53	22.69	40.20	32.84	28.58	27.99
Number of Listed companies	235	235	231	241	272	287	289
Average size per company (US $ Million)	32.14	18.24	41.33	82.67	71.46	59.14	65.07

Source: World Federation of Exchanges, World Bank

One of the key drivers of stock market growth at the Colombo Stock Exchange (CSE) has been the initiation of listing by introduction. 'Introduction' as a method of listing securities was introduced at the CSE in 2000 as a price discovery mechanism. Companies were permitted to list securities on the CSE without an Initial Public Offer (IPO). From 2000 to the end of 2012, 46 companies listed their shares on the CSE via Introduction. The listing by introduction was suspended in the year 2012 owing to abuse by market players, before being re-introduced with lock-in periods and more disclosure requirements in 2013. Listing by introduction was thus a key driver of growth in Sri Lanka in the last decade.

2.4 Privatization and Pension Reforms in Supporting Capital Markets Development: The Case of Kazkhstan

After eight years of severe transitional crisis, Kazakhstan experienced an economic boom from 2000 to 2006. With average annual growth rates of 10%, the country became a success story not only in Central Asia but also in the Commonwealth of Independent States (CIS). Kazakhstan's rapid growth in the last decade was as a result of market-oriented economic reforms, especially rapid price and trade liberalization, privatization, sound macroeconomic policy, and the promotion of entrepreneurship. Moreover, the income and wealth effects resulting from expanded primary production stimulated other sectors, namely financial and general business services and construction/real estate. The country's banking sector has been particularly praised by outside observers as Kazakhstan's major success and the most efficient one in the CIS.

As with most other transitional economies, banks in Kazakhstan played a core role than capital markets in attracting savings and allocating resources to the private sector in the early years of economic reforms. The first legislation on securities was adopted in 1993 and in the same year, the Central Asian Stock Exchange opened in Kazakhstan. However, trading only commenced in 1997 when the Kazakhstan Stock Exchange (KASE) was opened. KASE served foreign exchange and treasury instrument trading initially. However, there was an increase in activity at the KASE during the sluggish "Blue Chip" program that aimed at listing Kazakh companies in which the government had an interest. Development of national capital markets through public offerings of SOEs' was a significant factor influencing the privatization initiative. A significant impetus to the growth of capital markets was also provided by pension reforms. By the beginning of 2004, pension funds generated **US $ 2.5 billion** that was absorbed locally providing the much needed liquidity in the market.

Table 3: Key Market Indicators for the Kazakhstan Capital Markets

	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP (US $, Billion)	57.12	81.00	104.85	133.44	115.31	148.05	188.05	203.52	224.41
Market Capitalization (US $, Billion)	10.53	43.69	41.38	23.27	27.93	26.67	22.54	33.60	26.23
Market Capitalization/GDP	18.43	53.93	39.46	17.44	24.22	18.02	11.98	16.51	11.69
Number of Listed companies	62	67	66	72	70	61	63	74	72
Average size per company (US $ Million)	169.82	652.06	626.93	323.22	398.99	437.26	357.74	454.05	364.28

***Source**: World Bank, World Federation of Exchange*

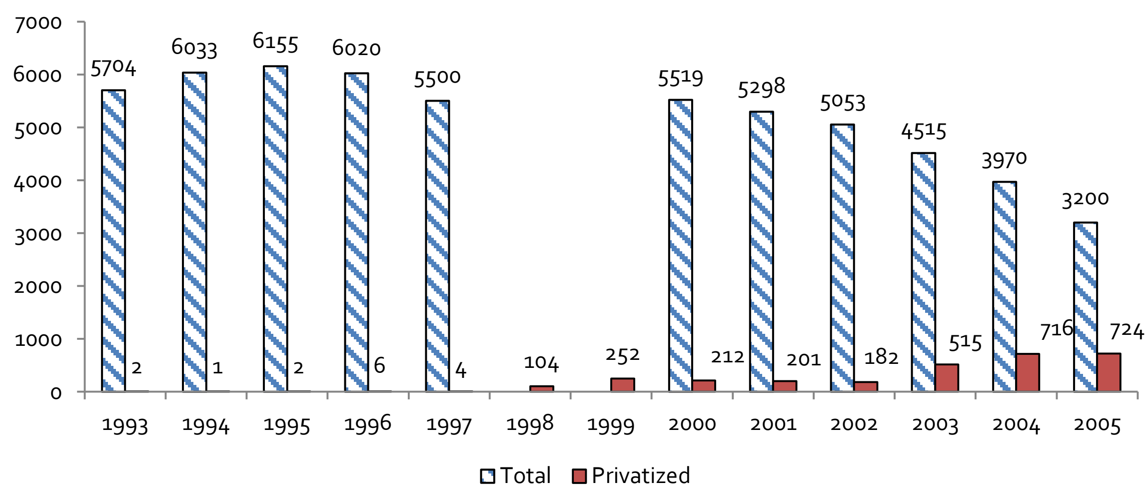
Significant recent developments in Kazakhstan's privatization plan, called the "People's IPO program," appear to be a starting point for a new phase of efforts to use SOE IPOs to support capital market development. According to the program, some of the largest SOEs' shares will be listed on KASE between 2012 and 2015. State oil Transportation Company KazTransOil, national grid company KEGOC and Air Astana have been announced as the first three companies to be listed on the exchange with a 5% -15% free-float ratio. The second phase of the program will include national gas transportation company KazTransGas, state shipping company Kazmortransflot and state power asset management company Samruk-Energo.

2.5 Privatization and Capital Markets Development in Vietnam

During the past quarter century, Vietnam has emerged as one of Asia's great success stories. It has transformed itself from a nation ravaged by war in the 1970s to an economy that, since 1986, has posted annual per capita growth of 5.3 %. Vietnam has benefited from a program of internal modernization, a transition from its agricultural base toward manufacturing and services, and a demographic dividend powered by its youthful population. Vietnam has also prospered by choosing to open itself more broadly to the outside world, joining the World Trade Organization (WTO) in 2007 and normalizing trade relations with the United States.

The evolution of the Vietnamese economy begun in earnest in the year 1986, with the adoption of market principles–"Doi Moi" in place of the socialist model. To facilitate the new economic model, the country embarked on a privatization process, which converted thousands of State-owned enterprises (SOEs) to joint-stock models. Partial ownership of these SOEs started to be sold to individual shareholders and foreign institutions, but majorly to inside managers and employees.

Figure 2: State Owned Enterprises: Total Number and Equitized



Source: *Nguyen, Oates, & Dunkley (2014)*[2]

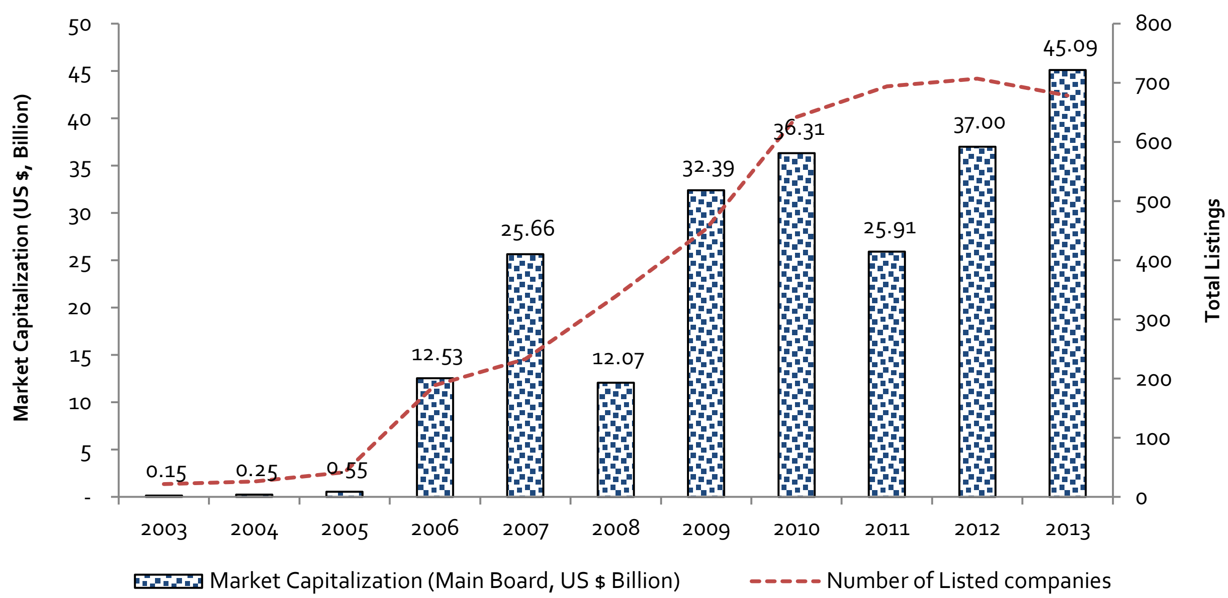
Capital markets in Vietnam have a short history. Pursuant to a a driective in July 1998, it was decided to open the Ho Chi Minh City Securities Exchange (HOSE) that begun operations in July 2000 and the Hanoi stock Exchange (which primarily deals in mid-sized strat-ups and government bonds) in 2005. The accelerated privatization of SOEs' at the turn of the millenium provided the much needed spur

[2] Nguyen, H., Oates, G., & Dunkley, M. (2014). A review of the establishment of the stock exchange in Vietnam-in relation to other transitional economies. *International Journal of Economics and Finance 6(10)*, 17-25.

for the operationalization of the stock exchanges. Vietnam was able to build its capital markets through mass privatization of SOEs' and listing them on the stock exchange.

From just 2 listed companies, the number of listed companies had increased exponentially to 678 by the end of the year 2013. The combined market capitalization of both exchanges stood at US $ 45.09 billion at the end of 2013. Privatized SOEs' have been the main suppliers of stocks at the stock exchanges. However, subjecting them to market practice had serious challenges, especially when the State still held significant portions of ownership in these enterprises. The continuous vitality of the private sector requires a strong capital support from the stock exchange; however the short history of the private sector in Vietnam suggests its underdevelopment and the limited ability to compete with the State companies.

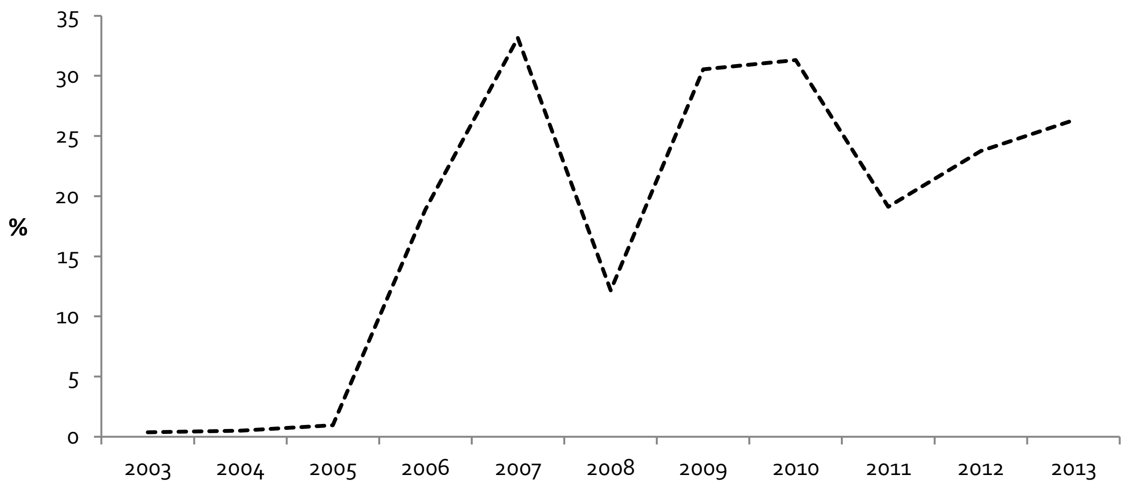
Figure 3: Trends in Market Capitalization and Number of Listed Companies



Source: HOSE & HNX

The capital markets have also grown in significance with market capitalization as a percentage of GDP rising to 26.31% at the end of 2013, having risen from a paltry 0.36% in 2003.

Figure 4: Trends in Market Capitalization to GDP (Vietnam)



Source: World Bank, HOSE & HNX

2.6 Key Takeaways

Uganda can learn from some of the jurisdictions that have been reviewed in this note. In Poland, the introduction of the alternative trading system targeting SMEs' with less stringent listing requirements helped deliver the desired growth. In the listing process, private placements which are less costlier were the preferred routes.

In Sri Lanka, the initiation of listing by introduction set in motion a process that saw 46 companies take advantage of this provision to list their shares without raising capital from the public. Listing by introduction provided a mechanism for price discovery as well as an exit mechanism for shareholders. Additionally, companies that were looking at raising capital in the future also opted for this route to join the bourse.

In Kazkstan, privatization of SOEs' provided the stimulus for the development of capital markets. Pension reforms also played a critical role in providing the necessary liquidity for the market. A similar situation played out in Vietnam where a massive provatization program was undertaken providing the markets with a long pipeline of listing candidates. With a weak private sector owing to the legacy of socialism, almost all the listings are former SOEs'.

Privatization

So what lessons can be drawn from these jurisdcictions? Privatization as a means of developing capital markets in Uganda could be unfeasible in light of the drying up of the privatization pipeline. With most former SOEs' that fit into the listing profile having been privatized through private sales, Uganda has a shortage of companies that could be privatized hence this remains improbable.

Private Placments and Listing by Introduction

The fusion of private placements and listing by introduction could be a better proposition for Uganda. Developing a vibrant private placement mechanism would enable companies raise funds from institutional investors and other high qualified investors before listing their shares by introduction to allow for price discovery and provision of an exit mechanism. This is a route worth taking into consideration in an attempt to grow the Ugandan capital markets.

Blue Chip Companies versus Small and Medium Sized Enterprises

Kazakshtan in building capital markets privatized blue chip companies. The number of listings have more or less remained the same over the last 7 years or so. On the other hand, New-Connect targeted small and medium sized enterprises and in a period of 7 years, listings have increased from 24 to 445 companies. Blue chip companies are usally characterized by high levels of float which can contribute to enanced liqudity as well as attract a broad base of investors. On the flip side, blue chip companies are usually few hence a limited number of listings can be made.

On the other hand for an economy like Uganda's where SMEs' are significant contributors to the economy and employment, encouraging SME fund raising activities would be sensible. However, the key drawbacks in this case would be the likelihood of low float as well as a narrow investor base targeting mostly institutional and other qualified investors owing to the high risk presented by SMEs'.

Pension Reforms

Pension reforms if accelarated can provide additional absorption capacity in the Ugandan capital markets. However, for the pension reforms to be meaningful, there is need for adequate supply of securities to take in the the new liquidity that will be created by the reform process.

Conclusion

From the review, private placements, listing by introduction as well as pension reforms can provide the much needed thrust for the growth of Uganda's capital markets. These are routes that if exploited could lead to the desired take off of Uganda's capital markets.