Illiquidity in African Stock Markets A Challenge for Private Equity

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In the world of private equity, the success of an investor's deployment of capital depends greatly on the investor's ability to earn a return on investments through dividends and distributions and/or to sell the investments for a profit within a finite period of time. In a mature market such as the United States or Europe, the sale of an investment is commonly affected by private equity investors through an "exit" via the public stock markets. In Africa, however, private equity investors have largely relied upon private trade sales to realize investment returns due to the difficulty in achieving timely public placements in the African markets. The inability to exit African securities markets is largely attributable to the lack of liquidity in these markets. So, what are some of the causes of this illiquidity and what is being done about it?

The African public securities market is comprised of a large number of small, dispersed stock exchanges spread across the continent – 29 separate "national" exchanges and two "regional" exchanges. Based on recent data, the Johannesburg Stock Exchange is the largest stock exchange in Africa by far with approximately 357 listed companies[1] and a total market cap in excess of USD 940 million. This is only a fraction of the size of a major international stock market such as the New York Stock Exchange – with approximately 2,800 listed companies[2] and a total market cap in excess of USD 28 trillion.[3] African stock exchanges can be generally described as having (i) a small number of stock listings and low daily trading volumes, (ii) inefficiencies and parochial trading systems resulting in high transaction costs, (iii) non-digitized trading platforms, and (iv) legal barriers to international participation – a majority of these stock markets require that investors be citizens or residents of the applicable country, which results in prohibiting even intra-Africa trading.[4] And there is, of course, an overlay of macroeconomic and political vagaries that plague all of these markets.

There are a number of regulatory, technical, and macroeconomic barriers that individually and in combination restrict liquidity in African stock markets. Regulatory barriers that need to be addressed include (i) prohibitions against market participation by investors outside of Africa, (ii) barriers that prevent investors from one African country from investing in another African country's stock exchange, (iii) foreign exchange restrictions and local currency instability, and (iv) an absence of laws which permit the kinds of trading activity that promote liquidity – such as short-selling and securities lending and borrowing. This lack of regulation is due in part to the mindset of the national regulators who are predominantly focused on protecting against the "downside risk" to investors (including pension funds) as opposed to promoting liquidity in the market. Also, many of these regulators, with good intention, have sought to import regulatory frameworks from more mature markets – for example, the United States and the United Kingdom. The problem with this approach is that these more developed legal frameworks are designed to prevent the kind of potential "bad behavior" that exists in more mature markets like the United States where more advanced trading activities, such as derivatives trading, occur. Such so-called "best practices" inherited from Europe and the United States have been brought into the less mature African stock markets seeking to prevent more sophisticated investor behavior which does not exist yet in these markets. So, ironically, these more advanced regulations inhibit the kind of liquidity which is necessary for the less mature African stock markets to grow and mature.

Technical barriers are also a major contributor to the liquidity problem. Such barriers result from the use of inefficient and/or outdated technology to operate and run trading platforms. When stock markets invest in technology – such as algorithms to digitize various trading processes and systems – they attract more participants, which in turn increases the volume of trade and liquidity. A number of components comprise the concept of a market being digitized, such as manual order execution as opposed to the "open outcry" method, manual paper-based processes such as settlement of orders, and "direct market access," which removes intermediaries and allows investors more control over their orders.[5] While digitized trading platforms are becoming more prevalent among the largest African stock markets, the majority of such stock markets are not yet digitized, or are still in the process of becoming digitized.[6] However, as exchanges continue to add digital components, each incremental step "can significantly reduce execution costs, transaction speed, and market transparency,"[7] which attract more participants and thereby add liquidity to such markets.

In addition to legal and technical impediments to market growth, many African countries face macroeconomic and political problems which also hamper the growth of their countries' securities markets. Nigeria, for example, has just recently recovered from a prolonged economic slump and suffers from weakened currency against the major international currencies. In South Africa, recent and ongoing violence against foreign nationals has reawakened xenophobic fears and the boycotting of foreign owned businesses in the country. Kenya, a country which has recently experienced economic growth, is a market which has long been challenged with corruption. In neighboring Tanzania, in spite of GDP growth over the last couple of decades, the country remains challenged with high poverty levels and the inability to diversify from a predominantly agricultural-driven economy.

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There is fairly common agreement among private equity investors about the ingredients needed for increasing the much-needed liquidity in the African stock markets. First, there needs to be meaningful amounts of capital to attract investors to the market. Simply put, there needs to be more money flowing through the system. Second, the markets need regulatory environments that incentivize investors to trade "in and out" of the stock exchanges. Third, these countries also need monetary policy and laws which will allow foreign capital into the market and provide strong foreign exchange capacity and local currency convertibility. To some extent, one could say that there is a need to deregulate in many of these African markets – to modify existing regulations that constrain the liquidity needed to grow the markets and allow them to be viable. Bryce Fort, a principal at the industry-leading African private equity fund manager, Emerging Capital Partners, comments, "As regulators across various African markets begin to adjust their focus more on promoting liquidity in the markets as contrasted with down side risk protectionist policies, we will likely start to see new legislation that will promote the increase of market cash flow and the number of listed companies and, consequently, more opportunity for private equity funds to utilize African stock exchanges for their exits."

Finally, what then is currently being done to address the liquidity problem in the African stock markets? First, some governments, like Kenya, for example, are trying to pass laws which allow short-selling and securities lending and borrowing. Many governments are also trying to put tax incentives in place, such as allowing transaction costs to be deducted or providing for exemptions from transfer taxes. Second, there is a significant effort underway to digitize stock exchanges, which has been effective in the seven or eight primary African stock markets. Successful digitization will allow for a number of benefits, including seamless cross-border sales, faster transaction execution times, and lower trading costs. Lastly, market reform programs are being pursued by some of the national stock markets and related market-based organizations. There are essentially two tracks of reform activity currently underway, which combined, are aimed

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at addressing the liquidity problem. The first track involves the reform programs initiated by the individual country stock markets – such as Nigeria, Kenya, and Casablanca, which are three of the most proactive. Several of these markets are exploring and developing new rules to allow for short-selling and cross-border trading of securities. The second track involves so-called "linkage" programs, which are designed to solve the problem of small market size and limited capital flow by "linking" several stock markets together.

There are a few regional "linkage" programs currently operating in Africa on a small scale, but perhaps the most significant linkage effort underway is the recently launched African Exchanges Linkage Project (AELP), which is being jointly developed by the African Securities and Exchanges Association and the African Development Bank. The AELP was officially launched in 2018 and is still in its initial phase of organization and development. This summer, the AELP began to put together technical and legal committees which will be focused on various work streams, including the development of rules and procedures for the functioning and coordination of trading activities of the linked exchanges. The AELP has also received a funding grant of USD 980 million from the Korea-Africa Economic Cooperation Fund.

The primary goal of the AELP is to link the seven largest stock exchanges in Africa, namely Casablanca, Nigeria, Kenya, Johannesburg, Egypt, Mauritius, and the Regional Securities Exchange SA (BVRM). By linking these seven exchanges, brokers from one stock market will be permitted to place trades on another "linked" stock market. Additionally, the AELP will work to educate and influence national regulators to advance pro-market rules such as short-selling and securities lending to promote liquidity. Although programs such as the AELP will take many months to have significant effect on African stock markets, they appear to have the support of the investment community, especially Africa-focused private equity funds which greatly need these markets to grow in order to provide meaningful returns to their investors. "We applaud the efforts of the ADB and the ASEA in promoting growth in the African stock markets," added Fort. "Programs like the AELP can contribute greatly to advance equity investment in the African continent and untap greatly needed additional sources of capital."

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Endnotes

1. https://www.ceicdata.com/en/south-africa/johannesburg-stock-exchange-number-of-companies/no-of-listed-companies-jse.
2. https://www.advfn.com/nyse/newyorkstockexchange.asp.
3. https://investopedia.com/terms/n/nyse.asp.
4. Note, however, that a few stock markets, including those in Egypt, South Africa, and Namibia, do currently allow for cross-border investment.
5. Wyman, Oliver, "Enhancing Liquidity in Emerging Market Exchanges," 2016, https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/oct/Liquidity-in-Emerging-Markets-Exchanges-.pdf.
6. Coetzer, Jacquelene, "African Stock Exchanges Hold the Key to Unlocking the Continent's Economic Growth and Development," November 5, 2018, https://www.inonafrica.com/2018/11/05/african-stock-exchanges-hold-the-key-to-unlocking-the-continents-economic-growth-and-development/, 11/5/2018 (last accessed 6/24/2019).
7. Wyman, Oliver, *Ibid*.