

**FACTORS AFFECTING THE DEVELOPMENT OF EMERGING  
MARKETS: A CASE OF THE NAIROBI STOCK EXCHANGE**

BY

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# DECLARATION

This project is my original work and has not been submitted for a degree in any other University.

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

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To my parents **Charles Ndegwa** and **Margaret Ndegwa**, who sacrificed greatly to start me out in life with an education that lay a foundation and desire to achieve what they never had. Your attitude towards me has sowed seeds of confidence. I see your stamp in all my achievements, both big and small. Thank you for believing in me.

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## ABSTRACT

The study looked at the factors affecting the development of the Kenyan stock market. The analysis was based on the effect of factors on the development of the NSE by examining the following characteristics: The legal and regulatory framework, Information disclosure requirements, Transparency of transactions, Accounting and auditing standards, Transaction costs, Delivery and settlement, Barriers to entry and exit, Taxation of investment income, Public knowledge of securities markets plus any other factors emerging in the course of the study.

Primary data was collected by a self administered questionnaire. A semi structured questionnaire based on a five point Likert scale was used. The data collected for the study was analyzed using factor analysis technique. Descriptive statistics were used to analyze data by way of frequency tables, percentage proportions and mean scores while content analysis was applied to data that could not be quantified.

The study established that factors particularly the legal and regulatory framework that ensures the protection and security of investors are in place, and that the call-over system of transactions is very transparent. Low levels of public awareness was found to be a major factor inhibiting the development of the stock market in Kenya. It also found that the delivery and settlement of transactions are performed satisfactorily by brokers; however the introduction of a fully centralized clearing system would significantly improve upon the clearing and settlement procedures. The study further establishes that the entry into and exit from the NSE are without any significant restrictions.

There is a need to educate the Kenyan public about the activities of the NSE and to promote investment in general. Also the government should give fiscal incentives in the form of taxation in favor of listed companies, and to pursue prudent macroeconomic policies, particularly in the area of inflation management. A regular review of the legal and regulatory framework within which the investment laws operate is necessary to boost the confidence of investors.



## CHAPTER ONE

### 1.0

## INTRODUCTION

### 1.1 BACKGROUND

The role of long-term capital in the economic development of a nation cannot be over emphasized. Most economic managers recognize that a well organized capital market is crucial for mobilizing both domestic and international capital. In many developing countries, however, capital has been a major constraint in economic development. Dailami and Atkin (1990) describe the provision of funds to finance domestic capital formation as a key factor in the prospects for long-term economic growth in developing countries. The authors observe that the reality of a much reduced supply of foreign funds from previous sources, such as commercial banks, compels governments in many developing countries to pay increased attention to capital market development as a way of improving domestic resource mobilization, enhancing the supply of long-term capital and encouraging the efficient use of existing assets. They contend that the ongoing debt crisis is serving to focus attention on the importance of equity rather than debt, particularly in the financing of risky projects with long gestation periods.

As Pardy (1992) observes, securities markets have an important role to play in financial liberalization and deepening. The author contends that apart from providing a means of diversifying risk for both capital raisers and investors, securities markets could play other roles. For example, they are a mechanism for capital allocation and corporate monitoring, and a means for government to exercise market-based rather than direct fiscal and monetary policies.

Demirgüç-Kunt (1992) observes that in the poorest developing countries, firms rely mostly on internal resources and informal credit markets for financing; Commercial banks are the main financial institutions. The author stresses that the loan contracts of commercial banks are generally short term, and formal direct credit markets for long-term debt or equity do not exist, thereby constraining both corporate and economic growth.

The jobs, businesses, prosperity and future of the region lie in the stock markets

Engberg (1975) recognizes the need for capital markets even for less-developed economies. He stresses that capital markets can significantly raise the level of domestic savings and contribute to a more efficient allocation of such savings among competing uses. The author emphasizes that through the capital market, a variety of financial assets, carrying different risks, yields and liquidity, is added to the traditional types of financial assets such as demand and savings deposits. He further observes that the availability of this wider range of financial assets will induce people to increase their rate of current savings. The reason is that the capital market enables savers to achieve a better wealth composition and also permits adjustments to be made in the wealth composition with speed and at low cost whenever circumstances change. Moreover, competition among the users of capital market funds, including business, government and individuals, will tend to increase the efficiency with which capital is used, with direct effect on the growth rate of the economy.

mobilize huge savings and channeled such savings to appropriate investments (IFC's Emerging Markets Data Base 1990).

The development of African stock exchanges is growing in importance because of the important role they play in facilitating higher savings rate of the working population; offering of a variety of securities to as many people as possible; flow of foreign direct investment into long-established or recently introduced companies; distribution on capital in the most productive sectors of the economy, redistribution of wealth in the economy and improved corporate governance through increased transparency.

expectations.

In addition, African stock exchanges have the potential to help create wealth and the long-term capital needed for development thereby facilitating poverty reduction and the improvement of living standards (Okereke-Onyiuke2003). It has been stated that the future of Africa's stock markets is the future of the poor in Africa (Brown , 2003).

The jobs, businesses, prosperity and future of the region lie in the stock 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 governmental policies (Sheehan and Zavala, 2005).

In Kenya, the capital market has not yet played its role in capital mobilization, though if properly organized it could be a source of the much needed capital necessary for economic growth (Wagacha 2001). Additional supply of capital is urgently required to maintain the momentum of the growth in GDP. Also in Kenya, an organized capital market can serve as a medium for transferring part of the business ownership of foreign corporations to the citizens. Central to the efficient functioning of a capital market is the development of the stock market. The emerging capital markets of Southeast Asia have successfully used the stock market to mobilize huge savings and channeled such savings to appropriate investments (IFC's Emerging Markets Data Base 1990).

In addition, capital markets facilitate the mobilization and allocation of medium and long-term funds for productive investment by: providing a simple mechanism for the transfer of funds; facilitating companies' access to a large number of local and foreign investors; widening the array of financial instruments available to savers and investors, increasing the diversity and competition in the financial systems and providing market signals on current situations and future expectations.

## 1.2 CAPITAL MARKETS IN AFRICA

In the past 15 years (1990 – 2005), liberalization and privatization have become dominant themes in development strategies in Africa. The changing attitudes towards the role of the private sector in the development of African economies has facilitated the development of the capital markets.

In the 1990s many countries in Africa set up stock exchanges as a precondition for the introduction of market economies under the structural adjustment programs propagated by the international monetary institutions and to facilitate the privatization of state owned enterprises. Currently, Africa has eighteen securities exchanges, eleven of which began operations in the 1990s (Sheehan and Zavala, 2005).

The Nairobi Stock Exchange was incorporated under the Companies Act of Kenya in 1991 as a company limited by guarantee and without a share capital (NSE, MA and AA, 1991). The NSE is an example of an emerging stock market that has been characterized by humble beginnings yet has grown considerably over time. It stands out as an average stock market with great potential for growth, one that is making considerable effort to be a more significant driver of economy in Kenya and the East African Region.

In 1994 the NSE was rated by the International Finance Corporation (IFC) as the best performing emerging market in the world with a return of 179% in dollar terms (Odundo, 2003). In the past two years (2003 - 2005) it has experienced robust activity and high returns on investment. It accounts for over 90% of market activity in the East African region and is a reference point in terms of setting standards for the other markets in the region (World Bank). As an emerging capital market, it has faced challenges to its development and growth such as economic depression and political uncertainty, among others.

NSE facilitates the mobilization of capital for development and provides savers in Kenya with an alternative saving tool. Funds that would otherwise have been consumed or deposited in bank accounts are redirected 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 (Solimano et al 1996). Long-term savings are, therefore, mobilized for financing long term ventures through competitive pricing mechanisms.

NSE 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 (Wagacha, 2001). The slow pace of listing on the NSE reflects the pace of growth of the capital market of Kenya.

### **1.3 THE NAIROBI STOCK EXCHANGE**

The NSE is an example of an emerging stock market that has been characterized by humble beginnings yet has grown considerably over time. It stands out as an average stock market with great potential for growth, one that is making considerable effort to be a more significant driver of economy in Kenya and the East African Region. In 1994 the NSE was rated by the International Finance Corporation (IFC) as the best performing emerging market in the world with a return of 179% in dollar terms (Odundo, 2004).

Before Kenya's independence in 1963, there were about 10 listed companies at the NSE. The period after independence, particularly the 1970s saw about 20 more listed companies. This was the largest number of companies listed in a span of about a decade. The 1980s recorded five new listed companies, a number which doubled in the 1990s (NSE Handbook).

Since 2000; there have been about five new listed companies. In total, there are fifty-four listed companies. Of these, thirty-nine are listed on the Main Investment Market Segment, nine in the Alternative Investment Market Segment and six in the Fixed Income Securities Market Segments (Listed Companies 2005). The slow trend at which companies are getting listed is a concern that needs to be investigated.

The NSE is today poised to play an increasingly important role in the Kenyan economy, especially in the privatization of state-owned enterprises. This implies, therefore, that its growth should reflect changes taking place in the economy as a whole. In the past two years (2003 - 2005) it has experienced robust activity and high returns on investment. It accounts for over 90% of market activity in the East African region and is a reference point in terms of setting standards for the other markets in the region (World Bank, 2002). As an emerging capital market, it has faced challenges to its development and growth such as economic depression and political uncertainty, among others. NSE facilitates the mobilization of capital for development and provides savers in Kenya with an alternative saving tool. Funds that would otherwise have been consumed or deposited in bank accounts are redirected to promote growth in various sectors of the economy as people invest in securities.

The government and local authorities use the NSE as an alternative source of funds to increasing 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 Exchange 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 the Kenya Airways, Mumias Sugar Company, Kenya Commercial Bank, among others.

NSE encourages the broader ownership of firms. The opportunity accorded the general public to have ownership rights over listed enterprises helps to reduce large income inequalities through the sharing of profits made by these enterprises, thereby facilitating the redistribution of wealth. The NSE facilitates improved corporate governance. The activity in the 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.

#### 1.4 STATEMENT OF THE PROBLEM

Many factors affect the development of the capital market. The capital market consists of the primary and the secondary markets. The primary market is the one in which underwriters help companies raise capital in the form of initial public offerings or by issuing seasoned stocks and bonds to investors.

Before Kenya's independence in 1963, there were about 10 listed companies at the NSE. The period after independence, particularly the 1970s saw about 20 more listed companies. This was the largest number of companies listed in a span of about a decade. The 1980s recorded five new listed companies, a number which doubled in the 1990s (NSE Handbook). Since 2000; there have been about five new listed companies (Listed Companies 2005). The NSE is today poised to play an increasingly important role in the Kenyan economy, especially in the privatization of state-owned enterprises. This implies, therefore, that its growth should reflect changes taking place in the economy as a whole. However, the slow trend at which companies are getting listed is a concern that needs to be investigated.

In a study by Morland (1995), he observed that despite the positive and encouraging developments in the restructuring of African financial systems, stock market development in Africa is grossly incomplete. With the exception of South Africa, the emerging stock markets in Africa are by far the smallest of any region, both in terms of number of listed companies and market capitalization.

Only four companies were trading in Swaziland in 1995, 12 in Botswana, 56 in Kenya, and 181 in Nigeria compared to over 7000 in the U.S. Moreover, the listed companies consist mostly of foreign firms, a reflection of the weak private sector in these countries. In absolute terms, market capitalization as of December 1995 ranged from \$189 million in Namibia to \$397 million in Botswana, \$1676 million in Kenya, \$2,033 million in Nigeria and \$2,038 million in Zimbabwe.

Again, the exception is South Africa with market capitalization of \$208,526 million (about ten times the combined capitalization of the remaining African stock markets), a testimony of what is possible even in Africa. (Emenuga, 1996).

Most Kenyan businesses lack long-term capital. The business sector has depended mainly on short-term financing such as overdrafts to finance even long-term capital. Based on the maturity-matching concept, such financing is risky. The need for a quicker development of a well organized and functioning capital market has become extremely important. In the light of these developments, it is necessary to identify and analyze all the factors that impinge on the development of the capital market in Kenya, especially the stock market, and to suggest necessary policy recommendations to rectify the situation sooner than later. The problem could be posed in form of the question:

What are the factors that affect the development of the Stock Market in Kenya?



## 1.5 OBJECTIVE OF THE STUDY

To determine the factors that affect the development of emerging capital markets especially in Kenya.

## 2.1 INTRODUCTION

### 1.6 IMPORTANCE OF THE STUDY

This study will be important to the:

**The Regulators:** In order to ensure orderly and equitable dealings in securities, as well as the protection and security of investors, all capital markets especially the NSE operates within a framework of laws and regulations enacted by the country. The extent to which these laws are enforced will have a direct bearing on the development of the stock market. The study will establish the legal and regulatory infrastructure needed for the securities market in general and the stock market in particular is in place, with laws and regulations necessary to protect investors and the integrity of the NSE.

**Academicians and Researchers:** Emerging capital markets recently have attracted the attention of global investors and scholars alike. The markets are characterized by high average returns, high volatility, and excellent diversification prospects in combination with portfolios from developed markets (Barry and Lockwood 1995).

Goldsmith (1969), in a study of 36 countries drawn from both developed and developing countries over the 100-year period 1860-1963, shows evidence of a positive relationship between the ratio of financial institutions' assets to GNP and output per person.

## CHAPTER TWO

### 2.0

## LITERATURE REVIEW

### 2.1 INTRODUCTION

There has been considerable interest in the development of capital markets in many developing countries in the last twenty years or so, and, evidence of the role of financial markets in economic development is well documented. Capital markets are an essential part of the financial sectors of modern economies. Providing alternative savings tools to savers and non-bank sources of financing for enterprises, the markets promote economic growth through improved efficiency in savings mobilization (Schmidt-Hebbal et al, 1996). Empirical studies support the view that stock market development plays a vital role in realizing sustainable economic development and growth through domestic resource mobilization. It helps mobilize domestic savings, thereby bringing about the reallocation of financial resources from dormant to active agents. (Masinde and Kibua, 2004).

Porter (1993) observes that over the past few years, investor interest in the world's emerging markets has expanded significantly. That interest has been fuelled by the relatively high returns recorded by emerging markets and by their perceived potential for large returns in the future. Barry and Lockwood, (1995) also note that emerging capital markets recently have attracted the attention of global investors and scholars alike. The markets are characterized by high average returns, high volatility, and excellent diversification prospects in combination with portfolios from developed markets.

Goldsmith (1969), in a study of 36 countries drawn from both developed and developing countries over the 100-year period 1860-1963, shows evidence of a positive relationship between the ratio of financial institutions' assets to GNP and output per person.

Goldsmith presented data showing that generally periods of more rapid growth in the economy have been accompanied by an above average rate of financial development.

Other researchers, including Barro (1989) and Romer (1989), have used cross-country data spanning several years to show very significant differences in per capita output growth rates and financial market development. Levine (1990) shows that stock markets accelerate growth by facilitating the ability to trade ownership of firms without disrupting the productive process occurring within firms, and allowing investors to hold diversified portfolios.

Kimura and Amoro (1999), found that there was a poor degree of correlation between economic growth and the growth of the stock exchange. The former averaged 3.8% p.a. in the period 1985-1996 while the latter averaged only 0.6% as measured by the number of quoted companies. The results indicated that a major factor is general lack of awareness and information on the role, functions and operations of the stock exchange.

## **2.2 DEFINITION OF EMERGING CAPITAL MARKETS**

Generally, there is no universally accepted definition of emerging capital market. The term 'emerging capital market' may be used loosely to mean the same thing as 'emerging stock market'. However, the term 'capital' could involve various combinations of debt and equity securities.

Also, 'capital' could be constituted by equity securities only or by debt securities only. The same would be true if we were to examine the meaning of the term 'stock' as it applies in the context of the title 'emerging stock markets'(Mwenda,1998). The broadness and similarities in what constitutes stock and capital explain why we use such terms as 'emerging capital market' and 'emerging stock market' interchangeably. In the strict legal sense, however, the two terms are somewhat different. In practice, they are hardly distinguishable.

Although there are other forms of capital markets, which by contrast are not stock markets, these markets fall outside the ambit of this work and they include institutions such as merchant banks (Mwenda, 1998).

The International Finance Corporation (IFC) defines an emerging market as one which is found in a developing country (IFC, 1994). By contrast, investors tend to focus their attention and investments on a more narrow definition than that emphasized by the IFC (Barry and Lockwood, 1995). Investors generally focus their attention and investments on a definition that emphasizes those developing countries in which capital markets are advancing in size, activity, or sophistication.

Interestingly, Barry and Lockwood observe on the definition provided by the IFC that the World Bank's guideline is that a developing country is one with low-to-middle income, which in 1992 meant a per capita GNP (Gross National Product) of less than US \$8,356. The IFC maintains a database including security prices on 26 markets out of the 169 countries that qualified as low-to-middle income in 1992 (Washington DC: IFC, August 1998).

The Economist publication (1999), by contrast, usually lists the following twenty-five countries as countries where emerging markets are located: China, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, Greece, Israel, Portugal, South Africa, Turkey, Czech Republic, Hungary, Poland and Russia. Generally, there is an overlap between markets identified by some as 'emerging' and those identified by others as 'developed'. Good examples are the classifications by the IFC and that by the Economist.

The Economist classified as 'emerging' the markets of Taiwan, Korea, Mexico, South Africa, Malaysia and Thailand, all of which had year-end 1993 market capitalizations in excess of US \$100 billion (Barry and Lockwood, 1995).

By contrast, the IFC classifies as 'developed' nine mostly European markets with capitalizations less than US \$100 billion (IFC, Emerging Markets Fact book). At the time that the IFC was compiling data on emerging markets and developed markets, Italy, one of the G-7 nations, had a smaller market capitalization than five emerging markets.

Clearly, there is need to have a well-defined criteria on which the classification of emerging stock markets should be based. If such criteria were to be spelt out, perhaps, a number of African stock markets would qualify as emerging markets. The evidence presented above on Italy shows that in reality some emerging markets can be significant in size. However, given the volatility of business in these markets, it is difficult to say with precision which is or is not an emerging market.

As a result of lack of clarity in the definition of emerging markets, the study will take a departure from the restrictive lists provided by the Economist and the IFC. Instead, it will argue that the term 'emerging market' covers mainly stock markets in developing countries which have not yet developed to the same levels of sophistication and market capitalization as stock markets in a number of developed countries.

Given that there is no universally accepted definition of emerging markets, these markets vary widely in terms of their structure, performance, prospects and principal features. In 1984, Gupta undertook a study on the role that the structure of financial markets plays in a number of developing countries (Gupta, 1984). His findings indicated that financial markets have sometimes encouraged development and at other times have resulted from development.

A similar study was undertaken by Barry in 1986 on Hong Kong, Korea, Singapore and Taiwan and it revealed the same findings (Barry, 1986). In trying to appreciate all these studies, we must bear in mind some of the constraints affecting the efficacy of the legal framework(s) for public distribution of securities in emerging markets. The unique environment in which emerging markets find themselves necessitates the adoption of a novel approach to the study of capital structuring (by companies) in emerging markets. Restrictions on investment behavior such as those described above can adversely affect the market value of a company (Van Horne 1983), while at the same time placing a limit on possible streams of debt financing available to companies. Such market imperfections can influence the choice between debt financing and equity financing on an emerging market. Indeed, a number of African, Asian and Caribbean countries have been said to experience such problems (International Law Institute 1999).

### **2.3 RATIONALE FOR THE EXISTENCE OF STOCK EXCHANGES**

Empirical studies support the view that stock market development plays a vital role in realizing sustainable economic development and growth through domestic resource mobilization. It helps mobilize domestic savings, thereby bringing about the reallocation of financial resources from dormant to active agents. Long-term investments are made liquid as the transfer of securities between shareholders is facilitated. (Masinde and Kibua, 2004)

The promotion, establishment and successful operation of an organized market for securities requires certain conditions to exist. First, there must be a considerable volume of securities whose ownership is widely distributed. This implies that there has to be some degree of industrialization or commercialization and there is the presence of fairly large firms. Second, there must be a sufficient number of well-endowed people wishing to hold their savings in form of financial assets rather than in business or real property. Third, there has to be a reasonably functioning tax system.

Fourth, there has to be a significant degree of long-term political and economic stability and finally the development of the market will also be greatly assisted if the law provides for an effective system of property rights that recognizes procedures for the transfer of title.

## 2.4 BENEFITS OF BEING LISTED

According to Kimura and Amoro, to be listed entails a certain level of expenditure in terms of time, money and effort on the part of the company. Companies are willing to incur this expenditure for a number of reasons which include: First, to raise funds especially for capital investment. The stock exchange provides a cheap source of funds for long-term investments.

Most of these funds are not refundable except on liquidation of the company when the shareholders would share out what is left after all liabilities have been settled. Dividends may not be paid annually if the company is experiencing financial difficulties. Secondly, it allows the citizens of a country to participate in the ownership of the company. Governments use the stock markets when privatizing public corporation to spread their ownership among the citizenry. Listed companies also enhance a company's prestige and public image. A widely-held company may appear less foreign to the public. Its products may become more acceptable as "our own".

## 2.5 CHALLENGES OF DEVELOPING STOCK MARKETS IN AFRICA

The political and economic decisions that were translated into legal framework for the establishment and operation of the stock exchanges were rushed in many African countries. Therefore, the exchanges have not been successful in attracting a large number of other market transactions in addition to the privatized public enterprises (Kariithi, 2002).

Many of Africa's stock exchanges are small, underdeveloped and illiquid. They tend to operate in isolation from other markets, have low trading volumes, are sheltered from competition by national regulations and face barriers to capital mobility because of high costs of travel and communications (Asea, 2003).

According to the NSE handbook, African exchanges tend to be highly concentrated with the best shares being held by local pension funds, banks and insurance firms that do not want to sell because they have few alternative assets to buy with sales proceeds. In addition, the market infrastructure is underdeveloped particularly with regard to trading, settlement and delivery as manual systems and processes dominate their operations. Bond markets are relatively underdeveloped in Africa's capital markets, yet they have the potential of mobilizing significant amounts of capital. They can also give African stock exchanges a tremendous boost in turnover as bonds are usually more attractive to investors than stocks. A well integrated and customized financial information service that provides timely and accurate information service to individuals and corporate institutions is necessary for the development of bond markets (NSE Handbook).

Stringent eligibility requirements have discouraged local entrepreneurs and indigenous enterprises that wish to raise funds from capital markets. The eligibility requirements as exemplified in the requirements for listing at the NSE have created high barriers to potential entrants to the stock exchanges such as the numerous family owned businesses in Africa. Thus, the stock exchanges tend to operate like closed membership organizations (Asea, 2003).

According to Sheehan and Zavala (2005), they observed that creating an efficient regulatory system for securities exchanges is a difficult goal to achieve and maintain. Hence, some African stock exchanges have limited institutional capacity to police and enforce rules.



Most of the smaller African exchanges lack the trained manpower and experience to adequately police the modern regulatory regimes they have adopted. Consequently, enforcement actions are rare and abuses are not uncommon. In addition, investors, particularly minority shareholders, lack confidence in the market as some listed companies continue to operate under poor corporate governance structures. In some stock markets, participants are subject to multiple regulators thereby causing regulatory complexities, uncertainties and increased costs of compliance with different regulatory regimes (Asea, 2003).

Low savings rate in many African countries has constrained demand and supply of equity in stock markets. Poverty, war, political unrest and disease have resulted in a large portion of the African population living on less than a dollar a day thereby constraining savings. There are serious challenges and impediments to the development of capital markets in Africa. While it is difficult to generalize about the disparate financial systems of a continent comprising over fifty countries, the study highlights certain challenges that are applicable in many country cases, particularly of the Sub-Saharan region.

Verrachia(1982)and Jensen and Murhy(1990)show that developed stock markets help mitigate the principal-agent problem. Efficient stock markets make it easier to tie manager compensation to stock performance. This helps align the interests of managers and owners. Furthermore Laffont and Tirole (1998) and Scharfstein(1998) argue that takeover threats induce managers to maximize the firms equity price. Thus, well functioning stock markets that ease corporate takeovers can mitigate the principal-agent problem and promote efficient resource allocation and growth. Moreover, Shleifer and Vishny(1986),and Bhide(1993) argue that greater stock development encourages more diffuse ownership and this diffusion of ownership impedes effective corporate governance.

In terms of raising capital, Greenwood and Smith (1996) show that large, liquid and efficient stock markets can ease savings mobilization. By agglomerating savings, stock markets enlarge the set of feasible investment projects. Since some worthy projects require large capital injections and some enjoy economies of scale, stock markets that ease resource mobilization can boost economic efficiency and accelerate long run growth.

Demirgüç-Kunt and Levine (1993) indicate traits of characteristics of stock market development as: Traditional characteristics, which include market capitalization, the amount of new capital raised through stock offerings, the number of listed companies and turnover; Institutional characteristics, which include regulations, information disclosure, transparency rules and trading costs; and Asset pricing characteristics, which is the efficiency with which the market prices risk and the degree of integration into world stock markets.

Pardy (1992) contends that there are two basic building blocks necessary for a thriving securities market. First, a macroeconomic and fiscal environment conducive to the supply of good quality securities and sufficient demands for them, secondly a market infrastructure capable of supporting efficient operation of the securities market. Under the first pre-condition, the author indicates that the demand for and supply of securities is crucially linked to the state of the macro economy. If the macro economy is conducive to profitable business operation, a sufficient number of sound businesses can develop to a stage where access to securities markets is useful for their continued growth.

This means that if there are not sufficient profitable businesses with good prospects for the future, there would be little reason to have a securities market.

According to Pardy, the market infrastructure that will make the securities market operate in an efficient, fair and stable manner, is broken into three parts: First, the institutional infrastructure; which provides the operational basis for the market, relates to intermediaries that provide trading, investment management and financial advisory services; market and market-related service providers for stock exchanges, over-the-counter markets, market information services, transaction clearance and settlement systems, and securities transfer, registration and custody. Finally the providers of ancillary services such as accounting and auditing, legal advice, and financial valuation and debt rating services.

Second, the regulatory infrastructure; relates not only to the government body that has the power and responsibility to supervise the market, but also includes self-regulatory organizations such as stock exchanges, accounting standards boards, and accounting and auditing professional associations and similar organizations. It also includes their rules and regulations, procedures, and facilities such as stock exchange listing and trading rules or accounting and auditing standards, plus the monitoring and enforcement of these rules. Finally, the legal infrastructure; provides the basis for the operational and regulatory framework. It provides for property rights, contractual relationships, forms of incorporation, and rights and responsibilities of participants in the market. It also specifies the powers and responsibilities of the government supervisory authority and self-regulatory organizations.

The first precondition for sound securities market development put forward by Pardy (1992) recognizes the importance of taxation (fiscal environment). The author finds that differential effective tax rates on either income or capital gains from different financial instruments will distort capital raising and investment decisions.

Pardy supports this conclusion by observing that quite a number of developing countries with state ownership of commercial banks have tax rates that discriminate in favour of savings and demand deposits as opposed to securities investment, and in favour of borrowing from banks as opposed to raising capital from the public. For capital market development, these taxation differentials must be removed.

Demirgüç-Kunt and Huizinga's (1992) study has implications for the design of tax policy related to foreign portfolio investment in developing countries. They indicate that the existence of foreign tax credits for dividend taxes paid suggests that a country should tax capital gains lightly in comparison with repatriated dividends. Lyon (1992) finds that differing tax treatment of equity and debt can create divergent costs in the use of retained earnings, new share issues and debt finance.

Another factor that affects the development of the capital market is information disclosure or transparency of transaction. Versluysen (1988) indicates that in markets for publicly offered securities, investor access to information pertaining to their prospective investments is more limited than that of professional intermediaries. Investors can therefore be protected by the compulsory disclosure of financial data and other relevant information relating to the issues of securities.

Pardy (1992) also contends that a company that raises funds from the public must be required to disclose sufficient information to allow an educated investor to make a reasoned investment decision so that the aggregate of investors' decisions may be a good assessment of a company's worth. This requires an effective legal infrastructure to specify and enforce disclosure standards for all companies issuing securities for the public.

Those companies that have securities listed for secondary trading on a market such as a stock exchange should be subjected to additional disclosure requirements imposed as listing rules.

Over the past few years, investor interest in the world's emerging markets has expanded significantly. This interest has been fuelled by the relatively high returns recorded by emerging markets and by their perceived potential for large returns in the future (Porter 1995). The strength of securities markets that make them focal points of modern finance is their ability to mobilize long term savings for financing long term ventures, to improve efficiency of resource allocation through competitive pricing mechanisms, to provide risk capital (equity to entrepreneurs), and to encourage broader ownership of firms. The latter function is jeopardized if there are few listings by eligible firms (Wagacha, 2001).

There are factors that have to be addressed in terms of the stage of development of the Kenyan market. Countries with big equity markets have less volatile, more price efficient markets with substantial degrees of liquidity. Most emerging markets, as in Kenya, are highly concentrated. As a result they tend to be undeveloped, and are small and illiquid, exhibiting pricing volatility and error. The more integrated the market to international markets, the less volatile the returns. A factor that drives markets strongly is the level of institutional arrangement and the regulatory framework (Wagacha 2001).

The problems associated with emerging markets include the views that these markets experience constraints such as inadequate liquidity, restrictive regulations on banking systems, and restrictive regulations on investment of pension assets and heavy reliance on privatizations as a source of capital growth. In general, however, the advantages of investing in emerging markets, when contrasted with the disadvantages of investing in these markets, show that there is a good case for investing in emerging markets.

The literature summarized above shows that many factors may affect the development of capital markets in the developing countries. Identifying the important factors for rectification will therefore quicken capital market development. The study will focus on the following factors:

### 2.6.1 THE LEGAL AND REGULATORY FRAMEWORK

In order to ensure orderly and equitable dealings in securities, as well as the protection and security of investors, all capital markets especially the emerging ones operate within a framework of laws and regulations enacted by the country. The extent to which these laws are enforced will have a direct bearing on the development of the stock market (Osei, 1998).

Sections 11(3) and 12 of the Capital Markets Authority Act (the Act) empower the Capital Markets Authority to make rules and regulations to govern capital markets in Kenya. It is also responsible for protecting the securities market against abuses such as insider trading practices. The stock market operates within a certain legal framework. The exchange has its own rules and regulations, including those for membership, listing, trading, settlement, mergers, and takeover. In addition, there is a multiplicity of regulators and regulations at play in the Kenyan capital market. They include the Central Bank of Kenya, Retirement Benefits Authority, Capital Markets Authority, and the Commissioner of Insurance. All these bodies enact policies that affect the development of the stock market.

A genuine capital market development is accompanied by a credible and rational regulatory scheme that promotes, rather than inhibits, private initiative, whereby investors and savers build confidence in the financial system. The environment should foster investment allocation to the most productive sectors and lead to growth in productivity and employment, (Barry, 1985).

Public disclosure of relevant information about securities is important for both pricing efficiency and market confidence. If investors are to make sound judgments about the value of securities, they must be fully informed of relevant facts.

Barry and Lockwood (1986), observe: "In many developing nations, security markets are either lacking entirely or are poorly developed. Further, financial reporting may be unreliable and access to company information highly limited. In such nations, banks and other financial intermediaries take on especially important roles.

In order to secure investment capital from banks, firms often must concede a strong role for the lenders, such as presence on the Board of Directors and access to inside information. In a market in which asymmetric information is especially problematic, the market can break down altogether without some way in which providers of capital can gain access to information.

Chuppe and Atkin (1992) contend that information asymmetries abound in financial markets. The managers of a firm know more about that firm's market prospects and investment opportunities than do outsiders. Financial market professionals often have access to information that is not widely available. In an unregulated market, the possibility exists that unsuspecting investors will be harmed by those with access to information not available to the public at large. This is important for the economy because lack of public confidence in securities markets would cause the supply of funds to the markets to dry up, thus depriving the economy of the benefits of a functioning market. The authors further observe that these information asymmetries are the basic justification for a large number of regulations. Disclosure requirements for public companies must ensure that financial information is available for investors in a way that facilitates inter-company comparisons. It must be noted, however, that disclosure is only effective if there are good accounting standards in place, standards that allow investors to assess the financial health of enterprises.

Section 22 of the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002 empowers the licensed securities exchange (NSE) to suspend and de-list listed securities subject to the approval of the Capital Markets Authority in the event a listed company fails to adhere to the continuous listing obligations particularly the regular and timely public disclosure of financial and other price sensitive information and a degree of control.

### **2.6.3 TRANSPARENCY OF TRANSACTIONS**

Transparency of trading and other procedures allows efficient price setting and confidence in the fairness of the market. Fragmented or privately conducted trading with limited disclosure of quantity and price means that each new transaction in effect must be based on relatively expensive search costs and there is a risk of the transaction going out of line with prevailing prices. Opaque trading procedures engender suspicion of market manipulation and may reduce the rate of investment (Osei, 1998). On the NSE, all buying and selling of shares are done through brokers or licensed dealing members who have the license to buy and sell shares on behalf of their clients on the exchange.

### **2.6.4 ACCOUNTING AND AUDITING STANDARDS**

Users of accounting information include the government, the regulatory agencies, the financial community, professional organizations, chartered accountants and accounting firms, the investing public, industry association, and the general public. These users may have both coinciding and conflicting needs for the various types of financial statements and reports. In meeting these needs, accountants and auditors prepare a single set of general purpose financial statements and reports that present objective, unambiguous and complete economic facts of the existence and operations of the enterprise (Osei, 1998). In order to narrow the areas of differences and minimize the dangers of bias, misinterpretation, inexactness and ambiguity, accountants and auditors have adopted generally accepted accounting and auditing principles or standards.



These standards allow financial statements and reports to be reasonably compared between enterprises and between accounting periods.

### **2.6.5 TRANSACTION COSTS**

Unreasonably high costs of transactions will affect market development since investors aim at minimizing cost to increase their returns. For companies going public through share issue and subsequently seeking listing on the exchange, the main costs are: Underwriting fee, Legal and accounting expenses, Brokerage commissions, Cost of printing and advertising prospectus and Fees for the NSE (including listing fees, application fees, and annual fees).

### **2.6.6 DELIVERY AND SETTLEMENT**

Under delivery and settlement, the study is interested in transactional clearance and settlement systems, securities transfer, registration, and custody. In some emerging capital markets, investors in securities have expressed concern about purchasing securities but not receiving either their certificates or their dividends. In other situations, investors who have sold their securities continue to receive dividends. This obviously shows poor securities transfer, registration and custody (Osei, 1998).

Prior to November 2004, NSE used a manual delivery and settlement system. The system involved the exchange of share certificates between stockbrokers, NSE and the relevant shares registrars of listed companies before a trading transaction could be completed and the buyer issued with a share certificate in his/her name. The delivery and settlement system was intended to take the T+5 cycle (day of trading plus five days). However, in practice it took an average of between eight and fourteen days (Kibutha 2004). In November 2004, an automated clearing, depository and settlement (CDS) system began operations. The legal and regulatory framework within which the CDS was established and continues to operate is embodied in the Central Depository and Settlement Act (CDS Act), 2000 and the Central Depositories (Capital Markets) Rules, 2004.

Differences in effective tax rates on income from different financial instruments

The CDS in Kenya is proceeding to complete immobilization. Therefore, once share certificates are deposited into the central depository, the delivery of shares after a trading transaction will be achieved through the change of records in the central depository instead of exchange of certificates (NSE Fact file 2004). It is intended that the CDS will move towards dematerialization where physical certificates no longer exist and if they do they will no longer be recognized as legal evidence of share ownership. The CDS is to provide additional functions such as mortgaging of shares as security for loans and receipt of entitlements such as dividends, bonus and rights from listed companies for onward transmission to shareholders.

### **2.6.7 BARRIERS TO ENTRY AND EXIT**

Excessive barriers especially to foreign investors hamper the development of any stock exchange. Any company incorporated in Kenya that issues securities to the public or that is listed at the NSE is required under the Capital Markets (Foreign Investors) Regulations, 2002 to set aside twenty five per cent of its ordinary shares for investment by local investors. This proportion of its ordinary shares is not to be offered for investment by East African or foreign investors. The remaining seventy-five percent is available for investment by the East African, local or foreign investors without any restrictions in the level of holdings other than what is stipulated under the Take over and Mergers Regulations. (Capital Markets (Take over and Mergers) Regulations, 2002).

### **2.6.8 TAXATION OF INVESTMENT INCOME**

In the classical Modigliani-Miller concept of perfect capital markets, financing decisions made by firms are irrelevant. Firms are indifferent between drawing on retained earnings, issuing new shares or issuing debt. However, in an imperfect financial market like Kenya's, one of the factors that influence firms' choice of financing is the taxation of income.

Differences in effective tax rates on income from different financial instruments can influence how individuals or corporate bodies make their financial and investment decisions. Such differences may also determine whether an individual should invest in securities or demand deposits or whether a corporate body should raise funds through equity or debt instruments (Wagacha 2004).

Individuals in Kenya investing in debt securities do not pay any taxes on interest from such investment. However, a withholding tax of 10% is deducted on dividend income from investment in equities and 5% for local investors. Capital gains are not taxed. For corporate bodies, dividend income and interest income are taxed at 10%, while capital gains are tax-free. With regard to incentives, in the 2001/2002 national financial budget, the government reduced the corporation tax rate from 30% (for local companies) and 32.5% (for foreign companies) to 25% on newly listed companies for five years from the date of listing. The companies are required to offer at least 30% of their share capital to the public.

Other incentives include: Reduction of withholding tax on dividend from 15% to 10% for foreign investors and 5% for local investors, Full tax deductibility of expenses related to issuing shares to the public, Exemption from stamp duty for new and expanded share capital, the transfer of assets for the issuing of asset-backed securities and transfer of listed securities, Ten-year tax holiday for venture capital funds and Tax exemption on income accruing to registered collective investment schemes.

The questionnaire was made up of two parts, A and B. Part A captured information on factors affecting development of the stock market and Part B sought to capture possible solutions suggested by the respondents. The questionnaires were delivered to the respondents and collected at a later date. Interview method was also used where possible. This is to increase responses and seek clarification to enhance accuracy (Churchill, 1987).

The data collected for the study was analyzed using factor analysis technique

### 3.0 RESEARCH DESIGN AND METHODOLOGY

This study is a survey to identify the factors affecting the development of Nairobi Stock Exchange as an Emerging Capital Market.

(2000), who did a study on factors influencing investments in Kenya

#### 3.1 POPULATION OF THE STUDY

The population of the study consisted of NSE, CMA, CDSC, Asset Managers and all the Stock Brokerage Houses members of the Nairobi Stock Exchange as at 31<sup>st</sup> December 2005. They consist of 18 Brokerage Houses (Population shown as Appendix 2), NSE, CMA, CDSC and Asset Managers. A census study was carried out so as to ensure representation due to the small number. These were selected because of their direct involvement in the stock market and the difficulty to access real investors.

#### 3.2 DATA COLLECTION

Primary data was collected by an exploratory survey method. A semi structured questionnaire consisting of mainly of closed ended questions and based on a five point Likert scale was used. The closed ended questions are appropriate as they provide a standard set of questions for all respondents as the information sought is qualitative in nature. Only one questionnaire was administered to all the respondents. The questionnaire was developed in line with the objectives of the study and was completed by the appropriate officials after an initial briefing of the required information (See Appendix 1 for sample questionnaire).

The questionnaire was made up of two parts: A and B. Part A captured information on factors affecting development of the stock market and Part B sought to capture possible solutions suggested by the respondents. The questionnaires were delivered to the respondents and collected at a later date. Interview method was also used where possible. This is to increase responses and seek clarification to enhance accuracy (Churchill, 1987).

### 3.3 DATA ANALYSIS

#### CHAPTER FOUR

The data collected for the study was analyzed using factor analysis technique. Descriptive statistics were used to analyze data by way of frequency tables, percentage proportions and mean scores while content analysis was applied to data that could not be quantified. This procedure has been used by Ndinya (2000), who did a study on factors influencing investments in Kenya.

A similar study by Osei (1998) used the data analysis techniques described above. The analysis was based on the effect of factors on the development of the NSE by examining the following characteristics: The legal and regulatory framework, Information disclosure requirements, Transparency of transactions, Accounting and auditing standards, Transaction costs, Delivery and settlement, Barriers to entry and exit, Taxation of investment income, Public knowledge of securities markets plus any other factors emerging in the course of the study.

Mean scores were used to gauge the overall opinions of the respondents in general. The factors are rated or ranked based on the mean scores.

Eigen values summary and total variances on Table 4.3(Appendix II) represents total variance explained by each component or factors. The total columns give the amount of variance in the observed variables accounted for by each component of the factor. The percentage variance gives the percentage of variance accounted for by each specific factor or component, relative to the total variance in all the variables. The cumulative column gives the percentage of variance accounted for by all factors or components up to and including the current one. The Eigen value or latent root is simply the extracted variance of the variables; we note that the value of the sum of squares (Eigen values) falls off from the first factor. The reason is because in factor analysis the maximum amount of variance is extracted by each factor in turn starting with the first factor. From the analysis for instance, 87.1 % of the variance observed in the constraint "High unemployment rate in the country" is explained by the factors jointly.

## CHAPTER FOUR

### 4.0 DATA ANALYSIS AND FINDINGS

In order to identify the factors affecting the development of Nairobi Stock Exchange as an Emerging Capital Market, a survey was undertaken and it was between the Stock Brokers who are members of the NSE, CMA, CDSC, Asset/Fund managers and NSE. Out of the 25-targeted 18 responded. This was a response rate of 72%, which is considered satisfactory. The summary analysis of the collected data on factors considered to be affecting the development of the capital markets in Kenya is presented below:

#### 4.1 DESCRIPTIVE STATISTICS SUMMARY

Descriptive statistics summary on **Table 4.1 (Appendix II)** shows the mean and standard deviation of the various factors considered to be affecting the development of the capital markets in Kenya. Mean scores were used to gauge the overall opinions of the respondents in general. The factors are rated or ranked based on the mean scores

Eigen values summary and total variances on **Table 4.3(Appendix II)** represents total variance explained by each component or factors. The total columns give the amount of variance in the observed variables accounted for by each component of the factor. The percentage variance gives the percentage of variance accounted for by each specific factor or component, relative to the total variance in all the variables. The cumulative column gives the percentage of variance accounted for by all factors or components up to and including the current one. The Eigen value or latent root is simply the extracted variance of the variables; we note that the value of the sum of squares (Eigen values) falls off from the first factor. The reason is because in factor analysis the maximum amount of variance is extracted by each factor in turn starting with the first factor. From the analysis for instance, 97.1 % of the variance observed in the constraint "High unemployment rate in the country" is explained by the factors jointly.

The most important factor considered to be affecting the development of capital markets is Manual procedures for delivery and settlement as it is contributing 98% then followed by high unemployment rate in the country with 97.1%. An analysis of the above communalities reveals that most of the variations in the external factors were captured fairly by the components. The lowest variation was captured for the statement "Transparent trading at the exchange" with a communality of 63.1 %, which is an indication that they are the least contributors in the factor analysis.

From table **4.3(Appendix II)**, component 1 accounts for 28.9% of the total observed variations, while component 2 explains 18.7% and component 3 for 16.3% and so on. The 5 components extracted from the variables explain 84.9% of the total observed variations for all the variables.

From the graph 4.1 (page 32), it shows that the respondents considered the factors tax incentives by government with a rank of 61%, and then followed by low levels of public awareness with a rank of 39% to be extremely important in considering the development of capital markets.

Absence of a real time central CDS with a rank of 72%, followed by transparent trading at the NSE with a rank of 68%. Manual procedures for delivery and settlement and poor implementation of corporate governance principal both with a rank of 56% were considered to be very important factors by respondents also in development of capital markets in Kenya

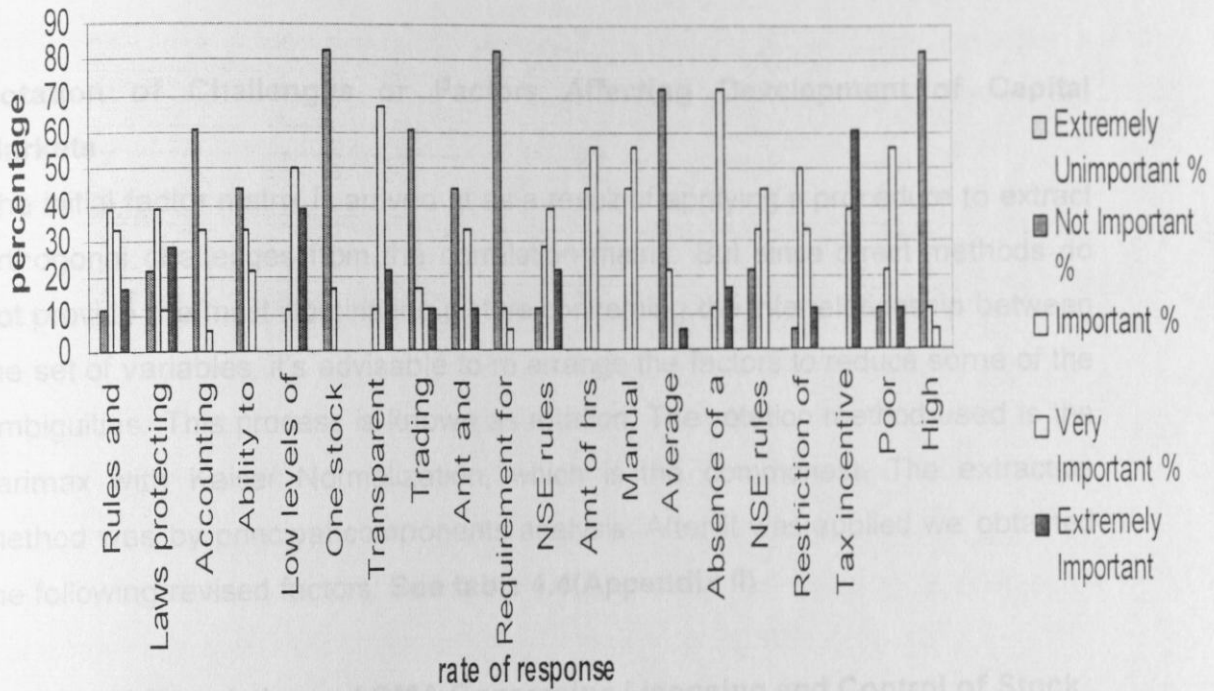
## 4.2 COMPONENTY MATRIX SUMMARY AND FACTOR LOADINGS

### Interpreting the Factors Loadings

In table 4.4(Appendix I), since the loading of a variable on a factor represents the correlation between the variable and the factor concerned, within any factor, we are interested in those variables with high loadings.

Graph 4.1

### Factors affecting development of capital markets in Kenya



We can also observe that the following factors high unemployment rate in the country, requirement for cross border listing and existence of one stock exchange in Kenya all have a rank of 83% and are regarded as being not important at all by the respondents and hence do not affect development of capital markets. Average duration of delivery and settlement between 2 brokerage firms followed with a rank of 72%.

#### 4.2 COMPONENTY MATRIX SUMMARY AND FACTOR LOADINGS

##### Interpreting the Factors Loadings

In table 4.4(Appendix II), since the loading of a variable on a factor represents the correlation between the variable and the factor concerned, within any factor, we are interested in those variables with high loadings.



For example 0.733 has the highest loading in the components rules and regulations, 0.676 in factor 2 has the highest loadings in Kenya laws protecting investors, and 0.687 has the highest loading in the accounting and auditing standards components.

### **Rotation of Challenges or Factors Affecting Development of Capital Markets**

The initial factor matrix is arrived at as a result of applying a procedure to extract orthogonal challenges from the correlation matrix. But since direct methods do not provide the most illuminating picture concerning the interrelationship between the set of variables, it's advisable to re arrange the factors to reduce some of the ambiguities. This process is known as rotation. The rotation method used is the varimax with Kaiser Normalization, which is the commonest. The extraction method was by principal components analysis. After it was applied we obtained the following revised factors: **See table 4.4(Appendix II)**

### **Rules and Regulations of CMA Concerning Licensing and Control of Stock Market**

This was rated as an important factor to the development of the stock market. This was ranked number 7 with an overall mean score of 3.5556. The legal and regulatory framework of the Kenyan capital market is reasonably sound and could serve as a basis of developing the regional market. This took position 9 with a mean of 3.5.

### **Information Disclosure Requirements**

The study found that the disclosure policies governing listed companies on the Nairobi Stock Exchange, as enshrined in The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002 are quite comprehensive. Various regulations under this legislative instrument touch on information to be disclosed to the general public. In overall this factor ranked position 12 with a mean score of 3.111. Therefore non-financial information should be disclosed to supplement financial matters.

### **Transparency of Transactions**

The study found that the system of trading on the NSE is quite transparent. There is therefore transparency of pricing. Generally all the brokers interviewed were quite satisfied with the transparency of pricing of shares on the NSE. It appeared, however, that the surveillance department of the NSE may need to be expanded as activity increases in the near future.

In the study this factor was ranked position 3 with a mean score of 4.111.

### **Accounting and Auditing Standards**

This factor was ranked position 16 with a mean score of 2.444 thus not rated as an important factor affecting the development of the stock market. In table 4.6 accounting and auditing standards load heavily on factor 1. Since accounts of listed companies are prepared by reputable firms, accounts submitted to the NSE can be expected to be of internationally acceptable accounting and auditing standards. Interviews with officials of NSE confirmed that this is the case.

### **Restriction of Foreign Ownership To 49% of Authorized Issued Share Capital**

This was regarded as an important factor affecting the development of the stock market. Even though this is aimed at protecting the local investors it is contributing to illiquidity in the market thus low turnover. This took position 9 with a mean of 3.5.

### **Delivery and Settlement**

Table 4.6 (Appendix) revealed that the average duration of delivery and settlement between 2 brokerage firms, absence of a real time central CDS, load heavily on factor 3. In overall this took position 4 with a mean score of 4.055 thus an important factor affecting the development of the stock market. The transactions at the NSE are towards automation with the introduction of the CDS although it is yet to reach full automation.

The delivery and settlement of transactions were performed satisfactorily by brokers. The need for a fully centralized settlement system is apparent, however. Such a system will not only reduce the settlement time but also reduce the settlement cost.

### **Barriers to Entry and Exit**

The restriction of foreign ownership in a quoted company to 49% of the authorized and issued capital is regarded as an important factor affecting the development of the stock market. Even though this is aimed at protecting the local investors it is contributing to illiquidity in the market thus low turnover. This took position 9 with a mean of 3.5.

### **Amount and Content Disclosed by Listed Companies**

The study found that the listed firms on the market complied with the information disclosure guidelines set by regulation. For example, financial reports, the amount of dividends declared, ex-dividend dates, etc., were regularly filed with the NSE. However, the ability of many investors to use the information in investment decisions appeared weak hence the inability of the market to price the financial assets efficiently. This factor ranked position 12 with a mean of 3.111.

### **Tax incentives by the Government**

In table 4.6 tax incentives by the government load heavily on factor 2. The mean scores for all the groups indicate that the respondents considered tax incentives by the government a major constraint facing the stock market. The stockbrokers felt that the corporation tax of 30% imposed on companies as too high and the current tax laws favour the use of debt instruments compared with equity.

### 4.3 FACTORS IDENTIFIED BY RESPONDENTS

This refers to analysis of the factors that were not listed in the Questionnaire but identified by the respondents.

The frequencies and percentages are based on the total numbers of respondents (18). From the analysis of the answers/responses given, the constraint that ranked the highest was Lack of awareness among the public members with a % response rate of 29% then followed by Lack of an appropriate regulatory framework for collective investment schemes with a percentage of 21%.

Lastly lack of an over the counter market OTC with a rate of 2%. These affect the development of the stock market negatively as it results to low stock turnover thus slow development. Poor implementation of corporate governance principles by CMA, low levels of public awareness load heavily on factor 4. NSE rules and requirements relating to listing of companies, manual procedures for delivery and settlement load heavily on the fifth factor.

Possible remedies suggested on part B of the questionnaire are shown on table 4.6(appendix II). They include: Tax incentives/rebates to investors, Implement an appropriate regulatory framework for corporate governance, Hold seminars to educate investors to enlighten the investors on interpretation of financial statements, Increase trading hours at the NSE, Relax on the listing rules and CMA take up their advocacy role fully to enlighten the public on investments.

### 4.4 COSTS THAT HINDER LISTING OF COMPANIES AT THE NSE

The respondents were asked to rank the costs, which they think are main hindrances to companies listing at the Nairobi Stock Exchange (NSE) in order of the most important first.

From the analysis of the data, costs which were found to be the main hindrance to companies listing at the NSE were ranked in order of preference as per the respondents as indicated in table 4.7, (Appendix). Registration fees, was the highest cost then followed by Brokerage fees, Listing fees paid to NSE, advertising, Printing, Application fees, valuation fees, Registrar's fees, Reporting accountant, then lastly the solicitors fees in that order and were a major hindrance to the development of the stock market. The stock brokers felt that these cost impede the development negatively as the low profits discouraged new entrants thus the market is not as vibrant as they felt it should be.

For individuals buying and selling shares on the stock exchange, the main cost is brokerage commissions. A latent cost is the interest forgone when payment is made to the broker while the investor waits, sometimes for a couple of weeks or more, before the stock is purchased. There is therefore no reason why these brokerage firms should not pay interest on clients' unused funds. It is expected that this practice would affect the development of the stock market, especially as clients become aware that brokerage houses invest such funds in short-term investments such as overnight money markets, treasury bills, etc.

After considering the factors and costs the services brokers offer to clients were also addressed. The findings were discussed below as follows;

On the average waiting period between orders to buy/sell by a client and Purchase/sell by stockbrokers was the study observed that 56% of the respondents said that the waiting period between order to buy and to sell was about 5 days from the day order is made. 17% reported that it took about 7 days before the transaction is complete. This is considered efficient enough though the introduction of a real time clearing and settlement system would reduce the same drastically thus promote development of the stock market.

On the Days taken by a broker to send a purchase or sale report to a client, it was observed that 67% of the respondents felt that when the client demanded the purchase or sales report the broker availed it as per the clients demand and when due. 17% reported that it took a broker 14 days from when the client asks for the report to get it ready and be sent to her. This was considered very long and slowing the development of the stock market. This was due to the large volumes of transactions handled by the brokers manually.

#### Days taken for the client to receive a report on purchase

**Table 4.8**

Days	Frequency	Percent
T+1	10	56
T+2	4	22
T+3	2	11
T+14	3	17
<b>TOTAL</b>	<b>18</b>	<b>100</b>

From the above analysis, 56% of the respondent's felt that it takes one day from the day the purchase is made. 17% felt that it takes 14 days for the client to receive the report of purchases made. The average duration for the securities buyer name to enter into the registrar's books through the manual transactions. This was considered standard by all the brokers thus not a factor impeding the development of the stock market in Kenya.

From the analysis, 90% of the respondents agreed that the body that oversees that quantity and price declared by a broker is correct was NSE and CMA. The other 10% felt that it was the CMA that was responsible for that and in all both bodies do regulate or oversee that investors interest are well taken care of.

### 5.0 CONCLUSIONS, LIMITATIONS AND SUGGESTIONS

#### 5.1 CONCLUSIONS

The findings indicate that quite a number of factors have affected the development of the Kenyan stock market. The government has put forward various direct and indirect policies since independence but they have achieved little success in developing the stock market. The most significant factors affecting the development of the Kenyan stock market as far as the local people are concerned are lack of national awareness, lack of knowledge about stock markets and low incomes of the bulk of the people. This translates into the low number of listed stocks, the low rate of listings, poor patronage in the market and other limitations. The need for a massive educational campaign cannot be over emphasized.

The greatest challenge to the NSE is to improve the level of knowledge of the local investors. A programme of continuous education for the investor, the intermediary, the issuer and the regulator is extremely important for the successful development of the Kenyan stock market. This education campaign should involve the development of financial journalists and improvements in the quality of financial market publications.

As markets become more sophisticated, there is increasing need for investment advisors and other personnel who are capable of analyzing complex financial concepts such as options and other derivatives. Radio and television should be used to reach more people explaining financial investments in securities in both English and local languages.

The macroeconomic environment seems very important for foreign investors. If more foreign investors are expected to play an active role on the Kenyan stock market, then serious attempts should be made to bring down the current inflation rate and the rapidly depreciating currency to sanity levels so that their capital base is not eroded.

The current tax laws favour the use of debt instruments compared with equity. If the number of firms on the stock market is to grow, then there is need to provide incentives for firms who may want to be listed on the Nairobi Stock Exchange. One such incentive is differential taxation in favour of listed companies. Such an incentive will help increase the number of listed companies on the exchange and improve liquidity of the market.

The practice whereby brokers do not pay interest on investors' unused funds is not only unfair but unethical for money accepting financial institutions. Since most of the brokerage firms are either merchant banks or non-bank financial institutions that actually invest such funds in short-term financial instruments, there is no reason why the owners of such funds should not benefit from the accrued interest of their own funds. If this practice is allowed to continue, the development of the NSE may be compromised.

There is need for the Kenyan government to follow prudent macroeconomic policies. The high interest and inflation rates, budget deficits, etc., that have become persistent not only create financial instability, but also feed uncertainty, which affects stock market development.

Because of the current trend of globalization of economies, the management of the NSE must aim at integrating the NSE into the international capital markets. If we are to succeed in this direction, the regulatory authorities must enforce the various regulations on securities.



If this is done, both local and foreign investors will feel much protected and freely commit more of their financial resources to the NSE.

The brief suspension of and the imposition of fines against three brokerage houses of the NSE for irregularities in late November 1995 is a sign that the regulatory authorities are enforcing the rules of the game. This is expected to raise investor confidence and integrate the market internationally.

The banking sector is vital to the development of the capital markets. A progressive and sound banking system is required to quicken the development of the financial market.

### 5.3 SUGGESTIONS FOR FURTHER RESEARCH

There is need for the government to improve the physical infrastructure, particularly the telecommunication infrastructure, which is the pivot around which business on the financial market revolves.

A study could also be conducted to determine the factors considered by individual investors and fund managers in investing in various investment instruments.

## 5.2 LIMITATIONS OF THE STUDY

The major limitation of the study was time and financial resources to undertake a rigorous analysis. Some corporate officers refused to participate in filling the questionnaires as they felt it was a waste of their valuable time. However there was no reason to believe that they would have responded differently.

The study did not establish the perceptions held by Non listed companies which qualify for listing at the stock market. It would also have been interesting to note the factors considered by investors and fund managers in investing in different investment instruments. This was however not within the scope of the study.

## 5.3 SUGGESTIONS FOR FURTHER RESEARCH

A similar study could be carried out to include de listed companies, listed companies and unlisted companies but which qualify for listing at the stock market to find out the perceptions held on the factors affecting the development of the stock market.

A study could also be conducted to determine the factors considered by individual investors and fund Managers in investing in various investment instruments.

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# APPENDIX 1: QUESTIONNAIRE TO BROKERS ON THE NAIROBI STOCK EXCHANGE

## PART A

### Please fill the Blank Space

Name of the Firm (Optional).....  
Date of Incorporation (Year).....  
Date Licensed to operate at NSE (Year).....

*Listed below are statements dealing with factors considered to be affecting the development of the capital market in Kenya. Please rate the factors by ticking the appropriate box.*

### KEY

- |                          |                        |
|--------------------------|------------------------|
| 1. Extremely Unimportant | 4. Very Important      |
| 2. Not Important         | 5. Extremely Important |
| 3. Important             |                        |

- |   |                     |
|---|---------------------|
| 1. Rules and regulations of the Capital Market Authority (CMA) concerning licensing and control of the Stock Market | [5] [4] [3] [2] [1] |
| 2. The Kenya Laws protecting investors' interests at the stock market   | [5] [4] [3] [2] [1] |
| 3. The accounting and auditing standards requirements   | [5] [4] [3] [2] [1] |
| 4. The ability to analyze and interpret the financial statements by investors                                       | [5] [4] [3] [2] [1] |

5. The low levels of public awareness of the stock market opportunities [5] [4] [3] [2] [1]
6. The existence of only one stock exchange in Kenya with no branches outside Nairobi. [5] [4] [3] [2] [1]
7. How do you describe trading on the Nairobi Stock Exchange?
  - A. Very transparent (every transaction is made known to the public) [5] [4] [3] [2] [1]
  - B. Some trading is conducted privately outside the NSE (e.g. over the counter market). [5] [4] [3] [2] [1]
8. Amount and content of information disclosed by Listed companies in the financial Statements [5] [4] [3] [2] [1]
9. Requirements for cross border listing for companies quoted at the NSE [5] [4] [3] [2] [1]
10. The NSE rules and requirements relating to listing of quoted companies [5] [4] [3] [2] [1]
11. The amount of hours allocated for trading at the NSE (10:00 to 12:00) [5] [4] [3] [2] [1]
12. Manual procedures for delivery and settlement of share transactions at the NSE [5] [4] [3] [2] [1]
13. Average duration of delivery and settlement purchases of shares between two brokerage firms [5] [4] [3] [2] [1]
14. The absence of a real-time central clearing and depository system (CDS) [5] [4] [3] [2] [1]

15. The NSE rules and requirements relating to delisting of quoted companies [5] [4] [3] [2] [1]
16. The restriction of foreigners holding in a quoted company to an aggregate of 49% of the authorized and issued share capital of a quoted company [5] [4] [3] [2] [1]
17. Tax incentives by the government [5] [4] [3] [2] [1]
18. Poor implementation of corporate governance Principles in the Capital Market [5] [4] [3] [2] [1]
19. High Unemployment rate in the country [5] [4] [3] [2] [1]
20. Which cost is the main hindrance to companies listing at the Nairobi Stock Exchange? Please rank them in order of importance most important first. Note that the list below may not necessarily exhaust the cost items.
- a. Listing fee payable to NSE [5] [4] [3] [2] [1]
- b. Application fee [5] [4] [3] [2] [1]
- c. Registration fee [5] [4] [3] [2] [1]
- d. Valuation fee [5] [4] [3] [2] [1]
- e. Advertising [5] [4] [3] [2] [1]
- f. Printing [5] [4] [3] [2] [1]



- Please use the space below to state and rank any other factors you feel are the most important in influencing the development of the industry. Use the KEY below to indicate the importance of each factor.
- g. Brokerage fees [5] [4] [3] [2] [1]
- h. Solicitors (to the issue, trustee, company) [5] [4] [3] [2] [1]
- i. Reporting accountant [5] [4] [3] [2] [1]
- j. Registrar's fee [5] [4] [3] [2] [1]
- k. any other please specify and rank

**PART B**

..... [5] [4] [3] [2] [1]

21. What is the average waiting period between order to buy/sell put by a client and purchase/sell by stockbroker?

Give number of days.....

22. How many days does it take a broker to send a purchase or sale report to a client?  
.....days.

23. How many days does it take a client to receive the report of purchase?  
.....days.

24. What is the average duration for the securities buyer's name to go into the registrar's books through the manual transaction?  
.....days.

25. Indicate period between date of offer to public and date of first trading on the NSE.  
After 1 month [ ] After 3 months [ ] After 6 months [ ] More than 9 months [ ]

26. Which body oversees that quantity and price declared by a broker is correct?  
.....



#### 4.1 Descriptive statistics summary

Table 4.1 Descriptive Statistics (mean score and rankings)

FACTORS	MEAN SCORE	STANDARD DEVIATION	RANK based on means
Rules and regulations	3.5556	.92178	7
Kenya laws protecting investors	3.4444	1.14903	10
Accounting and auditing standards	2.4444	.61570	16
Ability to analyze interpret Financial Statement	2.7778	.80845	14
Low levels of public awareness	4.2778	.66911	2
Existence of only 1 stock Exchange in Kenya	2.1667	.38348	19
Transparent trading at the exchange	4.1111	.58298	3
Trading conducted privately outside NSE	2.7222	1.07406	15
Amount and content disclosed by listed companies	3.1111	1.13183	12
Requirements for cross border listing	2.2222	.54832	18
NSE rules and requirements relating to listing of companies	3.7222	.95828	5

Amount of hours allocated for trading	2.8889	.90025	13
Manual procedures for delivery and settlement	3.5556	.51131	7
Average duration of delivery and settlement between 2 brokerage firms	2.3889	.77754	17
Absence of a real time central CDS	4.0556	.53930	4
NSE rule relating to delisting of quoted companies	3.2222	.80845	11
Restriction of foreign ownership to 49% of authorized issued share capital	3.5000	.78591	9
Tax incentives by the government	4.6111	.50163	1
Poor implementation of corporate governance principles by CMA	3.6667	.84017	6
High unemployment rate in the country	2.2222	.54832	18

Source: Research data

Extraction Method: Principal Component Analysis.

## 4.2 FACTOR ANALYSIS SUMMARY

Table 4.2 Communalities summary Table

FACTOR	Initial	Extraction
Rules and regulations	1.000	.784
Kenya laws protecting investors	1.000	.777
Accounting and auditing standards	1.000	.735
Ability to analyze and interpret FS	1.000	.856
Low levels of public awareness	1.000	.896
Existence of only 1 stock exchange in Kenya	1.000	.740
Transparent trading at the exchange	1.000	.631
Trading conducted privately outside NSE	1.000	.908
Amount and content disclosed by listed companies	1.000	.830
Requirements for cross border listing	1.000	.929
NSE rules and requirements relating to listing of companies	1.000	.923
Amount of hours allocated for trading	1.000	.946
Manual procedures for delivery and settlement	1.000	.981
Average duration of delivery and settlement between 2 brokerage firms	1.000	.967
Absence of a real time central CDS	1.000	.941
NSE rule relating to Delisting of quoted companies	1.000	.885
Restriction of foreign ownership to 49% of authorized issued share capital	1.000	.725
Tax incentives by the government	1.000	.833
Poor implementation of corporate governance principles by CMA	1.000	.722
High unemployment rate in the country	1.000	.971

**Extraction Method: Principal Component Analysis.**

### 4.3 Eigen Values summary & total variances

Table 4.3 Total Variance Explained

Com p	Initial Eigen values			Extraction Sums of Squared loadings		
	Total	% Of Variance	Cum %	Total	%Var	Cum %
1	5.795	28.974	28.974	5.795	28.974	28.974
2	3.738	18.688	47.662	3.738	18.688	47.662
3	3.325	16.626	64.288	3.325	16.626	64.288
4	2.775	13.873	78.161	2.775	13.873	78.161
5	1.350	6.749	84.910	1.350	6.749	84.910
6	.987	4.936	89.846			
7	.897	4.487	94.333			
8	.688	3.440	97.773			
9	.445	2.227	100.000			
10	7.206E-16	3.603E-15	100.000			
11	6.732E-16	3.366E-15	100.000			
12	2.767E-16	1.384E-15	100.000			
13	1.971E-16	9.857E-16	100.000			
14	1.073E-16	5.365E-16	100.000			
15	-6.039E-18	-3.020E-17	100.000			
16	-1.186E-16	-5.928E-16	100.000			
17	-2.412E-16	-1.206E-15	100.000			
18	-2.945E-16	-1.472E-15	100.000			
19	-4.732E-16	-2.366E-15	100.000			
20	-1.055E-15	-5.274E-15	100.000			

Extraction Method: Principal Component Analysis.

Extraction Method: Principal Component Analysis.

5 components extracted.

#### 4.4 Component Matrix summary and Factor loadings

**Table 4.4 Initial Factor Matrix Component matrix**

Components	FACT 1	FACT 2	FACT 3	FACT 4	FACT 5
Rules and regulations	.733	.422	-.256	.035	-.036
Kenya laws protecting investors	.676	.222	-.446	.206	-.170
Accounting and auditing standards	.687	-.428	-.259	-.109	-.024
Ability to analyze and interpret F/Statements	.633	.426	-.229	-.237	.406
low levels of public awareness	.220	.293	.431	.754	-.086
Existence of only 1 stock exchange in Kenya	.790	-.287	-.175	-.011	.059
Transparent trading at the exchange	-.488	.381	.489	-.089	.040
Trading conducted privately outside NSE	-.165	-.362	.843	-.194	-.029
Amount and content disclosed by listed companies	.422	-.628	.054	-.472	.176
Requirements for cross border listing	.860	-.360	-.058	.118	.208
NSE rules and requirements relating to listing of companies	.327	.489	.372	-.501	-.433
Amount of hours allocated for trading	.013	.700	.540	.267	.305
Manual procedures for delivery and settlement	.717	.253	.214	-.026	-.598
Average duration of delivery and settlement between 2 brokerage firms	.490	-.338	.431	.588	.285
Absence of a real time central CDS	.493	-.068	.751	-.358	-.030
NSE rule relating to delisting of quoted companies	.676	.530	-.073	-.341	.160
Restriction of foreign ownership to 49% of authorised issued share capital	-.172	.670	-.213	.215	.394
Tax incentives by the government	.159	.611	.185	-.607	.180
Poor implementation of corporate governance principles by CMA	.329	.294	-.054	.653	-.314
High unemployment rate in the country	.590	-.273	.675	.240	.187

**Extraction Method: Principal Component Analysis.**

**5 components extracted.**

**Table 4.5 Rotated Component Matrix**

	Component				
	FACT 1	FACT 2	FACT 3	FACT 4	FACT 5
Rules and regulations	.390	.631	-2.144E-02	.421	.235
Kenya laws protecting investors	.550	.397	-.136	.539	9.689E-02
Accounting and auditing standards	.838	9.534E-02	.118	-4.484E-02	8.979E-02
Ability to analyze and interpret FS	.281	.879	4.139E-02	8.932E-03	5.292E-02
Low levels of public awareness	-.235	-1.450E-02	.541	.740	2.031E-02
Existence of only 1 stock exchange in Kenya	.780	.239	.248	7.063E-02	8.947E-02
Transparent trading at the exchange	-.767	-1.793E-02	8.493E-02	-.116	.147
Trading conducted privately outside NSE	-.278	-.430	.588	-.432	.336
Amount and content disclosed by listed companies	.626	-2.058E-02	.264	-.591	.132
Requirements for cross border listing	.796	.247	.476	8.629E-02	-1.298E-02
NSE rules and requirements relating to listing of companies	-.146	.305	-2.937E-02	4.085E-03	.899
Amount of hours allocated for trading	-.664	.460	.445	.302	6.352E-02
Manual procedures for delivery and settlement	.316	.154	.138	.462	.791
Average duration of	.277	-7.128E-	.876	.280	-.195



delivery and settlement between 2 brokerage firms		.02			
Absence of a real time central CDS	6.502E-02	.122	.644	-.270	.659
NSE rule relating to delisting of quoted companies	.211	.838	2.698E-02	5.554E-02	.368
Restriction of foreign ownership to 49% of authorized issued share capital	-.443	.549	-.168	.265	-.360
Tax incentives by the government	-.296	.684	-6.498E-02	-.288	.437
Poor implementation of corporate governance principles by CMA	8.272E-02	2.984E-02	9.880E-02	.838	4.744E-02
High unemployment rate in the country	.228	9.289E-03	.938	6.577E-02	.186

Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser Normalization.

a Rotation converged in 23 iterations

**Table 4.6: Possible Remedies to Constraints**

Suggestions	Frequencies out of 18 respondents	% Of total respondents	Rank based on %
Public enlightenment campaigns on investments	13	72.2	3
Tax incentives/ rebates to investors	15	83.3	1
Relax on the listing rules	10	55.6	6
Give licenses to franchise this businesses	2	11.1	12
Reduce cost of licenses	4	22.2	9
Introduce a variety of Financial products	6	33.3	8
Hold seminars to educate investors on interpretation of financial statements	13	72.2	3
Increase trading hours at the NSE	11	61.11	5
CMA to carry out its advocacy roles	3	16.67	10
Implement an appropriate regulatory frame work for corporate governance	14	77.8	2
Implement electronic trading CDS	10	55.6	6
Empower banks to liaise with the investors	2	11.1	12
Introduce a Third tier market	3	16.67	10

Source: Research data