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Market liquidity and stock size premia in emerging financial markets: The implications for foreign investment

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ABSTRACT

Equity markets are increasingly seen as important sources of investment funds in many emerging economies. Furthermore, many countries see the development of such markets as a means to facilitate both foreign equity portfolio investment and foreign direct investment (FDI). This may occur through acquisition of shareholdings in domestic companies, which supplements the low levels of funding from domestic savings. But many emerging stock markets exhibit substantial risk premia that increases the cost of equity for listed domestic firms and deters potential foreign investors. This paper estimates the cost of equity in four major African markets: South Africa, Kenya, Egypt and Morocco. These represent the largest and most developed equity markets in Africa and also act as regional hub markets. London is also included as a link between the emerging and developed financial markets. The Fama and French [Fama, E., & French, K. (1993). Common risk factors in the returns on stocks and bonds. *Journal of Financial Economics*, *33*, 3–56] three-factor model capital asset pricing model is augmented to take account of company size and illiquidity factors that feature in African financial markets. The results show that the premia associated with size are more prevalent than with liquidity although both are highly significant in both valuation and cost of equity estimates. The evidence suggests that the lowest cost of equity is achieved in the two major international markets of London and Johannesburg, while the less-advanced North African markets of Morocco and Egypt have higher costs of equity. The developing Kenyan market has the highest cost of equity, although the costs associated with the main market are less than one-third of that in the Alternative Investment Market.

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1. Introduction

Equity markets are increasingly seen as important sources of investment funds in many emerging economies. Furthermore, many countries see the development of such markets as a means to facilitate both foreign equity portfolio investment and foreign direct investment (FDI). This may occur through acquisition of shareholdings in domestic companies, which supplements the low levels of funding from domestic savings. But many emerging stock markets exhibit substantial risk premia that increases the cost of equity for listed domestic firms and deters potential foreign investors.

This paper estimates the cost of equity in four major African markets that represent the largest and most developed equity markets in Africa and which act as regional hub markets. Johannesburg dominates the Southern African Development

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Community (SADC), Kenya is at the centre of the East African Union, and Egypt (the Cairo and Alexandria Stock Exchanges) leads the North Africa and Maghreb region. Morocco (the Bourse de Casablanca) is included as this is the only other major equity market in North Africa. Other markets have been omitted because of their very small size and severe illiquidity. All four markets have attracted interest from international investors and multinational enterprises. In particular, MNEs in the mining sector (for example, Anglo American, Anglo Gold, and Anglo Ashanti) and in the financial sector (such as Old Mutual, Standard Bank, Standard Chartered, Barclays, Société General, and BNP Paribas) participate in these economies. In many cases, these companies dominate the domestic markets and create a very uneven degree of liquidity. In addition, London is included as a representative of a developed market. This is especially appropriate as the London Stock Exchange and the African exchanges all fall within a ± 2 h time zone and London is the market on which many African firms are dual-listed.

The paper proceeds as follows. Section 2 describes the institutional characteristics of these markets, the source of the data and the construction of the illiquidity series. Section 3 provides a brief review of the literature on the capital asset pricing model (CAPM) and introduces the three-factor model of Fama and French (1993). Section 4 outlines the model to be estimated, which is based on the Fama and French (1993) model, but augmented with an illiquidity measure proposed by Amihud (2002). Section 5 discusses the construction of the data series, presents the descriptive statistics, and explains the estimation methodology. The results are in Section 6, including those for the grouped data and the individual markets. The final section concludes and offers some policy recommendations.

2. Institutional characteristics of the African markets

There are clear differences in the institutional design, market capitalisation and level of development of the four emerging markets considered in this paper. The major characteristics of these markets are summarised below, but see Piesse and Hearn (2005) for an extended discussion of African stock markets.

2.1. South Africa

The Johannesburg Stock Exchange (JSE) is the largest, most developed, and best regulated market in Africa. The JSE adopted the order-driven electronic trading platform used by the London Stock Exchange in 2002. Trading takes place daily and the market has a pre-opening electronic call auction 8:25 a.m. and 9:00 a.m. and continuous trading 9:00 a.m. to 4:00 p.m. Despite being classified as an emerging market there is considerable institutional investor participation and ownership is highly diversified, unlike any other market in Africa (Bloomberg, 2006). Settlement is through a central depository on a rolling contractual basis of trade date plus five working days (T + 5) and is largely G30 compliant (STRATE website, 2007).

The South African market has experienced two distinct periods of transition during the sample period. The first was 1990–1995 when the market was closed to foreign investors, largely due to sanctions by the rest of the world. Also at this time, domestic investors had to comply with the National Party's *prescribed assets regulation*, which emphasised investment in domestic equities rather than money or bond market instruments (Grandes & Pinaud, 2004). The second followed the ending of apartheid in 1995 and the subsequent real and financial market liberalisation that followed, including the opening up of markets to foreign institutional investment, the move to electronic trading and the introduction of formal legislation to ensure international levels of corporate governance.[1] Further revision of the Kingly report in early 2000 has led to increased investor confidence and market development although competitiveness has been hindered by volatility of the domestic currency and high risk premiums that have a negative impact on overseas investors (Grandes & Pinaud, 2004). This has also resulted in a loss of liquidity in the domestic market and the tendency for primary listings to take place on overseas exchanges such as London and New York in preference to the JSE.

2.2. Kenya

The Nairobi Stock Exchange (NSE) is the largest market in the East African Community (EAC) and is the only one open to foreign investors.[2] The policy to enhance competitiveness in the smaller financial markets relies on regional integration and the East African centre is Nairobi, which houses the central depository. Trading takes place daily by a central electronic book entry system, and is limited to the floor of the exchange between 10:00 a.m. and 12:00. The market is dominated by blockholders and smaller retail investors and free float percentages are low.[3] Order flow to the market is by a small network of licensed stock brokers and their regional affiliates. Investors are required to establish both a trading account with the broker and a separate individual account at the central depository. The dissemination of market sensitive announcements and real-time prices takes place through an investor relations officer inside the exchange and this is then passed to the financial press. Public releases of shares in the primary market and IPOs are managed through local investment banks, with the Capital Markets Authority responsible for regulation and supervision. There is no formal corporate governance regime, although larger companies try to follow best practice as set out in the Cadbury Report, particularly with respect to disclosure

[1] The King Report that regulates corporate governance practices in South Africa is very similar to the UK Cadbury Report and the US Sarbanes-Oxley Act.
[2] Countries in the East African Community are Kenya, Tanzania and Uganda.
[3] That is shares available to the public.

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