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PRELIMINARY REPORT

REPORT IN RESPONSE TO TASK ORDER NO. 49

CONCEPT PAPER

ON A VENTURE CAPITAL FUND FOR NIGERIA

AFRICA VENTURE CAPITAL PROJECT (AVCP)

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U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT - NIGERIA

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HC, under the AVCP, engaged Prince Lekan Fadina and Michel Courcelle in October, 1992 to prepare a concept paper on the Nigerian political and financial environment for the establishment of a venture capital fund. Prince Fadina is a principal in the Lagos based securities firm of Godinan & Partners. Michel Courcelle is a consultant to OECD, and the Club du Sahel in Paris. For additional information on the authors, please see Appendix A.

VENTURE CAPITAL FUND FOR NIGERIA

TABLE OF CONTENTS

Table of Contents 1

Introduction 2

Project Background 5

Federal Government of Nigeria
Involvement in the Project 6

Role of Nigeria in Africa 9

Significance of Study 11

Organization and Management 15

Market 17

Initial Funding Cost 20

Tax Implications 21

Project Implementation 27

Appendix 28

VENTURE CAPITAL FUND FOR NIGERIA

INTRODUCTION

The issue of Venture Capital Funds for Nigeria is currently being addressed by the Federal Government of Nigeria. The Ministry of Finance has been mandated to come out with a blue print on the project. It is toward the realization of this noble objective that Equity Securities Limited, an active capital market operator has taken the initiative to pursue the project to its logical conclusion.

Equity Securities Limited a finance and investment services company and a major operator in the Nigerian financial market has been holding discussions with various representatives of groups interested in starting a Venture Capital Fund (VCF) in Nigeria. These groups include U.S. Agency for International Development (AID), Harvey & Company, Incorporated, the IFC, financial regulatory authorities in Nigeria, the Organization of Economic Corporation and Development (OECD) financial institutions and potential private sector investors.

The VCF as a concept in Nigeria is to exist as a Finance Company under the existing laws - Companies and Allied Matters Decree of 1990, Banks and other Financial Institutions Decree (BOFI) 1991. The VCF fund shall operate as an Investment company.

The VCF shall aim at achieving the underlisted objections:

(1) To stimulate growth in the economy.

(2) To tap the abundance of resources that abound in the country.

(3) To harness the pool of professional local expertise and entrepreneurship capacity in creating new ventures.

(4) To improve the lot of citizens of the West African Sub region who rely mostly on Nigerian industrial output. The VCF will be a catalyst for growth in Nigeria and will definitely serve as an entry point for foreign investors seeking to reach a wider market given Nigeria's position in the African Continent.

The objective of this paper is to highlight the potential of a VCF in Nigeria. We have held preliminary discussions with some notable organizations both locally and internationally who have expressed agreement in principle to participate in the establishment of the VCF.

Nigeria is a Federal Republic comprised of 30 states with an Executive Presidency and operates a three-tier system of government, Federal, State and Local, with a two party system. The military has ruled the country for the substantial part of it's post Independence era. The present Military regime is likely to be the last Military government in Nigeria. The transition to civil rule will be completed with the hand over of power to a democratically elected president in August, 1993.

Within the existing frame work, the local governments are autonomous, each local government receives a statutory allocation from the Federal Reserve fund, thereby allowing for even development of the country.

In addition, the red tape associated with all disbursements coming from the Federal government has been drastically reduced. The country is endowed with untapped mineral resources like gold, bauxite, lime and other precious stones. Venture Capital with the fusion of both local and foreign expertise which the fund will generate, will greatly facilitate the development of these resources. The VCF will also stem the exodus of highly trained local professionals who are leaving the country due to a lack of funding and management expertise required to generate business and companies which could employ these individuals.

The experience of South East Asia highlighting the use of venture capital firms to fully utilize existing entrepreneurship, individual drive and initiative is a testimony to the use of such vehicles. Nigeria has resources which surpass those of South East Asia. An approach of capitalizing on the venture capital concept would serve as a catalyst for economic development.

PROJECT BACKGROUND

The decision to establish Venture Capital Funds for Nigeria is a welcome development. The Venture Capital (VC) concept has become accepted in many developing countries as a catalyst for stimulating economic activities. The example is South East Asia where the presence of such funds have stimulated the economic growth of countries on that continent.

The AID muted the idea of the African Venture Capital Project with a view to promoting an understanding of VC funding, as well as increasing the availability and use of VC in support of productive business development.

A consultancy firm Harvey & Company of Washington (USA) has been mandated to implement the project for AID.

FEDERAL GOVERNMENT OF NIGERIA'S INVOLVEMENT IN THE PROJECT

The monetary regulatory body in Nigeria - Central Bank of Nigeria (CBN) - has been working to convince the Federal Government of the numerous benefits of VCFs.

The local project promoters have tentatively convinced the Federal Government through CBN of the viability of the concept. The Apex Bank in Nigeria, the CBN organizes seminars and conducts public enlightenment campaigns through CBN's publications. The CBN has indicated its interest in participating at the VC Workshop in Abidjan Cote D'Ivoire, jointly organized by AID, African Development Bank and Harvey & Company.

The CBN is reviewing the possibility of accommodating the VC concept under existing companies enactments. The legal department of CBN has been mandated to come up with a legal blue print for the VC concept where the VCF cannot wholly fit into existing legislation.

The global economic recession of the 80's resulted in a World Bank/IMF structural adjustment programme (SAP), look-a-like, introduced in October 1986. The objectives of the programme are to put the Nigerian economy on course, stimulate growth and rearrange the country's priorities. As a by product of SAP, the Nigerian currency (Naira) was devalued. The value is now about N20.00 to one US dollar, a dramatic decrease from an exchange rate of N=0.85

to one U.S. dollar at the inception of SAP in 1986.

The government introduced the Dutch-Auction system for the sale of foreign exchange to industries, abolishing in its wake the issuance of import licenses for the procurement of raw materials and machinery. Expectedly, weak companies wound-up and the production capacities of companies dropped significantly as a result of many companies inability to obtain raw materials and spare parts.

However, in the last few years the gains of SAP have started to be seen. The Gross Domestic Product (GDP) grew by 4.4 percent in 1991 as against 8.3 percent in 1990. The rate of growth was lower primarily as a result of the poor performance of the manufacturing and tertiary sectors during the year. The government embarked on a move to divest its holdings in many companies. This is part of the governments efforts to allow for more free enterprise. The body set up for this purpose, the Technical Committee on Privatization and Commercialization (TCPC) recorded a huge success in reducing the dependence on the government treasury and improving operational performance of public enterprises. TCPC was able to generate N=800m ($40 million) from its operations at the end of 1991. The exercise still continues. TCPC had completed work on 78 out of 92 enterprises earmarked for partial or full privatization and also 30 out of the 35 enterprises slated for full or partial commercialization.

Available data shows that the manufacturing sector recorded a real growth rate of 6.1 percent in 1991 compared with 7.6 percent in 1990. The manufacturing sector was constrained by rising costs of production, particularly the high cost of imported raw materials, and spare parts, high interest rates, and sharp increases in the cost of energy. Aggregate bank credit to the economy rose from N=57.7 billion ($2.9 billion) at the end of December, 1990 to N=83.8 billion at the end of December 1991. The private sector accounted for N=45.3 billion of the aggregate credit. The government is still continuing with its program of financial liberalization, privatization and commercialization of its enterprises, and debt conversion. These programs continue to serve as catalysts for increased activities in the economy as a whole.

ROLE OF NIGERIA IN AFRICA

With a population of 88.5 million, Nigeria is perhaps the most economically viable country in Africa after South Africa. Up to the late 1970's Nigeria enjoyed an economic boom. The worldwide economic recessions of the 80's have affected the fortunes of the country. Nigeria now experiences high unemployment rates, low productivity, factory closures, and huge balance of payment deficits. Notwithstanding, Nigeria is a potential market for the developed nations.

The country is endowed with both human and material resources. The country has grown tremendously since independence in 1960. Social infrastructural facilities and the level of economic activity has increased significantly over the years. It is as a result of this belief in the potential of Nigeria that international finance organizations like IBRD, EIB, AfDB etc. have invested significantly in the country. The majority of Nigeria's neighboring countries depend on its industrial output.

The country has well over 200 universities and tertiary institutions turning out graduates and technicians. Many Nigerians move on to do graduate study abroad, usually in technical areas. Additionally, many more receive their degree/diplomas through correspondence and open studies departments of the country's major universities. More than 60 percent of the work force within the banking industries have professional qualifications like ACA, CPA,

ICAN, university degrees, professional diplomas (e.g., Ordinary National Diplomas), 49 percent hold the General Certificate of Education qualifications. Equally in abundance in the country are professionals in other fields, e.g., Engineering, Medicine, Law, Management, and etc.

SIGNIFICANCE OF STUDY

The essence of this paper is to establish the viability of a locally based and managed fund which will be attractive to local investors and introduce venture funding and management techniques to Nigeria.

The proposed VCF is to be run by an associated management company in conjunction with AID and CDC.

PROJECT DESCRIPTION

Nigerian Venture Capital Fund (NVCF) will be set up with a minimum of US$3m and a maximum of US$20m investible funds. Local institutional investors and high net worth individuals shall be encouraged to subscribe to the VCF.

The underwriting of the initial start up of the VCF shall be assisted by AID. It is assumed that the offer for subscription to local investors must be kept open for a long period since the VC concept is a new concept for this market.

The VCF will provide long and medium term capital with preference for equity and quasi equity type of investments. The VCF may, however, offer loans where needed. There will be an Operational Guidelines and a Policy Manual to guide the operator.

The bulk of the funds will be sourced from major insurance

companies, pension funds and selected private high net worth individuals.

The VCF, relatively small and being a pilot scheme, shall be wound up after a period of seven years and the proceeds distributed.

SALE OF INVESTEE COMPANIES INVESTMENTS

The VCFs income will arise mainly from the realization of capital gains on disposal of shares in investee companies. Most typically, shares will be sold at a stage when prospects of future profitability have been clearly established and are visible to potential purchasers. This will call for the exercise of judgement to ensure that profits are realized at the optimum time.

In cases where an investment does not meet its original growth expectations, and where prospects of achieving those objectives are not good, careful consideration should be given to the timely liquidation of NVCF's investment.

It is recognized that a small proportion of NVCF's investee companies may fail, but the majority should yield good returns and a minority should yield very high returns.

When disposal of an investment is under consideration, the full range of market mechanisms for valuing and promoting such transactions should be explored. In appropriate cases, NVCF's may

enter into subscription agreements that would give purchase options to promoters, founder shareholders or management. In such cases, a basis for share valuation should preferably be included in the subscription agreement.

NVCF, in conjunction with U.S. AID and the authorities concerned, should assist the development of secondary and informal securities markets. This will serve to develop wider share ownership and facilitate trading and disposal for the benefit of NVCF and other investors.

Where NVCF's shares in investee companies are intended for sale to the general public, NVCF's own shareholders should be allowed an opportunity to negotiate an allocation of such shares prior to the public offering.

The shares of the investee companies at the terminal year shall be deposed of as follows and proceeds distributed as agreed in the Memorandum and Articles of Association of the Fund:

- Shares disposed of on the 1st and 2nd tier market of the Nigerian Stock Exchange (NSE);
- Merger and acquisition with other companies;
- Outright sale to private individuals or government; and,
- Buy out arrangement with the Managers of the Investee Companies.

The financial performance of the VCF and the quality of its management shall form the basis of the review of the scheme at the expiration of the initial trial period. Management of the initial fund shall be vested in Venture Fund Management Company (VFMC) which will be set up with a shareholding which reflects the subscription made to NVCF. During its tenure as the initial VCF manager, VFMC shall endeavor to train local professionals so as to enable them to assume full management of VCF after the pilot scheme.

In order to expedite negotiations between the two parties, there will be a need for VFMC nominees to be resident in Nigeria during the preparatory period. Thereafter the board members will ensure control of the VCF.

ORGANIZATION & MANAGEMENT

Within the legal framework prevailing in Nigeria, the NVCF shall be set up as a limited liability company rather than a VCF administered by trustees. The board of the company shall be made up of tested professional businessmen. However, the management and the day to day running of the company for the first term of the VCF shall be vested in the VFMC, the composition of whose board will reflect its shareholdings.

The Company shall have a maximum of six directors. Any shareholder or group of shareholders holding between them 20 percent or more of the issued capital would have the right to appoint a director.

The board so constituted shall be vested with the power of formulating policy guidelines and would have the exclusive right of appointing the initial managers during the preparatory period.

The management composition of VFMC would at inception consist of one expatriate manager with experience in venture funding operations and two qualified and experienced Nigeria professional staff. VFMC will put in place a comprehensive training programme.

The VCF will be under the control of the board of directors (shareholders) comprising expatriates and Nigerians. The board of directors will appoint the Managing Director who will at first instance be an expatriate.

Two managers (Nigerian) will report to the Managing Director. One manager will be in charge of Finance and Administration while the other manager would be in charge of Project Implementation, Monitoring, and Training. These managers would be assisted by necessary supporting staff.

To obtain the expatriate quota for the VC will not pose any problem under current legislation.

MARKET

With the introduction of the SAP by the Nigerian Government in October 1986, the economy is being constantly reviewed with necessary regulatory guidelines being modified when necessary.

SAP has achieved the following amongst others:

- (1) Growth in transportation, capital markets, banks (including Merchant Banks), finance houses, agriculture, etc;
- (2) Backward integration, especially in raw material sourcing;
- (3) Cost control and profit maximization;
- (4) Non-oil export drive;
- (5) Devaluation of the Naira has greatly reduced capital outflow thereby encouraging capital inflow for investment;
- (6) Construction of new roads and better maintenance of existing ones; and,
- (7) SAP has also increased the tempo of privatization and commercialization.

Venture Capital can be a ready financial tool in purchasing some of the viable privatized companies which are becoming available as a result of the privatization exercise. The government is also divesting itself of ownership of most banks, the last of which are the privatization of the banks for which it has majority shareholding.

The mop up exercises being embarked upon to firm up the value of the Nigerian Naira have drastically reduced companies access to working capital.

The non banking financial sector could not find ways to finance small investors whose businesses are considered riskier coupled with crippling increased interest rates. The VCF will be a great relief for companies in this category.

Donor Nations (to be identified) can also provide lines of credit after careful appraisal, screening and close monitoring of potential companies by the VCFM.

- Nigeria boast of a fully developed capital market. The activities of its stock exchange is unparalleled on the African continent. The NSE was established in 1960 with branches in major cities of the country each with its own trading floor. The NSE will cater for the support needs of the VCF. The stock market can be used as one of the avenues for exiting the VCF.

- There exist in abundance investment opportunities which the VCF shall exploit. IBRD, EIB, ADB, and other foreign finance organizations have firm footings in the country.

- It is envisaged that VFMC will work closely with the local agencies like the Nigerian Industrial Development Bank Limited (NIDB), Nigerian Bank for Commerce and Industry (NBCI), National Insurance Corporation of Nigeria (NICON), and other Development Finance Institutions (DFIs) to assist in the identification of projects.

INITIAL FUNDING COST BY VFMC

The total cost of establishing VFMC for the initial three-year period are as follows.

	N'm	US$'000s
SET UP COSTS		
FIXED ASSETS		
Motor Vehicles	2.0	100
Office Furniture	0.8	40
Office Equipment	1.7	85
Preparatory Expenses	2.5	125
Operating costs for the first three years	32.0	1,600
	39.0	1,950

To be financed by:	N'm	US$'000s
Contribution from AID for setup	2.0	100
Annual Contribution ($5000,000 per year for three years)	30.0	1,500
Self generated fund	7.0	350
	39.0	1,950

TAX IMPLICATIONS FOR NVCF

The concept of company law is foreign to the customary and indigenous system of law in Nigeria. Nigerian Company law has devolved from the received English law which has been incorporated into the Nigerian legal system.

The Companies and Allied Matters Decree (CAMD), Decree No. 1, 1990 was promulgated to take into account the criticisms levelled at the 1968 Companies Act. It has made some fundamental changes to Nigerian Company law which shall be considered in detail later.

This is the current piece of legislation governing the operation of companies in Nigeria. It was to have come into effect on the 1st of January 1990 but this date of commencement was later amended to read 1st January 1991.

The Corporate Affairs Commission

The CAMD by Section 1 established a body known as the Corporate Affairs Commission (CAC). The function of the CAC is to, inter alia, regulate and supervise the formation, incorporation, registration, management and winding up of companies registry and offices in all the states of the Federation.

Thus the CAC was to take over the functions of the Companies Registry under the 1968 Companies Act. However, in addition to those functions the CAC is empowered to arrange or conduct

investigations into the affairs of the company. It has the right to sue for infractions of the CAMD and administer the sanctions given by the CAMD.

THE NIGERIAN ENTERPRISES PROMOTION ACT (NEPA) 1990

The NEPA 1990 contains a schedule which lists 40 types of business activity reserved primarily for Nigerians. A foreigner can only engage in a scheduled business (and even own 100 percent of the equity in such an enterprise) where he is prepared to invest at least N20 Million.

FOREIGN INVESTMENT APPROVALS, etc.

Before a non-Nigerian can hold any interest or equity in a Nigerian company, he or it (in the case of a foreign company) must secure foreign investment approvals discussed below .

THE INDUSTRIAL DEVELOPMENT COORDINATION COMMITTEE (IDCC)

The IDCC, a department of the Federal Ministry of Industries, is the sole agency authorized to give necessary preliminary approvals in respect of foreign investment in Nigeria. The IDCC was established pursuant to the Industrial Development Coordinator Decree, Laws of the Federation of Nigeria, 1990.

JOINT-VENTURE

In the cast of a joint-venture, the company should be incorporated from the outset (normally) using the proposed local partners as

initial subscribers/directors.

Preliminary Approvals

The IDCC grants the investor the following approvals:

i) Business permit (to enable the foreign investor to hold shares in the local company);

ii) Approved Status (to enable the investor to import his equity contribution and more importantly, to guarantee his right to remit dividends, royalties, technical fees, etc., gleaned from his investment);

iii) Expatriate Quota (each expatriate quota position enables the recipient company to employ one expatriate worker locally); and,

iv) Other Approvals A wide range of other approvals are sometimes necessary e.g., approvals on royalties and technical fees; pioneer status (i.e., tax holiday in certain special instances).

DISINVESTMENT

Foreigners holding shares in Nigeria companies are free to sell or transfer such shares to either Nigerians or other foreigners.

ROLE OF REGULATORY AUTHORITIES IN DIVESTMENT PROCEDURE

The main regulatory authorities relevant to the disinvestment process are the Securities and Exchange Commission, the Nigerian Stock Exchange, and the Ministry of Finance.

Their respective interests/roles are as follows:

i) Securities and Exchange Commission (SEC)

The SEC as stated above, must approve of the terms of the transfer, particularly the transfer price of affected shares.

ii) The Nigerian Stock Exchange (NSE)

Where the affected company is quoted on the Exchange, the NSE Council must be notified of the transaction. The NSE is interested in knowing whether the transfer will either result in a change in the business of the affected Company or will affect the status of the company as a quoted company.

iii) The Federal Ministry of Fiance & Economic Development (FMF)

The FMF must be approached to transfer status on the affected shares from the transfer to the transferee in the case of sale to another foreigner.

The profit from the VCF will be distributed to investors through dividends on which there is a 5 percent (formerly 15 percent) withholding tax. This is part of the Nigerian government's resolve to encourage both local and foreign investors.

Capital Allowance

The current rates applicable in respect of Capital Allowances are:

Qualifying Expenditure in respect of:	Initial Allowance %	Annual Allowance %
(a) Building Expenditure	5	10
(b) Industrial Building Expenditure	15	10
(c) Mining Expenditure	20	10
(d) Plant Expenditure (excluding furniture and fittings)	20	10
(e) Furniture and Fittings	15	10
(f) Motor Vehicle Expenditure	25	20
(g) Plantation Equipment Expenditure	20	33 1/2
(h) Housing Estate Expenditure	20	10
(i) Ranching and Plantation Expenditure	25	15
(j) Research and Development Expenditure	25	12 1/2

The amount of capital allowances to be enjoyed in any year of assessment is restricted to 75 percent of assessable profits in case of manufacturing and 66 and two third percent in cast of others, except that companies in the agro-allied industry are not affected by this restriction.

Tax Free Dividend

An individual or company deriving dividends from any company as from 1987 shall enjoy tax free dividends for a period of three

years if:

(a) the company paying the dividends is incorporated in Nigeria;

(b) the equity participation is imported into the country between 1st January 1987 and 31st December 1992; and,

(c) the recipient's equity in the company constitutes, at least 10 percent of the share capital of the company.

In addition to (a), (b), and (c) above, if the company paying the dividends is engaged in agricultural production within Nigeria or processing of such, or the production of petro-chemicals or liquefied natural gas, the tax free period shall be five years. There is an in principle understanding that the concession above will be extended after the expiration date.

Double Taxation (Income Tax Act 1979)

By Decree No. 4 1985 (Miscellaneous Taxation Provisions) the Income Tax Act of 1979 was amended. The effect of the amendment was to eliminate double taxation on investment income.

PROJECT IMPLEMENTATION

AID shall seek approval from its respective principals to make available necessary resources to establish the project.

APPENDIX

Notes to the Projections

It is assumed that U.S. AID would contribute the amount needed over an initial three year period so as to achieve the underlisted objectives:

- Build up the capital base which in turn will attract more local investment and also allow for wider investment;
- Beef up with staff complements necessary for a rapid build-up of its operations; and,
- To assist in the development of its investee companies by providing management services assistance.

FIXED ASSETS

Motor Vehicles - five cars will be needed to be allocated as follows:

- Expatriate General Manager	1
- Local Managers - One each	2
- Pool - for general use	2
	5

This will be capitalized along with other set up costs and depreciated over 5 years.

STAFF COST

The Expatriate General Manager sallary includes accommodation, medical expenses, traveling expenses etc. The amount is consolidated, i.e., will remain the same at least for the initial three year period.

The local staff salaries will increase by 10 percent yearly in line with inflationary trends in the country.

APPENDIX

NVCF'S OPERATING COSTS

		N'000 YEAR 1	YEAR 2	YEAR 3
Office Rental		200	200	200
Electricity, rated etc		500	500	550
Postage and Telephone		150	150	165
General Office Expenses		600	600	660
Audit fee		600	600	660
Vehicle running expenses		200	200	220
Insurance		100	100	110
Staff Cost:				
Expatriate General Mgr.	3,000			
Local Managers (2)	1,850			
Supporting Staff (5)	1,000			
		5,850	5,850	6,435
Training Cost		300	300	330
Miscellaneous Expenses		1,500	1,500	1,650
Consultancy fees		300	300	330
		10,300	10,300	11,310
Amortisation of set up cost		543	543	543
Total Operating Cost		10,843	10,843	11,853