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FINAL

VENTURE CAPITAL

FEASIBILITY ASSESSMENT

UGANDA

AFRICA VENTURE CAPITAL PROJECT (AVCP)

CONTRACT NO. APR-0438-Z-00-0006-00
TASK ORDER No. 67

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT - UGANDA

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INTRODUCTION

This report was conducted under the auspices of the United States Agency For International Development which is strengthening private sector activity in developing countries to stimulate and accelerate economic development and stability. Specifically, the Agency's African Bureau (Operations and new initiatives)has served as the facilitator of the African Venture Capital Project which is used to assist in the development of private sector investment. Under this project (task order No. 67) Harvey & Company conducted this project on behalf of the USAID Mission located in Kampala, Uganda. The evaluation of Development Finance Company of Uganda (DFCU) and the appropriateness of granting it funds which are to be used for the purpose of making equity investments into local Ugandan enterprises was a central and critical part of the consultancy. This report presents the overall conclusions as to this issue as well as an assessment of the overall soundness of DFCU. In addition, this report also presents several recommendations as to how the transaction could be performed and the identification of any conditions that should to be satisfied by DFCU prior to the transaction's execution.

All of the components of the statement of work were completed under this consultancy and included the following:

- An institutional analysis of the Development Finance Company of Uganda(DFCU) was conducted over a nine day period to assess its soundness, viability and qualifications for becoming a grantee organization and manager of the venture capital company to be funded under the USAID'S Rehabilitation of Productive Enterprises (RPE) Program. An analysis was also performed to determine the most appropriate form of the transaction. A five(5) page assessment was performed and is embodied in this report.

- USAID/ Uganda was advised during the consultancy on the suitability of the legal structure presently under consideration. In addition, the mission was advised on the best approach for securitizing the grant through a security instrument would provide maximum protection to fund proceeds, future growth and provisional entitlement in the event that the fund's existence or goals are jeopardized.

- USAID/ Uganda was also advised on the necessary criteria that should be included the grant agreement and how this criteria could be incorporated into the Articles of Association and the shareholder's agreement.

- In addition to the aforementioned, this consultancy also included a review of the draft grant agreement as well as preparation of written comments to USAID Counsel's preliminary review of the grant document.

- This consultancy identified and makes recommendations regarding conditions that must be satisfied by DFCU prior to it becoming a grantee organization. USAID/ Uganda has agreed to a have the consultant conduct a follow-up visitation to determine the degree of adequacy and compliance by DFCU in meeting those conditions. A calendar outlining the events to take place prior to signing the grant agreement are part of this report.

- In certain instances, this consultancy identified other pertinent issues and assessed these critical issues since they were determined to be applicable to the appropriate execution of the arrangement between USAID/Uganda and DFCU.

- Lastly, USAID/Uganda has asked for recommendations regarding the operating guidelines of the venture capital fund. This report includes such recommendations which are based on the experience of Harvey & Company and the existing operating structure of DFCU.

BACKGROUND AND ENVIRONMENT

Recent studies and surveys of the Ugandan financial sector reveal that credit schemes attempted by donor agencies have been unsuccessful. Prohibitive management costs, high interest rates funding instability and a high loan default rate have attributed greatly to the problem of undercapitalization. As of recent, interest rates in Uganda for example were as high as 25% with a maximum maturity of 120 days. Even more concerning is the lack or scarcity of venture capital financing. It is purported that there is no source of institutional equity capital in Uganda.

For this reason, USAID has determined that funding a venture capital fund will stimulate economic development and growth in the private sector. This form of financing will offer the type of flexibility needed for businesses which would otherwise suffer due to the lack of security, performance (start-ups) or cash flow for debt coverage.

USAID/Uganda, in seeking a solution to the circumstances, is considering issuing a grant to the Development Finance Company of Uganda which is to used to make equity investments in suitable enterprise.

LOCAL DEMAND FOR VENTURE CAPITAL

A survey was conducted of several institutions in order to assess Uganda's need and demand for venture capital. Discussions were held with the Ugandan Investment Authority, Nile Bank, Ltd., Sembule Investment Bank, Ltd., World Bank officials, Ministry of Trade and Industry and private business persons. Further, discussions were held regarding possible projects, industry growth and present financing mechanisms. It was determined that a venture capital pool of US$25 million could easily be invested in the Ugandan community over a 18-240 month period. This assessment is based upon an average transaction size of US$ 250,000- $500,000. DFCU presently invests in transactions having an average loan and/or venture capital investment value of US$1,000,000.

EVALUATION OF THE DEVELOPMENT FINANCE COMPANY OF UGANDA

A detailed evaluation of the Development Finance Corporation of Uganda (DFCU) was conducted as of 9/20/92. This review encompassed an evaluation of the institution's key functional areas for the purpose of determining its suitability as a grantee of funds for the United States Agency For International Development (USAID). The areas evaluated included management, financials, operations, investment management, audit, future prospects and other significant activities. Other specific areas of interest that were evaluated included loan loss reserve policy and trends, institutional liquidity, capital adequacy, earnings, and assets.

Evaluation of the Development Finance Corporation of Uganda(DFCU) reveals that it has a very experienced and proactive board of directors, a sound internal management team, sufficient capital and a suitable loan and equity investment track-record that evidences the performance of sound investment judgement. However, review of the company's financial statements for the period ending June 30, 1993 reveals that the company is having difficulty in achieving its operating income and pre-tax profit objectives. As of June 30, 1993, the company operating income was running a deficit of approximately US$(5,000.00) per month. Despite its less than marginal earnings performance over the last six months, the financial commitment of the shareholders and the company's plan for reorganizing its present operations are sufficient reasons to conclude that DFCU's overall condition is sound and that it would be a suitable grantee to USAID's private sector funding program.

Evaluation of the Supervision by the Board of Directors indicates that all major matters are approved and reviewed by this body. Review of the board minutes also indicates that all policies and procedures and subsequent amendments are done under the supervision of the board of directors. Two internal operating committees, the portfolio committee and the new business committee, conduct oversight and review efforts that are also supervised by the board of directors. The full board is also responsible for assuring that suitable audits are conducted as its relates to the company's financials and sound internal control and operating standards.

The senior management team of DFCU is headed by General Manager Martin Geake who is on contract from one of the company's shareholders, Commonwealth Development Corporation. His experience and background provides sufficient assurance that DFCU and its staff will function in accordance with USAID's provisions for managing the grant proceeds.

In addition, the managerial staff of DFCU possesses the requisite knowledge and skills necessary to smoothly transition into competently selecting and managing venture capital investments. The current venture capital effort of DFCU is also sufficiently supported by a team of technical consultants that provide specialized assistance in appraising the merits of venture capital transactions. With the expansion of the firm's operations into other core business areas and the implementation of this proposed venture capital fund effort, it is evident that senior management will need to reorganize its portfolio management team through training and reengineering of its investment identification and account management process in a manner that permits each staff member to be involved in the transaction from beginning to end. The net effect of this reorganization will result in higher efficiencies in investment transaction approval and monitoring.

The major shareholders of DFCU are financially sound and well capitalized and include Commonwealth Development Corporation, International Finance Corporation, the Ugandan Development Corporation and the German Finance Company For Investments in Developing Countries. Each owns an equal share in DFCU and constitute a major source of future private equity capital and credit that is available when needed. For this reason, the financial condition of the company is considered to be sound. The company was sufficiently capitalized upon its organization as a limited company in 1964 in the amount of US$1,000,000.00, most of which was depleted by working capital needs during periods of economic and political unrest.

A recent share subscription agreement dated 12/16/92 increased the equity capital position of the company to US$1.8 million. Another US$ 2,500,000.00 is in the process of being infused by the German Finance Company For Investments in Developing Countries (DEG) in the form of US$ 600,000.00 in cash and US$ 1,900,000.00 in income notes @ o% interest. The income notes have a interest rate of zero because they are considered to be a hybrid form of equity capital. Upon the close of this transaction the total equity capital position of DFCU will be approximately US$4,400,000.00. This consultancy has determined that the successful completion of this transaction is a critical component of the USAID/Uganda grant approval because it will further enhance the financial solvency of the company.

As of the June 30, 1993, approximately US$ 6 million was outstanding from a total combined credit lines of US$14,000,000.00. Each governing agreement for the lines of credit were reviewed to determine if the USAID grant would have any impact over the conditions of the lines or vice versa. No problems or concerns were evident from this viewpoint. To date, DFCU has abided by the payment terms and covenants of each of these agreements.

DFCU made a profit during each year between 1987 and 1992. In the last six months, however, profitability has been significantly hampered by bad debt charge-offs and insufficient portfolio growth. Because of the disruption of the company's business cycle during the years of turmoil and the historical default rate of the firm's clientele, DFCU's board modified its standards for making provisions for loan losses. Significant dollar provisions were made during 89-92 and are projected for 1993. It is evident that the charge-offs were higher during this period due to management's decision to make provision for all non-performing loans made during the years of political and economic instability. As a result, net operating losses, ending June 30,1993, were averaging US$5,000.00 per month. Management indicated that loan/venture capital portfolio growth, income from alternate product lines and continued economic stability will substantially reduce future provisions for losses and eliminate operating deficits. Until then, shareholder capital and related interest income is quite adequate to maintain operations.

Interest income from loans between 1987 to present constitute 50-70% of the firm's total net income from operations. Management of DFCU has initiated a strategic objective of developing revenues from sources other than interest income. To achieve this strategic objective, the firm has acquired a minority interest in two companies. It is anticipated that these investments will, in fact, diversify the firm's income stream. The firm has done well at managing its asset/liability spread. Although significant income was realized from foreign exchange gains, it is recommended that USAID/Uganda require DFCU to remedy the present tax dispute with the government in relation to these gains which were that result of positive movements in the value of the schilling vis a vis the U.S. dollar.
The firm's working capital position requires improvement which would enhance the firm's suitability as a grantee. The evaluation of the firm's working capital position revealed that the firm's financial obligations over the next year exceed current income earnings. This inability to break-even has been caused primarily by provision for loan defaults. Liquidity from equity capital investment was determined to be adequate. Management anticipates that interest income from a recent subscription shareholder account will sufficiently increase the firm's working capital position. The firm's ratio of debt to equity is considered adequate, however management is advised to continue monitoring the percentage of debt used to fund daily operations.

Venture capital and lending operations were reviewed to determine the adequacy of the firm's operating policies, procedures and internal controls. No major exceptions were noted and the firm is considered sound from this viewpoint. The major operational areas are documented by policy and procedure and internal control standards to assure that proper checks and balances are maintained through the separation of duties and reconciliations. All third party services were reviewed for the propriety of such arrangements. No deficiencies were noted.

It has been recommended that modifications be made to the present software system to accommodate the anticipated increase in equity funding transactions which will require maintenance of additional information not presently resident on the firm's lending system.

Analysis of the firm's venture capital investment management track record revealed that it has not had significant volumes of equity investing activity, but has demonstrated the ability and wherewithal to conduct such. There are four equity investments that were made prior to 1989 totaling US$50,000.00. These include Uganda Consolidated Properties, Uganda Grain Millers, Uganda Associated Industries, Hire Purchase Finance, and Housing Finance Company of Uganda. Significant unbooked appreciation and dividend returns of better than 30% per annum were observed in the shareholdings of Housing Finance and Uganda Grain Millers. The other investments from this period yielded returns that were marginal to poor. Recent equity investments include Uvan Ltd., Nile Roses Ltd. and Crown Titles. Each was reviewed to determine the adequacy of the analysis, review, and approval process. The firm is considered quite capable of making suitable venture capital investments as it transitions, through additional training and staff realignment, into a venture/merchant banking operation.

Overall, the firm's ability to make successful equity investment decisions rests with the experience of the board of directors, the general manager and the present manager of new business all of whom have participated in or actively conducted equity investments in the past. Most of the firm's existing equity portfolio was in place prior to the arrival of the existing management team and performance of these investments was interrupted during the periods of political turmoil, therefore it is difficult to assess management's success or failure in selecting good investments. The major indicators of future performance rests solely with present shareholder return and the yield on the firm's lending portfolio. DFCU's track record in this arena is considered good given the difficulty that the lending community has in collecting on loans in Uganda to date. The firm's dividend record is good.

Investment management policies at present are formulated by the board of directors and the firm's general manager. For the most part, the investment policy is strongly influenced by the covenants and lending restrictions established by each line of credit agreement.
It is recommended that the board and senior management of DFCU and the venture capital company establish an investment policy, strategy and approach that assures the long-term growth and preservation of the venture capital fund.

In practice, DFCU invests in various types of companies and in various industries. DFCU anticipates that the grant funds will be invested in several types of businesses as opposed to being limited to agribusiness loans. Although some start-up companies will be invested in, many investments of the VCC will be in seasoned companies having a sound track-record. Major emphasis will be placed on identifying companies that have been unable to achieve the next level of growth due to a lack of equity capital. Co-finance relationships will also be considered. The maximum investment stake that the VCC will take in an investment is 49% and the maximum dollar investment is US$ one million. With the lack of suitable exiting opportunities at this time, management believes that the investment term per transaction will be 7-10 years. The investment return goal for the VCC would be 25% - 30% annualized growth. DFCU is expected to take a management fee on the management of the venture capital fund in the range of 3% of the fund's fair market value.

The firm's general auditor is the international accounting firm of Price Waterhouse. The scope of the audit encompasses a review of the firm's financial records as well as the management and internal control review. The most recent audit resulted in an unqualified opinion in favor of the firm's financial records and accounting processes. The management and internal control review, on the other hand, disclosed several internal control and operating deficiencies which have since been corrected by senior management. In any event, it is recommended that USAID require DFCU in implement an internal audit process that will provide more frequent and broader hands-on monitoring of compliance to board policies, operating procedures/controls, regulations and sound fiduciary principles governing the conduct of venture capital and lending investment companies. It should be further recommended that this function be performed by some individual that is independent of daily operations and would report directly to the board of directors. Most importantly, this party would also be responsible for monitoring compliance to the terms of the USAID grant agreement. An alternative and more economic measure would be to have the scope of the external audit expanded as well as management reporting system.

The Board of directors of DFCU has established a strategic goal of increasing and diversifying the firm's revenue base. In striving to attain this goal, DFCU has recently acquired an equity stake in two associated companies. One company is a property company having the sole purpose of performing real estate development on one plot of land which will also house DFCU. Secondly, DFCU has also become an equity partner in a leasing company. The future for DFCU appears to be quite promising provided it is successful in expanding its loan and equity portfolio and adequately maintaining control over expenses as well as bad debt provisions. The firm is projecting pre-tax revenues in 1993 of US$126,000.00, US$165,000.00 in 1994, and US$439,000.00 in 1995 and US$439,000.00. These projections, however, do not include the incremental costs associated with the establishment of the venture capital company. It is recommended that USAID obtain a start-up budget as well as an operating budget for the first three years of the venture fund.

During the evaluation period, senior management discussed the need to offer technical assistance and support services to burgeoning entrepreneurs and enterprises that lack the required sophistication and capability. Based upon the merits of this assessment, DFCU management will be requesting that USAID/Uganda consider making provision to have a certain percentage of the grant proceeds used to fund an in-house technical assistance and support services program or perhaps funding this type of program under a separate contract. In addition, DFCU management would like to be reimbursed for some portion of the costs associated with launching the venture capital fund. This consultancy agrees with the merits of these requests, however recommends that such an effort be thoroughly structured prior to implementation.

Overall, DFCU is determined to be sound financially and its operating condition makes it a suitable grantee for USAID funds employed for the purpose of promoting and rehabilitating private enterprises. This assessment, however, is conditioned upon DFCU satisfying the financial and operating recommendations noted in the report.

RECOMMENDATIONS WHERE CORRECTIVE ACTION IS REQUIRED

Staffing

DFCU has recently made two investments for its own account. One investment constitutes a minority interest in a property development company and the other a minority interest in a leasing company. These expanded activities may create additional strain on management and its supervision of existing activities. In addition, DFCU has a present staff of portfolio managers and lenders that operate on a decentralized basis. As a result, no one individual participates in an investment or loan transaction from beginning to end.

Management was advised that its expansion activities and its present organization structure could interfere with the achievement of the proposed fund's objectives which will initially require dedicated management supervision. Management concurred with this finding and has agreed to revise its present portfolio management organization to accommodate the need to have a focused effort towards investing the grant proceeds into viable venture capital projects. In addition, the company has hired an attorney who will assume all legal document review function presently being performed by the portfolio managers. This effort is anticipated to provide managers with the additional time needed to focus on the financial aspects of the transaction as well as the additional volume.

Operating Systems Enhancements
A review was made of company's present data processing system and software capabilities. The present system was developed from the Lotus 1-2-3 software and is aimed primarily at the servicing of the company's present loan portfolio. In order to accommodate the recordkeeping that is necessary for greater equity investing activities, it was recommended that the company make the necessary software upgrades to its present system and thereby make it more suitable for equity investing.

Management agreed and had begun to conduct the software upgrades needing for venture capital investing.

Establishment of an Internal Audit
The latest internal control review conducted, as of 12/31/92, by the external accounting firm of Price Waterhouse identified numerous internal control deficiencies. As of this evaluation, it appears that management has corrected these deficiencies through the adoption of stringent procedures and policies. In any event, this consultancy recommended that the company implement an internal audit function as a result of the increasing volume of business and investing activities anticipated in the near future. A major responsibility of the internal audit function would be to ensure that the newly created venture capital company and the grant proceeds are being managed in accordance with the directions of the board and sound operating standards are being adhered to by management. DFCU's audit should also be expanded to assure compliance with policies and operating guidelines.

Management agreed that there is a need for an internal audit function but also expressed its concern that implementing this function is cost-prohibitive at this time. In view of this, it is recommended that the company have its external audit expanded by Price Waterhouse. Evidence of the expanded audit should be verified by an engagement letter.

Resolution of Working Capital Deficiency
During the evaluation it was noted that the company is presently operating at a monthly deficit of US$5,000.00. While this situation is partially attributable to the large loan loss provision taken in June, it is an unsound condition that should be resolved. Further examination of this situation revealed that resolution was imminent provided management continued to increase its earnings by expanding the loan portfolio with performing loans and interest income from future investments.

Senior management agreed to have the problem resolved and felt that interest income from a capital infusion from its shareholder,DEG, would be substantial enough to place the company in positive net operating earnings position. Consequently, management was advised that completion of the capital infusion by DEG may be a condition precedent to execution of the grant agreement with USAID.

Resolution of Unresolved Tax Issues
The most recent audit review by Price Waterhouse, dated 12/31/92, disclosed that the Uganda Revenue Authority has levied two major tax assessments against the company related to years 1991 and 1992. If the company had to pay the amounts due from these assessments in one payment, the company's capital base would be severely impacted and its liquidity would be dissolved.

The audit report discloses that the 1991 assessment is Shs 454,827,000 (US$ 387,100.00) and 1992 assessment is Shs 450,000,000 (US$383,000.00) and are the result of unrealized exchange gains. Although the Authority has given some consideration to a deferred payment plan for these amounts, there is no documented evidence that a deferred payment arrangement has been finalized. Management indicated that resolution was forthcoming and that written documentation to this effect would be obtained from the authority. In any event, USAID is advised to verify that DFCU has resolved this matter in a manner that provides assurance that the grant proceeds are effected by this pending liability.

RECOMMENDATIONS FOR CONDITIONS PRECEDENT PROVISIONS FOR THE GRANT AGREEMENT

The evaluation of the company identified several concerns where or corrective action is needed by the company. It is recommended that USAID/Uganda require DFCU to perform the following tasks prior to either the execution of the grant agreement or issuance of grant proceeds.

Recommendation #1

Taxation

It is recommended that USAID/Uganda require DFCU to obtain evidence from the Ugandan Taxing authority that all tax assessment matters outstanding from the recent Price Waterhouse audit are resolved and documented in the manner suggested in this report. (refer to previous section " Recommendations where corrective action is required")

In addition, it is recommended that USAID require DFCU to obtain acknowledgement from the local taxing authority that the grant proceeds, which are to be infused into the venture capital project through a stock issuance, will not be subject to taxation.

Recommendation #2

Corporate Authority

The Banking Act of 1969 establishes the legal requirements for banking companies operating in Uganda. DFCU is exempt under the "Act" because it does not receive deposits from customers. It appears, however, that the company was given a special charter/right by

the Minister of Finance to operate as a commercial banking enterprise. It is recommended that
DFCU be required to obtain a similar letter from the Minister of Finance acknowledges the establishment and legality of the venture capital company and the related fund.

Recommendation #3

Enhancement of Investment Accounting System

It is recommended that USAID/ Uganda require DFCU to complete any system enhancements or implement a new system that allows for the appropriate recordkeeping and reports for investment transactions. Failure to do such will give the company a limited capability of measuring the fund's investment return.

Recommendation #4

Investment Policy Formulation

It is recommended that DFCU develop an investment policy and strategy for the venture capital fund that assures long-term growth and preservation. The policy should address,but no be limited to, the following areas: a)investment diversification, b)maximum investment per transaction, c) percentage stake per transaction, d) desired return, e) retention of earnings from fund interest, dividends, recapitalizations, divestitures and retention, and f) reinvestment of proceeds from any forms of reflows.

Recommendation #5

Detailed Staffing Plan

Management indicated that a staffing revision was in process as a result of its awareness to the need for improved efficiency in identifying, appraising and approving transactions and well as improving the continuity of the staff.

It is recommended that USAID/ Uganda obtain and review the revised staffing plan developed by DFCU prior to execution of the grant agreement.

Recommendation #6

Working Capital

It is recommended that USAID/ Uganda assure that DFCU has taken the necessary steps conductive to sound fiscal management by assuring that current assets are 1.25 times current liabilities.

This condition should be achieved by the company prior to execution of the grant agreement.

Recommendation #7

Venture Capital Company Budget

Prior to execution of the grant agreement, an operating budget for the venture capital operation should be developed by DFCU for review by USAID/Uganda.

Recommendation #8

Technical Assistance/Support Program

The scope of this evaluation did not include an assessment of training and technical support needs. Management of DFCU, however, indicated that potential clients needed such support which would provide them such expertise as business plan preparation, strategic planning, accounting and marketing assistance. To provide these services on an ancillary basis to venture capital deals, DFCU management has requested that some portion of the grant proceeds be used to fund this effort.

This consultancy agrees with management's view and therefore recommends that some portion of the grant proceeds be used for technical assistance and support services. Further, DFCU management was advised to develop a written plan describing the training and support methodologies to used as well as a proposed budget for review by USAID/Uganda.

Recommendation #9

Completion of Financing

DFCU has received a equity commitment from DEG in the form of an income note and cash equal to US$2,500,000.00. As of the evaluation, this transaction was not completed. If this transaction is not completed, the current equity capital position of the company will be US$ 1.9 million.

Because the completion of this transaction will provide DFCU with assurance of future solvency, it is recommended that USAID/Uganda not execute the grant agreement with DFCU until this transaction is completed.

RECOMMENDED GRANT AGREEMENT TERMS AND RESTRICTIONS

The following represents the recommendations of this consultancy regarding those terms and restrictions that USAID/Uganda should require to be part of the grant agreement. It is recommended that these terms and conditions be incorporated by reference or provisionally addressed in the articles of Association and the shareholders agreement for the venture capital company. These terms and restrictions are primarily meant to assure: 1) the preservation and growth of the fund, 2) sound investment management 3) or alert USAID/Uganda to any concerns relative to the DFCU's financial condition or difficulties encountered in the management and operation of the venture capital fund. The grant agreement should specify that in the event that DFCU is unable to comply with any of these terms and restrictions, USAID/Uganda should be notified.

1) The grant agreement should require DFCU to maintain a working capital ratio of 1.25 times. In the event that DFCU does not comply with this covenant then it shall notify USAID/Uganda within 48 hours from the time the circumstance is identified.

2) The grant agreement should require DFCU to comply with the following annual reporting requirements:

    a) forward audited reports of DFCU and the venture capital fund/company to USAID/Uganda within ninety(90)days after the end of the calendar year.

    b) make written certification by audit that venture capital fund is being operated in accordance with the terms of the grant agreement/articles/shareholder agreement regarding the appropriation and investment of funds.

3) The grant agreement should require the establishment of a separate account that is not commingled with the general assets of the corporation. Grant fund proceeds, awaiting permanent investment or distribution, shall be invested temporarily in secure US$ accounts yielding an appropriate rate of return as determined by the fund's investment strategy.

    Nothing herein shall imply that all interest earnings are required to be reinvested in the segregated account. No foreign exchange trading other than to convert currency for investment in investee enterprises.

4) To alleviate the potential for conflict of interest, equity investments made to existing borrowers on the records of DFCU or its associated companies shall be made only where the investee company has complied with the established terms of the DFCU loan. Under no condition shall equity investments be used to accelerate or retire early outstanding debt to DFCU.

    Where appropriate, DFCU shall match the equity investment by DFCU on new investee companies on a 50%-50% basis, provided that it is commercially sensible. In the event that the potential investee is not a candidate for debt then DFCU is allowed to make an equity investment. Nothing in this provision shall preclude DFCU from lending an amount that is lesser or greater than the amount of the equity investment.

5) It is recommended that the grant agreement specify that neither grant proceeds nor reflows from said proceeds can be pledged, mortgaged or used in any manner so as to create any kind of lien or encumbrance.

6) In the event that either of the following situations arise, it is recommended that DFCU be required to make emergency notifications to USAID/Uganda.

Specifically, such emergency notification should be made by DFCU where:

a) DFCU gives notification to investors or other bodies regarding the firm's non-compliance or violation of governing instrument terms;

b) DFCU, the venture capital company or its shareholders reused in connection with its operation or management of the venture fund;

c) Where DFCU is unable to comply with any of the terms of the grant agreement, articles of association or the shareholders agreement

7) The grant agreement should specify that the occurrence of any of the following shall be cause for termination of the grant:

a) violations of the investment restrictions
b) misappropriation of funds
c) filing and/or bankruptcy by DFCU or VFCU
d) any activities constituting improper conduct as a fiduciary.

RECOMMENDED LEGAL AND BUSINESS STRUCTURE

Venture Capital Company Formation

The formation of a venture capital company (VCC)by DFCU will require the incorporation of a limited liability company that is a subsidiary to DFCU. Under the Companies Act of Uganda, the VCC must be formed and owned through the issuance of ordinary shares.

Capitalization

It is anticipated that all USAID/Uganda grant proceeds issued to DFCU will be used capitalize the VCC. This will involve the execution of a transaction whereby the VCC issues preference (preferred) shares that are acquired by DFCU. DFCU will acquire all of the VCC preferred shares with the grant proceeds. VCC will maintain all grant funds in a separate interest-bearing account in US dollar denomination.

Management

The Board of Directors for DFCU will also serve as the Board of Directors for the venture capital company. At present, CDC, DEG, and UDC each have two individuals on the board and IFC has one. This body will exercise manage the activities of the VCC through written investment policies and operating guidelines. Although senior management has not discussed the feasibility of having advisory directors, it is recommended that this be considered and that high-ranking or successful Ugandan business persons be considered.

Organization and Staffing

At present, DFCU has four divisions which are the new business, administration, technical, and portfolio divisions. Each of these divisions is represented on the company's internal management committee which is headed by the firm's general manager, Martin Geake. Other members of this committee include a technical advisor and a senior executive who manages the finances of the company. It is anticipated that this committee will also oversee the daily management of the VCC. While the VCC will be a separate company, there will be significant economies of scale through the use of an existing organizational structure which will operate the VCC as another funding alternative for executing transactions. Senior management is expected to conduct in-house training and execute a staffing realignment that creates greater efficiency in the work process. Management does not anticipate having a dedicated staff for the venture fund but rather will access the fund in the same manner that it accesses the lending and equity lines of credit from its shareholders. Under this arrangement each portfolio manager will make recommendations as to how a transaction is to be funded, i.e. equity, debt or both and the suggested ratio.

VCC Investment Strategy

The present investment strategy of DFCU requires that it invest in various types of companies and in various industries. While the RPE grant proceeds were originally for agribusiness loans, DFCU expects these funds to be invested in several other types of businesses as well. Although some start-up companies will be invested in, many investments of the VCC will be in seasoned companies having a sound track-record. Major emphasis will be placed on identifying companies that have been unable to achieve the next level of growth due to a lack of equity capital. Co-finance relationships will also be considered. The maximum investment stake that the VCC will take in an investment is 49% and the maximum dollar investment is US$ one million. With the lack of suitable exiting opportunities at this time, management believes that the investment term per transaction will be 7-10 years. The investment return goal for the VCC would be 25% - 30% annualized growth.

Fund Marketing and Promotion

The presentation of the VCC to the local Ugandan business community will be an essential component of the fund's success. Management intends to give seminars, presentation of the fund and support the efforts of other entities have a related interest to the fund's objectives, i.e. Ugandan Investment Authority. The present stream of potential clientele will also serve as an excellent marketing scheme.

Exit Strategy

DFCU management is convinced that most of the VCC investments will require 7-10 maturity term. This is partially due to the economic climate at this time and the lack of suitable exit vehicles, i.e., stock exchange, employee ownership schemes. However, management believes that as the portfolio achieves its return objectives an environment for a public offering for the fund might serve as an effective exiting tool. Based upon interviews conducted during the consultancy, it was determined that there is keen interest on the part of other local institutions investing in a successful equity capital venture.

Management Fees

VCC management should be permitted to take fees from the VCC fund through several or all of the following options: 1) Dividend income, 2) interest income, and 3) sales disposition proceeds. In realizing that there are serious exiting restraints at this time, it is conceivable that a significant portion of the fees taken by VCC will be from earnings from interest and dividends. Given that the proceeds are, in fact, a grant and not an investment fund for the benefit of USAID/Uganda, the traditional venture capital compensation strategies are not applicable. For the basis for applying some portion of the reflows to administrative expenses or retained earnings. It is recommended that USAID/Uganda give the DFCU Board of Directors the necessary flexibility and discretion to structure the fee remuneration guidelines and monitor such policies annually to assure compliance with the terms of the governing instruments, i.e. grant and shareholders agreement.

Technical Assistance and Support

DFCU, as the parent company to the VCC, intends to provide technical and support assistance to entrepreneurs. These services, however, will only be provided to those companies that have viable projects yet lack the capability of completing a business plan or conducting the research and analysis that is critical to the investment evaluation process. This will only be done upon the approbation by USAID/Uganda. This consultancy has confirmed that there is a need for such services which would result in higher efficiency in investment review, appraisal and approval process. Therefore, it is recommended that the VCC be permitted per a pre-authorized formula to employ some of the grant/investment proceeds for Technical Assistance purposes. In addition, it is recommended the DFCU be reimbursed for some portion of the expenses associated with meeting the requirement for the grant.

Recommended Security Instrument

Based upon review of Ugandan Law, it was determined and it is recommended to USAID/Uganda that grant proceeds invested by DFCU be invested in exchange for preference shares in the VCC. This consultancy determined that this form of share ownership would provide greater and clearer protection to the mission of USAID/Uganda and the overall strategic objectives of the venture capital fund. DFCU management has argued that ordinary shares could provide the same degree of protection to grant fund proceeds. This consultancy concurs with this view provided that the present shareholder agreements are amended to accommodate the conditions of the grant agreement.

FOLLOW-UP CALENDAR

October 1-15	DFCU initiates actions re: conditions precedents; Report by consultant submitted to USAID.
October 22	USAID submits report to USAID Counsel for final drafting of grant agreements and security instrument.
October 23-27	Doug Leavens visits USAID/Uganda Mission.
November 5	DFCU to acknowledge where it is with respect to completing those steps under the conditions precedents.
November 12-22	Follow-up review commenced by Harvey & Company.
December 9	DFCU Board meets to review draft grant agreement.
December 17	Grant agreement between DFCU and USAID to be signed.

Memo

TO: Holly Wise, USAID

FROM: Robert Kelley, Harvey&Co.

DATE: October 12, 1993

SUBJECT: venture capital-follow-up

Hello.

I am still recuperating from the travel, but I am making pretty good progress on the report. I am definately going to need up until the 15th of October.

In any event, I wanted to get you a copy of the calendar for closing the deal. This will also be in the report. The question I have is, Is there anything on your side of the effort that might make these dates unrealistic? **<u>I will not provide this to DFCU until I get your OK.</u>**

Hope to hear from you soon.

October 1-15	DFCU initiates actions re: conditions precedents: Report by consultant submitted to USAID.
October 22	USAID submitts report to USAID Counsel for final drafting of grant agreements and security instrument
November 5	DFCU to acknowledge where it is with respect to completing those steps under the conditions precedents
November 12-20	follow-up review commenced by Harvey & Company;
December 9	DFCU Board meets to review draft grant agreement
December 17	grant agreement between DFCU and USAID to be signed

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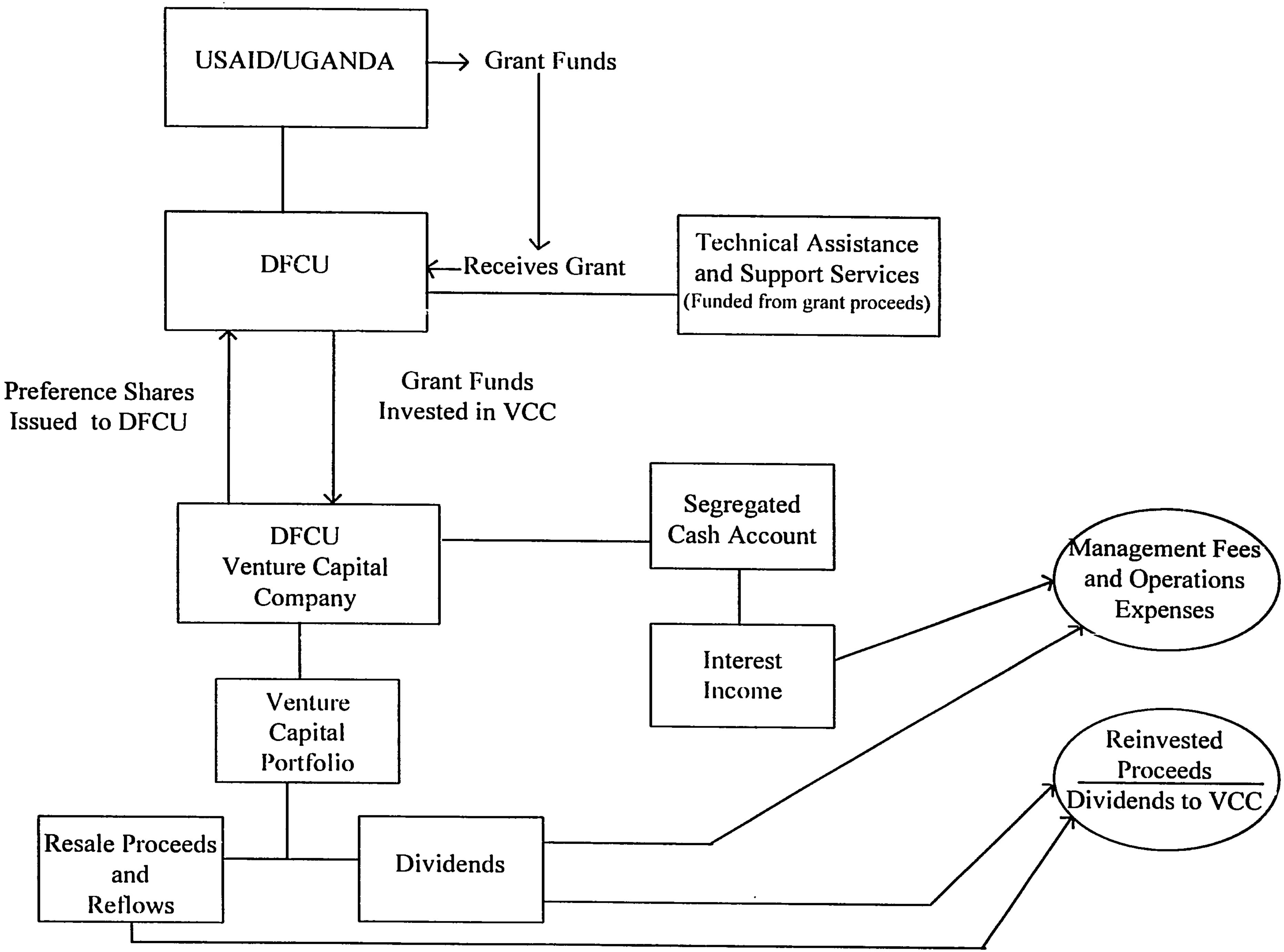
USAID/UGANDA
Grant Funds
DFCU
Receives Grant
Technical Assistance and Support Services (Funded from grant proceeds)
Preference Shares Issued to DFCU
Grant Funds Invested in VCC
DFCU Venture Capital Company
Segregated Cash Account
Management Fees and Operations Expenses
Interest Income
Venture Capital Portfolio
Reinvested Proceeds
Dividends to VCC
Resale Proceeds and Reflows
Dividends

DEVELOPMENT FINANCE COMPANY OF UGANDA LIMITED
Accounts for the six months ended 30th June 1993

BALANCE SHEET

ASSETS		Actual - 6/30/93 US$ '000
Fixed Assets at NBV		514.10
Investments	-Equity	246.10
	-Property Co.	357.50
	-Loans	2,418.80
Bad Debt Provision		573.60
Current Assets		
Debtors	-Principal	1,662.80
	-Interest	408.80
	-Sundry	146.40
Bank		978.80
Current Liabilities		
	-Creditors	(20.40)
	-Taxation	11.40
	-Dividends	12.00
	-Accrued Interest	60.80
	-Short term loan	53.80
Net Current Assets		3,079.30
Total Assets		6,042.20
CAPITAL EMPLOYED		
Share Capital		1,859.80
Reserves		545.90
Capital Reserves		301.00
Deferred Tax		319.70
Special Funds		133.60
Income Note		41.00
CDC loan		866.10
EIB/UDC loan		1,826.20
EIB 11 loan		0.00
KFW loan		149.00
Total Capital Employed		6,042.20

DEVELOPMENT FINANCE COMPANY OF UGANDA LIMITED
Accounts for the six months ended 30th June 1993

PROFIT & LOSS ACCOUNT

REVENUE		Actual - 6/30/93 US$ '000
Income from Investments		
	Dividends	13.90
	Loan Interest	156.80
		170.80
Less: provisions		(26.60)
Net Income		197.40
Bank Deposit Interest		35.90
Lease Rentals		0.00
Commission		26.40
Management Fees		19.50
Directors' Fees		1.40
Other		4.50
Income net of provisions		285.10
Less:	Long term interest	72.10
	Bank interest	0.00
Total Interest		72.10
Income from Operations		213.00
EXPENDITURE		
Audit & Legal Fees		0.60
Board Expenses		7.10
General Expenses		57.80
Premises	-Office	30.80
	-Residential	19.00
Staff		106.70
Travel		21.10
		243.10
Depreciation		21.30
Total Expenditure		264.40
Proift (loss) before:		(51.50)
Realized exch gains		6.40
Unrealized exch gains		(69.50)
Profit Before Tax		(114.50)
Tax Charge		0.00
Profit After Tax		(114.50)
Proposed Dividends		0.00
Retained Earnings		(114.50)

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