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AID/PRE - Financial Sector
Development Project

USAID/EGYPT - EQUITY FINANCE FACILITY

Phase I

DRAFT FINAL REPORT

June 30, 1989

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006
Telephone 202 296 0800

Price Waterhouse

June 30, 1989

Mr. Gregory F. Huger, Associate Director
Mr. Daniel R. Rathbun, Deputy Director, OF&I
USAID/Egypt
Cairo, Egypt

Dear Messrs. Huger and Rathbun:

Re: AID/PRE - Financial Sector Development Project (FSDP)
Contract No. PDC-2206-Z-00-8191-00
USAID/Egypt - Equity Finance Facility (EFF)
PIO/T No. 2630102-3-40239
Phase I - Draft Final Report

Attached please find the Draft Final Report for Phase I of the Equity Finance Facility engagement. This report puts forward a concept for an EFF in Egypt which we believe to be feasible and desirable in the current Egyptian context. This Draft Final version contains a number of clarifications in response to USAID's written comments on the Preliminary Draft Report, as well as inputs from PW's and Shearson Lehman Hutton's quality control review.

We have enjoyed the opportunity to assist you in carrying out this important assignment. We will await any further comments on this Draft Final Report, which we will be happy to integrate into the Final Report.

On behalf of Leigh Miller, Farid Saad and Bill Bardel of Shearson Lehman Hutton/American Express, Sandra Frydman of AID/PRE, and Mark Camstra of Price Waterhouse, I would like to thank you for this opportunity to be of service to USAID on this interesting and important engagement, which could be of great benefit for Egypt.

Sincerely,

Mark Camstra
for RB.

J. Richard Breen
FSDP Director

attachment

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I. INTRODUCTION

The Egyptian economy requires additional private investment to expand the industrial/commercial economic base, rectify inroads of inflation, and concentrate Egyptian capital on the domestic front. The GOE's current Five-Year Plan sets an ambitious target for increased private investment, but progress has been slow even though there is considerable liquidity in the financial system. Furthermore, chaotic conditions among a major group of investment companies have undermined a major source of potential private investment in Egypt.

USAID has requested that a program be designed to:

- Encourage domestic equity investment
- Establish institutions which channel private funds into productive Egyptian projects
- Maximize leverage of USAID resources with local funds.

To further the design of this program, USAID/Cairo, working through AID/PRE under the Financial Sector Development Project (FSDP), established a two-phase statement of work. Price Waterhouse, Prime Contractor under FSDP, sent a specialist team to Cairo to carry out Phase I of the engagement, composed of:

Leigh Miller, Team Leader, Shearson Lehman Hutton/American Express

Mark Camstra, FSDP Deputy Director, Price Waterhouse/Washington

Farid Saad, Shearson Lehman Hutton/American Express

The team also was supported by Afifi Shahawi and James Pearson of the Price Waterhouse-Cairo office.

The team assembled in Cairo on May 12/13, 1989, for two weeks and undertook Phase I, which consisted of a field survey effort (extensive interviews, data collection) with report of findings, consultations with USAID, and preparation of this concept paper with recommendations.

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II. FIELD SURVEY RESULTS

A. Introduction

The field survey portion of Phase I included discussions with Government officials, business leaders, investment and commercial bankers, among others, to solicit their views and recommendations with respect to the need for, and feasibility of, an equity financing facility in Egypt. The Project Team met with over 30 individuals from a number of institutions. (Appendix A contains a listing of specific individuals interviewed.)

A number of issues were discussed and views recorded during the interviews, including:

- Availability of privately held Egyptian capital for equity investments
- Demand for equity financing
- Opportunities for equity financing
- Type(s) of equity financing facilities needed by the Egyptian private sector
- The role of USAID in helping to mobilize private equity capital for equity investment
- How a USAID-assisted facility could leverage investment funds mobilization
- The estimated level of demand for such a facility
- The kinds of companies which would use the EFF (i.e., which industry sectors, size of companies, etc.)
- How an EFF might be set up and operated
- Role of existing institutions in domestic capital markets
- Constraints upon mobilization of savings for private investment
- Role of secondary markets in increasing private investment.

In addition, Price Waterhouse-Cairo, working closely with the Project Team, carried out a data search to support the information gathered during the interviews, particulary as it pertained to the need for equity financing in Egypt (see Appendix B).

B. Field Survey Findings

The field survey findings are:

1. The GOE's past policy, legal, and regulatory orientation has not been consistent with market-based financial resource allocation.

In general, survey participants felt that there has been an overwhelming Government presence in all economic activity in Egypt for quite some time, particularly in manufacturing and service delivery, which has had a highly adverse effect on private investment in this country. Government regulation and subsidization of industry and financial institutions has greatly distorted the efficient allocation of scarce resources, including capital. This has resulted in major impediments to productive activities, because of competition from Government-subsidized companies. It is felt that Government involvement in the economy has inhibited rapid growth, resulting in a limitation on investment opportunities in a wide spectrum of industry and commerce.

With respect to financial intermediation, the tax laws have created a strong disincentive to private investment in equity and, in view of the inflationary environment in Egypt, created a strong incentive to invest in foreign currencies (or other inflation hedges), thus skewing significantly the private investment of funds.

It was duly noted, however, that the GOE has over the recent past made significant progress in developing the infrastructure necessary to support the growth of the private sector (e.g., communications, roads, etc.), and that the current thrust of Government policy-making seems to reflect a somewhat more market-oriented approach. Nevertheless, the GOE clearly needs to continue current efforts to liberalize its policies and procedures, particularly as they pertain to the manufacturing and financial sectors.

2. <u>There is a substantial need and demand for private equity financing in the Egyptian private sector</u>.

The clear consensus among all survey respondents was that many investment opportunities in Egypt were not being realized. Some respondents indicated that there were an extremely large number of opportunities, particularly in the fields of tourism, agricultural processing, service industries, and small-scale industry. Others thought that there were a great many opportunities, but that Government constraints and the investment climate (particularly as a result of the recent so-called "Islamic" investment company problem) somewhat limited those opportunities. All thought that there were "ailing" businesses which, with a restructuring and recapitalization, could be turned around and become viable investments.

All respondents thought that there was no clear, professional process for identifying potential investment opportunities. At present, identification of potential projects is a "hit or miss" process based primarily on personal contacts, and often involving a series of middlemen interested only in a potential fee.

The need for additional equity financing was particularly noted by banks because overleveraging was becoming increasingly evident. The banks see inflation eroding the equity base of many of their clients (even if fixed assets are revalued), and noted that additional sources of equity finance would assist not only their borrowers, but would enable them to make additional, sound loans.

It was generally felt that many businesses were constrained from profitable expansions because they did not have access to long-term funding. Most respondents agreed that in today's high interest rate environment, long-term loans are prohibitively expensive for private companies and that equity investment was the only practical way to supply the long-term funding needs of private businesses.

Participants in the survey also generally indicated that the availability of US dollars for equity investment was desirable, so long as the foreign exchange exposure of the company was limited. This availability is needed because private companies often had foreign exchange requirements for new or expanded projects which could only be met at extremely high cost.

(See also Appendix B concerning need and demand for equity financing in Egypt.)

3. <u>There is ample liquidity in the Egyptian financial sector to support increased mobilization of private equity investment</u>.

All respondents agreed that there are plenty of funds available in the Egyptian financial system to support greatly increased levels of equity investment. For example, one survey participant noted that current liquidity, as measured by money and quasi-money aggregates, is greater than GDP. Others noted that the large amounts of private investment captured by the so-called Islamic investment companies was indicative of the large supply of investable funds available for investment in Egypt. Many noted that the banking system had more than enough deposits to meet their Egyptian pound banking needs, although some joint venture banks are somewhat constrained because of past deposit gathering policies.

Lack of funds was simply not seen as an issue. The real problem, it was noted, is the lack of mechanisms and appropriate incentives to channel these funds into profitable equity investments.

Some respondents believed that there were sufficient levels of foreign currency available to support any foreign currency requirements of increased equity investment. However, US dollars have become increasingly expensive and difficult to obtain in the unoffical markets in large amounts and, as such, many respondents suggested that USAID should include a foreign currency component in any future equity finance facility. (See generally Appendix B.)

4. <u>The current tax structure creates a major disincentive to investing in equity-based financial instruments, making it less attractive than alternative investment options</u>.

There are three basic investment alternatives available to an Egyptian investor: (a) depositing money in a bank in Egyptian pounds or foreign currency, (b) purchasing real estate, or (c) investing in equity. By depositing their money in a bank account, Egyptians get interest income at the fixed deposit rate. This income is perceived as being risk-free and incurs no income tax liability, although it does suffer from the effects of inflation.

By holding a foreign currency bank account, Egyptians benefit additionally by the pound's depreciation against these currencies, and are thereby additionally protected from the effects of Egyptian inflation. The general estimate appeared to be that dollar deposits gave a pre-tax, EL-equivalent yield ranging from 20-40 percent per annum. There was also a general consensus that real estate investment was not a favored investment form in Egypt because it did not appear to be an adequate hedge against inflation, it was expensive since it could not be financed, and the market was not terribly active should one wish to exit.

By investing in the equity of a company, Egyptians usually obtain dividend income (at least after start up) and, to the extent that they can sell their stock, a capital gain. While capital gains are not taxed, dividend income to the individual is generally subject to General Revenue Tax. (There may be some exceptions.) Equity investments also involve a larger element of risk, compounded by the lack of secondary markets to exit an investment. Hence, irrespective of the specific tax treatment of dividend income, equity investments are relatively unattractive in terms of the after-tax return an Egyptian can obtain, particularly in view of the higher risk and the absence of secondary markets. It is not surprising that, based on comments made by bankers, after-tax equity returns rarely outperform, and are normally perceived as being significantly below, established lending rates.

Most respondents believed that the tax treatment of dividends is therefore a key issue that must be addressed in designing an EFF. They indicated that the EFF design should provide clarification that dividends from the investment are tax exempt, and/or provide a package of incentives (including tax incentives) large enough to overcome the relative unattractiveness of equity investments, thereby encouraging investors to participate in the facility.

5. <u>The Egyptian financial sector currently lacks an institutionalized project identification, packaging and placement capacity to generate or support significant levels of equity financing</u>.

A clear consensus emerged that there is a need for an institutionalized project identification, packaging and placement capability in the Egyptian financial marketplace, and that having such a capability would help expand private equity investment in Egypt in a significant manner. While there are currently some Egyptian financial institutions which carry out the identification and packaging activity, they do it primarily for their own accounts. It is important to establish one entity that carries out this function on a market-wide basis, taking proposals to a number of investors and trying to raise capital from multiple sources, so that the project packaging and placement becomes an institutionalized process.

An important by-product of institutionalizing this function is that it could contribute to developing a secondary market for equity instruments. (See below.) Importantly, to the extent that such a project packaging process could be institutionalized and the level of equity investing augmented significantly, it would inject much-needed, additional activity into the currently dormant stock market.

6. <u>The lack of an active secondary market for securities is a significant disincentive to investing in equity-based financial instruments</u>.

Respondents indicated that there were no active secondary markets in Egypt for a number of reasons:

- The stock market was moribund and prices did not represent values
- No other organized trading markets exist for equity
- There are no real long-term securities markets for bonds or related financial instruments
- There are relatively few institutions prepared to purchase securities actively
- The basic thrust of many present Egyptian investors is to "own" rather than "invest" so that investments are not turned over.

Under these circumstances, survey participants noted that a major investment incentive for making equity investments--i.e., capital gains--was lacking in Egypt. Dividend returns are seldom a sufficient reason for making equity investments. This suggested that an EFF will have to be organized in such a way that it generates sufficient activity to help create its own private, secondary market as a first step, with a view to generating sufficient liquidity over the longer run that may contribute to activating the currently dormant stock exchange.

7. <u>Commercial banks do not participate actively in equity financing and should not be expected to do so because they are fundamentally loan oriented, do not possess the administrative capacity to analyze and manage equity investments, and may frequently be subject to conflicts of interest</u>.

While some of the commercial banks were involved in some equity investments, the respondents indicated that making this type of investment was simply not an active business activity for banks. (The nationalized banks were perceived as contributing little to this process.) One reason put forward for a commercial bank to get involved in an equity investment is to enhance its business position, not necessarily to earn a high return.

Respondents noted the large difference between commercial banking, which is the predominant banking activity in Egypt today, and investment banking, designed <u>inter alia</u> to supply equity as well as other types of long-term securities to business ventures. The former is fundamentally loan oriented, emphasizes short-term lending to primarily self-liquidating commercial transactions, and requires skills in credit analysis. The latter is an activity involving a different risk profile, requiring both market analysis and financial structuring skills as well as credit reviews. The activities of the investment bankers and commercial bankers are fundamentally different, and rarely do commercial bankers serve as effective investment bankers.

At the same time, commercial bankers frequently are caught in possible conflicts of interest in Egypt when they are both lenders and investors. (The Glass-Stegall Act prohibited this in the United States.)

The consensus was that commercial banks make few, if any, equity investment at this time because:

- Commercial banks are oriented towards short-term loans and lending returns, particularly in today's economic environment
- Commercial bank personnel are trained to review credits and not equity investments
- The experience of commercial banks making equity investments in the early 1980s is perceived as having been bad
- Commercial banks only invest when they see ancillary benefits for commercial banking business.

8. The "workout/turnaround" of over-leveraged Egyptian private companies, as well as the privatization of Egyptian public sector companies, appear to be areas of real potential for equity financing with shorter times for investment returns to begin. Employee ownership was seen as a method of achieving expansion of equity, not wider ownership.

On numerous occasions respondents mentioned that there were many companies, both private and public, which, if they could receive an injection of equity funds and a certain degree of "workout" assistance, could readily be turned around and become profitable ventures. The clear consensus was that some form of institutionalized mechanism that provided both equity financing and workout assistance was greatly needed in Egypt.

On the private sector side, the companies needing equity (some claiming that they number in the hundreds) were characterized as small- and medium-sized firms operating particularly, though not exclusively, in the light manufacturing sector. On the public sector side, it was mentioned that companies slated for privatization would need great amounts of equity to support the process of privatizing them. Although great care must be taken in analyzing such companies before making investments because they have demonstrated an inability to deal with the present market, they do seem to offer an opportunity for returns.

Reference was made to ESOPs as a potentially important ingredient in the equity investment process. Candidate companies are likely to be large (e.g., a tire company), with accompanying larger equity requirements and much more difficult to analyze. Therefore, ESOPs require careful, individual analysis, because they are essentially a debt investment with the loan convertible to equity shares if the company's shares fail to generate enough cash to service the loan. (Because secondary markets for shares are limited in Egypt, the share value as collateral is limited.) They do not provide large gain potential for private investors, and therefore are the province of the banking community. They were interesting to respondents because they offered a potential for equity funding. At some time in the long-range future, they may diversify ownership thrcugh public sale.

9. <u>Safety from and predictability of Government policy change is a fundamental Egyptian investor concern with respect to long-term investment</u>.

A key concern raised by private Egyptian businesspersons was predictability with respect to the "rules of the game" as set forth by the Government. Their past experience with subsidized competition from government-owned companies and with uneven interpretations of the various investment, tax, customs and similar laws has made them extremely cautious. Businesspersons, in view of GOE unpredictability and generally slow administration and inflationary economic conditions, do not find themselves in a position to take significant risks. They felt that if the rules of the game of the EFF were clear and predictable in their application, abundant funds would be put forward by private investors in support of equity investments. They consider USAID to be an institution which can provide credibility and exert leverage in this regard.

10. <u>All survey participants in the Egyptian public, private and financial sectors indicated that an equity financing facility (EFF) is needed in Egypt, and could be feasible if properly structured and managed</u>.

All survey participants indicated that there were ample Egyptian investment funds available and sufficient investment opportunities, but that a catalyst was needed. Although expressed in different ways, some participants indicated that USAID merely should provide "cheap money," and others believed that USAID should provide subordinated funds whose returns were deferred. All believed that USAID funds, if properly structured into a facility which provided equity to aggressively identified and prudently approved investments, could be a catalyst for Egyptian private investment funds.

11. <u>The consensus is that USAID's role in establishing an EFF is essential, and must be brought to bear at multiple levels</u>.

All respondents agreed that it would be extremely difficult, and probably impossible, for Egyptian private companies to initiate an equity investment facility in today's market without outside assistance from a credible institution because:

- Such a facility would require a number of GOE approvals which probably could not be obtained within a reasonable period of time and at a reasonable cost by a private institution

- A significant amount of funds would be necessary to achieve sufficient economies of scale to make such a facility profitable and those could not be obtained from the marketplace without a credible supporter

- A portion of the funding will have to be on a deferred yield basis to make equity funding attractive to Egyptian investors because returns appear necessary for Egyptian investors in the early years

- Availability of foreign exchange for foreign-sourced capital equipment is desirable for certain equity investments.

12. <u>The EFF design must accommodate a number of Egyptian- and USAID-specific factors in order to work in Egypt</u>.

There are several points concerning GOE rules that may require clarification prior to launching an appropriate equity financing facility. Although these points may be clarified in the near future, the respondents did not consider it likely. Mainly, the GOE needs to clarify:

- That Law 146 allows management of a pool of funds of non-shareholders of a Law 146 approved company

- That the GOE tax regime will allow those whose funds are managed to receive a yield from the pooled investments tax free or, at least, upon the same tax basis as any other recipient of the payment by the paying entity.

- That a Law 43 company with a tax holiday can be registered as a Law 146 company.

Respondents indicated that, for its part, USAID would have to consider a number of accomodations in order to increase the likelihood that an EFF would be viable, including:

- Accepting a deferral of yield on their funds

- Waiving, to the extent possible, the requirement of U.S. procurement upon the use of dollar funds.

Furthermore, respondents were quite firm in pointing out that both the GOE and USAID would have to allow wide latitude in the administration of both the monies put forward and the operation of the fund itself.

13. <u>There were strong indications from various parties that a comprehensive assessment of the current Egyptian capital markets is needed, with a particular focus on the relationship between Government policies, financial sector institutions, and financial instruments</u>.

A number of respondents articulated the belief that the GOE did not have a clear enough understanding of the effect upon capital markets of many laws, policies and actions. They suggested that a comprehensive review of the capital markets be undertaken to gain a fuller understanding of the multiple interrelationships involved. Such a review would also help USAID design a comprehensive strategy for financial sector development in Egypt.

III. PHASE I CONCLUSIONS AND RECOMMENDATIONS

The survey results give rise to the following conclusions and recommendations regarding the establishment of an equity finance facility in Egypt:

1. **Private intermediary institution required**: A private intermediary institution designed to seek out and place professionally developed equity financing proposals with Egyptian investors would provide the maximum mobilization of private investment funds, in both primary and secondary markets, by institutionalizing the equity investment process in Egypt.

2. **Investment pool of funds required**: An investment pool of funds is needed to support the placement function and mobilize directly Egyptian investment. Such a pool should be operated similar to a mutual fund and would require USAID support.

3. **Institutionalization of the equity financing process**: The team proposes an equity financing mechanism which institutionalizes the process of mobilizing more Egyptian private resources through a placement facility, and will also provide additional impetus to the development of Egyptian private capital markets through a professionally-managed pool of funds and trading activity in selected financial investments.

   It is concluded that such an equity financing facility is feasible and desirable, so long as the facility is properly structured, is operated in accordance with the principles set forth herein, and USAID suppc ts the facility as indicated.

4. **USAID support is essential**: The development of such a private intermediary requires USAID support to provide:

   -- credibility to the project in the Egyptian environment

   -- support during the institution's early years when earnings from equity placements and returns are very low

   -- access to assistance and expertise in focusing on effective pooling arrangements.

5. **The EFF requires maximum operational autonomy**: USAID and the GOE cannot be involved in investment decision-making of the entities making up the EFF: the private Egyptian equity finance facility must be free to make its investment decisions without special subsidy or constraint, even though the market may still be underdeveloped.

6. **Comprehensive assesssment of the financial sector**: Improvement in the Egyptian investment policy/ regulatory environment is needed to bring about greater predictability for private investors, faster response time of Government action, and appropriate interpretation of existing laws. An Egyptian capital markets assessment which focuses on the relationships between GOE fiscal and monetary policies and the capital markets should be undertaken, emphasizing policy-makers direct involvement in the assessment to the extent possible.

IV. CONCEPT PAPER: PROPOSED EGYPTIAN EQUITY FINANCE FACILITY FUNCTIONAL AND INSTITUTIONAL FRAMEWORK

A. Strategy and Program Conception

In light of the conclusions drawn above, the following is conceived as an overall strategy to develop an equity finance facility (EFF) under existing Egyptian law which would appear consistent with overall GOE policies, but nevertheless makes progress toward two goals:

- Mobilization of additional private investment funds for equity investments in Egypt
- Development of an environment which will assist in improving the freedom of capital markets in Egypt

This strategy is long term in nature, and it will take years to make a significant contribution to economic development in Egypt. There are no easy solutions or short cuts in the freeing up of capital markets, particularly those involving equity investment.

The strategy envisions the establishment of institutional mechanisms which will identify, develop and place Egyptian private investment opportunities with private investors. The institutionalization of the private placement process will achieve the greatest leverage possible because it focuses on the selling of investments to other private investors rather than on the direct investment of a pool of funds. At the same time, the findings and conclusions above point out that a pool of funds is presently necessary in Egypt because the poor state of Egyptian capital markets today requires catalyst funds in order to mobilize greater amounts of private investment in the country.

The program proposal is conceived as a design to:

- Mobilize funds for equity investment in Egypt from domestic and foreign investors (both individual and institutional), with an emphasis on domestic investors
- Provide a growing Egyptian institutional capability of identifying, packaging and placing Egyptian investments with private investors
- Enlarge private capital market activity in Egypt, including the development of more active secondary markets

- Utilize USAID resources to achieve the maximum leverage possible in a manner that does not involve USAID granting subsidies or taking equity positions, as well as insulate it from the decision-making process with respect to individual investment projects.

Most past strategies and programs designed to mobilize private investment have focused upon either:

- Providing long-term credit to the productive sectors through the provision of long-tenured loans, usually on a subsidized basis

- Developing the capability of the direct provision of long-term funds from a finite pool of funds.

In Egypt's current marketplace, long-term loan funds are almost prohibitively expensive because of inflation and GOE lending constraints. For USAID to provide long-term loan funds would require expensive subsidies, and would result in minimal leverage because of the subsidy element. Furthermore, even if interest rates decline, the development of direct lending capabilities (even with ancillary equity investment) does not usually lead to significantly greater amounts of private funds being mobilized because:

- The lending is from existing resources, not new private funds

- The successful, related equity investments are retained by the institution making the loan.

- Experience indicates great problems with this approach. (See discussion of Development Finance Intermediaries, p. 27 ff., in World Bank report, Financing the Private Sector, April, 1989, which indicates the ineffectiveness of this approach.)

It is only when equity investments, which have been identified and fully developed, are placed with other private investors on a systematic, ongoing basis that private investment funds are mobilized in significant amounts. At the same time, the placement process contributes to the development of a secondary market because equity sales increase and market knowledge is gained.

The specific program being conceived as a result of this engagement involves two basic activities/functions:

- Establishment of a <u>placement function/unit</u> charged with:
  - identifying potential investment projects in new or existing Egyptian businesses
  - reviewing and developing these investment projects
  - placing investments
  - trading securities

- Establishment of an <u>investment function/unit</u> which would manage a pool of funds obtained from private investors, USAID and other international institutions. The pool of funds would be used primarily to make equity investments in Egyptian projects, but would also be used to provide a liquidity reserve and current income. The fund would be:
  - managed by a professional portfolio manager
  - used to support the above placement activity
  - used to support selected secondary market trading activities
  - organized so that it will not provide a subsidy to Egyptian investors, but would allow them priority in receiving income generated in the earlier years of operation, but only to the extent that income was earned and not from principal.

Exhibit V-1 presents these functions graphically.

These activities would be placed in one overall entity because, while they are functionally distinct, they mutually support and reinforce each other.

FUNCTIONAL CHART

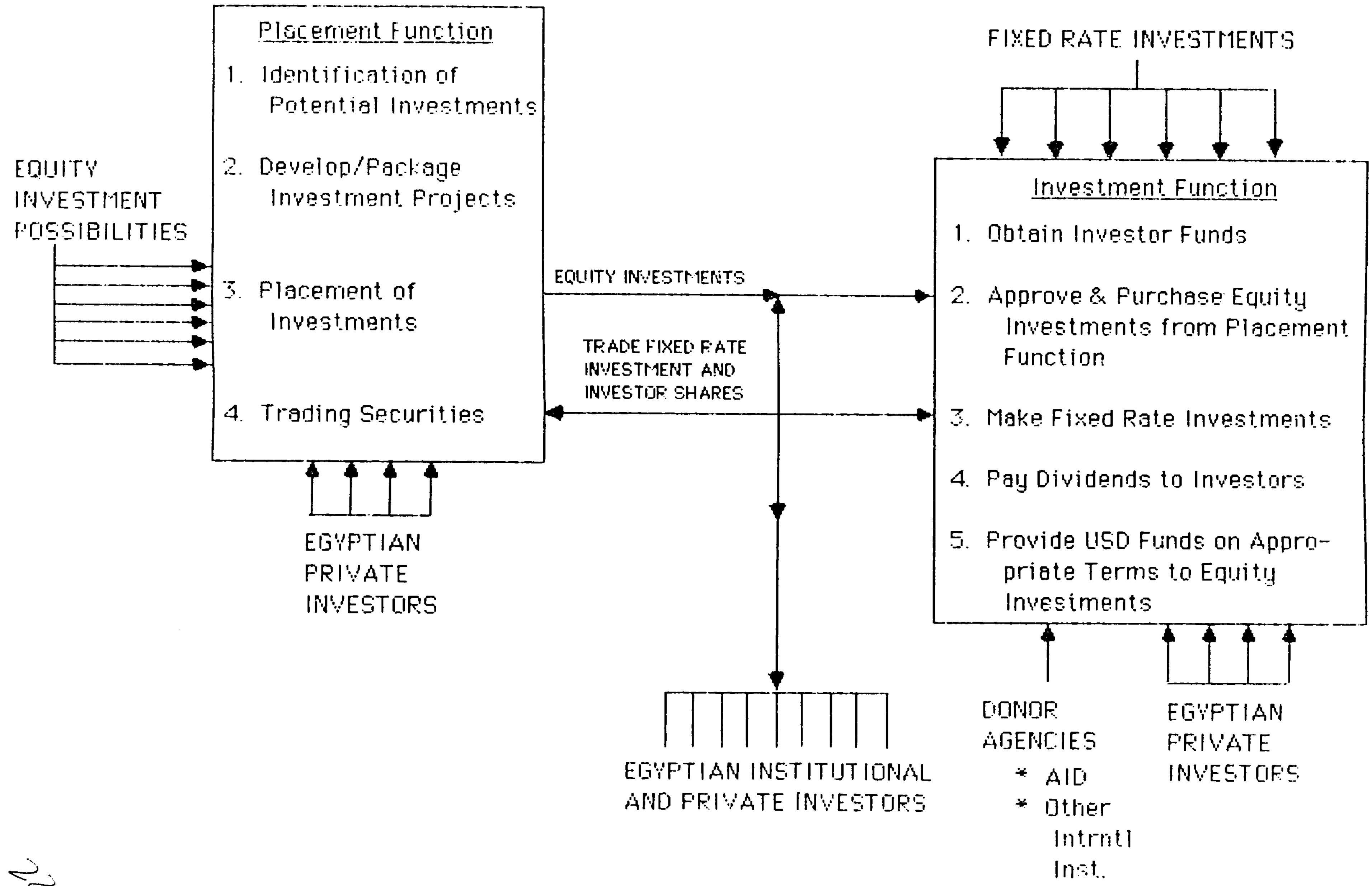

EXHIBIT V-1

B. Functional Activity Description

The following description of the two functions involved in the program concept will attempt to elaborate on the activities involved and place them within an institutional framework that could work within Egypt's current economic, legal and regulatory environment. It should be noted that this is a conceptual arrangement which will undoubtedly be adapted during the design stage to meet changing circumstances and priorities.

1. The Project Identification, Packaging and Placement Function

There is no organization in Egypt at this time which identifies, develops/packages and places private investments with other investors on a systematic, ongoing basis. (There was only one organization identified as planning to undertake several of the activities, but on a limited scale.) Other organizations which might be involved in equity financing are not undertaking all of these functions because they are not organized to do so:

- Commercial banks are deposit-taking institutions whose principal responsibility is to protect their depositors' funds and to produce profits for their shareholders; many have conflicts of interest, and none are normally staffed to analyze equity investments because they are fundamentally lenders

- Development banks are institutions normally created by governments to make available long-term funds to finance the accumulation of fixed assets in a manner consistent with public policy priorities and have problems generally similar to commercial banks

- Investment companies are interested only in identifying projects to invest their own funds and those of their backers

- Entrepreneurs are solely interested in the projects which they are promoting

- Individual investment managers concentrate only on the return on the investments they are paid to make for their clients.

The field survey indicated that most informed investors believe that there are many existing and potential equity investment opportunities which have not been professionally reviewed and prepared and which could be attractive opportunities for some investors on the one hand, and that there are funds available for equity investments in Egypt on the other. There is, therefore, a real opportunity for an organization which finds and places equity investments with others.

The proposed entity will undertake a number of functions, including project identification, project analysis/packaging, and project placement.

The <u>project identification</u> function encompasses a number of activities, including:

-- Identifying potential equity investment opportunities in Egypt by analyzing economic activity in the industrial, commercial, and financial sectors

-- Developing personal contacts in target areas

-- Marketing the entity's services to the private sector in Egypt and abroad

-- Developing relationships with service companies in allied fields (e.g., management consultants, banks, etc.), which will identify potential equity investments..

The <u>project analysis/packaging</u> function involves reviewing and developing those investment opportunities which give the greatest promise of being successfully placed with other investors. This is a difficult and expensive process because, generally speaking, a great number of investment opportunities have to be reviewed before any are accepted as properly developed to be packaged for sale. Furthermore, particularly at the outset, it may not be possible to place all the investments which are thoroughly reviewed and approved internally for sale. The project analysis and packaging function will therefore require people who have practical experience in investment development.

Another functional requirement is development of in-house expertise in certain industry sectors which give promise of profitability (e.g., agricultural processing, tourism, etc.). In addition, access to outside consultants who can provide additional assistance in preparing a potential investment for sale is necessary.

Under certain circumstances it may be desirable to undertake "bridge" financing for selected investments; i.e., put money up front to bridge a period when an existing company is being restructured and made profitable with the objective of being sold

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thereafter. The project packaging function will need access to a small funding pool for this activity.

The project placement function entails placing equity investments with third party investors. In view of the current inactivity of the Egyptian stock market, any placements will be necessarily private. (A private placement is the sale of equity shares to anyone other than through a public stock market; it can be an orginal issue by the company or a secondary offering of existing shares.)

In the current Egyptian financial marketplace, this is a very difficult process because alternative investment opportunities give high yields, hedge against inflation, and are comparatively safe. Under these circumstances, there is a great need for an associated equity fund which can provide at least a portion of the equity funds needed. At the outset, the proportions required to be put up by the entity may be relatively high, but will fall over time as the placers develop the Egyptian private placement equity market.

It is absolutely essential that the entity charged with carrying out these various functions be privately owned and operated, and that compensation for its personnel be based strictly on performance. The placement activity must be forced to be successful in placing equity investments with others by imposing a profitability requirement. If the activity is not profitable, it should be discontinued. The discipline of profit and loss is the only way that success can be measured in the private placement business. Even when shares are sold to an associated pool of funds, compensation for the placement function should be directly related to the amount placed and not any other basis.

A likely breakdown of income for the placement function would be as follows:

- Front-end, cash fees (about 2 to 5 percent of the amount placed)
- Equity "kickers" (i.e., a portion of the fee could be taken in equity through warrants, options or shares).

It is anticipated that the cash fees would cover out-of-pocket expenses, and the fees in the form of equity would provide the chance for significant gain. However, such an approach means that there is little chance for significant financial gain in the early years of operation. Furthermore, the process of identifying, developing, and placing equity investments takes longer to get returns than the activities of other financial service companies. For this reason, Egyptian equity investors will generally refuse to invest in such a financial service company because the returns are too slow in coming, even though the risks may not be large.

Appendix C contains an indicative profit and loss statement for the entity charged with identifying, packaging and placing equity investments under the proposed EFF (i.e., the Egyptian Equity Management & Investment Company, or EEMICo).

USAID's role, and perhaps that of other international financial institutions, would be to provide funding which would defer its return until a later date so that Egyptian investors would be willing to invest when they see that they will be able to obtain a reasonable return over a reasonable time frame, as measured by Egyptian equity investment standards. It is probable that USAID's funds will not be needed directly by this function. Rather, they would be invested in the funding pool. To the extent needed, USAID's funds would be provided on a subordinated, long-tenured basis so that its yield would be effectively deferred. Nevertheless, USAID should expect to earn a market-based yield on its investment, through an appropriate recapture provision. It is our view that USAID should not provide funds at a lower-than-market, or subsidized, rate of interest.

USAID's funds would not be used to make direct payments to Egyptian investors in the pool. It is anticipated, however, that in order to attract Egyptian funds into the investment pool, it will be necessary to pay those investors a cash return on their investment. The cash return would come from the investment profits generated by the pooled investments. The investment pool would be invested in both equities and debt (including bank deposits). In the early stages, the debt instruments would be larger than the equity investments. In order o maintain a reasonable payout to Egyptian investors from the fund's profits during early years prior to achieving returns on equity investments, it would be necessary for USAID to forgo returns at the outset, but have a "catch-up" arrangement that allows USAID to obtain an appropriate return in later years.

One further function that would be handled as part of the placement function involves purchasing and selling other types of investment instruments for the associated pool of investment funds. The investment pool will be professionally managed. To carry out professional portfolio management, it is desirable for the managers to have available as may investment instruments as possible. The present Egyptian array of possibilities is very limited. The placement function should encompass a trading activity in developing, packaging, purchasing and selling other instruments on behalf of the pool. (For example, placing and negotiating bank deposits at the best available rate, and

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developing new fixed-rate instruments.) This activity is important because the expansion of any secondary market in investment instruments assists the development of equity markets generally.

A second type of purchase and sale of securities should be undertaken by the placement function: making a secondary market in the certificates of interest in the investment pool itself. Most Egyptian investors in an investment pool will want the ability to exit if necessary. There is no such possibility today because there are no real secondary markets with any significant activity. The Cairo Stock Exchange is currently dormant and cannot be expected to provide such liquidity at this time. However, a secondary market for such certificates could be established by the placement function. The experience and expertise gained from such an activity would assist the placement function in its main activities. It is probably inappropriate to list the certificates of interest on the Cairo Stock Exchange because they involve a new, untried equity investment funds.

2. <u>Investor Funds Pool</u>

A pool of funds available for equity investments in Egyptian projects is necessary because alternative investments are more attractive than equity. However, a pool of funds which is professionally managed is able to achieve greater comparability because the managers can:

- Obtain maximum returns through leverage obtained by large fundings
- Locate special investment opportunities
- Take advantage of potential investment arrangements allowing greater comparability between equity returns and bank deposit returns
- Assess risk/reward possibilities accurately.

USAID funds (and possibly those of other international institutions) are necessary because:

- They lend credibility to the enterprise and can assist in the organization process.
- They will be utilized so that yearly yields for Egyptian investors are possible during the period awaiting capital gains, with USAID yields being deferred until a "catch-up" provision applies, which

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will be included for USAID for later dates. (Without this, Egyptian investors will be reluctant to invest because current alternative investments are more attractive; e.g., tax-free, Euro-dollar accounts with frequent interest payments and which act as an inflation hedge.) Investor payments/dividends would only be from profits; never from principal. USAID funds, along with Egyptian investor funds, would be invested in fixed-rate instruments (e.g., bank deposits) as well as equity securities. The income, however, in the early years would be used to pay the Egyptian investor, with USAID's income being deferred until later. This would allow the Egyptian investors to receive a steady return until equity investment returns begin to come in. USAID would receive income in later years from profits, and arrangements would be made so that it would receive an appropriate income overall.

- They can provide a US dollar pool for foreign exchange costs of equity investments at appropriate foreign exchange costs (e.g., USAID could provide dollar funds through the investment pool manager as a portion of the contribution of the pool provided that the foreign exchange risk is appropriate for the equity issuer).

A professional portfolio manager would manage the investor funds pool. The pool would be managed with the following objectives:

- Purchase non-controlling interests in Egyptian private companies with good prospects for dividend yields and capital gains.
- Support the placement function by purchasing equity investments and paying the standard placement fees for such purchases from its associated placement function
- Provide a diversified portfolio which would include both equity investments as well as investments in fixed-rate instruments to be held as a liquidity reserve and to support a reasonable rate of cash return
- Pay a current yield to its Egyptian investors as well as capital gains (the current yield being obtained by investing a portion of the investment pool in fixed-rate investments and by USAID deferring income).

In order to attract Egyptian investors to the pool it will be necessary to:

- o Obtain GOE clarification regarding certain tax-related arrangements which are presently ambiguous.
- o Allow investment of the pool of funds in any investment determined appropriate by the professional portfolio manager and the investment pool's management
- o Avoid any intrusion by the GOE or USAID in the management of the pool of funds so long as there is no fraud or mismanagement.

In order to raise funds from Egyptian equity investors, it would probably be desirable to pay a current yield on the investment because the most commonly used alternative investment is non-taxable bank deposits which offers cash income. It was the general consensus that Egyptian investors should receive some current cash income from their investments in the fund or, perhaps, other types of assurance. Otherwise, the only investors in the pool are likely to be just a few institutions (e.g., banks, insurance companies) that would look for ancillary benefits from the investment (e.g., banking business), and the mobilization effect on private resources would be reduced.

There may be other techniques which may be used to attract Egyptian investors. For example, it would be possible to guarantee the return of principal only at the end of the period of time (say, 5 years) by establishing a discounted fund with a bank guarantee at the outset. Other techniques to attract Egyptian investors may also be possible.

C. Institutional Framework

1. Background

The conceptual arrangement outlined above indicates two separate functions with many interrelationships. The actual implementation of the concept must at this time remain flexible because the development proces will dictate the final arrangements. This report will delineate what apparently are the optimum arrangements at this time, subject to further definition as the overall project moves forward.

An obstacle to a more precise proposal at this time is apparent ambiguity in the interpretation of GOE policy, regulations, rules, as well as tax law interpretations as they pertain the taxation of dividends. Further research and development is necessary to clarify this element of our concept. Some of these ambiguities may be further interpreted while this project is being considered and developed.

The impact of GOE laws presents a problem because:

- The main alternative investment avenues for Egyptian investors are tax advantaged (e.g., bank deposits). The non-taxability of bank deposits grants an enormous preference to this type of investment. Unless the effect of this tax preference is reduced, it will be difficult to raise significant amounts of equity investment funds from Egyptian investors.

- Law 146 affects Egyptian pools of investment funds, and its impact upon types of funds other than the bankrupt investment funds is not entirely clear.

- Egypt does not have any applicable law for trusts, unit trusts, mutual funds or similar intermediaries, particularly as it pertains to its non-taxibility.

- The tax effect of various types of pooling arrangements is uncertain.

The institutional framework:

- Would require GOE concurrence with certain interpretations of existing tax laws and rules, as indicated above, but would not require new laws nor major revisions of existing rules

- Might be handled through MIC concurrence with an <u>aide memoire</u> to the GOE approval of the transfer of USAID-generated local currency for this project (after appropriate clearance within the GOE).

- Would provide guidance for further pooling of private funds under similar arrangement when this pooling arrangement is perceived as successful.

2. The Concept of the Egyptian Equity Management & Investment Company (EEMICo)

There are two elements in the proposal:

- o An operating entity (EEMICo), which carries out administrative functions and probably would be owned and funded by Egyptian equity investors without USAID direct support

- o A pool of funds provided by Egyptian investors and USAID, which are managed by EEMICo in a fashion similar to mutual funds.

a. EEMICo functions

The Egyptian Equity Management & Investment Company, EEMICo, would be formed as a joint stock company under Laws 43 and 146 to provide the necessary services. Two separate company departments would undertake the two main functions described above:

- o The placement of equity investments in companies identified and developed by EEMICo, including trading of certain types of securities

- o The professional management of a portfolio of Egyptian investors' funds.

b. Funding sources for EEMICo and the investment pool

EEMICo would be formed and funded as follows:

- o At least twenty Egyptian shareholders would contribute not less than EL 50,000 apiece to form EEMICo

- o The investors would probably be associated with an existing entity in Egypt which has some of the skills and expertise already.

The investment pool would, in turn, be formed and funded as follows:

- o Approximately EL 50 million would come from Egyptian investors to be managed as an investment pool with each

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investor retaining an undivided interest in the investment pool equal to his proportionate interest in the total pool.

- Funds contributed by USAID (and perhaps other international institutions) in an amount of approximately EL 25 million with deferred payment of income until a later year--perhaps three years.

c. EEMICo shareholders

EMMICo will be an equity placement and management company organized under Law 43 to obtain tax and other advantages. It would be registered under Law 146 which apparently allows management of the funds of others, provided that the Law 146 requirements are met.

It is estimated that the amount of shareholder capital needed would be EL 5-10 million. This would be provided by at least twenty Egyptian shareholders as required by statute. It is anticipated, however, that an Egyptian group would provide 81 percent of the capital, or EL 4,050,000, and 19 shareholders would provide EL 950,000. The major shareholder would be determined in advance and would have a significant stake in the success of the venture. It is probable that the major shareholder would be an existing company with a number of the skills necessary to manage EEMICo successfully. This should allow a range of choices for USAID, as well as others, regarding the overall management of EEMICo.

d. Egyptian investor funds in EEMICo

The arrangement of EEMICo as presently conceived would envision Egyptian (or other) investors placing their funds with EEMICo for investment management. Initially, about EL 50 million is proposed as a target investment fund for an initial offering.

This arrangement would be somewhat similar to a mutual fund or unit trust. (No laws, rules or regulations exist in Egypt which directly cover mutual funds or trust arrangements.) The funds would be invested by EEMICo on a pooled basis: each investor would own his proportionate share of the pooled investment. Shares would not be issued to the investors; they would receive a document indicating their percentage of the total amount invested. (Herein, this document of investor interest is referred to as a "certificate of interest.") The certificate of interest would probably be a contract between each investor and EEMICo governing the investment management of his funds on a pooled basis.

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The certificate of interest will receive cash payments resulting from the pooled investments. These cash payments should be tax free, because they should be a tax incentived investment similar to bank deposits. In any event, the cash payments should certainly have the same character and carry the same taxability as the nature of the income paid by the payor. That is, if a pooled investment is deposited in a bank, the interest paid thereon should be non-taxable to the certificate of interest holder, in line with current Egyptian tax law. Similarly, if an investment is made in equity securities, capital gains would not be taxed, but dividends would be taxable to the extent, if any, that such equity dividends are taxable to individuals.

The combination of the above rules would allow investments on behalf of the certificate of interest owners to receive tax treatment that would mitigate some of the current tax disadvantages for equity investments in Egypt. It would also allow professional portfolio managers to demonstrate competence (e.g., during most of the past several years, a professional money manager would have placed offshore bank accounts in European currencies, which would have performed much better than in US dollars).

e. USAID contributions

In order to provide credibility and mobilize funds in the current Egyptian capital market, USAID would have to participate in the contribution of funds to the pool. It is presently estimated that a contribution of approximately EL 25 million would provide the necessary support while the equity investments mature. It is contemplated that the USAID funds would not provide an interest rate subsidy. Rather, the USAID investment of funds would receive a yield on a deferred basis. USAID funds would provide both economies of scale and allow profits to be paid out to Egyptian investors during the early years when equity investments pay little or no returns which USAID returns are delayed.

For example, USAID would agree with the GOE that EL 25 million would be contributed to the pool of funds for ten years, and that the GOE would begin receiving a 4 percent return per annum on its certification of interest after a sufficient period of time that would allow EEMICo to get on its feet, as appropriate. At the end of the tenth year, the certificate of interest representing USAID's contribution would be sold, and USAID/GOE would receive the proceeds, but not more than an amount equal to a cumulative, say, 6-8 percent per annum return plus the amount of the original contribution. The exact method of deferral and repayment could be worked out as the project is developed over time, but the fundamental principle would be similar: deferred payment of returns to USAID/GOE and an overall ceiling on a maximum, market-based rate of return on the USAID funds.

The USAID contribution would not be equity in the management entity, EEMICo. Its contributed funds would be managed by EEMICo, along with those of the Egyptian investors, but it would not have any indicia of equity ownership in any of the investment pool's equity participations except the right to receive revenue in accordance with stipulated agreements. EEMICo, as is usual with fund managers, would exercise all equity, debt and other investment rights.

However, if necessary for USAID, it would not be difficult to structure the USAID contribution as debt with a variable and deferred interest rate. It should be noted, however, that it is risky and counterproductive to lend funds to an equity investment fund.

In addition, it would be possible to arrange a two-step injection of USAID funds through an intermediary.

Furthermore, USAID should establish rules at the outset which will allow additional contributions to the fund provided it meets established targets for success. For example, USAID might agree to contribute another EL 25 million if:

- An additional EL 50 million of Egyptian investor funds are obtained
- The pooled funds have been invested in equities
- Pre-established standards of equity performance are met.

3. EEMICo Administration

The income stream of EEMICo and its pooled fund investors would have two parts:

- o EEMICo income from:
  - -- placement fees
  - -- fees from investment management of investors' pooled funds
  - -- trading income from secondary markets
  - -- investment of its capital in the pooled funds.

- o Investor income from:
  - -- interest or trading profits on fixed-rate investments
  - -- dividends on equity investment
  - -- capital gains from sales of equity investments

a. EEMICo Income

A very preliminary draft pro forma income statement for EEMICo based on likely assumptions is contained in Appendix C. A review of this data indicates:

- o EEMICo would very marginally profitable to its investors during its early years
- o EEMICo becomes very profitable when capital gains are achieved
- o USAID contributions to the pooled funds are essential in order to achieve marginal profitability in the early years because:
  - -- EEMICo's portfolio management fee is based upon total funds managed, and USAID funds substantially provide the differential between profit and loss during the early years
  - -- USAID's funds allow the investment pool to invest in equities placed by EEMICo and also invest in fixed-rate instruments which pay immediate cash returns.

b. Investor's Income

A very preliminary draft pro forma balance sheet and income statement for the Investment Pool based on likely assumptions is also contained in Appendix C. A review of this data indicates:

- Private investors achieve very small returns during the early years prior to capital gains
- If capital gains occur, total average annual gains over a five-year period of over 15 percent per annum become achievable. (These are not large on a pre-tax basis, but are reasonable.)
- USAID funds are essential to achieve this result.

D. EEMICo Risk Analysis

Various risks may be encountered in implementing the EEMICo concept requiring safeguards. These are briefly discussed below.

1. Political Risk

There is, as in other parts of the world, some danger that the political situation may change adversely to the private sector in Egypt. If this occurs, it could cause severe losses in the equity investments made by the fund. However, this risk can be controlled to some degree by the investment policy practiced by the manager. Investments should be made in industries or businesses which give the greatest prospect of success over the long run, which would tend to restrict the number of investments in sensitive areas. Furthermore, it is contemplated that the equity investments will be diverse, so that there is safety in diversification. Also, the investments will be made over a considerable period of time, and it is contemplated that there always will be some liquidity reserve, so that the political risks can are attenuated.

2. Investment Risk

Securities offered in starting, new ventures are, by their very nature, speculative and subject to a high degree of investment risk as compared to other investments. However, the objective of the EEMICo project is to obtain more Egyptian investments in equities. It is the team's view that the only way to use USAID funds to achieve this objective is to participate in the equity risk along with the Egyptian investors, so long as the funds are professionally managed. Safeguards have been built into the EFF concept as follows:

- The management chosen must be the most professional available. Investment management must also be dependent upon the involvement of the manager in the outcome. In this case, the manager will also be a shareholder in EEMICo, the managing company. The investment manager would thus stand to gain from good performance, but lose from poor performance. The actual portfolio manager should be divorced from the placement function so that the full effect of personal gains and losses will be felt.

- EEMICo placements of equity should not solely be with the investment fund. The added safeguard of concurring investor judgment in the equity investment provides considerable protection.

- The investment portfolio of equities will be diversified. Equity investments will ordinarily provide large gains for only a few of the investments. By diversifying, one increases the chance of success and reduces the chances for large overall losses.

- EEMICo will develop its own capacity to turn over investments. It may not be possible to exit from some of the investments made by the pool of funds because of the lack of secondary markets in Egypt. However, the EEMICo approach offers the best way of guarding against this risk because it develops its own placement capacity in the securities owned as a part of its normal placement business. EEMICo will place equity investments with others as well as the pool, and therefore it will have a better idea of where to sell such investments if an exit is desired. At the same time, EEMICo traders will have have been building up their knowledge of other capital markets, so that they will also have knowledge of other pools of funds which might be interested in purchasing equity securities.

3. Economic Risk

There is a substantial chance that the Egyptian economy will decline sufficiently to shut off investment flows and cause losses to the Fund's investments. This is the basic risk of all private investment. However, EEMICo and the investment pool will have several safeguards:

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- A diversified investment portfolio that limits undue concentration of economic risk

- The long-term nature of the investment portfolio that allows a reasonable period of time for forecasting long-range trends and avoiding the worst downturns.

V. IMPLEMENTATION/NEXT STEPS

The following steps should be taken in the following sequence:

1. Preparation of Phase I Reports: Promptly after the completion of the final USAID briefing on the EFF concept, the Preliminary Draft Report will be left with the Mission, and the team will return to the U.S. Once in the U.S., Shearson Lehman Hutton and Price Waterhouse will conduct desk and quality control reviews of the Preliminary Draft. The AID/PRE/PD/FSDP will also be fully briefed on the status of the Project. Price Waterhouse will subsequently forward the Draft Final Report to USAID/Cairo for its review and comment. A Final Report will be prepared upon incorporation of USAID comments into the Draft Final, as appropriate.

2. USAID/Cairo will decide whether to proceed further.

3. If USAID decides to proceed, it will inform AID/PRE and Price Waterhouse, and PW will proceed with Phase II, as appropriate.

4. Price Waterhouse will promply undertake to arrange Phase II actions, but the following should be noted with respect to Phase II:

   a. It is desirable to include an investment banker/underwriter function in the scope of work because a major element in moving EFF forward is the raising of funds from investors. Addition of such an entity in the scope of work may involve a separate fee structure for the syndication/ underwriting process.

   b. Because of the nature of the EFF, any agreement between the management of the proposed entity and USAID will be minimal because the equity facility management will be the sole determinant of investments.

   c. The selection process for the entity to manage the pooled funds should be developed by the Contractor. A final recommendation to USAID on the entity to be selected will be made after a careful review of all potential participants who can meet the Contractor's eligibility criteria.

d. The Contractor will make recommendations concerning the possible involvement of other international financial/donor institutions.

APPENDIX A

APPENDIX A

People and Institutions Interviewed

CAIRO, EGYPT

Ahmed Foda
Mohamed Foda
First Cairo Finance Co.

Mounir Kamel Hamdy, General Manager
Misr Finance Investment Co.

Mohamed E. Taymour
Egyptian Finance Investment Group

Omar Mohanna, Assistant General Manager
Misr Iran Development Bank

Omar A. Sakr
Bank of America

Ahmed Abdel Salam Zaki, Administrator
Ministry of International Cooperation

Zafer el Bishry
National Investment Bank

Mahmoud M. Fahmy
Corporate & Investment Law Expert

Wael Leheta, President
Egytrans

Mohamed Ragab, Chairman
Ragab Export & Import Co.

Hatem Moustafa
Nimos Engineering

Dr. Medhat Hassanein, Professor Banking & Finance
American University in Cairo (AUC)

Dr. Antoun Mikhail, General Manager
Banque Paribas

Mohamed Ozalp, General Manager
Misr International Bank

Elie Baroudi, Managing Director
Imran Khan, General Manager
Egyptian American Bank

Dr. Mounir Neamatalla, President
EQI

Jamil W. Saad, Chairman
Egyptian Finance Company

ALEXANDRIA, EGYPT

Mohamed Ragab, Chairman
Egyptian Trading & Industrial Co.

M.A. Korayem, Chairman
Dekheila Chemical Industries Corp.

Dr. N. Abou Taleb, Consultant
Former Governor of Alexandria

Nabil el Shami, Executive Director
Small Business Center

Kamal Sayed Ahmed

Mohamed Kayed

USAID, EGYPT

Gregory F. Huger, Associate Director
Daniel R. Rathbun, Deputy Director, OF&I
George M. Flores, Deputy Associate Director, I&S
Paul O'Farrell, Economist

PARIS, FRANCE

Gilbert N. Gargour, Managing Director
Middle East Associates, London &
Director
Lecico Egypt

NEW YORK, N.Y. USA

Mohamed Younes, Director
Concord Capital Company

Richard M. Bliss, Chairman,
Asian Oceanic Investment Co.

WASHINGTON D.C., USA

Michael P.W. Stone, Undersecretary of Defense and
former USAID Director-Cairo & President
Sterling Co., California

** *** **

APPENDIX B

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Price Waterhouse

MEMORANDUM

TO: Mark Camstra, FSDP Deputy Director, PW-International

FROM: James Pearson, Manager, PW-Cairo

DATE: May 24, 1989

RE: AID/PRE -- Financial Sector Development Project (FSDP)
USAID/EGYPT -- Equity Finance Facility (EFF)

The purpose of this memo is to quantify for you, as much as possible, the demand for and supply of equity capital in Egypt. According to our findings, the need for and availability of equity funding in Egypt cannot be clearly and reliably estimated. However, indications from a few statistics which are available and conversations with key business and government personnel indicate that equity capital can be made available under the right conditions, and that business has an immediate need for such capital.

Data Search

Our data search concentrated on library research and interviews with Government officials and businesspersons involved in the collection and analysis of economic and financial statistics. Library searches were conducted at the American University in Cairo (AUC), the United States Agency for International Development (USAID), and at the Egyptian Central Agency for Public Mobilization of Statistics (CAPMS). Persons interviewed represented AUC, USAID, CAPMS, and resident Price Waterhouse accounting personnel.

The consultant research team asked each contact for data concerning general statistics on capital investment in Egypt, company data normally found on balance sheets, and any government publications which may have attempted to determine equity needs in the past. All interviewees stated that company data on private companies is not reported in sufficient detail to answer our needs. Public companies do report some basic statistics, but the interviews were unanimous in concluding that this data was sufficiently suspect as to lend it unreliable.

The team did obtain some data on public companies. This is presented on Table I-1. This data, which should have been available from the CAPMS, was eventually found elsewhere. The CAPMS did supply the only other data found, an aggregate figure for capital formation by year by sector. This is presented on Table I-2.

Findings on the Need for Equity Capital

Results of the interviews presented in the body of this concept paper indicate a need for equity financing in Egypt. Given the poor state of statistical reporting in the commercial sector, this overall need cannot be reliably quantified. Our finding is therefore that personal interviews are the best means available to assess the need for equity capital, and that nothing in the available data undercuts the need claimed by business and government personnel elsewhere in this report.

While keeping in mind that a reasonable estimate of need cannot be made, we may guess at a conservative estimate by analyzing the two sets of data the consultants did find. The first set, debt/equity ratio information, presented in Table I-1, the small sample of companies has an average debt/equity ratio of over 6.80. Removing the company with the highest ratio still leaves a ratio of over 4.00, a very high level of debt. If these statistics are indicative of the rest of corporate Egypt, there is a very great need for additional equity to allow further expansion without deepening the cash-flow drain of such significant debt loads.

Other findings of need for equity are all based upon claims made by businesspersons and cannot be quantified to indicate a nationwide need. All businesspersons interviewed stated that there is an everpresent need for more equity financing. This allows the start of new ventures (many people had more than one firm), and expansion of current facilities. Equity financing also can be leveraged, increasing the new start and expansion opportunities.

Lack of equity can be crippling. A case in point is that of the auto manufacturing industry in Cairo. Officials in the NASCO/Fiat assembly plant here estimate that 25 percent of the local market need goes unmet due to their inability to expand production. This also prevents them from entering the export market. The new GM venture faces similar problems. As a result, prices for new cars remain very high in Egypt, and demand is not being met.

Findings on the Availability of Equity Financing

Investment statistics are available only from the CAPMS, and even then are neither up to date nor fully defined. Table I-2 presents capital formation data by year by sector. Officials we met at the statistics office did not know whether this data represented only public companies or private companies, new starts or expansions. Taking a conservative reading of the data, and keeping in mind that most data is available only for public companies, we may estimate that the data represent the low end of the capital formation pool.

The table indicates that investment leveled off at from six to seven billion LE over the years 1981-84. This is a significant amount of capital. As Egypt had a 1984 GDP of LE 28 billion, seven billion LE spent on capital formation represents nearly 25 percent of the GDP. Remembering at this point the lack of definition of this data, we may in any case conclude that Egypt does have capital available on an equity basis.

Egypt's Five-Year Plan (1987-1993) calls for a substantial increase in private sector investment. Currently, nearly forty percent of the businesses in Egypt are private, while sixty percent are partly or wholely owned by the public sector. Public sector firms have access to several sources of financing at the discretion of the Government. All persons interviewed agreed, however, that private sector businesses find it very difficult to obtain new financing for expansion or new starts. This situation must change if the goals of the Five-Year Plan are to be achieved.

It is also conceivable that more equity capital can be tapped with improvements in the secondary markets for such investments. Several of the businesspersons interviewed stated that equity investment here locked a person into a "marriage" with the company. Without a more formal, more anonymous means of exiting from equity investments, persons were hesitant to enter into ventures due to the nature of the commitment. On the reverse side, companies are hesitant to tap investors outside of the existing pool of shareholders for fear of "marrying" into an unhappy investor relationship.

The high volume of deposits in local banks (94.2 percent of the GDP in June 1988), combined with the popularity of investing in the so-called "Islamic" investment pools, indicate a willingness on the part of the Egyptian citizen to invest and save money. A well-functioning equity marketplace could add outlets to the average citizen and "liberate" capital from bank deposits.

<u>Conclusions</u>

Need for and availability of equity funding in Egypt cannot be clearly and reliably quantified. However, indications from a few statistics which are available and converstations with key business and government personnel indicate that equity capital can be made available under the right conditions, and that business has an immediate need for such capital.

Table I-2

GROSS FIXED CAPITAL FORMATION, BY SECTOR AND YEAR

(At current prices. In L.E. millions. Includes the portion of foreign partners.)

Sector	Year 1979	81/82	82/83	83/84	84/85	85/86	86/87*	Percent of Change 82/83-86/87
All Sectors...............	3763.0	6286.9	7301.1	6310.3	N.A	N.A	-	-
Commodity Sectors:	2110.5	3346.6	3744.1	2672.3	N.A	N.A	-	-
All Commodities...........	2110.5	3346.6	3744.1	2672.3	N.A	N.A	-	-
Agricuture..............	258.0	450.4	482.3	531.8	N.A	N.A	-	-
Industry................	1010.2	1277.1	1499.0	1445.7	N.A	N.A	-	-
Petroleum...............	448.0	1007.2	990.7	N.A	N.A	N.A	-	-
Electricity.............	234.0	372.0	547.9	509.2	N.A	N.A	-	-
Construction............	160.3	239.9	224.2	185.6	N.A	N.A	-	-
Services Sectors:								
All Services..............	1652.5	2940.3	3557.0	3638.5	N.A	N.A	-	-
Transportation and means of communication......	903.5	1190.7	1751.9	1633.4	N.A	N.A	-	-
Finance and trade.......	70.0	170.7	125.9	112.0	N.A	N.A	-	-
Housing.................	221.0	668.4	884.2	[illegible]	N.A	N.A	-	-
Public utilities........	165.0	[illegible]	[illegible]	554.3	N.A	N.A	-	-
Other services..........	293.0	522.5	443.1	505.4	N.A	N.A	-	-

Source: Egyptian Centeral Agency for the Public Mobilization of Statistics

Selected Public Company Debt/Equity Analysis — Table I-1

(Figures in 1,000,000 LE)

Company	Capital (Col. 1)	Reserves & Provisions (Col. 2)	Loans & Creditors (Col. 3)	Debt to Capital (Col.3/Col.1)
Company A	55	95	437	7.95
Company B	39	80	89	2.28
Company C	8	26	38	4.75
Company D	3	28	57	19.00
Company E	20	30	41	2.05
Two Trading Companies	26	67	135	5.19
Average Ratios				6.87
Without Company D				4.44

Source: MIDDLE EAST OBSERVER, 30/6/88 through 30/4/89

APPENDIX C

Investors Pool - Balance Sheet (in EL '000)

	Year 1	Year 3	Year 5
Assets:			
a. Fixed Income Securities	65,000	35,000	0
b. Equity Investments	15,000	45,000	80,000
Total Assets	80,000	80,000	80,000
Liabilities:			
a. Pool Investors	50,000	50,000	50,000
b. USAID	25,000	25,000	25,000
c. EEMICo Capital	5,000	5,000	5,000
Total Liabilities	80,000	80,000	80,000

'RE - Financial Sector Development Project (FSDP)
)/Egypt - Equity Finance Facility (EFF - Phase I)

:tors Pool - Income Statement (in EL '000)
mes no taxation)

	Year 1	Year 3	Year 5
Income:			
a. Interest Income [1]	5,200	2,800	0
b. Dividend Income [2]	0	2,100	4,200
c. Capital Gains [3]	0	0	30,000
Total Income	5,200	4,900	34,200
Costs:			
a. Management Fee [4]	938	938	938
b. Dist. to Investors [5]	3,850	3,850	31,763
c. Dist. on USAID Funds [6]	0	1,000	1,500
Total Costs	4,788	5,788	34,200
Net Income	412	(888)	0

Calculations/Notes:

[1] Interest income earned at 8% p.a.
[2] Equities pay dividends at 7% p.a. after one-year lag
[3] See page 4
[4] Management fee at 1.25% of funds managed
[5] Dist. to non-USAID investors equal 7% p.a. or capital gains plus dividends less dstribution to USAID and management fee
[6] Dist. to USAID @ 4% p.a. beginning in 3rd year and 6% in 5th year

AID/PRE - Financial Sector Development Project (FSDP)
JSAID/Egypt - Equity Finance Facility (EFF - Phase I)

Egyptian Equity Investment Company (EEMICo)

Income Statement (in EL 000's)

	Year 1	Year 3	Year 5
Income:			
a. Placement Fees:			
(1) Cash	625	1,250	1,875
(2) Capital gains			1,875
b. Management fee	938	938	1,289
c. Trading income	50	200	500
d. Investment income	280	280	110
Total Income	1,893	2,668	5,649
Costs:			
a. Personnel Salaries	765	765	1,148
b. Consultants	250	500	750
c. Operating Costs	765	765	1,148
Total Costs	1,780	2,030	3,045
Net Income	113	638	2,604

Notes:

[1] Assumes no taxation
[2] See pages 4 and 5 for detailed calculations of income and cost line items

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AID/PRE - Financial Sector Development Project (FSDP)
USAID/Egypt - Equity Finance Facility (EFF - Phase I)

Egyptian Equity Investment Company (EEMICo)

Income Statement (in EL 000's)

Notes/calculations:

Income:		Year 1	Year 3	Year 5
1. Placement fees:				
a. Number of placements		5	10	15
b. Value per placement		5,000	5,000	5,000
c. Total placement value		25,000	50,000	75,000
d. Placement fee @	2.50%	625	1,250	1,875
e. W/ EEMICo portfolio		(15,000)	(15,000)	(20,000)
2. Portfolio capital gains [1]:				
a. Value equity portfolio		15,000		
b. Appreciation @	200%			30,000
c. Value to EEMICo @	6.25%			1,875
d. Value to Fund				(28,125)
3. Management fee:				
a. Portfolio value		75,000	75,000	103,125
b. Fee @	1.25%	938	938	1,289
4. Trading income:				
a. Value traded		5,000	20,000	50,000
b. Fee @ basis point	1.00%	50	200	500
5. Investment income:				
a. Value of investments held		4,000	4,000	4,000
b. Investment income rate		7.00%	7.00%	7.00%
c. Total		280	280	110 [2]

[1] Assume 200% gain over 4 years, all sold at end of 4 years, and all capital gain goes to the fund

[2] Investment income distribution from pool equal to cap. gains plus dividends less management fee and USAID distribution

Egyptian Equity Investment Company (EEMICo)

Income Statement (in EL 000's)

Notes/calculations:

Costs:	Year 1	Year 3	Year 5
1. Fund management:			
a. Number	1	1	1
b. Annual salary	250	250	375
c. Salary cost	250	250	375
d. O/H %	100%	100%	100%
e. O/H value	250	250	375
2. Professional staff:			
a. Number	5	5	7.5
b. Annual salary	75	75	75
c. Salary cost	375	375	562.5
d. O/H %	100%	100%	100%
e. O/H value	375	375	563
3. Administrative staff:			
a. Number	7	7	11
b. Annual salary	20	20	20
c. Salary cost	140	140	210
d. O/H %	100%	100%	100%
e. O/H value	140	140	210
4. Consultants [2]:			
a. Number of projects	5	10	15
b. Cost/project	50	50	50
c. Total	250	500	750
5. Cost Summary:			
a. Salaries	765	765	1,148
b. Overhead	765	765	1,148
c. Consultants	250	500	750

[2] Includes failures

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