"Reports on Venture Capital in Africa"

by

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August 1990

Africa Bureau

Office of Market Development and Investment (MDI)

Africa Private Enterprise Fund: Africa Venture Capital Project
Project Number: 698-0438
Contract Number: AFR-0438-00-0006-00

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I. VENTURE CAPITAL IN AFRICA

II. SUMMARY REPORT OF DISCUSSIONS REGARDING THE PROPOSED VENTURE CAPITAL PROJECT IN GHANA

August 23, 1990

MEMORANDUM

TO: Richard Loth
AVCP

FROM: John Leech, RIO, Ltd.

RE: <u>Venture Capital in Africa</u>

I. <u>INTRODUCTION</u>:

The concept of Venture Capital (VC) has become accepted in many developing countries as a mechanism for funding modernization and new technology. These have been its classic uses in industrial countries, coupled with a measure of even more speculative turnaround investment which in LDCs may be equated to rehabilitation projects.

Not unnaturally, the swiftest development of VC has been in the dynamic economies of S-E Asia where entrepreneurial dynamism, experienced fund managers and willing foreign capital have found it a suitable marriage. In the more difficult economic circumstances of Africa, VC, with its emphasis on equity financing, is offering an alternative to the foreign currency lending of development banks which has been the classic and increasingly dangerous means of funding enterprises.

In the African context, therefore, VC is likely to mean principally the availability of equity funds, preferably with hard currency backing, to be subscribed and remunerated in local currency. The risk element, a feature of all VC, will lie in the finer arts of equity as distinct from fixed income financing, and in the added difficulty of realizing capital gains in the absence of reliable exit mechanisms.

An additional risk element would be introduced through concentration on smaller-scale projects. Such companies, usually with a highly specialized hi-tech product, are the potential high flyers for VC in industrial countries. In Africa, whilst having a special importance for creating an industrial fabric, small projects encounter special problems.

This paper seeks to examine the special needs of African VC vehicles in all these circumstances.

II. A TYPICAL VC COMPANY PROFILE:

A. Source of Funding:

A. company which engages in all-equity financing must itself be financed entirely with equity; it cannot in its early years afford to take on loan obligations. Likely sources of equity are -

1. local commercial funds, especially blocked or other nontransferable funds;
2. institutional funds (development banks, insurance companies, investment institutions, etc);
3. institutions, and particularly VC organizations in industrial countries;
4. funds held by nationals offshore or by overseas residents; and
5. fund managers willing to provide initial management support.

An advantage of encouraging the subscription of blocked funds is that these usually belong to companies capable of acting also as entrepreneurs, if they are given fresh confidence in the investment climate. This would help to develop a deal flow for the VC vehicle.

B. **Objectives and Activities:**

The overall policy objectives are likely to be to stimulate economic activity and efficiency by -

1. actively promoting opportunities for investment, particularly in small and medium-sized enterprises;

2. assisting entrepreneurs in developing their projects and in acquiring the skills to operate them successfully;

3. concentrating on downstream industrial sectors particularly suited to the economy;

4. assisting modernization, introduction of technology to achieve export quality standards, privatization and rehabilitation, and observing environmental standards.

Achievement of these objectives will include close co-operation with government and its agencies in helping to create a climate which favors such activity in the private sector.

C. Special Features:

Other characteristics and requirements of an African VC vehicle are likely to be -

1. a modest capital base, in line with its initially experimental nature;

2. high initial overhead costs because of the need for management specialized in VC and all-equity investment techniques which may not be available locally;

3. the need actively to stimulate the deal flow through a project development effort;

4. a fine balancing of revenue sources with the lead times required for investments to yield dividends and eventual capital gains, and the need to widen sources of revenue beyond financial charges;

5. the capacity to provide management support for investee companies so as to minimize risks and accelerate returns;

6. the need to assist the development of capital markets, formal and informal, so as to create a mechanism for disposal of shares;

7. considerable government support for the creation of capital markets, encouragement of the private sector and the supply of training and other services for SMEs;

8. a willingness to offer investment and subsequent remittance concessions to holders of blocked funds.

III. COSTS AND FINANCIAL SUPPORT:

VC companies typically finance themselves by charging investee companies for all services rendered in connection with the original investment, for operational supervision and management support, and for any other services provided during the life of the investment. Dividend income arrives later, and capital gains later still.

From the above characteristics it will be clear that most of them represent costs, provision for which will need to be built into the financial structure from the outset. It is also evident that, at least in the initial stages, the VC vehicle is unlikely to be able to bear the full costs of (2), (3), (5) and (6) from its own resources. A measure of starter finance and some technical co-operation packages will therefore be needed.

The precise functions likely to require TC or other special funding can be listed as -

1. preliminary study of the appropriateness of VC in a specific environment, including discussions with the major interests involved;

2. if warranted by the findings, a full business plan for an appropriate VC entity;

3. support during the pre-incorporation phase, notably the negotiations with prospective local and foreign partners leading to incorporation of a VC entity capable of taking all steps towards procuring its full capitalization and securing its ability to become operational;

4. provision of starter funds for this entity to cover defined expenditures before an adequate revenue stream develops;

5. support for the engagement of experienced VC personnel or a competent management organization;

6. support for the engagement of consultants specialized in identification and development of investment projects to stimulate a rapid deal flow;

7. a component for assistance to investee companies, e.g., project formulation, costs of management support, introduction of financial systems;

8. provision of an incubator fund for investment in SMEs or more marginal projects having special value or potential on an extended time scale;

9. assistance with capital market development.

This list is far from exhaustive but should illustrate some of the major needs for special funding of particular relevance to the problems of VC vehicles in Africa, especially those intended to invest in SMEs.

IV. <u>FORMS OF SPECIAL FUNDING</u>:

A. <u>Recipients</u>:

Funds can be disbursed in one of several ways -

1. to the VC entity once it is incorporated;

2. to an intermediary, local or offshore, charged with the promotion of such an entity through its various phases;

3. the consultant appointed to carry out the above functions at each stage.

B. <u>Type of Funds</u>:

It is sometimes argued that this type of funding should rank as equity, with the intention of applying a degree of financial discipline to the undertaking. This can have the opposite effect from that intended, since it fosters a belief that equity does not need to be remunerated. This will act as a disincentive for the real equity investors who will certainly need to look to future dividends to justify their investment.

It is also important for these funds to be off-balance sheet. Their declared purpose is to ensure to the extent possible that the VC entity will become a viable undertaking. In the environment described, this can be achieved only if the expenditures listed are treated totally separately and funded outside the VC entity's company accounts.

All such special funding should therefore be in the form of grants, preferably allocated in one of the ways described in (A) above.

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August 23, 1990

MEMORANDUM

TO: Richard Loth
AVCP

FROM: John Leech
Rural Investment Overseas, Ltd. (RIO)

RE: Summary Report of Discussions Regarding the Proposed Venture Capital Project in Ghana

As per our conversation in Washington, D.C. I am herewith summarizing the conclusions we reached regarding the broader conceptual issues as well as the specific criteria for our planned investigation in Ghana of a venture capital fund to be sponsored by the Commonwealth Development Corporation (CDC).

First, it is advisable to provide a definition for what we mean by venture capital in the Ghanian context. Briefly stated, it is long-term risk capital for business investment which is accompanied by value-added management assistance to investee companies. This definition's components can be further refined as follows: "long-term" probably means the duration of an investment from three to seven years, with five years being a stated objective for divestment. It is worthwhile noting that while the venture capitalist's position in an investee company is "temporary" it is of a relatively long-term nature. "Risk capital" refers to long-term debt, equity, and quasi-equity. In the case of debt, it would be structures in accordance with expected cash flows and not necessarily dependent or tangible collateral. Also, its repayment terms would have equity-like qualities, e.g., accommodating grace periods, flexible principal payment schedules, and variable interest payment dates and methods. Quasi-equity would include, among others, subordinated debt, convertible debentures, etc. "value-added management assistance" refers to the financial, marketing, production and planning support which a venture capitalist provides to investee companies as and when needed.

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Second, we would use basically five major criteria to assess the environment for a venture capital initiative in Ghana: (1) positive country conditions; (2) opportunities for business investment; (3) ability to raise a pool of capital; (4) competent professional venture capital management; and (5) divestment (exit) mechanisms.

Positive country conditions would included a recognition of the role of the private sector in the economy, a positive attitude toward privatization, implementation of a debt restructuring plan, adoption of a structural adjustment program supported by the IMF, World Bank, and donor community.

Opportunities for business investment are indicated by evidence of active private entrepreneurship, capital formation potential, value-added investment opportunities, and a positive attitude toward private investors and capital, both foreign and local.

Risk capital needs to be available from a variety of sources: international donor agencies, local institutions, companies, individuals, blocked funds, debt conversions, etc. A minimal level of working capital financing must be accessible from conventional banking sources.

A venture capital fund or company must have, or be able to obtain, a reasonable level of management capacity to raise funds, identify viable investment opportunities, monitor and aid the investee companies, and undertake eventual divestment of the investee companies.

In LDC markets in general, and Ghana would be no exception, the venture capital divestment possibilities are recognized as limited. The choices for "exiting" would most likely include corporate acquisitions, private placements, management buy-outs, and employee ownership. The regulatory environment and possibilities for strengthening secondary markets must be positive. Also, to some degree, the opportunity to experiment with creative, non-conventional, e.g., Islamic banking practices, financing approaches must be present.

Finally, with regard to the type of investment risk to be considered, it is recognized that decisions in this regard will be the responsibility of management and/or an investment committee and/or the managing parties. However, it is agreed that generally four types of investment opportunities are to be considered to give the venture capital fird a reasonable spread of risk. Start-up, (20%), early stage (30%), later stage (30%) and turnarounds (20%), with the indicated percentages, would be representative of the portfolio investments for a venture capital fund in Ghana.

Our on-site assessment in Ghana will be undertaken in the context of the above general conceptual considerations. Specific points for investigation will include the following checklist:

I. <u>GOVERNMENT POLICY FRAMEWORK</u>:

A. Investment legislation.

B. Legal framework.

C. Capital markets.

D. Macro-economic performance.

E. Foreign exchange regulation.

F. Tax considerations.

II. <u>PUBLIC SECTOR</u>:

A. Structure and condition of state owned enterprises.

B. Government controlled monopolies.

C. Potential for privatization.

III. <u>PRIVATE SECTOR</u>:

A. Structure (identify major companies, and industry sectors)

B. Business associations and leaders.

C. Investment/incentives/disincentives.

D. Volume of capital resources for effective investment.

E. Promising business opportunities/sectors for new investment.

IV. **FINANCIAL SECTOR:**

A. Central bank.

B. Financial system - regulations/practices.

C. Institutions - banks, insurance companies, development finance institutions, and others.

D. Identify potential sponsoring institutions.

V. **GENERAL:**

A. Update and confirm available existing reports, e.g., A.I.D. MAPS report.

B. Identify future potential fund investors/ management, both local and foreign.

C. Identify specific investment oppor- tunities which would be appropriate for the venture capital funds.

As we discussed, the in-country assessment is planned for October. Meanwhile, secondary sources can be researched to provide a great deal of the information we need. It the very least this material will greatly facilitate our investigations in Ghana. The object of this exercise would be to advise the CDC and A.I.D. on the prospects for the development of a venture capital fund in Ghana, and indicate the respective levels of support and an action plan required to accomplish this task.

It has been a pleasure working with you on this project and I look forward to collaborating with you again in the near future. I am providing you with RIO's concept paper on venture capital in Africa in a separate memorandum. I believe that our discussions and exchange of information on the venture capital process in the less-developed countries has built the foundation for a mutually beneficial working relationship which we can put to good use in Ghana as well as other selected countries.

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