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ZAMBIA INVESTMENT FUND:

PROSPECTS AND ALTERNATIVE STRUCTURES

Task Order 53

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Zambia Investment Fund: Prospects and Alternative Structures

Introduction

It has now been just over one year since Zambia's first multi-party election brought into office an opposition party determined to abandon the former president's "humanistic socialism" in favor an open, capitalistic and market-oriented economy. As part of this rather dramatic change the new government has launched a major privatization program, the intent of which is to transfer to private ownership and management, the government parastatals.* Simultaneously, the government is most interested in seeing that the country's existing private business community also receives financial and other support which, for a variety of reasons, it has not been able to access in the past. The government has requested assistance from donor organizations to support this initiative.

In response to this request for assistance, the World Bank mounted a small mission to Zambia in December to begin to examine the possibility of developing an investment financing vehicle that would provide needed investment capital and other financial services both to the existing private business community as well as to support the privatization initiative. Of critical concern to the mission in responding to this request was determining the availability of local financing, and specifically investment capital, to support the initiative; the legal and tax environment as it relates to finance and investment in the country; and the existing condition and requirements of the business community. This report summarizes the findings of the mission and offers recommendations on the establishment and management of an investment finance vehicle that will support the government's initiatives.

1. Background

1.1 Existing Financial Market

While there are numerous financial institutions in Zambia given the small size of the economy, they are all narrow in scope, providing limited products and services and they are severely constrained by a shortage of capital in the formal market. There are indications, however, of "hidden" liquidity that is outside the formal financial system and that might be tapped in selected circumstances to support incremental investment in the country.

1.1.1 **Commercial Banks.** At present, the country has 14 registered commercial banks all of which provide short term advances only. A combination of Bank of Zambia

(BOZ) imposed reserve and liquidity requirements forces the banks to maintain 66% of their deposits as reserves with the BOZ. This serves to eliminate any term financing, forcing the banks to lend short term only and even then only to "blue chip" clients. New clients or clients outside this elite group simply have no access to any type of formal bank financing.

Borrowing costs are extremely high. At present, the commercial bank base rate is approximately 60%. Prime clients--e.g. Anglo-American, Lonrho--are generally charged base plus 4%. In addition, the banks always charge up front commitment and arrangement fees in the 14% range. The best borrowing rates, therefore, are in the 78-80% range; clearly not sustainable for the most profitable of businesses, let alone for those that are less profitable or on the margin.

1.1.2 **Other Financial Institutions.** There are two other types of financial institutions active in the market.

- Leasing companies have developed-- there are now seven of them in operation, several tied to the major commercial banks--as a way to extend term financing with ownership of the asset transferring either from the leasing company to the lessee only at the end of the term or reverting back to the lessor for sale or other form of disposal. This type of financing was developed to support, and is currently used extensively in the transport sector and is gradually spreading to others--i.e. office machines and computers to name two.

- Merchant banks are recognizable by the services they provide rather than being incorporated under any specific piece of Zambian legislation since there is no law specifically governing the establishment and operations of such institutions. At present, there are only a few such banks, the best established of which are Meridien and Equator. In their merchant banking capacities, they provide trade financing facilities, usually to government agencies and always with repayments tied to known sources of foreign exchange--e.g. donor funding or receipts from the major commodity/mineral exports. They also provide assistance to the government in managing foreign exchange flows, providing short term bridging facilities as required by the government, again with the take-out tied to the sources of foreign exchange indicated above.

Other institutions in this select group include CAVMONT and Manifold Investment. Both are smaller than Meridien and Equator and while CAVMONT has provided some of the services indicated above, both they and Manifold have begun to focus on investment management.

1.1.3 **Investment companies.** These are few in number and their portfolios to date focus heavily on properties. Meridien has two funds under management--a property fund and a "baby bond" fund. Both have been in existence since 1987-88 and verbal reports the team received from a variety of sources, suggest that both seem to be doing well--i.e. showing a real positive rate of return that exceeds returns attainable on other investments--largely bank deposits. The property fund currently has Kw 600,000,000 invested while the "baby bond" fund has about Kw 100,000,000 (largely invested in the property fund). Redemptions are permitted four times per year, but to date incremental new investment by both existing and new investors has far exceeded redemptions so liquidity has never been a problem. Manifold Global Fund and Mutende Investments have also launched property funds, though they are much more recent than Meridien's and the sizes are much smaller. It is much too early to make any comments on their performance.

CAVMONT is in the process of launching a fund under CAVMONT Guaranty and Trust Company which will be sub-divided into four sub-funds namely, Property, Equity, Income (to deal in government securities, and the Mixed Portfolio Fund through which investment will be made in the other three funds in varying proportions as determined from time to time by the investment trustee. Plans were to launch the fund in early 1993 with an initial amount of Kw 200-400 million. The fund was meant to be open to both individuals and organizations willing to make investments, but limited by scarce resources. At this writing, we had no information on the success of the launch.

1.1.4 **Insurance companies.** Until quite recently, insurance companies have not played a major role in Zambia's financial community. Historically, the Zambia State Insurance Corporation (ZSIC), was the only such company in the country. Its investment portfolio is almost exclusively in properties, most of which are leased to government parastatals which frequently have not made required lease payments. A large percentage of the portfolio, therefore, is non-performing and the company has no funds to invest.

In the past year, a couple of private insurance companies have been established, most notably, Madison Insurance, which is part of the Meridien group of companies. Madison, along with one or two others, are just beginning to develop their business and are trying to build reserves. According to their executives, for the foreseeable future--i.e. over the next several years--they will have very limited resources to invest and must be very conservative in their investment policies. For this reason, combined with the absence of any experience in investing in stocks, it is unlikely that they will invest in equities for some time.

1.1.5 **Pension funds.** Like the insurance industry, pension funds are just now beginning to develop in the private sector. The government run funds have behaved like ZSIC in their investment policies and, it is widely believed, frequently used the deposits to fund recurrent government expenditures. As a result, these funds are now faced with massive unfunded liabilities.

In the private sector, pension funds are just now being established by some of the larger companies and financial institutions. They, too, will be most conservative in their investment policies and given the fact that there has been no tradition of investing in equities in the country, it is highly unlikely that they will begin to do so in the near term.

1.1.6 **Private placements and "over-the-counter" trading in equities.** These two activities have been extremely limited. The merchant banks and accounting firms have assisted in selected private placements--largely financial engineering assignments that have brought together external agency funding with limited internal resources (sometimes through debt/equity swaps). There has also been some "over-the-counter" trading in existing equities, though this has been very infrequent in view of the fact that there are only four public companies in all of Zambia. The "over-the-counter" trading has been done exclusively by the commercial banks and, at present, is totally unregulated.

Price Waterhouse is currently putting together two new issues that they intend to float, through Standard Chartered Bank, early in 1993. One is a joint venture with a publicly quoted (on the Johannesburg exchange) South African company in the agro-processing industry. The total investment is approximately US$ 11.0MM, of which US$ 3.6MM constitutes equity. Of the equity portion, the South African firm will take 60% (US$

2.16MM), leaving US$ 1.44MM (approximately Kw 500MM) to be floated locally in Zambia. The South African firm will underwrite the issue. The balance of the financing required (US$ 6.4MM) will be in the form of term debt from the European Investment Bank (EIB).

The second floatation involves an existing private Zambian leasing company that will first be converted into a public company. The objective of the issue is to raise Kw 200MM by selling 35% of the company's equity. Price Waterhouse does not anticipate any problems in raising the Kw 700MM required to complete these flotations successfully.

CAVMONT has also been involved, though on a relatively marginal basis, in over-the-counter trading. Through the funds they recently launched they intend to get much more involved, also using the commercial banking network to seek investors.

In addition to these activities, there has been considerable interest in forming a Zambia Stock Exchange, the main purpose of which initially will be to regulate trading and to protect the investing public. Given the very small number of public companies, the likely listing requirements, the thin market for capital and the fact that there has been absolutely no tradition in Zambia of investing in equities, even if an exchange is established it will be some time before there is much trading activity.

1.1.7 **Informal sector liquidity.** While financing of all forms is scarce in the formal sector, this does not necessarily appear to be the case in the informal sector going by limited, though telling, indicators. Mention has already been made of several "funds" already in existence, the sources of which are largely individual investors. Of note among these funds is the Kw 700,000,000 Meridien currently has under management and the recent activity in this business from other institutions including CAVMONT, Manifold and Mutende which suggests that they too perceive there to be "hidden" untapped liquidity available for investing.

The Price Waterhouse experience to date with the two flotations they intend to complete is also very revealing in this regard. They stated that they could easily place the Kw 700MM in equity for the two projects with two corporate players-- one for each project--who indicated they were prepared to take up the entire equity being offered in each.

These anecdotal indicators suggest that there is, potentially, quite a lot of "hidden" liquidity that is held outside the formal financial sector. Given the right opportunities in the Zambian environment, where attractive investments and investment vehicles are limited, and this "hidden" liquidity might very well be tapped. It is impossible at this stage, however, to determine the magnitude or overall appetite for equities outside the formal sector.

1.2 Legal/Tax Environment Related to Finance and Investment

At present, it is extremely difficult to comment on the overall environment for finance and investment from a legal and tax perspective in view of the fact that all the major Acts governing finance and investment are in the process of being revised. These include:

- Companies Act
- Banking Act (being revised to include banks and non-bank financial institutions)
- Investment Act
- Tax Code
- Stock Exchange Act

These, taken as a group, cover much of the legal and tax legislation that regulates business, investment and finance in the country. Later in this paper, we address some of the constraints and disincentives presented by the existing Acts and legislation. Clearly, if required changes are made the result could be a considerably changed playing field than the one currently in effect; this could dramatically change the overall environment for business, finance and investment. The team was informed that the government hopes to have these proposed revised Acts ready for review in the next Parliament scheduled to convene in February/March 1993.

1.3 The Business Community

For purposes of this report, we have divided the business community into three categories; i) existing private businesses, ii) parastatals, and iii) new investors. While the three groups are quite different, they face many of the same constraints in trying to invest and do business in the country.

1.3.1 Existing businesses. It would be extremely difficult for the government to implement a major privatization program, providing financial and other forms of needed assistance, and not offer the same types of assistance to the existing private business community. Private

businesses suffer from many of the same constraints facing the parastatal sector-- in particular an inability to access desperately needed term financing An indication of the size of the private business community is the fact that the Association of Manufacturers currently has 600 members.

As a result of the absence of long term financing, however, there is a heavy trade orientation among existing businesses. Manufacturers are at a severe disadvantage in that they are unable to secure financing for investment and, as a result, very little new investment has taken place in Zambia for many years. Much of the existing plant and capital infrastructure is in need of substantial rehabilitation.

1.3.2 **Parastatals.** The government's program to privatize it parastatals began at the end of 1992. Bids were requested (and received) on 19 parastatals. The Privatization Agency had hoped to complete these 19 privatizations by end February 1993. For 1993, an additional 32 companies have been targeted for privatization. The program itself has divided the privatization program into several tranches over the next five year period. All of the companies in each of the tranches are to be privatized. The government has indicated its preference for management buyouts and public flotations (to permit individual Zambian ownership) in transferring ownership of the companies from the government to the private sector.

For this ambitious program to succeed, the team concluded that there are three forms of assistance that must be provided; financing for capital rehabilitation and expansion, technical and management assistance, and dramatic changes in corporate culture.

- Capital, above all else, is required to complete the proposed privatization program. As indicated above, there is little liquidity in the formal financial system that can be accessed either by private entrepreneurs or by corporate players for the acquisition of parastatal assets. And while the limited experience to date with proposed private placements suggests that there is some "hidden" liquidity, it is not at all clear that such financing could or would be available for privatizations.

Further, every proposed privatization of a parastatal includes a provision for existing management to have an opportunity to bid for the parastatal assets. In the

initial tranche of privatizations, proposals were submitted by management in each and every case. And, in each and every case, there was no indication of how or where the required financing would be accessed. This will invariably be the case. The team was unable to obtain any estimates on the overall capital requirements simply to complete the acquisition of the existing parastatal assets; in the initial tranche, which included mostly small, non- strategic companies, one estimate provided by consultants working with the Privatization Agency and re-iterated by the Chamber of Industry and Commerce was that approximately US$ 5.0 million would be required to complete the acquisitions in that tranche of 19 companies.

The Privatization Act does call for the establishment of a "Privatization Trust Fund" in which the government will hold shares in trust for citizens of Zamiba for divestiture after a state owned enterprise has been privatized. To date, there has been little thought given to how such a fund would be capitalized or managed.

- Technical/management assistance. From what the team was able to learn in discussions with a variety of individuals and companies that have had experience with the parastatal sector, it appears that there are generally two broad categories of assistance that are likely to be required; sales and marketing, and technical/engineering. While general management assistance, and in particular financial management, is most definitely needed, most believe that there is sufficient talent available in Zambia that might be accessed to provide the required assistance. The other two, however, represent areas in which there will be a considerable need for external assistance, as there does not appear to be locally available expertise.

The absence of a competitive, open market orientation among the parastatals has resulted in a complete lack of any sales and marketing focus. In Zambia's highly protected environment companies were not forced to compete in order to survive, so there was little emphasis, in the management of these businesses, on such fundamentals as sales and marketing. While there is capability in this field within the private business community, those with such expertise have neither the time nor the incentive to provide it to the parastatal sector. This type of assistance will most likely have to be provided from external sources.

Similarly in such a highly protected market, product design, quality and reliability were never emphasized; the consumer has had little product choice so there has been no incentive for parastatal businesses to continue striving for improved quality. In such an environment, engineering and other technical product requirements have suffered. Similar to the marketing assistance indicated above, technical and engineering needs will most likely have to be accessed outside the country.

- Corporate culture. Changing the existing corporate culture within the parastatal sector - will be an absolute requirement and is without question the most difficult to implement. Historically, managers of parastatals were not held accountable to the Boards and the Boards were not held accountable to the shareholders. In a private setting, where owners expect a return on their investment, such a culture simply cannot continue. Changing it will be one of the biggest challenges facing the privatization program. This may mean, in the first instance, replacing key senior executives in the existing parastatals while simultaneously forming Boards that require management to be accountable and that, in turn, are accountable themselves to the shareholders. This is not going to be easily achieved as it requires a complete re-orientation of the responsibilities of management and Boards of Directors; but, it must begin immediately with the sale of the parastatals.

1.3.3 **New investors.** New investors coming into the market may be divided into two groups; local and foreign. For the most part, the team foresees few new private local investors coming into the market. To the extent there is incremental private investment from local investors, it will likely come from existing businesses that are prepared to rehabilitate, expand, or go into a new venture--quite possibly with a foreign partner.

Notwithstanding the local market, there are encouraging signs of interest among selected foreign investors and investor groups. Most notable among these are the South Africans. As indicated above Price Waterhouse is now putting together an investment in the agro-industrial sector in which the major shareholder and manager is a reputable and publicly quoted South African company. The Coca-Cola bottler in Johannesburg was recently sold the franchise (from Coca-Cola) to bottle Coke for the Southern part of Zambia. In addition, many in South Africa's agriculture sector have made visits to Zambia with the idea of producing

for export with a local partner or by leasing land from large players--e.g. Lonrho--in the economy and going it alone. Advantages that the South Africans have are at least three: their ability, generally, to finance the projects in which they intend to invest; their technical and management expertise, and their access to markets in South Africa (and, in some cases, outside South Africa as well).

In addition to the South African interest, a selected group of Zambian government officials and private businessmen recently concluded a mission to Germany and came back extremely encouraged by the interest expressed by the Germans in Kenya. According to Price Waterhouse, who participated in the mission, they expect to see four new investments in Zambia with existing German companies as a result of the mission and discussions/negotiations that had taken place prior to the mission between the Zambian and German companies. These investments are in mining (metals), pharmaceutical, finance and clearing/forwarding.

Finally, the Investment Promotion Center indicates that they have approved approximately 300 projects over the past year which include expansions of existing businesses, joint ventures between foreign investors and Zambian companies, and one hundred percent owned foreign ventures. Most of these are in agriculture (largely from South Africa and Zimbabwe), non-traditional export products (minerals and agriculture--wheat, cotton, paprika, flowers, and asparagus) and tourism, with some in transportation, communications, and manufacturing.

1.4 Implications for Zambia

The present environment in Zambia, as related to; i) the financial market, ii) the legal, tax, regulatory, and investment climate, and iii) the business community, has serious implications for the ability of any business, be it existing private or newly privatized, to succeed. Some of those implications are outlined in this section.

1.4.1 **Financial market.** The liquidity crisis in the formal financial sector has meant that there has been no funding available for term credit or equity investment. This, in turn, has severely restricted manufacturing activities that must have long term capital for investment in productive assets. Absent this financing, there can be little if any capital investment and with only limited short-term working

capital/overdraft facilities available, the system inadvertently encourages trading activity in which no term finance is required. This environment, in which confidence had been destroyed, resulted in (and continues to result in) capital flight and a drain of foreign exchange from the country.

1.4.2 **Legal/tax/investment/finance environment.** As indicated above, the major pieces of legislation governing new investment and general business activity are all in the process of being revised. In general, the existing Acts do not make Zambia a particularly attractive environment in which to invest or to conduct business, and absent a more attractive package for investors and existing businesses, it will be most difficult for the country to attract incremental investment.

Tax legislation, in particular, must be dramatically revised from the present code. To illustrate the point, an example of the effective tax imposed on a foreign investor under the existing tax code should suffice to demonstrate the unattractiveness of the current system. Let me use a South African manufacturing firm with a 50/50 joint venture with a Zambian company as an example in view of the fact that there does seem to be quite some interest expressed by South African firms in investing in the country.

The corporate income tax rate on manufacturing companies for 1993 is 40%. On top of this, the South African firm would have to pay a 20% dividend withholding tax. In addition, since the South African firm would most likely be managing the company and would charge a management fee, it would be subject to a 30% withholding tax on that fee. Assuming a 100% dividend payout policy and a pre-tax profit of US$ 100, of which US$ 50 would be for the account of the South African Firm plus a management fee of 20% (US$ 20), the tax obligation would be as follows:

Pre-tax profit	US$ 50
Less:	
Corporate income tax @40%	20
Dividend withholding @20%	4
Net	26
Plus:	
Management fee	20
Less:	
Withholding tax @30%	6
Net	14

Out of US$ 70 in income, the company would pay US$ 30 in taxes (exclusive of any South African tax it must pay), or an effective tax rate of 43%.

In addition, while there is no capital gains tax, there is a 7.5% property transfer tax on the sale of any shares based on the higher of market or nominal value; it is charged on the total value, not just the incremental gain since the original purchase. (The accounting firms and others believe that this property transfer tax will be eliminated in favor of a capital gains tax in the current revision of the Tax Code. This, of course, would simply be a further disincentive to investing in equities.)

There are also limitations on the level of profits that a foreign company may remit. At present, it is the lower of 20% of the share capital issued to the company, or 50% of the after tax profit. Revaluations do not qualify. Clearly, companies that may have invested some time ago suffer tremendously from this limitation. In the example above, therefore, of the US$ 26 in after tax profit, the company would only be able--at best--to remit US$ 13. Taking the US$ 13 from the US$ 40 leaves US$ 27 that could be remitted--meaning just under 61.5% of the profit would stay in Zambia in one form (tax) or another (restrictions on remittances). Again, the team was told that the new Investment Act is likely to provide for 100% of dividend remittances. Such a revision, of course, would improve the situation considerably.

1.4.3 **Business.** Not surprisingly, in such an environment as described above, businesses continue to suffer. There is no capital available for either rehabilitating or upgrading existing plant and equipment; nor is there any available for new investments.

The existing capital base is in a state of deterioration and little can be done about it given the lack of capital.

2. Indicators of Market Demand

The team did not conduct, in any sense of the word, a market survey to determine existing and potential demand for the services that are required by the business community in general and, specifically, for the parastatal privatization program. Nevertheless, there is sufficient anecdotal evidence to suggest that there is real demand for the services proposed in this paper.

For example, the Investment Promotion Center (IPC), which has been in operation for about one year, indicated that to date about 300 projects have been approved with total capital requirements of approximately $300.0MM. Obviously, this is on the high side and many of these will not materialize; nevertheless, the fact that this many project have actually been submitted by private investors and approved by the IPC is another indication of the potential demand for financing in the market. The specific industries in which projects have been approved by the IPC are varied. There is a heavy concentration in tourism and non-traditional agriculture with other projects approved in transport, communications, and manufacturing. The IPC has not yet developed data permitting them to provide the team with a detailed breakdown of project approvals by industry.

Further, without providing any specifics on the magnitude, all the commercial banks that the team met stated that they had clients requiring term financing for investment purposes--either to rehabilitate their existing plant or for expansion. For the reasons mentioned previously, the commercial banks are not in a position to meet these requirements.

Again, data has not yet been developed by the IPC or others to provide reliable information on the breakdown of foreign exchange versus local currency financing requirements. Reviewing the sectors in which the IPC has approved projects, however, one can draw some very preliminary conclusions about the requirements. Clearly, in the transport, communications, and manufacturing industries, foreign exchange requirements will most likely be substantial as the need for imported equipment, hardware and other inputs can be high. While there are certainly foreign exchange requirements in tourism and agriculture, these can be more effectively controlled than in the other industries mentioned. Our very preliminary estimate would be that of the $300.0MM in capital requirements indicated by the IPC, 40-50% would be in foreign exchange, while 50-60% would be in local

currency. These must be viewed as very preliminary estimates only, based on our knowledge of and experience with the likely capital requirements of the industries mentioned.

2.1 Capital Requirements

We have already indicated the tremendous gaps in the types of financing currently provided by the existing formal financial community. To summarize, they include; i) equity and quasi-equity, ii) term debt, and iii) permanent working capital.

2.1.1 **Equity/quasi-equity.** The country has no formal institutional vehicles for providing equity and/or quasi-equity capital so desperately needed by: existing businesses requiring capital for rehabilitation or expansion, new businesses in the process of starting up; and the parastatal sector in the process of being privatized. In discussions with both the Association of Manufacturers and the Chamber of Industry and Commerce, we were told many times that the absence of capital required for new investment, rehabilitation and expansion, is the key constraint to the further development of the business sector.

2.1.2 **Term debt.** For the reasons mentioned above with regard to the availability of bank financing, there are no sources of term debt; for businesses to expand or be rehabilitated (if they do not generate sufficient cash flow internally) the only option available is to borrow short term and even then, access is not assured.

2.1.3 **Working capital.** Even working capital, provided on an overdraft basis, is available only for the most valued clients. Businesses at the margin or those below the "blue chip" tier are finding it very difficult to secure bank financing. To the extent banks have any liquidity which they are able to utilize, it is reserved for their best, strongest and most favored clients.

2.2 Other Required Assistance

In addition to the capital requirements, which are quite extensive, businesses also require other forms of assistance that may be divided into five separate categories; i) management, ii) financial control/management/reporting, iii) sales and marketing, iv) technical/engineering, and v) changes in corporate culture.

2.2.1 **Management.** While those in the existing private business community believe that there is considerable talent in existing businesses and little if any assistance is required, this is not the case in the parastatals. There will clearly be needed changes in order for the businesses that are privatized to perform profitably. The extremely poor performance of the parastatal sector in general is indicative of the management assistance that is required to turn around historic results. As previously indicated, the consensus seems to be that there is locally available talent to meet these needs.

2.2.2 **Financial control/management/reporting.** From 1986-89, a World Bank funded effort analyzed and provided assistance to a number of businesses within the INDECO holding company. The objective was to turn around performance as at that time the prior government was not prepared to entertain a policy of privatization. Without exception, all of them suffered from a lack of adequate financial controls, financial management and systematic, periodic reporting on performance. If the parastatals proposed for privatization are to become profitable businesses, this is an area that must be addressed.

2.2.3 **Sales/marketing.** As indicated above, in the highly protected Zambian market since independence, monopoly positions were developed such that there was little competition among businesses, and sales and marketing skills were not emphasized. The concept of consumer preference and meeting consumer demands was never a market requirement and, as a result, such expertise did not develop.

2.2.4 **Engineering.** Similar to the above, in the absence of competition, the concept of high product quality and superior product design never fully developed in the Zambian environment. Product engineering, therefore, is an area in which considerable technical assistance will be required.

2.2.5 **Corporate culture.** Probably the area in which the biggest changes will be required relate to corporate culture. The work ethic in an environment where there is simply no accountability has led to tremendous deficiencies, not only in management but also in the involvement, activities and responsibilities felt by the various Boards of directors. Inculcating a capitalistic orientation and the concept of accountability to the parastatals that are to be privatized remains, most probably, the single largest

challenge that must be addressed if the privatization program is to be successful. As previously indicated, this will likely require major changes in key executives and in the composition of Boards of directors.

3. The Proposal

3.1 Objective

The objective of this proposal is to develop and implement a pilot project to address two critical constraints both to private business development and expansion, and to the success of the parastatal privatization program. Those two critical constraints are:

- the absence of investment capital for equity and quasi-equity financing; term debt for rehabilitation and expansion; and permanent working capital required for operations; and

- the absence of selected technical and management skills in the existing business community sufficient to provide for the needs of the parastatal privatization program in particular and to re-orient corporate culture in this sector.

This proposed initiative will develop and establish an institutional vehicle to provide needed capital and to access other forms of assistance as required by existing businesses and the privatized parastatals. The intent of this proposed project is not to replace what the financial market is currently doing or providing in Zambia, but rather is meant to be designed as a stop-gap, limited life program to meet certain requirements of the business community until local institutional capability is developed. The proposed project will, to a large extent, assist in this process. If successful, it will result in at least one such private institutional vehicle that will be in a position to provide, long term, the assistance required as outlined above.

3.2 Feasibility/Market Assessment

This section outlines the team's conclusions with regard to the capacity and capabilities within the existing business and financial community to provide both the capital and the various types of expertise that will be required to carry out the proposed pilot project versus those requirements that will most likely have to be met from sources external to Zambia. We have divided this preliminary assessment into three broad categories;

i) investment capital and other types of required financing, ii) management capabilities at two levels--to manage the pilot project and to manage the individual businesses being assisted, and iii) technical business requirements including, in particular, sales and marketing, engineering and financial management and control.

3.2.1 **Capital.** For the reasons mentioned previously, capital, be it equity investment, term debt, or permanent working capital, is scarce in Zambia. Other than overdraft facilities to provide working capital for prime bank clients, there are no other sources of capital from the formal sector; and most certainly no term financing from any internal source. The banks are illiquid, the private insurance and pension industries are just beginning to develop and must build reserves before they will be in a position to play an active role in Zambia's capital market, and the parastatal institutions that have been active in these two fields have extensive unfunded liabilities and, therefore, no funds to invest.

While the team did uncover some "hidden" liquidity whether or not such financing would be made available for capital investment in either existing businesses or in the parastatal privatization program remains highly uncertain. Presumably, the potential returns would have to be quite high and the downside risks quite well defined and manageable to attract such capital. Certainly, send capital cannot be counted on to supplement whatever comes in from external sources.

In the near and medium term, therefore, the team believes that for the most part, the only sources of capital must emanate from external agencies. There has been some, limited, private investor interest expressed from South Africa and, most recently, Germany. These initiatives, however, do have gestation and development periods that frequently require considerable time to complete. It will take some time for private capital to begin to consider Zambia an attractive market in which to invest.

3.2.2 **Management.** Management requirements must be addressed on two (and perhaps three) different levels. Briefly, they are:

- management of the institutional investment vehicle (the fund);

- management of the individual businesses--in particular those that are being privatized; and

- management assistance that will be required on a short (and perhaps long) term basis to restructure and to rehabilitate the various industries being privatized.

- Management of the fund. The team concluded that there is, without doubt, talent in Zambia to manage the proposed investment Fund, including, Meridien, CAVMONT, Mutende, Manifold and Equator. The real question will be in making the selection--something on which the report provides recommendations later in the text.

- Business management. This is an area in which deficiencies must be addressed, especially in the parastatal sector. While talent does exist in the private business community, it is focused, quite appropriately, on existing businesses. From what the team was able to determine, there is no excess capacity that might be accessed for the privatization program. It is most likely that long term business management requirements will have to be met from external sources.

- Short Term Management assistance. To be certain, there is a relatively well developed (given the size of the Zambian economy) consulting industry, largely dominated by the major accounting firms, in particular, Deloittes, Price Waterhouse, and Coopers and Lybrand. They are in a position to provide short term management assistance either from their local offices, or from their international network of partnerships. Some assistance would have to be accessed from outside sources.

3.2.3 **Technical.** As perceived by the team, the technical business requirements most in demand, especially in the parastatal sector, fall into three categories as indicated above.

- Sales and marketing expertise, other than what may be found in the private business community but which is fully committed to existing businesses, must be accessed from external sources. The non-competitive business environment that has characterized Zambia for decades has resulted in a dearth of talent in this area.

- Engineering skills, for the reasons mentioned earlier, will also have to be accessed from outside Zamiba. The absence of competition in the country has led to a deterioration of these talents and skills, and resulting inferior product quality.

- Financial management and control skills may be accessed from the major accounting and consulting firms active in the country as indicated above. To be certain, such assistance may, in most cases, be provided on a temporary basis. While long term secondments are a possibility, they are not necessarily desirable since such assistance will have to be replaced at some time in the future.

3.3 Proposed Investment Fund and Structure

This section of the report outlines the proposed investment Fund and a possible structure that the team believes would be workable in the Zambian context.

3.3.1 **The Business.** The pilot business effort, as envisioned, will have two principal segments--investments and management.

An investment Fund or Funds should be established that will focus on taking direct participations for its own account, in the form of both equity and quasi-equity, in both existing private sector businesses and parastatal privatizations. The Fund(s) must be highly commercial in nature in order to attract the limited private capital that might be available in Zambia for investing in such financial vehicles. This Fund(s) would be a holding company only and would have no operating staff. It would rely on a third party for investment management expertise.

The Fund's objective would be to invest in companies that demonstrate the potential for generating attractive financial returns through a combination of current income and future capital gain. Further, its specific policy would be to sell its shareholding interests in the companies in which it invests over a reasonable (i.e. 4-6 years) period of time.

A key element in this proposal is that the Fund(s) invests for its own account. The Fund(s) should not be a vehicle for making capital available, in one form or another, to third parties so that these third parties might in turn make investments. The Fund(s) should not, therefore, make capital accessible to existing management in parastatals for the purpose of management buyouts. The Fund(s) should, however, be seeking to structure exit options at the time of making any investment and should favorably consider structuring arrangements up front that will enable management or other interested third parties to acquire the

shareholding interests of the Fund(s) under terms and conditions, including an acceptable pricing formula, agreeable to both parties.

A management company would, therefore, be established to manage the investment Fund(s). Its responsibilities would include identifying attractive investment opportunities for the investors; analyzing such investment opportunities; structuring and placing the equity capital of the Fund(s) into viable and financially attractive projects; monitoring the performance of the portfolio and raising issues as required at the Board(s); and, ultimately, liquidating or cashing-out of the investments. Recommendations for the selection process of the management company are offered in the "Key Issues" section below.

3.3.2 **Products.** In addition to the equity and quasi-equity to be provided by the investment Fund(s) , long term debt is also required by the business community and parastatals to finance rehabilitation and capital expansion. To the extent a long-term debt facility and its source has been identified and organized, the management company, as a way of generating early cash flow through interest rate margins, or management fees may be in a position to manage such facilities. The real issue or potential problem with such an arrangement is that it immediately presents a conflict of interest--the interests of the equity investor are quite different from those of the lender; if the management company is responsible for both, the conflicts become quite apparent. Alternative scenarios for addressing this conflict are suggested in the "Key Issues" section below.

The management company should also be in a position to access sources of technical and management assistance (as identified above) from both internal and external sources. In the early years, for this to be successful, funding must be provided that will permit the management company to access such assistance. Through example, the value of such assistance will become quite apparent and companies will be expected to finance it from their own cash flow. This requirement is also further explored in the "Key Issues" section below.

3.3.3 **Legal Structure.** For various reasons which include capital base, regulatory restrictions, reserve requirements, and others, the team is of the opinion that both the investment fund(s) and the management

company should be incorporated under the Companies Act. The team was able to confirm with the Attorney General that this would be quite acceptable and consistent with existing Zambian law.

While this structure would limit certain activities--e.g. deposit taking, operating current accounts, etc.--such are not the types of activities in which the Fund or the management company should be involved. In fact, incorporating under the Companies Act would keep them out of businesses that are currently the domain of the commercial banking institutions in the country, thus limiting any possible competition with those institutions.

As indicated above, both the Companies Act and the Banking Act are currently undergoing review and revision. The revised Acts would have to be reviewed in the context of the incorporation of both the investment and management companies to be certain that neither is in violation of either of the Acts.

3.3.4 **Shareholders.** In view of the very limited local private capital available for investment, with one possible and special exception, it is the team's view that the major shareholders in the investment company must be external agencies that are interested in promoting the development of the private sector in Zambia--both the existing private business community as well as the privatization effort of the government.

- The investment Fund(s), which is where the major investment will be required, must be largely controlled--in terms of capital contributed--by external agencies. While there is local "hidden" liquidity that has been indicated previously and that might be accessed, it is uncertain whether such sources would be made available for investment in a fund given the total lack of any history of investing in equities in Zambia. This source, therefore, cannot be relied upon as a potential source of investment capital for the Fund(s).

Debt swaps, however, do represent a source of additional investment capital that should be explored in greater detail. Discussions with the Bank of Zambia suggested that it would be receptive to such a proposal. Under such a scheme, existing companies that are holding Zambian debt could swap that debt for equity in the investment Fund(s) under some agreed and pre-determined rate of exchange. Under such an arrangement, in return for the redemption of Zambian

debt, the holder of that debt would get shares in the fund; the fund, in turn, would get shares in a particular parastatal represented by assets valued at par with the debt redeemed.

Alternatively, the holder of the debt might wish to redeem the debt for a direct holding in a particular parastatal. This scheme, of course, would not benefit the Fund(s) and the debt holder would be limited to an investment in one company. To the extent that the debt holder was especially interested in a particular industry, this approach would be attractive. Otherwise, an investment in the Fund(s), as indicated above, would be more attractive as it would diversify the debt holder's risk. The debt swap possibility is explored in more detail in the "Key Issues" section below.

The team also strongly believes that the company that is ultimately awarded management of the Fund(s) also have an investment in the Fund(s). The investment need not be a major stake in the Fund(s), but must be of sufficient magnitude that it demand management attention. A stake in the fund(s) by the management company will help assure that it receives the management attention required.

- The management company that is responsible for managing the investment Fund(s) should be part of or supported by a local financial management institution. The team is of the strong opinion that a local private corporate entity must be the majority shareholder and manager of the management company. A strong corporate entity as majority shareholder. above all else, will help assure continued commitment to the initiative; while individual managers will, no doubt, come and go, an institution with a vested interest will always remain and will see to it that the management company is adequately staffed and properly managed. In addition, such an institution will have the infrastructure required to provide the support that such a management entity will require in order to be successful. It will also ensure continuity in management.

Notwithstanding the above, there are options that may be considered for the shareholding and management structures of the company. These are explored in the section on "Key Issues."

3.3.5 **Investment policies.** The management company must develop a set of investment policies for the Fund(s).

Such policies should include, at a minimum, the following:

- Return objectives (capital/income/combinations);
- Targeted investment size (absolute and relative to total investment in any given project or business);
- Financial instruments to be used (equity--ordinary and preferred--quasi-equity, convertible/non-convertible debt, income notes, or combinations);
- Portfolio mix considerations (generally a function of the risk/return objectives);
- Performance risk management by including criteria related to such factors as industry concentrations, exposure limits by investment (including foreign exchange exposure), management requirements, stages in the business development cycle eligible for financing (i.e. start-up, second stage/mezzanine, etc.), and liquidity considerations; and
- Cash-out strategies.

3.3.6 **Operating guidelines.** The management company will be responsible for developing a set of operating guidelines that will serve as parameters for the management of the company and that will define the process the company will go through in analyzing/approving any investment proposal. Such operating guidelines will include, among others, the following elements.

- Investment criteria for both privatizations and existing private businesses that include types of businesses to be financed, financing limitations, and return requirements (details to be included in the company's "Investment Policies").
- Financial instruments that the Fund(s) will use in making its investments, to include both equity (capital oriented) instruments as well as quasi-equity and debt (capital and income oriented) instruments that will assist in providing the fund and the management company with early cash flow (details to be included in the company's "Investment Policies").

- Conditions of any investment to include, for example; Board representation requirements, possible conversion to public company, key decisions that the management company must approve such as additional indebtedness above a certain level, the hiring and firing of key executives, the appointment of an audit firm, etc.

- Monitoring requirements to include, periodic management reporting and, most importantly, the types, sources, and financing of assistance that might be required by the particular business being financed.

- Exiting policies and strategies must also be included in the operating guidelines (to be included in the company's "Investment Policies").

In addition, the company must define the process it will follow in reviewing and approving any investment proposal. This process should include the following steps.

- Identification. Potential investments will be identified either by the Fund(s) manager or by third parties; potential sources of investments should be outlined.

- Due diligence. Management must complete detailed reviews of potential investee companies to include historic performance, management teams, ownership structure, future projections, competitive position in the market and the state of the industry in general.

- Board approval. Following completion of the due diligence process, the proposed investment should be presented to the Board of the relevant Fund for its approval.

- Negotiation. Once a positive determination has been made with regard to the attractiveness of the proposed investment, a detailed series of negotiations will commence with the investee company's existing shareholders in order to agree a financial structure for the investment. Agreements will have to be reached with any co-financiers; and insurance, risk mitigation strategies and legal structures will have to be drawn up, reviewed and accepted by all parties.

- Commitment/disbursement. Funds will then be made available under the terms and conditions of the negotiated agreements.

- Monitoring. Perhaps the most difficult aspect of the investment process, the manager will have to assure effective oversight through its Board representation; its receipt of monthly management accounts; and meetings to discuss the monthly performance and future prospects.

- Liquidating/trading. In the short term, this is likely to be somewhat difficult given the relatively thin market for capital in Zambia. The management company, nevertheless, must provide its ideas on potential exit strategies.

3.3.7 **Compensation structure.** The structure of the management company's compensation should be in three forms, all of which will ultimately be based on performance. They are outlined below.

- Management fees, tied to the value of the assets invested, should be paid quarterly and are normally in the range of 2.5-3.0% per annum. Until such time as a substantial level of funds are invested, of course, this will not be a major source of income for the management company.

- Capital gain and dividend distributions, in which the management company should share, forms another part of the overall compensation package. Normally, a management company can expect to share in the range of 20% of the distributed dividends and capital gains. In some compensation structures, such an element does not come into effect until the shareholders' capital, or capital plus a threshold rate of return, has been returned to the shareholders.

In the Zambian environment where; i) the capital market is very, very thin and realization of capital gain is especially difficult and problematical, and ii) dividends are likely to be forthcoming only after a relatively long gestation period, it might be argued that the share payable to the management company should be somewhat higher--i.e. 30%--than what might normally be expected. Further, given these conditions, the team believes it appropriate for the management company to share in distributed gains and dividends as they are earned.

- A carried interest in the company in which the investment is being made--i.e. a small (5-10%) shareholding interest--is yet another form of compensation and one which is highly recommended. Such a shareholding interest will help to focus the

attention of the management company such that the interests of the investment company and that of the management company coincide, providing yet additional incentives for the management company to take extreme care in selecting investments and in monitoring performance.

3.3.8 **Other required assistance.** Other assistance required by the investee companies must be provided either directly by the management company, or indirectly from other sources of such assistance to which the management company has access.

- Direct assistance by the management company will be extremely limited as the management company, in order to survive and become a profitable entity, must be thinly staffed by a few professionals with experience in investment analysis, structuring, monitoring and liquidation. The only assistance they will be in a position to provide, from a practical point of view, is in financial engineering--i.e. balance sheet re-structuring, additional financings, cash management, etc. Other forms of assistance will have to come from other sources as recommended by the management company resulting from its due diligence review of the particular investee company's requirements.

- Indirect assistance, therefore, will become very important if the management company is to succeed. The management company must have access to and financing for the various forms of required assistance as outlined previously in order to assure its fiduciary responsibilities to the investors are fulfilled. For this reason, it is highly desirable in the start-up years, for the management company to have a budget, funded by a donor(s), which might be utilized to hire technical specialists in the fields mentioned above--and perhaps others as required--to assist the businesses in which the Fund(s) take a position to help ensure their success. To be certain, to the extent an existing business is in a position to pay for such services, it should be so charged. Over time, this policy of charging for such services must be an integral part of any proposed investment package and viewed as part of the cost of the investment to the investee company.

3.3.9 **Pre-operating.** To be successful, the overall investment company/management company structure has several requirements that must be met before proceeding it may begin operating.

- Capital subscriptions for the Fund(s) must be in place in order to start operations and, more importantly, to give the management company some confidence that the capital will be available when called.

- A corporate entity for the management of the Fund(s) is an absolute must. Such an involvement, as indicated above, will assure that there will be continued commitment to the Fund(s) as individual managers come and go.

- Access to and funding for technical assistance is a must requirement for the project. The management company must have a way to take an active role in solving problems in investee companies before they become so large that effective corrective or remedial actions are impossible to implement.

- Financing for management company start-up is important in that the development periods tend to be quite long in making investments and, therefore, generating sufficient cash flow from operations to cover costs in the early years is difficult to achieve. These requirements, and how to meet them are outlined in the "Key Issues" set out below.

4. Key Issues

4.1 Tax

At present, as indicated above, the tax code as it applies to both individuals and corporate bodies, is not attractive; it is quite punitive for existing businesses and certainly offers few incentives for new investors. Some of the more critical disincentives include:

The tax code, however, is currently under review. Prior to its enactment, it should be thoroughly vetted to assure that it is conducive to business and to make certain that it does not include elements that will prejudice Zambia's ability to attract new investors to the country or penalize existing businesses.

4.2 Legal/Legislative

As mentioned previously, the major pieces of legislation that regulate business and investment are currently being revised, including:

- Companies Act

- Finance Act
- Investment Act
- Tax Code

Rather than comment on the various aspects of these Acts, in their present form, we simply wish to suggest that any new Act should be thoroughly vetted before it is enacted to assure that it does not include elements that will make Zambia an unattractive environment for business to develop and expand.

4.3 Structure of Fund(s)

An issue that must be addressed before putting together or trying to attract capital for the investment Fund(s) is whether to have one or two such funds. The objective of this pilot effort is to provide capital and other required support not only for the privatization program, but also for the existing private business community that has suffered in a capital scarce environment. The intent of this proposed project is to help assure that the existing private business community and privatized parastatals are in a position to access capital for new investment, rehabilitation and expansion; and not one at the expense of the other.

This being the objective, one issue is whether there should be two funds; one to support the privatization initiative and the other for existing and new private businesses. In making this decision, there are at least four factors that must be considered: i) shareholder preference; ii) management implications; iii) requirements of the two categories of businesses; and iv) financial return implications.

4.3.1 **Shareholder preference.** The major proposed shareholders in the fund(s) will be selected external agencies that have expressed an interest in supporting Zambia's economic revitalization program. First and foremost, their preferences must be sought as one or more may have mandates that will dictate how they view this issue.

4.3.2 **Management implications.** The only management implications relate to the legal, secretarial and administrative aspects (and, as a result, costs) of maintaining two separate funds as opposed to a single fund structure. These issues, however, are not of real substance and there should be few problems from a management perspective in having one or two funds.

4.3.3 **Requirements of the two categories of businesses.** This issue presents real substantive differences. Existing private businesses have suffered from the capital shortage that has plagued Zambia for many years. In many cases, plant and equipment has been fully depreciated and requires replacement or rehabilitation to increase and improve productivity. Historically, businesses have not had access to the required capital and that is precisely why these conditions exist. It can be argued, therefore, and Zambian manufacturers and industrialists certainly agree, that their key constraint is the lack of capital. Management teams are in place, however, and other technical requirements of the businesses are being met from within the various companies.

Parastatals, on the other hand, provide quite a different set of requirements. In many cases, the companies must be completely overhauled, meaning a need to; re-capitalize the business so that it might be rehabilitated from a plant and equipment perspective, provide management assistance to turn around performance, access technical, engineering assistance to develop/improve products and enhance product quality to make the particular industry competitive, and change the Board to assure active involvement in the company(ies) and instill the concept of management accountability.

The differences are obvious. Structuring financial packages for privatized parastatals will be a much more involved process, requiring substantial inputs on management, technical and policy issues. It is likely that outside assistance will be required to develop and implement such packages. The implications of such differences are several, including:

- longer development periods for packages to be completed and investments to close--in general--in the case of parastatals as compared to existing businesses;
- requirements to identify, access and finance outside assistance for the parastatals;
- higher degree of involvement--i.e. management attention--in the affairs of the parastatals given the more comprehensive assistance that must be provided.

4.3.4 **Financial return implications.** There are three aspects of the potential financial returns of each category to consider; timing of returns, rate of return and risk.

The timing of returns is likely to be more short term in the case of existing businesses, and longer term in the case of parastatals. This is a function of the requirements of the two categories. In the case of existing businesses in the process of expanding or upgrading capital equipment, where all other requirements are in place, it is likely that the returns will come quicker than in the case of parastatals that require a great deal more assistance simply to become profitable entities.

The likely rate of return is just the opposite. In the case of existing businesses, it is likely that the return achieved, on average, on an incremental investment by the fund will be substantially less than a similar investment made in a parastatal that is successfully turned around. In existing businesses, one is starting from a much higher base and incrementally expanding it; the parastatals will be largely starting from a much lower base. The capital injected in the latter, therefore, can be expected, on average, to generate a much higher return given the much lower base from which it is starting.

The risk associated with each investment will also differ. For existing private businesses, the returns are expected to come in the shorter term; risks will be lower, but so will the likely returns. For parastatals, the returns will likely take a longer period of time to materialize; risks will be higher, but so will the likely returns.

A fund combining the two types of investments will therefore be more diversified; some investments having a lower level of risk and a corresponding lower anticipated return, with others having a higher level of risk and a higher expected return. Separating them into two funds provides the investor a choice of the kind of investment more suitable to that investor. Ultimately, the prospective investors must decide whether to have one or two funds.

4.4 Structure of Management Company: Options

There are at least three options for the structure of the management company: i) 100% local--i.e. Zambian; ii) 100% foreign; or iii) some combination of the two. Some of the advantages/disadvantages of each of the options are outlined

below and must be carefully thought through in the context of the Zambian business environment before making any decision on which to adopt. While this is not meant to be an exhaustive treatment of the subject, it does provide some of the issues that should be considered.

4.4.1 **Locally owned/managed company.** While there are experienced, private corporate players in place in Zambia, there are both potential advantages and disadvantages in adopting this strategy for managing the Fund(s).

Advantages:

- Intimate market knowledge and understanding which provides the savvy required to operate successfully in a difficult environment.
- Local institutional infrastructure in place that is required to provide effective support from administrative, financial management and strategic perspectives.
- An established network in the market that will assist in deal origination and market intelligence.

Disadvantages:

- The local companies have limited experience in equity investment and management.
- In selecting a local company, there is the potential problem of vested interests and investment decisions being influenced by such interests.
- The perceptions held by the Zambian business community of any potential local manager will most likely vary considerably resulting in possible limitations on their ability to do business in certain business circles in the country.

4.4.2 **Externally owned/managed company.** A second option would be for the Fund(s) to contract with an external fund manager. To a large extent, the advantages brought by a local company are the disadvantages of the external company; while the disadvantages of the local company could likely be the advantages of the external company.

4.4.3 **Combination.** Conceptually, a combination of the above two options should be most desirable; practically, this may not be the case.

Advantages:

- The best of each option (presumably)

Disadvantages:

- There will always be the issue of who is to take the lead; both in ownership and in management. Our experience is that 50/50 joint ventures are not very satisfactory; both parties are responsible, yet neither is responsible; paralysis is often the outcome.

- A clash in cultures could also make it impossible for the two parties to work effectively together.

This being the case, one possibility would be for a local company to be the manager with technical and management assistance as required provided by an external party for a specified period of time.

4.5 Role of the Management Company vis-a-vis Government

This is a critical issue and will require the management company to play a difficult balancing act. While the managers will need to be helpful to the government in facilitating financial packages to assist in the privatization process, they must at all times protect the interests of the shareholders. This is of paramount concern if the project is to result in a self-sustaining, internal capability in Zambia to mobilize private capital and successfully invest it in attractive investment opportunities.

The government clearly has a serious problem; it desperately wishes to implement a successful privatization program in which assets pass from government to private concerns, however, there are very few sources of capital it can tap to achieve this objective. The management company is very much caught in the middle, but must be cognizant of its fiduciary responsibilities to its shareholders and to the longer term viability of the project concept. Adopting an extreme position, however, could result in the failure of the company and eliminate any possibility of the concept being implemented successfully over the longer term.

By playing too facilitative of a role in trying to assist the government in structuring packages that will result in privatized assets could result in less than attractive investments from a private, commercial perspective and, thereby, eliminate the possibility of attracting private capital over the long term. The management company will simply not be taken seriously by the private business community.

By being too adversarial in its relations with the government, however, could result in adverse reactions from and actions by the government to doom the management company to failure and also eliminating the possibility of longer term viability.

Any potential management company must be keenly aware of this problem. While there are no easy solutions, any company interested in managing the Fund(s) must demonstrate that, at a minimum, it recognizes the issue; and demonstrate that it has the requisite skills to negotiate solutions on a case-by-case basis as the issue arises as it inevitably will.

4.6 Debt Swaps

Debt swaps may be used either to capitalize the fund(s), or for direct investments by debt holders into specific parastatals. There are two debt-holder groups to consider; i) existing minority shareholders in existing parastatals who also hold non-performing Zambian paper and who would be prepared to swap that paper for equity in the respective company, and ii) other holders of non-performing Zambian paper. As indicated above, the Bank of Zambia has stated that it would be prepared to consider proposals for the incorporation of a debt swap element in the overall investment fund(s) package.

Before outlining possible scenarios, one critical issue should be addressed and will have to be resolved with the Bank of Zambia in order for a debt swap element to be successfully incorporated into the final proposal. Undoubtedly, the Bank of Zambia will want to agree a debt swap at some discount to face value and at a rate of exchange that is more current than historic, while simultaneously insisting on full value for the asset that will be "purchased or exchanged" for the redeemed debt. Clearly, this works to the advantage of the Bank of Zambia--retiring more debt for less--and to the extreme disadvantage of the holder of that debt. The debt holder will be penalized on two fronts; both the discount to face value and the more current versus historic rate of exchange will decrease the value of the debt.

If this is combined with an insistence on the part of the government that the assets be swapped at full value, the debt holder suffers further. The balance of the discussion on debt

swaps assumes that this issue will be resolved to the satisfaction of both the Bank of Zambia and holders of Zambian debt.

4.6.1 **Scenario 1.** Holders of non-performing Zambian debt are permitted to redeem that debt for shares in the investment fund(s) corresponding to a transfer in ownership of a percentage shareholding interest in a selected parastatal. Practically, the process would be along the lines of the following.

- A holder or holders of Zambian debt express an interest in investing in the investment fund(s) in return for a redemption of the debt.

- The fund(s) identifies a parastatal in which it chooses to invest or to acquire and a price is agreed between the fund(s) and the government.

- The fund(s) presents to the government a combination of cash and debt totalling the price of the shares to be transferred.

- Shares in the parastatal are transferred to the investment fund(s) in return for the cash and debt (at which point the debt is retired).

- Shares in the investment fund(s) are issued to the former debt holder corresponding to the value of the debt redeemed and the price of shares in the fund(s).

The government would, no doubt, wish to put some limits on the use of debt to acquire shares in a parastatal--e.g. in any such investment, perhaps no more than 50% of the total value could be paid in debt with the balance having to be paid in cash.

4.6.2 **Scenario 2.** A minority shareholder in a particular parastatal may be interested in converting any Zambian debt it is holding into additional shares in that parastatal.

This would be particularly attractive to the investment fund(s) if it, too, wished to invest in or acquire that same parastatal. In this case, the debt holder would have two options; increase its direct shareholding in the parastatal by making a direct swap--debt for shares in the parastatal or follow the process outlined above and become a shareholder in the investment fund(s).

It should be noted that when the Privatization Act was drafted and presented to Parliament for approval, it did have in it the use of debt/equity swaps as one way of acquiring parastatal assets. At that time, Parliament voted it down. The Privatization Agency indicated that they have plans to put the same proposal before the next session of Parliament. This, of course, provides an incentive to have detailed discussions with the BOZ to arrive at an acceptable structure for including debt/equity swaps in the privatization program that would be acceptable to both the Bank of Zambia and external donor agencies.

4.7 Types of Financing to Provide/Manage/Source

As indicated in several places in this paper, there is a need for several different types of financing, including equity and quasi-equity, term debt, and permanent working capital. The issue is which of these should be provided under the proposed pilot project and how each should be managed.

4.7.1 **Equity/quasi-equity.** The provision of this type of financing is precisely the mandate of the investment fund and management company, and the proposed structure was outlined earlier in this paper. Some of the key issues that must be addressed, nevertheless, include:

- delegations of authority to management;
- financing parameters--i.e. size of investments, types of businesses, purpose of financing (what is and is not eligible for financing under the fund);
- financial return objectives.

4.7.2 **Term debt.** The present unavailability of term debt financing in the formal capital market suggests that the project should provide for it until such time as this financing might be internally generated and sourced. To meet immediate requirements, however, it is the team's belief that such financing must be sourced externally from agencies that are in a position to provide such facilities. There are at least three possible alternative structures, each with its own advantages and disadvantages.

- Under Scenario 1, the investment fund could borrow in the international capital market. In order to do so, however, our understanding is that the investment fund would have to be incorporated under the Banking Act

(under revision). For a variety of reasons, this would most likely severely limit its flexibility: e.g. the stringent liquidity and reserve requirements that are currently imposed; restrictions on its investing capacity normally imposed on such institutions by banking regulations; such borrowings would have to be reflected on the balance sheet of the fund. Clearly, this is one option, but not necessarily the most attractive from the fund's perspective. The one advantage would be accountability; the investment fund would have a legal obligation to repay the facility(ies) under terms and conditions agreed in the loan documentation.

- Under Scenario 2, funding could be provided under a trust arrangement with the investment fund. (While Zambia has no specific legislation regulating trusts, the Attorney General did confirm that the courts would rely on English law and, therefore, a trust could be established under that legal system.) The fund could act as custodian trustee for a credit line or lines made available from selected external institutions. Funds would be placed in the trust (under specific repayment terms and conditions) and the investment fund would disburse, receive repayments and repay the facility(ies) under instructions from a manager (acting as agent) of the facility. Presumably, this manager would be the same as the manager of the investment fund and it would have a management contract with the lenders. There are at least two advantages to this arrangement. First, all funding--both equity and debt--would be under a single management entity. It would be in a position to access and provide both the equity and debt required by a particular business, thus simplifying and accelerating the review and approval processes. Second, it would provide additional management fee income for the management company, thus enabling it to become a self-sustaining entity in a shorter period of time. There is, however, one very real and potentially problematic disadvantage: conflict of interest. Under this arrangement, the manager will be responsible for investing equity and providing term debt facilities. The interests of an investor are quite different from those of a lender; thus the inherent potential for a conflict of interest. If and when a problem arises with a particular company, the manager will be tasked with protecting both the interests of the equity investor as well as those of the lender; an extremely difficult conflict to manage.

The one issue that would have to be addressed in the case of a trust arrangement is that of accountability.

In the event of a non-performing loan, or a default, who would have the obligation to repay the lender. It would not be the custodian trustee as such a relationship does not lend itself to accepting such responsibilities. Similarly, it is unlikely (unless the potential profitability of managing the facility(ies) was quite attractive) that the manager would be prepared to accept this obligation. One way to address this problem could be by detailing very tight lending criteria with high provision requirements for doubtful debts. Another possibility would be for the lender to make the ultimate lending decision and, in so doing, accept the credit risk rather than trying to pass it along to the manager.

- Scenario 3 would place term debt facilities with a third party: e.g. an existing commercial or merchant banking institution in the country. The funds could be borrowed outright, or placed under trust (with the investment fund, for example) but with management going out to a third party. In this fashion, management of the equity funds would be separate from management of the credit facilities. This eliminates the potential for a conflict of interest, clearly an advantage over Scenario 2 above. Finding a capable manager would be the task. Given the fact that commercial banking institutions have not been involved in this business suggests that they might not be the most appropriate source for management. Turning to the selected merchant banking groups might be a better alternative--some of them were described earlier in this paper.

- Scenario 4 would effectively permit all banking institutions to compete for the funds. Under such a scenario, there would be no need to select a single institution; rather, all institutions would have an equal opportunity to access the financing. This should help to spread the coverage as each institution will have a different client base and will eliminate any potential criticism that could arise as a result of selecting one institution over another. This would also make the management of the debt financing completely separate from the equity financing element; an advantage because of the potential for a conflict of interest indicated above. The drawbacks of this alternative are at least twofold; i) there is little, if any, existing capability in the country to do term debt financing since it is a product that has not been available in the market and, therefore, there will likely be the need to provide technical assistance in project analysis and in structuring term financing to

institutions that would like to access the financing, and ii) there will be no one responsible for moving the funds--it will be the equity side that will have to encourage the eligible financial institutions to participate in the debt financing by accessing the facility provided.

Another issue common to all four scenarios is that of foreign exchange risk. Clearly, the types of institutions suggested to provide term debt financing are external to Zambia and will likely land in foreign exchange. The FOREX exposure issue must be addressed for a term debt facility from such sources to be workable.

4.8 Commercial vs. Development Objectives

The types of institutions that will be tapped to provide investment capital (as well as term debt financing) under this proposal have a variety of objectives, some of which go well beyond strictly commercial, financial return requirements. Again, conflicts can easily arise unless the ground rules are well understood by both parties up front. Too much of an emphasis on "development" objectives can make it extremely difficult for the manager to be successful. The extent to which there are private investors in the fund(s) compounds the problem as they will be interested in an attractive commercial return.

To be successful, the overriding objectives of the fund(s) must be to generate an attractive financial return for the investors. It is only in this fashion that the project will be able to demonstrate that such a vehicle can be profitable and attractive and, in so doing, generate longer term private sector interest in participating.

4.9 Autonomy of Management Company

The autonomy of the management company may be viewed from two extremes: i) ideally, the investors in the fund(s) should provide investment parameters within which the fund manager may operate and under which the manager is delegated all investment- related decisions; ii) alternatively, and at the other end of the spectrum, each shareholder in the fund could retain a veto over any particular investment. The latter is simply not workable and will result in a paralysis in decision-making, while the former, though desirable and most commercial, is probably not acceptable to the shareholders. The more autonomy that is provided, however, the easier will be the management task. A compromise might be an executive committee of the Board--with rotating membership--that vets and approves all investments.

This is a critical issue, however, and no potential management company will be prepared to accept management responsibility unless the delegations of authority are both well understood and workable.

4.10 Potential Funding Sources for and Management of TA

While it is difficult at this time to estimate the exact level of funding required for a meaningful technical assistance program, clearly such a program must be included in the overall project given the deficiencies, particularly in the parastatal sector, outlined in this paper. Three issues must be addressed: i) funding sources; ii) sources of technical assistance required; and iii) management of the program.

4.10.1 **Funding sources.** This is relatively straightforward; from a practical perspective, the only real potential sources of such assistance are the donors who have budgeted grant funds for assistance to Zambia. Over time and as experience is gained, businesses must be expected to pay for such assistance and it should be a requirement for an investment to be concluded. During the early years, however, and while the program is being developed, it could be provided on a cost sharing arrangement, much like the programs of the International Executive Service Corps (IESC), the British Executive Service Corps (BESCO), African Management Services Company (AMSCO), and other such programs.

4.10.2 **Sources of technical assistance.** To the extent possible, assistance should be sourced in Zambia. The team's early judgment is that assistance in the areas of accounting, financial management and control, and management reporting, can most likely be accessed from the consulting practices of the existing major accounting firms in the country. Equally, it is the team's view that more technically oriented assistance in the fields of engineering, sales and marketing, and the like, will have to be accessed externally through such organizations as those indicated above.

4.10.3 **Management.** As it is the fund manager who will be identifying the assistance requirements, funding for that assistance should also be under that manager. The manager, however, will not have either the time or capability to identify specific companies or individuals to provide needed assistance so this function must be sub-contracted or, in some other fashion, be delegated to a third party. One option

would be to have a standing relationship with an organization(s)--e.g. IESC, BESCO, AMSCO and others--to whom the management company would turn whenever such requirements are identified. Another option would be to have a third party manage the overall technical assistance fund under the direction of the management company. Regardless of the option selected, of critical importance is that the management company have control over the funding as it will be this company that will be most informed on any potential investment and, therefore, on the particular requirements of the investee company.

4.11 Selection of the Management Company

The critical element in the selection of the company that will be responsible for the overall management of the program is agreement among the shareholders and the providers of the term credit facilities (assuming the management company will also have responsibility for this element of the program). From a practical point of view, there are two options from which to select, depending on how much the shareholders wish to be involved, up front, in setting investment policies and operating guidelines. While there may be "degrees" of involvement by the prospective shareholders under each option, nevertheless, the two define the practical options available. The two may be described as follows:

- Setting the broad objectives and requesting prospective management companies to develop proposed investment policies, operating guidelines and fee/compensation structures for consideration by the prospective shareholders.

- Developing the investment policies and operating guidelines and requesting prospective management companies to respond with regard to how they would manage the fund(s) within such parameters and also provide proposed fee/compensation structures for consideration.

Under each option, the shareholders would ultimately have to agree among themselves; the difference being that under the first option the prospective management companies would be required to develop and propose operating plans, while in the latter they would simply be reacting to plans already developed.

The advantage to the latter approach, of course, is that the shareholders will have already agreed on policies and operating guidelines and, presumably, the best management proposal would be selected, assuming competitive compensation structures. The key disadvantage is that the proposals would not require the

prospective managers to give their own thoughts on workable policies and guidelines in the Zambian environment that will enable the management company to become a profitable operation and to achieve the ultimate objectives.

The principal advantage to the former approach is that it would require the prospective management companies to give some real thought to developing policies and guidelines that would enable them, from a commercial perspective, to meet the objectives of the project in the Zambian context. Clearly, negotiations would then have to take place between the shareholders and the prospective management company to assure that shareholder objectives can be achieved.

The team's recommendation would be to opt for the former. In so doing, the prospective shareholders would be assured that they are receiving realistic and workable operating plans with commercially achievable objectives.

4.12 Funding the Start-up

Generating early cash flow to support operating costs in the start-up of an investment company is a constraint that must be addressed in order to attract the interest of any serious private management company. There are several options, and combinations of them, that might be pursued, but it is an issue that must be resolved prior to trying to attract a management company. The shareholders and other supporters of the initiative must decide how the operation will be financed until such time as it is in a position to generate sufficient cash from operations to survive. Experience in Kenya for example suggests that such support must be provided for a minimum 4-5 year period.

The ability of the operating company to generate revenue will be a function of a number of factors including the types of investments it makes (greenfield, second stage, etc.), the type of financing it provides (income oriented versus capital oriented or combinations thereof), and other business it is able to generate while the investment side of the business is developing. Options for providing the required support include the following:

4.12.1 **Donor support.** To date in Africa, this is the most widely used model for providing support in the early start- up of investment companies and has been followed in Kenya, Ghana and Tanzania. Typically, support is provided for a 4-5 year period on a declining basis over that time as the operating company is expected to begin to generate sufficient revenue to cover its operations and make a profit within that period of time. Clearly, as indicated above, the ability of the

company to generate revenue and cash flow will be a function of the factors mentioned above.

4.12.2 **Capital contributions.** Another way to provide early cash flow, though one that has not been adopted by any of the agencies supporting such initiatives to date, is for the shareholders to agree an up front capital injection that would be deposited in an interest bearing security, the proceeds of which would fund the operation until investments are made. In this scenario, two factors must be considered. First is the level of capital required to generate sufficient interest income support the operation; second is that it is likely this funding arrangement would lead to investments in second-stage financings that are likely to generate early cash flow to support the operation over "greenfield" projects that have longer development and non-income generating periods.

4.12.3 **Combination of i) and ii).** This option would provide some flexibility to the management company in managing its cash flow. It will only be some time after the initial start-up and operation of the fund(s) that management will have some idea as to the time it will take to begin to generate sufficient cash flow from operations to cover costs. Support, both from donor organizations and from interest on capital, will help assure that the management company has a cushion to see it through this difficult and, as yet undetermined, start-up period.