FINAL

EVALUATION OF VENTURE CAPITAL INITIATIVE WITH DFCU

UGANDA

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AFRICA VENTURE CAPITAL PROJECT (AVCP)

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TABLE OF CONTENTS

DRAFT REPORT

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In responses to a request from USAID/Uganda, Harvey & Company [HC], managers of the AID Africa Venture Capital Project [AVCP], undertook a five day evaluation of the USAID/Uganda initiative to provide a USAID grant to the Development Finance Corporation of Uganda [DFCU]. This grant would be used to provide investment capital for venture capital investment and is part of USAID/Uganda's RPE Project, which governs some aspects of the grant structuring and timing. This evaluation was prepared by Douglas L. Leavens, Project Director, AVCP, and included review of existing reports, draft documents, DFCU financial statements and discussions with USAID and DFCU staff and meetings with other representatives of the financial community. The work was performed from October 24 to 28, 1993 in Kampala, Uganda.

1. SCOPE OF WORK - TECHNICAL ASSISTANCE - DFCU

During a meeting on October 25, 1993 with Holly Wise, Chief, GDO USAID/Uganda, Patrick Fine, GDO, and Bruno Komakech, Private Enterprise Advisor and Douglas Leavens of HC, the following objectives were agreed to:

- Based on HC consultant Robert Kelly's draft "Venture Capital Feasibility Assessment-Uganda" dated October 15, 1993, 11 conditions precedent to USAID's finalizing a grant to DFCU were identified. These issues are to be researched and current status identified as part of increasing our comfort level with the DFCU as a grantee.

- The needs of DFCU for technical assistance [TA] in three areas are to be spelled out in detail adequate to permit design considerations for a Memorandum of Understanding [MOU] between USAID and DFCU.

- Outline the issues to be covered in a MOU in as much detail as time permits [4 days] and begin drafting of the MOU. Other USAID documentation to amend the current grant structure and modify the project paper will be undertaken by USAID/Uganda staff.

In order to accomplish the above, the following work plan was proposed:

1.1. Address each condition precedent identified in the Robert Kelly report, prioritized as to impact on DFCU's operations, identify resources required to resolve and a time line. Review DFCU's financial statements as of December 31, 1992.

1.2. Determine the TA support required by DFCU in the following areas: a) setting up the venture capital company; b) conducting feasibility studies for potential investee companies; c) providing management support following investment to investee companies. Describe the desire impact of the TA, resources required and timing.

1.3. Evaluate proposed venture capital company management structure and procedures for investment decisions and co-investing with DFCU debt.

1.4. Review financial projections for the venture capital fund, including rate of investments, ROI targeted, divestment options and management expense.

1.5. Outline key issues for USAID and DFCU to include in a MOU as the basis for a grant agreement. This should include the purposes for which grant funds can be utilized by DFCU, reporting requirements, tranching of grant disbursements [if any], segregation of grant funds and other conditionality as regards DFCU's future business performance and compliance with line of credit agreements.

1.6. Review USAID's draft grant agreement and Robert Kelly's comments there to.

1.7. Discuss operating guidelines for the venture capital company as proposed by Robert Kelly in his report.

1.8. Review overall conditions for venture capital to succeed in Uganda, including: the enabling environment, economic and political, the potential deal flow, the investment pool potential, other than USAID's grant, management skills resident in DFCU, the exit strategy options.

1.9. Identify follow-on Harvey & Company TA required and possible funding sources.

1.10. Identify limitations of USAID/Uganda's RPE Program for TA, direct contracts and buy-ins. Determine what TA DFCU can contract for.

2. DESCRIPTION OF THE GRANT STRUCTURE

2.1 The Grantor and Grantee

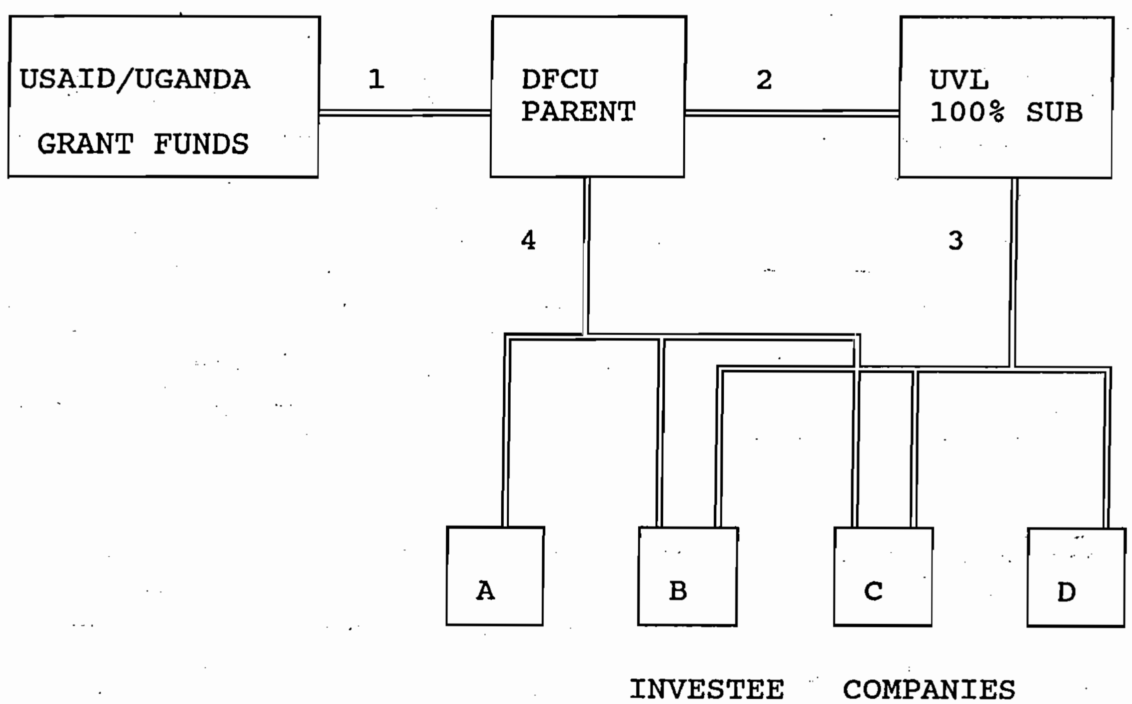
Under the RPE Project, USAID/Uganda, the Grantor, would make a grant in the range of $8 to 10 million to DFCU, the Grantee, to provide investment capital for equity investments in Ugandan companies. DFCU would use the grant to subscribe for ordinary shares in a new (to be formed) private limited liability company, Uganda

Ventures Limited [UVL]. DFCU would own substantially all of the outstanding shares of UVL and would thus consolidate the operations of UVL in the DFCU annual financial reports. This consideration is significant in terms of the structuring of the grant, the performance risk accepted by DFCU management and shareholders, an the ultimate potential for a successful equity investment, or venture capital, operation in Uganda. Under the terms of a Management Agreement, UVL will contract with DFCU to provide investment management of the equity investment funds.

2.2 Flow of Grant Funds

The flow of grant funds would be in a one time, lump sum for the provision of investment capital to DFCU for establishment of an equity investment fund. Grant funds would be disbursed at such time as the proposed Uganda Ventures Limited company has been legally established and can issue shares.

STRUCTURE OF USAID GRANT TO
DEVELOPMENT FINANCE COMPANY OF UGANDA



1. USAID makes a grant to DFCU to fully fund the investment capital of a new venture capital company.

2. DFCU uses the grant funds to subscribe for ordinary shares in the new Uganda Ventures Limited [UVL], a private, limited liability company.

2a. UVL deposits all of the share subscription money into a segregated interest bearing account, most likely managed by DFCU. These funds will be in U.S. dollars and will be retained in an off-shore account. The interest earned on the funds will accrue to the consolidated DFCU accounts and will be available to meet general operating expenses. Estimated interest income will be $300,000, at 3% per annum, until investments begin. Thereafter, the interest income will decrease as equity investments are made. At the same time, dividend and fee income from investee companies is anticipated to provide operating cash flow to DFCU.

2b. To fund approved equity investments, UVL draws on its account managed by DFCU. UVL deposit funds may only be used for direct equity investments in Uganda companies, as defined in the Grant Agreement.

3. UVL invests up to 49% in the share of a company on its own, <u>or</u> in conjunction with a loan from DFCU or another source of debt or equity financing.

5. DFCU approves a loan which **may** parallel an equity investment from UVL.

2.3 Ultimate Performance Risk

Under this structure, the management, staff and shareholders of DFCU will have ultimate risk for the successful investment of the equity pool of funds provided by the USAID Grant. Each decision to invest either equity through UVL or debt through DFCU will have a consolidated financial impact on DFCU. If there are profits and capital gains from investments, the shareholders and staff of DFCU stand to gain. Also, is there are losses on the equity investments, and there will be some, the DFCU shareholders and staff will share in the loss. Therefore, it is suggested that detailed investment restrictions, such as co-financing of companies by both DFCU and UVL, not be imposed under the terms of the USAID grant.

In order to encourage disciplined commercial financial decision making by DFCU, as the managers of the UVL equity fund, it is strongly recommended that all the DFCU staff, from the General Manager to the lowest paid employee, be placed on a performance bonus compensation scheme tied to the results of the combined investment portfolio. The details of the compensation scheme can be worked out by the management and shareholders of DFCU, but the bonus potential should represent a substantial percentage of the individual's annual salary, for example up to one third.

It is further recommended that establishment of such a performance bonus scheme be made part of the USAID Grant Agreement. Without such a scheme, the level of discipline and extra effort required to make equity investments viable is much less likely to occur and the potential for loosing qualified and trained staff to competing financial institutions will increase dramatically, with a corresponding negative impact on investment performance.

2.4 Additional USAID Support

In order to adequately support the start-up costs of establishing a new venture capital facility under the DFCU and to provide essential technical assistance to small and medium size enterprises [SMEs] in Uganda, both actual and potential investee companies for UVL, it is suggested an integrated Technical Assistance [TA] capability be included in this structure. We understand that a number of TA programs exist which could be utilized, or strengthened, to assist SMEs in evaluating industries and markets and developing skills to prepare feasibility studies and business plans. There are other donor TA programs, in addition to USAID, which provide similar or complimentary services. A facility to coordinate and simplify access to these TA services by SMEs would be of great value; in essence a clearing house or business support center is proposed.

In addition, DFCU will require start-up funding, over and above the grant, during the next year to pay management and legal costs related to incorporating a new limited liability company, UVL. Some of these costs could include staff recruitment, training, systems and equipment, public relations and limited travel to coordinate with existing DFCU shareholders. It is suggested USAID provide funding for these necessary start-up costs in a separate tranche of the Grant based on a detailed business plan and budget to be provided by DFCU.

To support development of venture capital awareness and supporting activities, a broad based public education program should be considered. Such a program would utilize high level seminars, workshops aimed at the financial community and private entrepreneurs, distribution of training materials for preparation of feasibility studies and business plans, and related public relations activities with the local media. One such public relations event could be connected with the launching of the new UVL venture capital fund. Harvey & Company has organized and conducted a similar public education program in Tanzania and could provide technical assistance.

3. CONDITIONS PRECEDENT FOR A GRANT

A number of issues have been identified during the course of our evaluation requiring further explanation, such as changes in DFCU's current operation or resolution with various authorities prior to conclusion of a USAID Grant. These Conditions Precedent are listed below with commentary as to the current status. In many instances, the issues have been resolved. Outstanding issues which should be included in the Memorandum of Understanding between USAID and DFCU are so noted at the beginning of the list.

CONDITIONS PRECEDENT FOR A GRANT TO DFCU FOR ESTABLISHMENT OF A VENTURE CAPITAL COMPANY

The following issues have been discussed with DFCU on October 25 and 27, 1993 with the following preliminary answers provided.

3.1. Completion of the capital restructuring with DEG.

The capital injection has been approved by DEG and is going through the Germany Ministry funding process. Final funding authorization is anticipated in time for the DFCU Board of Directors' meeting on December 9, 1993 which all the DFCU shareholders will attend.

3.2. Resolve outstanding tax dispute with the Uganda tax authorities.

It would appear the settlement of historical tax liabilities is nearing settlement. However, to date it appears each year requires a separate negotiation with the Internal Revenue regarding estimated taxes considerably in excess of DFCU's expected tax liability. The issue of unrealized capital gains on the line of credit loans used for funding and denominated in foreign currencies has played a major role in distorting the DFCU tax picture. Resolution of these issues should continue to be a condition of the grant.

ACTION: Stage 1 - a Price Waterhouse report is due in mid-November, 1993. Stage 2 - negotiation with the Revenue Authority will continue. It is recommended that disbursement of Tranche Two of the USAID Grant, which would comprise the totality of the equity investment capital for UVL, be conditional on resolution of the tax issues.

3.3. **Establish and approve a clear investment policy and strategy which takes into account the lending restrictions attached to the funding lines of credit.**

There is no perceived negative impact on loan growth due to any restrictive funding covenants. There are some size requirements and the usual restrictions as to armaments and environmentally unsound loans. The Board's current policy is to follow a "normal" dividend distribution scheme, that is not to accelerate dividend payout to maximize shareholder return. This policy should be referenced and incorporated in the grant agreement.

ACTION: Rick Phillips will draft an Investment Policy Paper for the December 9, 1993 DFCU Board meeting. Part of the Grant Agreement will stipulate that in the event of voluntary, or involuntary, liquidation of the UVL investment portfolio during the initial investment period, any uninvested funds remaining in UVL's account from the USAID Grant will revert to USAID through alternative projects to be provided for. However, once the UVL funds have been invested in shares of investee companies, and loss or gain will accrue solely to DFCU as the fund manager.

3.4. **Establish a Management Internal Control compliance process.**

The compliance function, or lack there of, was noted in the Price Waterhouse audit. It is essential to fully comply with all management policies, as approved by the Board. The monitoring of that compliance should be conducted on a regularly scheduled basis throughout the year. The compliance function should be the part time job of a well qualified officer reporting to the General Manager on a monthly, or more frequent, basis and quarterly to the Board. This could be a part time job for the in house legal counsel.

ACTION: The issue will be reviewed by DFCU management.

3.5. **Prepare an operating budget and cash flows, with assumptions, for the proposed venture capital company.**

The financial projections are being prepared now. The plan is to make one investment per quarter in the $250,000 range initially. A full financial projection should be part of the grant conditions.

ACTION: Rick Phillips will prepare the financial projections for presentation and approval at the December 9, 1993 Board meeting.

3.6. **Present a clear management plan for expanding the current lending activities of DFCU while starting-up a leasing company with Stanbic [Grindley's] and**

starting-up a new venture capital company as a subsidiary of DFCU. Timing, management resources, financing, staffing and controls should all be identified.

A plan was prepared in 1991 and will be reviewed.

As regards the new leasing company, DFCU will be a passive investor in the equity utilizing the EIB line of credit for equity investments. Loan funds will also be provided. The investment is on commercial terms. The leasing company will be managed by Grindley's and will not present a significant on-going management burden for DFCU.

A further investment is being made in construction of an office block, expected to be the most modern in Kampala and thus attractive to NGOs, DFIs and other development agencies. DFCU will take a very small portion of the space. The committed occupancy rate was not provided. A competent construction advisor has been provided to DFCU by the German government. This activity is not expected to place a significant burden on DFCU management.

The development of a venture capital fund is complimentary to the existing lending activities of DFCU and further develops their merchant banking capabilities to properly structure financial transactions. Loans of DFCU standing at UShs 4 billion as of year end 1992 have increased by UShs 3 billion approved in the first 9 months of 1993. Not all approved loans have been disbursed. However, given the current margin on loans of about 6%, up from 5% historically, the earnings gap on an operating basis should be more than covered within the next 6 months.

ACTION: Rick Phillips will prepare a Board Paper for December 9, 1993 which will present the current DFCU business plan with related assumptions, costs, staffing plans, and investment policy.

4. OTHER ISSUES IDENTIFIED

Additional issues have been identified which require and are receiving management attention, but do not constitute conditions precedent for the making of a USAID grant to DFCU. The following issues were discussed with DFCU on October 25 and 27, 1993 with the following preliminary answers provided.

OTHER ISSUES FOR RESOLUTION WHICH ARE NOT CONDITIONS PRECEDENT TO A GRANT

4.1. **Turn around the current monthly earnings losses.**

Management made a conscious decision in 1991, at the time a new 5 year plan was approved, to invest heavily in hiring highly qualified staff, primarily Ugandan, as the necessary basis for making good loan and investment decisions. Overhead expenses were up 77% in 1992 due to this decision and the staff is now in place. The loan portfolio is growing, although it increased only 5% in 1992 and net interest income [NII] grew 36%. With expenses held level, NII needs to increase another 22% in 1993 to breakeven on an operating basis. The plans for venture capital call for four investments per year initially totaling $1 million, which is reasonable.

After review of the financial statements, this consultant has concluded that the recommendation to establish a **working capital ratio of 1.25** needs to be revisited. The principal imbalance between current assets and current liabilities comes from the current portion of loans maturing in the current year being carried as short term assets, while the corresponding funding from lines of credit is carried as long term liabilities. This mismatch in tenor structure results in a negative working capital and is not a negative factor, provided there is proper treasury and funding management. There are other liquidity and solvency ratios as well as operating ratios which are more helpful in determining the financial soundness of DFCU under the circumstances. A separate financial analysis memo will be prepared by HC.

ACTION: A copy of the General Manager's December Report to the Board addressing these issues will be provided.

4.2. **Complete evaluation of and provision for bad and non-performing loans.**

A policy for providing for loan write offs is in place and was revised by the Board in June 1992. Any loan non-performing for 6 months is put on non-accrual. A copy has been provided. There is no revaluation policy with regard to equity investments, other than non-performance, at this time and one needs to be put in place.

ACTION: Price Waterhouse is preparing a position paper regarding revaluation of equity investments to properly reflect on the DFCU books significant changes in the current market value from initial investment value.

4.3. **Complete upgrade of the computer systems.**

Mr. Juma Kisaame is in charge of Finance and Accounting and provided the following. There are two main computer programs, the General Ledger and the Investment Register. It is the latter which is receiving an "add-on" and not a full upgrade. The Investment Register records both loans and equity investments utilizing a Lotus spreadsheet format. The "add-on" work is nearing completion and Mr. Kisaame is confident it will perform as required. Coincidentally, a consultant is designing a formal accounting program which will replace the Lotus Investment Register. To cope with the anticipated increase in investment activity, an additional accountant will be hired by DFCU in January 1994 to assist with financial management and portfolio tracking.

ACTION: A Management Paper presenting the systems support issues and actions taken will be prepared by DFCU and provided to USAID.

4.4. **Complete restructuring of the lending and financial analysis teams.**

This was completed in September 1993 and a copy of the new organizational chart will be provided. There are two person teams, one financial officer and one technical officer. Jointly, they take a loan from inception through to management of a portfolio which encourages essential relationship building with the customer base. This personal knowledge is vital to making good investment decisions and providing value added when management is in difficulty.

ACTION: Copies of the management team resumes have been provided to HC and will be incorporated in our final report along with a current organizational chart. A copy of the September 1993 Management Report to the Board recommending the organizational changes will be provided.

5. MEMORANDUM OF UNDERSTANDING

The Memorandum of Understanding [MOU] between USAID/Uganda and DFCu will provide the framework for preparation of other governing documents, including the Grant Agreement between USAID/Uganda as the Grantor and DFCU as the Grantee, a Management Agreement between UVL and DFCU and investment policies for DFCU as the equity fund manager.

This document will spell out:

The goals and objectives of the grant, including conditions for safeguarding the funds, use of funds for equity investments, use of funds for feasibility studies of potential investee companies, technical assistance to investee companies, and training for DFCU staff. Most of these issues have been discussed in this report and, upon approval of USAID and DFCU, can be incorporated in the MOU.

- The conditions precedent to disbursement have been presented and discussed in this report, and can be included in the MOU.

- The method in which disbursements will be made and any tranching. A suggestion has been made in this report that the Grant be in two tranches. The first tranche would cover operational start-up costs, as to be agreed, and would be disbursed as quickly as possible. The second tranche would be for the actual capitalization of the venture capital investment fund, through a share subscription by DFCU of UVL, and would be disbursed after the conditions precedent have been met. This would include legal incorporation of UVL and completion of all required documentation.

- The reporting required as to meeting the goals and objectives of the grant and the financial and operating condition of the Grantee. The Grantee reporting serves two purposes; first, to permit USAID to monitor proper application of the Grant during the disbursement period, until September 24, 1994 and to track accounting for the grant funds which may be completed during the succeeding six months; second, to provide periodic information regarding the performance and impact of the venture capital initiative without creating a USAID monitoring or evaluation requirement. It recommended that for the second purpose, routine internal Management Reports to the Board of Directors of DFCU plus annual audited financial statements will provide all the desired information regarding social and economic impact. That level of information should be pre-agreed in the MOU and incorporated by DFCU in their Management Report format.

- Conditions under which the grant would be recoverable by USAID, in whole or in part, and the mechanism for such recovery should be spelled out. The issue of recovery of uninvested Grant funds under limited conditions has been discussed in this report. It is recommended that no other investment or performance criteria apply.

6. REVISION OF THE DRAFT GRANT AGREEMENT

This refers to the Grant Agreement between USAID as the Grantor and Development Finance Corporation of Uganda as the Grantee. This document will contain the legal conditions under which the grant is made and will include the relevant governing conditions agreed to in the MOU.

A draft Grant Agreement, undated, has been prepared by USAID. A copy is attached to this report for reference with margin notes on some of the changes required. Rick Phillips also has a copy which he will mark-up and return to USAID. Given these suggested changes and the finalized MOU, a revised Grant Agreement can be drafted.

7. MANAGEMENT AGREEMENT

DFCU will prepare a Management Agreement between Uganda Ventures Limited [UVL] as the venture capital fund, and the management company, Development Finance Company of Uganda [DFCU]. The Agreement will be reviewed and approved by the UVL Board of Directors.

This document will spell out:

- The types of investments which can be made and the terms under which DFCU will manage and invest the funds held by UVL.

- The compensation to be paid by UVL to DFCU, as the fund manager, including annual fee and carried interest, if any, in the dividends and capital gains from investments. During discussions with DFCU management in the preparation of this report, it was recommended that UVL pay no management fee to DFCU. As discussed above, during the initial year until the UVL funds are fully invested, DFCU, on a consolidated basis, will receive interest income on the UVL pool of funds. This income will be in lieu of any management fee. When dividends or capital gains are received by UVL, the full amount will flow through on a consolidated accounting basis to DFCU as the parent. This revenue will be distributed according to a plan to be approved by the DFCU Board of Directors. However, the core funds provided under the USAID Grant will not be distributable. Also, the amount of dividends to be paid out of DFCU to its shareholders will be limited to a reasonable and normal level, generally considered to be up to one third [1/3] of the distributable income after taxes and reserves. The intent is to reinvest a substantial portion of investment income into UVL investments and to compensate management and staff as recommended above.

  It is also the intent of DFCU to raise and manage other equity funds in the future. Since those funds will likely not be "captive funds' in the sense that this fund would be, other management and fee arrangements would have to be agreed to.

- Reporting requirements from DFCU as the fund manager to UVL's Board of Directors should be spelled out. These will take into account the types of information which USAID would find useful and as specified in the MOU.

- Conditions under which the management contract can be altered or cancelled between UVL and DFCU. Although the fund will be captive, over time issues may arise which would cause the UVL Board to see alternative management for its portfolio of investment and other uninvested funds. These terms and conditions should be spelled out. Also, USAID might consider the desirability of having one or two local Ugandan members of the UVL Board who would provide local knowledge, managerial input and long term development of venture capital awareness in Uganda. However, there are potential negative factors associated with including outside directors and the matter should be thoroughly assessed before a decision is made.

8. DFCU INVESTMENT POLICIES.

This document will be prepared by DFCU and will set out the Investment Policies of DFCU as the fund manager. These policies will reflect the MOU and will be agreed to by the UVL Board. In the future, other funds which DFCU might management may have different investment criteria and separate Investment Policies will have to be established.

This document will spell out:

- The types of investments DFCU will make, including: target, and excluded, businesses, amount and structure parameters for investments [debt and equity mix, co-financing, maximum amount in any one investee, industry concentration], target Return on Investment [ROI];
- Policies regarding feasibility studies, business plans, conducting due diligence, content of loan and equity investment documents, transaction structuring terms;
- Policies for managing investments, DFCU board membership in investee companies, monitoring, follow-on technical assistance;
- Procedures for increasing the debt or equity investment in the investee company, taking a controlling interest, replacing the investee management;
- Procedures for investment committee approval of investments and necessary criteria for initial and subsequent investment approvals and criteria for disinvestment and write-offs.

9. CONDITIONS FOR VENTURE CAPITAL TO SUCCEED

We look at five factors in assessing the conditions for venture capital to succeed in a given country. While not exhaustive or predictive of success, we believe the presence of these conditions is essential.

- An enabling government environment of economic and political policies and regulations will provide a reasonable, stable and supportive climate for private sector business development. While a full feasibility has not been conducted as part of HC's technical assistance activities, we believe based on discussions and review of available documentation that the Uganda government has adopted policy of sustained private sector development and is putting the required policies and regulations in place. Continued donor monitoring and support for these private sector initiatives is essential.

- The potential for identifying and developing investment grade transactions, called the deal flow or pipeline, is essential. The critical factor is developing close working relations with reliable entrepreneurs. We have reviewed the DFCU portfolio and have discussed the types of transactions coming to market with DFCU, other bankers and with the Uganda Development Authority. Based on this information, we believe an acceptable level of transaction currently exists with Ugandan management. Our experience in Africa is that once an equity investment facility is available, other serious entrepreneurs emerge adding to the pool from which to select.

- The potential for raising an investment pool of capital is essential. In this case, it is proposed that all of the funds for the venture capital fund be provided by USAID. However, it is important to note that other investors have approached DFCU to discuss placing funds under management. While this interest does not confirm the availability of additional equity funds, it does support the likelihood that a successful venture capital fund could raise subsequent capital. It will be important in the future that local institutions provide a reasonable portion of equity funds to be invested locally.

- The availability of management skills to manage an equity fund is essential. In this case, DFCU, an established and functioning investment institution, has both expatriate and local management with demonstrated capability. DFCU has a portfolio of both debt and equity investments. They are taking steps to strengthen the staff skills, including hiring additional staff and providing off-shore training.

- The identification of exit or divestment strategies is important for the investors in the venture capital fund to eventually realize the capital gains on their investments which will provide the rate of return [ROI] necessary to compensate them for their risk. In this case, all of the investment funds are to be provided by USAID which is not seeking a financial return on the grant invested. However, for the shareholders in DFCU, as a consolidated entity, to receive a return on the management and director effort which will be expended, capital gains will have to be realized. The Investment Policy which DFCU will prepare should address this issue. Also, USAID in conjunction with other donors, should advance activities to promote development of the financial and capital markets, including development of a simple share trading activity.

10. FOLLOW-ON TECHNICAL ASSISTANCE BY HARVEY & COMPANY

Possible activities under this section have been discussed with Holly Wise, USAID/Uganda. They could include drafting of documents, structuring and delivering training, designing follow-on support for financial sector development and initiation of a share trading scheme and developing a public venture capital awareness program. Funding under the existing AVCP Project are very limited and can not support additional consultant TA. It was suggested Holly Wise contact the AVCP Project Officer, Michael Unger, in AFR/ONI/PSD, regarding TA desired and possible funding vehicles.

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