DEVELOPING PRIVATE SECTOR ENTREPRENEURSHIP: VENTURE CAPITAL IN NIGERIA

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Preface

The author of this report, Michael Warman, was engaged as a sub contractor by Harvey and Co. to visit Nigeria as part of USAID's Africa Venture Capital Project.

The author visited Nigeria between February 26 and March 3, 1993.

The recommendations of this report are based on this visit to Nigeria, the meetings with the people listed in Appendix 1 as well as the documents listed in the Bibliography.

The opinions expressed in this report are those of the author and should not be construed as those of the Government of the United States of America, the Government of Nigeria, or Harvey and Co.

The author would like to thank all those who generously gave their time and candid comments. In particular, the author would like to thank Prince Lekan Fadina of Equity Securities and Amah Iwuagwu of Credit Alliance.

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EXECUTIVE SUMMARY

The Consultant, Michael Warman, spent 3 business days between February 26 and March 3, 1993 in Nigeria. The purpose of the visit was, on an initial impression basis, to determine the need for and viability of Venture Capital. In pursuit of this objective, the current political environment, macroeconomic environment and other elements of the enabling environment for Venture Capital were examined. At the same time, on a preliminary basis, the micro factors influencing the viability of Venture Capital were assessed . The Consultant also was asked to recommend what role Prince Lekan Fadina of Equity Securities could play in this process. The trip was an addendum after a more extensive visit to Gambia which also concerned Venture Capital.

This report provides first impressions on the current situation in Nigeria, certain preliminary recommendations, as well as a frame of reference and methodology for examining in detail the need for and the viability of Venture Capital development in Nigeria.

What is required is a significantly more extensive follow up visit to flesh out the initial findings and to develop a comprehensive strategy which should be implemented once there is political stability. As the general election finally took place on Saturday June 12, it is hoped that the elected civilian party will take power as scheduled on August 27, 1993. Once the transition from the military Government to a democratically elected civilian Government occurs, then the process for political stability may begin.

The easy part is determining the need for Venture Capital. There clearly is such a need.

The difficult issue is determining how to provide Venture Capital in a form which is meaningful, viable and which maximizes the effect of Venture Capital's catalytic role in fostering private sector entrepreneurship.

Hence, in examining the viability of Venture Capital in Nigeria, it will be necessary firstly to achieve political stability and then to examine the enabling environment, including the soundness of the financial sector. These are necessary preconditions to Venture Capital.

The paradox is that although the need for productive investment, for Venture Capital is greater than ever, nevertheless, the environment could hardly be worse.

Political stability is the first and major precondition for developing Venture Capital in Nigeria. Without it, one cannot even begin to consider the environment for risk capital investment. Once there is political stability then there is a need to create a conducive enabling environment for investment whereby savings are efficiently mobilized and channeled into productive investments. Private sector financial institutions should perform this allocative function.

For Venture Capital to have a chance of succeeding, it must be private sector led, managed and focused.

In conjunction with creating a conducive enabling environment, a restructuring and consolidation of the financial sector is urgently needed. Many Nigerian financial institutions are fundamentally unsound - both in terms of their financial condition and the quality of their management. The proliferation of financial institutions is indicative of the banking licence being the latest vehicle for "hot money" and not a profession with fiduciary responsibilities to depositors, shareholders and clients. Before the banking licence, securing an import licence was the vehicle of choice for "hot money".

The situation in Nigeria is likely to worsen before getting better. As one local commentator stated, Nigerians will face up to the situation and start to make the tough decisions only when their backs are against the wall. At the moment there is still plenty of "hot money" around.

Nigeria has many skilled and talented professionals and entrepreneurs. The country is not lacking in entrepreneurship. Indeed, Nigeria is imbued with an entrepreneurial spirit and the Ibos are famous as traders. The problem is that much of the entrepreneurial activity is non productive. Nigeria also has relatively well developed money and capital markets which provide a number of exit mechanisms to realize capital gains or losses on risk capital investments. However, at the moment there is no incentive for skilled and talented Nigerians to focus on activities involving a medium to long term time frame.

The instability of the political environment and the volatility of the economic environment have created a situation where commercial and financial activities are skewed to the short term with the quick and easy buck mentality prevailing. Long term in Nigeria is 90 days. In the meantime, the industrial base is eroding as is the quality of life for most Nigerians. This is what has to change. Only by achieving political stability and by changing the enabling environment can one provide the incentive for people to refocus on the medium to long term rather than solely on the short term. The role of Government is to create the policy framework for a conducive enabling environment. It must lead decisively in this endeavor.

The focus of activity in Nigeria is on facilitating, intermediating or brokering. Few are willing to do, to act, to produce. Why engage in the latter when as an intermediary or facilitator or broker you can make easy and risk free money?

If a financial institution can raise deposits paying 45% and then lend at 9-10% a month to finance companies which provide Local Purchase Order (LPO) financing, or participate in the lucrative money market, foreign exchange and treasury trading activities, then what incentive is there to engage in Venture Capital?

If an entrepreneur can secure an LPO or engage in importing contraband and generate a handsome return over a short period of time, why invest in a project or a business which has a gestation period and a development lead time and where the country could be drastically different by the time this venture is projected to be generating positive returns even under the most optimistic scenarios?

Risk capital investment is hard work. It requires an active hands on involvement by both the financier/partner and the entrepreneur.

Why engage in this activity when excellent returns can be made without risk and without having to dirty your hands, roll up your sleeves or get into the trenches? If Venture Capital was lucrative now, then certainly at least some of the smart players would be engaged in it. The reason why none of the smart players are focusing on Venture Capital is because there are easier ways to make good money with less effort, less risk and with a minimal use of capital.

An example of the present level of uncertainty is the handling of the general election. The election, which already has been postponed on 3 prior occasions since 1990, was planned for June 12. However, on the night of June 10 Justice Ikpeme of the Federal High Court in Abuja issued a temporary injunction ordering the military Government to delay the election. The ruling came in response to a lawsuit by the Association for a Better Nigeria. This is a group of former politicians and businessmen with indirect military support which seeks an extension of military rule for at least 4 more years until "civilian politicians show themselves capable of establishing democracy". The association asserts that the transition to civilian rule has been marred by widespread vote tampering and corruption - allegations that Justice Ikpeme agreed should be given a court hearing before the election proceeded. However, on Friday, June 11 the national electoral commission dismissed the ruling, declaring that the court had no right to preside over the elections.

With all this occurring in the final 36 hours prior to the election, political uncertainty dramatically increased and people's faith in the political process is more sceptical than ever. In the end, the election did take place and the candidate for the Social Democratic Party, Moshood Abiola, appears to have won a clear mandate having won in a majority of the 30 states.

Nevertheless, in the next chapter of this saga, on June 16, the electoral commission appointed by the military leaders set aside the results of Saturday's election following an order from the Federal High Court of Abuja. Justice Mohamveg Saleh, the Chief Judge, ordered the electoral commission not to publish the results until legal arguments over vote-rigging were heard by the court. The chairman of the electoral commission stated that they had no choice but to suspend the elections as otherwise they would be held in contempt of the court. Meanwhile, on June 17, the Federal High Courts of Lagos and Benin ordered the Government to announce a winner within 24 hours.

Given the conflicting rulings by 3 different courts, legal experts opined that the logical step is for the case to be heard by the Supreme Court. This process could take months, effectively nullifying the election and keeping the military in power.

What is clear out of this latest political intrigue is that General Babangida does not intend to hand over power on August 27. In the meantime, the country becomes more unstable with each passing day.

Nigeria, for at least the past decade, has been characterized by perpetual potential along with continual current disappointment. For many, Nigeria is a very difficult environment in which to operate and of such a size that unless you commit to a comprehensive and major program, you are unlikely to have any significant impact. Furthermore, corruption is systemic.

Yet with its tremendous human and natural resources Nigeria cannot be ignored. With a population of 112 MM and a real GDP (PPP$1990) of $136 BN, Nigeria along with South Africa are the dominant countries of Sub Saharan Africa. However, upon examining the level of Official Development Assistance (ODA) for Nigeria compared with many other developing countries, the impression is that most donors regard Nigeria with justifiable caution and scepticism. ODA per capita for Nigeria in 1991 was only $3 with the total ODA amounting to $293 MM. In 1990 the American bilateral ODA program amounted to only $22 MM and this principally was allocated to health and population programs. These aid flows for Nigeria can be compared for example with Gambia and Mozambique. Gambia received in 1991 $106 per capita for a total amount of $95 MM including an American bilateral ODA program of a similar size to the program in Nigeria, a country more than 100 times the population of Gambia. Mozambique received in 1991 $70 per capita for a total of $1,022 MM in ODA.

Venture Capital involves investment. As Nigerians have significant holdings of capital, an excellent barometer for the investment climate is the level of investment in Nigeria by Nigerians. Why should foreigners invest in Nigeria when Nigerians themselves are not investing and when capital flight is increasing daily? As of the third quarter of 1992, the cross border bank deposits by Nigerians (excluding banks) amounted to $3.42 BN. This amount only has increased since then and this figure is the official version. It does not take into account informal capital flight. Foreigners should start to invest when the smart Nigerian money is investing in Nigeria as opposed to being deposited in Swiss, UK or American banks. This capital flight trend is unlikely to reverse, even under the best of circumstances, in less than a couple of years.

Once political stability is present in Nigeria and there is a conducive enabling environment for risk capital investment, there will be plenty of opportunities for Venture Capital. There are many undervalued assets in Nigeria where realizable values can be enhanced through outside management skills - financial and operational. This creates opportunities for corporate restructuring, turnarounds, workouts, deconglomerating privatized or commercialized parastatals and other forms of Venture Capital and corporate finance.

The privatization and commercialization of the parastatals, at the Federal, State and Local Government levels offer significant opportunities for corporate restructuring, especially deconglomerating some of the parastatals. Their breakup value, on a net asset basis or on the strategic basis that the parts are greater than the sum, will be interesting to value investors. For turnaround/workout specialists one of the key problems for the parastatals is the quality of management. Commercialization essentially involves a turnaround. The privatization of the state owned banks also will provide substantial opportunities for restructuring expertise.

What is necessary is for at least one group to actively pursue Venture Capital. The key is for this group to make excellent returns thereby creating a demonstration effect for others. As assets are so undervalued, there is no reason why supernormal profits cannot be generated.

The focus for private sector development should be on diversifying the export base. The recovery must be export led. At the moment, the few primary and secondary industries which are doing well are those with local costs and foreign currency revenues - particularly if they are exporting to the Francophone market.

These exporters, such as certain textile manufacturers and agriculture producers, are benefitting from the combination of a depreciating Naira and the overvalued CFA.

Therefore, in examining the viability of Venture Capital in Nigeria, the following process has to take place: political stability, the creation of a conducive enabling environment for risk capital investment, and a restructuring of the financial sector so as to avoid a system wide collapse due to the financial unsoundness of many financial institutions. Once this occurs, then there is no reason why Venture Capital should not flourish in the dynamic Nigerian market.

Nigeria has the human talent - well qualified and experienced managers and professionals as well as quality entrepreneurs; Nigeria has significant local sources of capital which can be mobilized for productive investment; Nigeria has a relatively well developed money and capital market, including a first and second tier stock exchange; Nigeria has substantial natural resources which can be tapped; and Nigeria has a large local market.

Section 1 defines the activities of a Venture Capital Unit; suggests a role for USAID; places Venture Capital in the context of the financial sector; examines the process by which Venture Capital can be a viable activity; outlines the criteria for investment, including Nigeria's advantages and disadvantages; and sketches the basic strategy for Venture Capital in Nigeria.

Section 2 examines the macro preconditions influencing the viability of Venture Capital in Nigeria. Elements of this enabling environment are: political risk/stability; the macroeconomic policy and conditions; relations with Nigeria's international creditors; relations with the multilaterals; Government investment policy; investing in education and training; the financial institutional environment; the legal environment; the prudential regulatory and supervisory environment; accounting, auditing and information disclosure; and the infrastructure environment.

Section 3 outlines in brief the micro factors critical for the viability of Venture Capital in Nigeria. These factors include: the financial vehicle to provide Venture Capital; potential promoters of Venture Capital; the type of activities which a Venture Capital Unit in Nigeria is likely to engage in; the availability of quality management; the entrepreneurial base; sources of capital; the legal structure for Venture Capital; and exit mechanisms.

Section 4 specifies a follow up action plan entailing meetings in Washington DC and Nigeria.

1. VENTURE CAPITAL

1.1 Define

The essence of Venture Capital is the provision of risk capital and needed skills to entrepreneurs. The process necessitates a very hands on, activist partnership between the Venture Capital Unit and the entrepreneur with the common goal of adding realizable value to the target business / project. What Venture Capital is all about is stimulating private sector entrepreneurship.

1.2 What a Venture Capital Unit will do in Nigeria

Particularly in developing countries, successful Venture Capital requires an active hands on involvement in the portfolio companies. The role of the Venture Capitalist goes far beyond that of a financier, let alone a fully secured commercial bank provider of term or overdraft finance. The Venture Capitalist is a partner in the fullest sense of the term. Moreover, the skills required are multidisciplinary and hence the need for a team oriented approach.

A Venture Capital Unit in Nigeria will engage in the following activities:

- *proactive identification of opportunities. The Venture Capital Unit will not be reactive waiting for business plans to appear on the desks.*
- *project / corporate appraisal*
- *project / corporate valuation*
- *structuring the financing, both in terms of equity, debt and hybrids*
- *negotiating the deal*
- *obtaining the financing, particularly mobilizing local sources of capital*
- *adding value to the project / corporate and filling the gaps:*

  There will always be gaps. A quality Venture Capital Unit will fill those gaps. Typically the gaps will be in one or all of the following areas:

  - *financial controls*
  - *an incomplete or poor quality management team*
  - *operational guidelines*
  - *marketing, especially international*
  - *international sourcing of raw materials, plant and equipment*
  - *strategic planning*
  - *management information systems*
  - *cost analysis*
  - *creative financing such as accessing blocked funds, discounted converted Paris or London Club debt.*

  To fill these gaps may require one or more of the Venture Capital Unit team members to spend 6-12 months working on the project / in the company.

- *monitoring the investment so that if there is a problem it is addressed at an early stage and if there is an opportunity it is seized upon.*
- *planning an exit mechanism so that the paper gain or loss can be realized.*
- *exiting.*

1.3 USAID's role

Nigeria is embarking on a significant political change. This will create new opportunities and it is to be hoped that USAID will want to play a proactive role in assisting in the transition and in helping to shape an enabling environment conducive to private sector development, of which Venture Capital is an integral element.

If this is the case, then it will be appropriate to devise both a FAPE and a FSR program for Nigeria. USAID Washington will be involved through programs such as AVCP.

The FAPE program will focus on a strategy for creating a conducive enabling environment for private sector investment.

The FSR program will focus on a strategy to restructure the financial sector.

The AVCP program will focus on the specific Venture Capital issues.

1.4 Nigerian context for Venture Capital

The current focus of business is on the short term. The main activities revolve around LPOs, trading and patronage.

The current focus of the financial sector is also short term. The banks' primary activities involve foreign exchange trading, LPO financing, money market trading, interbank activities and evergreen overdraft financing for the traders. The banks provide little secured investment capital, let alone risk capital. The banks are not performing their allocative function of channeling savings into productive investment. There is no incentive for them to do so.

The "lame duck" Transitional Government is like a "rudderless ship of state". Political stability, with whomever is in power, is a necessary precondition to beginning the process of creating an enabling environment which will lay the groundwork for facilitating private sector entrepreneurship: Venture Capital.

Nigeria has become a single commodity economy. Oil and petroleum products generate 97% of export revenues. Before the discovery of oil, Nigeria was an agrarian based society. Today, much of the agriculture lies fallow. It is only now starting to turn around. Not only did oil change the structure of the economy, it also changed the mentality of the people. Oil created instant wealth, instant gratification. This was totally different to agriculture where you had to plant, sow and reap over a period of 1-5 years, depending on the crop. The oil economy has been a catalyst for developing a quick buck mentality, a short term focus of activity and a culture of greed. For Venture Capital to succeed, this mentality has to change. This can only occur when there is political stability and a conducive enabling environment. The changes will not happen overnight. It will be a step by step process which will take years.

1.5 Venture Capital's context in the development of the financial sector

What we are examining is the scope for institutionalized Venture Capital. Informal Venture Capital already exists in Nigeria as it does in most communities. This type of activity involves an individual providing financial backing to an entrepreneur who lacks the capital. However, informal Venture Capital lacks liquidity and has inherent limitations. Most entrepreneurs need not only capital but also a whole range of skills and services. Therefore, when the term Venture Capital is used, it is in reference to institutionalized Venture Capital.

Venture Capital cannot be established in a vacuum. If one simply sets up a specialized Venture Capital company without taking into careful consideration the surrounding environment, then it is unlikely to succeed. In order to maximize the chances of Venture Capital succeeding, it is essential to understand its place in financial sector development - where it typically emerges at a fairly mature stage - as well as the many macro enabling environment preconditions and micro factors which need to be addressed and satisfied before one can engage in Venture Capital.

One of the main reasons for the relative lack of success of Venture Capital companies in developing countries is the lack of sensitivity and understanding of the importance of the enabling environment and financial sector development. These are necessary preconditions to Venture Capital.

A second factor in the lack of success is the type of vehicle and structure typically selected to provide Venture Capital: specialized Venture Capital companies and Venture Fund Management companies.

These specialized vehicles lack the synergistic and cash flow benefits available to a financial institution (for example, a merchant bank) which engages in a variety of financial products and services, one of which may be Venture Capital. Moreover, they tend to be capitalized primarily with foreign funding, largely donor or multilateral. This tends to create a perception held by investees that the funds received are entitlements rather than an investment with accompanying responsibilities. Mobilizing local sources of capital is essential to viable and successful Venture Capital. Finally, these vehicles typically are staffed with expatriate senior managers who may lack private sector, bottom line oriented, hands on experience while middle and junior management levels tend to be thinly staffed.

Where is Nigeria in terms of its financial sector development?

Nigeria has an extensive credit market, an active money market and a relatively well developed capital market. However, many financial institutions are fundamentally unsound. A restructuring and consolidation of the financial sector is required if one is to avoid a disastrous collapse of numerous institutions. Such a collapse would have a devastating effect on the public's confidence in the fiduciary role of the financial sector. At the same time, the resources of the prudential regulatory and supervisory agencies must be drastically increased both quantitatively and qualitatively.

1.6 Need for and viability of Venture Capital

There clearly is a need for Venture Capital in Nigeria.

There are a few groups which are engaging in certain aspects of Venture Capital or who have attempted to do so.

Ventures and Trust is a small boutique investment, finance and leasing company. They have acquired a portfolio of 6 companies. However, their involvement is primarily financial and the objective is to "flip" their portfolio companies through a public listing or a private placement as soon as possible.

The Raw Materials Natural Resources Council (RMNRC) has been trying to raise capital to establish a Risk Fund for Venture Capital. They are a public sector entity and primarily a research center.

Continental Merchant Bank tried in 1986 to establish with IFC the Premier Venture Capital Company. This $10 MM fund failed due to the prevailing unstable and deteriorating macroeconomic conditions - including the drastic devaluation of the Naira - and the lack of any regulations governing Venture Capital, let alone providing incentives for Venture Capital. Conditions now are worse.

Progress Bank of Nigeria has provided some Venture financing to small and medium sized enterprises. However, this has not involved taking any equity positions.

Prince Fadina of Equity Securities has been active in promoting the need for Venture Capital and raising the awareness of Venture Capital with Government and institutions.

Hence, it is evident that while there have been some piecemeal attempts at Venture Capital, for a country the size of Nigeria, Venture Capital is still "terra incognito".

The Nigerian commercial banks tend to lend, when they do, short term and fully collateralized with physical assets. There is minimal, if any, cash flow based lending and no pure risk capital investment based on management and growth prospects. Commercial banks tend to be risk avoiders and asset intensive. Yet the essence of Venture Capital is risk capital and a hands on involvement with management in all facets of the business. This situation prevents many young companies, which may not as yet have acquired many physical assets, from obtaining term finance. With established companies the cost of borrowing from the banks (the merchant banks are not active in term finance), taking into account interest rates and the hidden costs, is prohibitively expensive for all except those companies which are engaged in the short term oriented and profitable trading and LPO activities.

As there is a fairly mature capital market, it is possible for certain companies to raise equity capital through this avenue. However, this source of capital is not Venture Capital as it involves passive funding and not the hands on value adding participation of the Venture Capitalist.

Other potential sources of term finance are the state owned development finance institutions (DFIs). However, these DFIs are riddled with problem loans and many are technically insolvent and would fail if not for Government subsidies.

1.7 What investors look for

The enabling environment is vital to the concerns of the investor (both foreign and local) and to the entrepreneur / investee.

Key elements in the decision making process for risk capital investment: (yes/no indicates whether or not these elements are currently present in Nigeria)

- *stable political and economic environment* **(No)**
- *open, laissez faire government* **(No)**
- *transparency in decision making with little systemic corruption in dealings with Government and the banking system* **(No)**
- *ability to get things done: the hassle factor* **(No)**
- *incentives for investors - such as the ability to capitalize the venture via discounted debt or blocked funds or a preferential exchange rate for investors* **(Yes)**
- *foreign exchange which is market driven, relatively stable and lacking direct Government interference* **(No)**
- *ability to remit profits without restrictions* **(No)**
- *minimal risk of nationalization* **(No)**
- *low taxes, duties, charges, fees* **(Yes)**
- *quality and relative cost of labor and skilled management* **(Yes)**
- *availability of land and premises at competitive rates - ideally the ability to lease factory shells in an industrial park or export processing zone* **(No)**
- *access to sources of supply* **(Yes)**
- *sources of local financing at attractive rates* **(No)**
- *size of the domestic market* **(Yes)**
- *access to sales markets* **(Yes)**
- *transportation costs and efficiency level.* **(No)**

1.8 Nigeria's comparative advantages for risk capital investment

- *size of the market*
- *availability of certain natural resources*
- *relatively well developed money and capital markets*
- *availability of skilled management at a relatively low cost*
- *an entrepreneurial workforce*
- *suitability for labor intensive, low to medium skilled, light manufacturing, processing and assembly operations geared for the export market.*

1.9 Nigeria's comparative disadvantages for risk capital investment

- *political instability*
- *macroeconomic instability*
- *systemic corruption*
- *short term focus of business and the financial sector*
- *a fundamentally unsound financial sector*

- *high interest rates and little availability of term finance*
- *although the allocation of foreign exchange is market driven, the Government directly interferes in the process*
- *relatively low level of labor productivity compared with workers on similar wage rates in countries like Kenya, Ghana, Vietnam, China, Bangladesh, Guatemala*
- *lack of international marketing skills and knowledge*
- *a reactive and inefficient investment agency rather than a proactive service oriented agency*
- *lack of infrastructure*
- *high transportation costs*
- *few tangible incentives apart from the Debt Conversion Program (DCP) to attract foreign companies to invest in Nigeria*
- *a reputation for foreign investors being "burned".*

1.10 Strategy for successful Venture Capital in Nigeria

What is required is a step by step process which will focus on:

- *a transition to a democratically elected civilian Government with the mandate of the people which can be the basis for developing political stability. This in itself is a major challenge and not probable in the immediate future.*

- *once there is political stability, one can begin to address the recommendations concerning the enabling environment.*

- *financial sector stabilization and a shakeout whereby only the quality, healthy financial institutions survive.*

- *encouraging a number of quality merchant banks and corporate advisory companies to engage in Venture Capital as one of the activities of their corporate finance departments.*

- *focus on restructuring existing corporate entities such as privatized and commercialized parastatals where there is the potential for significant asset value enhancement through the services, both financial and otherwise, of a Venture Capital Unit. Moreover, the timeframe for realizing the potential capital gains should be quicker than when dealing with startup situations.*

- *focus secondarily on startup opportunities or expansions of existing corporations or projects which are export oriented.*

2. *MACRO PRECONDITIONS - THE ENABLING ENVIRONMENT - INFLUENCING THE VIABILITY OF VENTURE CAPITAL IN NIGERIA*

2.1 Political risk/stability

Politics is the dominant factor in Nigeria today. The military is due to return to the barracks on August 27, exactly 8 years after General Babangida came to power. Both Presidential candidates, M.K.O. Abiola of the Social Democratic Party and Bashir Tofa of the National Republican Party, are allies of General Babangida. The Nigerian military created these two parties, gave them their names, assigned them their party platforms, appointed senior party officials, provided funds and built hundreds of party offices. For these reasons many Nigerians have dismissed this whole managed process as a sham, saying that no matter who wins, the army will still be in charge.

The political scenarios between now and August 27 are most likely the following:

- *General Babangida declares that the Transitional Government has failed and takes back direct power*
- *the Transitional Government's term in office is extended*
- *M.K.O. Abiola of the Social Democratic Party assumes power on August 27*
- *a new military junta takes power.*

The concern of many Nigerians is that the military will deliver the country to the civilian Government in such a condition that the new Government can only fail. When that happens, the military will step back in, having "proven" to the people that a civilian Government cannot run the country.

Since independence, there have been seven successful coups and three of the nation's eight leaders have been assassinated. Two brief periods of civilian rule collapsed after allegations by the military of incompetence and wholesale corruption. The lack of political stability has been one of the fundamental factors in the poor economic development performance of Nigeria since independence. This is in spite of the discovery of oil.

If however, the sceptics are proven wrong and democracy takes root in Nigeria, then the country could become one of the few to make the leap from a mostly agrarian and then single commodity - oil - society to an industrial based society. This has been the tantalizing potential of Nigeria for at least the past decade. In the meantime, the reality has been devastatingly disappointing.

For a country which is a member of OPEC, Nigeria's 1993 UNDP Human Development Index (HDI) rating of 142 out of 173 countries is particularly low as was its GNP per capita ranking of 153 out of 173.

The potential for widespread civil unrest is increasing. There is hunger and significant pent up frustration. In the past two years there have been several serious civil disturbances: religious violence in Bauchi state in April 1991, religious riots in Kano in October 1991 and riots in Lagos and Kaduna in May 1992.

Religious, tribal, ethnic and social tensions are increasingly on the boil in Nigeria.

In terms of the potential for social unrest, the unemployment rate among secondary school graduates is a most telling statistic. Unemployment is estimated to be as high as 67% as of March 1992. The unemployment rate for college graduates also is very high. Social disturbances, demonstrations and riots historically are initiated not by the poor, but rather by the disenfranchised educated, unemployed middle class. This is a cauldron waiting to boil over. It is a major factor in the level of political instability. A stable political situation and a revived economy which creates jobs is essential if one is to avoid widespread and potentially catastrophic social unrest. Until these issues are addressed, one cannot seriously entertain long term risk capital investments.

2.2 Macroeconomic policy and conditions

The macroeconomic environment is unfavorable for risk capital investment.

The economy is characterized by the following conditions:

- *a rapid increase in the money supply*
- *high and unsustainable interest rates*
- *continued depreciation and occasional instability of the naira exchange rate*
- *an increasing and unsustainable fiscal deficit along with inadequate policy coordination*
- *excessive levels of extra budgetary spending*
- *unsustainable pressures on the balance of payments*
- *continued over dependence on oil and petroleum exports*
- *low output growth*
- *weak demand,*
- *a diminishing industrial and manufacturing base operating at very low capacity*
- *galloping inflation*
- *rising unemployment.*

Sadly, the situation is likely to worsen before beginning to improve.

Investment levels are weak in Nigeria. Gross domestic investment in 1990 was 15% of GDP. The average for Sub Saharan African countries was 25%, the average for all developing countries was 26% and the average in OECD countries was 22%.

However, savings levels are quite strong. Gross domestic savings in 1990 was 29% of GDP. This compares with an average of 21% for Sub Saharan Africa, 26% for all developing countries and 22% for OECD countries. The problem is that the private sector is crowded out by the public sector from receiving a majority portion of the domestic savings.

Monetary policy:

Monetary shock treatment is required. However, there is insufficient political stability to enforce these sort of measures. Moreover, due to the size of the informal sector it is difficult for the Government to implement effectively its monetary policy, even if it had a mandate to do so.

Interest rates

The liberalization of interest rates and the restoration of positive real interest rates are needed. These are areas where the IMF in its Structural Adjustment Programs has had some influence. Market driven interest rates are a key element in promoting a more efficient allocation of resources.

At the moment there is an inverted yield curve for interest rates, negative real interest rates due to galloping inflation and wild fluctuations in interest rates arising from the Government's credit policy and foreign exchange policy.

Interbank interest rates have been fluctuating between 50% and 120% over the past 6 months. This is due largely to the Government's unpredictability in its handling of the Interbank Foreign Exchange Market (IFEM) and the issuance of compulsory stabilization securities.

Lending rates to companies also have fluctuated wildly. The average over the past year has been between 40-120%. Few companies, unless they are engaged in short term activities, can sustain these rates. Moreover, the current high interest rates generate an exorbitantly high hurdle rate of return for equity investors. Inflation must fall, as well as Government expenditure levels, so that the pressures on interest rates can be lessened. Interest rates need to be in the 10-15% range in order to make risk capital equity investment attractive.

With deposit rates also nominally being very high, in the range of 45%, investors are encouraged to place their funds on deposit in the banks. The present system does not encourage manufacturing or productivity where the return will be low and the risk high. Capacity levels of industry are in the 30-40% range. Hence, the focus is on financial activities or short term trading arbitrages, rather than on production.

Stabilization securities

The Central Bank has relied on issuing stabilization securities as a means to mop up excess liquidity in the system. Financial institutions are compelled to subscribe to these securities. The unpredictability in their timing and amount has increased uncertainty in the financial sector and places pressure on interest rates when certain banks lacking liquid reserves are forced desperately to raise funds in the interbank market in order to meet their subscription commitments.

The Government has stated that it intends to phase out the stabilization securities. So far it has not done so. It should do so and move towards indirect monetary controls as opposed to these very direct controls.

Exchange rates

Oil prices are a major determinant of the supply of foreign exchange. As a consequence of recent low prices for oil, the amount of foreign exchange available to be auctioned has diminished significantly. There is tremendous uncertainty in the marketplace as to the Government's exchange rate policy. The general trend has been for continued depreciations of the Naira.

On March 5, 1992 the Naira was devalued from N10=$1 to N18=$1. During 1993, the exchange rate has been very volatile. The Naira has fluctuated between N23=$1 and N41=$1.

The IFEM auctions have on occasion been cancelled by the Government without notice and then auctions have been announced with little notice and no disclosure as to the amount of foreign exchange which is to be auctioned. The recent February 24, 1994 auction is a good example of the way in which the Central Bank has been executing exchange rate policy. This auction was cancelled by the Central Bank which complained at "outrageous bids that emerged". Bids went up to N33=$1 from the level at the previous auction of N25=$1. The Central Bank's distaste for "full market forces" was demonstrated. The effect of the suspension was to send the market haywire.

The dutch auction system is likely to change but no one knows when or what will replace it.

The Government actively manages the foreign exchange market. It is not even a dirty float. Allowing the Naira to float freely is recommended. However, it may have inflationary side effects.

Credit

The Government still influences the allocation of credit by the banking system through mandatory sectorial allocations of credit. 50% of credit is required to be allocated for agriculture and industry. There additionally are restrictions on the volume of credit which banks can grant to the private sector. For most banks the limit is a 16% growth. The exception is for the minority of banks which meet certain performance criteria such as strict adherence to the Central Bank's guidelines on specified cash reserves, liquidity ratios, statutory minimum paid up capital and proven sound management. This represents a step towards shifting the emphasis of monetary policy from direct to indirect controls.

M1 has been expanding very rapidly. M1 growth was running at more than 50% in September 1992 and total bank credit increased by 25% at the end of September. This will only further fan inflation.

Moreover, credit to the public sector has been crowding out the private sector. The figures for the period from December 1991 to September 1992 indicate that total bank credit to the public sector increased by 40.6% while the comparative figure for the private sector was only a 12.8% increase.

Open Market Operations (OMO)

OMO should be the prime means by which the Central Bank influences the reserve levels of financial institutions. This indirect form of monetary policy involves the purchase and sale of Government securities (treasury bills, treasury certificates and development stocks) and the operations of the discount and rediscount windows at the Central Bank. OMO is a flexible monetary policy tool which will assist the Government in the fine tuning of the economy.

Reserve requirements for financial institutions

The Central Bank has issued weighted risk adjusted reserve and capital adequacy requirements for the financial institutions. Many institutions are not in compliance with the requirements. Many are unable to meet the requirements. So far, the Government has not enforced the requirements.

Fiscal policy:

Budget deficit

The budget deficit is expected to remain high in 1993 at a level equal to at least 7.5% of GDP. This forecast is optimistic as it is based on the Government's spending plans not overshooting - which is optimistic to say the least in an election year when extra budgetary spending is out of control.

The public sector still plays too great a role in the economy and crowds out the private sector from investment flows.

Fuel subsidies

The total annual subsidy for gasoline in the 1992 budget amounted to N63 BN. This was more than total spending projected in the 1992 budget. Nigeria's domestic petrol price is only N 0.7c a liter (approximately 4US cents per gallon).

The removal of the fuel subsidy is a major precondition for the IMF to consider a program for Nigeria. However, the removal could lead to civil unrest and will be inflationary unless the money supply effect is sterilized.

Taxes

Nigeria requires a tax system which is transparent and which is attractive for investment, especially equity investment in the form of risk capital as compared with debt financing.

Nigeria has taken steps to reduce certain tax rates which are critical for investors. The RMNRC has played a role in these changes.

Withholding tax on dividends resulting from Venture Capital investments has been proposed to be reduced from 15% to 0%. This is part of a special Venture Capital Decree which is still in a draft form.

Capital gains tax is generally 20%. Under the special decree, it is proposed to reduce the capital gains tax on Venture Capital investments to 5% while losses can be carried forward. It may be possible to allow Venture Capital gains (not dividend income) to be passed through to the shareholders tax free.

Inflation:

Under the impact of the 40% devaluation in March 1992, inflation surged to 70% in 1992 while the Government admitted to 46%. Due to the explosion in extra budgetary spending and the sharp increase in the M1, inflation should be even higher in 1993.

2.3 Relations with international creditors and the multilaterals

Paris and London Club Agreements:

Nigeria' s total external debt amounts to $27.5 BN, the majority of which is Paris Club debt ($16.5 BN). The other components are London Club ($2.1 BN - down from $6 BN in 1991 due to the buyback program), Multilateral agencies ($4.5 BN), Promissory notes ($3.2 BN) and others ($1.2 BN). Full debt service obligations amount to $4.6 BN in 1993.

Due to lower than expected oil revenues, Nigeria is experiencing payment arrears on its external debts.

Nigeria only will be able to negotiate a Paris Club rescheduling and renewed foreign capital inflows when an IMF facility is in place and a stable civilian Government is in power.

The availability of Paris Club debt for conversion into Venture Capital activities would provide a major incentive for investors as it would create a substantial pool of discounted funds.

IMF Program:

Nigeria's negotiations with the IMF are presently stalled on four key issues: the Government's recurring fiscal deficit, the local fuel subsidy, the excessive monetary and credit expansion, and inadequate moves to narrow the gap between the official and parallel market exchange rates. Moreover, the IMF is reluctant to negotiate with a "lame duck" administration.

An IMF agreement should be a major priority for the new civilian Government, assuming that it takes power.

2.4 Government policy towards the private sector, specifically investment

Government investment policy must be a catalyst for mobilizing domestic and foreign sources of capital and to channel it into productive investment opportunities. This is critical for Venture Capital. Government must take the lead by establishing a policy which is actively pro private sector, pro investment and pro Venture Capital.

Political stability, a conducive enabling environment, transparent legislation with incentives for investment, and a truly one stop, streamlined investment agency are keys to achieving this objective.

Industrial Development Coordination Committee (IDCC):

IDCC Is the sole agency authorized to grant the preliminary approvals in terms of foreign investment in Nigeria. As decisions are made by a board which represents many ministries and Government agencies, decision-making is slow and cumbersome.

A wholesale restructuring of IDCC is recommended and should be modeled on Singapore's Economic Development Board.

The investment agency should have the sole authority to decide on specific investment applications with minimal formal input from Government. It will necessarily operate within the guidelines of the Government investment policy. In the practical sense, it will be a one stop investment shop.

The investment agency should be a proactive promoter of investment opportunities in Nigeria and be service oriented.

Debt Conversion Program (DCP):

The depreciation of the Naira has made the DCP less attractive as a vehicle for investing in Nigeria. The risk for investors in participating in the debt conversion auction is that if their bid succeeds, then it may be a number of months until the funds are converted and disbursed. In that period the Naira may have depreciated to such an extent as to wipe out the gain through participating in the auction. Yet investing through the DCP entails certain restrictions such as on dividend and capital remittances which are not present when a foreign investor invests with fresh capital.

The DCP has not been a success in attracting significant project investment flows to Nigeria.

Privatization and commercialization program:

The Government agency, Technical Committee on Privatization and Commercialization (TCPC), is in charge of the privatization and commercialization program.

TCPC has been in operation for 5 years. 88 parastatals have been privatized of which 35 through public issues. 3 BN shares have been offered for sale generating N5 BN. Individuals have acquired 68% of the shares, institutional investors 22% and ESOP 10%.

There are approximately 600 parastatals at the Federal level and 900 more at the State and Local Government levels which could be privatized or commercialized. It is potentially a massive undertaking involving a fundamental restructuring of the economy. Most of these parastatals are loss making if not technically insolvent.

The revitalization of privatized and commercialized parastatals through restructuring, workouts, turnarounds and asset breakups are a major source of business for those groups engaging in Venture Capital.

The parastatals are characterized by non performing or underperforming assets. There is a significant value arbitrage opportunity for those groups with the skills and capital to realize incremental value from this asset base.

2.5 Investing in training and education

In Nigeria the human talent is available. What the labor force and management need are skills and training.

The recently established Lagos Business School can be a model for developing business skills. It is a private sector initiative which seeks to develop a graduate level school of management.

Schools for entrepreneurial business and technical apprenticeship training should be established on a widespread basis.

Detailed recommendations need to be made concerning education, training, skills transfer and business development programs for entrepreneurs.

2.6 Financial institutional environment

The financial sector is fundamentally unsound and is a "bubble" which is likely to burst within the next 3 years unless substantive action is taken. The restructuring of the financial sector will involve a major shakeout and consolidation. Such a restructuring will take place. The only question is whether it occurs involuntarily because of a collapse of the "house of cards" of the financial sector, or else voluntarily due to action by the Government to manage the restructuring process.

All the ingredients for a collapse are present: minimal prudential regulatory and supervisory enforcement, many unscrupulous participants, undercapitalized institutions, explosive expansion in the number of financial institutions, most financial institutions are staffed with management lacking the needed professional skills, and the activities of the banks have been based on artificial factors such as foreign exchange allocation rather than on fundamentally sound criteria.

Obtaining a merchant banking licence, a mortgage banking licence, a community banking licence are all licences to print money through participating in the foreign exchange allocations at IFEM, money market and treasury activities, providing LPO financing and overdraft facilities for the traders. None of these activities are productive for the country.

The number of financial institutions, both banking and non banking financial intermediaries (NBFIs), grew exponentially in the past 5 years. In the banking sector there are now more than 100 merchant banks, approximately 20 commercial banks and more than 100 community banks.

In the NBFI sector there are more than 100 mortgage institutions, more than 100 bureaus de change and more than 100 stock brokers.

The regulatory and supervisory authorities have not kept pace with this explosive institutional growth. This has created a very dangerous situation in terms of the health of the financial sector. Now that the system for allocating foreign exchange has changed from that of a guaranteed participation to bidding competitively, many of the financial institutions which lack expertise are no longer creditworthy and are teetering on the brink of insolvency. Out of the commercial and merchant banks there are 15-20 quality banks, about 20 insolvent banks and approximately 80 banks in some degree of financial difficulty.

When the Government stopped approving new applications for merchant bank licences, the mortgage bank licence was identified as the next loophole allowing businessmen to participate in the allocation of foreign exchange and LPO financing. The modus operandi of the mortgage institutions is LPO financing, money market, foreign exchange and treasury operations. They are engaged in exactly the same activities as the merchant and commercial banks. These institutions are not providing mortgage financing. Yet they have tapped into a N500 MM Housing Fund at a subsidized cost of 4% which was designed for mortgage onlending. Apart from the Housing Fund, their main deposit base is short term. Therefore, for them to engage in mortgage financing would entail the classic term transformation risk which has so characterized the American Savings and Loan debacle.

It is not only the mortgage institutions which have lost touch with their primary responsibilities, but also the community banks. Most of these banks now operate outside their community localities, competing with the other banks in sourcing funds at whatever rates which they then trade in the money market at higher rates.

The incidence of fraud is system wide. It is estimated that the banking sector lost approximately N1 BN to fraudsters in the first two months of 1993.

At present, few financial institutions are interested, let alone capable, of engaging in Venture Capital activities.

Contractual savings organizations:

They potentially are a major source of funding for Venture Capital. Tax incentives and regulatory guidelines, such as encouraging these institutions to invest up to 10% of their assets with pre qualified parties engaging in Venture Capital transactions, will help.

Money market:

This market is relatively well developed in Nigeria. What it lacks is significant liquidity. If the Central Bank relies on OMO as a major tool of monetary policy, then this should substantially increase the trading volume in the secondary market.

Capital market:

As with the money market, the capital market is also relatively well developed.

IFC's Emerging Markets Data Base (EMDB) rated Nigeria the eleventh most attractive environment for foreign portfolio investors in 1991. This was out of 40 developing countries. In 1991 the ROE was 57% in Naira terms and 27% in US$s.

Even though deposit rates are very high, most equity issues, both private placements and public listings, are oversubscribed by the general investor public. This may be due to the lack of public confidence in the financial viability of many of the deposit taking institutions and their capacity to make good on their commitments to these deposit interest rates, let alone the security of the deposit capital. In fact there have been a number of failures and closings of these deposit taking institutions resulting from Ponzi type schemes. This has shaken investor confidence in these institutions.

The privatization campaign has deepened the capital market as well as increased investor awareness.

Stock exchange - first tier:

There is very little liquidity in the stock market : an average of N2 MM (approximately $60,000) turnover per day. Trading of equities in the second and third quarters of 1992 only was N72 MM (between $3 - $4 MM). The turnover ratio for the period of July through September 1992 was less than 1% for equities and less than 1% for Government securities.

As of February 1993, there are 254 listed securities of which 156 are equities. Market capitalization is N33 BN with 110 stockbroking firms, 60 issuing houses and over 200 floor dealers. Yet with such a small trading volume one wonders what all these market operators do.

Institutional investors hold 18% of listed shares, Government agencies 15%. foreigners 43% and individuals 24%.

The P/E multiple is between 7 and 8. This is relatively low for an emerging market.

The Security and Exchange Commission (SEC) has a dominant say in fixing prices of all new securities and regulating the prices of those already being traded. Deals of 50,000 shares or more are subject to SEC approval. It is recommended that the pricing of securities should be left to the market and not directly managed by the SEC.

Stock exchange - the Second Tier Securities Market (SSM):

The SSM provides an attractive exit mechanism for Venture Capital investments. This is due to the relaxed listing requirements as well as the reduction in the minimum corporate history required for listing companies from 5 years to 3 years.

The P/E multiple is around 11 on the SSM.

2.7 Legal environment

Existing legislation:

There is a need to review existing legislation in order to remove impediments to Venture Capital as well as to provide incentives.

The following legislation is representative:

- *Companies and Allied Matters Decree of 1990*

  Any restrictions on non strategic listed companies selling shares to foreigners should be removed. At present there are some restrictions, although minimal restrictions on the sale of non voting shares.

- *Banks and other Financial Institutions Decree (BOFI) 1991*
- *Capital Gains Act 1967*
- *Company Income Tax Act of 1979*
- *Trustee Investment Act of 1962*
- *National Provident Act of 1961*
- *Insurance Act of 1976*
- *Banking Act of 1969*

  Banks are effectively barred from investing in virtually all sectors of the economy although they can have a maximum 20% equity position in small scale business. This issue should be addressed if financial institutions are to engage in Venture Capital activities.

- *Industrial Development (Income Tax Relief) Act 1971*

  This law granted incentives to pioneer companies or projects. The definition of "Company" should be broadened to include Venture Capital activities. The whole Act should be reexamined in order to provide transparent, substantive incentives for productive investment.

New legislation:

Specific money and capital market legislation is appropriate.

The RMRDC indicated that there was in draft form a Venture Capital Development Decree (VDCC). This legislation will establish a separate legal framework for Venture Capital. As it has not yet been formally approved, the Consultant was unable to obtain a copy.

The Consultant was informed verbally that the key provisions of the Venture Capital Decree include reducing the capital gains tax to 5% and reducing the tax on dividends to 0%. These are steps in the right direction.

2.8 The legal process

One aspect of the legal environment is the legislation. Another aspect is the legal process.

Judicial independence, the ability for an applicant and a respondent to have a hearing in a timely manner and the capability to enforce judgements, are important elements in private sector development. A transparent, or at least a translucent, legal process is essential for investment.

If people or companies do not have confidence in their ability to exercise their legal rights, then this negatively impacts potential investors (local and especially foreign) and commercial development.

The legal process is a constituent element to creating an enabling environment conducive to private sector investment.

The court system:

It is essential for applicants to be able to obtain from the legal system judgements in a timely manner and without third party influence. In Nigeria due process is questionable and the courts, including the High Courts, are politically influenced. The latest example of the lack of judicial independence from the executive is the handling of the general election. A new civilian Government must address this problem as it negatively impacts not just the investment climate, but many other areas.

Enforcement of judgements:

The ability to enforce judgements and to exercise collateral, including the right of foreclosure, is an important element to the enabling environment for investment.

In Nigeria there are problems associated with enforcing judgements. A strengthened bailiff system and streamlined bankruptcy and liquidation legislation would help the enforcement process.

2.9 Prudential regulatory and supervisory environment

Governing regulatory and supervisory bodies are key elements in the enabling environment. Relative to the explosive growth in financial institutions, these entities are vastly undermanned, both quantitatively and qualitatively.

A FSR program should allocate substantial resources to devise a strategy to improve these agencies. They are critical both in a preventive capacity as well as an ongoing monitoring and supervisory role.

Banks are required to maintain minimum capital assets of at least 8% of total risk-weighted assets. Yet these regulations are not being enforced. If they were then the majority of banks would be in breach and many would be unable to meet the requirements.

Recommendations from a follow up visit should be made concerning the regulatory authorities for the banking sector, the NBFI including the insurance sector, as well as the securities market and stock exchange authorities.

Some preliminary recommendations concerning the Banking Supervision Department of the Central Bank include:

- *Tightening the evaluation process for bank licenses.*

  There must be clear and stringent guidelines to determine whether promoters of a potential new financial institution are fit and proper to receive a banking licence. It is also vital to monitor on an ongoing basis to determine whether they are fit and proper to keep their banking licence.

- *Implementing and monitoring risk adjusted / weighted capital requirements for financial institutions.*

- *Focusing on the quality of assets:*

  * *interest should be booked when paid, not automatically on an accrual basis*
  * *regulations should be established for the adequate provisioning of doubtful debts*
  * *non performing loans should be provisioned for and not simply rolled over*
  * *interest should not be capitalized - that is, loans should not be provided to cover unpaid interest.*

2.10 Accounting, auditing and disclosure of information

Timely and reliable information, both qualitatively and quantitatively, is essential to a conducive enabling environment for investment.

Recommendations from a follow up visit should be made as to how to improve these areas.

2.11 Infrastructure environment

There is a need to develop and to clearly articulate an industrial development program for Nigeria. This should be a priority issue for the new civilian Government.

For a country such as Nigeria, the current infrastructure environment is a major impediment to investment.

There are considerable problems even with basic infrastructure such as telecommunications, electricity supply, the ports, water and sewerage. What this does is to create tremendous inefficiencies. Instead of focusing on business, many companies have to be concerned with getting a telephone line, getting a call through, having a generator, getting goods discharged from the ports etc. These inefficiencies are major impediments for private sector entrepreneurship. They raise the cost of setting up a business, increase the time factor in getting up and running, as well as increase the overall costs of engaging in business.

An industrial development program for Nigeria should be export focused and the Government should provide the supporting infrastructure in the form of business incubator parks, industrial parks and export processing zones (EPZs).

An EPZ in Calabar has been under construction for a number of years. It is supposedly near completion. However, many are sceptical as to its usefulness and believe that many of the project monies have been siphoned off through corruption. For at least the past decade the construction of many large projects primarily have been viewed as vehicles for personal enrichment. Hence, many of these projects have become "white elephants".

3. MICRO FACTORS CRITICAL FOR THE VIABILITY OF VENTURE CAPITAL IN NIGERIA

3.1 <u>Financial Vehicle to Provide Venture Capital</u>

The following structures are possible:

Development finance institutions (DFIs):

Nigerian Industrial Development Bank Limited (NIDB), Nigerian Bank for Commerce and Industry (NBCI) and NACB provide development finance in the form of debt and equity long term financing. They are 100% Government owned and modeled on the International Finance Corporation (IFC).

The DFIs have been a failure for many of the classic reasons for the failure of DFIs worldwide: corruption, politically influenced loans, a technocratric approach and the perception by the investees that the funds received are an entitlement rather than a loan or an investment. 85% of NIDB's loan portfolio is value impaired while NBCI has negative net worth and is being kept alive only by support from the Government.

This structure is not recommended for developing Venture Capital in Nigeria. Governmental or donor involvement in Venture Capital is a recipe for failure.

Venture Capital has to be market driven and private sector led, owned and managed.

A specialized Venture Capital Management Company and a Venture Fund Company:

This is the model which has been used in a number of African countries and other developing countries. IFC and CDC have a portfolio of Venture Capital investments made with this structure. However, by any measure the performance of these specialized Venture Capital companies has not been a success thus far.

This structure is not recommended for Nigeria for the following reasons:

<u>Attitudes to investment and risk capital</u>

With traditional Venture Capital activities, you first find out about the problem investments. That is, the bad news will come before any good news. It is common to declare capital losses before realizing any capital gains. You tend to only know if you have a "winner" over a 3 to 5 year period. You are likely to start to reap the potential capital gains after 5 years. Naturally, the quality of staff and the degree of hands on involvement with the portfolio investment will be significant factors in the "hit - miss" ratio.

This 5 year time frame is a long term horizon in any market. In a country like Nigeria, where the short term traders' mentality typifies business practice, investors and the activities of financial institutions, it will seem like an eternity.

Cash flow considerations

Under the best case scenario, a specialized Venture Capital company investing mainly in startup companies and new projects, will be cash flow negative for the first 5 years. Few private sector businesses, with profit as a key criteria, can afford to take that outlook.

The effect of this is that in other African countries where this structure has been applied, USAID has provided grants and loans to subsidize the pre operating expenses and the operating losses for up to the first 5 years.

This sends a message of the institution being in the aid business as opposed to being market driven and market judged. It sets a poor and unnecessary precedent. There are alternative ways of developing Venture Capital which do not necessitate the American Government allocating millions of dollars to cover these projected losses. If one ends up calculating the cost incurred, via this structure, to generate each job in the invested businesses, it will be seen to be prohibitively expensive. This assessment is made assuming that the invested businesses turn out to be successes, let alone failures.

Tendency for the Venture Capital company to be donor capitalized

When structured in this manner donors tend to be the major participants in capitalizing the Venture Capital Fund. Yet all these countries have domestic sources of capital. The key issue is mobilizing this capital. This cannot be done without the enabling, institutional and attitudinal environments being in place.

A significant participation of local investors is vital for the success of Venture Capital as it will impose a level of market discipline on both the financial entity and the investees as the activity will be market driven, not donor driven.

Donor sourced capital does not impose discipline on investees

When an investee is funded through donor sources, it is common for the investee to regard the funds as an entitlement and not an investment with concomitant responsibilities and obligations. This results in a lack of discipline with many investees. This can be one of the factors in the high loss ratio of these investments under this type of structure.

Expatriate staffing

Many of these specialized Venture Capital companies tend to be managed by expatriate staffing. If the expatriate is a staff employee of a donor, then that person probably lacks the necessary skills and mentality of a tried and tested experienced Venture Capitalist. The expatriate management tend to have more experience in the public sector than in running private sector companies in this type of environment.

Additionally, the quality of staff and the degree of hands on involvement in the portfolio companies are critical to the success or failure of the investments. Yet many of these specialized institutions are thinly staffed at the middle and junior management levels.

Synergy

If the Venture Capital vehicle is specialized in this manner then it reaps no synergistic or cash flow benefits derived from engaging in a variety of financial products and services.

Venture Capital provided within an existing Commercial Bank:

As a general comment, commercial banks are poorly suited to engage in Venture Capital. The mentality and requisite skills for Venture Capital are totally different from those of commercial banking.

Venture Capital in its essence, is risk capital, value adding skills and services in a totally hands on manner. This does not describe the culture or the activities of the Nigerian commercial banks.

Venture Capital provided by Merchant Banks:

The concept is to attract a number of the existing quality merchant banks to develop a Venture Capital Unit within their corporate finance departments.

Key issues in examining the merchant bank as a suitable vehicle for Venture Capital in Nigeria are as follows:

Cash flow considerations

As the merchant banks will be engaged in a variety of activities, spread over a range of maturities and risk profiles, they will be self supporting and will not require donor subsidies and grants.

Viability

Unlike a specialized Venture Capital company, a merchant bank will achieve:

- *diversification of risk through:*
    - *having a range of products and services*
    - *maturity matching thereby mitigating term transformation risks*
    - *a widespread range of customers (individual and corporate) across a broad spectrum of industries*
    - *both a domestic and international orientation - thereby providing some degree of insulation from vicissitudes of the local economy.*
- *synergistic benefits:*
    - *economies of scale can be achieved as can cross servicing the needs of clients. This is lost in a specialized vehicle.*

* *an area of great potential for Venture Capital is restructuring privatized and commercialized parastatals as well as general corporate restructuring. Given that in these situations you are dealing with established entities rather than a startup situation, in an environment with a relatively well developed capital market the turnaround time from investing to resale could be as little as a year. In terms of startups and new projects, the turnaround period is in the 5 year range.*

Mobilizing local sources of capital

By incorporating the Venture Capital Units within the corporate finance departments of merchant banks, there will be synergistic benefits in the ability to mobilize local sources of capital - both risk equity, debt and hybrids.

Instead of following the traditional funding route of specialized Venture Capital companies - which is to raise a blind pool of capital and then to look for investment opportunities to place these funds in - the Venture Capital Unit first will identify a specific investment opportunity and then on a deal specific basis, the corporate finance specialists will set up a special purpose limited liability company and seek out targeted potential local investors who are likely to be interested in this specific tangible opportunity. That is, there will be no blind pool of funds. Investors will be investing in a specific deal in which they have a high degree of comfort with the project, the entrepreneur and those professionals in the Venture Finance Unit. There is a direct nexus between the investor and the investee. Due to this structure, there is no reason why the merchant bank cannot mobilize local sources of capital as its prime funding source for Venture Capital deals.

Staff and corporate culture / mentality

Merchant banks are better suited than the commercial banks and the DFIs to attract the top talent and to develop an appropriate corporate culture for Venture Capital activities.

Recommendation:

The recommended financial vehicle to provide Venture Capital in Nigeria is the merchant bank.

3.2 Promoters of Venture Capital

Raw Materials Research and Development Council (RMRDC):

This Government agency was established for the purpose of commercializing indigenous processes and technologies, as well as establishing resources based and strategic industries.

The RMRDC has been attempting to establish a Risk Fund for Venture Capital with an initial capital of N750 MM, as of December 1990. Given the depreciation of the Naira, the RMRDC is seeking to increase this amount to the Naira equivalent of $50 MM. The sources of the capital are proposed to be an external loan or grant, a concessionary loan from the Federal Government, equity capital from RMRDC and other Government agencies, and equity and loan capital from business and financial organizations - both obligatory and voluntary. The Risk Fund presently has N50 MM available for Venture Capital and total commitments from the private sector of N100 MM. Entrepreneurs would access the Risk Fund through financial institutions which will appraise and evaluate the potential investees. Priority is to be given to projects designed to address the problems of major investors.

Recommendations

- *It should not be obligatory for any groups, private or public, to contribute to a Venture Capital fund. This form of investment should be voluntary and as it is geared to be profitable, it should be self standing - voluntarily. Moreover, the investors should principally be from the private sector.*

- *RMRDC as a Government Agency is ill suited to be running a Risk Fund as Venture Capital should be private sector driven. The staff are well meaning technocrats with no expertise in Venture Capital or in running businesses.*

  Their role should be:

  * *catalytic in facilitating the development of an enabling environment which is conducive to risk capital investments.*
  * *to coordinate the Government ministries, agencies and bodies so that there is a complementary Government policy towards Venture Capital development and the creation of a conducive enabling environment.*
  * *project identification and an information clearing house and data base on natural resources potential.*

Equity Securities:

The Chairman of Equity Securities, Prince Lekan Fadina, founded the company in 1989. Equity Securities is a relatively small financial institution with a staff of approximately 20 individuals. Three of the major insurance companies, including National Insurance Corporation of Nigeria (NICON), are shareholders. Prince Fadina was the number two at the Nigerian Stock Exchange for many years. He also acted as the first General Manager of the Second Tier Security Market (SSM). Equity Securities' principal activity is stock brokering.

Equity Securities has acted as financial advisors for several significant transactions. These include acting for Continental Breweries in its merger with Eastern Breweries and for Sanyo Nigeria in its merger with Leventis Technical. Equity Securities has acted as agent for Dunlop Nigeria's acquisition of 4MM shares in Pamol Nigeria and as the issuing house and stockbroker for the sale by the Government of its 47 MM shares (for N42 MM) in the privatization and commercialization of Benue Cement (N83 MM) and in the privatization of the Durbur Hotel (N 43 MM).

With several client companies Equity Securities has provided Venture Capital type services. It has nurtured several companies, making small equity investments and/or taking the fees for services rendered in the form of equity in the company. These client companies are Flexible Packaging where Equity Securities has a 5-7.5% shareholding, Interlinked Technologies where Equity Securities raised N3.5 MM and Eko Hospitals where Equity Securities raised in a joint venture with Continental Merchant Bank, N31 MM.

Prince Lekan Fadina has a keen interest in developing entrepreneurship in Nigeria. Equity Securities is proposing a specialized Venture Capital Fund. The intent is to raise between $4-$5 MM from Nigerian investors (over 20 potential investors have been canvassed) and $3-$4 MM from foreign investors (mainly donors). The proposed Nigerian Venture Capital Fund (NVCF) will have available for investing between $3 MM and $20 MM.

It is being proposed that the set up costs, including operating costs for the first 3 years, should be financed by a $1.6 MM contribution from USAID.

The Consultant was asked to evaluate what role Equity Securities could play in developing Venture Capital.

Positives regarding Prince Fadina

- *excellent as a promoter, a missionary for Venture Capital and entrepreneurship at a time when Venture Capital is not fashionable nor feasible given the current instability and uncertainty*
- *well respected, both as a result of his long association with the Stock Exchange as well as the fact that he is a Yoruba Prince*
- *well connected*
- *honest*
- *energetic, tireless worker*
- *excellent relations with regulatory authorities*
- *excellent relations with Government*
- *excellent at mobilizing local sources of capital*
- *excellent in dealing with the stock exchange and the SSM, especially in terms of listings*
- *Equity Securities has nurtured several companies and raised capital by taking them public or through private placement.*

Negatives in terms of suitability for engaging in Venture Capital

- *primarily a stockbroker, not a serious player in terms of corporate finance and advisory work*
- *thin management level at Equity Securities*
- *poorly managed firm lacking focus*
- *Prince Fadina lacks many of the technical finance skills - more a Chairman of the Board type*
- *not sure how well or poorly Equity Securities is doing. The firm appears to be in need of a capital infusion.*

- *Prince Fadina is very involved in the policy framework for developing the capital markets. This pro bono work involves attending numerous seminars, conferences and other meetings. These activities take up considerable amounts of time, to the detriment of running his firm. No doubt this participation is helpful in terms of Equity Securities being allocated the role of stockbroker to place a percentage of listings or private placements.*

Recommendations:

- *Prince Lekan Fadina is the ideal person to be the "missionary" promoting Venture Capital. This is a vital role as the environment for Venture Capital could hardly be worse, yet the need is so great.*
- *Prince Lekan Fadina could coordinate Government with industry with the financial sector with the regulatory authorities to develop and implement the strategy to establish a conducive enabling environment for entrepreneurship.*
- *Prince Lekan Fadina should receive funding to cover the expenses of these needed activities.*
- *In terms of Equity Securities' present capabilities to engage on a widespread basis in Venture Capital activities, there are other financial institutions which are better suited and more capable to perform this role.*

Other financial institutions with capabilities to engage in Venture Capital activities:

This is far from being an all inclusive list. These companies are merely those which the Consultant is aware as to their capabilities and interest in engaging in Venture Capital when the environment is attractive.

- *Ventures and Trust - David Harper and Femmi Akigbe*
- *Continental Merchant Bank - Ganiyu Raji*
- *Credit Alliance - Amah Iwuagwu*
- *IBTC - Lawole Edun*
- *KMC - Kim Bela Osage*
- *ICMG - Mike Osime*
- *Toyin Munis - consultant with Arthur Anderson*
- *Adeboye Shonekan, with IFC's representative office.*

3.3 Activities and deal flow

In order of priority:

- *corporate restructurings, turnarounds, workouts, breakups, deconglomerations of private companies and parastatals - both privatized ones and commercialized ones. The holding time for this type of investment could be as little as a year.*
- *expansions of existing companies. The holding time for this type of activity is likely to be 1-3 years.*
- *startup companies and projects with a foreign partner. The holding time for this type of activity is likely to be 3-5 years.*
- *startup companies and projects fully owned and managed by Nigerian entrepreneurs. The holding time for this type of activity is likely to be 5-7 years.*

The Africa Project Development Facility (APDF) is opening an office in Nigeria. This should increase the deal flow generation. In 1992 IFC approved 7 projects for funding of $37 MM. They were all sponsored by the APDF. Given the size of Nigeria, IFC has relatively few Nigerian projects in its portfolio. One anticipates this changing when the enabling environment improves.

3.4 Availability of quality management

Few bankers have any experience in running businesses.

Nevertheless, the human talent is available. There are many talented Nigerians working overseas. They represent a very large skilled and experienced management and entrepreneurial pool which could be mobilized if the country's political, macroeconomic and other aspects of the enabling environment, were to fundamentally turn around.

3.5 Entrepreneurs

There is no shortage of entrepreneurs in Nigeria. What is required are tangible incentives to motivate entrepreneurs to focus on medium term activities rather than purely short term trading.

3.6 Capital

Local sources of capital:

Sources of local capital are plentiful in Nigeria. If the climate for investment is attractive, then mobilizing this capital should not be a problem.

There are 1.6 MM individual shareholders in Nigeria.

Soft loans for Venture financing are available from Nerfund.

Offshore sources of capital:

Soft loans for Venture financing are available from:

- *EIB at 3%*
- *EEC at 6%*
- *IFC at 11%*
- *ADB - export stimulation loans (ESL)*
- *CDC*
- *DEG*

Discount Investment Mechanisms (DIMs) which are available to investors:

- *the DCP*
- *liquidating blocked funds*
- *there has been some talk of introducing a preferential exchange rate for investment*
- *Paris Club Debt available for conversions - there also has been talk of this.*

3.7 Legal structure for Venture Capital

The limited liability company structure is the preference as the legal framework for limited partnerships is weak in Nigeria.

3.8 Exit mechanisms

Compared with most developing countries, Nigeria has a variety of exit mechanisms available for investors to realize capital gains or losses. These include the first tier of the stock exchange, the SSM, private placements, ESOPs, sale to management and mergers or acquisitions.

4. *ACTION PLAN*

4.1 *Washington DC*

- *Meetings to discuss preliminary findings and proposed next steps with:*

  Harvey and Co.
  USAID
  IFC
  IBRD
  IFC
  FIAS

4.2 *Nigeria*

- *A Consultant should spend at least 4 weeks in Nigeria to devise a strategy for developing private sector entrepreneurship to be implemented once there is political stability.*

- *The Consultant would brief USAID Nigeria and would work on this mission with local advisors. Possible local advisors include:*

  Equity Securities Limited
  Credit Alliance
  IBTC
  IFC resident representative office
  Dr. Kalu Kalu
  Odia and Associates
  KMC
  Continental Merchant Bank

Gbenga Oyebode -	*attorney*
Olabode Johnson -	*attorney*
ING -	*Phillipe Bosshard*
Enabling Environment Forum -	*Udochukwa Uwakaneme is the President*

- *Meetings would be held with various Government ministries and agencies including:*

Ministry of Finance -	*has a mandate to develop Venture Capital Funds*
Central Bank -	*has a mandate to determine any necessary legislative changes in order to accommodate Venture Capital Funds*

  RMRDC
  TCPC
  IDCC

- *Advise USAID on suitable programs to assist in promoting private sector entrepreneurship in Nigeria - for example, FAPE and FSR.*

APPENDIX : LIST OF PERSONS MET

Agama, Timmy; PW Enterprises
Aile, H.L; Nigerian Stock Exchange
Akande, Lawole; Slowe Group
Amachree, Nene; Guaranty Trust
Aribisala, Dr. R; Raw Materials Council

Bosshard, Phillipe; ING Bank

Chiavarole, Gene; USAID
Christiansen, Daniel French; US Embassy
Chukhuma, Cyril; NIB

Dawiene, B.O; Equity Securities
Dawodu, G.A; Equity Securities
Duncombe, Bruce; US Embassy

Edun, Lawole; IBTC

Fadina, Prince Lekan, Equity Securities
Fafowora, Niye; Trader

Gerrard, Peter; CDC

Iwuagwu, Amah; Credit Alliance

Kalu, Dr. Kalu; Dakal Services

Mohammed, Raheem; Equity Securities

Nwandwu, Valentine; Acess Africa

Obla, Sam; Liberty Merchant Bank
Odia, George; S.G. Odia & Associates
Olaniyan, S.B; Risk Fund, Raw Materials Council
Otiti, Alhaji; Olatis Consultants
Otiti, Hakeem; FIS Securities
Oyebode, Gbenga; Attorney
Oyewole, Bayo; IBRD

Phillips, Foluso; Phillips Consulting

Scott, Freddie; West Africa Committee
Seriki, Sola; Metroventures
Shonekan, Adeboye; IFC

Verr, Bernard; TCPC

Waismann, Robin; Standard Chartered Bank
Wilkey, Olumide; Key Investors

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Additionally the Consultant utilized notes from all the meetings held in Nigeria and Washington DC.