

A Survey of Private Equity Investments in Kenya

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Abstract

Private equity investments in the recent past have been very strong and using leverage to make deals has accelerated sharply as well in both developed and emerging economies. Therefore, private equity is a suitable alternative in financing organizations at their various stages of growth. Hence, this study uses an exploratory approach to establish the extent to which private equity investments are adopted by firms, the forms of private equity mostly applicable and the exit strategies of private equity funds. Primary data was collected using a questionnaire as the main primary data collection tool. The findings show that banks and development financial institutions are the top investors in private equity funds and large corporate companies are the top clients in adoption of private equity followed by SMEs while listed companies are the lowest adopters of private equity.

Key words: Private equity, venture capital, private equity investments, exit strategies.

1. Introduction

The establishment of a successful business entity is a great aspiration to many people since it creates job opportunities, improves living standards and it contributes to economic growth. This calls for exploiting the available business opportunities or creating them where there is none hence the need of financing to undertake such activities. The start or expansion of a business entity requires funds through retaining profits, borrowing from family/friends or borrowing from banks. However, such sources of financing may be difficult to access especially for small and medium enterprises (SMEs) hence private equity (PE) being a suitable alternative. European Venture Capital Association (EVCA) (2007) defines private equity as the provision of equity capital by financial investors over the medium or long term to non-quoted companies with high growth potential. PE is risk capital provided in a wide variety of situations, ranging from finance provided to business start-ups to the purchase of large, mature quoted companies (Gillian and Wright, 2008). Investment in PE may be in the form of venture capital, leveraged buyouts or mezzanine capital. It is notable that PE is increasingly becoming a source of finance for high growth potential companies whereby they assist several business entities achieve their growth objectives and provide strategic advice to businesses in their various stages of development. Gompers and Lerner (2001) indicate that venture capital or PE has developed as a vital intermediary in financial markets by providing capital to firms that might otherwise have difficulty attracting financing. These firms are mainly small and young, plagued by high levels of uncertainty and large differences between what entrepreneurs and investors know.

OECD-MENA report (2006) indicates that national, regional and international competitiveness of an economy is increasingly connected to the presence of an environment supportive of innovation and risk-taking. Therefore, innovation is gaining prominence on governments' agendas worldwide due to the need to develop knowledge-based economies as a prerequisite to competitiveness and growth. Hence a key challenge to entrepreneurship is lack of capital to formalize creative ideas into concrete and realistic business plans. The public sector can be involved in bridging this financing gap and also PE with regard to financing high risk and potentially high reward projects (Gompers and Lerner, 2004). Blundell-Wignall (2007) also indicates that PE plays a key role in transforming under-performing companies. Presently, PE deals are very strong and use of leverage in deal making is accelerating sharply, similar to the late 1980s. The process is being driven by a number of factors, particularly low yields which result from excess global liquidity.

EVCA (2012) report indicates that in 2012 fundraising for the Central and Eastern Europe (CEE) region reached €673m which represents a 28% decrease from 2011, but conforms to the overall trend across all of Europe. Government agencies are reported to be the largest source of capital providing 29% of the total capital raised, funds-of-funds were the second largest with 19% and followed by pension funds at 15%. Nevertheless, European investors from outside of the CEE region continued to be the leading source of funding in 2012, having invested nearly 60% of the total capital raised, while investors from the US accounted for 20% of the total. The report

further indicates that PE investment in the CEE region remained above the €1bn level in 2012, but decreased 19% in value terms compared to 2011, the same percentage decrease that was noted in investments across Europe. Also in the United States of America, venture capital under management in 2012 declined to \$199.2 billion compared to \$201.5 billion in 2011 (NVCA, 2013). However there has been a 32.4% decline in venture capital activity in US \$ from 2007 to 2012. This could be attributed to various factors such as the 2007-2008 global financial crisis that significantly affected investment activities globally.

However, in the developing nations there has been an increase in PE activity. Lerner and Schoar (2004) attribute this to two main reasons. First, is the accelerated integration of emerging nations into the world economy whereby many of these nations have undertaken radical financial reforms and innovation. Second, the changing views and conditions in developed nations which have resulted to reassessing the returns and risks associated with developing country investments and have generally found them favorable. Deloitte (2013) report shows that PE firms invested US\$1.13bn through 58 deals across sub-Saharan Africa in 2012 which was a slight decline in the number of deals compared to 2011. This decline seems to be a general trend across North America, Europe and African continents.

This paper is divided into five main sections namely; introduction, empirical review, research methodology, findings and conclusion. The objectives of the study are;

- i. To establish the extent to which PE investments are adopted by organizations in Kenya.
- ii. To find out the forms of PE investments utilized by PE funds in Kenya.
- iii. To determine the exit strategies of PE funds in Kenya.

2. Empirical Review

PE investments are made by PE funds or angel investors with each having their own set of goals. The PE funds aim to raise money from investors then making high return investments. There are other stakeholders involved in the PE business such as investors who aim to attain a balanced portfolio of investments that can achieve their desired returns and banks who can be lenders of loans or arrangers of loans to the investee firms (Gillian and Wright, 2008). Venture capital is a subset of private equity and it refers to equity investments made for the launch, early development or expansion of a business. When a management team requires financing to buy an existing company from its current shareholders then such a process is referred to as a buyout (EVCA, 2007). However, Gompers and Lerner (2004) note that the term venture capital has been used to give different meanings in USA where it refers to early stage investment while in Europe and Asia it refers to all aspects of private equity which includes buyout, late stage investment and mezzanine financing. Venture capital funds new and emerging businesses and this would entail either; seed capital or early stage capital or later stage capital.

In a leveraged buyout, a company is acquired by a specialized investment firm using a relatively small portion of equity and a relatively large portion of outside debt financing. In a leveraged buyout transaction, the private equity firm buys majority control of an existing or mature firm (Kaplan and Stromberg, 2009). Damodaran (2007) indicates that in a typical leveraged buyout, there are three components which include the acquirers borrowing a significant portion of a publicly traded firm's value (leverage), taking a key role in the management of the firm (control) and taking the firm off public markets (going private). Lerner et al (2009) indicate that mezzanine financing is mainly PE financing before an initial public offering or an investment that entails subordinated debt with mainly attached warrants. Mezzanine simply provides high-risk debt that carries a high interest rate and often includes other components such as warrants, options or preferred/common shares. Mezzanine finance is often used by private equity investors to reduce the amount of equity capital required to finance a leveraged buyout or major expansion.

PE investments provide exit routes and returns on investments to the investors of the PE fund. Hence, when a divestment is undertaken the PE industry would ultimately encourage recycling of capital into new opportunities for the benefit of an economy (EVCA, 2005). OECD (2008) report argues that there is a strong empirical support for the proposition that ease of entry and exit does lead to increased start-ups, a larger number of firms growing to public company status and ultimately higher economic growth. In support of the findings that PE exit success translates to better performance is Hochberg et al (2007) and Phalippou and Gottschalg (2006). However, Gompers and Lerner (2000) argue that investments made during times of high inflows do not translate into higher exit success rates.

3. Research Methodology

The study adopted an exploratory research design since it sought to investigate PE investments in Kenya. The research design was adopted since the study was exploratory in nature. Primary data was collected and descriptive statistics was used in analyzing data. The primary data was collected using questionnaires administered to the fund managers and administrators of the PE funds. The study population comprised of all the seven (7) PE funds which are the founder members of the East African Venture Capital Association (EAVCA) based in Kenya. These include; Abraaj, Actis, Africinvest, Catalyst Principle Partners, Centum, Fanisi Capital and TBL Mirror Fund.

4. Analysis of Findings

4.1 The Respondents and Organizational Profile

Primary data was collected from all the seven PE funds that were targeted. The respondents were mainly managers and administrators of the PE funds and were asked to indicate the top investors in their fund. The results show that 33% were banks, 19% were development financial institutions, 17% were corporate firms, 14% were pension funds, 11% were insurance companies while 6% were individuals. This indicates that banks are top investors in PE funds suggesting a high level of awareness of returns that can be obtained from PE investments and also due to their capacity to invest large monetary amounts. Individuals have the lowest level of investments in PE funds again implying that they have limited resources to commit in PE funds considering that most of these funds in Kenya require substantial capital amounts to finance large projects for their clients. The findings on the ownership status of the PE funds shows that 41% are jointly Kenyan and foreign owned, 32% of the PE funds are fully foreign owned while 27% are fully Kenyan owned. This implies that both foreigners and locals have ownership interests in PE funds based in Kenya.

4.2 Private Equity Investments

4.2.1 Top Clients in Adoption of Private Equity

The PE funds were asked to indicate their top clients in adoption of private equity. Figure 4.1 presents the findings of the respondents about their top clients in adoption of PE whereby 41% of the respondents indicated that their top clients are large corporate companies, 33% are SMEs while 26% are listed companies. This implies that large corporate companies are the top clients in adoption of PE even though SMEs and listed companies are vital clients in adoption of PE.

4.2.2 Reasons for Issuing Private Equity

The results in table 4.1 show that majority of the PE funds to a very large extent agreed that the growth potential of the client is the key reason why they issue PE as indicated by a mean of 4.567. The respondents to a large extent agreed that the size of the client's target market influences the issue of PE to the clients as shown by a mean of 4.231 while the respondents moderately agreed that innovative products and services of the client influences the issue of PE to the clients as shown by a mean of 3.987. However the amount of transaction costs has a weak influence on the whether to issue PE to a client as shown by a mean of 2.456. This implies that growth potential of the client is the main reason considered in issuing PE to the clients.

4.2.3 Key Challenges Faced in Issuing Private Equity

The results in the table 4.2 show that majority of the respondents to a large extent agreed that lack of awareness on private equity is the key challenge faced in issuing PE in Kenya as shown by a mean of 4.567 while the regulatory framework to a large extent affects the issuing of PE as shown by a mean of 4.193. The respondents to a moderate extent agreed that alternative cheaper sources of capital is the key challenge faced in issuing PE in Kenya as indicated by a mean of 3.149 while the level of taxation is a key challenge in issuing PE to a small extent as indicated by a mean of 2.192. This indicates that lack of awareness on PE is the key challenge faced in issuing PE in Kenya.

4.3 The Forms of Private Equity in Kenya

Figure 4.2 presents the findings on the forms of PE that is highly popular in Kenya. The results show that 51% of the PE funds indicated that venture capital was popular, 28% mezzanine capital while 21% consider leveraged buyout to be popular. Venture capital is seen to be more preferable because most PE clients are at their growth stage hence requiring additional capital to steer them to next level of growth of their products and services. However, some funds issue mezzanine capital due to its debt and equity composition. This means that the funds issuing this form of PE have guaranteed cash flows under the debt structure and also diversified risk as a result of this type of financing.

4.4 Exit Strategies of the Private Equity Fund

The findings as shown in figure 4.3 indicate that only 14% of the PE funds have exited a PE investment thrice previously, 14% have exited a PE investment twice and 29% have exited a PE investment only once previously while 43% of the PE funds have never exited a PE investment. It is notable that it takes five to ten years for a PE fund to exit in their investment hence this suggests that the PE industry in Kenya is young considering that most of the PE funds have not yet exited their PE investments. The results in the table 4.3 show that majority of the respondents agreed to a large extent that completion of the investment was the reason why PE funds exit PE investments in Kenya as indicated by a mean of 3.989 and earning the return on investment as shown by a mean of 3.255. Weak economic growth was to a moderate extent as to why PE funds exit PE investments as indicated by a mean of 3.152. This shows that completion of the investment and earning the return on investments as the main reasons for exiting a PE investment in Kenya.

5. Conclusion

The findings show that banks are the top investors in PE funds while individuals have the least control in the investments of PE funds. The results indicate that both foreigners and locals have invested in PE funds and that large corporate companies are the top clients in adoption of PE followed by SMEs while listed companies are less considered clients in adoption of PE. The growth potential of the client is the main reason considered in issuing PE to the clients whereas lack of awareness on PE is the key challenge faced in issuing PE in Kenya. Venture capital is the main form of PE issued in Kenya and the PE funds mainly issuing growth stage capital financing could be a reason as to enhancing their exit from a PE fund.

The PE funds should issue various forms of capital that the client can choose from, such as the early stage capital, seed capital or later stage capital to increase their revenues. Lack of awareness on PE is the key challenge faced in issuing PE thus more intensive marketing strategies should be developed in order to create awareness to the public about PE funds. Also the growth potential of a client should not be the key reason forming the decision to issue PE but also the innovativeness of the client's products and services.

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Figures and Tables

Figure 4.1 Top clients in adoption of private equity in Kenya

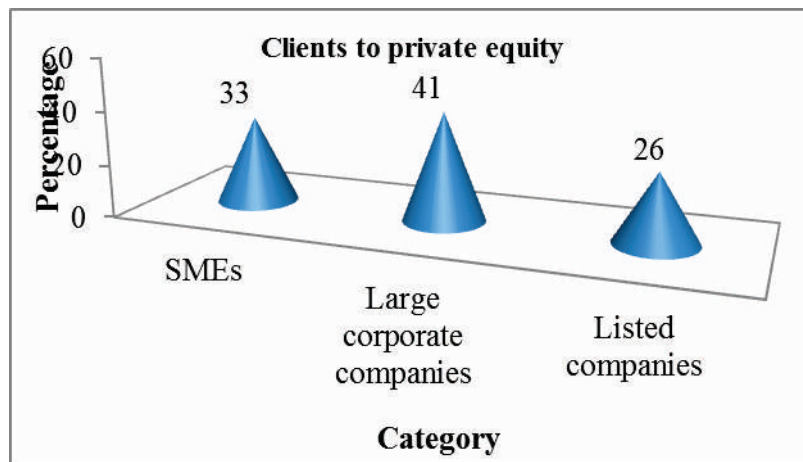


Figure 4.2: Popular form of Private Equity in Kenya

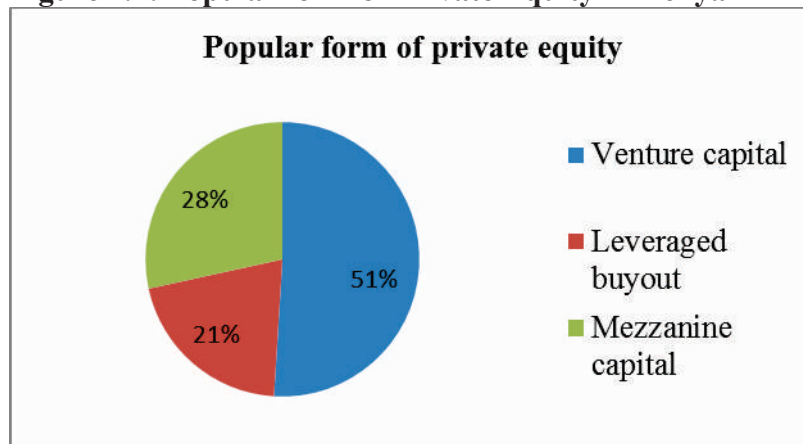


Figure 4.1: Numbers of Times a Private Equity Fund Exited a Private Equity Investment in Kenya

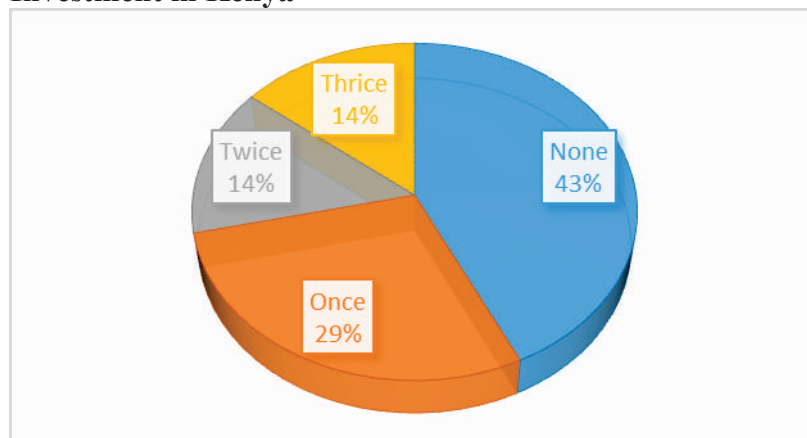


Table 4.17: Reasons for Issuing Private Equity

	Frequency	Mean	Standard deviation
Amount of Transaction costs incurred	7	2.456	0.1298
Regulation in the client's sector	7	3.567	0.5467
Innovative products and services of the client	7	3.987	0.4362
Size of the client's target market	7	4.231	0.1267
Growth potential of the client	7	4.567	0.2315

Table 4.18: Key Challenges faced in Issuing Private Equity

	Frequency	Mean	Standard deviation
Alternative cheaper sources of capital	7	3.149	0.6432
Regulatory framework	7	4.193	0.1783
Level of taxation	7	2.192	0.6239
Lack of awareness on private equity	7	4.567	0.8124

Table 4.3: Reasons for a Private Equity Fund Exiting a Private Equity Investment

	Frequency	Mean	Standard deviation
Completion of the investment	4	3.989	0.5476
Earning the return on investment	4	3.255	0.5521
Low cash inflows	4	3.236	0.6478
Weak economic growth	4	3.152	0.8511