ROLE OF PRIVATE EQUITY IN EMERGING MARKETS TO THE ECONOMY:  
CASE STUDY OF KENYA

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OCTOBER, 2014
DECLARATION
I, the undersigned, declare that this research project is my own original work and does not include any material already submitted for a degree at the University of Nairobi, or any other degree at any other university.

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R50/80541/2012

This research project has been submitted for examination with my approval as the university appointed supervisor.

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ACKNOWLEDGEMENTS
Mr. Gerrishon Ikiara has been the ideal project supervisor. His thoughtful advice, creative criticism and patient encouragement greatly aided the writing of this project. I have emerged from his tutelage as a transformed individual with a steely resolve and ability to critically analyze complex issues.
DEDICATION

My deepest gratitude go to my parents who through their sage wisdom and life experiences acquired through the years, frequently advised, counseled, encouraged and supported me during the entire duration of this challenging undertaking. This project is dedicated to my father, who taught me that the best kind of knowledge to have is that which is learned for its own sake. It is also dedicated to my mother, who taught me that even the largest task can be accomplished if it is done one step at a time.
ABBREVIATIONS AND ACRONYMS

ARDC – American Research and Development Corporation

AVCA – African Venture Capital Association

BO – Buy Out

EU – European Union

EVCA – European Venture Capital Association

FDI – Foreign Direct Investment

GDP – Gross domestic Product

GP – General Partner

LP – Limited Partner

MNC – Multi-National Corporations

PE – Private Equity

SME – Small and Medium Enterprises

UK – United Kingdom

US – United States

VC – Venture Capital
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ABSTRACT

Private equity is a new avenue of channelling foreign direct investment and is emerging in many countries especially in Africa where large sectors of the economies have remained unexploited. This paper seeks to examine the industry’s key actors in Kenya, their role, business processes and impact they have had on companies and the economy at large. There is limited information on the role and socio economic impact of Private Equity firms on Kenya’s private sector and this research seeks to address that deficiency while also establishing the industry’s growth and size.

The study examines policy issues such as legal and institutional regulations and relies on a mixed method study with qualitative data being collected through interviews conducted with private fund managers and beneficiaries.

Secondary quantitative data which was collected to support the qualitative data and assist in making accurate inferences about the industry was mainly collected from the records of PE firms, economics journals, websites, capital markets authority and Africa Assets.

With the increase in number of Private Equity funds in Africa over the last year with Kenya in particular getting many new foreign investments, it begs the question as to whether these foreign investors are exploiting the country to reap the benefits of an emerging economy or are they in fact growing the economy?
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CHAPTER ONE: INTRODUCTION
1.0 INTRODUCTION

Emerging markets in the world focus on growth of their economies. The growth may be seen to be in terms of the Gross Domestic Product of a country which is a function of capital, entrepreneurship, labour and land. The GDP of a country rises when there is increased capital productivity and capacity through advancements in technology and labour productivity through investment in people. With the successful business enterprises comes infrastructure development, signifying GDP growth and this is characterized by increased supply and demand, an export oriented market, business investment and increased development spending by governments.

Private equity is an alternative asset class investment which is a rising industry in Kenya and was not previously viewed as a viable investment channel. In the recent years there have been increased investments by the firms in companies and development projects. A research on the role PE firms on the economy is key as the asset class acts as a channel of foreign direct investment in the country which has implications for the emerging states such as Kenya and in international development. If the industry is an avenue for economic expansion in both developed and emerging markets, then it should be adopted and encouraged as vehicle for economic development.

Most of the investments by the PE firms have been on the small and medium companies which play a huge role in industrialization and economic growth. This is so as SMEs increases per capita income and output, create employment opportunities, promote effective resource utilization and enhance regional economic balance. SMEs have challenges in developing as they are constrained by inadequate funding and poor management (Boot et al.,
Challenges faced by the SMEs come up because of the lack of willingness by financial institutions to fund them as they lack credible information to show their credit worthiness. They lack audited financial statements as opposed to large corporations, they do not have publicly traded equity and lack public ratings that suggest their quality (Microfinance Risk Management L.L.C, 2008).

An unfavourable macroeconomic environment has also been identified as one of the major constraints which causes financial institutions to be risk-averse in funding small and medium scale businesses. The reluctance on the part of financial institutions to fund SMEs can be explained by the insufficient capital base of banks and information asymmetry that often exists between SMEs and lending institutions. Berger and Udell (2001) further noted that shocks to the economic environment in which both banks and SMEs exist can significantly affect the willingness and capability of banks to lend to small and medium scale firms.

The study looks at the relationship between the portfolio companies and the PE firms in terms of the willingness of the SMEs to relinquish equity in exchange of investment and the PE firms willingness to invest in these companies. This is done with the PE firms (Investor) undertaking risks by providing the money and the loss of stake that the investee firm will undertake as a risk.

1.1.2 Background to the Study
The traditional way of investors growing their funds is to acquire shares in a company and this has led to the term private equity which is the practice of owing equity in a private company. The objective of the private equity has always been investment of funds in small and medium enterprises so as to grow the companies and exit to get their return on the
investments. The rise in the activities of the PE have been witnessed in Kenya with large investments of capital that has generated publicity. PE is investment in a company in the hope of high returns and the target company is usually publicly owned but the PE firm privatizes it.

Private sector is the main driver of economic growth according to development research and with sights set on the achievement of the 2030 goals\(^1\), the private sector needs to be capitalized and private equity offers this alternative funding. Multi – National Corporation are usually seen as a form of Foreign Direct Investment (FDI) in the country. The Multi-National Corporations (MNCs) after investing in the emerging markets divest profits to their own home country and these capital outflows from the MNCs may result to the net loss for the developing host countries.

The MNCs also have the ability to phase out some of the home grown businesses and monopolize the use of local resources because they often have greater capacity than local businesses. Private equity has been seen as an alternative solution in Kenya and other emerging markets where the foreign investors can come and invest in the local economy in businesses that will continue to recirculate their profits in the local economy. One of the major aims of the this study on the Private Equity activity in emerging markets is to highlight the role this sector plays in the economy.

1.1 STATEMENT OF THE PROBLEM

The purpose of this research is to establish the role of Private Equity in Kenya’s economy. Lack of funds for capital to start, grow and expand business and projects has emerged as a

major challenge in the growth of the economy in an emerging market such as Kenya. One of the setbacks to getting capital for businesses has been the lack of security to secure developmental loans especially in financial institutions such as banks and microfinance institutions. There has been a rise in the number of the SMEs in the country which have grown as a result of the support they have received from the Micro finance institutions but some of the businesses have reached a point where micro credit cannot meet their growth needs.

The private equity industry which offers a long term and long value growth, remain unexplored in the continent largely and it is one of the solutions to the capital deficiency in many of the development sectors. Start-ups companies, development projects such as infrastructure development and investment in various sectors such as energy, agriculture and technology have stalled in progress or failed to take off yet private equity offers alternative funding to help these focal sectors to grow.

Private equity is emerging and there has been few studies conducted to explain the growth. There has been research in Kenya on PE by Njau (2013) which sought to establish the effect of selected macro-economic variables. Murithi (2012) set out to establish the link between risks and return trade off and Tuimising (2012), a study that analyzed the institutional and legal issues of the PE industry in Kenya. The authors noted there was an increased activity of the PE firms in the country and it was poised to increase over time as the fund investments are becoming dominant in many sectors of the economy.

Internationally, Ayman Ismail (2009) investigated the impact the private equity industry in Egypt. The results showed that the PE firms have been transforming companies in the region
including the MENA. Francesco Baldi (2012), examined the Role of Private Equity for Entrepreneurial Growth in Italy spanning 1995-2006 period to understand the characteristics of those companies that use private equity. The results were that the private equity as an asset class should potentially target companies so as to have an impact on the economy and the companies. A research gap exists in the study as no research has been done locally to explain the role of the PE firms to companies and the economy. The role of the PE firms vary in terms of regions and countries. The study is important as the local studies in PE done in Kenya have left it unaddressed.

This study will seek to fill this research gap by answering the question: What is the role of private equity in Kenya and emerging markets at large? It is important to understand this sector that is growing fast and is focal to the economic growth and development. This study will seek to answer the role of private equity in emerging markets to the economy in emerging markets and in Kenya.

1.2 OBJECTIVES OF THE STUDY

1.2.1 General Objective

1. To determine the role of Private Equity firms and their contribution in development of an economy.

1.2.2 Specific Objective

1. To provide awareness for private equity industry players, regulators and the general regarding the industry’s current state and how it can be improved.

2. Evaluate the realized and potential impact of a well-run private equity industry on the accessibility of capital by firms and its contribution to the economy
1.2.3 Research Questions

1. Are the Private Equity firms adding value to the portfolio companies and projects?
2. What are the economic development effects of the Private Equity activities in the country as an avenue of debt financing?
3. Why has there been an increased private equity activity in the country and are potential beneficiaries to the funds aware of this?

1.2.4 Hypothesis

1. Private Equity is an effective model for investing in emerging markets for foreign investors
2. The PE related government policies affects the private equity activity in the country
3. PE backed firms have a high rate of growth and sales
4. The active role of the Private Equity firms in portfolio companies achieve higher returns
5. Diversity in the sectors invested by PE firms safeguards returns in Investments

1.3 JUSTIFICATION AND SIGNIFICANCE OF THE STUDY

There has been a growth of the private equity investments in emerging markets. The research seeks to analyse the activities of the PE firms in these countries with Kenya as the case study. This research will look at their business practices, role played in the investee firms and the impact that they have to the portfolio firms. This study is expected to create awareness to business and the public as well as influence government policies. The study brings out the important information for investors investing in emerging markets showing the markets that have great returns on their investments.
The information will help the investors understand the policies, laws and the recent trends of this PE as an asset class in Kenya. The private sector will benefit greatly from the study which creates awareness for the SMEs to view PE as an investment channel. The study helps the government look at the PE industry more in – depth whereby if there is a positive role on portfolio companies and the economy at large, then the support of the positive government policies to make Kenya an attractive destination of the PE funds should be pursued. If there is a negative role on the economy, a recommendation to have more stringent policies to reduce and limit their practices in emerging markets and the country will be done.

1.4 LITERATURE REVIEW
Private equity literature review
The private equity literature that has evolved over the past 30 years and the topics that have received special attention from scholars will be provided. This section will also review the definitions of the private equity and emerging markets.

1.4.1 PRIVATE EQUITY
Private equity is a means to fund businesses and companies which require substantial capital to drive innovation and growth but lack sufficient funds\(^2\). In both developed and developing countries, some companies do not have the ability to raise capital due to being overburdened by debt, lack of transparent financial statements and records hence lack accessibility of funds from banks and micro finance firms. Some stages in the business growth require firms to make investments but the challenge of capital access will hinder them to grow.

Private equity is an attractive form of financing for such businesses for development and it fills the gap which is usually experienced by many business owners in self-financing and conventional capital market activity especially where debt from banks is a problem to the business\(^3\). PE is considered one of the Alternative asset class investments together with real estate, hedge funds and credit derivatives which are a form of business investment which can be Foreign Direct Investment (FDI).

PE is “capital to enterprises not quoted on a stock market”\(^4\). Private equity is usually used in development of new products and technologies, expansion of working capital, making acquisitions, strengthening balance sheets and to resolve ownership-management issues.

1.4.2 EMERGING MARKETS

Emerging Markets are countries that have an accelerated economic growth and have some characteristics of a developed market but have not yet attained the status of developed market. According to the Emerging Market Index which was developed by MasterCard, Kenya is one of the 65 countries in this category\(^5\).

According to Investopedia, emerging markets are characterized by higher return potential, higher levels of risk and market volatility due to political, economic and currency risks and are less affected by factors in developed world and as such they provide investors with an avenue by which they can diversify their investments\(^6\).

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6 Investopedia 2009
An overview of PE research streams

Cornelius et al show that, during the 1990s, only 29% of PE research was undertaken outside of North America although this number increased to 58% by the early 2000s, predominately from the EU (Cornelius and Persson, 2006). Today, PE research is a multifaceted discipline with topics ranging from the relationships between private equity firms and either their investors to valuation and performance of portfolio firms and private equity funds, as well as the performance of the industry as a whole.

In the review the topics of importance for this study, PE fund performance and associated performance determinants are important. In this structure of the review the researcher focuses on Private Equity Firms and the portfolio companies, as well as how the macro conditions may affect PE investing.

1.4.3 PE FIRMS AND THEIR PORTFOLIO COMPANIES

The focus of the earliest private equity studies was more inclined towards how the PE firms choose companies to invest in, made decisions, worked with the portfolio companies and exit strategy they employed.

Investor’s abilities to manage and control their portfolio companies are a common focus especially when evaluating venture capitalists as well as buyout firms governance processes. Special interest is devoted to control mechanisms outlined in contractual agreements between PE firms and their investees, including staged financing, liquidation, and other control rights. According to Kaplan and Strömberg (2004), the agency perspective on contracting is

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particularly popular in finance academia, typically assuming that entrepreneurs (or executives in investee companies) are agents of the PE firm whereby conflicts of interest may occur. Scholars such as De Clercq and Dimov (2008) and Wright and Locket (2001) argue that the PE firms also come together in the form of investment syndication networks. This usually happens when the firms want to target large acquisitions yet they do not have an individual capacity to do it. This is regarded as a good strategy as the portfolio companies can continue benefitting from the different funds and the collaboration of two firms can be good in terms of advisory and governance.

Another area of focus is determination of the extent to which PE firms add any value other than the much needed capital. PE firms as opposed to the other investors take active roles in the development of their portfolio firms by providing nonfinancial services. Identified value-added areas included: acting as sounding boards, assisting in additional financing rounds, recruiting management and boards of directors, monitoring financial and operating performances, and providing access to networks and contacts (Cressy et al., 2007).

Arguments as to whether or not an investor can contribute anything more than money however have begun to emerge and this is related more to the reputation as argued by Gompers (1996), and the individual investor’s experience as argued by Zarutskie (2010).

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while arguments by Sapienza (1992)\textsuperscript{14} are on the ability to create open environment and the learning ability of the investor to the portfolio firm. All these contribute greatly to investors growing an investee firm and the attractiveness for the investee firm to accept investment form a PE firm. Berg-Utby \textit{et al.} (2007) argues that there is a significant gap between entrepreneurs’ expectations and the perceived contributions from venture capitalists\textsuperscript{15}.

Scholars have also debated the PE firms’ abilities to add value and whether private equity-backed firms perform better than others. Looking at the portfolio firms, measurements to see the outcome to gauge their performance will be looking at the exits through initial public offerings, stock price development, employment growth, patent intensity, or company survival rates. In the early studies by Brav and Gompers, 1997, there was a perceived notion that the PE backed firms outperform the non-financially backed\textsuperscript{16}. In the later studies, suggest that the capability of the Private equity firm to a large extent determine the success of the portfolio company. Diller and Kaserer (2008) argue that an issue of causality seems to be ignored\textsuperscript{17}. This is where the determination of the investment to a company lies in the ability to choose ones that have ability to perform well or are already doing well. However, only few studies such as that of Harris \textit{et al.}(2005) who points out that PE backed firms do not generally perform better in terms of growth or financial returns than other companies because

of improvement in operational efficiency that is done by the PE firms, which in turn leads to superior performance\textsuperscript{18}.

1.4.4 Macro factors and private equity

On a macro perspective, a number of studies have examined the overall supply and demand for private equity on a societal level. The drivers for a ‘private equity demand’ include areas such as overall new venture growth and thereby the size of a possible investment market for PE firms, the competitiveness in the national science base, how technical innovations may be transferred from universities to industry, and the ability of entrepreneurs to capture the fruits of their inventiveness.

The key drivers of ‘private equity supply’ include the presence of well-functioning stock markets, the overall tax climate for entrepreneurs and investors, as well as other legislatures and overall structural issues Jeng and Wells (2000)\textsuperscript{19}. According to Leleux, B. and B. Surlemont (2003), examples of factors that are considered to increase the supply of private equity are GDP growth, deep and liquid stock markets, lower labour market rigidities, decreases in capital gains tax rates, and regulatory changes\textsuperscript{20}.

1.4.5 PE Fund performance

Private equity is an asset class with rather unique characteristics, and hence, evaluating PE fund performance is not a simple task. A number of studies, though they are still rare due to a


seemingly constant lack of data, have sought to measure private equity returns while correcting for a number of biases.

1.4.6 Private equity returns evaluation

Analyses of the profitability of investments in private equity face a number of problems. First and foremost, since information within the private equity industry by definition is ‘private’, compared to public markets, transparency requirements are limited.

Second, PE firms’ unclear and inconsistent reporting of net or gross returns, i.e., whether the reported results include or exclude fees to the PE firms, makes comparisons problematic. Third, reported data are based on unrealized as well as realized investments. Diller and Kaserer (2008) point out that secondary markets for PE investments, though still small, have grown rapidly over the last several years.

Valuations done externally on portfolio companies only exist in the events of Initial public offerings, trade sales based on tradable securities or cash, additional financing rounds with new investors or if the company files for bankruptcy as argued by Diller, C. and C. Kaserer (2008). Scholars such as Cumming, D. and U. Walz (2010) argue that experienced PE firms tend to report significantly lower valuations than their younger, especially early-stage and high-technology. Fourthly, Conroy, R. M. and R. S. Harris (2007) argue that there is a limited history on private equity, as compared to other asset classes. Thus, useful and comparable data is lacking. Fifth, evaluating performance returns alone provides an incomplete picture if the process of analysis does not incorporate the risks associated with an

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investment. Investing in private equity is considered to be associated with especially high risks.

1.4.7 Private equity performance

The literature on private equity performance has evaluated the performance at the PE firm level. Cochrane (2005) who measured the performance of the PE backed firms between 1987 and 2000 showed there was a great growth in the companies. Ljungqvist and Richardson (2003) analyzed the cash flow data of a single large US private equity investor between 1981 to 2001 with 85% of the firm’s holdings were BO funds. They concluded that private equity fund investments had a great performance but the studies were largely driven by a bias that the sample use comprised of largely mature buyout funds which outperform recently investments.

Looking at the private equity performance, the results that come out from the various scholars such as Conroy and Harris (2007) show that there is great variation with large differences between the best and the worst performing funds. This means PE firms vary in their ability to generate excess returns. Looking at the funds in general according to the scholars, it shows that there are lower returns than the comparable indices.

1.4.8 Performance determinants of PE funds

When the Private Equity firms invest there are a range of determinants that affect the performance in portfolio companies and projects. According to Söderblom and Wiklund (2005) the factors are the governance of the PE, the characteristics of the PE and the macro

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factors. These factors have both direct and indirect impact on the returns on investments. The subsequent section elaborates the impact.

1.4.9 PE funds’ focuses and characteristics

In Private Equity, there is a venture capital (early stage investment) and buy out (Later stage investment). When looking at the investments, venture capital which is performing well brings more returns than all the PE funds. This is because when investment is done at an early stage, there is always a significant room for growth hence the high returns (Schmidt, D, 2006)\textsuperscript{26}.

According to Das, S., M. Jagannathan and A. Sarin (2003), a high rate of early-stage investments has a negative impact on the proportion of successful exits\textsuperscript{27}. Looking at the returns in terms of the geographical origin and focus, there is a great return in investment in the emerging markets because there are many sectors that are developing at this stage as compared to the developed countries. Hege, U., F. Palomino and A. Schwienbacher (2008) elaborate further when they argue that the origin of the funds also matters in that there are significantly higher returns on investment on the US funds as opposed to the funds emanating from Europe\textsuperscript{28}.

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The degree in specialization of a PE fund also matters as the firms specialize in terms of the industry in investment have higher returns comparing to ones that invest generally (Gompers, P., A. Kovner and J. Lerner, 2009)\textsuperscript{29}. Also the right industry to invest in is also is crucial.

The characteristics of the PE funds also matter. The fund sizes of a PE firm show that there are better returns with smaller fund size and size is important because it affects the economies of scale and prominence. Hochberg, Y. V., A. Ljungqvist and Y. Lu (2007) argue that the larger PE funds have relatively higher rates of successful exits compared to the smaller funds\textsuperscript{30}.

The underperformance of the funds has been found to be closely related to the PE fund size. There are various disadvantages that come with having larger fund; one is finding a potentially lucrative deal is a challenge hence it will have diminishing returns (Gompers, P. and J. Lerner, 1999b)\textsuperscript{31}. Secondly, the large funds will invest in overseas deals for diversification and higher returns but this is sometimes affected by the fact that the interest among the partners in the deals may conflict or erode thus affecting the portfolio companies negatively\textsuperscript{32}. The number of portfolio a PE firm has matters when managing the funds. Schmidt, D. (2006), argues that with a higher number of the portfolio companies, there is a high diversifiable risk reduction (Phalippou, L. and O. Gottschalg, 2009)\textsuperscript{33}.


\textsuperscript{31} Gompers, P. and J. Lerner (1999b). \textit{The venture capital cycle}. The MIT Press: Cambridge, MA.


1.4.10 PE managers’ skills and governance of investments

Kaplan, S. N. and A. Schoar (2005) argue that the governance of the investments made by the PE firm largely influences the abilities to generate good returns. This lies in the management team skills which are the identification of the beneficial investments, professional guidance for the portfolio company and the ability to make better deals\textsuperscript{34}.

Phalippou, L. and O. Gottschalg (2009) further argue that the more experienced and skilled PE firms offer higher and better returns and high survival rates compared to the less experienced ones\textsuperscript{35}. When looking at the comparison between the high returns between the US based PE firms and the European, Hege, U., F. Palomino and A. Schwienbacher (2008) found that the US firms perform better because of the better screening capabilities\textsuperscript{36}. The differences in returns are related to the PE firms ability to grow the investments. The managers with great prior experience in the Private Equity industry have the ability to manage the funds in portfolio as well as the fundraising. The returns seen in newly established firm are lower than the ones in experienced ones (Walske, J. M. and A. Zacharakis, 2009)\textsuperscript{37}. The firms which have regular short interval between financing rounds increase the returns. This helps in making sure the investee firm have accomplished the set standards and goals for them to be funded for another round\textsuperscript{38}.


1.4.11 Macro factors

Macro-oriented factors are considered to have significant effects on private equity fund performance. In fundraising, there are funds raised in booming economic times and while some are raised in other economic situations. Diller, C. and C. Kaserer (2008) argues that usually, the funds raised in the boom time tend to have lower and poor results hence affecting the performance. The PE funds are also affected by volatility and illiquidity. Kaplan, S. N. and A. Schoar (2005) found out that the PE firms that are established are not highly sensitive to the business cycles and macro factors as the new and young firms.

1.5 THEORETICAL FRAMEWORK

Private equity is an emerging research field in economics. Research shows that the private owned companies run by the private equity firms affect the behaviour and performance compared to the firms publicly owned which are publicly traded and family owned businesses. When private equity firms take or buy a stake in a portfolio company they do so by ensuring that they get their returns back on the investment as well as grow the company they invested in. The PE firms look at various strategies to ensure that the company they invest in continues to grow and make substantial profits. The strategies as argued by different scholars are business model and governance as argued by Jensen (1989), Lerner (1995), Walker (2007), impact on portfolio company in terms of labour, wages and employment as argued by EVCA (2005) and Kearney (2007). Taylor and Bryant (2007) argue that the boosting the performance on the investment vehicle help in boosting the returns; Lichtenberg and Siegel (1989) argue that the firms should ensure the productivity of the portfolio.

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company grows while Himmelberg and Peterson (1994) argue that focus on innovation would drive the much needed returns.

According to Wright et al (1998), there are three types of business in every economy. They are the family owned, public corporations and private equity owned. The organizing models have distinct characteristics. Private Equity, which is the main focus of the research, is characterized by the ownership being concentrated by institutional investors and very wealthy individuals with high net worth. The financing of the PE owned portfolio firms is characterized by accessibility to equity by fund managers and access to debt financing and high leverage especially in Leveraged buy outs (LBOs). This ensures that there is liquidity for the portfolio firms in their operations. The governance structure is comprised of the investors of a PE firm, the PE firm, Portfolio Company Board where the PE firm is represented and Management of the Portfolio Company. The agency issues in this governance structure are between the investors and PE firm which are resolved though profit sharing incentives and fund term limit.

1.5.1 Agency Theory
The relationship between the portfolio company and a PE firm in terms of financing, ownership and governance is best explained by the informational asymmetry and the agency theory. Informational asymmetry occurs when one party may have an undue advantage of bearing more or better information over the other party when entering into a contract. Mas – Colell et al (1995), argues that if the information asymmetry takes place before the contract

occurs, it may lead to a moral hazard or adverse selection situation\(^42\). They further argue that if it takes place after the parties have already entered into a contract, it may lead to a principal–agent problem\(^43\).

Moral hazard is a situation where one party takes risks because the potential cost as a result is borne by another party. This cost may be borne wholly or in part by other parties that have not taken the risk. In the adverse selection in a Private equity transaction, a portfolio company can be on the verge of collapse (which they may withhold such information) when the PE firm invest in them. With the likelihood that the portfolio company may not survive without the investment, the PE firm may end up with an adverse selection situation.

The principal–agent problem arises when one party acts on behalf of another party or makes the decision which have an impact on the another party. It is a problem because the agent acts in ways that achieves his own interests rather than the principal’s.

Additionally, there are two types of informational asymmetry, the hidden actions and hidden information. According to Jensen et al (1976), hidden information occurs when the agent has more intimate knowledge of a firm’s operations than the principal. Hidden action is a situation where the principal doesn’t observe the actions of the agent. The agent in this case may be acting on their own interest rather than those of the principal. This may lead to a situation of moral hazard if the agents pursue their own interest rather than the ones of the principal\(^44\). The agency seeks to address the issue of alignment of interests between the principal and the agent. The governance process and performance incentives for management


\(^{43}\) Ibid

aim at syncing the interests of both contracting parties and ensuring that the agent acts in the interest of the principals (Shareholders). The second risk is the risk tolerance between the principal and the agent. The agent may be more unfavourable to risk or more risk seeking than their principals which the agency theory seeks to address. Issues such as changing market conditions and change in management may also affect the management’s behaviour to risk.

The emerging markets are characterised by family businesses, business conglomerates and state owned enterprises rather than public corporations. As the private equity activity increases in the emerging markets, the main target is the transformation of the family businesses into corporations, restructuring and sold to large corporations or through stock market. The characteristics of a family business or the SMEs (mostly family owned) are: ownership is by an entrepreneur or family, accessibility of finance is through equity and debt, they are risk averse grow slowly through the retained earnings.

Informational asymmetries bring the transaction cost as another theoretical issue. Investors in an emerging market are limited in choices of investment which are acquiring and managing a local company through the foreign direct investments, investment through private equity firms and buying of shares in an emerging country stock market. When investors invest through a private or public equity, there will be informational asymmetry which can lead to high risks and transaction costs which includes implementation, monitoring and exit transactions.
1.5.2 Portfolio Theory

According to Markowitz (1952), investors can reduce variance by diversifying their investments when building a portfolio. That is, they should avoid putting all their eggs in one basket. By investing in assets that fluctuate in different directions, investors can actively offset the specific risks inherent in individual stocks. As a result, Markowitz argues that investors select financial assets for their portfolio based on each asset’s contribution to the portfolio’s overall mean and variance. Through the power of diversification, investors can reduce the risk that is specific to an individual stock at virtually no cost (Crouhy et al, 2006).

Portfolio theory is a theory of investment which tries to maximize portfolio expected return for a given amount of portfolio risk, or lessen risk for a level of expected return, by choosing the proportions of several assets. Although Modern Portfolio Theory is widely used in practice in the financial industry and several of its creators won a Nobel Prize for this theory and has in recent years had the basic assumptions of MPT widely challenged by fields such as behavioural economics (Sharpe, William 1964).

MPT is a mathematical formulation of the concept of diversification of investing with the main aim of selecting a collection of investment assets that has collectively lower risk than any individual asset. Its possibility can be seen intuitively because different types of assets often change in value in various ways. For instance, when prices in the stock market drop, prices in the bond market usually increase and vice versa. Therefore, a collection of both types of assets can have lower overall risk than either individually. Diversification often lowers risk even if assets' returns are correlated both negatively and positively.
Since Daumont et al (2004), many researchers have tried to model portfolio optimization problems within an execrated utility maximization framework. Different utility functions have been used in this approach, and the most notable recent works in this area are those of Berger (2005), where log optimal portfolios are constructed and analyzed. Single period portfolio optimization theory was initially developed by Markowitz (1952), where he introduced mean variance portfolio optimization and efficient portfolio theory, which also led to the one fund theorem of Tobin (1958). However, these single period models were not sufficient to reflect the real financial world which is dynamically changing over time, and different approaches have been devised to solve multi-period portfolio selection problems.

1.6 RESEARCH METHODOLOGY
This chapter describes the procedures and methodologies that were undertaken in conducting the study to arrive at conclusions regarding the role of the private equity firms in emerging markets. Specifically, the chapter covers: research design, Variables, population, study sample, research instruments, data collection and data analysis.

1.6.1 Research Design
The study conducted research on books, articles, data and information on the PE industry as a whole and its activity in Kenya. The researcher used interviews to collect data from PE firms and portfolio companies. Major information collected was on PE cycle which included fund initiation and set up, investing, portfolio management and exit which brought out the practices in an emerging market. This was done through process tracing. The researcher also used a descriptive cross-sectional survey which sought to give the role played by the PE firms in Kenya.
1.6.2 Population and Sampling

Sampling is the process of selecting a number of individuals to represent the large group from which they are selected. The individuals selected are the sample and the large group from which they are selected is the population\textsuperscript{45}. Convenience sampling was used to get sample of the total number of the Private Equity firms. Convenience sampling subjects are selected because of their convenient accessibility, ease and proximity\textsuperscript{46}.

The total population of PE firms in Kenya as at 30\textsuperscript{th} July 2013 is 28 active firms. The names of the firms were identified by the researcher from different websites such as African Venture Capital Association (AVCA), Capital Market Authority, news and press releases that indicates existing 28 PE firms. The research included 3 local Private equity firms and 3 foreign PE firms in diverse sectors of the economy such as agricultural, financial services, manufacturing, telecommunication and real estate. The researcher reviewed 14 PE firm websites for information on PE investments, portfolio companies and returns on Investments.

Purposive sampling is whereby the researcher selects the item for the sample. The researcher deliberately selects the item for the sample\textsuperscript{47}. The researcher purposively sampled PE firms that have invested in more than three sectors which outlined diversity in the fields of investment. The respondents interviewed were from selected private equity firms in Nairobi, which has a concentration of PE firms. The sampling helped the researcher to gain information concerning their firms and the role they play in a portfolio company. The PE firms gave information of the portfolio firms and the impact they have had since they


acquired stake in a company. Where applicable and with the authorization from the PE firms the researcher interviewed the portfolio company respondent to gauge the impact that is at their companies.

1.6.3 Data Collection
Data was collected through structured interviews with the respondents at the six PE firms which invest in diverse sectors. Secondary data was collected from the PE firm websites, Africa assets, AVCA data bank, The World Bank, Capital Markets website and various sources like government and private financial reports publication journals, business magazines, news and press releases. The study also reviewed the annual reports for the companies and obtained the information on the performance. This enabled the study to look into role of PE in portfolio company, the impact or its role to economy and the risk return of the companies.

Table 1: Private Equity Firms Interviewed

<table>
<thead>
<tr>
<th>Private Equity Firm</th>
<th>Start Date in Kenya</th>
<th>Primary Ownership/Nationality</th>
<th>Person Interviewed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fusion Capital</td>
<td>2006</td>
<td>United Kingdom</td>
<td>Investment Analyst</td>
</tr>
<tr>
<td>Centum Investments</td>
<td>1967</td>
<td>Kenya</td>
<td>Investment Officer</td>
</tr>
<tr>
<td>TransCentury</td>
<td>1997</td>
<td>Kenya</td>
<td>Investment Analyst</td>
</tr>
<tr>
<td>Emerging Capital Partners</td>
<td>2000</td>
<td>United States of America</td>
<td>Analyst</td>
</tr>
<tr>
<td>Actis</td>
<td>2004</td>
<td>United Kingdom</td>
<td>Private Equity Analyst</td>
</tr>
<tr>
<td>Fanisi Capital</td>
<td>2009</td>
<td>Kenya</td>
<td>Private Equity Associate</td>
</tr>
</tbody>
</table>
1.6.4 Data Analysis

Data analysis of the qualitative data was done by analyzing the structured survey with the help of two assistants. They were reviewed to identify the trends, themes in terms of the opinions of the respondents. This helped the researcher gain data on the perception of the PE firms in the country and the portfolio companies. The performed a perform process tracing to ensure that look at the project cycle and operation in a company by a PE. This clearly showed the stages that the PE firm go through before, during and after the investment in a portfolio company. The raw data was scaled on a scale of one to five on a “positivity of response index” designed purposely for this study (see appendix C). This index ranks each response on a scale of 1(Negative) to 5(Positive) depending on the perceived nature of the response. The index was used only to gauge the attitude and perception of respondents towards practices in Kenyan PE. The study also adopted content analysis of the various websites, newspapers and journals such as the World Bank, Capital Markets Authority, African Assets and Deloitte which had information on the private equity in Kenya and emerging markets as whole. The information was analyzed and information rated in graphs and pie charts.

Quantitative data collected was fed into a spreadsheet and analyzed against figures from the general economy. This helped review the PE activity, the role played in firms and in the country in terms of employment, Kenyan Stock Market, profits and growth for the PE beneficiaries and the PE firms. Africa assets, Private Equity International, and AVCA collect quarterly information on individual funds in the PE industry. The data set was based on voluntary reporting of fund information by the General Partners (GPs) as well as by their Limited Partners (LPs). The databases claim that because they receive information from both the General Partners and Limited Partners in a PE, there is little opportunity for inconsistent
reporting. The quantitative data also included records of the PE firms from their website and this aided in making accurate inferences about the industry.

1.6.5 Data Management and Ethical Considerations
Getting information for the research especially the portfolio companies was challenge because of the confidentiality in the transaction with the PE firms. To ensure that the study attains information from the firms, the researcher sought direction and permission from the PE firms to directly get information from their portfolio companies. The researcher kept confidential information private ensuring no harm came to respondents or their companies.

1.7 Scope and Limitations of the Study
The researcher received authorization from a PE firm to approach and communicate with an investee firm that they have invested in. This was a challenge because the researcher depended on the direction of a PE firm on the companies to approach under their portfolio. This challenge was dealt with by looking at the financial statements of the portfolio companies before and after a PE firm has invested in a company. Secondly, due to the limitation of time and resources, the researcher had to get information for a few PE firms.

STRUCTURE OF THE THESIS
The thesis will be divided into five chapters.

Chapter 1 is the Introduction to the research study, the statement of the problem, justification, theoretical framework, literature review, hypotheses and the Research methodology of the study.

Chapter 2 is the Overview and The Nature of Private Equity and the Project Cycle

Chapter 3 is the Analysis of the Private Equity industry in Emerging Markets.

Chapter 4 is the Analysis of Kenya’s Private Equity Industry

Chapter 5 is the Summary, Review of Hypothesis, Conclusions and Recommendation
CHAPTER 2: OVERVIEW AND NATURE OF THE PRIVATE EQUITY

2.0 INTRODUCTION
The chapter outlines the history of private equity and its development in both developed and emerging markets. The nature of the private equity includes the types of private equity at the global level and Kenya as well as at various stages of the implementation of investment.

2.1 HISTORY OF PRIVATE EQUITY
The first Private Equity transaction can be traced back to the middle Ages, when Italian merchant families sponsored profitable exploratory expeditions\(^\text{48}\). This was followed by the 15\textsuperscript{th} Century Christopher Columbus expedition to the west. Columbus expedition was funded by Queen Isabella in exchange for 10\% of the carry or wealth that was discovered\(^\text{49}\). The formal process can be traced back to the UK in 1800s in regard to the land owners who were the wealthiest. With the industrial age beginning, there was a culture change from the agrarian society as there were new technologies used such as use of steam and adoption of factory systems. The land barons began investing in entrepreneurs in exchange of some ownership stake in their companies and businesses which helped them provide the needed products and services to consumers as well as the jobs in the economy.

In 1901, J. Pierpont Morgan bought Andrew Carnegie’s American Steel Company for $ 480 million. After the World War II private equity financing became a large-scale industry. The seeds of private equity were planted in the United States with the founding of two leading firms known as American Research and Development Corporation (ARDC) and J.H.

Whitney & Company as well as in Europe with the creation of Charterhouse Development Capital (1934) and 3i (1945) in the United Kingdom.

In the 1970s and 1980s, this industry experienced a boom as a result of the many PE activities taking place at the time. The revolution in the west still had little literature and so is private equity in Africa. Emerging markets begun to be a destination of the PE investment in the late 1990s when investors started seeking new investment territories. With the PE investment being highly lucrative and there being high returns on investments, the investors begun to question the sustainability of the returns especially in the developed world where the investments were done.

The developing countries also became more attractive to investors due to their transitioning of many of them to market economies. International organizations such as International Monetary Fund (IMF) prompted reforms such as tax accounting and disclosure making a contributing factor to the attractiveness in investments. Most of the companies in the developing world used the conventional ways of raising finance such as borrowing from banks but some of the companies were already struggling with huge debts or the financial institutions were not ready to invest in a young company. The international capital market was also not accessible to the many companies, and the PE investment became an alternative vehicle to solve the gap.

The attractiveness of the emerging markets to the PE investments declined before the 2008 global financial crisis as the expected returns on investments were not fulfilled. The exits for the PE firms in the invested companies were difficult which meant that it was difficult to conduct business. This was due to the lack of a clear strategy to exit an investment in order to
make returns and repay the investors. The PE firms later developed a strategy of training the local governance and management teams and improve on the corporate governance so as to attract more investments in the fast growing economies with the BRICS economies (Brazil, Russia, India, China and South Africa) leading the pack. Previously in Africa, South Africa accounted for more than half of the PE investments but recently Nigeria, Kenya, Ghana and Egypt have received more investments showing a shift in investment destinations.

2.2 NATURE AND TYPES OF PRIVATE EQUITY

Venture Capital
Business that is at a stage where it is about to launch or take off can benefit largely from the venture capital. It is a funding that is set up and meant for a start-up company, business or a project. The venture capital has been seen largely in the industrialized countries as creating innovative and high technological businesses. Venture capital can mostly be found in the application of the new technology, new marketing strategies and new products that are not already proven in the current market but require a substantial amount in the early stages of the company cycle. Venture capital is most suitable for companies that need a large capital at the inception which can hardly be financed by the traditional and cheaper alternatives such as bank debt or micro finance\textsuperscript{50}.

In venture Capital, there is investing by an individual, mostly known as an angel, who is wealthy. The angel in venture capital usually funds new business at the start-up stage before approaching a PE firm to further the business. This first source of funding in the PE circles is

\textsuperscript{50} Deloitte (November 2012), Private Equity: Theory and Practice, Turkey
usually seen to be highly risky and the probability of failure is concrete. On the other side the other side, the venture capital can be highly lucrative if a business or a project kicks off successfully as the returns can be high in the long run. Various popular firms especially in the developed markets such as tech firms like WhatsApp and Google benefitted from this type of funding to global brands that they are.

**Growth Capital**

Growth capital is a form of Private Equity investment in a mature company that seeks funds to grow or expand the business. It is development capital in a company which helps in opening and expanding a company operation. Some companies have previously had too much debt and were unable to operate effectively. The growth capital helps such companies to restructure the capital structures and reduce the amount of the debt the company has on the balance sheet. With the expansion of a business and growth it offers the shareholders in a company, an opportunity to unlock a cash value in their shares arises. According to Yates and Hinchliffe (2010), the growth capital can be used as a way to exit an investment either fully or partially as a way of share liquidation for a cash benefit. The growth capital can also help a mature company make an acquisition of another entity or other investments.

**Buyouts**

Private Equity firms use the buyout as a technique to purchase company’s shares in order to acquire the control of the management and direct the strategies. It involves corporate restructuring and taking over of the company assets. Borrowed money and issuing of more stock in a company are means used in a buyout. Buyouts have been popular especially in the developed markets as companies use the strategy as the fastest way to implement the

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51 Deloitte (November 2012), Private Equity: Theory and Practice, Turkey
company’s market share, align itself with other companies who are in the same sector and develop competitive comparative advantage.

Buyouts are quite different from the other private equity funds because they target the mature companies in their investments and they look at the broad array of the economy rather than focusing on technology and startups as venture capital funds do.

**Leveraged Buyout (LBO)**

Leveraged buyout is the acquisition of a company by investor(s) with a significant amount of the price paid by borrowed money. The funds that are generated in the acquired company is then used to pay the massive debt incurred. The transaction takes place in a debt to equity ratio. The assets of the acquired company are usually used as collateral for the debt structure therefore target companies must have strong balance sheets which can support a high leverage\(^2\). There was an increased activity of the leveraged buyouts in the 1980s and Jensen (1989) predicted it will be the dominant organizational form structure in the future. He further argued that the structure used by the PE firms were superior than those of the public corporations because of the form of the high capital structure, incentive systems put in place, concentration of the ownership of a company and efficiency of the organizations with low overhead costs\(^3\).

The Private Equity firms tend to prefer LBOs because there is a low equity capital needed to complete a buyout transaction. The LBOs are without a downside where they have made companies to receive 100% debt financing, driving some companies to bankruptcy as the

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\(^2\) Demaria, C. (2010). *Introduction to private equity*. West Sussex: John Wiley & Sons Ltd.

cash flows and liquidity reduces. The Successful LBOs allow the private equity fund to have a controlling stake in the company which is known as portfolio company upon acquisition and they will align to the investor and management goals. This alignment gives the portfolio companies an opportunity to focus on the long term competitive strategy and goals without the distraction of fluctuating quarterly earnings reports. Private equity firms usually take control of these portfolio companies for a period of five to seven which the firms exit for a profit or carried interest.

**Management buyout (MBO)**

Management buyout (MBO) occurs when the executive team in an existing company buys it out from the parent company. The management team need to put its own money in exchange of an equity in the company where they buyout the shareholders’ equity. In scenarios where there is a bigger deal which requires more funds, this method has become less common. Some managers who do not have capital for the buyout can get assistance from private equity firms because usually banks tend to see MBOs as high risk to finance through debt.

The private equity general partners are involved in the buyout transaction by raising debt and providing equity in exchange for controlling equity rights as well as strategic control of the portfolio company. Private equity funds issue buyout capital in the form of a loan or a combination both the loan and equity as they seek to balance their investment’s risk. The primary goal of MBOs is to pursue the management interest and strategy which they align with ownership interests. This is achieved by granting management substantial equity post-transaction as well as seats on the board of directors. MBOs are not limited to publicly listed companies as the management can lead a buyout of a privately held company.

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54 Fraser-Sampson, G. (2007). *Private equity as an asset class*. West Sussex: John Wiley & Sons ltd.
Management Buy-In (MBI)

Management buy-in occurs when outside investors purchase a company which substitutes the board of directors believing to generate a greater value than the current yields. Usually a team is put together to buy another company operating in the same sector. Pure MBIs are rare and often fall into the BIMBO category\textsuperscript{55}.

Buy-In Management Buy-Out (BIMBO)

Buy-in management buyout is a compromise or a combination between MBI and MBO. This occurs where outside executives join the existing executive team to buyout a company\textsuperscript{56}. Usually there is a continuity of the current management and an addition of key managers specialized with a capability to grow the business through their skills and expertise and also to raise more funding.

Private Investment in Public Equity (PIPE)

Private investment in public equity is a transaction that occurs when a particular investment instrument is created within a public company that may offer a private equity-type return. Usually, while the company’s equity is quoted the investment instrument is not. Such a transaction can occur when the private investments firm or mutual fund that purchases firm’s equity at discount to current market value for the purpose of raising the firm’s capital. Structured PIPE refers to the issue of convertible debt for the same purpose\textsuperscript{57}.

\textsuperscript{55} ibid
\textsuperscript{56} ibid
\textsuperscript{57} ibid
**Turnaround Funds**

Turnaround is a financial recovery of a company that is performing poorly for a long period and has negative projections in which the company will be unable to cover costs and presence of the following situations such as continued layoffs, difficulty in paying off creditors and significant decline in the stock units. The PE firm’s main objective is usually to identify problems in the portfolio company through a problem solving strategy and focus on transforming the company back to profitable ways like market competitiveness by focusing on the key factors.

**Distressed Funds**

Distressed private equity is private equity investment which is directed to companies that are experiencing financial distress. This occurs when there is a difficulty to pay off the obligations to its creditors. Financial distress is a situation where the company has high fixed costs, illiquid assets and the revenues are low. The opportunities for such companies to raise capital are hard and there is a chance of the company filing for bankruptcy. Private Equity firms invest in such companies because the securities in trading are hugely discounted and there is a projection of raising the company back profitable ways hence making their return on investment.

**Mezzanine Funds**

Mezzanine capital fund is capital provided to mid-sized companies for expansion of businesses and operations. Mezzanine finance helps a company to have cash flow which is lend by the Private Equity firm and sometimes some lenders are secured with operating assets in case of insolvency. Usually this debt bears a huge interest. The portfolio companies lure the private equity investors by giving them equity and compensate them on the risk taken.
The mezzanine investor secures a gap in the closing of a deal at a lower price than the company equity and it allows them to keep a huge majority of control of the business. (Cendrowski, Martin, Petro, & Wadecki, 2008). Mezzanine is usually a financial phase that takes place before a company’s IPO and the investors taking part assume a lower risk of loss than the investors who enter at an early stage. It is an aggressive type of financing so the expected internal rate of return is one of the highest during the company’s lifecycle.

**Public To Private/ Going Private (PTP)**

Private Equity firms can buyout the shareholders in a publicly traded company and convert it back to a private company. This leads to the shareholders being unable to trade their stocks in an open market. In many cases, this has occurred in situations where the companies being bought by the PE firms are close to bankruptcy and this transaction involves a significant amount of debt to restructure it before being listed in the stock exchange again.

**Reverse buy-out (RBO)**

This is a strategy used by companies to get cash for reducing their debt as a method to make more flexible the manageable levels. The companies at this stage are unable to repay debt that was used in the previous leveraged buyout and would like to raise a certain amount of capital quickly.

**Employee or Worker Buy Out (EBO/ WBO)**

This is an alternative to LBO for small or subsidiaries of a company in a solid situation or in a significant financial distress. In this instance, employees buy a majority stake in the firm they work for. Sometimes the employees may lack the fund for the purchase of the company and can get financial assistance from a Private Equity firm.
Family Buy-Out (FBO)

This is the financial support in the acquisition of a target company by one or more members of the family owner.

Institutional Buy-Out (IBO)

IBO is the takeover of a company made by a financial institution which essentially supports a group of managers who will run it.

Secondary Buyout

The private equity secondary market is defined as the buying and selling of pre-existing investor commitments to private equity and other alternative investment. Secondary transactions are split into two basic categories: Sale of Limited Partnership Interests and Sale of Direct Interests. Sale of Limited Partnership Interests is the common secondary transaction whereby the sale of an investor's interest in a private equity fund or portfolio of interests in various funds is done through the transfer of the investor's limited partnership interest in the fund. The Sale of Direct Interests is defined as the sale of portfolios of direct investments in companies rather than limited partnership interests in investment funds. The portfolios have historically originated from either corporate development programs or large financial institutions.\(^{58}\)

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2.2.1 Kenya’s structure of the Private Equity

In the Capital Market Regulations of the Venture Capital Companies of 2007, there are various types of venture capital. Under Section 2 it states there is the Seed Capital, Start Up financing, Mid Stage financing and Subsidiary financing. The Kenyan law states these types of Private Equity but it allows the other forms of PE practiced in developed markets. Seed Capital finances research, evaluation and development of initial concepts, creation of prototype in product development and marketing.

Secondly the Start Up financing targets the commencement of the operation, production of a concept and prototype implementation. This in the developed nations is popularly known as Venture Capital. Thirdly, there is the Mid Stage financing which is an investment which provides working capital in the expansion of a business. The capital is usually used to increase the production capacity, develop a product, marketing a product or funding for an Initial Public Offering (Initial Public Offering).

In the developed world, this usually referred to as the growth capital. Fourthly, subsidiary financing is finance meant for the trade sale transactions that create an opportunity for investment exits to the venture capital funds. This can be said to be an equivalent of the buy outs in the developed markets.

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60 ibid
61 ibid
62 ibid
63 ibid
Kenya’s Comparison of Private Equity Market with India, USA and Australia

Comparison with USA

The US private equity regulatory framework is similar to some level with that of Kenya. US has Security Exchange of 1934 which is similar to the Capital Markets Authority Act which sets CMA as a financial service regulator. USA is different in terms of having separate Acts such as US Investment Company Act of 1940 and Small Business Investment Act of 1958 which govern the Investment companies and the Venture Capital companies. In Kenya, these companies are regulated under the Capital Markets Authority Act.

Comparison with India

The Private Equity in India is fairly similar to that of Kenya. The main focus for both countries are venture capital. In both countries, they do not have the Real Estate Investments Trusts (REITs) and the Hedge Funds as compared to that of the UK and US. India has a Security Exchange Board which is similar to that of Capital Markets Authority which is a financial service regulator. Both Acts that set up the boards act in regulation of the venture capital. There are tax provisions for the venture capital firms in India which is quite different from than in Kenya which are regulated as private companies.

Comparison with Australia

The PE in Australia is regulated by Australian Securities and Investment commission and the Australian Prudential Regulation Authority while Kenya has the single regulatory organ, the Capital Markets Authority. Australia’s private equity is similar to Kenya with the focus on Kenya. Governments in both countries set up the firms to promote economic development. The PE market in Australia is more developed compared to the Kenyan one. The government
has always been supportive of the industry as they continue to invest in industrial investment funds (IIF) and bilateral investment treaties (BITS).

2.3 PRIVATE EQUITY PROJECT CYCLE

According to Gurung and Lerner (2008), the private equity firms in the emerging markets both local and international firms have been adapting to the business practices and process of doing business which is slightly different in operations according to the business environment\textsuperscript{64}. The PE firms in the emerging market have to adapt to the environment because there is a peculiarity in terms of the institutions such as the investor protections and the legal and financial systems, there is the macro economy where there are differences in terms of the fiscal policies and the economic growth.

This chapter looks into project cycle in both the emerging markets and the developed world through the process tracing method. The information was provided by the fund managers in Kenya and public information on websites and financial reporting by the PE fund manager both in developed and emerging markets.

2.3.1 Stage One: Initiating and Setting up of a fund

2.3.1.1 Setting up of a fund

When setting up a fund one of the key areas of which need to be followed up is the legal and governance framework. Issues that are important for a private equity firm is to ensure that the

investors are protected and the fund managers are well motivated to ensure that they work to bring in profits or the PE firm and the investors. In private equity, the financial investors are limited partners (LP) while the fund managers are the General Partners (GP). While the general partners play an active role in management of funds and decision making, the limited partners have no active role except for providing funds for investments.

The general partners are paid in terms of a management fee and a carried interest which is usually a 20% profit as long as they surpass targets set\textsuperscript{65}. The profits after investments are not taxed at the fund level but only at a partner level which enables the fund managers some preferential treatment. The investors also benefit with the taxes being seen as capital gains rather than income which allows the funds to be taxed under a lower tax bracket.

The structures in the private equity in the different countries differ whereby the developed countries are well structured in comparison to the developing countries. Countries in Asia such as China and in Africa such as Kenya and Egypt, lack structure such as protection of the investors, autonomy in decision making by the general partners and the performance incentives and bonuses.

Different countries have different legal framework which affect the private equity industry as a whole. Common law countries offer a better investment protection than the civil law countries. The common law countries will attract investment which will boost financial development\textsuperscript{66}. The contract structure is also important in the transactions between the PE firms and portfolio companies. Lerner and Schoar (2004) argue that the PE firms have to


adapt to the contract structure in the investment country according to the local environment. Judiciary efficiency, legal origin, and rule of law also influence the transaction in the countries.

Differences are seen in the legal structures in the countries with civil law and common law. The countries that have civil law are very prescriptive and the law is not flexible to the contracting parties when compared to common law countries. In Kenya, the judiciary process is tedious and lengthy. Such factors affect the private equity operations in the countries negatively as the process of transactions take longer than in the developed markets.

Private equity firms are incorporated in three ways where the funds are sourced and firms incorporated locally, other PE firms are incorporated off shore, and some firms are hybrid in terms of using both strategies that is, having some funds incorporated both locally and offshore. Firms that are incorporated locally get funds from institutional investors, high net worth individuals and local banks. In PE investments, there is the holding company and the limited partnership. In the case of a holding company, the investment does not have a specific period of time which the fund will be dissolved. In the limited partnerships, there is a specific fund duration which motivates the fund managers to get results, have great returns and exit from their investments.

The second type of incorporation is the registration of a firm in an offshore country but operate in an emerging market country. The registration for the firm is done as per the interests of the investor and according to the investor protections, tax privileges and legal

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flexibility. The location for the operation of the funds is done based on the location of the founders and management’s preference.

The third type of incorporation is the mixed strategy where the funds are sources offshore and local. The local investors are beneficial to the investments of the PE firms as they can make decisions fast as they have a great understanding of the local economy and investment trends. The offshore funds are large and help the PE firms make huge investment due to availability of funds.

2.3.1.2 Raising capital

According to Gurung and Lerner (2008), the sources of capital for the PE are institutional which include pension funds, sovereign wealth funds, investment funds and high net worth individuals. These sources are both local and international. In some cases, banks and governments have participated as sources of the funds for investments. For investors, debating on whether to invest in an emerging market or a developed one is crucial. There are two explanations on why the investors opt for the emerging market rather than the developed one. The emerging markets have been more attractive due to the growing populations, institutional reforms, opening of market to foreign investments and high growth rates. The developed markets are less attractive due to the higher valuations, unfavourable demographics and slow growth rates. In the emerging markets, China and India have received the greatest investments but Kenya has been the leading country in East Africa and the third in investments in the Sub Saharan region after South Africa and Nigeria.

68 ibid
The study through interviews and internet sources, the capital is usually raised from the developed countries. There has been challenges in Kenya in raising funds locally from investors which can be primarily be attributed by limited knowledge of the PE transactions and interactions in the country.

The second source of funding is the government. Governments in Europe and USA have been involved in funding PE firms especially the early stage companies especially in technology and space travels and an example of this model is Tesla Motors, which produces green energy efficient cars.

Germany, has accounted for more than 50% of the investments in the high technology firms while US government has accounted for the $3 billion in investments between 1958 and 1969 in the Small Business Investment Company (SIBC). Emerging market countries have also begun following this trend in the investments of Small and Medium Enterprises (SMEs) and technological companies. Some PE firms are also formed by governments such as Actis which operates in Kenya. The UK government owns 40% of the company with the intention of investments in British colonies.

The third source of funding is the banks. Banks, such as Standard Chartered Bank, has invested in PE firms and also has gone to an extent of creating a PE division in the firm.

There are certain issues such as political risks, lack of a solid track record, lack of a well-structured fund are regarded as risks by some of the EU and US investors investing in East Africa. But with the local and regional firms growing and maturing, they are slowly attracting these funds.
2.3.2 Stage 2: Investing

This section will focus on the investments done in Kenya as opposed to the ones in other markets. Issues of concern are the types of investments done, the identification of firms and due diligence process. As discussed earlier in this chapter, the investment types are venture capital, growth capital and the buyouts.

According to Lerner and Leamon (2008), there are five areas of investment in emerging markets. They are privatization, growth equity, strategic alliances, and corporate restructuring and infrastructure funds. Privatization is the acquisition and restructuring of privatized state corporations which need management restructuring and investments. An example in Kenya is the Citadel Capital purchase of the Rift Valley Railways which was performing poorly. Since the purchase of the stake by Citadel, 500 kilometres from Kenya to Tororo, Uganda has undergone rehabilitation and the company manages the network with a state of art GPS control room and the company is performing better as they adopt current rail network technology.

In the early 1990s, there was a drive by the Bretton Woods institutions to privatize state corporations. The challenge that came about was the fact that there was great opposition politically and through the public opinion. Valuation of the corporations is also another issue that is of concern. Another issue is the labour whereby with the privatizing a company, the bloated labour force that is under qualified is retrenched. PE firms avoid the privatization transactions. When the PE firms come in, they inject capital; restructure the balance sheet which helps the companies to grow.
Growth equity focus on the companies that have limited accessibility to financing and need funds to expand operations. According to the World Bank report on Egypt Investment Climate (2004), small companies have a potential to grow but there are challenges in accessing capital due to the bureaucratic lending procedures that increase risk of the bank loans. PE offers a great alternative to help the business grow. Strategic alliances involve MNCs making acquisitions, joint ventures and alliances in developing countries. The companies work closely with local PE firms which help them in the local environment knowledge. Corporate restructuring is operation and management improvements or working on small firms to make them grow and be large entities. Infrastructure funds focus on large capital incentive in an emerging country where the government have creates private financing such as the Public Private Partnerships (PPP).

Sectors for investments are key when the PE firms are looking for Return on Investments. Most of the private equity funds have put their money into financial services followed by agriculture and agribusinesses and health care and pharmaceuticals. These are sectors that have greater returns as they have showed a continued growth. When PE firms want to invest in a company, there has to be deal sourcing and due diligence. Deal sourcing is the ability to identify opportunities for potential investment which satisfy their investment strategy and risk appetite. The PE firms usually have to evaluate the number of potential transactions. This process of evaluation is called due diligence and it involves assessment of a company’s financials, assets, liabilities, management team and operations.

The evaluation is important as it determines whether a project of company is worth the investment and helps in coming up with a company valuation. Networks and contacts are important in the investment of PE funds as the fund managers can have local knowledge and
information. They also help in making a deal proprietary as at the point of due diligence, the private equity company prefer private transaction to avoid bidding wars with other firms which may lead to an investment being expensive.

PE firms also do market research to source for deals. They look at the publicly traded companies that are in need of expansion while lack funds. When identifying a family business, professional and personal contacts are crucial because they come in handy. The PE firms in Kenya, both international and local, have adopted the strategy of employing locals because they know the culture and the business community. It would be quite hard for a firm to operate from out of the country as monitoring and identification of the companies to invest in will be quite hard.

Having a great local presence is also key in due diligence process. There is information asymmetry between the PE firms and the company owners. During the due diligence, the PE firm finds out information about the business such as the legal, financial, operational and managerial details. The local fund managers will have an advantage on this as they can assess risks better as they have the local knowledge. Understanding the risks for investment and the returns is important and this is done through getting of the vital information. With the information, the PE firms can do a valuation of a company and also know all factors of operations in a company.
2.3.3 Stage 3: Portfolio Management

When the investment has been done in a firm, the next stage is portfolio management. When the PE firms invest in a company, they do so to increase their value and to ensure there is great profit as they exit. There are two ways the PE firm deals with the portfolio company that is in terms of governance and management and the value creation strategies.

2.3.3.1 Governance and Management

In the developed countries, PE firms engage with the portfolio company upon investment by changing management teams, appointment of the board members, disposal of assets and merging with other companies. In emerging markets, majority of the investors were passive on the investments and played supporting roles in the management of the firms while some PE firms have to play an active role. Earlier years in Kenya, a larger number of transactions were passive with the PE firms buying a minority stake in a company but as the PE activity continues to grow, the PE firms have been actively involved in their investments with many firms making significant investments in exchange of a significant amount of stake or on some cases even controlling stakes.

Centum Investments, in recent years make investments which will give them more than 50% ownership. Some firms such as Fusion Capital make investments where they own a minimum of 30%. Previously, the minority stake would earn the PE firms a board position to monitor their investments. Of recent years, the aggressive nature has seen the PE firms interested in the hand on approach on their investments.
Secondly, a PE firm plays an active supportive role for the managements of the investee firm. In this instance, the PE firm will strengthen the management and help them expand through opening up of markets, services and introduction of new products but does not engage actively in restructuring. PE firms usually trust and support the management teams and support the firm in terms of the opening markets, filling management gaps and professionalizing operations in a company.

Thirdly, the PE firm can also take up an active role in a company. This usually takes places when a PE firm is investing in a distressed company which need major restructuring. In the restructuring, it involves appointing a management team, changing a business strategy, restructure company’s capital structure, selling some assets and have governance processes. Portfolio companies backed by PE firms that have an active role have higher returns. There limited empirical data to support this assertion but there is some evidence that can shed more light to this as companies such as Helios Investment to Equity Bank saw the company expand regionally. A turnaround by the RVR after its acquisition by Citadel sees the company moving to greater heights.

2.3.3.2 Value Creation

PE firms coming in to invest in a company, there has to be a significant economic value in it. When the firm goes into a deal, there has to be an investment strategy on how they can boost the returns in a firm in emerging markets, the investments usually focus on growth of a business. The value creation strategies used are such as initiation, consolidation, professionalization, growing and globalizing companies. All the strategies focus on ensuring the company expands and unlocks potential of a company. Initiation involves starting new
companies to compete in the market or backing up individual with venture capital and helping them grow. Another strategy is starting a company in an industry such as gas and oil so as to compete with the already existing firms because there are no companies that they can acquire and grow. PE firms can also come and create a joint venture which is a partnership between two or more companies. Usually a MNC is interested in bringing a product or service or technical know-how while it needs another company to the local knowledge. A PE firm comes in as a financier.

In consolidation of businesses, PE firms acquire a number of small companies operating in the same area and consolidate them to be a large entity. This strategy is best implemented where there is no dominant player and it is highly fragmented. This helps a bigger entity realize a comparative advantage. Professionalizing is transforming an SME to operate more professionally. This is done through hiring of a professional staff, modernizing company’s operations; and creation of a governance structure and mechanism that has accountability and great performance incentive. Growing and globalizing companies is key to growth. Donckels and Frohlich (1991) look at SMEs and family business in their research. They found that the businesses are conservative in business strategy, more inward focuses and risk averse. The business owners fear to lose control of their businesses and this limit their growth potential. When PE firms take ownership, the only change needed to grow the company is expansion and opening new markets for products.

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2.3.4 Stage 4: Exit

The private equity investments are characterized by the limited period of investment so that they can exit and get their returns. This is usually between 5 and 7 years. The exit is important for investors as the investments are highly illiquid during the holding period\textsuperscript{70}. According to Wright and Robbie (1998), the exit from an investment by a PE firm is done through a trade sale, sale to another investor, Initial Public Offering, secondary buyout and share buyback. Some investments may not have returns and may be written off as bad investments. In Kenya, the PE industry is quite new and majority of the transactions are at the investment and portfolio management stage.

A trade sale is a sale of an investee firm to another company usually in the same sector. This exit strategy is called a merger and acquisition exit. According to the EVCA report (2009), in Europe in 2008, 40\% of exits were conducted through the trade sales\textsuperscript{71}. The Initial Public offering (IPO) is another exit strategy used in the PE exit. This involves selling of all or some of the company shares to public investors through listing in the stock market. The company shares are usually liquid and investors can liquidate their investments. This procedure is usually costly and cumbersome because listing requires regulatory procedures and due diligence. With public listing, the portfolio company will be under more scrutiny and increased financial reporting to the shareholders.

A secondary buyout involves sale of a portfolio company to another PE firm or financial investor. This happens when a PE firm is interested in purchasing a portfolio company held

\textsuperscript{71} European Venture Capital and Private Equity Association (EVCA) (2009). Research Statistics - Divestments
by another. Usually the values creation for the second investment is quite different from the first one. Another exit strategy is the share buyback which is the sale of the PE firm back to the company or entrepreneur who initially held the shares. This is exit comes up when the PE firm initially acquired minority stake in the company and the business owner is willing to buy back the shares. Usually this one is acquired through debt hence increasing debt liabilities in the company. An example is the buyback of the shares is by Craft Silicon. It is one of Kenya’s largest software firms, which bought back 30 per cent stake held by Fanisi Capital, a Kenyan PE firm which cost $2.5 million in November 2009.

2.4 Conclusion

The different types of investment by PE firms or activities in the country outline the ways which business can be affected by them. The project cycle shows the economic value that the private equity adds to the portfolio company and economy at large. Table 1 below outlines the phases both PE firm and the portfolio company go through in the cycle and how the economy is affected or stimulated by the PE activity. With an impact of greater innovation, increased productivity and the enhanced competitiveness that leads to economic growth, portfolio firms should look at the PE as a source of capital to be adapted in Kenya.
Table 2: Project Cycle in Private Equity

Source: Fusion Group of Companies
CHAPTER 3: THE PRIVATE EQUITY INDUSTRY IN EMERGING MARKETS

3.0 INTRODUCTION
According to the International Finance Corporation (IFC), Private equity investment in emerging markets cumulatively stands at approximately $320 billion today which is the most there has been but this is still a fraction of the $2.7 trillion global total\textsuperscript{72}. The Private Equity is important because 90 percent of the developing world’s jobs are created in the private sector, and private equity investment is an especially effective tool in building the dynamic, job-creating companies that drive economic growth.

Companies are increasingly allowing shareholding to be taken up by outside investors in exchange for funds and expertise which in turn helps the business to grow, expand and diversify. This is valuable in many developing countries where risk capital is scarce and institutional capacity is weak. Private Equity in the emerging markets complements the bank lending, microfinance, bond markets and other financial products which result to generation of returns to investors which leads to helping the countries reduce or eradicate poverty.

Investments in the emerging market regions have been driven by continued economic growth which is influenced by the growth of the middle class, investments into the infrastructure, and increased population wealth. Other factors that have attracted investors is the reduced reliance to foreign exports, improved corporate governance and good and improved public finance decisions. With the slow growth in the developed nations, emerging markets is seen to be less affected by the global financial crisis and economic downturns. The emerging markets also have shown strong manufacturing and service orientation, and with them having

\textsuperscript{72} International Finance Corporation (May 2013). IFC and Private equity Development Impact, Financial returns. Washington
a great raw material base, they have attracted numerous investors. Countries such as China, India and Brazil have received capitals due to the huge market for utilization and also diversity in investments such as banking, power generation and infrastructure.

Investors have developed a high tolerance for risk as compared to the former years as the capital is invested in countries that were previously seen as too risky such as Nigeria, Kenya and Chile as opposed to the mature emerging countries such as China and Poland. Despite the high returns that the PE industry in the emerging markets has presented to the investors, there have been challenges as they are affected by the changes in economic markets as well as some bear geopolitical risks. There have been returns that have not been consistent which reflects the high variability of returns in the public market. The challenges that some of the PE firms have experienced are such as the complexity of the legal regulations in the countries and poor accounting practices.

In times of exit the PE firms also experience challenges in public listing and also sales to strategic investors. The investors are slowly adapting to the business environment in the emerging markets as there is a need to have the improved regulations and development in institutions, legal infrastructure and exit opportunities. As the conduct their activities, the PE players are adapting to the business practices such as the operation costs, country’s customs, business climate, and deal flows. The PE firms have largely operated in the larger emerging market such as Brazil and China but the shift has deviating to the smaller markets such as Kenya, Nigeria and Indonesia.

Private equity in emerging markets has grown in terms of investing and fundraising activity. According to Emerging Markets Private Equity Association (EMPEA), between 2007 and
2011, fundraising for emerging markets grew from $3.2 billion in 2002 to $38.6 billion in 2011 with the largest fundraising taking place in 2008 when it was at $66.5 billion. There was fundraising for the emerging markets in 2012 at 15.2% of the global PE fundraising. Of the funds raised, 60.7% was meant for Asia while 23.8% was utilized in Latin America and the Caribbean. China has been the largest recipient of private equity investments in the world with the emerging markets.

Following the division in geographical regions according to the Emerging Markets Private Equity Association (EMPEA), the section below will focus on the regions with emerging market countries. They are Sub Saharan Africa, Asia, Middle East and North Africa (MENA), Latin America and the Caribbean (LAC) and Emerging Europe which comprise of the Central and Eastern Europe, the Commonwealth of Independent States (CIS), Russia and Turkey. The section will consist of the regional performance of the private equity in terms of fundraising, investing and exits. At the end of each region, the researcher highlights the major and leading PE player.

3.1 SUB SAHARAN AFRICA
Africa’s economy has always been growing with many countries averaging a GDP growth of 5-7% per annum ranked below the BRIC states. The continent has also largely benefitted economically and in development from Asia with China leading the pack especially in development of infrastructure in the country while Africa exports agribusiness commodities to the Asian continent. The continent has not been (and is still is) burdened by some challenges such as the lack of infrastructure such as poor road network, low power production. The attractiveness to the continent to investors has been the positive changes in economy such as the economic growth, trade liberalization and the privatization, the political
and legal reforms which have enabled democratic elections and civil liberties. According to Transparency International Corruption Perceptions Index 2013, the African nations have improved their ranking in the corruption index thus becoming more attractive in terms of doing business for investors who previously overlooked the continent.  

In the recent years, the private equity in the continent has shown the success across the emerging markets with the fundraising activities increasing from $0.1 billion in 2002 to $3.4 billion in 2007 (EMPEA Report). The continent has been viewed as the second most preferred investment destination after China and India. South Africa and Nigeria represent the most advanced PE market with countries such as Egypt and Kenya and Ghana growing their private equity market share in Africa.

The financial crisis of 2008 gave the African continent an opportunity to fundraise more as they were affected minimally. In 2013 alone, Africa fundraised $1.6 billion from $150 million fundraised in 2002. The fundraising hub of Africa, South Africa represents 28.2% of local fundraising in 2011 (EMPEA). Data from the Emerging Markets Private Equity Association shows that the Private Equity firms fundraise for Africa for company growth and expansion through use of leverage rather than financial engineering. East Africa which is on the brink of oil and gas mining has seen the biggest rise in deal activity. There were 84 PE deals in 2013, rising 52% from 54 deals in 2012. Kenya leads in the most deals done in 2013 having transacted 12 deals.

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73 Transparency International corruption perception index Report, 2013

74 World Investment Report 2013 (UNCTAD)
According to EMPEA, the largest amount of financial resources fundraised in Africa was done by Helios Investment Partners ($900 million in 2010). Other PE firms with largest funds raised are $880 million raised by Brait who raised in 2006, Ethos Private Equity’s $750 million in 2005 and Emerging Capital Partners’ $613 million in 2008.

The fundraising in Africa has been boosted by existing limited partners and banks such as the European Investment bank, African Development Bank and Development Bank of South Africa. Initially, the African PE investment destination was to South Africa but there has been a decline and investments have been meant for Kenya, Nigeria and Ghana in the recent years. The PE investments have also diversified in Africa with the initial sector to benefit from the funds being infrastructure and national resources such as roads, power generation and hospitals. The other sectors that have seen benefitted from the funds include agribusiness, healthcare, telecommunication, clean technology and banking. Challenges that the PE firms have experienced in Africa are poor industry regulations, currency risks, corruption, and proper skilled manpower in the sector.

The largest deals in the region include $178.7 million investment by Helios Investments LLC into Equity Bank in 2005\textsuperscript{75}, an investment of $151 million by Helios into InterSwitch, $56 million by IFC Asset Management into Ecobank and $48 million towards Seven Energy, a gas and company by Standard Chartered\textsuperscript{76}. In Africa, South Africa leads in the number of exits. Typically, exits are done through trade sales where the buyers buy regional companies as they try to expand their operations in certain regions. Exit deals are done through having


\textsuperscript{76} Emerging Markets Private Equity Association <http://empea.org/>
strategic partnerships with Multinational Corporations which is based on an agreed exit formula. Another popular exit strategy by the private equity firms is through the sale of the stake to other private equity firms. PE firms such as Aureos Capital, Actis, Avanz Capital have exited through the sale of the stake to the other PE firms. Another strategy is the public listing of the company in a stock market. This has been quite rare in the continent with South Africa PE firms earning a measly 5% of the exits proceeds. This clearly shows the underdevelopment in the stock markets in the continent. Most of the capital markets have a turnover ratio of 2 – 5% on about 20 companies listed which is comparable to the Nigerian and South African stock market which has a turnover ratio of 30% and 80% respectively.

Despite the weak capital markets in the continent, some PE firms have exited through an IPO. Wilderness Safari owned by Brait Private Equity was a success. The same can be said of StarComms, a Nigerian mobile operator which was listed by Emerging Capital Partners and Actis and the yield was quite high. Emerging partners had also listed the leading rubber producer Societe Internationale de Plantation d’ Heavas which was listed in the New York Security Exchange (Emerging Capital Partners, 2007). According to Africa Venture Capitalist Association, Broadening the Horizons (2014), they recorded 207 exits between 2007 and 2013. The number of PE exits in the region declined to 27 in 2013, down from 35 the year before and 29 in 2011.

South Africa remains a leading investment hub for the continent in Africa as the PE industry took place early on in the early 1990s. Many of the PE industries in Africa have taken shape after the millennium. South Africa’s PE industry continue to attract investors in the country due to their legal and regulatory infrastructure development, mergers and rise in the acquisition activities, well performing capital markets and the strong economic growth. The
sectors that continue to receive a huge chunk of the investments are biotechnology firms, software firms, medical equipment manufacturers and healthcare providers.

In Africa as it has been in the emerging markets, majority of the funds are destined to benefit the SMEs. The SME sector has been one of the leading job creator in the continent and the PE funds go a long way to boost the GDP and economy at large.

Figure 1: Deals, Investment and fundraising in Sub Saharan Africa (2000 – 2012)

Source: EMPEA (2012)
3.2 ASIA

Asia is the fastest growing region in terms of economy in the world. The growth has been influenced by the growth in the middle class, the growth of businesses and the large populations. The fundraising for private equity in the region has been high with $40 billion raised in 2008 and $30.3 billion invested. The countries in this region have specialized in different sectors with China specializing in manufacturing, India in the service sector and Thailand in the agriculture sector.

China and India has been the destination for the PE investments in the region which accounts to about 70% of funds invested. South Korea, Singapore, Indonesia and Malaysia are usually seen as the mid-market countries in the region as they have strong economic growth. They have received a done a huge number of the PE deals with countries such as Malaysia being attractive in terms of the capital markets where there are more than 1000 listed companies while Indonesia has a high FDI inflow.

Countries such as Vietnam, Philippines and Thailand have received less PE investment because they are perceived to have a poor institutional structure. The positive aspects of these three countries is that they have low valuations in entry and exits which is favourable to the PE firms as they can expand more to the region during the exits. The markets also are open towards the privatization of the state firms which has been seen as a strategy to grow local economies.

Asia is the leading fundraising region and it accounts for close to 70% of the total fundraising in emerging markets and about 10% of the funds raised globally. In 2011, there was a cumulative capital fund pool of $198.3 billion since 2001. China has been dominant in the
annual fundraising in the region accounting for $5.4 billion while India accounts for $2.6 billion. The investment firms in the region have been fundraising with there being a challenge to raise funds for new entrants in the PE market in the region. Most of the funds raised was done before the 2008 financial crisis with TPG raising $4.8 billion in 2008, CVC Capital Partners raised $4.1 billion in 2008 and KKR $4.0 billion (Asian Venture Capital Journal database).

Investment by the PE firms has been made in all the major sectors but the most active sectors are consumer goods and services, banking and financial services, manufacturing industry and technology. Local firms play a crucial role in the region’s growth and they average about $15.1 billion per annum. As they operate, they face challenges such as failing to meet the partners’ expectation and deal pricing. There is also competition for the local firms from the newly created funds, the Multinational Corporations and the existing players including the international PE firms.

Other challenges in the PE industry for the local firms is that some businesses are family owned and are not willing to give a stake in their business because they would want to maintain the decision making process to themselves. In a case of businesses in Malaysia, there is trading portfolio firms between themselves therefore crowd out PE firms. Deals in the region also are quite slow with them taking between 12 and 18 months to complete but the existing firms have an advantage over the local firms as they are well connections both political and business.
When PE firms are investing in portfolio companies, they conduct a due diligence process which may take a while at the companies may have conflicting accounts which may lack transparency. In Asia, the political environment is challenging as some governments influence different aspects in the PE industry such as approval of the transactions, accessibility to the investee firms, interference in operations and restrictions of some of the foreign organizations in some of the sectors which they reserve for the local population.

Political environment is one of the determining factors as to whether the country can attract foreign investment such as PE. Poor political environment affects the economy as there is lack of proper rules, regulations and laws to operate in thus may deter some major PE players. Huge transactions in the Asian markets conducted have been conducted by Goldman Sachs who invested $1.1 billion into Tiakang Life Insurance, investment of investment of $1.0 billion by Providence Equity Partners into Television Broadcasts Ltd. (a Chinese media operator), the buyout of PT Matahari Putra (an Indonesian retail chain) by CVC Capital Partners (equal to $0.9 billion) and an expansion investment of TPG and KKR into China International Capital Corporation (a financial holding)\(^7\).

In the Asian market, the exits have been quite challenging as many exits have to be done through an IPO. This is challenging as the stock market is usually dominated by the state corporations, there is poor liquidity and the regulations are weak. When a PE firm fails to exit through an IPO the other strategies would be to sell to other PE firms or a state corporations which are quite rare.

\(^{77}\) Asian Venture Capital Journal, 2013
In conclusion, the Asian PE industry continues to be dominated by China and India which take a bulk of the many PE deals and have large value. There is still a need to grow the Asian PE industry with an emphasis on China, the economic powerhouse which is set to surpass the GDP of USA in years to come. With China having an average of $5.6 billion per annum, there is an upward trend for the leading economy in the emerging market. Most of the transactions in China are directed towards expansion of operations in businesses with less than 10% targeting the start-ups. There are a number of challenges in the Chinese PE high entry valuations, complexity in the regulation structure, the oversupply of capital and the high competition in the PE deals. The exits in the country are quite challenging because many corporations being state owned and if a company is to exit through an IPO it has to get political backing. The process in the PE deals is largely marred by the political environment which is politicized from entry to exit.\(^78\)

India’s political environment is stable and is encouraging to market liberalizations. This has led to more investments in the country because of the attractiveness it has to the private equity. Between 2001 and 2011, India has attracted with cumulative fundraising equal to $44.3 billion of the PE investments which is second to China’s $77.0 billion in cumulative private equity. The average deal size in China is $33.8 million compared to India’s $20.7 million.

\(^{78}\) Emerging Markets Private Equity Association <http://empea.org/>
3.3 MIDDLE EAST AND NORTH AFRICA (MENA)
The Middle East and North Africa (MENA) region has 17 countries which are divided into three sub regions: the Gulf Cooperation Council: Kuwait, Saudi Arabia, Bahrain, Oman, Yemen, Qatar, and the United Arab Emirates; Levant: Iraq, Jordan, Syria, Lebanon; and North Africa: Morocco, Algeria, Egypt, Libya, Sudan, Tunisia). The MENA region has recently undergone political instability in the form of the Arab Spring which has led to uprisings, demonstrations and riots and social, economic and political grievances.

Some of the countries affected are Egypt, Tunisia (revolutions), Libya (Civil war) Yemen, Syria (Civil uprising), Algeria, Jordan and Kuwait (public protests) Sudan and Saudi Arabia (social demonstrations). Governments were overthrown during this spring with Tunisia, Egypt and Libya being the casualties. Egypt and Tunisia have begun a recovery path with
them having held elections and become politically stable but Libya continues to experience instability.

The business environments has deteriorated due to this uprising where there have been looting, vandalism, work stoppages, loss of jobs and supply chain disruptions. There is a huge optimism by the local investors that the region will go back to normalcy after being affected negatively. They view the disruptions as short term as the region remains attractive. To the foreign investors there is caution that has been taken up in regard to the investments done in the region as the market is too risky especially for the PE investments. The region is seen to have economic problems with there being budget deficits, inflationary pressure and fluctuations in the value of the currency and the economic slowdown. Despite this, the region remains attractive due to the abundance in the natural resources such as oil and gas, an expanding middle class, a youthful population which are factors that will help the countries grow their economies in the long term.

There has been a slowdown in the investments in the region after the uprising and most of the PE firms have concentrated on the existing deals till the region stabilizes. The firms also believe that the governments in the region need to develop their institutional infrastructure such as laws and regulations in order to attract more PE activity. Fundraising in the region was good before the uprising with the region fundraising $6.9 billion in 2008 but was affected and the fundraising in 2010 and 2011 was down to $0.4 billion.

For the last few years the biggest fundraisers in the region have been Abraaj-Riyada Enterprise’s $400 million in 2010 and EVI Capital Buyout Fund’s $400 million in 2010 which is down from Abraaj’s capital Infrastructure fund raised in 2007 at $2 billion. The
annual investment in 2010 was $793 million and $385 million in 2011. The sectors that attract investment the region are healthcare, infrastructure, education and warehousing which is a shift from the traditional sectors such as telecommunications, manufacturing, banking, technology and energy and oil. According to the Global Investment House (2008) UAE, Saudi Arabia and Egypt attract most PE investments.

The PE challenges in the region is that the deals are subject to auction process which does not given time for due diligence, there are inflated entry valuations and few deals for the capital at hand. The mezzanine and buyout opportunities are quite low. Investments in the region, like in the other emerging markets is that most businesses are family owned and transforming them to be corporate entities is a huge task especially when they are not familiar with the operations of a private firms.

Some owners are unwilling to sell a stake of their firms to unfamiliar entities. The structure of the family owned business is quite poor and they lack the operational transparency as well as financial plans and forecasts for the businesses. The process to review the businesses in the due diligence stage is quite a task that is time and funds consuming.

The PE firms also have an issue of the valuations of the businesses which have also been affected by the political downturn. The region also has a poor legal framework as they are inconsistent and legal arbitration take a long time to resolve. Some of the financial regulations deter some investors such as the strict regulations to the ownership of businesses, limited minority shareholder protections and the exit through IPOs is done through a book building process. The region has been characterized as having complexities in doing business and too much red tape.
The largest deals in the MENA region are Abraaj’s investment of $2.1 billion in Egyptian Fertilizers Company, $0.5 billion in EFG Hermes (banking) and $0.6 billion in Acibaden (healthcare). Exits in the region have been quite problematic as trade sales and IPOs have been low due to lack of interest by strategic investors. Most exits in company investments have been sold to other PE firms. The trade sales exit strategy which account about 75% of the exits take about close to 18 months to be completed.

Examples of trade sales include the sale of Atos Origin Middle East to Hewlett Packard by Injazat Capital, the sale of Arab Orient Insurance Co. Fairfax Financial Holdings by Foursan Group and the sale of Egyptian Fertilizer Company to Abraaj Capital by Citadel Capital. The IPO exits have been low due to the undeveloped public market industry. Examples of the exits or public listing is such as the Arabtec Holding (Construction) and Aramex (transportation) by Abraaj Capital in the Dubai stock exchange.

Egypt has the most active PE industry in the MENA region and is the third largest economy after UAE and Saudi Arabia. Egypt has more investments in the region than any other country which is about 25% of investment volume and 50% of the investment value. This however has been challenged by the UAE which in recent years has attracted more PE investors due to the political uprising in Egypt.

Egypt has attracted these investments due to having well developed legal infrastructure and the legal contracts are enforceable. The public markets are also the regulated well in the

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80 OECD 2012, “Opportunities and Challenges in the MENA Region”
region and has regulated issues to do with insider trading and financial disclosure. Egypt also has an expanding middle class, a skilled and educated labour force, a young population and is geographically placed in the region. The country also has diversity in the sectors for PE investment such as real estate, telecommunications, textiles, food production and natural resources, the country's PE.

Figure 3: Deals, Investment and fundraising in MENA Region (2000 – 2012)

![Graph](source)

Source: EMPEA (2012)

3.4 LATIN AMERICA AND THE CARIBBEAN (LAC)
Latin America and the Caribbean have continually had great economic growth with the GDP growth among the regional economic powerhouses ever growing. The increased population wealth, investment to infrastructure and the expanding middle class has led to this growth. The unemployment rate is declining and the countries can deal with inflation effectively through passing of policies and regulations. The region is seen to be politically stable despite some risks in some countries such as Venezuela.
In the early 2000s, the region received substantial PE investments but the returns were dismal leading to reduction in investment up until the early 2005 when the investments increased.

The major destinations for the investments was Brazil but with the returns going higher, the other countries continued to receive the investment leading to the LAC region being regarded as one of the PE investment destination. The region’s PE activity has also been boosted by the regulations that permit the local pension funds to invest in Private Equity. This law has varied between countries with the greatest beneficiaries being Brazil who have allowed up to 20% of Pension funds be invested in PE while Peru has no restriction in investing in the local PE firms. The investments have also varied among the countries with Brazil, Chile and Colombia being regarded as the favourable destinations.

According to EMPEA Report (2000 – 2012), fundraising in the region continues to grow with the $8.4 billion was raised for investments. 70% of the investments of these funds have been directed to Brazil. The largest fundraising in the region was by Gavea Investimentos in 2011 who raised $1.9 billion followed by Advent International in 2009 having raised $1.7 billion (Latin American Venture Capital Association, 2011). Other PE firms to raise funds are Southern Cross Group’s $1.7 billion in 2010, BTG Pactual $1.5 billion in 2011, Vinci Capital Gestora de Recursos $1.4 billion in 2011, GP Investments’ $1.3 billion in 2007 and Victoria Capital Partners’ $0.8 billion in 2012 (LAVCA, 2012).

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Two major players in the region have been Southern Cross Group and Advent International who have benefitted from the lack of competition and the scarcity of the capital in the region. In the region the average deal size is about $72.3 million in 2010, a significant rise from the $15.1 million in 2002\textsuperscript{82}.

Healthcare, education, food processing, banking and financial services and infrastructure are some of the sectors have received the PE investment in the region. The PE firms also undergo an array of challenges with the major ones being restrictive laws that bar PE operations, long time to complete a deal, limited information on a portfolio company and unpredictable exit strategies and opportunities.

The most well-known recent deals in the region include the acquisition of Grupo Qualicorp (a firm operating in the healthcare and life sciences sector) by the Caryle Group; the buyout of TIVIT (an information technology firm) by Apax Partners (for $0.5 billion); and Citi Venture Capital International’s investment in Transportadora de Ediciones SL, Colombia’s oil and gas company for $0.4 billion.

There is limited data on the exits in the LAC region and exits in the region in 2010 stood at $3.4 billion compared to the $0.6 billion in 2002 (Latin America Private Equity Association). The exits in the region have been through trade sales because of the lack of a strong local capital markets and their volatility to pursue the IPO route.

\textsuperscript{82} Emerging Markets Private Equity Association <http://empea.org/>
Brazil is the biggest economy in Latin America and it’s not a surprise the hot destination for the PE investments\textsuperscript{83}. The country has an economy that is well diversified having strong manufacturing base, an export oriented economy, good investment in agriculture and huge and cheap manpower. Since 2002, the value of total fundraising in Brazil has been equal to $13.8 billion, while investing has been equal to $16.4 billion. The PE industry expanded largely in the 2000s when the invested more on the capital market and concentrated on boosting the SME sector which is ever expanding and is reducing the unemployment rate in the emerging markets.

\textit{Figure 4: Deals, Investment and Fundraising in Latin America (2000 – 2012)}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure4.png}
\caption{Deals, Investment and Fundraising in Latin America (2000 – 2012)}
\end{figure}

\textit{Source: EMPEA (2012)}

\section*{3.5 EMERGING EUROPE}

The countries in the region are Russia, Turkey, the former Soviet Union countries in the Central and Eastern Europe and the Commonwealth of Independent States. The many countries in the Emerging Europe were formerly communist economies. Countries such as

Slovakia, Slovenia, Estonia, Czech Republic, Poland, Hungary, Latvia and Lithuania joined the European Union in 2004 while Bulgaria and Romania joined in 2007. Croatia, Turkey, Macedonia and Montenegro have all made applications to join the EU but their applications have not been completed. The fundraising in the Emerging Europe region accounts for 15.1% of the total fundraising in the emerging markets. Close to 80% of the PE funds are sourced in Europe majorly from pension funds, government agencies and insurance companies.

According to EMPEA, largest fundraising by PE firms in the Emerging Europe region include efforts have Mid Europa Partners’ $2.1 billion in 200784, Advent International CEE’s $1.6 Billion in 2008, Baring Vostok Capital Partners $1.1 billion in 2007 and Enterprise Investors’ 2006 fundraising of $0.9 billion. The trends in investments in the Emerging Europe region have increased significantly from $0.4 billion in 2002 to estimated $1.9 billion in 2012. Private Equity in the Emerging Europe represents 0.12% of the GDP. PE investments in the region have been done in Turkey with $2.9 billion invested between 2008 and 2012. Recently, Bulgaria, Poland and Estonia have also attracted large investment by PE firms85.

Private equity firms in the region have invested in different sectors such as financial services, energy, consumer goods, communication and retail. Buyouts in the region have remained predominant. Some of the investments done in the region include buyout of Ceske Radiokomunikace a Czech telecommunications company by Macquarie Capital for $770 million, a $250 million expansion deal by Russia Partners into Skolkovo Innovation City (a

telecom and internet infrastructure company in Russia), and an investment by Warburg Pincus into AmRest (restaurant in Poland).

The exits in the Emerging Europe region are done through the trade sales which account for the 35% of the exits while the IPO listing as an exit of a PE stands at 25%. The region has been characterized by exits mostly in Russia, Poland, Ukraine and the Czech Republic. Investors especially the limited partners look at the region as unfavorable for investments because they view it as the least attractive due the return on investment in comparison to other emerging regions. This is due to the lack of opportunities, the entry valuations are quite high and the accessibility to general partners is low. Another reason for the low investment is that the financial crisis in the developed world affected the returns and the PE firms are banking on the investment done in the other emerging market regions to recoup the investments lost.

In the Emerging Europe region, Poland is leading in the private equity investments due to the upward trend in economic growth, growth in businesses, institutional infrastructure such as regulations and laws in the legal and accounting fields and the great performance in the stock markets. Poland has accumulatively fundraised $5.8 billion between 1990 and 2011 while the local funds have invested $6.6 billion. Russia, also a major player in the Emerging Europe region, fundraised $5.6 billion and the investment was $7.2 billion since 2001 to 2011. In terms of the returns, the investment is quite favourable with 10 year investment having a return of 20% (EMPEA). Despite this, investors shy away from investing in the country because of a slow economic growth compared to the other emerging markets leaders such as China, India and Brazil.
Russia’s economy has been hampered by the high inflation of about 10%, high unemployment rate and the decline in the exports. The institutional structure in the country such as the legal and regulatory framework is quite opaque as well as its political instability deters investors. In comparison to the other major economic powerhouses in the emerging markets, there is high level corruption, business barriers and the lack of adherence to rule of law also affects the private equity industry. The PE firms that invest in the investee firms in the country have to deal with poor financial reporting, off balance sheet liabilities and governance and management issues which are deterring factors in the due diligence stage in investment.

*Figure 5: Deals, Investment and Fundraising in Emerging Europe (2000 – 2012)*

*Source: EMPEA (2012)*
3.6 CONCLUSION
Emerging markets are an influential force in the private equity industry the same way there are increased activities. The emerging markets have not been largely affected by the economic downturns and the economic recession that affected the developed markets. The markets have adapted well to the global markets and have changed and started embracing an export oriented market and looking for investment opportunities at the international market. The GDP and economic growth continues to grow as opposed to the developed countries hence the great focus to the emerging markets which can bring in returns.

While there are institutional challenges, there remains a great sense of optimism by both local and international PE firms about the long term prospects of private equity. The emerging markets have to make some improvements in the terms of the legal reforms, institutional restructuring and exit opportunities to be more attractive. The PE firms are currently adapting to the local market conditions as they establish their presence, develop networks and grow political and business relationships, develop the local expertise and improve a strong and proprietary deal flow as they hope for streamlined markets in the future.
CHAPTER 4: ANALYSIS OF PRIVATE EQUITY, THE KENYAN CONTEXT

4.0 INTRODUCTION
Investors in the world, both International and local have looked at Africa as a continent with a potential yet to be tapped. The World Bank (2002) came up with strategies that Africa can adopt in order to ensure that in the 21st Century, the continent can be a middle income economy. Investing in people, tapping into the agricultural sector and investment in infrastructure among others were strategies that other economies in the other continents used to grow their economies.

Private Equity, a financial vehicle has helped many businesses start, grow and expand to compete with other companies in the global market. PE investors have begun to tap on this African market to make their returns and help the businesses grow. Kenya, one of the favourable destinations has not been left behind. Local PE firms have been on the rise especially since 2005 as well as activities of the international PE firms who have gone to an extent or registering regional firms and opening offices.

International PE firms such as Emerging Capital Partners, Pine Bridge Investments and Citadel Capital have opened offices in the country and increased their activity in Kenya and the whole East African region. Private equity seen as an alternative to the Foreign Direct Investments (FDI), is an indicator of economic growth and catalyst of industrial development. Kenya’s PE activity is an indicator that there is continued economic growth.

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87 Ratio Magazine *Wap,* Kenya: SME Private Equity Undeterred by Global Crisis, 2010
4.1 FUND SOURCES
The funds raised in the country for the PE investments, 92% of all the funds are foreign meaning only 8% of the funds are raised within the country. There has been some signs of potential in the local investments as the local fundraising has started to gain ground for the PE activity. Kenya’s PE funds come are fundraised from development Institutions in the EU, USA, African Development Finance Institutions and recently from the BRICS. This accounts for the 75% of the funds, this means that the emerging market funds are largely “government” or “government linked”.

Figure 6: Private Equity Fund Sources

Source: Various Economic sources (Deloitte, African Assets, Interviews)

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89 Variousy sourced: including through interviews as well as survey questionnaire responses and information from websites.
Pension funds are a close second in the contribution of funds towards the private equity. Largely the sources of these funds are from western countries. Local fundraising of the pension funds has a great potential but has been limited by the existing laws and also the lack of awareness on the private equity as a suitable investment vehicle that can yield great returns.

There are signs on the shift of investment attitudes of the pension fund managers in the country with the first pension fund, Kenya Power, investing Sh351 million ($4m) in Ascent Capital\textsuperscript{90}. As in the developed markets, this will be a significant source of private equity in the coming years as the emerging middle class put their investments in pensions and not in children as it was originally the case. In Kenya, there is about KES 700 billion of funds that the pension schemes control. The PE investments have an average net return of 20 – 25% which compete with the returns from the property and the stock market sectors.

The challenge experienced at this stage is that the RBA has to approve every PE investment. This red tape bureaucracy impacts the pension managers’ investments which they concentrate on sectors with less lengthy processes. A strategy that the pension fund manager can adopt is to the use of Development Finance Institutions (DFIs) to co invest the pension funds in private equity.

Having the majority of funds sourced out of the country also affects the labour force in the PE firms. Of the 78% of the PE firms operating in the country, 50% of the senior management are foreign workers while measly 22% are Kenyan workers drawn out of a 50% labor force.

Kenyan PE workforce. This clearly shows that the private equity sector in the country is under developed\textsuperscript{91}. With development, there will be more local investors funding the PE activities in the country.

The insurance industry in the last two years has attracted great investments. This came about after the Kenyan Insurance Act 2012, wherein the individual ownership of an insurance firm was capped at 25%. This forced the insurance firms to restructure and seek new investors while at the same time learning to price their products appropriately. The PE firms have been instrumental in reducing individual ownership of firms below the 25% cap while also advising industry players on proper pricing levels to avoid making losses.

The PE firms have to assess the insurance firms ability to manage an investment strategy that is diversified and resistant to local economic shocks. With the Kenyan Insurance Act 2012 in force, it has seen the PE firm activities grow tremendously with firms receiving foreign investments. Among the notable recipients have been Resolution Health with an investment form the African Development Corporation and UAP Group with and investment by Aueros Capital together with Tuinvest – AfricInvest Group and APA Insurance investment of KES 1.2 billion by Leapfrog Capital.

\textsuperscript{91} Dr Tuimising NR 2012, ‘Private Equity in Kenya – An Analysis of Emerging Legal and Institutional Issues.’ (PhD Thesis, University of Warwick)
4.2 PRIVATE EQUITY DEALS

About 75% of the funds invested in projects and companies in the country are below $50 million while the range of the deals in the country is between KES 20 million to 2 billion. Deals over $50 million are few in Kenya which is quite low compared to the deals at the global level. In comparison to the other regions in Africa, the values of the deals in Eastern Africa are lower when compared with West Africa and Southern Africa in 2013 and 2014. The value in 2013 for the deals in Eastern Africa is $163 million, West Africa’s is $545 million and Southern Africa’s is $491 million.92

In Africa 84 deals were completed in 2013, 26 of those deals were done in Eastern Africa with Kenya accounting for 46% of those deals which is equivalent of 12 deals in the year 2013 which is a rise in the deals from the 9 deals done in 2012.93 This shows that most of deals in Kenya are targeting the SMEs which are looking for growth capital to grow their businesses. An example of companies to have benefitted from PE funds for the growth capital is the Emerging Partners investment in Java House.94 That has since seen the company expand to other regions such as Mombasa, a tourist destination. This will see their revenue shoot having recorded a turnover of 1 billion shillings in 2011.

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92 Deloitte report, East Africa Private Equity Confidence Survey; Seeing beyond the waves, 2014
93 Ibid
4.3 SECTOR FOCUS
In Kenya and Eastern Africa at large, the focus on investments is on financial services sectors, agribusiness, food and beverage, retail and healthcare & pharmaceuticals. Most of these sectors are consumer driven and have a direct link to growing middle class. In recent years (2012 – 2014), the interest in the real estate & construction sector has reduced from the PE players. The oil & gas sectors, green energy and infrastructure have received more investments. An example is the US$60m from Norfund’s and AIIM investment in a wind power project in Kenya.

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95 Deloitte report: 2013 & 2014

96 Deloitte report, East Africa Private Equity Confidence Survey; Seeing beyond the waves, 2014
According to Deloitte and African Assets survey on PE in Kenya, the deals will focus more on SMEs in consumer driven sectors as the middle class is raking in high revenues for different sectors. Such deals are usually small in value but many in quantity. The large deals will mostly be seen in the oil & gas due to exploration and infrastructure development.

Overall, the PE investments in Kenya have had a higher focus on financial services in terms of number of investments. The researcher found a good deal of information from African Assets, Deloitte and Capital Markets and interviews indicating that 17% of the deals have focused on financial services. Some of the beneficiaries in the sector are Amethis Finance and Swiss investment firm investment in Chase Bank, Helios LLC investment in Equity Bank and AfricInvest investment in Family Bank as earlier mention in the paper.

The second most invested sector at 15% is Agri-Business and agriculture where Pearl Capital Partners invested $600,000 in Freshco Kenya Ltd and closely following this sector was Manufacturing which stood at 14% investment such as the investment of US $5m in Almasi Beverages by Centum Investment.

Health Care & pharmaceuticals investment stand at 12%; an example being the Swedfund and The Africa Health Fund through The Abraaj Group investment of US$ 6.5 million in

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Nairobi Women’s hospital\textsuperscript{101}. Retail and other sectors stand at 12\% with Emerging Capital Partners investment in Java House being an example.

Telecommunication and media stands at 8\% respondents. Cellulant, a telecommunication company got an investment of $1.5 million by TBL Mirror Fund\textsuperscript{102}, Fanisi Venture Capital Fund made its investment in 2010 valued at KES 124 million in to Elris Communication\textsuperscript{103}, a telecommunications company in Kenya while Fusion Capital invested in Xtra Publishers Limited, first free and evening newspaper\textsuperscript{104}.

7\% of the firms are interested in information technology and mostly invest at an early stage of the company. The technology oriented venture capitalist firms that have set up technological hubs such as iHub, mLab and NaiLab. The PE firms are not more sector oriented but rather focus on sectors with great returns in a specific country. In the category under others (15\%) includes the Education, oil and Exploration and infrastructure sectors\textsuperscript{105}.

\begin{footnotesize}
\begin{enumerate}
\item Note the sectors are ranked in terms of number of deals already invested and the intended rather than the value of the deals. This is because some of the sectors can have one deal of a great value. An example is the RVR investment in 2011 by Citadel that had more value than nearly all the other deals combined.
\end{enumerate}
\end{footnotesize}
4.4 SYNDICATING TRANSACTIONS

Syndication is the collaboration between two or more investors for the financing of an investment opportunity\textsuperscript{106}. There are certain reasons that drive investors to partner so as to make a single investment. One is the size of the investment opportunity, whereby, the company being invested in needs a large size of investment that one firm cannot undertake. Some PE firms also have a cap on the maximum investment they can undertake per venture which in turns drives them to source for other partnerships. This is done so as to limit the risk of over exposure.

Secondly, the PE firms syndicate so as to expand their portfolio. This is seen in firms where fund size is too small to make numerous investments and have to partner with other firms to

\textsuperscript{106} Agasha Mugasha, \textit{The Law of Multi-Bank Financing: Syndicated Loans and the Secondary Bank Market}, (Oxford University Press, 2007) para.1.02, 2
ensure they increase their economic presence in a country. Thirdly, syndication in investment is a confidence building and risk reduction strategy. The transaction can take place when there is an aspect such as new economic aspect or trend or an investor is new to a legal jurisdiction. This usually takes place when the international investors with little or no local knowledge and in operations opt to partner with a local PE firm to make an investment. Both firms will contribute the funds for investment but the local firm will have an input of the local knowledge.

According to analysis of various sources, the motivation for the investment syndication is the deal size (70%), risk mitigation comes second (31%). Country risk is minimal in Kenya which is quite surprising as most PE firm owned and funded by foreign investors. There is minimal influence of the policies in Kenya on the syndication of the investments. Some firms also syndicate due to the cross border investments but it has minimal influence.

*Figure 9: Syndication drivers*

*Source: Various Economic databanks*
4.5 EXITS

In Kenya, there has not been a recorded case of an exit after less than two years of the investment. This shows that the Kenyan PE market has not experienced the early buyout and flipping that has been experienced in the developed economies. More than 50% of the companies exit after 2-5 years of the holding period while over 60% of the hold portfolio companies and investments over 5 years of the investment. This can be seen with the exits that are experienced in Kenya which are over 5 years of investment while some companies go beyond 9 years.\textsuperscript{107} Centum Investment Limited is an example of a firm that has held their minority stake in General Motors since the early 1990s. This can be attributed in part to the returns and dividends earned from a company with great profits and a high annual turnover.

When investments take more than 7 years, the returns are higher however buyers may shy away from buying such a stake because it may be deemed expensive. This is because of higher transaction costs and heightening losses accruing from opportunity costs.

*Figure 10: Life Cycle from Initial Investment to exit*

![Life Cycle from Initial Investment to exit](image)

*Source: Various Economic Databanks*

\textsuperscript{107} Deloitte and African Assets Reports, 2011 – 2014 and primary data collected through interviews from PE fund managers
In Kenya, the exits are quite rare to find because most of the PE firms are at the investment stage as there have been new PE entrants to the market.

*Figure 11: Preferred exits by PE firms*

![Preferred exits by PE firms](image)

**Source:** Various Economic databanks

The research brought out an aspect of preferred exit options in Kenya. There is a similarity with other emerging markets where IPO (5%) is not a preferred option of exit in comparison to the other developed markets. This is due to low maturity of markets. There has been one reported case of IPO exit in Kenya.

There are plans for firms such as Fusion Capital to exit its 45 per cent stake in GAL Baking Services Ltd, a bakery in Nairobi by listing on the Growth Enterprise Market Segment on the NSE\(^\text{108}\). Since its GEMS creation in late 2012, only one company has come on board, that is, the property developer Home Afrika Ltd - in July 2013. GEMS is an equivalent of Egypt’s Nilex SME exchange which has less stringent requirement compared to the NSE. The most preferred is trade sales (52%) which are usually a sale to a firm in the same operating sector.

Secondary Sale to PE investor (22%) is also common in Kenya as an exit option followed by the partial exit via refinancing (21%) which involves a PE firm selling some of the shares held. There is also the sale of shares as an exit mechanism\textsuperscript{109}. One example of an exit in Kenya is Centum Investment exit from the Carbacid Company in 2011 through sale of shares which made them a profit of close to KES 800 million from KES 418 million investment in 2009 to a sale of 1.2 billion in 2011\textsuperscript{110}. This was easier because Carbacid was already in the NSE Market. The buy backs (15%) which involve selling shares to the company management is also taking place in Kenya.

There has not been a case of any reported write down, which usually takes place when the PE firm has been in a bad investment. From the study, the sectors that are easier to exit in Kenya are Banks and insurance due to the eager PE firms ready to invest in the sectors. These are sectors that will also be the best to exit via an IPO in the near future.

4.6 PUBLIC AWARENESS

The first private equity firm to be formed was the government affiliated Industrial and Commercial Development Corporation in 1954\textsuperscript{111} later to be known as Centum Investment in 1967\textsuperscript{112}. There has been little public awareness on the private equity investments and their activity in the country up until the transaction of privatization of the Rift Valley Railways by TransCentury, Centum and Citadel Capital which attracted political criticism. Other notable mentions which people outside the financial circles may have come into contact with are the

\textsuperscript{109} The data was collected through interviews and analysis of secondary data from Africa Assets, Deloitte and Capital Market Authority
\textsuperscript{111} The Industrial and Commercial Development Corporation , < http://www.icdc.co.ke/about-icdc.html>
purchase of a stake by Helios Investments LLC into Equity in 2005. With the increase in the PE activity in the country, the media has continually reported on the transactions which in turn give the public information on the operations.

### 4.7 CHALLENGES OF THE PE FIRMS

A number of challenges affect the PE firms from making investments in Kenya. The challenges are well represented in a graph below:

*Figure 12: Challenges experienced by PE firms in Kenya*

![Challenges experienced by PE Firms in Kenya](image)

*Source: Various Economic databanks including Africa Assets and Deloitte and interviews*

According to the World Bank Kenya Enterprise Survey (2007), many small business enterprises are involved in corruption such as evading taxes through under reporting income.
Such an activity is usually challenging to the PE firms because they must make great investments in due diligence to come up with reports on the true financial position of companies. This may lead to some investors shunning away because the correct position and financial health of a company may be in doubt.

The survey also outline that 80% respondents were involved in corruption practices which is usually in the registration phase and operations. The amount of the bribes paid is also high which shows that there is a high level of corruption in the country. PE fund managers also point this out as a challenge in the operations because they have to deal with the investors who do fail to reveal source of their money while also deal with bribes that have to be paid to corrupt public officials.

Businesses in Kenya are opaque in terms of their operations and have weak financial disclosure which deters PE from investing in them. This is because they do not show their credit worthiness and at time may warrant a PE firm to have more than one member on the board to monitor their investment in the company. The companies also have weak financial structures and reporting which may also shun investors. According to a World Bank Enterprise Survey in 2007, more than 50% of companies in Kenya do not employ auditors in their firms on an annual basis and this can be attributed to the lack of well accounting structure and advisory in the companies.\textsuperscript{113}

According to Tuimising (2012), his study outlined that 44% of the fund managers believed that the financial statements by companies represent a true view of the actual statement. 33% \textsuperscript{113}ibid
of the fund managers are of the opinion that the accounts are open to manipulation. 44% of the fund managers believe that the accounts are not open to manipulation and that companies followed the right procedures in accounting and are therefore true.

Figure 13: Reliability in the financial statements

![Reliability in the financial statements graph]

Source: Dr. Tuimising (2012)

Bureaucracy is also another deterrent to investments in the emerging markets. Businesses and PE firms have to go through numerous licensing in the country hence increasing red tape and slowing down the investment process. According to the World Bank Index 2013, there are long procedures in getting licenses for operating, registering and importation and also involve many institutions.

The insecurity in the country also affects the investments because there are many losses to business caused by vandalism, robbery and arson. There is also a significant amount of
money paid to the private security due to this which would be used otherwise in growing a business. This cost to the private security is estimated to be about 3% of the sales\textsuperscript{114}.

Poor infrastructure also complicates the operation of businesses. Cost of doing business is high in the country due to the huge power bill that businesses have to pay. With power and water outages also experienced in the country, there is a cost having bureaucratic red tape to fix them hence causing losses to the businesses. Some businesses have to tap in to the extra cost of doing business such as use of generators which pushes the cost of doing business higher. The road network of recent has been improving with the country embarking on a road construction drive. However, majority of the roads also cause losses to the businesses as they cause damages on items on transit.

Human Capital deficiency in portfolio companies is the most challenging aspect that the fund managers have to deal with. PE firms who invest a stake in a portfolio company have to advise and come up with strategies to grow and expand the companies. The staff is often unmotivated or does not adopt the vision of the organization leading to staff retrenchments or reassignments. This can mostly be seen in distressed companies that where a major turnaround of senior management is needed followed by employment of competent staff.

Lack of acceptance of private equity is the second most challenging factor that the fund managers have to deal with. In a survey of the top 100 SMEs carried out by Nation Media Group and KPMG in 2011, most companies said they relied on the bank loans and savings for expansion/ growth capital. 14% of the respondents were positive about PE as a source of

funding while only 3% would consider an IPO. This data shows that the business owners are not yet open to PE investments in their companies, most of which are family businesses and are not ready to let go of their ownership stake.

Unlike other markets in the West, there is a difficult exit market in Kenya with which PE investors have to grapple with. Prior to making investments in Kenyan companies, Fund Managers have to consider their exit options because the market cannot absorb liquidities of certain amounts. Some of the popular options in the country would be through trade sales, sale to secondary PE firm or buyback to the company owners.

The Market reputation of a country is also key in investment making. The PE firms will look at the Return on Investment based on the sector the investors intend to invest in. There are sectors in the market with greater returns than others hence the biasness to industries such as financial services and agriculture & agribusiness.

Lack of awareness of PE as source of finance is also another issue because it is new in the country and few people know how they operate. This makes it an uphill task for the PE firms who have to do a market education as well as rely on the media to cover the news on the operations. Outside the financial circles, few people know about PE as a source of funding and if they do, some have a negative view to it based on limited information.

Economic down turn may be affected by a number of factors that the PE firms have to keep a track of. They need to assess how companies they invest in may be affected by various economic scenarios and deal with issues such as loss of client to bankruptcy or other markets
conditions. There also other factors that will affect the investments such as the political risks in a country and also the frequency of policy changes.

Lack of quality deal flow is yet another impediment to investments as there are a number of challenges such as red tape and bureaucracy for any transaction to take place. A deal can take as long between 12 to 18 months for completion due to the procedures. This may affect a deal because either party may pull out prior to completion.

Shortage of large scale deal opportunities for some of the PE firms is a challenge especially if they have raised enough funds for huge investments. Most of the firms available for investments are the SMEs which are now the driving sectors of the economy. The number of deals in Kenya is high compared to the rest of the economies in Africa but the deal value in West Africa especially Nigeria and Ivory Coast and in South Africa remains higher.

Lack of GP reputation and track record is not helping the PE industry at all as it is a new source of finance in the country. The intended businesses in the country have minimal data to compare to for confidence building to allow the PE firms to invest in their portfolio companies. PE firms being a new investment in Kenya also find that there are Human Capital deficiencies with local staff lacking requisite experience and technical know-how. The result is often that many of these PE firms have more than 50% of senior management being foreign workers. These foreign workers have to teach the local workers on the investments, operations and risk management.

There is always a need for the PE firms to establish contacts in a country of investment. Lack of GP local contacts or presence may affect the operations as the fund managers may lack the
local knowledge for the operations as well as procedures. Investments in PE industry are mainly about networks and without them many firms may lack opportunities to know the firms to be invested in at the right time.

Macro factors (Inflation and Foreign exchange) affect the investment opportunities in Kenya. In Kenya and also in Africa at large, there has been an appreciation of the US dollar over the past years but there are always fluctuations that occur and affect the investment yield. Some of the fund managers however can handle this issue by investing in diverse of currencies by use of hard currency and invest in companies with a hard currency revenues. In general, investment in Kenya is seen as a worthwhile risk investors are willing to make due to the high returns.

An inadequate or cumbersome regulatory environment also affects PE investment in Kenya because of weak regulations in the country especially affecting those investors who come from well developed markets that boast good fiscal conventions. Investors have to look at the local policies such as the capital gains, repatriation of dividends and taxation. PE firms must then put in a lot of effort to adapt to the local market environment.

An example of the effects of a difficult regulatory environment can be seen in the PE investment in Specon – a construction company in East Africa. Emerging Capital Partners, an International PE firm faced double taxation on repatriation of its profits due to the lack of bilateral tax treaties. The company adapted to the local environment by setting up the
company in Mauritius so as to benefit from the bilateral tax treaties enjoyed by East African countries.\textsuperscript{115}

There are also government policies that deter the PE investments or reduce them thereof. The Revenue Benefits Authority Act of 1997 for instance classifies the private equity as “unquoted equities” and as “as any other asset” which reduces the investment of PE in the country. The “any other asset” has a limit of 10% of the net pension scheme value while the unquoted equities are limited at 5%. With the limit, there is also another limiting factor of the funds being subject to the approval by the RBA\textsuperscript{116}.

The act was put in place under the Government Financial regulations to have the pension funds invested in the government and government approved security. This step came to contain the loss making schemes in the country. However as the years have moved forward, there were changes in terms of the pension firms looking for investments with great returns. This shift change can be seen in the Capital Markets Authority and Revenue Benefits Authority partnering to educate the pension fund managers on the Pensions funds’ investments in the private equity firms\textsuperscript{117}.

There have also been the reforms on Investment Guidelines in Schedule 1 of the Retirement Benefits Act No. 3 of 1997 that have led to the investment on the Kenya Power pension fund

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\textsuperscript{112}Carolyn Campbell, Emerging Capital Partners, , 6 April 2010 <www.africanbusinessreview.co.za> accessed on 16\textsuperscript{th} September 2014

\textsuperscript{116}Act No.3 Laws of Kenya, ss 18, 37, and Column 2 Table G, First Schedule.

\textsuperscript{117}Retirement Benefits Authority, Held at the Serena Hotel, Nairobi, 23-24 March, 2011 <http://www.rba.go.ke/index.php?option=com_newsarticle&view=newsarticle&n=3> Key presentations were made by the EMPEA, the United States of America International Development Agency (USAID), Africa Venture Capital Association (AVCA) and a range of private equity fund managers.
\end{footnotesize}
in Ascent Capital. With the reforms being done, a change in attitude by the pension fund managers and the government, there is bound to be more pension fund investments in PE.

Another law that is a challenge to the PE investment is the Capital Markets Regulations of 2007 which outlines the sectors that have been barred from investments. The law in Capital Markets (Registered Venture Capital Companies) Regulations of 2007, Regulation 8(2) under the Capital Markets Act of 1989, Cap 485A of the Laws of Kenya, outlines sectors not to be invested which is trading in real property, banking and financial services and retail and wholesale trading.

If followed to the letter, the transactions investments in Family Bank, Equity Bank and Chase Bank ought not to have taken place but it was approved by the Central Bank. There is a need to reform the law as there is seen to be success in the financial institutions invested in. These laws may affect some transactions in the future if followed. Judicial framework is also another hurdle to jump as the process in Kenya is long and tedious and may take long for deals to go through.

4.8 CONCLUSION
Kenya’s Private Equity industry has operations and has characteristics similar to the other emerging markets. Investments in the different sectors and the value for the deals vary according to the regions while the exits in the country are challenging especially through an IPO resulting to investors viewing trade sales as most popular. The industry in Kenya and emerging markets is set to grow in the coming years.
CHAPTER 5: SUMMARY OF FINDINGS CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter provides a summary of the findings, revisits hypotheses and research questions and gives a conclusion and recommendations based on the objectives of the study. The objective of the study was to determine the role of the Private Equity firms in their contribution in development of an economy.

5.2 Summary of the Findings

In Chapter 2, the study looked into the types private equity to get an understanding and overview of the structure of the funds. In the study, most funds raised were typically invested in growth capital which seek to grow and expand firms and their operations. This usually targets the SMEs which are mostly family owned. They get the businesses and professionalize them or grow and globalize them hence growing the companies. Most of the Venture Capital investments are usually technology related companies that are at an early stage and need funding to kick off and young companies who are expanding range of products.

The study also looked into each step that the PE firm takes in the market. This helped in understanding the different strategies implemented in both developed and emerging markets. It brought the aspect of understanding the PE industry model in the country and in a company. Looking at the initiation bring out the setting up of the fund while making the investors attracted to the investment vehicles. The information also brought the fact that the fundraising of the funds is usually abroad. Due diligence in the companies has to be conducted to ensure that the companies invested in are most suitable and will have great
returns. Trade sales are the suitable exit routes for the firms with the IPOs not being the popular in the emerging markets due to the lack of active stock markets.

In Chapter 3, the study looked at the emerging markets around the world and looked at their performance at the world stage. There has been a recorded increase in the PE fundraising share which accounts for 15% currently from the former 3.9% in 2003. China as a country and Asia as a continent is the major beneficiary of the funds. The activity in the emerging markets has greatly increased due to the attractiveness that they have over the developed countries. This is due to the high return on the investments and the tapping of the markets is a driving force.

The PE sector has however not been without challenges due to the poor legal and institutional setting, low local fundraising, the geopolitical issues coming up and poor stock markets. The PE firms are slowly adapting to the local business environment as they establish their presence, develop networks and grow political and business relationships, develop the local expertise and improve a strong and proprietary deal flow as they hope for streamlined markets in the future.

The governments have seen the positive aspects of the PE and are positioning themselves with great policies and legal structure to ensure their countries are beneficiaries to the funds as they are of positive impact to the economies. They are making companies realize their full potential through their investments. In countries seeking to be major producers and exporters of commodities, they are benefitting from the PE activities. This will have a long standing benefit in the emerging markets as jobs are created, poverty levels go down, higher income and better service delivery.
In Chapter 4, the study examines Kenya as a case study in regard to the PE activity. Kenya, a middle income economy is one of the suitable PE investment destinations. The study examines the sources of the funds used and implemented with the increased number of deals in the country. More than 90% of the funds have been sourced from the developed nations with the EU and USA leading as the major sources. Majority of these PE funds have been fundraised by the government and the government linked organizations. The local fundraising has been low due to lack of awareness to institutions and the public which would include the high net worth individuals, pension funds and insurance firms. Lack of laws and policies that have not changed to allow the institutions to invest in the PE and too much of red tape in government linked organizations has also reduced the local fundraising.

In the deals that have been done in the world, Kenya is the leading destination for the number of investments but more than three quarters of the deals have a value of below $50 million with most of the funds going to the SMEs and the family owned business. The SMEs are the key drivers of the economy with the great contribution they have in terms of the output and job creation.

In the sector, financial services are getting the bulk of investments with agribusiness coming a close second. The ever expanding middle class is a factor that is driving the PE firms to invest as they are the target market. This is because of the funds that are at their disposal and most sectors would profit from this.

PE firms syndicate or come together to invest in a project or a company because the investments are large in size, they limit their exposure, risk reduction of deals, PE firms looking to expand portfolios yet they are small. Other factors that lead to syndication of PE
firms are influence of the government policies that affect deals and the cross border investments that may need consultation and a consortium.

The exits in Kenya are usually done between 5 – 7 years of investments. Some of the PE firms hold a company for more than 7 years due to the high dividends they receive and high return upon. Most of the exits done in the country as in most of the emerging countries is through trade sales with the Initial Public Offering (IPO) being the least.

Challenges experiences in the country by PE firms are such as corruption. Corruption in the country is affecting the PE industry. Corruption leads to the cost of operation, makes the PE procedures such as due diligence expensive and tedious due to lack of proper and clean financial records. The human capital deficiencies is the most challenging issue to PE managers and this is due to the PE industry being new to the country and getting qualified staff with PE experience is quite hard.

5.3 Research Questions and Hypotheses

The study examined the Research Question, Are the Private Equity firms adding value to the portfolio companies and projects? With the transactions that have taken place, the PE firms have a positive effect on the investee companies as they act as a catalyst to start a company, merging firms, professionalizing, growing and globalizing products and companies.

The second question was What are the economic development effects of the Private Equity activities in the country as an avenue of debt financing? PE firms are beneficial to the business people due to their ability to use their venture capital funds on early stage
companies. The traditional debt financing institutions rarely finance such companies especially the technological and green field investments. This helps companies kick off and has a positive effect in Kenya’s economy.

With the PE investment in a company, they can also help the small companies to merge to form large corporations which can compete with other companies globally creating competition at the global stage. PE firms offer capital for growth and expansion which can make the firms open up their services and products to a larger clientele thus boosting profits for companies and more tax for the government.

Why has there been an increased private equity activity in the country and are potential beneficiaries to the funds aware of this? was the third research question. Growth of the local PE firms with local knowledge and foreign technical know-how has led to the growth. Previously, most of the PE firms operating in the country were foreign. The firms have the proficiency which has enabled their competitiveness leading to the local growth and presence. The proficiencies are such as access to information on deals, knowledge of deal structure, business transformation knowledge and political connections.

The local firms are also learning the global practices and experimenting them on the local market according to the business needs. The firms are following the structure in terms of operations of the PE globally such as the project cycle, registration of companies offshore due to the limitation in terms of the taxation and use of the value creation strategies.

The public is slowly getting information on the activities of the PE firms through the media while the business persons have slowly started learning about the PE debt financing through
contacts, networks and trainings. The government is also gearing to the rise in the investments in the country to ensure that they also benefit from it by making investments.

**Government policies affect the private equity activity in the country** in that they are important in boosting or reducing the PE investment. The insurance industry in the last two years has attracted great investments which came about after the Kenyan Insurance Act of 2012 which capped the individual ownership of an insurance firm at 25%. This forced insurance firms to sell their stake to other investors and a majority of them were PE firms.

Government policies also reduce the PE investment such as the Revenue Benefits Authority Act of 1997 which classifies private equity as “unquoted equities” and as “as any other asset”. This classification limits as it is subject to approval by RBA which creates bureaucracy. Another law that is a challenge to the PE investment is the Capital Markets Regulations of 2007 which bars investment to real property, banking and financial services and retail and wholesale trading sectors. This limits the PE investment to these sectors yet the PE firms have ignored the law and grown companies in the barred sectors.

With the positive impact of the PE, there is a need to attract their activities in the country. The government policy should encourage the PE activity in the country just like in the case for the foreign direct investments. There are a number of ways that the PE firms could benefit from government support. Government should first make the business environment conducive for the PE investments such as putting up laws that protect investors, reduction of the government red tape and unnecessary bureaucracy and the modernizing of financial laws such as bankruptcy and tax. The PE firms exiting an investee firm after the investment is also another challenge which the government should invest in the stock market to ensure it is
easier for exits. The local banks should also support the PE firms with loans as it provides leverage in terms of buyouts. This has not been seen in Kenya as the banks are quite reluctant to give such loans because they regard them as too risky.

Support in terms of the regulations that allow more flexible governance structure such as the limited partnerships that are used by PE firms in the developed markets should be pursued. This will help in boosting the PE business model. Some funds set up for specific sectors can help in achieving governments goals. Kenya, which hopes to attain the Vision 2030 goals should pursue this as projects such as Communications Hubs like Konza City, Infrastructural projects such as the Standard Gauge Railway and the Lamu Port Project would benefit greatly especially in the schemes such as the Public – Private Partnerships (PPP).

The governments should also improve the regulatory measures to boost the taxation and transparency. The exclusivity in the details of the transactions in PE deals due to the nature of transactions should be reduced to some extent to boost transparency especially as they grow to make large transactions that affect the economy in a big way. The PE firms as it is today, are incorporated as joint stock company, offshore as limited partnerships and are regulated by the corporate law like any company. The PE firms have a control of many companies in the country which makes them an important industry to the economy. This however should be regulated not like a company but like a non-banking financial institution so as to limit the risks that may emerge from the industry.

Another issue is the disclosure the PE firms should be subject to by the government. With them being private, they are subject to disclosure of information to their investors and not the public. However, an issue that comes up is that some of the firms have an influence and
impact the economy, should there be a need for public disclosure? This is an issue that has been debated on in the developed market.

Private equity is a highly illiquid investment as the investments are usually long term. With the PE investors investing in such a long term investment, they have a positive aspect on the economy and the prospects. The investments are affected with the performance and growth of the economy in that there is a gain in more profits with the fast growth of the economy and if the portfolio companies grow faster. Therefore it is in government’s interest to attract the PE investments as they are quickly growing as an investment vehicle.

The active role of the Private Equity firms in portfolio companies achieve higher returns is a hypothesis that the study examined in detail. There is not sufficient evidence to prove this hypothesis but looking at the portfolio companies invested in Kenya, shows how PE with active involvement in companies can post higher returns. An example is the distressed companies that are invested in show how they can drastically change and begin to post profits. The Rift Valley Railway invested in by Citadel and Centum shows that a collapsing parastatal is now concentrating on building more railway line and station which can be suitable transportation line for cargo and also opening up of the borders in East Africa. This is due to the active involvement of the PE firms which changed the managements since the purchase of the stake.

Investments done before 2005 in Kenya, the level of interaction between the PE firms and their portfolio companies were passive acting more like asset managers just like the companies at the security markets. The varying in involvement also ranged on passive roles, play supportive roles to the managements and take active leading roles. In some of the
companies that PE firms, have the passive involvement in the business or the operations of the company are ones where the management is performing satisfactorily and only make a growth capital investment.

In some of the transactions where the PE firm plays a supportive role is where they strengthen the management teams or open new markets for the investee company. There are some transactions which involve the turnaround where they come and execute a business strategy. This usually involves to a large extent restructuring the firm and changing some of the operations.

Passive investments may not have the same performance in comparison. What is not clear is whether the differences are based in the level of engagement by the PE firms or competency level of either the PE firms or portfolio companies. A future research exploring the differences using a bigger data set would be key to understanding the aspect.

**Private Equity an effective model for investing in emerging markets for investors (local and foreign)** as the economic shifts the focus to the emerging markets. Investors are seeking to get the higher returns in the developing countries as they record higher economic growth compared to the developed markets. With the avenues for investments limited, Private equity offers the vehicle for the large investors. PE firms offer a suitability for investment due to their strong governance and accountability for investors, they have a good and efficient capital structure, they can structure their investments to have tax exemption status of the investors and get opportunities that are not in the stock market yet.
PE offers great investments for locals who diversify their businesses. PE is attractive to the investors because they offer proprietary transactions not available to the public and they can also be involved in large buyouts of investments in firms which can boost their high return on investment. Firms in Kenya such as Centum and TransCentury have the ability to invest in huge companies and exit by making profits.

Secondly, the investors can benefit from the due diligence conducted by the PE firms which reduces information asymmetries. The PE firms use professional such as law firms, audit firms, research consortiums so as to get information in the suitability of investment in a company or a project. This is highly beneficial to the foreign investors who have little knowledge on the emerging market business operations that can boost returns. Thirdly, PE offers the competitive transaction cost which competes with investing in the public traded firms. This lowers the cost for the due diligence and the transaction executions which is distributed across the investors.

Fourthly, the PE investment is also suitable because it has a predictable and lower cost for the investors. The investors know the profit sharing structure in the PE which is in alignment with the PE firm interest and their personal interests. PE has a motivating factor of performing and having great returns because they want more investments from their current investors and this confidence will build which in turn will attract prospective ones through their networks and new investments.

The negative aspect of the study hypothesis is that the funds invested in the PE firm are usually illiquid and the investors have access when the PE exits from their investments or they liquidate investments. This makes it attractive to the long term investors. Another aspect
is the fact that the investors are largely high net worth individuals and institutional investors due to the minimum amount of investment needed. This limits the investors who cannot meet a certain minimum threshold.

The PE investment is an effective model of investment for investors as there is an increasing economic growth in the emerging markets. If the hypothesis holds, there will be increased PE investments in emerging markets such as Kenya especially from institutional investors and as the industry grows, there will be more investments which will reduce the returns for investors.

The hypothesis **PE backed firms expand and grow at a high rate and increases its turnover** is supported by the study carried out. When the PE firms make an investment, changes in the portfolio companies begin to occur in terms of employment, innovation, productivity and governance. This is due to the value creation strategies adopted by the firms which have a positive impact on the companies.

As opposed to the other financial institutions such as the banks and the Micro Finance Institutions (MFIs) who only provide capital for the businesses, the PE firms offer capital as well as expertise which act as catalysts in professionalizing, consolidating, initiating and growing and globalizing the investee companies. Companies such as ones at the early stage benefit from the venture capital investment offer capital and governance and management support to individual business persons. The companies that benefit from the initiation of the joint ventures by the PE firms benefit from the support as they get into a joint venture to start a new line of business.
The PE firms also help the portfolio companies in consolidation of small companies to become a large company which can compete for the share market of the products and services. This occurs through PE firms buying companies and merging them, setting up a holding company then acquiring smaller companies and facilitation of a multinational corporation to enter a local market by acquiring and consolidating companies.

The PE firms also professionalize the operations in an investee firm. They grow the potential of the management and strengthen their capabilities. This can go as far as restructuring the corporate governance as they institute new practices and processes. They do this by changing the managements and hiring new ones, strengthen company boards and help the companies restructure and come up with business plans for growth and expansion. This has been beneficial to the portfolio companies majority of which are family owned and have not professionalized their operations yet.

The PE firms also help the companies grow and expand by increasing their value. Many of the companies in this category are ever expanding and becoming global brands. PE firms do this by offering capital, professionalize the management, support in the strategy in expansion and gain market access.

**Diversity in the sectors invested by PE firms safeguards returns in Investments** is a hypothesis supported in research. The majority of the PE firms are regarded as generalists rather than the specialists due to the returns they can get from each industry. First the value creation in the emerging market is not based on the sector knowledge but rather management, financial and turnaround skills applied in any given sector. Secondly, with the investments in different sectors of the economy, it allows a PE firm to benefit in each and every sector they
have invested in. When a particular sector is hit by challenges such as macroeconomic factors as taxation, inflation, tariff barriers, the firms can still make returns in a different sector to give back to the investors. Majority of the PE firms have invested in more than one sector so as to boost their returns and ensure they can also benefit from the returns in many sectors.

**5.4 Conclusion**

The study concluded that Private Equity is a good way for capital financing in the emerging markets especially Kenya as it helps the portfolio companies achieve their great potential. Low activity in the PE industry when compared with the developed countries is due to the lack of awareness which can be dealt with to ensure entrepreneurs embrace this source of funding.

In comparison to the other sources of funding such as banks and micro finance institutions, it is desirable due to the technical expertise that businesses receive and also the networking that they get exposed to. Fundraising locally has also been a challenge for the PE firms because the government and government linked firms have slowly initiated the investment to the PE firms. Being a suitable financing strategy, the policies and laws being drafted and reviewed should attract the PE activities in the country so as to boost investments like the FDI.

**5.5 Recommendations**

With the positive impact of the business, more funds can be encouraged into the industry through coming up with attractive laws that are suitable for both the investors and the companies invested in. Encouragements and motivation of local institutions to invest in the PE industry should be pursued. Institutions such as the insurance companies, pension firms and other government institutions should be encouraged. Unclaimed Assets is also another
institution that can invest in the PE firms to boost their returns and create capital for the local PE firms.

With the capital in place, there is a need to increase the number of the beneficiaries of the PE funds. This can be done through trainings and awareness to ensure that the local entrepreneurs understand PE as a source of financial capital and operations they have in the country. The PE industry should also have investment guidance to entrepreneurs before they can invest in the portfolio companies.

Steps should be taken to ensure that the local stock exchange grows as it offers the PE firms an exit route after the investment period. The PE firms are not ready to list on the exchange because they are not active, are illiquid and the high returns through this route will not be realized which makes less attractive to the investors. To the firms, being listed and the stock prices goes down, it may lead to board wrangles and takeovers that may affect the form. Increased investment and reforms in the stock markets in Kenya and other emerging markets will boost the economic growth in the long run.

5.6 Suggestion for further research

The capital structure in private equity transactions is limited more in the emerging markets in comparison to the developed markets. The ability of PE firms to leverage their transactions is limited because the banks are unwilling to offer unsecured loan and the loans are quite expensive. In the future research, the capital structure in the PE activities should be looked into.
Secondly, research on way to make the stock markets in emerging markets vibrant like in the developed ones should also be a basis for future research to boost IPO, a suitable exit route being poorly utilized. A vibrant stock market will stimulate the economy.
REFERENCES


APPENDICES

Interview Guidelines for PE firms (Appendix A)

While Interviews were generally unstructured, PE fund representatives will be asked questions with regards to their company and industry wide experience in the following areas.

1. What is the Portfolio company size
2. What is the Composition of Portfolio by Industry and how many deals have been done so far
3. Is there a speciality in the investment sectors? And if there is why?
4. What size of portfolio company usually invested in (Small, medium or large)
5. How does the PE firm fundraise and what is the source?
6. In the investment
   a) How are target companies identified
   b) Due diligence process conducted before the investment
   c) After how many years is there an exit from a company
7. What influence is there to the portfolio company in terms of
   a) Value creation model (Financial restructuring, new investments, management change)
   b) Governance model
8. How are government policies favourable or challenging to the operations in terms of stock market, labour issues as well as the different stages such as deal acquisition, restructuring and exits
9. Anticipated Exit Strategy and how the companies do after the exit
10. Challenges experienced in an Emerging country such as Kenya
11. Future of Kenyan PE: Prospects for Industrial Groupings

PE Beneficiaries Interview Guidelines (Appendix B)

While Interviews were generally unstructured, PE fund beneficiaries will be asked questions with regards to their company experience with PE funds in the following areas.

1. What is amount of Funding sourced?
2. Period taken to source for funds
3. Investment Period agreed upon
4. Reason for sourcing funds and alternatives weighed
5. What is the contribution of PE on firm? i.e. employment, profitability, expansion, company control
6. General Private Equity Experience
7. Having experience both Debt and equity, which is the preference?
8. Level of business development assistance
9. What are the changes in management and operations after financing?
10. Is there a great involvement with the financier in terms of business development assistance?
11. What are the monitoring and evaluation mechanisms done by the PE firm (Board meetings, financial reports)
12. Does the PE firm financing new expansion projects in a portfolio company
13. Generally, what is the contribution of the PE industry to the economy?

Data Analysis tools (Appendix C)

Positivity of Response Index
Scale:
1 – Negative. Response was unequivocally downbeat
2 – Fairly Negative. Response was downbeat
3 – Indifferent. Response was neither upbeat nor downbeat
4 – Fairly Positive. Response was upbeat
5 – Positive. Response was upbeat with conviction