



**ADDIS ABABA UNIVERSITY**  
**SCHOOL OF GRADUATE STUDIES**

**PRIVATE EQUITY INVESTMENT IN ETHIOPIA:  
PRACTICES AND CHALLENGES**

**BY**

**HAYAT AHMED**

**A RESEARCH PROJECT SUBMITTED IN PARTIAL  
FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD  
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I, the undersigned, decided that this is my work and has not been presented for a degree in any other universities and that all sources of materials are used for the project have been duly acknowledged.

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This is to certify that the project paper prepared by Hayat Ahmed topic entitled: “*Private Equity Investment in Ethiopia: Practices and Challenges*” and submitted in partial fulfillment of the requirement of the degree of Masters of Business Administration in Finance complies with the regulations of the Addis Ababa University and meets the accepted standards with respect to originality and quality:

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## ABSTRACT

*Private companies are important to national economies because they contribute significantly to employment and GDP growth of a country. However, the source of finance to help the growth of the private sector in Ethiopia is limited to the country's commercial banks, which lack the capital or capacity to fund the growth needed by the private sector. Private equity can be a complementary source of finance to help grow the private sector in Ethiopia. The general objective of this study is to examine how the phenomenon of Private Equity investment is practiced in Ethiopia and to assess challenges of private equity investment in Ethiopia, mainly from fund manager's perspective. In line with the stated purpose of using a fund manager's perspective as well as limited time and resources, pure asset owners and entrepreneurs were not interviewed. The study used qualitative data, which were gathered through literature study and in-depth interview. The thesis adopted exploratory approach. The study is qualitative and based on in-depth interviews with people active in the Ethiopian PE investing space. Findings are analyzed and discussed based on data gathered and through a literature study reviewed. The major findings of this study revealed that PE firm in Ethiopia is at early stage but still growing and also identified challenges for both privately owned companies and private equity investors. For privately owned companies, the challenges include loss of ownership stake, loss of management control, and lack of understanding of private equity investment. For private equity investors, the challenges include lack of exit options, risk of capital repatriation, difficulty to register capital, complexity of family-owned business, size of exiting enterprise, lack of financial reporting standard, and regulation restriction and modification. In addition, two major categories of benefits of private equity investment were identified. Finally, the study concluded by providing recommendations that enable Ethiopia to benefit from private equity, which includes exit strategies, easing capital repatriation, improving registration process, supporting improvement of financial reporting, and policy consistency.*

*Key Words: Private Equity, Private Companies, Investment, Ethiopia*

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# LIST OF ACRONYMS

AfDB – African Development Bank

AVCA-African Venture Capital Association

BEE-Business Enabling Environment

EAVCA-East African Venture Capital Association

EPAAA - Ethiopian Professional Accountants and Auditors Association

ESG-Environmental Social Governance

EY – Ernst & Young

FDI – Foreign Direct Investment

FII-Foreign Indirect Investment

GDP – Gross Domestic Product

GIIN-Global Impact Investing Network

GTP – Growth and Transformational Plan

IFRS - International Financial Reporting Standards

IMF – International Monetary Fund

IPO – Initial Public Offering

LBO – Leveraged Buy Out

MBI – Management Buy-In

MBO – Management Buy-Out

M&E – Monitoring and Evaluation

NVCA – National Venture Capital Association

OECD – Organization for Economic Cooperation and Development

PE – Private Equity

R&D – Research & Development

SSA: Sub Sahara Africa

UNECA – United Nations Economic Commission for Africa

UNDP – United Nations Development Program

VC – Venture Capital

SRI- Social Responsible Investment

WEF-World Economic Forum

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# CHAPTER ONE

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## INTRUDUCTION

### 1.1. BACKGROUND OF THE STUDY

The World Bank estimates that 2.5 billion people globally have no access to formal financial services. The lack of access to reliable financial services may negatively affect welfare, economic or health service development and individuals may be unable to get sufficient capital to invest in potentially profitable economic activities. (World Bank, 2018)

A lack of access to financial services is reflected in Ethiopia's agriculture and socioeconomic development. In the most recent Ethiopian enterprise survey conducted by the World Bank, businesses ranked access to finance as the second most severe constraint on their development. Equally, the results of a survey conducted by UNDP show that about 93% of commercial farm investors fail to obtain agricultural loans from the domestic banking sector, largely because the process of applying and accessing loans is too cumbersome, requiring 100% collateral on loans and banks not accepting leased land as collateral(UNDP,2013).

Mega public projects and private investments continue to demand increasing amounts of finance in the country. In addition to the characteristics of the financial sector, several characteristics of the agricultural sector make it less attractive to financial institutions. These factors include low levels of profitability due to limited economies of scale, as well as high transaction costs for financial institutions when serving the sector. Most Ethiopian business are SMEs, so typically have insufficient collateral, poor financial recording and poor loan track records, among other characteristics (Birbirsa, 2018).

Private equity can be a complementary source of finance to help grow the private sector in Ethiopia. PE firms do not just provide funding but also bring a wealth of experience, knowledge, expertise, networks, alliances and new customers to the businesses they fund. They provide capital to high-risk businesses that other capital providers would not fund. These include

businesses without track records, rapidly growing businesses in constant need of external funding and distressed or troubled companies

There are a number of reasons why private equity represents an attractive alternative to debt and other forms of investment from a developmental perspective. Its focus on investing in existing businesses, growing them and then exiting, is by its very nature a suitable vehicle for knowledge transfer to a domestic private sector sorely in need of it. It is also much more vested in the success of the investment than something like a bank would be since its success is directly linked to that of its investments in a way that generally outperforms its industry peers. Consequently, PE firms will generally spend a lot of time and effort in equipping themselves with the best possible business intelligence in order to maximize their prospective investment's ROI. Finally, they bring with them management expertise including institutionalized governance models, proven operational frameworks and best practices as well as market and supply linkages that can sometimes be as valuable to the recipient company than the attendant infusion of capital. Furthermore, they do so in foreign exchange. All taken together, Access to finance, limited management capacity and shortage of foreign currency for a very sizable portion of the challenges most businesses in Ethiopia face (UNDP, 2013).

Compared to other emerging markets, the PE industry in Africa is still at an early stage of development but several circumstances suggest that its growth is proceeding at a sustained pace. (AVCA, 2016).<sup>1</sup> Sub Saharan Africa in particular has been outperforming other emerging markets with regards to increased inflow of private equity investment showing an increase in 2014 of 13% year-over-year while others all declined compared with 2013. (EMPEA, 2016).<sup>2</sup>

Private Equity activity has increased in East Africa in the last decade, with more and more funds backing local businesses and setting up shop in the region, including in Ethiopia. Schulze Global Investments (SGI) became the first such Private Equity firm that set up shop in Ethiopia. (AVCA, 2016)

Ethiopia is an attractive market for PE in general terms, given the size of its population (more than 100 million, the second largest on the continent), its relatively high economic growth rate,

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<sup>1</sup>The African Private Equity and Venture Capital Association is the pan-African industry body which promotes and enables private investment in Africa

<sup>2</sup>Emerging Markets Private Equity Association is global industry association for private capital in Emerging Markets.

as well as being the home of the African Union and other initiatives on the continent. (GIIN, 2015)

There is tremendous interest to invest in Ethiopia by both multinational companies as well as private equity funds. From Ethiopia's perspective, private equity firms have the capacity to provide critical funding and capacity development to the private sector. The accelerated growth of private enterprises that can be catalyzed through these investments can help Ethiopia achieve the goals set in the Growth and Transformation Plan (GTP) and beyond more readily. Thus, private equity can be a complementary source of financing to go forward. (UNDP, 2013)

Considering the importance of private equity, it is therefore imperative to conduct a study, which focuses on assessing the landscape of PE firms and identifying challenges of Private Equity investment in Ethiopia. In addition, this paper draws recommendations on how privately-owned companies specifically and Ethiopia in general will benefit from private Equity investments.

## 1.2. STATEMENT OF THE PROBLEM

Private equity broadly refers two forms of investments; venture capital (VC) and buyouts. While PE is commonly used to refer to the buyouts of later-stage businesses, VC provides seed or start-up capital to early-stage and high-growth businesses, mostly innovation-based. (Saunders M, 2007). PE investments are defined as investments that are made to generate a measurable social and environmental impact alongside financial returns.<sup>3</sup> PE investment is a growing phenomenon, providing capital to address the world's most pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, micro-finance, and affordable and accessible basic services including housing, healthcare and education. Increasing numbers of people are making PE investments in Africa, seeking both to be of help to the people there and to take advantage of the rapidly growing economies. East Africa is one of the centres of PE investment, as activity has grown strongly throughout the region over the past five years. More than USD 9.3 billion has been disbursed in the region by more than 1,000 direct deals by DFIs and other impact investors active in East Africa until today, most happened in the last ten years. Almost half of the USD 9.3 billion capital disbursed in East Africa has been in Kenya (GIIN, 2015).

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<sup>3</sup>GIIN definition.

Investments made by PE funds in Africa have not been extensively covered by the media nor specifically addressed by academic research. This is partly due to the fact that they are relatively new to the region and partly because of the scarce information available on these deals. Most of the information publicly available comes from media sources such as online journal articles and dedicated websites. (Laura Silici and Anna Locke, 2013)

In May 2017, the EAVCA estimates that around 72 private equity funds are investing in East Africa. There are different types, such as global, regional and East African funds, as well as country- or purpose-specific funds. Most of the funds are less than 10 years old (61%)<sup>4</sup>. It is estimated that of the total PE funds raised globally (USD 4.8 trillion) between 2007 and 2016, approximately 0.6% (USD 28 billion) was earmarked for Africa and 0.06% (USD 2.7 billion) for East Africa. The main source of funds is investors from Europe and North America, largely consisting of DFIs, high net worth individuals/family offices, and others such as insurance/asset managers'/partners' equity (75%). The average investment size grew to USD 17 million in 2015–2016. Kenya remains the most popular investment destination in EA, with financial services, energy and natural resources, and FMCG (fast-moving consumer goods) as the dominant sectors. Most of the investors indicate that they give environmental, social and governance matters very high importance during the lifetime of their investment.

The sector has seen a shift in PE investment – from an agribusiness focus, to financial services and manufacturing. During the period 2015–2016, 25% of the deals recorded were in financial services, followed by manufacturing at 22%. Agribusiness accounted for 6% of the deals recorded in the same period, compared to 27% of the deals recorded in the period 2007–2014.

PE investors are also particularly attracted to consumer-related sectors in Ethiopia, keen to capitalize on increasing urbanization and the emerging middle class. Companies which have attracted PE investment include Africa Juice (Agri-Vie, 2010), Alemayehu Makonnen Farm (Pearl Capital Partners, 2012), Awash Wine Share Company (8 Miles, 2013), Dashen Breweries (Abraaj Group & Duet Group, 2012), Medpharm Holdings (Ascent Capital, 2015), and Yes Brand Food & Beverages (Catalyst Principal Partners, 2013). (Annual AVCA Report, 2017)

The shift in sector interest in private equity deals is reflective of the region's emerging trend of moving into value-added industries and service sector industries. Countries such as Ethiopia,

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<sup>4</sup>KPMG and EAVCA, Private Equity Sector Survey of East Africa for the period 2015 to 2016 June 2017

Kenya and Tanzania have adopted economic growth plans that identify industrialisation as their next frontier for growth and economic empowerment.(EAVCA,2018)

There is less competition for PE deals in Ethiopia, compared with other countries such as Kenya; an advantage for General Partners (GPs) that focus on the country. However, sourcing deals in a country where the majority of companies in the private sector are owned by families requires trust to be built over a long period of time. (Annual AVCA Report, 2017)

The purpose of this Master's thesis is to examine how the phenomenon of PE investing is practiced in Ethiopia, mainly from a fund manager's perspective. By doing so the author hopes to expand the knowledge of how and why PE funds are operating and interacting in the country. The Study presents some specific opportunities that make it particularly suitable as a tool to foster development in Ethiopia. At the same time it has also examined a number of challenges that PE in Ethiopia has faced. PE investing in Africa in general, and in Ethiopia in particular, is a relatively new and unexplored subject (AVCA, 2017). Another purpose is therefore to best describe, analyze and discuss PE investing in Ethiopia.

### 1.3. RESEARCH QUESTIONS

The major research questions of this study are;

- What is the overall Practice of Private Equity investment in Ethiopia?
- What are the challenges of Private Equity investments in Ethiopia?
- What are the benefits of Private Equity investment in Ethiopia?
- What measures should be taken to attract more private equity firms in Ethiopia?

### 1.4. OBJECTIVES OF THE STUDY

#### 1.4.1. GENERAL OBJECTIVE

The general objective of the study is to assess practices and challenges of private equity investment in Ethiopia from fund manager perspectives.

#### 1.4.2. SPECIFIC OBJECTIVES

The study mainly focuses on achieving the following specific objectives;

- To assess the overall Practices of Private Equity investment in Ethiopia

- To assess challenges of private companies in PE investment.
- To identify benefits of Private Equity Investments in Ethiopia;
- To suggest some recommendations; which will help Ethiopia to attract more Private Equity investors.

## 1.5. SIGNIFICANCE OF THE STUDY

This research attempts to bring about an understanding the landscape of private Equity investments in Ethiopia. Students and researchers are one of the target groups because the thesis hopes to inspire further research into the subject as well as increase interest and knowledge. The objective of the study is to enhance the existing body of knowledge by adding a qualitative perspective to the PE investment scene. By doing this, the study also hopes to give investors a better picture of how PE investment is practiced in Ethiopia and the aspects that can be improved. Therefore, it should appeal to both aspiring and existing investors. It also provides a better insight on how Ethiopia can benefit from private equity investments by overcoming its challenges and constraints. Lastly, entrepreneurs should be able to get a better picture of what potential investors want and how they operate.

## 1.6. SCOPE OF THE STUDY

The study focuses on private equity investment in Ethiopia, mainly from a fund manager's perspective. The scope of the study concentrates on private equity investments in Ethiopia by conducting interviews with private equity firms in Ethiopia.

## 1.7. LIMITATION OF THE STUDY

Private equity investments in Ethiopia are at an infant stage; therefore, this study faced some limitations including lack of reference materials and challenges in collecting data. In line with the stated purpose of using a fund manager's perspective as well as limited time and resources, entrepreneurs and pure asset were not interviewed. Moreover, conducting the research with few respondents limits the subject area and the generalization of the study.

## 1.8. ORGANIZATION OF THE STUDY

This research report is organized in five chapters:

**Chapter One:** this chapter deals with general introduction of the study. It consist of 6 subtitles; Background of the Study, Statement of the Problem, Basic Research Questions, Objectives of the Study, Significance of the Study, Limitation and Scope of the Study.

**Chapter Two:** presents review of related literature, which discusses some concepts as reference for the study. It provides the theoretical foundation upon which the research is based on and states the basic ideas and concepts in relation to the specific issues under study. It is foremost based on previously written reports on PE investment. The definition of Private Equity as well as a brief overview of the history of the subject is outlined alongside a brief overview of what the PE investing sector looks in Africa and Ethiopia.

**Chapter Three:** deals with the methodological choices made. First selected approaches are described, followed by the data gathering process. Finally an elaboration of the credibility is presented. The chapter aims to provide the reader with sufficient information to be able to replicate the study.

**Chapter Four:** presents the results of the interviews conducted. The layout of the presented findings is based on the previously mentioned specific objectives, along with certain additional findings the authors found interesting, complemented by a few quantifiable data entries. The results and findings of the study are discussed based on the theoretical framework as well as the authors' insights and thoughts

**Chapter Five:** in this chapter, conclusions are drawn from the findings, and recommendations aimed to improve the challenges for private equity investment in Ethiopia are presented.

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# CHAPTER TWO

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## REVIEW OF LITERATURE

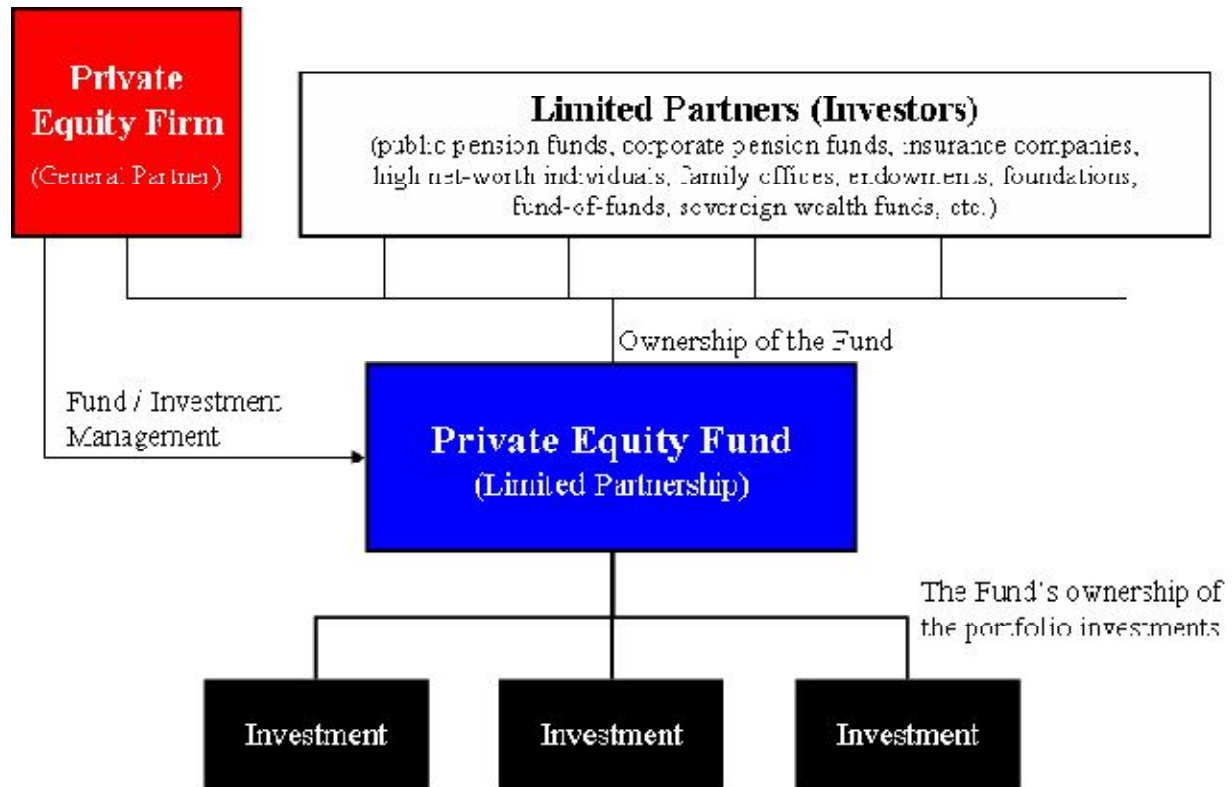
Fundamental principles, theories, past research works, suggestions of different scholars, are of vital importance in any study. Even though finding research reports relating to this study are a challenge to find, the section attempts to highlight pertinent issues related to the topic. The theoretical review covers the definitions and concepts of private equity and challenges in private equity investments, while the empirical review includes a case study on private equity investment in China and India and trend and characteristics of private equity in Africa in general and Ethiopian particular.

### 2.1. THEORETICAL FRAMEWORK

#### 2.1.1 PRIVATE EQUITY

Private equity is capital that is not noted on a public exchange. Private equity is composed of funds and investors that directly invest in private companies, or that engage in buyouts of public companies, resulting in the delisting of public equity. Institutional and retail investors provide the capital for private equity, and the capital can be utilized to fund new technology, make acquisitions, expand working capital, and to bolster and solidify a balance sheet. Private equity comes primarily from institutional investors and accredited investors, who can dedicate substantial sums of money for extended time periods. In most cases, considerably long holding periods are often required for private equity investments, in order to ensure a turnaround for distressed companies or to enable liquidity events such as an initial public offering (IPO) or a sale to a public company. (Zutshi, R., Liang, Tan, & Allampalli, D. G., G., 1999)

**Figure 1: Private Equity Fund Structure**



Source: Andrew, Types of Private Equity Funds, 2015

## 2.1.2 HISTORY OF PRIVATE EQUITY AND VENTURE CAPITAL

Venture capitalists often relate the story of Christopher Columbus. In the fifteenth century, he sought to travel westwards instead of eastwards from Europe and so planned to reach India. His far-fetched idea did not find favor with the King of Portugal, who refused to finance him. Finally, Queen Isabella of Spain decided to fund him and the voyages of Christopher Columbus are now empaneled in history. (Andrew, 2015)

Private Equity firm began taking shape in the post of World War II. It started with the establishment of American Research and Development Corporation, formed in 1946, whose biggest success was Digital Equipment. The founder of ARD was General Georges Dariot, a

French-born military man who is considered "the father of venture capital." But it was in 1980 venture capital industry began its greatest period of growth with an investment of USD 600million. (Andrew, 2015)

### 2.1.3. DEFINITION AND CONCEPTS OF PRIVATE EQUITY

The financial dictionary defines private equity as an umbrella term for large amounts of money raised directly from accredited individuals and institutions and pooled into a fund that invests in a range of business ventures. The attraction is the potential for substantial long-term gains.

Private equity capital is capital that is not quoted on a public exchange. Private equity investors or funds make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Capital for private equity is raised from retail and institutional investors and can be used to fund start-ups (venture capital), make acquisitions (growth equity, buyout), or strengthen a balance sheet (special situations). Private equity investments are commonly made by private equity firms, venture capital firms or "angel investors" (Pictet Alternative, 2014).

Basically, private equity firms attempt to invest in a company to improve the company and then exit their investment at a large profit. In order to magnify returns, private equity firms make use of leverage (borrowed money) to conduct Leveraged Buyouts (LBOs)(Wall Street Oasis, 2012).<sup>5</sup>

Private Equity firms can either focus on a specific sector (Energy, Technology, Healthcare etc.) or operate across a broad spectrum. The larger the firm, the more likely it is to cover more sectors (Wall Street Oasis, 2012).

Private equity firms look for companies with solid management teams, recurring customers, high margins, strong balance sheets, and the ability to generate significant free cash flow. The best candidates are private companies that are experiencing rapid growth (organically or through acquisition), a management buyout (MBO), or expansion into a new market (Divestopedia, private equity definition). They usually have a leading position in their industry,

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<sup>5</sup>available at <http://www.wallstreetoasis.com/financedictionary/private-equity-overview>

significant barriers to entry, and a differentiated product or service that commands a valuation premium over the competition

**Table 1: Definition of Private Equity**

Author	Definition of private equity
<b>Demaria(2010)</b>	PE can be described as investments in private companies in privately negotiated transaction.
<b>Caselli(2011).</b>	Institutionally, PE is the provision of capital and management expertise given to companies to create value and, consequently, generate big capital gains after the deal.
<b>EVCA (European Private Equity &amp; Venture Capital Association, 2015)</b>	<p>Private equity is a form of equity investment into private companies not listed on the stock exchange.</p> <p>It is a medium to long-term investment, characterized by active ownership.</p> <p>Private equity builds better businesses by strengthening management expertise, delivering operational improvements and helping companies to access new markets. Venture capital is a type of private equity focused on start-up companies.</p> <p>Venture capital funds back entrepreneurs</p> <p>With innovative ideas for a product or service who need investment and expert help in growing their companies.</p>
<b>NVCA(National VentureCapital Association, 2015)</b>	<p>Private equity – equity investments in non-public companies, usually defined as being made up of venture capital funds and buyout funds. Real estate, oil and gas, and other such partnerships are sometimes included in the definition.</p> <p>Venture capital – a segment of the private equity industry which focuses on investing in new companies with high growth potential and accompanying high risk.</p>

**Source: Author’s own compilation according to different sources**

## 2.1.4. TYPES OF PRIVATE EQUITY INVESTMENTS

According to Pictet Alternative Advisors (2014), there are three types of private equity investments:

**Primary investments or primaries:** are investments in newly created closed-end private equity partnerships. After conducting due diligence on the general partner, its strategy and track record, limited partners commit a certain amount to the new fund. However, at the time of commitment, limited partners have little visibility on the underlying investments that are made by the fund.

Capital is called as investment opportunities arise. The general partner will call and deploy the funds during the typical four to six years' investment period.

**Secondary investments or secondary's:** are existing limited partner private equity interests available on the secondary market. Secondary investors enjoy shorter investment periods and accelerated returns on invested capital. As secondary's are composed of existing assets, which means the fund has already deployed majority of its capital to portfolio companies. The risk associated with investing in a "blind pool" of assets is reduced. Furthermore, write-offs and losses, which may occur in the early years of a private equity investment, can be avoided when acquiring a fund at a later stage of its life.

**Co-investments:** is a direct investment by the limited partner in a company alongside a private equity fund. This occurs when general partners want to acquire a stake in a company larger than the one allowed by the diversification requirements laid down in the limited partnership agreement.

Consequently, general partners will syndicate part of their exposure to this single company by offering it to a handful of existing limited partners.

Co-investments allow the limited partner to increase his exposure to a particular opportunity through both the fund and direct investment. Co-investments are very often offered on a no-fee, no-carry basis.

## 2.1.5. TYPES OF PRIVATE EQUITY FUNDS

Private equity is a generic term used to identify a family of alternative investing methods; it can include leveraged buyout funds, growth equity funds, venture capital funds, certain real estate investment funds, special debt funds, and other types of special situation funds. (Andrew, 2015)

Funds can specialize in particular industries or be industry-agnostic, and they can focus on particular geographies as well. According to Andrew, 2015, the most common types of private equity funds include:

**Angel Investors:** are usually wealthy individuals, either former founders of startups or executives, who put up capital to finance a startup in exchange for either equity or convertible debt. Due to limited due diligence resources available to angel investors, and due to the fact that they invest their own funds on their own (as opposed to pooling as venture capital and private equity investors do), the angel investors assume the highest risk as a category of investors, compared to the private equity (PE) and venture capital (VC) investors. Their investments are usually diluted dramatically in subsequent rounds of funding, and are completely wiped out if the startup fails. As a result, angel investors demand extremely high rate of return to compensate for the risk assumed, usually 10-20x of original invested amount within five years (Yevgeny, 2015).

**Venture capital funds:** refers to investments made in young companies with no or limited revenues (Pictet Alternative Advisors, 2014). These days, venture capital firms basically come in two flavor very early stage vs. later stage funds. They typically do not invest based on cash flow modeling (as PE firms do). Instead, “early” stage funds typically invest in companies that have raw technical talent to invent and commercialize new technologies; they help fund them to show proof of concept, feasibility, and consumer desirability. “Later” stage funds invest in companies that have largely demonstrated these things already, and are looking to scale operations to true viability.

Their strategies generally involve helping portfolio companies maximize their growth potential by introducing them to new customers and partners, helping them recruit world-class engineering, technical, and managerial talent, and coaching them on how to expand and professionalize various corporate functions (e.g., finance, marketing, sales, human resource and legal).

**Growth equity funds:** refers to equity investments, most frequently minority investments, in relatively mature companies that are looking for capital to expand or restructure operations, enter new markets or finance a major acquisition without a change of control of the business (Pictet Alternative Advisors, 2014). They invest more broadly than venture capital funds in terms of industries, and somewhat more agnostic about whether the target industry is “high growth” (compared to venture capital funds). They sit a little ambiguously between pure-play Leveraged Buyouts (LBOs) funds and “later” stage venture capital funds.

Sometimes, venture capital or private equity funds will have a growth equity division, which also blurs the line even further. The growth equity fund can be thought as a “bridge” funds between venture and private equity.

**Leveraged buyout funds:** consist of acquiring a stake in a private company (non-listed or public to be taken private) with the intention to exercise influence on the company (Pictet Alternative, 2014). The companies involved in these kinds of transactions are usually mature firms with the ability to generate operating cash flows (Vasvari and Talmor, 2011, p.28). To finance these transactions, they will use a combination of debt (in the form of bank and term loans and subordinated or mezzanine debt) and equity capital (from the general partner and limited partners). That means private equity firms buy companies using a little bit of their own money, and a lot of borrowed money. In return for loaning the private equity firm money to finance abuyout transaction, the private equity firm collateralizes the debt using hard assets and cash flow/ working capital pledges of the company, allowing the lenders seniority in the event of bankruptcy liquidation.

This kind of financing structure benefits Leveraged Buyout's financial sponsor in two ways: the second one is that the returns to the investor will be enhanced (as long as the return on assets exceeds the cost of the debt).

## 2.1.6. STAGES FOR PRIVATE EQUITY FINANCING

According to Matteo Tosca (2013), there are three stages of financing activities and they can be classified as follow:

### **A. Early Stage Financing (VC activities)**

1) Seed capital stage. The term seed implies an early investment meant to support the business until it can generate cash flows, or at least until it is ready for further investments. Seed money options include Angel funding, friends and family funding and in a recent year also crowd funding. The venture capital is usually involved in financing an idea that is still at the experimental stage, as a result the overall amount of money invested is, in most of the cases, limited but there is still a high risk of not being able to translate the idea into a real and sustainable business.

2) Start-up financing stage. In this phase, the company should already have an ongoing business plan and it should be ready to initiate its marketing effort. Thus, the investor finances the start of production, product development and marketing activities and unlike the previous stage the company has proved it can survive in the business environment.

Even in this case, there are high risks of failure considering the fact that these activities require higher amount of investments compared with previous stages.

3) Early business stage. At this stage, the company has already initiated its sales efforts.

### **B. Expansion / Growth Stage Financing (PE activities)**

On the other hand, the expansion and growth stage financing involve Private Equity firms. It involves the development of a business, which has already reached a level of maturity, may be achieved by increasing or diversifying production capacity (internal growth). This can be done through acquisition of other companies (external growth) or through integration with other businesses (network development) (Andredakis, 2005)

1) First stage: financing is required for full-scale manufacturing or production and sales facilities.

2) Second stage: additional financing is essential to expand operations to full plant utilization levels (if the first stage only covered complementary inputs at less than full output or “normal” production levels). Thus, the contribution will be made through financial and strategic consulting.

3) Third stage: financing is for major plant expansion projects and introduction of facilities to produce new product lines, and it often takes the form of “mezzanine finance”. In this stage the company takes advantage of the network available from the investor.

4) Fourth stage or bridging financing: is usually to prepare a company for going public or for strategic acquisition by larger companies and the initial investment is usually repaid depending on the particular type of exit (Initial public offering or monitoring & acquisition transaction).

### **C. Turnaround Stage Financing (PE activities)**

1) Replacement capital: with this action the private equity fund repurchases shares from stockholders who do not agree with the new strategic plan agreed by the majority.

2) Leverage buy-out (LBO): refers to a strategy of making equity investments as part of a transaction in which a company, business unit or business assets is acquired from the current shareholders typically with the use of financial leverage (usually done by creating a company Newco). Through LBO the investor itself needs to provide only a fraction of the capital for the acquisition while the Company’s ability to generate cash or sale of assets will pay back the debt required for the acquisition.

3) Management-employee buy-out (MBO): internal managers or employees repurchase stocks of the target company with the financial help of the investors.

4) Management buy-in (MBI): an external management team raises the necessary funds to buy the target company with the final result of becoming the company's new owners. In most cases, the team is led by managers with significant experience at managing director level.

5) Family buyout: financial investors support family members with entrepreneurial vocation in repurchasing shares from other members of the family.

6) Turnaround financing: funding to implement restructuring plans, in this case investor will assume the majority in order to operate with freedom. In recent years another form of investment

took place, Delisting, and it usually takes place through the launch of a takeover bid in order to delist the target company

## 2.1.7. WHAT DRIVES PRIVATE EQUITY INVESTMENT?

The company may need a large inflow of capital for long-term productivity investments such as research and development. Rather than waiting several quarters (or years) to gather sufficient capital, the company may choose to sell part of its interests in exchange for the ability to pursue development projects sooner. This may be especially true of highly time-sensitive industries such as technology (e.g. software, telecommunications, and Internet services), where a few quarters may make a critical difference in a company's ability to gain (or maintain) a market advantage. According to Roger Kelly (2010), potential drivers of private equity investment activity include cyclical and structural factors.

### **A. Cyclical Factors**

The impact of cyclical factors on investment activity, Romain and van Pottelsberghe de laPotterie (2004) find evidence for the recurring nature of private equity investment activity, and its close correlation to GDP growth. This stands to reason; a fast-growing economy is likely to provide more opportunities for entrepreneurs, as noted by Gompers and Lerner (1998). Unemployment tends to be inversely related to the economic cycle, and Meyer (2008) finds unemployment to be negatively correlated with private equity investment, which he attributes to the cyclical nature of private equity investing.

### **B. Structural Factors**

#### **• Entrepreneurial Environment**

Most basic of all, without a demand side there can be no supply side. If there are no entrepreneurs there will be no demand for venture capital. There are different forms of entrepreneurship, and one can differentiate high growth from general forms of entrepreneurship, with high growth-oriented, early stage entrepreneurial activity driving venture capital investment demand (Roger Kelly, 2010). Below is a distinction between necessity-driven and opportunity-driven entrepreneurship, noting that the latter is more likely to give rise to venture capital investment demand. By contrast, the entrepreneurial environment is not such a significant factor

for the buyout side of private equity, which is less innovation driven (Roger Kelly, 2010).

Innovation potential depends on having an active research & development (R & D) culture, and this will be influenced by government support to R&D, across the range from supporting university research, through technology transfer and on to realization. Romain and vanPottelsberghe de la Potterie (2004) find a relationship between entrepreneurship, technological opportunities and the number of patents, and the R&D capital stock. Gompers and Lerner (1998) find that industrial and academic R&D expenditure is correlated with venture activity. Similarly, Meyer (2006b) finds a robust and positive relationship between expenditures on R&D and venture capital investment, but finds no similar relationship to the buyout side of private equity. Meyer takes this as evidence that venture capital backed start-ups and young firms operate closer to the technology frontier than other private equity financed firms. Schertler (2003) finds a strong positive correlation between number of patents, number of scientists engaged in research, R&D expenditure, and venture capital activity. Clarysse et al. (2009) find similar results using the Global Entrepreneurship Monitor's measure of Total Entrepreneurial Activity.

#### • **Institutional Environment**

As discussed above, an entrepreneurial culture is important for generating demand for venture capital, however in itself it is not sufficient. Entrepreneurs must be able to benefit from the fruits of their labors. Likewise, in order to generate a supply side, from the perspective of both buyout and venture, it is important for general partners to know that if they invest in a portfolio company, their investment will be protected, and for limited partners to know that the funds they provide to general partners are safeguarded against misuse. These require the existence of adequate legal and regulatory structures and the protection of property rights, as noted by Desai et al. (2006). What is the key that the institutional environment be appropriate: sufficient to protect, but not so much as to act as an administrative deterrent to new venture creations (Lee and Peterson, 2000).

Another important consideration is the existence of an institutional environment that allows private equity investors to implement their model. Schertler (2003) notes that from a supply side perspective, the supply of 'active involvement' by experienced venture capitalists is only positive if regulations and contract law do not prevent venture capitalists from having exclusive control rights, such as board and voting rights, in the enterprises they have chosen to finance. The same holds for buyout investors.

Finally, the scope to provide employee incentivization schemes such as share ownership schemes will affect the success of innovative companies, and hence the demand for venture capital (Clarysse et al., 2009): stock options enable technology-intensive and highly risky startups to attract, compensate, incentivize, monitor and retain quality employees.

- Taxation Regimes

The tax regime is an important consideration for both funds and potential investee companies. The tax regime affects the risk-return relationship of private equity investments relative to other investments by affecting the return without affecting the risk. Thus it can favor particular forms of investment, influencing the supply of capital from investors to private equity funds. Gompers and Lerner (1998) note that low capital gain tax makes people more inclined to start their own company or undertake a spin out from an existing company, thereby affecting demand for private equity; also the relative rates of income, capital gains and corporation tax are an important influence in the decision to become an entrepreneur (Bruce and Gurley, 2005). Poterba (1989) notes that the tax system determines the revenue and profit of entrepreneurship. Thus one might expect that the higher the capital gains tax rate, the lower entrepreneurial activity would be in an economy, and therefore the lower the demand for venture capital (Djankov et al. 2008).

- Labour Market

The rigidity of the labor market, or the degree of employment protection, has important implications for both the supply and demand side of equity finance. On the demand side, particularly for venture investments, labor market rigidities, or high degrees of employment protection which make hiring and firing difficult, can discourage entrepreneurship and with it the demand for venture capital funding (Roger Kelly, 2010). The opportunity cost of becoming an entrepreneur is higher in the context of rigid labor markets, as the latter are associated with safer wage incomes thanks to increased job security. Thus, in theory, the incentives for opportunity-driven entrepreneurial activity is lower in economies with rigid labor markets (Roger Kelly, 2010).

However, as noted by Schertler (2003) it is more difficult to enter the labour market when the labour market is rigid, so there is a higher incentive for those who are unemployed to start their own enterprises, becoming necessity-driven (as distinct from opportunity-driven) entrepreneurs.

The opposing forces suggest that the overall effect of rigid labor market on venture capital demand is not clear, but it is likely that, as suggested by Meyer (2008), those who are entrepreneurs by necessity rather than choice (such as the unemployed) are less prone to use venture capital. Hence on balance we would expect labor market rigidity, or high employment protection to be associated with lower venture activity. Interestingly, as noted above, Schertler (2003) found a positive relation between venture activity and labor market restrictions, which he interpreted to suggest that enterprises operating in economies with rigid labor markets, demand more capital per employee than their counterparts operating in flexible labor markets.

Of course, supply of venture capitalists, which in turn impacts the supply of venture capital in a particular country, also depends on the labour market. Schertler (2003) notes that labor market rigidities affect the decision of individuals to become venture capitalists in the same way that they affect the decisions of individuals to become entrepreneurs. Thus, labor market rigidities may increase the opportunity cost and thus lower the incentives of individuals to become venture capitalists, reducing venture capital activity.

- Capital Market

Companies and indeed entrepreneurs have a choice when it comes to finance: debt or equity, with the former from the banking sector or capital markets, depending on accessibility. The presence of a deep, liquid capital market is important for a number of reasons.

First, a deep, liquid capital market provides an important exit route for private equity, allowing investors to recoup their funds in the future. A lack of an appropriate exit is one of the main factors discouraging private equity investment (NVCA, 2010). Bringing a company to initial public offering is a valuable signal of the quality of a general partner, and is recognized during subsequent fundraisings.

Second, liquid stock markets are also important in ensuring the supply of investment capital. There is a transaction cost that arises due to information asymmetries between a general partner and a potential investee company or entrepreneur. Initial public offerings help reduce this information asymmetry, and hence the transaction cost, as they signal the experience of the

general partner to the investee company/entrepreneur. Also, successful initial public offering encourage capital providers to provide more capital and at more favorable conditions (Schertler, 2003).

Third, the depth and liquidity of capital markets is an important proxy for financial depth, and hence the availability of leverage, something that is key to the buyout model. Finally, the existence of a liquid stock market can help promote venture capitalism, and thus the supply of venture capital, as it allows necessary skills to be developed (Schertler, 2003).

## 2.1.6. CHALLENGES OF PRIVATE EQUITY INVESTMENTS

Private equity (PE) investments in Africa are typically considered to be high risk. Among the challenges that PE share with other financing vehicles, some are of a technical nature – such as unreliable energy supply or low labor productivity – or linked to social and institutional factors such as poor governance. As these challenges are very specific and the knowledge of the local context is so important, there is more scope for inexperienced managers to make mistakes. Highly specialized experience in the sector, acquaintance with the region and good local connections are critical drivers of success. As with other investing vehicles, private equity could help fill the financing gap that precludes in Africa from expanding and becoming more profitable. Private equity investment in Africa faces a number of challenges raised by specific characteristics.

These characters include:

### **A. Regulation of Institutional Investors**

Some countries in Africa place significant restrictions on foreign institutional investors. Such restrictions limit the growth of the private equity investing industry as much-needed domestic capital is prevented from flowing into private equity investing vehicles (Dalberg, 2011). For example, In Ethiopia banking and insurance, packaging and shipping service, legal constancy, advertisement and promotional works are reserved for domestic investors only (Investment Proclamation No. 270/2012, Article 3).

Capital flow restrictions between African countries and the rest of the world represent another major challenge. Many countries are reluctant to open up their financial systems for fear of abuse, and most of the continent's financial systems are underdeveloped, making it difficult for

capital to flow. In some cases, delays in processing paperwork and lengthy reserve bank approval procedures for moving funds further hamper the private equity industry (UNECA, 2014).

### **B. Addressing the Missing Middle**

African economies are characterized by the large presence of family-run small and medium enterprises (SMEs), which operate in fragmented markets with poor access to functioning financial services. This makes conventional private equity tools based on a western concept of financial structuring less adequate to the African market, and even less to the agricultural sector.

On the other hand, the possibility of funding these firms would allow private equity funds to include a larger number of deals in their portfolio and, most importantly, would help the local economy to fill the largest capital financing gap – the so-called missing middle (Laura and Anna, 2013).

In addition, foreign investors are always more comfortable when a funding team has managed to attract local money first, but there is a general lack of local investors in the private equity sector in Africa, with the possible exception of South Africa (UNECA, 2014).

### **C. Business Owners' Resistance to Giving up Equity**

Owners of small and medium businesses are wary of accepting equity investments. They fear losing control and lack knowledge of financial and governance structures. In these businesses, private equity investments stir fears of losing decision-making authority and ultimately losing control of the business (Dalberg, 2011).

The lack of awareness of the actual implications of engaging equity investors prevents many business owners from accepting this type of capital, leaving them with a limited range of debt options. On the other hand, investors looking to deploy equity in Africa would equally benefit from taking the time to build a stronger trust relationship with potential investees to overcome their hesitations. This often requires a significant time commitment and flexibility in the terms and conditions of the financial instruments they use (Dalberg, 2011).

### **D. Excessive Confidentiality and Lack of Transparency**

Private equity funds invest in private (i.e. not publicly listed) companies and they do not have extensive reporting obligations. Consequently, they usually disclose very little information on their portfolio companies and the respective activities (Laura and Anna, 2013). The excessive confidentiality and the poor transparency of investments is a major criticism of private equity.

Due to lack of publicly available information, pinpointing private equity investments may be problematic for third parties and regulatory authorities (McNellis 2009). This may allow some funds to minimize the taxes paid to the host country, by combining the exemptions offered by offshore headquarters (Timmerman 2012) with aggressive tax optimization schemes (d'Aubert 2011), the latter often being available in African countries keen on attracting more foreign investors.

A further risk stemming from the absence of mandatory disclosure rules is that of biases in the reporting of returns (Kropp 2010). These risks concern private equity investments in all the economic sectors. However, lack of transparency and accountability may be particularly problematic for agricultural investments, for instance when they imply the acquisition of land titles or when production activities are especially detrimental to the environment.

#### **E. Lack of Data on Financial and Non-financial Performance**

Though there is an abundance of entrepreneurs looking for finance, finding opportunities and screening them for “bad deals” are both fraught with difficulties. Deal-flow in Africa is mainly proprietary and generated by the personal networks of fund managers. Indeed, nearly half of all deals are sourced via networks or relationships, while one third are identified through company and sector tracking, and the main constraint identified not undertaking cross-border investments is a lack of local networks (UNECA, 2014). This challenge makes it difficult for new impact investors who lack local partners to move into Africa. It is often not possible to gather sufficient information to conduct due diligence prior to making a deal (Dalberg, 2011).

#### **F. Focus on Short-term Profit**

A further criticism of private equity investors is that they pursue short-term profit at the expense of business stability. This may happen at times, as private equity funds seek to raise profitability in order to generate high returns for General Partner's and Limited Partner's over a relatively short time horizon. However, at the same time, they need the investment to be financially viable and economically sustainable in order to secure an exit (Laura and Anna, 2013).

#### **G. Lack of Options for Exit**

Exiting investments is one of the major challenges in private equity investing in developing markets (Dalberg, 2011). The nascence of the capital markets in Africa limits the initial public offering (IPO) options available to investors. Although this may be seen as a major

barrier to outside investors looking at Africa, fund managers operating locally expressed less concern.

Most use alternative exit strategies such as sale to sponsors, self-liquidating structures, and trade sales. Fund managers negotiate liquidity and exit options prior to investment as part of the investment due diligence. Despite the range of exit options available, information on successful exits is limited; this may discourage potential new entrants in the market (Dalberg, 2011). Other challenges include high borrowing costs (interest rates of up to 40% in some countries); high taxation rates; a lack of experienced and proven fund managers; and not enough institutional platforms for discussions between private equity players and Governments on issues affecting the industry (UNECA, 2014).

The above stated challenges are common to most developing nations and emerging markets. In chapter 4 the researcher identified the major challenges faced in the private equity investment industry in Ethiopia.

## 2.2. EMPIRICAL REVIEW

Private equity is a relatively young asset class as the private equity market formally began in the 1970s (Kocis, 2015), approximately \$160 million was committed in 1979. Although a few venture capital firms started in the 1940s, it was not until the Employee Retirement Income Security Act was finalized in 1979 that corporate pension funds began increasing their interest in private equity, which significantly drove fundraising and private equity growth (Kocis, 2015). Strong relative returns continued to drive fundraising for the following few decades. There are now over 200 private equity and venture capital funds targeting Sub-Saharan Africa (Economist, 2015). These include funds currently raising capital as well as funds that have completed their raising and are now seeking to invest. These funds go beyond the traditional strategy of investing in the natural resources sector to sectors such as infrastructure, financial services, consumer, and telecommunications. Estimates of 2012 fundraising are at an all-time high of \$3.2 billion, and while South Africa has been the only or major recipient of private equity flows to Sub-Saharan Africa, it is now a minor recipient (Economist, 2015). The drastic decline of South Africa as a destination for private equity capital in Sub-Saharan Africa underscores the sentiment by the Economist Intelligence Unit that investors now seek higher yields potentially attainable in less-developed, faster-growing Sub-Saharan markets.

## 2.2.1. CASE STUDY OF CHINA AND BRAZIL

There are several new middle-income countries that provide good examples of how private equity can positively contribute to the growth of an economy. Two examples that are relevant to Ethiopia are Brazil and China. China is relevant because of its history of central planning and Brazil is because of the contribution of the agricultural sector to its overall economic growth (UNDP Ethiopia, 2013).

In 2005, private equity funds raised for China were less than \$2 billion. By 2011, \$23 billion was committed for private equity (EY, 2013). China was able to attain this much growth in its private equity industry in a relatively short period because it continued to be one of the fastest growing economies in the world throughout that time coupled with the fact that it slowly began opening up various sectors that were traditionally closed to foreign investors (Ally Z., Ralph J., Angela Y. and Joe Z., 2014).

China's economy has seen extraordinary growth over the past decade, driven by market-oriented reform, industrialization, and urbanization. On average, GDP has grown 10% annually since 2003, making China the world's second largest economy (Ally Z., Ralph J., Angela Y. and Joe Z., 2014). Profit growth and valuation arbitrage, two of the most important sources of returns for PE managers in China over the past decade, have been propelled by strong GDP growth, rapid capital markets expansion, and high trading multiples of the domestic A-share market (especially the ChiNext stock exchange) (Ally Z., Ralph J., Angela Y. and Joe Z., 2014). In turn, the influx of private equity helped China achieve three major economic goals: Job Creation, Innovation, and "Go West Policies" (UNDP Ethiopia, 2013).

The total employment at private equity-financed companies has increased by 16% over the period 2002 to 2008. Measured as a percentage of revenue, R&D spending at private equity-backed companies was more than 2.5 times that of their publicly listed counterparts (Ally Z., 2014)). Forty-two percent of private equity funding went to companies based in inland China as opposed to the coastal regions, thereby helping China's "Go West Policies" which attempted to move capital from the overfunded coastal regions into Mainland China (UNDP Ethiopia, 2013). The underdeveloped financial market has been a factor in the advancement of China's PE industry. Despite more than two decades of progress in the capital markets, bank loans continue

to act as the major source of financing for companies in China (Ally Z., Ralph J., Angela Y. and Joe Z., 2014).

The majority of Chinese banks are state-owned and, therefore, most loans are made to state-dominated sectors such as transportation, telecom and energy. While the private sector now generates over 60% of the country's GDP, it accesses only 25% of the credit extended by domestic banks (Ally Z., Ralph J., Angela Y. and Joe Z., 2014). As a result, small and medium-sized private companies, the key growth drivers of the country's future economy, have suffered from a significant funding gap. The Brazilian private equity experience is underpinned by heavy investment in the financial sector along with the technology and consumer goods sectors. However, as a country that is rich in land and agricultural products, private equity also helped transform the agricultural sector (Spectra Investments, 2015).

A few of what are now considered major South American food production and processing conglomerates were initially provided seed money by private equity funds. Furthermore, Brazil was extremely ahead of its time in devising policies that created higher value goods out of abundant domestic resources so as to minimize large foreign exchange outflows. These policies were particularly successful in the case of refining ethanol from sugarcane, where Brazil has created a global standard (Spectra Investments, 2015). Both China and Brazil are now significant recipients of private equity and also have homegrown domestic private equity funds looking outside their borders and into markets such as Sub Saharan Africa for investment opportunities. The biggest Brazilian private equity story as it relates to Africa is Brazil's BTG Investment firm that announced in early 2013 that it intends to raise \$1 billion to invest in Africa's infrastructure (UNDP Ethiopia, 2013).

## 2.3. OVERVIEW OF PRIVATE EQUITY IN AFRICA

### 2.3.1. EVOLUTION OF PRIVATE EQUITY IN AFRICA

Private equity in Africa was pioneered by the Development Finance Institutions (DFIs), who had a mandate to invest in private sector businesses in developing countries. The DFIs aimed to stimulate economic growth, create jobs, develop better business standards and encourage commercial investors to also invest in these developing regions. (AVCA, 2017)

DFIs investing in African countries at this time included the African Development Bank (AfDB), the UK's CDC Group plc (CDC), Germany's Deutsche Investitions (DEG), the European

Investment Bank (EIB), the Netherlands' Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V (FMO), the World Bank's International Finance Corporation (IFC), France's Proparco, and Sweden's Swedfund, amongst others. The DFIs are strategically aligned: all investing in Africa to achieve a positive impact through building businesses, creating jobs and sustainably improving the lives of people in poorer communities. (AVCA, 2017)

Prior to the 1990s, DFIs predominantly supported African economies by providing loans, frequently in government-initiated development projects, then DFIs extended their activities to investing in private companies independent of government sponsored initiatives. (AVCA, 2017)

Around this time, DFIs also shifted to providing equity capital to private companies in addition to the loans they had historically provided. This strategic shift resulted from the acknowledgement that equity investments better supported businesses to grow and prosper. More importantly, this shift provided greater alignment with the objectives of the DFI community. (AVCA, 2017)

Given their government ties, experience, and history in the region, the DFIs were in a good position to work with governments, policymakers and regulators. They were uniquely placed to educate these groups on the benefits of privatizing assets and of private sector investment. They worked with governments to increase their openness to private sector development, reduce the legislative barriers to invest and create more enabling environments for both domestic and foreign investors. (AVCA, 2017)

Together, the DFIs went on to initiate the private equity industry in Africa. They introduced governments and businesses to the benefits of private capital and, by backing the pioneering Africa-focused fund managers, the DFIs created a real capacity for private equity practitioners to enter the market and build upon their achievements. (AVCA, 2017)

While there were some early adopters, in the early 1990s, the DFIs were joined by the first wave of Africa-focused private equity firms, which largely emerged in South Africa. By 1997, there were 12 private equity funds that had raised US\$1 billion collectively to invest in Africa. These funds were largely concentrated on investing in the South African market, but soon commenced

investing in other parts of the continent including Botswana, Côte d'Ivoire, Ghana, Kenya, Mauritius, Zambia and Zimbabwe.<sup>6</sup>

Today, there are over 140 private equity firms targeting Africa.<sup>7</sup> Between them they offer an increasing array of sophisticated investment strategies varying from generalist or country-focused funds, to more sector or region-specific funds, including pan-African funds. Increasingly these managers are now based around the world, with majority on ground in Africa.

DFIs continue to perform a critical role in the industry. They remain some of the largest investors in private equity funds today. They will often back first-time fund managers where others will not, which helps the manager to build a track record and supports the industry's growth.

The evolution of the industry has also increased the awareness of entrepreneurs, business owners and governments to the benefits of private equity investment in businesses, economies and communities.

Sharing the success of this evolution has improved the perception of Africa and attracted a greater number of global institutions to Africa. Additionally, and importantly, this has translated into more Africa-based institutional investors investing in Africa, which is key to the ongoing growth of the industry and ultimately, the continent.

### 2.3.2 CHARACTERISTICS OF PRIVATE EQUITY IN AFRICA

Africa's Private Equity firm's have peculiar characteristics when compared with developed countries. Accordingly, the African venture capital association listed some of it.

**a) It is primarily growth capital:** Private equity investment in Africa is chiefly growth capital. There is little or no debt used in these transactions. This is in contrast to the more well-known strategies of the global leveraged buy-out private equity firms who operate in more mature markets.

In Africa, the dynamic combination of emerging industry and the demographic trajectory mean the strategies used by private equity firms to create value often focus on supporting sustainable expansion.

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<sup>6</sup>How Can Sub-Saharan Africa Attract More Private Capital Inflows? F Amar Bhattacharya, Peter J. Montiel, and Sunil Sharma, Finance & Development, International Monetary Fund, June 1997 (Volume 34, Number 2)

<sup>7</sup>African Private Equity and Venture Capital Association, 2017.

These strategies may support the company to develop and capture more of the value chain of an industry, or to capitalize on increasing distribution channels and regional trade flows, or a combination of these factors.

**b) It has a strong focus on environmental, social and governance standards:** -Globally, there is increasing recognition that strong environmental, social and governance standards are material factors in driving business value. This has long been the case in the private equity industry in Africa for two reasons. First, with strong historic and ongoing support from the DFI community, most fund managers in Africa have had knowledge, understanding and experience of improving ESG standards embedded in their operating model since inception. Second, in countries where local standards are poor or enforcement is lacking, a failure to understand ESG issues can have a significant impact on the prospects and ambitions of businesses.

Majority of fund managers consider ESG improvements integral to their approach and many have developed advanced systems and processes. These managers frequently tackle ESG issues as part of the investment strategy. This means identifying and prioritizing opportunities for improvement, allocating resources and measuring and improving outcomes.

**c) Minority stakes are prevalent:** -In line with the concept of growth capital, private equity firms in Africa tend to take minority stakes (less than 50%) in companies. This is typically alongside management, who remain majority shareholders.

Minority stakes in Africa are also common due to the developing nature of markets and the consequently shallow pool of executive talent. The shallowness of this pool makes incumbent management and effective successive planning important for success.

To protect their interests in a minority equity position, private equity firms typically implement contractual protections. This ensures they have sufficient influence on the portfolio company's major decisions, including its strategy and board composition.

**d) Majority of investments are below US\$50 million:** - Given the stage of maturity of African economies and the significant role of private equity firms in financing the growth of small- and medium-sized enterprises (*SMEs*), most private equity investments in Africa are under US\$50 million in equity value. These investments are also largely unlevered.

According to proprietary research conducted by AVCA in 2016, under 80% of private equity investments in Africa were below US\$50 million, and they accounted for over 10% of the total value of investments in Africa.

This level of investment is expected to remain the norm for private equity in Africa in the short to medium term. However, as markets mature and governments continue to privatize assets; deal sizes will increase with the natural growth in the size of businesses and the need for investment in larger scale opportunities.

**e) A place for patient capital:** -With the amount of hands-on support and strategic effort private equity firms in Africa apply to their portfolio companies, average investment hold periods are just over 5 years. Often businesses are not only building their operations, but also building the ecosystem to support the industry in which they are operating.

**f) Provides exposure to sectors not represented in public markets:** -The private sector, rather than public markets, is the means by which investors can gain the greatest exposure to Africa's growth potential.

Across Africa's 54 countries, there are only 23 securities exchanges, with around 1,500 publicly-listed companies' collectively.<sup>8</sup> By comparison, the main market of the London Stock Exchange has 2,467 listed companies.<sup>9</sup>

To further illustrate the size of the private sector relative to public markets, in South Africa, there are an estimated 400,000 private companies compared to fewer than 400 publicly-listed companies on the Johannesburg Stock Exchange.<sup>10</sup> In addition, public markets in Africa tend to be dominated by companies in mining, natural resources and financial sectors. As such, they do not fully reflect the range of industries that contribute to consumer-driven economic growth.

### 2.3.3. PRIVATE EQUITY DEALS IN EAST AFRICA

In May 2017, the EAVCA estimates that around 72 private equity funds are investing in East Africa. There are different types, such as global, regional and East African funds, as well as country- or purpose-specific funds. Most of the funds are less than 10 years old (61%)<sup>11</sup>. It is estimated that of the total PE funds raised globally (USD 4.8 trillion) between 2007 and 2016, approximately 0.6% (USD 28 billion) was earmarked for Africa and 0.06% (USD 2.7 billion) for East Africa. The main source of funds is investors from Europe and North America, largely consisting of DFIs, high net worth individuals/family offices, and others such as insurance/asset

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<sup>8</sup>African Securities Exchanges Association, 2014 Yearbook.

<sup>9</sup>London Stock Exchange, as at 31 October 2014.

<sup>10</sup>African Consumers: Driving the African Private Equity Opportunity, FMO Fairview

<sup>11</sup>KPMG and EAVCA, Private Equity Sector Survey of East Africa for the period 2015 to 2016 June 2017

managers'/partners' equity (75%). The average investment size grew to USD 17 million in 2015–2016. Kenya remains the most popular investment destination in EA, with financial services, energy and natural resources, and FMCG (fast-moving consumer goods) as the dominant sectors. Most of the investors indicate that they give environmental, social and governance matters very high importance during the lifetime of their investment. The sector has seen a shift in PE investment – from an agribusiness focus, to financial services and manufacturing. During the period 2015–2016, 25% of the deals recorded were in financial services, followed by manufacturing at 22%. Agribusiness accounted for 6% of the deals recorded in the same period, compared to 27% of the deals recorded in the period 2007–2014. The shift in sector interest in private equity deals is reflective of the region's emerging trend of moving into value-added industries and service sector industries. Countries such as Ethiopia, Kenya and Tanzania have adopted economic growth plans that identify industrialisation as their next frontier for growth and economic empowerment.

## 2.4. OVERVIEW OF PRIVATE EQUITY INVESTMENT IN ETHIOPIA

### 2.4.1 COUNTRY CONTEXT

Ethiopia's location gives it strategic dominance as a jumping off point in Horn Africa, close to Middle East and its markets. Bordering Eritrea, Somalia, Kenya, South Sudan, and Sudan, Ethiopia is landlocked, has been using neighboring Djibouti's main port for the last two decades. However, with recent peace with Eritrea, Ethiopia is set to resume accessing the Eritrean ports of Assab and Massawwa for its international trade.<sup>12</sup>

With about 109 million people (2018), Ethiopia is the second most populous nation in Africa after Nigeria, and the fastest growing economy in the region. However, it is also one of the poorest, with per capita income of \$790. Ethiopia aims to reach lower middle-class income status by 2025. (World Bank, 2019)

After decades of authoritarianism, Ethiopia's economy is on the rise. Exceptional growth rates, spurred by a wave of privatization and robust foreign direct investment (FDI) flows, have fueled rapid modernization, especially in the past decade. Nonetheless, Ethiopia's living standards lag

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<sup>12</sup>,Ethiopian Economic Update, World Bank Report,2019

behind those of its peer countries; the economy is still overwhelmingly agriculture-based, and linkages between urban affluence and rural populations are weak. (GIIN, 2015)

Over the last decade, high growth has led to a significant reduction in poverty and improved living standards for many Ethiopians. The country's large infrastructure investments are beginning to bear fruit and the provision of public services such as education and health has increased dramatically. As a result, the population has enjoyed important welfare gains.<sup>13</sup>

Ethiopia has become one of the world's fastest growing economies and the government is implementing the second phase of its Growth and Transformation Plan (GTP II) which will run to 2019/20. GTPII targets to achieve an annual average real GDP growth rate of 11% and realization of Ethiopia's vision of becoming a lower middle-income country by 2025. One of the major strategic pillars of GTP II includes a concerted effort to increase private sector investment (domestic and foreign) and promoting private sector development to accelerate economic growth underpinned by job creation, export promotion and technology transfer (IMF World Economic Outlook, 2019)

The IMF recently stated in their report that Ethiopia's economy experienced strong, broad-based growth averaging 9.9% a year from 2007/08 to 2017/18, compared to a regional average of 5.4%. Ethiopia's real gross domestic product (GDP) growth decelerated to 7.7% in 2017/18. This is due to civil unrest, political uncertainty, and policy adjustments that involved fiscal consolidation to stabilize the public debt. Real GDP growth is projected to recover from 7.7% in 2017/18 to 8.2% in 2018/19 and 2019/20., supported by industry and service sector expansion and agriculture sector recovery.<sup>14</sup>

Ethiopia experienced double-digit inflation during the current fiscal year; however, it is expected to normalize to single-digit inflation in 2019. Annual inflation in 2018 was registered at 11.2% (vs. 9.9% in 2017) is expected to average 8.6% in 2019 and to fall to 8.0% in 2020. (IMF, 2019)

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<sup>13</sup> International Monetary fund, 2019

<sup>14</sup> African Economic outlook (AEO), 2019

Foreign currency availability remains a significant challenge to the Ethiopian economy; however political reforms, expected growth in export volumes, and new foreign investments are expected to alleviate foreign currency dependency.

Political reforms implemented in the last few months led to stabilization of the Ethiopian economy and restored overall calm in the country. The reform focused mainly on institutionalizing democracy and rule of law and expanding the political space. But these achievements are not without risk, there are disruptions of economic activities in some parts of the country, displacements of people in large numbers, skirmishes that could affect overall economic performance in the short to the medium. (AEO,2019).

## 2.4.2 FOREIGN DIRECT AND INDIRECT INVESTMENT IN ETHIOPIA

Globally, there will be an estimated USD900 trillion in financial assets by 2020. Even a small fraction of that amount could help unlock capital resources for the modernization of emerging markets. Investors are increasingly helping to drive capital towards investments that target both a financial return and some social or environmental outcome: they want to ‘do good’ and ‘do well’ simultaneously with at least a portion of their portfolios. These investors are driven by personal interest, deep-seated worries about the future of the planet and interest in low-volatility opportunities and segments of the market that are uncorrelated with mainstream global benchmarks, such as absolute return and capital guarantee products. In the world’s developed capital markets, investors increasingly look for ethical funds – socially responsible investments (SRIs).

Even though the growth rate is not comparable to other Eastern and Southern African countries, the direct and indirect investment into Ethiopia is increasing. Specifically, foreign direct investment (FDI) is on the rise, despite global and national challenges.

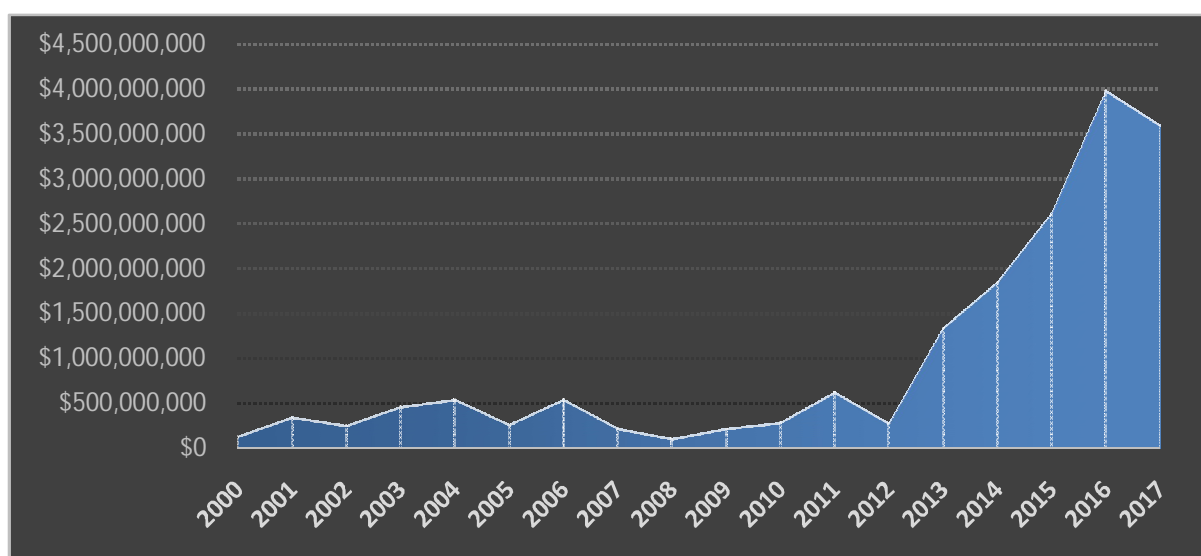
### 2.4.2.1. FOREIGN DIRECT INVESTMENT TREND IN ETHIOPIA

Foreign direct investment refers to direct investment equity flows in the reporting economy (destination country). It is the sum of equity capital, reinvestment of earnings, and other capital

established in a significant long-term business interest in a foreign country, often starting up a new business or buying an existing one.

FDI in Ethiopia has reached 3.3 billion USD in 2018, with 18% decline from 2017. The main sectors that foreign investors are focused on are manufacturing, agriculture including horticulture, construction, hotels and real estate.<sup>15</sup>

**FIGURE 2.1: ETHIOPIAN FDI FLOW, USD (2000–2017)**



Source: UNCTAD, 2018

#### 2.4.2.1. FOREIGN INDIRECT INVESTMENT TREND IN ETHIOPIA

Indirect investments are where companies or financial institutions purchase positions or stakes in companies. FII is typically foreign equity investment that is ‘liquid’, with quicker realisation periods than FDI. The capital is invested in private (non-listed) companies; the aim is to realise investment return on exit, and to exit investors must sell their shares to other investors.

There are different categories of FII and terminologies used. Some of the categories overlap and share a number of characteristics. For example, a ‘private equity fund’ in East Africa is a

<sup>15</sup>UNCTAD, World investment Report, 2019

collective term used for a wide variety of financial investors. Such financial investors include direct equity investing arms of Development Financial Institutes (DFIs); traditional private equity funds, i.e. general partners; impact investors; venture capitalists; family offices; and hybrid funds focused on mezzanine financing and distressed opportunities.

### 2.4.3. PRIVATE EQUITY DEALS IN ETHIOPIA

Ethiopia is an attractive market for PE in general terms, given the size of its population (more than 100 million, the second largest on the continent), its relatively high economic growth rate, as well as being the home of the African Union and other initiatives on the continent. As confirmed by intermediary KI, the Ethiopian market has become one that investors can no longer ignore and there are a significant number of informed investors looking to engage with the Ethiopian growth story. Some are waiting, some have already opened offices, and others have earmarked funds.

PE investors are particularly attracted to consumer-related sectors in Ethiopia, keen to capitalize on increasing urbanization and the emerging middle class. Companies which have attracted PE investment include Africa Juice (Agri-Vie, 2010), Alemayehu Makonnen Farm (Pearl Capital Partners, 2012), Awash Wine Share Company (8 Miles, 2013), Dashen Breweries (Abraaj Group & Duet Group, 2012), Medpharm Holdings (Ascent Capital, 2015), and Yes Brand Food & Beverages (Catalyst Principal Partners, 2013).

There is less competition for PE deals in Ethiopia, compared with other countries such as Kenya; an advantage for General Partners (GPs) that focus on the country. However, sourcing deals in a country where the majority of companies in the private sector are owned by families requires trust to be built over a long period of time. (AVCA, 2016)

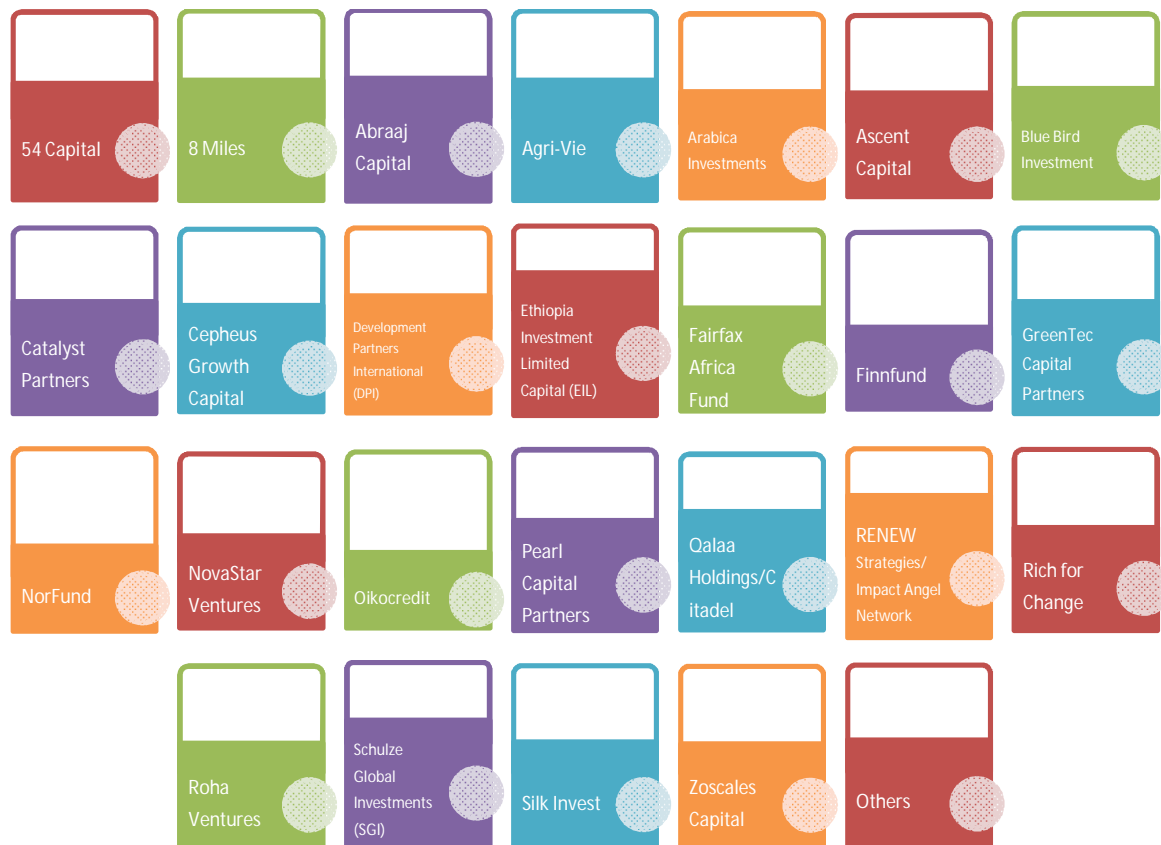
Given the stage of maturity of Ethiopian economies and the significant role of private equity firms in financing the growth of small- and medium-sized enterprises (*SMEs*), AVCA reported that 80% of PE deals in Ethiopia are below US\$50mn.

Companies in most sectors in Ethiopia, operate at a small or medium level. Most Ethiopian companies depend on internal resources. As per the WB-Enterprise survey report, the source of

83% of the investment is internal. These include their own savings, mobilising Iquib<sup>16</sup>, with a quarter of their capital coming from family and friends to start the business.

The situation in Ethiopia has some different characteristics from other East African countries in terms of financial regulation and business community behaviour. In terms of number, of the PE investors who are active in East Africa, about 50% have in one way or another targeted the Ethiopian market. (EAVCA, 2019) As per KPMG and EAVCA 2019 report, private equity investors who are active in Ethiopia with an office presence or with some type of arrangement are at least 30, with many others that target the market with other intermediaries (see Figure 7). About 50% of these PE investors are able to conclude funds and make investments in different companies in the country.

**FIGURE 2.2: ACTIVE PRIVATE EQUITY INVESTORS IN ETHIOPIA**



Source: KPMG and EAVCA 2019

<sup>16</sup>Iquib is an informal association established by a small group of people in order to provide substantial rotating funding for members, who take loans on the basis of drawing lots.

PE investors are particularly attracted to consumer-related sectors in Ethiopia, keen to capitalise on increasing urbanisation and the emerging middle class. Examples of companies PEs have invested in the past few years are listed in Figure 2.3.

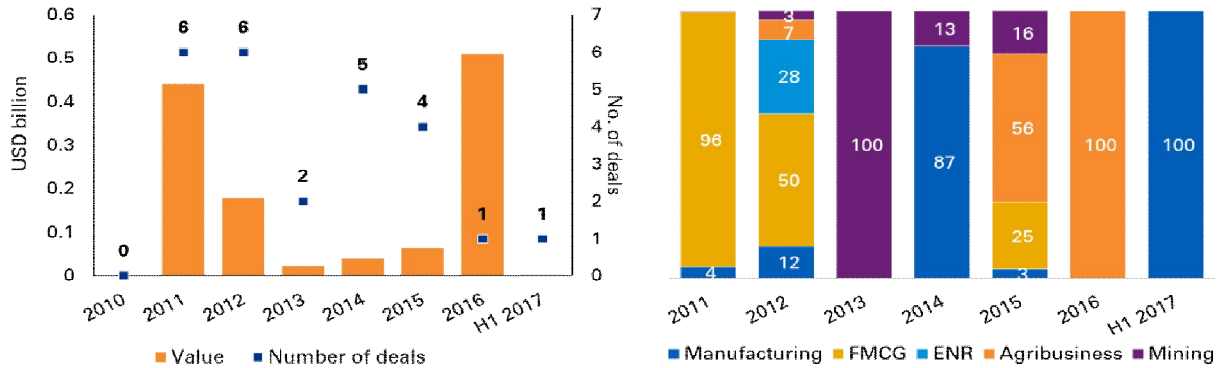
**FIGURE 2.3: PE INVESTED COMPANIES LIST**



**Source: Researchers Customize from different sources**

As reported in AVCA Reports, the manufacturing sector witnessed the highest share in terms of investment volume in the past 7 years. Mining, FMCG and agribusiness are the next popular sectors for investment in Ethiopia. The size of private equity deals in Ethiopia is quite small compared to other countries. From 2012-17, According to the annual survey of AVCA in 2018, Ethiopia accounted for only 10 percent of 180 PE deals in East Africa. As per KMPG’s survey report, there has been a decrease in investment activity in the country over the past few years. The volume of deals has decreased significantly to one in 2017, compared to six in 2012 and 2011. This decline may be related to the country’s security situation in the past two years.

**Figure 2.4: Trends in the no. of deals (2010-2017) and type of deal (2010–2017)**



Source: KPMG, 2017

## 2.5. Conclusion

While Private Equity investment is defined differently by different researchers, some common themes emerged during the literature review. Private equity is a form of equity investment into private companies not listed on the stock exchange. It is a medium to long-term investment, characterized by active ownership. Private equity builds better businesses by strengthening management expertise, delivering operational improvements and helping companies to access new markets. Venture capital is a type of private equity focused on start-up companies.

The literature reviewed practices and deals of Private Equity investment in Ethiopia. It shows that Ethiopia is an attractive market for PE in general terms, given the size of its population (more than 100 million, the second largest on the continent), its relatively high economic growth rate, as well as being the home of the African Union and other initiatives on the continent. However, Ethiopia has not captured its fair share of private equity investment in the region. This literature review framed the researcher interview questions that will be extracted from the reviewed literature. This study identifies the major challenges of Private Equity investment in Ethiopia.

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# CHAPTER THREE

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## RESEARCH METHODOLOGY

This chapter briefly discusses the methodology used in this research. It covers explanations of the research approach, research design, data sources, population and sampling techniques, data collection methods and instruments, method of data analysis, ethical considerations, and reliability and validity of the research.

### 3.1 RESEARCH APPROACH

Research approach is to be selected based on the research purpose, the nature of the research, the problem area, and research questions. (Alhamadni, 2006) According to Creswell (2003), there are three basic types of research approaches including quantitative, qualitative, and mixed approach.

**Qualitative research** is an approach for exploring and understanding the meaning individuals or groups ascribe to a social or human problem. The process of research involves emerging questions and procedures, data typically collected in the participant's setting, data analysis inductively building from particulars to general themes, and the researcher making interpretations of the meaning of the data. The final written report has a flexible structure (Creswell, 2003).

**Quantitative research** is an approach for testing objective theories by examining the relationship among variables. These variables, in turn, can be measured, typically on instruments, so that numbered data can be analyzed using statistical procedures (Creswell, 2003).

**Mixed methods research** is an approach to inquiry involving collecting both quantitative and qualitative data, integrating the two forms of data, and using distinct designs that may involve philosophical assumptions and theoretical frameworks. The core assumption of this form of inquiry is that the combination of qualitative and quantitative approaches provides a more complete understanding of a research problem than either approach alone (Creswell, 2003). A mixed approach is useful to capture the best of both quantitative and qualitative approaches.

Thus, in order to achieve the objective of this study and answer the research questions qualitative research approach was used.

## 3.2 RESEARCH DESIGN

A research design is a set of advance decisions that makes up the master plan specifying the methods and procedures for collecting and analyzing the needed information (Burns & Bush, 2003). Saunders, Lewis and Thornhill (2007) indicate that research design is the general planning about how the researcher will go about answering his or her research questions. According to Burns and Bush (2003) research designs are classified into three categories: exploratory, descriptive, and causal. The choice of the most appropriate design depends largely on the objectives of the research. . Exploratory research design is adopted in this research thesis. It is most commonly unstructured, informal research that is undertaken to gain background information about the general nature of the research problem

The sources of the data were both primary and secondary in nature. Primary data were collected by conducting structured and semi structured interviews with private equity companies.

## 3.3. DATA SOURCES

The researcher uses both primary and secondary data sources. The primary data were collected through interviews. The secondary data were collected from the organization policy, procedure and other document which can be linked with Private Equity investment and also from different literatures in the area.

Collis and Hussy (2003) identified two main sources of data; primary and secondary. Primary data is data collected at the source in uncontrollable situations by asking questionnaires, conducting interviews or making observation. Secondary data is that already exist.

## 3.4 POPULATION, SAMPLING SIZE AND SAMPLING TECHNIQUES

### 3.4.1 POPULATION

Private equity firms refer to companies registered under the Ethiopian legislation to perform consulting and private equity investments in Ethiopia. These companies refer to firms mainly established for the purpose of profit making by investing in companies and receiving returns.

In order to conduct this study, all private equity firms in Ethiopia were targeted. According to survey report on KPMG and EAVCA, currently there are a total of 32 private equity firms in Ethiopia.

The researcher targeted total population since the population that the researcher is going to study is small (32). Therefore, the researcher tests the study using the entire population size. It helps the researcher reduce risk of missing potential insights from members that are not included.

### 3.4.2 SAMPLING SIZE AND SAMPLING TECHNIQUES

Sample size determination is an important element in any research. “The sample is part of the target population and is carefully selected so that it represents the population (Bumberg et al, 2008). out of thirty-two private Equity firms invested in Ethiopia, only 20 of them were willing to make the interview that the researcher conducted.

Sampling is a selection of sampling techniques in which the chance or probability of each case being selected from the population is known. While, non-probability sampling (Convenience sampling) is a selection of sampling techniques in which the chance or probability of each case being selected is not known.

The researcher uses convenience sampling while selecting interviewees from PE firms. A convenience-sample of interviewees was used because of the lack of interview persons. Networking with persons within the field of PE investing was crucial because of the author limited amount of time. Participants in the PE investor space in Ethiopia have little time and are often difficult to get a hold of. Getting in touch with investors to get sufficient material was therefore vital. The strategy was consequently to target the most outspoken representatives of PE investors. These include Fund Managers, Senior Analysts and CEO’s.

Due to the exploratory nature of the study representativeness of the interviewees is of less concern. Thus, the convenience sample should have less impact on the outcome of the study.

## 3.5 DATA SOURCES AND COLLECTION METHODS

### 3.5.1 DATA SOURCES

This section describes how the data was collected and the methods that were used. There are many ways to collect data in a qualitative and exploratory study, such as: interviews,

observations, document analysis or focus groups. This study used two different methods of data collection: a literature study and in-depth interviews, both presented in the described order.

By conducting a literature study before drafting the questionnaire the main topics were chosen, with support of the general and specific objectives. Since the study has adopted an exploratory approach the questions changed over time, especially after the first few interviews. This is in accordance with what Saunders et al. express (2007, 134). They argue that when conducting exploratory research, the researcher ought to be willing to change his/her direction as a result of revelations of new data and new insights.

## 3.6 METHODS OF DATA ANALYSIS

This section describes how the both the primary and secondary data was analyzed. Descriptive analysis was used to analyze the data. Descriptive analysis refers to the transformation of raw data into a form that would provide information to describe a set of factors in a situation that will make them easy to understand and interpret. The data, which were collected through interview literature review, were analyzed qualitatively. It is divided into two sections: the interview analysis and the literature analysis.

### 3.6.1 INTERVIEW ANALYSIS

All interviews were recorded and transcribed, in order for the authors to analyze the material in an effective manner. The transcriptions of the interviews were made word by word as they were stated. Sentiment such as laughter or other expressions were also noted.

The data was first comprehended by thoroughly reading through all the interview transcripts. The information was then sorted in Excel, separated based on the prepared and follow-up questions posed. In excel the answers were color coded, depending on the type of institution that answered. Each category, grouped together based on the original questionnaire, was then studied with the synthesized information related to that category.

The most interesting quotes were picked out. In order not to miss any information search words related to the category were used. For example, *challenge* was used when analyzing what the interviewees said about challenge in the PE market. When needed the recordings were restudied to get a better picture. The information gathered was synthesized and analyzed to see if there were any patterns or other interesting findings. Finally, the results were discussed and generalized in order to find new, perhaps better frameworks for future research.

### 3.6.2 LITERATURE ANALYSIS

The literature found was read thoroughly by the author. Each author marked thesections of the texts that they found particularly interesting and relevant. This was primarily done in Adobe Reader by using the built-in marker function. In printedmaterial a pencil was used. Notes were then compared and discussed; content of the different literature sourceswas also compared to note what was most relevant. More recent sources were given moreemphasis.

### 3.7 ETHICAL CONSIDERATIONS

Ethics are norms or standards of behavior that guide moral choices about our behavior and our relationships with others. The goal of ethics in research is to ensure that no one is harmed or suffers adverse consequences from research activities (Cooper and Schindler, 2003). Obeying ethical rules is vital in conducting research. Hence, the following ethics were considered while conducting this research.

Informants were provided detail explanation about the overall objective of the study ahead of time. Participants of the study were informed that the data will be used only for the intended academic purpose and respondents were inquired in highly respected manner.

### 3.8 DATA CREDIBILITY

This section elaborates on the credibility of the methods through two differentperspectives: reliability and validity. Research need to stand up to close scrutiny bytesting the evidence and conclusions through these two views (Raimond, 1993)

#### 3.8.1 RELIABILITY

According to Collis & Hussey (2014, 52) 'reliability refers to the precision and accuracyof the measurement and absence of differences if the research were repeated.' One needsto ask if the results can stand thorough scrutiny.

In order for the results to be replicable the interview guide is enclosed in appendix8.1. That being said, one should keep in mind that the interview guide consists of open-endedquestion, hence every interview might bring different results - if the study was tobe repeated other results are likely. Follow-up questions differed depending on theanswers of the person interviewed and are therefore not included in the questionnaire.

Because the interview questions were changed during the course of the study it might be difficult for future researchers to pose the exact same questions and change the questionnaire in the same way. Furthermore, the responses of the interviewees may be interpreted differently depending on the interpreter. Key data and quotes were verified with the interviewees to minimize the risk of any faulty information. The author of this study has to the extent possible tried to keep in mind, both during interviews and when designing the questionnaire, that interviewees want to present themselves and their employer as positively as possible and that everyone has an agenda.

### 3.8.2 VALIDITY

Validity is to what extent a test measures what it aims to measure and to what degree the results reflect the phenomenon studied. (Collis, 2014, p. 53) When conducting qualitative research based on in-depth interviews validity is normally less of an issue compared to quantitative research. By not steering the interviewee in a desired direction, but rather let him or her speak freely validity is improved. (Holme, 1997)

In order to ensure the highest possible validity for this study, leading questions were avoided. The aim was to let the subject speak his or her mind as freely as possible, while still acknowledging the fact that he or she could have objectives conflicting with those of the study. To strengthen the validity of the study three forms of triangulation were used: Data triangulation, mixed methods and investigator triangulation. Data was taken from several sources and gathered in different ways. Secondary data was found in the literature and primary data was obtained in the field. The data was then analyzed by the author; thus, two points of view were considered and consequently investigator triangulation was used.

There may be errors in which the way the questions were posed that could have led to ambiguous answers, which might affect the validity. Also, it is possible that the respondents could have been emotionally distressed or have had their minds elsewhere and therefore not delivered the most accurate answers. While the former was handled by carefully going through the questionnaire before each interview, the latter is hard to address.

A limitation with this study that could affect its validity is that the sample is a convenience sample rather than a random sample. Interviewees at different firms did not always have equal seniority and could therefore have different levels of insight.

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# CHAPTER FOUR

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## DATA PRESENTATION, ANALYSIS AND FINDINGS

Below the findings from the conducted in-depth interviews are presented. First some quantifiable data deemed relevant is presented to give a rough overview of the companies whose representatives have been interviewed. Afterwards more detailed qualitative results are described. In addition to this some other qualitative results are laid out as well. The results of the interviews are compared with the data discovered in the literature study and followed by topics that the author found interesting. Together these results give the reader insight into how PE investment will have benefit to Ethiopia and comprehend major challenges for private Equity investment in Ethiopia particularly from Fund Manager Perspectives.

### 4.1 GENERAL PRACTICES OF PE FIRMS IN ETHIOPIA

Private equity companies were interviewed regarding their experience, investment size, sector preference, preferred portfolio stage development, post investment services, and exit strategy;

Based on the data collected from interview, there is only one company that has more than five years of experience in private equity in Ethiopia, the rest had from 2 - 4 years. Regarding investment size of private equity firms in Ethiopia, it ranges from USD 300,000 to USD 15,000,000. One of the private equity firms targets mostly small and medium size with an investment that ranges between USD 300,000 to USD 2,000,000. The remaining minimum investment requirement is higher than USD 2,000,000.

Most private equity firms invest a large amount of capital (Dalberg, 2011). This is due to the large transaction cost incurred during the due diligence process. The exception for one of the private equity firms in Ethiopia is due to the partnership with developmental agencies to cover their transaction cost incurred during the due diligence process. Eighty Percent of the private equity firms are willing to invest in sectors that are open for foreign investment. Some of the private equity investors prefer to invest in fast moving consumer goods due to the fact that

government supports such sectors. Others are open to sectors that are allowed for foreign investors except real estate, primary agriculture, mining and hotels.

Regarding portfolio stage development, 99% of private investors prefer growth/expansion stage. Typically, private equity firms prefer companies with a track record minimum of at least 2 - 3 years of operation and with good growth prospect. Based on an interview with one of the private equity firms, there was an exception made to this requirement. The company that received a private equity investment at an early stage was due to the experience of the entrepreneur in the sector. In addition, the product they were manufacturing was a value addition to the previous product they were marketing.

All private equity firm works with the companies in an effort to increase the value of their portfolio. The private equity firms work with their portfolio to restructure the business, source raw material, market penetration and improving the corporate governance systems. One of the private equity firms gives a post investment service to restructure the finance, marketing and governance units of the company. Private equity firms typically exit their investment after 5 years. Some of the firms hold their investment for a maximum of 10 years and a minimum of 3 years. The major decision to hold the investment or to sell is determined by the amount of price the business can generate at the time of the sale.

Ethiopia's large population, expansion of infrastructure and high economic growth rate were means that a lot of investors are present. The field is perceived as especially crowded when it comes to investments in the growth stage. Other investors surveyed point out Ethiopian cultural differences between the East African countries as an advantage.

In the period from 2000 to 2016, Ethiopia averaged annual GDP growth of 9.2%. The country has seen significant investment in infrastructure, with recent projects including the Addis Ababa-Djibouti standard gauge railway; a metro line in the capital; and the 6,000MW Grand Renaissance Dam hydropower facility, which is currently under construction. The government is also encouraging investment in the manufacturing sector through attractive incentives and the construction of industrial parks. H&M and Tesco are already sourcing garments from the country,

A local PE representative said that people in Ethiopia compared to some of its neighbors are generally easier to do business with. It is Populous & ethnically-diverse Country Facing drastic economic expansion. Types of equity investment vary based on the firm stage (start-up, early stage, growth and expansion/diversification). Ethiopian companies' dominant source of capital is own means with the limited other access like equity or debt finance instruments. (GIIN, 2015).

Most PE investors are interested in the stage where they can relay and harvest their return (financial and impact-employment, environment) in companies at the growth stage. Companies at the growth stage typically have certain attractive attributes for many investors. They have a product; it has been tested and they are now selling that product; they are generating revenue through sales (post-revenue); and are seeking to expand their business operation in their market

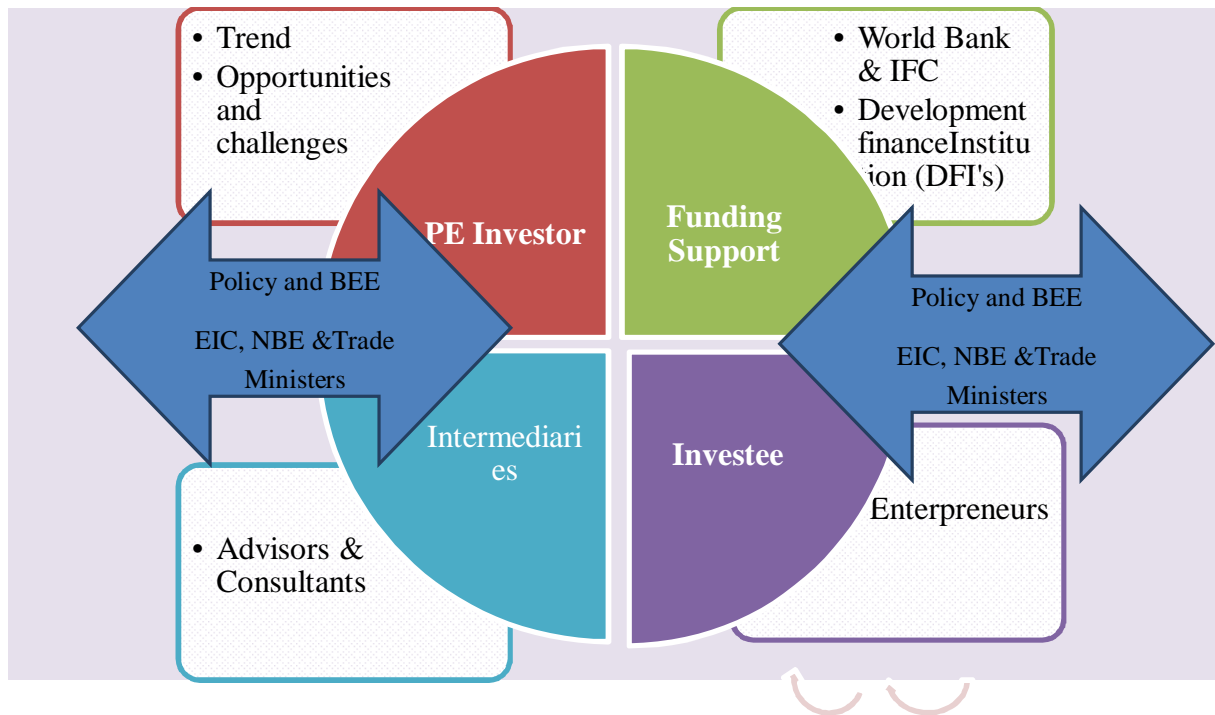
The private Equity investors also identified actors of Private Equity investment. These include PE investors, investees and intermediary players, and the overall policy ecosystem. Figure 4.2 investors', investees' and intermediary players' perspectives, and the overall policy ecosystem.

There are many types of intermediary organisation in the country, providing different services to facilitate PE. These include specialised fund management firms, different types of consultant and NGOs.

Some of the intermediaries focus on the early stage of companies, starting with incubation service provision. Intermediary organisations, such as Blue Moon, X-Hub and Precise Consult, incubate companies in different sectors, including agribusiness. In addition to providing working space, guidance and mentoring, these organisations broker links between entrepreneurs and potential investors.

As observed in other countries, most investors in Ethiopia are focused on the growth or expansion stage of companies, rather than at the incubation or early stage. There are NGOs and donors that support such kinds of intermediary services by covering the technical support costs and making available some type of grant or seed money. There are very few PE venture capital funds that invest in the early stage of companies, although there are some, such as Nova Star ventures. Taking higher risks, such companies expect higher returns, both commercially and in terms of social impact.

**FIGURE 4.2. PE INVESTMENT ACTORS**



Source: Researchers own Customize

## 4.2. BENEFITS OF PRIVATE EQUITY INVESTMENT

### 4.2.1. BENEFITS OF PRIVATE EQUITY INVESTMENT TO ETHIOPIA

The private equity firms were interviewed about how private equity investment benefits Private companies in particular and Ethiopia in General. The opinions vary among the surveyed actors in Ethiopia's investing space on how PE investing can benefit Ethiopia. While all the PE investors interviewed claim that they have a way in strengthening industry and private sector, economic growth through contribution of GDP, fill the gap of source of financing and supply of foreign exchange.

The examples of Brazil and China provide insight into the types of economic development and private equity can foster and support in the Ethiopian context. The catalysts that are needed

include a continued increase in government investment in infrastructure combined with access to capital by the private sector. Given the right planning and investment, Ethiopia's economic complexity will most likely look like a hybrid between China, given the emphasis on growing manufacturing, and Brazil, due to the ability to significantly increase agricultural production. Achieving that sort of mix would certainly push the country to becoming not only industrialized but on a solid path to becoming a middle-income country. (UNDP, 2013)

Ethiopia is one of the world's fastest growing economies and has ambitions to continue its rapid rise as evidenced by the goals outlined in the GTP II. However, the country's commercial banks lack the capital or capacity to fund the growth needed for private sector growth, and the Development Bank of Ethiopia (DBE) does not have the capacity to provide the only source of substantial capital for the private sector if Ethiopia is to meet its GTP II goals. (African Economic outlook, 2019)

Private equity offers alternative source of finance, especially in developing countries like Ethiopia, financing is one of the major challenges for growing businesses. In Ethiopia, Only banks and small and micro finance institutions provide capital. However, huge collateral is required to secure funds from banks, which is not feasible for most businesses.(GIIN,2015)

Private equity provides the solution by offering growth/seed finance for worthwhile and investable companies. Private equity can complement the work of the domestic banking sector. Private equity firms can support different business and reduce investment risks by working alongside commercial banks.

The following includes benefits of private equity firms without affecting domestic banks:

- Owners of the companies may not have collateral to access debt financing from banks, therefore, by giving up part of their ownership the companies can access private equity investment. Bringing in much needed capital to the business community improves corporate governance system of businesses (modernizes business administration system), if successful companies grow (private equity firms offer additional services to portfolio companies, which otherwise are not available in the country or are expensive).
- Creates employment opportunity and revenue for the government.

Private equity can also be a valuable source of foreign exchange for the country. The source of foreign exchange can be from both foreign funds that enter the country through injection of capital or shareholder loan as well as export revenue generation and import substitution. (AVCA, 2017)

Fifty Percent of PE firms claim that PE firm is source of foreign exchange for the country. They want to be able to generate their own foreign currency because it is one of the big issues here. Ethiopia has a lot of seeds, grains; has a lot of potential in raw materials that instead of being exported raw, it can be transformed into a product with a high value addition for the local market and for export. Many of the PE firms bring their own dollars instead of cueing at the banks and so on. Their next step is to generate dollars from export.

#### 4.2.2. BENEFITS OF PE FIRMS TO PRIVATE COMPANIES

Private Equity in Ethiopia has different roles in the local investing market: partly as asset owners investing in funds, partly as direct investors, funding companies through equity.

Several PE investors claim that Private equity is a great way for a company to achieve success, as well provide the business with a stable background for making decisions based on strategy. Companies that are backed by private equity will usually grow much faster than other types of businesses. This is due to the combination of capital and experienced management skills that come from company's executives to set different types of financing from private equity investment. This will improve the overall business of the company by introducing an improved system, new ideas to help grow the company, increase the capacity of the company in both production and services (UNDP, 2013)

According to the executive director of one interviewed PE investor, their role as investors in the business have the ability to influence them to adopt practices and methods that improve business & operational process. Representatives for the PE interviewed for this study emphasize that the goal is not to force funds to adopt new guidelines and report systems just to satisfy investors, but to persuade the business owners that embracing standards and developing report systems actually creates long-term value.

Many private equity investors have successfully raised technical assistance facilities for portfolio companies (Giin and Open Capital, 2015). Increasingly, technical assistance funders recognize the importance of pre-investment support to get companies to the point where they can pass rigorous investment committee requirements. Targeted, tailored support, whether from the private equity investor or a third party, requires an upfront commitment of resources. In Ethiopia it has reportedly proven effective in preparing potential targets for investment and building high quality deal flow (Giin and Open Capital, 2015). This can reduce due diligence timelines if the investor is able to increase familiarity and visibility pre-investment in order to assess the company's operations and ability to execute.

### 4.3. CHALLENGES OF PRIVATE EQUITY INVESTMENT

While the macroeconomic benefits for private equity in Ethiopia is clear, there are challenges that the industry faces when it comes to investing in the country. Accordingly, the following challenges were identified.

#### 4.3.1. CHALLENGES FOR PRIVATE COMPANIES

Some key challenges private companies face includes dilution/loss of ownership stake, loss of management control and lack of understanding of private equity investment.

Several PE investors claim that private owned companies are afraid to engage with PE firms because of dilution/loss of ownership stake in their company. Only few private companies see the value of bringing on outside investors to grow their company, even though it means they lose partial ownership of their company.

In private equity investment, the companies get more money but usually have to give up a much larger share of their business. Private equity firms often demand a majority stake, and sometimes the company owners are left with little or nothing of the ownership. For a company to be suitable for private equity, it is also necessary that private equity fund is able to have significant influence over decision-making process.

Private equity is not passive equity. For private equity fund, it is more certain that value can be created and an exit achieved in a limited time period if the fund has either outright control of a company or a minority position with significant control-like rights through a shareholders'

agreement. For private equity to take root there must be a large group of owners of companies who are willing to give up total or partial control of their companies. It is not only enough that owners of companies would like additional equity financing. They need to be prepared to give up some degree of control to obtain it. It's a much bigger trade, and it's one that many business owners will hesitate to accept.

The surveyed PE firms also claim that Private companies are not comfortable engaging with private equity firms because of loss of management control while some of the Private companies consider this as an opportunity to institute changes in the enterprise.

The management/owners can lose control of the direction of the business. The private equity firm will want to be actively involved; and that can be a good thing. But it can also mean losing control of basic elements of business-like setting strategy, hiring and firing employees, and choosing the management team. (Locke, 2013)

Some of the other options involved include relinquishing control, but because the private equity firm's stake is usually higher, the loss of control is much greater. This is especially true when it comes to the private equity firm's "exit strategy." That may involve selling the business outright or other options that don't form part of your plans. (Locke, 2013)

According to the PE investors, privately owned companies had difficulty of understanding private equity investment, how they operate and what they expect from companies they invest in. However, some of privately-owned companies had a fair understanding of how private equity firms operate due to the previous exposure and educational background.

Ethiopia has attracted large inflows of donor funding from multilateral aid agencies and foundations. Investors report that decades of grant funding have considerably diluted Ethiopian entrepreneurship and understanding of investment (Giin and Open Capital, 2015). Seeking grants remains the default for many companies, which often specifically position themselves to be attractive to grant money. Private equity investors need to ensure that businesses are sufficiently educated on the private investment process and the value it can provide. Furthermore, private equity firms are looking for particular types of companies to invest in. They have to be large enough to support major investments, and also, they have to offer the potential for large profits in a relatively short time frame. Generally, this means either the company has very strong growth

potential or the company is under financial difficulties and is currently undervalued. A business that can't offer investors a lucrative exit within about five years will struggle to attract any interest from private equity firms.

In addition, there are common mistakes that PE investors claim when companies approach private equity firms. Initially, when entrepreneurs in Ethiopia approach investors, it is at an early stage. Some of them do not have a company; they may have an idea or a product, not a company. The opinion of informants is companies/entrepreneurs should look for private equity investment at a growth stage. Investors weigh many risks before making decision to invest including the business risk. They can reduce such a risk and offer attractive returns only when they have proven track record of sales. Seed investment is very risky in countries like Ethiopia where there are no strong regulations supporting proprietary rights or consumers do not respond quickly. All components of the company i.e. its product, process and management must be developed before going out to raise capital from private equity firms. Second, entrepreneurs do not prepare well when approaching investors. Companies approach PE's without clear growing direction. Lack of basic understanding their own business and fail to answer questions. Most companies do not have a business plan or a strategy paper. Even if they do, the projections in the plan are unrealistic.

#### 4.3.2. CHALLENGES FOR PRIVATE EQUITY FIRMS

Some key challenges private equity investment firms face include exit options/strategy, currency convertibility, closed financial services sector, dominance and complexities of family-owned businesses, and the size of existing enterprises.

According to an interview with private equity firms, several of the respondents have a challenge finding a company to invest in due to mismatch between capital investment and size of the enterprise. The rest of the respondent's investment range starts from USD 300,000, which can accommodate small and medium sized companies.

A constant challenge that investors face is that they cannot find businesses that are large enough to invest in. The due diligence and continuing logistical and executive support associated with any private equity investment creates significant transactional costs. Often times, this is tied to the fact that most of the businesses are family-owned and managed. The size of most businesses in Ethiopia is still relatively small. The private equity firms indicated that the investment they

seek to make is with a range of USD 3 million – USD 15 million. An exception to this one few private equity firms seeks a minimum of USD 300,000, which shows private equity firms have an appetite for small business if the long-term opportunity is large enough.

A number of investors require investees to have a capital requirement of more than USD 3 million, which is difficult for many businesses. Senior analyst of one PE firm said that the monetary values that owners place on their businesses often vary significantly from professional estimates, and owners are therefore reluctant to agree on the estimated value. The issues here may relate to business recording and value of Fixed Assets, or significant hidden costs incurred in the business that are undocumented. These can lead to valuations that underestimate the value of the business and there by not meet owners' expectations.

According to an interview with private equity firms, some claim that exiting option is barrier for PE investment in Ethiopia.

One of the key criteria that investors focus on when assessing an investment opportunity is their exit strategy. There are several forms of exit strategies besides initial public offerings. However, most other options (outside of selling to another private equity fund) also require a vibrant private sector. Given Ethiopia is still in the early stages of developing a vibrant private sector, equity investor's face a number of challenges. That said, these are sophisticated investors that navigate a myriad of country conditions. Given the right opportunity, it is a challenge they can address through lengthening the anticipated time horizon of their investment. Lack of exit options found in this study is consistent with the finding by Dalberg (2011).

According to this paper, it can be explained that lack of exit options in developing markets are amajor challenge for private equity investment. Furthermore, the lack of capital market in Ethiopia limits the initial public offerings option available to investors.

A number of respondents have a fear about repatriating their capital investment due to foreign currency shortage. Article 26 of the Investment Proclamation 769/2012 provides foreign investors with capital repatriation right, provided that they observe the necessary requirements for foreign investment, to remit out of Ethiopia in convertible foreign currency (i.e., to repatriate) at the prevailing exchange rate profits and dividends accruing from investment, principal and

interest payments on external loans, and certain other specified payments and proceeds related to the investor's economic activities in the country.

While it is legal for foreign investors to repatriate their profits, the repatriation of profits continues to be a concern for most private equity due to currency convertibility constraints coupled with the constant shortage of foreign exchange reserves. This poses a challenge since an increase of private equity flows can potentially help increase foreign exchange reserves, but the current lack of reserves signals a warning sign for those interested in repatriation of profits.

According to an interview with private equity firms, more than 50% of respondents face a difficulty of registering capital. Private equity firms are currently taking multiple trips to Ethiopian Investment Commission to register a capital. The improvements made by the Ethiopian Investment agency; process is a welcoming improvement in the registration of foreign investment. However, private equity firms have to take multiple trips over a course of ten days to two months. Staff at the various government agencies have varying levels of understanding about equity investing and, thus, provide instructions and interpretations on the applicable laws that are, at times, inconsistent.

Finally, notaries public undertake lengthy, substantive reviews of investment documents, despite often not being trained in finance, securities or investing. The result is a process that has the characteristics of a "black box" such that private equity investors are unable to structure investments in a way that they can reliably assume will be approved.

A number of the respondents have a challenge of finding a suitable company to invest in due to complexity of family owned business. The challenges of family-owned businesses and size are inter-connected. Most businesses in Ethiopia are family-owned. Families are very protective of their finances and therefore view private equity as intrusive. There is also a lack of accounting transparency, which often causes problems during the due diligence process. Trying to generate relatively close reflection of most companies is very difficult.

As commented by one of the informants, engaging with family-owned businesses requires investors to develop greater levels of relationship- and trust-building. This takes time, and as a result, numbers of deals that have been done in the country to date are fewer than expected

compared to similar-sized developing economies. Most deals closed in the country passed with the help of a trusted intermediary.

To mitigate this, private equity firms might build close relationship with the management team, but this takes time. Even then, most owners/managers have exaggerated perception of their companies' value. They rely on hockey stick projections and inflated asset values. This makes negotiation time-consuming, and sometimes unsuccessful.

This finding is consistent with Laura and Anna (2013), McNellis (2009) and Kropp (2010). According to these reports, most family owned business discloses very little information on their activities. In addition, the absence of mandatory reporting obligations and lack of publicly available information biases the reporting returns to investors.

Some of informants have a challenge to evaluating company during the due diligence process due to inaccurate and inconsistent financial statement. There is a considerable quality variation in financial reporting by privately held companies. Part of this inconsistency appears to be caused by the lack of a common set of standards applied in the Country. Inconsistency and unreliable financial information generate a lack of confidence for private equity firms on privately held companies. In addition, private equity investors unanimously lament the informality of financial record keeping, especially in smaller businesses. Corporate bank accounts and personal bank accounts are often mingled, even for large businesses. Most businesses are family-owned and struggle with transfer pricing between sister companies. This creates private equity firms to have a doubt in the quality of earnings, reporting of net income and dividends. However, this can be improved with current implementation International Financial Reporting Standard for Business Enterprises.

Someof the respondents have difficulty in operating in Ethiopia due to constant changes and restrictions of investment areas. The PE investors claim that this creates a difficult environment for private equity investors to increase their portfolio variety and actively engage in investment. In addition, unpredicted arbitrary changes in regulations produce uncertainty and present private equity firms with risks such as revenue loss and inability to expand their business or investments as planned. For example, government cancellation of business and investment licenses changes in the sectors open to foreign investment, and limitations on the issuance of business licenses to foreign firms, among others.

This finding is consistent with Dalberg (2011). According to this paper, regulation restriction limits the growth of the private equity investment, because capital is prevented from flowing into countries. Furthermore, the close of financial sectors due to fear of abuse contributes for the underdevelopment of financial sector, which leads to difficult capital inflow.

The investment areas that are allowed for foreign investment are widening from year to year, with significant decisions made by the government that include opening business areas that were exclusively reserved for government investment. As per the Investment Proclamation of 2012, there are areas that are still not open for foreign investors, as listed below, although some have now changed because of recent government decisions.

**Areas exclusively reserved for the government:** Postal services, except courier services; transmission and supply of electrical energy through the Integrated National Grid System; passenger air transport services using aircraft with a capacity of more than 50 passengers.

**Areas reserved for joint-venture investment with the government:** production of weapons and ammunition; telecommunication services.

**Areas exclusively reserved for domestic investors:**

- export of raw coffee, khat, oil seeds, pulses, precious minerals, natural forestry products, hides and skins bought from the market, and live sheep, goats, camel, equines and cattle not raised by the investor
- import trade (excluding LPG and bitumen)
- wholesale trade (excluding supply of petroleum and its by-products, as well as wholesale trade by foreign investors of their locally produced products)
- manufacturing of ice cream and cakes; finishing of fabrics, yarn, warp and weft, apparel and other textile products by bleaching, dyeing, shrinking, sanforising, mercerising or dressing; tanning of hides and skins below finished level; manufacture of cement; manufacture of clay and cement products
- tour operation below grade 1; construction, water well and mining exploration drilling companies with below Grade 1

- kindergarten, elementary and junior secondary education by constructing own building; diagnostic service by constructing own building; clinical service by constructing own building
- capital goods leasing (this does not include leasing of motor vehicles)
- Printing industries; manufacturing of plastic shopping bags; manufacturing of corrugated metal sheet for roofing and nails.

**Areas exclusively reserved for Ethiopian nationals:** banking, insurance, micro-credit and saving services; broadcasting and mass media services; attorney and legal consultancy services; preparation of indigenous/traditional medicines; advertisement, promotion and translation works; domestic air transport services using aircraft with a seating capacity of up to 50 passengers; packaging, forwarding and shipping agency services.

Some of the PE firms also mentioned the recent political instability caused by ethnic groups as a challenge for their investment. One of surveyed informant says period from 2016 to 2018 was a difficult period for the country. However, he views social instability as a side-effect of economic growth. “We’ve seen quite a bit of rioting and... land issues and other that come as a result of economic growth. But we’ve seen that stabilize again. And our prediction is that things will go back to normal.”

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# CHAPTER FIVE

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## CONCLUSION AND RECOMMENDATION

### 5.1. INTRODUCTION

The previous chapter presented the analysis of the findings and discussions of the study. The purpose of this chapter is to discuss the conclusions and recommendations. Accordingly, the chapter is organized in two sections, the first section presents the conclusions of the study and the second section presents the recommendations provided based on the findings of the study. In addition, the limitations and directions for future research are also presented.

### 5.1. CONCLUSIONS

The private sector will need to play a critical role in meeting the large financing needs for sustainable development. However, source of finance to help the growth of private sector in Ethiopia is limited to the country's commercial banks, which lack the capital or capacity to fund the growth needed for private sector. (World Bank Report,2019) Therefore, private equity investors have been looking towards greatest potential to finance sustainable development. However, Ethiopia is currently one of the lowest recipients of private equity capital on the African continent. (AVCA, 2016)

Most funds have a regional or sectoral focus, and those with an East Africa focus are heavily invested in Kenya, Uganda, and Tanzania (AVCA, 2016). The General objective of the study was to assess the Practices, Trends and challenges of private equity investment in Ethiopia. The specific objectives of the study include, identifying major benefits of private equity investments in Ethiopia; identifying the major challenges for privately owned companies in private equity investment from Fund Manager Perspectives.

In order to achieve the objective of this study, data were collected from both primary and secondary sources. The primary data were collected from 20 private equity firms that have made investments in Ethiopia.

Private equity funds are attracted to economies with vibrant private sector. In order to competitively attract a sizeable share of global equity funds into the economy, Ethiopia needs to deepen its private sector development and build a dynamic entrepreneurial base (UNDP Ethiopia, 2013). This will benefit privately held companies in particular and Ethiopia in general.

In addition, this paper found that private equity investment benefits privately held companies through developing the companies; creating employment opportunity and bringing international exposures; and leveraging technical assistant facilities.

It is important to note that private equity is not a closed form suggestion but rather an adoptive system that is good at applying the core values of investing within a local economy (UNDP Ethiopia, 2013). Given this fact, Ethiopia is at an appropriate moment where its economy is growing rapidly and can benefit from measures aimed at promoting smart and long-term capital flows to finance the GTP. Creating the right framework to encourage private equity investments that are in line with the growth plans of the country will be highly beneficial. Ethiopia can foster the private equity investment flow to create opportunities for privately owned companies to grow. This potential is also an opportunity to earn foreign exchange and contribute for the development of the national economy. Thus, private equity investment could directly contribute to the growth of privately-owned companies as well as benefit Ethiopia's economy. The growth of private equity investment in Ethiopia will open up new opportunities to privately owned companies and the country.

However, challenges remain to keep Ethiopia from capitalizing on these growth opportunities. The major challenges identified for privately owned companies include lack of understanding of private equity investment; dilution or loss of ownership stake; and loss of management control. In addition, lack of exit options, risk of capital repatriation, difficulty to register capital, complexity of family-owned businesses, size of exiting enterprise, lack of financial reporting standard, and regulation restriction and modification were identified as challenges more specific to private equity investors.

Alleviating the challenges private equity investors face will create a system in which deployed capital has a greatest chance of succeeding, That development will not only translate to success for the investor but also contribute to the growth of the Ethiopian economy and the realization of the GTP goals (UNDP Ethiopia, 2013). There are many global examples of development patterns

that have leveraged private equity flows to support country-specific growth and industrialization patterns. In this report, the cases of China and Brazil were briefly reviewed, to offer unique examples that Ethiopia can reflect and build on to create its own framework and strategy to attract private equity to boost domestic financial resources for investment.

Ethiopia can proactively develop a deliberate policy to attract private equity funds and putting the right legal and institutional framework that encourages orderly entry and exit of capital, and promotes longer-term sustainability of private equity funds in the country. In addition, there is a need to consider the major challenges identified from this study.

## 5.2. RECOMMENDATIONS

Ethiopia can proactively prepare itself for, and encourage, the flow of private equity funds into the country by crafting the right policy and regulatory framework. It must think very strategically about the creation of a strong private sector in order to maximize the opportunity associated with private equity investments. In developing a framework, Ethiopia must take into account the following minimum conditions required for a robust private equity and venture capital sector.

**a) Exit Strategies:-**The lack of a stock market presents a ready challenge to private equity investors in Ethiopia, but as outlined above, there are multiple strategies that can be applied. Ethiopia's sizeable current account deficit and frequent shortages of foreign currency reserves will be a concern for private equity investors, and a challenge for the government of Ethiopia to address as it seeks to attract greater private equity flows. The net benefit to the current account deficit however is clear. First, private equity firms generally look at investing in companies that are export oriented or substitute imported goods. Therefore, over the 5-10-year investment period most of these investments will have more than accounted for their exit price in foreign currency through the dollars revenues they would have generated. Second, successful private equity engagements where investors have smooth access to repatriated funds often result in larger subsequent rounds of investment in the economy reducing the pressure on the country's foreign exchange needs.

**b) Ease Capital Repatriation:-**While it is legal for foreign investors to repatriate their profits, the repatriation of profits continues to be a concern for most private equity due to currency convertibility constraints coupled with the constant shortage of foreign exchange reserves. To

mitigate this risk, the Ethiopian National Bank publishes their track record of paying remittances, including processing time. This would provide investors with some assurance that they also will be able to repatriate repayments of principal and profits.

Provide foreign investors with means of registering their investment properly after the fact if they failed to do so properly at the time of their initial investment. Private equity investors have heard stories of foreign investors not being able to repatriate their funds occurred when the investor discovered only years later that they did not register the investment or that the attempt to do so was unsuccessful. These stories continue to discourage other prospective investors.

**c) Improving Registration Process:** - Investors take multiple trips over a course of ten day to two months to register a capital. To enhance this process, training government officials responsible for registering foreign investments for consistence decisions and instructions and reducing the number of agencies responsible for approving investments is important. In addition, restricting notaries to ensuring the authenticity of documents, so that they do not hold up the investment process with substantive reviews of investment documents (which is performed by the Ministry of Trade and Ethiopia Investment Authority).

**d) Support Improvements of Financial Reporting:-**Increasing the role of the Ethiopian Professional Accountants and Auditors Association (EPAAA) in providing regular training of auditors and accountants and expanded oversight is essential. The EPAAA or similar body might consider the means of increasing its oversight of auditors and accountants to ensure that they are consistently applying International Financial Reporting Standards (IFRS) and imposing penalties for repeat offenders. In addition, providing training to companies and other users of financial statements on IFRS so that demand drives improvements in the quality of financial reporting. Furthermore, private equity firms require high financial reporting standards. There is both a regulatory and self-interest element that motivates this requirement. From a regulatory perspective, private equity firms have domestic reporting requirements that they will pass on to portfolio companies. From a self-interest perspective, private equity firms as partners in business will be concerned to their portfolio companies and need to competently account for all the company's economic activities.

e) **Policy Consistency:**-Private equity companies are sophisticated investors that operate in challenging country environments and are able to adapt to varying country conditions. That said, because of the extended length of their investments, one of the minimum conditions they require is a consistent policy framework to operate. This applies both to the mobility of capital as well as operating regulations, which impact their portfolio companies. To reduce policy inconsistency, providing additional notice periods of regulatory changes so that investors and business owners can plan accordingly is highly essential. In some cases (for instance, the closing of a sector to foreign investment), issuing adequate notice may be several years. In addition, soliciting public comment on regulatory changes and incorporate feedback into the final bill. Continue robust oversight of regulatory agencies to reduce risks of corruption and to ensure that regulatory changes reflect economic realities and serve the public interest, rather than those of individual regulators or their patrons.

### 5.3. LIMITATIONS AND DIRECTIONS FOR FUTURE RESEARCH

Although this study achieves its main objective, it is also with some limitation that suggest for future research. The first limitation is the study used samples from companies, which have so far received investment only. There was no consideration of privately-owned companies who have failed to receive private equity investments and those who did not attempt to access private equity investment were not included in the sample size. In addition, in order to identify the major benefits and challenges of private equity investment the researcher depended more on the qualitative data analysis. Based on the findings in this study, future quantitative research can be conducted on the following issues. For instance, this study identified economic growth, alternative source of financing, and foreign exchange as benefits to Ethiopia from private equity investment. For future research, other researchers can measure how private equity investment helps Ethiopia in economic growth; improving alternative source of financing; and also becoming valuable source of foreign exchange.

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# APPENDIXES

## STANDARD INTERVIEW QUESTIONNAIRE

### Introduction

- Presentation of our thesis
- Short introduction of interviewee and the business he/she represents

Main questions for Fund Managers

### *Company specific questions:*

1. Are you PE investor?
  - How do you define PE Investment?
2. Number of Years of experience in Ethiopia?
3. In what stage do you preferably invest?
  - Why?
4. Have you made any exits?
  - What is your typical exit strategy?
5. Are there particular sectors the company invests in (such as technology, agriculture, healthcare...)?
6. Is there any post-investment service your company provides?

### *Ethiopia specific questions on PE investing climate:*

7. What is your general view regarding Private Equity investment in Ethiopia?
8. What are the factors that drives you to make Private Equity investment in Ethiopia?
9. At what stage do you think companies should look for an outside investor to raise capital?
10. Do you think private equity benefits a country's economy? If yes, in what ways?
11. Are there any intermediaries in the country that give service for PE firms? What is their roles?
12. In your Opinion what are the major challenges a private companies face when approaching a private equity firm? And how do you think they can overcome that challenge?

13. In your Opinion what are the major challenges a PE firm face while investing in Ethiopia? And how do you think Ethiopia can overcome those challenges?
14. Based on the investments you have done, what factors do you think are most important for the outcome your investments?
15. How do you think government should support PE firms to facilitate smooth functioning of their work?
16. Is there anything that we have not touched that you would like to add?