Development Brief

Towards a Framework for Attracting Private Equity and Venture Capital in Ethiopia

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I. Introduction

The African continent is increasingly viewed as having the strongest overall investment potential of all emerging markets globally. The African economic growth story is one that continues to make headlines throughout the investment community, and investors are no longer simply focused on natural resources but have a desire to participate in the growth of Africa’s emerging middle class. As a result, institutional investors plan to significantly increase their asset allocation in African markets over the coming five years. Recent surveys conducted by The Economist suggest that by 2016 all major institutional investors expect to have some exposure in Africa1.

What is encouraging about this trend is that investors are not simply focused on short-term yields but are rather moving towards longer-term investment strategies for Africa. When looking at flows into African capital markets over the last four years, it is apparent that institutional capital has taken the place of retail money that was exiting. This change in behavior has been driven by both a change in the perception of Africa as well as increased volatility in the markets, which requires investors to have much longer-term views.

While some of this new capital will come in the form of investments in publicly traded stocks, it will mostly come in the form of private equity and venture capital because of the limited size and depth of most African stock markets. To put it into perspective, of the 45,000 funds with $17.5 trillion under management that EPFR Global (a leading provider of fund flows and asset allocation data to financial institutions) tracks, approximately $2 billion has been allocated to African bonds and $800 million into African equities this year. Although Africa has benefited from the expansion of private equity into emerging markets thus far, the private equity industry across the continent remains small in comparison to the North American, European and Asian regions.

As one of Africa’s fastest growing economies and second most populous country, 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 more readily achieve the goals set in the Growth and Transformation Plan (GTP) and beyond. However, attracting these investors will require the creation of an environment that is conducive for private equity and venture capital in Ethiopia. This concept note is organized as follows. Section two briefly describes the objectives followed by definitions of private equity and venture capital. Section four dwells on macroeconomic context and the need for private equality and venture capital in Ethiopia. Section five presents trends in Private Equity and Venture Capital in Africa followed by review of lessons learned from China and Brazil. The linkage between PE and economic growth is discussed in section seven. Section eight and nine respectively deal with challenges and minimum conditions required to institute PE and VC in Ethiopia. Finally the paper gives concluding remarks.

1. Economist Intelligence Unit
II. Objectives

The general objective of this concept note is to provide background information on the fundamentals of private equity and venture capital as well as lay out a framework for how Ethiopia can proceed towards attracting private equity and venture capital into the country. It has the following specific objectives.

1. Provide background information on the concepts and fundamentals of private equity and venture capital funds,

2. Review the development, benefits and rational for attracting private equity and venture capital and draw critical lessons from China and Brazil;

3. Identify major areas of policy focus and minimum conditions for attracting private equity and venture capital in Ethiopia.

III. What is Private Equity and Venture Capital?

Private equity refers to medium to long-term private shareholder capital investment in private companies as opposed to publicly-traded companies. By raising capital primarily from institutional investors, private equity funds typically buy stakes in operating companies. The average life span of an emerging market private equity investment is five to seven years. Venture capital is a form of private equity specifically employed in the early stages of business development.

The private equity industry in emerging markets shares characteristics more common to venture capital. The main reason is that many emerging markets are in high-growth mode and are generally in the concurrent process of developing financial services market that can support rapid growth levels. Limited access to expansion capital for small and medium companies and new enterprises often lead entrepreneurs to turn to private equity investors for growth capital to fill the gap in their capital requirements. The benefits of Private equity and venture capital investment are not limited to the provision of expansion capital. From a capital perspective, private equity investments can be applied to the development of new products and technologies by setting clear innovation priorities for portfolio companies and introducing best practices to increase quality and productivity, strengthen balance sheets, or make acquisitions. Given the stage of growth that Ethiopia is currently in, combined with the fact that local banks on their own cannot meet the growth aspirations or capital requirements of local companies, private equity is an ideal form of capital injection into the economy.

Private equity firms are also actively engaged in capacity development. By actively engaging with the managers of their portfolio companies, private equity investors not only provide capital but also introduce their portfolio companies to new management practices, better financial controls, improved brand development, and enhanced corporate governance to improve performance. Private equity funds often provide more resources for research and development and can therefore help strengthen innovation. Major impacts associated with better corporate governance include the improvement of account transparency and tax disclosure by the portfolio companies due to the accounting standards that the private equity firms themselves must adhere to for their domestic reporting purposes. These capacity interventions not only enhance
the governance and operations of the portfolio company, but serve as a template of best practices for partners in the value chain, competitors, and government.

When looking at investment opportunities, private equity funds place an emphasis on exit strategies. Funds can exit portfolio companies through several avenues. These include a trade sale, whereby the fund sells the portfolio company to an existing firm that is in a similar industry, or a sale of their stake to another private equity firm. Additionally, the portfolio company itself can use its excess cash to buy out the private equity fund, or the portfolio company could go through an initial public offering (IPO) process to be listed on a stock exchange.

IV. Macroeconomic Context for Private Equity and Venture Capital in Ethiopia

Ethiopia has become one of the world’s fastest growing economies and has set forth its third edition of the midterm development strategy called the Growth and Transformation Plan (GTP). The GTP spans from 2010/11 to 2014/15 and aims to double the country’s GDP, achieve the MDGs in the plan period and expected to drive the country towards becoming a middle income country by 2025. The principal objectives of the GTP include sustaining the rapid and broad based growth—particularly transforming agriculture and strengthening investment for strong industrial sector development, improve qualities of social services and create conducive environment for the creation of a democratic and developmental state. Ethiopia also launched its Climate Resilient Green Economy (CRGE) strategy in 2011, which anchored Ethiopia’s ambition to become a low carbon emission middle-income economy by 2025.

Ethiopia has witnessed strong economic growth of over 11% in the last decade. According to the 2012 African Economic Outlook, the country is rated as one of the fastest growing economies in Africa. In 2011, Ethiopia recorded an economic growth rate of 11.4%. The services sector accounted for 46% of the GDP followed by 41% and 13% for the agricultural and industrial sectors, respectively. According to the national poverty line, the incidence of poverty has been reduced from 38.7% in 2005 to 29.6% in 2011. The country has also significantly enhanced its domestic resource mobilization with commendable improvements in tax collection and administration systems even though tax collection to GDP ratio is still below the Sub-Saharan African average. Expansion of the domestic resource base was complemented by a steady flow of external resources, including official developmental assistance of US$3.28 billion in 2011, a strong export performance of $3.1 billion in 2012, and improving foreign direct investments.

Traditional sources of investment have proven inadequate in Ethiopia, as domestic savings are very low at 8.8% of GDP and potential to raise public savings by enhancing tax collection is limited. This is coupled with modest foreign direct investment inflows on both an outright basis and relative to its neighboring countries (Figures 1-2). Moreover, credit markets are constrained by lack of liquidity and excessive collateral requirements from banks. When combined, these facts make traditional sources of financing inadequate. Thus private equity and venture capital can be a complementary source of financing going forward.

2. 2012 African Economic Outlook
Fig. 1 Trends in gross domestic saving and fixed capital formation as % of GDP

Source MoFED

Fig. 2. Trends in net FDI inflows (US$mm)

Source MoFED
V. Trends in Private Equity in Africa

Africa is now seen as having the greatest overall investment potential of all emerging markets globally. According to the IMF, seven of the ten fastest growing economies from 2011-2015 will be from Sub-Saharan Africa: Ethiopia, Mozambique, Tanzania, DRC, Ghana, Zambia and Nigeria. Recent surveys conducted by The Economist suggests that by 2016 all major institutional investors expect to have some exposure in Africa, with one third allocating 5% of their fund value to the continent. However, current allocation to Africa is less than 1% and is mostly concentrated in the natural resources sector.

There are now over 200 private equity and venture capital funds targeting Sub-Saharan Africa. This includes funds currently raising capital as well as funds that have completed their raising of funds 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, the consumer sector, and telecommunications (Table 1). 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 into Sub-Saharan Africa, it is now a minor recipient (Figure 4). The drastic relative 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 the higher yields potentially attainable in less-developed, faster-growing Sub-Saharan markets.

As one of the fastest growing economies and the second most populated country in Sub-Saharan Africa, Ethiopia should be a natural beneficiary of increased private equity and venture capital flows to Africa. However, Ethiopia is currently one of the lowest recipients of private equity capital on the African continent. Most funds have a regional or sectoral focus, and those with an East Africa focus are heavily invested in Kenya, Uganda, and Tanzania. Schulz Capital is the only fund solely dedicated to Ethiopia, with a reported $100 million under management. Given that this is the beginning of a new paradigm in Africa investing is timely for Ethiopia to develop an investment environment which will position it to become the largest recipient of private equity capital in Africa. If well prepared, Ethiopia is poised to be one of the main beneficiaries from the influx of equity and venture capital funds.

3. AfDB, Governor’s Dialogue, Long-Term Strategy 2022, Issues Paper
4. Economist Intelligence Unit
5. EMPEA, Africa Assets, Gro Intelligence
6. EMPEA, Gro Intelligence
Table 1. Recently closed funds 2011

<table>
<thead>
<tr>
<th>Fund</th>
<th>Manager</th>
<th>Size US$</th>
<th>Industry Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>African Global Capital</td>
<td>OchZiff Capital Management</td>
<td>400</td>
<td>Energy, mining, natural resources</td>
</tr>
<tr>
<td>African Infrastructural Fund II</td>
<td>African Infrastructural Investment</td>
<td>500</td>
<td>Infrastructure</td>
</tr>
<tr>
<td>ECP Africa Fund III</td>
<td>Energy Capital Partners</td>
<td>613</td>
<td>Telecom Consumer Products, Financial Services, Oil &amp; Gas, Mining, Insurance</td>
</tr>
<tr>
<td>Hellos Investors II</td>
<td>Hellos Investment Partners</td>
<td>900</td>
<td>Telecom, Health Care, Consumer Products, Financial Services, Agriculture Infrastructure</td>
</tr>
<tr>
<td>Capital Alliance Private</td>
<td>Africa Capital Alliance</td>
<td>450</td>
<td>Diversified</td>
</tr>
<tr>
<td>Pan African Investment Partners III</td>
<td>Kingdom Zephyr</td>
<td>492</td>
<td>Telecom, Consumer Products, Financial Services</td>
</tr>
<tr>
<td>Carlyle Africa Fund</td>
<td>Carlyle Group</td>
<td>750</td>
<td>Consumer Products, Financial Services</td>
</tr>
<tr>
<td>Ethos Private Equity Fund VI</td>
<td>Ethos Private Equity</td>
<td>750</td>
<td>Technology, Consumer Products, Retail, Manufacturer, Financial Services, Diversified, Infrastructure, Telecom Media</td>
</tr>
<tr>
<td>8 Miles Fund I</td>
<td>8 Miles</td>
<td>250</td>
<td>Diversified</td>
</tr>
<tr>
<td>Catalyst Partners</td>
<td>Catalyst Partners</td>
<td>150</td>
<td>Diversified</td>
</tr>
<tr>
<td>EVI Capital Buyout Fund</td>
<td>EVI Capital</td>
<td>400</td>
<td>Diversified</td>
</tr>
</tbody>
</table>
VI. Lessons Learned from 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 applicable to Ethiopia are Brazil and China. China is relevant because of its history of central planning and Brazil because of the contribution of the agricultural sector to its overall economic growth.

In 2005, private equity funds raised for China were less than $2 billion. By 2011, $23 billion was committed for private equity in China. China was able to attain this much growth in its private equity industry in a relatively short period of time because it continued to be one of the fastest growing economies in the world throughout that time period coupled with the fact that it slowly began opening up various sectors that were traditionally closed off to foreign investors. In turn, the influx of private equity helped China achieve three major economic goals: Job Creation, Innovation, and “Go West Policies”. The total employment at private equity-financed companies has increased by 16% over the period of 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. Forty-two percent of private equity funding went to companies based in inland China as opposed to the coastal regions, thereby helping with China’s “Go West Policies” which attempted to move capital from the overfunded coastal regions into mainland China.

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. 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.

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 earlier this year that it intends to raise $1 billion to invest in Africa’s infrastructure.

Fig 4. Distribution of Private Equity by Sector in Brazil

The biggest Brazilian private equity story as it relates to Africa is Brazil’s BTG Investment firm that announced earlier this year that it intends to raise $1 billion to invest in Africa’s infrastructure.

VII. Private Equity and Economic Growth

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. 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 reach its GTP goals. Private equity can complement the work of the domestic banking sector.

Private equity can also be a valuable source of foreign exchange for the country. Both via foreign funds that enter through the injection of capital as well as export revenue generation and import substitution. Potential sectors where private equity and venture capital funds can invest include agriculture and agro processing, manufacturing,
consumer goods, healthcare, infrastructure, and parastatals (a company or agency owned or controlled wholly or partly by the government).

The key goals identified in the GTP focus on creating the foundation for Ethiopia to move towards being an industrialized nation. Industrialization is directly linked to economic growth. Economic growth is achieved through economic complexity: the rate of economic growth will be higher and sustainable in a complex or transformed economy. Economic complexity is not simply diversification in a country’s export base but rather an increase in the “collective knowledge of a society”\(^8\). Greater investment will lead to a path of increased economic complexity that Ethiopia aspires to achieve, is poised to move beyond agriculture into industrial manufacturing-based value creation. While the sale of agricultural exports declined to about 70%, industrial exports increased to 26%\(^\text{10}\). The examples of Brazil and China provide insight into the types of economic development private equity and venture capital 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.

**VIII. Challenges for Private Equity and Venture Capital in Ethiopia**

While the macroeconomic benefits for private equity and venture capital in Ethiopia is clear, there are challenges that the industry faces when it comes to investing in in the country. Some key challenges include exit options/strategy, currency convertibility, a closed financial services sector, dominance and complexities of family-owned businesses, and the size of existing enterprises.

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 that Ethiopia is still in the early stages of developing a vibrant private sector, equity investors face a number of challenges. That said, these are sophisticated investors that navigate a myriad of country conditions and given the right opportunity, it is a challenge they can address through lengthening the anticipated time horizon of their investment.

While selling to a strategic investor seems like a relatively straightforward proposition, it presents a bit of a chicken and egg problem in that more private equity attracts more strategic investors, but the lack of strategic investors could detract from, or significantly slow down, the growth of the private equity industry in a country. Ethiopia can prepare itself for this challenge by having a proactive policy towards encouraging private equity and putting the right ecosystem in place to encourage orderly exits that ensure longer-term sustainability of private equity funds 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.

The challenges of family-owned businesses and size are connected. Most businesses in Ethiopia are family-owned. Families are very protective of their financials and therefore view private equity as intrusive. There is also a lack of accounting transparency, which often causes problems during the due diligence process.

Furthermore, 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. Generally, private equity and venture capital firms seek investments within $3 million to $5 million range. The issue of size, however, is not one to dwell on given that venture capital has the appetite for small businesses if the long-term opportunity is large enough.

**IX. Minimum Conditions for Successful Private Equity and Venture Capital in Ethiopia**

Ethiopia can proactively prepare itself for, and encourage, the flow of private equity and venture capital funds into the country by creating 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 and venture capital investments. In developing a framework, Ethiopia must take into account the following minimum conditions required for a robust private equity and venture capital sector.

**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 in. This applies both to the mobility of capital as well as operating regulations which will impact their portfolio companies.

**Adequate Regulatory Framework:** While private equity firms will find this important, they will be acutely sensitive to regulatory frameworks pertaining to the treatment of the informal shares market and the enforcement of financial contracts. Weak frameworks will generally result in private equity firms limiting their risk by investing in fewer companies or not entering a country at all, exerting exacting a higher country risk premium and thus lowering the enterprise value of the target company, or placing onerous terms to ensure compliance.

**Exit Strategies:** The lack of a stock market presents a ready challenge to private equity investors in Ethiopia, but as we have 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
and venture capital flows. The net benefit to the current account deficit however is clear. First, private equity firms generally look to invest in companies that are export oriented or substitute imported goods. Therefore over the 5-7 year investment period most of these investments would 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 seamless 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.

**Intellectual Property Laws:** Private equity funds will often impart new products, enhancements, and process as in portfolio companies. The inability to enforce intellectual property rights will necessarily limit their investment in these critical national capacity building investments and limit knowledge transfer to investor companies.

**Accounting, Auditing and Banking Standards –** 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.

**Vibrant private sector:** Continued nurturing and development of the nascent private sector will need to continue to be a policy priority for the Ethiopian government in this regard.

### X. Conclusion

To attract private capital into Ethiopia, the identified minimum conditions must be proactively built, creating an ecosystem in which deployed capital has the 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.

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 exits of capital, and promotes longer-term sustainability of private equity funds in the country. Such a framework would include the introduction of international accounting standards for local companies that would immediately create a comparable template for investors to use. Strong internal structures are important to attract investment capital, encourage business longevity, and create maximal values for exit.

It is important to note that private equity is not a closed form proposition but rather an adoptive system that is good at applying the core values of investing within a local economy. Given this fact, Ethiopia is at an opportune 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 and venture capital investments that are in line with the growth plans of the country will be highly beneficial.

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

Private equity and venture capital funds are attracted to economies with vibrant private sector. In order to competitively attract a sizeable share of global equity and venture capital funds into the economy, Ethiopia needs to deepen its private sector development and build a dynamic entrepreneurial base.

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