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SECURITIES & EXCHANGE COMMISSION

TRENDS IN PRIVATE EQUITY MARKET

Investor Education

SECNG

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1.0 INTRODUCTION

Private Equity (PE) can be described as capital provided by investors to non-quoted companies with a high growth potential in the medium to long term. Private Equity investors make investments directly into private companies or conduct buyouts of public companies which eventually result in a delisting of the public equity. In other words, PE capital is raised from retail and institutional investors, and can be used to fund start-ups, buy new technologies, expand working capital within an owned company, make acquisitions, or strengthen a balance sheet (Investopedia).

According to Gillian and Wright (2008), PE is a risk capital provided in a wide variety of situations ranging from finance to business start ups to the purchase of large, mature quoted companies.

PE investments are usually made by private equity firms, venture capital firms or 'angel investors' through a fund partnership. Some of the features are:

i. The funds are closed-end investment structures;
ii. The tenor of a fund ranges between 10 and 12 years;
iii. A fund's terms and conditions are usually defined in a limited partnership agreement;

2.0 HISTORY OF PRIVATE EQUITY TRANSACTION

The purchase of private companies has been in practice since the Industrial Revolution, however it is generally accepted that the first true buyout was J.P. Morgan & Co's purchase of Carnegie Steel Company from Andrew Carnegie and Henry Phipps in 1901.

Private Equity as an organized form of funding started after the World War II. Prior to the said War, private equity investments were orchestrated by large family businesses, wealthy investors and university endowments.

The pioneers of an organized PE transaction are believed to be two US based PE firms, American Research and Development Corporation (ARDC) and J.H. Whitney & Co., both founded in 1946. It started as venture capital firms, metamorphosed into leveraged buyouts and culminated in dedicated investments made by institutionalized PE players.

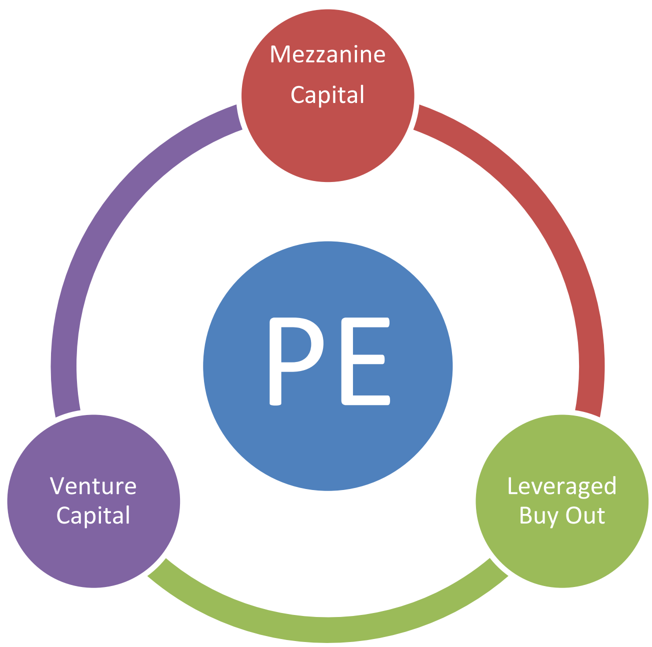
The industry started in the UK around the same time as in the USA, but suffered setbacks due to adverse investment conditions imposed by various governments.

However, in the mid 1980's, the government took progressive steps to promote the venture capital industry. The establishment of the Unlisted Securities Market (USM) during this period became necessary to facilitate the exit of small firms due to its less stringent listing requirements.

In India, PE is still relatively new – while early stage investment vehicles or venture capital funds were launched as early as the mid-1980s, it was only in the mid-1990s that dedicated PE firms started investing in Indian companies.

3.0 FORMS/STRATEGIES OF PRIVATE EQUITY

PE can be in various forms which include venture capital (VC), leveraged buyouts and mezzanine capital.



Venture/Growth Capital: venture capital mainly refers to investments made in young companies with limited or no revenues. Venture capitalists are ready to accept a potential risk of failure of the companies and of course, the returns are relatively high. In other words, an unsuccessful investment can lead to a total loss, while a successful outcome can yield a very high return on investment

On the other hand, growth capital means equity investments, often minority investments, in already established or mature companies planning to expand, restructure operations, introduce new products or finance a major acquisition without diluting the control structure.

Leveraged buyouts: popularly known as LBOs refer to the acquisition of a stake in a private company (unlisted or public to be taken private) with the intention to exercise influence on the company. Buyout funds, usually managed by specialized investment firms using a mixture of equity and debt financing, invest in mature, established companies with a strong market position.

Mezzanine capital: refers to financing composed of both debt and equity. According to Investopedia, it is a hybrid of debt and equity financing that is typically used to finance the expansion of existing or established companies. Mezzanine financing is basically debt capital that gives the lender the right to convert to an ownership of equity interest in the company if the loan is not paid back on time and in full.

In Mezzanine financing, the return on investment is in the range of 20%-30% since the loan is usually provided with little or no due diligence by the borrower and little or no collateral by the lender. To this end, it is treated like equity in the balance sheet.

4.0 TYPES OF PRIVATE EQUITY INVESTMENTS

There are different types of private equity firms in existence. Some are strict financiers, hence, have passive investors who are wholly dependent on managers of the company to grow the business and reward the owners with appropriate returns. On the other hand, some consider themselves active investors because they provide operational support to the managers of the company leading to its growth and development. Notwithstanding, there are three types of private equity investments:

- Primary investments;
- Secondary investments; and
- Co-investments

Primary Investments

Primary investments or primaries are investment in newly created closed-end private equity partnerships. After conducting a due diligence on the general partner, its strategy and track record, limited partners commit an amount to the new fund, though not visibly knowing the underlying investments that will be made by the fund. Capital is called for as investment opportunities arise. The general partner will call and deploy the funds during the investment period.

Secondary Investment

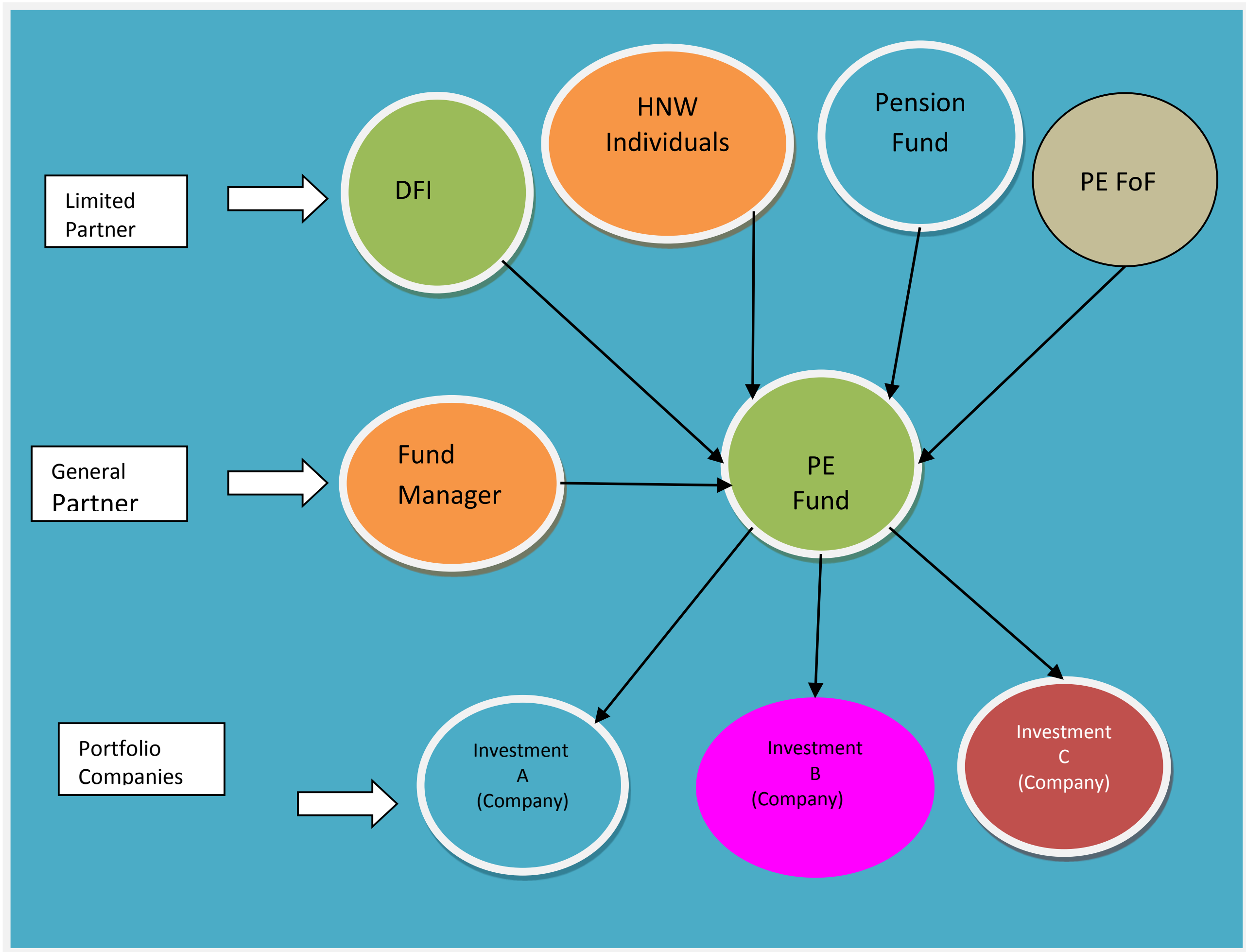
Secondary investments or secondaries, are existing limited partner private equity interests available on the secondary market. Secondary investors enjoy shorter investment periods and accelerated returns on invested capital. Secondaries are composed of existing assets, i.e., the fund has already deployed the majority of its capital to portfolio companies, thereby reducing the risk associated with investing in a 'blind pool' of assets. Furthermore, losses which may occur in the early stage of a private equity investment can be avoided.

Co-Investments

A Co-investment 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-investment allows the limited partner to increase his exposure to a particular opportunity through both the fund and direct investment.

PE can be in various forms which include venture capital (VC), leveraged buyouts and mezzanine capital. VC mainly refers to funds offered to a firm at start up or early stage or at later stage of their growth life cycle. Leveraged buyouts popularly known as LBOs refer to the acquisition of a firm by a specialized investment firm using a relatively small portion of equity and a relatively large portion of outside debt financing (Kaplan and Stromberg, 2009). Finally mezzanine capital refers to financing composed of both debt and equity.

5.0 PARTIES TO A PRIVATE EQUITY FUND



Source: RisCura Fundamentals

Limited Partner: From the above illustration, the limited partner represents the investors. These are the people that provide funds for the purpose of investing in private equity for financial returns. The investors include high net worth individuals, insurance companies, pension funds, investment banks/institutions, non-financial corporations and foreign investors amongst others.

The General partner is also known as the Fund Manager who manages the pool of funds. In most cases, the general partners are associated with venture capital firms or affiliates of a financial institution. In Nigeria, the general partner may be incorporated as a Company under CAMA with the objective of conducting business as a private equity investment company, venture capital, etc.

The fund manager is responsible for the Fund's financial and operating performance as well as for the legal and other aspects of the Fund's formation. The manager is to monitor and supervise all investment activities related to the Fund including accounting and financial reporting issues to ensure that the Fund and Sub-Funds are in compliance with applicable laws/statutes/Codes.

Portfolio Companies: these are companies in which the Funds are invested. They may be young firms that have potentials for high growth rate in future. They may be early stage companies, companies in research and development stage, those in the earliest stage of commercialization or later stage companies with several years of sales without meaningful growth. Some of these companies may be seeking the private equity capital for expansion, acquisition and/or change in capital/ownership structure.

Public companies also may seek private equity financing for a number of reasons. Some of these may be to avoid registration costs and public disclosures associated with public offerings or in situation where they intend to go private, issue both debt and private equity to finance their management or leveraged buyouts.

6.0 GROWTH/CONTRIBUTIONS OF PRIVATE EQUITY FUND

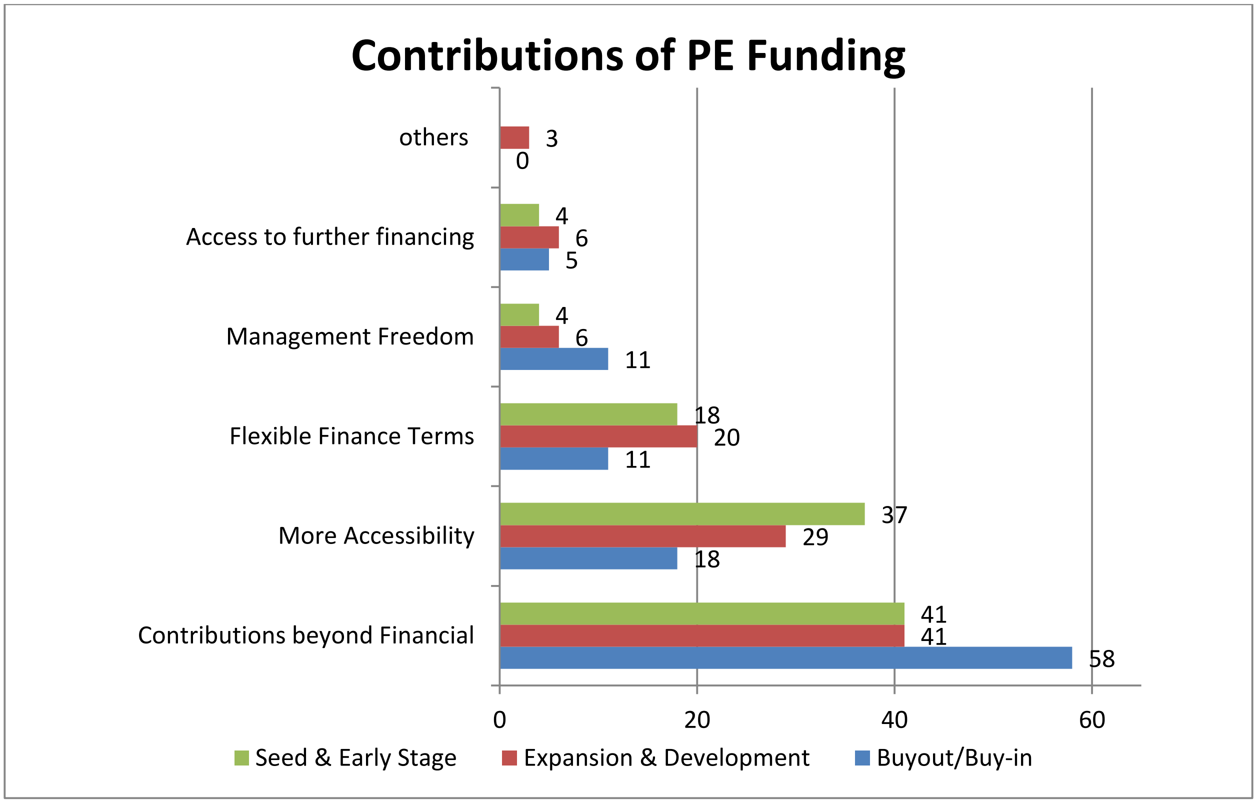
The PE industry has enjoyed significant growth since the 1970s although in the recent past it has played a stronger role in developing economies than in developed ones where there has been a decline. In Europe, PE investments were above €1 billion in 2012 despite a 19.2% decline from the 2011 figures. In the same year, fundraising amounted to €673 million which represents a decline of 28% compared to the previous year. This could be attributed to the global trend in 2012 whereby fundraising required more time to complete relative to prior rounds that occurred before the global financial crisis (EVCA, 2013).

According to a private equity research firm, Preqin, at the end of 2011, the Net Asset Value (NAV) of PE investments totaled USD 3 trillion. The industry has grown through a process of consolidation and the number of funds has fallen from its peak of 1,923 in 2000 to 1,029 in 2013.

In Africa, investments by PE firms from 2009-2014 totaled US$13.18 billion. PE investment has witnessed a meaningful growth in value (Info Africa: the rise of PE, Freshfields Bruckhaus Deringer).

6.1 CONTRIBUTIONS OF PE FUNDING

Chart 1



Source: SAVCA, Development Bank of Southern Africa, The Economic Impact of Venture Capital and Private Equity in South Africa survey 2009

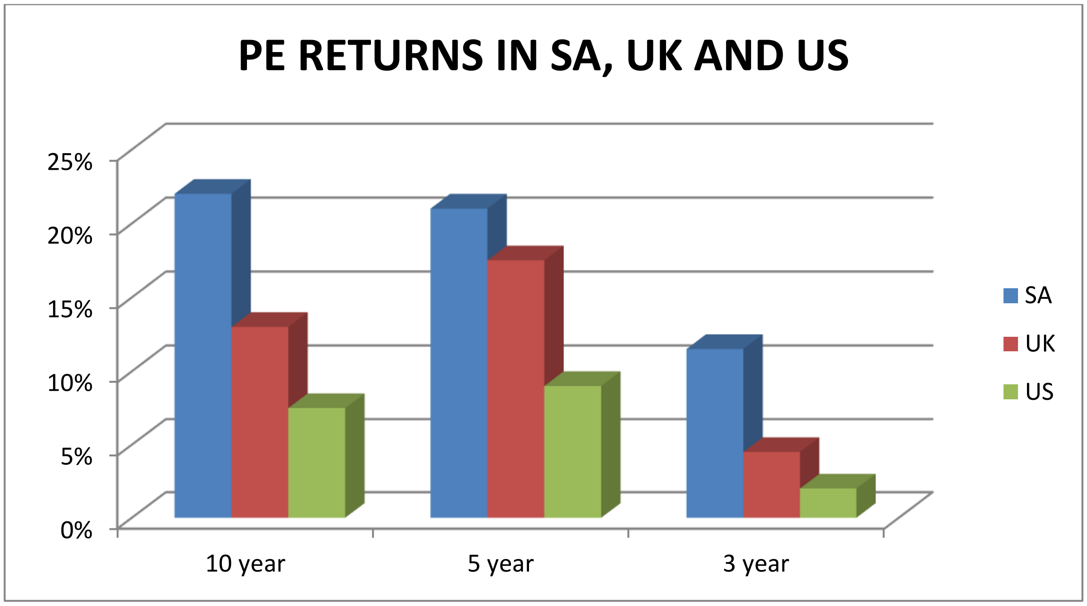
From the chart above, 37% of the respondents agree that private equity funding contributes more accessible finance to Seed and Early Stage companies compared with the other two options, i.e., Expansion & Development and Buyouts/Buy-in.

On contributions beyond financial, the survey revealed as indicated in the chart that private equity contributes more in Buyouts/Buy-in investments than in Seed and Early Stage as well as Expansion & Development.

Seed & Early Stage recorded the least in management freedom and access to further financing because private equity investors form part of the management team of the firm to ensure speedy growth and further financing from the conventional mode is usually not possible at this stage because the companies may not have collateral which is a requisite condition for such loans.

6.2 PRIVATE EQUITY PERFORMANCE IN SA, UK AND US

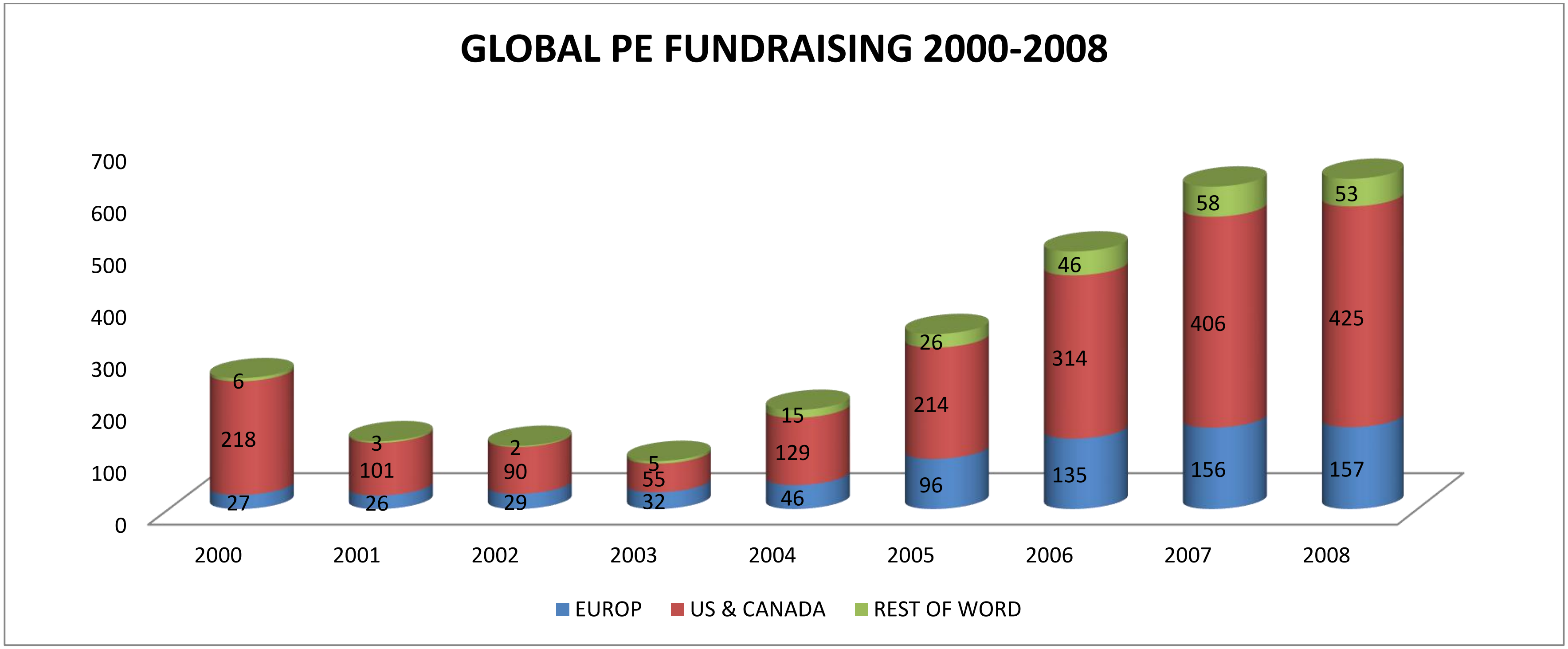
Chart 2



Source: RisCura Fundamentals
Source: British Private Equity and Venture Capital Association Private Equity and Venture Capital Performance Measurement Survey 2009
Source: Cambridge Associates LLC U.S. Private Equity Index Sept 2010

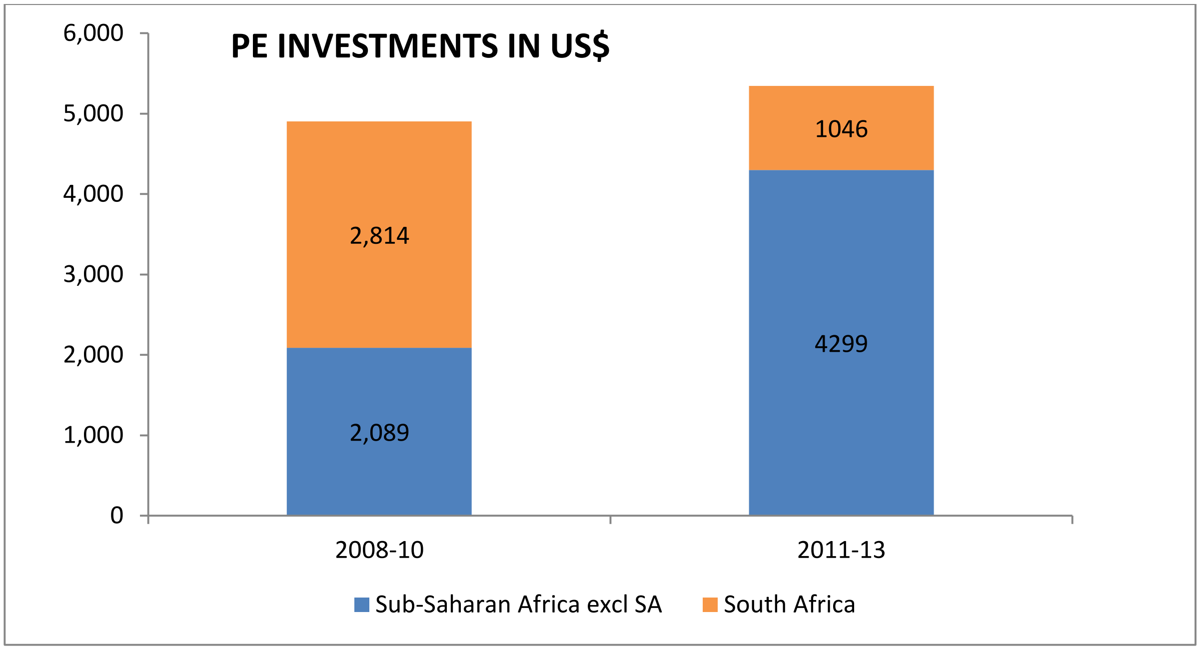
6.3 GLOBAL PE FUNDRAISING (2000 TO 2008)

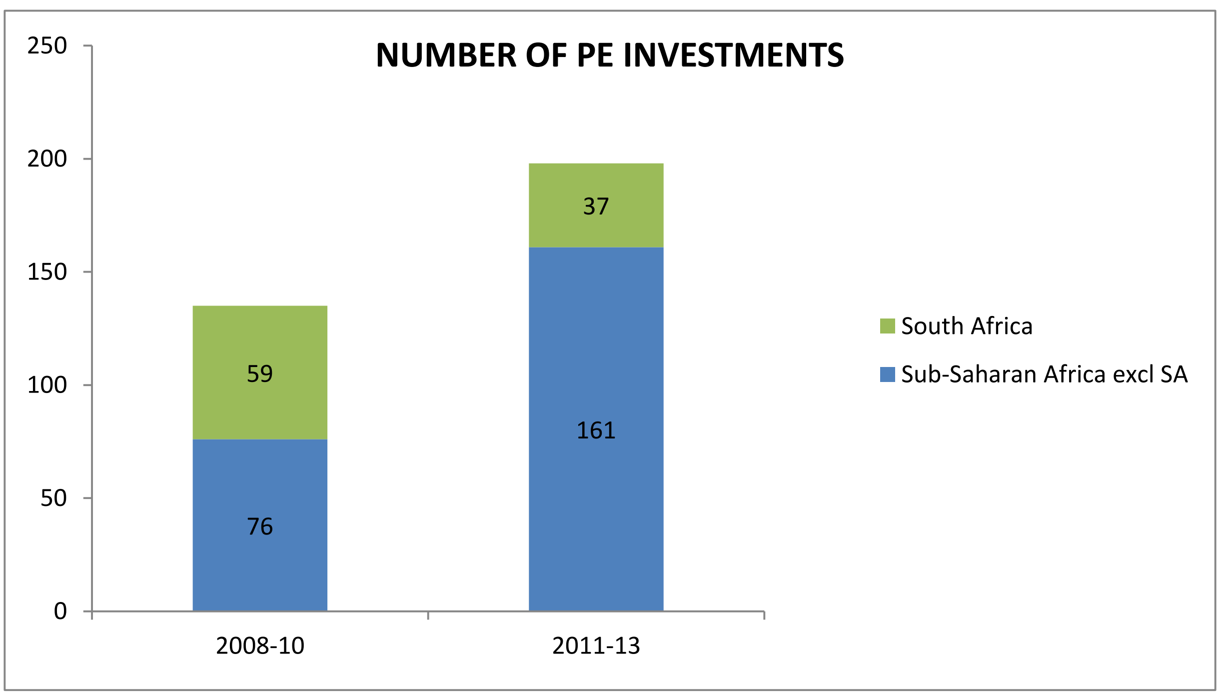
Chart 3



6.4 PRIVATE EQUITY INVESTMENTS IN SA AND OTHER SUB-SAHARAN AFRICA 2008-2013

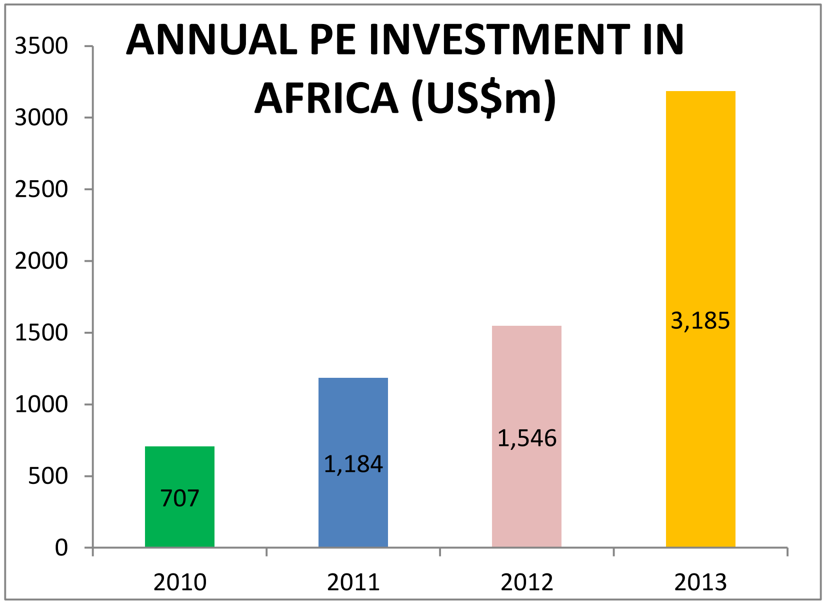
Chart 4



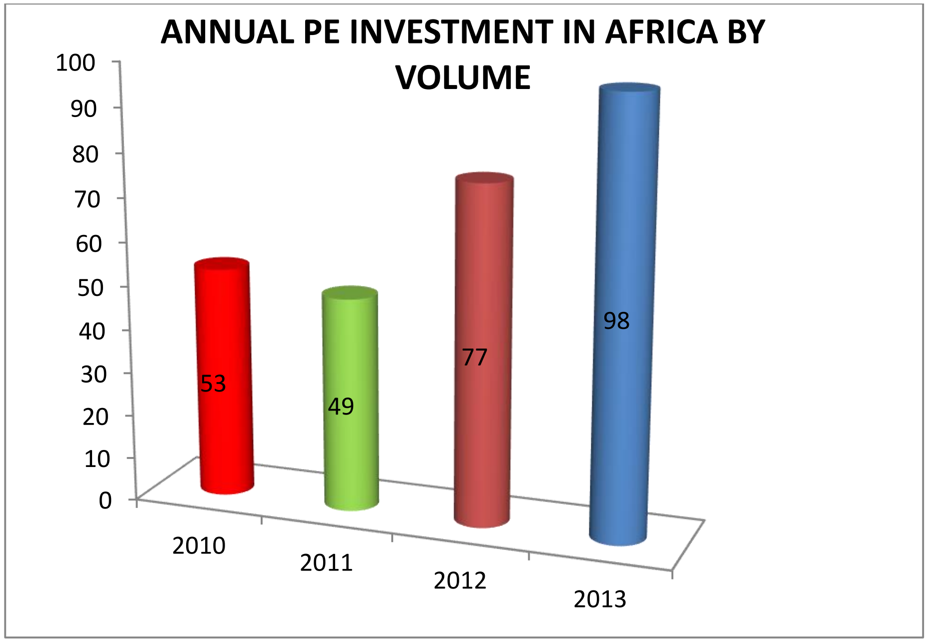


6.5 TOTAL PRIVATE EQUITY INVESTMENTS IN AFRICA

Chart 5



Source: EMPEA (2010-12 data), AVCA (2013 data. Investment totals reflect total equity amounts for transactions in which financial details have been disclosed



Source: EMPEA (2010-12 data), AVCA (2013 data.

7.0 NIGERIAN PERSPECTIVE

In the last decade, the Nigerian private equity industry has also grown from about three players with approximately US$75 million under management to 10 indigenous players with about US$2 billion under management, 15 international funds and about 30 new funds under formation (Private Equity Review, 3rd Edition, Chapter 17 by Folasade Olusanya et al). However, the Nigerian private equity industry is still in its infancy stage compared to the developed and other emerging markets.

Private equity investment in Nigeria has been by way of acquisition of significant minority stakes in businesses with good track record of performance and growth potential. There is also an increase in mezzanine financing, i.e., a combination of equity and debt components.

Leveraged buyouts which constitute a major part of private equity deals in advanced economies are also witnessed in Nigeria, e.g. GTB Asset Management Ltd/Kakawa Discount House and the acquisition of Conoco Philips Businesses by Oando Plc. However, private equity deals are usually consummated by identifying competent entrepreneurs and management teams with a proven track record of performance with respect to an existing or new business plan. This is because they possess significant understanding of the relevant market as well as required local networks for the business since they are majority owners of the business.

7.1 RECENT DEVELOPLENTS IN PRIVATE EQUITY IN NIGERIA

The Nigerian private equity market may have significant risks, a number of developments/reforms have reduced the risk factors in the market thereby making it the preferred investment destination. Some of these reforms are improvement in Code of Corporate Governance, migration to International Financial Reporting Standard (IFRS) and Risk Based Supervision (RBS), improvement in the legal structure and establishment of investment infrastructure like the Investment and Securities Tribunal (IST) and the enhancement of securities regulation generally.

According to a paper by Bisi Sanda of Ernst and Young titled "Size Dynamism of PE industry & valuation issues in Africa", **Nigeria has topped the table for PE deal value in Africa from 2012 to date, attracting about a third (31.4%) of the total private equity investment in the continent from 2009 to**

2014. It is noteworthy that from available data, PE firms invested US$925 million in Nigeria between January & July 2014.

The above mentioned paper also reported that the deal size of US10 million and above adapted to mid-sized companies is typically on offer in Nigeria and the rest of Africa. However, there are large deals of up to US$1 billion especially in power, oil and gas and infrastructure.

As at 2014, four (4) Private Equity fund managers made investment in Nigeria, they are, Africa Capital Alliance, Carlyle Group, Helios Investment Partners and Synergy Capital Managers. Notable investments by other Private Equity fund managers in the previous year include Helios, Africinvest Capital Partners (Africinvest), Data Bank Agrifund Manager Limited, Emerging Capital Partners, Africa Capital Alliance, Investec, Assets Management Goodwell West Africa, Alitheia Capital and Abraaj Group. Due to the dearth of data on deal activity within the industry, it was difficult to ascertain the total investment size of the deals concluded in 2013, coupled with the fact that some of the investment amounts in the respective private equity transactions were undisclosed.

The sectors attracting significant investments cut across telecoms, oil and gas, consumer goods, information technology, agriculture, manufacturing and financial services. Other sectors like the media and entertainment as well as advertising are gaining the attention of private equity investors in recent times.

Various sectors of the Nigerian economy experienced significant investments by private equity funds in 2013 and 2014. Some of these include:

- Participation of Emerging Capital Partners (ECP) and Investec Management in the US$1.035 billion equity and debt financing to fund the upgrading of existing towers and the construction and acquisition of new telecoms towers belonging to HIS, an ECP portfolio company headquartered in Lagos.
- Investment by Africinvest in Broron Oil & Gas Ltd, an oil and gas offshore service company providing offshore support services.
- The Carlyle group invested US$147 million in Diamond Bank;
- IFC, a member of world Bank Group announced a US$9.5 million investment in Jabi Lake Mall;
- African Capital Alliance invested part of its third fund (CAPE III, a US$400 million private equity fund, which includes:

- investment in Gas Train Ltd, a gas infrastructure development platform operating in Nigeria; and
- Wakanow, a leading Nigerian online travel agency.

7.2 REGULATORY DEVELOPMENTS

In evaluating the interrelationship between PE regulation and economic growth, there seems to be agreement that a well developed legal and regulatory framework would lead to increased financial activities in a country.

Consistent with the above, the Securities and Exchange Commission (SEC) in exercising the powers vested in it by section 313 of the Investment and Securities Act, 2007, amended the SEC Rules and Regulations in 2013 to regulate private equity funds. Consequently, Rule 557-563 of the SEC Rules 2013 provide rules guiding the operation of private equity funds in Nigeria. The SEC Rules define a private equity fund as a type of collective investment scheme that invests primarily in private equity / unlisted companies, whether or not in an attempt to gain control of the company.

The SEC Rules apply to private equity funds with a minimum commitment of N1 billion of investor funds and prohibits private equity funds from soliciting funds from the general public while permitting them to source funds from qualified institutional investors. Registered private equity funds are also prohibited from investing more than 30% of the fund's assets in a single investment.

The minimum paid-up capital required of a registered fund manager of a private equity fund is to be determined by the SEC from time to time but is currently put at a minimum of N150 million. Private equity funds are also expected to submit quarterly returns, annual account or report of the fund to the SEC and semi-annual reports to its investors. Also, Rule 494 of the SEC Rules and Regulations provides that a fund manager seeking to invest the assets of a fund in unlisted securities shall have a paid-up share capital of N500 million that is unimpaired by losses. In addition, the partners of such fund managers shall have a minimum of five years' experience in private equity fund management.

It is important to note that the PENCOM recently included private equity funds as part of the classes of portfolios in which pension funds can be invested. Pension Funds Assets Investment Regulation only permits investment of 5% of the pension assets in private equity funds. As a result, pension fund administrators' contributions in private equity fund investments in Nigeria account for 1% of the total value of private equity funds investments in Nigeria (Private Equity in 29 Jurisdictions worldwide, contributing Editor, Bill Curbow, (page 98, content of Nigeria by Ajibola Dalley of GRF Dalley & Partners)).

In addition, the proposed amendment to the Regulation on Investment of the Pension Fund Assets provides that a minimum of 60% of a private equity fund in which a pension fund is an investor must be invested in Nigeria as against the initial proposal of 75%. (Private Equity Review, 3rd Edition by Stephen L. Ritchie, Law Business Research Ltd, page 388).

It is also note worthy that only private equity and infrastructure funds registered with SEC are permitted instruments for the investment of pension funds. Therefore only private equity and infrastructure funds registered with SEC will be permitted to approach pension fund administrators to raise funds from Nigeria's over N2 trillion of pension fund assets (Regulation on Investment on Pension Fund Assets).

8.0 CONCLUSION

PE as a financing tool is desirable for Nigeria with its large informal sector particularly as the traditional means of financing is often not available to companies in the early growth phase. The opportunities that are available in the Nigerian PE industry are huge as every sector, ranging from financial services, e-commerce & IT, power, oil and gas; services, telecommunications and agriculture are potential goldmines for investors.

PE is an added form of diversification for PFAs as the Nigerian stock market does not adequately reflect the economy with the absence of sectors such as oil and gas (upstream), power, telecoms, and Agriculture.

A lot of the stakeholders would like to see Nigerian pension funds invest more in PE. The impression that PE exits are difficult in Nigeria and Africa, may actually be a myth as exits are happening at an average of 30% per year.

Finally, it is expected that Nigeria will continue to attract foreign investments. The consumer goods sector will remain attractive to private equity investors in view of Nigeria's huge and growing middle class. The oil and gas sector will also attract private equity investment due to the Nigerian Oil and Gas Industry Content

Development Act, which provides that there shall be exclusive consideration given to Nigerian indigenous service companies that demonstrate ownership of equipment and Nigerian personnel capacity in relation to bids for contracts in the oil and gas industry. Interest in the IT and e-commerce space will continue as internet penetration expands and a preference for online purchase continues to increase. All other sectors mentioned earlier are expected to attract private equity investments in 2015.

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