NIGERIA AS AN EMERGING MARKET FOR PRIVATE EQUITY INVESTMENTS

INTRODUCTION

> ***"Investing in emerging markets doesn't mean that you have lost faith in the U.S. market. The U.S. market could go on from here to even new highs, baffling the experts much as it has done for the last several years. But diversification into emerging markets, though it hasn't proved out to be worthwhile for a long time, may make a lot of sense now."*** **A quote from 'where there's Risk, there's Opportunity: Revisiting Emerging Markets'**
> **by Max Isaacman**

Since 1999 Nigeria has experienced a profound level of structural, political and economic changes that have made it one of the emerging markets in Africa as well as a vital contributor to the world economy. Nigeria has evolved to the point where there are excellent investment opportunities in multiple asset classes, including public equities, debt, and private equity.

The key themes creating this opportunities are well known, including the re-capitalisation of Financial institutions and Insurance Companies, the trend towards privatisation of state-owned companies, the emergence of world-class companies and an overhaul of legal regulations guiding Investments.

WHY INVEST IN NIGERIA?

The fundamental case for Nigeria's high economic growth combined with valuations that are near historic lows is due to the various economic reform programmes the Government has embarked on. Gross Domestic Product (GDP) growth of Nigeria is almost double that of developed markets **(In 2006 GDP growth rate of Nigeria was 5.6 percent and GDP growth rate of England was 2.8 percent source Economist Intelligence Unit)**, **The inflation rate has also falling to a single digit of 7.5 percent and economists forecast that this trend is likely to continue for the foreseeable future.**

The private equity markets are still at an early stage of development compared to public equity and debt, but this asset class offers substantial opportunities to invest in a broad range of smaller, rapidly growing companies. Various foreign companies have commenced to harness this gold mine. For instance no fewer than six Nigerian banks have raised fresh funds from foreign institutional investors.

While Nigeria may have significant risks, a number of developments have reduced risk in the markets. Improvements in corporate governance, accounting, local securities regulations, and the investment infrastructure, such as the Investment and Securities Tribunal, have all seen steady improvements and significantly reduced the risk factor.

To fully appreciate the viability of the Nigerian economy, some structural changes that have occurred over the years shall be intrinsically considered:

Improving Corporate Governance:

Poor corporate governance is often cited as a reason to avoid making investments in Nigeria. But many emerging markets governments are moving to enhance their regulatory frameworks with an eye toward maintaining interest from foreign investors. Many companies are also moving on their own to adopt U.S.-style corporate governance standards.

The Securities and Exchange Commission, the Nigerian regulatory body saddled with the responsibility of regulating the investment market in conjunction with the Corporate Affairs Commission published a code of best practice for Corporate Governance. While attitudes towards corporate governance vary substantially from country to country, the risks can be managed by active portfolio managers who carefully evaluate individual companies. In the wake of Enron and WorldCom, it has become more difficult to make the case that corporate governance risk in at least some emerging markets is greater than similar risks in developed markets.

Improving Legal Structure:

The investment infrastructure in Nigeria is rapidly evolving in addition to is becoming friendlier to foreign investors .Many countries realize they need to strictly enforce their securities rules and regulations if they want to boost investor confidence. In the past, paperwork burdens created enormous obstacles for foreign investors, but many countries are working to relax restrictions.

Nigeria is not left out of this metamorphosis, in 1999 the Investment and Securities Decree (now Act) was passed into law. An intricate part of this new legislation was the freedom of any foreigner to invest, transfer and sell stocks in Nigeria unlike the restriction in **Section 7** of the old law. Furthermore to enhance speedier resolution of disputes that arise from investment transactions, the Investment and Securities Tribunal was established.

Reduced Trading Costs:

Commissions in Nigeria have decreased dramatically over the last eight years, much more dramatically than in the developed markets. In some instances, in percentage terms, emerging markets commission rates will be below those of developed European countries as well as the U.S. and Canada. In 1995 the rates for executing trades in Eastern European countries ranged between 1% and 2%. Today the standard is below .5%, a 50% to 75% decrease. In Nigeria the Securities and Exchange Commission recently revised the transaction cost of the primary market for equities from 6.92% to 4.32 % which is a 45 percent decrease.

Commission rates for developed and emerging markets around the world seem to be converging. The explicit transaction costs are nominally higher in emerging markets, but this cost factor is not as significant as it once was. There is no reason why commission rates should not continue to decline. They may eventually approach parity across multiple markets. Transaction costs can be expected to continue trending downward for several reasons, the improved data transparency in a growing number of markets; and an increased emphasis on "index" names for emerging countries, which allow for improved risk hedging.

Low Correlation:

Diversifying across countries and industries can reduce risk, yet increase potential returns. Despite their reputation for volatility, investments in emerging markets could actually lower portfolio risk assuming a low correlation either to developed markets or to each other.

Historically, developed markets and emerging markets have not moved in unison. Market leadership has changed year to year from one market to another. For the five-year period ended August 25, 2003, the correlation coefficient of the emerging markets (as measured by the MSCI Emerging Markets Free Index) to the U.S. (as measured by the Standard & Poor's 500 Stock Index) was 0.35. Emerging markets have also tended to have low correlations to each other. While some regions may record poor or steady performances, others can record robust performances.

For example, early this year some of the major stock markets in the world experienced a fall in majority of its stock; the stock market in Nigeria was not affected by this surge. This further reinforces the need for diversifying across countries.

Where are the Opportunities?

Emerging markets constitute a small part of the current total global market capitalization, but their rapid growth rates and steadily improving risk profiles justify higher valuations over time. At the end of 2000, the total capitalization of the world's three major stock markets (the U.S., the U.K., and Japan) was about $20.7 trillion. By comparison, emerging markets represented only a small portion at $3.3 trillion, or 16%.

However, between 1991 and 2000, the market capitalization of Emerging markets grew faster, at 716%, compared to developed markets, which grew about 231%. Various Foreign companies have started to harness this potential through equity funding in Nigeria as stated above.

Private equity is another type of FPI(Foreign Portfolio Investment) which various companies are starting to harness in Nigeria. The advantage of private equity is an injection of fresh funds into the business without the burden of debt payment. **Private equity mean funds from private investments**

collected in a pool of funds investments which is professionally managed by an investment manager (private equity manager), in the unregistered securities of private and public companies.

The major players in the private equity market are the investors (fund providers), intermediaries (fund mangers) and the Issuers. We will briefly examine the private equity market institutional structure in detail.

1. **Investors (Fund Providers)**

   These are typically the class of person(s) who provide funds for the purpose of investing in private equity for strictly financial reasons, specifically because they expect the risk-adjusted returns on private equity to be higher than the risk-adjusted returns on other investments and because of the potential benefits of diversification. This class involves wealthy families and individuals, bank holding companies, Insurance companies, investment banks, non-financial corporations, and foreign investors.

2. **Intermediaries (Fund Manager)**

   These are the mangers of the pool of funds. In Nigeria, these may be in the form of a Company under CAMA or a Partnership under any of the Partnership laws.

   Under the partnership arrangement, institutional investors are the limited partners and professional private equity managers, working as a team, serve as the general partners. In most cases the general partners are associated with a partnership Management firm, such as the venture capital firms, or affiliates of a financial institution (an insurance company, bank holding company, or investment bank); the affiliated firms generally are structured and managed no differently than independent partnership management firms.

   Under the corporate structure, the fund manger would be incorporated a s a company under CAMA, with the objective to conduct business as a private equity investment company, venture capital, publicly traded investment companies, and other companies.

   The Fund Manager will be responsible for the Fund's financial and operating performance, as well as for the legal and other aspects of the Fund's formation. The Fund Manager will actively monitor and supervise investment activities and review all documents related to investments. The Fund Manager will enter into a Fund Management Agreement with the Fund providing for a Fund Management Fee to the Fund Manager for services performed. The Fund Manager will also oversee accounting and financial reporting and ensure that the Fund and Sub-Funds are in compliance with applicable laws as well as with the applicable statutes, corporate documents, Fund Management Agreements, and other related agreements. Investments will be structured generally in anticipation of exits through management buybacks or sales of shares to strategic investors within a short period of time of investment.

3. **Issuers**

Issuers generally are companies that cannot raise financing in the debt market or the public equity market. Issuers of traditional venture capital are young firms, most often that are developing innovative technologies and idea and are projected to show very high growth rates in the future. They may be early-stage companies, those still in the research and development stage or the earliest stages of commercialization, or later-stage companies, those that have several years of sales but are still trying to grow rapidly.

Some may be companies with stable, profitable businesses i.e. Low technology Manufacturing, distribution, services, and retail industries who want to finance expansion through new capital expenditures and acquisitions and/or to finance changes in capital structure and in ownership.

Public companies also issue private equity to help them through periods of financial distress and to avoid the registration costs and public disclosures associated with public offerings or in situation where they want to go private, issue a combination of debt and private equity to finance their management or leveraged buyout.

How do you get involved?

We shall briefly consider the regulatory frame work of starting Business as an equity funding company in Nigeria. The prospective equity funding company must first be incorporated pursuant to the Companies and Allied matters Act (CAMA). The Company will be a Special Purpose Vehicle (SPV) through which the investments will be made. It must be noted that the Memorandum and Articles of the company must specifically state the kind of business it intends to carry out.

After the company has become registered, if the company intends to deal in securities of a public company akin to buying into a listed company, the Investment Securities Act provides that the company must seek the approval and register with the Securities and Exchange Commission the apex investment regulatory body in Nigeria. It should also be noted that Section 17 of the Nigerian Investment and Promotion Commission Act (NIPC) allows a non Nigerian to invest in any Nigerian enterprise; however such interests must be registered with Commission.

The company must also register the securities it intends to invest in pursuant to the Securities and Exchange Rules; this may either be a public offer or a private placement. It should however be noted that only investments in public companies require registration with SEC.

The company will also have to be aware of the various tax laws in Nigeria including the Personal Income Tax, Companies Income Tax Act, Capital Gains Tax Act and Stamp Duties Act to mention but a few. It should however be noted that the Government in encouraging venture capitalist passed the Venture Capital (Incentive) Act which provides Tax relief on personal investments by venture capital company/projects where such investment is not less than 25 % of capital required for venture project and the company engages in:

I. Acceleration of industrialization by nurturing innovative ideas , projects and techniques to fruition:

II. Commercialisation of research findings with high potential for far reaching forward or backward linkages

III. Promotion of self reliance through the establishment of resource based and strategic industries through the provision of risk guarantee and insurance:

IV. Encouragement of indigenous processes and tech:

V. Promotion of the growth of small and medium scale enterprises with emphasis on local raw material development and utilization:

VI. Such objectives as specified by the FIRS(Federal Inland Revenue Service)

Conclusion

Nigeria has become a significant option in the realm of global investment. While investing in Nigeria involves significant risks, substantial progress has been made on a number of fronts to reduce risk in those markets. Corporate governance, accounting, and local securities regulations have all seen steady improvements and the Government has shown a genuine desire to nurture the growth of FPI through private equity investments.

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