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THE ROLE OF PRIVATE EQUITY IN ENTERPRISE DEVELOPMENT AND ITS CHALLENGES

A Case Study of Access Capital Services Share Company

Research Project Submitted to the Department of Accounting and Finance, College of Business and Economics, Mekelle University for the Award of Degree of Master of Science in Finance and Investment

By

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May 2010

DECLARATION

I, Tsion Taye, hereby declare that the research project work entitled "The Role of Private Equity in Enterprise Development and Its Challenges: A Case Study of Access Capital Services Share Company" submitted by me for the award of the Degree of Masters of Science in Finance and Investment to College of Business and Economics, Mekelle University through the Department of Accounting and Finance, is my original work and it has not been presented for the award of any other Degree, Diploma, Fellowship or other similar titles of any other University or institution.

Place: Mekelle　　　　　　　　　　Signature:___________

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CERTIFICATION

This is to certify that the project work entitled "The Role of Private Equity in Enterprise Development and Its Challenges: A Case Study of Access Capital Services Share Company" is an authentic work by Mrs Tsion Taye Assefa who carried out the research under my guidance. Certified further, that to the best of my knowledge the work reported herein does not form part of any other project report or dissertation on the bases of which a degree or award was conferred on an earlier occasion on this or any other candidate.

Place: Mekelle

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LIST OF ACRONYMS

ACSSC	Access Capital Services Share Company
BOD	Board of Directors
CEO	Chief Executive Organization
EVCA	European Venture Capital Association
IPO	Initial Public Offerings
IT	Information Technology
IVCA	Irish Venture Capital Association
LBO	Leveraged Buyouts
MENA	Middle East and North Africa
MFI	Micro Finance Institutions
PE	Private Equity
PLC	Private Limited Company
R&D	Research and Development

ABSTRACT

Several studies have documented that private equity, leveraged buyouts in particular, can fill the financing gap that exists when it comes to risky firms, such as distressed firms. This is, basically, because private equity firms not only provide patient capital but also close nurturing of investments by the financiers-characteristics which other forms of financing such as public equity and debt do not have. However, the role that a private equity firm can play in solving the challenges of risky firms is unknown in Ethiopia. To provide 'real-life' evidences of such role, the case of Access Company Service Share Company, the sole investment firm providing private equity services (to the researcher's knowledge) was used. Such role was examined from the point of view of corporate governance, management system, business networks, innovation and access to further finance. For that purpose, in-depth interviews with the general managers of each investee firm were made and few secondary documents reviewed as a supplement. The findings revealed that the main areas in which Access Capital has contributed are in improving the governance and management systems of investees. As it was deemed necessary to provide evidences on the general practises of private equity investments and the related challenges that these pose to investors as well, an assessment of such practises and challenges were also made. For that purpose, in-depth interviews with the vice president at Access Capital and a senior analyst were made, again supplemented by a review of few secondary documents. These have revealed that the most serious challenges faced by Access Capital are disorganized records of investees hindering the smooth undertaking of the deal sourcing and due diligence process, finding a skilled management team for investee firms and the potential challenge of making a fair exit. Even though the study is a quite useful one because of the insights it gives on Private Equity in Ethiopia, it is limited by the lack of financial

data. Thus, further research should be done to objectively measure the impacts that Access Capital has in its investee firms.

Key words: Private equity, leveraged buyouts, value addition (enterprise development)

CHAPTER ONE

INTRODUCTION

This chapter presents the background of the study, the problem to which the study gives solution, the main objectives and research questions, the methodologies used to answer the research questions and achieve the research objectives, the importance of undertaking the study, the scope to which the study is limited, and the limitations of the study.

1.1.Background of the study

Private sector development is a key factor if a country is to achieve sustainable growth. The best way to pull people out of poverty, the real exit strategy from dependency on aid, is inclusive growth. Economic growth is driven by private investments and improved productivity. Private sector development leads to innovation, new approaches, higher productivity, technology diffusion, more and better jobs, higher incomes, empowerment and economic freedom, higher tax revenues that finance services, better goods and services, real choices for the poor, increased capabilities for government, etc. In short, central to the private sector contribution is its role as the ‘engine of growth’.

But for the private sector to grow, there are a number of things that need to be in place. One of the most important things is access to finance. Financial development spurs economic development, but the other way round is also true. According to Karlan and Morduch (2009, p.10), the association of financial expansion and economic growth is well-established in the empirical literature.

In developing countries in general, poor households' access to finance or how to avail them micro-credits to help eradicate poverty is the focus area of most researchers. In Ethiopia, most of the research papers the researcher has examined in this area put their main focus on micro-finance institutions. But in order to have an inclusive financial system in Ethiopia, it does not suffice to concentrate on micro-finance institutions. This is so because MFIs in Ethiopia lend in average not more than 5,000 birr to an individual (Wolday, 2008; Getaneh, 2005), which is a very tiny amount for those firms which wish to obtain larger amount of financing to satisfy their working and investment capital needs. On the other side, there are also firms which are too risky for bank financing, but which are large for MFIs. Such firms can be those which do not possess the required collateral, firms which do not have regular cash flow, and distressed firms with huge bank loan and are near to bankruptcy. A study made by ACSSC (undated) on credit in Ethiopia provides further evidence on the difficulty to access bank loan in Ethiopia, mainly due to the restricting action that the National Bank of Ethiopia took to curb inflation. The study has shown that the average private bank has recently been giving out just 30 million birr in loans per month. And given that each bank has in average 45 branches and an investor borrows in average 1 million birr, this results into less than one borrower per bank per branch per month—a major slowdown in bank operations by any measure. These facts indicate that access to debt in general, leaving alone by distressed and risky firms, is something which is getting tougher.

On the other hand, equity financing through public share offerings is costly for risky firms such as small firms and those which are poorly performing. This is so because the cost associated with being registered as a public company, such as the legal and accounting costs involved in the provision of semi-annual public financial statements, annual auditing, and other disclosure requirements, as well as the cost of raising the shares are substantial (Kadikwa et al., 2005).

Difficulty to easily access finance is not the only problem that enterprises, particularly small and those with difficulties, in Ethiopia face. According to Bekele and Muchie (2009), Ethiopian enterprises, in addition to lack of finance, face a lack of good governance, research and development and technical skills.

This suggests the need for a financing instrument that not only provides patient risk capital but also non-financial inputs that can be invested in promising businesses unable to secure financing from traditional sources. This can be done by taking the high risk of such investment but also by rewarding investors with exceptional returns. If financial intermediaries that could provide risk capital are developed in Ethiopia, they can also create a good opportunity for investors to earn multiples of the risk-free rate of 5% (The Ethiopian Macroeconomic Handbook, 2009) that banks offer to them on their deposits.

In this connection, the private equity industry has an important role in filling the financial gap which cannot be addressed by other sources of financing such as commercial banks (Khadikwa *et al.*, 2005). The non-financial benefits that private equity firms provide to their investees have been well documented by numerous researchers. Some of the benefits that private equity firms bring in their portfolio companies include patient capital, corporate governance, general management guidance at board level, ability to recruit the best managers, ability to optimize the financial structure, and formation of business networks (Dagogo, 2009; EVCA, 2008; KPMG, 2007).

1.2. Statement of the Problem

As argued above, the distinguishing features of private equity financing such as its long-term nature and the hands-on investment nurturing by the private equity fund managers makes it an ideal form of financing to achieve sustainable growth of firms seeking both financial and

non-financial assistances. If private equity industry is developed in our country, it can be argued that it will strongly contribute to a faster growth of enterprises facing difficulties and that of the private sector in general.

However, the problem is that very little is known about private equity investments in Ethiopia and there is hardly any research done so far in that area. For the industry to develop and solve the multifaceted challenges that enterprises face in Ethiopia, the researcher believes people need to be aware of its potential benefits. On the other hand, potential private equity investors also need to know what challenges they are likely to face when investing in a developing country such as Ethiopia. To provide evidences on the roles that a private equity can play in its investee firms and the challenges it is likely to face, the researcher has used the case of Access Capital Services Share Company. This firm is to the researcher's knowledge, the sole investment firm providing private equity services in Ethiopia.

1.3. Objectives of the study and research questions

General objective

This study's overall objective was to shed light on the role that private equity firms play in enterprise development, while also creating awareness about the possible challenges of such investments using 'real life' evidence.

Specific objective

This study had the following specific objectives:

- To give a general picture of what private equity investment practices look like at the private company called "Access Capital Services Share Company", (referred to hereafter as "Access Capital" or ACSSC)
- To identify the positive changes that Access Capital's interventions have brought to investee firms,
- To identify the challenges that Access Capital has faced as a private equity investor at the different stages of the investment process.

Research Questions

The following research questions were addressed:

Q.1: *What positive changes has Access Capital's intervention brought to investee firms?*

Q.2: *What do Access Capital's private equity investment practices look like?*

Q.3: *What are the challenges that Access Capital has faced as a private equity investor?*

1.4. Research Methodology

Research design

This study was a case study of Access Capital Services Share Company. The researcher has selected ACSSC due to the inexistence (to the researcher's knowledge) of other investment firms providing private equity investment services in the country. The case study was intended to provide a 'real life' evidence of private equity investment practises, related challenges and benefits.

The study was also a descriptive one, intended to describe how ACSSC has benefited portfolio companies and the challenges it has faced in the investment process.

Data source

The researcher has used both primary and secondary data. The primary data was collected through semi-structured interviews and the secondary data included the private placement memorandum of Access Capital Services Share Company, a video of the chief executive officer's presentation to its shareholders, a documentary film on the portfolio companies, and other materials that Access Capital uses to guide its investment processes. Literature on the subject accessed from the Internet and the Library were also used. The interviews were basically made with representatives of two parties: the private equity firm –Access Capital – and the investee firms. The whole population of investee firm managers were used, except that of Piko Juice, and purposive sampling was used to select the interviewees at Access Capital. It was purposive because the researcher believed that the selected two interviwees at Access Capital knew the most about the private equity services being provided and could give a holistic picture. Interviewees from the investee firms included the general managers of Thermoplastic Industries, Polytech PP woven bags, the flour mill, and Real Water; on the side of Access Capital, the interviews were made with two individuals (the Vice-President of Investments and a senior analyst) working on private equity transactions. The interviewed general managers of investee firms were actually three in number because the flour mill and Polytech PP bag shared the same general manager. The general manager of Thermoplastic Industries was interviewed together with the human resource manager of the same enterprise. This was done because the human resource manager was not replaced by ACSSC and is more able to see the differences that took place after the firm was acquired. Piko juice was

excluded from the study because the investment is a Greenfield project, and the positive changes brought by Access Capital cannot be evaluated.

The reason for choosing the general managers of the investee firms was primarily due to the short period of time available for the study, making it difficult to consult all heads of departments (such as marketing and production departments). Besides, the researcher believes that the responses from the general managers are useful to get a holistic and comprehensive picture of the positive changes brought by ACSSC's interventions.

Data analysis

The interviews with the general managers were intended to give some insights into the contributions of private equity investments to investee firms. On the other hand, the interviews with the individuals at Access Capital were intended particularly to give some insights on the practices and challenges of private equity investments.

The secondary data were used as additional inputs to support the interview responses.

Qualitative data analysis, namely, content analysis was used to analyze the data. This is so because the collected data are qualitative in nature, extracted from the interviews and secondary documents.

The interview responses were analyzed context wise. The interviews to the general managers were analyzed with respect to the variables identified from the literature review and appearing in the conceptual framework. Similarly, the interview responses from the senior staff at Access Capital were analyzed content wise, with respect to the different steps involved in the private equity investment cycle.

1.5.Significances of the study

This study is significant as the findings and the selected related literature will provide useful evidences to the readers in general and to potential investors and investees in particular:

- on the existence of private equity investment services and its practice in Ethiopia, thus adding to existing knowledge on the Ethiopian financial sector;
- on the non-financial contributions (in addition to financing) of private equity firms to investee firms;
- on the challenges of undertaking smooth private equity investments and thus allowing prospective investors to devise mechanisms to avoid or reduce the impact of such challenges on the performance of their investments;
- to create awareness about private equity form of financing as an alternative to debt financing to enterprises which are facing difficulties to access traditional bank finance and require larger amount of financing than what can be supplied by MFIs; and those firms whose difficulties go beyond lack of finance.

1.6.Scope of the study

This research was limited to showing how investee firms benefit from the interventions of Access Capital and the challenges that the latter faces in the process. The study, thus, does not attempt to evaluate the full benefits likely to accrue to investors (or ACSSC) from their private equity investments.

Moreover, the study considers as investors the fund management company (Access Capital) and not the limited partners as these are difficult to find due to their dispersed nature. Thus, the challenges to investors (in the private equity investment process) in this study were

investigated from the perspective of the fund management firm (Access Capital) or the general partner.

More importantly, the study was limited to showing the non-financial contributions (which of course are made using finance as well) that Access Capital has made in its investee firms. The study does not attempt to measure the impacts that Access Capital's interventions have had on portfolio firms in financial (measurable) terms due to scarcity of financial data and the short duration since the launch of the investment.

Though the study is aimed at showing the role that private equity firms play in general, only particular issues related to Leveraged Buy-Outs are addressed and specific issues related to other forms of private equity (namely, venture capital and growth capital) are not concentrated on.

1.7.Limitations of the study

The research suffers mainly from lack of financial data availability. Financial data are confidential and could not be accessed by the researcher.

The lack of financial data has hindered the researcher from measuring and showing at least the short term impacts of ACSSC on investee firms' performances with the help of a trend analysis using financial ratios.

Even if the financial data were accessed, the fact that Access Capital is a recently established company (started operations in June 2007) makes it impossible to evaluate the post buyout impacts of ACSSC on investees using metrics such as investee firm profitability, sales or firm value growth. Such measures (growth in sales, profits and firm value) of the long-term

impacts of ACSSC on investee firms and comparison with pre buyout situations could have served as a reliable indicator of the positive contributions of a private equity firm.

Thus, the researcher is obliged to assess only the role that ACSSC has played in enterprise development qualitatively based on the interview responses of the management of the investee firms; without objectively measuring the impacts.

Another limitation of this study is the fact that it is difficult to generalize on the challenges of private equity investments and the positive changes that such investments bring to investee firms using a single case study. The researcher was forced to use a single case study as ACSSC is (as per the researcher's knowledge) the only investment company operating in Ethiopia. Despite such limitations, the study will still provide an opportunity to learn from the 'real-life' experiences pertaining to private equity investments in Ethiopia.

CHAPTER TWO

LITERATURE REVIEW

This chapter deals mainly with the existing literature on the types of private equity, the private equity investment process, and empirical researches on how private equity firms in general and LBO firms in general add value to their investee firms. It helps the reader, especially the one not acquainted with private equity investments, get to learn on the area as put by other researchers and then later make comparisons with the findings of this study.

2.1 What is private equity?

According to Sami (2002), private equity is capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, to strengthen balance sheets and to resolve ownership-management issues. Frederikslust and der Geest (undated) define private equity as risk-carrying capital invested in privately held companies, and subsequently divested once the investee firm's financial and operational performance has been optimized. Such definition emphasizes the distinguishing characteristic of private equity investments; namely, exiting after the value of the firm has been optimized. Hopkins *et al.* (2003, p.8) define on the other hand private equity as "financing for early- and later-stage private companies from third-party investors seeking high returns based on both the risk profiles of the companies and the near-term illiquidity of these investments". This definition brings to light the fact that investors of private equity do not make investments directly but indirectly through an investment company, namely, the Private Equity Fund Management Firm. It also shows the illiquid nature of private equity investments. In a summarized fashion, private can thus be

defined as equity investment in firms made through an investment company (the private equity firm) with the purpose of divesting once the investee firm's value has been optimized.

2.2 Forms of private equity investments

Private equity investments can be divided into three major categories depending on the life stage, or maturity of the company being supported: venture capital, growth capital and buyouts (EVCA, 2009).

Venture capital

Venture capital refers to financing of a business in its early stage. We can identify three broad classifications of venture capital financing: seed capital, early stage and late stage financing (EVCA, 2009). Seed capital refers to funding for research, evaluation and development of a concept or business before the business starts trading (Abereijo and Fayomi, 2005). Early stage financing refers to the financing of new companies being set up or the development of those which have been in business for a short period of time. Late stage financing refers to financing of companies that have completed product development and which require funds to start commercial sales (Khadikwa, 2005).

Venture capital backed companies are usually financed with equity capital because they do not generate enough cash flow to support interest payments in the early stages of their lives. Once they have started to generate positive cash flow, these are usually re-invested for expansion purposes (EVCA, 2009). According to EVCA (2009), in most of the cases, the companies that receive venture capital financing are those seeking to commercialize a specific innovation- generally technology driven. For this reason, projects financed by

venture capital are characterized by a high level of uncertainty (both economic and technological) (Kõomägi and Sander, 2006).

Growth capital

According to EVCA (2009), growth or expansion capital refers to investments (usually a minority stake), in small and medium sized companies to help with specific growth challenges such as entering a new market, developing a new product, or making strategic acquisition. In contrast to venture capital backed companies, firms that receive growth capital or expansion capital have stable cash flow, are break-evening or are recording positive profits (Abereijo and Fayomi, 2005). Growth capital investments are thus considered as less risky and more certain than venture capital.

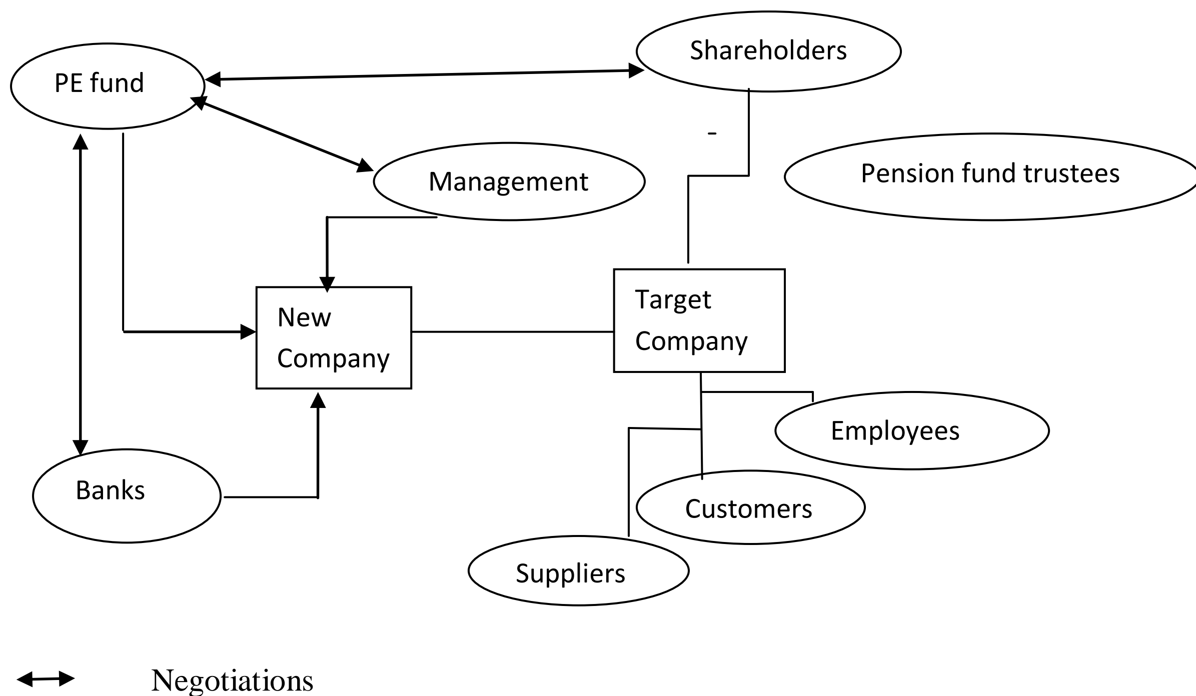
Buyouts

EVCA (2009) defines buyouts as investments in mature businesses with strong cash generating potential. The private equity firm and the management team "buys out" all (or a majority) of the shares in the company and refinances its debt causing a change in control (in contrast to expansion and growth capital). As put by Makhene (2008, p.21), a buyout is a partial controlling stake or full acquisition of the target company. There are two types of buyouts in private equity— management buyouts (MBO) and leveraged buyouts (LBO). MBOs are initiated by the management team of the target company and typically involve management buying out shareholders' equity and making the public company private. Because of the difficulty that the existing management faces to secure debt financing for the buyout, the former seeks the assistance of a private equity firm. The private equity firm will sponsor the buyout transaction by raising debt and providing equity in exchange for

controlling equity rights as well as strategic control of the target company (Makhene, 2008). LBOs, on the other hand, are initiated by the private equity firm itself which has the option of replacing the existing management. As the name implies, an LBO is an acquisition of a target company through a high debt-to-equity ratio transaction (EVCA, 2009; Makhene, 2008). An MBO can be considered as a form of LBO.

Though there are many forms of private equity present in Western markets, the most common strategy is leveraged or management buy-out – in which a firm acquires under-managed, or undervalued, public or private companies, potentially turns them around and uses financial leverage to enhance real returns (Amwal, 2009).

Figure 1. Participants in a leveraged buy-out



Negotiations

Source: Giligan and Wright, 2008

As shown in Figure. 1, the parties in a leveraged buy-out are the private equity (PE) firm, the target company of the acquisition (with its employees, customers and suppliers) and its

management, the shareholders of the target Company, and banks which are proposing to lend money to finance the acquisition. Negotiations take place between the PE fund and banks on the debt financing required for the acquisition, between the existing shareholders and the PE fund on the terms of the acquisition (on the percentage of the PE's stake in the new company, on the valuation of the target company, and other items), and between the PE firm and the management of the target company. The role of the management depends on the particular buy-out; they may be part of the group seeking to purchase the business and therefore be aligned with the private equity fund (in which case the buy-out is termed as a management buy-out – MBO) or alternatively, the private equity fund may be seeking to introduce new management if they successfully acquire the business (we speak here of a management buy-in – MBI) (Giligan and Wright, 2008).

The New Company appearing in the above figure refers to the newly formed company, after a successful acquisition, funded by the lending bank/s and the private equity fund.

The differences between venture capital, expansion or growth capital and leveraged buy-outs are summarized by Zalan and Lewis (2009) as follows:

Table 1. The difference between venture capital, expansion or growth capital and leveraged buy-outs

Basis	Venture capital	Expansion capital	Leveraged buy-outs
Risk and return	High risk and high return (significant operational, technical and market risk)	Low risk and low return (more of financial risk)	Low risk and low return (more of financial risk)
Extent of ownership	Minority positions (gradual increase of equity position as business matures)	Typical minority position (so equity position increases) but could be majority position	Private equity firm owns the company (or a majority stake)
Risk diversification/ minimization	Investments in many portfolio and staged investments	Many portfolio investments	Many portfolio investments
The investee firms	Generally high-tech firms start-ups but can include any innovative business	Investing in established firms-good businesses with growth potential	Large capitalization companies with good cash flow
Mode of financing	Usually in equity form, but debt instruments are also used	Both debt and equity, but mostly equity	Very high financial gearing plus equity

Exiting	IPO is preferred	Exit via MBO or trade sale – less frequently IPO	Exit via re-float, trade sale

Source: Zalan and Lewis, 2009,

2.3 The private equity investment process

The major steps in the private equity investment process can be identified as fundraising, deal sourcing, conducting due diligence, valuation and deal structuring, monitoring and exiting. An explanation of each of the steps is provided below.

Fundraising

The private equity firms raise capital from a variety of sources such as institutional investors, wealthy individuals, corporate investors and government agencies. The funds are raised in a blind pool; that is, investors do not know for which purpose the funds will be used at the time of the fundraising (Khadikwa, 2009). In a leveraged buy-out, the sources of financing are bank loans and equity from the private equity firm. The use of leverage increases the returns for private equity investors from successful investments and creates financial risk in under-performing investments (Giligan and Wright, 2009). According to Snow (2007, p.7), 'The fundraising market is the greatest barrier to entry in private equity'. He argues that if a team of general partners have not previously managed a fund together and exited profitably several private equity transactions, it is often difficult getting limited partners to commit, regardless of the merits of the investment strategy. It can be assumed from Snow's (2007) statement that the limited partners will take a more risk averse position particularly if the portfolio companies are distressed ones and need the assistance of the general partners to turn them around.

Deal sourcing

This step refers to the search by the private equity firm for quality deals on which it will invest. A deal can be originated through the use of agents such as investment banks who would search on behalf of the PE firm, or the potential investees themselves can come at the desk of the private equity firm. Private equity firms need to be skilled at finding attractive investment opportunities, at generating great deal flow (Snow, 2007). According to Snow (2007), today a large percentage of investment opportunities go through intermediaries such as investment banks whose job is to secure the highest valuation possible. This suggests that, in the absence of either a professional general partner or an intermediary that can source quality deals, the search cost incurred may not be one that is proportional to the return that the sourced deals can generate. Deal sourcing among small companies seeking for financing is particularly a difficult task that causes investors to incur high search costs (HM treasury, 2003). In addition, in developing countries, it is difficult to find quality deals easily due to the unreliable information that small and medium businesses (which constitute the majority of businesses) provide to investors. This finding was made by Abereijo and Fayomi (2005), who asserted that the elements that hinder the development of a flow of quality projects are the lack of businesses that have good business plans and well presented financial statements. This erodes the confidence that the investors have on the entrepreneurs and the financial projections they have made.

Conducting due diligence

Once a target company has been identified and after obtaining the latter's consent, the next step is to conduct a due diligence before the acquisition decision is made. As put by Makhene (2008), due diligence is the process of assessing the target firm's financial statements, weighing strengths and weaknesses of the target company's business model, evaluating

market opportunities, market trends and projecting strategy fit with the fund's portfolio of acquired target companies. The due diligence process includes extensive financial, legal and commercial investigation on a business and studies the sustainability of its businesses (EVCA, 2009). The findings of the due diligence process may or may not result in the acquisition of the target company. In the event that the due diligence process reveals more on the weaknesses of the target, such results can still serve as an input to the target company.

During the due diligence step, investors face serious difficulties in assessing the integrity and competence of the entrepreneurs (Hopkins et al, 2003). This is because firms have the habit of maintaining two or more sets of accounts to avoid the tax collector, hindering the due diligence team from getting an accurate picture of the firm's performance. In addition, according to Hopkins et al. (2003), opaque bookkeeping and disclosure habits also may impede access to other important information that might alter investor perceptions of company value, such as environmental liabilities or unresolved legal disputes.

Valuation and deal structuring

If due diligence provides enough evidence of the target firm's intrinsic and synergistic value, then the next step is acquisition. The acquisition process includes a negotiation on the value of the target firm, on the rights and obligations of investors, the composition of the BODs, the share of ownership of the private equity firm and other agreements between the promoter and the LBO firm (or private equity firm in general). According to Bene (2005), by far the most common legal structure for private equity funds is the limited partnership in which the general partners assume unlimited liability whereas limited partners' is limited to their investments. The general partners are in charge of monitoring the day-to-day activities of the investees whereas limited partners do not have such rights and are silent partners.

The valuation of established companies which are target of LBO firms can be done primarily using the discounted cash flow method and market comparison (Bene, 2005). Market comparison refers to comparing revenue multiples, net earnings and earnings before interest, taxes, depreciation and amortization with another firm in the same business and with the same risk level. As valuation practically depends on the financial statements available, these should be of good quality in order to fix a fair price. According to a study made by Abereijo and Fayomi (2005, p.225) in Nigeria, valuing businesses is a serious challenge [in developing countries such as Nigeria] because of

> *"lack of reliable historical financial information or meaningful financial projections; limited financial skills and industry data for valuations; entrepreneurs' ignorance on subject and negotiations tend to be long drawn; and lack of reliable data to base macro-assumptions".*

Monitoring/Value addition

Once the target company is acquired, the private equity firm closely monitors its operations to make sure the intended objectives are in line with set targets. Representatives from the private equity, often highly experienced in the industry of the portfolio company, take a very active governance role in directing the company's strategy and supervising management (though leaving day to day operational control to managers) (EVCA, 2009). The role that the private equity firms play in their portfolio companies is put by EVCA (2009, p.15) as follows:

> *They act as very engaged non-executive directors to the company, with strong participation in determining the composition of the board, deployment of management incentive systems, selection, support and revision of management teams,*

development of strategy, monitoring of performance and, increasingly, introduction of best management practises.

Constant monitoring and overseeing the developmental stage of the company is one of the key roles of the private equity firm. Though the monitoring role of the private equity firm can be hands-off as well, it is rather hands-on in developing countries where the need for assistance of businesses is much stronger. Academic evidence suggests that this active management style may be a significant factor in the increase in the value of many successful investments (Giligan and Wright, 2008). The same finding is put by EVCA (2009, p.16) as follows: "active ownership does indeed lead to better management practises and higher productivity growth".

This emphasizes the need for the representatives of the private firms handling the monitoring role to have excellent skills in management and have excellent knowledge in the industries the portfolio companies operate. In addition, the management team of the portfolio companies put in place by the private equity firm needs to be a competent one in order to speed the growth of the investees. A study made in the MENA Region by Amwal (2009) reinforces this by revealing that expertise and leadership role of the management team are necessary if the firms are to be run professionally. The study also adds that

external introductions by private equity firms often are not enough, and that a lot of work may have to be done in training management to be more professional and in bringing in best practices to companies that are often parochially run (Amwal, 2009, p.4).

The costs associated with monitoring portfolio companies can be significantly higher particularly if the business' management team is relatively inexperienced (HM treasury, 2003) and non-responsive to change.

Exiting

After a due diligence and a negotiation period, investors commit capital and, after some years, sell their shares either via trade sales (sale to another industrial buyer), an IPO or a secondary transaction (sale to another financial investor) (Weidig and Mathonet, 2004) or back to the original entrepreneur/promoter of the business. According to EVCA (2009), success or otherwise of the private equity investment is determined at the sale of all or a large part of the portfolio company's equity (exit), usually after a period of 10 years from the date of investment. This suggests the need for a favourable environment in which the different possible exit routes can be easily accessible. Exits achieved through IPOs tend to maximize firm value, relative to the alternatives of selling shares to strategic investors or back to the original owners (through management buy-outs) (Hopkins et al., 2003). However, according to an unpublished paper by Lerner and Schoar (undated, p.8), "Perhaps the most vexing aspect of private equity investing in developing nations has been the difficulty of exit". In the absence of a vibrant stock market that could facilitate the IPO process and the lack of other private equity firms that could buy the firm (secondary transaction), the most feasible exit route will be to seek strategic buyers (industrial buyers), and has been the case in most developing countries (Lerner and Schoar, undated).

2.4. How do Private Equity firms and in particular LBOs create value?

An empirical research made in France by Le Nadant and Perdreau (2006), shows that LBO targets are firms which are less indebted, are more profitable and have pre-deal higher income taxes than their industry counterparts. They have also argued that these firms have higher working capital requirements and have higher volatility of performance or exhibit higher business risk. The reason why firms which are more profitable and are less indebted are the choice of LBO firms is because the latter expects to use the free cash flow (adjusted profits) of the firm for post deal interest payments (and thus minimizes its risk). On the other hand, the reason why firms with higher income tax are targeted is because most LBO firms expect to benefit from tax shields arising from future interest payments. Their arguments, when summed up, show that LBO targets are firms with good operating performance. This view contradicts with the argument of Braun and Latham (2007) who argue that LBOs are a response to defective Board of Directors (BODs) (whose roles are to maximize shareholder's value through monitoring and to bring in expertise to enhance value) whose consequence could only be poor operating performance. Le Nadant and Perdreau (2007) thus view LBO firms not as firms which intend to create operational value in target firms but as those which want to benefit from tax breaks (in the form of interest tax shield).

Chung (2009) also supports the argument of Le Nadant and Perdreau (2007) that target firms have higher profitability, more favourable cash position and with better growth prospects (more investment opportunities) than their peer firms. He also argues that LBO targets are those that have underutilized debt capacity or are underleveraged. Chokski (2007) also

supports the view that targets chosen by the LBO firm are those with steady cash flow, significant debt capacity, have steady growth and those that have a strong management team, among other things. The views of Chung (2009) and that of Le Nadant and Perdeau (2007) are an indication that LBO firms seek firms which are in a good financial position and do not put them in a significantly risky position. Though LBO targets are mostly firms with strong cash flow position, this does not hold the latter from adding value to their investees. As put by Andre et al (undated, p.19), "the organizational changes inherent with the leveraged buyout (better monitoring and incentive alignment) create value in these companies".

According to Blaydon and Wainwright (undated), there are three ways in which a buy-out can build value: buying low and selling high, structuring an improved combination of debt and equity, and by improving operations to increase cash flow. The strategy of buying low and selling high consists of anticipating increase in the value of a firm which has low value at the time of acquisition. Such a firm may be one that has cyclical performance, suffering at some period and prospering at others. Such strategy is nowadays not succeeding as sophisticated sellers are now aware of the value increase that private equity acquirers are anticipating. This has led to sales being frequently achieved through auctions or multiple bilateral negotiations; relatively few are unilateral proprietary acquisitions.

The second strategy is recapitalizing to add value. This consists of using a high level of debt and small amount of equity to benefit from the interest tax shield. However, today, restructuring the balance sheet to add value to firms is commonly practised by all qualified companies and is not a practise which is exclusive to private equity groups

According to Blaydon and Wainwright (undated), because private equity investors realised that they could no longer rely on finding acquisitions at attractive prices and aggressively adding debt to achieve their investment objective, they had to actively encourage or even

intervene to achieve improved operating performance of their acquired companies. They thus worked closely with management and hired consultants and experts to improve the performance of operations and maximize cash flow. This shows that LBO (and private equity firms in general) firms add value to investees through their constant monitoring of the latter either using internal experts or by hiring external ones.

The hands-on involvement of PE firms in their portfolio companies is also supported by Dagogo (2009, p.41) who asserts that, '[private equity firms] foster growth in companies through hands-on involvement in financing, management, and technical support'. Private equity firms support their investees in terms of financial advice, corporate strategy, innovative ideas, market access and information (Sami, 2002; Makhene, 2008).

The definition of private equity as given by EVCA (2009) is also an indication of the holistic contributions of the private equity to group companies. EVCA defines private equity as equity capital raised by private equity firms (professional services firms) from investors with a mandate to invest the money in equity stakes in companies; participate in the governance of these companies by joining the board; improve their operational and strategic performance; realize resulting increase in the value through private sale or public flotation and return funds with accumulate gains or losses to investors usually at the end of 10 years (from the date of investment).

EVCA (2008, p.4) describes the contributions of private equity firms to their investee firms as follows:

> *Key financial and operational contributions by the private equity provider were found to be the monitoring of financial performance, regular budget reporting and monitoring operating performance. In terms of non-financial contributions, the*

private equity investor functions were mainly seen as a sounding board for management ideas, a provider of business and industry contacts and supporting the management's recruitment and development. Hence, private equity [...] supports the growth and the development of the company after the buyout by strengthening their performance and business procedures.

Empirical evidence has shown that private equity financing plays a tremendous role in improving the management system and corporate governance of the investee firms (IVCA; Amwal, 2009; Bloom et al., 2009). According to Bloom (2009), private equity backed firms are better managed than government-owned, family-owned and privately owned firms. Their management systems also tend to improve quickly. The superior management system of private equity backed firms is also reflected in the attempts the management makes to create a conducive environment to the portfolio firms' employees.

According to EVCA (2008), private equity involvement increases employee commitment through financial invectives and greater employee engagement, though regular team briefings, training programs and harmonized terms and conditions between management and non-management. Such characteristics of private equity form of financing can be of great help to support the efficiency of investees' business operations.

The other area in which private equity firms contribute is corporate governance. According to Braun and Latham (2007), leveraged buy-outs are a response to defective BODs and that post-buyout, the restructured board of director serves as a distinctive source of value. They, however, present such an argument from the perspective of two theories, which mostly are incongruent: the theory that supports the agency role of the board of directors and that which supports the resource dependency role of the board of directors. Each theory is a proposition of the 'optimal' BOD. According to Braun and Latham (2007), the agency theory views the

role of the BODs mainly as a controller of management's activities and ensuring that the latter works towards protecting the interest of shareholders (or simply said, eliminating the agency cost arising from the separation of ownership and control). On the other hand, the resource dependency theory views the optimal BOD as one which primarily brings expertise, experience and a set of connections with the external environment and benefits the firm by enhancing its reputation and thus its value.

A summary of the differences between the two theories can be put as follows:

Table 2. The difference between Agency role of BOD and Resource dependant role

	Agency role of BOD (Optimal BOD)	Resource dependence role (optimal BOD)
Board size	Small size	Large size
Board leadership structure	Non-Dual leadership	Dual leadership
Board dependence	More outside members	More outside members
Director's experience	More directors with past membership in other boards	More directors with past membership in other boards
Director's expertise	More members with monitoring level expertise	More members with monitoring level expertise

Source: Braun and Latham (2007)

Braun and Latham (2009) have demonstrated their earlier qualitative work on the leveraged buyout BOD as a source of value creation quantitatively to show further the benefits of board restructuring in LBOs. In this study, they have shown that the large board size, board capital and dual leadership structure (structure where the CEO and the board chair are the same) supported by the resource dependence theory have improved firm performance. They have also supported the monitoring role of the BODs (agency theory) to protect the interest of shareholders as a contributor to improved firm performance.

According to IVCA, the use of Non-Executive Directors is another way of accelerating the development and growth of businesses; whether it is a longstanding traditional business or start-up seeking equity finance, non-executives can bring added value with objectivity drawn from their own experience and skills. And it is normal practise for venture capital investors to place a Non-Executive Director (one who has sectoral, market, or management expertise) on the board of the investee company to represent their interests.

Private equity investors accept higher risk than traditional banks, do not require collateral, provide long-term or at least medium term capital (patient capital in contrast to short term loans provided by traditional banks), provide managerial knowhow in addition to finance, and provide networks with suppliers, customers, other investors (Dagogo, 2009; Macht, 2006). In addition, the financing that private equity investors provide flexible terms in contrast to fixed regular payment of interest in debt financing. Khadikwa et al. (2005, p.1) have also put their argument in favour of private equity for smaller companies' growth as follows:

> *[Private Equity] has a role to play in improving the overall efficiency of business financing, by not only providing a source of funding for smaller and riskier companies with a great potential to grow and which may face difficulty in raising funds in public markets, but also mentoring and management support.*

In addition to the above, private equity firms also play the role of certification in the IPO process at the time of exit and in obtaining easier access to debt financing in better terms than if the firm has not received any private equity backing (Kovner and Ivashina, 2008; Frederikslust and der Geest, undated). Kovner and Ivashina (2008) argue that the repeated interactions of LBO firms with banks that finance their portfolio companies lower the cost of debt by reducing asymmetric information between the bank and the LBO firm (financial sponsor). The cost of financing is lower because banks have acquired information about the LBO firm from prior transactions, such as gaining confidence in the LBO firm's due diligence process.

Research has proven that private equity investments can yield very high return to investors and is a good financing option to SMEs, particularly to those with high growth prospects. As put in the report by Khadikwa et al. (2005, p.4), "the transformational impact of private equity, applied over decades in various parts of the world, has been well documented". The same report asserts that whole new industries have been fostered and their growth accelerated by the injection of risk capital seeking high absolute returns for both investors and entrepreneurs.

Chung (2009) has shown that private targets grow substantially post-buyout through larger investments and acquisitions. This supports the view that leveraged buyouts alleviate the investment constraints of privately held targets. He argues that the purpose of the LBO firms when acquiring privately held companies is not to reverse investment inefficiencies but to exploit the investment and growth opportunities that these companies have. Post-buyout, they import operational and industry expertise as well as industry and regional networks into the target companies. They also solve the problem of easily accessing public resources to exploit

the identified investment opportunity and the risk aversion of exploiting such opportunity that existed while the firms were privately held (by few individuals).

2.5. The conceptual framework

Existing literature has provided enough evidences on the contributions of private equity investments and the challenges of undertaking private equity investments in different parts of the world. The aim of this study is to look for evidences on the benefits (to investees) and challenges of private equity investments in the case of Ethiopia. The aim is thus not to fill a gap that exists in literatures related to private equity financing but to provide additional evidences on the facts identified in the literature by taking the Ethiopian case.

A conceptual framework was developed to guide the research and to define the main variables that are addressed therein. For that purpose, a number of variables that describe how a private equity firm plays its role in enterprise development (described above as the benefits of private equity to investee firms) and challenges of private equity investments were identified from the literature review.

The challenges of undertaking private equity investments will be seen from the whole investment cycle point of view. That is, from the stage funds are raised from various investors up to the stage the funds are divested. This is because the challenges that private equity investors can possibly face arise at one or more stages of the investment cycle. Thus, the challenges that the private equity investors face at the fundraising, deal sourcing, due diligence, valuation and deal structuring, monitoring and exiting stage will be examined. Each of these stages was defined in the literature review part of this report.

The role that private equity firms play in enterprise development will be examined with respect to variables identified in the literature review. The benefits of private equity

investments can be defined as the contributions that private equity firms make to their investee firms in addition to long-term finance (and by using long-term finance as well) or simply put, the value additions that a private equity firm makes to investees. Such value additions by the private equity firm are referred to as Enterprise Development in this study.

To avoid confusion on the meaning of ‘enterprise development’, the definition which follows is used in this study:

Enterprise Development: it is a business development, in which investment of time and capital is made in expanding or improving the operations of an enterprise. It is a holistic process of positive change that expands, enlarges, strengthens, grows or improves the operational quality of an existing business. As the investees studied were distressed firms pre-acquisition, enterprise development in this study particularly refers to the process of revitalizing such firms. This definition, thus, limits enterprise development to the process of value addition to an existing business and does not refer to the process of creation of new ventures.

Having this said, the identified major ways in which private equity firms (in addition to long-term financing) play their role as value adders (or contribute to enterprise development) are through ((IVCA; Amwal, 2009; Bloom et al., 2009, EVCA , 2008):

- The creation of business networks
- Building innovative capabilities
- Facilitation of further financing
- Improvement in corporate governance
- Professionalizing management
- Other ways, if any.

Each of the identified variables is defined as follows:

Creation of business networks: This is defined as the creation of industry contacts with potential buyers and sellers both at local and international levels, building strategic partnerships that can help future divestitures, and other personal contacts that can add value to the investee firm. Business networks also include better marketing strategies as these ultimately result in the creation of strong networks with long-term buyers.

Building innovative capabilities: this refers to the introduction of new products and services after the interventions of the private equity firm, new technologies that improve the efficiency of the production process and introducing new IT systems, improved research and development expenditures.

Facilitation of further financing: this refers to the facilitation by the private equity firm to access further debt financing or equity financing.

Improving corporate governance: This refers to improving the transparency of the accounting and reporting systems of the investee firms, and respect of other common corporate governance principles.

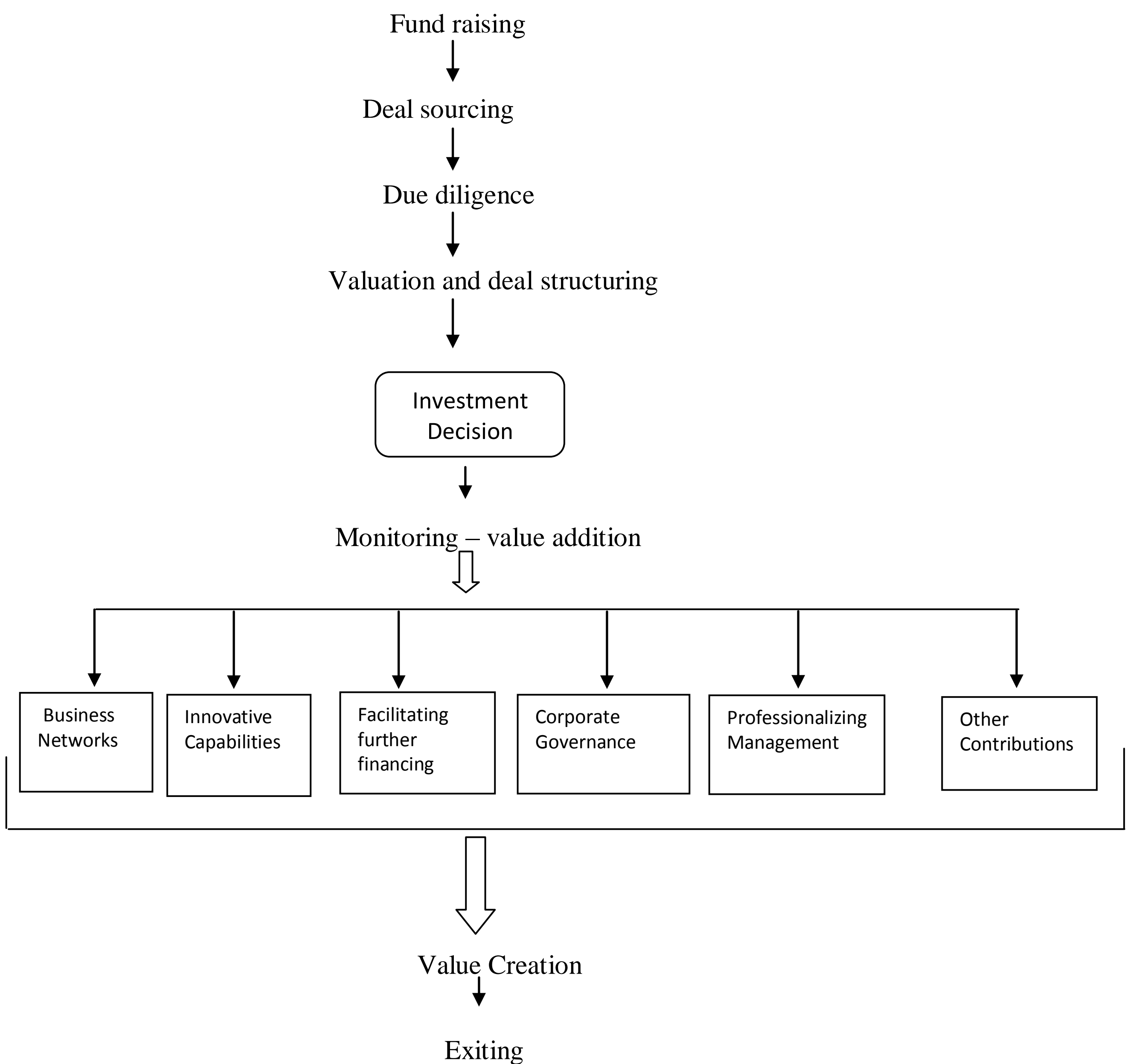
Professionalizing the management system: This refers to hiring outside experts that lead operations strategically, designing compensation plans both for the management and line employees, introducing best management practises in general.

Other contributions: These are contributions other than the above mentioned, which can be identified in the Ethiopia case.

Designing the research in such a manner will give a clear picture and evidence of the role that private equity firms play in Ethiopia. The researcher expects the findings of this research to

show the role that private equity investments could play in promoting the growth of target companies. But the researcher also would like to 'warn' prospective private equity investors, wishing to enter the Ethiopian private equity market; about the possible challenges they can face at different stages of the investment cycle. Below is a diagrammatical illustration of the relationships between the identified variables

Figure 2. Diagrammatical representation of the conceptual framework



Source: Author's own construct

CHAPTER THREE

BACKGROUND OF THE ORGANIZATION

This chapter introduces Access Capital and its investee firms to the reader. It gives a highlight to the reader on the general profile of ACSSC, the services that it provides in addition to private equity and the profiles of each of the investee firms.

3.1 General profile

Access Capital was formed after a successful capital raising share offer. It is a share company established in accordance with the Ethiopian Commercial Code (1960). The company was registered on 26 May 2007 and started operations in June 2007. Its head office is on the same building with the new Zemen Bank in Josef Broz Tito Street (in Kazanchis area of Addis Ababa).

Access Capital Services Share Company is an innovative company which supports economic growth in Ethiopia by helping dynamic Ethiopian businesses raise funds and widening the opportunities for investors. It seeks to encourage the growth of sustainable and productive businesses and economic infrastructure while achieving above average returns for its shareholders.

The business objectives of the Company (extracted from the Memorandum of Association, 2007) are:

- To invest in different sectors of the economy,
- to render advisory services to investors regarding investment,

- to buy shares from different companies and sell the same, and
- to do other businesses related to the above.

3.2 Main activities of Access Capital Services Share Company (ACSSC)

The main activities of ACSSC can be grouped into three main categories: Private Equity investments, Corporate Advisory Services, and Liquidity Creation (ACSSC private placement memorandum, 2009). A description of each activity is briefly provided below.

a. Private equity investments

The main activity of ACSSC since November 2007 has been to invest into distressed companies. Their target enterprises are those which have faced problems with working capital and management. By adding a small amount of capital, for instance by bringing loans up-to-date, Access Capital has been able to purchase majority (90%) stakes in four businesses. Making investments in group companies includes:

- Taking controlling stakes, ‘turning-around’ the businesses and then managing them for growth,
- Setting up and running new businesses for identified business opportunities,
- Setting up and administering investments on behalf of overseas investors wishing to enter the Ethiopian venture capital market (Ibid).

Access Capital is concentrating on opportunities which offer a payback period of approximately one year or less. So far the concentration has been on the fast moving consumer goods market.

Access Capital's group companies, to date, are five in number; namely, TGMD Trade works (Real Water), Polytech PP Woven Bags, MA Thermoplastic, a Flour Mill and Piko Juice Factory. A brief profile of each of the companies is provided below.

Real Water (TGMD) PLC

Real Water is a factory that produces bottled drinking water in different sizes from 0.5 litre to 2 litres. The majority shareholder of Real Water is Access Capital with its recent acquisition of 90% stake, while Ato Tadele Galecha (the original owner) owns the remaining 10%. The firm was acquired on July 1, 2008. The plant is located in Burayu Town, Oromia Region, along the Addis Ababa-Wollega road. It shares premises with Polytech PP Woven Bags factory, another Access Capital investment. The type of the acquisition deal is a leveraged buy-out but destined to saving distressed companies (Ibid).

Polytech PP Woven Bags Factory

Polytech is one of the few polypropylene bags manufacturing companies established in Ethiopia. The factory was established in 2001 and has been producing different types of bags and hessian clothes of different sizes and shapes. Since its inception, the factory has supplied the nation's economic driving engines (i.e. agriculture and manufacturing industries) with quality packaging. Access Capital has purchased 90% of the company, following its objective of purchasing companies that are facing financial and related difficulties. The remaining 10% share is retained by the founder. The plant is also located in Burayu town where it shares premises with Real Water. The acquisition is a leveraged buy-out but destined to saving distressed companies (Ibid).

Thermo Plastic Industry Private Limited Company

MA Thermo Plastics Industry PLC is one of the largest plastic manufacturing companies in Ethiopia. Established in 1971, it is the oldest plastic producer in the country. Its objective is to produce plastic products locally as a substitute for imported plastic items and produce plastic products as an alternative to wood and steel products. It is engaged in almost all plastic processing technologies, including: Film blowing, extraction, injection molding, blow molding and compression molding. As of January 2008, Access Capital has acquired 90% of the company and the founder has retained the remaining 10% of the company. The investment deal was a leveraged buy-out but destined to saving distressed companies (Ibid).

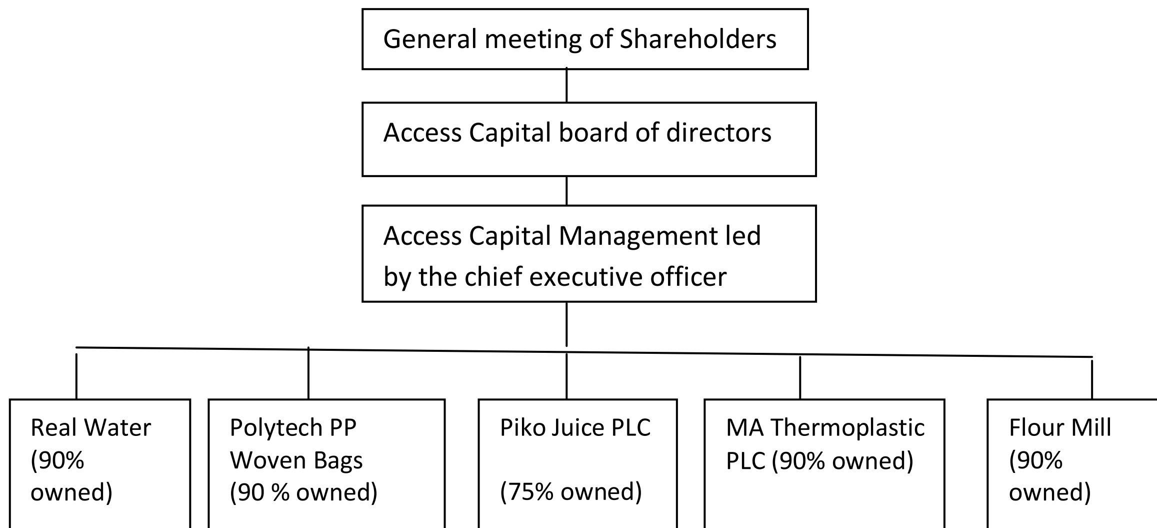
A flour mill

This medium-sized flour mill factory was acquired in July 2008. Access Capital has acquired 90% of the company with 10 % retained by the original owner (Ibid).

Piko Juice factory PLC

Piko is a start-up manufacturing company involved in the production and distribution of juice products in Ethiopia and neighbouring countries. In Ethiopia, its products are established by the brand, “Snap!”. It is a private limited company owned by Access Capital (75% of equity) and Prisma Investment PLC (25%). There is no leveraged buy-out deal related to Piko Juice factory PLC and the project is a Greenfield project. It is more of a company formed through a partnership between Access Capital and Prisma Investment PLC (Ibid). The following figure is a framework of the management system of the group of companies:

Figure 3 : The framework of the management system of the group of companies



Source: Private Placement Memorandum, 2009

The other activities of Access Capital are Corporate Advisory Services and Liquidity Creation. Each is briefly described below.

b. Corporate advisory creation

It consists of assisting growth businesses to raise long-term funds for expansion. This would include advising businesses and helping them to prepare financing proposals and presenting these with economic analysis and other background materials to key investors. The financing instruments may include equity and/or equity securities. Organizations raising capital could include private sector companies as well as publicly-owned enterprises, for instance raising finance for infrastructure expansion. Access Capital may assist companies to raise finance without committing its own funds but it may also take a role in investing in the offer or other

participation. This helps to raise long-term finance by tapping investors who may be interested in diversifying some of their savings away from low-interest bank deposits into equity investments that have the potential to pay higher returns (Ibid).

c. Liquidity creation

One key reason why long-term equity investments may not be attractive to savers in Ethiopia is that, to date, such securities have been illiquid, making it difficult to exit the investment. For instance, a share may be valid as long as the company is in business, which could be decades. ACSSC can help by providing a facility for people wishing to sell securities by buying the shares itself or by finding buyers. If the security is liquid, this makes it more attractive to savers (Ibid).

CHAPTER FOUR

RESEARCH FINDINGS AND ANALYSIS

This chapter presents the main findings of this study. The findings can basically be classified into three: the practices of private equity at ACSSC, the challenges that the later has faced in its investment processes and the value additions that ACSSC has made in its investee firms. The practises and challenges were analysed with respect to steps in the PE investment process and the value additions were examined with respect to the variables appearing in the conceptual framework.

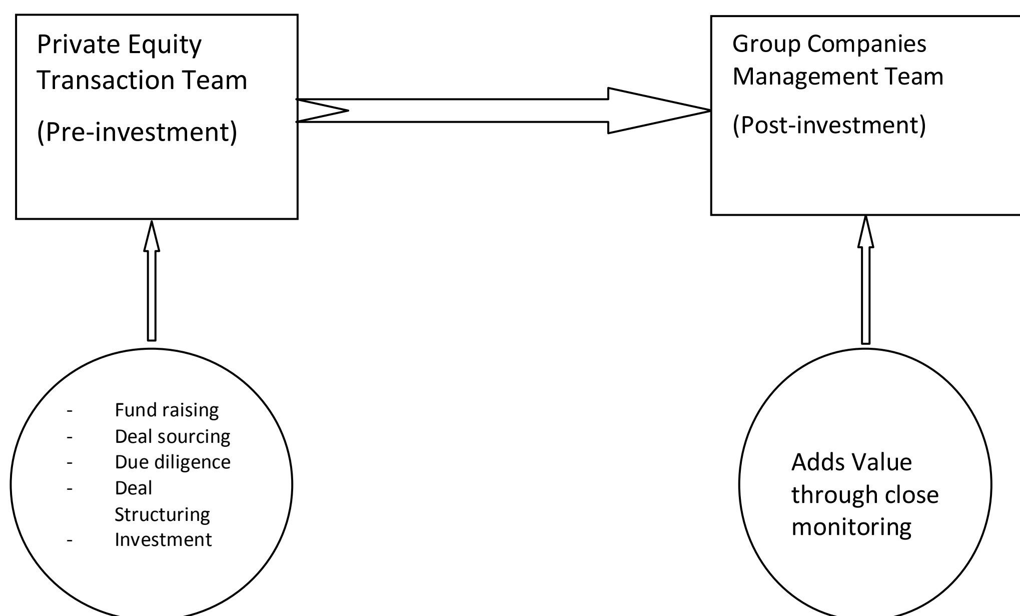
4.1 An overview of Access Capital's private equity investment process

As stated in the methodology part, a review of secondary source documents and interviews to the senior staff of Access Capital were made to learn about the Company's private equity investment process. Accordingly, the review has revealed that private equity investments are undertaken by two teams, namely, the private equity transaction team and the group companies' management team.

The Private Equity Transaction team sources new transactions and negotiates, structures, finances and does due diligence and other studies related with acquisitions, as well as executing the acquisitions. The Group Companies Management team takes over once the Private Equity Transaction Team has completed a transaction.

The Private Equity Transaction team thus handles all pre-investment activities and once the investment has been made in a company, the second team – Group Companies Management team – will handle post-investment activities. Post-investment activities consist basically of monitoring the activities of the portfolio companies. Diagrammatically, the investment process at Access Capital can be summarized as follows.

Figure 4: Investment process at Access Capital Share Company



4.1.1 Pre-investment process practices at ACSSC and related challenges

The Private Equity Transaction team assigns a team of one associate (Senior Analyst) and one junior analyst to each transaction. The team gets support from Access Capital research including any sector specialists or external sector specialists. A description of the practise of pre-investment processes and a discussion of the challenges that ACSSC faces in each step are made in the following.

Fund Raising

ACSSC raises funds that will be invested in selected private companies from the general public through over-the-counter share offerings. Investors consisted of wealthy individuals, 'ordinary investors', institutional investors such as insurance companies and other large companies, Diaspora members, and a Kenyan investment bank called Kestrel Capital (East AFRICA). However, according to the vice-president, ACSSC did not succeed in getting funds from the Ethiopian Pension Fund Authority. This is in contrast to the general practise in other parts of the world, thought in some countries pension funds are prohibited from making such risky investments. The reason why ACSSC was unsuccessful in securing funds from the authority may be because the latter considers such investments risky too. ACSSC issues shares to the general public and through private placement memorandums. The founders of ACSSC have also made their contributions by purchasing equity shares.

ACSSC has also partnered with a US-registered stock broker with the name of Auerbach Grayson, which assists ACSSC in its share offerings and does research through the help of its network with researchers and analysts. In addition, ACSSC makes use of local brokers and its own share marketing team to raise funds for private equity purpose. This shows that ACSSC has well established systems and networks that will help it raise the funds needed to help

distressed companies. Particularly, the international network that it has formed will enable it to raise funds from well recognized private equity firms which in turn can bring additional expertise and networks. Such competitive advantage in raising funds is primarily due to the fact that ACSSC has a separate division (apart from the private equity investment section) for corporate advisory in which it specializes in helping other firms raise long-term finance. In addition, the fact that ACSSC also performs extensive research using its own research team in trying to find the most promising investment opportunity makes it a reliable firm and thus helps it to attract investors more easily. Moreover, the fact that ACSSC performs extensive due diligence (discussed in detail later on) before investing in prospective portfolio companies makes it reliable and helps it raise funds more or less easily. Thus, the overall package that ACSSC brings as a private equity firm has helped it to secure long-term risk capital (which will be used to acquire prospective investees). In addition to the equity capital raised through share offerings, ACSSC also makes use of the fee income from its corporate advisory and stock dealing (of other companies) services to make its private equity investments. This of course helps it to broaden its capital base.

The main source of financing of ACSSC is debt financing from banks. The portfolio companies of ACSSC were ones that were highly leveraged before acquisition and had their debts rolled over at acquisition. This has helped ACSSC to take a controlling interest in all investee firms by using a small amount of equity – the reason why the acquisition is a Leveraged Buy-out. Thought LBO firms are usually motivated by the tax shield that high leverage brings and the disciplinary role that the latter plays, using high leverage is also crucial because of the limited equity funds required to purchase a majority share (Brinkhuis and Maeseneire, undated). In the case of ACSSC, the choice of LBOs is motivated by the fact that only small injection of equity is needed to acquire a controlling stake in investee firms.

In cases where further bank finance is constrained for the companies, for instance due to previous problems or lack of further collateral, ACSSC has also made temporary loans, in terms of loan agreements at stated interest rates. These are expected to be paid back and substituted with loans from commercial banks. The interview made with the Vice President of the investment team and a review of the private placement memorandum of ACSSC have revealed that the confidence that the banks had in ACSSC's ability to achieve a turnaround was the reason previous debts were rolled over. This shows the certifying role that ACSSC plays in accessing debt financing. The due diligence that ACSSC performs particularly adds to the confidence that banks have in the former. According to Adams et al (2007, p.64), "due diligence significantly enhances the buyer's position in the potential transaction". In this quotation, the buyer is the private equity firm which obtains its funds in the form of debt from banks and in the form of equity from other investors. According to Adams et al (2007), the due diligence process verifies the accuracy of the seller's representations and discovers undisclosed problems. This in turn results in the building up of investors'' (lenders and equity capital providers) confidence in the private equity firm opening the way to easy access to finance.

Despite the range of networks and other efforts that ACSSC has made to secure enough financing, it has faced challenges of finding enough investors, and in particular foreign investors to participate in the equity of portfolio companies. The potential cause for this (and particularly for the difficulty to attract foreign investors) is the illiquid nature of equity investments in Ethiopia due to the absence of a stock market. This is in line with statement of Lerner and Schoar (undated), who asserted that the most vexing aspect of private equity investing in developing nations has been the difficulty of exit". The action that ACSSC took to overcome this challenge is to offer to buy back its own shares or find other buyers when people wish to sell securities (liquidity creation). Another potential reason for the difficulty of

raising enough funds can also be the unfamiliarity of the Ethiopian investing community with investment firms such as ACSSC.

Sourcing deals

The interview with the Vice President of investments has revealed that sourcing deals is practically easy for ACSSC. A number of sellers come at the desk of ACSSC or ACSSC can go itself to banks and ask for those companies that are in a distressed situation. This is in line with the statement made by Ivashina and Kovner (2009) who asserted that LBO sponsors actively seek to work with as many banks as possible to maintain broad relationships to maximize opportunities for deal sourcing. As to the four investees currently in the portfolio of ACSSC, they succeeded in being acquired due to the personal relationship that existed between the original promoters and the promoter of ACSSC. When asked why the owners looked for the assistance of ACSSC, the general managers of all investee firms have replied that they simply did not have the choice. They also added that if these firms had not been acquired by ACSSC, their fate would simply have been continuous drop in sales level, bankruptcy and foreclosure. This implies that such distressed firms are not fit to other acquirers nor to banks, who consider them as very risky.

Regarding the challenges in the search for deals, the main one that arises is finding quality deals. According to the Vice President, the most challenging thing is information scarcity. This particularly refers to the lack of audited financial statements that ACSSC could use to evaluate the performance of the potential investee firm. This is consistent with the research made by Abereijo and Fayomi, (2005) who asserted that the elements that hinder the development of a flow of quality projects are the lack of businesses that have good business plans and well presented financial statements. The lack of well prepared business plans was also mentioned by the ACSSC Vice President who also confirmed that such lack is not much

of a challenge to them. This is so because ACSSC makes extensive digging to check whether the projections made by the prospective investees in their business plans are accurate enough. This is done, according to the vice-president, by the use of industry experts internal to ACSSC or hired by it.

The Private Equity Transaction team screens a large number of investments to find a few interesting prospects. And for the selection, they use blanket screens such as minimum payback period. The time taken from the time a deal is sourced until the actual investment takes place is 6 to 8 months. According to the Vice President, this is a duration which is tolerable and she believes that 2 to 3 deals per year are quite enough.

Due diligence

Once a few deals are screened, further due diligence is undertaken by ACSSC before making an investment decision. Such due diligence is intended to select the most promising investment. In contrast to the general practise of undertaking due diligence only during pre-investment, ACSSC undertakes due diligence twice: pre-investment and post-investment due diligence. The post-investment due diligence is made in order to get a closer look at the investee companies and to identify needs for change of previous situations (like replacing existing management). The due diligence checklist prepared by ACSSC is handed to the prospective investees who are in turn required to supply all the information and documentation related to the items listed on the checklist. Experts at ACSSC will supplement the due diligence process through their further investigation of the performance of the prospective investee firm based on the documentations and on-site investigation.

The due diligence checklist, in a digest, includes the following elements (these were printed out from Access Capital's database):

- Corporate documents: includes items such as articles of incorporation, shareholder agreements, minutes of BODs, certificates or proper legal documents from all provinces (States), districts (Woredas) and kebele/s where the company does business, etc.;
- Previous securities issuance: complete shareholder contact information, number of outstanding shares, dates of issuance, and percent ownership;
- Financial information: audited financial statements, accounting methods and practises, a three-year budget and financial projection, a complete and accurate business plan, a summary of all bad debt experiences, details of any outstanding contingent liabilities, extraordinary income and expense details, etc.;
- Tax status: income tax returns for the last three years, ministry of revenue registration, trade license, VAT registration certificate, etc.;
- Contracts and agreements: list of bank and non-bank lenders, purchase agreements, equipment leases, mortgages or any other outstanding loans, insurance contracts and agreements, contracts with suppliers, vendors and customers, etc.;
- Government regulation: copies of all permits and licenses, detail of any inquiries made by any Kebele, Woredas, or federal agencies, etc.;
- Products and services: details of product offering including market share by product line, inventory analysis including turnover, obsolescence and valuation policies, list of all major suppliers including birr amount purchased per year, etc.;

- Marketing: list of competitors, list of major clients, analysis of pricing strategy, sales commission structure, sales projections by product line, etc.
- Management and personnel: organizational chart, details of any labor dispute, employee compensation plans including pension, profit sharing, deferred compensation, retirement and non-cash compensation, employee confidentiality agreements, number of employees, turnover, absenteeism, outstanding debt report on all principals, managers and directors, etc.;
- Property and equipment: list of all properties owned by the company, an appraisal of all equipment and fixed assets, copies of titles, mortgages and deeds of trust, lease and sub-leases, patents, trademarks, and other intangible assets, etc.
- Research and Development: details of all research and development in progress, commercial analysis of R&D efforts, etc.;
- Other company information: copies of all past and planned company press releases, company newsletters and any investor relations material, etc.;
- The kitchen sink: any other information that might be pertinent to full disclosure of all company issues.

The post-due-diligence process is particularly aimed at investigating the existing management's capabilities in achieving set projections. Though the pre-due-diligence provides enough evidence of the outside picture of the firm's performance, the capability of the existing management in achieving set plans cannot be evaluated easily using financial reports. The time period taken by the post-due- diligence phase is much shorter than that taken by the pre-due-diligence phase.

To undertake overall due diligence, experts from Access Capital specializing in particular areas such as human resource, production, accounting, marketing, etc., are sent to the investees' premises. These are first given the required trainings, which can also take some time.

In addition to common problems of resistance to show an accurate picture of the firms on the part of owner/managers, the most serious problem that Access Capital is facing is lack of information primarily caused by disorganized records that prospective investees have. For instance, documentation needed to know technical details of machineries such manuals of the machineries and detailed schedule of repair and maintenance of the machineries are usually missing. ACSSC, to overcome such challenge, hires outside experts in addition to the internal ones and takes time to investigate the exact situation in which the machineries and other equipment are found.

In line with the findings made by Hopkins et al. (2003), ACSSC also faces the difficulty of checking the competence and integrity of entrepreneurs who would hide critical information about their companies. This challenge, according to the vice president, was however not a major one to them.

When asked what ACSSC would do in the event of facing strong resistance from the owners who do not want to provide a complete documentation and information of their companies, the Vice President answered that this was not a problem to them at all. This is so because ACSSC enjoys the competitive advantage of accessing a large number of deals (particularly accessing distressed firms who need assistance) from which it can choose. Thus, the moment that ACSSC realizes that the documentation supplied by the owner/managers of the investees are incomplete and unreliable (and such unreliability can have grave consequences in the future – such as pending lawsuits), it will simply drop the deal and look for another one.

If ACSSC still faces the problem of information unavailability which it cannot solve using its own experts, according to the Vice President, this will be to the advantage of ACSSC. This is so because ACSSC can justify a low valuation of the prospective investee, and thus be able to acquire it at a lower price.

Another challenge that ACSSC faces is that prospective investee firms that undergo the due diligence step in pre-acquisition attempt to disclose the outputs from ACSSC due diligence on their companies, to other potential acquirers and try to negotiate better deals. To overcome this challenge, ACSSC has made such prospective investee firm owners to sign a binding non-disclosure agreement. Such agreement, thus forces the investee firm to keep the outputs of the due diligence process confidential.

During the due diligence process, to gather market and industry information, ACSSC makes extensive use of its own research department, who would particularly make studies at macro level (general economic situation, government regulations, etc.). To learn, for instance, about product specific attributes such as the level of demand that exists for it, ACSSC also makes use of the existing marketing staff of the prospective investees. This is done because the latter are better positioned to know more about the products.

All such extensive and professional due diligence made by ACSSC helps it to select only the most promising investments. It also creates a confidence in the outside business world which includes lenders, investors, suppliers and customers. Such confidence will in turn help ACSSC, as a PE investor, to easily create a network of financiers, investors, suppliers and customers which will highly contribute to its effective and efficient operations. All this is because the information asymmetry that exists particularly when financiers approach a firm to buy them or invest in them is almost totally eliminated. The role of the LBO firm as a certifier of portfolio companies is also stressed by Ivashina and Kovner (2009) who argue

that banks' confidence in the portfolio companies is, among other things, caused by the LBO firm's due diligence process.

Valuation and deal structuring

It is only when the private equity transaction team is satisfied with the findings of the due diligence process that the investee firm will be appropriately valued and a deal structured. Three things are considered during the valuation process at ACSSC: the book value of the assets, the present value of discounted cash flows, and a negotiation on the value between ACSSC and the owner of the firm. An average of the book value of the assets and the present value of discounted cash flows (discounted at the appropriate weighted average cost of capital) is calculated and further negotiations are made. A proper valuation lies in the accuracy of the projection of earning streams made based on the accuracy and reliability of the financial statements supplied by the investee firm. The interview with the Vice President and another staff at ACSSC has revealed that only the audited statements are used for projection purposes. However, audited statements do not always show the true financial status of the firm, as the latter can maintain two or more set of book of accounts as put by Hopkins et al. (2003). According to the interviewed senior analyst at ACSSC, to make accurate cash flow projections, ACSSC again makes use of its research team who would study the general market for the product, gather industry and general economic data. ACSSC makes use of reports on the general economy and industries as prepared by governmental institutions. The challenge of such data is that the government may not always give the true picture of the economic performance of the country. The reason why ACSSC supplements such data with the data that its own research team gathers is to get a more accurate picture. The challenge related to valuing a firm is not new to ACSSC and is mostly caused, as put by

Abereijo and Fayomi (2005, p.225) by the lack of reliable historical financial information or meaningful financial projections.

Once valuation of the firm is done, ACSSC structures a deal with the previous owner on the percentage of ownership, on board composition and other issues. In contrast to common practise in other parts of the world, ACSSC holds common shares of investee firms and does not have any anti-dilution rights provision. The evidence for the last finding is the second round share offer it made after one year of private equity operation. The finding that ACSSC holds only common stocks is in line with the finding made in the unpublished study of Lerner and Schoar (undated). They asserted that 'more than one-half of the transactions employ common stock in developing countries (Lerner and Schoar, undated). The possible reason for holding common stocks can be the fact that ACSSC holds a majority stake of the investees, eliminating the risks that can arise if the stake was a minority. Such risk includes the inability to directly control the activities of the firms and force the management team of the latter to strive for growth. To avoid such risk, minority shareholders would prefer to hold preferred stocks. On the other hand, ACSSC, as a majority stockholder, can intervene in the operations of investees and take actions that speed up investees' growth in the event that the latter's management team are not performing as per its expectations.

ACSSC has taken a controlling stake of all its investees so far (90%), with the previous owner holding only 10% of the company. As mentioned earlier, the firms are highly leveraged ones, and ACSSC has purchased them together with their bank debts. The fact that ACSSC took a controlling stake has helped it have a strong influence on the directions of the companies and drive them towards faster growth. As put by KPMG (2009, p.4) "Private Equity is seen as a catalyst for change but this is a more difficult role to fulfil when working within the constraints of a minority stake".

A board member consisting of five members oversees the management teams of investee firms. In contrast to common practise, the previous owners of the portfolio companies are not members of such board. According to the Vice President, the previous owners do not show any interest in involving in the day-to-day operations of the business during negotiations on the board's structure. Such lack of interest is in contrast to the assertion of HM Treasury (2003) that the promoters' fear of losing control and management freedom is a factor making the deal negotiation process a challenging one. Such lack of interest has helped to avoid the conflicts of interest that usually arise between a private equity firm and the promoters of the business in other parts of the world.

The interview with the senior analyst at ACSSC has revealed that ACSSC has not faced any challenge in trying to negotiate a deal. According to the senior analyst, this is mostly due to the fact that ACSSC holds a controlling stake of the companies and the previous owners do not resist giving up such controlling stake to ACSSC. This is because they come to ACSSC in the first place to give away a company in which they have lost hope of turning around on their own. This is not a surprising finding given the fact that the previous owners are left only with a minority stake after acquisition and specially due to the fact that they give a majority stake willingly.

4.1.2Post investment process practices at ACSSC and related challenges

The items which will be discussed below will be categorized into two parts: Monitoring and value addition, and exiting. Such categorization is made because the two main activities post-acquisition are monitoring and exiting. The researcher will present and interpret the interview responses pertaining to these two main activities.

Monitoring and value addition

As mentioned earlier, the post-investment process is handled by the Group Companies Management (GCM) Team, which takes over once the Private Equity Transaction Team has completed a transaction. This is a specialized investee company management team which runs investee firms for long-term growth and profitability. The specialists on the team are finance specialists, operations management specialists and marketing specialists. Their role is to run and develop the Operational/Subsidiary/ Group Companies, improving the efficiency and productivity of manufacturing operations and all other aspects including finance, marketing and human resource management.

The team is responsible for:

- Reviewing any business plans prepared by the Transaction Team, or preparing a new 3-year business plan as a rolling plan altered every 3 months and giving specific targets and milestones;
- Setting up and managing the company, while developing its capacity for expansion,
- Selecting and putting in place a suitable general manager and management team for the company including existing management if applicable, as well as appointments;
- Monitoring performance and taking remedial action, using weekly and other reports; Giving strategic input and other added value, including synergies with other group companies;
- Coordinating outsourced support: IT and Finance/Management information system; best practises for human resources management such as training, etc.; and other support through the Access Capital back office (sales, marketing, finance and administration) (Private placement memorandum, 2009).

An important event that takes place post-investment is the replacement of existing management. The LBO (private equity) firm puts in control a top management team of its choice at the time of acquisition, hiring dedicated professionals if necessary (Loos, 2005). The LBO form at ACSSC is not a management buy-out where the existing management completes a deal with the owners of the firm and then involves financial investors to fund the change of control. Rather the promoters have spun off or divested and ACSSC has bought the businesses and then partnered with the existing management which it can replace at its discretion.

When asked if ACSSC has faced strong resistance on the part of the existing management when trying to replace it, the Vice President replied that there was some resistance and that it was something normal. In most of the cases, ACSSC was forced to replace the existing management team as most of them were holding that position not because they were highly qualified but because they were family members of the owners. Where there is a chance that the existing management can keep their positions, ACSSC provides the required extensive trainings and follow ups and tries to upgrade their skills.

Once an existing manager (it could be the general manager which in most cases is the owner as well) has been replaced, the biggest problem that arises post-investment is the difficulty of finding the right person who has the abilities that the position requires. They make use of their industry contacts, and use traditional advertising means such as newspapers to find the managers. According to the interview with the Vice President, the challenge is not to find a person having the required educational background, but rather to find someone who is innovative, has leadership skills and can help create a conducive environment that helps the company grow. The difficulty to find a qualified and professional management team and one with strong leadership skills is not new to ACSSC and the study made by Amwal (2009) in

the MENA region has confirmed the same fact. As also put by HM Treasury (2003), the costs associated with monitoring portfolio companies can be significantly high particularly if the private equity firm's management team is relatively inexperienced.

In private equity investment monitoring, good skills of the private equity firm's team members are another requirement if the investment is to go smoothly and succeed. Skill in private equity investment stemming from long-standing experience in the industry and particularly, skill and experience in the industry in which the investee firms operate is critical.

At ACSSC, only the Vice President of investments has long-standing experience in the private equity industry. She actually gained most of her private equity and accounting expertise in the US financial market. In addition, the chief executive officer (and promoter) of ACSSC and senior staff members have a number of years of experience in corporate America. As to the rest of the management team, relevant training was given to them so that they could conduct the monitoring function properly. The training takes up some time but is worth it at the end, according to the Vice President. She also added that ACSSC has not faced any serious challenge in regard to availing itself with skilled personnel, and that their main challenge was rather to find skilled management that can lead the investee firms.

Another challenge that is frequently raised in academic and other research works is the information asymmetry that arises between the investors and the management of a firm. In our case, if we consider ACSSC as the principal (the investor) and the investee firms' management as the agents, we would expect the agents to have information advantage over the principal. As put by Smith (2004), the investor will have more information about financial management and risk handling than will the personnel of the investees whereas the latter will know more than the investor possibly could about the running of the business, about the firm's target market, and about the industry as a whole.

To avoid such information asymmetry, ACSSC has put in place a reporting system as per its own standard which will enable it to obtain the exact form of information when it needs it. According to the Vice President, such system include preparing reporting formats as per its standards with some modifications of the previous ones. It is also establishing a centralized management accounting IT system which will provide accurate feedback on production, sales, supply chain and other aspects of monitoring the group companies' daily and weekly performance. The reporting system that existed before the advent of ACSSC is not practically changed but some modifications were made. Where there is doubt on the reports coming from the finance departments of investee firms, immediate checking is made by the staff at ACSSC. As per the interview made with the Vice President, ACSSC has not witnessed any purposeful attempt to hide information on the part of investee firms so far. The only challenge they faced is delay in reporting. This is partly due to negligence and also difficulty to fit with the system easily.

Last but not least, the issue of high leverage in portfolio companies of LBO firms is a major concern that is raised by many researchers. Though the high use of leverage can discipline the management team of the investee firms who will be forced to work at their level best towards generating enough cash flow (Braun and Latham, 2009), it still creates a huge financial risk and reduces R&D expenditures. According to Loos (2005, p.16), 'LBO firms are frequently accused of achieving the high post-buyout returns through an underinvestment in the long-term future of the target'. That is, allegations are made that cutbacks in expenditures for maintenance and repairs of existing capacity, R&D and advertising expenditures, replacement and/or expansion of existing of existing facilities can weaken the competitive positions of investee firms in the long-run. Contrary to such popular view, the Vice President at ACSSC does not think that the high level of debt reduces the budget for R&D. Though she admits that there are no separate R&D departments in each company, the necessary R&Ds are still being

undertaken by the head office (ACSSC). A possible reason for the absence of separate R&D departments in each investee firm can still be because the latter are highly leveraged and cannot afford to constrain their cash flows through interest payments. The fact that the necessary research is mainly undertaken by the head office may be due to the fact that the office can secure funds easily from its brokerage and advisory services as well as from the profits it shares with some of the firms it advises (in which he has made a few share purchases). The Vice President also argues that R&D is not always about developing new products but also about upgrading existing products through quality, design and size. ACSSC's research has evolved mainly around such purpose.

Exiting

ACSSC expects to exit its investments within 5 to 7 years from now, which is a period of most private equity exits worldwide. The expected challenges are mainly finding the right number of buyers and buyers who would offer a profitable price. As its investments date a maximum of 3 years, ACSSC has not exited any of them so far. They also expect a stock exchange to be established by that time so that they can sell their stake through an IPO. The choice for such form of exit may be due to the popularity of IPOs in enabling sellers to secure a reasonable price for their shares. The interesting finding from the interview with the Vice President is that ACSSC is also considering the option of not selling its stake for a much longer period. The justification for considering such option as an alternative to exiting is the fact that it won't be that bad to stay longer in business with existing firms if these are making attractive profits. If this option is selected, it will make ACSSC a holding company rather than a private equity firm; that is a deviation from the 'buy low and sell high' strategy to the 'buy and hold' strategy. ACSSC is, however, undecided on whether it will exit soon or not

and on the mode of its exit yet, and has not made any move so far to find strategic buyers as well.

4.2 Value addition by Access Capital on investee firms - investees' perspective

This section presents details of the positive changes that ACSSC has brought about in investee firms from the investees' perspective. As clearly explained in the literature review, private equity firms in general provide other critical inputs to investee firms in addition to long-term financing. Research has shown that the return achieved by 'financial acquirers' such as LBO firms is seen to be higher than 'strategic acquirers' (Loos, 2005). 'Strategic acquisitions' help the acquirer to benefit from the redeployment and sharing of resources that the latter's horizontal and related acquisition bring. In contrast, 'financial acquirers' acquire to later divest their investments and not to benefit from the sharing of resources and synergies with the acquired firm. According to Loos (2005), the returns that are brought by 'financial acquirers' outperform those that 'strategic acquirers' can help generate. The higher return of LBOs (financial acquirers) is due to key value drivers which I have identified from existing literature on private equity. As indicated in the conceptual framework, the areas in which LBO firms or private equity firms in general add value are management, corporate governance, marketing, networks, innovation, and access to traditional sources of financing.

The in-depth interviews made with the general managers of each investee firm is intended to learn if the latter have actually benefited from ACSSC's intervention with respect to the above cited value drivers; and if they have benefited, what positive contributions were made by ACSSC. All interviewees have responded that ACSSC has made contributions to the firms

post-acquisition with respect to almost all of the value drivers mentioned above. The detail of the contributions made by ACSSC is presented below.

Professionalizing management

A number of changes have been brought in by ACSSC into investee firms with regards to professionalizing their management system. It can even be said that the contributions made with this regard are the most satisfactory ones, and also ones that can help the firms grow faster. The improvements made to the management system particularly helped Polytech PP Woven bags, which before being acquired by ACSSC was shut down due to management problems. The other firms also were previously facing management problems, which are being alleviated by the intervention of ACSSC.

The main changes that ACSSC brought in are creation of a conducive environment to employees, accreditation of professional's contribution, and a dynamic management system.

By conducive environment, the researcher refers to the increase in the pay of employees than what it was before and creation of a safe environment particularly to employees working in the factories. Also, the researcher has been told that a canteen was being established for employees where they could have good lunch at a very fair price. The creation of a safe environment and the opening of a canteen are one of the few initiatives that ACSSC is introducing as part of its corporate social responsibility plan.

Such initiatives, according to the general manager of Real Water in particular, have resulted in a major improvement in the employee turnover that existed before the firm was acquired. The improvement in the compensation plan was actually the major reason that reduced the

employee turnover that existed in Real Water in particular. The employees have also exhibited stronger commitment in their jobs.

The contribution of ACSSC that the interviewed managers stressed as being the major one is the accreditation that ACSSC gives to professional contributions. The managers mentioned that before the advent of ACSSC, people got hired not because they were qualified for the job, but because they had family ties with the owner or other managers of the company. Another precondition that previous management members used to set to hire a person was the amount that that person would cost the firm. Thus, unqualified labour would get the chance to take the position of a manager with a low pay but at the expense of skills and expertise. This is an indication of the low value that is given to what a management system led by a qualified management could contribute to the growth of a firm. The interviews responses of all three interviewed general managers is an indication of the high priority that ACSSC has given to radically improving the existing management system and the high value it gives to a well functioning management system.

ACSSC has particularly given full authority to the management it appointed at the time of acquisition to make use of their professional knowhow in making decisions. According to the general manager of Polytech PP Woven Bags, the job interview at the time of hiring is a major reflection of ACSSC's focus on a professional management system. It can be said that ACSSC has helped make the traditional system of hiring family ties (instead of being based on professional qualification) a history in the investee firms.

The other improvement that the general manager of Polytech PP Woven Bags (and that of the flour mill) has mentioned is the dynamic nature of the management system. That is, a manager is made to move (by maintaining his/her original position, though) from one portfolio company to another. This, according to him, helps the person being moved to learn

various situations and the challenge of facing a different environment is by itself a good learning experience. Thought it can be argued that specializing in a particular firm would be much better as the person will have full acquaintance of the firm it manages, it can be considered also as a good learning point.

The improvements made to the management system have had, according to the interviewed managers, lots of benefits. The firm that benefited the most from such improvements was PP Polytech Woven Bags. This is so because the firm was in the first place shut down and was waiting for the lending bank to foreclose it mainly because it had serious management problems. The moves that ACSSC made to show that the management system can be improved and lead to improvements in the production and sales level, according to the general manager, has convinced the bank to roll over the large level of existing debt. Thus, it can be said that the reputation that ACSSC has in bringing strong management systems into its investee firms has helped the investee firms to revitalize.

Besides saving the firms from being closed down or going bankrupt, the improved management systems have had a lot of indirect contributions to the firms' performance post-acquisition. According to the human resource manager of Thermoplastic Industries (who was interviewed on behalf of the general manager), the positive changes observed (particularly due to the professional accreditations and autonomy given to the management) are the accessing of new markets, quick delivery services, increased motivations, initiations and loyalty of employees, proper documentation of accounting records through use of computer systems (facilitating the easy access to information from database), autonomy given to the management teams who do not have to deal each time with the general managers, etc.

Though the use of high leverage disciplines the management team of investee firms in other parts of the world, it is difficult to say so in the case of the investees of ACSSC. This is so

because the large debts that the investees have were also there even before the acquisition (a debt ratio of 90% in average), and were not actually added by ACSSC. If they had a strong disciplining effect, the researcher assumes it could have disciplined the previous management team as well. But this cannot be a definite conclusion as the management team introduced by ACSSC is a much more professional one. The researcher can therefore say that maybe the huge level of debt may have also had a disciplining role of the new management team.

Another system that is widely used by LBO firms to control the management team of investee firms is to require them to make equity investment in the firms they manage (Kaplan and Stromberg, 2008). Such a system is not yet applied in ACSSC but, given the role it could play in obliging the management to work harder, the researcher believes it is something that ACSSC should consider.

Corporate governance

The improvement in the corporate governance of investee firms stems largely from the improvements in the management systems of the investee firms. The conducive environment that Access Capital has created for the employees of investee firms has made these to be loyal and committed and have a sense of responsibility. Though there are not much better incentive plans for the management team different from the other employees, the full authority that ACSSC gives to the former, is according to the interviewees, enough incentive for them. The interference of the previous owners in the management of the firms was a serious challenge that hampered their growth. Thus a clear separation of ownership from management has been the most important contribution as related to corporate governance. The fact that management is left to professionals and the owner's (ACSSC) presence remains only in the BOD (whose members are put in place by ACSSC as it is the majority stakeholder) has led to the creation of a feeling of responsibility and accountability among the management team.

The other improvement that the interviewed management team says is also important is the positive communication that exists between the senior staff at ACSSC and the management team of the factories. Such open communication (leading to transparency), which was also a frequent one, has helped to quickly solve any trouble or problem that arises in the course of business operations.

In addition to the positive relationship that ACSSC has helped to maintain between itself and investees' management team, it has also helped the relationship among the department heads of each investee firms to be a positive one. According to the human resource manager of Thermoplastic Industries, there is a weekly management meeting in which each department head brings its own issues to the table and a discussion on different agendas are made. This particularly helped to create a team spirit which in turn helps to provide solutions to the challenges that the firm faces in holistic way (that is, in a way that does not harm the objectives of the human resource department, the production department, marketing department and the finance department). The fact that the meetings are held frequently also helps in solving difficulties on time, to monitor closely the overall performance of the firm and to closely see if targets are being achieved. It also helps each department head to be fully informed about the activities of the other departments.

Line employees are also given the opportunity to present their complaints on a monthly basis, according to the human resource manager of Thermoplastic Industries. The complaints could be about workloads, on inter-staff conflicts, on problems facing business operations such as failure of machineries. Such a meeting is participative, helps to empower the lower level staff members and helps to create a transparent relationship between the management team and the line employees.

Lastly, as put by IVCA, the use of Non-Executive Directors is one way of accelerating the development and growth of businesses; whether it is a longstanding traditional business or a start-up seeking equity finance, non-executives can bring added value with objectivity drawn from their own experience and skills. Accordingly, the governance structure put in place by ACSSC is such that all of the boards are non-executive directors, except for the chief executive officer who has a seat in the board and also has the executive power.

It is to be reminded that the resource dependence role of the BODs supports the dual role of the chief executive officer (CEO) both as a CEO and chair of the BODs. Such dual role has been shown to lead to effective decision making thus benefiting the acquired firms (Braun and Latham, 2009). This is so because, according to Braun and Latham (2007), the absence of authoritative leadership in the form of a dual leadership structure (according to those who support the resource dependence role of the BODs, of course) will lead firms to lose external constituents. In other words, the CEO who is also chair of BODs is the best source of external networks that the firm can benefit from and one who knows the details of the firm's operations. Such a dual leadership structure, according to Braun and Latham (2007), creates an 'illusion of stability and a sense that a dominant leader, not the environment, is determining organizational destiny".

When summed up, it can be said that ACSSC has helped in a creation of a smooth working environment in which independence, responsibility, and transparency particularly reign.

According to the private placement memorandum of ACSSC (2009), further steps are also being implemented to ensure ACSSC complies with international standards of governance.

Business networks

The network that ACSSC has helped to create is particularly with input suppliers. The industry knowledge and links that ACSSC's team (senior staffs in particular) have helped the investee firms to secure raw materials easily. In particular, it has helped the firms to have secured sources of raw material as well as continuity of the supply. The general manager of Real Water also mentioned that the time that it used to take to import raw materials from abroad has been greatly reduced after ACSSC's intervention. This has been facilitated because Real Water works closely with Highland Springs (which is owned by the founder of ACSSC), another bottled water producing firm which supplies the former with the required inputs. The general manager of PP Polytech Woven Bags has also mentioned the benefit of getting raw material at a lower cost, thus giving us an indication of ACSSC's negotiation skills. The same manager has also added that ASSCC follows the international market closely, which further enables the firms to acquire quality raw materials.

Such ease to access raw materials brought about by ACSSC into investee firms highly solves the working capital shortage that these firms were facing before being acquired. Thus production and sales were made to go smoothly, without interruptions caused by shortages of raw materials.

According to the resource dependence role of BODs, the optimal BOD is one with monitoring level expertise among other things and one whose members have experiences as members of other boards (Braun and Latham, 2007). This is so because such members bring experience and a set of connections with the external environment and benefit the firm by enhancing its reputation and its value. At ACSSC, the board members are from the law, finance, accounting, management and economics field. They have the required educational qualifications and numerous experiences as managing directors and other top positions in the same areas abroad and locally. Thus, the connections and expertise that the members have is

a critical input to the creation of networks not only for the supply of production inputs but also to find the appropriate person that can take the management position at the investee firms.

Though the support given by ACSSC in relation to improving investees' marketing capabilities is not as strong as the support related with improving the management system, it has still made good contributions. The contribution is particularly in the form of a strong market research, existing product development/upgrading, strong customer relationship, and improved distribution systems. Regarding new product development, the case of Real Water can be mentioned. ACSSC is now on its way to introduce a five-litre bottled water in addition to the existing ones with 0.5 to 2 litres. This can be expected to increase the market share of Real Water and even help it compete with the imported ones. New printing designs are also introduced to upgrade the Polytech Woven Bags. Such expansion project within a period of not more than two years, and particularly in firms that were losing sales (Real Water) and also ready for bank foreclosure (Polytech Woven Bags) just before acquisition is something that is quite noteworthy.

In relation to improving the distribution system, ACSSC has made some increase in the capacity of Real Water by purchasing additional distribution cars, and by expanding its distribution to other regions of the country such as Gondar, Harrar and Dessie. The product's distribution were concentrated before around Addis Ababa.

Concerning Polytech PP Woven Bags, ACSSC is also reaching new customer lines, particularly institutional customers such as Almeda Textile and sugar factories and is trying to build a permanent relationship with them. Before the advent of ACSSC, the product buyers were limited to retailers and wholesalers.

The only area in which ACSSC has not done much so far is on advertisement, though the pictures of Real Water (the products) displayed on the distribution cars are still advertisements. Researchers argue that the cash flow problem caused by the high use of leverage is the main reason why portfolio companies cut back expenditures such as advertisement (Loos, 2005). However, the responses of all interviewed general managers were similar in this respect; they believe that the products are well known in the market already and that they believe there is no need for increasing the budget for advertisement. Despite such a position, aggressively advertising the products could add more value and increase the market shares of the firms. Thus, it can be said that, maybe it is the cash flow constraint created by interest payments that caused a pull back on advertising expenditures.

It is to be reminded that all four investee firms were having serious difficulties before being acquired by ACSSC. Their sales were dropping and one was even shut down. But the responses of the general managers indicate that the problem of these firms was not a lack of demand for the products, but a problem of management in particular and a lack of working capital.

Though the main problem is not how to maximize market share (as a response to small demand for the product), it can be said that what ACSSC has done in this regard is significant.

Innovation

The issue of whether LBO firms in particular lead to innovative investee firms is a matter of debate among many researchers. In the case of LBO firms, the common factor mentioned as a reason for the low expenditure in R&D and new product development is the use of high leverage and the short term orientation of such firms (Ughetto, undated). As the interview

with ACSSC's Vice President of investments and general managers of investee firms reveal, the portfolio companies do not have a separate research and development department. As mentioned earlier in the report, this can be caused by the shortage of funds caused by the high use of leverage. However, regarding the short-term investment orientation of ACSSC, the Vice President has mentioned that it is possible that they may not divest in a short period of time though they have set an exit period of up to 7 years from now. Thus, the argument that it is the short-termism of ACSSC that caused the absence of R&D departments at investee level does not hold.

Though there are no intentions to introduce new, untested products into the market, product upgrading through further expansions is one of the agendas that ACSSC is working on. The previously mentioned expansion project to introduce a new five- litre bottled water in Real Water, drilling of a new well to extract more mineral water, expansion projects at PP to improve the quality of existing woven bags, introduction of new production processes at Thermoplastic Industries to increase the quality and reduce the cost of the products are examples of such expansion projects and product upgrading.

Thermoplastic Industries is even on the way to start the production of PP Woven bags as the management team strongly believes that the product has a huge demand in the market. They believe that the revenue from the sale of the Woven Bags can help to quickly pay off the debt that Thermoplastic Industries has as the demand for the former's product is much greater than the latter's.

All these projects are on the way and not yet implemented. So far, existing machineries are being used with the necessary maintenance and supervision.

Access to finance

The first thing that ACSSC did was to raise the necessary equity capital from the public and ask the lender banks of the investee firms to roll over the existing debt. As any acquirer, the fact that it raised such fund cannot be a surprising thing. However, the fact that the acquired companies were distressed ones and could not have extended their debts by themselves shows the certifying role that ACSSC has played in helping to get the debts rolled over. Thus, the reputation that ACSSC has as a firm with a pool of professionals has built the confidence that the banks have in it. In particular, the extensive due diligence that ACSSC performed to determine the viability of the investees (before acquisition) and the working capital that it has brought in (from its own funds) to restart or continue the businesses has shown the banks that ACSSC is confident enough to bring a turnaround in the distressed firms. In this regard, we can say that ACSSC has played its role in helping the distressed firms acquire the necessary funding that helped them revitalize.

Though the firms are still highly leveraged at this point, according to the general manager of PP Polytech Woven bags, they are thinking of getting more working capital loans. They are preparing a business plan for that purpose and are confident that the improved cash flow that the firm is generating will help them obtain the approval of the lending banks.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1. Summary of findings and conclusions

The researcher has attempted to show in this study the role that a private equity firm plays in adding value to its portfolio companies by using as evidence the experiences of ACSSC, the sole investment firm (to the researcher's knowledge) in the country. Researches on how private equity firms add value to investee firms have been well documented by other researchers in different parts of the world. However, there are practically no studies made so far on private equity in Ethiopia. The researches pertaining to the Ethiopian financial sector are particularly limited to studying microfinance institutions and in some cases commercial banks. Thus, in the researcher's knowledge, those firms seeking long-term financing but are too large for MFIs and too risky for banks are uninformed (except for few who might have heard about Access Capital) of the existence of a financial intermediary that provides patient capital together with a package of non-financial benefits. Though the study focuses particularly on the benefits of private equity to investees, the researcher has also tried to see the investors' side. What the researcher has tried to show is what PE investments look like in

practise and some of the challenges that come along. The findings from the point of view of the investors is intended for those investors who wish to enter the PE industry and contribute to the growth of Ethiopia's private sector. The researcher, however, did not attempt to show the benefits likely to be accrued from their investments as it is too soon to do such a study.

To learn on the contributions of Access Capital's interventions on investee firms, the researchers has conducted in-depth interviews with 3 general managers (one was actually interviewed on behalf of the general manager) of the four investee firms. And on the side of the investor (Access Capital), in-depth interviews with two staff members were conducted: the vice-president of investments and a senior analyst. Secondary documents were also referred to, to supplement the data and its analysis.

The main findings regarding the contributions of ACSSC to investee firms are mostly in line with the findings made in the same area by other researchers. That is, the study has shown that ACSSC's interventions have contributed (within the very few number of years it has been in this business) in professionalizing the management system of investees, improving their corporate governance, creating business networks, improving the marketing capabilities, encouraging product upgrading trough expansion projects and helping the companies roll over their debt.

The major contributions that ACSSC made to investees are improving their management systems and their corporate governance. In particular, the authority and independence it has given to the management teams (clear separation of ownership and management) and the strong accreditation that it has given to professionals' contributions should be mentioned.

As regarding the PE investment practises studied with respect to the steps in the investment cycle, the purpose was to show what such practises look like in real-life and in Ethiopia in

particular. A major difference identified is that, ACSSC focus on distressed companies having serious management problems and a shortage of working capital. Contrary to this, the targets of LBO firms in other countries are firms with strong management team, recording strong profits and have no cash flow problems.

The challenges identified related to undertaking private equity investments are not raising enough funds due to risk averse behaviour of the general investing public, the potential challenge of not finding foreign investors due to the absence of a stock exchange, lack of audited financial statements and organized documentation to source quality deals and to conduct due diligence, not finding easily a qualified management team and finally, the potential challenge of finding enough buyers offering a fair price at time of exit. The most serious challenges, however, are the lack of organized documentations to be used in the due diligence process and finding an innovative and skilled management team for the portfolio companies. Most of the identified challenges are, nevertheless, being dealt with by ACSSC aided by the pool of professionals and the strong research department it has.

The above findings lead to the following major conclusions regarding PE investments in general and LBOs in particular:

- Private equity investment requires strong research particularly in the due diligence process. Thus, a strong research team and a pool of professionals (especially those experienced in the private equity industry) are key if a private equity firm is to successfully add value to portfolio companies.
- The most significant role that a private equity firm plays is professionalizing the management system (particularly through total accreditation given to professionals' contributions) and corporate governance of portfolio companies. This is mainly due to the fact that the staffs at the private equity firm are professionals who strive to

incorporate in their investees best management and governance practises, leaving the day to day operations to the management teams of investees.

- With a small injection of capital and taking a controlling stake (LBOs), it can help distressed companies (which would have been shut down otherwise) revitalize. Such companies can be public enterprises operating inefficiently due to working capital shortages and in particular enterprises with governance and management problems. LBOs can, thus, be good tools to speed privatization in Ethiopia.
- The challenge of acquiring the right amount of information on prospective investee firms in the deal sourcing process can be a serious potential hindrance for the growth of the private equity industry. This is so because sourcing poor quality deals means failure of the private equity investments.
- The most serious constraint that may hamper the prospective LBO firms from adding maximum value to portfolio groups is finding easily competent management team than can lead the latter. This is so because the private equity firm leaves the authority to the management teams at the investee firms to manage all day to day operations which in turn determine the success or failure of the firms.
- Because the essence of private equity investments is the exit made after few years from the date of investments, the absence of a stock exchange can pose a serious barrier for the growth of the industry.

5.2. Recommendations

Given the evidences of the benefits that private equity firms (LBO firms in particular) offer their portfolio companies, it is clear that a package of incentives should be put in place for more investors to enter the industry. Such incentives should be particularly be directed to those LBO firms that concentrate on distressed companies having minimum chance to get

financial assistances from banks or the general public. Also, it should give focus on those LBO firms which have made their focus the privatization of inefficient and distressed public enterprises. Such incentive schemes could be profit tax breaks until the acquired firms start to generate enough profits, easy access to bank credit and with better credit terms, and duty removal or reduction on imported machineries.

To date, there are no separate provisions for investment companies such as Access Capital which is operating as any other share company. The main financial institutions operating in Ethiopia are commercial banks, micro-finance institutions, financial cooperatives and insurance companies (though, informal and NGO finance providers also exist). But for an incentive package to be obtained from the government, it is necessary that clear laws and regulations be set separately for Investment Companies such as ACSSC.

Empirical studies have shown that exits achieved through initial public offerings (facilitated by a listing on a stock exchange) offer investors attractive prices for their investments, compared to other means of exit. Thus, this implies that in the long-term a stock exchange should be established in Ethiopia. It will rather be a must to establish a stock exchange particularly if foreign investors, foreign private equity funds and other investment companies are to operate in the country. Otherwise, it will be a delusion to think that foreign private equity funds would come and operate in Ethiopia. The recent initiatives by the Ethiopian government to establish a stock exchange is thus one that should be given great appreciation.

Moreover, the creation/establishment of intermediaries with a pool of professionals such as investment banks is one that is recommendable to source quality deals, refer competent managers in each industry and help in the valuation process.

The researcher, as mentioned in the limitation part, was restrained from measuring the financial impacts of ACSSC's intervention in investee firms, though such measures would have helped to produce a complete research paper. Therefore, the researcher recommends that further researches be done in the future to objectively measure the long-term impacts that ACSSC has in investee firms. Such further research can and should particularly be undertaken by the research team of ACSSC itself as it is the party that has the access to the financial statements of its investees. Such research can be helpful in tracking the measurable impacts that the value drivers discussed in this paper have on investee firms' performances.

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ANNEX

Interview questions to investee firms' general managers

General questions

1. How did you learn about and reached Access Capital?
2. What was the form of ownership of your firm before AC's intervention (family owned, sole proprietorship, involved non-family owners)?
3. What were your reasons for selling a majority of the stake?
4. What was/were your reason/s for seeking AC's assistances or for choose private equity form of financing?

5. If you had not succeeded in closing a deal with AC, what would have been the fate of your firm?

Business Networks

Did Access Capital's intervention help in creating business networks with strategic buyers and suppliers both at local and international level?

1. If yes, what was AC's particular intervention that resulted in increased networks?
2. Who were they in the case of your firm?
3. How did it benefit your firm?
4. Do you believe AC's intervention has resulted in marketing capabilities (in terms of improved media usage, distribution methods, and pricing capabilities, customer maintaining)?
5. If yes, did it result in improved sales level, improved number of customers, reaching new customer lines...?

Professionalizing management

1. Did AC's intervention help in professionalizing the management system (as compared to pre-investment)?
2. If yes, how did it professionalize your firm's management system?
3. How do you think such professionalization has helped or benefited your firm?

Access to traditional financing

1. Has AC's intervention resulted in improved access to traditional sources of financing like debt and further equity financing?

2. If yes, is the eased access in terms of lower interest rate, better covenants, longer loan period, larger amount of debt (all compared to the pre-investment situation)?
3. What factor as related to AC's intervention did exactly led to improved access to financing?

Corporate governance

1. Do you thing AC has improved the corporate governance of your firm?
2. If yes, what were the improvements made?

Innovation

1. Did AC's intervention result in improved innovation?
2. How did such improvement improve your firm's performance?
3. Has AC's intervention lead to increased R&D expenditures?
4. How do you think such expenditures have benefited your firm so far?

Interview questions to Access Capital on the challenges of private equity investments

Pre investment

Raising the fund

1. Who are your investors?
2. Have you made equity investments besides the financing you raised from LPs?

3. When acquiring the firms, did you face any difficulty (because the firms had bad past performance) in getting the debts of investees rolled over? If yes, what were they and how did you handle them?
4. What were the challenges involved in securing sufficient amount of financing to finance the investments?
5. Have you ever tried to find institutional investors such as pension funds, insurance companies, and developmental financial institutions to invest?
6. Did you face difficulties in convincing them to invest?
7. If yes, what were the root causes behind their resistances?
8. Have you designed plans to attract institutional investors in the future?
9. Have the raised funds always been sufficient to achieve the intended purposes?

Sourcing the deals

1. How do you source deals?
2. Do you face high transaction costs in finding quality deals?
3. What are the main reasons behind such transaction costs?

Due diligence

1. What are the main areas/points that are covered/investigated in your due diligence process?
2. What are the difficulties that you face during the due diligence process?
3. Is accessing industry/market a difficulty while performing due diligence before investments?
4. If yes, How did you handle the difficulties involved in the due diligence process

5. What were the main difficulties/problems that you identified of the investees during your due diligence process?
6. How long does it take you in average from the step of due diligence to finally acquiring an individual firm?

Structuring the deal + valuation

1. What is the form of ownership that you take during deal structuring?
2. Convertible preferred stock ownership is not legally recognized in Ethiopia, though it is the preferable form of ownership. How do you think that affected you?
3. How do you ensure that your firm secures the best deal that minimizes your risk and optimizes your return?
4. What are the major difficulties you encountered in your attempt to negotiate and structure the deal in your favour
5. How did you handle those difficulties?
6. What valuation method do you use to value investee firms?
7. What were the difficulties in determining the right valuation of investee firms?

Post investment

The skills at AC

1. Are your transaction and investment teams previously experienced in private equity transaction screening, structuring, financing and overseeing?

2. Have lack of skills (for example to analyze investee firm performance) and industry knowledge ever been barriers to successful private equity investments (the whole cycle)?
3. If yes, how did they impact your investments?

Reporting

4. While monitoring the activities of your investees, have you ever faced problems of information asymmetry caused by inaccurate and untimely accounting and reporting information?
5. If yes, what impacts did it have on your investments?
6. What measures do you take when you realize that the reports coming from investees are inaccurate, untimely and not as per your required formats?

The management

7. How do you find the skilled managers that you replace?
8. What challenges did you face in finding them and how did you handle it?
9. Have you designed measures in response to difficulties (if any) in finding skilled managers and on time?
10. Have you faced any resistances, complications in trying to replace existing management?
11. Do you face any conflicts of interest with other BOD members or any other forms of resistance (regarding business operation decision) while trying to improve investee firm performance?
12. How do you resolve such conflicts or resistances?

The consequences of using high Leverage

13. What is the debt to equity ratio or debt ratio of each investee firm or the average for all firms?
14. Do you believe the use of debt has caused any cash flow problem?
    [is the EBIT plus noncash items sufficient enough to cover interest expenses]
15. Do you believe the high use of leverage has a negative impact on research and development expenditure (because of fixed charges) that could contribute to innovation?
16. If it has a negative impact, how do you reconcile your need for cash for interest payments and your need for cash to make R&D expenditures?

Exiting

1. How many years before you exit your investments?
2. Do you see any future challenges in your exit?
3. Have you made any arrangements now to avoid prospective difficulties in your exit?
4. If yes, what are they?