Private Equity Financing in Zambia:

Determinants and Constraints

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For the afro-optimist

Abstract

Growth and development of small and medium-sized enterprises (SMEs) are the key drivers of economic growth and development in Africa. While this has become a widely accepted idea, access to financing for growth remains a stumbling block for many enterprises in Zambia. Traditional lenders (i.e. banks) are risk averse because they may not understand the SME market and have been negatively impacted by information asymmetry that is often associated with these ventures. As a result, they tend to charge exorbitant interest rates that are unsustainable for long-term growth. The existing focus of many microfinance institutions in Zambia is typically directed towards salaried employees which crowds out lending to SMEs. Private equity financing, on the other hand, presents an alternative solution to the long-term financing dilemma faced by enterprises. The Zambian private equity market is itself in a nascent space but shows much potential. This dissertation seeks to determine what drives private equity financing in Zambia and what constrains it. The dissertation adopts a qualitative research approach relying on the interviews of various Fund Managers who are familiar with investing in Zambia. The paper finds that private equity investment in Zambia is determined and catalysed broadly by business attractiveness and the business environment. Business attractiveness is underpinned by management capacity, the business track record, exits and returns, impact potential and business scalability. The business environment is driven by political stability, GDP growth and population growth. The sector is however, constrained by a less developed private equity culture, limited opportunities to invest and currency risk.

Keywords: private equity, SMEs, access to finance, Zambia

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"*Great is Thy faithfulness!"*

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List of commonly used acronyms

AVCA	African Venture Capital and Private Equity Association
CAGR	Compounded Annual Growth Rate
CDC	CDC Group plc (formerly The Commonwealth Development Corporation)
DFI	Development Finance Institution
FDI	Foreign Direct Investment
FoF	Fund of Fund
GP	General Partner
IFC	International Finance Corporation
IPO	Initial Public Offering
LBO	Leveraged Buy-Outs
LP	Limited Partner
LuSE	Lusaka Stock Exchange
MSME	Micro, Small and Medium Enterprise
PE	Private Equity
SME	Small and Medium Enterprise
SSA	Sub-Saharan Africa
VC	Venture Capital/ Venture Capitalist

1.0 Introduction

1.1 Background of study

Strong businesses are the backbone of any economy. They provide much needed products and services to consumers, employment and income to employees, create value for shareholders, and generate valuable fiscal revenue for the government. Besides the obvious monetary and product offerings associated with businesses, they also foster innovation and creativity – bringing new ideas and inventions to the fore that are long-term game changers. The complete evolution of the music industry away from compact disks to electronic devices and interfaces (for example the iPod and iTunes provided by Apple Inc.), is an example of a revolutionary business idea that disrupted and transformed an entire industry.

It is clear that the development of businesses in any country is critical for meaningful growth and development. Africa's catalogue of development problems is vast and well documented. Part of the solution to the economic challenges that the continent has faced and continues to face has been the generally accepted idea that the promotion of enterprises can propel the continent forward and alleviate its financial and economic woes.

There are different interpretations across various countries of what constitutes small and medium enterprises (SMEs). Total employees, net assets, revenue and investment levels are popular measures used to define SMEs with the most popular measure being employee numbers. Generally, SMEs are defined as employing between 0 and 250 staff (Ayyagari, Beck, & Demirgüç-Kunt, 2007). They can be disaggregated further as follows: micro-enterprises that employ 1-9 people, small firms that employ 10-50 people and medium firms that employ 50-250 people (Sveinung, Leo, & Chris, 2010). In Sub-Saharan Africa, typically 90% of SMEs are micro enterprises and these are often not a part of the formal economy (Sveinung et al., 2010). This publication is more concerned with formal enterprises.

SMEs contribute to economic and social development. Generally, they create employment, improve competition, establish new industries, grow existing industries

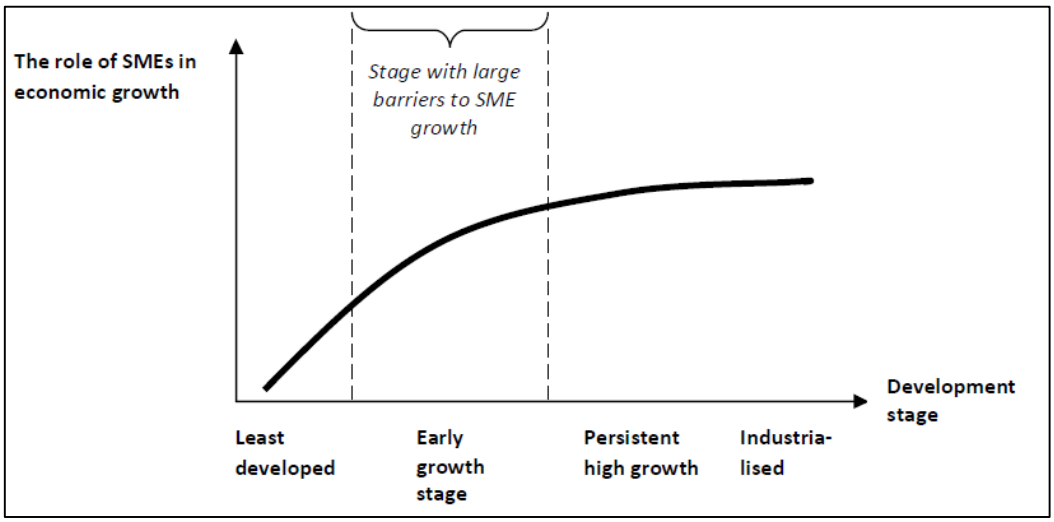
and positively impact the economy. SMEs also drive rural development and trade between regions (Shinozaki, 2012).

Because SMEs constitute a large part of a country's work force, employment creation, especially in rural areas is an important aspect of their contribution towards development, especially in Africa. According to Katyal & Xaviour (2015), SMEs are able to provide employment at a cost of capital that is lower than larger industries and help rural areas industrialise. This helps with improvements in the equitable sharing of income and wealth as well as with correcting imbalances between regions. Tambunan's (2008) study of Indonesia showed that SMEs accounted for 90% of total employment and produced basic consumer goods for the national market. They also contributed more than 50% of the country's GDP between 2001 and 2006 and performed better than larger enterprises. The average GDP growth shares of Indonesian SMEs stood at over 2% compared against larger enterprises whose GDP growth share was below 2%.

SMEs improve competition, innovation, and productivity. SMEs can create value chains with mutually beneficial sales and production processes through clustering together. Clusters are able to catalyse competition, encourage the development of start-up enterprises, boost product quality and increase production efficiency. Clusters also make it easier to access financial services, trade partners, raw material suppliers and skilled employees. According to one study, export-focussed SME clusters helped some Asian countries weather the effects of the 1997/98 Asian financial crisis (Shinozaki, 2012). Larger enterprises are also able to subcontract certain processes or product needs to SMEs in a bid to become more efficient, presenting an opportunity for the SME to grow with the large enterprise (Sveinung et al., 2010; Tambunan, 2008).

Flexible specialism is a theory that emerged in the 1980s after the re-birth of craft-based SMEs in Western Europe. Flexible specialism is characterised by the usage of technology, high-skilled and multi-skilled employees, and the small-scale production of specific products for global markets. Through flexible specialism, Western nations like the USA and Sweden as well as other nations like Japan, have seen their electronics and automotive subsectors generate innovative and efficient products. With flexible specialism, SMEs are able to grow just as fast if not faster than larger enterprises and can withstand the competition (Tambunan, 2008).

Figure 1: The role of SMEs in economic growth



Source: Sveinung et al. (2010, p.14)

In their assessment of Sub-Saharan African (SSA) economies, Sveinung et al. (2010) note that SMEs begin to impact economic growth when income levels rise. They observe that SMEs become more important to a country's economic development when a country has persistent levels of economic growth and is focussed on development. This relationship is presented in Figure 1 above. With the growth of developing economies, the services sector also expands due to increased demand for transportation, personal and business services and utilities to name a few. Further, a growing economy incentivises firms to go beyond informal structures and practices. In SSA, growth has mainly been predicated on minor business environment improvements and increases in foreign investment. However, within the context of globalisation, for an economy to grow, businesses need to specialise. They should be able to produce efficiently to make their products competitive both domestically and internationally. This explains why Asia has developed a reputation for low and medium cost technological and industrial production (Sveinung et al., 2010). This should be the bigger picture objective for SMEs.

Zambia's story is no different from the typical African country. According to the latest available World Bank data, 54.4% of the Zambian population is considered poor and 40.8% is considered as extremely poor. More than three-quarters of the poorest in Zambia live in rural areas (World Bank, 2016, p.1). Business innovation and success

represents a critical lifeline for the country. SMEs all require financing to help them grow and transform into stable, viable corporations (Abor, 2017) but access to finance, especially long-term finance, is a commonly faced growth constraint by most Zambian entrepreneurs and business houses (World Bank & IFC, 2013).

The Zambian private sector can be divided between micro, small and medium enterprises (MSMEs) which employ 88% of workforce and large corporate enterprises which employ 7% of the workforce but generate most of Zambia's economic output (Clarke, Shah, Sheppard, Munro, & Pearson, 2010). It is estimated that as at 2010, there were 1.05 million MSMEs of which only 29,350 were considered formal MSMEs as per Zambia Revenue Authority data (Shah, 2012).

As earlier alluded to, SME definitions are varied across different countries. The Zambian government defines them across the following variables: total fixed investment, total revenue, total number of employees and legal status. Micro enterprises invest up to K80,000 ($8,000), have annual revenue of up to K150,000 ($15,000) and employ up to 10 people. Small enterprises invest between K80,000 and K200,000 ($8,000 to $20,000), have annual revenue of between K150,000 and K300,000 ($15,000 to $30,000) and employ between 11 and 50 people. Medium enterprises invest between K151,000 and K500,000 ($15,100 to $50,000), have annual revenue of between K300,000 and K800,000 ($30,000 to $80,000) and between 51 and 100 people (Ministry of Commerce Trade and Industry, 2008).

The latest available detailed Zambian private sector survey conducted in 2010 defines enterprises differently. Large enterprises employ over 50 people and are a few thousand in number. 50% of large enterprises employ between 51 and 70 people, 33% employ over 100 employees and just 2.5% employ over 500 people. Three quarters of large businesses are incorporated as limited liability companies and large businesses in general are primarily engaged in manufacturing (24%), agriculture (14%) and wholesale and retail trade (9%). The formal private sector only employs 7% of the labour force despite 200 of the largest companies accounting for the majority of industrial output. Although mining generates 70% of Zambia's exports, it only employs 2% of the workforce (Clarke et al., 2010).

Zambia has a large informal private sector that, as at 2010, employed 88% of the workforce despite not contributing to the country's GDP as significantly as the larger companies. The SMEs are mostly informal, owner-operated, have 5 or less employees and are mostly found in rural Zambia (81%). They engage primarily in agriculture followed by wholesale and retail trade. These SMEs can be broken down into tiny, owner-operated businesses referred to as "survivalists" (77%), high-potential enterprises that are not adequately serviced (13%) and urbanised businesses led by the well-educated (16%). The last two segments represent the two groups of SMEs that have the most potential for growth (Clarke et al., 2010).

Zambian firms, specifically manufacturing firms, face the challenge of not being as productive as their peers in countries like South Africa and Kenya and in major export nations like China. Low levels of productivity combined with high unit labour costs make Zambian enterprises less competitive. Low levels of competition in the Zambian market mean that large organisations are likely to command a significant market share and possess a monopoly over prices. If market share was based purely on productivity, some Zambian businesses' market shares would be eroded. Because of low domestic competition, large firms are able to offset the costs of low productivity levels with higher prices. These higher prices coupled with low levels of competition create a high-cost economy. Competition is hampered by the high cost of financing, volatile exchange rates due to dependence on mining, tax policies that place a disproportionately higher burden on smaller enterprises, corruption and infrastructure weaknesses especially in the areas of electricity and transportation (Clarke et al., 2010).

Access to finance remains a challenge for Zambian firms, specifically SMEs. 27% of enterprises surveyed in the most recent World Bank Enterprise Survey indicated that obtaining a loan was a constraint to their operations (World Bank, 2013). Private equity (PE) financing presents an alternative source of long-term capital for both new and established SMEs with high-growth potential. The PE industry in Zambia is fairly nascent and from an academic perspective, it has not been an area of research focus. Therefore, the overall objective of this paper is to shed some light on the sector and in doing so, increase awareness amongst business owners and policy makers alike. It is envisioned that Zambian SMEs that fall into the PE "sweet spot" will come to appreciate and understand what these financiers are looking for in a potential investee.

It is also hoped that policy holders will understand what matters to equity financiers from a business environment perspective. Finally, it is expected that recommendations that encourage the growth of PE financing as a means of financing businesses for the country's long-term economic growth and development will also be presented.

1.2 Problem statement

The most recent and comprehensive access to finance survey of Zambian enterprises was conducted by the World Bank in 2013 and is presented in Table 1. Generally speaking, Zambian firms lag behind the average SSA firm. On average on 9% of firms had access to a bank loan or line of credit compared against a SSA average of 21%. 34% of Zambian enterprises' loan applications had recently been rejected at the time of the survey. In the small enterprise tier, the loan rejection rate stood at 53%. It is not difficult then, to understand why 27% of the firms surveyed considered access to financing as a serious impediment to their growth.

Nominal interest rates can get as high as 40% amongst commercial banks and up to 70% amongst microfinance institutions (Ministry of Finance, 2017a). In addition to this, Zambian lenders have higher collateral lending requirements than the average SSA lender (see Table 1). 91% of loans required collateral and the value of the collateral required was 237% the value of the loan (World Bank, 2013). Zambian lenders tend to prefer to secure debt on immovable property like land and buildings because the Ministry of Lands is considered to be a trustworthy asset registry source (Mseteka, 2018). To address this challenge, the Zambian legislature enacted the Movable Property Act in 2016, which allows security interests to be created on movable property. They also established a Collateral Office and Collateral Registry (Ministry of Finance, 2017a). However, as at 2018, only 2 banks are reported two have started accepting movable assets as collateral (Manda, 2018). The reality is that many Zambian SMEs do not possess immovable property.

By their inherent nature, small enterprises like sole-traders are unlikely to have a credit history or the means to acquire immovable property (Beck & Cull, 2014). High collateral requirements and high interest rates, coupled with poor lending tools and-

Table 1: Access to finance for Zambian firms

Indicator	Zambia Small Enterprises	Zambia Medium Enterprises	Zambia Large Enterprises	Zambia Total	Sub-Saharan Africa Total	All Countries Total
Firms with a bank loan/line of credit	5.2%	13.9%	34.0%	8.8%	21.0%	31.6%
Firms whose recent loan application was rejected	52.8%	9.4%	0.0%	34.1%	15.1%	10.9%
Firms using banks to finance investments	8.2%	17.7%	24.7%	12.2%	20.0%	24.4%
Proportion of investments financed by banks	5.4%	7.2%	13.2%	6.6%	9.4%	13.8%
Proportion of investments financed internally	82.9%	75.9%	78.4%	80.5%	74.0%	71.7%
Proportion of loans requiring collateral	88.0%	92.1%	93.7%	90.6%	85.7%	79.2%
Value of collateral needed for a loan (% of loan amount)	239.7%	188.9%	314.2%	236.6%	215.6%	206.9%
Firms identifying access to finance as a major constraint	29.6%	24.2%	12.7%	27.4%	39.6%	25.4%

Source: World Bank (2013)[1]

Definitions: Small enterprise = 5 to 19 employees, medium enterprises = 20 to 100 employees, large enterprises = +100 employees

- structural challenges all constrain access to finance for SMEs (Ministry of Finance, 2017a). Zambia's ratio of domestic credit to private sector by banks as a percentage of GDP falls significantly below lower middle income countries and SSA countries. In 2017, the ratio stood at 11% for Zambia, 44% for lower middle income countries and 48% for SSA countries (World Bank, 2019). This ratio is a proxy for financial deepening which is the expansion or penetration of financial services (Erdene & Sun, 2014). It can be inferred that in relation to the size of Zambia's economy, commercial bank lending to the private sector is not where it ideally should be.

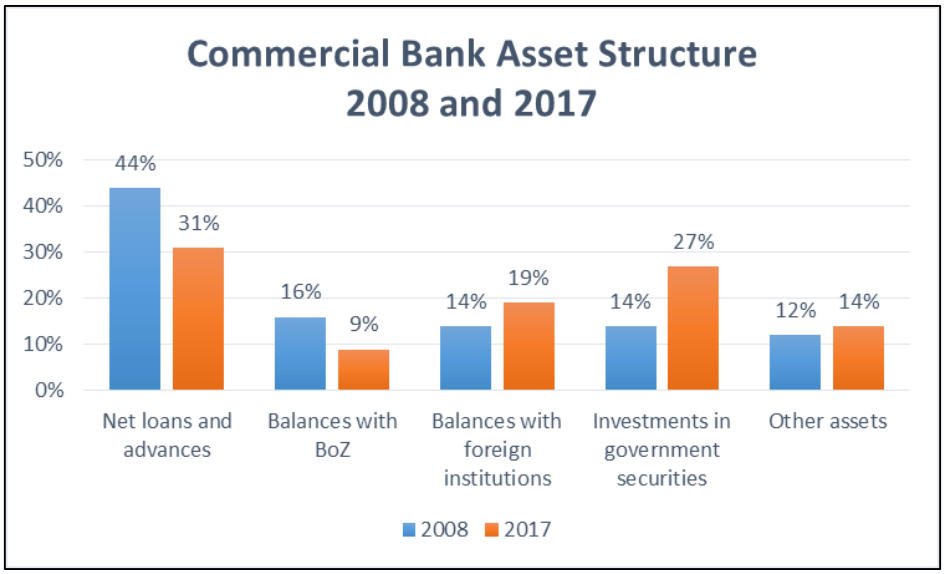
Private commercial banks, most of which are foreign-owned (12 of the 17 banks present in the country), dominate the local credit market in Zambia (Bank of Zambia, 2019b). In 2017, foreign-owned banks provided 69% of local credit (Bank of Zambia, 2017a). The concentration of a few banks limits competition in the banking and financial services sector which negatively affects more modestly-sized borrowers. There also exists a significant spread between lending rates and saving rates which is as a result of limited competition and -

[1] The table indicates that larger enterprises require a greater proportional value of collateral than smaller enterprises which is counter-intuitive considering the higher risks involved in lending to smaller enterprises. However, it could be so because of the comparatively higher loan values extended to larger enterprises.

- structural inadequacies (Ministry of Finance, 2017b).

Looking over the past 10 years, lending peaked in 2014, but by 2017 the number of commercial bank borrowers had declined by 31% from the 2014 peak. Bank lending per capita increased at a dollar compounded annual growth rate (CAGR) of 6% from K792 ($206 or $240 in today's dollars) in 2008 to K3,266 ($342 or $350 in today's dollars) in 2017. Despite this increase in lending per capita, commercial banks cut back on lending as measured by loans as a proportion of total assets (Bank of Zambia, 2017b). Figure 2 below shows that between 2008 and 2017, the proportion of loans advanced as a proportion of total assets by all Zambian commercial banks declined from 44% to 31% while investments in government securities as a proportion of total assets increased from 19% to 27% over the same period. The non-performing loan (NPL) ratio also increased from 7% in 2008 to 12% in 2017 (Bank of Zambia, 2017b). According to the Zambian Banking and Financial Services Act, NPLs are principle or interest repayments on loans that are more than 90 days in arrears (Zambia Legal Information Institute, 2019).

Figure 2: Commercial bank asset structure



Source: Adapted from Bank of Zambia (2008, 2017a)

Based on the data, it appears that the local credit market has contracted over the last few years – NPL ratios have increased, allocations to loans and advances have declined and investments in stable government securities have increased. Looking at the –

- actions of banks, it would appear that they have become more risk averse. Because lending to SMEs is riskier than lending to large enterprises, this apparent risk aversion is likely to further constrain SME financing.

The current credit environment is explained by the economic challenges that Zambia began experiencing in 2015. By the last quarter of 2015 the Zambian kwacha had depreciated significantly and a corresponding increase in food prices which saw inflation rise to 21% ensued. To lower inflation, the Central Bank raised interest rates which reduced enterprise access to credit and further impeded SME lending (Ministry of Finance, 2017a).

For the SMEs that do obtain loans from banks, the average SME loan tenure in Zambia is 21 months (World Bank & IFC, 2013). This short-term credit means that SMEs are restricted in the investments that that they can make over a long period of time. Long-term investments are necessary for growth. Different stages of a firm's life cycle will place different demands on capital (Abor & Biekpe, 2009). As Table 1 shows, only 12% of Zambian firms use banks to finance investments compared to 20% of SSA firms pointing towards under capitalisation. In 2017, the SME Forum in partnership with the International Finance Corporation (IFC) and the World Bank, released a report on the global MSME financing gap. This report assumes that MSMEs employ between 0 and 250 people (Bruhn et al., 2017). Zambia has an estimated 21,416 formal MSMEs with a total demand for $5.2 billion in financing. Out of this financing demand, it is estimated that $3.7 billion or 71% is unmet (World Bank Group, IFC, & SME Finance Forum, 2017). It can be concluded that the formal SME market in Zambia is under capitalised and as such, its growth prospects are limited to the available capital.

Alternative sources of capital for Zambian SMEs include the stock market and the bond market. Realistically, a SME is unlikely to list on the Lusaka Stock Exchange (LuSE) – the exchange is illiquid and heavily concentrated with a few firms. SMEs are also unlikely to meet the minimum listing requirements which include reporting 3 consecutive years of profit as well as a host of compliance-related obligations and fees (Lusaka Stock Exchange, 2018). A quick review of the history of corporate bond issuances in Zambia shows that bonds are mostly utilised by large established enterprises (Lusaka Stock Exchange, 2014).

La Rocca, La Rocca, & Cariola (2011) make four hypotheses about capital structure decisions made over a business's life cycle. Capital structure refers to the debt and equity mix used to finance businesses. Only two relevant hypotheses relevant to this study are highlighted below:

The first hypothesis is the *pecking order theory*. The theory is that businesses lean more towards using internally sourced capital and only turn to external sources when these resources have been used up. Due to information asymmetry associated with their businesses, SMEs would rather use capital that is less sensitive to information needs. The preferred order of financing as the business grows is therefore, retained earnings, then debt and finally equity. Debt is only contracted out of necessity and the more profitable a firm is, the less reliance it places on debt since it is relying on retained earnings (La Rocca et al., 2011). In their study of SSA SMEs using Ghana as a focus, Abor & Biekpe (2009) find that more profitable firms use less debt in accordance with the *pecking order theory.* They also find that there exists a positive relationship between the growth of SMEs and their contraction of long term debt.

The second hypothesis is different to the pecking order theory. It assumes that firms will rely on obtaining equity first, then retained earnings and finally debt. Due to information opacity, banks level higher interest rates against new businesses which limits them from obtaining debt. Firms turn to insiders, angel investors and venture capitalists (VCs). Equity is patient and can be invested for longer-term gains while allowing the robustness of the investment to be watched carefully. VCs assist the entrepreneur with skills development in addition to capital provision. Debt is only contracted after the firm has sufficient tangible assets to use as security. As the business grows, debt increases, especially at the maturity stage (La Rocca et al., 2011).

In both the two hypotheses presented above, PE has a role to play in the capital structure of firms both at the early stage and later stage of their life cycles. This forms the premise of this research. Having shown that Zambian SMEs are under capitalised, bank debt supplied to SMEs is short-term and that debt supply has declined, PE financing is an alternative asset class that is worth exploring.

1.3 Research objectives and questions

To obtain a better understanding of PE as an alternative asset class that can bridge the SME financing gap described earlier, this research seeks to investigate what drives the decision of PE financiers to supply funds to enterprises in Zambia.

Thus the research objectives and questions are as follows:

Research Objective 1 (RO1): To determine what private equity financiers are looking for in potential Zambian investees.
Research Question1 (RQ1): What drives private equity financing in Zambia?

and

Research Objective 2 (RO1): To determine what prevents private equity financiers from investing in Zambia.
Research Question 2 (RQ1): What prevents private equity investments in Zambia?

1.4 Justification of study

Preliminary reviews indicate that the Zambian PE sector is relatively small. To bring this into perspective, the nearest African PE hubs in South Africa and Kenya have 118 and 43 local PE offices respectively. Zambia has 7 (Asoko Insight, 2018). Obtaining detailed information about PE financing and PE firms in Zambia is challenging. Unlike publicly traded equities on a stock exchange, by its nature, PE operates in privacy. Because of the sizes of their PE industries, Kenya and South Africa have PE associations which publish reports containing relevant industry data. Zambia, however, is not yet at the stage where such an association is required.

The preliminary review of literature reveals that there has not been an academic exploration of the determinants of PE investing with an exclusive focus on Zambia. The majority of the studies under taken have been on the determinants of investment in the United States and Europe. In the recent past, there have been studies undertaken on the determinants of PE investment in emerging market economies because of the high rate of returns that they offer (Babarinde, 2012; Groh, 2009).

From a Western perspective, La Porta, Lopez-De-Silanes, Shleifer, & Vishny, (1997) found that the legal environment impacted PE activity. Black & Gilson (1998) found that the presence of a stock market increased VC activity. Gompers & Lerner (1998) showed that a growing economy, capital gains taxes and the levels of research and development impacted VC activity in the USA. Romain & van Pottelsberghe de la Potterie (2003) found that higher corporate tax rates were a constraint to PE financing.

From the emerging markets perspective, Groh's (2009) survey of international investors found that corporate governance and the protection of property rights were the most important determinants of PE investment. This was followed by the quality of management, expected deal flows and bribery and corruption. Divakaran, McGinnis, & Shariff (2014) identified unattractive regulatory environments, unwillingness of family-owned businesses to give up shares, limited exit opportunities and western funding structures as constraints to PE financing in developing countries.

Loos (2010) researched the determinants of PE investing in SSA and identified resources, returns, risk and the business environment as the key determinants. Babarinde (2012) explored the African continent and noted that a rising middle class, comparatively higher return on investment offerings and the participation of large international development finance institutions (DFIs) in PE financing all catalysed PE investment in Africa.

IESE Business School developed a PE and VC attractiveness of index of 125 countries across the world. According to their latest ratings, Zambia was ranked 78th and the most important determinants of PE investment in Zambia were taxation, economic activity, investor protection and corporate governance. The constraints were human capital, depth of capital market and entrepreneurial opportunities (Groh, Lieser, Biesinger, & Liechtenstein, 2018).

The IESE ranking is the only research where determinants and constraints pertaining to PE in Zambia are identifiable. However, it is limited in that, the factors affecting PE investment were not obtained directly from Fund Managers that make investments in Zambia. The researchers identified these factors through literature review. Using the factors that they considered most relevant to VC and PE, they measured and ranked the

attractiveness of each factor across 125 different countries. Because the factors are uniform and are spread across multiple regions, it is likely that the index fails to take into account unique, country-specific factors that affect one country and not the other. The difference with this research is that it intends to shed light on the specific factors that drive and constrain PE financing in Zambia by engaging with Fund Managers that are familiar with investing in the country. It is hoped that those who are unfamiliar with PE financing, are able to come away from reading this research with an improved awareness of how PE financing works in Zambia. It is also the expectation that the results will help SMEs broaden their financing options beyond commercial bank loans and also elicit some introspection on how they can make their enterprises attractive financing targets.

1.5 Organisation of paper

The next chapter will cover key PE terms and global trends, ending with an exploration of the historical PE trends in Zambia. Chapter 3, which is the Literature Review will outline the key theories and studies that underpin PE. The Literature Review will specifically highlight results of previous studies on the constraints and determinants of PE financing. Chapter 4 will outline the methodology involved in the research undertaking and Chapter 5 and 6 will present the results of the research and the conclusion respectively. The research will end with recommendations for policy makers and future researchers.

2.0 Background

2.1 Introduction

This chapter is an overview of PE covering its definition, its structure and the general merits and demerits of its usage. The chapter also explores the historical trends of PE financing in the USA, Europe, Asia and Sub-Saharan Africa. The chapter ends with a brief history of the PE industry in Zambia.

2.2 Definition and structure of private equity

(a) Private equity

Private equity is defined as "an asset class consisting of equity securities and debt in companies not quoted on a public exchange" (Baker, Filbeck, & Kiymaz, 2012, p.3). The European Venture Capital and Private Equity Association (EVCA) adds that PE is a medium to long-term investment in high-growth or high-growth potential investees (EVCA, 2007). There are six major classes of PE investments: VC, growth capital, leveraged buyouts, mezzanine capital, distressed investments and funds of funds (Baker et al., 2015).

(b) Private equity funds

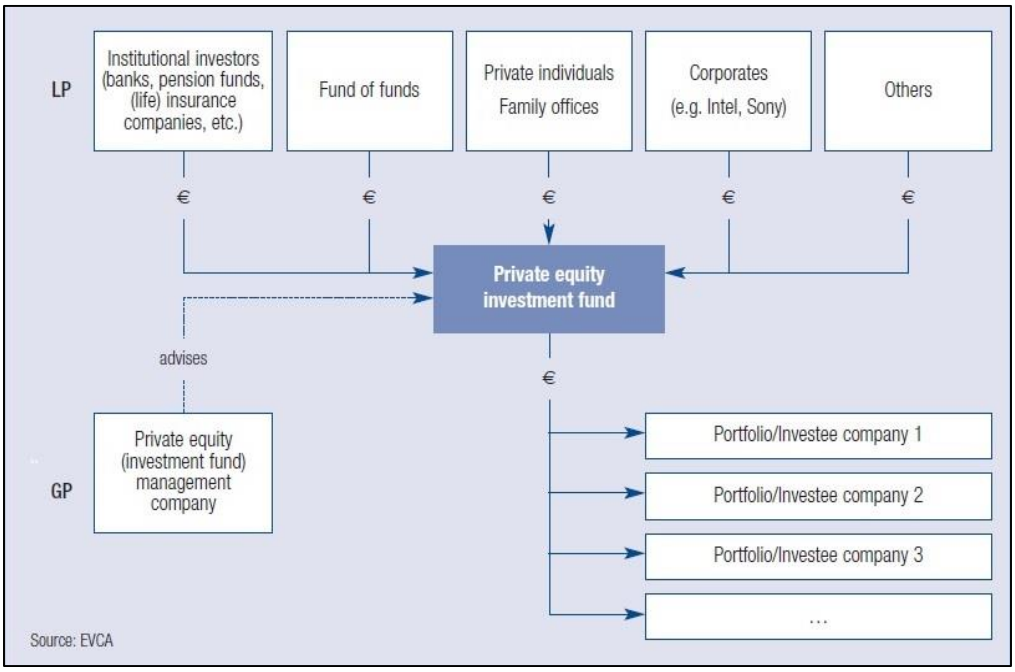
Institutional investors like pension funds, banks, insurance companies, endowments, development finance institutions, and high-net worth individuals use structured investment vehicles known as "funds" to make investments in various entities (Gilligan & Wright, 2014).

Funds are managed by skilled fund managers also known as General Partners (GPs) who make investments on behalf of the investors or Limited Partners (LPs) (African Development Bank, 2017). The term GP and PE firm are used interchangeably. The fund established by the GP acts as an important financial intermediary between return-seeking investors and privately held companies that require capital (Sommer, 2012). The funds are structured as limited partnerships between the GPs and the LPs, where the GPs handle the daily running, fund-raising and investment decisions of the fund. The failure or success of the investments lies solely with the GPs. To keep the LPs and GPs interests aligned, the GPs invest a negligible amount of their own money into the fund and are paid a management fee which is between 1% and

2% of the capital being managed. GPs also get carried interest or a performance fee upon realisation of the investment which is typically 20% of the capital gain made on the investment (D. J. Cumming & Johan, 2014; Divakaran et al., 2014).

PE funds are typically closed-ended and mature after 10-12 years. After closing on fundraising, GPs make investments in the first 5 years of the fund's existence which they return the LPs after 5 to 8 years (Sommer, 2012). The GPs' objective is to invest in a diversified portfolio of privately held companies for growth purposes to increase shareholder value and long-term capital gains which the fund realises upon exit (Gilligan & Wright, 2014).

Figure 3: Private equity business model



Source: EVCA (2014, p.9)

Overtime, the PE industry became more competitive forcing GPs to implement strategies to give them a competitive edge. These strategies included developing specialisations in specific industries and actively managing the operations of the investee (Gilligan & Wright, 2014).

This hands-on investment management style is known as a *capital-plus approach* involving the deliberate capacity building and strengthening of management and an emphasis on market development and growth (Divakaran et al., 2014).

(c) Types of private equity

Figure 4 on page 18 displays how some of the types of PE described below interact with the life cycle of a company in the developing world.

Venture capital is equity that is invested "typically in less mature companies for the launch of a seed or start-up company, early stage development, or expansion of a business" (Divakaran et al., 2014, p.3). *Seed and start-up capital* are very small amounts given to the business owner to help prove their business concept. They typically involve angel investors (Metrick & Yasuda, 2010). *Angel investors* are wealthy individuals that fill the gap that VC firms (whose focus is on potential high-growth firms) are unable to fill due to high risks and high fixed costs associated with undertaking such deals (Erickson & Vinturella, 2013). *Early stage capital* is given to businesses that are testing or piloting production or existing businesses that are less than 3 years old. At the early stage, a company would already have a business plan, a management team, and market studies in place. Normally institutional investors participate in this round of financing and the VC expends more effort on networking and business support than at later stages (Metrick & Yasuda, 2010). *Expansion stage /mid-stage capital* is working capital supplied to a company that is producing goods and has inventory, accounts payable and accounts receivable. The company may not be reporting a profit but the expansion capital is necessary for production expansion, marketing, or product development and improvements. At this stage, there are more institutional investors involved in financing the firm and the VC takes on the role of a strategist (Metrick & Yasuda, 2010).

Growth capital/equity lies between VC and leveraged buyouts. This type of investment is typically a minority or majority stake in the investee without the extensive usage of debt. It is used to propel growth, finance acquisitions or provide the investee company's shareholders with liquidity. The PE firm works closely with

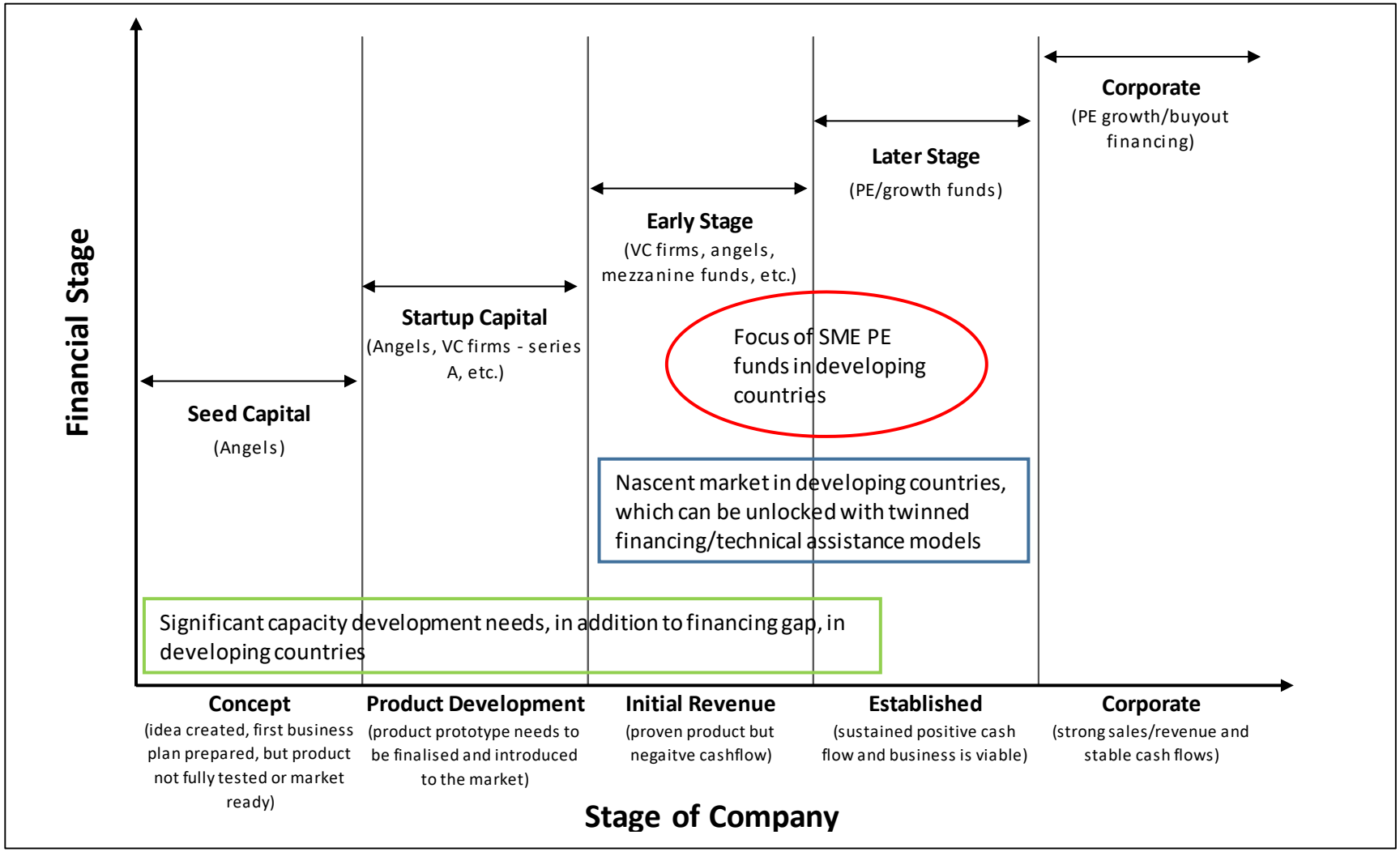
the investee company's management to expedite improvements in operations and increases in revenue. Growth companies are normally established, well-managed businesses with strong management teams and the potential for high revenue growth (Venero Capital Advisors, 2018).

Leveraged buyouts (LBOs) occur when, using a small proportion of equity and a large proportion of debt or leverage, the PE firm acquires a controlling stake in a mature business. (Kaplan & Strömberg, 2009). In order to provide the fund's investors with a return, PE firms either recapitalise the target company using by using a high proportion of debt or use value-enhancing strategies that eliminate operating inefficiencies to restructure the entire business (Rauch & Umber, 2015).

Mezzanine capital "refers to subordinated debt or preferred equity securities that often represent the most junior portion of a company's capital structure that is senior to the company's common equity" (Baker et al. 2015, p.3). Subordinated debt means that the debt is unsecured so the investor will demand a higher return than secured debt. The investor may also opt to preserve the company's cash by converting interest repayments to equity. This is favourable to the business owner because it is less dilutive than a full equity investment and it preserves cash (EVCA, 2007). It can either be a form of very late stage VC or an LBO (Metrick & Yasuda, 2010).

Distressed investments are debt and equity investments made specifically in companies that are in financial distress. Distress investment funds are structured like buyout funds, however the capital is invested in the target company's debt securities as opposed to its equity. Funds may make these investments to obtain control of a company by converting the debt to equity. Another distressed investing strategy is to offer expensive rescue loans to very desperate target companies to refinance existing loans and revive the company. If the business fails to turnaround, the fund takes control. Finally, turnaround investments are equity placements in struggling companies that the investor hopes will turn its fortunes around (Moyer & Martin, 2015).

Figure 4: Financial life cycle of a company



Source: Divakaran et al., (2014, p.6)

Fund of funds (FoFs) are simply funds that invest in other funds. Funds invest in other funds to diversify their portfolio, tap into fund managers with specific expertise and to access certain market (Harris, Jenkinson, Kaplan, & Stucke, 2018).

(d) Investment process

The investment process is divided into four stages: selection, structuring, monitoring and exit. Selection involves screening and evaluating the potential investee against the firm's standard investment criteria. 90% of all potential targets are rejected at this stage (Sommer, 2012). Privacy underpins PE and as such the PE industry tends to operate in an environment of secrecy because investee companies (often family-owned ventures) want to protect their intellectual property and privacy (Cendrowski, Petro, Martin, & Wadecki, 2012). The culture of privacy means PE firms must develop a very strong network of businesses to generate deal flows (Sommer, 2012). After the selection process, an offer is made to the investee and if accepted, a deal is structured. During this stage there is a detailed due diligence review covering the target's financial statements, management, business prospects and legal matters. If the results of the due diligence are acceptable, a purchase price is added to the investment agreement as well as key aspects of ownership, governance, incentives and control. Once the deal is signed and closed the PE firm monitors the investment by taking a seat on the board. The GPs use their deep industry experience and networks to execute operational and financial improvements in the investee that ultimately increases its overall value. Lastly, an exit plan must be drawn with a defined method for exit either through a stock exchange listing, secondary buyout or full/partial private sale (Sommer, 2012).

(e) Advantage and disadvantages of private equity

Some of the most successful companies in the world were backed by PE investments mostly in the form of VC. These include Microsoft, Sun Micro Systems, Intel, Apple, Compaq , WhatsApp, Facebook, Alibaba, Google and Twitter (CB Insights, 2019; Jeng & Wells, 2000).

PE enables companies that would have otherwise been unable to grow, to experience tremendous success by focussing on business performance

improvements. PE firms help establish high performance management standards while providing strategic guidance and support, a vast network of contacts, improved visibility amongst bankers, suppliers and customers and, a stable partnership in which risks and rewards are shared (EVCA, 2007).

The obvious disadvantage of PE to the entrepreneur is loss of control over the business. LBOs in particular face heavy criticism for saddling the target company with debt and cutting employee numbers to save costs. PE firms are also frequently accused of not paying their fair share of taxes and being more concerned about their earnings than the welfare of employees in their target companies (The Economist, 2016).

2.3 Global private equity history and trends

(a) North America

The genesis of the PE industry[2]

Various modes of PE financing have existed since time immemorial. When it comes to the USA, its VC roots date back to the 1800s when private financiers helped develop the railroad and textile industries (Cendrowski et al., 2012).

The First World War (WWI) marked the introduction of VC in the USA.

The War Finance Corporation (WFC) founded in 1918 by the US Congress was responsible for financing war industries. It lent $71 million ($1 billion in today's dollars) to banks during WWI. After WWI ended, WFC's mandate allowed it to play a critical role in financing the rail and agricultural sectors. The WFC laid the ground work for the existence of future government-led investment funds for private enterprises (Cendrowski et al., 2012).

Between 1929 and 1939, the USA experienced a period of difficult economic times known as the Great Depression. Small businesses bore the brunt of the Great Depression and many closed down. To remedy this, the Reconstruction Finance Corporation was created in 1932. Its mission was to finance businesses through

[2] This section is mainly adapted from Cendrowski et al. (2012)

loans. To help out small businesses, Congress created the Smaller War Plants Corporation (SWPC) in 1942 during World War II (WWII). The SPWC was the first government institution to lend money to private businesses only and it became a champion of small businesses, encouraging other larger providers of credit to follow in its footsteps (Cendrowski et al., 2012).

Establishment of PE industry in the 20th century[3]

In 1946, American Research and Development Corporation (ARD) recognised as "the first modern venture capital firm" was founded (Gompers & Lerner, 1998, p.151). ARD made investments in companies that were developing technology for WWII. In 1957 ARD invested $70,000 ($ 1 million in today's dollars) in Digital Equipment Company. "Because institutional investors were reluctant to invest, ARD was structured as a publicly traded, closed-ended fund and marketed mostly to individuals" (Gompers & Lerner, 1998, p.152). Other VC firms formed after ARD followed a similar structural pattern.

In 1953 the Small Business Administration was created to help entrepreneurs with training and financing. The Small Business Investment Company (SBIC) was founded in 1958 to finance and regulate private VC firms. The SBIC was the beginning of the VC industry as we know it.

VC transformed from a small industry financed by the wealthy to a well-structured asset class. By the 1960s a strong stock exchange provided a viable exit for ARD and similar venture firms, earning them sizeable returns on their investments. The Digital Equipment Company was worth $355 million ($3 billion in today's dollars). The sixties also heralded the introduction of the LBO (Cendrowski et al., 2012; Gompers & Lerner, 1998; Gordon, 2012).

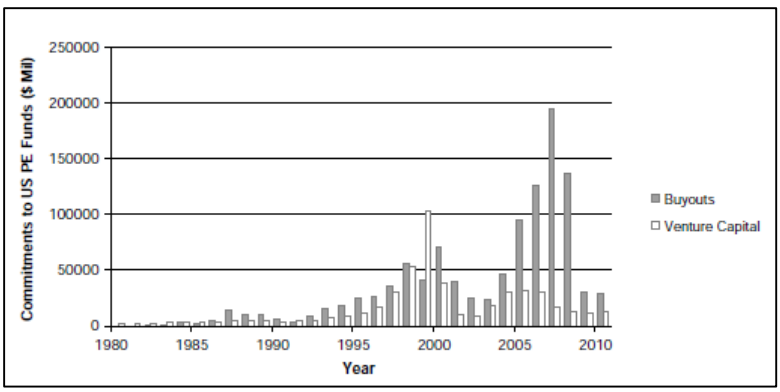
[3] This section is mainly adapted from Cendrowski et al. (2012)

A weak 1970s stock market weakened initial public offering (IPO) exits and the Employee Retirement Income Security Act (ERISA) made the rules for pension fund investments stricter. Pension fund managers stopped investing in VC because it was deemed high risk. ERISA's "Prudent Man Rule" was clarified in 1978, explicitly allowing pensions to invest in PE. Capital gains tax rates were also cut from 49.5% to 28% and then eventually to 20%, earning PE investors even greater return on their investments. LBOs surpassed VC –was spurred on by low interest rates on bank debt and low capital gains tax rates (Cendrowski et al., 2012).

From the late 70s to the mid-90s PE and VC investments began to drop with a recession in the early 90s adding to the industry's problems. VC returns dropped sharply from averages of 33% in the late 70s and early 80s to less than 12% in the late 80s and early 90s. LBO returns followed a similar pattern dropping from 35% to 13% over the same period. Commitments declined while real GDP growth remained stagnant (Cendrowski et al., 2012).

The mid-90s saw a resurgence in US PE investments. It was also the beginning of the dot-com boom. From 1992 to 1995, the American GDP grew by 3% per annum which boosted the IPO market and its new darling – internet companies known as "dot-coms". As IPOs delivered 100% returns on dot-coms, the investment atmosphere became euphoric. VC investments grew at a CAGR of 56% from $12 billion ($20 billion in todays' dollars) to $111 billion ($162 billion in today's dollars) between 1995 and 2000. (Cendrowski et al., 2012).

Figure 5: Commitments to USD PE Funds (1980-2010)



Source: Cendrowski et al (2012, p.32)

21st Century boom and bust cycles[4]

By the late 90s VC commitments were 6% higher than the combined total market capitalisation of the New York Stock Exchange and NASDAQ. VC was poured into start-ups that did not possess the business acumen to succeed and standard market-based valuation fundamentals were disregarded in the quest to cash-in on the dot-com frenzy. In 2000 the dot comb bubble burst and VC and PE began to decline. Returns on investments plummeted with investors losing 40% on their investments on average, fundraising declined at a CAGR of -36% from the 2000 high of $111 billion ($162 billion in today's dollars) to $29 billion ($40 billion in today's dollars) in 3 years. The US PE industry ebbed until 2004 (Cendrowski et al., 2012).

By 2005, the PE sector was rallying back and buyout funds had more than doubled within a year. In 2007 the value of PE and VC funds raised in the US were around $302 billion ($366 billion in today's dollars) and deals were worth $938 billion ($1 trillion in today's dollars) (PitchBook, 2016b; Vijayakumar, 2008). Blackstone, one of the world's largest PE and alternative asset management firms, successfully listed on the New York Stock Exchange in 2007 (Baker et al., 2015). This positive sentiment, however, was short-lived. The collapse of Bear Stearns, Lehman Brothers and the 2008 global financial crisis created deep uncertainty. Investors held off investing in PE funds due to liquidity constraints and portfolio erosion (Cendrowski et al., 2012) .

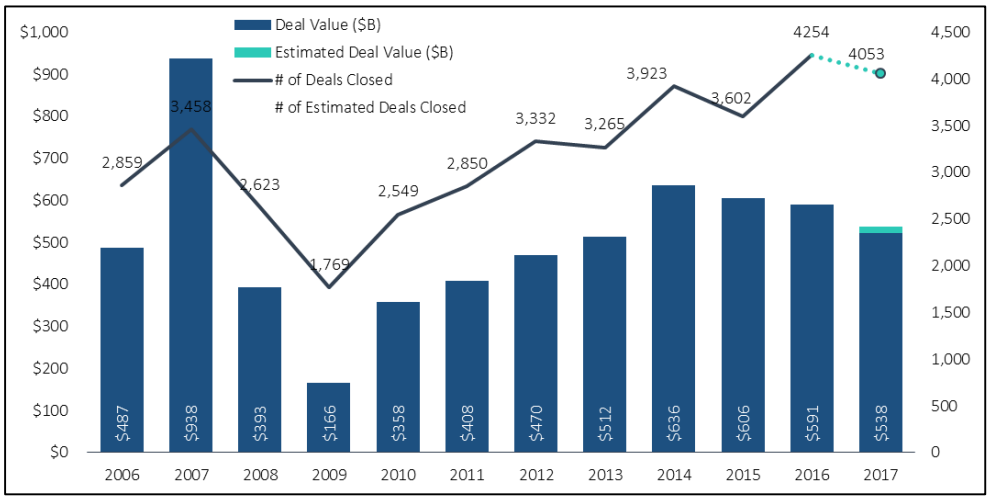
The period after the financial crisis was a period of recovery. Funds raised for US PE and VC were at their lowest value of around $70 billion ($102 billion in today's dollars) in 2010 (Lewis, 2018). Because of the weaknesses in the design of the financial system exposed by the global financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in 2010, regulating the previously unregulated PE industry. Now PE firms had to be registered with the Securities Exchange Commission (SEC), disclose information to SEC and in some cases be brought under the supervision of the Federal Reserve (Baker et al., 2015).

[4] This section is mainly adapted from Cendrowski et al. (2012)

The US PE market today

As at 2017, US PE funds raised stood at $233 billion ($239 billion in today's dollars) across 247 funds and an estimated 4,053 deals were made at a value of $538 billion ($551 billion in today's dollars) (PitchBook, 2018b). Dealmakers were concerned about insufficient quality targets and ever increasing competition – between 2000 and 2016 the number of global PE firms had tripled in number (Bain & Company, 2018b; Heberlein, 2017).

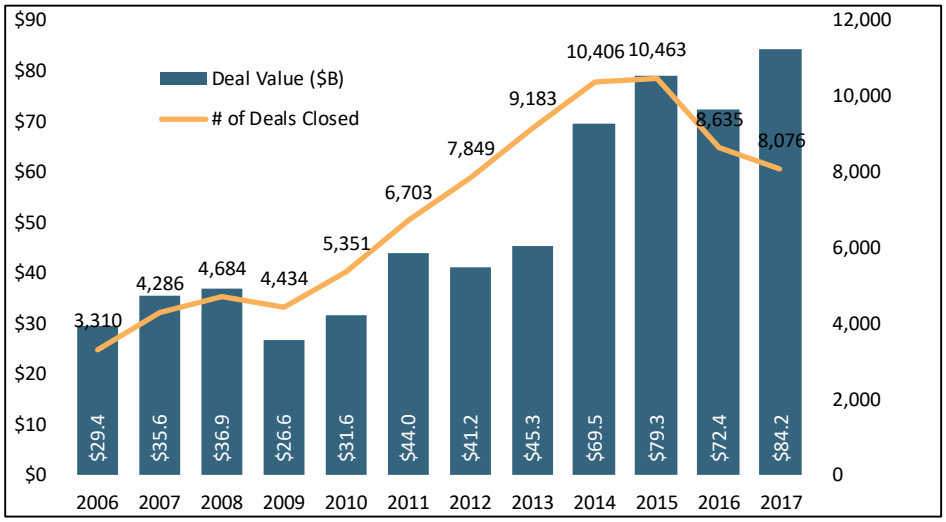
Figure 6: US PE Activity (2006-2017)



Source: PitchBook (2016, 2018)

PE firms also faced increased competition from highly liquid corporates that participated directly in acquisitions. *Dry powder*, which is capital that is yet to be invested, was also a source of concern, increasing year-on-year (Bain & Company, 2018b; Heberlein, 2017; PitchBook, 2018b). The most popular sectors for PE investment in 2017 were the information technology (IT), healthcare, business to business and business to consumer sectors (Bain & Company, 2018b).

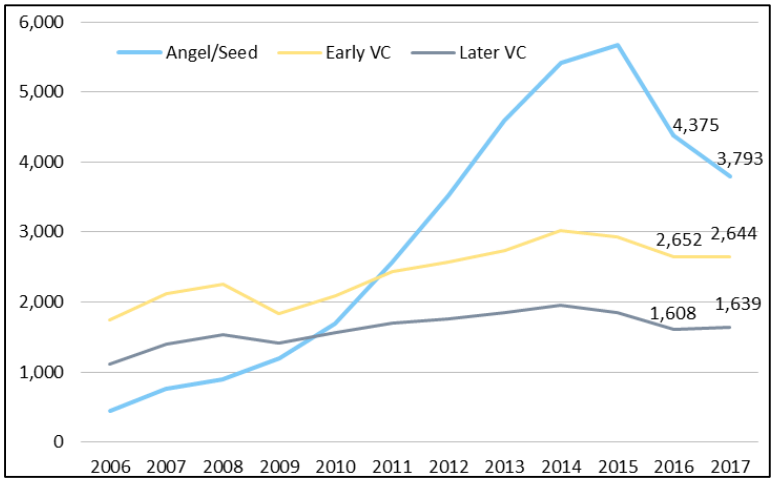
Figure 7: US VC Activity (2006-2017)



Source: PitchBook (2018b)

In 2017 American VCs made $84 billion ($86 billion in today's dollars) in investments spread across 8,076 closed deals – this was the highest level of investment since the 2000 internet bubble era. Unicorn investments (individual investments in excess of $1 billion) were also at their highest level in VC history. The investment focus shifted to companies over 5 years old, due to the need for resilient KPIs given the increase in deal sizes. (PitchBook, 2018c). However, this approach resulted in a decline in early-stage investing which is key to the VC ecosystem. (Kilroy, 2018).

Figure 8: US VC Activity (2006-2017)



Source: PitchBook (2018b)

(b) Europe

1990s and the dot-com era

Between 1995 and 2000, European PE investments experienced an astronomical increase in size at a dollar CAGR of 54% from around €5 billion ($5 billion or $9 billion in today's dollars) to close to €50 billion ($46 billion or $67 billion in today's dollars). As with the US PE market at the time, the growth in this sector was bolstered by the boom in the high-technology industry space. The Euro as a single currency created a more connected market for European debt and equity to flourish. The Euro also increased competitiveness between firms which positively influenced the growth of PE in Europe (European Central Bank, 2005). Changes in Basel II banking regulations in the 1990s restricted the ability of banks, for example in Germany, to finance risky investments, which pushed the demand for PE upwards (Sommer, 2012).

When the dot-com bubble burst in the US in 2000, the resultant slump in stock market prices lead to a substantial decline in European PE activity which dropped at a dollar CAGR of -5% from the 2000 high of close to €50 billion ($46 billion or $67 billion in today's dollars) in investments to just under €30 billion ($37 billion or $50 billion in today's dollars) in investments by 2004. In response to the lessons learnt in the dot-com era, PE sought less risky investments and LBOs in more mature sectors as a portion of investments began to increase (European Central Bank, 2005).

Post dot-com era

Before 2003, the prudential choices of European pension funds and insurance companies were determined by their respective governments. However, in 2002 and 2003 the European Commission issued legislation that stopped insurance companies and pension funds respectively from adhering to national legislation that prevented them from investing in risk capital markets i.e. VC. This changed the fundraising dynamic and in 2006 pension funds overtook banks and became the biggest source of funds for PE investments. Also as a result of this change in regulation, VC funding levels increased in countries like Sweden, Denmark and

Finland placing their investment as a percentage of GDP at par with the US (Popov & Roosenboom, 2009).

By 2006, European PE fundraising had broken its own records as shown by Figure 9, raising an unprecedented €112 billion ($141 billion or $175 billion in today's dollars), its highest level of fundraising to date. The largest contributors to these funds were the USA, the United Kingdom and France (Thomson Financial, EVCA, & PricewaterhouseCoopers, 2007).

2008 Global financial crisis

In 2008, the global financial crisis resulted in the contraction of the US credit market by 80%, choking the availability of syndicated loans which were used to back LBOs (Sommer, 2012). By 2009, fundraising, investments and divestments fell to their lowest levels since 1999 at a dollar CAGR of -31% from 2006 to 2009. Between 2006 and 2009, fundraising dropped from €112 billion ($141 billion or $175 billion in today's dollars) to €20 billion ($28 billion or $33 billion in today's dollars), investments dropped from €71 billion ($89 billion or $111 billion in today's dollars) to €28 billion ($39 billion or $46 billion in today's dollars) and divestments from €33 billion ($41 billion or $52 billion in today's dollars) to €16 billion ($22 billion or $26 billion in today's dollars) (see Figure 9). However, with the crisis also came opportunity - rescue and turn around deals increased by 40% in 2009 from 2008 (EVCA, 2009).

European PE market today

As at 2017, the European PE market had recovered from the crippling effects of the 2008 crisis. Fundraising had increased and was at its highest level since 2006, standing at an impressive €92 billion ($104 billion or $106 billion in today's dollars). Funds had primarily been provided by pension funds (29%), FoFs (20%), family offices and private individuals (15%), sovereign wealth funds (9%) and insurance companies (8%). Non-European institutional investors provided more than 40% of these funds (with Asia having a 15% share of this) (Invest Europe, 2018).

Buyout investments which stood at €72 billion ($81 billion or $83 billion in today's dollars), had increased year on year by 29% and continued to be historically higher than VC activity whose fundraising has declined from 2016's record year (Invest Europe, 2018). Axelson & Martinovic (2015) note that European entrepreneurs had been smaller in number because of the societal stigma associated with business failure and personal bankruptcy filings. European VCs had also been criticised for not possessing sufficient expertise in VC.

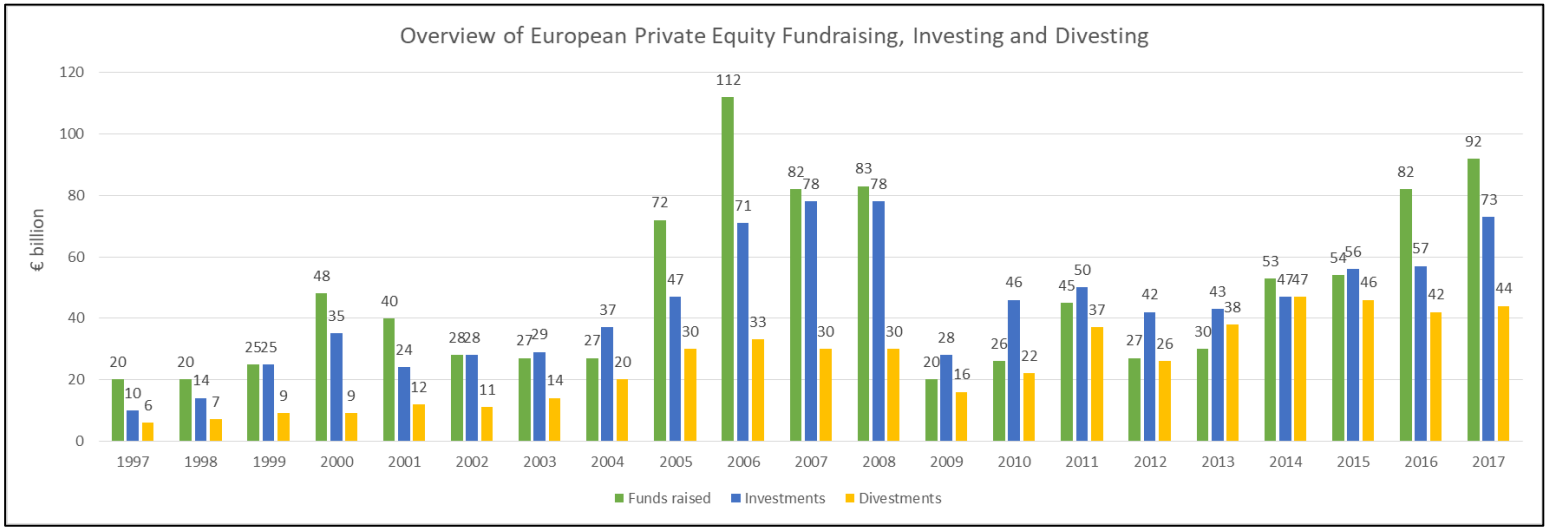
Sectors of PE and VC investment tend to mirror those of the USA. The most popular PE investments sectors are business services, consumer, industrials and chemicals, technology, media and telecommunications, pharmaceuticals, medical and biotech and financial services. Ireland and UK are the biggest markets for European buyouts, however, fund managers are cautious about financing companies in the UK and Ireland in light of their exposure to the effects of inflation caused by Brexit (Naydenova & Roberts, 2018).

Despite fund managers' concerns about Brexit, the UK and Ireland still remain the biggest markets for European PE (30%) and VC (38%) (PitchBook, 2018a). The Benelux (Belgium, the Netherlands and Luxembourg) and DACH (Germany, Austria and Switzerland) regions are the third and fourth most popular investment destinations.

According to PricewaterhouseCoopers's Naydenova and Roberts (2018), it is likely that the UK will continue to lead the PE market in the years to come. Groh, von Liechtenstein, & Lieser (2010) also ranked the UK as number one in their European VC and PE attractiveness indices. The index showed that the UK outperformed other European nations on investor protection and corporate governance scores due to its legal history of protecting minority shareholders and the depth of its capital markets.

The Financial Times reported that until recently, London was the world's top global financial centre but concerns over the uncertainty of Brexit have pushed New -

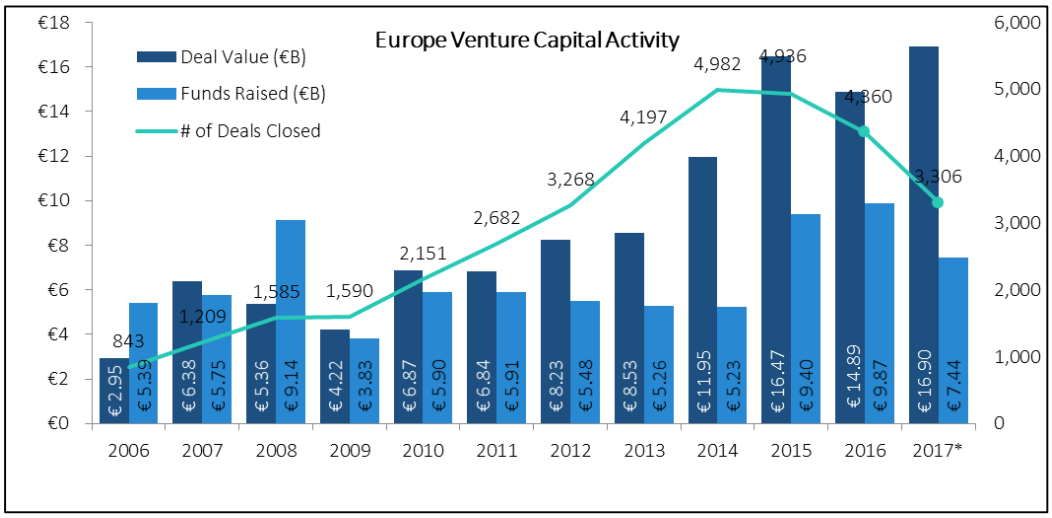
Figure 9: Overview of European private equity fundraising, investing and divesting (1997–2017)



Source: Invest Europe (*2018. p.5)*this data is a summation of both venture capital and private equity.*

- York City into the top spot while questions continue to arise over the London's ability to sustain its capital attractiveness (Murphy, 2018). The short-term outlook for the European PE market is positive. A survey of fund managers across Europe performed by Roland Berger indicates that more PE-backed mergers and acquisitions are expected with the most sought after industries being pharmaceuticals, business services, technology and media & telecommunications. The managers also see divestment as a key priority due to overvalued assets (Roland Berger Strategy Consultants, 2018).

Figure 10: European venture capital fundraising and investing activity (2006-2017)



Source: PitchBook (2016a, 2018a)

(c) Asia

Early history of private equity financing in Asia

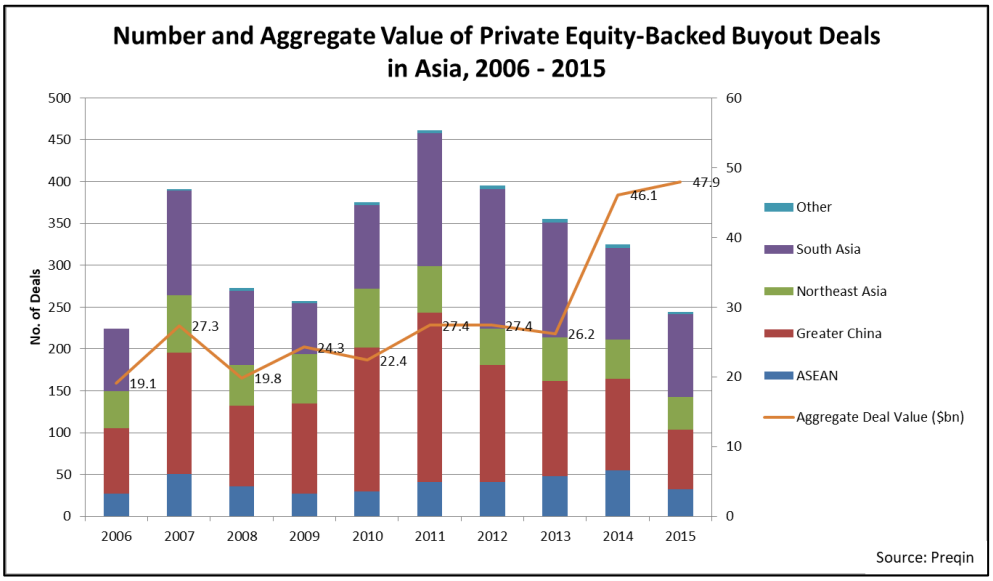
The Asian PE industry was founded in late 1980s by a few individuals to take advantage of the opportunity to buy into the continent's growing consumer market and to assist with outsourcing of Western companies to the region (AVCJ, 2012). Before the 80s, the market had been existence for decades, it just was not formally organised and structured like Western PE. Funds were often provided by banks or wealthy families (Prahl, 2010).

From 1992 to 1998, foreign direct investment flowed into Asia, growing at a CAGR of 19%. Bank financing was only accessible to a small set of companies which increased the demand for PE. Between 1992 and 1999, $50 billion ($75 billion in today's dollars) was raised for Asian investments. These funds did not perform well due to poor corporate governance standards, information asymmetry, poor legal systems, limited exit prospects and lack of experience amongst Asian fund managers (Prahl, 2010). The Asian market's problems were deepened further by the effects of the Asian financial crisis of 1997 - volatile currency fluctuations and increased market risk (Prahl, 2010). As with all financial crises, it presented PE firms with buyout opportunities for distressed companies (AVCJ, 2012). Distressed

companies in Indonesia, Korea and Japan became sought after targets for investors and yielded satisfactory returns. Shinsei Bank in Japan is an example of one such investment that yielded more than 6 times return on investment for the PE firm Ripplewood (Prahl, 2010). Consequently, several Western firms flocked to the region to set-up bases there to tap into the new market (AVCJ, 2012). Investments were mostly focussed on early-stage capital but the deals were of sub-standard quality because the industry lacked maturity. When the dot-com bubble burst in 2000, risk averse investors moved their investments to safer markets (Prahl, 2010).

One of the significant catalysts for growth of the Asian PE market was China joining the World Trade Organisation in 2001. This was a very clear indicator to PE investors that China was open to investment (AVCJ, 2012). Deals flowing to Asia after 2001 were mostly buyouts and expansion investments. With the presence of large international firms in the local market, the Asians benefited from learning more about the benefits of PE. These firms advocated for regulatory reforms and proved that they could make returns on their investments. The Asian market transformed and nations like Vietnam, India and China that opened themselves up to PE from international firms now possess a substantial share of the Asian PE market (Prahl, 2010).

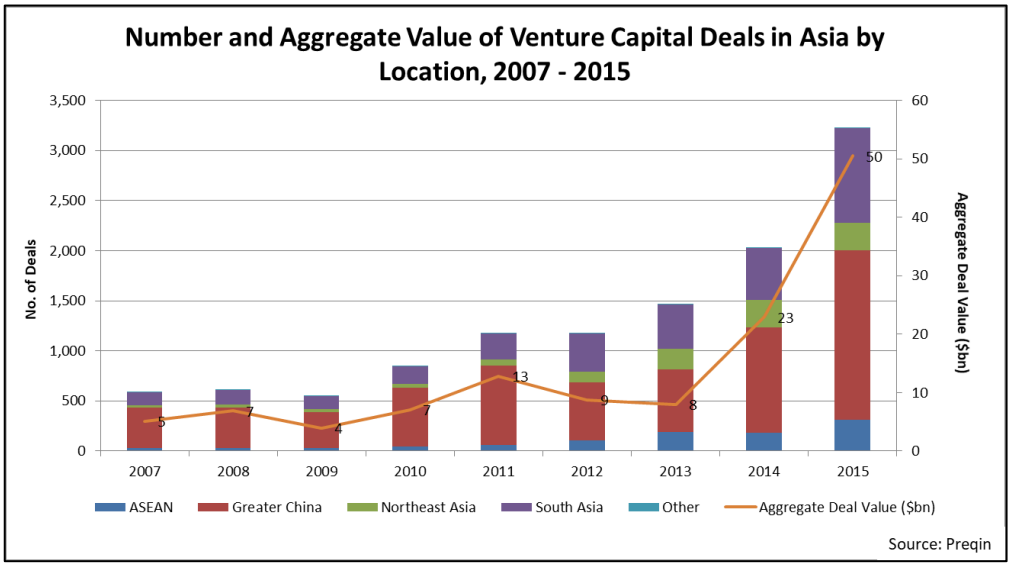
Figure 11: Asian private equity buyout deals (2006-2015)



Source: Preqin (2015)

As Figures 11 and 12 show, the aggregate deal value of buyout and VC investments in Asia has increased steadily over time. The number of buyout deals has decreased in number while the value has increased. For VC, both the deal value and the number of deals have increased.

Figure 12: Asian private equity buyout deals (2007-2015)



Source: Preqin (2015)

Private equity in Asia today

Between 2007 and 2017, Asia increased its share of the global PE market from 9% to 23% (Bain & Company, 2018a). As at 2017, the Asian PE market's investments stood at $158 billion ($162 billion in today's dollars) up 38% from 2016, placing the region ahead of Europe for the first time in history. When compared against other markets, the Asian region continually experiences strong economic growth making it an attractive market for investment (Kodaira, 2018). According to Yamashita (2018), because Asia is responsible for driving two-thirds of global economic growth, long-term investment funds find the region attractive. Asia is also experiencing a generational shift as reported by the Financial Times. Older/founding generations are more willing to sell their business stakes especially when the process of handing over the company to their heirs sours family relationships (Weinland, 2018). The Carlyle Group established a $7 billion Asia

fund while the Blackstone Group closed on a $2 billion Asian-focussed fund in June 2018 (Kodaira, 2018).

China and India

China, Japan and India are the region's leaders for investment (Bain & Company, 2018a). Both China and India have implemented economic reforms that have eased the way of doing business and contributed to increased economic growth. With populations in excess of 1.3 billion each, they share a large pool of low-cost labour resources that adds to their appeal (Ippolito, 2007).

India has chosen to make improvement in its institutional framework, productivity and IT exports as a path to development. However, low savings and insufficient infrastructure have hindered its growth potential (Ippolito, 2007). As a result of these infrastructural weaknesses, the Indian infrastructure market has become a prime investment area. Blackstone made a $1 billion real estate deal in Indian Bulls Real Estate while Macquarie made a highway operation contract for $1 billon (Yamashita, 2018).

China followed the traditional East Asian export-led growth model focussing on manufacturing. Capital accumulation generated from foreign direct investment and high savings were ploughed back into infrastructure to build scale and make the country an even more attractive investment destination (Ippolito, 2007). Today, the most popular sector of interest for funds in China is the innovative start-up technology space, given that it is now moving away from manufacturing to being more of a consumer-driven market. Ant Financial which operates Alipay and is an affiliate of the Alibaba Group managed to raise $14 billion in Series C funding from VC investors, making it the single largest fundraising of its kind in history (Albers-Schoenberg, 2018; Yamashita, 2018). Of the 10 largest deals reported in the Asian region as at June 2018, China obtained 6 at a total of $23 billion. Chinese early stage investments received $56 billion by June 2018, surpassing similar American companies that received $42 billion. Between 2010 and 2017, early stage investments in China increased by more than 14 times to $64 billion ($66 billion in

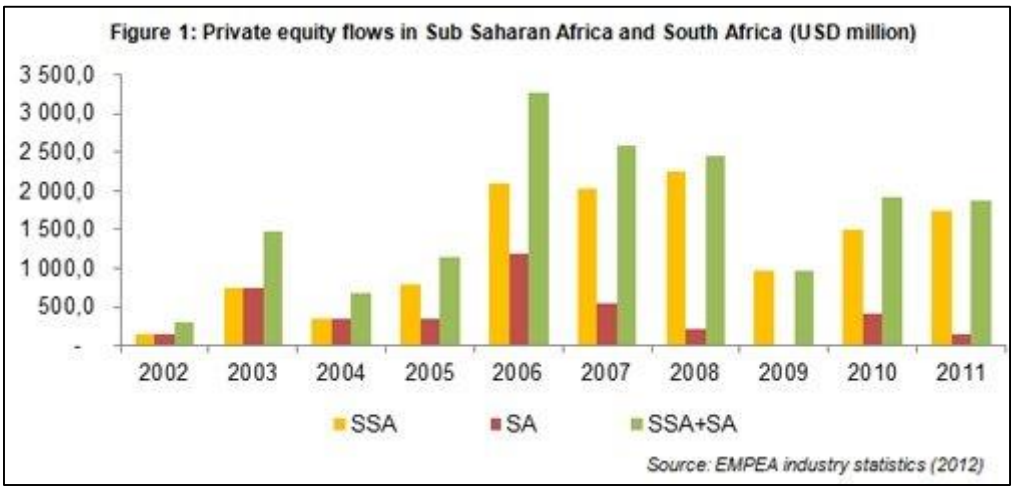
today's dollars). (Albers-Schoenberg, 2018). Despite this success, the recent trade war that has arisen between China and the USA under the Trump administration may restrict American funds investing in China and vice-versa. (Yamashita, 2018).

(d) Sub-Saharan Africa

The development of the PE sector within the SSA region was initiated by DFIs in the 1990s. Before embarking on this new financing strategy, DFIs had focussed on assisting African governments with debt security for development-related projects. With time, they extended their focus to investing in independent private companies that did not have government ties. PE firms with an African mandate emerged in the 1990s primarily out of South Africa. In 1997, $1 billion ($2 billion in today's dollars) had been raised by 12 PE funds for African investments mostly centred on South Africa. However, the funds also began investing in other African countries like, Botswana, Kenya, Zambia and Zimbabwe. Most of the investments were under $5 million ($8 million in today's dollars) (AVCA, 2014).

According to Figure 13 between 2002 and 2006, PE flows in the SSA region were just over $6 billion ($7 billion in today's dollars) with South Africa receiving at least half of these inflows (African Development Bank, 2012).

Figure 13: Private equity flows in Sub-Saharan Africa (2002-2011)



Source: African Development Bank (2012)

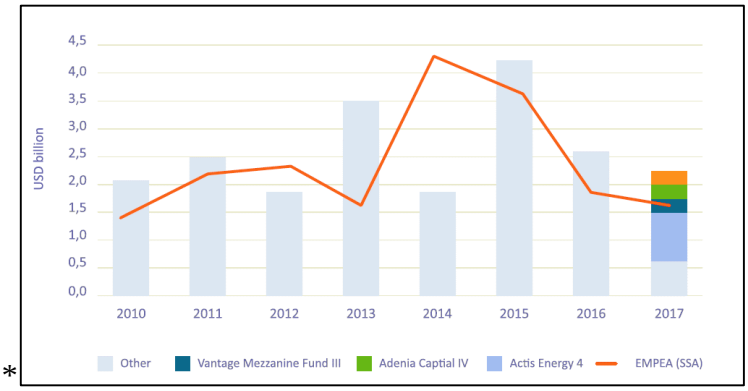
Due to the effects of the financial crisis, inflows declined steadily between 2007 and 2009, at which point, they were at their lowest level since 2005. Despite the shocks of the financial crisis, momentum in SSA was stronger than in other developing regions. However, the region still received a comparably lower share of PE than other developing nations (African Development Bank, 2017; Maimbo, Faye, & Triki, 2011).

In 2013, $330 billion ($356 billion in today's dollars) was raised around the world for PE funds, of which only 3% was allocated to SSA. (Oxford Analytica, 2014; Tyson, 2015). There were more than 200 PE funds targeting investments in Africa. Investment strategies varied between generalist, sector-specific, country-specific and regional-specific. DFIs continued to play an important role in the industry, often backing fund managers that others were unwilling to fund. They also anchored PE funds and attracted more investors (AVCA, 2014). Most investments made in Africa were no more than $50 million ($54 million in today's dollars). The average ratio of PE investments to the GDP of the SSA region was 0.09% in 2012 compared to 0.86% in the USA. The dominant global PE firms with funds dedicated to the SSA region were The Abraaj Group, Helios Investment Partners, The Blackstone Group, KKR & Co., The Carlyle Group and Actis Capital (Oxford Analytica, 2014).

PE in Africa today

Data for fundraising and deal flows in the SSA region exclusively as at 2017 has been challenging to obtain, however data for the African continent as a whole indicates that in 2017, the region raised over $2 billion in funds for investments (RisCura, 2018). According to the African Venture Capital Association (AVCA), in 2017, $4 billion in investments were made in the African region, a number unchanged from 2016 (AVCA, 2018b).

Figure 14: African private equity fundraising (2010–2017)



*

Source: RisCura (2018, p.30)

PE investments in Africa were mostly focussed on growth. The African outlook is ever evolving and emerging industries and changing demographics mean that PE financing is mostly expansionary in nature. This expansionary focus helps businesses occupy most of the value chain. Because Africa is still developing, PE financiers in Africa prefer to take minority states in investments alongside management who maintain ownership of the companies. To protect the PE firms' interests, financing contracts are arranged in such a manner as to still give the PE firm a strong influence on the company's governance, decision-making and direction (AVCA, 2014). PE firms in developing nations also typically target larger, more established operations with average investments of $10 million (Divakaran et al., 2014).

Deal activity shows that the most popular regions for PE financing in the SSA region between 2012 and 2017 were Southern Africa, East Africa and West Africa, accounting for 72% of deal activity in Africa. In terms of actual deal value, the most popular regions were West Africa ($11 billion), Southern Africa ($4 billion), and East Africa ($2 billion) (AVCA, 2018a). The most popular sectors were consumer, financial services, healthcare, agribusiness and infrastructure (AVCA, 2018a).

Nigeria

West Africa is dominated by Nigeria. Nigeria is the largest PE market in the West African region, accounting for 42% of deal volume and 73% of deal value. In 2017, the Nigerian government made very specific efforts to improve the ease of doing business. It established the usage of an online registration portal for companies and created a foreign exchange window for investors and exporters to aid in liquidity. Changes in pension fund investing regulations allowed funds greater leeway in investing in PE and infrastructure (AVCA, 2018a). Because PE investors favour markets with growing populations to consume goods, Nigeria is an attractive investment destination given its status as the most populous country in Africa (Tyson, 2015).

South Africa

South Africa is the PE investment destination of choice in Southern Africa with 73% of investment deals by volume and 74% by value (AVCA, 2018a). In the past, South Africa was the most popular destination in the whole of Africa due to its economic stability and development.(Oxford Analytica, 2014; Tyson, 2015). However, due to persistently poor GDP growth rates, increasing unemployment levels and growing political uncertainty, by 2017, it only possessed a 31% share of deals in Africa, losing 19% of its investment shares to Nigeria and Kenya (RisCura, 2018). The Southern African Venture Capital Association reported that in 2017, South African PE attracted R31 billion in investments which is equivalent to around $2 billion (SAVCA, 2018). Despite the economic challenges that South Africa faced in 2017, it still remained a premier choice for PE investments because of its well advanced and integrated financial system (Deloitte, 2017).

Areas of PE investment focus in South Africa are the food and beverage industry, manufacturing and financial services industries. Investors are more focussed on later-stage investments due to lower risk in an uncertain environment (Deloitte, 2017).

Kenya

East Africa is now the most attractive PE investment destination in Africa according AVCA's 2017 annual LP survey. 85% of LPs surveyed expressed a desire to invest in the region (AVCA, 2017). The region also led fundraising within SSA in 2017 (Deloitte, 2017). Kenya held 49% of deals by value and 56% of deals by volume between 2012 and 2017 in the East African region (AVCA, 2018a).

Kenya has a sizeable economy that is not reliant on the extractive industry (RisCura, 2018). 'Silicon Savannah' is Kenya's technology sector which is growing rapidly and attracts a lot of investor interest. The country has substantial smart phone penetration, skilled IT developers and a good business environment thanks to government reforms (Business Daily Africa, 2018). It is anticipated that agriculture/agribusiness, financial services and health care and pharmaceutical ventures will take the lead in East Africa due to its economic growth, desire for investors to invest along the value chain and increasing middle class population. The region is also supported by an innovative financial services sector that is well managed and underpinned by a highly integrated region (Deloitte, 2017).

(e) Zambia

1964 - 1991[5]

In 1964, newly independent Zambia was one of the most industrialised and urbanised independent nations in Africa with a GNP twice the size of South Korea's standing at $2 billion ($16 billion in today's dollars). The country's wealth came primarily from copper mining (Rakner, 2003).

From 1968 to 1971, the then president of Zambia, Kenneth Kaunda oversaw the nationalisation of significant parts of the economy. The Zambia Industrial and Mining Corporation was created to manage the state's investments. Between 1964 and 1971, parastatals increased in number from 14 to 147 and by the mid-70s, 80% of the Zambian economy was controlled by the state. By 1972, Kaunda had

[5] This section is mainly adapted from Rakner (2003)

abolished the previous two-party political system and established a one-party state (Rakner, 2003).

Kenneth Kaunda's leadership principles were based on Humanism. He sought to hold on to African traditions in a non-capitalist manner whilst pursuing economic growth. Under the Kaunda era, the Mulungushi Reforms and the Humanism philosophy discouraged private sector lobbying and business ownership. Because 90% of the government's revenue came from mining, other industries within the public and private sector were neglected. The Kaunda era was also marked by trade restrictions, price restrictions and exchange rate controls. (Rakner, 2003).

By 1974, global copper prices experienced an extreme decline while oil prices began to increase. The Organisation of the Petroleum Exporting Countries oil crisis, global recession, global production cuts and global uncertainty negatively impacted Zambia. From the 1970s to the 1990s, Zambia's real per capita growth declined by 30%. International Monetary Fund structural adjustment programmes implemented to stabilise the economy proved to be very unpopular. Zambia embraced multi-party democracy and President Frederick Chiluba was ushered into power in 1991 (Rakner, 2003).

1991 - 2001

The new government embarked on a strategy of trade liberalisation and privatisation of state owned enterprises. Unfortunately, its economic policies were haphazard and created mistrust within the business community. Political uncertainty, public sector over spending and tight monetary policy did nothing to encourage the local business community. The privatisation exercise was also a contentious matter with allegations of corruption and critics pointing out that instead of creating more locally owned businesses and enterprises, the state had simply shifted ownership from itself to foreign interests (Rakner, 2003). The new government did manage to do away with price controls, liberalise interest rates, eliminate foreign exchange rate controls, promote free entry investment in most economic sectors, and abolish quantitative import restrictions (OECD, 2011).

While Zambia still relied on mining, its manufacturing sector waned and retail trade activities increased. A few family run medium-sized businesses emerged often run by indigenous Zambians. Driven by retrenchments and unemployment, the formal and informal SME sector began to grow in the areas of petty trade and business. It must be noted that often, those participating in informal trade, were doing so not by choice but due to unemployment. In 1996, the Small Enterprise Development Act was written into law. It provided incentives such as 3-year tax exemptions for businesses in urban areas of a certain size (NORAD, 2002).

In 1996, the Zambia Venture Capital Fund (ZVCF) was created. It was the first VC and PE fund to be set up in Zambia. It was created and funded by the then Commonwealth Development Corporation now known as CDC Group plc (CDC), the European Investment Bank, DEG of Germany, Swedfund of Sweden, Sanlam of South Africa and the First Merchant Bank of Zambia (Times of Zambia, 1999).

By 1999, the ZVCF had invested close to $13 million ($19 million in today's dollars) in 11 different ventures with significant growth potential across the tourism, agriculture and services industries. Half of its investments at the time were made in Zambian-owned businesses. ZVCF's investments included Manda Hill Mall, Zambia's first shopping mall (Times of Zambia, 1999). Amongst its accomplishments, ZVCF oversaw the very first private management buyout in Zambia of Hybrid Poultry Farm (Commonwealth Development Corporation, 1998).

2002 to present

As at 2002, economic reforms had managed to reverse the previous reliance of the economy on the state. The economy of Zambia was now 80% in the hands of the private sector. However, high interest rates, poor infrastructure and an unreliable judiciary undermined private sector development (NORAD, 2002).

At the time there were bilateral investment funds operational in Zambia through DFIs such as Investment Fund for Developing Nations (IFU) of Denmark,

Swedfund of Sweden, FMO (Dutch Development Bank) and CDC of the United Kingdom. CDC was the biggest DFI investor in Zambia, holding about $100 million ($140 million in today's dollars) in different sectors with a focus on the mining and agricultural sectors (NORAD, 2002).

By 2006, the ZVCF had wound down and until 2009, the country was without a local VC and PE firm. Kukula Capital, founded in 2009, was a joint venture between Zambian and Danish financiers and enjoyed moderate success as a pioneer PE and VC firm in Zambia. It is still in existence today and employs a debt-equity financing mix to invest in Zambian SMEs. It currently oversees 6 equity investments in the agri-products and consumer industries which have created about 170 jobs (Kukula Capital, 2017). The fund has also managed to make 1 successful exit (Kukula Capital, 2017).

Historically and presently, major international DFIs like CDC and the IFC continue to play a pivotal role in anchoring PE investments in Zambia. With their focus on making an impact, experience working in emerging markets and a large pool of funds to invest from, they are in a position to make riskier investments in developing countries like Zambia that other purely commercial firms are unwilling to make. This in effect de-risks the investment and encourages other firms to invest in local funds or ventures.

IFC invested $2 million in equity in Madison Financial Services Zambia to deepen the financial services sector in Zambia in 2007 (IFC, 2007). It successfully exited the business through an IPO on the LuSE in 2014 (Lusaka Times, 2014). CDC acquired a $65 million ($68 million in today's dollars) 17.5% stake in Zambeef Plc in 2016 (CDC Group, 2016). Zambeef is the largest food processing company in Zambia and is listed on the LuSE. Prior to the Zambeef investment, past CDC investments in Zambia included the investment in Chilanga Cement which was purchased by Lafarge Holcim in 2001 and IHS Towers of Strength (a multi-national company that constructs telecommunications towers). Emerging Capital Partners (ECP), has invested over $50m in Zambia. Past investments were in the mobile

telecommunications company Celtel which was sold off to Airtel and in Blue Financial Services. Currently ECP has one running investment in Zambia in IHS Towers of Strength (Emerging Capital Partners, 2017). Phatisa, a sector-specific PE firm with a Sub-Saharan outlook invested $24 million ($25 million in today's dollars) in Golden Lay Zambia, a chicken egg producer and distributor in 2012. In 2016, it invested an undisclosed amount in Camland Estates, a residential property development in Lusaka, the capital city of Zambia. (AAFTA, 2012).

Zambian pension fund regulations appear to restrict local investment in PE funds. Out of approximately $2 billion in assets under management as at June 2013, Zambian pension funds had invested $3 9million ($42 million in today's dollars) in PE funds. For a pension fund to invest in PE, it needs the approval of the registrar – discretionary conditions may then be set for the investment. No specific allocation class has been recognised for PE, so it may fall under unlisted securities or more likely under collective investment schemes. Investment guidelines prohibit funds from making speculative investments making PE financing quite difficult to undertake (Ashiagbor, Satyamurthy, Casey, & Asare, 2014).

The Securities and Exchange Commission only recently recognised PE funds under collective investment schemes in 2016 and there is still much room for regulatory improvements in this regard (The Securities and Exchange Commission, 2016).

As stated in Chapter 1, there are 7 PE firms operational in Zambia out of 214 firms across the SSA region. There is a push for more SMEs to participate in PE financing. Local Zambian PE investment professionals Bright Nundwe of Inside Capital Partners and Valentine Chitalu of CDC and Phatisa are encouraging SMEs to broaden their financing scope and strategy beyond debt financing in a bid to tap into the rapid growth and expansion that PE financing offers (Chitalu, 2014; Mulambia, 2015).

The long-term outlook for PE financing in Zambia is positive. Zambia ranks 78th in the world in the 2018 IESE Business School annual VC and PE global attractiveness

index. The index examines economic activity, depth of capital markets, taxation, investor protection and corporate governance, human and social environment, and entrepreneurial culture and deal opportunities in arriving at their scores. 125 countries around the world form the attractiveness index. In Africa, Zambia was the 7th most attractive country for PE and VC investments (Groh et al., 2018).

2.4 Conclusion

This chapter defined PE, described its structure and discussed the advantages and disadvantages of its usage. It explored the history of PE across the USA, Europe, Asia and Sub-Saharan Africa. The chapter ended with a review of Zambia's private sector development history and the introduction the PE industry in Zambia.

3.0 Literature review

3.1 Introduction

The first part of this chapter explores the theory behind domestic investment levels, foreign direct investment and firm-specific investments in order to set the theoretical framework for PE investment determinants. In the second part of the chapter, empirical studies that test the determinants of PE investment across the USA, Europe, Asia and Africa are explored. The objective of the empirical review is to outline past research results, to identify common trends in the results, to observe methodologies used and to identify any particular gaps in the literature. The literature examined covers both PE and VC, however, it is expected that the value of the conclusions drawn from these studies will not be altered by this duality.

3.2 Theory on determinants of investment

Generally, the factors that affect PE investment are split between macroeconomic factors and firm-specific factors.

(a) Determinants of domestic investment[6]

The neoclassical theory of investment indicates that there exists a positive relationship between the growth rate of real output and investment. As the aggregate demand changes for output, investors strive to meet that demand (Fielding, 1993, 1997; Wai & Wong, 1982). Oshikoya, (1994) observed a relationship between macroeconomic variables and private investment levels in middle and low income African countries in the 1970s and 1980s. Specifically, he observed that slower economic growth resulted in lower private investment levels.

Other literature suggest that government policies also impact domestic investment levels. Consumption spending may have the effect of raising interest rates, reducing market funds and increasing distortionary taxes which crowds out investment. Government borrowings, if not repaid timeously, may also strain the country's

[6] This section is primarily based on Ndikumana's (2000) paper.

financial system and lower investment. Inefficient government policies which result in higher inflation and instability have been visible in several African countries. Inflation is product of the quality of decision-making. High levels of inflation and instability create uncertainty and depress investments (Ndikumana, 2000). Investors are generally not incentivised to make any investments in countries where the government does not appear to be in control of the macro-economy (Fischer, 1993).

Domestic investment levels are also impacted by the country's openness, namely its import and export flows. Increasing levels of exports can contribute to increased levels of foreign exchange which can be used to pay for imported capital goods and enlarge the domestic product market. The enlargement of the domestic product market positively affects investment. Imports of mostly consumer goods have the reverse effect on investment levels and discourage domestic production (Ndikumana, 2000).

(b) Determinants of foreign direct investment[7]

As described in Chapter 2, there has been a significant increase in PE flows in emerging market regions like South East Asia and Sub-Saharan Africa from the 1990s to date. A significant portion of this capital is from Western nations. Agmon & Messica (2009) put forward the notion that PE in emerging markets is a form of foreign direct investment (FDI). FDI is defined as occurring when "firms from developed countries export specific factors of production (their ownership advantage) to small countries and emerging markets (new locations) as a way to generate value to all stakeholders." (p.12). In this case, foreign PE funds export risk capital to emerging market economies (Agmon & Messica, 2009).

With respect to the drivers of FDI specifically, Dunning's (1977, 1993) Ownership Location Internalisation framework is used to describe the principal determinants of FDI. Ownership advantages like property rights, expertise, and patents give the give foreign firms a fair chance to compete in foreign markets. The location

[7] This section is based primarily on Anyanwu's (2012) paper.

advantages are the unique factors that make the foreign country attractive. Location advantages include natural resources, skilled labour, culture, macroeconomic stability and government policies. Internalisation advantages arise as a result of taking advantage of external market imperfections like uncertainty and high transaction costs to create knowledge more efficiently. FDI is motivated by the opportunity to obtain resources, access a foreign market, exploit inefficiencies and obtain strategic assets (Dunning, 1993).

On modelling the policy and non-policy determinants of FDI, Mateev (2009) suggests that government policies in relation to taxation, openness, labour, and infrastructure drive FDI. The size of the foreign market, transportation costs, economic stability and political stability are some of the non-policy factors that FDI investors take into account too.

Sekkat and Veganzones-Varoudakis (2007) identify economic factors, trade and exchange market policies and the investment climate as broad FDI drivers. Economic factors include the rate of return on investments and the size of foreign market. Trade and foreign exchange factors consider the volatility of the exchange rates and liberalisation (Froot & Stein, 1991). General investment climate factors depend on cost of labour, education standards, access to skilled labour, political risk, GDP growth rate, urbanisation, political stability and the legal environment(Schneider & Frey, 1985).

Lall, et al. (2003); Ning and Reed (1995); and Tsai (1994) look at FDI from the supply and demand side. Focussing on the demand-side, they identify host country pull factors like, interest rates, taxes, size of market, trade policies, fiscal policies, exchange rates and human capital development. Institutional factors like bureaucracy, corruption, political risk, property rights and transaction costs are also identified as factors that impact FDI levels.

(c) Firm-specific determinants of investment

Tyebjee & Bruno (1984) suggest five broad investment criteria used by VCs to determine whether or not to make an investment. These factors are market attractiveness, product differentiation, managerial capabilities, environmental threat resistance and cash-out potential. Market attractiveness considers the size of the existing market of the target company as well as its growth prospects and ease of access. VCs also consider whether there is an existing market need. Product differentiation is dependent on the ability of the business owner to produce a unique and profitable product that adequately staves off competition. Managerial capabilities are a reflection of the business owners/managers; ability to successfully manage the enterprise. Environmental threat resistance examines how shielded the target company's products and services are against a broad range of environmental threats that they are unable to control. These threats are due to competition, macroeconomic conditions and technological advances. The final criterion is cash-out potential which is simply the ease of investment liquidation.

Macmillan, Siegel, & Narasimha (1985) identify five criteria: personality and experience, product and market characteristics, financial considerations. Personality and experience are in relation to the business owner/management. Fund managers consider this to be the most important criteria for investment. The factors considered in reviewing one's personality and experience are: being able to manage risk, being able to stay in a position, having a track record of experience in the relevant industry/with the business and being of good repute. In the product and market characteristics segment, the ability to generate high growth rates and being able to protect proprietary information are the most important factors. Financial considerations are synonymous with high potential returns. The study confirms long-held views in the VC community that the entrepreneur is whom the decision to invest rests on. 50% of the criteria identified are related to the entrepreneur's capabilities or skillsets. "There is no question that irrespective of the horse (product), horse race (market), or odds (the financial criteria), it is the jockey (entrepreneur) who fundamentally determines whether the venture capitalist will place a bet at all" (1985, p.119).

Fried & Hisrich (1994) split investment criteria into 3 categories; concept, management and returns. Concept refers to potential growth of earnings, a business idea that works or will work, products that offer significant competitive advantages and capital requirements that are within reason. Management is expected to be able to lead, especially under pressure. Returns mean that the investments should provide a viable exit, a high rate of return and a high absolute return.

(d) Summary of investment determinants from theoretical review

Having reviewed the theoretical literature, the determinants of investment are summarised in the table below:

Table 2: Investment determinants from theory

Investment Determinants based on Theory	
Macroeconomic Environment	**Firm-Specific**
Growth - overall economy - sectors of interest	**Market attractiveness** - high growth sector - ease of access
Trade - openness - barriers	**Product** - competitive - innovative
Legal system -property rights	**Returns** - high potential returns
Human capital - skills - affordability	**Management** - skills - track record/reputation
Monetary and fiscal policies - taxation - foreign exchange - inflation	**Exit** - ease of liquidation - available market

Source: Author's research

3.3 Empirical review of the determinants of investment

This this section of the chapter reviews the result of empirical studies that specifically test the determinants of PE financing in North America, Europe, Asia, Africa and Zambia.

(a) North America

Gompers and Lerner (1998) published their seminal piece on the drivers of supply and demand of VC in the USA. They used regression analyses across a 22-year period. They found that IPOs were the main factor driving VC in the USA confirming the generally accepted idea that IPOs and VC were linked. They also found that higher GDP growth and increased research and development expenditure increased levels of VC financing. Research and development expenditure was considered a proxy for innovation. They found that lower capital gains taxes increased the supply of VC, only because lower taxes motivated employees to become entrepreneurs which drove up the demand for VC. Later, Bruce's (2000) examination of the US tax system found that reducing an employee's average tax rate in self-employment increased their probability of transitioning into self-employment, thereby potentially increasing VC demand.

Kortum and Lerner (2000) examined the relationship between innovation and VC in the USA. They used reduced-form regressions to analyse twenty manufacturing sub-industries within the US manufacturing sector over a thirty year period and found a relationship between VC and patenting activity. This is in keeping with Gompers and Lerner's (1998) findings with respect to research and development expenditure as a proxy for innovation.

Hellmann and Puri (2000) surveyed 173 Silicon Valley start-ups and concluded that firms that follow an innovator strategy are more likely to contract VC than firms that follow an imitator strategy. Their findings are similar to Gompers and Lerner (1998) and Kortum and Lerner (2000).

(b) Europe

Muzyka, Birley, & Leleux (1996) identified different investment criteria and administered a trade-off questionnaire to 73 VCs. They concluded that European VCs were mostly attracted to solid management teams and sufficient financial and product market conditions. They also observed that European VCs collectively

would invest in a target with strong management and financial product market considerations even if it did not meet the fund and deal requirements.

La Porta et al. (1997) found that legal systems with regards to investor protection were important in determining the size of a country's capital market. In countries with robust legal and investor protection structures, suppliers were more likely to provide financing to businesses than in countries that lack these structures. They examined 49 countries and found that those with weaker legal systems had smaller capital markets and vice versa. The French legal system in particular was singled out as having a negative effect on the size of capital markets.

Jeng and Wells (2000) built on Gompers and Lerner's (1998) paper and performed an analysis of the determinants of VC funding across 21 countries including the USA. 17 of the countries were European, the rest were: USA, Canada, Israel, and New Zealand. They used panel data over an 11 year period and performed regression analyses to arrive at their results. They found that IPOs were the main driver of VC financing and that later stage investments in particular responded more strongly to IPOs than early stage investments. Unlike Gompers and Lerner (1998), they found GDP growth to be statistically insignificant in driving VC.

A comparison of the Polish and Czech legal systems showed that Poland adopted stricter securities regulations than the Czech Republic. Its laws protected investors, required significant information disclosures, and made use of a 'motivated' regulator to enforce them. The results were that the Polish capital market grew at a faster rate than the Czech market, external financing was easier to source and investor expropriation was kept at a minimum (Glaeser, Johnson, & Shleifer, 2001). These findings support the view that stronger legal systems increase the level of financing in the market according to La Porta et al. (1997).

Romain & van Pottelsberghe de la Potterie's (2003) used panel data regression analysis of 16 Organisation for Economic Co-operation and Development countries over an 8-year period to identify the determinants of VC activity. They found that

VC activity was strongly related to GDP growth. This mirrors Gompers and Lerner (1998) and Jeng and Wells's (2000) findings. They also found that increases in short-term interest rates increased the demand for VC. Technological opportunities identified by patenting, research and development also increased the supply of VC. These findings were similar to Kortum and Lerner (2000) and Hellmann and Puri's (2000) conclusions that innovation and VC activity are linked. Increases in corporate tax were found to reduce VC activity.

Félix, Pires, and Gulamhussenb (2007) analysed the determinants of VC activity in Europe. Their data covered 5 years and 23 European nations. Using panel data regression analysis, they found that increased mergers and acquisitions volumes lead to increases in VC activity while increases in unemployment lead to decreases in VC activity.

Engel and Keilbach (2007) investigated the relationship between innovation and VC activity amongst young German start-ups. Using patenting activity they analysed German start-ups and found that more innovative firms were more likely to engage with VCs and attract VC. Romain & van Pottelsberghe de la Potterie (2003), Kortum and Lerner (2000) and Hellmann and Puri (2000) all found a link between innovation and VC activity.

Bernoth and Colavecchio (2014) used an extreme bound analysis and fixed effects panel estimation to determine the macro-economic investment determinants of PE in Central and Eastern Europe (CEE) and Western Europe. They focussed on testing the extent to which the economic environment, financial market, labour market and the political, legal and social environment affected a country's PE investment attractiveness. Using data over a 10-year period and reviewing 16 countries, they found different results for each region. For CEE countries, they found that GDP per capita, GDP growth and private sector bank claims as a proportion of GDP were robust and significant determinants of PE investment activity. For Western European nations, they observed that inflation levels, unemployment rates, GDP per capita and GDP growth all displayed a significant and robust relationship with PE

activity. The pro-cyclicality in their results is consistent with Gompers and Lerner (1998) and Romain & van Pottelsberghe de la Potterie's (2003).

(c) Global

Djankov, Ganser, McLiesh, Ramalho, and Shleifer (2008) analysed the effect of corporate income tax rates on FDI, aggregate investment and entrepreneurial activity across 85 countries. They found that increases in higher corporate income tax rates negatively impacted aggregative investment, FDI and entrepreneurial activity. They found a positive relationship between corporate income tax rates and the size of the informal economy.

Groh & Wallmeroth (2016) expanded on the Jeng and Wells's (2000) research on the determinants of VC investing by focussing on emerging market economies. Their data set was composed of 118 countries, 78 of which were considered emerging market economies. By analysing panel data over a 13 year period they found that the drivers of VC investing were different for emerging economies and developed economies. They found that the investment volumes of mergers and acquisitions and legal rights all have a positive effect on VC but are reduced in emerging markets. They also found that bribery, corruption and innovation played a particular role in affecting VC activity in emerging markets.

(d) Asia

D. Cumming, Fleming, Johan, and Takeuchi (2012) examined the relationship between legal protection, corruption and PE returns in Asia using univariate and multivariate statistical analysis. They focussed on reviewing the LBO sector in 20 countries over a 21-year period. They found that legal protection is a determinant of PE returns in Asia. They found that weak legal protections have a negative effect on transaction structures and create uncertainty during exits which depresses returns. However, when controlling for legal systems, they found that PE returns were higher in countries with corruption. They found that even in environments characterised by weak legal protection, PE fund managers are able to change organisations and counter the costs of corruption, which increased returns.

(e) Africa

Using semi-structured interviews of 12 PE firms and 8 DFIs that invest in Sub-Saharan Africa, Loos (2010) identified four broad categories of Sub-Saharan African investment determinants. These were resources, returns, risk, and business climate. Resources were constituted of: availability of skilled entrepreneurs, availability of skilled management, availability of investments between $15 million and $50 million, and natural resources. In looking at returns, returns on investment, GDP growth rates and business scalability were the main factors identified. Risk covered political and economic risk. Finally the business climate was representative of the legal framework and corruption. The factors generally identified in relation to skilled management and business scalability generally mirror the findings of (Fried and Hisrich, (1994); Macmillan et al. (1985) and Tyebjee & Bruno (1984).

Adongo (2011) observed 36 different African countries to identify the determinants of VC activity on the continent. Using OLS regression analyses, he found that the rule of law, disclosure index, and research and development expenditure were all positively related to VC activity on the continent. This would suggest that the general legal framework and innovation are the biggest drivers of VC activity in Africa. Capital gains taxes were found to reduce the demand for VC from the entrepreneur. Like Jeng and Wells (2000), GDP growth rate was not identified as determinant of investment.

Babarinde (2012) carried out a non-statistical analysis of the PE environment on the African continent. He suggested that a rising middle class, comparatively higher return on investment offerings and the participation of large international development finance institutions (DFIs) in PE financing all catalysed PE investment in Africa.

Mlambo & Jover (2014) administered a survey to 18 PE funds and conducted 10 expert interviews to determine the factors affecting the attractiveness of Angola to PE. They concluded that the factors were country growth, access to viable

investments, the target company's competitive advantage and the availability of natural resources. Their findings are similar to Loos (2010).

IESE Business School developed a PE and VC attractiveness index of 125 countries across the world. According to their latest ratings, Zambia is ranked 78th and the most important determinants of PE investment in Zambia are taxation, economic activity and investor protection and corporate governance. The constraints are human capital, depth of capital market and entrepreneurial opportunities (Groh et al., 2018). The IESE index is the only observable empirical data on the factors that influence PE in Zambia. It is limited, however, in that it did not take the actual views of PE investors that invest in Zambia into account. The index is a calculation of fixed factors applied across the world.

3.4 Conclusion

This chapter established the theory behind PE investment levels and identified broad macroeconomic and firm-specific determinants of investments. The macroeconomic determinants are growth, trade, legal system, human capital and monetary and fiscal policies while the firm-specific factors are market attractiveness, product, returns, management and exit. In exploring the empirical results there is an identifiable gap in Zambia-specific research which this research seeks to bridge.

4.0 Methodology

4.1 Introduction

This chapter describes the methodology that guides the research process and answers the two research questions identified in Chapter 1. The chapter describes the overall research strategy, the research design and the method of data collection and analysis while providing justifications for the strategies selected in executing the research. The limitations of the methods used are also described and discussed.

4.2 Research approach

There are two distinct styles of research, the quantitative or deductive type of research and the qualitative or inductive type of research (Xavier University Library, 2012). Quantitative research makes use of quantitative measurement and statistical analysis tools to investigate a research problem while qualitative research uses non-quantitative data collection and analysis tools to describe "reality as experienced by the respondents" (Adams, Khan, & Raeside, 2014, p.6). Jonker & Pennink (2010) describe the aim of quantitative research as being "to identify the characteristics and structure of phenomena and events examined in their natural context" (p.91). The two styles can either be used separately or mixed optimally.

The qualitative method of research is necessary when knowledge of the topic being explored is limited, hence its exploratory nature. As such, qualitative analysis has often preceded quantitative analysis in social science research (Ghauri & Grønhaug, 2005). Given the identified gap in qualitative and quantitative data on this research topic as well as the inherent restrictions on access to private financing information, a qualitative approach to the research was identified as the best approach to answering the research questions.

In drawing up the research strategy, reference is made to Loos (2010) who conducted a similar research on PE financing in SSA. Similar methods in structuring the research methodology are used in this research.

4.3 Research design

(a) Data collection

In order to conduct a qualitative research, Jonker & Pennink (2010) advise on an open-minded approach to the research. This approach is supported by the findings of the literature review which highlighted various different approaches to obtaining data on the factors that affect PE investment levels. Working with an open-ended question makes the research more flexible.

To answer the research questions about the determinants and constraints to PE financing in Zambia, the researcher had to obtain the information directly from the Fund Managers and Investment Professionals who undertake these investments. As noted by Eriksson and Kovalainen (2008), companies and corporations are the sources for research questions and empirical data in studies business phenomena like this research. As such, interviews were the preferred method of data collection.

The research was predicated on exploration, the researcher was not an expert and was hoping to find information on the topic. The researcher was conducting the research in the context of a specific topic, the main source of the specific topic was primary data, and the researcher was attempting to see things from the interviewee's perspective (Jonker & Pennink, 2010).

According to Adams, Khan, & Raeside (2014) there are different interview styles, namely, exploratory, design, in-depth, and longitudinal interviews. Exploratory and design interviews were considered inappropriate for the kind of data being sought because their results lacked the depth required. Longitudinal interviews are concerned with interviewing and re-interviewing the research participants over a long period of time. Given the time frame and availability of the interviewees, this too was considered an inappropriate interview style. In-depth interviews are more appropriate for qualitative research as they tend to yield valuable information. In-depth interviews are normally unstructured and tend to last for about an hour. The researcher prepares an interview road map and asks questions as the interview develops based on the responses of the participant.

Because data is being compared against different respondents, an in-depth semi-structured interview approach is best as it allows for flexibility and general comparability (Guthrie, 2010). Semi-structured interviews were selected as the method of obtaining the information required from the Fund Managers. According to Bradford and Cullen, (2012), semi-structured interviews are one of the most popular qualitative data collection techniques because they allow the researcher to explore the interviewee's view points and obtain first-hand, detailed accounts from their experiences. Given the exploratory nature of the research, it was important for the researcher to obtain first-hand information from the interviewees.

The researcher used a combination of face to face and telephonic interviews to obtain the data. All interviewees present in Zambia were interviewed in person and all interviewees based outside Zambia were interviewed telephonically. In person interviews were all conducted at the interviewees' offices. The interviews lasted anywhere between 29 minutes and 1 hour, with the majority of the interviews lasting one hour.

After conducting the first two interviews, the researcher adapted their interview questions and added more structure to the interviews to ensure that the research questions were being addressed by the interviewees. The researcher then applied a standard set of 10 questions to the remaining population based on their experience with the first two interviewees.

All interviews were recorded with the interviewee's permission and later transcribed using transcribing software to prepare the data for further analysis.

(b) Population and sampling

According to Asoko Insight (2018) there were 7 VC and PE firms with offices in Zambia. Due to the lack of availability of a centralised database of VC and PE firms in Zambia, it was difficult to use any sort of secondary database as a basis of firm selection. As such, the sample was drawn up using industry knowledge from

interactions with local fund managers and investment advisors familiar with the Zambian industry.

From the above interactions and an exploration of the internet, the researcher drew a sample of 16 firms with experience investing in Zambia to approach with preliminary interview requests. The firms were domiciled both locally and internationally. In selecting the sample, the researcher sought to obtain a variety of opinions from early stage investors (VC), late stage investors (PE) and development finance institutions (FoF and/or PE). The researcher also sought to obtain information from individuals that were experienced with making PE investments in Zambia and Africa. In drawing this sample, the researcher noted that Loos (2010) was able to identify determinants of PE financing in SSA with a sample of 12 PE firms. The researcher was assured then that a sample of 16 firms was more than sufficient for a single country, especially one with a nascent PE industry.

Of the 16 firms, 12 individuals representing 11 local and international firms and institutions agreed to participate in the research. Noting that the researcher did not use a verifiable secondary database to obtain the sample, the two tables on the pages that follow provide an insight into the composition of the final sample to enhance the credibility of the research and the sampling technique. To protect the interviewees' confidentiality, the fund sizes and average ticket sizes represented in Table 4 cannot be directly correlated with the numerical arrangement of the persons interviewed in Table 3.

Table 3: Sample selection - position and firm-specialism

No.	Position	VC/PE/FoF
1	Associate	VC
2	Associate	VC
3	Manager	FoF and PE
4	Manager	VC
5	Director	FoF and PE
6	Director	FoF and PE
7	Partner	PE
8	Partner	PE
9	Partner	VC and PE
10	Partner	VC
11	Partner	VC
12	Partner	PE

Source: Author's research

Table 4: Sample selection – average ticket size and fund size

No.	Average Ticket	Fund Size
1	$1.5m	$113m
2	$4m	$150m
3	$6m	$181m
4	$7m	$34m
5	$2.5m	$50m
6	$3m	$50m
7	$30m	$5bn
8	$30m	$5bn
9	$7m	$63m
10	$25m	$8bn
11	$1m	Not disclosed
12	$1m	Not disclosed

Source: Author's research

(c) Data analysis

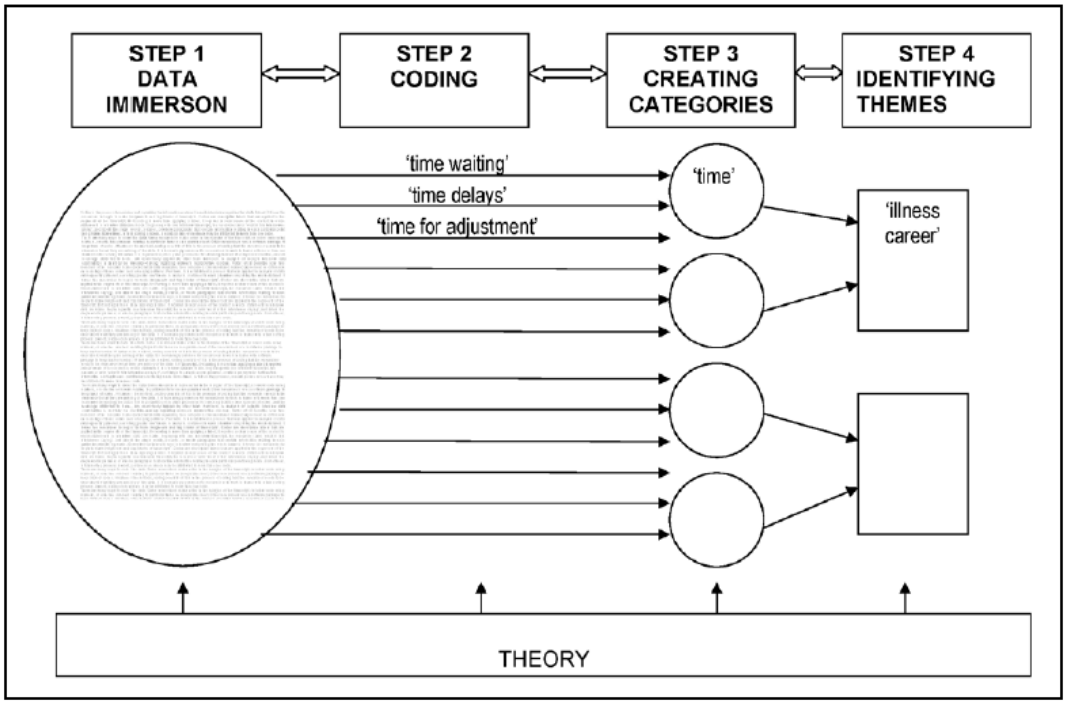
It is important to establish the common links between the different interview responses to appropriately synthesise and make inferences from the data. Adams et al. (2014) present four methods for analysing qualitative data: content analysis, summarising, the "Framework Approach" and the grounded theory approach. The semi-structured interview style approach selected results in information which may

be difficult to standardise. For this type of data, a grounded theory approach is often recommended.

According to Jonker & Pennink (2010) the grounded theory methodology's core aim is defined as "the development of a theory that is 'grounded' in practice" (p.84). The essence of this approach is to develop theories from the data during collection. The data is reviewed to identify different categories and characteristics relevant to the identified categories. The different categories are then continually compared against the other to identify any relationships that exist. Critics of grounded theory argue that it requires great research skills (Allan, 2013) and that novice researchers are highly prone to making methodological errors (El Hussein, Hirst, Salyers, & Osuji, 2014). As was concluded by Loos (2010), using this method strictly to analyse data was not suitable for the researcher considering their novel research skills.

In keeping with Loos's (2010) approach to identifying the determinants of PE financing in SSA, analysis of the interview data was modelled on the works of Green et al.'s (2007) refined approach to the grounded theory below:

Figure 15: Data analysis



Source: Green et al. (2007, p.547)

Immersion

In this first step, the researcher made notes and transcribed the recorded interview data into text using software to familiarise themselves with the interviewees responses.

Coding

Coding is defined as "the process of examining and organising the information contained in each interview and the whole dataset. It forces the researcher to begin to make judgements and tag blocks of transcripts" (Green et al., 2007, p.548). In this step the researcher reviewed the interview transcripts and highlighted responses in two different colours. One colour was for answers to the determinants of investment and the second colour was used to highlight answers to the constraints to investment. The researcher then attached one to three-word codes to these responses.

Categorisation

The researcher then analysed the codes using a spreadsheet and highlights for similar codes, highlighting them according to their relationship with one another to make more sense out of the data. The researcher noted the codes that appeared frequently on the transcripts as those pointed strongly towards central ideas.

Themes

Finally, the researcher attached identified themes in the data in relation to the research questions. This process involved "interpreting the categories based on theoretical concepts to arrive at generalisable conclusions from the results obtained" (Loos, 2010, p.47).

The coding process appears in the appendix.

4.4 Research limitations

Quantitative PE data in Zambia was difficult to source. This limited the study from using a mix of both qualitative and quantitative data to answer the research questions. A quantitative analysis would have strengthened the results of the qualitative data analysis.

Data about PE in general in Zambia was also limited. In selecting the samples, PE firms that have invested in Zambian ventures may have been erroneously excluded due to lack of data. Data about other players in the SSA market, especially, the global funds was difficult to source from PE and VC associations because they keep that information for paying members.

The sampling method was largely based on the researcher familiarising themselves with the industry and conducting online research to determine which firms fell within the subject-matter. Sampling from a single observable database would have eliminated any bias in the research.

Finally, information about PE financing in Zambia is non-existent. Researchers would have to rely on the PE industry to disseminate information about it. Because this information is not independently verifiable, it may be unreliable.

4.5 Conclusion

The chapter has provided an overview of the research methodology selected. A qualitative approach using semi-structured interviews of a sample of local and international Fund Managers is the chosen data collection technique. A four-step data analysis approach is the tool used to disseminate the interview responses. The chapter ends by identifying research limitations associated with the methodology selected.

5.0 Research findings, analysis and discussion

5.1 Introduction

This Chapter provides the findings to research questions first posed in Chapter 1:

Research Question1 (RQ1): What drives private equity financing in Zambia?

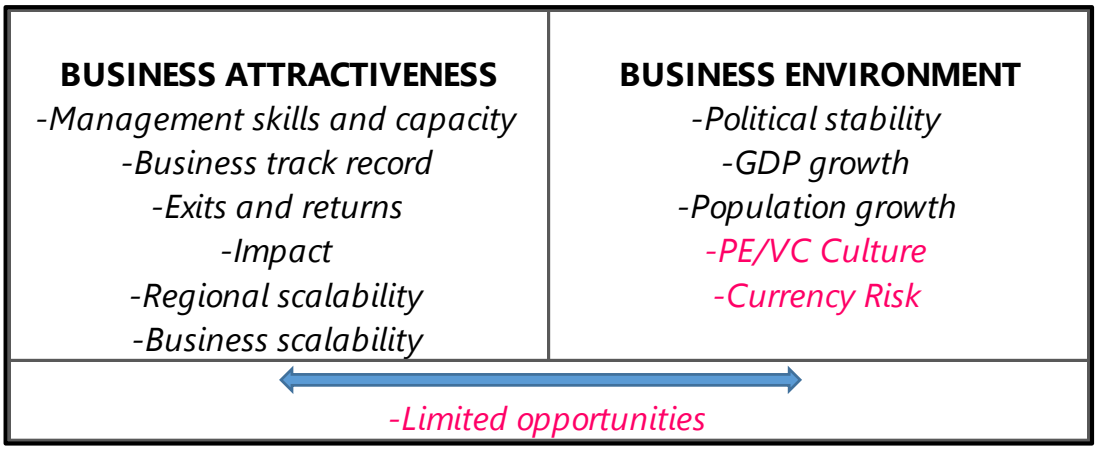
Research Question 2 (RQ1): What prevents private equity investments in Zambia?

The Chapter discusses the results of the findings, referencing back to literature where necessary.

5.2 Research findings

Based on the methodology employed in Chapter 4 and the results of the data analysis which have been filed in the Appendix, the two broad drivers of PE financing in Zambia are the attractiveness of the business and the business environment. Underpinning each of these broad drivers are sub-drivers or constraints to investment. This is represented in Figure 16 below:

Figure 16: Determinants of venture capital and private equity financing



Text in pink represents constraints.

Source: Author's research

5.3 Research analysis and discussion- Business attractiveness

In keeping with the literature, the overall attractiveness of the business is a consideration that fund managers take into account when making their investment decisions. The major drivers of investment identified in assessing a business were; the management team, the scalability (growth) of the business, the opportunities for regional trade, the track record of the business, the opportunity to make an impact and the visibility of an exit. The interviewees identified insufficient business opportunities as an investment constraint.

(a) Management skills and capacity

92% of the interviewees identified the management team as key factor that they took into account in making their investments. There was an underlying theme that the potential investee company was only as good as its management team and their related skills and experience. One interviewee remarked “100% of the investment is in the team”. This finding is in keeping with the theory in the literature review that identified the management team as the most important factor to investors (Macmillan et al., 1985).

In evaluating the management team, the respondents were looking for skilled middle managers with strong management capabilities and a track record of being able to perform in their roles. The Fund Managers saw themselves as partners with the team in delivering results. References to “partnership” came out a number of times in the responses from the interviewees indicating that it was important for the Fund Managers and the management team to work together towards a common goal for the organisation. Further, for the Fund Managers, whose objective it is to maximise returns, having a competent team in place contributes to the company’s performance and future financial returns.

For the early stage investors, there was the added layer of the integrity of the business owner. Because PE is not publicly traded or highly regulated, PE firms take a significant risk when they choose to make a private investment in a firm,

especially in Zambia where one could argue that information asymmetry is prevalent in smaller firms and even medium-sized firms. Added to this, the Zambian PE sector has already been described as small so even information within the sector may be limited to some degree.

For some of the interviewees, character and integrity becomes even more important when they cannot place sufficient reliance on the country's legal system. While opinions on Zambia's legal system were generally positive, there were a few interviewees that considered the system ineffective and so to effectively hedge themselves against losses due to legal system failures, they chose to pay more attention to the business owner as part of their due diligence procedures. Fafchamps, Pender, & Robinson (1995) and Bottazzi, Rin, & Hellmann (2009) found that weaker legal environments that failed to adequately address contract breaches gave entrepreneurs a moral hazard and a reduced need to actively commit themselves to the investment.

For smaller firms and even medium-sized firms that are owner-managed, a lot of the firms' success and potential is predicated on the owner. As much as PE firms may consider the robustness of the company's financial statements, the proof of concept and the long-term prospects for the product/service, all these factors are only as good as the character of the person who is actually behind the business. In changing, dynamic environments, in particular, investors want to be assured that they are in partnership with an honest and dependable individual who is committed to the long-term objectives of the company. To this, some GPs also added that they considered how much of a stake that the owner had contributed to the company in assessing their commitment and their character.

(b) Domestic and regional scalability

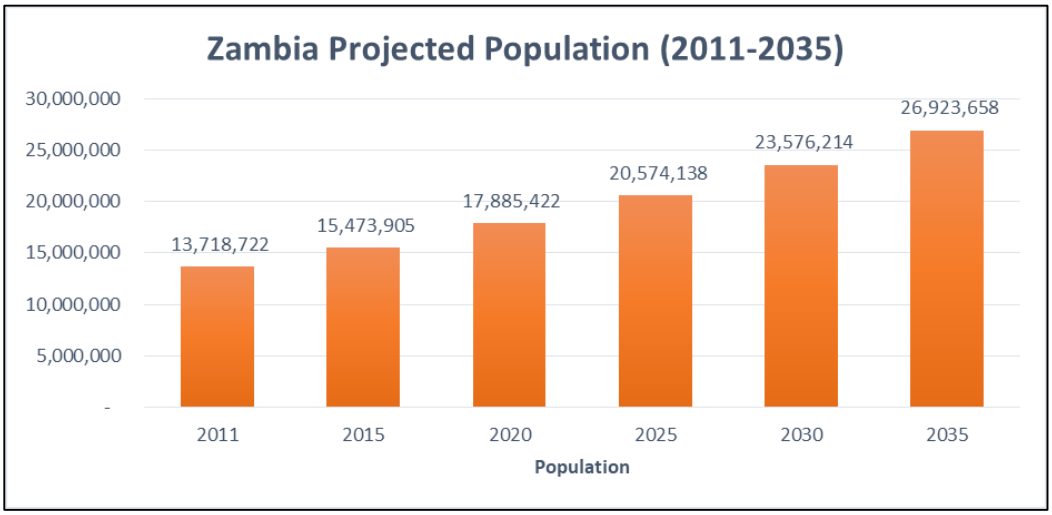
Scalability was a concept that was brought out by all the respondents. All the respondents were looking to grow the business in some way or form with 75% of the respondents indicating that they specifically took cross border trading potential into account in evaluating the future growth prospects of the target investee's business.

It is only natural for PE investors to be attracted to markets and sectors that are growing. Part of the premise of PE and VC investing described earlier in this study, is that it is focussed on companies that have high growth potential. These companies should have the ability to scale their operations to deliver on the growth targets of the investors in order to enable a successful exit.

Scalability and the size of the population were linked. Most of the interviewees alluded to additional growth factors including population growth, increases in disposable income, rising middle class levels and urbanisation as considerations that they made in determining the scalability of a business. A growing population coupled with an increasing middle class represents a future market that is able to consume the products and services on offer from target companies. It was observed that interviewees leaned towards food, agriculture and agro processing as their preferred sectors of investment. All these sectors share a common thread of being dependant on a sufficient level of consumer demand which makes population growth an important contributor towards their long-term success.

As shown by Figure 17 on the next page, Zambia's population is expected to double over a 25 year period between 2011 and 2035 at an annual rate of around 2.8% growing to around 26 million people of whom young people from the ages of 0 to 35 represent more than 51% of the population (Central Statistical Office, 2017). This is a positive signal for PE investors interested in companies that produce goods and/or services that there is likely to be a growing market for their consumption over time.

Figure 17: Zambia projected population (2011–2035)



Adapted from Central Statistical Office (2013, p.10)

75% of the Fund Managers were interested in regional consumption of Zambian-produced goods. Most of interviewees did remark that although Zambia's population growth forecasts are impressive, the country's population is comparably smaller than other countries which sometimes cast a shadow on the scalability of a project. They therefore considered the export potential of the products on offer in a target company in making their investment decisions.

Zambia's central location within the Southern African region with 8 bordering countries, gives it an attractive export market advantage. Countries like the Democratic Republic of Congo (DRC), for example, rely heavily on imports to supplement low domestic production levels, presenting Zambian goods with a readily available market for consumption. DRC's population of over 81 million people provides Zambia with a significantly larger market for export exploration (World Bank Group, 2017).

According to Zambia's Central Bank's Direction of Trade Reports, 6.0% of Zambia's exports equivalent to around $488 million ($500 million in today's dollars) in 2017, were to the DRC. In the African region, the DRC was Zambia's biggest export destination followed by South Africa which took up 5.6% of exports equivalent to $453 million ($464 million in today's dollars) (Bank of Zambia, 2017a, 2017b, 2017c, 2017d).

(c) Impact potential

Half of the Fund Managers were looking for opportunities to make an impact through their investments. All the Fund Managers seeking a development impact were clear that the desire to make an impact and earn a return for their funds were of equal importance and they could not have one without the other. This was clarified to dispel the notion that impact-seeking investors were perhaps not as concerned about returns as generalist investors.

The Fund Managers were commonly led by environmental, social and governance guidelines that their firms adhered to. This was common amongst the DFIs and the Fund Managers that were recipients of DFI funds. Most of the impact-seeking Fund Managers were particularly drawn to businesses with the potential to employ large numbers of people and in doing so, transform the social and economic trajectories of workers. This partly explained why agriculture, food and agri-business were identified by 75% of the Fund Managers as one of the most attractive investment sectors in Zambia. Apart from the natural resources and skills that Zambia has in this sector, it is also a large scale employer in the rural areas where farms are located.

These findings marry those of the Global Impact Investing Network who note that opportunities continue to exist for DFIs and PE firms to make their mark in Zambia through impact investments. Investors with a long-term horizon that are able to fund several capital rounds of increasing amounts have an opportunity to capture long-term growth in the Zambian market. The bulk of Zambia's impact investments come from DFIs and Zambia is the second largest DFI impact investment destination in Southern Africa based on the most current available data as at 2015, having received close to $2 billion in investments across 105 deals. Behind, South Africa and Angola, Zambia is the third largest recipient of non-DFI impact investments in the Southern African region, estimated at $157 million ($166 million in today's dollars) across 58 deals as at 2015 (Global Impact Investing Network, 2016)

(d) Exit and returns

Exit opportunities are closely linked with growth prospects. It follows that a growing sector/company with long-term future potential will attract suitable buyers

when the time of exit arises. Almost all the interviewees preferred method of exiting a business in Zambia is through trade sales and secondary sales to other financial investors or in some cases buyouts to the management team. Because the stock market is viewed as illiquid it did not come across as an attractive exit option.

Either directly or indirectly, the interviewees identified returns as a driver of investment. Desired returns varied between US Dollar internal rates of return of 10% to 25% with some investors pointing out that Zambia was very attractive because it offered comparatively higher returns that similar countries.

The essence of PE financing is not to hold on to an investment but to grow and sell the investee company so as to earn a return on investment. As such, exit visibility was a theme that came out of the interviews. It is tied in with market growth in that PE financiers believe that a growing sector will also be attractive to potential buyers in the long-term. Growing investor interest and increases in activity in a particular sector are often a signal to PE financiers of a potentially viable investment sector. Due to the illiquid nature of the LuSE, most of the interviewers prefer to exit through trade sales.

In some way or the other, 58% of the interviewees pointed to attractiveness of returns as a driver of investments. Ultimately, this is the goal of investing. It was observed that impact investors placed impact at par with returns while generalist investors pointed out that the potential to make good returns in Zambia was quite high based on their experience.

(e) Business track record

50% of the respondents identified the track record of the business as being a determinant of investment. In reviewing this, the Fund Managers were looking for enterprises with a history of doing business even if the businesses were young or unprofitable. They wanted to observe the proof of concept actualised, to confirm that the business actually does work. Even if a business was unprofitable, the Fund Managers wanted to observe that the business had a growing revenue figure and

customers and suppliers that they could point to. Financial statements and record-keeping become important here, as it's the only way of quantifying the businesses' performance.

(f) Limited opportunities

50% of the Fund Managers identified limited opportunities for investment a constraint to making investments in Zambia. At least 25% mentioned that they were actively looking for opportunities to make investments but were failing to find the right kind of business to invest in.

This could be because Zambia is a young nation from an entrepreneurial perspective. Due to the country's socialist economic history highlighted in Chapter 2, up until the mid-1990s Zambians were not conditioned to be entrepreneurs. In a capitalistic society, plant and equipment which are considered to be the elements of production are owned and operated privately (Baumol, Litan, & Schramm, 2009). The opposite is largely the case in a socialist society. So essentially, with the liberalisation of the economy in the early 1990s, Zambians have had to familiarise themselves with the workings of capitalism. This understandably affects the quality of business ventures and of entrepreneurs especially given all the economic challenges faced by the country when it began to liberalise.

"Entrepreneurial capitalism" refers to economies where the market is ruled by competitive forces, new companies are created often and small businesses make large contributions towards production. A hallmark of this form of capitalism is innovation and the USA is a prime example of such an economy. Entrepreneurs are incentivised and relentlessly driven to innovate. These innovations tend to change history, create entirely new industries and offshoots and ultimately drive economic growth. Innovation may thrive in free markets where risk takers are well rewarded and experimentation and knowledge sharing is common (Baumol et al., 2009).

Innovation drives VC financing. Gompers & Lerner (1998), Kortum & Lerner (2000), Hellmann & Puri (2000), Engel & Keilbach (2007) and Groh & Wallmeroth (2016) all find that innovation increases VC activity. Innovation and

Zambia's score on the 2018 Global Innovation Index (GII) is a source of concern. Out of 126 countries, Zambia ranked 120th and out of 23 countries within the SSA region it placed 18th. The 2018 GII report noted that countries with rich, diverse economies and export portfolios were likely so score higher on the index (Cornell University, INSEAD, & WIPO, 2018).

5.4 Research analysis and discussion- Business environment

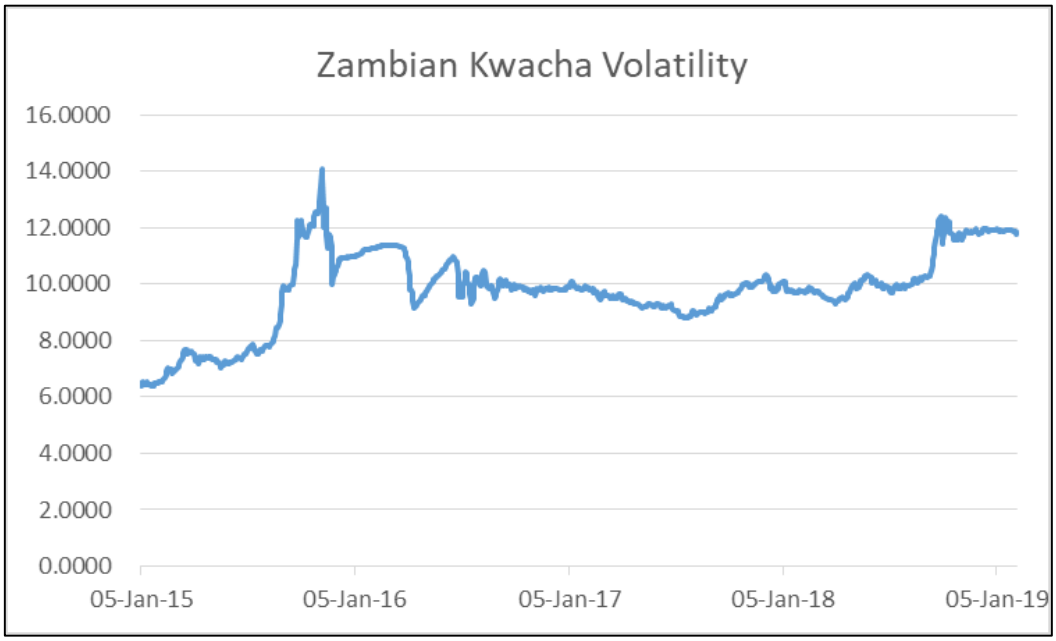
The drivers of PE and VC investment in Zambia under the business environment were GDP growth rates, population growth and political stability. The constraints identified were PE and VC culture and currency risk. Population growth was explored when analysing the business scalability under section 5.3(b) of this Chapter so it will not be covered further here.

(a) Currency risk

50% of the fund managers identified currency risk as a part of the business environment that posed a risk to their investing activity. This is because the Fund Managers invest US dollars into Zambian entities that operate using Zambian kwacha. When the local currency depreciates against the US dollar, the investment is eroded and may potentially reduce the PE firm's return on investment at exit.

Zambia has experienced exchange rate volatility since 2015 as show by Figure 18, which justifies the concerns of Fund Managers. Loos's (2010) findings were also that Fund Managers investing in SSA were concerned about the erosion of their investments due to currency volatility on the continent.

Figure 18: Zambian kwacha volatility (2015–2019)



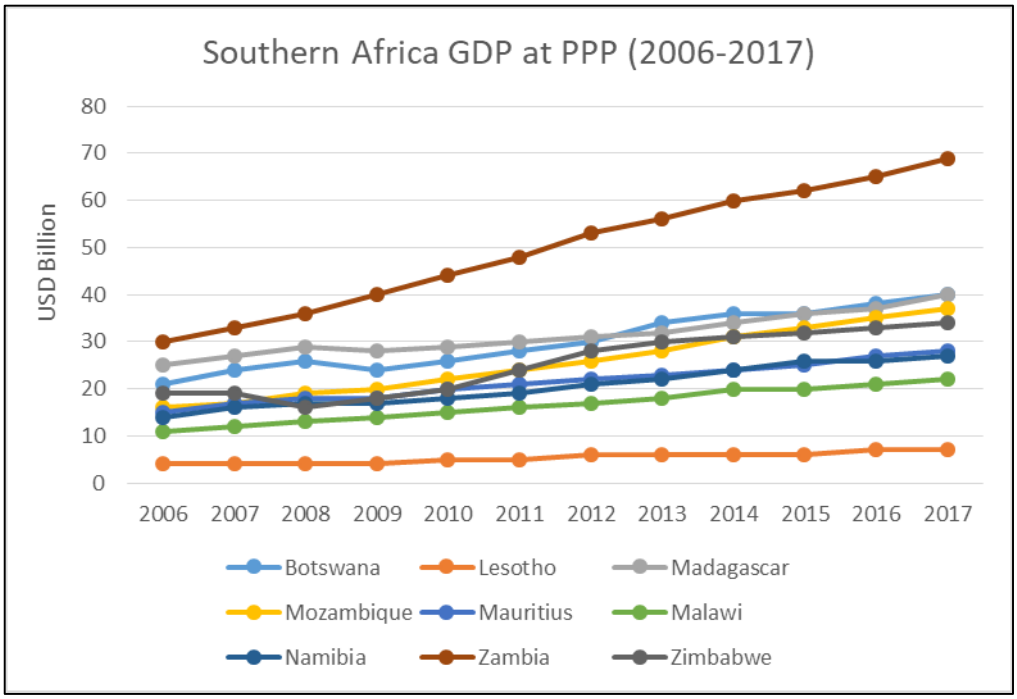
Source: Bank of Zambia (2019a)

(b) GDP growth rate

GDP growth was mentioned by at least 50% of the Fund Managers as a positive determinant of investment when assessing the business environment of the country. The Fund Managers were interested in the long-term macroeconomic fundamentals of the country in making their investment decisions and took GDP growth as an indicator of better opportunities for investment.

Figure 19 shows that Zambia's compounded annual growth rate of GDP at PPP between 2006 and 2017 has averaged around 7%. The graph excludes South Africa and Angola because the large size of their economies distorts the graph.

Figure 19: Southern Africa GDP at PPP (2006-2017)



Source: World Bank Group (2017)

Groh et al. (2018) observe that GDP growth rates are commonly associated with having a more prosperous society in which entrepreneurship is likely to increase. This is because the capital accumulation associated with higher GDP growth rates and development is able to finance the entrepreneur's risky investments.

This echoes the findings of Gompers & Lerner (1998) who found that economies that grew quickly were likely to increase the number of firms and therefore increase the number of firms that required access to PE financing. Van Pottelsberghe de la Potterie & Romain (2004) also linked VC activity to GDP growth, showing that the activity was closely linked with the pattern of GDP growth.

(c) The culture of PE and VC in Zambia

As has been brought out at various points in this research, the Zambian PE sector is still very small. 50% of the Fund Managers identified this as a constraint for three reasons. Firstly, because PE is still relatively novel, there is a general lack of understanding and appreciation of its workings amongst SMEs. Secondly, as a result of this lack of understanding, most family-run businesses are less likely to be

willing to have an equity investor partner with them. Thirdly, because of the small size of the sector, it's difficult for PE investors who are looking for co-investors to partner with to make deals where they can share risk. The Fund Managers did note that the culture slowly was changing but the sector was still small.

(d) Political stability

Half the fund managers mentioned Zambia's long standing reputation for peace and stability within the region as a positive determinant of investment. Instability breeds uncertainty and most of the fund managers indicated that businesses do not like uncertainty. These findings are similar to Le's (2004) findings on the effects of political instability on private investment.

5.5 Research recommendations

One of the underlying objectives of this research was to create awareness amongst SMEs in particular about the opportunities that exist for business financing outside of bank lending. The research also sought to make recommendations on policy changes that could influence the growth of the usage of PE financing in Zambia.

(a) Recommendations for SMEs

The feedback from the Fund Managers on their outlook on Zambia was very positive. All but one were very optimistic about the country's long-term prospects and were keen to make an impact on Zambia, several were actively looking for investment opportunities and saw the SME sector as one ripe with potential.

For SMEs it is important to realise that VC can scale their businesses and take them beyond their current limits. Microsoft, Facebook and Alibaba are just a few of the companies that have used VC in the past to accelerate growth. VCs seek to work in partnership with entrepreneurs to grow their businesses. It is a team effort and they care about partnership. In order to build the business, the VC is likely to invest in training and transferring skills to the SME business owner and their team. VCs are highly skilled business managers and strategists, this exposure is invaluable to an SME.

To make an SME attractive for investment, it is essential for the owner and management team to present themselves as being worthy investment partners. Despite the great interest that the Fund Managers have shown in Zambia, they have mentioned that limited opportunities constrain them. Noting that they place great emphasis on management teams and business owners, it is recommended that SMEs take proactively seek opportunities to upskill themselves through SME accelerator programmes and business mentorship.

A testament to the growing demand for impact investments in Zambia is the creation of Impact Capital Africa in 2018. This is a platform that seeks to bridge the demand

and supply gap between impact investors and Zambian companies. Most of the companies that make up this forum are successful ventures seeking to raise between $250 thousand and $5 million in equity, debt or blended finance (PEP Zambia, 2018). SMEs are urged to take advantage of such platforms.

Development Finance Institutions (DFIs) are instrumental in funding some of the PE regional funds that invest in Zambia. DFIs care about making an impact while making a profit. It was very encouraging to note that half of the Fund Managers surveyed in this study considered making an impact an important part of their decision to invest. This means that aside from purely financial gains, the SME has the added benefit of working with an investor that cares about development impact too, making the venture more sustainable in the long term.

From the research, regional integration and cross border training potential was identified by 75% of the Fund Managers as determinant of investment. This was one of the most insightful revelations of this research. In developing their products and services, SMEs should consider the possibility of one day extending their products and services beyond Zambian borders.

(b) Policy recommendations

The only policy recommendation that this research finds is with regards to pension fund investing in Zambia.

Zambian pension fund regulations appear to restrict local investment in PE funds. Out of $2 billion in assets under management as at June 2013, Zambian pension funds had invested $39 million ($42 million in today's dollars) in PE funds. For a pension fund to invest in PE, it needs the approval of the registrar – discretionary conditions may then be set for the investment (Ashiagbor et al., 2014).

It has been observed that all the participants in the Zambian PE sector have to source funds from outside of Zambia to invest in the country. To mitigate against some of the impacts of currency risk highlighted in this survey, a greater injection of local currency into PE funds from Zambian pension funds would be welcome.

Local pension fund participation would also be encouraging to international financiers and a positive signal about the SME business prospects in Zambia. In addition to this, it offers the pension funds an opportunity to diversify their portfolio while contributing to local business development and earning a return on investment for the fund.

5.6 Conclusion

This Chapter has provided detailed analyses in response to the research questions about what drives and deters PE financing in Zambia. The main drivers of PE financing in Zambia have been identified as management skills and capacity, business track record, exits and returns, impact, domestic and international scalability, political stability, GDP growth and population growth. The main constraints are limited business opportunities, the nascent culture of PE and VC in Zambia and volatile foreign exchange rates. SMEs are encouraged to take upskill themselves and take full advantage of the benefits that PE has to offer while policy makers are encouraged to reconsider pension fund regulations with regards to PE investments.

6.0 Conclusion

The objective of the study was to determine what drives PE financing in Zambia and what deters it. The paper was centred on two simple research questions and the results of these questions are summarised below:

PE investment in Zambia is determined and catalysed by business attractiveness and the business environment. Management skills and capacity, the business track record, exits and returns, impact potential, local and international business scalability, political stability, GDP growth and population growth rates are all positive drivers of PE investing in Zambia. The sector is however, constrained by a less developed PE culture, limited opportunities to invest and currency risk.

The study makes the following broad recommendations:

- SMEs should consider the export-potential of their products. Financiers are interested in scaling businesses to other regions.
- SMEs should take advantage of business mentorship and accelerator programmes. They should also participate in the local finance forums that connect impact investors to Zambian SMEs.
- To improve local PE fundraising prospects and mitigate against currency risk, the Pensions and Insurance Authority is encouraged to revisit their PE investment thresholds.

PE in Zambia still remains largely unexplored academically. The sector could be described as boutique/niche/specialised. However, it's potential to transform businesses through the unique value addition that it provides is tremendous. It is hoped that this paper has shone a small light into what is a small but growing alternative sector for financing businesses in Zambia.

Future researchers may consider exploring the actual structure of financing deals and case studies or general studies on the impact of impact investments. As the industry grows and

data becomes easily available, researchers may consider performing a quantitative analysis of the determinants of PE and VC investing in Zambia.

Appendix

Interview Question	
Q6. When you look at Zambia, what positive factors do you take into account in making your equity investment decision that encourage you to close a deal?	Q. 7 When you look at Zambia, what negaitive factors do you take into account in making your equity investment decision that put a damper on you closing a deal?
Codes	
GDP growth rate Population growth Consumer demand Business scalability Regional scalability Cross border trading Business track record Mangement skills and capacity Impact Exit Returns Political stability Business track record	Limited opportunities PE/VC culture Currency risk
Categories	
Business environment -Political stability -GDP growth -Population growth **Business attractiveness** -Management skills and capacity -Business track record -Exits and returns -Impact -Regional scalability -Business scalability	**Business attractiveness** -Limited opportunities **Business environment** -PE/VC culture -Currency risk
Themes	
Business environment -Stability and predictability are good for investment -Economic growth attracts investment -Population growth increases consumer demand **Business attractiveness** -The business's performance is dependent on the owner and/or team -Established track record of business -PE exists to make an exit and a return on investment -DFIs and VCs are attracted to businesses with development impact potential -Low population in Zambia means businesses must look beyond borders -Business should be able to grow	**Business attractiveness** -Limited opportunities that meet PE/VC requirements **Business environment** -VC and PE still new, businesses unwilling to give up equity -Volatile exchange rates erode USD investments

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