PRIVATE EQUITY IN KENYA: AN ANALYSIS OF EMERGING LEGAL AND INSTITUTIONAL ISSUES

BY

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A Thesis Submitted in fulfilment of the requirements for the award of the Degree of Doctor of Philosophy in Law (Research)

University Of Warwick, School Of Law

April 2012

TABLE OF CONTENTS

CHAPTER 7 – TAX PLANNING FOR PRIVATE EQUITY

CHAPTER 8 - THE ROLE OF COURTS IN FINANCIAL CONTRACTING

LIST OF TABLES, CHARTS, FIGURES AND CASES

Tables

Charts

Figures

Cases

Bristol and West Building Society v Mothew [1998] Ch 1 18 CA

Caparo Industries plc v Dickman [1990] 2 AC 605.

Carlill v Carbolic Smoke Ball Company [1893] 1 QB 256 (CA)

Chevron Kenya Limited v Tamoil Kenya Limited [2007] HCCC 155

Christ For All Nationals v Apollo Insurance Co. Ltd [2002] 2 EA 366

City and Westminster Properties (1934) *Ltd v Mudd* [1959] Ch 129

David Thuo & 8 Others v First America Bank of Kenya Ltd [2005 HCC 494/2005] eKLR

Don-Wood Co. Ltd v Kenya Pipeline Ltd Civil [2004] HCCC 104

Edwards v Skyways Ltd (1964 1 W.LR. 349)

Epco Builders Limited v Adam S. Marjan-Arbitrator & Another [2005] HCC 248

Estate Finance Company of Kenya Ltd v Narok Transit Hotel Ltd & 2 Others [2011] HCCC No.710/1999 eKLR

George M Musundi & 2 Others v Small Enterprises Finance Company Ltd [2007] eKLR, Civil Case No.1861/1995

George M Musundi & 2 Others v Small Enterprises Finance Company Ltd [2007] eKLR

Hedley Byrne & Co. Ltd v Heller & Partners Ltd, (1964) AC 465 (HL)

Helmet Integrated Systems v Tunnard [2007] CA

Henderson v Merrett Syndicates Ltd [1995] 2 AC 145

International Standard Elec. Corp (ISEC) v Bridas Sociedad Anonima Petrolera Industrial Y Comercial, 745 F. Supp. 172, 178 (S.D.N.Y. 1990) in VII Y.B. COM.ARB.312(1982)

J. Evans & Son (Portsmouth) Ltd v Andrea Merzario Ltd, [1976] 1 WLR 1078 (CA)

Kenya Institute of Management v Kenya Reinsurance Corporation [2008] eKLR

Kundan Singh Construction Ltd v Kenya Ports Authority, HCC 794/2003

L. Schuler v Wickman Machine Tool Sales (1974) AC 235 (HL)

Lombard North Central plc v Butterworth (1987) QB 527 (CA)

London and Mashonaland Exploration Co. Ltd v New Mashonaland Exploration Co. Ltd [1891] WN 165

McRae v Commonwealth Disposals Commission (1951) 84 CLR 377

Mumias Sugar Company Ltd v Freight Forwarders (K) Ltd Nairobi CA 297/2003

Nakumatt Holdings Limited v Kenya Wildlife Services [2001] HCCC 1131

National Bank of Kenya Ltd V. Wilson Ndolo Ayah [2009] eKLR

Nokes v Doncaster Amalgamated Collieries Ltd [1940] A.C. 1041

Pamela Akora Imenje v Akora ITC Intenational Ltd & Another [2007] eKLR

Peter Muema Kahoro & another v Benson Maina Githethuki [2006] eKLR

Phillip Goldstein, et al, Petitioners, vs. Securities and Exchange Commission, Respondents District of Columbia Circuits, No. 04-1434

Rawal v Mombassa Hardware Ltd [1968] EA 398

Reading Intl, Inc., v Oaktree Capital Management LLC, 317 F.Supp. 2d 301 – 331 (S.D.N.Y. 2003)

Robert F. Booth Trust v Crowley et al & SEARS Holding Corporation, No. 09 C 5314 N.D.I.[2010]

Robinson v Harman (1848) 1 Exch 850, 855

Ruxley Electronics & Construction Ltd v Forsyth [1960] 1 AC 344 HL

Shepherds Investments Ltd v Walters [2007] 2 BCLC 202

Standard Bank Ltd v Mehotoro Farm Ltd & 2 Others CC 54 [1972] CA

Thermascan Ltd v Norman [2009] EWHC 3694 (Ch)

US v Dairy Farmers of Am., Inc., 426 F.3d 850 – 855 (6^{th} Cir. 2005)

ACKNOWLEDGEMENTS

First and foremost, my gratitude goes to my God for the gift of life, good health, mental sanity and spiritual stability – the very values that nudged me to this finish line.

This work could not have been completed without the faith and constant support of my supervisor and friend, Dr. Dalvinder Singh, Associate Professor of Law at the Warwick University School of Law. In addition to his incisive and direct academic criticism of my thinking and writing, he was a pillar of faith and basic common sense when it came to my staying the course.

I acknowledge in a special way my examiners – Prof. Charles Chatterjee (internal) and Dr. Nicholas Ryder (external), for interrogating the quality and consistency in this work, and for the lively engagement and profoundly insightful recommendations on how to improve this work at the publication stage. Their experience and wise judgement brought this work to an illustrious conclusion.

I especially acknowledge all individuals and institutions in Kenya that supported the empirical aspects of this study: without their granting access, this work could not have taken the practical form that it has.

But most of all, my affectionate and lovely wife, Beverlyn, and our two children, Tanya and Nate-Jr., for their steady love and unfailing belief in the end of this road (especially during the long periods when days fused into nights before the computer screen, and weekdays into weekends). In many ways, this achievement is theirs: we came, we saw, we accomplished, and together we are better than either one of us.

My journey through Warwick undeniably bears the positive impact of various individuals who, in their different ways, have their indelible influences woven into the fabric of this academic achievement. They include my parents and family, the Government of Kenya through Mr. Wanjuki Muchemi, CBS, Solicitor General of the Republic of Kenya (2002-2012 – whose vision and selflessness facilitated my continued engagement with advanced education), Dr. Jorge Guira, my first supervisor, Dr. Lydia Schulz, my friend and mentor, Dr. Rodrigo Olivares Caminal (member of my upgrade panel in 2008), Prof. Istvan Pogany (Director of Post Graduate Research at the Law School, 2010), Ms Jennifer Mabbett (the gentle and indefatigable Post-Grad Secretary at the Warwick Law School), the Students Finance Office, the Warwick Board of Graduate Studies, my doctoral colleagues at the Law School, Dr. Ambreena Manji and Dr. Upadhya Radha both of the British Institute for Eastern Africa, and Prof. Yash Pal Ghai of Katiba Institute, Steve Sitienei and Dr. Billingsley Kaambwa (my friends), as well as Mrs. Joy Warmington, CEO Brap Ltd, Mrs. Siobhan Harper-Nunes, Ghiyas Somra, Amy Wilkins, Emma Wright, Safia Lul, Dr. L Sitienei - for the various parts they each played to support me through.

DECLARATION

I, the undersigned, hereby confirm that this thesis is my own original work and does not include any material already submitted for another degree at the University of Warwick, or material I have previously had published. I also confirm that the thesis has not been submitted for a degree at another university.

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Abstract

In Kenya, like in many other countries around the world, private equity's emergence as a creative method for financing companies, is attracting attention as the government seeks new ways of financing its private sector – which it now recognises as the engine for Kenya's economic development. This policy outlook is undermined by the reality of a yet extensively under-capitalised private sector, and the lack of a coherent body of knowledge and experience on Kenyan private equity. This study, for the first time, brings together that dispersed body of knowledge to facilitate coherent analysis of the emerging legal and institutional issues that private equity introduces. Using case law and statutory analysis, documentary reviews, interviews and surveys to construct the complete picture of Kenyan private equity, this empirical legal inquiry finds that the law on private equity in Kenya is incomplete: it is patchy and dispersed, and is not uniformly applied among and across all private equity market intermediaries. Secondly, the institutions charged with supervising the implementation of the law are under-capacitated, with the result that regulatory supervision within the private equity industry remains weak and largely unfelt. Thirdly, the legal institutions supporting private equity practice in Kenya (security of property rights, security of financial contracts and integrity in financial reporting) are in a nascent state of development. Fourthly, there is no clear policy on alternative investments generally, and private equity particularly, in Kenya, undermining precision in regulatory objectives. These realities combine to blunt the impact of private equity in driving creative entrepreneurship. These realities support the need for structured national capacity enhancement across all spheres of private equity practice, such as would strengthen regulatory supervision, the emergence of a 'home brand' to private equity, the increased visibility of structured government engagement in channelling private equity into economically productive sectors linked to the nation's development strategy. These findings mirror earlier research investigating the under-performance of private equity in emerging markets, with the upshot that a *Law and Institutional Growth Model for Private Equity in Kenya* is the necessary catalyst that will trigger the rapid expansion of the Kenyan private equity industry in aid of national development.

ABBREVIATIONS

ARDC	American Research and Development Corporation
AVCA	Africa Venture Capital Association
CBK	Central Bank of Kenya
CMA	Capital Markets Authority of Kenya
EMPEA	Emerging Markets Private Equity Association
ERS	Economic Recovery Strategy for Employment and Wealth Creation
EVCA	European Venture Capital Association
GP	General Partners
ICAP	Investment Action Master Plan
ICAP	Investment Climate Action Plan
LLP	Limited Liability Partnership
LP	Limited Partners
MAPSKID	Master Plan Study for Kenyan Industrial Development
MFI	Microfinance Institution
MoTI	Ministry of Trade and Industry
MSME	Micro Small and Medium Enterprises
NSE	Nairobi Stock Exchange
NVCA	National Venture Capital Association
PE	Private Equity
PSDS	Private Sector Development Strategy
SACCO	Savings and Credit Cooperatives
SASRA	SACCO Societies Regulatory Authority
SBIC	Small Business Investment Companies
SBIR	Small Business Investment Research
SME	Small and Medium Enterprise
SMEx	Small and Medium Enterprise Exchange
VC	Venture Capital

1

SETTING OUT THE PROBLEM AND SCOPE OF STUDY

1.1 Introduction

Private equity - a financial and investment intermediary between holders and providers of capital on the one hand, and specific types of private companies, on the other[1] - can be catalytic in transforming the way in which a country's most productive economic sectors develop.[2] This is particularly true in a developing country context like Kenya, a sub-Saharan African country whose private sector is still under-capitalised and under-developed.[3] Development research indicates that the private sector is the main driver of economic growth,[4] a position adopted in development literature[5] as well as in Kenya's ambitious economic development plans which seek to transform Kenya into a middle-income economy by the year 2030.[6] Yet to be an effective partner in development, the private sector needs to be adequately and appropriately capitalised.

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[1] Douglas J. Cumming and Sofia A. Johan, *Venture Capital and Private Equity Contracting: An International Perspective* (Elsevier, USA, 2009) 3, 4

[2] Richard Kitchen, 'Venture Capital: Is It Appropriate for Developing Countries?' In *Business Finance in Less Developed Capital Markets* (1992) Klaus Fischer and George Papaioannou (eds), Hofstra University– private equity is (a) a type of investor, (b) a financial contracting strategy through which equity capital is made available to private companies, and (c) an investment management service.

[3] Mukhisa Kituyi, Improving the Investment Climate and Participation of the Private Sector in the Economy (Ministry of Trade and Industry, Policy Briefing Paper, Nairobi, 11-12 April 2005) 2,3 <http://siteresources.worldbank.org/INTKENYA/Resources/improveing_ic_Kituyi.pdf> accessed 29 December 2011; also: IMF Financial Access Survey (2009) <http://fas.imf.org/> - accessed 5 February 2012 – key indicators are that out of 1000 adults, less than 74 have access to a bank loan, and less than 370 own a savings account. There are 2 bank branches in every 1000 square kilometres (or 7 ATMs to every 100,000 adults), and lending to private sector stood at 32.6% of GDP, while deposits were 46% of GDP.

[4] Yochanan Shachmurove, 'An Introduction to the Special Issues on Financial Markets of the Middle East' (2004) 9(3) International Journal of Business 213

[5] DfID, 'The Engine of Development: The Private Sector and Prosperity for Poor People' (DfID, 2011) <http://www.dfid.gov.uk/Documents/publications1/Private-sector-approach-paper-May2011.pdf> accessed 5 October 2011. Also: Asian Development Bank, 'Overview' (ADB, 2011) <http://beta.adb.org/themes/private-sector-development> accessed 20 October 2011 – 'private sector has been, remains and will be the engine of growth'.

[6] Government of Kenya, 'Vision 2030' <http://www.vision2030.go.ke/index.php/front/vision> accessed August 2007.

There is extensive evidence from multilateral development institutions that financial infrastructure in emerging markets remain under-developed.[7] 'Financial infrastructure' includes all the institutions, technologies, standards and rules that support financial mediation in a country.[8] Bossone, Mahajan and Zahir find that weak financial infrastructure tends to drive selection bias, that is, providers of enterprise capital tending to withhold financing from borrowers deemed to carry too much risk.[9] Rajan and Zingales had earlier lead evidence suggesting that efficient financial infrastructure improved quality and quantity of business finance.[10] A World Bank and IFC study in 2010 suggested that laws and regulations support the efficient operation of a country's financial infrastructure and financial system, thereby indirectly the direction in which a country's private sector develops.[11]

This study argues that private equity can be a useful partner in expanding sources and types of business finance, enabling private companies to more efficiently access the types of enterprise capital in the right amounts.

Why is private equity uniquely well-suited to resolve these challenges?

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[7] Margaret Miller, Nataliya Mylenko and Shalini Sankaranayanan, 'Financial Infrastructure – Building Access Through Transparent and Stable Financial Systems' (2009) International Bank for Reconstruction and Development and International Finance Corporation, <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTFINANCIALSECTOR/0,,contentMDK:22298550~menuPK:6434193~pagePK:210058~piPK:210062~theSitePK:282885,00.html> accessed 23 January 2012 – "access to finance is the result of a complex interplay of different financial intermediaries, the right kind of financial infrastructure, and a sound legal and regulatory framework", 1

[8] Penelope J Brook, 'Foreword' *in Margaret Miller, Nataliya Mylenko and Shalini Sankaranayanan*, 'Financial Infrastructure – Building Access Through Transparent and Stable Financial Systems' (2009) International Bank for Reconstruction and Development and International Finance Corporation, <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTFINANCIALSECTOR/0,,contentMDK:22298550~menuPK:6434193~pagePK:210058~piPK:210062~theSitePK:282885,00.html> accessed 23 January 2012 -'Institutions' in this context include payment remittance and securities settlement systems, collateral registries and credit reference bureaux.

[9] Biagio Bossone, Sandeep Mahajan and Farah Zahir, 'Financial Infrastructure, Group Interests and Capital Accumulation: Theory Evidence and Policy' (2003) IMF Working Paper 03/24

[10] Rajan Raghuram and Luigi Zingales, 'Financial Dependence and Economic Growth' (1998) 88 (3) American Economic Review 559-86

[11] Miller, *et al.*, 'Financial Infrastructure' (2009) (n 7), 1 "access to finance is the result of a complex interplay of different financial intermediaries, the right kind of financial infrastructure, and a sound legal and regulatory framework"

Industry studies[12] on the one hand, and development literature,[13] on the other, have urged the argument firstly that private equity drives economic development because it promotes innovation. European studies, however, suggest a less optimistic impact, finding mixed results in Italy[14] and UK.[15] The general weight of opinion nonetheless suggests a positive relationship between the introduction of private equity into a company and its rapid growth.[16] The argument is that this type of finance improves corporate performance by increasing productivity[17] and disciplining management efficiency.[18] These studies ascribe these outcomes to the private equity contracting model, which introduces close monitoring of management action – and the overall impact, it is argued, is stronger business entities in the economy.

Private equity, unlike collateral-based business credit, does not operate on a lending basis – it becomes a shareholder in a business, strengthening balance sheets, providing financing for a company's most risky ventures, and enabling a company to unlock matching traditional credit where needed, aiding promising new businesses to blossom. Research

[12] Samuel Kortum and Josh Lerner, 'Assessing the Contribution of Venture Capital to Innovation' (2002) 31(4) RAND Journal of Economics 674-692

[13] Josh Lerner, Morten Sorensen and Per Stromberg, 'Private Equity and Long-Run Investment: The Case for Innovation', *The Global Economic Impact of Private Equity Report (2008)* World Economic Forum, January 2008.

[14] Stefano Caselli, Francesco Corielli, Stefano Gatti and Francesca Querci, 'Corporate Governance and Independent Directors, Much Ado About Nothing? The Evidence Behind Private Equity Investment Performance' (2008) CAREFIN-Universita Bocconi (unpublished); cf: Francesco Perrini, Ginevra Rossi, and Barbara Rovetta, 'Does Ownership Structure Affect Performance? Evidence from the Italian Market' (2008) 16 (4) Corporate Governance: An Intenational Review 312-325 - explores the cause-effect relationship between private equity and innovation; inconclusive whether innovation follows private equity, or vice versa.

[15] Robert Cressy, Federico Munari, Alessandro Malipiero, 'Creative Destruction? Evidence that Buyouts Shed Jobs to Raise Returns' (2011) 13(1) Venture Capital: Journal of Entrepreneurial Finance, 1-22

[16] Johan Per Stromberg, 'Private Equity, Industry Performance and Cyclicality' (2010) The Global Economic Impact of Private Equity Report, World Economic Forum, 19 part 2

[17] Kevin Ames, 'Management Buyouts and Firm-Level Productivity: evidence from a panel of UK manufacturing firms' (2002) 49(3) Scottish Journal of Political Economy, 304-317 – studies 78 UK buyouts between 1986-1997; Richard Harris, Donald Siegel and Mike Wright, 'Assessing the Impact of Management Buyouts on Economic Efficiency: Plant-Level Evidence from the UK' (2005) unpublished working paper – studying 979 UK buyouts between 1994-1998.

[18] Oliver Hart and John Moore, 'Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management' (1995) (85) 3The American Economic Review 567-585; Cf: Matthias Dewatripont and Jean Tirole, 'A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence' (1994) 19 (4) The Quarterly Journal of Economics 1027-1054

suggests that private equity is effective in introducing new technologies and new ideas into the marketplace and dispersing them across an economy.[19] Such investments, it is said, encourage and spur innovation,[20] generate good returns to investors thereby aiding in the mobilisation of capital,[21] encourage robust corporate growth and expansion.[22] It is also argued that it improves corporate governance[23] and promotes research and development as lucrative commercial undertakings.[24]

With all this promise, private equity does warrant serious academic investigation, a pursuit that would model options for its growth within a developing country context. This is all the more pertinent given its origins in North America and Western Europe, countries with highly developed legal systems and institutions, compared to the relative under-development of legal systems in developing countries. [25]

This chapter does five things. Firstly, it sets out, in section 1.2, the main research question underpinning this thesis and motivates it through a reflection on how various governments around the world have employed legal instruments in public policy targeted at private equity, and an exploration of private equity as a problem in law. Section 1.2 ends with a statement of supporting questions that help in focusing the scope of the study. Secondly, In

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[19] Richard Kitchen, Venture Capital in Developing Countries (n 2) 1

[20] Marcos A. Mollica and Luigi Zingales, 'The Impact of Venture Capital on Innovation and the Creation of New Business' (2007) Working Paper Chicago University; *cf*: Josh Lerner, Morten Sorensen and Johan Per Stromberg, 'Private Equity and Long-Run Investment: The Case for Innovation' (2008) The Global Economic Impact of Private Equity, World Economic Forum Alternative Investment Working Paper Series <http://www.weforum.org/> accessed January 2011.

[21] European Private Equity and Venture Capital Association, 'Survey of the Economic and Social Impact of Venture Capital in Europe' (2002) <http://www.evca.eu/UploadedFiles/surv_econ_soc_impact_vc.pdf> accessed 20 October 2011

[22] Shai Bernstein, Josh Lerner, Morten Sorensen and Johan per Stromberg, 'Private Equity, Industry Performance and Cyclicality' (2010) The Global Economic Impact of Private Equity Report, World Economic Forum, 19 <http://www.weforum.org/> accessed January 2011

[23] George P Baker and Karen H Wruck, 'Organisational Changes and Value Creation in Leveraged Buyouts: The Case of OM Scott & Sons Company' (1989) 25 Journal of Financial Economics 163, 190

[24] European Private Equity and Venture Capital Association, Special Paper on Technology Success Stories (2002) <http://www.evca.eu/uploadedFiles/eur_tech_success_stories.pdf> accessed 4 June 2011 - research and development is especially important to growing economies that need innovative solutions to long-standing economic challenges.

[25] ch 3, 65, for a succinct history of private equity.

section 1.3, a number of justifications are offered why a study of private equity is important to a developing economy like Kenya. Thirdly, in section 1.4, the study is delimited through ascribing meaning and context to the two central themes of the inquiry, that is to say, 'laws' and 'institutions'. This section also sets out the claims to originality, and justifies the choice of Kenya as a case study in this investigation. Fourthly, in section 1.5, some of the key concepts underpinning the study are defined, notably the richly nuanced and contextual meaning of the term private equity, and the meaning of emerging markets. Lastly, in section 1.6, the chapter concludes with an outline of the way in which the remainder of the thesis has been organised.

1.2 The Questions

1.2.1 Main Question

The general reflections in the preceding section suggest the existence of a dependency between the state of a country's economic , financial and private sector development. If private equity offers a viable part solution to the unlocking of a nation's private sector potential in driving economic growth, a fundamental policy question becomes how can a country grow private equity? In other words, what factors must a country secure for a robust and economically significant private equity industry to grow – that is deepen its financial infrastructure and its financial system?[26] What would those factors mean for a country's law and institutional development process?

[26] Miller *et al.*, 'Financial Infrastructure' (2009) (n 7) 1

Opinion is generally united among private equity practitioners,[27] investors[28] and academics[29] that the following four broad country characteristics influence the emergence of private equity markets:

(i) economic growth rate and size of the economy;

(ii) size of stock markets and or depth of debt markets;

(iii) levels of entrepreneurship; and

(iv) quality of the legal system and regulatory practices.

The first three determinants are macro-economic in character, while the fourth is socio-legal in nature. There is much less agreement, unfortunately, on which, if any, of the four factors wields the greater influence – the deterministic effect, so to say – in catalysing a sure start to the industry's emergence and robust growth. This mix of factors, it is clear, transcend any single academic discipline, but the fourth set of factors (legal system and regulatory practices) to varying degrees appear to influence the manner in which the first three conditions develop. In light of the foregoing, this study asks the following main question -

> *Are laws and legal institutions really relevant to the growth of private equity in an emerging market like Kenya? If so, what are the key emerging legal and institutional issues?*

This thesis argues that in an emerging market context, the law, and its legal institutions, are likely to be more influential than macro-economic factors in nurturing fortuitous environments for a robust private equity industry to emerge and expand. In

[27] Heino Meerkatt and Heinrich Liechtenstein, 'New Markets, New Rules: will emerging markets reshape private equity?' (IFC, November 2010) <www.ifc.org/...Markets.../BCG+New+Markets+New+Rules+Nov+10.pdf> accessed 11 October 2011.
[28] International Finance Corporation, 'The Case for Emerging Markets Private Equity' (IFC, February 2011) <www.ifc.org/.../EM_PE_Sharing_IFCs_Experience_v9_February2011.pdf> accessed 16 October 2011
[29] Marina Balboa and Jose Marti, 'Conceptual Model for Private Equity Markets: Proposal and Empirical Test on Fundraising' (EFMA London Meetings 2002) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=313934> accessed 16 November 2011.

adopting this proposition, this study views the first three elements as the 'external factors' that create the economic opportunity, while the fourth element is viewed as the 'internal factor' that qualitatively unlocks both demand and supply of private equity through creating crucial platforms for efficient financial contracting. In effect, the law is viewed as an 'enabler', hence the question what can a country do to enable the emergence of conditions that support the growth of private equity.[30]

As chapter 5 discusses in detail,[31] Kenya has a nascent private equity industry, suggesting it is still a new form of financial contracting and intermediation in Kenya. The second part of the main question, hence, seeks to explore the legal and institutional issues that private equity raises and how the practice of private equity is anchored in the law. To what extent are the issues raised by private equity efficiently resolved within the Kenyan legal and institutional system? These are the central themes holding this investigation together.

This study thus unpicks the fourth element from among the four broad country characteristics for private equity set out above – from the perspective of its likely disproportionate influence on how the other three factors develop.[32] A discernible theme arising from the literature, as far as emerging markets private equity is concerned, is the notion that socio-economic environments, with particular emphasis on legal and regulatory conditions, are especially crucial to private investment. This line of thinking argues that "*the most attractive markets for investors are determined (...) by the relative sophistication of (...) their regulatory and legal systems*."[33]

Without prejudice to the thesis statement set out above, the macro-economic factors (economic growth rate, size of the stock market, depth of local debt markets, levels of entrepreneurship and infrastructure), which are styled 'the external factors' in this chapter,

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[30] Miller *et al.*, 'Financial Infrastructure' (2009) (n 7) 1 – laws and regulations support financial infrastructure components to perform optimally
[31] ch5, 158
[32] Miller *et al.*, 'Financial Infrastructure,' (2009) (n 7), 1-2
[33] Meerkatt and Liechtenstein 2010 (n 27) 1

are *not* unimportant in the wider scheme of private equity growth.[34] The argument in this thesis, however, is that for these external factors to be highly effective, a supporting legal and regulatory framework is necessary.[35]

Evidence by Armour and Cumming[36] that stock markets do play a role in the growth of private equity, also places heavier weight on the impact of laws that support entrepreneurship, tolerates business failure, and protects shareholders, in addition to supporting a low-tax environment. These, they find, play a potentially larger role in determining whether private equity markets deepen in an economy. Their finding on taxation resonates with earlier work by Porteba,[37] while their findings on the legal determinants (including pension fund regulations and tax policy) extend similar findings by Jeng and Wells.[38]

These notions have certainly found currency in public policy, as the next section illustrates. Studies by the private equity industry itself lend support to the core argument in this study: the Latin America Venture Capital Association,[39] the British Venture Capital Association (BVCA),[40] as well as the European Venture Capital Association (EVCA)[41] all agree on the importance of law and legal institutions in culturing conducive environments for private equity to emerge and grow.

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[34] Maria Ahmed, 'Strong Prospects for African Private Equity' (Emerging Markets, 24 April 2006) <http://www.emergingmarkets.org/Article/1039301/Strong-prospects-for-Africa-private-equity.html> accessed 16 October 2011

[35] Wei Xiao, 'The New Economy and Venture Capital in China' OYCF (2002) 3 (6) Perspectives

[36] John Armour and Douglas Cumming, 'The Legislative Road to Silicon Valley' (2006) 58 Oxford Economic 596-635

[37] James M. Porteba, 'Venture Capital and Capital Gains Taxation' in LH Summers (ed), *Tax Policy and the Economy*, (Cambridge, MA, MIT Press, 1989) ch 347-67

[38] L.A. Jeng and P.C. Wells,' Determinants of Venture Capital Fundraising: Evidence Across Countries' (2002) 6 Journal of Corporate Finance 241-89

[39] Jenna Gottlieb, 'Evolving Regulation' (LAVCA, 8 March 2011) <http://lavca.org/2011/03/08/evolving-regulation/> accessed 23 January 2012

[40] British Venture Capital Association, 'A Guide to Private Equity' (2010) <http://admin.bvca.co.uk//library/documents/Guide_to_PE_2010.pdf> accessed 23 January 2012

[41] EVCA Benchmarking Tax and Legal Environments (2008) <http://www.evca.eu/publicandregulatoryaffairs/default.aspx?id=2414#2008> accessed 23 January 2012

1.2.2 Legal Instruments in Public Policy for Private Equity

Governments across North America and Western Europe, as well as others around the world (see table 1, below), have adopted varied public policy measures targeted at crafting more conducive national environments for private equity. A strong tenet of these public policy responses has been the employment of legal instruments.

The first column in the table shows the year when governmental responses to private equity was undertaken. The second column shows the country implementing the measure, and in the third column, the policy measure is depicted. Column four summarises the impact each policy measure helped deliver.

Table 1 Cross-Country Evidence of Policy Interventions in Private Equity/Venture Capital

Year	Country	Policy Intervention	Impact
1958	USA	Small Business Investment Companies Act[42]	Larger fund pools, PE/VC Professionalization
1974	USA	Employee Retirement Investment Scheme Act[43]	Chocked off pension Investments in PE/VC
1978	USA	"Prudent Man" ERISA clarification[44]	Triggered rapid investments in PE/VC
1980	USA	Small Business Innovation Research Programme[45]	Channelled billions into PE/VC
1992	Israel	Yozma Programme – USD100m Govt VCF[46]	Rapid co-investing by private Sector
2000	UK	Numerous specialist government funds[47]	Targeted small firms

[42] U.S. Small Business Administration, 'Small Business Investment Act of 1958' <http://www.sba.gov/about-sba-info/13754> accessed 24 October 2011

[43] ERISA, Pub. L. 93-406 - USCS s1002 of 2 September 1974

[44] Title 29-18 1B-4 USCS s1104 – 'Fiduciary Duties', s1104(a)(1) 'The Prudent Man Standard of Care'.

[45] Joshua Gans, and Stern Scott, 'When does funding Research from Smaller Firms Bring Fruit? Evidence from the SBIR Programme' (2003) 12 (4) Economics of Innovation and New Technology 361-384

[46] Gil Avimelech and Morris Teubal, 'Israel's Venture Capital Industry: Emergence, Operation and Impact' in David Citendamar (ed.), *The Growth of Venture Capital: A Cross-Cultural Analysis* (Westport Praeger 2002)

[47] British Venture Capital Association, 'A Guide to Private Equity' (2010) <http://admin.bvca.co.uk//library/documents/Guide_to_PE_2010.pdf> 8-13

2001	Denmark	Danish Growth venture Fund[48]	Market Stimulated
2001	EC	European Investment Fund[49]	Euros 2 billion fresh capital
2003	France	Plan Innovation[50]	Targeted at innovative firms;
2006	Netherlands	Regulatory Harmonisation[51]	More investments into PE/VC
2002	Singapore[52]	Tax Incentives (Silicon Valley Model)	Rapid growth of local PE
2002	Taiwan[53]	Tax Incentives/Business Regulation	Explosive growth in VC
2003	India[54]	Venture Capital Regulations / Capital Markets	Rise of Technology Valley
2003	China[55]	Changes to PE Laws – 2003; 2006; 2007	Increased fundraising for China
2003	Japan[56]		
1998	Brazil	Various regulatory improvements since 2003[57]	Brazil more attractive to global Private equity firms

The role and influence of public policy in the emergence and growth of markets for risk finance is thus well documented. It is telling that a substantial number of the foregoing public policy responses employed legal instruments, and were targeted at shoring up the supply, or quantity, of private equity/venture capital in an economy.

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[48] Vækstfonden's (Danish Growth Fund), 'The Best Market for Innovation Finance in Europe' (2001) <http://www.vf.dk/OmVaekstfonden/Vision.aspx> accessed 25 October 2011

[49] *Europa*, 'European Investment Fund' (1994) < http://europa.eu/about-eu/institutions-bodies/eif/index_en.htm> accessed 8 December 2007

[50] Marco Da Rin, Giovanna Nicodano and Alessandro Sembenelli, 'Public policy and the creation of active venture capital markets' (2006) 90 (8-9) Journal of Public Economics 1699-1723

[51] Douglas Cumming and Sofia Johan, 'Regulatory Harmonization and the Development of Private Equity Markets' (2007) 31 Journal of Banking and Finance 3218-3250 – see chapter 3, section 3.2.2c for detailed discussion.

[52] Winston T.H. Koh and Francis Koh, 'Venture Capital and Economic Growth: An Industry Overview and Singapore's Experience' (2002) Singapore Management University, school of Economics and Social Sciences Workong Paper 21 /2002

[53] L Songtao, 'The Stage and the Character of Venture Capital Development in Taiwan, Asia and Pacific Economies' (2000)

[54] Mike Wright, Andy Lockett and Serika Pruthi, 'Internationalization of Western Venture Capitalists into Emerging Markets: Risk Assessment and Information in India' (2002) 19 (1) Journal of Small Business Economics 1 – 62 Springer Netherlands

[55] Lutz-Christian Wolff, *Mergers and Acquisitions in China: Law and Practice 2008* (2nd edn, CCH Hong Kong Limited 2008), ch 5, 6, 7, 8 and 15 - These include the *Regulations on the Administration of Foreign-Invested Venture Capital Enterprises, 2003* (which sets out express prohibitions on the types of investment activities foreign-invested enterprises cannot undertake), the *Interim Measures for the Administration of Venture Capital Funds, 2006,* which apply to non-foreign invested venture capital undertakings, and revisions to the Chinese partnership law in 2007, which had revisions impacting foreign-invested partnerships. Chinese law distinguishes between onshore and offshore funds, and subjects offshore funds and special purpose investment vehicles to specific restrictions.

[56] Masaki Kuroki, Mark P. Rice and Pier A Abetti, 'Emerging Trends in the Japanese venture Capital Industry' (2000) Journal of Private Equity 39 -49

[57] Generally,[Editor], Latin America Venture Capital Association, 'Evolving Regulation' (8 March 2011), <http://lavca.org/2011/03/08/evolving-regulation/> accessed 23 January 2012

Korosteleva et al[58] suggest that regulation is an important catalyst of start-up capital into the economy, but find that 'over-regulation' has a stifling effect. However, 'over-regulation' within that study is not precisely defined, and it is doubtful whether the term means the same thing in different economic contexts, casting some doubt over the 'stifling effect' argument. From a public policy perspective, nonetheless, the effectiveness of a country's financial system's regulatory model would seem to have a strong impact on how financial markets develop.

Bose, Panini and Chitralekha find that while there is broad consensus that enforcing property rights accounts for the emergence of financial markets, causation could run in the opposite direction as well: so that financial development can trigger or catalyse property rights reforms.[59] Other factors include, on the one hand, taxation policies and how the capital gains system is organised,[60] and, on the other, the assurance of an exit framework from investments.[61] These issues have been categorised by other commentators among the qualitative elements of public policy.[62]

The main line of inquiry in this work is motivated by the notion that at the heart of the private equity investment decision in emerging markets lie perhaps two fundamental worries: firstly, the extent to which property rights in financial investments are secure, and secondly,

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58 Julia Korosteleva, and Tomasz Mickiewicz, 'Property Rights, Supply of Formal Informed Finance and Business Start-up Financing' (2008) <http://www.hse.ru/data/445/633/1233/Mickiewicz%20&%20Korosteleva_Start-up%20Finance_EACES.pdf> accessed 25 October 2011

59 Niloy Bose, Antu Panini Murshid, Chitralekha Rath, 'Finance and Property Rights: Exploring Other Directions' <www.isid.ac.in/~pu/conference/dec_10_conf/.../NiloyBose.pdf> accessed 25 October 2011

60 James Porteba, 'Capital Gains Tax Policy Toward Entrepreneurship' (1989) 42 (3) National Tax Journal 375, 90; Christian Keuschnigg and Soren Bo Nielsen, 'Public Policy for Venture Capital' (2001) 8 (4) International Tax and Public Finance 557, 72; Christian Keuschnigg and Soren Bo Nielsen, 'Start Ups, Venture Capitalists and Capital Gains Tax' (2004) 88 (5) Journal of Public Economics 1011,1042

61 Claudio Michelacci and Javier Suarez, 'Business Creation and the Stock Market' (2004) 71(2) Review of Economic Studies 459, 81

62 Colin Mason, 'Public Policy Support for the Informal Venture Capital Market in Europe: a critical review' Working Paper 08-07/2008 <http://www.strath.ac.uk/media/departments/huntercentre/research/workingpapers/Public_Policy_Support_For_Informal_Venture_Capital_Market_in_Europe_A_Critical_Review.pdf> Accessed 25 October 2011

the extent to which acceptable investment returns can be earned, from such markets. Both worries have been mainstreamed by a literature strand backing a role for law and legal institutions in financial market development,[63] and secondly, links contract and divestment efficiency to earnings or realized returns.[64]

The main question is also motivated by the experience of private equity in emerging markets.[65] Once an exotic and limited investment and financial contracting activity, it has rapidly globalised,[66] having first appeared in North America and Western Europe, where it is also highly sophisticated and well developed.[67] According to Preqin,[68] the industry raised over USD1.8 trillion[69] globally between 2006 and 2008 – the highest in history, and a period that came to be known as the 'golden age of private equity'.[70] During the same period, the number of private equity fund managers doubled – from 918 fund managers in January 2007 to 1,673 in March 2009.[71]

Statistics collated by the Emerging Markets Private Equity Association ('EMPEA') on fundraising, the number of active funds and fund managers, and the geographic spread of

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63 For example, Hernando De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (Black Swan, Bantam Press, Great Britain, 2000).
64 Douglas Cumming and Grant Flemming, 'A Law and Finance Analysis of Venture Capital Exits in Emerging Markets' (2003) Australian National University Working Paper Series in Finance.
65 Emerging Markets Private Equity Association < http://www.empea.net/.> Accessed 16 September, 2010 – these markets, for private equity, are Latin America, India, China & Asia, Eastern Europe, Middle East and North Africa, and sub-Saharan Africa - South, East, Central and West Africa
66 Mike Wright, Sarika Pruthi and Andy Lockett, International Venture Capital Research: From Cross-Country Comparisons to Crossing Borders (2005), Nottingham University Business School Centre for Management Buy-Out. See also: W. Megginson, Toward A Global Model of Venture Capital? The University of Oklahoma (2002) 2, 5, 23-28 < http://faculty-staff.ou.edu/M/William.L.Megginson-1> accessed 2 April 2008.
67 Steven M Davidoff, 'The Failure of Private Equity' (2009) 82(3) Southern California Law Review 481-546 - for history of private equity, go to chapter 3, 65.
68 Preqin, 'Global Quarterly Private Equity Fundraising 2004-2009' (USA, 1 July 2009) 1 <www.preqin.com/.../Q2%20**2009**%20**Private**%20**Equity**%20**Fundraising**%20Up%2.> accessed 15 September 2010
69 ibid
70 Richman Lou and Elaine Cummings, 'Global Private Equity Report' (Bain & Company Inc. , 2010) 2 < http://www.tricappartners.com/images/Bain_-_Global_PE_Report_2011.pdf.> accessed 30 September, 2010
71 ibid.

private equity, indicate phenomenal growth in emerging market private equity activity.[72] Indeed, by 2008, the OECD observed that 'private equity is the African investment story to watch'.[73] Private equity has thus become a global phenomenon.

It is unsurprising, hence, that Kenya has in the last decade witnessed an increasing number of private equity companies setting up office in the country.[74] The quality of financial transparency – ultimately a question of business and securities regulation – is already recognised as one of the areas relevant to private equity that calls for development to promote access to enterprise finance.[75] Other barriers stem from firm characteristics such as family ownership of business, especially the impact of relinquishing control of family businesses.[76] Amidst this fast-changing space, Kenyan investment managers are setting up funds of their own, riding on their stellar investment records.[77]

Private equity's arrival on the world stage has not induced similar economic impact across countries, however, with industry statistics demonstrating its early underperformance in emerging markets.[78] Research continues to vex the question why it has not always 'transplanted' successfully in emerging markets.[79] The general question that arises is whether

[72] EMPEA, 'Emerging Market Private Equity Industry Statistics: Fundraising and Investment' (Q4 2009) < http://www.empea.net/> accessed 6 April 2010

[73] Thomas Dickson, OECD, *Policy Insight No.60, Private Equity: An Eye for Investment under African Skies?* (OECD African Economic Outlook, 2008) < http://www.oecd.org/dev/insights > accessed 6 April 2009

[74] Wanjiru Waithaka, 'Kenya Becomes a Magnet for Private Equity' *(BiD Network*, 7 March 2008) <http://www.bidnetwork.org/page/84199/en> accessed 5 April 2008. See chapter 5 for a full discussion of the Kenyan private equity industry.

[75] George Omondi, 'Lack of Disclosure Blocking SMEs from Funds' (*All Africa*, 22 April 2010) <http://allafrica.com/stories/201004210993.html> accessed 22 April 2010.

[76] George Omondi, 'Small Firms Shy Away from Private Equity Lenders' (*All Africa*, 4 May 2010) <http://allafrica.com/stories/201005040973.html> accessed 4 May 2010.

[77] Emanuel Were, 'Kenya's New Capitalists Go Big on Private Equity' (*Business Daily*, 5 June 2009) <http://www.businessdailyafrica.com/-/539552/606824/-/item/0/-/cs7v4d/-/index.html> accessed 5 June 2009.

[78] Emerging Markets Private Equity Association, 'Emerging Markets Private Equity Fundraising and Investment Review 2008' (2009) 22 <http://www.empea.net/EMPEA_Fundraising_Investment_Report_2008_nonmember[1].pdf.> Accessed 27 July 2010

[79] Josh Lerner and Antoinette Schoar, 'Private equity in the developing world: the determinants of transaction structures' (2003) Harvard Business School/Massachusetts Institute of Technology Working paper, *cf*: Douglas Cumming and Grant Fleming, 'The impact of legality on private equity markets: evidence from the Asia-Pacific (2004), EFMA Conference, Glasgow, unpublished)

the experience of emerging markets private equity is a case of an investment model that has proven unsuitable to emerging market conditions, or of incomplete market institutions in such markets that cannot effectively support the asset class, or primarily a problem in law – legal frameworks with structures that cannot support the needs of the specialised financial contracts that underwrite private equity?[80] These issues underpin the main themes of this study.

1.2.3 Private Equity: A Problem in Law

To amplify the preceding issues, it is observed that in practice, private equity occurs as a set or series of financial contracts that define 'the private equity cycle'.[81] The 'cycle' has three main phases of occurrence –

(i) the *fundraising* phase when investors make funds available for private equity ventures;

(ii) the *investment* stage when specialist fund managers identify, select and invest in private companies;[82] and

(iii) the *divestment* stage when fund managers unlock the value in their investments through a range of liquidation strategies.[83]

Each stage is underwritten by a specific type of financial contract, hence there are three main sets of contracts: contracts governing the relationship between capital holders and fund managers, contracts between fund managers and investee (venture) companies, and contracts

[80] Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, 'Economic Development, Legality and the Transplant Effect' (2003) 47 European Economic Review 165-95
[81] Paul Gompers and Josh Lerner, *The Venture Capital Cycle*, (MIT Press, Cambridge, Massachusetts 2004) ch 2 (An Overview of Venture Capital Fundraising) 23; ch 3 (What Drives Venture Capital Fundraising?) 33
[82] ibid 157
[83] ibid 345 ch 3 s 3.3 for an exposition of the nature of private equity.

between fund managers and third-party acquirers of fund manager-held securities at the time of divestment. At the level of the venture company (stage II of the cycle, above), three specific sale and purchase agreements underpin the private equity 'event'.[84] They are –

(i) a share acquisition transaction;

(ii) an equity finance transaction; and

(iii) a debt finance transaction.

The research question asks in effect: at each of the key stages of the private equity cycle, what role do (or can) laws and legal institutions play in expanding fundraising, or driving demand for private equity, or creating efficient conditions for the conclusion and execution of financial contracts?[85]

At first glance – and as economists readily argue - the very design and nature of private equity as a monitoring-based financial contracting strategy would seem to discount a central role for the law and by extension its legal institutions in the emergence and expansion of the industry.[86] This argument rides on the much-flaunted ability of private equity to effectively assess investment risks through thorough pre-investment screening processes, overcome informational asymmetries, and align ownership and management interests thereby ruling out or sufficiently internalising agency risks through negotiated compensation structures embedded in the investment agreement.[87] It is upon this basis that arguments have been advanced that macroeconomic factors that drive the external environment for private

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[84] Jack S Levin, Structuring *Private Equity, Venture Capital and Entrepreneurial Transactions* (Aspen, 2011), 5-12, and for background: 1-3, 1-8, 1-10, 2-10, 4-4 and 4-68

[85] Ronald J Gilson, 'Engineering a Venture Capital Market: Lessons from the American Experience' (2003) 55 Stanford Law Review 1067-1103

[86] Michael Gorman and William Sahlman, 'What Do Venture Capitalists Do?' (1989) 4 Journal of Business Venturing 231-248

[87] From the framework of an economic conception of property rights – for instance: starting with Coase 1937 (contract theory of the firm); Alchian and Demsetz 1972 & Jensen and Meckling 1976 (incentives theory and residual claims); Klein, Crawford & Alchian 1978; Williamson 1979 (limitation of post-contract alienations); Grossman and Hart 1986, and Hart and Moore 1990 (detangling of hold-ups); Aghion and Bolton 1992 (incomplete contracts).

equity (availability of investment opportunities and exit avenues), rather than internal factors (legal factors such as systems for contractual integrity) play a deterministic role in the occurrence and growth of private equity markets.

This thesis takes the view that an exclusivist approach to the subject's study, either economic and fiscal, or legal, would yield misguided results in an emerging market context for at least five primary reasons.

Firstly, private equity is structured as a set of financial contracts, and as such, raises issues in contract law.[88] The mere fact that lots of resources are devoted to a pre-investment discovery process that leads to the adoption of financing agreements that in some cases run into hundreds of pages suggests not only the critical importance of pre-investment covenants, but also the importance of clarifying a logical basis for the allocation of rights and obligations. It would be folly otherwise.[89] As much, therefore, as other environmental factors such as macro-economic determinants may be important variables in a country's attractiveness to investment, the foregoing argument asserts that legal determinants could be the decisive variable, in the investment decision.

Secondly, as a monitoring-based contracting and investment strategy, the private equity financial contract is a relational contractual coalition that relies on external agencies for the resolution of contract-based disagreements – which introduces a role for dispute-

[88] To illustrate the intensely law-based private equity process, model private equity contract templates can be found at the American National Venture Capital Association website at <http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136> (current as of February 2011) accessed 17 February 2012 – These include a term sheet, a stock purchase agreement, a certificate of incorporation, investor rights agreement, voting agreement, rights of first refusal and co-sale agreement, management rights letter, indemnification agreement and legal opinions.
[89] id – the USA private equity industry is estimated to spend over USD200 million annually in pre-investment contract negotiations.

resolving institutions. These institutions include courts, but also norms of behaviour supporting positive reputations.[90]

Thirdly, by virtue of its methodology - share capital and acquisition-type investments – private equity raises issues under both corporate and securities laws.[91]

Fourthly, in an emerging context where legal and market institutions are still nascent or absent, and macroeconomic instability common, an important role arises for the law in organising market structure and behaviour.[92]

Fifthly, macroeconomic factors depend on legal instruments. Thus to achieve deep debt markets in a country, that country will rely on bank sector regulation and capital markets regulations in organising market activity, establishing trading and other rules of exchange, punishing errant behaviour – in effect, employing the law to deliver the macroeconomic effect of 'confidence' in a financial system.[93]

It can be observed that in an inter-disciplinary industry such as private equity, no one academic discipline in isolation is able to deliver a definitive model for growth. Nonetheless, this thesis argues that legal and institutional factors are likely to wield a stronger influence than the other competing explanations to the emergence and growth of private equity in developing countries like Kenya.

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[90] Eric A. Posner, 'A Theory of Contract Law under Conditions of Radical Judicial Error' (August 1999) University of Chicago Law School, John M. Olin Law & Economics Working Paper 80 <http://ssrn.com/abstract=173788> accessed 23 October 2007.

[91] Luc Renneboog, and Tomas Simons (2005), 'Public-to-private transactions: LBOs, MBOs, MBIs, and IBOs,' Finance Working Paper 94/2005 European Corporate Governance Institute.

[92] Douglass C North, 'Institutions' (1991) 5(1) Journal of Economic Perspectives 97-112

[93] Joseph J Norton, Taking Stock of the First Generation of Financial Sector Legal Reform, (2007) SMU Dedman School of Law Legal Studies Research Paper 9, 32 <http://ssrn.com/abstract=981226> accessed 28 October 2011; cf: JJ Norton, 'Financial Sector Reform and International Financial Crises: The Legal Challenges' (1998) 16 Essays in International Financial Economic Law; Davide Lombardo and Marco Pagano, *Law and Equity Markets: A Simple Convergence and Diversity of Corporate Governance Regimes and Capital Markets,* J. McCahery, P. Moerland, T. Raaijmakers, L. Renneboog (eds.) (Oxford University Press, 2002)

The foregoing themes are central to this inquiry for two reasons. Firstly, economic,[94] financial economists[95] and legal[96] scholars have and continue to clash over attempts to answer the main question in this study, with the former two pointing to macroeconomic factors as the deterministic elements, while the latter holds up the defining role of the law and legal institutions in facilitating private transactions. All disciplines lend forceful and persuasive arguments in support of the divergent views. Secondly, for Kenya, which is seeking to unlock channels for financing its private sector in an effort to catalyse economic development, and given private equity's promising emergence in Kenya, modelling approaches could not be more confusing and uncertain.[97] This is thus an important question from both academic and practical perspectives.

1.2.4 The Secondary Questions

To fully explore the variables to the research themes outlined above, the following secondary questions appear pertinent to the totality of this inquiry:

- Firstly, if the law is relevant, whether it plays a deterministic or supporting role.
- Secondly, if relevant, in what ways it is so.

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[94] Alexander I. J. Dyck and Luigi Zingales, Private Benefits of Control: An International Comparison (2002) CEPR Discussion Paper 3177 <SSRN: <http://ssrn.com/abstract=301200> accessed 28 October 2011 – the argument is that legal institutions do not exert a first-order impact in financial development: key questions in this thinking include whether investor protection is relevant to financial development in the first place, and whether the law is relevant to private contracting, economic development, corporate finance or even the growth and expansion of the private sector.

[95] Raghuram G Rajan and Luigi Zingales, 'Financial Dependence and Growth' (1998) 88 American Economic Review 559 - 586, and Asli Demirguc-Kunt and Vojislav Maksimovic, 'Law, Finance and Firm Growth' (1998) 53 Journal of Finance 2107 - 2137 – financial institutions crucial for company and industrialisation.

[96] Rafael La Porta, Lopez des Silanes, Andrei Shleifer and Robert Vishny (LLSV) 'Determinants of External Finance' (1997) 52 Journal of finance 1131 - 50; LLSV, 'Law and Finance' (1998) 106 Journal of Political Economy 1113 - 55; LLSV, 'Investor Protection and Corporate Governance' (2000a) 58 Journal of Financial Economy 3 - 27.

[97] Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, 'Economic Development, Legality and the Transplant Effect' (2003) 47 European Economic Review 165-95.

- Thirdly, which strands of the law are particularly important in delivering the desired public policy objective of developing an efficient market for enterprise finance generally, and private equity in particular?
- More generally, does the state of economic development influence the extent to which the law becomes an effective tool in designing and growing markets for enterprise capital? To varying degrees, a sub-issue is whether it is defensible to argue that the state of the law and legal institutions can and does constitute a sufficient and necessary condition for the emergence of strong markets for private equity in an emerging market.[98]

In exploring the role of the law in financial market development, particularly where alternative investment segments like private equity are concerned, the notion of 'investment risk' serves a useful purpose. Emerging markets are developing country markets, and these markets carry investment risk, driven by a combination of contracting and regulatory risks. 'Risk' is a term employed in this work to refer to uncertainties associated with the making of private equity investments – and they occur at each cycle of private equity: fundraising, investment and divestment. Each cycle, it has been shown, is rooted in a financial contract, which occurs amidst a charged space of varying risks. These types of risks could include but are not limited to the following examples:

(i) *at the fundraising phase*, risks whether fund managers are adequately skilled to select good corporate candidates to invest in; whether the investments will succeed in the long term; whether government policy with respect to specific

[98] But see: Benjamin Powell, *Making Poor Nations Rich, Entrepreneurship and the Process of Economic Development* (Stanford University Press, 2007) Foreword and ch.1: there are unsettled questions whether institutions per se cause growth, or whether the human capital within institutions, operating within boundaries of appropriate conduct clearly defined by laws and market practice, bring about economic growth. More confusingly, it is unsettled whether causation is uni-directional, bi-directional or iterative: that is, from institutions to economic growth, or economic growth to stronger institutions, or in an iterative, continuous, mutually-reinforcing basis.

investment sectors hold constant for the duration of the investment; whether the state of money markets in a jurisdiction allow the necessary bank facilities to be put in place to complete private equity investments;[99]

(ii) *at the investment stage*, whether target investment companies tell the whole truth with respect to the financial and legal condition of the company's business, whether owners and managers of the business will operate in a manner that promotes the interests of the private equity investors, whether and how tax law treats specialised compensation structures such as stock options, whether courts will enforce financial contracts should the need arise, whether regulatory requirements relating to the practice of private equity changes during the course of the investment;[100]

(iii) *at the divestment stage*, whether a profitable exit opportunity and route is available, whether capital gains are subject to tax and how tax law treats capital gains, whether taxation laws allow for the avoidance of double taxation, whether mergers and acquisition regulations as well as securities regulations as they relate to share transfers will permit desired exit strategies, whether certain types of exit strategies embody undesirable features such as possible investor lock-ins in stock market exits, as well as whether the law generally changes during the course of the investment in a manner that negatively impacts an investment's planned exit strategy.[101]

'Risk' is thus a dynamic concept in financial investing embodying –

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[99] Gompers and Lerner, *The Venture Capital Cycle* (2004) (n 81)
[100] Rafael Repullo and Javier Suarez, 'Venture Capital Finance: A Security Design Approach' (2004) 8 *Review of Finance* 75-108.
[101] Stephen Kaplan, Johan Per Stromberg, 'Financial Contracting Theory Meets the Real World: An empirical analysis of venture capital contracts' (2002) 18 *Review of Economic Studies*38-67.

- *Contracting Risk* – a risk that the disclosures and representations that inform the contracting decision are untruthful;
- *Commercial Risk* – a risk that the company invested in fails to perform because of a product that fails to succeed in the market or because some exigent market development introduces product failure;
- *Regulatory Risk* – a risk that the law changes in a manner not anticipated under contract, rendering the purpose of the contract unattainable or increasing the business costs associated with its attainment beyond the economic value of the venture;
- *Foreign Exchange Risk* – a risk that economic fundamentals in an investment host country fail, triggering capital flight, or a financial crash in the markets, introducing foreign exchange volatilities, leading to radical changes in investment valuations;
- *Political Risk* – a risk that in-country governance upheavals lead to social and economic instability, the introduction of radical shifts in policy especially where foreign-held investments are concerned (including the risk of expropriation).

Private equity, as an economic activity, is not immune to these permutations to investment 'risk', and risk management forms a critical part of the private equity investment design. It is interesting to explore how the various laws and the legal institutions compound or ameliorate these myriad risks within an emerging market context.

These secondary themes are probed to varying degrees to aid in the clearer understanding of the themes flowing from the main research question.

1.3 Why is a study of private equity important to Kenya?

Private equity, as a source of business finance and investment know-how, supports creative entrepreneurship. Entrepreneurship is the process by which firms are born and others phased out - new ideas emerge as old ones die off: a process termed 'creative destruction'.[102] Entrepreneurs are business people that seek to generate value through the creation or expansion of some economic activity, by identifying and exploiting new products, processes and markets.[103] Schumpeter (1934)[104] and Baumol (2008)[105] define entrepreneurial activity in terms that closely match the impact of private equity: the introduction of new goods; introduction of new production methods; opening of new markets; establishing new supply sources; or carrying out the new organisation of an industry. In this sense, entrepreneurship is a fundamental catalyst to economic growth.[106]

Kenya's public policy has not always matched the policy-recognition of the importance of entrepreneurship to economic growth with commensurate public policy measures that translate such recognition into market practice. Development research illustrates that the historical mismatch between academic and policy recognition of that role is increasingly being bridged, as governments across the world give closer attention to the determinants of entrepreneurship.[107] Three main elements are said to drive entrepreneurship: *determining factors* (regulation, culture, market conditions, skills, research and development and access to finance); *performance measures* (firm-based and employment-based indicators); and *impact* (job creation, economic growth and poverty reduction).[108] It is interesting to

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[102] Powell, *Making Nations Rich* (2007) (n 98) 1, 79, 112.
[103] ibid
[104] Joseph A Schumpeter, The Theory of Economic Development: an inquiry into profits, capital, credit, interest and business cycle (Transaction Publishers, 1982 reprint), ch 1
[105] William J Baumol and Robert Strom, 'Entrepreneurship and Economic Growth' (2007) 1(3-4) Strategic Entrepreneurship Journal 233-237
[106] Powell, *Making Nations Rich* (2008) (n 98) 112
[107] OECD, 'Measuring Entrepreneurship – A Digest of Indicators' (2008) OECD – *Eurostat Entrepreneurship Indicators Programme*, 5, 6 <http://www.oecd.org/dataoecd/53/23/41664409.pdf> accessed 15 December 2008 - These indicators canvass a wide range of sub-themes: levels of expenditure on research and development as a proxy for the creation and diffusion of knowledge; collaboration on innovation – for the joint development of products, processes and networks, as well as linkages between large and small companies within an economy; ease of access to loans – especially against the strength of a business plan without collateral (debt; equity); population size, and education levels; ease of doing business (including clear and enforceable regulatory framework, supported by property rights, dispute resolution institutions and protection of contractual partners; and efficiency of the tax system as an important regulatory tool.
[108] ibid

observe that the determinants of entrepreneurship are closely associated thematically to the four factors said to drive the emergence and growth of private equity – discussed earlier in this chapter.

Kenyan public policy since 2003 is increasingly emphasising the instrumental role of Kenya's private sector in driving sustainable economic development, job and wealth creation.[109] The leading policy statements on point are: the *Economic Recovery Strategy* (henceforth ERS) of 2003-2007, *Vision 2030* of 2007(henceforth Vision 2030),[110] the *Private Sector Development Strategy* (henceforth PSDS) 2006-2012,[111] and the *Master Plan Study for Kenya's Industrial Development* (henceforth MAPSKID) 2007.[112] This recognition mirrors global practice, reinforced by recent and ongoing governmental reactions to the 'Great Recession' – the banking crisis of 2007-2008 – which saw governments around the world directly channelling huge amounts of public funds into private businesses to stem a drawn-out recession.[113]

The government is matching these policy pronouncements with specific programmes such as allocating funds to a Youth Development Fund, Kazi kwa Vijana, Small and Micro-Enterprise Fund, Women Enterprise Fund, Kenya Youth Empowerment Project and the wider economic stimulus programme under implementation since 2008.[114] It is also continuously

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[109] Government of Kenya, Budget Statement for Fiscal Year 2011 2012, (Uhuru Muigai Kenyatta, Minister for Finance & Deputy Prime Minister, 8 June 2011), paras 10, 19, 22, 35 – focusing on tax and business regulatory reforms <http://www.treasury.go.ke/index.php?option=com_docman&task=cat_view&gid=110&Itemid=86> accessed 23 January 2012

[110] Government of Kenya, 'Vision 2030' <http://www.vision2030.go.ke/index.php/front/vision> accessed August 2007.

[111] Republic of Kenya, Private Sector Development Website <http://www.psds.go.ke/index.php?option=com_content&task=view&id=28&Itemid=32> accessed 8 January 2008

[112] Republic of Kenya, Ministry of Industrialisation (2011) <http://www.industrialization.go.ke/index.php?option=com_content&view=article&id=164:mapskid&catid=59:downloads&Itemid=131> accessed 21 October 2011

[113] Masaaki Shirakawa, 'The International Policy Response to Financial Crises' (2009) <http://www.kansascityfed.org/publicat/sympos/2009/papers/Shirakawa.08.24.09.pdf> accessed 18 October 2011

[114] Government of Kenya, Budget Statement, 2011/2012 (n 109) paras.10, 19, 22.

reforming the business environment including through introducing the Single Business Permit (SBP) initiative (funded by DfID in 2000) that collapsed 16 business licenses into a SBP.[115] While laudable, the persisting fragmentation of the business licensing regime, driven by statutory requirements under the Local Government Act of 1963, mean that if a business operator wishes to establish business operations in more than one local authority, they would be required to seek and obtain separate SBPs for each locality.[116] The government has since 2003 phased out over 1,300 business licenses that added immense cost and opacity to business set-up in Kenya, and since 2006, has adopted a 'guillotine' strategy by which inefficient and unnecessary business regulations and permits are phased out through the annual budget process – arguably a more efficient strategy for dealing with an overly-bureaucratic regulatory system.[117]

It is also widely recognised that Kenya's private sector, like others around the world, has experienced a long-standing funding gap.[118] The PSDS recounts the numerous structural inefficiencies private businesses face in Kenya including a narrow formal economy, a large informal economy, a lack of access to credit and related financial services, a festering system of regulatory arbitrage, and disconnects between small and large entities within the economy.[119] On the difficulties surrounding access to finance, the constraints include limited access to bank credit, prohibitive collateral requirements, a narrow range of financial products, and limited financial services for small and medium enterprises.[120] Private equity is not a panacea to these myriad development issues: it is merely a part solution to a much larger problem, and other programmes are necessary to bring about sustainable development.

115 Kituyi, 'Improving the Investment Climate' (2005) (n 3) 2,3
116 Cap 265, ss163, 163A, 164, 165 and 166
117 Kituyi, Improving Investment Climate (2005) (n 3) 4-6
118 World Bank, IFC, Financial Investment and Advisory Service, 'Review of Administrative Barriers to Investment in Kenya' (2004) <http://www.ifc.org/IFCext/fias.nsf/..../> - the study found that among others, access to finance remained a challenge.
119 Government of Kenya, 'PSDS 2006-2010' (Ministry of Trade and Industry) 16-18 http://www.psds.go.ke/images/stories/psds.pdf accessed 12 January 2012
120 Investment Climate Action Plan (2005)

The question of increasing the supply of creative capital remains a long-standing agenda, however. For instance, in 2005, the Ministry of Trade, with World Bank support, launched the Micro Small and Medium Enterprise (MSMEs) Competitiveness Project to promote the flow of capital to MSMEs, as well as the provision of institutional and capacity building programmes for these businesses.[121] Improvements to the business environment, training of businesses in enterprise skills, and building market linkages were additional objectives.[122] Financial deepening involved the establishment of a Financial Sector Deepening Trust to pilot a range of financial services and products tailored to the needs of MSMEs. The programme additionally involved a MSME Risk Capital component – which was aimed at pioneering a new range of risk capital instruments including mixed debt and equity finance, and related variants.[123]

The cited studies and policy pronouncements underscore government's growing recognition of the sense of urgency surrounding the need to create structures that enable the private sector to flourish – and one such response is expanding access to finance and related services. These studies also show that a recurrent theme is not just a lack of access to adequate amounts of business finance, but specifically access to appropriate types of business finance. The needs of Kenya's small and microenterprise entities (SMEs)[124] are particularly acute, as chapter four elaborates.[125] Some of the policy responses since 2005 propose solutions that strikingly mirror the private equity contracting strategy, as the preceding paragraph clearly outlines.

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[121] Kituyi, Improving Investment Climate (2005) (n 3) 3
[122] This theme was recognised in the form of 'Measure 6', in the 'Blue Book on Investment Best Practice in Investment Promotion and Facilitation – for Kenya' (2005), developed under UNCTAD's technical assistance: <http://www.unctad.org >
[123] ibid 3
[124] The Capital Markets (Registered Venture Capital Companies) Regulations 2007, section 2, defines a small and micro-enterprise (SME) to mean 'any business whose annual turnover does not exceed Kenya shillings five hundred million' - the vast majority of the Kenyan private corporate sector falls within this financial bracket.
[125] Ch 4, 129-131

If Kenya is to achieve economic prosperity through its private sector, access to innovative business finance must be expanded, not incrementally, but exponentially. This work argues that private equity offers a potential part-solution to this need, justifying an exploration of legal and institutional factors that can support its emergence as a significant segment of a country's financial system.

1.4 Scope of Study

1.4.1 Legal and Institutional Elements

In this study, 'laws' mean actual statutory instruments and legislative provisions in Kenya addressed to the subject under investigation – 'private equity'. To answer the question whether law is relevant, either as a determining or partly influential factor, in the emergence of private equity markets in developing countries, this study explores five key themes with respect to Kenyan private equity:

(i) laws and institutions for private contracting;

(ii) laws and institutions for financial transparency;

(iii) laws and institutions for securities dealings;

(iv) laws and institutions for corporate activity; and

(v) laws and institutions for the taxation of investment activity.

By 'institutions' are meant not just the Kenyan regulators (or implementing agencies tasked with the administration of the law), but also legal institutions in the sense in which

North[126] employs the term, that is to say, entrenched standards of conduct across disparate economic spheres, and in this study, they include –

(i) the institution of property rights security;

(ii) the institution of contract integrity;

(iii) the institution of financial reporting.

The study's empirical chapters (introduced below) are devoted to an investigation of the issues set out above. To effectively achieve the study objectives, it was deemed necessary to adopt a methodology that brought the researcher into direct contact with the key subjects of study. The actual empirical approach undertaken is fully reported in chapter two of this work.

Financial contracting is adopted as a linking theme throughout the thesis on the basis that, as already alluded earlier in this chapter, private equity occurs a set of financial contracts. As Cumming and Johan put it, "financial contracting is not just what private equity and venture capitalists do; it is in essence what they are."[127] In addition, all the themes investigated in this work are analysed from an empirical law and finance perspective, with financial contracting as a key prism through which findings are ascribed meaning.

This work adopts a law and policy orientation, which choice was consciously made given the fact that it is in many respects the pioneering academic work in this area for the study economy. This choice is furthermore driven by the intrinsic nature of the primary research question.

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[126] North, 'Institutions' (1991) (n 92)
[127] Cumming and Johan, Venture Capital and Private Equity Contracting (2009) (n 1) ix

1.4.2 Originality and Contribution to Knowledge

Originality in this work is firmly embedded in the empirical chapters – chapters four through eight. The general law in Kenya is evaluated in light of both the traditional methods of legal inquiry (statutory and case law analysis) and the voices of a broad range of research participants engaged in the primary data collection stages of this study. Chapter two reports fully on the empirical method and process.

This work is also original in the sense that it is the first comprehensive study of Kenyan private equity. As a contribution to knowledge, therefore, this study extends the frontiers of what we know about African private equity in particular, and more broadly, what we know about emerging market private equity. It brings together the regulatory and statutory experience of private equity in Kenya, permitting the comparison of how the various pieces of legislations and regulations fit together, where inconsistencies in the law exist, where practice is incongruent with the law, where the law is vague or silent, and how private equity intermediaries have related with the laws and institutions supporting their business. As such, this study serves as a baseline for future academic endeavour – and future extensions will find a coherent basis upon which to extrapolate.

1.4.3 Why Kenya is Selected as a Case Study

To answer the research themes set out in the preceding sections, it is necessary to interrogate the relationship between the law and the strength and structure of the private equity industry within a defined legal system. Such a legal system, for purposes of this inquiry, needs to have an existing and active private equity industry, and varying levels of market imperfections (institutional, regulatory and macroeconomic). Under these conditions, it is easier to isolate elements in public policy that can have an immediate impact in the observed behaviour of private equity industry – hence the choice of Kenya as an 'emerging market' means Kenya is an appropriate jurisdiction as a case study for private equity research in emerging market contexts ('emerging markets' defined under section 1.5).

Kenya, an African developing country, answers neatly to Pereiro's typology of an emerging market. It had a per capita income of $780 in 2010 – falling within the World Bank definition of a 'low income economy'.[128] IMF's financial access survey for Kenya confirms the under-developed financial infrastructure in the country,[129] illustrating the widespread institutional and regulatory challenges facing Kenya – answering to an 'emerging market' typology.

Kenya, as it was shown in the opening pages of this chapter, is also one of the countries in Sub-Saharan Africa where private equity has taken root. African trends in private equity investing show that there are primarily four regions of concentrated private equity activity: Southern Africa (with South Africa as the leading destination of all private equity investments in Africa), West Africa (with Nigeria being the lead destination), East Africa (with Kenya being the lead destination), and North Africa (which is lumped with the Middle East in industry surveys).[130] This means that in Kenya, there is a reasonable number of private equity intermediaries (fund managers and advisors, as well as investors) that can support an empirical enquiry on all research questions raised earlier.

Furthermore, the basic elements constituting the necessary financial infrastructure onto which private equity could anchor also exist in Kenya. Kenya has a well-developed banking sector, a wide mix of financial service providers, as well as a functional public equities market that has three investment segments: the main investments segment, the

[128] World Bank Group, Kenya Country Data (2011) <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/KENYAEXTN/.../> - mirror's IMF Country Classifications for Kenya. A deeper discussion on these features is provided in chapter 4.
[129] IMF Financial Access Survey (2009) (n 3) 2-3
[130] EMPEA (n 65)

alternative investment segment, and the securities investments segment.[131] Kenyan law and financial management policies have given rise to other specialised financial regulators including independent pensions and insurance regulators, both creatures of statute. With these antecedents, Kenya provides sufficient depth of experience to support an inquiry of the scale herein.

From a juridical perspective, Kenya has a defined regulatory framework for private investment, a judicial structure, and a well-developed contract law system. Jurisprudential peculiarities lend an opportunity for insights into how adaptive private equity finance is to national legal and institutional environments.

These conditions render Kenya a good choice for an in-depth case study on the interactions between law and financial development, employing private equity as a case study. Besides contributing fundamentally to deepening existing work on Kenya from a financial reform perspective, this study directly expands the depth of law and finance literature available on the state of private equity in Kenya, and, indirectly, in Africa.

With the foregoing broad issues in mind, the next section explores the key terminology used recurrently across this work. Owing to private equity's different manifestation in different jurisdictions, the term can mean different things, and not defining it introduces an element of uncertainty over what specific classes of private equity this work dwells on. 'Emerging markets' for private equity purposes also raise specific issues that a definition would serve well to clarify. Similarly, the notion of 'risk' deserves clarification and delimitation for purposes of the inquiry. All of these issues are explored in the next section.

[131] Ch 4 explores the structure of Kenya's financial system, ch 110

1.5 Key Terms

'Private equity' comes in many flavours, types and styles, and it can mean different things in different jurisdictions.[132] Generally, there are two principal ways of looking at private equity – either as the type of finance (transaction type) or the type of company it is invested in (stage of investment).[133] Below, a 'jargon buster' is provided to demystify the different types of private equity transactions as they have occurred around the world, and as they have been used in Africa's emerging markets. A specific introduction to the terminology used under Kenyan law is provided as well.

1.5.1 Venture Capital

Webster's dictionary defines 'venture capital' as "money invested in stocks, especially in new or expanding enterprises, with the expectation of repayment in profits and dividends but subject to the hazards of ownership – as distinguished from capital loaned by banks." It is also called 'equity capital.' 'Venture' is defined in the Random House Dictionary of English Language (1966 ed.) as 'a business enterprise or speculation in which loss is risked in the hope of profits; a commercial or other speculation.'

The terms 'private equity' and 'venture capital' have been used almost interchangeably across legal jurisdictions, giving rise to some measure of confusion over the distinctions between the two. In the USA, the term 'venture capital' has historically had a distinct meaning, and has been used to refer to private equity investments in younger growing companies, and especially companies that are technology-led.[134] The term 'private equity' in the USA has, in contrast, been reserved for private equity investments in mature businesses,

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[132] Geoff Yates, and Mike Hinchliffe, *A Practical Guide to Private Equity Transactions* (Cambridge University Press, 2010) 2
[133] Levin, *Structuring Entrepreneurial Transactions* (2011) (n 84) ch 2.
[134] Levin, *Structuring Entrepreneurial Transactions* (2011) (n 84) 2-7, 1-8

and notably to define transactions that employ substantial debt in completing the acquisition.[135]

In the UK, the two terms ‘venture capital’ and ‘private equity’ were used loosely and virtually interchangeably until as recently as 2006, when the leveraged buyout boom skyrocketed in the UK, and industry practitioners started distinguishing between the two terms, reserving ‘venture capital’ as reference to investments in less mature businesses in the technology, biotechnology and life science fields (healthcare and pharmaceuticals).[136] The British national association for private equity is until now referred to as the ‘BVCA’ – the ‘British Venture Capital Association’.[137]

Under Kenyan law, there is no distinction between private equity and venture capital.[138] Industry practitioners, on the other hand, like to refer to their business as ‘private equity’, perhaps taking a cue from the position of the African Venture Capital Association, which refers to all forms of private equity occurring in Africa as ‘private equity’.[139] All fund managers interviewed in the course of this study referred to their businesses as ‘private equity’, in spite of terminology under the law.

Under Section 2 of the Capital Markets (Registered Venture Capital Companies) Regulations of 2007, Laws of Kenya, [140] the following types of venture capital are contemplated.

[135] Levin 2011 (n 84) 1-3, 1-9
[136] Yates and Hinchliffe 2010 (n 132) 4
[137] British Venture Capital Association < http://www.bvca.co.uk.> accessed 23 July 2010
[138] R 2, The Capital Markets (Registered Venture Capital Companies) Regulations, 2007, Legal Notice No.183 of 2007
[139] Africa Venture Capital Association 2005 Yearbook < http://www.avcanet.com > accessed 23 July 2010
[140] Capital Markets Act, s 12, Cap 485A, of 1990, Laws of Kenya.

(i) *Seed capital* – defined as financing targeted at research, assessment and development of initial concepts, prototypes for product development and initial marketing;[141]

(ii) *Start-up financing* – defined as financing to aid in commencing operations, production or concept/prototype implementation;[142]

(iii) *Mid-stage financing* – defined as investment to provide working capital or capital expenditure in the commercialisation process, or additional capital injections to increase production capacity, marketing or product development, and funding in aid of the listing (or going-public) process;[143]

(iv) *Subsidiary financing* – defined to mean financing for trade sale transactions that provide investment exits to venture capital funds.[144]

It is significant that Kenyan law does not make reference to buyout transactions directly – and in practice, the regulatory recognition of 'subsidiary financing' has been adopted as a veiled reference to the buyout segment of local private equity transactions. As Part III of the thesis discusses, various regulatory factors constrain the emergence of a full-blown buyout segment to local private equity deals in Kenya.

1.5.2 Growth Capital

Growth capital is a term used to refer to investments in relatively mature companies that are looking to grow or expand their businesses.[145] Under Kenyan definition, this would

[141] Capital Markets (Registered Venture Capital Companies) Regulations 2007, R 2
[142] ibid
[143] ibid
[144] ibid
[145] Yates & Hinchliffe 2010 (n 132) 4

equate well with what the law terms 'mid-stage financing'.[146] In the global scene, another term that refers to roughly the same type of private equity funding is 'development capital', a term not frequently met in Kenyan usage.

Growth capital is also frequently applied to the restructuring of capital structures especially where earlier transactions saddled the company with too much debt. Business growth or expansion can frequently offer existing shareholders an avenue for unlocking a cash value in their stockholding – so growth capital can frequently be employed to achieve investment exits to varying levels – either fully or partially by way of share liquidation for a cash benefit.[147] Finally, this type of private equity can also be used in an investment strategy known as "buy and build" – a process whereby private equity investors support management teams in companies they target to carry out buy-in or buyouts - also known as Management Buy-Ins (MBI) and Management Buyouts (MBO). This can be understood as a series of corporate acquisitions aimed at consolidating a specific market segment.[148] MBOs and MBIs are not common in Kenya yet, as chapter 5 (pp.190) demonstrates.

1.5.3 Management Buyouts (MBOs) and Management Buy-ins (MBIs)

An MBO occurs when a company's incumbent management acquires the company with the support of private equity financing. Prior to the buyout transaction, the management may either hold a minority ownership in the company, or it may have no shareholding at all.[149] Buyout transactions are driven by corporate restructuring needs – either because large

[146] Capital Markets (Registered Venture Capital Companies) Regulations 2007, R 2.
[147] Yates and Hinchliffe 2010 (n 132) 5
[148] Yates and Hinchliffe 2010 (n 132) 5
[149] Yates and Hinchliffe 2010 (n 132) 2

corporations seek asset disposal to unlock some value, or when they want to specialise through the sale of non-core subsidiaries and corporate divisions.[150]

An MBI is identical in transactional process to an MBO, save for the fact that in the former, the management team has not previously been involved in the management of the target company.[151] In other words, an MBI enables a team of outsiders to take over the management of a target company.

1.5.4 Leveraged Buyouts (LBOs)

LBOs are buyout transactions that employ a large proportion of debt in the structure of the acquisition finance.[152] This transactional structure was popularised in the 1980s LBO decade, and in the period between 2005 and 2007, when some of the largest private equity transactions occurred in Europe.[153] The LBO transaction is the most popular and well-known face of the buyout market, and the one that has also attracted significant public opposition around the world.[154]

1.5.5 Institutional Buyout (IBOs)

This buyout market is identical in virtually all respects with the LBO transaction, except that unlike in the LBO process where management takes the lead in structuring the

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[150] Levin, 2011(n 84) 1-9; ch 5

[151] Yates and Hinchliffe 2010 (n 132) 3

[152] US Government Accountability Office, Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention (GAO-08-885, 2008) <http://www.gao.gov/new.items/d08885.pdf > accessed 21 October 2011.

[153] Patrick A Gaughan, *Mergers, Acquisitions and Corporate Restructurings* (John Wiley & Sons, 5th edn, 2011) 298

[154] GAO, 2008 (n 152) 16-19

investment opportunity, it is the institutional private equity investor that takes the lead in structuring the IBO deal.

1.5.6 Secondary Buyouts (SBOs)

This term is used to refer to buyout transactions that involve the sale of a company's shares from one private equity investor to new private equity investors without winding down the investment in the company. The same term is used when a 'special purpose vehicle' employed in the completion of an investment (as the investment holding entity) is transferred through share dispositions.[155]

Secondary buyouts are not very common in Kenyan private equity practice. The private equity secondary market is expanding, and is increasingly attracting investors from outside its traditional investor base.[156]

1.5.7 PE for Infrastructure

Infrastructure assets relate to essential community services, represent natural monopolies and strategic competitive advantage, and have reasonably predictable and long-term cash flows. They also have a high fixed capital base with comparatively low operating costs - on average of between 10% and 30% of revenue. Along with the long-term operating

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[155] British Venture Capital Association, 'A Guide to Private Equity' 17 < http://admin.bvca.co.uk//library/documents/Guide_to_PE_2010.pdf> accessed 23 January 2012

[156] Preqin, 'Secondary Market Activity in 2011 (Preqin, 17 February 2011) <http://www.preqin.com/blog/101/3459/secondary-market-activity-2011> accessed 26 October 2011 - Secondary buyouts are facilitated by secondary funds. These funds specialize in buying out primary private equity funds, affording investors early exits from funds. All shares in a fund can be bought out where both managers and investors agree to the transaction. They can also buy portfolios of primary funds. These transactions offer primary investors an arbitrage between quicker cash flows and a discount to immediate portfolio value.

licence and predictable demand, often in a regulated environment, this allows the manager to forecast cash flows with accuracy.

Private equity funds for infrastructure[157] have increasingly gained currency in recent years.[158] These funds are specialized investment vehicles through which institutional investors achieve exposure to infrastructure assets. . Infrastructure funds finance projects such as airports, sea ports, toll-roads, railroads, and utilities such as water, electricity and gas. Infrastructure assets are not elastic to equity markets, and can represent valuable diversification in an investment portfolio for pension funds and other institutional investors with long-dated liabilities because of its comparatively stable, long-term and inflation protected returns.

1.5.8 Real Estate Private Equity

Private equity has forayed into real estate investing through a specialised investment vehicle called the Real Estate Investment Trust (REIT). REITs enable the pooling of investment capital targeted at estate and other housing development projects, and can be particularly instrumental in the provision of housing needs, urban development and related programmes.[159] REITs, with cash-flows structured around either leases or recurrent investment receivables, promise liquidity with growth protection, which real estate property offers. The uniqueness of medium-term predictability in property income streams reduces

[157] Preqin, '2011 Preqin Global Infrastructure Report' (Preqin, 2011) <http://www.preqin.com/item/2011-preqin-global-infrastructure-report/4/3364#DescriptionLong> accessed 25 October 2011.

[158] Jason Kelly and Jonathan Keehner, 'KKR Fund Tripped Up as Infrastructure Challenges Private Equity' (Bloomberg, 4 March 2010) < http://www.bloomberg.com/apps/news?pid=newsarchive&sid=azDCuFomQ47A> accessed 25 October 2011

[159] Government of Kenya, Budget Statement 2011/2012 (n 109) para.135

volatility in earnings, making REITs a predictable type of investment. Predictability of earnings protects against inflationary pressures.[160]

1.5.9 Distressed, Turnaround and Special Situations PE

Distressed private equity refers to private equity investments dedicated to investments in companies that are experiencing financial distress.[161] For instance, a common feature is the acquisition of distressed debt securities in the hope they appreciate in economic value over time, or as a strategy to acquire control of the entity. Turnaround investments refer to private equity financing made into businesses experiencing commercial difficulties. This investment is intended to 'turn around' the company into profitability, and can be employed as an avenue to gain access to corporate ownership.[162]

Special situations private equity is event-driven and exploits complex opportunities that for instance enable a fund manager to exploit pricing inefficiencies following a 'significant event' or in anticipation of one. This investment category specializes in financially distressed entities, buying out the debt portfolios in troubled investments where it believes there is a reasonable chance for a positive turnaround. At the height of the 'Great

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160 REITA, 'About REITS' (Reita, UK) < http://www.bpf.org.uk/en/reita/reits/about_reits.php> accessed 26 October 2011 - pension funds wanting stable balance sheets at maturity will find REITs an attractive asset class.

161 Preqin, 'Special Report: Distressed Private Equity' (2011) 3 <http://www.preqin.com/listResearch.aspx> accessed 23 January 2012

162 Kelly DePonte, 'Guide to Distressed Debt and Turnaround Investing: making, managing and exiting investments in distressed companies and their securities' (Private Equity International, 2007) < http://www.peimedia.com/productimages/Media/000/165/467/Sample-16.pdf> accessed 15 October 2011.

Recession', private equity made massive investments in the distressed debt market.[163] It is a substantially lucrative, but highly specialised market place.[164]

1.5.10 Mezzanine Funds

Mezzanine funds are specialized private equity funds that provide the middle finance essential in the completion of the financial engineering process of a private equity deal.[165] Mezzanine funding is structured as high-yield debt, often with warrants which allow for convertibility at exit. These types of finance are subordinated to other acquisition debt, and structurally carry a medium investment risk, reflected in the higher current return it carries. It could also comprise of bridge financing, which financing is made available on short-term bases, to be bridged out once the deal's main financing is in place. This term is also used to refer to the short-term financing provided to a company undergoing a listing process (to facilitate the listing).[166] The 'bridge-out' deal often entails substantial profits to the fund provider.

In Summary…

Confronted with the dizzying number of monikers associated with the term 'private equity', it is easy to see why Yates and Hinchliffe have described the terminology

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[163] Helia Ebrahimi, 'Private Equity Firms Rush to Distressed Debt Assets' (The Telegraph 2 December 2008) < http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/privateequity/3543216/Private-equity-firms-rush-to-distressed-debt-assets.html> accessed 26 October 2011.

[164] Ann Cullen, 'Distressed Private Equity: Spinning Hay into Gold' (2004) Harvard Business School < http://hbswk.hbs.edu/archive/3914.html> accessed 26 October 2011.

[165] Preqin, Research, 'Mezzanine Fundraising' (June 2011) <http://www.preqin.com/listResearch.aspx> accessed 23 January 2012

[166] BVCA, 'Guide to Private Equity' (February 2010) 17 <http://admin.bvca.co.uk//library/documents/Guide_to_PE_2010.pdf> accessed 23 January 2012

surrounding the practice of private equity as creating "shin and shimmer."[167] In this study, all forms of private equity are referred to generically as private equity.

1.5.11 'Emerging Markets'

In this inquiry, 'emerging markets' is a term used to describe countries and regions of the world where the practice of private equity (in its three phases) is still nascent and growing. According to EMPEA, there are seven geographical regions classified as emerging markets for private equity: Latin America; Central, Eastern Europe and Russia; China; Asia; India; Africa; and Middle East and North Africa.[168]

What are the defining features of an 'emerging market'?

An emerging market, according to Louis Pereiro[169] is any economy that is still developing. Key features of such an economy include emerging technologies, emerging capital markets, and emerging firms. In terms of structure, such a market frequently suffers various market imperfections including barriers to entry, intrusive and often volatile regulations, political risk, uncertain legal doctrines or institutions, agency costs, informational asymmetries occasioned from lack of transparency in financial reporting, and volatile investment returns.[170] In other words, it is an uncertain market from an investment perspective. Market uncertainty from an investor's viewpoint could mean financial uncertainty (risk the investment will fail), opaqueness (steep monitoring and due diligence

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[167] Yates and Hinchliffe (2010) (n 132) 2
[168] EMPEA, 'EMPE Fundraising and Investment Review' (*EMPEA* 2010) < http://www.empea.net/Main-Menu-Category/EMPEA-Research/Fundraising-Review.aspx> accessed 15 October 2011.
[169] Louis E. Pereiro, *Valuation of Companies in Emerging Markets: A Practical Approach* (John Wiley & Sons, New York, 2002) 3, 4
[170] ibid

costs, raising transaction costs), and insecurity (property and contractual rights will not be secure). Arkelof defined such a country as “a market of lemons”.[171]

1.6 Structure of the Thesis

The question of private equity, this thesis introduction has shown, is an important one, especially for a country like Kenya that stands in continued need for more creative methods of financing its private sector. The tensions between economists and lawyers over the determinants of private equity markets in the developing world were explored, yielding the proposition underlying the main research question, summed up in the thesis statement. Being a contested claim, this chapter has laid the framework for an evaluation of the reality of the Kenyan private equity experience, enabling an eventual deduction of lessons that can inform future efforts to strengthen the framework for private equity in Kenya.

Having clarified the research problem, and contextualised it within a specified economic and legal context for investigation, and having explored various underlying concepts and issues, including an exposition of the varied terminology employed in describing the problem at hand, the rest of this thesis is organised as follows.

The thesis is organised into three main parts. Part one includes chapters one to three, and these are background chapters to the study. Part two comprises chapters four through eight, and these are the empirical chapters in the study. Part three presents the study’s conclusions, implications and thoughts on further research, and includes a bibliography of references consulted in completing this work. Each chapter is now briefly introduced in the paragraphs that follow.

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[171] George A Akerlof, ‘The Market for ‘’Lemons’’: Quality Uncertainty and the Market Mechanism’ (1970) 84 (3) The Quarterly Journal of Economics 488,500

Chapter two presents the Study's methodology. This includes a discussion of the empirical design, data descriptions, the qualitative evaluation model and analytical strategy.

Chapter three is a primer on private equity, and tackles three issues: it discusses the history, the nature and the characteristics of private equity in economic development.

Chapter 4 discusses three core issues: how enterprises are financed in Kenya, whether there exist barriers to enterprise capital, and concludes with an assessment of the issues private equity financing solutions give rise to. In essence, this chapter defines the character of demand for private equity in Kenya.

Chapter 5 delves into the structure and organisation of the Kenyan private equity industry. It looks at the players, fundraising trends, fund structures, deal structures, the qualitative environment for deal making (including financial disclosure), avenues to contract enforcement and investment exits. It concludes with an assessment of the medium-term outlook for private equity in Kenya. In other words, this chapter defines the character of the 'supply' of private equity in Kenya. From that empirical review, key issues become evident on the impact of private equity on the country's legal and institutional development.

Chapter 6 analyses the legal framework for the practice of private equity in Kenya, highlighting several issues on the relationship between private equity and the law of financial markets, corporate and tax laws and policies, supporting deductions on a law reform agenda.

Chapter 7 moves the regulatory assessment into the tax law and policy framework, offering an assessment of the extent to which Kenyan law supports efficient tax-planning for private equity investments.

Chapter 8 evaluates the framework for the protection of property rights and the enforcement of contracts. It explores the systems for dispute resolution in the practice of private equity, assessing the extent to which financial contracts are secure in Kenya. Particular focus is given to the role of arbitration and litigation in financial contract management. Like the preceding empirical chapters, it is grounded in survey findings, statutory and case law analysis, and secondary documentary evidence.

Chapter 9 is a short, reflective and analytical chapter that draws learning and implications from across the study, deducing specific practice and policy implications, as well as setting out what this study means for future research.

2

RESEARCH METHODOLOGY AND EMPIRICAL DESIGN

2.1 Introduction

It was alluded in the preceding chapter that this study was orientated towards a law and policy framework, with the central theme of financial contracting weaving through each chapter.[1] To explore these issues, this study was designed as an empirical legal research, as opposed to doctrinal research. Doctrinal legal research is concerned with the letter of law, its motivations, and its practice, that is to say, an analysis of statutes, case law and regulatory practice.[2] This orientation in practice adopts a dogmatic approach.[3] The evidence in the dogmatic approach is gathered from within the law, which is seen as self-sustaining and self-consistent, as well as being accessible through legal interpretations in case law with little need to look outside the four corners of the law for textual understanding.[4]

Empirical legal research enables an understanding of how law and legal institutions operate in the wider social economic and political contexts.[5] Unlike doctrinal research, therefore, empirical legal research permits an observation of the law in society.[6] This approach employs two main methods of inquiry – quantitative and qualitative methods. Quantitative research rides on the notion of 'quantity', that is to say, the statistical recurrence of observable instances. It is the mathematical certainty – that is, the use of numbers,

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[1] ch 1, 3-19

[2] Mike McConville and Wing Hong Chui, 'Introduction and Overview' in McConville and Chui (eds), *Research Methods for Law* (Edinburgh University Press 2007) 1,15

[3] Sharon Hanson, *Legal Method, Skills and Reasoning* (3rd edn, Routledge-Cavendish 2010) - involving an identification of facts and issues to be investigated, the gathering of background information, an assignation of key words underpinning the study, an identification of the legal sources, the organisation of material, citations and completion of the analytical assessment.

[4] Ian Dobinson and Francis Johns, 'Doctrinal Legal Research and Non-Doctrinal Research' in Mike McConville and Wing Hong Chui (eds), *Research Methods for Law (*n 2) 22,45

[5] J Paul Lomio, Henrik Spang-Hanssen, and George D Wilson, *Legal Research Methods in a Modern-World*: A Course Book (3rd edn DJOF Publishing)

[6] Nuffield Inquiry on Empirical Legal Research, Law in the Real World: Improving Our Understanding of How Law Works (2006) <http://www.ucl.ac.uk/laws/socio-legal/empirical/docs/inquiry_summary.pdf> accessed 10 October 2011.

percentages and numerical values - that lends this method 'objectivity' or 'hardness'. To assure integrity of findings, quantitative methods employ statistical tools in data interpretation. Qualitative research methods, in comparison, are distinct in their dependence on 'quality', as opposed to 'quantity' – that is to say, data integrity does not depend on the sheer strength of statistical recurrence of observable instances, but on how they are interpreted using words or pictures. It is this data capture and analytics that makes the method to be criticised as 'subjective' – that is, not free from researcher bias. These distinctions are generally overstated, as the next paragraph illustrates.

In terms of tools, quantitative methods employ such instruments as surveys and questionnaires, while qualitative methods use such tools as interviews and observations. Most legal research today embeds both methodologies to varying degrees. In fact, the intrinsic character of instruments like surveys and questionnaires allow for the capture of both types of data, narrowing the distinctions between 'doctrinal' and 'non-doctrinal' legal research. These two research orientations are thus complementary, not exclusive.[7]

This chapter is devoted to an exposition of how this study was conducted. It details the methodology, and sets out the research model that guided the collection of primary data. It then describes the conceptual framework for the data and categorises data by type of impact (either institutional or legal), as well as discussing the analytical approaches applied to the data. The various limitations applying to the chosen methodology and methods are acknowledged, and distinctions made as to the rigour of the factual findings in the study.

2.2 Conceptual Reflections

In undertaking a legal inquiry, legal scholars ordinarily investigate statutes and their legislative histories on the one hand, and case law on the other hand to induce specific

[7] Dobinson and Johns 2010 (n 4)

results.[8] Comparative legal studies usually take into consideration language nuances, isolating identified formal differences where such yield similar functional ends upon interpretation.[9] Validity of results turns on the rigour of methods and tools employed, as well as on the qualitative aspects of the analytical models employed. Generalisation is not always an absolute end in qualitative work, but 'relatability' tests are central:[10] that is to say, where the principal variables and socio-legal conditions in a given study generally mirror those obtaining in a similarly placed context, the results of a qualitative piece of research could, subject to the scale of the completed work, be illuminating and influential in predicting the likelihood of similar outcomes for the unstudied but similarly placed socio-legal context.

Each method has its strengths and weaknesses. Neither is adequate in the absolute in testing competing theories.[11] This thesis is not about discovering an 'existential truth' about emerging market private equity behaviour generally, or in Kenya specifically. Rather, it seeks to understand the relationships between the identified variables (laws and institutions), and to deduce the meanings of those relationships from a policy and practice framework. Flexibility was built in to enable the assimilation of unfolding reality, and methodical approaches were adjusted as necessary.

Methodological studies have shown that designing approaches to inquiry constitutes a critical process in the conduct of any investigation, one which if ignored or poorly managed, will negatively impact successful project implementation or its value. This process is

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[8] Detlev Vagts, 'The New Wave' in Festschrift Fur Jean Nicolas Douey, Rainer Schweizer et al (eds), Comparative Company Law (2002) 595-96, 605

[9] Paul Davies, Gerard Hertiz and Klaus Hopt, 'Beyond the Anatomy, in Rienier Kraakman et al (*eds*), *The Anatomy of Corporate Law* (2004) 216-7

[10] Michael Bassey, 'Pedagogic Research: on the relative merits of search for generalization of single events' (1981) 7(1) Oxford Review of Education 73,94 <http://www.tandfonline.com/doi/abs/10.1080/0305498810070108> accessed 10 October 2011

[11] Mark J. Roe, 'Legal Origins and Modern Stock Markets' (2006) 120 Harvard Law Review 460

structured, and follows certain rules, especially when the research project has academic or policy/practice goals.[12]

Methodology selection is guided by the nature of the problem to be investigated, the study objectives, the theoretical frameworks and target data character. [13] The actual tools/instruments of inquiry are dependent on the chosen methodologies, which on their part are influenced by the researcher's theoretical perspectives. Theoretical perspectives are ultimately influenced by the researcher's individual world view of "what it means to know" (also termed 'epistemology').[14] These concepts guide in the determination of what types of knowledge are valid and adequate in any type of academic endeavour.

Epistemological stances and theoretical perspectives influence methodology design: going beyond mere choice of research tools, to questions of the kind of evidence necessary to build knowledge, where that evidence should be gathered from, and how it is to be interpreted.[15]

Quantitative methods focus on the relationships between sets of facts, while qualitative methods are more concerned with understanding human perceptions of phenomena. Qualitative approaches seek to tell the "inside view" (*ideographic*),[16] as it were, while

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[12] For some excellent reference works on research design: Judith Bell, *Doing Your Research Project: a guide for first-time researchers in education and social science* (Buckingham: 2nd edn, Oxford University Press, 1993); Abbas Tashakkori and Charles Teddlie (eds.), *Handbook of Mixed Methods in Social and Behavioural Research* (Sage Publications, 2003); Zina O'Leary, *Researching Real World Problems - A Guide to Methods of Inquiry* (Sage Publications, 2005); Carol M. Roberts, *The Dissertation Journey – A Practical and Comprehensive Guide to Planning, Writing and Defending Your Dissertation* (California: Corwin Press, Sage Publications, 2004); Jan Dul and Tony Hak, *Case Study Methodology in Business Research* (Oxford: 1st edn, Butterworth-Heinemann, Elsevier, 2008).

[13] Roberts 2004 (n 12) 109.

[14] David E Gray, *Doing Research in the Real World* (Sage Publications, 2004) 16 – epistemology is influenced by whether the researcher sees the observed experience as a static reality (the Parmedian 'unchanging reality' – c.445BC – or a dynamic world view where observed phenomena continuously changes, following Heraclitus c.475BC: 'a becoming ontology'.

[15] Gray, 2004 (n 14) 17.

[16] Roberts, 2004 (n 12) Ch 11.

quantitative methods tend to "describe" factual relationships (*nomothetic*).[17] In other words, its focus is not quantity, but the essential character of phenomena. Qualitative research is contextual, capable of telling how and why things happen as they do. Through permitting a 'human interface', this methodology allows personal viewpoints to emerge.[18] The core characteristics of qualitative research include:

- intense contact within a 'field' – or the research context;
- a desire/objective to attain an integrated understanding of the study, including the attitudes of research subjects;
- iteration – with room for continuous feedback to research field for verification;
- a desire to understand motivation to human conduct within the research context.

Unlike for the quantitative methodology, qualitative data requires the intermediate steps of data reduction and classification before analysis is undertaken. Analysis as a research process is not necessarily sequential to data collection, as happens in statistical analysis, and may happen in the process of data reduction and classification, when patterns are teased out, themes emerge, and definitive blocks of group findings emerge. It is in the context of these themes and patterns that generalizations are made possible from a qualitative perspective.[19]

As to design, qualitative research is generally constructed as a conceptual framework, where a set of variables are identified, and these are then discussed often in detailed narrative form, exposing their relationships. The study variables constitute 'intellectual bins', and effectively operate as receptacles for research findings according to variable.[20] Generating a conceptual framework effectively imposes some level of structure to a study, defining what

[17] Roberts, 2004 (n 12) 111.
[18] Gray, 2004 (n 14) 320.
[19] Generally: Roberts, 2004 (n 12) 142-146.
[20] Matthew B. Miles and Michael A. Huberman, *Qualitative Data Analysis: an expanded source book* (London & Thousand Oaks California: 2nd edn, Sage Publications 1994) 18

falls within the study parameters and what doesn't. With this sort of structure, it is possible to hypothesize the relationships between variables.[21]

With a research conceptual framework in place, it is possible to delimit the amount of data needed to be gathered to establish the aims of study. 'Serendipity' (completely unexpected 'realities') is an important exception to a structured inquiry design. Such findings may open up completely new frontiers of thought/knowledge. Allowing for serendipitous findings is important in qualitative research, which often adopts a significant inductive leverage in its processes (seen in the frequent use of semi-structured questionnaires and interview schedules, or completely unstructured interviews/survey methodology).[22]

With the forgoing conceptual issues to hand, the next section sets out the menu of tools employed to underpin the study's empirical design.

2.3 Methods

This research explores the following variables, drawing from the legal issues identified for resolution in the preceding chapter:[23]

(i) The sources of enterprise capital and constraints experienced by private companies;

(ii) The structure of the private equity industry – by type of institution, investment segment, funding structures and matters incidental and integral thereto;

(iii) The legal framework for private equity fund registration, management and investment;

[21] Pamela Baxter and Susan Jack, 'Qualitative Case Study Methodology: Study Design and Implementation for Novice Researchers' (2008) 13(4) The Qualitative Report 544, 545-6 <http://www.nova.edu/ssss/QR/QR13-4/baxter.pdf> accessed 11 October 2011.
[22] Gray, 2004 (n 14) 319.
[23] Ch 1, 5, 17, 25

(iv) The tax framework for private equity investment activity;

(v) The design of private equity financial contracts – in terms of rights distribution, the types of rights and how they are clustered in the contracts; and

(vi) Avenues and strategies for contract enforcement.

To gather evidentiary material relating to each of the variables above, therefore, the following inquiry tools were employed:

- Document analysis – including laws, policy papers, published research, newspaper reports, texts, case law analysis;
- Questionnaire survey – fully structured; and
- Interviews.

These methods are consistent with inquiry tools within the qualitative research design framework described above. Each instrument can be used either independently or in combination with other instruments.[24]

2.4 Research Model

To guide in data collection and interpretation, a simple model was adopted for the 'intellectual bins' in this study – contained within the research questions stated in chapter

[24] Interviews permit in-depth discussions around the key study variables. They also allow for the pursuit of emerging thoughts and iteration – the flexibility to revisit discussions and positions in light of expanding knowledge. Questionnaires allow wide reach, especially where the sampled populations are widely dispersed geographically. Document analysis is a non-obtrusive tool that is especially valuable when some of the variables include a study of public policy papers, legislations, published research and other information 'in the public domain'. Many qualitative studies often begin on the strength of document analysis.

one.[25] The model is informed by and closely mirrors the private equity cycle: fundraising, investment and divestment.[26] The key elements of this model are as follows.

The private equity investment cycle is depicted in three phases within the frame of a contractual coalition. In the first phase, pre-investment hurdles are overcome and investors are able to make investments into private equity (the investment contract at the fundraising phase). In the second phase, pre-contract hurdles are overcome and financial investment contracts are entered into with private companies (due diligence, related undertakings, and the financing contracts). During this phase, fears about integrity are resolved and the contractual coalition is facilitated to last the duration of the investment, usually anything up to 10 years (cash flow and control rights – the investment contract). In the third phase, benefits are paid (contractual value extracted) following successful divestment, and the contractual coalition is brought to an end (the sale agreement).

Laws and legal institutions influence and impact the occurrence, the form and the terms of the various contracts that define each phase of the private equity cycle. Laws and legal institutions might also influence the behaviour of market intermediaries during each phase of the private equity cycle. The central question is what should the foundations focus on – capacity building of relevant institutions, or strengthening supervisory bodies or the development of legislation. This model permits the acquisition of a granular understanding of the law and practice of private equity in each of its phases of occurrence in Kenya. Such an observation also permits deductions on the impact that elements found to be either present or absent in a country's legal and institutional structures have on how private equity markets grow.

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[25] Ch 1, 4
[26] Ch 1, 13

Given the tenderness of the industry, a time-series analysis of trends was not possible, not least because of data unavailability and the fact that most of the funds presently active are less than six years old, and have yet to exit a single position. Any time series analysis would be incomplete for a narrow data range. This presents an opportunity for future studies of all types (qualitative/empirical) to extend this initial work.

The research model suggests firstly that removal of structural and regulatory barriers such as improper business practices (bureaucracy, enforcement and corruption), and improvements to the business environment (regulatory efficiency and favourable public policy on taxation) can increase the quantity of private equity finance, perhaps as a proxy to increased property rights. Secondly, that financial transparency of the firm lowers the motivation for price protection, suggesting that under conditions of transparent financial contracting, 'trust' increases the quantity of property rights, and tends to motivate an expansion in the supply of private equity/venture capital. This is tested in the structured survey and interview sessions, and triangulated through the experience of differently placed subjects.

2.5 Applying Model to Data

The study's empirical strategy attempts to evaluate, with the guidance of the foregoing model, the impact of alternative policies on the quality and quantity of private equity/venture capital. Three broad types of policies are considered for this purpose.

Firstly, policies that determine the entry of private equity/venture capital into a legal jurisdiction. In this category are included fit and proper requirements for setting up a private equity business, the quality of financial reporting (to understand reading costs and covenants in private equity financial contracts).

Secondly, policies that determine the strength of property rights (investment protection; contract enforcement).

Thirdly, policies that affect returns either directly or indirectly. Policies with a direct impact include taxation of capital gains, treatment of stock options, dividend regulations, regulations relating to access to public equity markets for entrepreneurial firms, as well as policies related to research and development. Policies with an indirect impact on returns include policies that create/reduce barriers to entrepreneurship – both for the venture capitalist and the entrepreneur (policies relating to barriers to enterprise; barriers to enterprise capital; public equity markets; and formal credit).

Each of these themes are explored within self-contained but intrinsically inter-linked chapters that make up the empirical content of the study.

2.6 Data Sources

The study is designed as a single-country study, rather than a cross-jurisdictional comparative analysis. Evaluating the relationship between laws and legal institutions on the one hand, and financial intermediaries on the other, and the impact of those relationships on the structure of financial contracts , and the distribution as well as design of property rights within a single legal and market jurisdiction, is ideal for exploring how similarly situated investors respond to the common regulatory environment. All study subjects are linked by a common market, operate under an identical legal policy framework, and compete for financial contracts in a fairly homogenised playfield of capital consumers.

The data was collected from a range of sources including statutory instruments, legislations, case law, policy documents, private equity fund managers, financial sector regulators, policy makers, accounting firms and legal professionals. To gain interview access, however, fund managers required anonymity, and non-attribution of responses. For most respondents, this was the first formal academic discourse in their Kenyan investment experience, and given the industry's penchant for confidentiality and 'secrecy', many did not feel sufficiently disposed to unconditional participation. As the study was not geared to an exposition of the investment strategies of any one firm, this condition was embedded into the study's empirical design.

As such, the results are reported at a generic and synthesised level. Where specific individuals are identified, it is with the express consent of those respondents. Where fund-specific information already existed in the public domain, however, direct attribution of apocryphal origins is made. Some public sector agents requested anonymity too, while others gave permission to be identified in the study as and where appropriate.

Identities of interviewees have consequently been coded as follows:

- Fund managers are identified by the prefix 'FM' followed by a 3-digit number starting with 101.
- Regulators are identified by the prefix 'RG' followed by a three digit number starting with 201.
- Policy makers are coded 'PM' with a suffix containing 2 digits.
- Tax firms and tax experts are coded 'TX' with a single digit.
- Lawyers, and judicial officials are coded 'LX' with a two-digit number.

Where direct quotes are made, the attribution will be to the general codes laid out above.

Kenya did not at the time of the study have a national private equity association as is the case in countries such as South Africa[27] and Egypt.[28] Both these countries have larger private equity markets compared to Kenya. Consequently, there is very little data available on the industry's track record, growth trajectory, investment strategy, entry multiples, earnings by exit volumes and multiples, or indeed the structure of compensation structures. A few local funds are members of the continental industry body – Africa Venture Capital Association (AVCA) – which started annual publication of industry statistics only in 2005.[29] Even then, however, that data set is shallow, narrow and unreliable. Any empirically orientated study of the Kenyan private equity/venture capital industry must therefore rely on hand-collected data.

To achieve the foregoing objective, companies answering to the following carefully crafted inclusion criteria were traced and added to the study sample:

(i) *structured all or a substantial portion of their investments as equity or quasi-equity;*

(ii) *engaged in active value-add services, e.g., active engagement with the investee company beyond the simple provision of finance;*

(iii) *actively sought to impact the investee's corporate strategy;*

(iv) *invested with a focus on a medium-term divestment;*

(v) *was controlled by an independent team of professional managers; and*

(vi) *had made at least one investment.*

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[27] The South Africa Venture Capital Association < http://www.savca.co.za/.> accessed 21 January 2008
[28] The Egyptian Venture Capital Association < http://www.avcaegypt2009.com/> accessed 21 January 2008
[29] African Venture Capital Association (AVCA), (*AVCA 2005 Directory*, November 2005) <www.avcanet.com.> accessed 21 January 2008

Out of 43 companies whose business involved investments of a financial nature, only 27 answered all the inclusion criteria. Out of these, 10 were set up (registered) in Kenya before 2005, while the vast majority 17 funds were set up and/or registered between 2006 and 2010. That is 10 funds in over 50 years, compared to 17 funds in just four years. This represents a sharp spike in the number of private equity intermediaries interested in Kenya as an investment location.

Data on the legal framework covered business regulations (registration, licensing, mergers and acquisitions, pension and insurance fund regulations), tax regulation, investment incentive policies, financial reporting, and contract enforcing institutions. Other data related to private equity contract design, enforcement trends and practices, exit or divestment avenues, and macroeconomic indicators central to the development of financial markets.

2.7 Instrumentation

To collect the foregoing data bands, the following instrumentation was designed:

(a) a series of prompts to aid in information capture in doctrinal research (document analysis of policies, statutes and case law and academic literature);

(b) a structured comprehensive questionnaire to gather information from private equity fund managers on the state of their world – fund formation, fund sources, fund management, investment design, cash flow and control rights, sector focus, enforcement choices and exit strategies – attached as Appendix 'A';

(c) an interview schedule titled "The Earnings Question", having 8 questions, used to gather data at a discursive level from fund managers – attached as Appendix 'B';

(d) an interview schedule comprising ten questions surrounding the integrity of financial statements in the study economy, and specifically the extent to which international financial reporting and accounting standards have found local implementation, and also data on the strength of auxiliary enforcement/compliance mechanisms/institutions – attached as Appendix 'C';

(e) an interview schedule comprising 5 questions surrounding the question of the judicial integrity and efficiency, attached as Appendix 'D'.

Where an inquiry demands complex iterative processes, such as in this research where several societal features affect each other, the approaches here employed offer real value. In an inquiry that embodies an intense iterative approach, the methodology employed here works well in shedding necessary light upon otherwise disconnected instances of observations, which, upon iteration, expose intrinsic inter-connectedness, or reverse causations. This mirrors approaches in studies of similar scale.[30]

The interview method permitted the triangulation of findings. For instance, the same interview schedule administered to the Judiciary was administered to the Law Society of Kenya and to a range of independent law firms; similarly, the interview schedule administered to the Capital Markets Authority was administered to the Institute for Certified Public Accountants of Kenya (ICPAK) and to three out of five largest multinational tax and audit firms operating in Kenya. In like manner, the same set of questions were separately put to all financial sector regulators engaged in the study: the State Law Office, the Capital Markets Authority, the Ministry of Finance, the Retirement Benefits Authority and the Insurance Regulatory Authority. As far as the fund managers were concerned, the central themes in the interview schedule were designed to build upon and shed light on their

[30] Stefano Caselli, Francesco Corielli, Stefano Gatti and Francesca Querci, 'Corporate Governance and Independent Directors, Much Ado About Nothing? The Evidence Behind Private Equity Investment Performance' (2008) CAREFIN-Universita Bocconi (unpublished) 11

responses to the structured questionnaire. This approach permitted the drawing out of data relationships a structured survey is not well suited to elicit.

2.8 Data Description

Data relating to the number of private equity firms operating in Kenya was hand-collected through interviews with the Attorney General's Office (Registrar General), the Capital Markets Authority, interviews with private equity intermediaries and professionals, document analysis, and web-trawling. Data on funds raised was similarly hand-collected and counter-checked against data reported on each fund manager's website (not all fund managers operated out of a website, however, and the fundraising picture for Kenya is far from complete: this is worthy of separate specific investigation).

Data relating to investment stages was collected through a questionnaire survey of all known fund managers that met the selection criteria outlined earlier.

Data on environmental factors (i.e., business climate) including investment freedom (the latitude that capital holders have in channelling their investments into various economic sectors) was collected from secondary sources – published policies of the Government of Kenya, and findings in development literature such as the World Bank (publishing the Doing Business Index), United Nations Committee on Trade and Development (on statistics relating to foreign direct investment), the International Monetary Fund (publishing varied country statistics and prescribing country programmes), the World Economic Forum (publishing global competitiveness reports), and the Fraser Institute (publishing the freedom of the world index).

The measures of barriers to entrepreneurship are adapted from the World Bank Doing Business Indices, World Economic Competitiveness Reports by the World Economic Forum, the World Competitiveness Yearbook by the IMD and the Freedom of the World Index, and are (i) the quality of enforcement; (ii) financial reporting; (iii) bureaucracy; (iv) prevalence of improper business practices (corruption) in legal institutions; (v) labour market rigidities; (vi) investment restrictions (vii) starting and closing a business; (viii) getting commercial credit; and (ix) investor protection.

The more open an economy, the wider the opportunity for selection. Such freedom might have a strong impact on the contribution of private equity/venture capital to economic development. It would also permit specialisation, helping to develop local talent and disperse opportunities across economic sectors. To account for this element, data on investment segments (sectors – which are defined as infrastructure, agribusiness, entertainment, manufacturing, media, retail, telecoms, healthcare, information technology and financial services) was collected through the structured questionnaire survey, followed by in-depth personal interviews.

Data on fund structures, employment, fund sources and geographic spread, the length of financial contracts, exit strategy, as well as the attitudes of local fund managers to the regulatory and financial contracting realities in Kenya were collected through a structured questionnaire survey. Interviews were subsequently held to more deeply explore dynamics around investment hold periods and exit frameworks.

To measure the quality of the exit framework (hence the security of property rights through value extraction), the study assesses the availability and accessibility of stock markets to investee companies, and the extent to which stock markets provide a dedicated platform for entrepreneurial companies.[31]

Barriers to entry might turn capital holders away from investing by lowering returns - through raising transaction costs - in the form of reading costs (due diligence) and monitoring. Exponentially high reading costs can turn capital seekers away, further perpetuating the funding gap. To measure barriers to entry on the supply side, data on taxation is introduced including tax avoidance, capital gains tax rates, treatment of stock options, dividends and compensating tax, tax incentives to private equity/venture capital, and compliance data for financial reporting purposes.

Investment regulations are also collated including on fund structures, regulation of capital structure, income tax rules on thin capitalisation, fund registration, approval and licensing, reporting and investment restrictions. For these data, an analysis of the law was conducted, together with individual meetings with three key regulators: the regulator for business registration, the regulator for investments, and the regulator for financial reporting.

2.9 Analytical Strategy

The empirical findings are interpreted through a financial contracting framework, underpinned by the notion of property rights security. Several reasons explain this framework. Firstly, the study is designed as a diagnostic tool to help identify and locate historical impediments to the growth of private equity with the view to equipping legal reformers with specific response tools. This has significant ramifications for economic development.

[31] Laura Bottazzi, and Marco Da Rin, 'Europe's New Stock Markets' (2002) CEPR Discussion Paper 3521/ 1990s, many European countries opened such platforms within their stock exchanges.

Secondly, financial contracting as an analytical concept permits an evaluation of the manner in which law and finance interface in Kenyan private equity practice. The unit of analysis for this purpose – it was shown earlier – is the private equity cycle – impact on fundraising, investment and divestment.

Thirdly, data availability, depth and reliability were a concern prior to the launch of the inquiry. Several factors informed that premonition. Private equity is a relatively young industry in Kenya – as chapter 5 documents. The general public, policy makers and the local business community are still struggling to acquire a proper understanding of the industry's manifestations.

2.10 Limitations to Chosen Method and Impact on Results

This inquiry has adopted the classical tools of legal inquiry. However, even this approach does not yield tight results when the law is linked to finance – results that clearly indicate in which direction causation runs. Thus from a methodological framework, the central line of inquiry would lend the following three alternative questions:

(i) do laws cause strong private equity markets to develop? or

(ii) does the development of private equity markets trigger the emergence of strong law? Or

(iii) would a developing economy that does not boast either strong laws or strong financial markets induce both?

A practical evaluation could be useful in the conduct of value judgements over this methodology. A nascent financial market, it could be hypothesized, would demand supporting legal structures, and as these structures are operationalised, the markets expand

and mature. With maturing markets and an enlightened set of market participants, the demand for even better law is made. This cyclical process between strengthened law and strengthened financial markets appears to be a continuous process.[32] This interpretation particularly sits well with the theoretical posturing in the study: that the law and legal institutions are likely to play stronger roles vis-à-vis macroeconomic (read financial) factors in the emergence of efficient private equity financial markets in a developing or emerging market context.

Nonetheless, the strict empirical question – in which direction does causation run in this context? - admits of no neat answer. The question, however, must be asked: would such an answer present more functional practical policy outcomes? Alternatively, would the primary fact of dependability between the state of the law and the state of the market suffice to inject impetus to the notion that law is and does operate to engineer financial markets – whether such engineering is uni-directional or bi-directional? Either way, it seems the debate would be academic. The evidence suggests a dependability between the state of the law and contracting choices within the private equity practice in Kenya, but does not establish the direction of that dependability. This is work for future research, especially work favouring quantitative empirical legal research.

The classical methodology of legal scholars that look to laws, legislative history and judicial precedent would not be adequate to capture this iterative process on how law and finance interact. Neither would those of legal comparativists nor financial economists: their structural strictures do not permit the bi-directional nature of the causation under study.

Another possible weakness of this work's methodology, however, can be found in the chosen analytical frame: financial contracting and property rights. This approach is likely to have omitted the evaluation of other equally critical variables. Furthermore, as a qualitative

[32] Roe, Modern Stock Markets (2006) (n 11)

study, the data was not well suited to an econometric analysis of study variables – a fact likely to draw criticism from empiricists – on the question of results replicability. As Bassey (1981) noted, however, in qualitative inquiries, it is the *relatability,* not *replicability,* of findings, that counts, provided process rigour is evidenced.[33]

The acknowledged methodical weaknesses in this inquiry's selected methodology are compensated for by the intrinsic rigour of the methodical approaches. The data is triangulated by use of different data collection tools, and the iteration of inquiry points across chosen tools. Furthermore, differently placed subjects within the two key areas of inquiry – finance and law – were engaged on similar inquiry points.

In this sense, this work follows the theory of 'fuzzy logic', led by Michael Bassey.[34] The theory offers a possible solution to the problem of generalisation in social research (empiricism) by propounding the replacement of scientific certainty (encapsulated in the normativeness of empirical approaches, hence observing 'a' so many times in 'b' always leading to 'f') with the uncertainty (fuzziness) of qualified statements (encapsulated in the non-empirical approach of qualitative research, hence observing 'a' in 'b' so many times 'may' lead to 'f'). To the extent that these fuzzy predictions are supported by a logical narrative, grounded in a research account that evinces process rigour and that makes clear the context for the predictions in the fuzzy logic, those predictions offer forceful bases capable of supporting targeted reforms. If this fuzzy logic and its predictions motivate replication of this methodology, either to support, augment, or otherwise qualify it, then this work would have contributed substantially to legal development, and to the law and finance theory as applied to private equity.

[33] Michael Bassey, 'A Solution to the Problem of Generalisation in Educational Research: fuzzy prediction' (2001) 27(1) Oxford Review of Education 18 <http://www.jstor.org/pss/1050990> accessed 10 October 2011.
[34] ibid

A final possible limitation of this work is the fact that it is primarily a study of a single economy, raising the valid argument its findings may not necessarily be relevant to other jurisdictions. The choice was consciously made with these facts in mind, motivated by the acknowledged need for financial sector deepening in Kenya, and in light of the fact that the private equity industry in Africa is still nascent. At the very least, this study offers a useful law and policy model upon which to model larger, cross-country comparisons, perhaps after the manner of the European Venture Capital's popular 'Benchmarking European Tax and Legal Environments' studies since 2004.[35]

2.11 Conclusion

This chapter has presented the central pillars underpinning this inquiry – and in many ways, its effective implementation underlies the quality, content and structure of this work. The tools encompass all inquiry points – both legal and institutional variables, and the analytical frame provides the prism for drawing out implications of the study's findings. Its strong empirical ethic proved valuable in discovering primary knowledge on the research questions.

[35] European Venture Capital Association, 'Benchmarking Tax and Legal Environments' (2008) <http://www.evca.eu/publicandregulatoryaffairs/default.aspx?id=2414#2008> accessed 23 January 2012

3

HISTORY AND NATURE OF PRIVATE EQUITY

3.1 Introduction

Private equity, both as a contracting strategy and as an industry, is relatively young, as this chapter shows. It first emerged in its organized form in the USA, which is also the largest private equity market in the world.[1] The chapter begins by tracing significant instances of private investments in risky ventures, from its innocuous beginnings in the early 18th century,[2] and traces its metamorphosis[3] to its present-day highly visible,[4] if sometimes controversial,[5] market standing. It answers the questions where private equity began, how it emerged, and how it spread around the world. Furthermore, it explores the various structures and institutions, and highlights the role of public policy in shaping the growth of private equity in the last century. Through a review of its history, it is also possible to acquire an appreciation of why public policy responses to its emergence have increasingly gained currency around the world.

This approach provides a useful understanding on the type of investor, the investment vehicle and investment sectors, as well as the dependencies between private equity and the wider financial markets.

This review draws mainly from the experience of private equity in the United States of America (USA) and Western Europe. Section 3.2 explores the evolution of private equity,

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[1] Douglas J. Cumming and Sofia A. Johan, *Venture Capital and Private Equity Contracting: An International Perspective* (Elsevier, USA, 2009) 1

[2] Charles P Kindleberger, *A Financial History of Western Europe* (2nd edn, Oxford University Press, 1993) 110

[3] Charles Morris, *The Tycoons: How Andrew Carnegie, John D Rockefeller, Jay Gould and JP Morgan invented the American Super-economy* (Reprint edn, Owls Books, US, 2006).

[4] World Economic Forum, The Global Economic Impact of Private Equity Report 2010 (2009), Anuradha Gurung and Josh Lerner (eds.) Globalization of Alternative Investments, Working Papers 3 <http://www/weforum.org> accessed 21 October 2010

[5] Poul Nyrup Rasmussen, 'Taming the Private Equity Fund "Locusts" ' (Europe's World, Spring 2008) <http://www.europesworld.org/NewEnglish/Home/Article/tabid/191/ArticleType/articlereview/ArticleID/20433/Default.aspx> accessed 5 June 2011

with section 3.2.1 starting by showing that in the very early days, private equity was dominated by high-net-worth individuals – right up to the 1950s.[6] Unlike merchant banking that first appeared in Europe,[7] modern-day private equity first appeared in the USA. It was led by some of America's richest entrepreneurs of the time, hence squarely located within the private sector of the US economy even in its early manifestations.[8]

As the benefits of private equity-led investments became increasingly known, government venture funds slowly flowed into private sector-led investments. The entry of government into private equity heralded the beginnings of public policy interventions in private equity activities,[9] interventions which, as the discussion in section 3.2.2 amplifies, would in the decades following the 1950s expand to include non-fiscal policy measures. Different approaches to public policy design for private equity is reviewed through a consideration of experiences drawn from the USA, the UK, the Netherlands, Israel, Chile, Spain and Taiwan.

Section 3.2.3 through 3.2.5 review the progressive institutionalisation of private equity transaction structures, the segmentation of the private equity industry and the emergence of various sub-classes of private equity finance, the drivers of fundraising into private equity, as well as some of the negative corporate practices associated with private equity over time.

Section 3.2.6 explores the globalization of private equity – its spread beyond North America and Western Europe after the 1990s decade. This section considers the factors that acted as precursors to the emergence of a global era for private equity. These include the relationship between private equity and public equity markets, the availability of credit (both bank loans and "junk" bonds), regulatory reforms and public policy support measures. This

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[6] Morris, *The Tycoons* (2006) (n 3) 2-4
[7] Charles P Kindleberger, *A Financial History of Western Europe* (1993) (n 2) - for detailed background.
[8] Morris, *The Tycoons (* n 3)
[9] Ch 1, 9

review helps in demonstrating that over time, a relationship between legal development and private equity growth is discernible.[10]

Section 3.3 turns from historical accounting to a focus on the character and nature of private equity – both the finance and the practice. It is shown that it is an adaptive kind of enterprise capital, versatile in overcoming business uncertainties, unlimited by the asset characteristics of venture companies, and employs specialised financing techniques to underpin its unique investing model. Section 3.4 concludes.

3.2 The Evolution of Private Equity

3.2.1 Very Early Private Equity

As stated at the start of this chapter, private investment in business has been with man as far back as human commercial history goes.[11] In the medieval ages, the financing of sea voyages – such as those by Christopher Columbus (by the Spanish monarchy and Italian investors) and the ventures of the well-known British East India Company in the 18th Century – was venture capital at work.[12] Other structured investments can also be traced back to Europe at the dawn of the industrial revolution, for instance when merchant bankers financed industrial enterprises in the 1850s in London and Paris.[13]

In 1854, Credit Mobilier was founded by Jacob and Isaac Pereire, two Jewish journalists, and it became an aggressive and future-looking investment bank across Europe and North America.[14] These two later teamed up with Jay Cooke, a New York tycoon, and

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[10] Ch 1, 6 - the leading proposition suggested an interdependency between private equity markets and legal development.
[11] Richard Brealey and Stewart Myers, 'How Corporations Issue Securities' ch 15 in *Principles of Corporate Finance* (4th edn, McGraw Hill, USA, 1991) 339-346
[12] Spencer E Ante, *Creative Capital: Georges Doriot and the Birth of Venture Capital,* (Harvard Business School Press, 2008) Introduction, xiii.
[13] Valentine V Craig, 'Merchant Banking: Past and Present' (2000) FDIC Banking Review < http://www.fdic.gov/bank/analytical/banking/2001sep/article2.html> accessed 1 October 2011
[14] Charles P Kindleberger, *A Financial History of Western Europe* (1993) (n 2) 110

they jointly provided part of the financing for the American Transcontinental Railroad, built between 1863 and 1869.[15]

Later, in 1901, J. Pierpont Morgan, through his company J.P. Morgan & Co., acquired Carnegie Steel Company from Andrew Carnegie and Henry Phips for USD480 million.[16] The moneys involved in the acquisition of Carnegie Steel Company was not public money; it was entirely private finance.

By the 1930s, individual venture capitalists included the Rockefellers, [17] the Vanderbilts[18] and Jay H Whitney – all very wealthy American families.[19] It is significant that very little is recorded about venture investing by wealthy individuals before the 1930s in the USA, just as is the case for Western Europe. Nonetheless, the few recorded cases illustrated the power of risk capital in nurturing innovative entrepreneurship.

Developments in the 1950s, following the economic shocks of the Second World War, heralded a new era for private equity, as the next section illustrates.

3.2.2 Government Venture Capital and Public Policy in Private Equity

The motivations for early government involvement in private equity can be traced to studies just after the Great Depression on both sides of the Atlantic (USA and UK) that documented what has come to be known as 'the funding gap', a phrase used to refer to the difficulty faced by small enterprises in accessing appropriate forms of enterprise capital.[20] One study was conducted by the USA government in 1935; the other by the UK government

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[15] Sven Beckert, *The Monied Metropolis: New York City and the Consolidation of the American Bourgeoisie, 1850-1896* (New Edition, Cambridge University Press, 2003)

[16] (….) 'Henry Phipps – The Founder' (*The Phipps Houses Group*) < http://www.phippsny.org/about_h_phipps.html> accessed 1 September 2011

[17] Ron Chernow, *Titan: The Life of John D Rockefeller, Sr* (2nd edn, Vintage Books 2004) - helped found Eastern Airlines and Douglas Aircraft in 1938.

[18] T.J. Stiles, *The First Tycoon: The Epic Life of Cornelius Vanderbilt* (Reprint edn, Vintage Books 2010) - 1938: founded E.M. Warburg & Co., which later became Warburg Pincus LLP.

[19] Spencer E. Ante, *Creative Capital: Georges Doriot and the Birth of Venture Capital* (Harvard Business School Press 2008)

[20] Stratos Papadimitrou, Panos Mourkoudoutas, 'Bridging the Start-up Equity Financing Gap: Three Policy Models' (2002) 4 (1) European Business Review 104-110

in 1931. Both studies triggered public policy responses that were to mark the start of a long string of public policy measures in support of private equity, models that have found favour even outside the developed markets of North America and Western Europe, as this section shows further below.[21] In the following sub-sections, the experiences coming out of the USA, the UK, Netherlands, Spain, Israel, Taiwan and Chile are briefly reviewed. The models that emerge indicate the difficulty that countries seeking to model successful national private equity industries are faced with.

3.2.2a - USA

In 1958, the USA government enacted the Small Business Investment Companies (SBICs) Act of 1958.[22] The Act achieved two main objectives: firstly, it facilitated the pooling of federally chartered funds that venture investors could leverage; secondly, it enabled the formation of special companies that could gain access to such federally chartered fund pools (which they could leverage up to four times the capital they had in aid of their investment funds – that is, for every private dollar raised towards investment in technology start-up companies, an additional four public dollars could be leveraged in a form of government match-funding). The companies that could access this facility were known as small business investment companies (SBICs).

It can be deduced that the SBIC Act of 1958 supported capital formation in the USA private sector, and promoted the emergence of investment specialisation through creating an enabling environment for novel investment solutions.

In addition to the SBICs, the USA government implemented from 1958 the Small Business Investment Research (SBIR) programme, which was designed to support innovative

[21] Charles M. Noone, 'The 1968 Model SBIC' (1967-1968) 23 Bus.Law 1214, 8
[22] Charles M Noone and Stanley M Rubel, *SBICs: Pioneers in Organized Venture Capital* (Chicago Capital Publishing Company1970); Charles M. Noone, 'The Various Sources of Venture Capital available to Small Business Concerns,' (1970-1971) 26 Bus. Law 721

research by start-up companies, as well as create and advance industry linkages between small and large technology-driven enterprises. This programme aided in stimulating rapid technological advancements, and was instrumental in heralding the take-off of internet and telecommunications technologies in the 1990s.[23]

Between the 1970s and the 2000s, the USA government undertook a series of additional policy measures specifically aimed at unlocking fundraising for private equity investments. These policy measures included changes to the tax codes to create investment incentives targeted at institutional and individual investors, as well as regulatory changes that empowered institutional investments into private equity.

In other indirect policy interventions, the USA government introduced legislation that supported the emergence of professional services around private equity, starting with the role of investment advisors which was subjected to legal treatment from 1940. Table one below summarises the footprint of USA public policy for private equity over time. The first column indicates the policy measure, while the second column summarises the impact of the measure as observed over time.

[23] Joshua Gans and Stern Scott, 'When does funding Research from Smaller Firms Bring Fruit? Evidence from the SBIR Programme' (2003) 12 (4) Economics of Innovation and New Technology 361-384

Table 3.1 – USA Legal Policy for Private Equity 1934 - 2010

Law/Development	**Impact**
Securities Exchange Act of 1934[24]	Established the American financial services regulator – the Securities Exchange Commission, one of whose functions is the regulation of alternative investments (including hedge funds, private equity).
Investment Company Act of 1940[25]	Made provision for stringent disclosure standards for investment companies and investment advisors. Exempted investment advisors from extensive registration requirements.
Small Business Investment Act of 1958[26]	Established federal fund pools that could be leveraged by venture capitalists up to 4 times the amount of private funding. It expanded sources of private equity capital, supported the emergence of a pool of private equity professionals, and progressed technological development in the USA.
Employee Retirement Income Security Act (ERISA) of 1974[27]	Prohibited corporate pension funds from investing in risky investment vehicles, including in unquoted/privately held companies. It further demanded that investment risk was to be assessed at the individual investment level, upping the barriers to investment.
The US Department of Labour promulgated the "Prudent Man" rule (Section 404(a)(1)(B), ERISA 1974)	Required fiduciaries to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
Economic Recovery Tax Act of 1981[28]	Lowered the capital gains tax rate to 20% from 28%, further sweetening risky investments.
Tax law reforms – USA – 1986 through 1997[29]	Tax Reform Act of 1986 – reversed the ERTA tax reductions, including the capital gains tax rate (raised to 28%). 1993, Clinton tax reforms–14% capital gains tax incentive for investments held for more than 5 years. 1997 – the Clinton administration lowered capital gains tax rate to 20%.[30]
DODD-FRANK Act, 2010 **Part IV (Title IV, s 403-417**	Extends exemptions applicable to investment advisors under the Investment Advisors Act of 1940 – by raising the minimum threshold from USD25 million to USD100 million.

[24] P.L. 111-257, approved October 5, 2010 <http://www.sec.gov/about/laws/sea34.pdf> accessed 27 October 2010.

[25] P.L. 111-257, approved October 5, 2010 <http://www.sec.gov/about/laws/ica40.pdf> accessed 27 October 2010.

[26] Small Business Investment Companies Act 1958, 15 U.S.C. § 661 et seq; Regulations - Part 107 Title 13 Code of Federal Regulations, 13 C.F.R. § 107.20 et seq

[27] P.L. 93-406, 88 Stat. 829, enacted September 2, 1974

[28] P.L. 97-34, ERTA ("Kemp-Roth Tax Cut): large increase in revenue from capital gains tax after ERTA; declined when taxes were subsequently raised to 28%

[29]Paul Gompers and Josh Lerner, *The Venture Capital Cycle* (MIT Press, MA, 2nd edn, 2004) 36

[30] PricewaterhouseCoopers, 'National Venture Capital Association "MoneyTree" Report' < www.pwcmoneytree.com/moneytree/nav.jsp?page=historical> accessed 10 September 2011 – strongly influential on fundraising: in 1995, USD8 billion invested in USA venture capital; in 1998 investments rose to USD28 billion, and to over USD50 billion in 1999.

	Introduces a new range of exemptions: investment advisors with assets less than USD150 million and advising private equity funds purely are exempt from SEC registration requirements. Advisors to venture capital funds are exempt as well. Foreign private equity advisors are also exempt, provided they avoid permanent establishment in the USA, have fewer than 15 clients and do not advise any registered investment company. Family offices are exempt. Advisors solely advising SBICs are also exempt.

The experience of the USA thus offers a useful point for reflection on how public policy can indirectly be employed to support the development of specialised types of funding sources to the private sector. From the perspective of this inquiry, it is notable that the USA placed emphasis on legal instruments, but did not adopt a dedicated law on private equity.

The legacy of the USA SBIC programme is mixed, however.[31] The SBIC programme was layered with complex, expansive regulation. In spite of the extensive regulation of the SBIC programme, screening procedures were inefficient, and allowed the entry into the field of ill-qualified players. The result was that unqualified applicants ended up selecting portfolio companies poorly, and realized negative returns, placing large investor capital at stake.[32] Nonetheless, the SBIC programme was instrumental in incubating and maturing the first batch of professional private equity investors, and, SBICs continue to invest in early stage private equity to date.[33]

3.2.2b – UK

In the United Kingdom (UK), a 1931 study identified – like the USA study of 1935 considered in the preceding sub-section - '*the Macmillan Gap*', a 'chronic' funding gap in the

[31] Jeffrey Nuechterlein, *'International Venture Capital – The Role of Start-up Financing in the USA, Europe and Asia*' Patrick deSouza (eds), *Economic Strategy and National Security: a next generation approach* (Westview, 2000) 6

[32] Gompers and Lerner, *The Venture Capital Cycle (*2004) (n 29) 147 - these developments were to foreshadow the savings and loans crisis of the 1980s, when most SBICs collapsed

[33] David H Hsu and Martin Kenney, 'Organizing Venture Capital: the Rise and Demise of American Research and Development Corporation' (1946-1973) Working Paper 163/2004

financing of small UK enterprises.[34] Research indicates that Britain's banking sector was centralised ('oligopolistic' in Scott's words), pursuing a strategy of liquidity maximisation and risk minimisation over the provision of long-term capital that the majority of SMEs required to grow.[35] Banks during this period favoured the provision of short-term credit such as working capital and cash flow management having such near term horizons as 13-19 months. While many of these loans could be rolled over repeatedly, the key feature was their 'recallability' at short notice, which precluded the deployment of leveraged finance in capital expenditures.[36] It recommended the establishment of an independent government-funded company to focus on working with the marginalised small businesses.[37] This company was to provide financing structured as preference shares, debentures and common equity, and it was to act as a bridge between the smaller companies and the bigger companies (effectively a market-maker). In 1945, the UK Labour government formed two companies – the Industrial and Commercial Corporation and Finance Corporation for Industry – both of which were to merge in 1975 when it was floated as "3i" as it is known today.[38]

The UK government in 1983 conducted a review of progress since the 1931 study, and the findings confirmed the MacMillan Gap persisted. In response, it initiated the Business Expansion Scheme (BES), by which it made available tax relief for investments in unquoted securities.[39] By 1988, however, the BES programme had not left a positive legacy as investors in unquoted equity avoided early stage and start-up companies, which were

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[34] Harold MacMilan, Report of the Committee of Enquiry into Banking, Finance and Credit, Cmd. 3897 (London 1931) – phenomenon named after the Committee's report.

[35] Peter Scott and Lucy Newton, 'Jealous Monopolists? British Banks and Responses to the MacMillan Gap During the 1930s' (2007) 8 (4) Enterprise and Society 881-919

[36] Duncan M. Ross, "The MacMillan Gap" and the British Credit Market in the 1930s, in PL Cottrell, A Teichova and T Yuzawa (eds), *Finance in the Age of the Corporate Economy* (Aldershot, UK, 1997) 209-226

[37] Lord Piercy, 'The MacMillan Gap and the Shortage of Risk Capital' Series A (General) (1955) 118 (1) 1 Journal of the Royal Statistical Society 1-7

[38] 3i's full history < www.3i.com/about3i/history-of-3i.html> accessed 15 January 2012

[39] Richard T Harrison, and Colin C Mason, 'Risk Finance, the Equity Gap and New Venture Formation in the United Kingdom: the Impact of the Business Expansion Scheme' in B.A. Kirchhoff, W.A. Long, W.E. McMullen, K.H. Vesper, and W.W. Wetzel (eds), *Frontiers of Entrepreneurship Research* (Wellesley, MA: Babson College, 1988) 595-609.

viewed as unpredictable commercial ventures.[40] Effectively, the gap persisted. Between then and now, the UK government has implemented a long series of direct engagement in availing funds in attempts to bridge this perceived funding gap – including the Small Firm Loan Guarantee Scheme; Enterprise Finance Guarantee Scheme; Regional Venture Capital Funds; Enterprise Capital Funds; Early Growth Funds; Grants for Business Investments; University Challenge Seed Fund Scheme; Grants for Research and Development; UK Innovation Investment Fund; Enterprise Investment Scheme; and Venture Capital Trusts.[41]

In terms of strategy, the foregoing UK public policy measures included the provision of choice over organisation form (hence private equity companies could register as limited liability partnerships, trusts, limited companies and even investment funds). The UK government also employed tax tools in driving investments into private equity. The most notable included the provision of tax reliefs for investments into private equity and small enterprises. Share disposals meeting specified thresholds were variously exempt from capital gains taxes, as well as the non-accrual of withholding tax on some dividends. Deductibility of certain expenditures in private equity-related activities was allowed. Underlying all the foregoing was a strong culture of efficient business regulation.[42]

3.2.2c – The Netherlands

According to the European Private Equity and Venture Capital Association (the EVCA), the Netherlands follows France, Ireland, Belgium and the UK, as being among Europe's most efficient markets for private equity. There are no quantitative, qualitative or geographic restrictions on pension and insurance funds investments into private equity. In

[40] Richard T Harrison and Colin Mason, 'The Role of the Business Expansion Scheme in the United Kingdom' (1989) 17 *Omega* 147-57.
[41] British Venture Capital Association, 'A Guide to Private Equity' (2010) <http://admin.bvca.co.uk//library/documents/Guide_to_PE_2010.pdf> 8-13
[42] The Takeover Panel, United Kingdom – established in 1968 to oversee the orderly conduct of all takeovers, mergers and acquisitions, including private-equity led transactions.

addition, Dutch law provides two domestic fund structures that are tax transparent. Fund management is VAT-exempt, and investments into private equity attract fiscal incentives. In fact, the Dutch have a law styled the R&D Promotion Act.[43]

In 2006, the Dutch Pension and Insurance Funds implemented regulatory changes relating to risk management in institutional investments within the pension and insurance fund industries, based on three tests: 'continuity'; 'solvency'; and 'minimum' tests, motivated by Basel II principles on risk management, adequate capitalisation and greater transparency.[44] During the same year, the Dutch Parliament approved a bill seeking to entice unlisted companies to apply international financial reporting standards (which, among other things, requires the proper recognition of losses) in their accounting. This latter move was aimed at harmonising regulations on investments across institutional investors. The impact was increased investments into private equity.[45]

On 4th October 2011, the Dutch Parliament approved a new business form for private equity with limited liability, hailed by the industry as introducing greater flexibility in Dutch private equity fund structures.[46] This new vehicle does not require a minimum share capital, nor separate authorized share capital. The reforms also introduced relaxation to previous strict provisions relating to the prohibition of certain forms of financial assistance, and the requirement of a two-month 'no objection' period to all proposals to reduce a company's issued share capital. Under the new framework, there is no longer an 'objection' period, subject to required safeguards being met.[47]

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[43] European Venture Capital Association, Benchmarking European Tax and Legal Environments 2008 (EVCA Tax and Legal Committee), 10, 107 http://www.evca.eu/uploadedFiles/Benchmark.pdf, accessed 28 February 2012
[44] Douglas Cumming and Sofia Johan, 'Regulatory Harmonization and the Development of Private Equity Markets' (2007) 31 Journal of Banking and Finance 3218-3250
[45] id
[46] Marco de Lignie, 'The Netherlands – Tax and Legal Update' (EVCA Tax and Legal Committee), (January 2012), www.evca.eu/publicandregulatoryaffairs/ accessed 28 February 2012
[47] id

In 2012, the Dutch government proposed (under the tax bill) to tighten safeguards against overleveraging private equity transactions through limiting eligibility for tax deductibility where excessive debt is employed. The 2012 Dutch tax bill also tightened safeguards around tax avoiding strategies aimed at avoiding withholding taxes when distributing earnings to investors.[48]

The impact of Dutch reforms in this area has been increased fundraising, and wider availability of financing to innovative start-up technology firms in the Netherlands, an experience that supports the observation that the law can be employed as a 'dispersal' instrument – aiding in the allocation of available capital to the most productive economic sectors of a nation.[49]

3.2.2d – Israel

Israel, an economy outside of Europe, is known in the industry to have demonstrated a successful face to government venture capital, under the 'Yozma' programme, launched in 1993.[50] Under Yozma I, the Israeli government helped set up and capitalise 10 venture capital companies, providing USD20 million in seed funding to each fund. These funds were dedicated to investing in start-up companies specialising in areas where Israel has demonstrated world leadership: communications, information technology, and life sciences. It also invested directly in its own portfolio companies – and it became a startling success, transforming Israeli venture capital into a world-class private equity industry in under ten

[48] id

[49] EVCA, 'Venture Capital Incentives in Europe, Europe Private Equity Special Paper' (1997) 1-30 – other countries implementing active incentive schemes for private equity include Sweden, Germany, Spain, Italy, France, Finland, and Denmark.

[50] The Yozma Group, 'Overview'< http://www.yozma.com/overview> accessed 23 January 2012.

years.[51] By 1998, Yozma II had been launched, with strong investor participation from USA and Europe.[52]

The Israeli venture capital model is unique,[53] and serves to illustrate the depth of forethought any government would need to engage in when considering public policy support measures aimed at growing a market for risk finance like private equity. An analysis of the Israeli model reveals the following five well-defined pillars -

(i) it involved the creation of a substantial government fund pool that could operate as a fund of funds;[54]

(ii) it required the establishment of a specialist public office to manage and oversee the programme – the Office of Chief Scientist (OCS) – which was made a department of state. The OCS oversaw Yozma investments in start-up companies, supervised Yozma investments in the 10 drop-down funds it set up to kick-start Israel's venture capital industry, and to ensure that Yozma was invested in high-growth technology companies;[55]

(iii) Yozma also involved the establishment, culturing and nurturing of links with Israel's scientific and academic institutions (as this facilitated the sustained commercialisation of research, and ensured academic programmes met the real needs of the Israeli economy);[56]

(iv) Yozma additionally forged and sustained good working relationships with overseas top-tier private equity funds that allowed for the attraction into Israel of

[51] Uzia Galil, 'Before the Boom: The First Three Decades of Venture Capital in Israel' (1997 Yearbook), Israel Venture Capital Association 22
[52] id
[53] The Yozma Group, 'Uniqueness'< http://www.yozma.com/uniqueness> accessed 23 January 2012.
[54] id
[55] id
[56] id

high quality talent, the sharing of good practice, and the opening up of Israeli private-equity backed companies and their products to overseas markets;[57]

(v) Yozma furthermore developed a network of technology incubators all over Israel. This network facilitated the rapid transformation of ideas into commercially viable programmes.[58]

From a systems transplant perspective,[59] the Israeli model is a very interesting case study for Kenyan policy makers. The Israeli model offers the lesson that to successfully target public policy in growing a robust and dynamic private equity market, prioritising economic sectors to address is a good strategy. Every country has certain aspects of economic competitiveness that can provide an entry point to public policy targeting. It is also significant that the Israeli model, like the American model, does not involve changes to the law. However, like it was in the USA, the Israeli regulatory framework was already sophisticated by 1993 – hence the absence of regulatory reforms does not suggest the law is irrelevant. Applying the logic from a model transplant framework, it appears that legal development is a critical ingredient to the success of public policy for private equity.

3.2.2e – Chile

Approaches to the design of private equity markets have varied around the world. In Chile, the government enacted the Chilean Venture Capital Law in 1989 to establish a legal framework for the establishment of venture capital funds and to promote pension fund investments into private equity. The law created a special fund structure, the *FIDEs* (under Act 18,815). These fund structures were closely regulated and in time, remained attractive

[57] id
[58] id
[59] Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, 'Economic Development, Legality and the Transplant Effect' (2003) 47 European Economic Review 165-95

only to pension and insurance funds.[60] In 2000, a new law, Act 19,769 was adopted to amend Act 18,815, and a new Act 18,046 for other corporate activity. Act 19,705 was introduced in 2000 to govern stock listings. Act 18,815 created a new fund structure whose impact was tax deferment, providing a new reinvestment option that promoted share exchangeability, hence improved exit mechanisms. The Chilean initiative did not include tax incentives, and there is a general perception that the 1989 law failed to achieve its intended objectives. In 2006, a new bill was introduced to create a framework for the formation of limited liability partnerships in Chile – to improve clarity in the governance of the investment process that was missing under previous law.[61] In 2010, wide-ranging reforms to Chile's financial system were promulgated under Law No. 20,448 of 3 August 2010.[62]

3.2.2f - Spain

Spain,[63] like Chile, enacted a dedicated law on private equity in 1999, on the back of European policy statements recognising the importance of private equity to European economic development. Unlike the Chilean approach, however, Spain's Venture Capital Law of 1999 included a generous package of tax incentives relating to business expenditure, capital expenditure, contracting researchers and technology transfers. There is no capital gains tax on earnings from private equity investments, and the fund structures ensure that international investors do not attract 'permanent establishment' for domestic tax treatment under Spanish law.[64]

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[60] Rafael Hernandez Mayoral, Thomas L Eldert and Gustavo Struck, Comparative Review of Legal and Regulatory Frameworks Supporting Venture Capital (Morrison & Foerster LLP, 2003)
[61] Jason Mitchell, 'Venture Capital: Chilean Reforms Fail the Entrepreneur Test' (*Euromoney, October 2006*) <http://www.euromoney.com/Article/1079933/Venture-capital-Chilean-reforms-fail-the-entrepreneur-test.html> accessed 17 February 2012
[62] Miguel Massone and Felipe Cousino, 'Developments and Trends in Chiliean Capital Markets' (Allesandri Compania, Abogados, 16 August 2011) <http://www.alessandri.cl/press/2011/08/developments-and-trends-in-the-chilean-capital-markets-felipe-cousino>
[63] Spanish Law 1/1999
[64] EVCA, Benchmarking Tax and Legal Environments 2008, (n 43) 142-43.

Spanish law furthermore provides for two specialised organisational forms for private equity: the 'SCRs' (*Sociedad de Capital de Riesgo*), and the 'FCRs' (*Fondo de Capital Riesgo*).[65] Both structures are non-tax transparent, however. For instance, it is noted that while management fees are VAT exempt, advisory fees are not. Nonetheless, Spain is today one of Europe's most progressive, reformative, jurisdictions for private equity.[66]

3.2.2g - Taiwan

Taiwan's experience is an easy case study in early successful transplantation of the private equity model to a developing country. Taiwan employed a three-pronged strategy: the adoption of a dedicated private equity law, the provision of government funding to kick-start the industry, and the use of creative tax incentives. The Venture Capital Investment Enterprises Regulations were adopted in 1983 – establishing the venture capital enterprise as the dedicated venture capital organisational form. A government fund-of-fund was set up, and the National Industrial Technology Research Institute was set-up to spearhead research and development in high technology. A national Science and Technology Park was also set up to nurture high-tech businesses.[67]

In 2005, legislative amendments introduced a number of improvements to the legal framework for private equity, removing investment restrictions, improving exit regulations via the stock market that previously had a mandatory lock-in of four years, and further restrictions on non-transferable minimum shareholding in listed companies, as well as removal of restrictions on investing in venture capital enterprises. [68]

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[65] EVCA, 'Private Equity Fund Structures in Europe (2010), An EVCA Tax and Legal Committee Special Paper 4 < http://www.evca.eu/uploadedfiles/home/public_and_regulatory_affairs/doc_sp_fundstructures.pdf> accessed 24 February 2012
[66] EVCA, Benchmarking Tax and Legal Environments 2008 (n 43) 10
[67] Taiwan Venture Capital Association, 'Venture Capital as Policy Tool' <http://www.tvca.org.tw/en/policy.php> accessed 24 February 2012
[68] Taiwan Venture Capital Association, 'Laws and Regulations' < http://www.tvca.org.tw/en/laws.php> accessed 24 February 2012 - 'Scope and Guidelines for Venture Capital Enterprises' approved 31 March 2006

3.2.2h – Lessons from Competing Models

The varying design of national approaches to private equity development from a public policy perspective suggest that national peculiarities and policy emphases can result in substantially different outcomes across jurisdictions. Both Chile and Spain attempted a stimulation of an Over-the-Counter market to promote stock-market trading of invested companies, for instance, but early experiences were dismal in outcome. Taiwan, on the other hand, had enjoyed a strong public equity market since the early 1960s, and had in 1983 an active OTC market. By the close of the 1980s decade, the Taiwan Stock Exchange allowed for small and medium enterprises to list, leading to the emergence of the Taiwanese OTC as the second largest in Asia.

These public policy responses suggest several potentially definitive lessons in the context of this study. Firstly, both the USA and UK governments recognised the link between technological advancement and the role of their respective private sectors. Secondly, they recognised that an under-capitalised private sector would not deliver its full potential – and hence employed targeted public policy instruments in triggering private sector capital mobilisation. Thirdly, the policy ingredients included actual financing through the creation of dedicated government funds, tax incentives and general business regulation. Fourthly, a developed legal environment that provided alternatives to business forms available for private equity investments facilitated specialisations within the industry. The combined experience emerging from the foregoing reviews support the proposition that well-planned, public policy measures for private equity could become phenomenally successful.

These are fundamental lessons for countries in the developing world seeking models to adapt in the culturing of their own local private equity industries. For a developing country that does not have an advanced legal system and a sophisticated financial sector, developing both would not be options, but mutually reinforcing objectives. It would also seem that to develop strong financial infrastructures and systems, strong laws would be necessary to regulate conduct and standardise rules of engagement.[69] Public policy modelling thus would do well to take into account domestic realities in seeking models to transplant.

It has also been shown that the legacies of both SBIC and BES programmes are mixed, unlike the Yozma success story – suggesting there is no clear-cut formula against which to judge the ingredients of a successful programme for government investing as a venture capitalist. These would depend on peculiar country factors. The combined experiences of the reviewed economies demonstrate the wide range of possible policy measures a government can deploy in culturing and nurturing the emergence and growth of markets for innovative enterprise capital. The challenge is to accurately assess national peculiarities and structure country-specific public policy measures.[70]

3.2.3 Institutionalisation and Segmentation of Private Equity

Investment advisory services and capital mobilisation were the first triggers to the institutionalisation of the private equity contracting strategy. In 1940, USA public policy found investment advisors to be engaging in activities that warranted regulatory intervention.[71] In 1946, the American Research and Development Corporation (ARDC) and JH Whitney were formed,[72] both organised as 'closed-end funds'.[73] Other investment

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[69] Margaret Miller, Nataliya Mylenko and Shalini Sankaranayanan, 'Financial Infrastructure – Building Access Through Transparent and Stable Financial Systems' (2009) International Bank for Reconstruction and Development and International Finance Corporation. 1 < http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTFINANCIALSECTOR/.../...0.html> accessed 23 January 2012 – access to finance is the result of a complex interplay of different financial intermediaries, the right kind of financial infrastructure, and a sound legal and regulatory framework

[70] Berkowitz et al, 'Legality and the Transplant Effect' (2003) (n 59) 165-95

[71] Aug.22, 1940, ch. 686, title II, 54 Stat.847 amended through P.L. 112-90 3 January 2012 – the public policy rationale for this law is set out SEC 201: (a) the totality of investment advisory services occurred by means and instrumentalities of interstate commerce (b) their advisory services permeated every sphere of securities-related dealings at an interstate level (c) the transactions over which they lent advice occurred in such volume as to substantially affect interstate commerce, national equity markets, the banking system and the national economy.

[72] Gompers and Lerner, *The Venture Capital Cycle* (n 29) 8, 146.

advisory companies continued to emerge[74] so that by the 1970s, investment advisory services were a substantial part of the private equity industry. The number of these market intermediaries was sufficiently high that in 1973, the National Venture Capital Association (NAVCA) was formed.[75]

Fund management as a distinct service emerged in the 1970s, and was greatly consolidated in the 1980s, making it one of private equity's most visible institutions to date. In the USA, this took the form of the limited liability partnership (LLPs), a form of business organisation within which the roles of investors and that of fund management and investment services are distinguished, allocated and managed. The fund management and investment placement roles fell to the general partner (GP), responsible for the day to day administration of private equity investments into companies. Investors into private equity (both institutional and individual) became the limited partners (LPs), playing no direct management or administrative role within the LLP framework. The relationship between GPs and LPs is secured under contract,[76] and their respective roles are usually grounded on statutory requirements relating to business partnerships.[77]

The partnership agreement stipulates how much the investor commits into the fund, how commitments are drawn down, how long a fund manager has to make the draw downs,

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[73] Paul Gompers and Josh Lerner, 'The Venture Capital Revolution' (2001) 15 (2) Journal of Economic Perspectives 145, 146 - designed like mutual funds: shares that trade from investor to investor on an exchange (like a stock), but not redeemable against the issuer firm, shielding issuers from redemption claims: this enabled issuers to raise capital upfront through share sales to institutional investors, and to make medium to long-term capital investments. Investment exit is via share transfers to other investors. *See* JB De Long and Andrew Shleifer, 'Closed-End Fund Discounts,' (1992) 18 Journal of Portfolio Management 46-53: The publicly-traded structure of closed-end funds came under abuse, with unethical brokers promising rewards that the markets could not sustain, and failing to advise pensioners of risks associated with stock markets. Private equity investment advisors practiced discounted trading of the publicly traded securities, a wrong market practice that introduced substantial losses to investors in private equity in the 1980s.

[74] Gompers and Lerner, *The Venture Capital Cycle (* n 29) 9-14 - notably on Sand Hill Road, California, including Kleiner Perkins Caufield & Byers and Sequoia Capital in 1972

[75] ibid, 8

[76] Douglas J Cumming and Sofia A Johan, *Venture Capital and Private Equity Contracting: an International Perspective,* ch.5, 'Limited Partnership Agreement', (USA, MA, Elsevier, 2009) 93-128

[77] Generally, James M Schell, *Private Equity Funds: Business Structure and Operations* (*Corporate Securities Series*), (Law Journal Press, New York, 1999) – by 1992, LLPs accounted for 81% of all private equity activity in the USA.

the investor's claw-back powers, the fund manager's compensation frameworks, the mandatory minimum return expected, and other matters including tax issues. Inability to complete draw downs within stipulated periods significantly lowers a fund manager's positive performance standing.[78] The LP agreement employs three main covenant categories: (i) covenants governing the management of the private equity fund,[79] (ii) covenants covering the activities of fund managers,[80] and (iii) covenants restricting the types of investments fund managers may undertake.[81]

The LLPs of the 1980s were exempt from the disclosure requirements under the Investment Company Act of 1940, but were restricted as to the number of partners in the partnership (both individual and institutional).[82] They were also structured to have a finite life-time, and unlike the closed-end funds of the 1950s, investors by the 1980s expected a return on their capital within the fund's ten-year lifespan.[83] This organisational form also permitted tax efficiency (as 'pass through' investment vehicles, with no entity-level tax).[84]

With sophistication in investment advisory and fund management services, and as participants in the private equity industry increased, GPs and LPs increasingly sought to differentiate their services, increasingly became specialised, pursuing higher returns and unique market positioning. This specialisations gave rise to what is now known as 'market segmentation' in private equity. Sections 3.1 and 3.2.1 of this chapter demonstrated how

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[78] Gompers and Lerner, The Venture Capital Cycle (2004) (n 29) 28
[79] Gompers and Lerner, *The Venture Capital Cycle* (2004) (n 29) 73-75 - limits on maximum investment in any one entity, restrictions on the leveraging of funds, limits to investment debt at the fund level, capital structuring and caps on permissible deal debt levels, restrictions on co-investments with follow-on funds, and restrictions on investment of profits (partnership capital gains).
[80] ibid 75-77 – GPs restricted in permissible co-investments, sale of partnership interests, fund raising activities, 'outside' activities (non-partnership business), and addition of new GPs. Derogations sometimes allowed, subject usually to majority or super-majority decision of LPs or the advisory board.
[81] ibid 77 – restrictions: the type of assets in which the fund can invest in; investments in other venture funds, public securities, LBOs, foreign securities or other asset classes.
[82] Investment Advisors Act 1940 15 U.S.C s80b-1 et seq. S 203(2)(c)
[83] William A. Sahlman, 'The Structure and Governance of the Venture Capital Organizations' (1990) 27 Journal of Financial Economics 473-521.
[84] Generally, Gompers and Lerner, *Venture Capital Cycle*, (2004) (n 29) 65 ch 4– 'How are Venture Partnerships Structured?

venture capital was the main form of private equity in the early days. By the 1970s, this had changed substantially.[85]

Exogenous factors contributed to the process of market segmentation in private equity. These include both positive and negative market events. The positive events included the three periods of credit 'booms' in the 1980s, 1990s and the 2000s. The negative events include the failure of private equity in the 1980s (collapse of the leveraged buyout market), happening on the back of a stock market crash[86] and the savings and loans crisis in the USA,[87] failure of investment banks that underwrote junk bonds[88] and the 'blind pools' of the 1980s,[89] followed by the stock market crash in the year 2000 and the credit crunch in 2008.

During periods of cheap credit and robust capital markets activity, fundraising for private equity can reach phenomenal levels – as fundraising statistics indicate. For instance, industry commentators spoke of 'too much money chasing too few deals'[90] in private equity. Investment bankers in the USA underwrote a huge market of high-yield bonds ('junk bonds').[91] In the 1980s, increased fundraising led to increasing transaction values[92] (peaking

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[85] ibid 8, 146

[86] Mark Carlson, 'A Brief History of the 1987 Stock Market Crash' – with a Discussion of the Federal Reserve Response (2006) Board of Governors of the Federal Reserve, <http://www.federalreserve.gov/pubs/feds/2007/200713/200713pap.pdf> – it happened on 19 October 1987: the stock market and its associated futures and options markets failed, with the S&P 500 index plunging 20%. Key drivers included over-pricing of equities markets, and risky behaviour among financial institutions.

[87] For a comprehensive chronology of the events that built up to the crisis of the S&Ls industry in the USA by 1985, see USA Federal Deposit Insurance Corporation, 'The S&L Crisis: A Chrono-Bibliography' (FDIC website) < http://www.fdic.gov/bank/historical/s&l/ >accessed 23 January 2012 – the crisis merely peaked in the late 1980s, but its roots trace back to 1966.

[88] Mary Zey, *Banking on Fraud: Drexel, Junk Bonds and Buyouts (Social Institutions and Social Change)* (Aldine Transaction 1993); cf: James B Stewart, *Den of Thieves* (Simon & Schuster Paperbacks, 1992) 267 - Burnham Lambert of the investment bank Drexel Lambert – USA's largest junk bonds underwriter then, was found guilty by the USA SEC in 1986 of market misconduct, fined USD650 million, and by 1990, was bankrupt, taking with it a huge funding source for LBO transactions (it was the lead funder of 'blind pools' used to finance LBOs in the 1980s).

[89] Miles Livingston and Glen Williams, Drexel Burnham Lambert's Bankruptcy and the Subsequent Decline in Underwriter Fees (2007) 84 Journal of Financial Economics 472-501 – with a market dominance of over 50%, underwriting fees for junk bonds were on average 3.5% in the 1980s, but with Drexel's bankruptcy, market competition opened up, and underwriting fees fell to below 2.5% yield levels, and have stayed there.

[90] Paul Gompers and Josh Lerner, 'Money Chasing Deals? The Impact of Fund Inflows of Private Equity Valuation' (2000) 55 Journal of Financial Economics 281–325.

[91] Robert A Taggart, 'The Growth of the "Junk" Bond Market and its Role in Financing Takeovers' in Alan J Auerbach (ed) Mergers and Acquisitions, (University of Chicago Press, 1987) 5-24. <http://www.nber.org/chapters/c5819.pdf>

with the RJR Nabisco – or SunGuard Systems - LBO by KKR in 1989 valued at USD31.1 billion – the biggest LBO until then).[93] The number of LBO transactions increased during this period from a few hundred in the 1970s to over 2000 by 1989.[94]

Cheap credit supported the emergence of highly leveraged financial engineering structures in private equity practice, designed to suit different kinds of buyout transactions. They included the leveraged, management, institutional, secondary and other forms of buyouts, most of which feature private equity's unique monitoring-based contracting strategy. Banks, riding on the private equity promise, have been party to the development and mainstreaming of unique financial products closely associated with the private equity financial engineering method, including '*covenant lite* loans,'[95] *Pay-in-Kind* (PIK)[96] and *Pay-in-Kind Toggle* (PIK-T).[97]

When markets for complex financial engineering imploded, private equity investors sought safer investment exits for their portfolios in private equity. During each period of crisis, many highly leveraged investments (buyouts) experienced financial distress. The practice of selling troubled investment portfolios at the secondary market grew into the now well-defined and highly sophisticated private equity secondaries market.[98] Other troubled specialist investment funds and advisors emerged to take advantage of cheaply priced high-value corporate portfolios. These included a private equity market segment styled 'special situations private equity' and 'distressed private equity'.[99] This category of funders take up

[92] Gompers and Lerner, *Venture Capital Cycle* (20040, What Drives Venture Capital Fundraising (n29) 36
[93] Bryan Burrough and John Heylar, *Barbarians at the Gate* (Arrow Books, 2004)
[94] Tim Opler and Sheridan Titman, 'The Determinants of Leveraged Buyout Activity – Free Cash Flow vs. Financial Distress' (1993) 45 (5) Journal of Finance
[95] Geoffrey Parnass, 'High Yield Debt Issues Trigger "PIK" Options' (*EGS LLP, Private Equity Law Review,* 19 April 2009) < http://www.privateequitylawreview.com/tags/pik/> accessed 29 April 2011.
[96] id
[97] id
[98] Campbell Lutyens, *The Private Equity Secondaries Market: a complete guide to its structure, operation and performance* (PEI Media Ltd, 2008) 11.
[99] Stephen Kaplan and Per Stromberg, 'Leveraged Buyouts and Private Equity' (2008) 22 Journal of Economic Perspectives 4

market positions grounded on either price mispricing or some analytical basis that indicates the underlying asset value will turnaround, promising high returns.

For instance, responding to the turmoil in USA financial markets, the USA Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989,[100] which prohibited S&Ls companies from investing in junk bonds. S&Ls were to invest only in investment-grade bonds. Instantly, a huge funding pool had been taken out of the LBO financial market. That Act further required S&Ls companies holding junk bonds to sell their holdings by the end of 1993, precipitating a situation whereby the market was awash with low priced assets, while conversely, the market for new issuances was frozen (as lower rated issuers could not afford to underwrite funding at the new costly rates) – creating a situation of substantial financial strains among corporations that had become extensively exposed to the private equity financing method. Special situations and distressed private equity thrive under these circumstances. Fund managers that still had uncommitted capital found high-quality assets to buy at distressed prices. Distressed private equity had emerged as a new high-earning investment activity.

With experience of cyclicality in mainstream-market linked private equity, the industry sub-specialised into asset bases that were more resilient to exogenous shocks like real estate investment trust (REITs) and the infrastructure fund for private equity (IFPEs), both of which were subsequently created as dedicated investment vehicles, both attractive new asset classes for private equity.

In 2008, new segments to private equity investing emerged. These included PIPEs (private investments in public equity) and debt purchases in existing LBO transactions.[101] Furthermore, publicly traded private equity emerged, with private equity adopting publicly

[100] Publ. L. 101-73, 103 Stat. 183, enacted 9 August 1989
[101] For instance, in 2008, Apollo Management, TPG Capital and Blackstone Group bought $12.5B bank loans from Citigroup, comprising senior secured leveraged loans made to finance buyout transactions. Similarly, in 2008, TPG Capital invested $7B in Washington Mutual, a struggling S&L company to stabilise the Company's balance sheet.

traded vehicles. This market convergence between private equity and public equity markets is still metamorphosing. In 2007, the Blackstone Group successfully went public. Trading was robust at opening, with an opening price of USD35 a share, it closed with USD38 on day 1, but subsequently lost nearly 90% of its value to trade at USD3.55, with minimal recovery since.[102] KKR's public offering a year earlier of KKR Private Equity Investors or KPE, raised USD5 billion through a listing on the Euro-next exchange in Amsterdam. Initially, the offer was over-subscribed by more than 3 times what it had expected. Trading subsequently did not fare too well, dampening investor appetite for publicly traded private equity.[103]

To summarise the preceding discussion, it can be seen that private equity's institutionalisation, segmentation and fundraising processes have all been impacted by myriad external factors including the impact of laws and regulatory policies, developments in the wider financial markets, as well as the impact of regulations on institutional investors. A close appreciation of these issues is important to an understanding of the dynamics that define a country's stage of private equity development – and while it is automatic that historical development models can be mimicked, general lessons can be drawn to inform current and future efforts aimed at expanding national markets for private equity.

3.2.4 Drivers of Private Equity Fundraising Since the 1950s

Three key themes tend to stand out in private equity's fundraising experience since the 1950s: the first is the impact of government policy and regulation; the second is the role of investment banks and the high-yield-bond market; the third is innovation within credit

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[102] Peter Lattman, 'Suit Over Lack of Disclosure in Blackstone I.P.O. Sent Back to Trial Court,' (*The New York Times, 11 February 2011*), http://query.nytimes.com/gst/fullpage.html?res=9E0CE2DA1639F932A25751C0A9679D8B63&ref=blackstonegroup, accessed 26 February 2012

[103] Julie Creswell, 'After Years of Anticipation, a Subdued Public Offering for Kohlberg Kravis,' (*The New York Times, 15 July 2010*), http://www.nytimes.com/2010/07/16/business/16place.html accessed 26 February 2012

markets. Underwriting all of these factors is the market segmentation process already discussed.

To illustrate the first driver of private equity fundraising, the case of the USA stands out. Fundraising drivers included the formation of SBICs in 1958 and the 1979 clarification of the "prudent man rule" under ERISA, which saw pension fund investment into private equity increasing.[104] The language of the law was as follows:[105]

'S.1104(a)(1)

(a) Prudent man standard of care
(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—
(A) for the exclusive purpose of:
(i) providing benefits to participants and their beneficiaries; and
(ii) defraying reasonable expenses of administering the plan;
(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.'

The ERISA clarification applied a fiduciary standard to investment decision-making, in place of applying a regulated threshold to exposure limits.

As already alluded above, the role of investment bankers and underwriters of sub-investment grade corporate securities ('junk bonds') was a substantial driver of fundraising for private equity LBOs in the 1980s. Investment bankers like Drexel Burnham and Michael Milken (1980s) and Chemical Bank (1990s) supported 'blind pools'. After the bankruptcy of Drexel,[106] Chemical Bank quickly became the largest lender in LBO financings by 1993.

[104] Gompers and Lerner, *The Venture Capital Cycle* (2004) (n 29) 'What Drives Venture Capital Fundraising?' 36
[105] USC Title 29-18 1B(4) s1104(a)(1)
[106] Mary Zey, *Banking on Fraud: Drexel, Junk Bonds and Buyouts (Social Institutions and Social Change)* (Aldine Transaction 1993); cf: James B Stewart, *Den of Thieves* (Simon & Schuster Paperbacks, 1992) 267

Furthermore, Chemical bank established new off-shoots around the private equity market, styled syndicated leveraged finance businesses and related advisory services. This signalled a new dimension in the private equity industry – a deepening and sophistication of operations and investors.

The 2000s period was marked by a significant level of risk-tolerance in primary financial markets, made prominent by the PIK and PIK-T as well as '*covenant lite'* methods of refinancing non-performing loan portfolios. PIK-toggles are indentures issued by companies facing cash flow problems to holders of high yield debt. Their issuance triggers interest rate increases, at a compounded rate. With the PIK toggle flexibility, cash-strapped debt issuers were able to avoid technical default. The problem was that the issuing companies got deeper into debt. In 2005-2007 when private equity fundraising was particularly robust, the 'covenant lite' financing feature was mainstreamed: private equity fund managers negotiated very favourable terms with lenders on both senior and subordinated loans. Senior debt would usually carry minimum capital ratio requirements on the borrower, but during this period, these automatic conditions were suspended, hence the '*covenant-lite*' funding terms.[107]

Regulatory changes can also have negative impact on the private equity industry. For instance, regulatory changes following corporate failures in the USA in 2000-2001 in the form of the Sarbanes Oxley law, officially titled the Public Company Accounting Reform and Investor Protection Act, 2002, had two unintended effects: firstly, it created a new regime of rules to govern publicly traded corporations that sharply raised the bureaucratic costs of compliance, prompting many public corporations to support going-private buyouts. Secondly,

[107] David Stowell, Investment Banks, Hedge Funds and Private Equity: The New Paradigm (Elsevier, London, 2010) 361

for venture capital, exit avenues narrowed: going public was no longer a very attractive proposition, owing to the heightened scrutiny by the SEC.[108]

Following the 'Great Recession', the availability of issuers narrowed down and yield spreads widened significantly from 2008, precipitating a pull-back by investment banks. Deals could not price. The leveraged finance markets ground to a halt, forcing buyout firms to withdraw from, renegotiate or re-price deals completed prior to the downturn.[109]

The foregoing review illustrates a close nexus between private equity fundraising and robust primary markets. In virtually all of the three decades since the 1980s when private equity has benefited more from institutional investors as opposed to government funding sources, private equity has succeeded when primary credit markets do well. Whenever investment banking or the traditional banking industry experienced shocks, private equity fundraising and investments suffered. From a law and policy perspective, these experiences suggest that in crafting a legal framework for private equity, its design ought to take into account how private equity-specific law reform impacts or otherwise relates with the wider regulation of a nation's financial and capital markets.

3.2.5 Negative Corporate Practices

The practice of corporate raiding (also known as 'hostile takeovers') involves the subjection of companies to forced acquisition, against management and shareholder wishes.[110] Private equity intermediaries perfected the corporate raiding art in the 1980s. Most buyouts during that decade were public-to-private transactions, that is, public companies

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108 Gary Fooks, 'Auditors and the Permissive Society: Market Failure, Globalisation and Financial Regulation in the USA' (2003) 5(2) Risk Management 17

109 Steven M Davidoff, 'The Failure of Private Equity' (2009) 82 Southern California Law Review 481, 483-5

110 Andrei Shleifer and Lawrence H Summers, 'Breach of Trust in Hostile Takeovers' in Alan J Auerbach (*ed*), *Corporate Takeovers Causes and Consequences* (The University of Chicago Press, 1991) 33 – Illustration: 1985 hostile takeover of TWA by Carl Icahn. Subsequently, Icahn sells off TWA's assets to repay buyout debt. Other notorious corporate raiders : Victor Posner - hostile takeover of Sharon Steel Corporation in 1969, ended in bankruptcy in 1987.

getting delisted from regulated securities exchanges, reverting to private ownership. Corporate raiders were motivated more by the promise of windfall earnings through over-leveraging their targets' balance sheets, undertaking subsequent asset stripping in some cases, or structuring huge payouts to themselves post-acquisition, than in long-term value addition to corporate assets.[111]

The most negative legacy of the corporate raids of the 1980s appear, however, to have revolved primarily around two key issues: saddling acquired companies with too much debt, and the entry into the industry of persons not well qualified to undertake complex financial contracting and investment management. As a result of these twin issues, a number of takeover transactions ended in bankruptcy.[112]

Managers, detesting hostile takeovers, adopted defensive measures in response. The defence mechanisms included 'poison pills' (actions that accelerated a company's internal self-destruction, such as varying management contracts in a way that introduced substantial new underlying corporate liabilities), 'golden parachutes' (employment contract clauses that ensured that redundancies occasioned by a hostile takeover would require massive payments to senior management members at the end of their service contracts), taking on new loans that render a target company unprofitable, as well as the practice of 'greenmail' (where a corporate raider would agree to abandon a hostile takeover provided the corporate raider

[111] Burrough and Heylar, *Barbarians at the Gate* (2004) (n 93): On the first accusation, fingers point to the personal earnings drawn by such investors as Simon Ray in the Gibson Greetings buyout - 1982 (USD66 million). *Cf*: the 1985 buyout by Thomas H. Lee of Sterling Jewellers for USD28 million. Lee put up USD3 million in equity, leveraged the rest. 1987, sold Sterling Jewellers for USD210 million, earned USD180 million in profits. To many commentators, this translated to pure greed.

[112] Michael C Jensen, Willy Burkhardt and Brian K Barry, "Wisconsin Central Ltd Railroad and Berkshire Partners (A) and (B)" Harvard Business School Case Study, 9-19-062, 9-190-070 (1990) - business strategy fell apart soon after the transaction was completed: investors failed to deploy management IT systems against which financial modeling had depended; financial and cash flow projections were flawed.

received a significant stake in the company and he received an incentive payment from the company in lieu of the hostile takeover (essentially a bribe).[113]

The use of very high debt thresholds as part of the acquisition finance in 1980s LBOs became the bane of the corporate raiding phenomenon of the decade, although this strategy had earlier roots: the takeover of Pan-Atlantic Steamship Company on 21 January 1955 by McClean Industries Inc illuminates this strategy. Borrowing USD42 million for the transaction, McLean issued itself USD7 million preferred stock as part of the acquisition settlement, and, upon completion of the acquisition, used USD20 million of the company's cash and assets to retire USD20 million of the borrowed acquisition capital. Shortly thereafter, the board voted a dividend payout to McLean of USD25 million.[114]

Investment bankers in the 1980s also engaged in illegal investment activities, as the case of Drexel Burnham amply illustrates. Drexel was fined USD650 million dollars, the largest fine ever handed down by the SEC until then, for stock manipulation, stock parking, insider trading and defrauding its clients. Furthermore, it agreed to implement stricter safeguards on its oversight procedures.[115] In February 1990, however, Drexel Burnham Lambert filed for Chapter 11 bankruptcy protection.

Towards the end of the 1980s, the earlier supernormal returns that the private equity contracting strategy had boasted could not be sustained. Several companies bought out by private equity went into bankruptcy, while others such as RJR Nabisco were in financial distress.[116]

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[113] US Government Accountability Office (GAO), 'Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks that Warrant Continued Attention' (GAO-08-885, 2008) 17 <http://www.gao.gov/new.items/d08885.pdf> accessed 21 October 2011

[114] Marc Levinson, *The Box: How the Shipping Container Made the World Smaller and the World Economy Bigger* (Princeton University Press, 2006)

[115] Mary Zey, *Banking on Fraud: Drexel, Junk Bonds and Buyouts (Social Institutions and Social Change)* (Aldine Transaction 1993); cf: James B Stewart, *Den of Thieves* (Simon & Schuster Paperbacks, 1992) 267 – "junk bonds" were crucial to the completion of financial structuring in LBO transactions in the 1980s.

[116] Stephen J Davis, John Haltiwanger, Ron Jarmin, Josh Lerner and Javier Miranda, 'Private Equity and Employment' (2011) NBER Working Paper 17399, 45 < http://www.nber.org/papers/w17399.pdf> accessed 28 October 2011

Market intermediaries are adept at exploiting the limits of regulatory inefficiencies – and it can be observed that the corporate raids of the 1980s, Drexel's misconduct, and the misrepresentation of returns expectations to institutional investors by investment advisors all happened within the framework of USA regulations for investment activity. The USA government response to the crises of the 1980s suggests that regulatory framework was inadequate, inefficient or otherwise incomplete to have permitted the pursuit of the various negative corporate activities. As the review under this section has demonstrated, the consequences can be quite damaging. It can be deduced then, that the promise of private equity needs strong laws and institutions in emerging markets: but then, where should that law be sourced? This is an important question that underpins this work in many ways.

3.2.6 Globalisation of Private Equity

European private equity came of age in the 2000s decade, although private equity had taken root in Europe in the 1980s, with the European Venture Capital Association being formed in 1984.[117] Prior to the 2000s decade, private equity investing was largely dominated by USA private equity. The stock market crash of 2000 humbled American private equity markets, but European private equity was resilient and for the first time in 2001, European private equity overtook USA activity.[118]

Private equity outside the USA has picked up strongly in the 2000s, as chart 3.1 below shows. Emerging market-focused funds raised a total of USD32 billion in 2011,[119] way below the pre-crisis high of USD 67 billion raised in capital 2008, and USD59 billion in

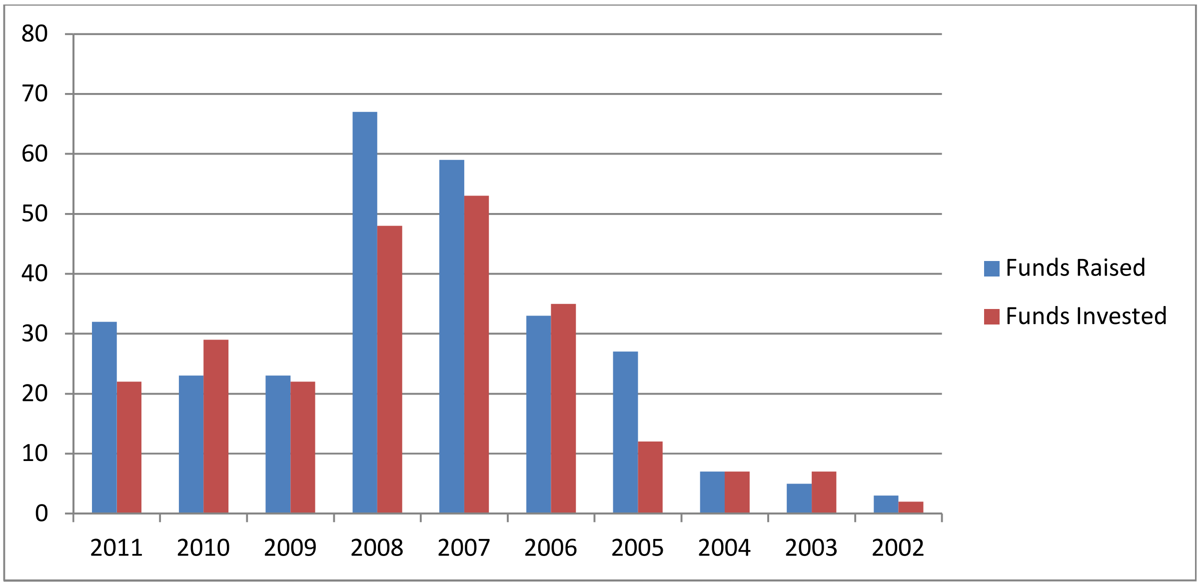
117 European Venture Capital Association, 'Introduction' < http://www.evca.eu/knowledgecenter/default.aspx?id=544> accessed 29 October 2011

118 European Venture Capital Association, 'Preliminary Annual Survey Figures Indicate Difficult Fundraising, But Steady Investment in 2002' (EVCA Press Release, Geneva, 12 March 2003) < http://www.evca.eu/Toolbox/Search.aspx?s=fundraising+2000> accessed 29 October 2011

119 Emerging Markets Private Equity Association, 'Industry Statistics, EMPEA Q3 2011EM PE Industry Statistics' <http://www.empea.net/Main-Menu-Category/EMPEA-Research/Industry-Statistics.aspx> accessed 18 July 2010.

2007. Even then, however, emerging market fundraising has come a long way since 2003, when USD3 billion was raised.[120]

Chart 3.1 Fundraising and Investment Trends, Emerging Markets



Source: EMPEA

In terms of the number of funds, as of December 31, 2008, there were a total of 352 funds active in Emerging Markets. As of March 2009, a total of 371 funds were targeting to raise USD144 billion in capital.[121] African fundraising experienced the strongest year-on-year growth in the 2007/2008 period.[122] In 2011, a total of 119 funds accounted for all the fundraising up to October.

China continues to dominate all fundraising and investment activity in emerging markets.[123] In 2011, China attracted 73% of all the fundraising, while Brazil for the first time

[120] Jennifer Choi, Emerging Markets Private Equity Funds Raise Record Amount of Capital Despite Global Slowdown: US USD66.5 Billion Raised in 2008. Emerging Markets Private Equity Association, Press Release (Washington D.C., February 2009) <http://www.empea.net / > accessed 18 July 2010.

[121] Emerging Markets Private Equity Association, Emerging Markets Private Equity Fundraising and Investment Review, 2008 (April, 2009) 14 <http://www.empea.net/EMPEA_Fundraising_Investment_Report_2008_nonmember[1].pdf> accessed 27 July 2010.

[122] EMPEA, 'Industry Statistics: Fundraising and Investment' (2010) <http://www.empea.net/EMPEA_IndustryStatisticsUpdate_PublicVersion[1].pdf>accessed 27 July 2010.

[123] Emerging Markets Private Equity Association, 'Fundraising for Emerging Markets Tripled in 2005' (EMPEA, 2006) < http://www.empea.net/Main-Menu-Category/EMPEA-Research/Fundraising-Review/Fundraising-Review-2003-2005.aspx?FT=.pdf> accessed 28 October 2011.

overtook India as the second largest emerging market. Eastern European private equity also picked up strongly: Africa's emerging markets continue to trail all emerging market regions. [124] Within Africa, South Africa continues to dominate African private equity, attracting over 70% of all Africa-focused fundraising and investment activity. Outside of South Africa, private equity activity is increasing in West, East, North and Central Africa.

3.3. Transactional Features of Private Equity

3.3.1 Specialised, Adaptive Enterprise Capital

The foregoing discussion has shown that private is a type of corporate finance potentially useful in the development of new products and technologies, [125] expanding working capital, making acquisitions, strengthening a company's balance sheet, resolving ownership and management issues (such as succession in family-owned companies), or undertaking buy-out and buy-in transactions. [126] It emerged to fill gaps that conventional financial intermediaries have historically not bridged. As a specialised type of corporate finance, private equity employs a number of strategies to achieve this. Firstly, it exploits market mispricing, a key element in the buyout market.[127] Secondly, it fills the funding gap through superior risk-mitigation and risk-pricing techniques – supplying Arkelof's "lemons gap".[128] Thirdly, it exploits operating inefficiencies in firms – be they at the individual firm level where corporate restructuring would create value or where divisional spin-offs would permit operational and synergistic focus.[129]

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[124] Ch 1, 13
[125] SJ Davis, JC Haltiwanger, S Schuh, *Job Creation and Destruction* (Cambridge, MA, MIT Press, 1996)
[126] European Venture Capital Association < http://www.evca.eu/toolbox/glossary.aspx?id=982> accessed 12 August 2008
[127] Preqin, 'Special Situations Private Equity' < http://www.preqin.com/listResearch.aspx > accessed 12 August 2010
[128] George A Arkelof, 'The Market for "lemons": Qualitative Uncertainty and the Market Mechanism' (1970) 84 Quarterly Journal of Economics 488-500. cf: Richard Kitchen, 'Venture Capital: Is It Appropriate for Developing Countries?' In *Business Finance in Less Developed Capital Markets* (1992) Klaus Fischer and George Papaioannou (eds), Hofstra University
[129] Preqin, (n127)

3.3.2 Overcoming Business Uncertainty

Although the transactional form of private equity involves dealing in corporate securities primarily, it was shown in the preceding sections that it is unquoted. Its strategy is focused on unlisted companies presenting prospects for strong growth, but facing different types of barriers in accessing needed enterprise finance. These barriers exist either because companies have no pre-existing cash flows and therefore not able to support collateralized lending, or represent emerging sectors or untested technologies, typifying business and market uncertainty. This is the reason private equity venture companies are said to be 'high risk'.[130]

Three factors generally influence a company's financing choices. Firstly, there are issues around business uncertainty. Secondly, there is the problem of asymmetric information. Thirdly, there is the problem of the nature of company assets (also known as 'asset quality').[131] These three problems can become complex depending on the state of financial development, and the depth of market development, within a given jurisdiction. The effect of these issues is the introduction of business uncertainty, rendering most traditional financiers wary of assuming unascertainable risks bound up in such companies.

The problem of uncertainty stems from the business characteristics of the enterprise. Questions here can include, for instance, whether the entity will succeed or fail post-financing, whether the product will be a success or whether the research programme behind the product will succeed. Market competition complicates these uncertainties even more.[132]

Holders of capital including traditional credit markets such as banking institutions, and institutional investors such as pension funds and university endowment funds, are ill-suited to assess business risk outside of an assessment of collateral sufficiency relating to a

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[130] Gompers and Lerner, *The Venture Capital Cycle* (2004) (n 29) 23-25
[131] ibid 157-169
[132] ibid 157

loan application, rendering them incapable of undertaking monitoring-based financing.[133] Some of these limitations stem from regulatory constraints and lending protocols defining bank credit. Institutional investors frequently have neither the time nor the industry expertise to mitigate the types of business uncertainty that private companies present. These realities limit their ability to make informed investment decisions about the capital seeking company. Regulations frequently limit the type of investments regulated institutional investors can make.[134]

Private equity, unlike both bank and institutional investors, tends to manage investment risk better, owing to its monitoring-based investment model, as the following sentences attempt to show. It has the ability and resources to conduct comprehensive due diligence which enables fund managers to assess investment risks more robustly, overcoming the limitations that both banks and regulated institutional investors cannot surmount. It also does not operate from a 'lending' framework: it is a business partner, tying its fortunes to those of venture companies invested in. It stages its financing, ensuring progressive and sustained attainment of mutual business objectives, and enabling for conflicts and non-performance to be addressed as soon as they arise. It assumes executive powers that enable it control management. Where the size of the financing is substantial, it can syndicate its investments, more effectively managing risk. It can vary corporate reporting and accountability requirements beyond the minimum required under statutory edicts, reducing the scope for asymmetric information between investors and investees. [135]

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[133] ibid 163

[134] ibid 162

[135] There is extensive research on the problem termed 'agency' in financial contracting, both theoretical and empirical. They are grounded in the notion of incomplete contracts. A review of the theory of agency is not directly central to this study, and is not done. However, some illustration of key thinking on agency can be found in: Michael C Jensen and WH Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 Journal of Finance 305-60; Michael C Jensen, 'Agency Cost of Free Cash Flow, Corporate Finance and Takeovers' (1986) 76 American Economic Review Papers and Proceedings 323-29; Paul A Gompers, 'Optimal Investment, Monitoring and the Staging of Venture Capital' (1995) 50 Journal of Finance 281-325, In Paul Gompers and Josh Lerner, *The Venture Capital Cycle*, (MIT Press 2004) ch 8: Why Are Investments Staged? 171-200. Paul Gompers, 'Grandstanding in the Venture Capital Industry' (1996) 42 Journal

Private equity furthermore has become well-known for its hands-on approach to investing, colloquially referred to as 'monitoring-based' financing[136] - the fund manager gets directly involved in the operations and leadership of the companies brought under its investment portfolio. [137]The fund manager provides professional and technical investment support services to the company. This business model extends the financier's role into an advisory and disciplining role, as well as a market support role.[138] This strategy is heavily linked to the twin institutions of cash flow[139] and business control rights.[140] In addition, it affords a platform for the alignment of interests on both sides of the funding stream, but with control flowing from the fund manager's end of the contractual relationship.[141] Private equity intermediaries design the capital structures[142] of their investments in a way that ensures investor capital is not only preserved, but grown.[143]

3.3.3 Unlimited by the Asset Characteristics of Venture Companies

The asset character problem that limits the ability of firms to raise capital relates to the frequent lack of tangible assets that can be collateralised. Research by Titman and

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of Financial Economics 133-156; Rafael La Porta, Florencio Lopez-des-Silanes, Andrei Shleifer and Robert Vishny, 'Investor Protection and Corporate Governance' (2000a) 58 Journal of Financial Economics 3-27; Gavin Reid, *Venture Capital Investment: An Agency Analysis of UK Practice - Routledge Studies in the Modern World Economy* (Routledge 1998).

136 ibid 25 – they advise on the development of new business plans, advise management on product or service development, sit in the board, can hire and fire management.

137 EVCA, ' Key Facts and Figures' < http://www.evca.eu/publicandregulatoryaffairs/default.aspx?id=86 > accessed 1 September 2011>

138 Paul Gompers, 'Optimal Investment, Monitoring and the Staging of Venture Capital' (1995) 50 Journal of Finance 1461-1489

139 Jonathan E Cole and Albert L Sokol, 'Structuring Venture Capital Investments,' in Bokster, D. (edn), *Pratt's Guide to Venture Capital Sources* (New York, Securities Data Publishing 1998) 31-39

140 Thomas F. Hellman, 'The Allocation of Control Rights in Venture Capital Contracts' (1998) 29 Rand Journal of Economics 57 – 76. Also: Eric Berglof, A Control Theory of Venture Capital Finance (1994) 10 Journal of Law, Economics and Organization 247-67

141 Stephen N Kaplan and Per Stromberg, 'Financial Contract Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts' (2003) 70 Review of Economic Studies 281-315

142 Edgar Norton and Bernard Tenenbaum., 'Factors Affecting the Structure of Venture Capital Deals' (1992) 30 (3) journal of Small Business Management 20-29 <http://www.epnet.com/ehost/login.html>

143 William A Sahlman, 'Aspects of Financial Contracting in Venture Capital' (1988) 1 Journal of Applied Corporate Finance 23-26

Wessels,[144] Friend and Lang,[145] and Rajan and Zingales[146] sought to show a positive correlation between increased debt and expanded tangibility of assets, consistent with the argument positively linking leverage to the liquidation value of assets as propounded by such commentators as Williamson[147] and Shleifer and Vishny.[148] 'Asset tangibility' refers to the ability of a capital-seeking company to evidence tangible assets owned by it (in practice, found in its balance sheets). Since formal credit is generally collateralised, the deeper a company's tangible asset base is, the higher the leverage it can raise.

Other writers suggest that enterprises dependent on future growth for firm value (like most venture companies in the early and growth phases) employ little or no debt supporting the notion of 'ideas-based financing', such as private equity. Frequently, these choices are not optional. The long-and-short of this problem is that the more easily company asset-type allows entrepreneurs to abscond with investor capital, the more difficult it will be for that company to raise external finance. Asset characteristics that discourage leveraging (bank credit) make monitoring-based financing ideal.[149]

3.3.4 The Elements of a Private Equity Transaction

Private equity involves, at a very simplified level, a purchase and a sale agreement. The process of acquiring shareholding in a company involves a share acquisition (or subscription) transaction. Realising the value in the shares would require the shareholder to sell its stake in the company – a sale transaction. These basic transactions underline any

[144] Sheridan Titman and Roberto Wessels, 'The Determinants of Capital Structure Choice' (1988) 43 Journal of Finance 1-19.
[145] Irwin Friend and Larry HP Lang, 'An Empirical Test of The Impact of Managerial Self-Interest on Corporate Capital Structure' (1988) 43 Journal of Finance 271-81.
[146] Raghuram G Rajan and Luigi G Zingales, 'What Do We Know About Capital Structure? Some Evidence From International Data' (1995) 50 Journal of Finance 1421-60.
[147] Oliver Eaton Williamson, 'Corporate Finance and Corporate Governance' (1988) 43 Journal of Finance 567-91.
[148] Andrei Shleifer and Robert W Vishny, 'Liquidation Value and Debt Capacity: A Market Equilibrium Approach' (1992) 47 Journal of Finance 1343-66 - extending Williamson (1988), argue that asset specificity lower leverage opportunities, because industry-specific assets are less liquid than non-industry specific assets.
[149] Rajan and Zingales, Capital Structure 1995 (n 146)

private equity transaction, regardless of investment segment. The core elements in a private equity deal could thus be summarized as follows.

Table 3.2 Summary of Elements in a Private Equity Transaction

<table>
<tr><th>Primary Transactions[150]</th><th>Financing Mix[151]</th><th>Auxiliary Services</th><th>Priority Order[152]</th></tr>
<tr><td>Acquisition transaction

Debt finance transaction

Equity finance transaction</td><td>Debt (loans)

Mezzanine (loans)

Bridge (loans)

Equity
• Common
• Preferred
• Convertibles
• Options
• warrants</td><td>Merchant Bankers

Lawyers

Accountants

Tax Consultants

Investment Advisors

Analysts

Capital Markets[153]</td><td>Senior Debt (Banks)

Shareholder Loans
• merchant banks
• private equity partners
• other lenders

Mezzanine Finance
• Sr. subordinated debt
• Subordinated debt
• Bridge loans
• Partnership loans
• With/without coupons

Equity layers</td></tr>
<tr><td>• Usually involve a ‘cash sweep’ feature
• Usually build in revolving credit facility</td><td colspan="3">• Financing mix conveys investment control rights – over the business cash-flows and management decision making (board seats).[154]
• Share classes carry class rights, even within same share classes, based on pre-negotiated contract-based rights and obligations[155]
• Transactions structured to guard against liabilities migrating upstream[156]
• Transactions structured to anticipate exit strategy</td></tr>
</table>

[150] Jack S Levin, *Structuring Private Equity, Venture Capital and Entrepreneurial Transactions* (Aspen, 2011) 1, 1-8, 1-12

[151] Titman and Wessels, ‘Capital Structure Choice’ (1988) (n 144), 3

[152] Li Jin and Fiona Wang, ‘Leveraged Buyouts: Inception, Evolution and Future Trends’ (2002) 3(6) Perspectives < http://www.oycf.org/Perspectives2/18_093002/contents.htm> accessed 15 October 2007

[153] E.g. Laura C. Field and Gordon Hanka, ‘The Expiration of IPO Share Lockups’ (2001) 56 Journal of Finance 471, 2-3

[154] Hellman, ‘Control Rights in Venture Capital Contracts’ (1998) (n 140) 57-76; cf: Stephen Kaplan and Johan Per Stromberg, ‘Financial Contract Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts’ (2003) 70 Review of Economic Studies 281-315

[155] Yosha S Chan, ‘On the Positive Role of Financial Intermediation in Allocation of Venture Capital in a Market with Imperfect Information’ (1983) 38 Journal of Finance 1543

[156] Levin, *Structuring Entrepreneurial Transactions* (2011) (n 150) 5-29 – 5-32; 5-56 – 5-63: including unpaid tax liabilities, pension plan liabilities, withdrawal liabilities for underfunded union pension funds, medical and life insurances of target’s retirees, environmental cleanup, impact of tax on capital structures, and similar issues.

Private equity employs different strategies to effect the deal finance transactions it can leverage the target's balance sheet, issue subordinated or mezzanine debt which could be structured as shareholder loans in a stock or share purchase transaction, amalgamate the target with a new acquisition entity or special purpose vehicle, or use specialised cash mergers (reverse subsidiary cash merger, reverse to party cash merger or part purchase plus part redemption of target's stock).[157]

Senior debt is secured against the venture companies asset base. Each debt class and tranche carries varying maturities and repayment terms, however. Some require the amortisation of principal and scheduled interest payments together. Others have warrants attaching to the debt, allowing lenders to participate in the equity upside should the investment be a "home-run" (highly successful).[158] Employing PIK-toggles can marginally raise interest rates.[159] Preference share classes can also be designed to accept PIK dividends, representing interest payments in the form of additional shares of preferred stock.[160]

The 'cash sweep' provision ensures that any cash surpluses (the free cash flow remaining after priority and mandatory amortisation payments are made) are employed in principal down payments for all debt classes in order of their seniority. It is not a floating-charge type instrument; it is attached to specific debt classes during the deal structuring phase.[161]

Revolving credit is a type of line of credit that allows the invested venture company access to working capital should it experience difficulties post-investment and enables the

[157] ibid
[158] Jonathan Olsen, 'Note on Leveraged Buyout,' (2003) Tuck School of Business (Dartmouth, unpublished), <http://www.tuck.dartmouth.edu/search/> , 4
[159] Geoffrey Parnass, 'High Yield Debt Issues Trigger "PIK" Options,' (EGS LLP, Private Equity Law Review, 19 April 2009) <http://www.privateequitylawreview.com/tags/pik/> accessed 29 April 2011
[160] Olsen, 'Leveraged Buyout,' 2003 (n 158)
[161] ibid

acquired business to make certain capital investments, and to meet unforeseen costs, including overruns in operating expenditures, without having to raise new debt.[162]

Taking the totality of the foregoing transactional features of private equity, it becomes clear that a country's legal and institutional environment can potentially exert a strong influence over how the private equity industry evolves. For instance, questions on the extent to which companies can self-finance in the buyout process become pertinent. Similarly, the overall legal framework for mergers and acquisitions could determine the extent to which a buyout market can grow in a given legal system.

3.4 Conclusion

This chapter has demonstrated that private equity in its modern form is a relatively young phenomenon, but one that has undergone substantial changes in its methodology, sophistication and role in the economic fabric of the countries it has grown in. Four key observations arise from the discourse in this chapter.

The first is that private equity as an industry can respond to targeted public policy interventions, yet the reviewed experiences of some less successful public policy projects offer lessons on design elements: a country seeking to grow private equity through employment of public policy tools ought to undertake careful evaluation over which aspects to target.

The second is that private equity is sensitive to shocks in public equity markets, and to volatility in the banking sector, suggesting the existence of an influential link between private equity and traditional financial markets – with private equity's resilience riding substantially on stability in these primary financial markets. The implication of this deduction is that

[162] Li Jin and Fiona Wang, 2002 (n 152)

public policy for private equity needs to be holistic, taking into account the need for financial sector deepening across all sectors of the economy.

The third relates to the nature of private equity – and the review in this chapter indicates that private equity holds out the promise of surmounting barriers to innovation, creativity and enterprise – by facilitating access to risk capital for firms that would otherwise not access funding. It has over time developed and adapted specialised financing packages, investment conditions and approaches, well-suited to differently placed companies. As a tool in economic management therefore, private equity holds out the opportunity for private sector growth and development.

Lastly, private equity, like all corporate activity, is prone to excesses. The extent to which its negative manifestations find room to occur depends strongly on a country's legal standards and enforcement ethic. These latter elements frequently turn on the 'culture' and 'ethics' of the legal system.

4

SOURCES OF ENTERPRISE FINANCE IN KENYA

4.1 Introduction

In the preceding chapter, it was shown that private equity is a type of investor that is focused on private sector businesses which require different forms of external capital to finance their operations. The sources of finance available to them vary across jurisdictions, but generally include bank credit (commercial banks, development banks), and nonbank credit (investment banks and companies, savings and credit cooperatives, building societies, and microfinance institutions), public equity markets (stock exchanges, over the counter markets, bond markets and other regulated equity exchanges), and equity finance (private equity in all its varieties). This chapter is devoted to an exploration of how private companies raise their capital requirements. It speaks to four specific questions: what are the sources of enterprise capital in Kenya? What types of enterprises seek and need financing in Kenya? What barriers exist in their accessing desired types of financing? What is the private equity opportunity in Kenya?

In reviewing the sources of enterprise capital in Kenya, this chapter draws partly from the empirical findings of the surveys and interviews that underpin this study.

Research suggests that the quality of a country's private sector can be influential in determining the type of financing available to businesses.[1] Development literature is bold in modelling a similar pathway: that finance and private sector growth revolve around the

[1] Thomas Hellman and Manju Puri, 'The Interaction Between Product Market and Financing Strategy: The Role of Venture Capital' (2000) 13:4 Review of Financial Studies 959-984. Cf: Thomas Hellman and Manju Puri, 'Venture Capital and the Professionalization of Start-Up Firms: Empirical Evidence' (2002) 57:1 Journal of Finance 169-197; Samuel Kortum and Josh Lerner, 'Assessing the Contribution of Venture Capital to Innovation' (2000) 31:4 Rand Journal 674-692.

behaviour and performance of firms.[2] The 'quality' of the private sector is the sum of the type, condition and structure of the entrepreneurial space in an economy.[3] For instance, a country with a highly formalised private sector is likely to witness a stronger demand for formal types of business finance compared to a country with a business community that is preponderantly informal.[4] The level of formalisation could affect the quality and extent to which good collateral can be mobilised by economic operators. Secondly, the financing options available could turn on factors outside the private sector – such as prudential regulations, and the ability or, more frequently, the willingness, of formal credit markets to lend against ideas as opposed to collateral.

Private equity is a commercial undertaking, and a central argument in this investigation is that the quality of business climate in a country is likely to influence how private equity grows as an industry in that country. This chapter consequently includes a short review of the business climate in Kenya, with the objective of illustrating aspects that could benefit from direct public policy interventions to improve the quality of the business climate such as would enable private equity to grow.

To set the stage for the discussion that follows, section 4.2 offers a number of reflections on the supply and demand factors underpinning risk finance generally. Section 4.3 reviews the three main sources of enterprise capital in Kenya: microfinance, bank loans and public equity sources. These review highlights the central features underpinning each type of finance: in effect, the providers, and what type of commercial enterprise is most likely to be well-suited to each.

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[2] The World Bank, 'Finance and Private Sector Research' (2010) <http://econ.worldbank.org/external/default/main?menuPK=478071&pagePK=64168176&piPK=64168140&theSitePK=478060> accessed 20 October 2011.

[3] OECD, 'Measuring Entrepreneurship – A Digest of Indicators' (2008) OECD – *Eurostat Entrepreneurship Indicators Programme*,<http://www.oecd.org/dataoecd/53/23/41664409.pdf>

[4] By formal is meant the status of a business enterprise as an officially registered or otherwise legally constituted venture. By informal is meant businesses that are unregistered, often led by sole entrepreneurs, frequently do not have fixed and known business addresses, and mostly family-based.

To resolve the second issue, section 4.4 offers an analysis of the investment climate, as well as a descriptive analysis of the structure of the private sector in Kenya. This review shows how a challenging business environment negatively impacts the emergence of strong companies which would in turn drive a stronger demand for different types of enterprise finance. In addition, the review offers a typology of an average capital-seeking enterprise in Kenya: showing how a certain type of company would experience significant barriers in raising different types of enterprise capital in Kenya.

To address the third issue (barriers to enterprise capital in Kenya), section 4.5 teases out the most prevalent forms of barriers identified in the course of the study: including the quality of collateral necessary to support bank loans, the cost of bank loans (interest rates), the problem of business informality and how this relates to both bank and capital market sources of finance, the impact of negative business practices as a barrier to finance. In addition, the quality of the banking sector is reviewed, with special focus on the historical fragility of the banking sector and how negative public policy contributed to weakening the commercial banking sector, and how a weak banking sector in turn failed to serve the country's business community. Finally, the section also reviews the range of products available in the formal credit markets.

Based on these reviews, section 4.6 reflects on the implications this chapter raises for private equity development in Kenya. Particularly, it highlights the role that private equity could play, better clarifying the extent to which law and legal institutions have a part to play.

4.2 Supply and Demand Drivers to Risk Finance – Some Issues

Research has shown that public policy can impede or promote access to enterprise capital.[5] The condition of a country's private sector, thus, could be said to mirror that country's legal and political outlook: if the legal system is effective – that is, stable and predictable - and the political philosophy supports enterprise and protects private property, productive entrepreneurship that supports economic growth is likely to expand.[6] Such entrepreneurship requires fit-for-purpose financing for optimal expansion. These are the demand drivers for business finance. The thesis in official studies and policies on private sector development in Kenya suggest that difficulties in accessing finance, opaque tax regimes, poor infrastructure, corruption, insecurity and burdensome business regulations continue to frustrate entrepreneurship.[7]

Supply-side factors are just as important, however – and by this are meant the various sources of and motivations for making financing available to business ventures. In this respect, therefore, the depth of the money and capital markets in a country, can effectively determine both type and quantity of enterprise finance available for business ventures. By money markets are meant credit sources such as bank financing and other sources of debt finance. By capital markets is meant the market for securities either through a regulated exchange or bond markets. If a country's money and capital markets are shallow from a liquidity perspective, it is not likely that sources of business finance would be well-developed.

[5] Deepak Lal, Foreword, in Benjamin Powell (*ed*), *Making Poor Nations Rich: Entrepreneurship and the Process of Economic Development*, (Independent Institute, Stanford, California © 2008)
[6]ibid, Benjamin Powell, ch 1.
[7] These policy studies include the *FIAS Study on Administrative Barriers to Investment in Kenya, 2004*; the *Sessional Papey 2/ 2005 on the Development of Micro- and Small Enterprises for Wealth and Employment Creation*; the *Private Sector Development Strategy (PSDS) 2006-2010, the Economic Recovery Strategy for Wealth and Employment Creation (ERS) 2003-2007*; the *Investment Climate Action Plan (ICAP) 2005;* and *Vision 2030*. Also, *The Master Plan Study for Kenyan* Industrial Development (MAPSKID) 2007, Ministry of Trade and Industry < http://www.ministryoftradeandindustry.go.ke/ > accessed 20 January 2011

In situations where demand for enterprise finance outstrips supply, it is likely that institutional sources of enterprise finance would be inefficient.[8] Procedural barriers that complicate access to finance – for example, bureaucratising collateral requirements on both quantity and quality, or the length of time the applicant enterprise should have been trading successfully prior to applying - might be observed more frequently. The more onerous these requirements are, and depending on the structural context of the private sector, the higher the likelihood that businesses within such a jurisdiction would experience financial exclusion to varying degrees.[9]

In contrast, where money and capital markets are well developed, and the number of intermediating institutions is high, there is likely to be a healthy competition in financial product innovation, meaning the financial markets are more likely to be responsive to the needs of an economy, and likely to be more able to innovate financing solutions to meet the needs of the business community. Conditions for access to financing would also most likely be less onerous, and may not be motivated by an intrinsic desire to limit the number of qualifying applicants.[10]

In reality, however, but without prejudice to the generality of the foregoing, the demand and supply factors do not operate in isolation. For the capital provider, the quality of the 'demand' can effectively shape the quality and type of the supply. This is how: business lenders and financiers are motivated by profit. How much profit a financing opportunity promises depends on any number of factors including the volume or scale of financing (larger

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[8] Bengt Holmstrom and Jean Tirole, 'Financial Intermediation, Loanable Funds and the Real Sector' (1997) 112:3 Quarterly Journal of Economics 663-91.

[9] Simon Johnson, John McMillan, and Christopher Woodruff, 'Property Rights and Finance' (2002) 92:5 The American Economic Review 1335-1355.

[10] Margaret Miller, Nataliya Mylenko and Shalini Sankaranayanan, 'Financial Infrastructure – Building Access Through Transparent and Stable Financial Systems' (2009) International Bank for Reconstruction and Development and International Finance Corporation. 1 <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTFINANCIALSECTOR/.../...0.html> accessed 23 January 2012 – "access to finance is the result of a complex interplay of different financial intermediaries, the right kind of financial infrastructure, and a sound legal and regulatory framework".

credits yield higher profits, lowers monitoring costs), character of the opportunity (e.g., a very high risk, high return venture), consumer profile (e.g. a captive market, a growing market, a single consumer), regulatory costs (issues around compliance) and, frequently in a developing economy context, the prevailing economic policies of the day. Any funding application would invariably ride on the foregoing pillars, and this is what is characterised as demand in this chapter.

From a financial contracting framework, private equity financial contracts - like all commercial contracts - are designed to speak to (i) the dynamics of the business transaction, (ii) the special circumstances of the contracting parties – especially those likely to introduce risks to contract objectives, and (iii) the various options available within a legal jurisdiction for the promotion and, where necessary, the enforcement of obligations. Understanding the larger themes defining the occurrence – and terms - of financial contracts in Kenya, is a useful step towards exposing elements open to policy reform with the view to improving the business climate for private equity finance to occur.[11]

4.3 Kenya's Financial and Money Market Institutions

4.3.1 The General Financial Infrastructure in Kenya

Kenya's financial sector, generally considered to be one of the broadest and most sophisticated in Sub-Saharan Africa,[12] is made up of two main types of institutional intermediaries: money market institutions and financial market institutions. Money market

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[11] Marco da Rin, Giovanna Nicodano, and Alessandro Sembenelli, Public Policy and the Creation of Active Venture Capital Markets, European Central Bank, Working Paper Series 430/2005 <http://www.ecb.int.> accessed 20 October 2011.

[12] Klaus Schwab, 'Global Competitiveness Report 2011' (World Economic Forum, 2011) 55 <http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf> accessed 20 October 2011.

institutions refer to financial institutions affiliated to the banking sector, while capital markets institutions are those financial institutions affiliated directly with the public equity markets in the country.

As of 2011, money market institutions comprised 43 banks, [13] 6 licensed deposit-taking microfinance institutions(MFIs)[14] and 52 unregistered micro finance institutions, 5,892 licensed banking agents, 6 nonbank financial institutions, 1 mortgage finance institution,[15] 4 building societies, 127 licensed foreign exchange bureaux, 17 pension funds supporting 1,216 pension schemes,[16] and 6,473 Savings and Credit Cooperative Companies (SACCOs), as well as a range of insurance schemes and mutual funds.

Within the capital market framework, there were, in 2011, 4 types of approved institutions, 6 stock brokers, 19 investment banks, 20 investment advisers, 18 fund managers (6 being high-risk debt and related investment services, 1 being a venture capital fund, and 11 being traditional asset management companies), 7 approved Employee Share Ownership (ESOP) schemes, 11 approved collective investment (CIS) schemes, 15 authorized depositories, and 20 investment advisors.[17]

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[13] Schedule 1, Central Bank of Kenya Act of 1966, Cap 491 Laws of Kenya; Central Bank of Kenya, 'Introduction to Financial System' <http://www.centralbank.go.ke/financial system/banks/Introduction.aspx > accessed 15 August 2011: Out of the 44 banks, 31 are locally owned; 13 are foreign owned. Out of the 31 local banks, 3 comprise banks with significant government state corporations shareholding (National Bank of Kenya is 70.6% government owned; Consolidated Bank is 77% government owned; Development Bank of Kenya is 100% government owned); 27 are commercial banks.

[14] Central Bank of Kenya, 'Deposit Taking Microfinance Institutions' <http://www.centralbank.go.ke/financialsystem/microfinance/deposittaking.aspx> accessed 15 August 2011: these are Faulu Kenya DTM Ltd; Kenya Women Finance Trust DTM Ltd; Remu DTM Ltd; SMEP DTM Ltd; UWEZO DTM Ltd; Rafiki DTM – with a total of 54 branches nationwide between them.

[15] Central Bank of Kenya, Introduction to Financial System (n 12)

[16] Retirement Benefits Authority, 'Registered Schemes', <http://www.rba.go.ke/media/docs/schemes/Registered-Schemes.pdf > accessed 8 October 2011

[17] Kenya Gazette Vol.CXII-No.45 of 30 April 2011, published by the CMA in compliance with sections 11(3) and 27(1) of the Act.

In the following sub-sections, each of the financing options outlined above is considered in greater detail under four themes: micro-finance, credit and cooperative societies, bank finance and capital market financing solutions.

4.3.2 Micro-Finance

The micro-finance sector in Kenya comprises a range of institutions including microfinance banks, wholesale MFIs, retail MFIs, development institutions and insurance companies.[18] The MFI industry currently serves an estimated 6.5 million Kenyan families and households through its 52 registered members, all of whom are currently overseeing an outstanding loan portfolio of KES29 billion (roughly USD310 million).[19]

MFIs in Kenya can be either registered as deposit-taking MFIs or non-deposit taking MFIs. MFIs subject to regulatory oversight are regulated by the Central Bank of Kenya, under the Microfinance Act of 2006.[20] As of at end 2011, there were 5 licensed deposit-taking MFIs.[21] A deposit-taking business is one that holds itself out as accepting deposits on day to day basis, and conducts its business through lending or extending credit at its own risk.[22] The Central Bank has additionally approved 34 other microfinance business names – the first step towards registration as a deposit-taking MFI in Kenya.[23]

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[18] Association of Microfinance Institutions of Kenya (AMFI), 'Membership' <http://www.amfikenya.com/pages.php?p=1> accessed 10 October 2011: serving 6.5 million clients, with outstanding loan portfolio of over Ksh.29 billion (roughly over $310 million).
[19] ibid
[20] No.19, s 5, Laws of Kenya
[21] Central Bank of Kenya, 'Deposit Taking Microfinance Institutions' < http://www.centralbank.go.ke/financialsystem/microfinance/deposittaking.aspx> accessed 9 September 2011.These were: Faulu Kenya DTM Ltd; Kenya Women Finance Trust DTM Ltd; Remu DTM Ltd; SMEP DTM Ltd; and Uwezo DTM Ltd – all licensed between May 2009 and December 2010.
[22] Microfinance Act 2006, s 2
[23] Central Bank of Kenya, 'Annual Report' (2010) 44 < http://www.centralbank.go.ke/downloads/publications/annualreports/cbk/annual_2009-10.pdf> accessed 10 September 2011

Micro-finance has been catalytic in the emergence of some of Kenya's major commercial banks. Equity Bank Ltd and Family Bank Ltd were initially building societies.[24] K-REP Bank Ltd was a non-governmental organisation offering microfinance services.[25] Cooperative Bank of Kenya Ltd was a cooperative society.[26] All four banks grew out of the historically narrow market penetration of traditional forms of banking in Kenya, and they continue to define the country's microfinance landscape. It was estimated that in 2010, formal banking institutions held \$17.8billion in assets, compared to \$1.5billion held by MFIs.[27]

There are in Kenya a number of other institutions whose financing solutions fit properly within a 'micro-finance' definition – and these include unregistered micro-finance lenders, mobile money payment systems, development finance institutions, non-governmental organisations practising micro-finance, and informal self-help groups and unlicensed money lenders.[28] In terms of relative market share, commercial banks are estimated to serve a total of 22.6% of Kenya's adult population, while microfinance institutions serve an estimated 17.9%. Informal financial markets including non-governmental organisations, self-help groups and money lenders serve an additional 22.8% of Kenyans. The foregoing suggests that a total of 32.7% of Kenya's adult population do not have access to any form of financial services.[29]

Micro-finance in all its varieties is provided in the form of short-term loans, usually secured against some form of collateral. Sector specialisation within the micro-finance

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[24] Mix Market,' Micro Finance in Kenya: Country Briefing' (2010) < http://www.mixmarket.org/mfi/country/Kenya/report#node-26111-link> accessed 6 September 2011
[25] ibid
[26] ibid
[27] CIA Fact Book 2010 < https://www.cia.gov/library/publications/the-world-factbook/geos/ke.html> accessed 18 August 2011
[28] Consultative Group to Assist the Poor, Kenya (March 2011) < http://www.cgap.org/p/site/c/template.rc/1.26.13733> accessed 20 October 2011
[29] Mix Market, 'Micro Finance in Kenya: Country Briefing' (2010) < http://www.mixmarket.org/mfi/country/Kenya/report#node-26111-link> accessed 6 September 2011

industry also aids in relational contracting, reducing the perception of risk and driving commercial trust. The simple fact of the sector's substantial growth in Kenya is indicative that the unique contracting strategies within the industry continue to be effective.

The Microfinance Act of 2006 imposes licensing and transparency requirements,[30] deposit protection requirements (up to Ksh.100,000 per depositor)[31] and also makes provision for dissolution of institutions,[32] corporate governance,[33] performance and accounting standards[34] and supervision by the Central Bank of Kenya.[35] The Act was revised in 2008 to create two categories of deposit-taking MFIs, one styled 'community-based MFIs' and the other 'nationwide MFIs'. Capital requirements were relaxed for the former, and they can convert to the nation-wide status. Nation-wide MFIs cannot convert to community-based status because of the lighter operational conditions.[36]

Non-deposit taking (or 'credit only') MFIs are not regulated by the Central Bank of Kenya. They can be regulated by the Savings and Credit Cooperatives Societies Regulatory Authority (SASRA) where they qualify as SACCOs, or by the Non-Governmental Organisations Council under the NGO Coordination Act No.19 of 1990 if they are NGOs. All other MFIs that do not fit any of the foregoing descriptions are unregulated – and there is an ongoing debate on how to bring this unregulated group of MFIs under the sector's broad regulatory framework.[37]

The AMFI has adopted a code of conduct and a generic constitution that it recommends to all its members to abide by. These efforts augment the minimum statutory

[30] Microfinance Act, ss 4,5,6,7,8,9,10
[31] ibid, The Microfinance (Deposit Taking Microfinance Deposit Protection Fund) Regulations, 2009
[32] Microfinance Act No.19 2006, s 38, Laws of Kenya
[33] ibid ss 11-22, Part III (Governance)
[34] ibid ss 23-34
[35] ibid ss 8, 37, 39, 40, 41, 42
[36] ibid s 7, 48(2) – implemented in: The Microfinance (Categorization of Deposit-Taking Microfinance Institutions) Regulations, 2008, Legal Notice No.57 of 2008.
[37] Mix Market, 'Micro Finance in Kenya: Country Briefing' (2010) <http://www.mixmarket.org/mfi/country/Kenya/report#node-26111-link> accessed 6 September 2011.

standards, and importantly introduce development-orientated standards including social responsibility, environmental management and financial sustainability.[38]

For purposes of this thesis, micro-finance, while serving an important economic role, is not a solution well-suited to the kind of economic activity that private equity financing would be financing – supporting the need for private equity's specialised approaches and solutions to enterprise growth.

4.3.3 Savings and Credit Cooperative Societies

Savings and Credit Cooperative Societies (SACCOS) are regulated by the SASRA, in accordance with the SACCO Societies Act No.14 of 2008.[39] As stated earlier, there were some 6,473 such schemes as at end 2010. This estimate is inconclusive, however, as there does not yet exist a national unified register of such entities.

SACCOs fill a critical gap left open by stringent bank regulations on personal finance. There are generally three core types of SACCOs in Kenya, clustered according to either type or geographic location. Firstly, there are the urban SACCOs, headquartered in Nairobi, with branches around the main cities and towns in the country, and managing substantial asset bases (up to KES15 billion in some SACCOs by some estimates).[40] Then there are rural SACCOs, serving rural populations (most of whom are otherwise unbanked as section 4.4 establishes). Rural SACCOs are frequently the only form of financing available in some of Kenya's remotest communities. Thirdly, there are employer-based SACCOs, set up by

[38] AMFI, 'Kenyan MFI Practitioners Make Historic Decisions on 20th August 2010' <http://www.amfikenya.com/pages.php?p=65&ID=26> (n 17)
[39] ss 4 (establishment), 5 (objects and functions), 23-28 (licensing regime), 48 (regulation of SACCO Societies)
[40] FSD Kenya, 'Automation of SACCOs: An Assessment of Potential Solutions' (March 2010) 13 <http://www.fsdkenya.org/pdf_documents/10-09-22_SACCO_automation_report.pdf> accessed 19 February 2012

employers across different economic sectors to expand financing solutions to their employees. Fourthly, there are agricultural SACCOs, linked to the main agricultural sectors in Kenya (such as tea, coffee, rice), and they serve agricultural communities (farmers) across the country.

In terms of structure, SACCOs fall into two types: credit only and deposit-taking SACCOs. The former simply make credit available to members through giving their members a flexible savings facility implementing a check-off system managed by the various payroll services. Entry is easy and exit is easy. Members are allowed to access their savings at any time, and when they require a loan, the terms and conditions are easy to comply with. They generally permit members to leverage their shares up to three times ('shares' being the face-value of their cash savings in their SACCO account), repayable over a maximum period of 48 months in most cases. SACCOS have also diversified their financing products ('development loans', 'emergency loans', 'school fees loans', and 'construction loans') while preserving the procedural simplicity of the funding framework.[41]

Deposit-taking SACCOs offer front office savings activities (FOSA), and are now subject to stringent regulations under the SASRA. It was estimated that there were about 200 deposit-taking SACCOs in Kenya in 2010, and it is on record that at least 66 more were licensed by SASRA by the end of 2011. [42]

SACCOs enable the lower end of capital consumers to finance small-scale business ventures, as well as various consumer needs. Importantly for this study, SACCOs are not

[41] For an illustration: Kenya Union of Savings and Credit Organisations (KUSCO), 'Loans' <http://www.kuscco.com/index.php/publications/cat_view/50-loans> accessed 19 February 2012 accessed 19 February 2012

[42]KUSCO, 'Deposit-Taking SACCOs Licensed by SASRA' (2011) <http://www.kuscco.com/dmdocuments/licensedsaccos.pdf> accessed 19 February 2012

sources of substantial enterprise capital, and while they serve a critical socio-economic need, the critical problem of lack of effective enterprise capital for fast growing SMEs persists.

Contextualising the foregoing framework into this study, both MFIs and SACCOs meet a critical societal need, but do not effectively address the funding gap in Kenya.

4.3.4 Bank Loans

Medium and large enterprises in Kenya can, generically speaking, raise their financing requirements from (i) commercial banks, (ii) development finance institutions, and (iii) investment companies.

When providing an overview of the financial system in Kenya earlier in this chapter, it was shown that there are 43 banks in Kenya. 31 of these are commercial banks. A review of the broad range of bank products available to the business community shows the following products on offer by Kenya's banks:[43]

- Short-term, syndicated and term loans and overdrafts – loans can be secured or unsecured – conditions vary across banks
- Bonds and commercial paper
- Trade finance (letters of credit, pre/post import finance, invoice and bill discounting, stock finance, guarantees and bonds, business advisory services)
- Asset finance (vehicle/assets, insurance premium finance, leasing)

[43] Generally, Barclays Bank of Kenya Ltd < http://www.barclays.com>; Kenya Commercial Bank < http://www.kcbbankgroup.com>; Cooperative Bank of Kenya Ltd < http://www.co-opbank.co.ke>; Standard Chartered Bank of Kenya Ltd < http://www.standardchartered.com/ke/en>; CFC Stanbic Bank < http://www.stanbicbank.co.ke/portal/site/kenya> all accessed 8 October 2011

- Custodial services

- Transactional banking

- SME loans (Cooperative Bank making available up to Ksh.50 million per borrower, and Standard Chartered Bank offering a range of specialised products for SMEs including working capital, business expansion, business protection, yield enhancement and cross-border banking).

Commercial bank loans and advances attracted a lending rate of 14.29% in July 2010, compared to 13.3% in 2007, and 13.1% in 2005, while savings yielded 1.55% and deposits 3.85% returns in July 2010, compared to 1.55% and 1.7% respectively in 2007, and 1.4% for both in 2005. Overdrafts in July 2010 attracted an interest rate of 14.03%, compared to 13% in 2007, and 13.7% in 2005.[44]

As of October 2011, lending rates had risen beyond 25% for commercial loans as a result of a devalued shilling, which shed nearly 25% of its value over the preceding twelve months (October 2010). The main factors driving the depreciation of the Kenya shilling included the effects of the Great Recession (which slowed down Europe as an important export market for Kenya),[45] and capital flight[46] (estimated at over USD201 million – or KES17 billion).[47] Governments around the world have responded differently to the Great Recession. In the UK, quantitative easing measures formed a central part of the credit

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[44] Kenya National Bureau of Statistics (2008) < http://www.knbs.or.ke/> accessed 10 October 2011
[45] BBC, 'G20 Ministers Meeting to Discuss Eurozone Debt Crisis' (BBC, 14 October 2011) < http://www.bbc.co.uk/news/business-15302908> accessed 20 October 2011.
[46] Andrew Burns and Theo Janse van Rensburg, 'Global Economic Prospects: Vulnerabilities and Uncertainties' (The World Bank, 2012) 8, 27-28. <http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/GEPEXT/0,,contentMDK:21021075~menuPK:51087945~pagePK:51087946~piPK:51087916~theSitePK:538110,00.html >
[47] Geoffrey Irungu, 'Flight of sh17bn in foreign currency sparked shilling's rapid fall as banks moved to cash in' (Business Daily, Nairobi, 16 February 2012) <http://www.businessdailyafrica.com/Corporate+News/Flight+of+Sh17bn+in+forex+sparked++shilling+rapid+fall/-/539550/1329102/-/9gxeegz/-/index.html> accessed 19 February 2012

response mechanisms,[48] in addition to other approaches adopted generally across Western Europe.[49]

Commercial banks in Kenya lend against collateral for the most part. As the discussion below suggests, for the SME sector, business informality militates against the accumulation of good collateral, meaning that access to substantial amounts of bank finance to meet business needs will be a significant barrier for a large proportion of the private sector. The effect of the Great Recession in Kenya on enterprise finance has been on the cost of bank credit.[50] With strict collateral requirements, enterprises that do not have strong asset bases find formal credit inaccessible.

4.3.5 Public Equity Markets

Public equity markets are another source of substantial enterprise finance in Kenya, but only to specific types of businesses that can meet the stringent listing requirements, detailed below. A company in Kenya can meet its financing requirements by selling its shares to the public through the regulated capital markets operating under the Nairobi Stock Exchange (the NSE). Where this avenue is adopted for the first time in a company's capital structuring, the process is termed an initial public offering (IPO), subject to specified listing rules.[51] The Nairobi Stock Exchange (NSE) was officially established in

[48] David Miles, 'Monetary Policy and Financial Dislocation' (Bank of England, 10 October 2011) <http://www.bankofengland.co.uk/publications/news/2011/093.htm> accessed 20 October 2011 – as of January 2012, a total of £325 in quantitative easing had been injected into the British economy.

[49] The World Bank, Global Economic Prospects 2012 (n 45) 5 – including bank sector reforms, facilitated access of banks to dollar markets and medium-term ECB funding, reinforcement of European financial stability, passage of fiscal and structural reform packages in Greece, Italy and Spain, and agreement on a pan-European fiscal compact.

[50] The Central Bank of Kenya < http://www.centralbank.go.ke/> accessed 10 September 2011

[51] The Capital Markets (Securities)(Public Offers Listing and Disclosure) Regulations 2002.

1954 as a voluntary association of stock brokers registered under the Societies Act of the Kenyan Colony.[52]

The NSE has three investment segments: the main investment segment or the MIMS, the alternative investments segment or the AIMS, and the Fixed Income Security Market Segment or the FISMS.[53] As of August 2011, there were 58 listed companies on the MIMS (7 agribusiness firms, 8 companies in commercial services, 2 telecommunication and technology, 4 automobiles and accessories, 10 banking, 5 insurance, 4 investment businesses, 9 manufacturing and allied firms, 5 construction and allied, and 4 energy and petroleum). There were 8 companies on the AIMS, and 13 fixed income securities on the FISMS (including preference shares, floating rate notes, medium term floating rate notes, medium term unsecured notes, subordinated bonds, public infrastructure bonds, government infrastructure bonds and treasury bonds).[54] In total, there are 79 listings as of 2011 - in 56 years since the Exchange was first established.[55]

There is anecdotal evidence that an over-the-counter (OTC) market that expands trading platforms within the capital markets framework is currently operational and quite active in Kenya.[56] It is unregulated, however, and register keepers for trading companies are reluctant to divulge information about their clientele. Newspaper reports suggest that as many as 200 companies are gearing for trade within the OTC market, which became fully active

[52] Nairobi Stock Exchange, 'History of the Organisation' (*Nairobi Stock Exchange*, 10 October 2011) < http://www.nse.co.ke/about-nse/history-of-the-organisation.html > accessed 10 October 2011 – for a detailed history of the NSE

[53] The Nairobi Stock Exchange, Listing Manual, para 7.2, 31 <http://www.nse.co.ke/listed-companies/listing-rules.html> accessed 10 October 2011.

[54] Nairobi Stock Exchange, < http://www.nse.co.ke/> accessed 22 September 2010

[55] Nairobi Stock Exchange, 'Equity Statistics' (*Nairobi Stock Exchange,* 10 October 2011), <http://www.nse.co.ke/market-statistics/equity-statistics.html> accessed 10 October 2011. As of 7 October 2011, market capitalisation stood at KES884.29 billion – down from KES1.136 trillion in August 2010, and KES1.143 trillion in July, 2010. As a share of GDP, this represents a market capitalisation of 0.39486% in August 2010, and 0.39729% in July 2010 – based on current GDP calculated at USD35.611 billion at market prices.

[56] John Gachiri, 'Vibrant over the counter market lists 13 new firms' (*Nairobi, Business Daily*, 26 October 2011) < http://www.businessdailyafrica.com/Vibrant+over+the+counter+market+lists+13+new+firms/-/539552/1262376/-/c8k7yo/-/index.html> accessed 28 October 2011

from around the year 2006. The Capital Markets Authority is working on amendments to the Capital Markets Act of 1989 to mainstream the OTC market – for businesses in the market to fundraise through listings.[57]

It is thus defensible to observe that the stock exchange is yet to see robust activity in terms of listings especially by SMEs, supporting the general trends in private equity exit strategies that currently disfavour the stock markets.[58]

Listing regulations for the MIMs at the NSE require the following of every company seeking to list for the first time on the bourse:[59]

(i) *the issuance of an information memorandum meeting the requirements of the CMA, and so approved by the CMA, and carrying a whole range of disclosures for that purpose;*

(ii) *the issuer must be an incorporated company limited by shares under national law;*

(iii) *the issuer's authorised and issued share capital must be not less than fifty million Kenya shillings of ordinary fully paid up shares;*

(iv) *the issuer's net assets immediately prior to listing must be not less than Kenya shillings one hundred million;*

(v) *additionally, the issuer is required to have current audited financial statements, in the IFRS format, not older than four months prior to listing application, prepared on going concern basis;*

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[57] Capital Markets Authority, 'Amendments to the Capital Markets Act to Remove Barriers to Trading of Listed Securities 2011' <http://www.cma.or.ke/index.php?option=com_docman&task=doc_download&gid=151&Itemid=32>
[58] Ch 5, 188
[59] Regulation 6, Capital Markets (Securities)(Public Offers Listing and Disclosure) Regulations 2002.

(vi) *the issuer is also required to procure that 25% of its issued shares are held by no less than 1000 subscribers immediately following the offer;*

(vii) *and there are various stringent requirements on the integrity and competence of the directors and senior management of the listing firm.*

As section 4.4 demonstrates, a large proportion of Kenya's private sector would not be able to meet the foregoing basic listing requirements, meaning that a large proportion of the country's private sector is structurally excluded from the country's equity markets. As an economic tool for enterprise development, therefore, the NSE is yet to become a strategic development partner in Kenya, 57 years on.

With the proposed establishment of a new market segment as a regulated exchange to serve microenterprises, this legacy might change.[60] To list, a microenterprise will be required to meet a lowered asset threshold, but be required to have sound management standards sufficient to engender investor confidence and market probity.[61] This is not a novel idea – it has been adopted, with varying outcomes, in other jurisdictions in the past.[62] However, the manner in which a country's capital markets are organised could have a lasting effect on how businesses are created and grown – and the law has been a popular instrument in achieving these goals.[63] To understand the character and size of the demand for private equity in Kenya, the next section considers the quality of Kenya's private sector.

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[60] John Gachiri, 'Bourse plans to lower barriers and attract SMEs' (*Business Daily, Nairobi, 6 April 2010*) <http://www.businessdailyafrica.com/Bourse+plans+to+lower+barriers+and+attract+SMEs/-/1248928/893458/-/qw5k5m3/-/index.html> accessed 10 October 2011.

[61] Capital Markets Authority, 'The Capital Markets (Securities) (Public Offers, Listings and Disclosures) (Amendment) Regulations 2011 – yet to be approved: propose to set up the Small and Medium Enterprise Market Segment, and to regulate a new cadre of investment advisors named 'nominated advisors' <http://www.cma.or.ke/index.php?option=com_docman&task=cat_view&gid=9&Itemid=32 >

[62] Laura Bottazzi and Marco Da Rin, Europe's New Stock Markets, CEPR Discussion Paper 3521/2002 – during the 1990s, many European countries opened such platforms within their stock exchanges.

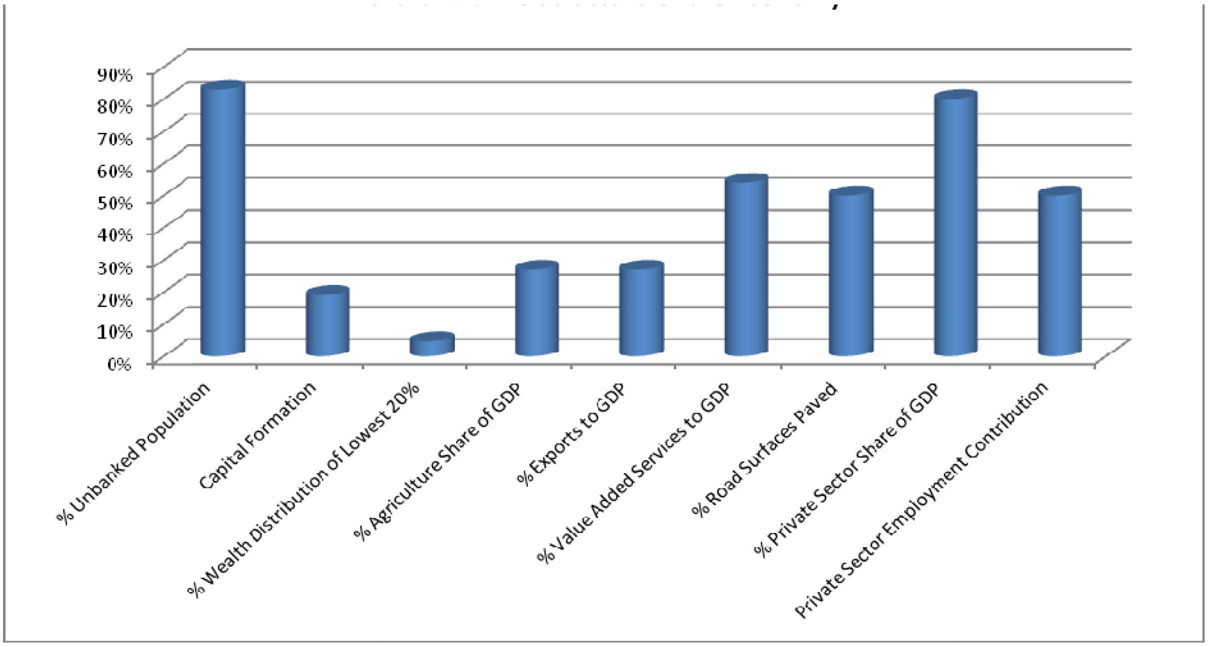
[63] Claudio Michelacci and Javier Suarez, 'Business Creation and the Stock Market Studies' (2004) 71:2 Review of Economic 459-81.

4.4 Analysing Kenya's Capital Consumers: The Private Sector

4.4.1 High-Level Demographics

Kenya had a population of 38,610,097 million according to the 2009 Population and Housing Census report.[64] 32.3% of Kenyans under that report are urbanised, while 67.7% remain rural. Only 3.6% households own at least one computer, while about 63.2% own or have access to a mobile phone.

Chart 4.1: Selected Economic Indicators



Source: Kenya Population and Housing Census Report, 2009

For consumer-orientated industries, persons aged 15-64 years number 20.7 million, with under-14s numbering more than 16.4 million, and the over-65s numbering only 1.3

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[64] Kenya National Bureau of Statistics, 'Kenya Population and Housing Census Report' (2009) <http://www.knbs.or.ke/Census%20Results/KNBS%20Brochure.pdf.> accessed 23 0ctober 2010

million persons. This latter statistic is consistent with the low longevity among Kenyans (life expectancy currently placed at around 58 years).[65]

These indices are illuminating when viewed as proxies to an entrepreneurial culture. A majority of the populace is un-urbanised, and there are very low levels of internet technology penetration – proxied by computer ownership and mobile phone ownership. These facts suggest a low information and communication technology uptake in the country, implying innovative entrepreneurship in this sector remains shallow. As drivers of risk capital, therefore, the foregoing development indices would have a strong bearing on the type of business enterprise that is likely to be preponderant in Kenya: one that is likely to be small or informal.

Access to modern living amenities remains low: 74.1% of Kenyans use a pit latrine, while a substantial 20.7% still go to the bush: a poor human development indicator. Access to piped water remains low as well, with only 15.6% of the rural and 52.6% of urban populations having access to piped water. The rest of the population draw their water from a variety of sources including ponds, dams, rivers/streams, boreholes, lakes, rain-harvest and water vendors.[66] With a largely rural population, and strong indices of human under-development, it is not surprising that the unbanked population stood at 77.4%, as shown in the chart above. This has contributed to a low capital formation in the country – placed at about 20%, also depicted in the chart above.[67] Financial exclusion (a term used to describe lack of access to any form of banking services) has a negative effect on the quality of

[65] ibid 4,5
[66] ibid 5,6.
[67] ibid

collateral that organisations or business people are able to consolidate, complicating the prospects of accessing different types of external finance.[68]

The debt literature suggests that ability to raise debt finance into a company's balance sheet operates as a positive signal to other external investors.[69] Firstly, it might indicate that the company's shares are not over-valued; secondly, since debt finance is usually through a bank loan, the ability to acquire debt funding signals the lender's confidence in the borrower as a creditworthy and stable (profitable) bet; thirdly, it suggests the borrower's ability to generate free cash flows while still meeting its debt finance obligations. Companies without sufficient asset depth would usually have thin balance sheets that cannot support formal bank loans – a factor that could operate to turn private equity away.[70]

Applying Porter *et al's* (2002)[71] taxonomy of factor-driven economies (that is, under-developed economies facing multiple development challenges) to Kenya based on the demographic profile laid out above, Kenya is a factor-driven economy with institutional, infrastructural, macro-economic, health and primary education challenges. In World Bank parlance, it is a 'low income' economy, denoting widespread under-development across all sectors of development.[72] Under these conditions, the private sector labours under various

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[68] FSD Kenya, 'Costs of Collateral in Kenya: Opportunities for Reform' (September, 2009) 8 <www.fsd**kenya**.org/pdf.../09-11-24_Costs_of_Collateral_Study.pdf> accessed 21 December 2011

[69] Bengt and Tirole, Financial Intermediation, (1997) (n 7) 663.

[70] H. Kent Baker and Halil Kiymaz (*eds*), *The Art of Capital Restructuring: Creating Shareholder Value through Mergers and Acquisitions* (new Jersey, John Wiley & Sons, 2011) 210, 211.

[71] Michael E. Porter, Jeffrey D. Sachs, and John W. MacArthur, 'Executive Summary: Competitiveness and Stages of Economic Development' in M.E. Porter, J.J. Sachs, P.K. Cornelius, J.W. MacArthur and K. Schwab (*eds*), *The Global Competitiveness Report 2001-2002* (2002, New York, NY, Oxford University Press) 16-25.

[72] World Bank Country Classification: Kenya – using the GNI methodology, < http://data.worldbank.org/about/country-classifications/country-and-lending-groups#Sub_Saharan_Africa> accessed 23 October 2011

structural inefficiencies, and the entrepreneurial culture is necessity-driven, meaning people are forced to create self-employment to survive.[73]

Private equity, chapter 3 illustrated, follows fast-growing and innovative firms. Given the statistics set out above, it is defensible to observe that an economy that fails to address human development issues would find it extremely difficult to culture and nurture conditions that support creative enterprise, and consequently would not be likely to support the growth of an influential private equity industry. Public policies aimed at addressing the preceding human development needs would indirectly help unlock entrepreneurship in Kenya. It was suggested in the introduction to this chapter that the type of private sector that prevailing economic conditions permits to emerge would significantly shape the forms and types of financing solutions that emerge and develop within that economy. These are thus interdependent factors.

4.4.2 Selected Economic Indicators

According to the World Bank, in 2010, Kenya's GDP stood at USD31,408,632,915, while GNI per capita stood at USD790, and the estimated population stood at 40,512,682.[74] As depicted in Chart 4.1, above, dependency on agriculture (27% of GDP), exports (27% of GDP) and services – including financial intermediation - (54% of GDP) are the defining symptoms of the developing nature of Kenya's economy.[75] These features are largely

[73] N. Bosma and J. Levie, 'Global Entrepreneurship Monitor (2009) Executive Report' 8 <http://www.gemconsortium.org/download/1280955713663/GEM%202009%20Global%20Report%20Rev%20140410.pdf> accessed 3 August 2010.
[74] ibid (employing the GNI methodology).
[75] Kenya National Bureau of Statistics, 'Facts and Figures' (2008) <http://www.knbs.or.ke/knbsinformation/pdf/Facts%20and%20Figures%202009.pdf> 5, 11,17 accessed 23 0ctober 2010

consistent with the demographic profile set out in the preceding section: that a majority of Kenyans are remain un-urbanized

Inflation largely remained in single digits for the most part of the 2000s decade, save the year 2008 when it hit 13.1% as a result of exogenous circumstances arising from a violent protest at disputed presidential elections. In 2011, inflation jumped above 20%, and lending rates increased as the cost of inter-bank borrowing rose. In effect, economic volatility in Kenya is a substantial impediment to a robust entrepreneurial space. High interest rates, low gross capital formation as a percentage of GDP, and an overwhelming section of the populace remaining unbanked, limit opportunities for a high quality private sector to emerge, stifling the demand for enterprise capital.

Between 2003 and 2007, Kenya's economy was strongly resurgent, registering growth rates between 4.5% and 7.1%.[76] In 2008, it dipped to 1.8% in the first two quarters of that year following political instability, but recovered during the fourth quarter and the following year to the region of 5%.[77] In 2011, the target growth rate was revised downwards as a result of exogenous shocks in the global commodities markets, debt crises in Europe and the cost of imports into Kenya.

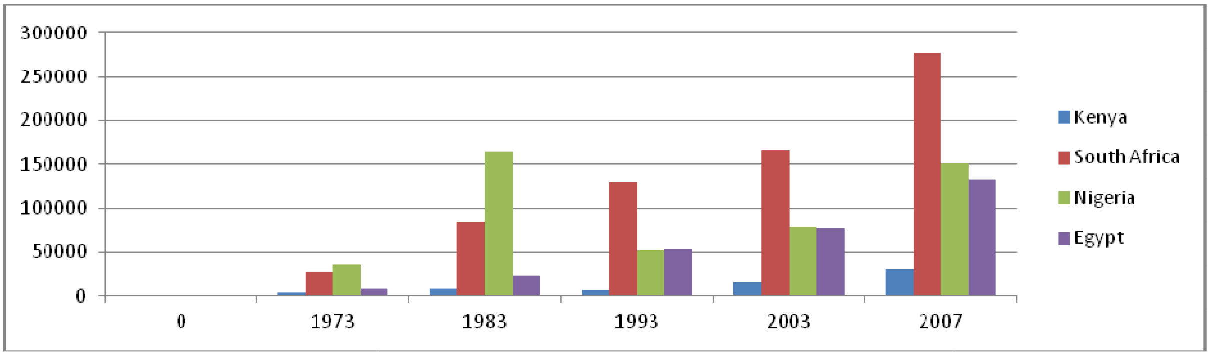
Chart 4.2 below compares the growth trajectory of Kenya's economy to a few comparator African economies: Nigeria, South Africa and Egypt. The chart demonstrates that it is only the South African and Egyptian economies that have sustained constant and dynamic growth paths over the last three decades, with South Africa's being more dramatic.

The Nigerian economy grew robustly in the 1970s, and fell sharply in the 1980s, recovering modestly in the 2000s. Kenya's economy, in comparison, recorded near-flat

[76] ibid
[77] ibid, Facts and Figures 2010.

growth in the two decades between 1970s and 1990s, recording some modest growth in the early 2000s, and doubling up in the late 2000s.

Chart 4.2: GDP Per Capita in Current Prices – Comparative View (in USD thousands)



Source: UNCTAD 2008 Statistics, 8.2

It has been suggested above that economic volatility has been a problem, and in this study is viewed as a contributing factor to Kenya's poor economic performance over time.

Private equity has in its short history tracked a clear pathway after robust economies. It is of anecdotal significance to draw parallels based on this yardstick: the South African private equity industry is the largest in Africa – just as the South African economy is the largest and most sophisticated in Africa. The Egyptian economy is smaller than the Nigerian economy, and strikingly, Nigeria has enjoyed higher fundraising for private equity compared to Egypt. These trends hold true for Kenya: a much smaller economy, whose private equity industry is also much smaller.[78]

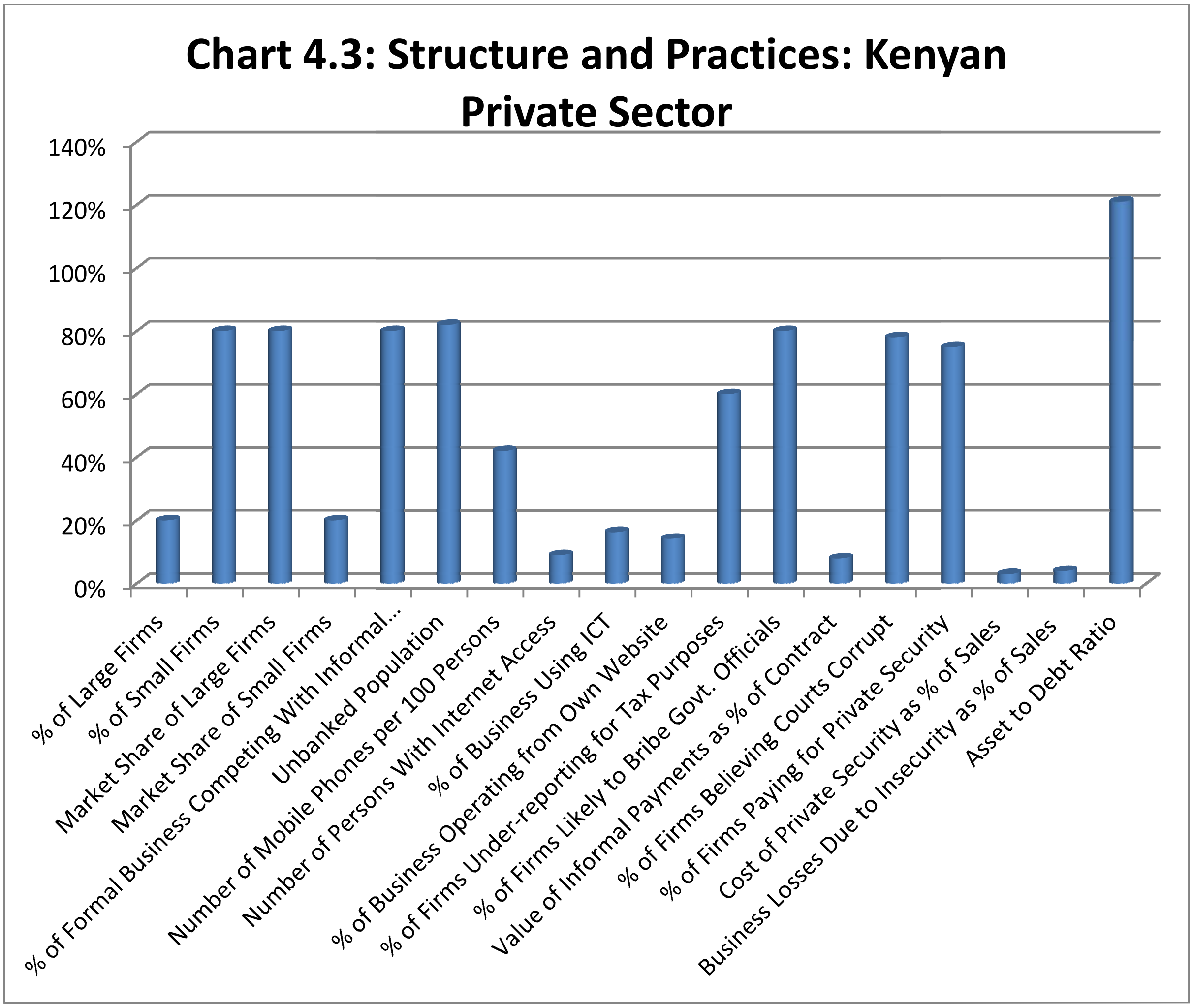
From an economic growth perspective, there seem to exist reason, grounded in the preceding short review of economic fundamentals in Kenya, for the proposition that public policies that support robust economic growth are likely to contribute to private equity's

[78] Emerging Markets Private Equity Association, Quarterly Review, 'The State of Emerging Markets Private Equity: Turning a Corner' 4/2008, 1 < http://www.empea.net/Main-Menu-Category/EMPEA-Research/Quarterly-Review/Quarterly-Review-Individual-Articles/EMPE_QR_VolIV_1_Article1_StateofMarkets.pdf.aspx?FT=.pdf> accessed 29 October 2011

growth. The discussion on barriers to access, coming in the second part of the chapter, clearly illustrates how legal tools can aid public policy in delivering these objective.

4.4.3 Business Informality

The Government estimated that 65% of the small and microenterprise sector in Kenya is informal – and this segment, as seen below, accounts for 80% of the private sector. Even where businesses are 'formal', they demonstrate features suggesting relative under-sophistication. For instance, only 16% of surveyed business entities indicated they owned a business website, while a lower 14% indicated they operated regularly through their websites.



Source: Various (PSDS 2006-2010; World Bank Enterprise Survey – Kenya 2007)

It can be seen from chart 4.3 that large companies in Kenya account for about 20% of the country's private sector, suggesting that the remaining 80% comprises small companies and the informal economy. In contrast, however, the minority large firms control 80% of private sector wealth in Kenya, while the majority small companies control only 20% of the private sector wealth.

4.4.4 Preponderance of Small Companies

Large firms in Kenya are mostly subsidiaries of multinational corporations, and do not have extensive links with the small firms – who account for 67% of all informal sector operations.[79] According to the Government, there were an estimated 1.7 million small and medium scale enterprises in Kenya in 2006 – compared to just 40,000 large companies.[80] Under-developed linkages between small and large businesses suggests an element of de facto market dominance in favour of the large corporation. From an economic development paradigm, this perpetuates the poor-rich divide, excluding the small enterprise from financing as a proxy for lack of market access.

For innovation to flourish, a market must exist into which to sell the products of innovative enterprise. Linkages between small and large enterprises is critical in building such a market. It would drive research and development as lucrative commercial activities, enhancing the attractiveness of Kenya to such creative capital as private equity.

Placing these realities in a market-making perspective, these ratios (*large firm/small firm; formal/informal*) must metamorphose if private equity is to be cascaded across a more

[79] id.
[80] PSDS 2006-2012 (Ministry of Trade, Government of Kenya) < http://www.psds.go.ke/index.php?option=com_content&task=view&id=28&Itemid=32> accessed 5 October 2007

diverse economic landscape. As it stands today, the Kenyan private sector that is likely to be attractive to private equity is associated with the 20% where economic development and relative sophistication already exists. Private equity could become a development partner for Kenya, but Kenya would need to improve frameworks for stronger small and microenterprises. These would support a new niche for research and development activity as the Kenyan economy rapidly progresses. It is not necessary for all small firms to transform into large enterprises, but it is necessary for small enterprises to transform into mature businesses able to innovate and supply the larger economic players, specialising in services and solutions.

4.4.5 Negative Business Practices

Drawing from chart 4.3, corruption is a significant problem. From a statistical perspective, 60% of the private sector – formal and informal, large and small – indicated in the World Bank Enterprise Survey that they routinely under-report for tax purposes.[81] Tax evasion is thus a common practice in Kenya, suggesting a weak or inefficient legal and or institutional regime for this purpose. Either way, this suggests the regulatory framework is lacking a specific quality that would engender compliance. This is a strong piece of circumstantial evidence supporting the broad themes in this work – that legal and regulatory conditions are likely to wield a disproportionate amount of influence over the manner in which financial markets shape up in a country.

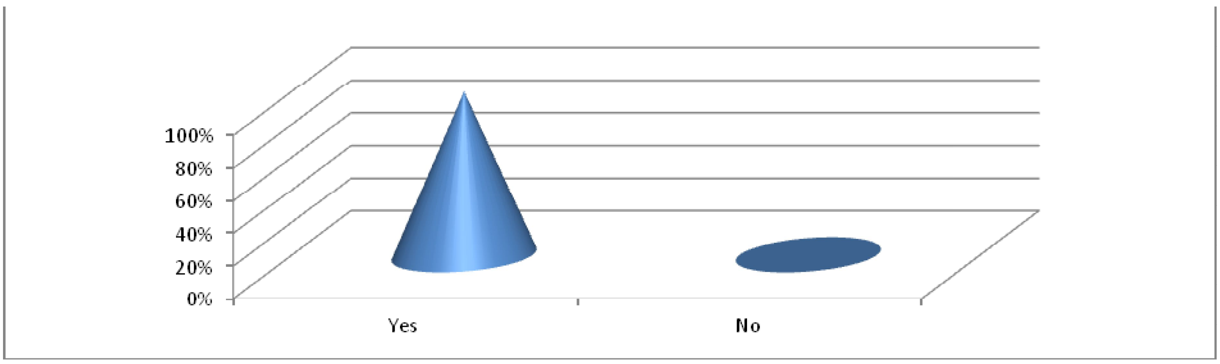
Quite consistent with the high proportion of routine tax evasion, a very high 80% of the respondents in the above survey indicated they were most likely to meet one form of corruption or another involving a public official – either in the licensing process, during the

[81] The World Bank Group,' Kenya Enterprise Survey' (Enterprise Surveys 2007) <http://www.enterprisesurveys.org/ExploreEconomies/?economyid=101&year=2007> accessed 4 August 2010.

operations phases, or at the point of making tax returns. The cost of such bribes was estimated to stand at about 8% of their annual sales values. A nearly equal 78% of the respondents indicated they distrusted courts in Kenya, citing widespread corruption as the main driver to such distrust.

To test how important corruption is in private equity investing, all fund managers interviewed[82] were asked whether corruption is an important problem in their Kenyan operations. 100% answered in the affirmative, as shown in Chart 4.5, below, with respondents indicating corruption in private equity occurs at the entry and fundraising phases. This is consistent with the general perception within the business community that the process of obtaining operating licences is riddled with corruption. Furthermore, some 32% of the interviewed fund managers indicated they have had to deal with investors who cannot or are unwilling to adequately explain their fund sources. Under Regulation 29 of the Venture Capital Regulations, fund managers are placed under express anti-money laundering obligations.[83]

Chart 4.4: likelihood of corruption impacting private equity



Source: Fund Manager Survey 2009/2010

[82] Interviews with FM101-FM113, Nairobi, Kenya, between August 2009 and January 2010.
[83] R.29, the Capital Markets (Registered Venture Capital Companies) Regulations of 2007

4.4.6 Bureaucracy and Other Constraints

Closely linked to corruption is bureaucracy – which refers to the system of rules and procedures that commercial entities must abide or otherwise satisfy to attain regulatory legitimacy. For instance, there exist numerous licensing regimes governing business activity, with variations across municipalities in the country. In the tax framework, businesses in Kenya spend an average of 471 man hours annually to comply with tax obligations, equivalent to around 5% of their business time annually.[84] Similarly, World Bank's Doing Business Index 2012 shows that the times taken to obtain an operating licence, an import licence, or registering business or property, are inordinately long, and involve a multiplicity of procedures and institutions.

Bureaucracy and corruption combine to deliver a lack of institutional transparency. The country's ratings on the indices of corruption, bureaucracy and the burden of business regulations suggest a close inter-dependence among these variables.[85] This is significant in formulating a law reform agenda around these issues.

Insecurity (both person and property) exacts a significant toll on Kenyan businesses, with losses nearly hitting 4% from theft, robbery, arson and vandalism. In light of this, 74.6% of firms pay for private security, at a cost of up to 3% of their sales. This is a substantial cost on the operating capital of firms, an indirect tax as it were.[86]

Furthermore, businesses in Kenya operate under an environment of challenged infrastructural services.[87] Aside from a low penetration of ICT, critical infrastructure like roads introduce high costs to business. Firms expend upwards of 1.6% of their sales value in

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[84] Kenya Enterprise Survey, 2007 (n 80)
[85] World Economic Forum, 'Africa Competitiveness Report 2009, Kenya 2007 Investment Climate Profile' < http://www.weforum.org> Accessed 10 July 2010.
[86] World Bank, 'Kenya Enterprise Survey, Kenya' (2007) <http://enterprisesurveys.org/ExploreEconomies/?economyId=101&year=2007 >accessed 2 November 2007
[87] ibid.

replacing products broken in transit. Access to electricity and water similarly remains problematic at both the household and industrial levels, and bureaucratic red tape in fixing outages and disconnections impose substantial costs on businesses (nearly 60 days in combination, and over 6% of sales value).[88]

While corruption in the public sector may not per se be a direct problem in private equity investing, these negative business practices complicate the business environment, raising operational costs and introducing secondary uncertainties to investment dynamics.

4.5 Barriers to Finance

In section 4.2, it was shown that businesses can raise their financing needs from a variety of possible sources: banks, microfinance institutions, investment companies as well as listing on the national public equity market. Far from being able to access the right type of enterprise capital at the right prices, however, it has been illustrated in the preceding section that various structural features can either promote or degrade the ease with which needy businesses can access finance. The following sections draw out the key barriers.

4.5.1 Collateral Quality

Collateral requirements vary for different types of financial products. A feature common to all requirements, however, is the difficulty faced by the SME sector in consolidating good collateral. This is partly owing to the widespread reality of business informality, and secondly, historical difficulties in accessing finance. Collateral frequently

[88] ibid.

equates to assets, and the type of asset that banks can accept as security against lending is narrow – usually an all-asset debenture.[89]

Factors like corruption operate to complicate collateral laws even more. For instance, property titles would ordinarily be good collateral, but corruption at the Lands Registry has given rise to a situation whereby false title deeds have been issued. It is a frequent occurrence in Kenya to have several title deeds issued to different people over the same piece of property. Establishing good title is problematic, and banks are wary of lending against certain property deeds. This was compounded by a long practice by the government of allocating public land irregularly.[90]

Several other factors combine to render the creation, perfection and enforcement of security interests inefficient in Kenya, especially where such interests relate to or are otherwise associated with land. The first is the multiplicity of statutory instruments on the creation and perfection of security interests. There are over 20 legislations that govern the creation of security interests, and they do not prescribe a consistently coherent regime.[91] Each piece of legislation lays down a different registration procedure, but there is no law that prioritises interests so created.

On land-related security interests, more than five statutes govern land rights, creating at least three different distinct legal frameworks for land rights – under the Government

[89] FSD Kenya, 'Costs of Collateral in Kenya: Opportunities for Reform' (September, 2009) 8 <www.fsd**kenya**.org/pdf.../09-11-24_Costs_of_Collateral_Study.pdf> accessed 21 December 2011

[90] A recent classic illustration is the Syokimau Demolitions saga: where scores of Kenyans were left homeless following a decision by government agencies to flatten their homes citing impropriety in land titles. To access video footage, follow: <http://www.youtube.com/watch?v=0X8MczAumYU&feature=related>; for a trail on newspaper reportage, see for instance, Mutinda Mwanzia and Judy Ogutu, 'Court Stops Demolitions' (East African Standard, Nairobi, 16 Nov 2011), <http://www.standardmedia.co.ke/InsidePage.php?id=2000046838&cid=4&> accessed 16 Nov 2011.

[91] These legislations include: Transfer of Property Act, Group 8; Law of Contract Act Cap 23; Registered Land Act Cap 300; Registration of Titles Act Cap 281; Government Lands Act Cap 280; Land Titles Act, Cap 282; Sectional Properties Act No.21 of 1987; Companies Act Cap 486; Limitation of Actions Act Cap 22; Stamp Duty Act Cap 480; Evidence Act Cap 80; Land Control Act Cap 302; Registration of Documents Act Cap 285; Banking Act Cap 488; Traffic Act Cap 403; Chattels Transfer Act Cap 28; Advocates Act Cap 16; Agriculture Act Cap318; Arbitration Act No.4 of 1995; Notaries Public Act Cap 17 of 1958.

Lands Act of 1915, the Registered Land Act of 1963, the Registration of Titles Act of 1920, the Land Control Act of 1967 and the Sectional Properties Act of 1987. The recently adopted National Land Policy has as one of its core aims the consolidation and rationalisation of laws relating to land.[92] In addition, the legal framework on land creates two estates in land – freeholds and leaseholds.[93] To make matters worse, the Land Control Act of 1967 voids any transaction in land unless the Land Control Board consents thereto. These boards are administrative, dispersed across the country in every district, sit once a month in most cases, but generally apply no predictable system in their decision-making processes, rendering the process of granting consent non-predictable.[94]

Section 96 of the Companies Act of 1962 lists a limited range of registrable interests that include fixed and floating charges. In Kenyan practice, floating charges are not preferred by funders for three reasons: first, they are defeated by priority creditors; secondly, they are subject to a hardening period during which they can be challenged in a liquidation process; and thirdly, the holder's rights are limited to payments made into a specific account. Dishonest borrowers could easily default through asset management schemes.

To further complicate the foregoing scenario, there is no single registry for the lodgement of security instruments – meaning that the multiplicity of registries renders the discovery of priority securities difficult. Besides the different registries, the laws prescribe different time periods within which securities must be registered. For instance, under the Chattels Transfer Act of 1930, it is 21 days;[95] under the Companies Act of 1962, it is 42

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[92] Republic of Kenya, Ministry of Lands, Sessional Paper 3/2009 on National Land Policy (Government Printer, 2009) < http://www.ardhi.go.ke> accessed 5 July 2010

[93] ibid 18,19

[94] For more detailed reviews, see Jose E Mantilla, Peter M Mwangi and Jennifer W Kibaara, '*Costs of Collateral in Kenya: Opportunities for Reform*' (Financial Services Deepening Kenya, September 2009) <http://www.fsdkenya.org/pdf_documents/09-11-24_Costs_of_Collatral_Study.pdf> accessed 19 October 2011.

[95] s 6

days;[96] and under the other laws providing for security interests, it is on average 30 days. Computerisation of government functions has just recently started, meaning that in the past and even now, most security interest registries operated manual databases, and remain isolated. Validating titles and interests is an odious and imprecise process. The effect of the preceding difficulties is that even in cases where capital-seeking enterprises show collateral, the 'bankability' of the collateral is not assured.

To address these issues, law reform offers an important part solution. The law reform agenda stands out clearly in each of the preceding paragraphs, and include, in summary, the need to deal with corruption, the creation of stronger regulatory frameworks around registration of interests in land, the consolidation and clarification of the legal regime on security interests that includes systems for the establishment of a national registry of securities, with all supporting institutions.[97]

4.5.2 Cost of Bank Credit

It has been shown under section 4.3.3 that accessing bank credit is costly in Kenya. Lending rates are controlled by a disparate range of economic and regulatory factors, as development literature has documented. In the latter part of this chapter, a range of barriers to finance are explored with respect to the issues already addressed in this chapter. When lending rates are high, and collateral requirements steep, enterprises suffer. Institutional lenders are known to hedge against 'risk', as the experience of the UK, reviewed in chapter 3, illustrated.[98] Improving the quality of the private sector through increasing institutional transparency might be one method to driving down the risk aversion pervading formal credit

[96] s 96
[97] FSD Kenya, Costs of Collateral (2009) (n 88)
[98] ch 3, 73

markets. Yet access to finance, this chapter suggests, is itself fundamental to supporting the consolidation of good quality collateral. Legal instruments are likely to be valuable tools in achieving these private sector development policies.

4.5.3 Business Informality and Financial Reporting Standards

Business informality and firm opaqueness driven by a weak financial disclosure environment generate negative reputational effects on businesses, making credit access steep because of the difficulty of establishing the soundness of collateral and creditworthiness.[99] Business informality and low capital formation are inimical to asset tangibility, that is, the consolidation of assets that can serve as good collateral.[100] Other factors include general regulatory arbitrage (as tax evasion, considered in the next chapter, suggests), and the non-standardised application of the IFRS reporting template.

Kenya applies the International Financial Reporting Standards (IFRS) model in its accounting and auditing practices, officially adopted in 1999.[101] The duty to apply IFRS, however, is not statutory-based: it is the administrative edict of the Institute of Certified Public Accountants of Kenya (ICPAK),[102] but the duty to produce accounts is variously mandated under securities-related laws including Companies,[103] Securities[104] and Banking Acts.[105] A World Bank Enterprise Survey in 2007, however, found that less than 50% of the companies in Kenya employ an auditor on annual basis.[106] More problematic, however, is the

[99] Bengt and Tirole, Financial Intermediation (1997) (n 7) 663 - 66.
[100] ibid
[101] Interview with Mr. Evans Mulera, Director of Professional Services, Institute of Certified Public Accountants of Kenya (ICPAK offices, Nairobi, Kenya January 2010)
[102] ibid
[103] Companies Act of 1978 Cap 486 1962, ss 147-176, Laws of Kenya.
[104] Capital Markets Authority Act Cap 485A 1989, s 23, Laws of Kenya.
[105] Banking Act 1989, Cap 488 s 21, Laws of Kenya.
[106] World Bank, Enterprise Survey 2007 <http://www.enterprisesurveys.org/ExploreEconomies/?economyid=101&year=2007> accessed 14 July 2008

fact that the widely accepted accounting standards are, from a regulatory perspective, only required of listed companies (that is, public companies) and other capital markets regulated persons (for example, entities regulated by the Capital Markets Authority).[107]

According to a representative of a leading multinational tax and audit firm in Kenya –

> "Most companies engage in special-purpose accounting – primarily to comply with KRA requirements, hence driven by end-user of prepared accounts. Implementing IFRS is expensive, and while Kenyan accountants have the skills generally, the IFRS system requires continuing research and engagement with international developments, and associated routine staff training: most companies do not have the budgets for that. We can do it because part of our market-leading role is grounded in a fully resourced R&D unit, one of whose mandates is to keep constant tabs on happenings in the IFRS field – these standards change almost on an annual basis, and to be truly IFRS compliant, one would have to constantly update one's systems and skills. That is why IFRS compliance as a concept for most companies in Kenya is a fairly relative concept in practice – and it will remain a tough task for financial regulators to enforce here." [108]

TX1 and TX2 echoed these viewpoints, with TX1 adding the observation that "financial reporting, and the IFRS model, are really a question of economic development."[109] TX2 clarified that this means "when everybody plays by the same rules, conditions are

[107]Interviews with Mr. Mulera, Director, ICPAK (n 100) and with RG201, Financial Accounting, (CMA Offices, Nairobi, Kenya, January 2010).
[108] Interview with TX3, Legal and Tax Manager, Nairobi, Kenya, August 2009.
[109] Interview with TX1, Compliance Manager, Nairobi, Kenya, August 2009.

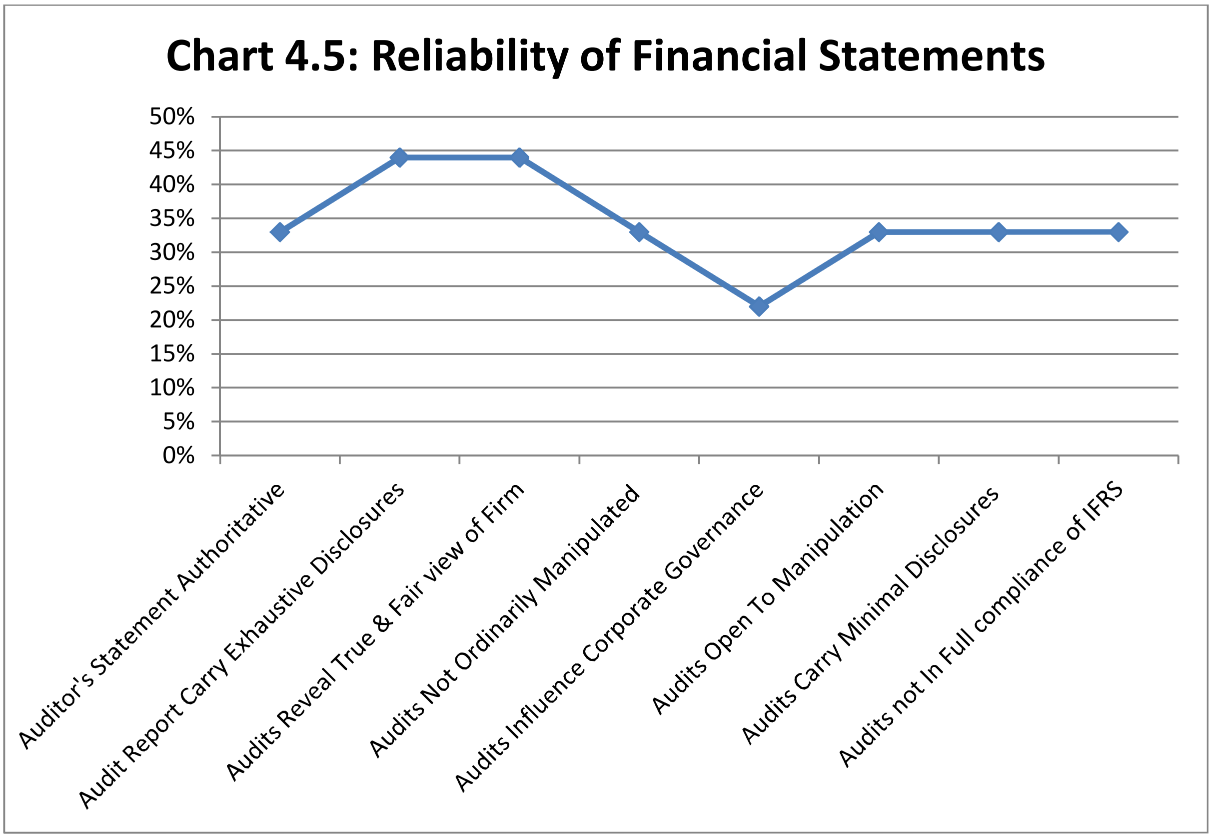
created for greater trust within the markets, which can promote greater synergy and commercial partnerships between private companies."[110]

These deductions were intriguing, and private equity fund managers were surveyed for opinions over their levels of trust in Kenyan financial statements. A low 40% of interviewed fund managers believe private company financial statements in Kenya present a true and fair view of the corporation in question, and therefore can be relied upon. In contrast, 30% of the fund managers believe such accounts to be open to manipulation, carry minimum disclosure, and therefore not in substantial compliance of IFRS standards – as chart 4.5, below, demonstrates. As the chart shows, 8 questions were put to each interviewee, and the statistical instances of answers to a 'yes'/'no' response matrix were captured. The first 5 questions elicit general opinions, and the last 3 questions interrogate the reasons for their choices. Their responses are captured in chart 4.5 below.

It is significant that about 33% of the interviewees felt that financial statements in Kenya are open to manipulation, and do not present a true and fair view of the corporation. This group of fund managers also believed that reporting companies in Kenya do not disclose fully, and did not comply with IFRS standards, opinions that generally support the deductive observations of TX3.

In contrast, about 44% of the interviewees believed that Kenyan financial statements presented an authoritative view of the reporting organisation, carried sufficient disclosure in compliance with the IFRS reporting template, revealing a true and fair view of the company. This group of fund managers consistently felt that financial accounting in Kenya was not readily open to manipulation.

[110] Interview with TX2, SMEs Section, Nairobi, Kenya, August 2009.



It was related earlier how a number of licensed stockbrokers went into financial distress between 2007 and 2010, and RG201 was asked whether the failures were because of poor financial accounting or the regulator's inability to effectively police the sector. RG201 opined that –

> "there were too many factors at play, and certainly, truthful accounting was one of the key issues, but it cannot be said this was the main reason they failed. Just a few entities have not done well, but most of the others are doing alright. We cannot say the system is perfect, but there is a lot of effort into

> making the capital markets a lot stronger from an institutional oversight perspective."[111]

RG201 was unwilling to be drawn into more nuanced debate on the full set of factors behind the failures. There have been investigations into the failing stockbrokers, but none of the reports had been made public at the time of completing field study.

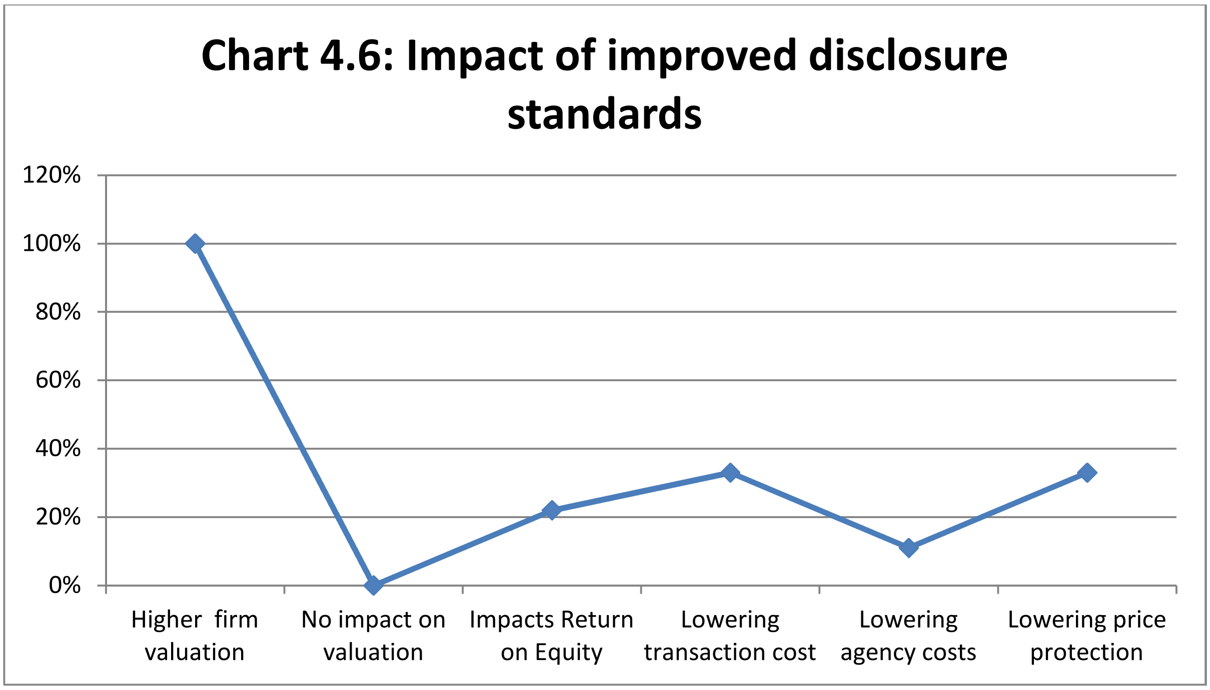
The foregoing findings suggest, on a par, that more fund managers had higher faith in Kenyan financial reports than those that doubted their integrity. To the extent, however, that less than 50% of the market in the aggregate placed substantial faith in the reliability of financial statements, it is worrying that financial reporting standards remain problematic. This suggests that the doctrine of corporate transparency has achieved shallow penetration in Kenya today – supporting the minority opinion of local fund managers about the unreliability of financial statements.

About 22% of the interviewees felt, however, that there were no links between the quality of financial reporting and a company's corporate governance framework and practice. This perspective is sceptical of financial reporting generally. All fund managers indicated, in answer to a related question, that they place great importance on the discovery process (due diligence) as a vital pre-investment condition.

In view of the opinions of fund managers on financial reporting and corporate governance, it was necessary to ask of the same set of fund managers whether the quality of financial disclosure was an important factor to the practice of private equity in Kenya.

[111] Interview with RG201, August 2009 – it is on record, however, that even listed companies are struggling to comply with IFRS standards: in the Capital Market Authority's Annual Report for 2010, it is reported at pages 15-16 that not all regulated entities complied fully with the requirements of regulation on financial reporting and corporate governance.
<http://www.cma.or.ke/index.php?option=com_docman&task=doc_download&gid=191&Itemid=30 >

100% of the respondents opined that improved disclosure standards would improve company valuation, while 33% believed it would reduce agency costs and lower price protections – all bottom-line improving dynamics. Importantly, none of the interviewees believed that improving financial reporting standards would have no impact on valuation.



About 22% indicated that improved reporting requirements would improve profitability through raising return on equity, while 33% felt it would lower transaction costs. 11% of the interviewees believed improved disclosure standards would also lower agency costs, while another 33% believed it would lower the motivation for price protection at the time of investment exit, greatly aiding the efficiency of the divestment process.

These are important findings. They confirm anecdotal evidence indicating that target assets in African private equity are routinely undervalued for want of transparency – as much as 50% of deal value rides on the quality of the target from an accounting perspective, according to one leading fund manager.[112] In light of the findings in chapter 5 about the main focus of Kenyan private equity on growth companies, a case is made for strengthening the regulatory framework for financial reporting.

Clearly, the quality of financial reporting is an important issue to investors as it impacts various aspects of an investment. It can also be an important tool in corporate governance, instilling accountant, management and director discipline in resource management.

To improve the quality of financial reporting, however, requires multiple interventions. On the one hand, legal instruments may be necessary – including the use of statutory instruments to strengthen the framework for financial reporting. Secondly, it may require stricter enforcement for violations. Thirdly, it might require further engagement between the regulator and the regulated with the view to broadening a framework for continuous learning. Fourthly, there might be need to review the legal framework for misconduct by auxiliary institutions supporting the financial disclosure industry. Fifthly, and at a broader macroeconomic level, there might be need to deepen the increasing predictability and efficiency of the judiciary at managing disputes that stem out of corporate governance failures and misconducts.

4.5.4 Negative Business Practices

From an access to finance perspective, corruption is an environmental factor that drives and complicates the main parameters determining access. For instance, in the area of title to property, corruption often undermines the soundness of title, casting doubt on the quality of collateral, thereby directly inhibiting access to sought after capital. Similarly, if a

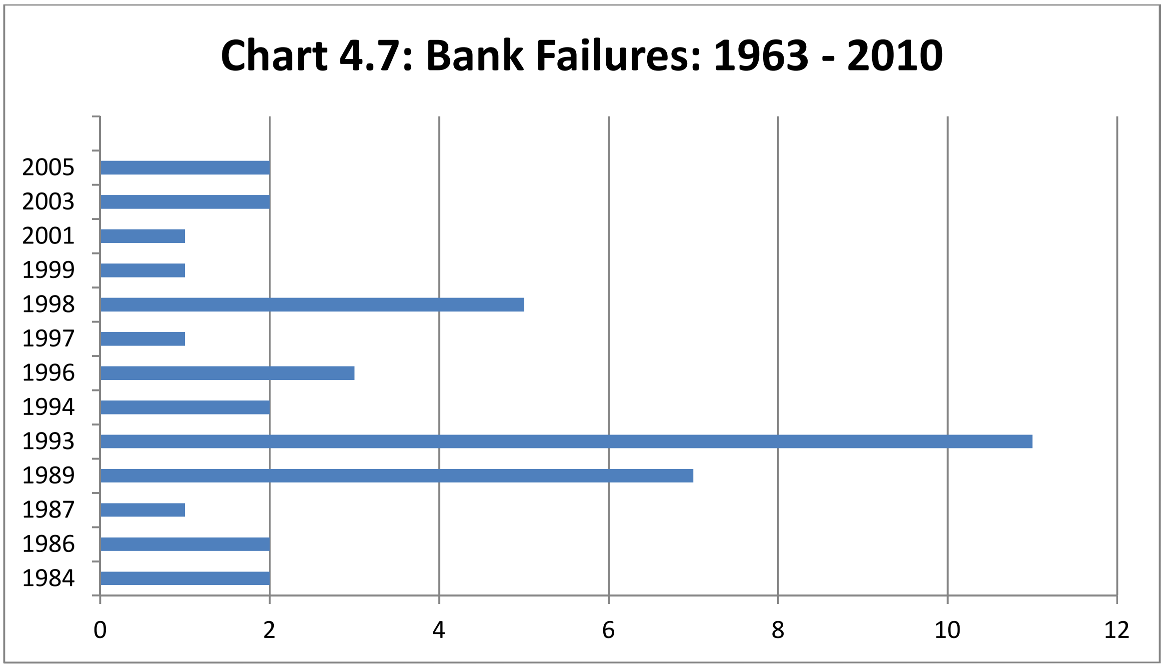
[112] Interview with FM105, Nairobi, Kenya, September 2009.

critical licence or business permit takes inordinately long to obtain owing to barriers introduced as a result of corrupt practices, access to finance based on or dependent upon the obtaining of such licence or permit becomes delayed. For most business operations, timely access is fundamental to business efficiency. Corruption thus introduces unnecessary and disruptive costs to businesses.

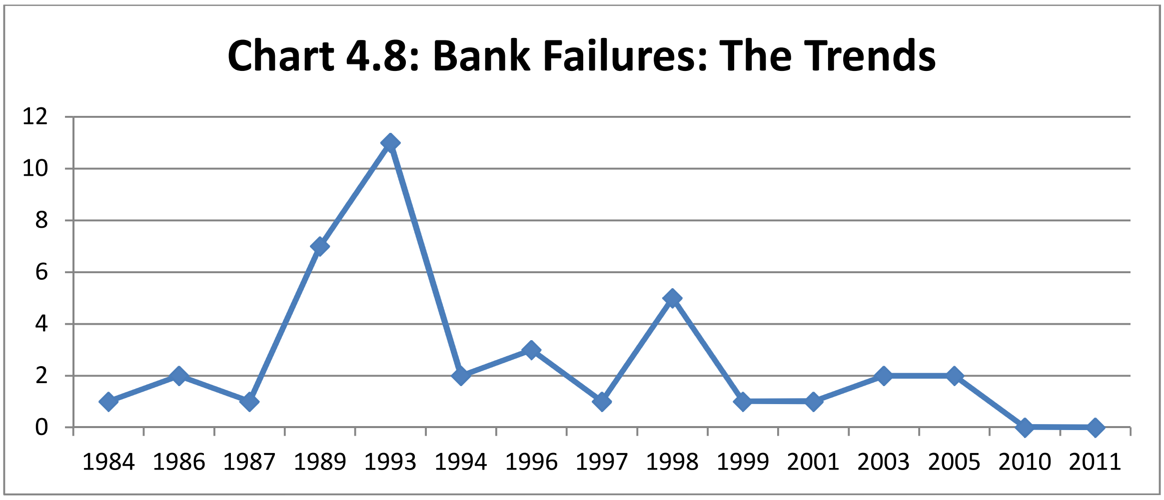
Kenya's problem with corruption appears to ride on weak institutional ability to enforce regulations. With respect to the issues addressed in the preceding paragraph, it is public sector corruption that is problematic. The legal framework for dealing with corruption exists in (i) the Anti-Corruption and Economic Crimes Act Cap 65 of 2003, which punishes all corruption and economic crimes set out in the law; (ii) the Public Officer Ethics Act Cap 183 of 2003 which requires public officers to act with propriety, and sets out a series of offences pegged to integrity, and (iii) the Constitution of Kenya 2010, Cap 0, which under Article 10 and in Chapter 6 dedicates considerable space to questions of integrity in public service. The country additionally has an anti-corruption watchdog in the form of the Ethics and Anti-Corruption Commission, established under Act No.22 of 2011. Institutionally, the Office of Director of Prosecutions, the Police Department and the Judiciary are all, prima facie, well-positioned to address corruption. For the foregoing reasons, the problem of corruption is more an institutional reform question rather than a law reform issue.

4.5.5 Weak Financial Institutions: History of Bank Failures

The Kenyan banking sector has not always been stable. Between 1984 when the first bank failure occurred, and 2005, there have been no less than 30 bank failures and 10 cases of bank crises that have involved varied interventions including financial institutions being placed under receivership or being consolidated.[113]



Source: Central Bank of Kenya



Source: Adapted from Central Bank of Kenya statistics

As the two charts above illustrate, the period between 1987 and 1994 was the most volatile, with 24 bank failures. 1993 was the worst – with eleven banks being placed under

[113] Central Bank of Kenya, 'Bank Crises Failures and Closures in Post-Independence Kenya' (*CBK, Nairobi*) <http://www.centralbank.go.ke/dpfb/background.aspx> accessed 15 July 2008.

liquidation. This period was characterised by the strange phenomenon of politically correct funds – a situation that saw the proliferation of banks licensed for political exigencies.[114]

After the year 2005, there has been no bank failure. Between 2001 and 2005, there were five failures (one in 2001, 2 in 2003, and 2 in 2005).[115] At least one of the banks, Charterhouse Bank, was implicated in extensive money laundering. It was put under receivership for two years, then its banking license was withdrawn five years ago.[116]

This history suggests that commercial banking in Kenya is slowly coming out of a prolonged period of instability – offering an explanation on why until the 2000s decade, the range of financial products and the stock of loans was narrow. The government has tightened the regulatory framework for all banks, starting with the enactment of the Finance Act 2008 which requires banks and mortgage companies to raise their core capital to KES1 billion by December 2012 and encouraging smaller banks to merge to create stronger brands.[117] Certain macroeconomic factors added to this benevolent state of being: the economy grew robustly between 2004 and 2007, achieving an average of 6% year on year growth rate. This progress was set back by a series of both internal and external shocks starting at the end of 2007 (including political turmoil over a disputed presidential poll, escalating commodity prices and the global credit crisis).[118] With the strong macroeconomic performance between 2003 and 2007, private sector activity picked up, driving up the demand for business finance. This

[114] ibid
[115] ibid.
[116] John Ngirachu, 'Anti-Corruption Commission Backs Bank's Re-opening' (*Daily Nation, 2 September 2010*) <http://allafrica.com/stories/201009030194.html> accessed 1 January 2012 – it is ludicrous that investigations should last 7 years, and signals either deep-seated institutional weaknesses in financial sector regulation or entrenched sectarian interests (more candidly, a compromised institutional network).
[117] PwC Kenya, 'Key Issues Facing the Banking Industry in Kenya' (PwC, 2011) <http://www.pwc.com/ke/en/industries/banking-issues.jhtml> accessed 20 October 2011.
[118] International Monetary Fund, IMF Executive Board Concludes 2009 Article IV Consultations with Kenya (*PINs*: January 7, 2010) <http://www.imf.org/external/np/sec/pn/2010/pn1002.htm> accessed 1 January 2012

allowed most commercial banks to deepen their profits, emboldening them to innovate their range of products.[119]

Another factor that spurred bank sector reforms was the shrinking of government stakes in commercial banking – currently it maintains significant ownership stakes in just three institutions.[120] Nonetheless, it has been shown above how accessing bank finance remains constrained, in spite of increasing evidence the financial market is slowly becoming innovative, responsive and more equipped to assume risk-types they hitherto could not assume, or were ill-equipped to manage.

In spite of these fundamentals, the Doing Business Index 2012 ranks Kenya 8th in terms of access to credit. What the Index does not state, however, is that this is restricted to the kind of firms that are capable of collateralizing loan applications – which remains the core feature of formal credit in the country. The index does not consider the range and type of financial products available in a country. The matrix assesses how quickly and easily an applicant meeting all lending requirements is able to get a decision on the application. Most commercial banks would reach a decision within seven working days currently. This efficiency belies the fact that many would-be capital consumers are not able to muster sufficient or acceptable collateral – so the index is partially correct.[121]

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[119] FSD Kenya, 'Financial Inclusion in Kenya: Survey Results and Analysis from FinAccess 2009' (July 2011) <http://www.fsdkenya.org/finaccess/documents/11-06-27_finaccess_09_results_analysis.pdf> accessed 4 January 2011

[120] Central Bank of Kenya, 'Commercial Banks and Mortgage Finance Institutions' (*CBK*, 2008) <http://www.centralbank.go.ke/financialsystem/banks/introduction.aspx> accessed 15 July 2007.

[121] World Bank Doing Business Index 2012 – Kenya – Country Tables: <http://www.doingbusiness.org/reports/global-reports/~/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-Chapters/Country-Tables.pdf >

4.5.6 Narrow Range of Creative Financial Products

Prior to 1995, the banking industry in Kenya was not liberalised.[122] Exchange controls were only lifted in 1992.[123] Banks operated under difficult regulatory environments, stifling their freedom to commercialise and merchandise.[124] For nearly four decades following independence, only short-term loans were available from Kenyan banks, and these were accessed against collateral.[125] This scenario is slowly transforming, as lending windows are incrementally expanded.[126]

4.6 How Private Equity Intermediation Resolves Barriers Identified

This chapter has established the existence of the 'proverbial' "funding gap" in Kenya. It was shown in chapter 3 how private equity by its very character is well-suited to overcoming some of the challenges identified in this chapter. Barriers related to collateral quality, for instance, are not significant impediments to a private equity financier, since private equity is not a 'lending' business, it is an equity investment. It is grounded in the business 'idea', and is structured in a participatory manner, as chapter 3 explored in great detail.

A key feature of private equity investments is the leadership development emphasis: the investor provides both finance and leadership to companies. It strengthens, through very close monitoring, a company's ability to make strategic and market-sensitive decisions. It

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[122] FSD Kenya, Financial Inclusion Survey 2009 (n 116)
[123] The Exchange Control Act was repealed in 1992: <http://www.kenyalaw.org/klr/fileadmin/pdfdownloads/RepealedStatutes/Exchange__Cap_113_.doc > accessed 20 October 2011.

[124] PwC Kenya, 'Banking' (*PwC*, 2011) <http://www.pwc.com/ke/en/industries/banking.jhtml> accessed 20 October 2011.
[125] FSD Kenya, Costs of Collateral (2010) (n 88)
[126] FSD Kenya Financial Inclusion Survey 2009 (n 116)

disciplines corporate performance through various strategies explored in the previous chapter. It also frequently unlocks additional financing into the business through strengthening the company's balance sheet.

Private equity is also capable of maximising 'local knowledge' through building partnerships with intermediaries already working within a specific market. For instance, in 2011, a venture capital fund (Acumen Fund) and a microfinance institution (Grameen Foundation) partnered in co-lending a quasi-equity facility of USD1.75 million to an agricultural microfinance institution in Kenya (Juhudi Kilimo Ltd).[127] Juhudi Kilimo has demonstrated impressive success in supporting agricultural businesses that would neither meet the 'safe investments' threshold that primary lenders like banks demand, nor the 'scale' preferred by most private equity investors. This new strategy offers one way of mitigating the risk of direct investment in a sector or section of the economy about which high-end investors feel uncertain. Through such innovative partnerships, the financial divide can gradually be bridged. More importantly, it offers an opportunity for private equity to be spread more creatively into the really productive sectors of the economy. This is a unique feature of emerging markets private equity.

According to the International Finance Corporation, emerging market opportunities are small in value (like the Acumen-Grameen investment above), but lucrative.[128] The structure of Kenya's private sector bears this fact out. For private equity in Kenya, therefore, there opportunity to conclude multiple investments of a much lower cross-portfolio value exists in abundance. The opportunity invites flexibility in the investment strategy of private

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[127] Grameen Foundation, 'Acumen Fund and Grameen Foundation Invest in Agricultural Microfinance Company Juhudi Kilimo Company Limited' (9 May 2011) < http://www.grameenfoundation.org/press-releases/acumen-fund-and-grameen-foundation-invest-agricultural-microfinance-company-juhudi-ki > accessed 19 October 2011.

[128] International Finance Corporation, 'The Case For Emerging Markets Private Equity' (February 2011) < http://www.ifc.org/ifcext/cfn.nsf/AttachmentsByTitle/EM_PE_SharingIFCsExperience+February2011/$FILE/EM_PE_Sharing_IFCs_Experience_v9_February2011.pdf> accessed 2 October 2011

equity funds. Leeds and Sunderland suggested that transaction structures, approaches and tools for emerging markets private equity would be different from those that prevail in developed markets of Western Europe and North America.

4.7 Conclusion

This chapter has sought to demonstrate that market conditions in Kenya create attractive justifications for the role of private equity intermediation. This attractiveness is driven by the quality of Kenya enterprises, the depth, accessibility and responsiveness of the locally available sources of business finance, the prevailing constraints to financial access, as well as the general state of development within the capital markets framework. The general idea achieved suggests that the more enterprises are able to access business finance, the more sophisticated that country's economy becomes. Where sources of finance are limited, private sector efficiency is compromised. In the case of Kenya, this chapter has demonstrated how varying structural inefficiencies have compromised its ability to leverage the kind of enterprise capital it would require to grow.

Legal development appears to be a key driver of many of the structural inefficiencies identified within the Kenyan economy. It would appear that improvements to the legal framework for enterprise would lead to improved outcomes for Kenyan private enterprise. Legal and institutional interventions can be useful tools in this process, and in improving the framework for the macroeconomic factors to flourish.

It was proposed in chapter 1 that out of the four categories of 'country factors' that drive the emergence of private equity industries in countries, availability of enterprise finance belongs to the cluster styled 'external factors' in that chapter – that is, the 'macroeconomic' elements. Access to finance, however, has been constructed in this chapter as an 'internal factor', facilitated by an efficient legal system. It is the submission in this chapter that this view is consistent with the core thesis in this work: that to support the growth of private equity, introducing efficiencies to systems supporting entrepreneurship would be fundamental if developing economies are to deepen their 'financial systems and infrastructure'. Only then can the private sector be enabled to play its lead role in driving economic growth – and employing legal instruments is a viable strategy.

Perhaps more fundamentally, however, this chapter's findings on the constraints affecting the private sector in Kenya (including the negative practices of corruption, bureaucracy and institutional weaknesses) are capacity issues, that raise the important notion that reflecting close and hard on the foundational elements necessary to secure a sustainable basis for financial development would be an important development exercise for Kenyan policy makers and industry players. This 'capacity' need introduces a wider nuance to the institutional paradigm canvassed at chapter one: beyond the legal institutions of secure financial contracts, strong private property rights doctrine and integrity in financial reporting, the human capacity elements, the aspect of institutional effectiveness among regulatory agencies, and the capacity of policy makers to model national conditions and market principles that would promote sustainability in market development. In the end, this deduction is perhaps the most fundamental finding in this chapter.

5

FEATURES OF KENYA'S PRIVATE EQUITY INDUSTRY

5.1 Introduction

Like all private sector activity, private equity in Kenya operates within the same difficult business environment that supports all entrepreneurs in Kenya – canvassed in the preceding chapter. It is of great interest to explore the extent to which it has adapted its practices and methodologies to internalise the inevitable negative externalities these conditions gives rise to. This chapter consequently explores the makeup of the Kenyan private equity industry: who are the players, what is the personnel structure like, who are the investors, and the extent to which it is possible for Kenyan institutional investors (e.g. pensions and insurance funds) to invest in private equity. The investment strategy, including capital structuring preferences, investment life cycles, whether investments are syndicated, and how exit strategies are managed are additional themes explored in this chapter. In exploring these issues, this chapter is extensively grounded on survey findings of Kenya-based fund managers and other market intermediaries conducted between 2009 and 2010. The survey for this purpose is styled 'Fund Manager Survey 2010'.[1]

The empirical findings in this chapter help in crystallising issues which public policy designed to support private equity can help address. Through understanding how the industry works, an evidence base is created that can support a structured framework for consultation over a policy framework that serves the needs of the industry and the legitimate ends of regulation. In this sense, this chapter is crucial in contextualising the next part of the thesis which is devoted to an analysis of the legal framework for this industry.

[1] Ch 2, 53-60

This chapter is organised as follows. Section 5.2 traces the manner in which private equity was brought into 'the public consciousness' in Kenya. This is followed in section 5.3 and 5.4 by an evaluation of private equity fund characteristics in Kenya, starting with the features attaching to fund managers, as well as the structure of the funds themselves. Section 5.5 through 5.8 analyse the design of private equity investment through assessing disclosed investment strategies, how long private equity investments generally last, how rights and obligations are allocated within the financial contract, and whether private equity financing is syndicated at all in Kenya. Section 5.9 evaluates the exit framework, and the chapter closes with a report of the survey findings on fund manager perceptions about the direction in which they saw the industry taking in the medium-term. Their opinions provide a picture of current unfolding market practice.

5.2 Private Equity in the Public Consciousness

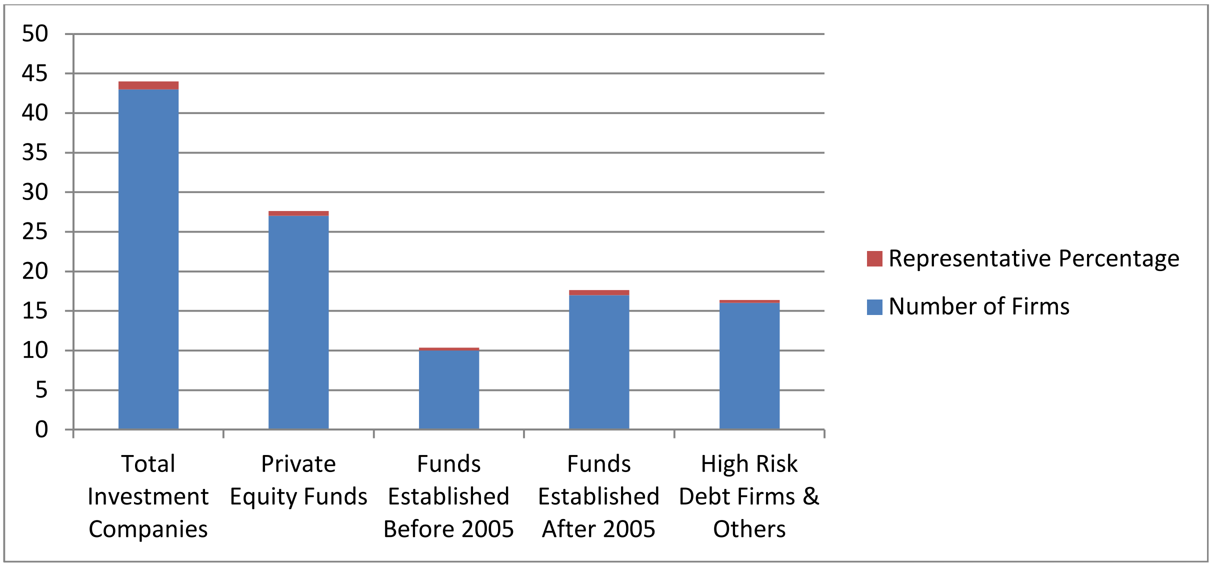
Reflecting the trend in many emerging markets,[2] field research for this study documented a substantial increase in the number of private equity companies setting up commercial operations in Kenya, especially since 2005. At the time of conducting the field work between 2009 and 2010, 43 investment companies whose business involved the making of investments of a financial nature and involving aspects of hands-on engagement in addition to capital provision were identified. As reported in the study's methodology,[3] there were six inclusion criteria in sample selection, and only 27 out of the 43 companies included in the initial sample answered to all the inclusion criteria.[4] The six criteria were specially

[2] Ch 1, 12-14
[3] Ch 2, 55
[4] ibid, 55,56.

designed to discount investment companies that are not in the proper business of private equity.[5]

Out of the 27 private equity companies selected for study, it was informative of market trends that only 10 funds had been set up in Kenya before the year 2005, while the remaining 17 funds established their local presence between 2006 and 2010. This is explained further in the paragraphs below.

Chart 5.1: Number of Private Equity Firms in Kenya



Source: Various

From a purely statistical perspective, the period after 2005 has witnessed phenomenal growth in Kenya's private equity landscape: compared to the sluggish growth of 10 funds setting up office in Kenya over a 50 year period. Reflecting the increase in private equity market activity since 2005, reports on private equity in the local press have become frequent

[5] Because private equity, as an alternative investment, is not open to retail investing like regular investment funds are, and employs specific methodologies not employed by other types of investment vehicles.

since 2005, suggesting there is a growing awareness and recognition of private equity in the Kenyan economy.[6]

A number of private equity investments in Kenya serve to illustrate why and how it has been brought to the public consciousness so strongly and so quickly. On the one hand, there was the high-profile private equity investment in the Kenya Railways Concession project, a highly visible and critical piece of public infrastructure, which initially saw two local private equity companies – Trans-Century Ltd and Centum Investments Ltd[7] – purchasing significant minority stakes in the project's ownership structure.[8] The project's lead investor experienced difficulties reaching financial closure on the project,[9] and after five years of unsuccessful fundraising for the project, sold its ownership stake to the Egyptian private equity company, the Citadel Capital S.A.E.[10] This project has had a difficult history, grounded in part in the Corporation's severe loss-making history, and partly in its high-profile public standing. Being an important piece of public infrastructure, the slow turnaround following the concession programme attracted criticism from the government, and negative press reviews.[11]

On the other hand, there have been less contentious but substantial investments of private equity in some of Kenya's leading brands. A case in point is the investment of USD178.7 million by Helios Investments LLC into Equity Bank in 2005, with the approval of the Central Bank of Kenya, to enable the bank to expand its services extensively across the

[6] George Omondi, 'Small Firms Shy Away from Private Equity Lenders' (*All Africa*, 4 May 2010) < http://allafrica.com/stories/201005040973.html> accessed 4 May 2010.
[7] 'Exit' is a term used in private equity practice to mean 'divestment' of an investment through a sale of shares held in a corporate entity. 'Acquisition', conversely, denotes the purchase of ownership through a share buy.
[8] TransCentury Limited, 'Rift Valley Railways Secures USD 164 million Debt Package' (*Press Release*, 23 August 2011) < http://www.transcentury.co.ke/main-news-gid-26> accessed 20 October 2011.
[9] Nick Wachira, 'How Plan to Privatise Railways Became Country's Public Sector Reform Nightmare' (*All Africa*, 24 January 2010) < http://allafrica.com/stories/201001250112.html> accessed 20 October 2011.
[10] Citadel Capital has for three consecutive years been ranked Africa's largest private equity firm <http://citadelcapital.com/about/who-we-are/> accessed 2 January 2012
[11] Jeff Mbanga, 'RVR Gets New Investor as Sheltam's Empire Crumbles' (The Observer, 24 February 2010) < http://www.observer.ug/index.php?option=com_content&view=article&id=7388%3Arvr-gets-new-investor-as-sheltams-empire-crumbles&catid=38%3Abusiness&Itemid=68> accessed 21 October 2011.

country.[12] Centum Investment Ltd had earlier in the 1990s invested in to General Motors of Kenya, helping to modernise production and expand the assembly plants at GM, an investment that saw GM's market share achieve dominance of the new car market in the country, in the process it became a hugely profitable investment for Centum Ltd. More recently, AfricInvest acquired 24.99% of Family Bank – in a deal that mirrors the 2005 Equity Bank deal with Helios LLC.[13]

Private equity investments in public infrastructure was pioneered by Trans-Century Ltd. Prior to its investment in to Rift Valley Railways, this fund had invested heavily in the power sub-sector and in specialised engineering equipment. Fanisi Venture Capital Fund, established in Kenya in 2009, made its third investment in 2010, valued at KES 124 million in to Elris, a telecommunications company in Kenya, a Kenya-based company that provides network implementation and management services to the telecommunications and broadcasting sectors in Kenya.[14] Earlier the same year, it invested KES80 million into card payment company Paystream Kenya to expand visa card technology in Kenya.[15]

An important element that continues to define public consciousness of private equity is the sector focus or investment strategy of local funds. As illustrated further below, the strong investment presence in healthcare, financial services, agribusiness, infrastructure, retail, manufacturing and other service sectors means that Kenyans are increasingly coming

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[12] Helios Investment Partners, 'Representative Investments' <http://www.heliosinvestment.com/representative-investments> accessed 11 October 2011; cf: Michael Omondi, 'Equity Races Ahead of Rivals with Sh.11 billion Capital Injection' (*Business Daily,* 15 November 2007) < <http://www.heliosinvestment.com/support/uploads/1208187763equity-races-ahead-151107.pdf> accessed 11 October 2011.
[13] Johnstone Ole Turana, 'Private Equity Fund Acquires Major Stake in Family Bank' (*Business Daily*, 18 October 2010) < http://www.businessdailyafrica.com/Corporate%20News/Private%20equity%20fund%20acquires%20major%20stake%20in%20Family%20Bank/-/539550/1034628/-/13mu2ie/-/index.html> accessed 18 October 2010.
[14] Fanisi, 'Fanisi Invests in Elris Communications Ltd' (*Nov 12, 2010, Nairobi, Kenya*) <http://fanisi.com/news.php?id=8> accessed 2 January 2012
[15] Fanisi, 'Investments' <http://fanisi.com/page.php?id=10> accessed 21 October 2011.

into daily contact with private equity by way of products and services financed by private equity.

It was also observable that during the post-2005 period, there was an increase in the number of debt-providing companies, including micro-finance companies, in Kenya. Their investment strategies in certain respects mimicked private equity investment strategies, and in some cases, have led to investment syndication, as the Acumen Fund and Grameen Bank joint lending to Juhudi Kilimo, discussed in the last chapter, illustrated.[16] This is a significant new trend towards improving liquidity in the market. These issues are reviewed in more detail in section 5.8 of this chapter, titled 'syndicating Transactions' .

5.3 PE Funds in Kenya: Statistics

Excluding dedicated debt-providing companies, the cumulative Kenyan private equity market in 2010 exceeded an estimated USD1.5 billion in capital raised, since the first investment vehicles were set up in 1954[17] and 1967,[18] respectively. This capital has been invested in over 180 Kenyan companies over that period.[19]

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[16] ch 4, 149-150
[17] The Industrial and Commercial Development Corporation , incorporated in 1954 as a government-affiliated investment entity < http://www.icdc.co.ke/about-icdc.html> Accessed January 2010.
[18] Centum Investments Company Limited, 'History of Centum' < http://www.centum.co.ke/index.php?option=com_content&view=article&id=99&Itemid=97.> Accessed 20 January 2010.
[19] Caution in interpreting these numbers is necessary: they are estimates based on publicly available information – and the Kenyan private equity industry does not collect statistics in any known structured way. Hence it is incomplete.

Less than 11% of the fund managers are government private equity. This is significant when placed into the context of the vexed literature arguing that too much direct government private equity has a stifling effect on private equity.[20]

The remaining nearly 90% of the Kenyan private equity market is made up of independent fund managers – meaning funds funded and managed by private actors. It is notable that 'captive funds', that is, funds that are part of financial institutions such as banks, are not yet part of the Kenyan private equity landscape.[21] The ongoing strong shift in attitudes by banks towards the SME sector and their expanding risk appetite coupled with government's policy shift in its approaches to financing large public infrastructure projects, indicate that it is likely that the Kenyan private equity market will in the medium term witness the emergence of captive funds – that is, institutional venture capital.[22]

5.4 Fund Characteristics

Chart 5.2 below reports on available fund structures in Kenya, the sources of private equity funds, the structure of fund management, the question of fund size and how the market is split between local and foreign funds.

Under the Companies Act of 1962, three types of private companies can be incorporated in Kenya: companies limited by shares; companies limited by guarantee; and unlimited companies.[23] The Capital Markets Authority Act of 1989 specifies that a private

[20] James Brander, Thomas Hellman, Qianqian Du, 'Government as Venture Capitalists: Striking the Right Balance' in the Global Economic Impact of Private Equity Report 2010 (*World Economic Forum* 2010) 3 Globalization of Alternative Investments Working Papers 26.
[21] Barclays Bank of Kenya has since launched its own private equity fund (in 2011) – hence the situation that prevailed at the time of field study has since changed.
[22] This 'prophecy' has actually come to pass.
[23] Cap 486, s 4(2)(a)(b)(c).

equity company must be a company limited.[24] This is a legal requirement – meaning that currently, only one form of fund structure is available to private equity in Kenya.

The limited partnership fund structure, discussed in chapter three, was not available in Kenya at the time of study. Ongoing review of company law, however, led by the Kenya Law Reform Commission (KLRC), include the creation of a new legal framework that would for the first time allow the formation of limited liability partnerships in Kenya – similar to the British limited liability partnership.[25] The instrument for this purpose is a proposed new law, embodied in the Limited Liability Partnership Bill 2010.[26] According to the KLRC, which led in the drafting of the bill, the new LLP framework incorporates many attributes of a private company, and it is intended to serve the needs of professional business organisations like law firms, accounting and audit firms, fund managers and other services.[27]

FM109 and FM106 observed, virtually identically, that "adopting a legal framework that accommodates choice over fund structures would improve the attractiveness of Kenya to global private equity funds seeking investment opportunities in emerging markets."[28]

Secondary evidence by Emerging Markets Private Equity Association (EMPEA), and the position taken in some Western literature, corroborates this view.[29] The central argument here is that unfamiliar fund structures in foreign markets are perceived to require different approaches to investment design.

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[24] Cap 485A, sections 23 and 28 - to be registered as a private equity company or a fund manager, the applicant must be a limited liability company.

[25] United Kingdom, Limited Liability Partnership Act of 2000 <http://www.legislation.gov.uk/ukpga/2000/12>

[26] Parliament of the Republic of Kenya, (Bill Tracker 2011) 4 <http://www.parliament.go.ke/index.php?option=com_content&view=article&id=113:bill-tracker&catid=46:house-business> accessed 11 October 2011. The Cabinet has endorsed the Bill, but it awaits the third reading (Committee of the whole House) before presidential assent.

[27] Interview with Mr. Johnston Okello, Senior State Counsel, Kenya Law Reform Commission (KLRC, Nairobi Kenya, 5 January 2010).

[28] Interviews held at Nairobi, Kenya, in September 2009 and January 2010 – both fund managers in Kenya.

[29] Roger Leeds and Julie Sunderland, 'Private Equity in Emerging Markets' (2003) 15(4) Journal of Applied Corporate Finance 8-17 < http://www.sais-jhu.edu/sebin/y/i/journal_of_acf_final_5102.pdf> accessed 12 September 2010

It is significant, therefore, that current law reform in the area of fund structures is at an advanced stage. Signalling the government's commitment to improving the business environment for alternative investments, the Minister for Finance in the 2011 Budget Speech urged Parliament to prioritise the enactment of the proposed LLP corporate vehicle[30].

In terms of role delineation, it was observable that the organisation of the Kenyan private equity industry evidenced a clear differentiation of roles between fund managers (GPs) and fund investors (LPs). The GPs in Kenya are responsible for the day-to-day management of the funds, and are responsible for sourcing investment opportunities. LPs lay down the conditions attached to their investments within the framework of the limited partnership agreement. As far as the form and structure of the limited partnership relationship is concerned therefore, Kenyan private equity follows global practice – and this is significant in demystifying what to expect in Kenya.

Chart 5.2 below indicates that the preponderant majority of private equity funds operating in or out of Kenya have finite lifetimes, on average about 10 years, but which can be extended by agreement of the LPs. Among the interviewed GPs, 89% were closed-ended funds, while only 11% were open-ended funds. Among this latter category were a government private equity fund, and two local funds. These trends are good because to global private equity funds looking to set up operations in emerging markets, the Kenyan private equity landscape does not present unfamiliar features – as far as the investment lifetime is concerned.

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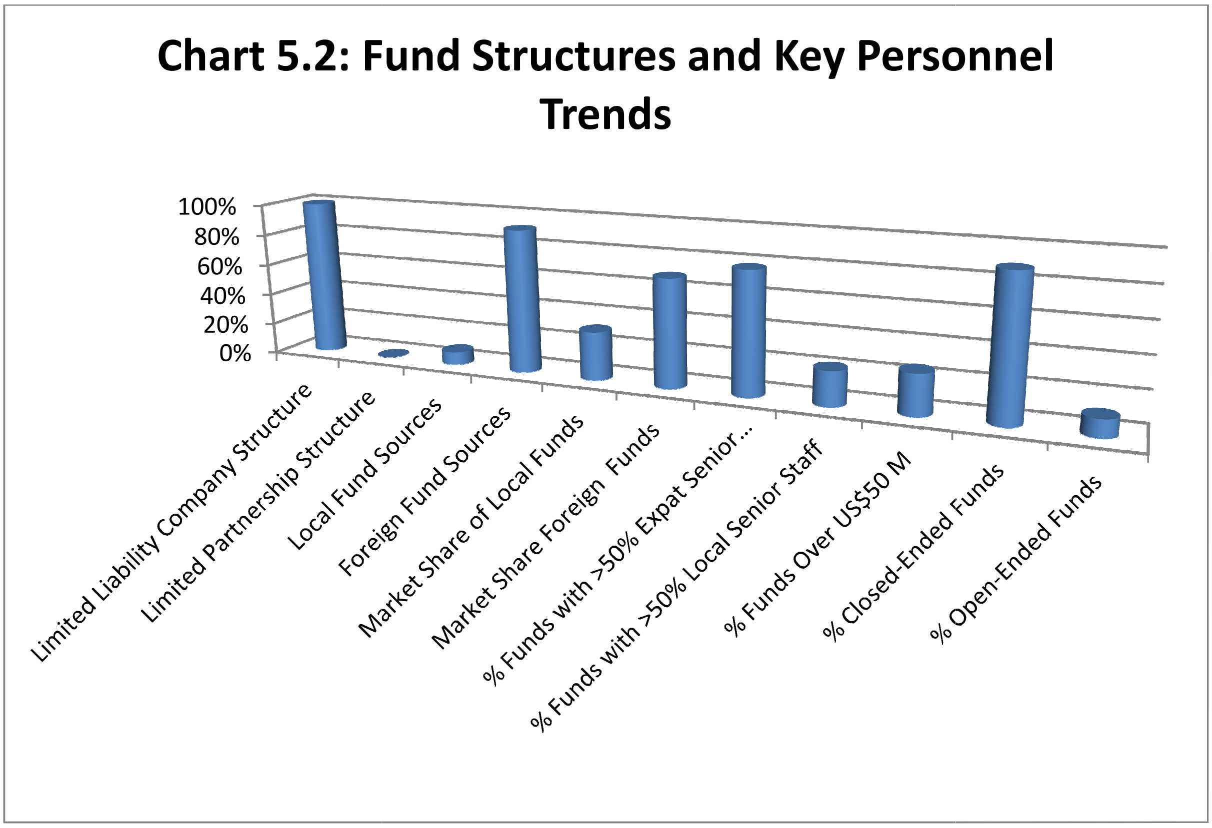
[30] Hon. Uhuru Muigai Kenyatta, EGH, MP, Deputy Prime Minister and Minister for Finance, 'Budget Statement for the Fiscal Year 2011/2012' (Government of Kenya, Ministry of Finance, 8th June 2011) 10 para 36. <http://www.finance.go.ke/index.php?option=com_docman&task=cat_view&gid=110&Itemid=86> accessed 9 June 2011– besides the bills on companies and insolvency, both of which are part of the package of reforms to Kenya's company law – in order to support the growth of specialised investments



Source: Fund Manager Survey 2010

Over 74% of the funds are sized below USD50 million. Consistent with this fund size profile, the prevalent deal size in Kenya ranges between USD0.2 million and USD20 million. This finding correlates with the observations identified in the preceding chapter about the structure of Kenya's private sector. Whereas the narrow segment of the private sector comprising medium and large enterprises can support larger private equity investments, the preponderant bulk of deals flow from the innovative, but small-sized segment of the private sector. It was illustrated in the previous chapter that 80% of Kenya's private sector is made up of small micro-enterprises – 65% of which are informal.[31] It is thus unsurprising that deal flow and deal size mirrors the prevalent firm size.

This reality has ramifications for the global private equity investor – to whom size matters. According to FM111, one of the larger foreign-owned and foreign-led private equity

[31] Ch 4, 129, (chart 4.3)

companies interviewed, deals valued at over USD50 million in Kenya are few and far between, while those valued at less than USD20 million abound. FM111 indicated it was winding down its affairs in Kenya as it was not generating sufficient deal flow at the desired size thresholds. It was thus astounding, however, when FM104, one of the locally-owned and locally-led, and older, fund managers roughly corroborated the challenge of deal sizes where global private equity firms are concerned. FM104 related how it had to turn down potentially lucrative partnership deals with a foreign, non-Kenya based, investment fund that was attracted by the generally good returns Kenyan private equity has demonstrated. That global investor conditioned the proposed partnership on an annual deal flow of four investments valued above USD50 million annually. FM104 could not guarantee deal flows at the deal size.

Interestingly, 69% of the Kenyan private equity market in 2010 was under the control of foreign-led private equity funds, with the remaining 31% of the market being controlled by local funds.[32] Consistent with the respective market shares, it was found that 78% of the funds operating in Kenya featured senior managements comprising over 50% expatriate (non-Kenyan) workers, while only 22% of the funds featured senior managements with more than 50% local (Kenyan) workers. The proportion of foreign-owned and foreign-led funds suggests that local ownership of private equity is still under-developed, giving rise to issues over strategic financial sector development. This reality might also have implications for the policy behind investment restrictions in private equity (discussed further below). These realities perhaps warrant an argument in favour of retaining such restrictions, but in the absence of a clear, written policy on alternative investments such as private equity, it will remain a difficult regulatory point to debate. Focused work in this area would be a worthwhile extension of this work.

[32] By foreign fund is meant a fund led by expatriates and domiciled in a foreign jurisdiction, and the converse is true for 'local' funds: led by Kenyans and domiciled in Kenya.

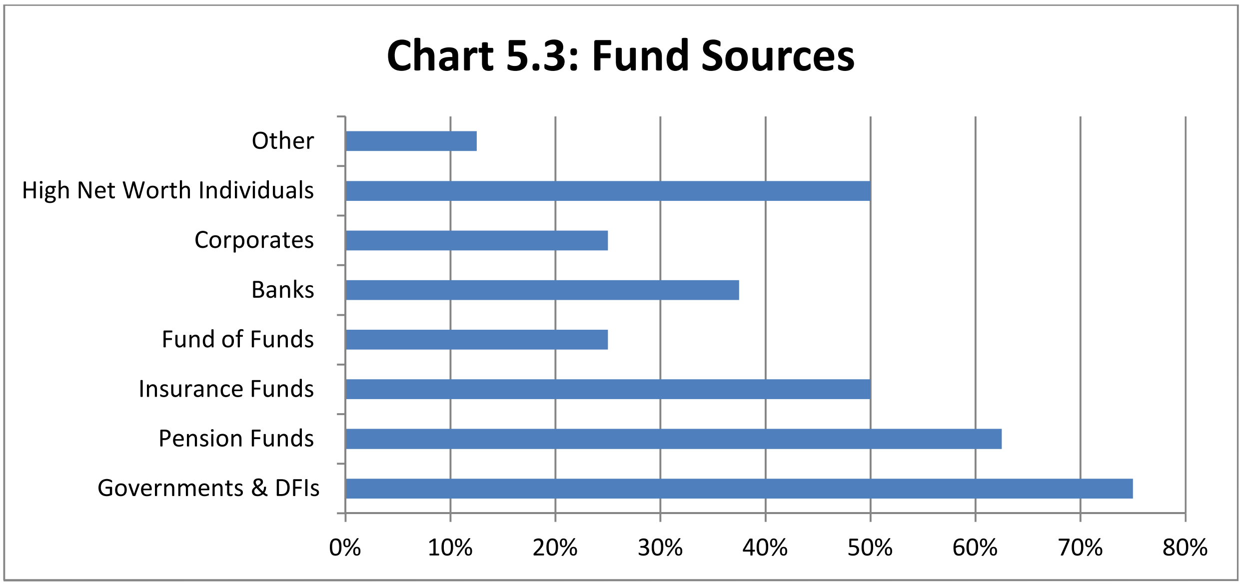
These features motivated the need to seek an understanding of fund sources. The evidence shows that 92% of all funds made available for private equity investments in Kenya was sourced from foreign investors, meaning that only 8% of the private equity capital was raised within Kenya. The local funds (excluding government-invested funds) have a combined capital of more than USD300 million dedicated to private equity, and have invested in 23 companies – out of over 181 traced private equity investments in the country up to 2010 July: or 30.7% of all private equity investments in Kenya.[33] A number of the post-2000 independent funds have also attracted some local institutional support, signalling the potential of the local market to generate substantial investment funds for this investment class.[34] The trends above suggest, nonetheless, that even the locally owned funds substantially fundraise externally. Local fundraising, therefore, remains constrained, and, industry-wide, the number of local experts engaged at management levels remains low. Recent newspaper reportage confirms this situation prevails.[35]

Chart 5.3 below illustrates that fund managers in Kenya mostly draw their investment capital from government and development finance institutions (75% of the funds), including European, American, and African development finance institutions.

[33] Caution in interpreting these statistics is necessary: without a pre-existing and historically significant databank of private equity in Kenya, and the inherent inclination within the industry towards limited disclosure, these statistics are without doubt incomplete. Abstractions therefrom must hence relate to the universe of studied instances, as opposed to generalising for the industry as a whole. Their value, however, lies in typifying market trends.

[34] Variously sourced: including through interviews with FM102, FM103, FM 105, FM106, FM107, FM108, FM109, FM110, FM111 and FM113, as well as survey questionnaire responses and information from websites.

[35] Cosmas Butunyi, 'Africa-focused "PE" Way to Go' (*The EastAfrican, Nairobi, 18 February 2012*) <http://www.theeastafrican.co.ke/business/Africa+focused+PE+way+to+go/-/2560/1330202/-/shvsj6/-/index.html > accessed 19 February 2012



Source: Fund Manager Survey 2010

This is an illuminating finding – suggesting that 'government' and 'government-linked' institutional investors predominate emerging markets private equity, a position local media anecdotally corroborates.[36] In view of the market split between local and foreign funds in Kenya, there is evidence indicating the increasing attractiveness of Kenyan private equity to international institutional investors, supporting the notion of a portfolio diversification strategy.[37]

Going back to the type of investors in Kenyan private equity, chart 5.3 indicates that pension funds (63%), insurance funds and high net worth individuals (50% respectively) constitute other substantial sources. It is significant, however, that the pension fund investors are largely foreign funds. Pension fund regulations in Kenya limit the exposure of local pension schemes to private equity, a structural barrier to more robust local fundraising for private equity.

[36] ibid
[37] Paul Gompers and Josh Lerner, *The Venture Capital Cycle* (MIT, 2004) 'What Drives Venture Capital Fundraising?' ch 3, 38-9.

Under the Retirement Benefits Authority Act of 1997, the *Investment Guidelines* classify private equity as "unquoted equities" and "any other asset" – with specified caps on investment exposure. Where a scheme fund makes a direct investment in 'unquoted equities', the maximum exposure is capped at 5% of the pension scheme's net value. Where an investment is made through a structured investment vehicle like a private equity fund, which falls under "any other asset", that threshold rises to 10%, but is subject to approval by the Authority.[38] These conditions stem from Government Financial Regulations, issued by the Ministry of Finance - the official policy is to invest secured funds in government or government-approved securities.[39]

These limitations are intended to serve prudential goals. The Minister's statement explained that the directive requiring all scheme funds to be invested in government security papers was driven by a documented string of imprudent investments which had occasioned losses to some schemes, leading to difficulties in meeting annuity demands.[40] The unintended effect, however, has been a holding back of wider exposure to private equity funds in Kenya, suppressing the role and impact of local institutional investments into private equity.

The Retirement Benefits Authority (RBA) ascribes the uncertainty over private investments to a poor understanding of private equity. According to the Chief Executive Officer at RBA, private equity's long-term profile offers a good fit to the long-dated liabilities of the pension fund industry, and that greater understanding of the dynamics and nature of private equity was clearly called for.[41] He also opined that the pension fund industry could be engaged as a home-based financing solution in structured investments forming part

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[38] Act No.3 Laws of Kenya, ss 18, 37, and Column 2 Table G, First Schedule.

[39] Uhuru Muigai Kenyatta, Deputy Prime Minister and Minister for Finance, 'Budget Speech for Fiscal Year 2009/2010'*(Government of Kenya, Ministry of Finance*, 11 June 2009) Para. 137 <http://www.finance.go.ke/index.php?option=com_docman&task=cat_view&gid=88&Itemid=54> accessed 17 June 2009.

[40] ibid para.136-137.

[41] Interview with Mr. Morris Odundo, Chief Executive Officer, Retirement Benefits Authority (RBA, Nairobi, Kenya, 29 August, 2009).

of the flagship programmes under Vision 2030. The Government echoed these themes in the 2011/2012 budget round, acknowledging that partnerships with the private sector were the only realistic and sustainable mechanism in delivering the country's development agenda.[42]

It is instructive that in 2011 the Kenyan pension fund industry has exceeded KES450 billion– a substantial pool of investable capital.[43] 31.9% of these funds were invested in government securities, while 28.9% were invested in quoted equities. 17.8% was invested in immovable property and 7.4% was invested in guaranteed funds.[44] Fixed income and fixed deposit investments accounted for 8.5% of that asset base, while offshore investments accounted for a shallow 3.5%, and, more tellingly, only 0.6% was committed to unquoted equities.[45] This investment portfolio mirror government regulations on the investment of scheme funds.

The Minister for Finance's directive on how pension scheme funds are to be invested in Kenya is prescriptive, and does not allow room for informed risk taking in the allocation of investments – potentially a ground for moral hazard in asset management.[46] Adopting a risk-based supervisory model would permit fund managers the flexibility to adopt responsive risk management protocols in allocating investments.

In evidence of the level of keenness to demystify private equity, the RBA in partnership with the CMA have initiated 'educational' workshops on how pension fund

[42] Uhuru Muigai Kenyatta, EGH, MP, 'Budget Speech 2011/2012 (n 31) 5, 6 para10-13
[43] Retirement Benefits Authority, 'Pension Assets Hit 451 Billion Mark', (Press Releases, June 2 2011) <http://www.rba.go.ke/media/docs/press-releases/pension-assets-hit-451-billion-mark.pdf> accessed 9 October 2011.
[44] id
[45] id
[46] Budget Speech 2009/2010, (n 43)

managers can invest in private equity, starting with a workshop held in March 2011 – appropriately titled *'Private Equity Workshop for Pension Fund Trustees'*.[47]

Nonetheless, Government Financial Regulations – as depicted in the Budget Speech of 2011/12, and as entrenched in the Investment Guidelines in Schedule 1 of the Retirement Benefits Act No.3 of 1997 – still operate to impede exposure to private equity and other structured alternative investments beyond the stated thresholds. To consolidate these positive developments, there is a case for law reform to the Retirement Benefits Act of 1997 to reflect the emerging policy shift.

Developing mechanisms by which structured investments can benefit from this and other massive fund pools – like the insurance industry – would open up new frontiers in the financing of critical development projects. To support these aims, the Government is now positively predisposed to creating legal frameworks for structured investment vehicles such as Real Estate Investment Trusts (REITS).[48] Drawing lessons from 'successful' models in this regard (notably USA and Dutch models reviewed in chapter 3) would be a practical strategy to adopt.

87.5% of the interviewed fund managers believe the local pension funds represent immense fundraising possibility for private equity funds. The same respondents indicated they would be happy to fundraise locally were investment regulations governing the pension fund industry further relaxed. This is a significant reform agenda for the country if local private equity fund sources are to be improved in a sustainable manner.

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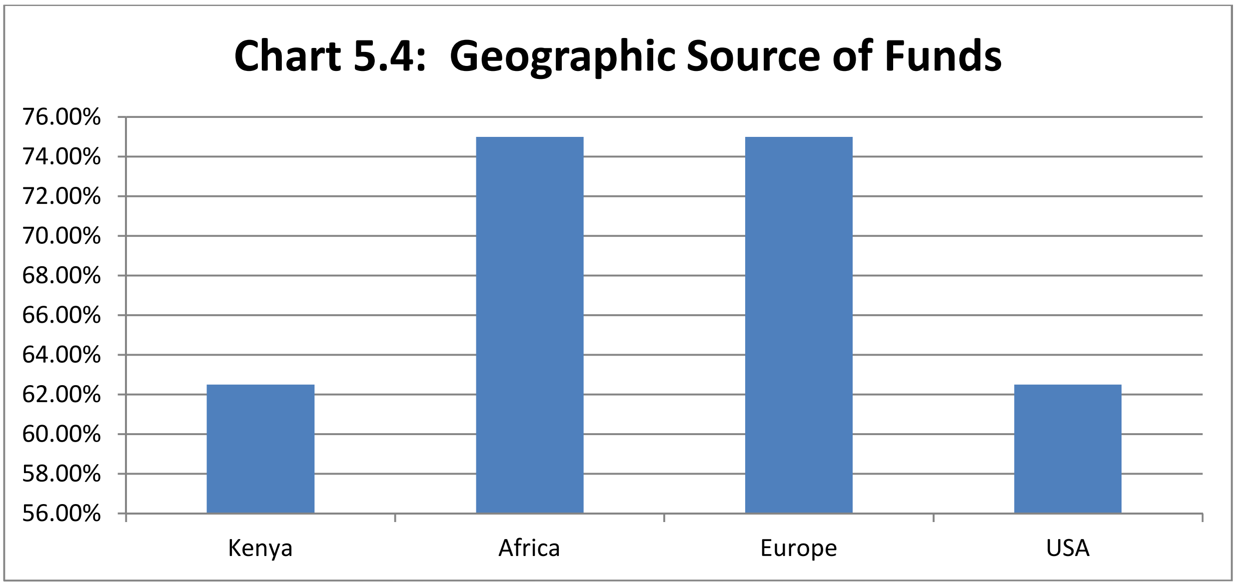
[47] Retirement Benefits Authority, Held at the Serena Hotel, Nairobi, 23-24 March, 2011 <http://www.rba.go.ke/index.php?option=com_newsarticle&view=newsarticle&n=3> accessed 9 October 2011. Key presentations were made by the EMPEA, the United States of America International Development Agency (USAID), Africa Venture Capital Association (AVCA) and a range of private equity fund managers.

[48] Budget Speech 2011/2012, para.135 – including proposed amendments to Income Tax Act of 1974 to exempt REITs from corporation tax and not to levy withholding tax on dividends earned from investing in REITs.

For 37.5% of the fund managers interviewed, banks are a substantial source of private equity funds. Like for the current sources of pension funds into private equity, bank finance into private equity is sourced mostly from foreign countries and non-local banks. 33% of the interviewed fund managers revealed they had investments by Kenyan banks, suggesting a growing predisposition towards private equity and other structured alternative investments in portfolio risk diversification within the country's money markets. For 25% of the interviewed fund managers, corporates and fund of funds represent additional investors respectively.

To summarise the evidence on fund sources above, and to put a face to the term 'foreign' fund sources, chart 5.4 below illustrates the geographic source of funds for Kenyan-active private equity firms.



Source: Fund Manager Survey 2010

It is significant that European and African fund sources top the chart (at 75% respectively), while Kenyan and American sources closely follow at 62.5% respectively. This is largely consistent with the findings depicted in chart 5.2 that the market share of locally raised funds in Kenya stood at 31% of the Kenyan private equity market in 2010, while that of foreign-sourced and foreign-owned funds stood at a substantial 69%.

A review of fund ownership by nationality revealed an interesting fact: funds linked with specific European countries for instance (in terms of domicile) sourced the bulk of their investment capital from the country of their domicile. This relationship between fund domicile and fund sources was intriguing. Fund managers, however, did not see this as being particularly significant, based on responses to the structured questionnaire. From a policy agenda framework, however, it should be instructive that this trend suggests investor confidence in investment vehicles within the alternative investments sector substantially determines the extent to which domestic sources of funding can be generated.

As far as the job spread generally across the fund is concerned, the findings (depicted in chart 5.2, above) revealed that most funds recruit locally at the technical level. These are the mid-level officials who facilitate deal sourcing, deal evaluation (due diligence), and provide local understanding to Kenyan investments. The fact that the technical roles are staffed by locals even among the foreign-owned and foreign-led fund managers indicated recognition of the importance of local expertise to the success of the investment. This view is consistent with the research strand suggesting that emerging markets private equity needs to have local connections to succeed.[49]

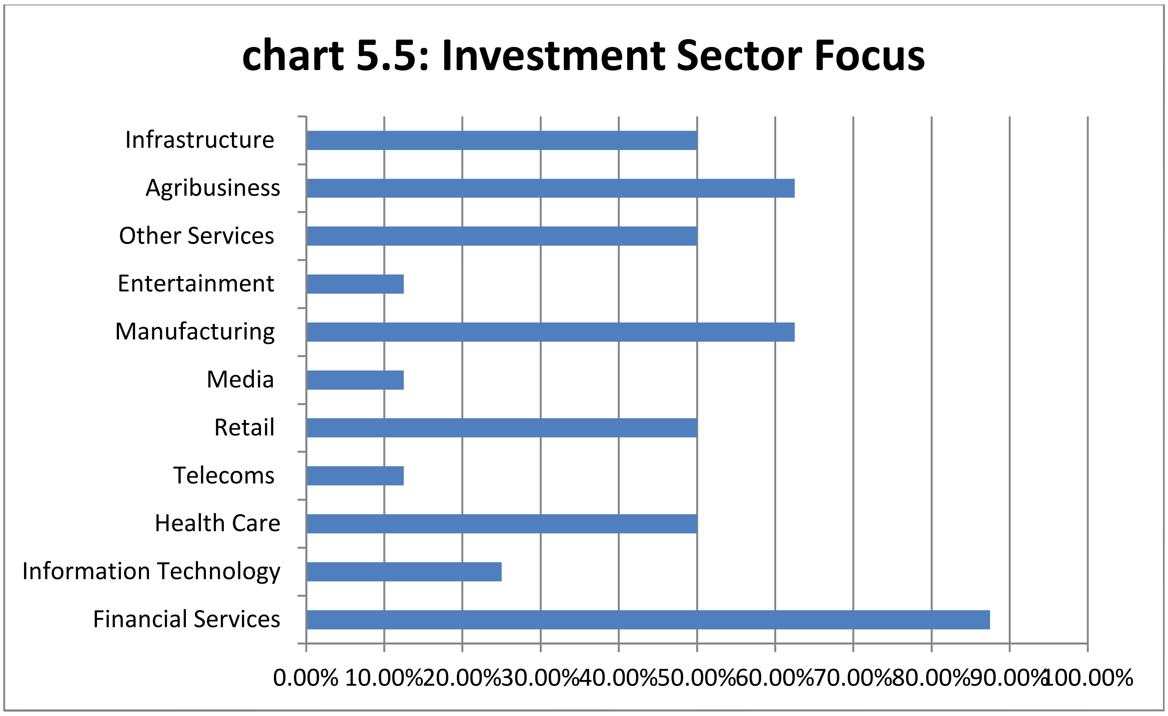
5.5 Investment Strategy

Chart 5.5 below is a depiction of the investment focus of Kenyan-based private equity funds, both foreign and local. It is notable that there is a strong focus on financial services (87.5% of the respondents), and manufacturing and agribusiness (62.5% of the respondents respectively). Other key investment sectors for the locally active funds include infrastructure,

[49] Leeds and Sunderland, 'Private Equity Investing in Emerging Markets' (2003) (n 30)

other service sectors, retail and healthcare (50% of the fund manager respondents respectively).

Entertainment, media and telecommunications investments represent attractive investment sectors for a small 12.5% of the respondents. Information technology is an attractive investment segment for 25% of the fund managers interviewed – consistent with the results reported in the preceding chapter illustrating the shallow penetration of information and communication technology in Kenya.[50]



Source: Fund Manager Survey 2010

These preferences are not indicative of exclusive investment strategies. In fact, all respondent funds pursue a largely generalist investment strategy – suggesting that local deal flow realities guide a fund manager's overall investment strategy. Kenya's economy is highly

[50] Ch 4, 123, 129

liberalised, and these investment preferences are not driven by regulatory restrictions: they are driven by the strong economic performance of the preferred sectors and opportunity for growth that Kenya offers.

Two key observations appear pertinent here. Firstly, the substantial interest in financial services and retail investments appear to directly go counter to Regulation 8(2) of the Capital Markets (Registered Venture Capital Companies) Regulations of 2007, issued under the Capital Markets Act of 1989, Cap 485A of the Laws of Kenya, which provides:

> *8.(2) The eligible venture capital enterprises for purposes of these Regulations shall be enterprises whose primary business activity* <u>*does not*</u> *include any of the following-*
>
> *(a) trading in real property;*
>
> *(b) banking and financial services;*
>
> *(c) retail and wholesale trading services. (emphasis added).*

In the express language of the law, these types of investments are treated as excluded economic sectors, meaning that private equity investments into these economic sectors would not ideally be permissible investments. In fact, private equity deals in these sectors have happened in Kenya, including in the banking sector, and with the express recognition and approval of the Central Bank of Kenya.[51] It was reported earlier in this chapter that private equity investments into Kenyan banks have taken place (Equity Bank Ltd and Family Bank Ltd). These were not transactions aimed at shoring up the banks' liquidity – both banks were simply seeking additional investments to finance their growth strategies.

[51] Section 13(1) of the Banking Act of 1989, Cap 488: cf: Omondi, 'Equity Races Ahead' (2007) (n 12) and Ole Turana, 'Private Equity Fund Acquires Stake in Family Bank' (2010) (n13)

This reality indicates a conflicting regulatory framework that could drive a degree of market uncertainty. The investment restriction under Cap 485A of 1989 is worded in terms that do not, prima facie, suggest there is room for derogation of the statutory principle of excluded investment sectors for private equity.

Discussions with the CMA did not establish a clear policy motivation for exclusions under the Venture Capital Regulations of 2007. The CMA respondent observed that -

> "As a regulator, our primary business is to ensure market players follow the laid down rules, as they are for the time being. It may well be that the law will change; if it does, we will implement the new system."[52]

When asked whether the law was, in the regulatory experience, equivocal on these particulars, the respondent observed that the whole question of private equity was not, at the time, a regulatory priority for the CMA. Under these circumstances, it looks set that bank sector regulators will continue acting differently from capital markets regulators.[53] This is an undesirable status quo, and there is, in the view of this study, justification for regulatory debate on how to harmonise the country's legal framework for private equity, including on the contested question of investment restrictions.

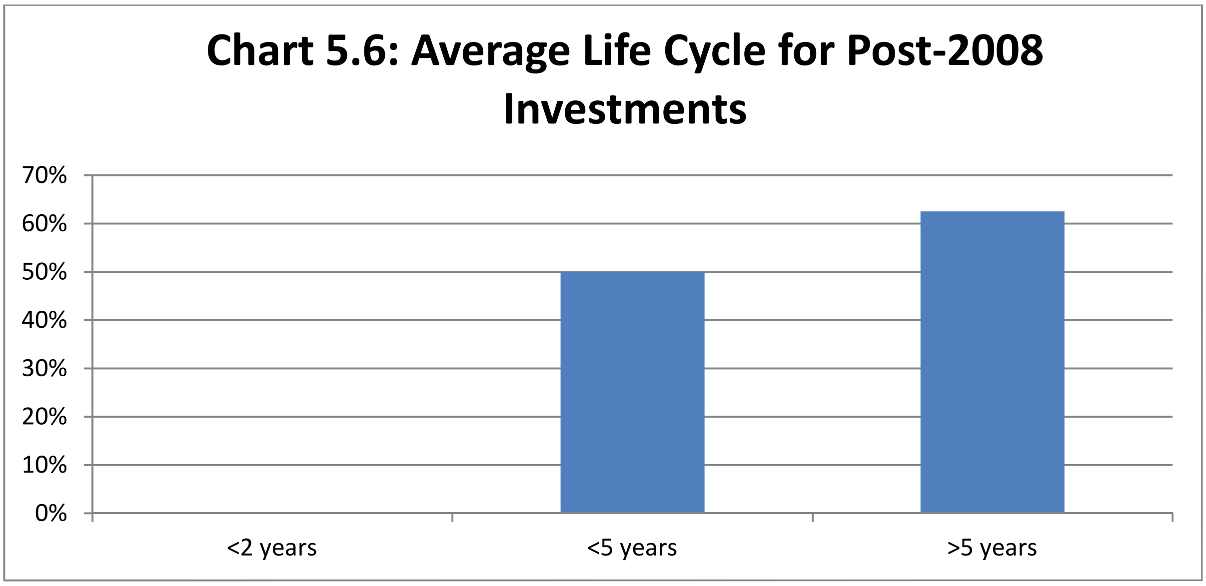
The second key observation arising from chart 5.5 is the similarity of the investment focus of Kenyan-based private equity funds to the general trends within the wider emerging markets as documented in Emerging Markets Private Equity Association surveys. Most emerging market private equity funds are generalist in strategy. 2007 statistics indicated that 58% of the emerging market funds (representing 66% of capital commitments) were generalist funds. The remainder focused on infrastructure, energy, mining, agri-business, environment and consumer sectors. 50% of the funds targeted growth opportunities, while

[52] Interview with RG201, Nairobi, Kenya, (January 2010).
[53] ibid

25% were venture, 7% were mezzanine funds, and 21% were buyout funds respectively. These trends have remained roughly consistent with trends in 2006 and 2005.[54]

5.6 Investment Life Cycle

The respondent fund managers were asked about their investment hold periods (or the average investment life cycle for their Kenyan positions). It was significant that none of the respondents indicated an investment life-cycle of less than two years. This means that “quick flip” investments are not the norm in the Kenyan market, consistent with the inherent illiquid profile of private equity as a financial asset.[55]



Source: Fund Manager Survey 2010

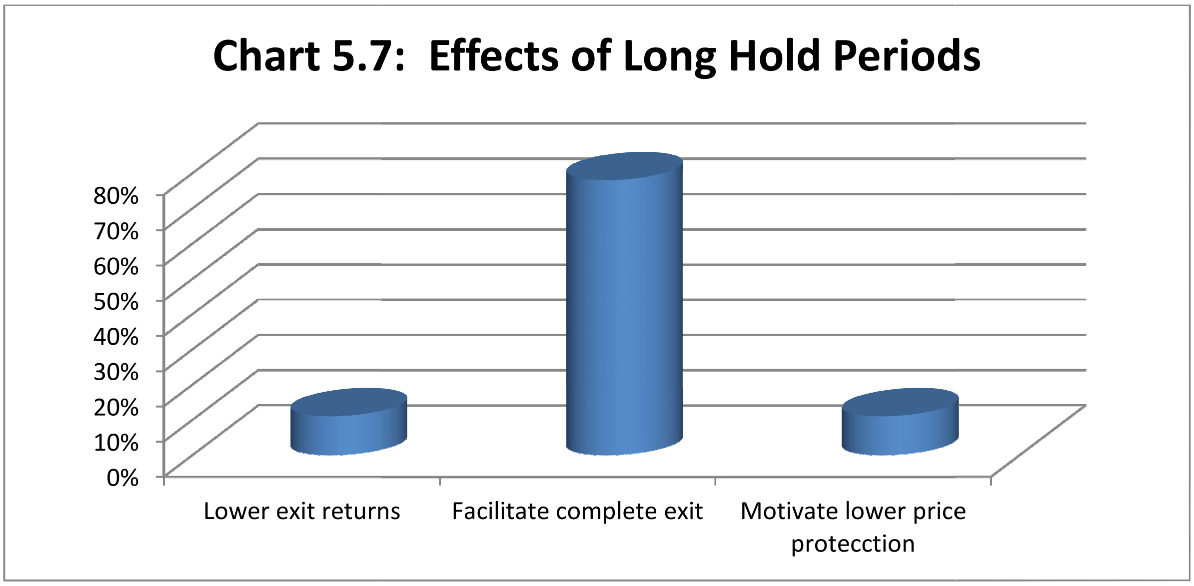
A solid 50% of the fund managers interviewed indicated a preference for the two to five year investment hold period, while a larger 63% indicated their expected investment life cycles to be greater than five years. This is consistent with the few publicly available records

[54] EMPEA 2007 Fundraising Review, 7 < http://www.empea.net/fundraisingreview/2007.> accessed 2 August 2010

[55] ‘Quick flip’ is a term used to refer to the practice of acquiring a corporate asset and disposing of it in under two years, a practice observed in early leveraged buyout transactions.

of exited positions among Kenyan-based private equity funds. Where full exits have been recorded, those exits mostly occurred after 5-7 years. Where partial exits have occurred, those exits have in some instances happened after 9 years. These responses were intriguing, and further investigations within the framework of face-to-face interviews revealed interesting explanations on the motivations informing this market trend.

Specific questions were put to the fund managers on interview: Do longer hold periods increase transaction costs? Would they facilitate complete exit? Would it improve returns? Questions on tax considerations were not put to the respondents in this context in light of the fact that under Kenyan law, there is no capital gains tax on investment earnings.[56]



Source: Fund Manager Survey 2010

As depicted in chart 5.7 above, 78% of the respondents opined that holding investment positions for more than five years tend to facilitate complete exits, as opposed to investments held for a shorter period of time. 11% of the respondents felt that longer hold periods lowered the motivation for price protection by buyers – which could be interpreted to mean higher net returns upon divestment. These first two perspectives are consistent with the

[56] For a fuller discourse on tax policy and private equity in Kenya, see Ch 7, 265.

general profile of investment life cycles among respondent fund managers, most of whom keep their investment positions on average between 5-7 years.

Another 11% believe the contrary: that longer investment life cycles actually does harm to risk-adjusted returns on equity, primarily through upping transaction costs and heightening losses accruing from opportunity costs. One of the recently established fund managers opined –

> "Investment turnover is important. There is an opportunity cost to holding onto investments too long, regardless of whether the investment is performing well. The way I see it, it is better to exit a position as soon as pre-targeted thresholds have been hit, and move onto new opportunities. You might be earning good from the one in hand, but you do not know the prospects of what you are letting go by holding onto this one." [57]

This crop of fund managers in the Kenyan market favour a divestment strategy of 2-5 years. It was notable that all of those who held this view started operations as fund managers in Kenya after the year 2005 – as chart 5.1 illustrated. Several of them were in fact in the fundraising stage for their first funds, and keen to break apart from the investment model of older funds.[58]

In contrast, one of the home-grown funds observed –

> "The whole purpose of investing is the opportunity to build great companies and turn a neat profit. If the one investment in my hand is yielding good returns and I can see another potentially lucrative opportunity, it is not a question of 'either' 'or' – our strategy is to hold onto both. If necessary, we

[57] Interview with FM113, Nairobi, Kenya,(August 2009)
[58] Interviews with FM109, FM106, FM102, FM103, FM113, Nairobi, Kenya,(August, 2009; January 2010).

liquidate a small portion of what we hold to facilitate a new acquisition. A good investment for us is good for the long haul, and that is not necessarily opposed to the private equity strategy."[59]

Both viewpoints summarise the interesting mix of private equity intermediaries currently operating in Kenya. From the framework of this study, the issue of investment hold periods simply relates to institutional efficiencies around contract management.

5.7 Capital Structuring in Private Equity

Under the Companies Act of 1962, a company in Kenya can raise capital through share placement, either in public equity markets or among private investors. This is the process termed capital structuring, and there are, under the law, several types of possible shares that a company can issue in exchange for capital investments into the company. These include common equity or ordinary voting stock,[60] redeemable preference shares[61] and other special share classes including share warrants,[62] debentures and other securities bearing debt features.[63]

Issuing shares alters a company's capital structure, for which special authority is required under the law. Such authority exists under Kenyan company law. Section 63 of the Companies Act of 1962, provides as follows:

"63. A company limited by shares (...), if so authorized by its articles, may alter the conditions of its memorandum as follows (...) it may –

(a) Increase its share capital by new shares of such amount as it thinks expedient;
(b) Consolidate and divide all or any of its share capital into shares of larger amount than its existing shares;

[59] Interview with FM112, Nairobi, Kenya, (August 2009)
[60] Companies Act 1962 Cap 486, ss 49, 50.
[61] ibid s 60.
[62] ibid s 85(1).
[63] ibid ss 88, 89.

(c) Convert all or any of its paid-up shares stock, and reconvert that stock into paid-up shares of any denomination;
(d) *Subdivide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum, so, however, that in the subdivision the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived; (...)"*

A company can thus raise capital through new share issuance, and in the process it can consolidate or divide all or any of its existing share capital into new share types and categories, including converting common equity into redeemable preference shares or vice versa, and can subdivide existing shares into lower-denominated securities provided the overall effect is not to reduce the company's share capital. According to section 69 of the Companies Act of 1962, a special resolution by all shareholders, and court approval, is necessary prior to any share capital reduction. Any capital structuring process following a private equity investment into a venture company therefore needs to ensure the company's share capital is either varied upwards or preserved after the conclusion of the share re-distribution following an investment.

In practice, a condition attached to private equity investments is the requirement for amendments to a venture company's memorandum and articles of association to entrench necessary powers and commitments in those constitutive instruments so that the investment can be supported under law.[64]

Section 61 of the Companies Act of 1962 enables companies to 'issue shares of difference', that is to say, shares of the same class but carrying different amounts and subject to different times on payment calls. This is an important instrument in the hands of both the venture company and the private equity investor. It allows for the navigation of potentially

[64] For instance, FM 101 and FM104 and FM112, in their Share Subscription and Shareholders Agreement, all carry the similarly worded clause: "*The Company shall deliver to …… a certified copy of a duly executed shareholders' resolution and adopting the new Articles and Memorandum of Association and shall carry out amendment of the said Articles and Memorandum of Assocition to recognize the provisions of the Option Agreement relating to…."*

difficult financing propositions, enabling the contracting parties to institutionalise their respective positioning in light of the intrinsic characteristics of the investment opportunity.

Section 74 of the Companies Act of 1962 makes provision for variation of share class rights – a powerful tool in the structuring of relationships within a financial contract framework. The provision reads as follows:

> *"74. (1) If in the case of a company, the share capital of which is divided into different classes of shares, provision is made by the memorandum or articles for authorizing the variation of the rights attached to any class of shares in the company, subject to the consent of any specified proportion of the holders of the issued shares of that class or the sanction of a resolution passed at a separate meeting of the holders of those shares, and in pursuance of the said provision the rights attached to any such class of shares are at any time varied, the holders of not less in the aggregate than fifteen per cent of the issued shares of that class, being persons who did not consent to or vote in favour of the resolution for the variation, may apply to the court to have the variation cancelled, and, where any such application is made, the variation shall not have effect unless and until it is confirmed by the court."*

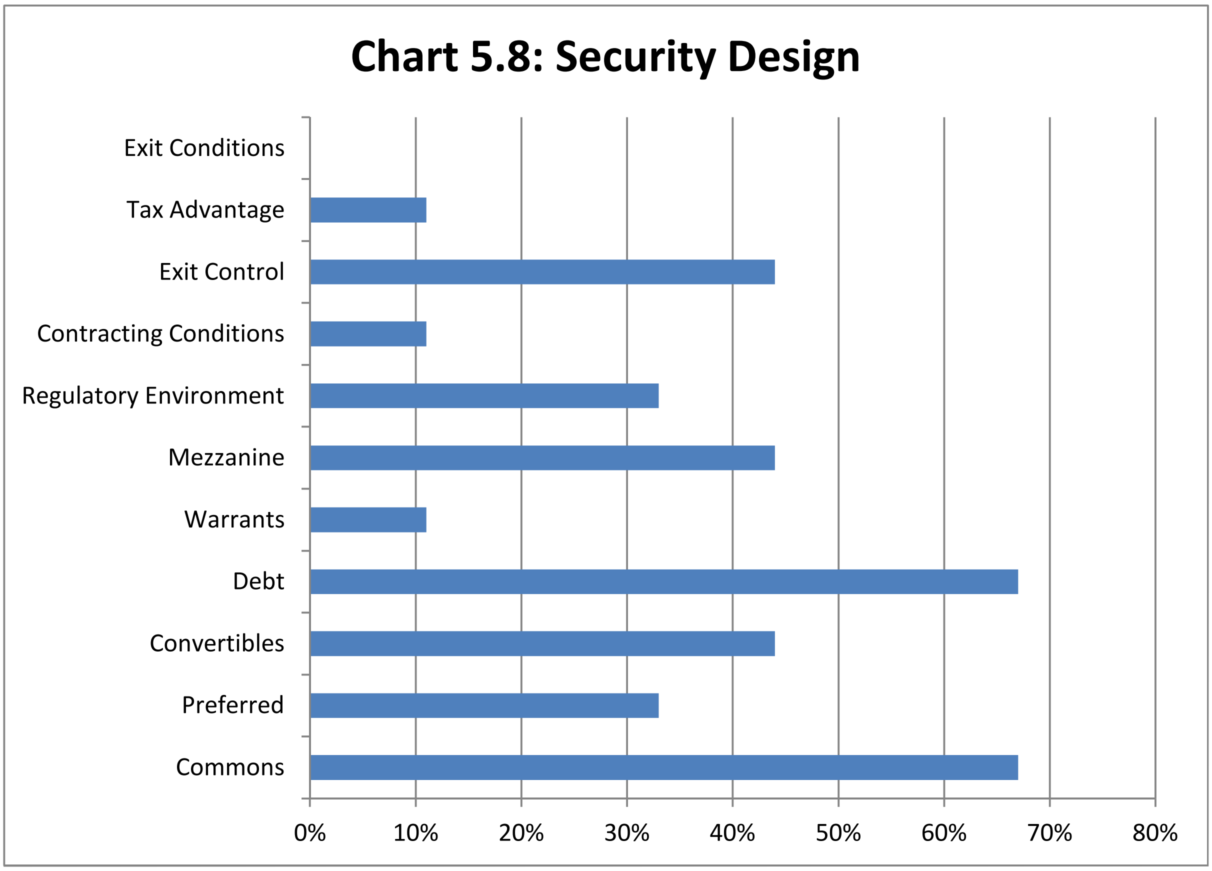
What the provision means in practice is that where ordinarily holders of preference shares may not be entitled to voting rights, or to regular dividend payments, a company may under section 74 of the Companies Act of 1962 introduce new class rights for this special share category to allow them a form of voting rights, including veto rights, as well as entitle them to periodic dividend payments. Conditions could also be attached to the vesting of shares, whatever class the shares may fall into. These conditions could include performance indicators, and triggers to conversion based on exigencies defined under the financing agreement (also known as anti-dilution rights).[65]

Section 85 of the Companies Act 1962 empowers companies to issue share warrants – with or without coupons for the payment of future dividends on the shares included in the

[65] Jack S Levin, *Structuring Venture Capital, Private Equity and Entrepreneurial Transactions* Martin D Ginsburg, Donald E Rocap and Russell S Light (eds), (Aspen, 2011) ch 2, 2-10 to 2-27.

warrants. Section 88 grants power to issue debentures, and provides for administrative incidentals integral thereto.

Kenyan company law therefore supports a range of corporate securities useful in capital structuring for private equity investments into venture companies. Chart 5.8 below details the capital structuring preferences observed in Kenyan private equity. It is shown that the capital structures in Kenya favour straight common equity and debt (over 60% of fund manager interviewees), followed closely by both convertible and mezzanine shares (over 40% of respondents). Fewer than 30% of the fund managers employ preference shares in their capital structures, and less than 10% employ warrants.



Source: Fund Manager Survey 2010

Furthermore, 100% of the independent fund managers take out either a controlling stake in the venture companies they invest in (over 25%), or a significant minority stake that incorporates investment control rights (under 25%). Information in the public domain bears this strategy out.[66] The Africa Venture Capital Association directory of members reveals that most investments in African venture capital adopted a similar 'significant minority' strategy.[67] Information gleaned from the websites of such fund managers as InReturn Capital Ltd and TransCentury Ltd demonstrate a similar investment strategy.[68] Vindicating the tested wisdom of this strategy, the International Finance Corporation has reported that its emerging markets funds and investments, structured into minority stakes (of as little as USD2 million) in invested companies have performed as admirably as the larger ticket transactions.[69]

Given the strong preference for debt (debentures) in private equity capital structures in Kenya, it is not surprising that warrants do not play a strong role. Warrants with or without coupon payments are preferred where the capital structures favour the use of preference shares[70] – and in the chart above, preference shares appear not to be very popular in Kenyan private equity.

Convertible securities and mezzanine-type deal structures feature frequently in observed transactions. The convertibility was in many instances tied to exigencies brought on by changes in the circumstances of the company, for instance, where a company varies its share structures, or class rights, or executes a given transaction whose effect is to vary or

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66 For instance, Centum Investment Ltd's private equity portfolio, set out in its website, shows a 'significant minority' strategy with shareholdings mostly above 17% and below 45%: < http://www.centum.co.ke/our-business/private-equity/pe-portfolio> accessed 21 October 2011.

67 Africa Venture Capital Association, '2005 Yearbook' <http://findarticles.com/p/articles/mi_qa5327/is_315/ai_n29225750/> accessed 19 August 2011

68 InReturn < http://www.inreturncapital.com/portfolio/portfolio>; TransCentury< http://www.transcentury.co.ke/> both accessed 20th August 2011.

69 International Finance Corporation, 'The Case For Emerging Markets Private Equity; (February 2011) <http://www.ifc.org/ifcext/cfn.nsf/AttachmentsByTitle/EM_PE_SharingIFCsExperience+February2011/$FILE/EM_PE_Sharing_IFCs_Experience_v9_February2011.pdf> accessed 2 October 2011

70 Thomas F Hellman, 'The Allocation of Control Rights in Venture Capital Contracts' (1998) 29 Rand Journal of Economics 57-76; cf: Stephen Kaplan and Johan Per Stromberg, 'Financial Contract Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts' (2003) 70 Review of Economic Studies 281-315

otherwise dilute the rights and entitlements of existing shareholders. The convertibility feature therefore serves as an anti-dilution protection, but also as a participating enabler, ensuring that the investor partakes in the company's success. Where a venture company executes an initial public offering during the subsistence of the private equity investment, for instance, a number of the seen agreements provide for the conversion of all preference shares held by the investor at the time of listing to convert into common equity and be made part of the stock of shares sold in the initial public offer.[71] The conversion price can be predetermined, or it can be pegged onto an agreed valuation criteria to be implemented at the time of conversion.[72]

As discussed later in this chapter, two prevalent exit strategies are buybacks (i.e., share redemptions) and dividend payouts. These strategies make sense when assessed from the prevalent capital structuring options in Kenyan private equity. Debt is by nature self-liquidating, and its repayment assures the private equity investor a steady stream of interest earnings. This translates to an early realisation of part of the investment's value. Regular dividend payments attaching to a number of class rights also secure an early return to private equity investments. Both value extracting mechanisms progressively alter the balance in the relationships between the investor and the venture company – as the debt is paid down, the investor's power in the venture relationship progressively reduces. In effect, repayments of debt, redemption of debentures, and liquidation of any mezzanine facilities operate as progressive sale-back of the venture to the company. The financing agreements seen make provision for a lump sum (bullet) payment at the end of the investment period representative

[71] Confidential contract documents accessed in location at the premises of FM104, FM112, FM101, August – September 2009; January 2010.
[72] Confidential contract documents, accessed at FM 104, FM112, FM113, FM101 - on shareholding 'options agreements', August – September 2009; January 2010, Nairobi Kenya.

of the value addition into the company by the investor, on top of any dividends and or interest payments made to the investor over the life of the investment.[73]

An important driver of the capital structures observed (depicted in Chart 5.8, above) was stated to be a desire to control for exit (over 40% of the respondents), and the nature of the regulatory environment (33% of the respondents). The first is keyed to the profit objective, the core aim of the investment activity: a natural and rational self-interest. The second is linked to the qualitative aspects of the overall framework for the investment activity – the subject of the next four chapters.

As there is no capital gains tax on investment earnings under Kenyan law, tax considerations have no impact on capital structures. None of the respondents indicated tax as a factor in security design. Similarly, the framework for entering into contracts, as well as the framework for their enforcement, did not appear to play a significant role in capital structuring options – only 11% of the fund manager respondents indicated this parameter might influence their capital structuring decisions.

Intriguingly, while contracting conditions are not a concern for most respondents, 'regulatory conditions' was a cause of concern to 33% of the aggregate interviewees.[74] This suggests that contract conditions viewed in isolation are not substantially problematic, but the dynamics change when lumped with other factors surrounding the investment decision. This finding is important as it informs broad principles impacting investment promotion policies.

[73] Confidential documents viewed at FM101, FM104, FM112, FM105, FM113, August-September 2009, January 2010 - suggesting that the notion of 'large' is 'lucrative' because of 'higher rates of return' and that 'it takes longer to exit the 'J-Curve' in emerging markets because of smaller deal size' (that is, move from negative annualised performance to positive performance) may not necessarily be truisms typifying private equity in emerging markets.

[74] By 'regulatory conditions' was meant the general framework for financial contracts, the framework for share structures under company law, the state of local institutions in contract enforcement, as well as compensation structures (including legal framework for stock options) and taxation.

The issuance of redeemable preference shares is subjected to a string of conditions under the Companies Act of 1962 – which might partly explain the higher prevalence of other types of corporate securities in Kenyan private equity. The conditions under section 60 of the Companies Act of 1962 are -

> "*(i) no such shares shall be redeemed except out of profits of the company which would otherwise be available for dividend or out of the proceeds of a fresh issue of shares made for the purposes of the redemption;*
>
> *(ii) no such shares shall be redeemed unless they are fully paid;*
>
> *(iii) the premium, if any, payable on redemption, must have been provided for out of the profits of the company or out of the company's share premium account before the shares are redeemed;*
>
> *(iv) where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend be transferred to a reserve fund, to be called the capital redemption reserve fund, a sum equal to the nominal amount of the shares redeemed, and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as it the capital redemption reserve fund were paid-up share capital of the company.*
>
> *(2) Subject to the provisions of this section, the redemption of preference shares thereunder may be effected on such terms and in such manner as may be provided by the articles of the company.*
>
> *(3) The redemption of preference shares under this section by a company shall not be taken as reducing the amount of the company's authorized share capital.*
>
> *(4) Where in pursuance of this section a company has redeemed or is about to redeem any preference shares, it shall have power to issue shares up to the nominal amount of the shares redeemed or to be redeemed as if those shares had never been issued, and accordingly the share capital of the company shall not for the purpose of any enactments relating to stamp duty be deemed to be increased by the issue of shares in pursuance of this subsection:*
>
> *Provided that, where new shares are issued before the redemption of the old shares, the new shares shall not ,so far as relates to stamp duty, be deemed to have been issued in pursuance of this subsection unless the old shares are redeemed within one month after the issue of the new shares.*

> *(5) The capital redemption reserve fund may, notwithstanding anything in this section, be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares."*

These conditions in isolation are not sufficient to explain the low presence of preferred share capital in Kenyan private equity. When viewed in combination with other factors, especially the desire to control for exit, the conditions attached to preference shares may be seen in practice to introduce onerous requirements that can be avoided through the adoption of alternative capital structures.

5.8 Syndicating Transactions

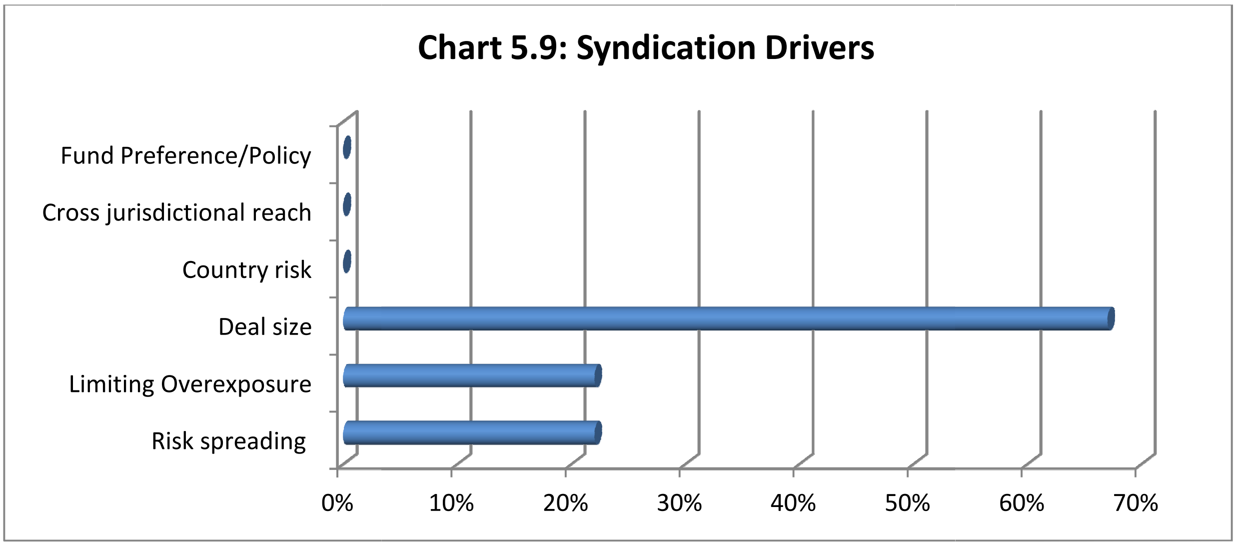
The process of syndication involves the coming together by two or more investors for the financing of a single investment opportunity.[75] Several factors can motivate investors to partner in financing a venture company. Firstly, the transaction value could be very large, and most investors limit the risk of over-exposure by capping maximum investment per venture company. Where an opportunity exceeds permissible thresholds, the venture company could approach one funder and request it to front-run the syndicating process, to find partners, and to work out dynamics around syndication terms.

Secondly, the transaction could be in a new economic context or a new legal jurisdiction, with the 'newness' driving risk. In this sense, syndicating the financing of the opportunity could be a confidence-building strategy that sees a local investor partnering with an international investor. The local investor brings the local knowledge into the transaction, building the confidence of the foreign partner. Syndication in this sense is a confidence-signalling strategy, as well as a risk-mitigation strategy.

[75] Agasha Mugasha, *The Law of Multi-Bank Financing: Syndicated Loans and the Secondary Bank Market*, (Oxford University Press, 2007) para.1.02, 2

Thirdly, an investor might want to syndicate primarily to expand its portfolio. This is frequently the case where the investor has a small fund at its disposal, but wishes, for strategic reasons, to increase its economic presence.

Fund managers were asked whether they syndicate their investments in Kenya, and if they did, what their motivators for so doing were. Their responses are captured in the chart below.



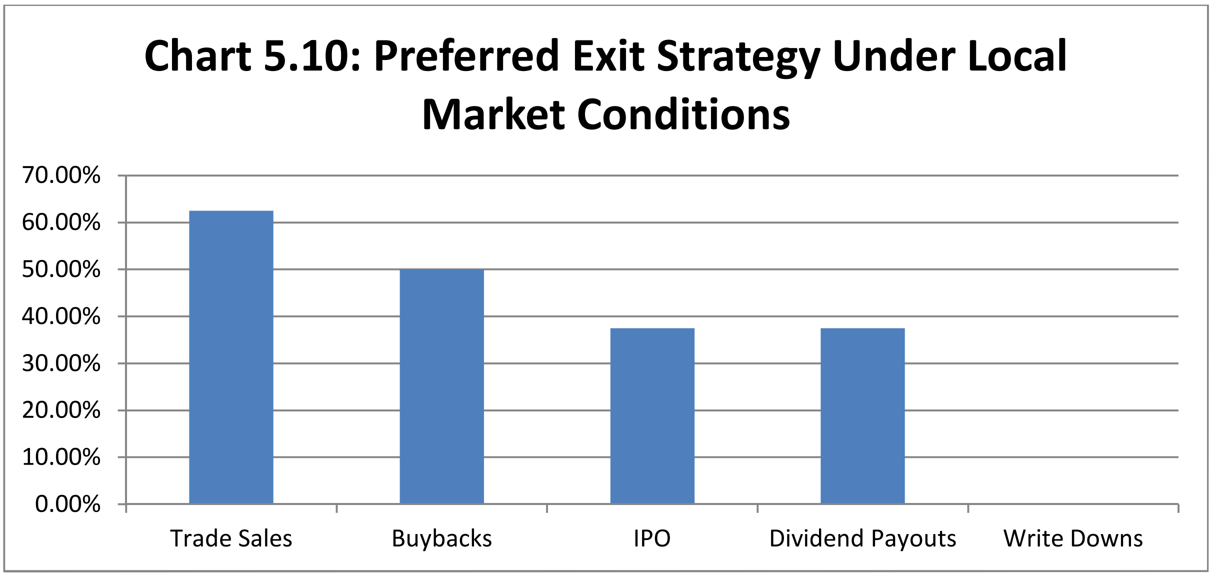
Source: Fund Manager Survey 2010

It is telling that the main driver to investment syndication in Kenya is deal size (67% of the respondent fund managers). 22% of the respondents mentioned the motivation for risk mitigation as the second main driver to syndication in Kenya. It was shown above that fund size in Kenya is preponderantly below USD50 million, which corresponds with the general deal size witnessed in the market.

Country risk, surprisingly, is not a driver for syndicated investments in Kenya; and neither are cross-border opportunities, nor inherent fund policy stipulations. The country-risk parameter is surprising because most of the foreign-owned and foreign-led private equity funds that dominated the market during the study period applied varying levels of country risk premia, with most charging between 5% and 10%.

5.9 The Exit Framework

The chart below is a representation of preferred exit strategies among interviewed fund managers. A cautious interpretation is in order, however, in light of the very few instances of documented and reported private equity exits in Kenya. Very few exits relative to the total number of traced investments could be documented, and several of the documented exits were partial exits to the extent that fund managers retained substantial ownership thresholds in investee companies, entitling them to dividend streams.

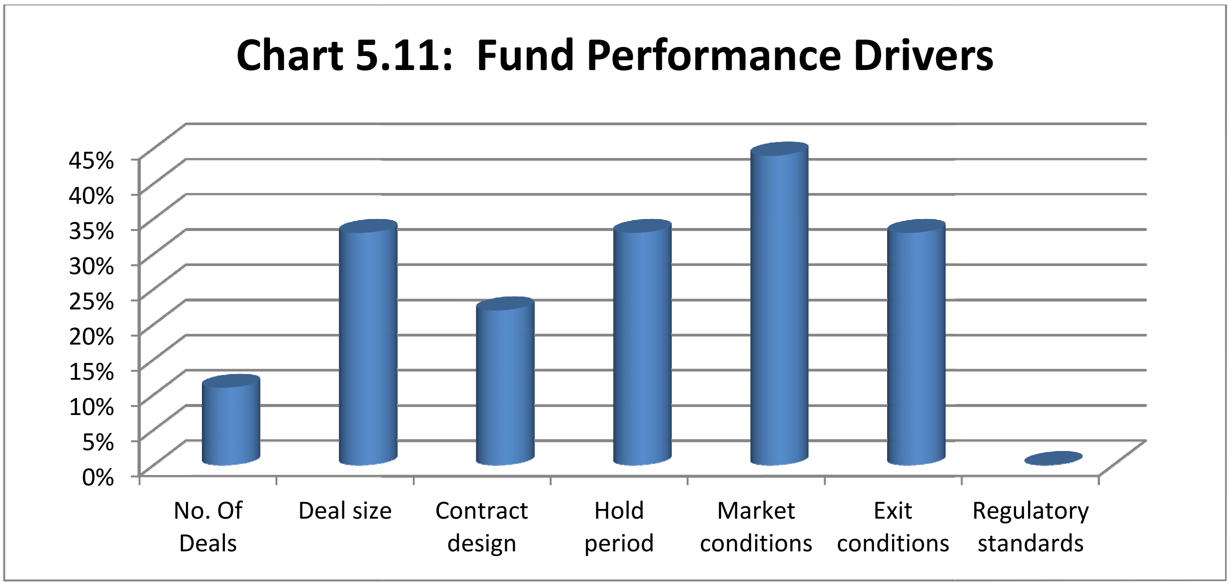


Source: Fund Manager Survey 2010

The preferred exit vehicle is a trade sale/sale to another private equity firm (62.5% of the respondents) as shown in chart 5.10 above. Buybacks (or re-sale to investee companies, that is, a process whereby company owners buy out the private equity investor through share re-purchase) is an attractive exit strategy to 50% of the respondents. These favoured exit strategies – trade sales and buybacks - are consistent with the interpretations of findings on the intrinsic capital structure of Kenyan private equity deals.

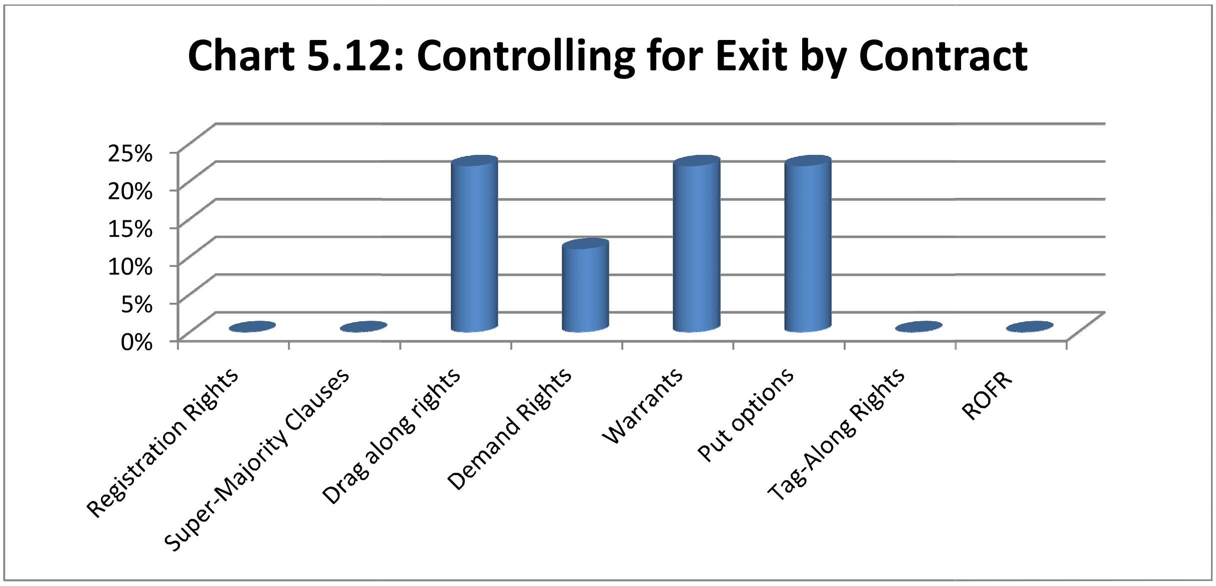
Exit through stock market listings represent an attractive exit avenue to 37.5% of the respondents, while dividend payouts as a form of investment liquidation is favoured by an equal 37.5% of the respondents. In light of the secondary evidence led in the preceding chapter about constraints to stock market listing, and given the fact that only one exit via the stock market could be documented, it is credible to deduce that the sentiments of fund managers favouring public offerings suggests that an accessible stock market would promote private equity divestments.

It is notable that the market is not considered unprofitable, gauged from respondent perspectives that they do not anticipate write-downs on their Kenyan investments. This is a significant finding that confirms the appeal of emerging markets – from the point of view of returns on investment. In the next section, the drivers of these performance are considered.



Source: Fund Manager Survey 2010

Respondent fund managers indicated that they routinely write exit control clauses into their contracts, the most prevalent clauses being drag along rights, warrants and put options – in fairly equal proportions, and warrants as a less common exit control mechanism. These contractual choices are entirely consistent with the strong preference for voting equity thresholds in local investments. In other words, the allocation of rights within the private equity contractual coalition conveys to the private equity investor a substantial set of control rights that enable it to engineer a desired exit strategy, at a time most conducive to the investor.



Source: Fund Manager Survey 2010

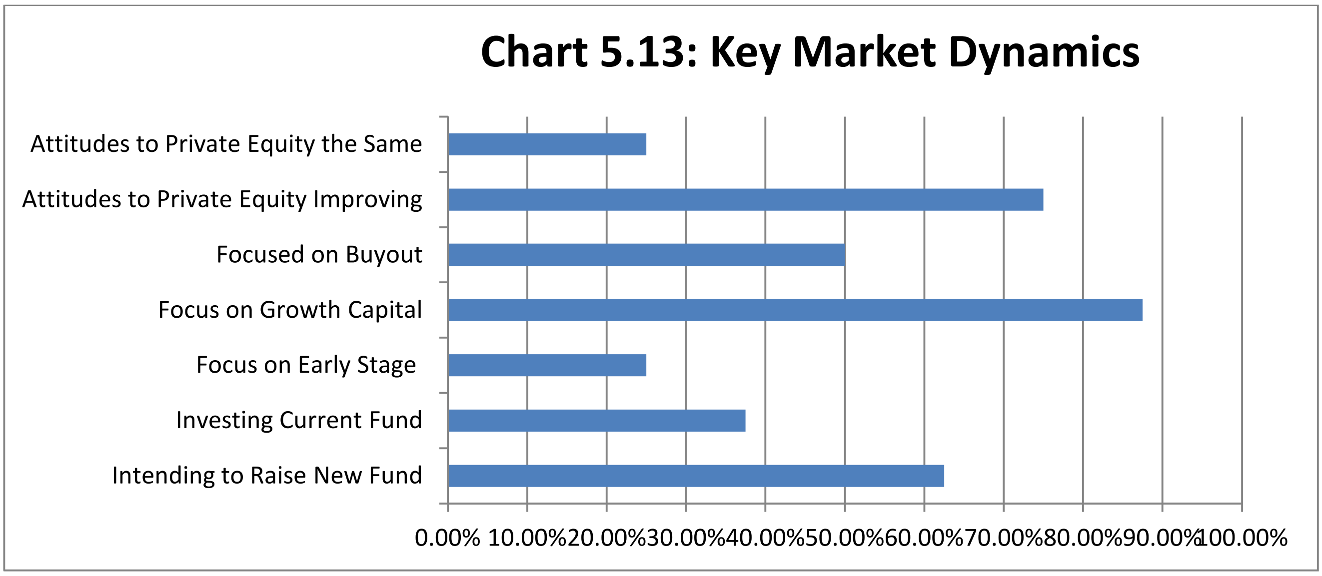
The absence of registration rights clauses in Kenyan private equity contracts is consistent with the low profile that the country's capital markets play in private equity exit strategies as the market stands in 2010. Registration clauses give investors the right to demand for and get their shares included among the block to be sold to the public. The non-use of share class rights such as super-majority,[76] tag-along,[77] and rights of first refusal[78] as

[76] Clauses conditioning certain corporate decisions on the vote of a super-majority of board
[77] Ensure the position of prior investors are not diluted by subsequent rights distributions
[78] Secures that important corporate events do not occur without the investor learning about them

exit control mechanisms is consistent with the capital structuring observed in Kenyan private equity reported under section 5.7.

5.10 Future Outlook of Kenyan Private Equity

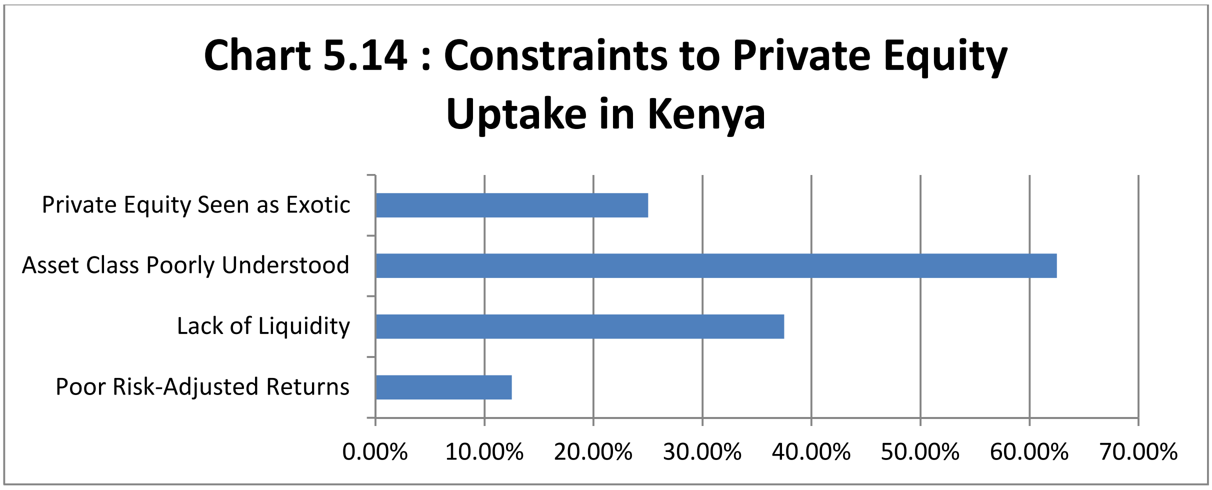
Chart 5.13 below sets out the prevailing attitudes of fund managers to private equity in Kenya. Out of all those active fund managers interviewed in 2009 and 2010, 37.5% were focused on investing their current funds, while 62.5% were planning to raise a new fund. Asked about their perceptions of the attitude of the local business community to private equity, 75% thought the attitudes were improving, while about 25% thought the attitudes to private equity remained the same. This is consistent with responses to the question "what are the main constraints to private equity in Kenya?"



Source: Fund Manager Survey 2010

62.5% of the fund managers believe private equity as a financial asset class is still poorly understood in Kenya, while a further 25% thought the local business community considered private equity an ‘exotic’ type of financial product. These perceptions have contributed to the still-low uptake of private equity in Kenya.

In a country whose private sector suffers various structural constraints, and where access to bank credit for business finance is expensive, it is interesting to note that investments focused on early stage private equity represent only 25% of market activity. In sharp contrast, growth-stage investments represent a considerably larger 87.5% of market activity, while about 50% of the funds are interested in buyout opportunities. According to the respondent fund managers, these current trends are set to hold over the medium-term.



Source: Fund Manager Survey 2010

The inter-segment spread of private equity revealed in the preceding paragraph creates an opportunity for public policy consideration. In the preceding chapters, the role of the private sector in driving economic growth was considered. It was seen how the small and microenterprise sector is particularly axiomatic to Africa’s resurgent economies. In its current manifestation in Kenya, however, the private equity ‘miracle’ remains elusive to the SME sector – the sector that matters most to the country’s long-term economic sustainability. The

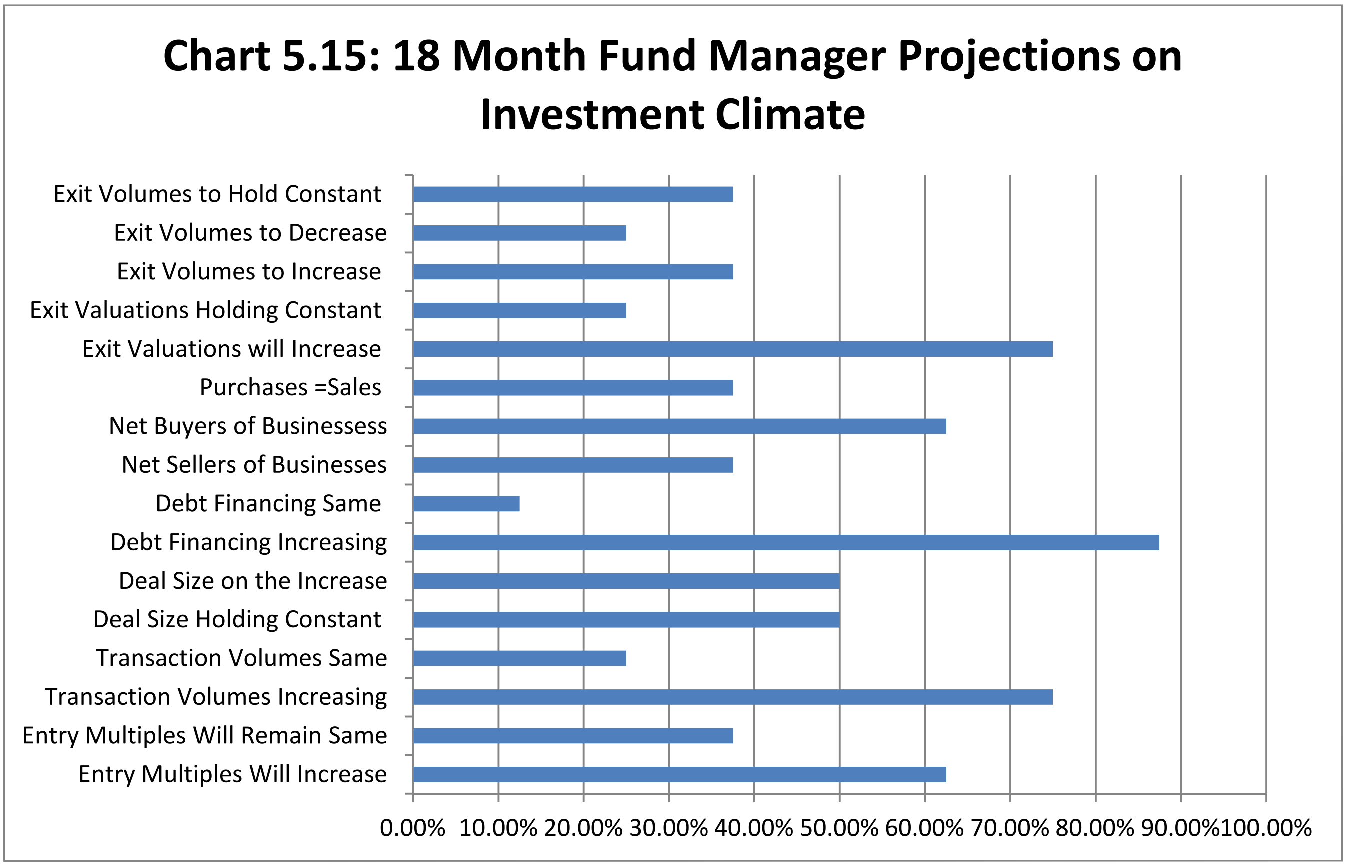
Acumen Fund-Grameen Bank co-investment into Juhudi Kilimo, reviewed in chapter 4, offers a functional model for public policy design.[79]

The preceding chart illustrates further that a lack of liquidity in Kenya is seen by 37.5% of the interviewed fund managers as a constraint to deal closure in Kenya, while a small 12.5% of the funds have experienced poor risk-adjusted returns. This latter view could be consistent with the wider state of the business climate in the country. Nonetheless, it is significant that the remaining 87.5% of the active funds in Kenya do not think the market suffers poor returns.

It would seem that one of the main constraints facing private equity in Kenya is that it still remained little understood by the business community. Secondly, deepening the financial markets appears to be an important agenda going forward if the liquidity constraint is to be resolved. This second deduction reinforces the nexus between private equity and the wider financial and capital markets, supporting the tentative proposition, based purely on the factual findings so far, that strong financial and capital markets positively influence the growth trajectory of private equity markets. For public policy, the question is to decide what mix of tools to deploy, and in what priority or sequence or combinations, in culturing, nurturing and nudging environments that accelerate growth across sub-segments of the financial and capital markets.

All the respondent fund managers were asked to indicate their projections on the private equity investment climate in Kenya over the next 18 months on a variety of issues depicted in the chart below. Their responses in the aggregate suggest a fairly optimistic attitude of fund managers, who appear confident about their Kenyan private equity investments.

[79] ch 4, 149-151



Source: Fund Manager Survey 2010

First of all, 62.5% believe that in 2010 and 2011, investment entry multiples are likely to increase; while 75% of the respondents believe that transaction volumes will increase. In contrast, only 37.5% of the respondents believe the entry multiples will remain the same, and 25% believe transaction volumes will remain at current (2009) levels, respectively. On deal size, the market mood is mixed, with 50% believing Kenyan deals will increase in size, while an equal 50% think the deal sizes will remain at current levels.

As far as capital structuring is concerned, 87.5% believe that local deals will benefit from increasing debt financing (which in certain respects is largely consistent with the viewpoints on anticipated increased deal flow), while only 12.5% of the respondents believe debt financing thresholds will hold constant at the 2009 levels.

Consistent with the findings in Chart 5.15 above, 62.5% of the respondent fund managers said they will be net-buyers of businesses in 2010 and 2011. A straight 37.5% of the respondents indicated they will be focused on divesting their positions over the same period. A significant 37.5% of the respondents also indicated that their sales are likely to equal their purchases over the same period.

Significantly, however, about 75% of the respondents believe that exit valuations will increase over the projected period, while 25% of the fund managers think that exit valuations will hold constant at the current (2009) levels.

On exit volumes, the market is ambivalent: an equal 37.5% presents contrarian views: with one group of respondents believing exit volumes will increase, while the other group believe the volumes will remain constant. However, a significant 25% of the respondents believe the exit volumes will actually decrease going forward. The latter is a rather dim view, especially in light of the preponderant viewpoint of all respondents on the question of their perception of the economic conditions within sectors of investment. 87.5% of the respondents thought the overall economic climate in Kenya would improve. Nonetheless, it is significant that the overall perception of the exit climate is understated, and not quite as robust compared with, for instance, the perceptions on deal volumes, or entry multiples. Clearly, the exit framework in the country is a problematic area for private equity investments.

Interestingly, the foregoing views are vindicated by independent reviews by EMPEA, which has consistently since 2008 reported that Sub-Saharan Africa is no longer an over-looked region, having attracted fundraising worth USD2.2 billion in 2008, USD2.3 billion in 2007, USD2.4 billion in 2006, and only USD800 million in 2005. In effect, Sub-Saharan Africa is one of the biggest growth stories in emerging markets private equity – and the level of market activity in Kenya by fund registration since 2005 entrenches this view.[80] While fundraising between 2006 and 2009 has roughly stagnated, investment activity has consistently increased. In EMPEA's view, the region has continuously improved and proved its investment brand, hence its growing allure.[81]

5.11 CONCLUSION

This chapter has established that Kenya's private equity industry is a rich mixture of independent, local and foreign funds, as well as government-initiated private equity. The investment strategy unveiled mirrors trends across the emerging markets, with the distinct variation that technology is not a core driver of private equity in Kenya - yet. The Kenyan market turns out to be a lucrative market in the experience of the few traced exited positions, but capital structuring circumvents the challenges of a still-nascent public equity market. Investment lifecycles mirror general international practice (between 3.5 and 7 years between investment decision and exit).

This chapter further finds that private equity returns are driven strongly in Kenya by a combination of deal size, capital structures, investment hold period, the general conditions of the market and exit conditions. Significantly, regulatory standards do not feature as a driver of returns among the fund managers interviewed. Similarly, the number of deals (portfolio size) does not appear to be a substantial earnings determinant either. Regulatory conditions appear to be important to contract design and execution, however. Exit conditions appear to be an important driver of fund performance, though not of security design. Contract design, conversely, appears to be an important exit determinant.

[80] EMPEA Insight: Sub-Saharan Africa (October 2008, October 2009) <http://www.empea.net/Main-Menu-Category/EMPEA-Research/copy%20of%20EMPEA-Insight.aspx> accessed 21 October 2011.
[81] ibid, Special Edition Insight Sub-Saharan Africa, November 2010.

In the preceding chapter, the Kenyan financial system was found to be fairly sophisticated by international standards – meaning that there exists a market for transaction debt. Although a section of the respondent fund managers expressed the view that liquidity was likely to become problematic in the medium term, a majority of the players indicated plans to fundraise – suggesting confidence in the underlying fundamentals supporting the investment decision.

In view of prevailing themes in Western literature about transaction structures in emerging markets, it was anticipated that capital structures in Kenya would evince a sophisticated mix of equity securities.[82] In fact, it has been established that private equity investments in Kenya are concentrated in the growth segment – employing common equity and substantial amounts of debt finance.

To the extent that this capital structure found explanation in an exit strategy calculation, it suggests the qualitative deduction that the exit environment is a source of worry in private equity investing in Kenya. This is a legitimate policy agenda.

Features and rights attaching to different share classes are remarkably unsophisticated: the debt is simple debt, for instance, and the 'common stock' is not structured as 'common preferred' or 'convertible commons' or 'superior commons' or 'commons with warrants' – among a host of other shades and qualifications. This indicates an ethic of 'simple is clear' in Kenyan private equity practice. This relatively unsophisticated deal structure has not negatively impacted returns.

The available fund structure has no demonstrable impact on performance – at least none that the fund manager respondents admitted to. The only noticeable drawback of the available fund structure – and something public policy would do well to resolve – is to render

[82] William L. Megginson, 'Toward A Global Model of Venture Capital?' Journal of Applied Corporate Finance, Vol. 16, No.1 [2004], pp.8-26.

Kenya a non-attractive jurisdiction for fund registration. Most of the funds are registered in jurisdictions such as Mauritius that offer tax advantages not available in the Kenya legal system. There is a benefit to improving legal environments for fund registration – besides the obvious impact on stimulating the deepening of a local culture toward innovation, more funds based in and operating out of Kenya would promote the country's leading position as a hub for financial services, in addition to deepening local capacity.

Lastly, it has been shown in this chapter that there is some government involvement in Kenyan private equity, but there is no recognisable official policy on either private equity specifically, or alternative investments generally. In light of the prevailing positive policy environment for support to SMEs in Kenya and hence financing solutions targeting private investments, there is opportunity for stronger policy support for private equity. One clear area for government policy relates to the regulatory framework for private equity, which the next chapter explores in detail. Expanding structures and avenues for investment exits, including through further developments of Kenya's capital market institutions, presents another policy arena for government support for Kenyan private equity. Overall, this chapter's findings support the proposition that the future looks bright for Kenyan private equity. From an economic development perspective, this is a good prospect for Kenya.

6

THE REGULATORY FRAMEWORK FOR PRIVATE EQUITY

6.1 Introduction

A legal jurisdiction that offers its entrepreneurs choice in organisational forms for business activity is attractive to investors for being sophisticated.[1] Different legal structures deliver different functionalities to businesses. It was established in the preceding chapter that for private equity in Kenya, the available organisational vehicle for private equity business is the limited liability company, without option. It was argued that this limitation potentially slows the rate of entry for global private equity firms seeking opportunities in emerging markets – for want of tax transparency.[2]

Organisational vehicles are subject to varying levels of regulation across jurisdictions.[3] The motivation for regulation stems from a diverse range of possible justifications,[4] and could be aimed at achieving different outcomes including either to create better market efficiency (establishing rules for economic activity),[5] to promote the ends of regulatory supervision and oversight of market actors,[6] or to protect the public interest,[7] or even national security.[8] Regulation can also be grounded on

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[1] David Milman, *Regulation of Business Organisations: Into the Millennium* (Hart Publishing, Oxford, 1999) 1, 2
[2] Ch 5, 160
[3] Anthony Ogus, *Regulation: Legal Form and Economic Theory* (Oxford, 1994) ch 3
[4] Richard A Posner, 'Theories of Economic Regulation' (1974) 5 Bell Journal of Economics 335
[5] James Q Wilson, *The Politics of Regulation* (New York, 1980) 357-94
[6] Anthony Downs, *An Economic Theory of Democracy* (New York, 1957) 1
[7] Stephen Breyer, *Regulation and Its Reform* (Cambridge, Mass., 1982) ch1
[8] Barry M Mitnick, *The Political Economy of Regulation* (CUP, 1982) ch 3 – for a detailed review of regulatory theories.

justifications of 'market failure' – when private economic actors engage in activities deemed harmful to the wider society of civilised states.[9]

Private equity, as has been shown, is a form of financial intermediation that facilitates the pooling of capital that is then channelled into the economy, financing corporate investment. Besides its intermediation characteristics, it is a corporate and capital market activity. It is thus a financial activity whose impact can to varying levels fall on sections of society usually protected under law.

While the practice of private equity has generally escaped robust regulatory oversight around the world compared to other forms of regulated financial activities – such as the banking sector, or the capital markets – the legal forms through which it is conducted have been subject to regulation, and most countries where it has emerged have adopted varying forms of legal frameworks that enable private equity investing activity. This chapter, thus, explores the broad regulatory framework governing the practice of private equity in Kenya. The core aim is to assess the extent to which the current state of the law promotes or inhibits the emergence of a stronger, more economically significant private equity industry in Kenya.

To motivate the discussion, then, on how Kenyan law addresses private equity, section 6.2 reviews the high-level aspects of private equity practice open to regulatory action. Section 6.3 follows with an assessment of what can be found in Kenyan law about private equity practice. This discourse canvasses securities, corporate, and competition law provisions. Section 6.4 evaluates the extent to which there exists compliance with the law, and evaluates whether the current legal framework is fit for purpose. Section 6.5 offers a short review of international experience, to provide

[9] Emmette S Redford, *Administration of National Economic Control* (London 1952) 251-2. cf: Cass R Sunstein, 'Paradoxes of the Regulatory State' (1990) 57 University of Chicago LR 407

qualitative counterpoints with which to evaluate the Kenyan reality. Section 6.6 analyses the Kenyan experience, and section 6.7 concludes.

6.2 Regulating Private Equity – which way?

Global practice on the regulation of private equity is varied, with each jurisdiction selecting aspects of private equity practice to subject to regulation. This is because private equity, as a commercial activity, comprises a range of distinct components including:

a) Fund management activity

b) Fundraising activity

c) Investment activity

d) Business management activity

e) Employment activity

f) Trading activity (including the purchase and sale of ownership stakes in companies).

These features are not peculiar to private equity, however: most private companies would fit this profile. What sets private equity apart, however, is its methodology and its clientele at both ends of the private equity stream – investors at the top, and venture companies downstream. Regulation, where it occurs, is directed at one or more of these features or manifestations of private equity.

There are thus three possible approaches to the regulation of private equity, guided by the intrinsic structure of the industry. The first is to regulate the private equity fund. The second is to regulate the private equity fund manager. The third is to regulate the private equity activity. And there is a residual fourth – which combines two or more of the preceding models. From a public policy framework, risk analyses of electing to place regulatory focus on either is necessary.

The fund is merely a legal structure that facilitates the pooling of resources that can then be disbursed at the whim of the fund manager. Of itself, the fund, regardless of size, is passive.

The fund manager, unlike the fund itself, is not passive. The fund manager controls the fund: applying it to investments, employing it to design differently structured deals, using it as a tool in determining governance structures, and in a host of other disparate ways. It can be argued, drawing from this characterisation, that a measure of regulatory risk lies with the fund manager.[10] Regulatory effect on the fund manager could be designed around the following key areas:

(i) decisions on investment;

(ii) use of leverage;

(iii) governance structure and internal systems of risk management and the avoidance of conflicts of interest;

[10] Commission of the European Communities, 'Commission Staff Working Document' Accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directive 2004/39/EC and 2009/…/EC: Executive Summary of the Impact Assessment, Brussels, 30/4/2009, SEC(2009) 577, 6 <http://ec.europa.eu/internal_market/investment/docs/alternative_investments/fund_managers_executive_summary.pdf.> accessed 15 October 2010.

(iv) the management of relationships with investors, counterparties and regulators, including the provision of information;

(v) organisation of administrative functions – including valuations;

(vi) safe-keeping of assets; and

(vii) audit.

As the discussion at section 6.3 suggests, different jurisdictions follow different models in their legal frameworks for private equity, supporting the notion that public policy perception of 'risk' posed by private equity varies across jurisdictions. These cross-jurisdictional differences centre on the elements of the private equity phenomenon, enumerated above. One jurisdiction might view investor protection and transparency to public authorities as frontline issues of regulatory concern. Another will view market access, integrity, and perhaps financial transparency and accountability of the industry as the main regulatory drivers. Yet others will view governance, the use of leverage and risk appetite in the riskier end of market structures – effectively systemic stability - as the main issues. The common denominator among all of these approaches is the firm focus on the activities of the fund manager, rather than the fund itself.

Is any single model superior to the other? Is it preferable to create a unified body of law that can be styled 'private equity law' or to adopt a set of enabling principles that can be translated into both legal and institutional edicts to support the industry? Some of the more well-known concerns about private equity (for example, the use of too much leverage, asset stripping, corporate raids) are questions that could be addressed under a country's corporate and securities legislations. These issues are important when considering how best to evaluate the legal and institutional needs of the private equity industry.

With the preceding reflections to hand, the next part of the chapter, turns to an analytical description of the structure of Kenya's regulatory framework for private equity. This review provides a contextual framework within which to further reflect on the broad aims of this study – that is, the extent to which the law and legal institutions are important variables in the growth of private equity in a developing country.

6.3 Private Equity in Kenyan Law

6.3.1 Definition of Private Equity

Under the Capital Markets (Registered Venture Capital Companies) Regulations 2007, a venture capital company is defined as one incorporated under the Companies Act of 1962, with its main business being the provision of *substantial* risk capital to small and medium-sized businesses in Kenya through equity, quasi-equity and other financial securities including convertible securities.[11] Furthermore, such a company must structure its financing with substantial levels of managerial or technical expertise to qualifying enterprises.

It is notable that nowhere in the law is a meaning assigned to the phrase "substantial risk capital". In practice, delimiting its threshold is problematic, raising issues around regulatory in-exactitude. If a regulator is unable to precisely isolate a

[11] R.2, Legal Notice No.183 of 2007, promulgated under S 12, Capital Markets Act 1989, Cap 485A, Laws of Kenya

violation of a regulatory standard because that standard is vague, regulatory certainty cannot be claimed on that specific regulatory aspect.

Secondly, the phrase "private equity" as distinguished from venture capital is nowhere referred to in the Venture Capital Regulations of 2007. It is notable from the Regulations that the following types of venture financing are contemplated:[12]

(i) *seed capital* – defined as financing targeted at research, assessment and development of initial concepts, prototypes for product development and initial marketing;

(ii) *start-up financing* – defined as financing to aid in commencing operations, production or concept/prototype implementation;

(iii) *mid-stage financing* – defined as investment to provide working capital or capital expenditure in the commercialisation process, or additional capital injections to increase production capacity, marketing or product development, and funding in aid of the listing/going public process;

(iv) *subsidiary financing* – defined to mean financing for trade sale transactions that provide investment exits to venture capital funds.

From the stage dynamic of the private equity business model, the private equity landscape defined under the Kenyan regulations encompasses the following stages of the firm life-cycle: seed, start-up, growth/expansion, and aspects of the buyout segment. From the analyses in the preceding chapter, it is notable that in practice, private equity activity in Kenya eschews the early stages of the firm, focusing on the mid-stage enterprise seeking to expand its business in terms of output or through

[12] ibid s 2

introducing higher efficiencies in supply-chain management. What the law contemplates appears to be private equity in everything but name.

A qualifying enterprise under the Venture Capital Regulations 2007 is termed a "venture capital enterprise", and is defined as a small or medium-sized business entity incorporated under the Companies Act of 1962 and standing in need of venture capital investment to enable it to finance a new product or expand its business. The Venture Capital Regulations of 2007 define a 'small and medium-sized business' to be one with an asset net-worth or annual turnover of less than five hundred million Kenya shillings.[13]

In sum, private equity under Kenyan law is defined as the provision of medium-to-long term risk capital/finance to small and medium-sized enterprises at various stages of the firm-cycle (start-up/growth/buyout), mostly in the form of equity injections, and accompanied by technical and managerial support.

6.3.2 The Law on Registration

The law on private equity is contained in the Capital Markets Act of 1989. Section 12 empowers the Capital Markets Authority (CMA) to issue necessary regulations periodically for the better implementation of the Act, while section 23 empowers the CMA to regulate all persons carrying on businesses relating to dealings in securities – either as advisers, issuers or buyers.[14] Section 23 of the Act provides as follows:

[13] Venture Capital Companies Regulations (2007) (n 11) R.2
[14] s 12(1)(g)(k), Cap 485A.

> *"23. (1) No person shall carry on business as a securities exchange, stockbroker, dealer, investment adviser, fund manager, investment bank, authorised securities dealer, authorised depository, or hold himself out as carrying on such a business unless he holds a valid licence issued under this Act.*
>
> *(2) No person shall carry on or hold himself out as carrying on business as a registered venture capital company, collective investment scheme, central depository or credit rating agency unless he is approved as such by the Authority.*
>
> *(3) A person approved by the Authority to carry out any business required by this Act to be approved shall comply with all requirements of the Authority and pay an annual fee to the Authority at such rate as the Authority may prescribe.*
>
> *(4) Nothing in this section shall be construed as limiting the powers of the Authority to approve or license any other person operating in any other capacity which has a direct impact on the attainment of the objectives of this Act."*

It emerges from this provision that Kenyan law regulates two aspects of private equity practice: firstly persons requiring licensing and, secondly, businesses requiring authorisation. The lexicon is 'approval' and 'licensing'. There are no definitions for the terms 'approval' and 'authorisation' in the Capital Markets Act of 1989. The Interpretation and General Provisions Act, Cap 2 of 1956 (the residual legislation ascribing meanings to legal terms not otherwise or specifically defined under a substantive piece of legislation) does not carry definitions for any of these terms, either.

The contextual meaning of the terms 'authorise' and 'approve' can be gleaned from the Foreign Investments Act Cap 518 of 1964, which defines an 'approved business' as one that receives an 'approval certificate'. This imports the suggestion that the authorisation and or approval process involves a certification exercise.[15] Licensing, on the other hand, has a meaning attached to it from general business practice, and can be said to entail the process of vetting a business entity for

[15] ss 2, 3

compliance, and the issuance of a business permit, with or without conditions, and valid for a specified period of time.

Investment advisers and fund managers are required to be licensed under the law.[16] The business of a venture capital company is included in the list of businesses requiring the Authority's approval.[17]

Prima facie, there is a supposition that the law views the licensing process as different from the approvals process – hence the employment of two specific terms as regulatory alternatives, as opposed to equivalents. If to 'approve' were the same as 'to licence', logic suggests it would have been legislatively sensible to elect on one or the other of the terminologies. The law, however, embeds both terms within the provisions relating to fit and proper requirements for organisations seeking to carry on the listed types of commercial activities. No case law was found on point to deduce how Kenyan courts have or might interpret the language of the law.

Section 26 of the Capital Markets Act of 1989 also employs the terms 'licensed' and 'approved' within the context of licence revocations. The sub-title to that section reads 'revocation of licence' – importing the idea that to be 'approved' is equivalent to, or is evidenced by, the holding of a 'licence'. This idea of the possible inter-changeability of the two terms in practice – 'licensed' and 'approved' - is strengthened by the wording of section 27 of the Act, set out below:

> *"27. (1) The Authority shall -*
>
> *(a) before the thirtieth day of April in each year, cause the names and addresses of all persons licensed or approved during the current year to be published in the Gazette; and*

[16] Capital Markets Act (1989), s 23(1)
[17] ibid, s 23(2)

(b) within thirty days of revocation of a licence, cause the names of any persons whose licence is revoked to be published in the Gazette.

(2) The Authority shall keep in such form as it deems appropriate a register of the holders of current licences specifying, in relation to each holder of a licence -

(a) his name;

(b) the address of the principal place at which he carries on the licensed business; and

(c) the name or style under which the business is carried on if different from the name of the holder of the licence."

Licensing and approval requirements are stipulated under sections 24 and 29 of the said Act of 1989. Regulations issued under section 12 of the Act provide elaborate rules relating to setting up, conduct and governance of private equity funds in Kenya – and even within the Regulations, the apparent inter-changeability of the terms is noted.[18]

To be licensed as a fund manager, investment advisor or private equity company, all licensees must be entities incorporated under the Companies Act of 1962 – or foreign companies recognised as such under the registration requirements in the Act.[19] Secondly, all directors of licensees must be above reproach and meet minimum requirements – meet what the law terms 'fit and proper person' criteria.[20] Thirdly, executive directorships are restricted to individuals owning no more than 25% of the ordinary voting equity of a given corporation.[21]

From a legal policy perspective, these requirements are in the first instance aimed at promoting legality in the practice of private equity (only legitimately incorporated entities can be licensed). The fit and proper requirements for a private

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[18] Venture Capital Companies Regulations, 2007 (n 11)
[19] Capital Markets Authority Act, 1989, s 29(1)(a)
[20] ibid s 29(1)(b-i,ii,iii)
[21] ibid s 29(5),

equity fund or company to be registered in Kenya are enshrined in sections 3 and 4 of the Venture Capital Regulations of 2007, which are reproduced below.

> ***"3.*** *A venture capital company shall be entitled upon making an application to the Authority in the prescribed form and on payment of the prescribed fee to be registered under these Regulations as a registered venture company if it has–*
> *(a) been duly incorporated under the Companies Act as a company limited by shares;*
> *(b) as its principal object the provision of risk capital to small and medium size businesses in Kenya;*
> *(c) a minimum paid up share capital of one hundred million shillings;*
> *(d) a minimum fund of one hundred million shillings;*
> *(e) audited financial statements for the three years immediately preceding the date of*
> *application, the latest of which shall not be older than six months as at the date of application (where applicable);*
> *(f) have a demonstrable track record as a venture capital company of at least three years or in the alternative, one or more of its directors shall have a demonstrable track record in the management of venture capital funds for a period of at least three years;*
> *(g) engaged a fund manager duly licensed by the Authority;*
> *(h) a board of directors of which at least one third of the directors are independent directors;*
> *(i) appointed an auditor who is a member of the Institute of Certified Public Accountants of Kenya; and*
> *(j) appointed a secretary who is a member of the Institute of Certified Public Secretaries*
> *of Kenya.*

It can be seen from Rule 3 of the Venture Capital Regulations of 2007, reproduced above, that an applicant needs to have as its principal object the provision of risk capital to medium sized businesses in Kenya. It must also have a minimum paid-up share capital of one hundred million Kenya shillings, and have a minimum fund of one hundred million Kenya shillings.

In addition, the fund needs to have contracted a fund manager to oversee and allocate investments,[22] and be capable of demonstrating a three-year track record of operating as a venture capital company, evidenced in investment practice, and backed

[22] In chapter 5, it was shown that fund managers in Kenya are both local and foreign – 161-162.

up by audited accounts dating three years previous to the date when the application for registration is made. The applicant is furthermore required to produce bank references to accompany the registration application.[23]

These rules establish a minimum capital requirement for persons seeking to get into the business. Under section 23 of the Capital Markets Act of 1989, the all-inclusive tone of the law's letter means that it is a contravention of the law to hold out as a private equity company or fund in Kenya if the person does not meet the share capital and minimum fund size requirements. There is no provision for exemptions under Kenyan law similar to the section 203(b)(c) in the American Investment Advisors Act of 1940, which exempts investment advisors from certain registration requirements.[24]

Regulation 4 of the Registered Venture Capital Companies Regulations 2007 (excerpt below), sets out requirements relating to capitalisation, organisational structure, board constitution, and general qualifications of fund managers. These requirements must be met at the time of making an application for registration as a registered venture capital company in Kenya.

> ***4.****(1) An application for registration shall (...) be accompanied by the following– (...)*
> *(d) details of the investment policy in respect of each fund to be operated by the applicant setting out the following particulars-*
> *(i) investment objectives;*
> *(ii) minimum and maximum investment amounts in any single enterprise;*
> *(iii) investment rules, investment process (including minimum commitment and investment periods and procedures for draw down) and exposure limits to individual eligible venture capital enterprises;*
> *(iv) preferred mode of divestiture from eligible venture capital enterprises;*

[23] R. 3, R.4, Venture Capital Companies Regulations 2007, (n 11)
[24] 15U.S.C. s80b-1 to s 80b-21

> *(v) disclose a clear strategy for the diversification of investments in eligible venture capital enterprises.*
> *(vi) policies on fees and charges;*
> *(vii) profile of companies invested in (where applicable); and*
> *(viii) details of risks factors that are specific to the chosen investment sectors, or sectors intended to be invested in;*
> *(g) audited financial statements of the applicant for the last three financial years immediately preceding the date of application (...)*

The requirement on bank references could be understood from the "know-your-customer" ethic, and perhaps from money-laundering concerns.[25] This deduction presupposes the need for systems and procedures that would ensure this is undertaken by relevant institutions – importing the recurrent theme of capacity requirements. Institutional capacity to implement systems supporting financial market institutions remains a key constraint in emerging markets, and a matter for closer public policy and governance reform. For most of the funds that set up in Kenya after 2005, for instance, there was no capacity to satisfy the longevity of operations requirement. But set up shop they did. Law and policy reform can be useful tools in redressing this.

Furthermore, the company's incorporation documents need to disclose the applicant's investment policy through a declaration of: (i) the investment objectives, (ii) minimum and maximum deal size contemplated under each fund raised and managed by applicant, (iii) investment rules and process – including minimum commitment and investment periods and draw-down procedures, and exposure limits to any one company making up an investment portfolio, (iv) preferred exit strategy, (v) portfolio diversification strategy, (vi) policies on fees and charges, (vii) profile of portfolio companies where applicable, and (viii) a risk assessment of the chosen investment sector.

[25] R 29, Venture Capital Companies Regulations, 2007 (n 11)

A closer look at the theme underlying these Regulation 4 requirements appears to be prudential management principles. The tone struck in the regulations is strikingly similar to that surrounding prudential management of banking sector financial institutions.

From a regulatory policy perspective, the level of statutory requirements underpinning the registration process appears to straddle elements of public interest and private interest goals.[26] For instance, sector risk assessment and exit strategy declarations could arguably align with the public interest theory,[27] while portfolio risk diversification strategies and investment rule declarations could align more closely with the private interest theory.[28] It is not readily appreciable what regulatory ends declarations around minimum and maximum deal sizes, or exposure limits to a single venture company, or the profile of target venture companies serves from a regulatory perspective. If the objective is to reduce the likelihood of corporate sector instability, for example through reducing the chances for bankruptcies, that policy objective does not clearly stand out. Judging from the CMA Enforcement Manual, however, it is possible to deduce that the Kenyan regulatory model attempts a preventative enforcement strategy,[29] a tool more efficiently linked to risk-based regulatory approaches.[30]

[26] Mitnick, *The Political Economy of Regulation* (1982) (n 8) ch 3
[27] Posner, 'Theories of Economic Regulation' (1974) (n 4)
[28] Wilson, *The Politics of Regulation* (1980) (n 5)
[29] Capital Markets Authority, Enforcement Manual, http://www/cma.or.ke/Enforcement , accessed 21 November 2011
[30] Julia Black, 'The Emergence of Risk-Based Regulation and New Public Risk Management in the United Kingdom' (Autumn 2005) P.L. 512-548

6.3.3 A Dual Regulatory Framework

Section 23(1) of the Capital Markets Act of 1989 and Regulation 3(1) of the Registered Venture Capital Companies Regulations 2007 have the effect of creating a dual framework for the regulation of private equity activity. The Act, on the one hand, requires fund management and investment advisory services to be subject to regulation, and the provisions are not necessarily targeted at private equity per se. The Regulations, on the other hand, are dedicated to private equity investment activity. The problem, however, arises from the language of the both section 23(1) and Regulation 3(1). The language of Regulation 3(1) reads as follows:

> *'A venture capital company shall be entitled, upon application, to be registered…' R.3 (1), CM (Registered Venture Capital Companies) Reg., 2007.*

This wording suggests that an entity can operate as a venture capital company without registering, and that registration as a venture capital company is optional – hence left for companies that wish to register. While an applicant must meet the minimum capital requirements to register, having a capital base larger than the minimum required to qualify for registration does not give rise to a mandatory requirement to register – under current law.

In effect, some venture capital companies will register as venture capital companies, and be subject to the full measure of the law on compliance requirements, while another set of venture capital companies will remain unregistered. There is nothing in the law to suggest this latter set of private equity intermediaries are required to abide by the full requirements of the Registered Venture Capital Companies Regulations of 2007. The implication is that private equity companies in

Kenya can effectively choose whether to subject themselves to regulation or to operate outside of the capital markets regulatory framework. This is, prima facie, an absurd regulatory outcome.

The language of section 23(1) of the Capital Markets Act of 1989, in comparison, does not create two types of market players as the Regulations appear to do. It is couched in the following terms:

"No person shall carry on business as (...) fund manager (...)".

Assuming for the moment that the preceding deductions were contemplated by the law makers, it remains difficult to see how toclassify unregistered companies, unlicensed fund managers and unapproved investors without an exemption regime for funds below one hundred million shillings. In an interesting twist, however, every interviewed fund manager preferred the uncertainty over intrusive regulation.

It is not clear the foregoing regulatory effect was the intention of the legislature. It was not clear from interviews with the Capital Markets Authority that this was the intention.[31] A problem of construction arises under these statutory requirements.

6.3.4 Control of Mergers and Acquisitions

The Competition Act No.12 of 2010 repealed the Restrictive Trade Practices and Monopolies Act Cap 504 of 1988, which previously regulated, inter alia, mergers and acquisitions in Kenya. Under the new legal framework, mergers are defined to

[31] Interview with RG201, Nairobi, Kenya, January 2010

include takeovers, however instituted.[32] The Act applies to all persons engaging in commerce, including Government.[33] Takeovers and mergers can be allowed or disallowed on a number of grounds, including, how it would affect employment in the takeover target.[34] Any party intending to undertake a merger or acquisition is required to submit information to the Competition Authority detailing everything listed under section 46 of the Competition Act of 2010. Under the same provision, any interested party is permitted to make representations to the Authority on any matter relevant to the proposed merger or acquisition. Importantly, no merger can take place in Kenya without the Authority's approval.[35]

In *David Thuo & 8 Others v First America Bank of Kenya Ltd* [2005] eKLR (HCC 494/2005), HC, the defendant was the subject of an approved bank merger with Commercial Bank of Africa Ltd, with the consequence that the employment contracts of the Defendant's employees would be taken over by the merged bank (Commercial Bank of Africa Ltd). The employees sought injunctions against the defendant, arguing their consent for the transfer of employment contracts had not been sought. They relied on the decision of Viscount Simon, LC, in *Nokes v Doncaster Amalgamated Collieries Ltd* [1940] A.C. 1041 that - *"contracts of a personal service are not automatically transferred by an order."* p1021-1022. Judge JB Ojwang, dismissed the suit, (taking judicial notice of the general state of unemployment in Kenya, and the fact that the bank merger had received governmental approval under s.9 of the now repealed Restrictive Trade Practices, Monopolies and Price Control Act of 1988) holding that there was no employment crisis as a result of the merger.

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[32] Competition Act 2010, Cap12, s 41
[33] ibid s 5
[34] ibid s 46(2)(e)
[35] ibid s 42

Under the Competition Act 2010, perhaps the outcome would have been different, as there now exists a duty to demonstrate that all matters arising as a consequence of a proposed merger must be given due consideration. Indeed, the unfolding case of Shell Africa's planned buyout by Vitol and Helios Investment Partners,[36] Kenyan workers moved to court for the protection of employment interests, arguing, like in the case of First American Bank of Kenya Ltd, that they had not been consulted about the merger and had not been informed how the merger would affect their employment interests.[37] The court granted an injunction against the completion of the transaction in Kenya (as the deal involves the buyout of Shell operations in 15 other African countries) until employment questions were resolved.

The Employment Act of 2007 does not make specific provision for employee rights under situations of corporate mergers and acquisitions – leaving the stipulations of section 46 of the Competition Act 2010 to protect employee interests. It is arguable, however, that under section 15 of the Employment Act of 2007, which imposes an obligation on employers to inform employees of their general rights, a duty might have existed on the part of Shell plc to inform its employees in Kenya of their rights within the private equity buyout process. The fact that their case received court backing suggests this might indeed be the law as applied by the Courts.

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[36] Shell, 'Shell Vitol and Helios reach agreement on African downstream business' (*Shell Global,* 19/02/2011) <http://www.shell.com/home/content/media/news_and_media_releases/2011/shell_vitol_helios_agreement_19022011.html> accessed 5 October 2011- deal announced 19 February 2011; involve divestiture of 80% Shell Africa; affects over 2,500 employees, storage facilities amounting to 1.2 million cubic metres, and 1,300 retail outlets covering 3.5 million cubic metres of retail space.

[37] Cosmus Butunyi, 'Helios Vitol To Buy Shell's Africa Petrol Station' (*sic*), (*The East African*, Nairobi, Monday, November 1, 2010) <http://www.theeastafrican.co.ke/news/-/2558/1043330/-/item/0/-/79vcnbz/-/index.html.> accessed 1 November 2010 - workers demand choice over staying or quitting: redundancy package should include 6 months' gross salary for each year of service; 5 months' gross salary in lieu of notice and 3 months' gross salary resettlement allowance; transport and relocation allowance as well as performance bonus for 2010 and other arrears from previous years. Any taxes arising from the redundancy package should be borne by Shell. Where expatriate workers are involved, they should receive payment in full for the period remaining on their severed contracts. Similar unrest was reported in Ghana where Shell workers threatened to go on strike, and in Senegal, where workers staged street demonstrations against the deal, saying they are not for sale.

This value judgement finds resonance under the on-going registration obligations under section 28 the Capital Markets Act of 1989 which require the lodgement of compliance statements with the regulator each time a deal is being concluded, a point illustrated in another Kenyan case – identity neutralised at the request of interviewee. In that case, a fund manager sought the approval of the regulator over a planned takeover in the beer manufacturing industry in Kenya, which approval FM104 claims was granted. Subsequent to the conclusion of the takeover transaction, a representative of the regulator sought to order a reversal of the transaction on the basis that regulatory approval of the takeover was neither sought nor received by FM104, hence the deal was null and void *ab initio*. FM104 protested the threatened regulatory action, arguing the deal was legitimately concluded. The regulator threatened to institute legal proceedings, and FM104 indicated willingness to permit the matter to proceed to full hearing. In the end, the regulator did not bring a law suit, and the fund manager scooped a symbolic win.[38]

This altercation is quite dramatic. Fund managers interviewed were asked about their relationship with the regulator, RG201. 78% of the respondent fund managers opined that RG201 is a weak regulator that seems removed from the goings-on within the private equity market place in Kenya. FM113 observed:

> "RG201 does not understand the private equity industry in this country –they went and borrowed some foreign rules and regulations and just inserted them into the legal framework – they cannot work. What we need is dialogue, and we can help RG201 to help us – but

[38] Interview with FM104, Nairobi, Kenya (August 2009)

> there must be learning. But first, RG201 must fix the capacity issues – they need to attract talent to provide critical leadership."[39]

This is a fundamental finding for regulatory reform.

The foregoing general perception was largely corroborated by the oral evidence of RG201 during interview, whose representative stated –

> "Private equity is a sophisticated type of commercial activity, and given the very high financial thresholds applying to entry, it is an activity open to a privileged few in society. I believe that if one is sufficiently wealthy to invest in private equity, such a one can appreciate the special risks attendant on private equity investments. Our current policy priority is in the area of protecting retail investors within the listed market segment."[40]

The problem between FM104 and the RG201, in the second case, it would appear, was one of institutional incoherency on the part of the regulator, where institutional knowledge does not approximate to individually-held knowledge: a challenge around institutionalising procedures and decisions, and a key failing that market intermediaries are exploiting. Regulatory efficiency, and therefore intermediary compliance, appear to be very closely intertwined: two sides of the same coin as it were.

[39] Interview with FM113, Nairobi, Kenya (January 2010).
[40] Interview with RG201, Nairobi, Kenya (January 2010).

6.3.5 Regulating Corporate Governance in Fund Management

Corporate governance standards are also addressed by the Registered Venture Capital Companies Regulations 2007 in Part V which stipulates that fund managers are required to implement the investment policies disclosed under Part III of the Regulations. The Regulations further stipulate the methods by which fund managers may resign their offices, how fund managers can be removed from office, how leadership changes to new managers should be effected, and how new fund managers are to be appointed.[41]

Drawing on the experience between FM104 and RG201, the regulatory ability to effectively enforce the law remains a challenge, leaving it open to market intermediaries to play around the law. While opinion is mixed on where to place the blame, it is on record that no less than five stockbrokers collapsed between 2007 and 2010, and that others are operating under the 'extended licence' provisions.[42] RG201 at interview was hesitant to place entire blame on ineffective financial reporting that ensured the failed institutions continued operating under the appearance they were financially sound. Like all regulated entities, they were subject to stringent reporting standards, as the next section explores. Their true state of affairs (like it was for Enron in the USA[43]) was not picked up early to pre-empt institutional failure and losses to investors. Was it a case of ingenuity on the part of market intermediaries or a statement on the quality of regulation? The issues this question raises go beyond the scope of this study, but serve to illustrate the point on regulatory capacity to enforce market rules.

[41] R 8-14, Venture Capital Companies Regulations, 2007 (n 11)
[42] Capital Markets Authority, 'Annual Report 2010' <http://www.cma.or.ke/index.php?option=com_docman&task=doc_download&gid=191&Itemid=30>
[43] Gary Fooks, 'Auditors and the Permissive Society: Market Failure, Globalisation and Financial Regulation in the USA' (2003) 5(2) Risk Management 17

A more poignant point for reflection is the question whether the issues underpinning the corporate governance standards under the Regulations of 2007 do not or should not apply equally to those private equity funds that opt not to register as venture capital companies under the law. It certainly seems inefficient to subject one set of market intermediaries to a stringent set of regulatory standards while creating an 'easier' regulatory option for similarly placed market intermediaries. These factual realities are likely to drive a choice against subjecting oneself to regulation, as the facts at section 6.3.3 above establish.

6.3.6 Reporting Obligations

Once licensed or approved, the law imposes continuing compliance obligations on such entities under sections 25 (renewal of licences) and 28 (obligation to report changes) of the CMA Act of 1989. Licensees must report changes to the name of the business entity, address of the principal place of business, shareholders, directors, chief executives and key personnel.[44] Any changes ought to be notified to the CMA within 14 days of their occurrence.[45] The CMA maintains a register of all licensed persons, which includes the name, address and type of business of licensees. This register is updated and published annually in April (and this is a statutory requirement).[46]

In addition, fund managers are obliged to keep books of accounts and maintain all necessary records of the operations of the fund for at least seven years after the close of each investment. Fund managers are also under obligation to make both

[44] Capital Markets Authority Act, 1989, s 24(8), s 27(2) and 28
[45] ibid s 28
[46] ibid s 27

quarterly and annual returns, whose key tenets involve the disclosure of investments undertaken, including disclosure of consideration paid, disclosure of divestitures, and a statement of profits or losses incurred thereby. In relation to profits and losses, the method by which they were calculated is required to be disclosed.[47] Registered fund managers thus have elaborate annual and quarterly reporting obligations. There is cause to wonder whether the preference not to register with the regulator as registered venture capital companies is reminiscent of the 'death by documents' syndrome introduced by the post-Enron Sarbanes-Oxley law reforms in the USA in 2002.[48]

6.3.7 Investment Restrictions

Certain economic sectors are excluded from eligible private equity investments in Kenya. These are real property, banking and financial services, and retail and wholesale trading services.[49] Other than these, the rest of the economy is open to private equity.

It was discussed in the preceding chapter that this prohibition appears not to be absolute, judged from the two documented cases of private equity investments into two of Kenya's commercial banks (Equity Bank Ltd and Family Bank Ltd).[50] It was also demonstrated that Kenya-based private equity fund managers are very interested in the three restricted economic sectors.[51]

The complications raised by the apparent dual regulatory framework arise under Regulation 8(2) as well: it is not clear, from a regulatory point of view, whether

[47] R 19-22, Part VII, Venture Capital Companies Regulations 2007 (n 11)
[48] Gary Fooks, Market Failures (n 43)
[49] R 8(2), Part IV, Venture Capital Companies Regulations 2007 (n 11)
[50] Ch 5, 156,157
[51] Ch5, 170,171

fund managers of unregistered private equity funds are free to invest in the three excluded economic sectors, especially noting that there exists, prima facie, a conflict between s.23 of the CMA Act of 1989 and R.8 of the Venture Capital Regulations 2007.

A second category of investment restrictions relates to investing in related third parties: it is not permissible under Regulation 28 of the 2007 Regulations. This prohibition extends to directorships in affiliate companies. The language employed is

> *(...) exposure to any of (its) directors, affiliate companies or companies in which the fund's directors and their close relations hold substantial interest.*[52]

The Kenyan Companies Act of 1962 does not carry such an explicit limitation on impermissible associations within the institution of directors. This regulatory prohibition rings in similar vein with the prohibitions under the American Clayton Anti-Trust Act (Title 15), of 1914.[53] The practice implication is substantial: in selecting an investment portfolio, fund managers would be under strict regulatory requirement to ensure companies within its portfolio do not offend this rule on permissible associations. Similar themes arise under competition rules, explored under section 6.3.11, below.

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[52] R.28, Venture Capital Companies Regulations, 2007(n 11)

[53] Title 15 U.S.C. ss12-27 (Pub. L. 63-212, 38 Stat.130) – section 13 (Discrimination in Price, Services or Facilities).

6.3.8 Fundraising Rules

Like in most jurisdictions, private equity companies in Kenya cannot fund-raise by making offers to the public – the offers are made to private holders of capital. However, they are required to file the private placement memorandum with the Capital Markets Authority at least one month before publication. The memorandum must contain details of the terms and conditions on which investors can invest in the target funds. Within fourteen days of closing, fund managers are required to make returns of the funds raised to the Authority.[54]

Extrapolating from the dichotomy between registered and unregistered venture capital companies, there is a measure of uncertainty whether unregistered fund managers are automatically exempt from the regulatory requirements, and whether that effect was either intended or anticipated.

The following sections now turn to a consideration of corporate law issues in private equity practice, and how Kenyan law addresses them. As a corporate activity, private equity raises issues in interest conflicts, financial assistance, and minority rights. It is necessary to establish the extent to which Kenyan corporate laws create specific duties and obligations on private equity companies and their agents that define the outer limits of permissible private equity corporate action.

6.3.9 Restrictions on Financial Assistance

Financial assistance relates to the giving of a loan, security, or other form of financial guarantees, by a company to aid in the acquisition of its own shares, or

[54] R.15-18, Venture Capital Companies Regulations (2007) (n11)

shares in its holding company. Section 56 of the Companies Act of 1962 prohibits financial assistance in the following terms:

> *56. (1) Subject as provided in this section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company, or where the company is a subsidiary company, in its holding company.*

The position under English law is different from Kenya's situation. Under Part 18, Chapter 2 of the UK Companies Act of 2006, sections 677 to 682 address the question of financial assistance.[55] Section 677 defines financial assistance to include any gift, guarantee, security, loan, indemnity, release or waiver, as well as novation or assignment. Under section 678, if for instance a private equity fund manager is in the process of acquiring shares in a listed company, the listed company is not permitted under law to offer any form of financial assistance to its acquirer, whether prior to the transaction or post-acquisition, even if the buyout or share acquisition leads to new liabilities on the part of the acquirer. This prohibition extends to all subsidiaries of such listed company, whether the subsidiary is itself a public company or a private company. Under section 679, the converse is true: if the acquisition involves a private company which has a listed subsidiary, the listed subsidiary company is not permitted under law to aid the acquisition process by granting financial assistance to the acquirer.

The law creates a number of exceptions, however. Firstly, under section 678(2) of the UK Companies Act 2006, a public company can give financial assistance

[55] UK Companies Act, 2006, ss677 – 682, <www.legislation.gov.uk/ukpga/2006/46/.../ukpga_20060046_en.pdf> accessed 11 January 2012

provided such assistance is not directed at aiding prohibited kinds of share acquisitions, or where the giving is merely incidental to a larger corporate purpose. Under section 679, it is also provided that where the giving of financial assistance forms part of the company's ordinary business (such as the making of loans), then the prohibitions do not apply.

Section 681 of the UK Companies Act 2006 sets out a list of unconditionally excepted kinds of financial assistance, including dividend distributions in the ordinary course of the company's business, the allotment of bonus shares, reduction in the capital of the company under relevant provisions of the Act, the redemption of its own shares in the ordinary course of business, and anything done pursuant to financial distress under insolvency provisions in the Act.

Under section 682, private companies in the UK are generally excepted from the provisions of sections 678 and 679, and public companies with sufficient asset depth can give financial assistance, so that the net assets of the company are not reduced beyond a certain threshold post-assistance, or the company is left without any assets.

By contrast, under section 151 of the old UK Companies Act of 1985, the prohibition had extended to both private and public companies,[56] which generally prohibited financial assistance given by a company in the acquisition of its own shares.

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[56] UK Companies Act of 1985 <http://www.legislation.gov.uk/ukpga/1985/6/pdfs/ukpga_19850006_en.pdf?timeline=true > Section 156 of the UK Act created a special exception in the case of private companies where the private company's board of directors gave a solvency declaration, and the company's auditor issued a report evidencing the solvency of the corporation. These liquidity guarantees were in law required to demonstrate that the financial assistance would not reduce the company's net assets by more than the amount of its accumulated distributable profits.[56] Secondly, financial assistance could be given where there existed, in addition to the liquidity guarantees, a special resolution of the company's shareholders authorising the company to give such financial assistance.[56] Thirdly, the exception would not apply if the financial assistance was intended to aid the purchase of shares in a holding/parent company, where that holding company was a listed company.[56]

The section 151 prohibitions related to the giving of guarantees, upstream loans, gifts, contribution of assets and assumption of liabilities of all kinds – very much akin to the stipulations of section 56(1) of the Companies Act Cap 486, laws of Kenya, quoted above.[57]

Where private equity transactions involve the acquisition of shares in a private company, the current law in the UK permits such private company to aid in the acquisition transaction. They would, however, still be subject to general business conduct rules, and the common law duties relating to fiduciaries, discussed elsewhere in this chapter.

The prohibition on financial assistance in Kenya is absolute. There do not exist any exceptions to the general rule that make it possible for financial assistance of the kind desired by Kenyan private equity intermediaries to be granted. One fund manager expressed it this way:

> "Section 56 of the Companies Act continues to frustrate LBOs in this market: we would like to do LBOs here, and given Kenyan private equity's conservative deal structures, LBOs would be both lucrative and sustainable financing strategies for Kenyan companies, especially the new crop of cross-border corporations. The East African Community presents an unparalleled opportunity: we would be happy

[57] ibid, s 157 (UK law) - Where a holding company's shares were the subject of acquisition, the law required a special resolution of the shareholders in the parent company authorising such acquisition. The law further required the directors of each company concerned in the acquisition to swear statutory declarations to the effect that the company would remain solvent immediately after the assistance was given, and for a period of twelve months thereafter. Finally, an auditor's report speaking to the reasonableness of the solvency declarations was required.

> to engage regulatory agencies on the merits of evolving the law on LBOs and financial assistance."[58]

In *Standard Bank Ltd v Mehotoro Farm Ltd & 2 Others* CC 54 [1972] CA, the appellant provided a loan to the company to enable the respondents to purchase the company's shares. This was completed by the making of a direct payment to two directors through the company and releasing the directors from their joint and several guarantees in respect of outstanding bank overdraft. The share acquisition transaction was secured by fresh guarantees by the acquiring directors in respect of the cost of the shares to be purchased, which guarantees were up-stamped by instruments of variation, and charged on the immovable assets of the company. Justice Lutta, BCW, JA, held the transaction amounted to financial assistance under section 56 of the Companies Act, and was void for illegality. [59]

A private equity transaction that raises the opportunity for such guarantees would, under current law, be illegal in Kenya. Judge Lutta, BCW, observed, orbiter, in the *Mehotoro Farm Case,* that -

> "[financial assistance] covers any transaction where not only money but also security or guarantee and indemnity, is provided by a company in order to enable a person to purchase or acquire its shares". P.12.

A private equity transaction that involves the raising of debt as part of the acquisition finance might require the target company or its subsidiaries to give security or other guarantees to collateralise the acquisition loan. The board of directors in the target company would usually pass a resolution authorising the

[58] Interview with Legal Manager, FM112, Nairobi, Kenya, August 2009.
[59] Pp.12-14. <http://kenyalaw.org/CaseSearch/>

issuance of such guarantees or security. This action, however, would, under current law in Kenya, give rise to two corporate law problems: a public policy question on corporate stability, and a conflict of interest question on the part of the directors. From a company law point of view, any action by company directors ought to be *bona fide* in the interest of the company. A private equity takeover may not necessarily be in the interest of a target company. Section 56 of the Companies Act of 1962 has the effect of expressly prohibiting any form of financial assistance relevant to the conduct of private equity transactions.

6.3.10 Conflicts of Interest – Directors

Closely related to the prohibition against financial assistance is the question of interest conflicts relating to actions of company directors. Directors in Kenya are required, under section 200 of the Companies Act of 1962 to disclose any interest they might have in either the affairs, contracts or information of the company. In *Azim Virjee & Two Others v Glory Properties Limited* [2007] eKLR, CC559/1999 (HC), it was held by Justice OK Mutungi that a director who holds 50% beneficial ownership in a property owned by the company suffers a direct conflict of interest, in contravention of the law.

Under English law by comparison, the UK Companies Act of 2006 in s.170 provides that general fiduciary duties of company directors are based on common law rules and equitable principles, and are to be interpreted in the same way as common law rules and equitable principles. This common law duty was confirmed in *Thermascan Ltd v Norman* [2009] EWHC 3694 (Ch), where it was held that English courts are under a duty flowing from section 170(4) of the Companies Act, 2006, to apply common law rules and principles in the construction of new provisions of the Act.[60]

In a buyout context, the directors of a company will usually need to align themselves with the external private equity investors, while at the same time still remaining directors of the target buyout company. This is a case of split allegiances, falling under section 200 of the Companies Act of 1962.

The duty to act in the best interests of the company may operate to fetter the freedom of directors to divulge confidential corporate information to third parties unless such disclosure is in the course of the company's business. A buyout, however, does not qualify as 'company business'. Special authorisations may be required prior to such engagement with external buyers commencing. The private equity process, however, raises additional issues: it is frequently the case that parties to a takeover negotiation must enter into confidentiality and non-disclosure undertakings. But the target's board of directors may need to disclose the elements of the deal to their shareholders with the view to obtaining their consents to the transaction – amounting to a violation of the non-disclose undertaking, but congruent with statutory requirements. The options under Kenyan law are not entirely clear, as a search of case law on point returned zero hits in the Kenya Law Reporting database.

On another level, all types of private equity involve the private equity partner playing different roles at the same time – in the corporate sense. One role is that of the

[60] UK law on the duties of directors is very well developed: s171 requires directors to act strictly within their powers; s172 imposes the general duty to act in the company's best interest; s.173 imposes the duty to exercise judgement independently; s.174 requires directors to act with reasonable care, skill and diligence; s175 creates the duty to avoid conflicts of interest, and under UK law, this duty is both actual and constructive: even the appearance of conflict of interest is disallowed. Section 176 creates the duty not to accept external inducements in the discharge of corporate affairs; s177 creates the duty to declare interest in proposed transactions; while s.182 imposes the duty to notify interest in existing transactions.

financier. The second role is that of a business partner, which allows him to actively influence the direction which business actions should take. This 'hat' enables the private equity partner to veto, overrule, or otherwise colour corporate decisions (a corporate governance question). The third role is that of an 'inspector,' or 'judge'. The private equity provider is enabled by this 'hat' to evaluate contract performance, to enforce remedies to contractual breaches – either by way of withheld funding, or other contract law enforcement mechanisms. It is this third hat that complicates matters under the legal construct of conflicts of interest: does the third 'hat' free the private equity intermediary from responsibilities flowing from the first two?

The law on interest conflicts is not fully developed under the Companies Act of 1962. For instance, the question of multiple directorships is not addressed under that Act. However, the new Competition Act of 2010 has provisions relating to multiple directorships, addressed next.

6.3.11 Limitations on Multiple Directorships

Section 21 of the Competition Act, 2010, provides as follows:

> ***"21.*** *(1) Agreements between undertakings, decisions by associations of undertakings, decisions by undertakings or concerted practices by undertakings which have as their object or effect the prevention, distortion or lessening of competition in trade in any goods or services in Kenya, or a part of Kenya, are prohibited, unless they are exempt in accordance with the provisions of Section C of this Part.*
>
> ***(…)***
>
> *(5) An agreement or a concerted practice of the nature prohibited by subsection (1) shall be deemed to exist between two or more undertakings if—*

(a) any one of the undertakings owns a significant interest in the other or has at least one director or one substantial shareholder in common; and

(...)

(6) The presumption under subsection (5) may be rebutted if an undertaking or a director or shareholder concerned establishes that a reasonable basis exists to conclude that any practice in which any of the undertakings engaged was a normal commercial response to conditions prevailing in the market.

(7) For the purposes of subsection (5), "director" includes—

(a) a director of a company as defined in the Companies Act (...)"

Multiple directorship would occur within what the cited law terms horizontal relationships, and by virtue of section 21(5), there arises a presumption by default that a concerted practice potentially restrictive of trade exists where two or more undertakings share a director – or where one entity owns a substantial interest in more than one entity.

Section 21(6) of the Competition Act of 2010 offers a reprieve to the automatic liability that arises under subsections (1) and (5), placing the burden of proof, however, on the entity in question to establish that an impugned act is a normal commercial response by the economic entities in question, as opposed to a concerted restrictive practice. From a private equity perspective, this reality is a factor to constantly evaluate in management decisions on portfolio selection.

The following illustration clarifies why the problem of multiple directorships is a matter of regulatory interest, not just in Kenya. The context is simple: if a private equity investment manager buys stakes in two companies operating in the same sector, and such stake entitles them to sit in the boards of the invested or acquired companies, (as it does in most private equity transactions), the director might act as a conduit, conscious or unconscious, of commercially sensitive information between the portfolio companies, and could easily motivate sector behaviour.

Multiple directorship is regulated by some countries around the world. For instance, in the USA, the Clayton Antitrust Act (Title 15) of 1914[61] and the Federal Trade Commission Act of 1915 prohibit such directorships.[62] The effect of the prohibition is that a director shall not serve in two competing companies.

In *Robert F. Booth Trust v Crowley et al & SEARS Holding Corporation*, Hon. Judge Ronald Guzman found the defendants in breach of the rule against locked directorships under section 8 of the Clayton Act of 1914. William Crowley, as President and Chief Operating Officer of ESL Investments, a hedge fund, was forced to resign his board seat in Sears Inc., which he owned 54% through his hedge fund. Crowley sat on three boards of corporations owned by ESL Investments (Sears, AutoNation and AutoZone), while his co-director at ESL, Ms Reese, held 29% in Jones Apparel – all competitors in auto spares, repairs and auto service.[63]

In *Oaktree Capital LLC*,[64] a private equity firm, was also sued under section 8 of the Clayton Act of 1914 when it acquired 40% of Loews Cineplex Entertainment Group and 17% of Regal Entertainment Group, both operating cinema chains, and placed representatives on both boards. The US District Court of the Southern District of New York ruled that 'deputization' occurs when two representatives of one

[61] US Laws, ss 8, 18 <http://www.globalcompetitionforum.org/regions/n_america/USA/The%20Clayton%20Antitrust%20Act.pdf> accessed 15 October 2011.
[62] FTC Act s 5 < http://www.fdic.gov/regulations/compliance/manual/pdf/VII-1.1.pdf> accessed 15 October 2011.
[63] No. 09 C 5314 N.D.I.[2010], In the United States District Court for the Northern District of Illinois, Eastern Division, <http://docs.justia.com/cases/federal/district-courts/illinois/ilndce/1:2009cv05314/234810/65/0.pdf?1269886256>
[64] *Reading Intl, Inc., v Oaktree Capital Management LLC*, 317 F.Supp. 2d 301 – 331 (S.D.N.Y. 2003)

company sit in two separate boards, especially if it is established they act pursuant to some defined corporate will.

In *US v Dairy Farmers of Am., Inc.,* 426 F.3d 850 – 855 (6th Cir. 2005),[65] Dairy Farmers Association sought to acquire 50% beneficial ownership in Southern Belle Dairy company. At the time, Dairy Farmers of America *Inc* owned 50% shareholding in National Dairy Holding, L.P. The latter was a direct competitor in the same market for school milk. The court found that a bar arose under section 7 of the Clayton Act of 1914, and went further to find that for a violation to arise, mere evidence of substantial ownership was enough, rather than proof of actual abuse.

In the UK, substantial case law on the question of multiple directorships exist. In *Mashonaland Exploration Co. Ltd*,[66] the court held that there did not exist any rule of law that prevented a director from becoming a director in a competitor company. Similarly, in *Headline Filters*,[67] it was held that a director who formed a company and took orders for future delivery and agreed a leasing arrangement with the new company did not breach the duty on conflict interest. More recent cases, however, take a divergent view, for instance, in *Bristol and West Building Society*,[68] it was held by Millett J that a director that works for two competitor companies "without obtaining the informed consent of both" breaches the duty of undivided loyalty, giving rise to a conflict of interest. But in *Shepherds Investments Ltd*,[69] it was held that each case must turn on its own facts, but overt actions that clearly show a conflict of interest are prohibited (e.g., staff and customer poaching schemes sometimes

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[65] *US v Dairy Farmers of Am., Inc.,* 426 F.3d 850 – 855 (6th Cir. 2005)
[66] *London and Mashonaland Exploration Co. Ltd v New Mashonaland Exploration Co. Ltd* [1891] WN 165
[67] *Balston v Headline Filters* [1990] FSR 385
[68] *Bristol and West Building Society v Mothew* [1998] Ch 1 18 CA
[69] *Shepherds Investments Ltd v Walters* [2007] 2 BCLC 202

observed in private equity transactions). *Tunnard*[70] does not find the development of a competing product and formation of a company to amount to 'overt' actions giving rise to a conflict of interest.

The combined effect of these cases is to render the actual content of 'common law rules and principles' under sections 170 and 175 of the UK Companies Act of 2006 uncertain, leaving it open for courts to apply the law on the unique facts of each individual case.

A case search on the question of interest conflicts relating to multiple directorships in Kenya returned zero findings. It will be interesting to see how the law develops in the future, noting that the Competition Act of 2010 is still a recent regulatory framework. For private equity investment planning, however, these are important issues to keep in mind when designing a portfolio.

6.3.12 Minority Shareholders

Kenyan company law protects against squeeze-outs and sell-outs, albeit inexhasutively. Under section 210 of the Companies Act Cap 486 of 1962, minority shareholders can only be coerced into selling out to the acquisition shareholder where the buyout involves the transaction of over 90% of the shares in the company acquired. In addition, section 47 of the Competition Act No.12 of 2010 conditions mergers and acquisitions on, among other things, the protection of the legitimate interests of all stakeholders affected by the transaction. The law furthermore entrenches minority shareholder protections through guaranteeing that where shareholders holding at least 10% of the company's issued share capital demand an extraordinary meeting of the

[70] *Helmet Integrated Systems v Tunnard* [2007] CA

company, directors must convene such meeting. In addition, 15% or more minority shareholders aggrieved by a decision or action of the directors can petition the court for protection.[71]

It is thus easy, on the face of the law, for minority shareholders in Kenya to force corporate dialogue or bring legal action against the majority shareholders whenever majority oppression is perceived.[72] Nonetheless, the Kenyan board of directors is typically a powerful institution, frequently able to manipulate circumstances in their favour. One of the law reform points in the proposed framework for a new companies law is to strengthen the de jure and de facto rights of minority shareholders.[73] These are important issues in designing private equity investments.

Kenyan law furthermore does not expressly prohibit corporate raids and such negative practices as "greenmails" and "poison pills".[74] Being strategies that private equity has employed before, the tenor of a given country's corporate law would be an important issue informing the legal infrastructure for private equity in that country.

6.4 State of Regulatory Compliance

Among the independent private equity funds (meeting the inclusion criteria), only one is licensed as of 2011.[75] In the surveys, over 90% of the post-2005

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[71] Companies Act 1962, Cap 486, s132.

[72] Companies Act, 1962, s 210; Competition Act No.12, 2010, s 47 – Kenyan shareholders in most public companies are highly dispersed, a fact that militates against their ability to leverage the statutory facility that empowers them against majority oppression.

[73] Interview with Mr. Johnstone Okello, Senior State Counsel, Kenya Law Reform Commission (Nairobi, Kenya, January 2010)

[74] Generally, Companies Act of 1962 and Competition Act, 2010.

[75] Capital Markets Authority, Annual Licensees, Gazette Notice No.4937 of 29th April 2011 (Government Printers, Kenya) <

independent funds did not indicate they were bothered to comply with the licensing requirements. This is significant, and could find possible explanation in three main factors. The first could be the minimum paid-up share capital and fund thresholds required to qualify for registration. The second could be issues to do with the strength of enforcement under the regulatory framework applying to this segment of intermediation. This second factor takes on substantial force when the regulatory focus is taken into account. In the alternative, it could have everything to do with the language embodied in the law, canvassed above.

While Kenyan law prescribes a minimum capital requirement for registration as a venture capital company in Kenya, the law does not prescribe *prima facie* that a fund manager subject to licensing requirements under the law must be a fund manager of a registered venture capital company or one seeking such registration. Rule 3(1) of the Venture Capital Regulations of 2007 simply prescribes that for a venture capital company to be registered, one of the requirements is that the applicant must have appointed a fund manager licensed by the Regulator, besides complying with other licensing preconditions.

This suggests that a private equity business in Kenya can be conducted without registration and without necessarily appointing a licensed fund manager – unless one wishes to be registered at some point. In the alternative, a fund manager can be licensed, but need not necessarily at the same time register as a venture capital company.

The parent legislation, however, is authoritative and all-encompassing in language: section 23(1) of the Capital Markets Act, Cap 485A, Laws of Kenya, states:

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http://www.cma.or.ke/index.php?option=com_docman&task=cat_view&gid=15&Itemid=30> accessed 7 October 2011.

*"**23.** (1) <u>No person shall carry on business as</u> a securities exchange, stockbroker, dealer, <u>investment adviser, fund manager</u>, investment bank, authorised securities dealer, authorised depository, or hold himself out as carrying on such a business <u>unless he holds a valid licence</u> issued under this Act."* (emphasis added)

Prima facie, fund management, whether private equity or not, is a regulated activity, importing the principle of universality of application. The norm within the parent law does not appear to be faithfully translated into the subsidiary level. Had the law employed the terms *<u>"no person shall carry on business as a ...fund manager of a..."</u>*, a different extrapolation might have been possible.

The preponderant majority of fund managers in Kenya could then simply argue that as fund managers of funds not meeting the regulatory threshold re: capital requirements *and* type of activity, they are not obliged to seek and maintain investment licences.

In response to the question why RG201 had not implemented the law stringently, over 75% of the interviewed fund managers cited the regulator's capacity constraints. In their view, the Regulator either had not applied punitive measures for non-compliance, or simply did not have the resources (institutional, knowledge and human) to implement the law to the letter. Furthermore, concern over the perception within the industry that the Kenyan law on private equity is built on a non-growth-oriented model was pervasive. Below is provided a small sample of the oral evidence by respondent fund managers supporting this deduction:

a) FM113: "The regulations are not based on a formal, declared policy."

b) FM112: "The regulations have features alluding they were borrowed from different jurisdictions and were not and have not been consistently adapted and modelled into the Kenyan context."

c) FM104: "There have not in the past been any frameworks for regulatory consultations between the private equity industry and the Regulator –it is the prerogative of the Regulator to facilitate such dialogue."

d) FM106: "The private equity business model is still a puzzle to the Regulator, which is playing catch up, and is hampered by other more politically-correct pressures such as the troubled stock-broking industry and corporate governance challenges within the Nairobi Stock Exchange."

e) FM108: "The regulations are very prescriptive, foray into areas difficult to police, and is self-defeating on the amount of information it demands reporting organisations to produce in compliance – formal compliance would yield more information per regulated entity than the regulator would be able to put to good use."[76]

It is readily observable that both the law and the legal institutions underpinning the practice of private equity in Kenya continue to drive a certain measure of market uncertainty that introduces varying levels and types of inefficiencies. Firstly, clarifying the law on each of the headings reviewed above would be a useful exercise for the country. Secondly, strengthening regulatory action,

[76] This opinion is vindicated partially when one takes into account the Capital Markets Authority Enforcement Manual – which runs to 91 pages with hundreds of offences and enforcement formulas (and corporate governance scandals still abound within the capital markets framework) – for details: Capital Markets Enforcement Manual 2008 (CMA, Kenya) <http://www.cma.or.ke/images/stories/docs/ENFORCEMENTMANUAfinal.pdf> accessed 15 December 2009.

once the legal framework has been rationalised, is the next most critical aspect for reform in Kenyan private equity practice.

Competition concerns appear to be key motivators to fund manager resistance to registration, and notions under data protection legislations would appear to be pertinent. Corruption was noted to be a key institutional factor in Kenya, and there could be legitimate apprehension about security of disclosed information. Without a clear legislated duty to protect data, it is uncertain the extent to which market data disclosed to the regulator will remain confidential. The fact that Kenya in 2010 did not have a law on data protection only exacerbates matters.[77]

In response to the same question, the CMA admitted two constraints.[78] Firstly, there is a capacity problem: institutional incapacity to effectively regulate private equity intermediaries. Secondly, the Regulator's first concern for public interest protection – which essentially interprets investors in private equity to be sophisticated entities and individuals who are assumed to appreciate the risks the investment entails. In fact, the law treats private equity placements as offers to a sophisticated circle of investors believed to be knowledgeable about the risks attendant on that type of investment. To aid in entrenching this regulatory assumption, the law restricts private placements to no more than 100 persons, whose minimum subscription is pegged at one hundred thousand shillings. Furthermore, securities issued in pursuance of a private placement are not freely transferable, establishing the illiquid nature of private equity as a financial asset.[79]

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[77] See: <www.kenyalaw.org>
[78] Interview with RG201, CMA Offices, Nairobi, Kenya (January 2010).
[79] The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, (2002) under the Capital Market Act 1989, Cap 485A, Regulation 20.

In light of the preceding review on the general design of the law in Kenya as it relates to private equity, it seems worthwhile to explore, briefly, the thinking in other jurisdictions. To do this, experience is sourced from the European Union, the United Kingdom and the United States of America, as the next section attempts to achieve.

6.5 International Perspectives on the Regulation of Private Equity Activity

6.5.1 Experience of the European Union

The European Union is an international legal institution, while Kenya is a country, and, at first glance, there does not exist a basis for comparability between the two. However, the EU has been catalytic in spearheading the development of a pan-European regulatory framework for alternative investments, although leaving untouched the prerogative of nation states within the membership to regulate fund structures nationally. Kenya will therefore need to carefully assess what elements to consider for transplantation.

In the European Union, private equity is classed as an alternative investment, subject to regulation under the EU Directive on Alternative Investment Fund Managers, which came into force in 2011.[80] EU Regulatory focus is on fund managers as opposed to private equity funds.[81] The regulatory justification is grounded in recent turmoil within global financial markets, with EU legislators arriving at the conclusion that alternative investment fund managers employ strategies that are 'vulnerable to some or several important risks in relation to investors, other market participants and

[80] European Union, Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, in L. 174/1 Journal of the European Union 1 July 2011.
[81] EU Directive 2011/61/EU (2011) 2 para. 10

the markets'.[82] The EU AIFMD establishes a single harmonised internal market for fund management in the EU, but leaves the regulation of alternative investment funds (AIFs) to Member States to deal with under national law, given the wide variety of AIFs. The regulation of private equity is driven by concerns over financial stability, transparency and investor protection. With an asset base of over Euro 2 trillion as at end 2008, AIFs and AIFMDs constitute significant actors within the EU financial markets.[83]

Most EU countries already regulate private equity funds, fund managers and the private equity investment activity in different ways, yielding a fragmented approach to regulation at the pan-European level.[84] The main areas of concern include interest conflicts management, management of risk-taking behaviour, adequate capitalisation, asset valuation standards, among a whole spectrum of other issues that cascade across the investment process in private equity activity.[85]

6.5.2 Experience in the United Kingdom

In the United Kingdom, regulatory concerns over private equity are driven by concerns over institutional leverage and a desire to identify relevant risks posed by the industry to financial stability. To achieve these policy goals, the UK Financial Services Authority in 2006 published a discussion paper on risk and regulatory engagement, document DP06/06.[86] The FSA summarises[87] the key risks the private

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[82] EU Directive 2011/61/EU 1 para.3
[83] Commission of the European Communities, Staff Working Document(n 11) 3
[84] ibid 3
[85] EU Directive 2011/61/EU (n 80) from para.22.
[86] Financial Services Authority, 'Discussion Paper 'Risk and Regulatory Engagement' <http://www.fsa.gov.uk/pages/About/ > accessed 17 February 2010.

equity industry poses to include (i) excessive leverage,[88] (ii) unclear ownership of economic risk,[89] (iii) reduction in overall capital market efficiency,[90] (iv) market abuse,[91] (v) conflicts of interest,[92] (vi) market access constraints,[93] and (vii) market opacity.[94]

The FSA already regulates the private equity industry, however, albeit in a light manner. Firstly, it has close and continuous supervisory relationship with 14 of the largest private equity and venture capital fund managers operating out of the United Kingdom. Secondly, it develops risk mitigation programmes for the relationship-managed firms. Thirdly, it undertakes frequent dialogue with market

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[87] Financial Services Authority: Private Equity ' A Discussion of Risk and Regulatory Engagement Briefing' (Note 028/06 of Nov. 6, 2006) <http://www.fsa.gov.uk/pages/About/Media/notes/bn028.shtml> accessed 17 February 2008.

[88] ibid, The question is whether to cap leverage or to tighten controls on imprudent lending practices.

[89] ibid, Private equity transactions can get complex, especially where secondary deals are concerned. For instance, the duration and potential impact of credit events could get complicated by operational issues which make it difficult to identify who ultimately owns the economic risk associated with a leveraged buyout deal and how these owners will react in a crisis. This can be complicated by the employment of complex deal structures such as assignment, participation and credit derivatives – frequently opaque and time-consuming. Particularly with the latter, a main problem is the mismatch between communication and transaction time, often meaning transacted amounts exceed underlying asset values. Furthermore, new market participants may favour business models that disfavor turnaround of distressed firms. All these issues could create confusion which could damage the timeliness and effectiveness of workouts following credit events and could unwind sound restructurings.

[90] ibid, Regulatory rationales on this head surround the questions: how could the types and sources of capital be widened, company valuation made more precise, capital structures optimized, and corporate development and transformation be facilitated – especially in light of the huge wall of money thrown at private equity firms?

[91] ibid, Driven by the substantial flow of price sensitive information to private equity transactions, and complicated by cross-border transactions and the ever-widening participant base.

[92] ibid, Between fund managers and their investors; between fund managers and their investee companies. In addition, advisors and providers of leverage finance experience interest conflicts especially where they play multiple roles in relation to an individual transaction – either between their proprietary and advisory activities or between their different clients.

[93] ibid, This relates to concerns over mechanisms for expanding retail investor participation in private equity.

[94] ibid, While transparency to existing investors in private equity is extensive, there exists substantial opacity on the fee structures, valuation methodologies and formats as far as the wider market is concerned, rendering performance comparisons difficult and inexact, and potentially a barrier to investments as well as potentially a basis for misguided investment decisions.

participants on private equity sector issues. Fourthly, it includes private equity firms in its thematic reviews on market issues.[95]

6.5.3 Experience in the USA

In the United States of America, private equity has also largely escaped burdensome regulation, notably under the "private advisor exemption" clause in section 203(b)(3) of the Investment Advisors Act of 1940,[96] and the extensions of that exemption under Part IV of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* of 2010 (Dodd-Frank Act 2010).[97]

Under the Investment Advisors Act of 1940, fund managers and investment advisers that had fewer than 15 clients during a given financial year, did not advise registered investment companies or business development companies, and whose total assets under management did not exceed USD25 million, were exempted from registration requirements with the Securities Exchange Commission (SEC).

A regulatory decision by the SEC in 2005 to equate 'clients' with 'investors' was challenged in Phillip Goldstein, *et al.*[98] Under the new rule, the SEC had effectively pierced the veil behind the term 'client', numbering instead "shareholders, limited partners, members or beneficiaries" as clients.[99] The historical interpretation under the Investment Advisors Act of 1940 and within the industry was to count

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[95] The Financial Services Authority (n 86)
[96] Securities and Exchange Commission, Investment Advisors Act 1940 <http://www.sec.gov/rules/extra/ia1940.htm> accessed 4 April 2010.
[97] H.R. 4173 - United States Government Printing Office, Dodd-Frank Act of 5 January 2010 <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf> accessed 4 April 2010.
[98] United States Court of Appeals, for the District of Columbia Circuits, No. 04-1434, *Phillip Goldstein, et al, Petitioners, vs. Securities and Exchange Commission, Respondents,* argued Dec. 9, 2005, decided June 23, 2006. Decided by Circuit Judge RANDOLPH.
[99] ibid 2.

clients at the level of the fund rather than its investors. Goldstein brought a legal action against the SEC, successfully challenging the constitutionality of the new rule. The court held that the SEC was wrong in piercing the veil of the fund structure, and upheld the historical interpretation of 'client', effectively reinstating the private adviser exemption ousted by the impugned SEC rule.

In arriving at its decision, the Court relied on earlier decisions,[100] stating that an agency construction of the statute could not survive judicial review, as such an interpretation would be akin to saying just because a lawyer has a corporation as a client, a client-lawyer relationship is thereby created between the lawyer and all shareholders and other beneficiaries, as well as persons interested in, the corporation. Furthermore, such a construction would raise interest conflicts between the advisor and the fund, vis-a-vis the advisor and the investors behind the fund.[101]

The Court further recalled that the policy goal under the Investment Advisors Act of 1940 was to exempt those advisors whose activities were not large enough (scope-wise and geographically) to cause systemic trouble in the event they suffered stress.[102] This impact was to be measured from the volume of assets under management, or the extent of liabilities a fund has, not from the number of investors in such funds.[103]

It went on to clarify that this law was a companion statute to the Investment Company Act of 1940, mainly a registration and anti-fraud legislation that substituted the philosophy of full disclosure for the philosophy of *caveat emptor* among

[100] Including: *Aid Ass'n for Lutherans v. United States Postal Serv.*, 321 F.3d 1166, 1174 (D.C. Cir. 2003); *see also id.* at 1177-78; *Am. Library Ass'n v. FCC*, 406 F.3d 689, 699 (D.C. Cir. 2005), and *Abbott Labs. v. Young*, 920 F.2d 984, 988 (D.C. Cir. 1990)
[101] ibid, generally discourse at 14-17.
[102] ibid 18.
[103] ibid 19.

investment advisors.[104] Non-exempt advisors are required to register with the SEC, but all investment advisors are prohibited from engaging in fraudulent and or deceptive practices. The court further stated *obiter* that maintaining a census of qualifying investment advisors served the regulatory purpose of focusing and expediting necessary regulatory interventions within the investment advisory services.[105]

Under the Dodd-Frank Act of 2010, the minimum threshold of USD25 million has been raised to USD100 million, ostensibly to allow the SEC to focus regulatory oversight on systemically important market participants. While the new law removes the 'private advisor exemption' in the 1940 Act, it introduces a new range of exemptions.

Advisors with less than USD150 million assets under management in the US and who only advise private funds are exempted from SEC registration requirements.[106] Secondly, advisors to venture capital funds are exempt.[107] Foreign private advisors are also exempt, provided they have no permanent establishment in the USA, have fewer than 15 clients, manage assets worth USD25 million or less, do not hold out as investment advisors, and do not advise any registered investment company or a business development company.

Furthermore, the Act exempts family offices, which it distinguishes from investment advisors. Finally, investment advisors that solely advise small business investment companies are exempt. The Act also requires the undertaking of a study on

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[104] ibid 5, relying on the decision in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)
[105] ibid 5.
[106] Dodd-Frank Act of 2010, Title IV, s 403.
[107] ibid s 407.

a self-regulatory framework for private funds, to be completed within a year of the date that Title IV came into effect.[108]

Notwithstanding the foregoing, earlier discussions under 'multiple directorships' in this chapter demonstrated that private equity investment practice is subject to anti-trust regulation as are all corporations in the USA.

6.5.4 Distilling Lessons from International Practice

The experiences of the three legal jurisdictions reviewed above with respect to legal frameworks for private equity lend instructive object lessons. Firstly, the policy rationales are well articulated, and the private equity market is dichotomized into actors and instruments as embodied in private equity capital structures. The overwhelming focus of regulatory discourse in each of those jurisdictions is on activities of the fund manager and the impact of some of private equity's favoured capital structures.

Secondly, the regulatory discourse divides market participants into two main categories: those that are sufficiently big to have a systemic impact in the event of their investment portfolios becoming distressed, and those that operate small outfits with little national or systemic impact in the event of similar distress. Regulatory focus is on the former.

Thirdly, even where systemically significant operations are identified and subjected to regulatory requirements, evidence suggests a very light-touch approach to the regulation of the alternative investments sector. In *Goldstein vs. SEC*, Circuit

[108] ibid s 414.

Judge Randolph observed that this type of regulation serves the alternative investments sector well because of its unique business models.[109]

In terms of the transplant effect, key lessons from the European, British and American regulatory discourse include

(i) the need for clarity in the policy goals of any regulatory action,

(ii) clear analyses of risk factors, risk incidence, and risk sources in private equity investing,

(iii) stakeholder mapping to determine the protected interest – whether market orientated or consumer orientated regulation, and

(iv) whether the regulation should be prescriptive, that is, statutory, or market-based, that is self-regulation.

These considerations would guide the proportionality of regulatory response, as well as the proper distribution of regulatory burdens with the view to achieving a benevolent balance between promoting the public interest vis-a-vis developing the market.

6.6 Analysing the Kenyan Experience

This chapter reveals various shortcomings and inconsistencies between the law and practice of private equity in Kenya. To all intents and purposes, the industry operates as though the country had no overarching legal framework underpinning its activities. Has this mismatch impacted either contract design, investment monitoring,

[109] *Goldstein v SEC* (n 98) 3-6.

exit strategy or the overall attitude of fund managers to setting up office in the country? These are interesting questions whose answers remain empirically untested.

The following key issues appear pertinent to the law and institutional prism of this study:

(i) Uncertainty and imprecision in the use of regulatory terminology ('registration', 'approval', and 'licensing') undermines the authority of the law by creating room for unwarranted competing interpretations. These can be fixed by adopting appropriate legislations or effecting amendments.

(ii) In prescribing a minimum threshold for registration based on share-capital and fund size parameters, the law ought to be clearer what the policy justification is – and the solution could be found in clarifying a clear national policy on private equity and alternative investments.

In remaining silent on operations that do not satisfy the registration requirements, the law tacitly creates an exempted class of private equity practitioners, yet remains silent as to their general duties on, for instance, investor protection, disclosure and fraud. This is a yawning gap in the law that demands deliberate re-evaluation and redress. Parallels drawn from the EU model indicate that funds that do not exceed the stipulated minimum of Euro 100 million are not exempted altogether from regulation: but are subjected to a lighter regime commensurate to their operational levels. The unintended impact of the current state of the law in Kenya is the likely introduction of distortion to economic competition among market intermediaries.

(iii) Corporate law litigation on the emerging areas of multiple directorships under the Competition Act 2010 are yet to occur in Kenya, but in light of the trends depicted in chapter 5, it is likely that cases of litigation over interlocking directorships will increase as private equity activity increases.

(iv) The experience in Europe, UK and the USA on approaches to the regulation of the private equity industry offer valuable lessons on the depth of considerations and policy choices that must be made in designing national markets for private equity.

(v) Enforcement of the law is essential for market discipline. While the Regulator currently focuses on the public equities market, market participants in the Kenyan private equity world are entrenching market practices that may run counter to public policy. Impunity breeds arrogance. From an institutional perspective, non-enforcement robs the Regulator of the empowering opportunity to learn through regulatory action, and its removal from the private equity market place robs it of the opportunity to keep abreast with an industry that is continuously innovating products, practices and other possible anti-regulation posturing.

6.7 Conclusion

In sum, while an elaborate legal infrastructure exists in Kenya that can support private equity, there exist gaps and cross-negating overlaps and inconsistencies in the law. These detract from an efficient legal infrastructural platform for financial intermediation, and raises issues in the practice of private equity as well as on an agenda for law reform.

After analysing the state of Kenyan law on private equity practice, it is possible to observe that it cannot definitively be concluded what regulatory model motivates current design of the law on private equity. The relative detachment of the CMA from the industry (save for the occasional interface with the industry in the context of mergers and acquisitions especially where target companies are listed in the national bourse) does little to clarify what that motivation might be. With the mooted plans to establish a special SME counter at the Nairobi Stock Exchange, however, stock market listings by small and medium enterprises are likely to peak in the medium term, providing private equity investments with an expanded exit menu. It is likely that regulatory interest in the industry is likely to expand as market activity picks up.

Ongoing law reforms to the companies legal framework are also likely to usher in new changes that will have an impact on how private equity is conducted in Kenya. It is anticipated that there will be significant expansions in the corporate governance standards which might trigger amendments to existing law. Financial assistance prohibitions are likely to be softened too. In addition, it is likely that Kenya will see more litigation around the question of multiple directorships. In short, the regulatory landscape for private equity in Kenya remains unsettled. What this study has established within the strict context of this chapter is the urgent need to work out an evidence-based policy framework for private equity. This can only be done through engaging the industry. A well-informed public policy is likely to highlight areas for government to take a lead role in promoting the occurrence of private equity in Kenya.

7

TAX PLANNING FOR PRIVATE EQUITY

7.1 Introduction

The conduct of private equity, from a tax administration perspective, is similar to the conduct of any commercial venture within an economy. On this basis, private equity business is a legitimate target for tax policy, and rightly so. Industry-led evidence lend the wisdom that the tax treatment of private equity business can have positive or negative consequences to how deep a private equity industry can grow in any given legal jurisdiction.[1] The theme here is tax efficiency – and this is the principle issue explored in this chapter. The issue is wider than merely the cost of tax to business.

For private equity practitioners, taxation laws and policies – as fiscal tools in the regulation of business activities - are important beyond simply lowering the cost of doing business and extending profit margins. Industry studies single out company tax rates, taxation for individuals, tax rate for small and medium enterprises (SMEs), taxation of stock options and capital gains tax as important determinants in tax law for private equity investments.[2]

This chapter explores the structure of tax law and policy in Kenya, and discusses how tax planning within the private equity contracting market might occur. This chapter highlights the legal obstacles that current tax law and policy presents in the quest to grow a robust and efficient market for private equity in Kenya. Such an analysis has value to both policy maker and private equity practitioner. For policy makers, it enables an understanding of how innocuous legislative prescriptions can potentially yield dramatically different outcomes for

[1] European Venture Capital Association, 'Benchmarking European Tax and Legal Environments' (October 2008) < http://www.evca.eu/uploadedFiles/Benchmark.pdf> accessed 30 October 2008
[2] Christian Keuschnigg and Soren Bo Nielsen, Start-ups, 'Venture Capitalists and the Capital Gains Tax' (April 2004) 88(5) Journal of Applied Economics 1011-1042

economic players in different economic sub-sectors, sometimes quite unintended. For practitioners, including fund managers, it allows for an understanding of ways in which investment choices promote efficiency across all regulatory fields of compliance, besides facilitating the possible emergence of industry-driven regulatory reorganisation aimed at improving the objectives of both regulator and economic players.

This chapter contributes to a deeper understanding of the legal and institutional factors impacting the practice of private equity in Kenya. It builds on the expanding list of constraints, both institutional and regulatory, that impede the efficient conduct of commercial enterprise in Kenya. Any reform initiative aimed at improving legal and institutional environments for private equity would thus do well to give account to issues raised in this chapter. In fact, this study argues that to do otherwise is inefficient, and would not yield long-term benefits in the development of Kenya's financial markets.

With the foregoing themes in mind, this chapter is organised as follows.

Section 7.2 presents a short discussion on how tax law and policy impacts private equity, setting the context within which the findings in the rest of the chapter will be analysed. Section 7.3 discusses the general principles for taxation in Kenya. This discourse sets out the principles under-pinning tax liability and avenues available for tax planning – pointing out that while tax avoidance is illegal, tax planning is not.

In section 7.4, a wide-ranging discussion of the high impact tax elements for Kenyan private equity is provided. These include a review of the country's corporation and individual tax rates, the tax treatment of management and professional fees, VAT and other business taxes. Tax headings carrying very particular relevance to the structure of private equity financial contracts are subsequently reviewed. These include consideration of the taxation of capital gains, the tax treatment of dividends, and the levying of compensating and withholding taxes. Next the discussion turns to a consideration of deductible expenses in the conduct of private equity investments, the question of state subsidies on certain types of investments and earnings, and the risk of double taxation for income accrued in Kenya. The extent to which these are available could determine the investment decision – by capital holders. Furthermore, it could definitively determine whether entrepreneurs are encouraged or motivated to innovate, which itself could be a substantial factor in determining the flow of private capital.

Certain incentive structures employed to make private equity more attractive (including the tax treatment of stock options and fiscal incentives for research and development) are next considered. These are important questions in the design of private equity investments, since they determine the efficiency of investment exits and return of profits to investors. How stock options are taxed can definitively determine their efficiency in employment compensation. Section 7.4 thus goes to the heart of the relationship between private equity and tax law in Kenya.

In section 7.5, an analytical reflection is offered on the state of play between private equity and tax law. An important element of this analysis is: To what extent is tax transparency and efficiency possible in Kenyan private equity practice? From an investment risk evaluation perspective, these are crucial questions. Section 7.6 concludes.

7.2 How Tax Law Impacts Private Equity

There are at least five ways in which tax law and policy can impact private equity in a given legal system. Firstly, research has demonstrated that it can impact capital raising and consumption. For instance, low capital gains tax rates and non-prohibitive pension fund regulations have been shown to positively influence investor commitments to private equity on the one hand, and encourage increased research and development expenditures[3], on the other. This is historically borne out by American experience with pension fund regulations following the 1979 'prudent man rule' under the ERISA regulations.[4]

Secondly, research has suggested that state subsidies specific to private equity can positively influence the decision to invest in private equity.[5] This is a tax law and policy question in the Kenyan legal system, as it indeed is in most legal systems. A South African governmental review recommended that to promote private investments in small business, fiscal reliefs for investments into private equity funds that invest in small businesses, in addition to exemption from capital gains tax for investments held beyond five years, and limited tax deductions for the acquisition of new shares in a venture capital trust, are some of the necessary measures. These recommendations were hinged on the belief that tax regulations impact private investments.[6] Chapter 3 offered a wider discussion on tax policy measures employed around the world in growing private equity.

Thirdly, tax law and policy has been shown to influence how fund managers structure their investment vehicles, also known as 'fund structures'. For instance, the findings in an American study on the role of USA tax and securities laws on the USA venture capital sector suggests that favourable tax structures support the formation of specialised fund structures

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[3] Paul A. Gompers and Josh Lerner, 'What Drives Venture Capital Fundraising?' Brookings Papers on Economic Activity – Microeconomics (1998) 149-92, in Paul Gompers and Josh Lerner, *The Venture Capital Cycle* (MIT Press 2004) ch 33.

[4] Ibid, (2004) 8.

[5] Josh Lerner, 'The Government As Venture Capitalist: The Long-Run Effects of the SBIR Program' (1999) 72 Journal of Business 285-318

[6] Government of South Africa, Treasury, 'SME's Access to Finance in South Africa – A Supply-Side Regulatory Review' < http://www.treasury.gov.za/publications/other/Access%20to%20Finance%20in%20South%20Africa%20-%20A%20Supply-Side%20Regulatory%20Review.pdf> accessed 7 November 2010

that maximise earnings for investors, while favourable capital gains tax rates spur entrepreneurship.[7]

Fourthly, research evidence has shown that tax law and policy can influence capital structuring options under the investment contract.[8] In other words, the design of contractual control and cash flow rights in the private equity contract could be determined by various tax advantages and disadvantages in the employment of specific security instruments, such as common or ordinary equity shares vis-a-vis preferred shares. That study offers a tax explanation for the popularity of convertible preferred stock in USA venture capital contracts. The use of convertible securities offers more favourable tax treatment for incentive compensation paid to entrepreneurs and its employees by deferring taxation to the date when the incentive compensation is sold, and often beyond the date of sale. In effect, the holder of a convertible stock option has an incentive to defer or entirely avoid capital gains tax by holding onto the investment for five years or more.[9]

Fifthly, tax law and policy has been shown to influence investment exit strategies and how earnings (profits) are returned to investors. For instance, a study by Gompers and Lerner (1998) provide a USA-specific explanation to the increasing use of share distribution for investments exited through an IPO, rather than cash payments. In the USA, when a private equity fund sells its shares in a public offering, that shareholding represents immediate capital gains, and the fund manager, together with all taxable limited partners, realise a capital gains tax upon sale. A share distribution does not amount to a sale, and does not attract capital

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[7] Christian Keuschnigg and Soren Bo Nielsen, 'Tax Policy, Venture Capital and Entrepreneurship' (2002) 87 Journal of Public Economics 175-203

[8] Ronald J Gilson and David M Schizer, 'Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock' (2002-2003) 116 Harv. L. Rev. 874

[9] ibid – an indirect benefit of holding onto stock options is that key workers within the invested company remain within the organisation for most of the investment lifetime (see chapter 5), ensuring that key talents are locked in. The dual benefit of this is that the investor is assured of reasonable investment performance through staff continuity, and the industry cultures and develops a critical mass of investment managers for future investment cycles. On a wider platform, this has long-term economic benefits to a country's financial development.

gains tax, and also does not raise registration requirements (in the USA). Share distribution therefore allows limited partners to time their own market exits.[10]

7.3 General Principles of Taxation in Kenya

7.3.1 Tax Liability

The Income Tax Act, Cap 470 of 1974 (the Income Tax Act), is the primary legislation governing questions of business and personal tax in Kenya. Tax policy in Kenya is reviewed annually within the framework of the annual national budget, promulgated each year in the month of June. The broad principles of tax liability, however, have remained static over the years since the Income Tax Act was enacted nearly four decades ago.

Section 3 of the Income Tax Act lays down the broad principle that gains or profits from business, employment or services are subject to taxation in Kenya. Furthermore, dividends and interests, however defined, are also subject to taxation.[11] The definition of 'business' is very broad: it includes any trade, profession or vocation within the meaning of the Income Tax Act.[12]

Individual and corporate liability to tax in Kenya accrues on the 'residency principle' which is defined to mean all business gains or profits are taxable where a business is deemed to be resident in Kenya, regardless of whether the entirety or only a portion of that income is locally derived.[13] For corporates, residency is deemed to arise where the management and control of the enterprise or business or the affairs of a body corporate are exercised in Kenya

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[10] Paul A Gompers and Josh Lerner, 'Venture Capital Distributions: Short-Run and Long-Run Reactions' (1998) 53 Journal of Finance 2161-83, in *The Venture Capital Cycle* (MIT Press, 2004) ch19, 462

[11] Income Tax Act, 1974, s 3(2), Cap 470 Laws of Kenya < http://www.kenyalawreports.or.ke/kenyalaw/klr_app/frames.php,> accessed January 2, 2010.

[12] ibid s 2

[13] ibid s 4

over the course of the year to which the income relates.[14] Where the business presence continues beyond a period of six months, the attribute of "permanent establishment" for tax purposes is accorded that entity under the Income Tax Act.[15]

For individuals, residency means physical presence in Kenya during the course of employment.[16] The same principles on the derivation or accrual of income applies to employees: any income or gain that is realized in Kenya, whether an employee is resident or not, is deemed to be taxable income in Kenya.[17]

What this means for private equity companies operating in Kenya is that tax liability accrues on all private equity investment income generated in Kenya, regardless of the nationality of the fund – that is, whether the private equity company is registered as a Kenyan company or as a foreign company operating in Kenya. Further specifics are explored below under consideration of the corporate tax burden in Kenya.

7.3.2 Tax Avoidance and Evasion

Tax avoidance is not permissible under law in Kenya. Firstly, the Income Tax Act specifically addresses the question of tax avoiding business transactions and arrangements, and makes provision for tax reassessment assumptions that enable the Kenya Revenue Authority (KRA) to recover what it deems to be the due tax were the tax avoiding transactions not undertaken.[18]

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[14] ibid s 2
[15] ibid
[16] ibid
[17] ibid s 5
[18] ibid s 23

Secondly, decisions not to distribute income by corporate entities, deemed by the KRA to be motivated by the desire to avoid tax liability, are illegal under the Act.[19] The law permits the KRA Commissioner to deem that portion of a company's income that it should have distributed as dividends to have been paid on a date twelve months after the end of that accounting period. This means a readjustment of the company's liability, and in most cases attracts a penalty interest charge for the late payment. Because the attribution is calculated on shareholder dividend entitlement, the net liability actually falls on the individual shareholder, especially since the Act entitles the company to recover from the shareholder what it is made to pay to the KRA following adjustments to its tax liability.[20] In the end, a company engaging in this type of activity is engaging in a losing game.

Similarly, tax evasion in Kenya attracts serious business and personal penalties, ranging from business closure, hefty and painful fines, as well as possible jail terms that could exceed two years.[21]

7.3.3 Tax Planning Principles

Unlike tax avoidance and evasion, tax planning is not illegal in Kenya. 'Tax planning' is a term used in this thesis to refer to the system that businesses and individuals employ to achieve the greatest advantages in the manner in which their overall tax liability is calculated. In the first instance, it involves activities that maximise available tax breaks for a specific economic activity. Secondly, it involves the intensification of business activities that permit the recognition of deductible expenditures. Kenyan law recognises a range of such economic activities that fit within the mould of private equity investment activity, making it possible for

[19] ibid s 24(1,2)
[20] ibid s 24(3)
[21] ibid s 107 - 120

businesses in Kenya – including private equity - to organise their affairs in a way that makes their operations tax efficient.

The Income Tax Act recognises venture capital as a special economic activity for tax purposes, embodied in The Income Tax (Venture Capital Enterprise) Rules of 1997, issued under the Income Tax Act, and updated vide Legal Notice number 31 of 2008. This subsidiary legislation provides a mechanism by which venture capital fund managers in Kenya can register their businesses with the Commissioner-General for income tax purposes.[22]

To register, the venture capital business must first have been registered with the Capital Markets Authority of Kenya, under Cap 485A of 1990. Rule 3 of the Income Tax (Venture Capital Enterprise) Rules, 1997 stipulates that such a company must be incorporated in Kenya, must have a fund manager, must structure 75% or more of its investments as equity or quasi-equity, and must not invest within the three excluded economic sectors (banking and financial services, retail and wholesale trade, and trading in real property).[23]

Under Income Tax rules, a venture capital company is required to invest in "venture companies", defined as companies with a total asset value or annual turnover of less than five hundred million Kenyan shillings at the time of first investment.[24]

In the following sections, a concise review of the full range of tax planning tools available to private equity investors and investment managers under the Income Tax Act is provided.

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[22] The Income Tax (Venture Capital Enterprise) Rules, (1997) <http://www.kenyalawreports.or.ke/kenyalaw/klr_app/frames.php, > accessed 2 January 2011.
[23] ch 6, 198, 212, for fuller treatment on venture capital company registration in Kenya.
[24] Income Tax Act (n 12) s 2

7.4 High Impact Tax Elements for Private Equity

7.4.1 Corporation Tax

Schedule Three of the Income Tax Act sets out the various tax rates applicable to corporate bodies and individuals. These rates are set out in two main bands: rates for residents, and rates for non-residents. 'Residency' is applied to both moral and legal entities under the law. The corporation tax rate for resident companies is 30% since 2002, down from 32.5% in 1998. In contrast, foreign company subsidiaries in Kenya pay a corporation tax of 37.5%, down from 40% in 1998. In addition, whenever dividends are distributed, a withholding tax of 5% (7.5% in 1998) is payable by resident companies, and 10% by foreign companies. In addition, foreign companies pay 25% tax on payable interest income, compared to 10% by resident companies.[25]

A foreign company is defined under Section 365 of the Companies Act of 1962 to mean any company incorporated outside Kenya.[26] To register a foreign company in Kenya, the applicant is required under the Companies Act of 1962[27] to provide to the registrar -

(i) certified copies of the foreign company's memorandum and articles of association; and

(ii) a certified copy of the certificate of incorporation certified by a notary public in the country of incorporation.

To support the application, the applicant needs to complete a set of prescribed forms:[28]

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[25] Income Tax Act 1974 (n 12) ss 30, 50; Schedule Three

[26] Cap 486, Laws of Kenya

[27] ibid s 366

[28] Registrar of Companies, State Law Office <http://www.attorney-general.go.ke/index.php?option=com_content&task=view&id=100&Itemid=138> accessed 15 September 2011.

(iii) Form 236 - List of documents delivered for registration by a company incorporated outside Kenya;

(iv) Form 237 - List and particulars of the directors and secretary of a company incorporated outside Kenya;

(v) Form 238 – List of names and addresses of the persons resident in Kenya authorized to receive service on behalf of a company incorporated outside Kenya;

(vi) Form 250 - Notice of situation of registered or principal office or change therein of a company incorporated outside Kenya.

Once the Registrar is satisfied that the applicant has met all registration requirements as a foreign company, a certificate of compliance is issued to the applicant. The Compliance Certificate enables the applicant company to apply for a personal income number (PIN) for tax purposes, a PAYE number for payroll administration, and a VAT registration certificate. These latter documents are mandatory and no company can operate in Kenya without them.[29]

Contributions to employees medical insurance and to their pension schemes is mandatory in Kenya for all companies, whether local or foreign. Medical contributions are made into the National Hospital Insurance Fund (NHIF) as stipulated under the NHIF Act No.9 of 1998 (NHIF Act).[30] Pension contributions are made into the National Social Security Fund (NSSF) as stipulated under the NSSF Act of 1965 (revised 1978, and hereafter 'the NSSF Act').[31] The NSSF Act makes provision for a limited number of exempted persons for

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[29] Kenya Revenue Authority, 'Type of Taxes' < http://www.revenue.go.ke/index.php/domestic-taxes/income-tax/type-of-taxes> accessed 18 September 2011.

[30] s 15, National Hospital Insurance Fund Act 1998, Cap 9, Laws of Kenya < http://www.kenyalaw.org/kenyalaw/klr_app/view_content.php?ContentHistoryID=15536> accessed 18 September 2011.

[31] s 5, National Social Security Fund Act Cap 258 < http://www.kenyalaw.org/kenyalaw/klr_app/view_content.php?ContentHistoryID=2175> accessed 18 September 2011.

whom contributions are not mandatory.[32] For private equity businesses, these exemptions would not apply.[33] Every company must register for both NHIF and NSSF at the respective offices of either fund. A number is issued to the applicant upon registration. In addition, every business is required to hold a valid business permit – issued by the local authority of the region the business is set up in. This is a function discharged by the relevant local authority but the applicant must have obtained office space prior to submitting this latter application.[34]

Kenya does not have a special tax rate for SMEs. All corporate entities constitute a single tax class for income tax purposes. The question whether a lower tax rate for SMEs is the right incentive is an open question, however, given that other elements defining the business climate in Kenya remain challenging as chapter four discussed.

From a tax planning perspective, the statutory requirement in Kenya for venture capital companies to be incorporated as limited liability companies,[35] limits the flexibility of fund managers to employ tax transparent fund structures.[36] Tax transparent fund structures are also known as 'pass through vehicles'. They ensure that rather than tax recognition arising at the point of earnings, it occurs at the point of distribution. That is to say, whenever a fund manager disposes of its shareholding in a venture company by whatever exit strategy, the earning from the shares sale is not open to taxation, but becomes taxable once it is distributed to investors, and when fund managers receive their compensation under the investment agreement. Tax liability is effectively not avoided; in fact, it is not even delayed. It is made a

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[32] ibid s 7

[33] National Social Security Fund Act Cap 258 Schedule II < http://www.kenyalaw.org/kenyalaw/klr_app/view_content.php?ContentHistoryID=18381> accessed 18 September 2011.

[34] s163-165, Local Government Act Cap 265 of 1963

[35] Rule 3, Income Tax (Venture Capital Enterprise) Rules 1997, under the Income Tax Act of 1974, cap 470 Laws of Kenya;

[36] Capital Markets Authority Act of 1990, s 23, Cap 485A; Capital Markets (Registered Venture Capital Companies) Regulations, 2007.

little 'smarter' – ensuring taxation happens once on the same batch of earnings accrued. In a sense, it qualifies the 'accruals' principle under the Income Tax Act, subjecting it, in the case of private equity, to a time and party context.

The desirability of availing such tax transparent structures is defensible. Firstly, it affords investors the possibility of maximum return, through obviating the inevitability of a double tax effect: the income of the company is taxed, and the income of the shareholder is taxed. A tax transparent fund structure would allow fund managers to realize maximum earnings, and allow shareholders a potentially higher volume of returns. The Kenya Law Reform Commission agrees with this analysis,[37] and evidences the legal policy aim of availing such a choice. As discussed in the preceding chapter, the Limited Liability Partnership Bill 2010 is currently pending Parliamentary approval,[38] together with the proposed Companies Bill to replace the Companies Act of 1962. The limited liability partnership structure is intended to avail the tax transparent functionality.[39]

7.4.2 Taxation of Management and Professional Fees

Management and professional fees that are deemed to accrue in Kenya are taxed at 20% for non-residents, and 5% for residents. Royalty is taxed at 20% for non-residents, and 5% for residents. Tax on rents (on moveable and immoveable property) and premiums stands at 30% for non-residents, and 3% for residents.[40]

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[37] Interview with Mr. Johnston Okello, Senior State Counsel, Kenya Law Reform Commission, (Nairobi, Kenya, January 2010)

[38] Kenya National Assembly, Bill Tracker, Bills 2011, 4 http://www.parliament.go.ke/index.php?option=com_content&view=article&id=113:bill-tracker&catid=46:house-business accessed 24 February 2012

[39] Interview with Mr. Okello, (n 38), 2010

[40] Income Tax Act of 1974, Third Schedule,

7.4.3 VAT and Other Business Taxes

Value Added Tax (VAT) is payable on most goods and services in Kenya since 1990 at the rate of 16%.[41] VAT is payable on all taxable goods and services generally, except for zero-rated supplies (including exports, machinery, agricultural equipment, pharmaceutical products).[42] From a tax planning perspective, this is an inconsequential tax strand for private equity.

There are additional charges, however, that could pose significant and sometimes not-readily-discoverable cost to business operations. The Local Government Act of 1963[43] empowers local authorities to regulate all aspects of business activity falling within their municipal boundaries. This regulatory activity comprises licensing, the charging of fees, and compliance enforcement with administrative/regulatory procedures.

It is significant that municipality charges are neither standardised nor published for transparency. Besides, these charges are not contained in one centralised, searchable database.

From a business operational level, these municipal charges, while legitimate, tend to impose additional 'tax' centres that vary by type and value, especially where a business has operations and or offices in different municipalities across the country. The cost of discovery becomes an additional cost to doing business. The lack of transparency in business regulation with regard to municipal charges is an area that ought to be addressed if the business climate is to be optimised for such investments as private equity.

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[41] Value Added Tax Act of 1990, Cap 476

[42] Kenya Revenue Authority, 'VAT Overview' < http://www.revenue.go.ke/index.php/domestic-taxes/vat/66-vat-overview> accessed 18 September 2011.

[43] Cap 265 of 1963: for instance, s 148 (power to impose fees and charges for business licenses and permits), s 163A (powers in relation to the grant of business permits) and s 164 (powers in relation to licenses), Laws of Kenya

World Bank Doing Business statistics for 2012[44] indicated that corporate tax, social security contribution and value added tax involve significant bureaucracy in Kenya, with each respectively taking up 60, 57 and 276 hours of corporate time in compliance (total: 393 hours). This is a substantial transaction cost for businesses, and it would greatly benefit from policy review to reduce the bureaucratic burden.[45]

7.4.4 Capital Gains and Dividends

Capital gains could be defined as any income that is realised out of an investment, and the simplest computation would be the difference between the eventual sale price and the original purchase price of an asset (e.g. from stock or share disposal). Capital gains tax is a tax that is payable whenever a property owner sells the property at a higher price than what it was bought for. In this sense, the taxation of capital gains has come to be styled a “wealth tax”. This tax can be imposed on earnings derived from the disposal of capital assets (such as buildings, plant and machinery) or the disposal of property in corporate stocks. It is the latter that is of direct interest to private equity investors, as all capital gains in the practice of private equity derive from share dealings.

To appreciate the capital gains tax framework for private equity, it is useful to recall the structure of the private equity revenue streams. Fund managers extract value from their investments in several ways. These include earning a dividend stream annually from a cash-generating business, linked to the capital structure of its investment in the venture company. A dividend stream would usually be supported by a shareholder loan facility, or other debt-

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[44] The World Bank, ‘Doing Business’ (Index 2012 - Kenya) <http://www.doingbusiness.org/data/exploreeconomies/kenya/#paying-taxes> accessed 5 May 2010.

[45] id

like finance provided to the venture company (including mezzanine finance, and participating preferred equity). Secondly, progressive share vestings in some of the shareholders could involve periodic payouts to the investor, and these represent capital gains. Thirdly, when investments are exited, the investor's entire shareholding is frequently transferred either to the company or to another investor (or to the public if the exit is through an IPO), with the investor unlocking the full financial value of the share assets. It is clear thus that capital gains can be realised at progressive stages of an investment's life cycle.

In Kenya, there is currently no wealth tax on individuals under the Income Tax Act following share disposals.[46] Under section 7A(7) of the Income Tax Act , gains from trading in venture capital enterprise shares are treated as dividends. Within the meaning of section 7 of the Income Tax Act 1974, dividends are taxable income in Kenya. However, the deemed dividends under section 7A(7) are exempted from tax under Schedule One of the Income Tax Act. Under paragraph 46 of Schedule One thereof, dividends received by a registered venture capital company are exempt from tax.

Under paragraph 47 of Schedule One of the Income Tax Act, gains arising from trade in shares of a venture company earned by a registered venture capital company within the first ten years from the date of first investment in that venture company by the venture capital company are exempt from tax, provided the venture company has not been listed in any securities exchange operating in Kenya for more than two years. This is consistent with the provisions in Schedule 8 of the Income Tax Act 1974, paragraph 21, where gains realised in share transfers by corporate investors are exempted from income tax deductions.

[46] Charles Muchuha and David Kabeberi, 'Githongo Tax Consultants' < http://githongo.com/docs/Githongo_Tax_Newsletter_2006.pdf > - Capital gains tax (CGT) on property sales (land and building) was suspended in Kenya in 1985, but, re-introduced in the 2006 budget and came into effect in January 2007

To take advantage of this tax planning option, a venture capital company must be registered as such with the KRA Commissioner under the Venture Capital Enterprise Rules.[47] Several observations are worth making with respect to the foregoing discussion of the capital gains framework in Kenya.

Firstly, there is an apparent system of repeated data capture within the regulatory requirement of 'registration as a venture capital company'. This requirement applies to private equity practice under the Capital Markets Authority Act, Cap 485A of 1989, the Income Tax Act and the Venture Capital Enterprise Rules. Various regulatory and governmental agencies require businesses to abide by prescribed bureaucratic processes in order to access specific facilities. Because data has historically been generated and kept manually in paper form, there was no framework for cross-government data capture. The problem is exacerbated by a plethora of licensing regimes. For purposes of this chapter, however, the point to note is that private equity businesses are required to provide the same set of corporate information to each regulator on matters impacting taxation. It is a cost, nonetheless.

Secondly, it would appear that capital gains realised from investments held for more than 10 years, whether the venture company remains private or not, would attract a capital gains tax – but the law does not seem to attach a specific tax band to the levying of such a tax. The assumption is that at the elapse of the ten year window, tax liability accrues on the regular principles as to threshold. This has interesting ramifications for investment design, especially from a hold-period perspective. It was shown at chapter 5 that most fund managers in Kenya prefer a strategy of holding investments for between 5 and 7 years. From the framework of the discussion in this section, this appears to be a sensible strategy for tax planning purposes. In other words, given the statutory reality of the tax-free window, it

[47] Venture Capital Enterprise Rules, 1997 (n 36)

makes sense to plan private equity investments in Kenya in such a way that would reduce the total investment tax burden through divesting within the ten-year period.

7.4.5 Compensating and Withholding Tax on Dividends

Although there is no wealth tax on individual earnings, a compensating tax at the corporate level is payable if a company distributes dividends out of capital gains. Where a tax liability arises consequent upon dividend distribution, the distributed dividend is taxed at the applicable company tax rate.[48]

Similarly, if a company is entitled to claim depreciation for tax at a rate higher than the account depreciation (e.g., where differences in rates or capital allowances exist[49]), the company will be liable to pay a compensating tax. Compensating tax is administered through a Dividend Tax Account (DTA), which every corporation is required by law to maintain.[50] The DTA traces the movement of dividends received or paid and taxes paid, and from a purely functional perspective, appears to aid in the efficiency of tax administration. Compliance with this requirement did not appear to be an issue to interviewed fund managers – so it is probably working well for both regulator and economic players.[51]

The payment of withholding tax on dividends can be legally avoided if companies pay dividends to shareholders in the form of bonus shares or through a share repurchase programme (a process whereby a company redeems its own shares from selling shareholders).[52] Bonus shares issued on a pro rata basis to existing shareholders are not at

[48] Income Tax Act 1974 s 7A(5); cf: Kairo Thuo, 2009: 'Kenya – Compensating Tax: The Forgotten Levy' (*All Africa,* 10/10/2009) <http://www.allAfrica.com/stories/200909110078.html> accessed 11 September 2009.
[49] In this case, the accounting profits will be higher than the tax profits, and the difference becomes liable for compensating tax.
[50] Income Tax Act 1974, s7A
[51] Interviews with FM101 – FM113, Nairobi, Kenya, August 2009; January 2010.
[52] Income Tax Act 1974, s7

present taxable.[53] Stock dividends ordinarily become taxable only in cases where they are not issued on a pro rata basis (that is, according to the respective shareholdings) to eligible shareholders.[54] Dividend distributions under a share repurchase programme are not subject to any capital gains tax.[55]

There are other circumstances under which dividends are taxed in Kenya. Under section 7(1)(d) of the Income Tax Act of 1974, if a company issues debentures or redeemable preference shares to its existing shareholders as part of a recapitalisation scheme, the receiving shareholders are deemed to realise a gain in the form of dividend, of an amount equal to the nominal or redeemable value of the issued securities, whichever is greater.

Under section 7(1)(e) of the Income Tax Act of 1974, where a company issues debentures or redeemable preference shares to its existing shareholders at a price lower than the nominal or redeemable value of the relevant security, whichever is greater, the receiving share issue is deemed to include the payment of a dividend payment to the receiving shareholder, on those held shares, of an amount equal to the difference between the nominal or redeemable value and the market value of the under-priced securities. However, if the price of the debentures or redeemable preference shares is greater than 95% of the nominal or redeemable value, this requirement does not apply (as the excess is insignificant in value).

Under section 7(1)(f) of the said Income Tax Act, if a company issues ordinary shares or other shares or rights to acquire shares to any of its shareholders pro-rated to their existing shareholding in the company, the distribution is treated as a dividend to the receiving shareholders to the extent of the proportionate increase in their ownership of the company.

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[53] ibid, s7
[54] ibid, s7(1)
[55] ibid

For private equity, these are important law and policy points when it comes to the design of portfolio management policies. Since cash flow rights are embedded in the shares held by each class of investor, it would appear that share class rights assume a distinctly important place in investment negotiations. In this sense, tax law is a potentially important factor in investment design.

7.4.6 Deductible Expenses for Tax Purposes

Kenyan tax policy recognises that certain business costs constitute legitimate justifications for deductions from overall tax liability. Maximum utilisation of available avenues for lessening the tax burden through permissible deductions is a good tax planning tool for any business venture, including private equity. The following paragraphs summarise some of the more relevant tax deductible cost centres for a private equity investor or fund manager.

Tax losses in Kenya are carried forward perpetually to be allowed against future income. This is allowed only on income from specific sources, including business activities.[56] But there is no tax-loss transferability between entities. Losses are not allowable as tax deductions under Kenyan law. Expenses are also not allowable on the dividend income or any other income of the taxable person. This is because dividends are taxed on a withholding basis as a final tax.

For resident corporate shareholders controlling less than 12.5% shareholding in the dividend-paying company, however, dividends are tax-exempt.[57] Dividends received by financial institutions are also tax exempt. But should such non-taxed income (such as capital

[56] ibid, s 36
[57] ibid, s 7(2), Cap 470, Laws of Kenya

gain or profits on capital allowances) be distributed, a compensating tax may arise. Compensating tax is an additional charge levied by the KRA, technically penalising non-payment of tax.

Expenditure incurred wholly and exclusively in producing income or profits is tax deductible.[58] In this category, research and development costs are permissible deductions.[59] Similarly, business advertisement costs are permissible deductions.[60]

Interest on corporate debt incurred wholly and exclusively in the production of income is deductible, and companies can maximise this tax advantage. Section 16(2)(j) of the Income Tax Act, however, offers a sobering regulatory stricture on thin capitalisation for entrepreneurs inclined to over-leverage their companies with the view to minimising the tax burden. This section provides that where a company (not being a bank) is controlled by a non-resident person, interest deductibility is allowed only to the extent that the total indebtedness of the company does not exceed three times the paid-up share capital and revenue reserves.

Bad debts and doubtful debts incurred in the production of the company's income and which the Commissioner determines to be bad or doubtful, are also permissible deductions under section 15(2)(a) of the Income Tax Act. Expenditure of a capital nature in lease acquisition for business premises, specifically as it relates to attendant legal and stamp duty costs, are tax deductible under section 15(2)(d) of the Income Tax Act. Maintenance costs (but not the costs of extending, remodelling or other new structures) for business premises are

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58 ibid s 15(2)
59 ibid Second Schedule, para (n)
60 ibid, para (p)

also tax deductible.[61] The law makes provision for guidelines to govern the administration of tax deductible bad debts.[62]

For fund managers thinking about public listing as an investment exit strategy, the costs of authorisation and share issuance are legitimate deductible costs for tax purposes.[63] Furthermore, the actual listing costs[64] are tax deductible, and so are any rating costs for listing purposes.[65] Under the third schedule of the Income Tax Act, an extra tax break is offered to businesses listing for the first time on any securities exchange in Kenya, and provided it lists at least 30% of its shares: such a company would pay corporation tax rate at 25% for the first five full years following the listing (instead of 30%).[66]

Besides the foregoing, the employment of lease financing arrangements in asset acquisition offers a useful tax-planning tool for business operators in Kenya. Lease payments made under capital and operating leases are tax deductible on the lessee.[67]

7.4.7 State Subsidies

Generally, in Kenya, there are very limited tax incentives for investments, and especially such as would be distinctly attractive to private equity. At the general economic level, a few designated enterprises operating under Economic Processing Zones manufacturing goods for export enjoy limited fiscal incentives. Such firms enjoy a tax holiday of 10 years, and thereafter, for a limited period of time, enjoy a reduced tax rate of

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[61] ibid, para (f).
[62] Income Tax Act of 1974 Cap 470, Guidelines on Allowability of Bad Debts 2011, <http://www.kenyalaw.org/kenyalaw/klr_app/view_content.php?ContentHistoryID=25474> accessed 18 September 2011.
[63] ibid para (s).
[64] ibid para (ss).
[65] ibid para (u).
[66] Para.1(d), Third Schedule, Income Tax Act of 1974, Cap 470.
[67] Income Tax Act of 1974, s 36

25%. Tax exemptions are also available for organisations involved in charitable, medical, alleviation of poverty and religious activities.

The main fiscal incentive for private investments in small and medium enterprises so far relates to the provisions made under the Income Tax (Venture Capital Companies) Regulations, 1997. This reality becomes an important law reform agenda in markets that experience low impact of private equity.

7.4.8 Risk of Double Taxation

On the avoidance of double taxation and the reduction of the tax burden, Kenya currently has only ten double tax treaties (DTAs) between herself and foreign governments.[68] Foreign tax relief is limited only to these countries. This is a very narrow range of DTAs, and could have implications for tax avoidance strategies of multinational and foreign investors. The following illustration serves this point.

Spencon Ltd, a construction multinational corporation, headquartered in Kenya but operating extensively in the East African region, found itself facing multiple double taxation on its income generated in different East African countries, which did not have double tax avoidance treaties. To overcome this barrier, Spencon incorporated a holding company for its Africa businesses, in Mauritius, a Sub-Saharan Africa country that has extensive double tax agreements with most countries in Africa.[69]

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[68] Republic of Kenya, Ministry of Finance, 'Avoidance of Double Taxation' <http://www.treasury.go.ke/index.php?option=com_docman&task=cat_view&gid=111&Itemid=151> accessed 05 October 2011 – the list includes agreements with the Kingdom of Sweden, Republic of Zambia, United Kingdom of Great Britain and Northern Ireland, Federal Republic of Germany, French Republic (2 agreements), India, Kingdom of Denmark, Kingdom of Norway and Canada. This is a curious list when viewed from the perspective of Kenya's external trade statistics. One would imagine that DTAs would strongly follow the direction of the country's external trade and investment policy – but the Kenyan reality does not.

[69] Spencon, 'Company Profile' < http://www.spencon.com/> accessed 5 October 2011.

7.4.9 Taxing Stock Options

Stock options are a compensation and incentive tool used by companies to align the interests of management with those of investors. In practice, they involve the issuance of shares to employees as part of their compensation packages, subject to benefiting employees achieving predetermined performance targets.

There are three possible methods of taxing stock options, and these differ across jurisdictions. They can be taxed either upon –

(i) grant, or

(ii) vesting or

(iii) exercise.[70]

Whenever a company 'grants' stock options to its employees, the employees must 'make an election' whether to take up the options or not. If they do, then the beneficial interest in the option crystallises, but may not necessarily pass immediately to the grantee.[71] They would be conditioned on specified events. At the occurrence of the specified events, the benefit either hardens in entirety, or is subjected to a progressive vesting programme.[72] It is important to note that crystallisation of the beneficial interest through the mere act of vesting or grant does not, in fact, unlock the financial benefit in the option.[73] That happens only upon exercise – that is to say, when the grantee of the options liquidates those options through a share transfer in consideration for the relevant equivalent monetary value.[74]

[70] Jack S Levin, Structuring Venture Capital, Private Equity and Entrepreneurial Transactions, Martin D Ginsburg, Donald E Rocap, Russell S Light (eds.), (Aspen, 2011), 2-26
[71] ibid
[72] ibid
[73] ibid
[74] ibid

The taxation of stock options at 'grant' or upon 'vesting' would appear to be inefficient because the gain potential of the stock option remains locked at either of these intermediate stages. In this sense, such a taxation strategy is disadvantageous to the holder of the options, making it an inefficient employment compensation tool. It is therefore reasonable to argue that in jurisdictions that tax stock options at any of the two intermediate stages, the popularity of stock options as an employment compensation tool would be low or altogether absent.

Taxing stock options upon 'exercise', in contrast, is more efficient since it is at this point that the holder of the option realises the gain. In addition to taxing stock options at exercise, the tax treatment of the gain is important. The gain could be treated as ordinary income, or treated as a capital gain. Taxing stock options as capital gains has two potential effects: firstly, it lowers the overall tax burden, since capital gains are generally taxed lower than ordinary income; secondly, it can potentially defer the time when the tax becomes due, and, in some cases, dissipate the permanent likelihood of a tax ever arising, especially where such options are held over the long term. Where stock options are conferred in conjunction with a restricted stock, taxation happens upon extinction of the restriction.

In Kenya, the gain in a stock option is deemed to be realised upon grant, hence taxed upon grant.[75] Furthermore, since capital gains are not taxable on investment income, tax treatment of stock options is as ordinary income.[76] It is thus unsurprising that as a general practice, remuneration of employees by way of stock options is uncommon in Kenya. As of 2011, for instance, there were only 7 registered Employee Share Ownership Schemes (ESOPs). For private equity practitioners in Kenya, this is an issue that policy makers could review.

[75] Income Tax Act of 1974, s 5(1)(a)
[76] ibid, s 3(2)(f) and s 15(3)(f) – capital gains on property transfers are taxable – but gains from investment share transfers is exempt.

7.4.10 Fiscal Incentives for Research and Development

Research and development, though recognized to play a crucial role in the development of a country, is practically absent as a business engagement in Kenya.[77] Kenya's Vision 2030 which aims to convert Kenya into a middle-income industrialised economy by the year 2030 is anchored on the three pillars of science, technology and innovation – yet anecdotal data places the total stock of public funding for research and development at only 0.3% of the country's gross domestic product.[78] The private sector's participation in R&D activity remains low.

Research findings of the few state-funded research institutions generally reach the policy implementation or commercialisation phase in inconsequential amounts. This is generally corroborated in the 2010 UNESCO Science Report – which places patents registered to Kenya at 24 compared to 462 registered to South Africa under the review period. The experience of Kenya Industrial Research and Development Institute (KIRDI), established by an Act of Parliament in 1979, illustrates why this is the case. In the last decade, it has spent over KES500 million in research and development, yet on its website, there are no published research findings. In the list of its 'achievements', research and patent registration are not listed. Without knowledge management, aggressive commercialisation of ideas, and clear pathways linking innovation to large industry, noble intentions contained within the vision that created KIRDI will remain elusive.[79]

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[77] Government of Kenya, Ministry of Trade and Industry, 'the Private Sector Development Strategy' (2006-2010) <http://www.psds.go.ke/index.php?option=com_content&task=view&id=28&Itemid=32> accessed 19 October 2011

[78] Budget Estimates 2011/2012 – National Council for Science and Technology – KES 300 million assigned, supporting 150 research projects.

[79] KIRDI, 'Achievements,' http://www.kirdi.go.ke/AboutUs/Achievements.aspx accessed 28 February 2012

The current realities in Kenya suggest that links between researchers and technology developers on the one hand, and industry on the other, would be weak and shallow. It is therefore not surprising that there is a chasm between university research and industry, and weak uptake of academic research into the commercial world. Furthermore, expert mobility between academia and industry, and vice versa, is yet to become widespread as a practice. University research, on its own, remains low key, according to a recent ranking of universities around the world.[80]

Apart from the tax deductibility of R&D expenses, there are no fiscal incentives for research and development in Kenya. This partly explains why within the world of private equity, R&D investments are not common in Kenya. In chapter 4, it was shown that ICT penetration in Kenya remains very low, and ICT investments constitute a very low proportion of the market segmentation of private equity in Kenya.[81] This is set to change following massive infrastructure development in ICT carrying systems in Kenya. Two undersea fibre optic cables, 5,000km in length, have been landed in Kenya, delivering high-speed internet connectivity.[82] Overland, the government has completed the laying of 5,500km of terrestrial fibre optic backbone cables all over the country – to support business process outsourcing, digital villages around the country, and techno-cities currently under development.[83]

Over the same period, there have been investment-grade technology innovations cultured in Kenya, with press reports asking questions like "*Is Kenya the Next Silicon*

[80] One fund manager observed: "We really do not make time for researchers – we are busy." Interview with FM105, Nairobi, Kenya, January 2010.
[81] ch 4, 123
[82] Republic of Kenya, 'Second Annual Progress Report, On the Implementation of the First MTEF (2008-2012) of Kenya Vision 2030' (Ministry of Planning and National Development) <http://www.opendata.go.ke/api/file_data/zF8ojyoGLyfgA97OZZnZuRojLqC-FUCnDJgVVJOFD-4?filename=Vision%25202030%2520progress%2520report.pdf >
[83] ibid, xxv

Valley?"[84] Current trends demonstrate an increasingly rapid assimilation of ICT in Kenya, and it is predictable that this is the next big thing in Kenya as the economy transitions into a knowledge economy.[85] Significantly, this is a core pillar of the country's development blueprint, Vision 2030.[86] Evidence from Israel and USA illustrate the potential financial and economic benefit that a country could reap from policy reforms that entrench and high-profile ICT investments, backed up by a strong R&D ethic.[87]

7.5 Evaluation of the Tax Environment for Private Equity

The chapter started by predicting five ways in which a country's tax law and policy would likely impact private equity. These were (i) possible impacts on fundraising for private equity, (ii) impact on innovation through increased research and development activity, (iii) impact on selection of fund structures, as well as on (iv) capital structuring (investment design through choice of securities), and (v) impact on exit options and strategies.

After canvassing the structure of the tax framework as it applies to private equity investing, it is illuminating to analyse the extent to which the overall tax environment provides an efficient environment for private equity to thrive in Kenya. In doing this, it must be remembered that tax law and policy is but one piece of the wider puzzle defining the private equity environment in Kenya. While important, therefore, tax law and policy offer but a small body of evidence explaining the condition of the private equity industry in any legal jurisdiction, not just Kenya. It is an important little piece, nonetheless.

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[84] Harry Hare, 'Kenya: Is Nation Inching Closer to Being Next Silicon Valley?' (*Business Daily, 25 March 2010*) <http://allafrica.com/stories/201003250882.html> accessed 05 October 2011

[85] (…), The Next Silicon Valley: 'Mobile Apps Growth in Kenya Catches Tech Investors' Eyes' <http://thenextsiliconvalley.com/technews/7111/mobile-apps-growth-kenya-catches-tech-investors%E2%80%99-eyes> accessed 05 October 2011

[86] Republic of Kenya, Vision 2030, (n 82)

[87] ch 3, 69,75

It is settled, from discussions in chapter 6, that there was no choice on investment vehicles (fund structures) other than the company limited in Kenya. Tax law and policy, as it currently stands, offer no additional advantages to private equity as to fund structure choice.

Fundraising is a function of a myriad of factors. It was seen earlier that a majority of Kenyan based private equity funds are domiciled outside Kenya, and source their investment capital through the international markets. Domestic sources of fundraising for private equity, it was observed earlier in this chapter and in earlier chapters, remain suppressed. From the tax review above, a couple of observations appear pertinent.

The absence of tax incentives to invest in private equity could be wielding a negative effect on private equity fundraising locally. It was shown that there is no special tax rate for investing in small and medium enterprises. It was also illustrated that there is no private-equity specific tax or other fiscal incentive for investing in high-risk innovations. This could find some explanation in the country's generally depressed market for research and development – although causation could run the other way as well. Viewed in a wider context, this reality is significant, as the next paragraph points out.

The PSDS 2006/2010 identified an important gap in the business relationships between Kenya's blue chip companies and the country's SME sector, and observed that in a more mature economy, the blue chip corporates would create opportunity for the smaller corporate sector to provide auxiliary services – which include research and development, innovation and similar services that feed into the larger operational frameworks of the blue chip companies – as the Israeli venture capital model reviewed in chapter three illustrates. Without these linkages, it can be argued that investing in innovative businesses without a clear route to market would be assuming unreasonable investment risk. Capital holders, motivated by profit, would hold back, suppressing fundraising for private equity. The implication of the foregoing, from a tax law and policy perspective, is that promoting investments in the SME sector through creating tax breaks or other incentives for businesses that invest in fund managers whose main portfolio is the provision of enterprise finance to the SME sector, would do private equity a lot of good.

Secondly, government's policy of closely regulating the investment portfolio selection by pension funds – and all other public funds – has achieved in Kenya an ERISA-type effect prior to the 1978 clarifications.[88] These include, for instance, regulatory requirements limiting pension schemes managing under one hundred million shillings to 100% investments in government securities. Without a formal change in official policy, pension, insurance and public trust funds exposure to private equity will be thin, further suppressing the local market for private equity fundraising.

The absence of a capital gains tax is, on the face of it, a good thing, as it has the effect of projecting high returns vis-à-vis investment costs. The continued existence of a compensating tax, however, in spite of industry wisdom it serves no positive economic role even from purely tax policy perspective, stands in need of policy review. Some tax experts opine that the compensating tax is an unnecessary and unjust tax, and ought to be repealed from the Income Tax Act.[89] It is not explicit in the law at what point the principle of 'dividend' becomes recognisable for tax purposes: is it at the time of distribution of the capital gains from investment exits, therefore at the GP level – or is it at the LP level? A tax transparent fund structure might make this objective clearer. It has been discussed above how proposed legislative changes to the Companies Act of 1962 is set to introduce wider choice of business organisational forms that would improve tax planning choices for investors.

[88] ch 5, 159-169
[89] Interview with TX77, Legal Manager, Nairobi, Kenya (August 2009)

7.6 Conclusion

The possibility of tax planning for private equity investments is not entirely efficient in Kenya. It is a good thing for the private equity industry in Kenya that a capital gains tax on investment income is not levied. This country advantage is eroded by the presence of the compensating tax structure. To give businesses the full benefit of the absence of a capital gains tax, there is a defensible case for a review of the tax policy on the compensating tax structure.

Kenya's tax policy on the taxation of stock options is inefficient to the extent that it deems a gain to be realised when in fact the option has not been exercised. There is a need for law reform on this point to ensure that stock options become amenable to tax when the value in the option is redeemed, that is, upon exercise.

The findings in this chapter also establish a case for an expansion of incentives for R&D, as well as the need for encouragement of private investments in Kenya. On the basis of the findings in this chapter, a model for tax law reform aimed at benefiting the private equity industry is recommended.

Most of the fund manager respondents, however, indicated that taxation is not a significant entry barrier and that operationally, the prevalence of investment opportunities in Kenya, tended to off-set regulatory inefficiencies from a tax law framework. Respondents from among the auxiliary industries, however, opined differently: that policy and regulatory inefficiencies ought to be addressed, regardless of whether direct harm is suffered.

8

THE ROLE OF COURTS IN FINANCIAL CONTRACTING

8.1 Introduction

Private equity contracts are long-term agreements, and fall among that class of contracts called 'relational contracts'.[1] Relational contracts theory attempts to explain the dynamics that hold parties together in a contractual relationship, especially one like private equity's that subsists for a prolonged period of time. Originated by Macneil as a radical restatement of contract law, it has attracted competing explanations, mostly grounded on what a relational theory of contract implies for the courts. Hence for instance, Goetz and Scott[2] perceive the role of the courts to be that of resolving contractual disputes by supplying terms that promote the contractual relationship. This view presupposes the competence of courts who engage in interpreting the contract ex-post. Schwartz,[3] on the other hand, perceives the role of the courts to be strictly interpretative, on the face of the record. This viewpoint presupposes, on its part, the perfect competence of courts in interpreting and understanding contract terms, whatever they may be. Macneil viewed the role of courts to be the determination of the 'norms' underpinning the contract, and enforcing those norms, a view that tacitly suggests omniscience on the part of courts.

Posner[4] adopts a fourth view, holding that courts are radically incompetent: both in understanding the intention of the parties and in the interpretation and application of declared contractual terms. In consequence, he holds up the reputational nature of contracting attitudes,

[1] Ian R Macneil, *The New Social Contract: An Inquiry Into Modern Contractual Relations* (Yale University Press, 1992)
[2] Charles Goetz and Robert E. Scott, 'Principles of Relational Contracts' (1981) 67 Virginia Law Review 1089-1129
[3] Alan Schwartz, 'Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies' (1992) 21 Journal of Legal Studies 271
[4] Eric A Posner, A Theory of Contract Law Under Conditions of Radical Judicial Error (1999) University of Chicago, Chicago Working Paper in Law 2

proposing that while parties honour contracts out of a desire to enjoy repeated custom and general positive commercial standing, they also apply considerable effort developing legally enforceable agreements, because courts and contract law remain central to agreements.

Schwartz shifts the burden to the courts entirely, while Macneil reposes the duty on the parties while asking the courts to somehow divine contested norms. Posner argues that even under conditions of "radical judicial error", courts have a deterrent effect on opportunistic behaviour, introducing a 'commitment effect', which has the strongest impact where high-value contracts are involved.[5] Scott argues that Mcneil's relational theory over-emphasises the social aspects of contract relationships, ignoring the central role of consent,[6] and Posner places greater emphasis on opportunity cost (therefore, parties to a contract avoid breaching it if the cost of remedying the breach is higher than the benefit of observing the contract).[7]

Admittedly, the rich and textured discourse on relational contracts is beyond the scope of this work. However, adopting Posner's notion of 'high-value undertakings', it is ventured that perhaps at the heart of the private equity investment decision in emerging markets sits the fundamental question: to what extent property rights are secure. Secure financial contracts ensure investment ventures are profitable.[8] In practice, 'profitability' is achieved through each contracting party faithfully undertaking their end of the bargain. The fact that so many commercial contracts are entered into, repeatedly, suggests that the benefits of contracting outweigh the costs of contracting. This chapter is devoted to a discovery of contracting practices within the Kenyan private equity industry, primarily from a contract enforcement perspective, whether through courts or otherwise. The 'voices' of interviewed fund managers

[5] Ibid, 8, 14
[6] Robert E Scott, 'A Relational Theory of Default Rules for Commercial Contracts: in The Law and Economics of Risk' (1990) 19(2) The Journal of Legal Studies 597-616
[7] Posner, Radical Judicial Error (1999) 14
[8] Joseph J Norton, 'Taking Stock of the First Generation of Financial Sector Reform' (2007) SMU Dedman School of Law, Legal Studies Research Paper 9, 32 <http://ssrn.com/abstract=981226> accessed 5 July 2010

and legal professionals come strongly through, and the analysis of Kenyan law as it relates to contract enforcement, and is evaluated through these empirical findings.

In exploring the foregoing themes, it seems inevitable to colour that discourse with the notion of property rights. Research appears to show that in countries with weak property rights, there is a concomitantly low level of external investments both at the company and country levels.[9] This is readily borne out by UNCTAD statistics on foreign direct investment flows.[10] Property rights have been shown to encourage investment (Besley 1995;[11] Knack and Keefer 1995;[12] Johnson et.al 2002[13]), entrepreneurship (Murphy et. al 1991)[14] and innovation (Stern, Porter, and Furman 2000).[15] Recently economists have recognized that property rights can catalyze "collateral benefits" which can raise growth through indirect channels, for example, through progressing financial sector development (Kumar et. al,[16] 2001; La Porta et. al, 2002;[17] Claessens and Laeven, 2003;[18] Beck et. al, 2005[19]). Alternatively, it can improve contracting efficiency by allowing borrowers to pledge collateral (De Soto, 2001;[20] Djankov

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[9] Stephen Knack, Philip Keefer, 'Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures' (1995) 7:3 Economics and Politics 207-28; Cf: Mauro, Paolo, 'Corruption and Growth' (1995) 110:3 Quarterly Journal of Economics 681-712; and Acemoglu, Daron, Simon Johnson and James Robinson, 'The Colonial Origins of Comparative Development: An Empirical Investigation' (2001) 91:5 American Economic Review 1369-401

[10] UNCTAD, 'FDI Statistics/World Investment Reports' <http://www.unctad.org/> accessed 5 July 2010

[11] Timothy Besley, 'Property Rights and Investment Incentives: Theory and Evidence from Ghana' (1995) 105:3 Journal of Political Economy 903-37

[12] Knack et al, Institutions and Economic Performance, 1995 (n 9)

[13] Simon Johnson, John McMillan, Christopher Woodruff, 'Courts and Relational Contracts' (2002) 18(1) Journal of Law, Economics and Organization 221-77

[14] Kevin Murphy, Andrei Shleifer, and Robert Vishnu, 'The Allocation of Talents: Implications for Growth' (1991) 106:2 Quarterly Journal of Economics 503 – 30

[15] S Stern, M.E. Porter and J.L. Furman, The Determinants of National Innovative Capacity. NBER Working Paper 7876 /2000

[16] Krishna B. Kumar, Raghuran G. Rajan and Luigi Zingales. What Determines Firm Size? NBER Working Paper 7208/1999

[17] Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer, and Robert Vishny, 'Investor Protection and Corporate Valuation' (2002) 57 Journal of Finance 1147-1170

[18] Stijn Claessens, and Luc Laeven, Financial Development, 'Property Rights and Economic Growth' (2003) 58 Journal of Finance 2401-2436

[19] Thorsten Beck, , Asli Demirgüç-Kunt and Vojislav Maksimovic 'Financial and Legal Constraints to Firm Growth: Does Firm Size Matter?' (2005) 60 Journal of Finance137-177

[20] Hernando De Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere* (New York, NY: Random House 2001)

et.al 2007;[21] Besley and Ghatak, 2009).[22] In other words, a strong system of property rights appears indispensable to the emergence and development of financial markets.

It is striking that the causality vein in the foregoing works is uni-directional: from property rights to financial development. Bose, Panini and Chitralekha have modelled a bi-directional pathway between property rights and financial markets, suggesting a mutually reinforcing growth nexus.[23]

This work has attempted to build evidence around the notion that in a developing country, contracting efficiency is driven by laws and legal institutions.[24] Property in a financial investment, of course, is the financial worth of the investment, represented physically in the security instruments issued to the investor, and the contract evidencing the same. The extent to which the security of property rights is linked to the law, contracts and legal institutions in Kenyan private equity practice in many ways guides the discussion in this chapter.[25] In exploring this issue, this chapter contributes to the objectives of this study by attempting to discover the extent to which, in Kenyan practice, law is relevant to private equity market development.

To achieve the foregoing objective, this chapter is organised as follows. In section 8.2, consideration is given to the classification of contract terms (conditions and warranties), and an exploration of two contract law doctrines (reliance and expectancy), two notions that are

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[21] Simeon Djankov, Caralee McLiesh and Andrei Shleifer, 'Private Credit in 129 Countries' (2007) 84 Financial Economics 299-329

[22] Timothy Besley, and Maitreesh Ghatak , Property Rights and Economic Development, CEPR Discussion Paper 7243/2009

[23] Niloy Bose, Antu Panini Murshid and Chitralekha Ratha, Finance and Property Rights: Exploring Other Directions,

[24] Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else,* (Britain, Bantam Press, 2000)

[25] Douglas Cumming and Grant Flemming, 'A Law and Finance Analysis of Venture Capital Exits in Emerging Markets' (2002-03) Australian National University Working Paper Series in Finance, , <http://www.cbr.cam.ac.uk/people/armour.htm> accessed 5 July 2010. *Cf:* Douglas Cumming and Jeffrey McIntosh, 'A Cross-Country Analysis of Full and Partial Venture Capital Exits' (2003) 27 Journal of Banking and Finance 511-548

potentially value-maximizing in a relational contract. Section 8.3 introduces the general principles for contract-based conflict management in Kenyan private equity, drawing from the experiences of interviewed research participants. Section 8.4 is devoted to a discussion of commercial arbitration in Kenya, and the law is evaluated through the empirical findings of the attitudes of Kenya-based fund managers to resolving commercial disputes in Kenya, under Kenyan laws. Section 8.5 considers the framework for commercial litigation in Kenya, and similarly empirically assesses the contracting choices of fund managers in relation to dispute resolution under Kenyan law and Kenyan courts.

The chapter finds a general disinclination by the fund management community in Kenya to write in Kenyan dispute resolution options in their agreements. Consequently, section 8.6 provides a short review of the constraints facing the Kenyan judiciary, while section 8.7 offers some deductive reflections on what this chapter's findings mean for private equity development in Kenya. Section 8.8 concludes.

The general discussion and conclusions in this chapter arise from the interviews completed with the various stakeholders that participated in this study in Kenya. In particular, the general law relating to contract enforcement is explored in light of those interviews.

8.2 Classification of Contract Terms:

8.2.1 Conditions and Warranties

A well-established principle of common law is that the intention to create legal relations in commercial agreements is presumed.[26] This is also the position in Kenya as stated by the Learned Justice MK Koome in *Estate Finance Company of Kenya Ltd v Narok Transit*

[26] Jill Poole, Casebook on Contract Law (OUP, 8th edn, 2006) 185

Hotel Ltd & 2 Others [2011]eKLR, where, citing *Edwards v Skyways Ltd (1964 1 W.LR. 349),* she holds in part –

> "…in ordinary commercial transactions it is not necessary to prove that parties in fact intended to create legal relations. The onus of proving that there was no such intention is on the party who has asked that no legal effect is intended, and the onus is a heavy one."[27]

This presumption rides on a promise, however, as established in *Carlill v Carbolic Smoke Ball Company* [1893] 1 QB 256 (CA), where it was held that an advertisement carrying an intention to be bound through its acceptance is not a mere puff. In *Bowerman v Association of British Travel Agents Ltd* [1996] CLC 451 (CA), the plaintiffs booked a holiday through ABTA, a tour operator, which became insolvent prior to the date of the holiday. ABTA reimbursed the cost of the holiday but deducted £10 per head to cover insurance premiums paid on the holiday. ABTA argued this sum was excluded from the ABTA protection scheme. Plaintiffs claimed reimbursement of deducted sums, asserting a contractual relationship between ABTA and themselves obliging ABTA to fully reimburse, based on ABTA's holiday advertisement. In the first instance, it was held that the notice was too vague and inconsistent to constitute a legally enforceable promise. On appeal, this was overturned, with the Court of Appeal holding that the notice must be construed in the manner in which the consuming public would understand it – and that was ABTA made a promise to reimburse holiday booking costs should ABTA be unable to consummate the contract.

Private equity, made available under a commercial agreement, is presumed to carry the intention to create legal relations between the contracting parties. This presumption does

[27] High Court of Kenya Civil Case No.710/1999 (*National Council for Law Reporting*), paragraph 12 <http://www.kenyalaw.org/CaseSearch/view_preview1.php?link=13550320180909331435563> accessed 25 December 2011

not apply, however, where the allegation relates to unwritten agreements. In *Baird Textiles Holdings Ltd v Marks & Spencer plc*, [2001] EWCA Civ 274, [2001] 1 All ER (Comm) 737 (CA), Mance LJ held that –

> "(…) for a contract to come into existence, there must be both (a) an agreement on essentials with sufficient certainty to be enforceable and (b) an intention to create legal relations." Paragraph 59

He went on to say:

> "Both requirements are normally judged objectively. Absence of the former may involve or be explained by the latter, but it is not always so. A sufficiently certain agreement may be reached, but there may be […] no intention to create legal relations." Paragraph 60

The Kenyan position on collateral contracts is well-stated in *George M Musundi & 2 Others v Small Enterprises Finance Company Ltd* [2007] eKLR, (the SEFCO case) where Justice JG Nyamu observed –

> "a collateral contract can only be proved where it neither alters nor adds to the whole agreement as agreed by the parties or where the written agreement is silent."[28]

In the English case of *City and Westminster Properties (1934) Ltd v Mudd* [1959] Ch 129, it was held that the terms of a collateral contract can supersede conflicting terms in the written agreement.[29]English jurisprudence has also established that in certain circumstances, as was

[28] High Court of Kenya Civil Case No.1861/1995, <http://www.kenyalaw.org/CaseSearch/view_preview1.php?link=13409345844122979681569>, accessed 25 December 2011.

[29] In that case, the defendant leased a shop property from the plaintiff, and used the back rooms as a lodging. When the lease period came to an end and a renewal was due, the plaintiff inserted a clause in the draft lease to the effect that use of the premises as a sleeping quarter would not be permissible. While presenting the draft

the case in *J. Evans & Son (Portsmouth) Ltd v Andrea Merzario Ltd*, [1976] 1 WLR 1078 (CA), decided by Lord Denning MR, courts can determine that there exist two contracts, one a written agreement governed by the parole evidence rule, and one an oral agreement, to which the said rule does not apply. However, where a written contract carries an 'entire agreement clause' or any of its variants, collateral contracts are deprived of their legal effect[30] – as the Learned Justice JG Nyamu decided in the SEFCO case.[31]

In private equity contracts concluded in Kenya, the device of the 'entire agreement' clause is employed, excluding collateral understandings when disputes arise.[32] This accords with the position under section 3 of the Law of Contract Act, Cap 23 of 1961, which generally requires contracts likely to give rise to pecuniary loss to be in writing.

The covenants clause in a private equity agreement stems from a body of representations and warranties that form the basis of contract rights and obligations. These representations ride on a promise, and are usually made with the intention of inducing a financing contract.[33]

Contract law distinguishes generally between two types of contractual terms: conditions and innominate or intermediate terms.[34] Conditions are important contractual terms, and they go 'to the heart or the root of the contract'.[35] Intermediate terms, in comparison, do not go to the root of the contract, and are capable of remedy by monetary compensation. Conditions, going to the root of the contract, are sufficient to form a basis for

lease to the defendant, the plaintiff represented that if the defendant signed on the lease, the plaintiff would not object to the defendant's continued use of the back rooms as a sleeping quarter. In effect, the court found that this was a promise aimed at inducing a future contract.

[30] Jill Poole, *Contract*, (n 26), pp210, 211
[31] The SEFCO Case (n 28)
[32] Confidential access to Contracts of FM101, FM104 and FM112, Nairobi, Kenya, January 2010
[33] Confidential access to FM104's standard '*Termsheet'* – viewed in confidence
[34] Jill Poole, *Contract* (n 26) 244 (Classification of Terms)
[35] Mustill LJ in *Lombard North Central plc v Butterworth* [1987] QB 527 (CA) – at paragraphs 1 – 6.

contract rescission.[36] Conditions can be promissory, giving rise to remedies for breach in the event of their non-performance, or non-promissory, that is, dependent on the occurrence of some specified secondary event for their effectiveness.[37] Non-promisory conditions are not frequently written into formal agreements.

In determining whether a term is a condition or a warranty, the provisions in the laws of a country having relevance to the contractual transaction in question play an important role – in addition to the intention of contracting parties and the general practice within that contracting industry. As far as statute-based conditions are concerned, the question to ask is whether a specific statute classifies a term expressly. Where the law is silent, the next question to determine is whether the parties have themselves classified the term. The words employed in such classification include terms such as "it is of the essence of this contract"[38] or "it shall be a condition of contract".[39]

From a contracts framework, Scott opined that the role of contract law is to set default rules by which rational commercial partners can bargain and adjust their claims.[40] Barnett argues that "contracts are transfers of entitlements",[41] and that consent sits at the heart of contractual relationships.[42] Contractual terms, whether giving rise to reliance or expectancy, and whether conditions or warranties, enable, in Barnett's view, "the existence of a relational

[36] See for instance, the decision of Lord Reid in *L. Schuler AG v Wickman Machine Tool Sales* [1974] AC 235 (HL) – where he observes that a term can be classified as a condition by law or by the choice of contracting parties who elect to confer on a term the effect of a condition, that is, the sufficiency of a term to support an action for contract termination as a result of breached performance. He finds, however, that where contract terms properly construed lead to unconscionable or otherwise unreasonable outcomes, the true meaning of the terms must be made sufficiently clear.
[37] Jill Poole, *Contract* (n 26) 244
[38] *Lombard North Central plc v Butterworth (1987) QB 527 (CA).*
[39] *L. Schuler v Wickman Machine Tool Sales (1974) AC 235 (HL).*
[40] Scott, 'Rational Commercial Actors' (1990) (n 6) 605
[41] Randy EBarnett, 'Conflicting Visions: A Critique of Ian Macneil's Relational Theory of Contract' (1992) 78(5) Virginia Law Review 1175-1206, 1181
[42] ibid 1180

order of actions that enable parties to arrive at mutually beneficial adjustments" in futuristic exchanges.[43]

8.2.2 Doctrine of Reliance

Commercial agreements give rise to the principle of reliance. *Hedley Byrne v Heller*[44] involved a question under the tort law principle of misrepresentation giving rise to a breach of a duty of care. The plaintiff sought a credit-worthiness reference from the defendant, which supplied a positive reference with the disclaimer neither the defendant nor its employees assumed responsibility for the reference. Relying on the good reference, the plaintiff advanced sums to its customer (about which the reference was requested), but the customer soon after went into liquidation, occasioning the plaintiff direct financial loss. It was held by Lord Morris of Borth-Y-Gest that -

> "…(I)rrespective of any contractual or fiduciary relationship and irrespective of any direct dealing, a duty may be owed by one person to another…if a person takes it upon himself to give information (….) or allows his information (…) to be passed on to another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise."

In situations where a special relationship exists between parties – such as in a private equity financing relationship, the representations made by one to the other give rise to a duty of care that would be owed if and when the other party suffers loss as a result of acting on the strength of the representations made. In *Mumias Sugar Company Ltd v Freight Forwarders*

[43] id
[44] *Hedley Byrne & Co. Ltd v Heller & Partners Ltd, (1964) AC 465 (HL).*

(K) Ltd Nairobi CA 297/03, Kenyan courts have held, like English courts have,[45] that 'contractual reliance' arises where the following can be demonstrated:

(i) The person making a representation aimed at facilitating or inducing a contractual relationship possesses some special knowledge or information about the subject matter - in the private equity financing context, the venture company possesses insider knowledge about the true state of its business, placing it a special position in the contractual relationship;

(ii) The person to whom the representations are made is expected to place reliance on the declared statements or claims – in private equity financing, investors place reliance on the representations of the venture companies, which are translated into covenants that carry various sanctions if they are violated;

(iii) The person making the representations must know the other party will rely on the statement or it must be reasonably foreseeable that he will so rely on the representations, - in private equity financing, venture companies know that unless the private equity investor can reasonably rely on their representations, they will not invest in the venture company – so the representations of the venture company are designed to induce the decision to invest;

(iv) The person making the representations must have some knowledge of the type of transaction for which the information is required[46] - and in private equity financing, the venture company knows that the 'type of transaction' intended is a financing transaction. Equivalent principles were reiterated in *Kenya Institute of Management v Kenya Reinsurance Corporation* [2008] eKLR, a Kenya High Court decision.

[45] In - *Henderson v Merrett Syndicates Ltd [1995] 2 AC 145.*
[46] *Caparo Industries plc v Dickman [1990] 2 AC 605.*

Where a future contract is frustrated because the representor fails to perform or because some of the pre-contract representations turn out to be falsehoods, the injured party can sue for 'reliance loss' to recover wasted expenditure.[47]

8.2.3 Doctrine of 'Expectancy'

Separate from the doctrine of reliance is the contract law doctrine of 'expectancy'. Having relied on some representation or conduct of a party to a contract, and having been induced into taking steps to expose oneself to the vagaries of a contractual relationship, contract law secures that the relationship of parties now anchors on the principle of expectancy: the expectation that both parties to a contract relationship will undertake in good faith the observance of their ends of the bargain. Should one party suffer loss of expectation, that is, loss of a benefit directly linked to the other party's failure to perform a specified contractual obligation, the injured party can take recourse to the courts for the award of damages as compensation. This was the common law rule in *Robinson v Harman* (1848) 1 Exch 850, 855. There are several ways for determining the measure of damages for this purpose. Where the monetary value between what was expected and what is actually received is readily ascertainable, then the damages are the difference in value. The quantum of damages could also be determined by the cost of curing the defective performance.[48]

In private equity contracting, pre-contract conditions, representations and warranties giving rise to either contractual reliance or expectancy, play a central role in determining whether investments occur. The security of contract-based entitlements therefore depend on both built-in enforcement mechanisms and the availability of a range of external institutions that act as motivators to contract-based recompense or normalisation of conduct. In private

[47] *McRae v Commonwealth Disposals Commission* (1951) 84 CLR 377 (High Court of Australia).
[48] *Ruxley Electronics & Construction Ltd v Forsyth* [1960] 1 AC 344 HL.

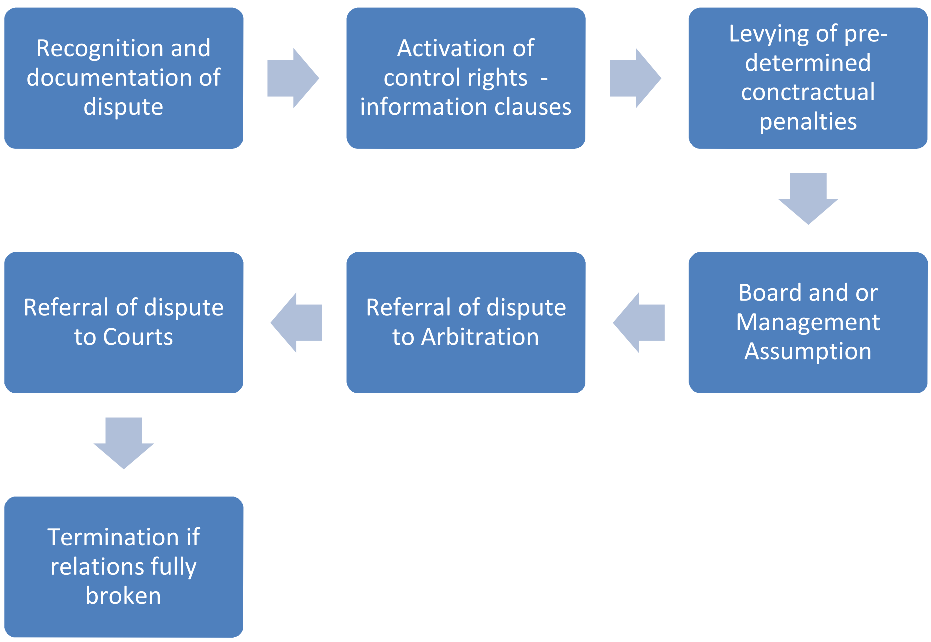
equity practice, actual recourse to such external agencies need not be taken; but their availability would appear to be crucial to the financing relationship, as the following sections illustrate.

The following sections of the chapter focus on how private equity contracts are managed in Kenya.

8.3 Conflict Management in Private Equity: The General Principles

Every private equity financing agreement carries a dispute resolution clause. The typical resolution regime availed under such a clause paints a picture of progressive escalation of measures and choice of dispute management tools as opinion differences become intransigent. This could be depicted as follows.

Fig 8.1: Typical Private Equity Conflict Management Continuum



Source: Interviews with Fund Managers, 2010

From financing agreements accessed confidentially in the course of this study's field work,[49] summarised in the following paragraphs are the strategies employed by fund managers in preventing disputes from full scale disputes.

Fund managers write in monetary penalties for violations of representations and warranties that form part of the closing conditions. In the case of FM109, the penalty is pegged at 5% of the invested capital. Where a penalty is actually levied, the venture company may be additionally required to reflect the penalty liability in its company accounts. This latter stipulation is a strong deterrent to corporate misconduct, as it would be plain to future investors in the company that the venture company could potentially be untrustworthy as to its representations – in a sense, indicative of Posner's reputational basis for contract observance.

The venture company is more frequently required to remedy default or breach within a period usually prescribed in financing agreements (shareholders agreement) – the most frequently observed period for the remedying of contractual breach in Kenyan private equity was 30 days. Where the venture company fails to remedy the breach within the stipulated time, and in cases where the venture company is not substantially performing to budget or in accordance with the corporate business or development plan, the investor can employ several strategies to enforce contract performance:

a. It can require the venture company to supply to the investor any information in relation to any aspect of the venture company's business and affairs, whether on a day to day basis or at greater intervals;

[49] Documents seen at FM101 (January 2010 – a government-linked fund), FM104 (January 2010 – one of the Kenyan-owned older funds), FM112 (August 2009 – another Kenya-owned fund set-up post-2000) FM107 (September 2009 – an African Fund with significant development fund investor base) - all at Nairobi, Kenya

b. It can nominate, and the venture company is contractually required to appoint, such number of additional directors of the venture company as will give the investor board majority in the venture company; or

c. It can require that the venture company retains as consultants such accountants, professional advisors, management consultants or other consultants including employees of the investor (at rates to be determined by the investor) to prepare a detailed report in relation to the company's financial and trading performance and prospects. This will usually be aimed at informing an exit strategy, or to justify forced management changes in the venture company.

(ii) Activating termination clauses – which can be triggered by a range of corporate actions of noncompliance.

(iii) In addition, the investor's put and call options, as well as the contractual preservation of the investor's rights even under contract termination, operate to powerfully motivate contract compliance, or to dislodge intractable points of difference.

Fund managers FM102, FM103 and FM113 concurred in opining that most venture companies found it important to avoid permitting differences to escalate to formal disputes because of future financing rounds.

In addition to the foregoing, private equity investors employ other soft tools in conflict management.[50] This strategy includes the use of 'financing rounds' mentioned above– a process whereby investor's capital commitments to the venture company is made available in tranches, with each tranche being subjected to a predetermined set of

[50] Jack S Levin, *Structuring Venture Capital, Private Equity and Entrepreneurial Transactions* Martin D Ginsburg, Donald E Rocap and Russell S Light (eds.) (Aspen, 2011) ch 2, 2-10 to 2-27.

performance targets.[51] These performance targets are tied into the venture company's business plan that guides the investor's profit objectives. It will be recalled here that the private equity investments are provided with an exit event in mind.[52] Each financing tranche that unlocks the next round of capital for the venture company is designed to move the venture company closer to the state the investor desires for it to support a pre-planned exit strategy. To sustain this staggered financing commitment, it is in the venture company's interest to avoid permitting differences to degenerate into full disputes that introduce disruptions to contract performance. Non-attainment of performance targets to the satisfaction of the investor can mean a withholding of capital injections, and that could trigger business closure for the venture company. In practice, most venture companies do everything in their power to meet their performance targets.[53]

Other tools available to fund managers include their board and share class rights that convey strong control to the financier. The use of anti-dilution provisions in the financing conditions ensure that pre-emptive rights are passed onto the fund manager at the start of the financing relationship. In addition, all seen contracts carry a 'restricted transactions' clause, which typically features no less than 26 different types of corporate activity subject to close oversight, and frequently, investee companies are required to execute an indemnity agreement that shields the new investment from undisclosed liabilities.

With these intense monitoring tools at their disposal, fund managers that participated in the study stated that in their experience, very few circumstances lead to formal disputes: frequently, differences are resolved early. FM107 noted,

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[51] FM101 employs the following language: *"5.22. The Disbursement of (investor's) equity funds is subject to the (investee company) meeting ALL THE TERMS AND CONDITIONS contained herein."*
[52] FM106, in its standard shareholders agreement, uses the terms: *"9.1. The Company and each of the parties hereby covenant with and undertake to (investor) to use its best endeavours to promote, enhance and improve the business of the Company with the view to obtaining a market flotation at the earliest opportunity."*
[53] Erik A Berglof, 'Control Theory of Venture Capital Finance' (Oct.1992) 10:2 Journal of Law, Economics and Organisation 247-267: [Oxford University Press].

> "We do not wait for the roof to come crashing in – at the first sign of trouble, we act, and act decisively. It is what we are known for, what makes private equity a unique investment solution."[54]

Being a commercial activity, however, private equity disputes can become intractable for soft tools, in which recourse to extra-contractual mechanisms becomes necessary. There are two external mechanisms available for that purpose: (i) referral of disputes to arbitration or (ii) recourse to courts. To achieve this end, Kenyan private equity agreements seen contain two additional clauses: the 'jurisdiction clause' and the 'choice of law clause'.[55]

The jurisdiction clause serves the purpose of guiding contracting parties on the country or place where disputes under that contract are predetermined to be processed. Kenyan jurisprudence does not allow parties to oust the jurisdiction of Kenyan courts by contract. However, Kenyan law permits parties to a private contract to freely choose what law to apply to their agreement and which legal jurisdiction to locate their choice of forum.[56]

The choice of forum clause provides for the physical location where dispute resolution proceedings are to be held, and it usually follows the jurisdiction selected under the choice of law clause. For instance, it would usually follow that parties selecting to apply English law to their contract would elect upon English courts for the determination of contract-based disputes. There is nothing under private international law, however, to prevent parties to a private commercial contract from selecting a separate forum different from the forum of the selected law.[57] Hence parties to a private equity financing agreement could

[54] Interview with FM107, September 2009, Nairobi. Kenya.
[55] CMV Clarkson and Jonathan Hill, *The Conflict of Laws* (OUP, 3rd edn, 2006) 250 - 254
[56] Arbitration Act No.4 of 1995, ss 21 and 29
[57] Clarkson and Hill, Conflict of Laws (n 55) 255, 256

perfectly apply Dutch law to their Kenyan investment agreements, and select a forum in Belgium.[58]

8.4 Commercial Arbitration in Kenya

This section reviews the design of Kenyan arbitration law from an analysis of the Arbitration Act No.4 of 1995, which is the operative legislation governing the arbitration of contract-based disputes in Kenya. The review is then followed by an assessment of routine contracting choices by Kenyan fund managers, drawing from interviews concluded with research respondents in the course of this work.

Section 2 of the Arbitration Act applies this legislation to domestic and international arbitration proceedings. The provisions of the law are quite liberal: under section 11(1) of the Act, parties to an agreement are free to determine the number of arbitrators to any dispute that might arise in the course of their contractual relationships. An arbitration agreement, the law provides, may be in the form of a clause embedded in a contract or contained in a separate agreement or addendum to a contract.[59] In terms of form, such an agreement must be in writing, and the law construes an arbitration agreement to be in writing if it is contained in a document signed by the parties, or contained in a facsimile, telegram, telex, exchange of letters, electronic mail or other means of communication providing a record of communication between parties to a contract. The existence of an arbitration agreement could also be construed from an exchange of letters of claim between the parties in which one party alleges the existence of an arbitration agreement and the other party does not deny.[60] Failure

[58] Interviews with Lawyers LX71, LX77 and LX79, Nairobi, Kenya (August 2009; January 2010; telephone interview of February 2010)
[59] Arbitration Act Number 4 of 1995, Section 4(1), Laws of Kenya.
[60] ibid s 4 (3) (a, b, c)

to state the number of arbitrators is remedied by the legislative provision that imputes an implied agreement on one arbitrator.[61]

In terms of qualifications, nationality (including race and ethnicity) are not effective barriers to appointment as an arbitrator.[62] Sections 14, 15 and 16 of the Arbitration Act of 1995 make provision for challenging the appointment of an arbitrator, and for the removal of an appointed arbitrator.

Kenyan law is flexible as to forum selection. Parties to an agreement are free to determine the juridical seat for their arbitral proceedings.[63] Without prejudice to seat selection, the law permits the arbitral tribunal to sit anywhere and hold its meetings wherever the circumstances of the case deems proper.[64]

Similar to the enabling about choice of forum, Kenyan arbitration law permits contracting parties to select a law to govern the arbitration proceedings.[65] Choice of law within an arbitration agreement, however, is limited to the substantive law of the selected forum, and not to its conflict of laws rules.[66]

International arbitration awards are granted recognition under section 36(2) of the Arbitration Act of 1995. The basis for recognition is the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958,[67] to which Kenya is a signatory. Subsections (3) and (4) of section 36 lays down specific requirements for a foreign arbitral award to be granted recognition under Kenyan law:

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[61] ibid s 11(2)
[62] ibid s 12(1)
[63] ibid s 21(1)
[64] ibid s 21(2)
[65] ibid s 29(1)
[66] ibid s 29(2)
[67] United Nations, 'Final Act of the United Nations Conference on International Commercial Arbitration and Convention on the Recognition and Enforcement of Foreign Arbitral Awards' (1958) < http://treaties.un.org/doc/Publication/UNTS/Volume%20330/v330.pdf> accessed 24 October 2011

(i) An original award or a duly certified copy thereof must be availed to the High Court in Kenya;

(ii) The original arbitration agreement or a duly certified copy must be availed as well;

(iii) If the original award is not in the English language, a certified copy translated into the English language must be availed.

If these requirements are not met, the arbitration award granted in foreign jurisdictions will not be granted the force of law in Kenya, and will go unsatisfied. In *Kundan Singh Construction Ltd v Kenya Ports Authority*, HCC 794/2003, the court struck out an application for the confirmation of an arbitral award on the ground that the neither the authenticated original award nor a certified copy thereof had been proven.

Courts around the world have similarly set aside arbitral awards on varying grounds. For instance, in the Russian case of "Yukos Capital,"[68] Yukos entered into four lending agreements with "Rosneft", the borrower in the relationship, by which Rosneft became part of the Yukos group. Subsequently, disputes arose relating to the loans, and Yukos filed for international arbitration with the Court of Commercial Arbitration at the Chamber of Trade and Industry of the Russian Federation. Arbitrators found in favour of Yukos on 19 September 2006 (a total of four awards), and Rosneft was required to pay Yukos some 13 billion roebel. The judgement-debtor approached the *Arbitrazh* Court of the City of Moscow, which by judgements dated 18 and 23 May 2007 annulled all four awards on the grounds that:

(i) They violated the right to equal treatment

(ii) There was a violation of agreed rules and procedures and

(iii) There appeared to be a lack of impartiality and independence on the part of the arbitrators.

[68] Albert Jan van den Berg, 'Enforcement of Arbitral Awards Annulled in Russia' – Case Comment on Court of Appeal, Amsterdam (2009) 27(2) Journal of International Arbitration 179-198

The Federal *Arbitrazh* Court of the District of Moscow, and the Supreme *Arbitrazh* Court, both affirmed the annulment.[69] It is clear, thus, that national courts can, and do, often exercise jurisdictional powers to police the integrity of commercial arbitration.

Section 36(5) of the Arbitration Act, 1995, introduces an important qualification to the sweeping liberality of the law under section 36. Only awards granted by foreign jurisdictions that have acceded to the New York Convention can be recognised in Kenya.[70] This is how Kenyan law words this requirement:

> *"36(5) In this section, the expression "New York Convention" means the Convention on the Recognition and Enforcement of Foreign Arbitral Awards adopted by the United Nations General Assembly in New York on the 10th June, 1958, and acceded to by Kenya on the 10th February, 1989, <u>with a reciprocity reservation</u>."*

In practice, countries that recognise arbitral awards made in Kenya will have arbitral awards awarded in those countries recognised in Kenya. Under section 37 of the Arbitration Act 1995, however, strict conditions are laid out for the testing of the validity of foreign arbitral awards. Regardless of the provisions in section 36 of the Act, if any of the grounds laid out in section 37 are violated, foreign arbitration awards will not receive recognition under Kenyan law. These grounds include:

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[69] Yukos approached Dutch courts for enforcement of the award, and in the court of first instance at Amsterdam, got judgement, with the court arguing the Russian judges did not demonstrate impartiality and independence. Rosneft appealed to the Dutch Court of Appeal. But in *International Standard Elec. Corp (ISEC) v Bridas Sociedad Anonima Petrolera Industrial Y Comercial*, 745 F. Supp. 172, 178 (S.D.N.Y. 1990) in VII Y.B. COM.ARB.312(1982) International Council for Commercial Arbitration – Bridas won an award made in Mexico City, and ISEC brought suit in a USA court to set it aside. The arbitration applied substantive USA law, and ISEC argued that this bestowed jurisdiction on USA courts to vacate the award. The USA court agreed with Bridas that only Mexican courts had jurisdiction, observing that Article VI(e) of the 1958 UN Convention on the Enforcement of Arbitral Awards placed emphasis on procedural, as opposed to substantive, law as a basis for such action.

[70] For a review of American practice on point, a good article is Bishop R Doak and Elaine Martin, 'Enforcement of Foreign Arbitral Awards' <www.kslaw.com/library/pdf/bishop6.pdf>

(i) incapacity of one of the parties to the arbitration – at the time of arbitral proceedings;

(ii) some invalidity of the arbitration agreement under the governing law of the agreement, or the law of the state where an award is made;

(iii) violation of due process, especially with regard to the judgement debtor;

(iv) arbitral award settling questions not reserved for arbitration under the agreement of the parties;

(v) some incompleteness as to bindingness – either because the award has not become binding or it has been subjected to legal challenge in the courts of the awarding state;

(vi) the subject matter of the dispute is not capable of settlement by arbitration under Kenyan law or

(vii) the recognition or enforcement of the award is contrary to the public policy of Kenya.

These elements constitute what in practice is termed 'judicial risk' – and as the Arbitrazh case illustrates, countries can misapply them to serve nationalistic objectives. The lessons for Kenya include the need to render the policy framework for the enforcement of foreign arbitral awards generous, without necessarily giving a blanket enablement.

The High Court of Kenya is granted an important role in the arbitration process under the Arbitration Act of 1995. It can assist parties appoint an arbitrator or settle disputes over the appointment of an arbitrator.[71] It can assist parties in the taking down of evidence.[72] It can grant interim orders of relief either prior to or during the course of arbitral proceedings.[73] It

[71] ibid s 12
[72] ibid s 28
[73] ibid s 7(1)

can set aside arbitral awards.[74] It can recognise foreign awards, and it can grant relief against the recognition of unjustly obtained foreign awards.[75] It can also determine questions of law arising from domestic arbitrations.[76]

The court in Kenya can intervene to secure procedural justice in arbitration proceedings. Thus in *Epco Builders Limited v Adam S. Marjan-Arbitrator & Another* [2005] HCC 248, the applicant (EPCO) moved the High Court on grounds that the arbitrator's procedures were unfair and likely to prejudice its interests in the arbitration. The majority decision held that the application raised substantive issues to be determined at full hearing, but also expressed caution that the courts should be hesitant to entertain any complaint of potential procedural unfairness in the interest of preserving efficiency in alternative dispute resolution mechanisms. The dissenting opinion, expressed by Justice Githinji JA (and, it is submitted, the truer view), held the appellant sought remedies under section 84(1) of the Constitution, which are remedies in public law, when arbitration law and procedure provided adequate options for redress.

The court can also intervene prior to start of arbitration proceedings. In *Rawal v Mombassa Hardware Ltd* [1968] EA 398, it was held the existence of an arbitration clause in an agreement cannot prevent a party from electing recourse to court. In *Peter Muema Kahoro & another v Benson Maina Githethuki* [2006] eKLR, the court upheld *Mombasa Hardware*, holding that section 6 of the Arbitration Act did not grant that power to the courts.

Only parties to a valid agreement to arbitrate have locus under Kenyan law. It was thus held, in *Chevron Kenya Limited v Tamoil Kenya Limited* [2007] HCCC 155, and in *Pamela Akora Imenje v Akora ITC Intenational Ltd & Another* [2007] eKLR, that privity of contract

[74] ibid s 35
[75] ibid ss 36, 37
[76] ibid s 39

is an important notion under Kenyan arbitration law, and strangers to an agreement to arbitrate cannot benefit from court protection and assistance.

Kenyan courts have also intervened in the granting of interim reliefs. In *Don-Wood Co. Ltd v Kenya Pipeline Ltd* Civil [2004] HCCC 104, it was held that the court's powers under section 7 of the Arbitration Act were designed to support the arbitral due process, and the relative balance of the parties.

Procedural propriety in moving Kenyan courts is just as important as the substantive bases of the motion. In *Nakumatt Holdings Limited v Kenya Wildlife Services* [2001] HCCC 1131, it was held that an application to the court that did not disclose under which arbitration law it was being brought, and under what heading of the court's procedural rules was incurably defective.

In designing arbitral clauses, therefore, private equity fund managers and venture companies in Kenya need to ensure the validity of their agreement from a statutory perspective, first and foremost. Secondly, they will need to be careful in determining whether the selected forum enjoys 'reciprocity' under section 36 of the Arbitration Act of 1995 – to obviate an automatic voiding of both the contractual agreement to arbitrate and the enforcement of awards stemming therefrom. Thirdly, any matter subjected to arbitration needs to be a qualifying subject matter for settlement by arbitration under Kenyan law – otherwise a section 37 bar automatically arises. Due process is a key requirement under Kenyan law – hence parties need to ensure that any contractual agreement to arbitrate must be grounded on the intention to observe due process – proper notifications and avoidance of under-hand tactics like corruption.

Any arbitral agreement or award that is likely to violate Kenya's public policy is equally barred under section 37. In *Christ For All Nationals v Apollo Insurance Co. Ltd* [2002] 2 EA

366, Ringera J (as he then was) conceded the lack of precision in Kenyan statutory and judicial law on what 'public policy' meant, and ventured to define matters opposed to public policy to be likely to include anything inconsistent with the Constitution and any other law of Kenya; anything that contravenes Kenya's national interest (another 'grey' and 'broad' concept, it must be observed); matters repugnant to both justice and morality; as well as arbitral awards tainted by corruption, bribery, fraud, or undue influence (these are the principles implied under section 35(2)(ii), (v) of the Arbitration Act of 1995).

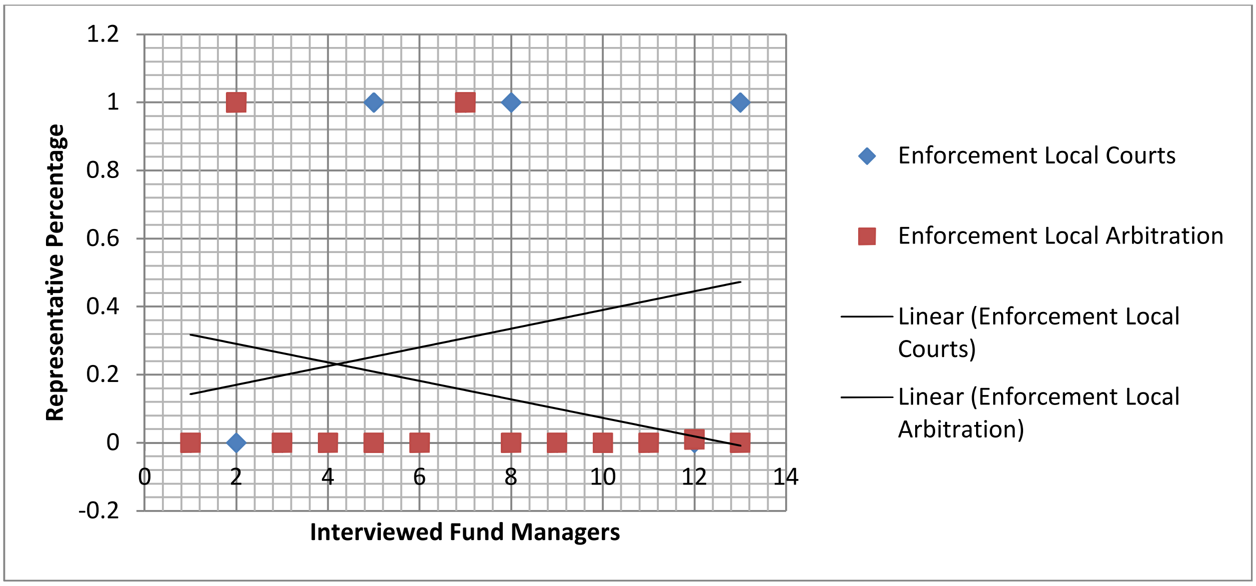
Overall, Kenya's legal framework for commercial arbitration, on the basis of the written law, is 'competitive'. Kenyan courts, similarly, adopt a generally strict narrow view of the court's jurisdiction in arbitral matters, signalling a general institutional inclination to a market-led system for the resolution of commercial disputes.

Recalling the principles addressed at the start of this chapter, if the role of law is to set down default rules by which parties organise their affairs in the market place, then the letter of the Arbitration Act of 1995 and the court's narrow construction of its jurisdiction, tend to achieve, prima facie, that objective. It is instructive, hence, to observe the actual enforcement choices of local fund managers engaged in the course of this study.

So Where do Kenyan Private Equity Investors Arbitrate?

Of all interviewed fund managers, only 23% will arbitrate their investment disputes under Kenyan arbitration laws – as depicted in chart 8.2, below.

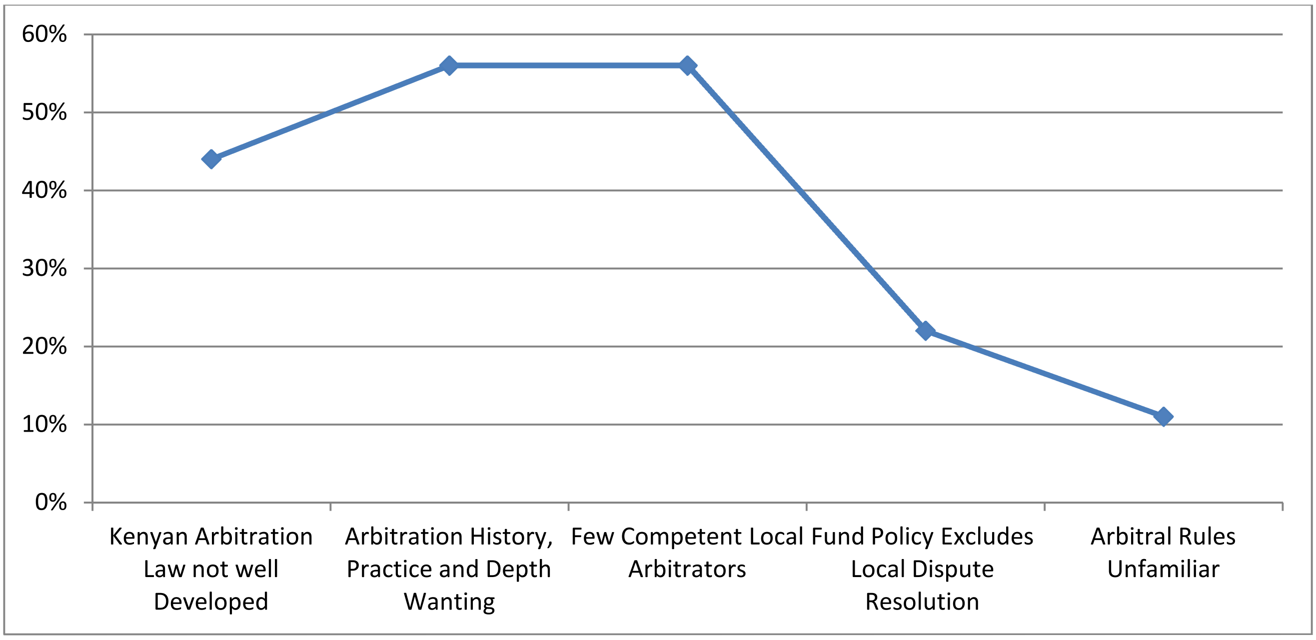
Chart 8.1: Contract Enforcement Trends



Source: Fund Manager Survey 2010

In rejecting local arbitration, over 50% of the surveyed fund managers cite a shallow arbitral doctrine and the absence of properly qualified arbitrators in Kenya as the main push factors. Close behind these is a group of about 40% of the fund managers who view the local law as under-developed on arbitration for the complex needs of managing a financial contract such as private equity. Unfamiliarity with local arbitration rules is not a substantial impediment, and neither are fund policies that mandate external dispute resolution mechanisms.

Chart 8.2: Why Fund Managers Reject Local Arbitration



Source: Fund Manager Survey 2010

In light of the provisions in the Arbitration Act of 1995, the first justification for avoiding arbitrations in Kenya, that is to say, Kenyan law is under-developed on arbitration, would appear at first to lack substantive merit. The law on arbitration is broad and flexible. When one takes into account the lack of enabling regulations under the Act, however, the reticence of fund managers as far as applying Kenyan law and selecting Kenya as a forum for private equity arbitrations become more understandable. A competitive statutory framework for arbitration requires an elaborate system for the clarification of the underlying procedural questions in an arbitral process. These include:

(a) clear principles for the determination of governing law – including a process for the determination of what law would apply in the determination of whether an agreement to arbitrate exists, and whether the dispute between the parties falls within the scope of that agreement;[77]

(b) clear principles for determining the law governing the proceedings of an arbitration (quite separate from the law that governs the arbitration – or indeed the law governing the merits of the dispute between the parties). This point is important to consider because every agreement to arbitrate imports two elements: firstly, a procedural one (which procedure to follow) and an empowerment one (what powers the arbitral tribunal will have in determining the dispute); secondly, powers of the court of the selected forum in supporting the arbitral process. The first is an internal procedure, while the latter is the external procedure. The court's powers, as the review of the Arbitration Act of 1995 above demonstrated, include powers to appoint an arbitrator, to grant interim injunctions (such as asset freezing, or the requirement of security deposit in court), as well as the setting aside of awards where a tribunal exceeds its powers or the judgement creditor is found to have employed corruption in securing the award – or other procedural misconduct;[78]

(c) clear principles for the determination of the rules that must apply to the determination of the merits of the dispute – the arbitration option permits parties to an arbitration agreement to choose a legal standard to apply to their commercial understanding. These standards can vary – from national legal standards of one or the other of the parties, or common standards between the laws of the contracting parties, to the selection of the law of some neutral foreign government, or the application of such non-national corpus of rules as the UNCITRAL or UNIDROIT principles of international arbitration or 'internationally accepted standards of law governing

[77] CMV Clarkson and Jonathan Hill, *The Conflict of Laws* (3rd edn, OUP, 2006) 251
[78] ibid 252

contractual contracts' (also known as *lex mercatoria*), or even equity or the principles of fairness (arbitration *ex aequo et bono*);[79]

(d) principles governing the application of a governing law where parties fail to make a choice, and a formula to be applied by arbitrators when selecting a governing law for the parties;[80]

(e) principles securing that jurisdictional mandatory rules are not evaded where arbitrators choose conflicts rules in determining the applicable law – to avoid arbitral awards being rendered legally ineffective.[81]

These issues are not exhaustively addressed under the Arbitration Act of 1995, and there is yet an absence of a tried and tested body of arbitral case law to shed unequivocal standards bearing on each of the highlighted practice areas. This would also partially vindicate the empirically established opinion that there would be few competent local arbitrators. In essence, therefore, there is an opportunity here for a reform process that improves the quality of the law and procedural aspects to render the Kenyan forum and law as attractive as the more competitive foreign jurisdictions.

22.5% of the interviewed fund managers (chart 8.3) indicated that their fund policies excluded local law and local arbitration. A further investigation revealed an illuminating pattern: for all funds falling in this category, their main investors were foreign governments and international development finance institutions, or other governmental investment agencies. Fund management leadership at such funds, chapter 5 shows, are consistently drawn from overseas. The converse is true for local-led funds: these funds apply Kenyan law to their investments, and to their arbitral agreements and select Kenya as the forum for the

[79] ibid 254-56
[80] ibid 256
[81] ibid 257

tribunal. On the merits of the dispute, local funds apply Kenyan law, and there is ordinarily no conflict of laws arising from their transactions that demand the selection of conflict rules.

It is instructive that a judicial Committee appointed to investigate moral rectitude within the judiciary in 1998, chaired by Justice Richard Kwach, recommended in its report, the Kwach Report of 1998, a reorganisation of case handling and management systems and the introduction of alternative dispute resolution (ADR) mechanisms in the judicial process.[82] The Arbitration Act of 1995, was not the first piece of legislation supporting a formal ADR framework in Kenya – it repealed Cap 49 of 1968, the earlier legislation on the subject.[83] In effect, a statutory basis for ADR had been in existence in Kenya for nearly a decade prior to the Kwach recommendations in 1998.

For the Kwach Committee to revisit this recommendation in 1998 suggests that as of that year, the impact of the Arbitration Act of 1995 remained limited. In other words, ADR was not yet practiced at a widespread level in Kenya by 1998. More poignantly, as recently as 2007, Justice JG Nyamu, in *George M Musundi & 2 Others v Small Enterprises Finance Company Ltd* [2007] eKLR, took considerable time in his judgement to emphasise the benefits of ADR in commercial disputes in Kenya, highlighting the fact it is still substantially underdeveloped.[84]

This deduction vindicates the views of the majority of Kenya-based private equity fund managers who opined that they would not prefer local arbitrations because the arbitral doctrine in Kenya remained shallow – at least as of 2010.

[82] The Report of the Committee on the Administration of Justice 1998 (The Kwach Report)
[83] Arbitration Act 1995, s 42.
[84] In the High Court of Kenya, No.1861 of 1995, 10

8.5 Commercial Litigation

8.5.1 Constitutional Basis for the Kenyan Judiciary

If arbitration is not an ideal or preferred option, to what extent do local fund managers embrace Kenyan courts for the resolution of investment disputes? To assess this option, this section reviews the structure of the Kenyan judiciary, and the attitudes of fund managers with respect to referring disputes to Kenyan courts.

Litigation is the business of the judiciary. The Kenyan judiciary is provided for under Chapter 10 of the Constitution of Kenya.[85] It was adopted on 27 August 2010, and it replaced the constitutional order that had governed the country since independence in 1963. Under the new Constitution, the judiciary is named as one of the three arms of the Kenyan government.[86] The other two are the executive and the legislature.[87]

According to Article 2(1) of the Constitution, the Constitution is the supreme law in Kenya. Other sources of law include laws enacted by Parliament, the Senate, and County Assemblies, treaties and conventions ratified by Kenya and general rules of international law.[88] In addition, certain applications of English law, and the doctrines of English common law and the principles of equity constitute sources of law in Kenya.[89]

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[85] Constitution of Kenya Act 2010, Cap 0 Laws of Kenya < http://www.kenyalaw.org/kenyalaw/klr_app/view_content.php?ContentHistoryID=24359&CapID=661&preamble=1> accessed 15 October 2010.

[86] ibid Art. 159

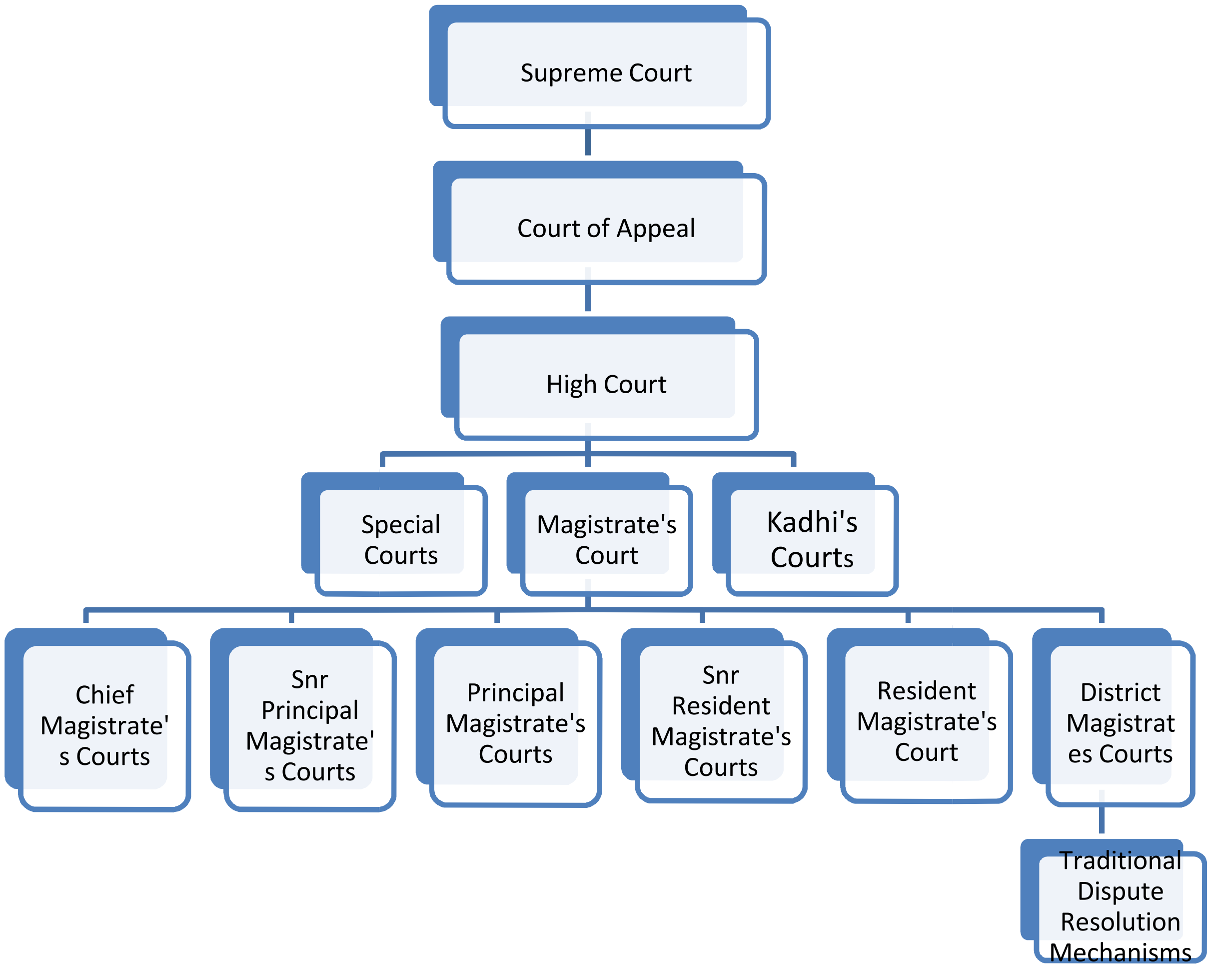
[87] ibid Art. 130, 93, respectively.

[88] ibid Art. 2(5), 2(6), 94, 96, 185. The Constitution, however, is silent on the procedures for ratification. It is not clear whether that process will be centralised in the Executive, or left pretty much as it was under the previous regime, which permitted disjointed and uncoordinated ratification processes and ethics. Reading the spirit of the Constitution, however, it is valid to deduce that convergence on centralised and rational ratification protocols is likely to be the way of the future. This is an improvement from the previous constitutional dispensation, which had the extra bureaucratic layer of domestication requirements to apply international law to Kenya.

[89] Judicature Act 1967 s 3 and First Schedule, Cap 8, Laws of Kenya

The judiciary is made up of a two-tier system of courts: superior and subordinate courts.[90] There are three superior courts: the Supreme Court – which is also the highest and final court of the land,[91] the Court of Appeal,[92] and the High Court.[93]

Figure 8.2 Judicial Structure



Source: Constitution of Kenya, 2010

[90] Constitution of Kenya (n 85) Article 163 - 165
[91] ibid Art 163
[92] ibid Art 164
[93] ibid Art 165

If private equity disputes were to be litigated in Kenyan courts, the court of first and original jurisdiction to hear and determine the matter would be the High Court. The reason rests on the value of the contract: lower courts would not have the monetary jurisdiction to handle such disputes.

8.5.2 Fund Manager Attitudes to Local Litigation

80% of the interviewed fund managers are happy with the commercial division of the High Court of Kenya. Development studies, for instance the World Bank's Doing Business Index 2012, documented that judicial cases still take a long time to resolve in Kenya – on average, 465 days. The process involves 40 procedures, 9 more than the OECD average, and costs 47.2% of claim (more than double the OECD average). This renders the enforcement of property and contractual rights particularly bothersome.[94]

Table 8:1 Kenya - Contract Enforcement

Indicator	**Kenya**	**Sub-Saharan Africa**	**OECD Average**
Procedures (number)	40	39	31
Time (days)	465	655	518
Cost (% of claim)	47.2	50	19.7

Source: World Bank Doing Business Index 2010

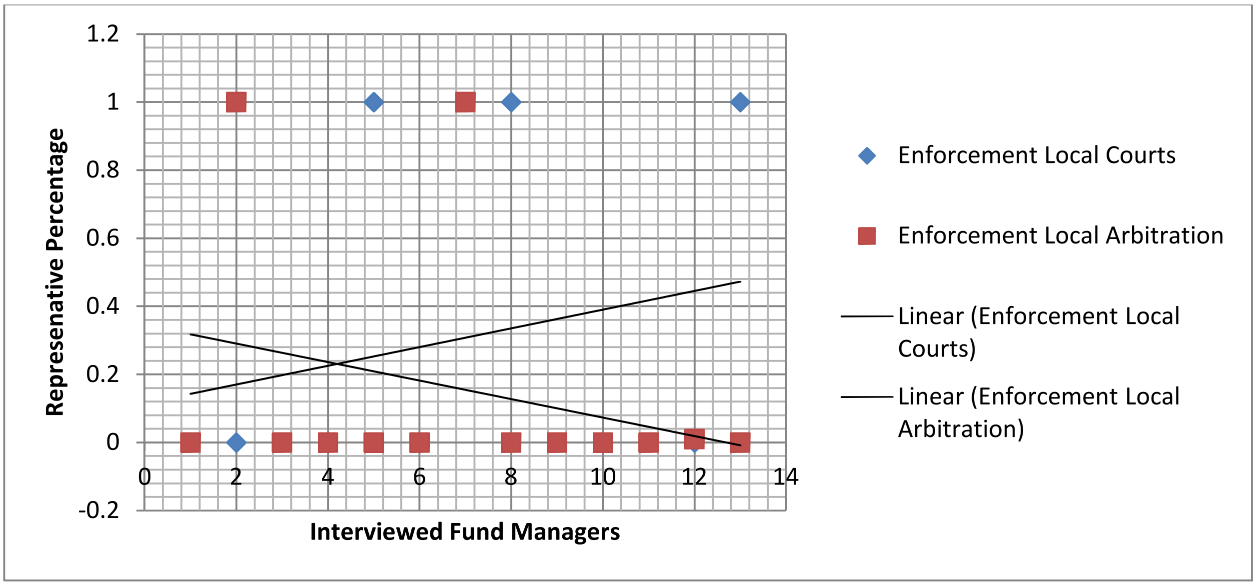
The Commercial Division has generally enjoyed widespread support for professionalism and competence since its establishment, but like all other branches of the

[94] World Bank Doing Business Index 2010, <http://www.doingbusiness.org/data/exploreeconomies/kenya#enforcing-contracts> accessed 29 December 2010

judiciary, suffers the problem of acute case backlogs. It was not surprising, therefore, that the same number of private equity fund manager respondents (80%) decried the lengthy case back logs.

Given these antecedents, only 31% of the interviewed fund managers indicated they would most likely be willing to litigate their investment disputes in Kenyan courts – quite proximate to the 23% that indicated willingness to arbitrate their investment disputes under Kenyan arbitration laws – as depicted in the figure below.

Chart 8.3: Contract Enforcement Trends



Source: Fund Manager Survey 2010

These findings are worrying when placed in the wider frame of legal and institutional frameworks for the development of financial markets. It would appear logical that an efficient framework engenders trust across the investment community. The contract enforcement choices illustrated so far run in the opposite direction: demonstrating a sense of mistrust to local legal institutions. Norton observes that -

> "(…) financial law reform in developing countries is (…) about (…) the creation of a viable and coherent financial legal infrastructure suitable for the development of well-functioning financial markets and sound business environment(s) (…) These include laws in the areas of contracts, property, property security rights, commercial and financial law (…)."[95]

To assess these issues at closer range, all respondents were asked to assess the extent to which they would relate to seven possible explanations on why they would not take their disputes to Kenyan courts. The seven options were whether it was because they thought:

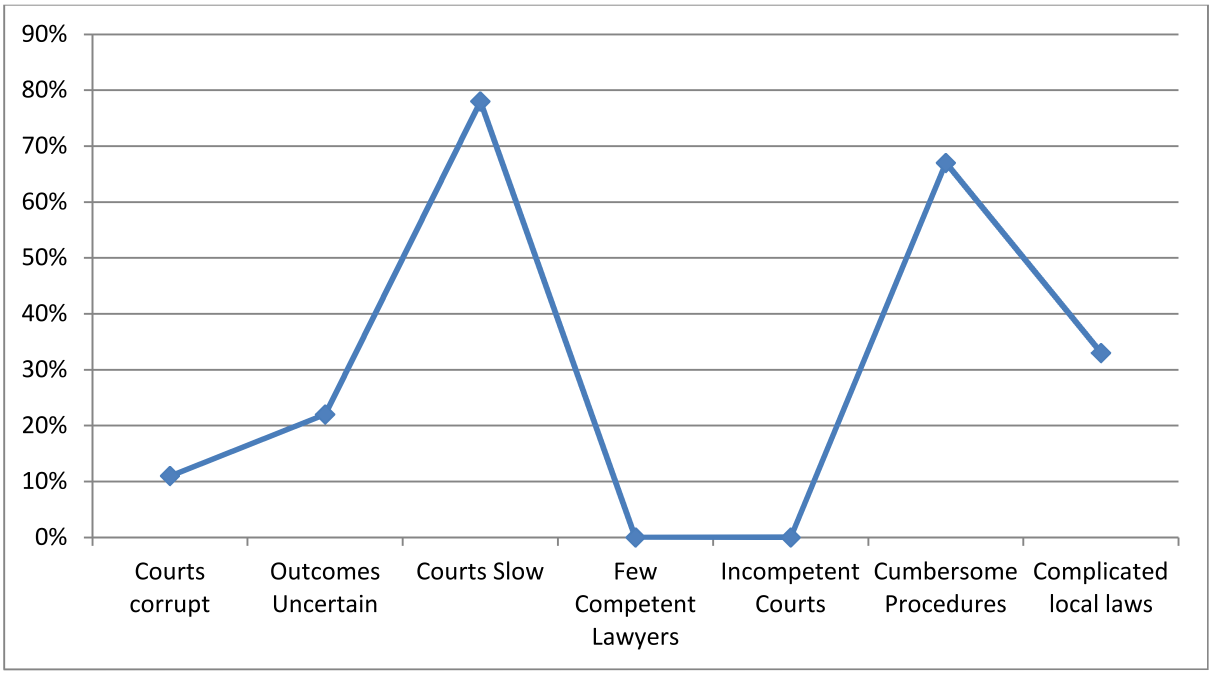
1. *Kenyan courts were so corrupt.*
2. *Litigation outcomes could not be reasonably predicted for a variety of reasons.*
3. *Court process was too slow.*
4. *Kenya had too few competent legal practitioners able to effectively litigate complex financial contracts.*
5. *Courts were incompetent and ill-equipped to handle complex financial contracts.*
6. *Court procedures were too complex and cumbersome and difficult to understand, especially when you are a foreign investor.*
7. *Litigation laws are too complicated and difficult to understand.*

Their responses are captured in chart 9.5 below.

Over 70% of fund managers, it can be seen, view local courts as too slow, and over 60% believe court procedures are cumbersome. Close to 30% think local laws relating to litigation are complex and convoluted, while around 11% are concerned with judicial corruption as it impacts the stability of commercial doctrine in the country - in spite of the common law doctrine of *stare decisis* that is applied in Kenya.

[95] Joseph J Norton, 'Taking Stock of First Generation of Financial Sector Legal Reform' (2007) SMU Dedman School of Law Studies Research Paper 9, 32 < http://ssrn.com/abstract=981226 > accessed 25 October 2011

Chart 8.4: Push Factors to Litigation in Kenya



Source: Fund Manager Survey 2010

Interestingly, the competence of legal practitioners in Kenya is not in question; neither is the technical competence of the High Court in question as far as determining complex financial disputes.

The last two opinions in the preceding paragraph are indicative that the Kenyan legal profession has the basic tools necessary to create a competitive market for trade in legal services. That competitive edge is undercut, however, by institutional weaknesses within the judiciary: procedures, bureaucracy, opacity of rules, and sporadic application of judicial precedent. To the extent these ailments strike at procedural as opposed to substantive qualifications of the judiciary, it is a shame and an indictment of the Kenyan judicial system, something policy makers ought to pay immediate attention to as the market increasingly attracts more private equity intermediaries – as documented earlier in this study.[96]

The following discussion illustrates that these problems have had a long history – as long as the age of independent Kenya, quite literally.

8.6 Constraints in the Judiciary

Confidence in the Kenyan judiciary's ability to be an impartial and independent arbiter in the determination of disputes, whatever the character of those disputes might be, has historically been impaired by well-documented cases of corruption in the corridors of justice. Corruption is a complex problem, driven by a mix of factors ranging from the terms and conditions of service in the judiciary, the issue of the quality and quantity of the human resource, infrastructural constraints, and executive interference. In 2003, the *Report of the Integrity and Anti-Corruption Committee of the Judiciary* (The Ringera Report),[97] a judicial committee appointed by the Chief Justice Evan Gicheru to investigate the causes, forms, extent and solutions to judicial corruption, found that out of a judicial sector comprising 3,234 officials (judges, magistrates, Kadhis, and paralegals), a total of 152 judicial officers were directly linked to overt acts of corruption, that is -

- 5 out of 9 Court of Appeal judges (56%)
- 18 out of 36 High Court judges (50%)
- 82 out of 254 Magistrates (32%)

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[96] ch 5, 158; 189

[97] Government Press, September 2003

<http://www.marsgroupkenya.org/Reports/Government/Ringera_Report.pdf> accessed 11 September 2011. The implication was either a direct act of corruption, or conduct closely linked to corrupt practice, or otherwise unethical conduct.

- 43 paralegal staff.

These findings were restatements of long-standing reform agenda previously visited by other committees appointed to look into the question of improvements to the judicial system in the Kenya.[98] On 7^{th} January 1998, for instance, a committee chaired by the Hon. Justice Richard Kwach, appointed by the then Chief Justice Hon. Z. Chesoni (*deceased*) to review the administration of justice in Kenya, documented widespread patterns of corruption, incompetence, neglect of duty, theft, drunkenness, lateness, sexual harassment and racketeering in the judiciary. To resolve these issues, the Kwach Committee recommended several measures including: the improvement of the terms and conditions of employment of judicial officers, reorganisation of case handling and management methods, introduction of alternative dispute resolution mechanisms in Kenya (ADR), and an increase in the number of judicial personnel to ease the pressure of case backlogs.

In 2009, it was estimated that there were in total 910,013 cases pending in the Kenyan judiciary (2,372 before the Court of Appeal; 115,344 before the High Court; and 792,297 before various magistrate's courts). The key drivers for this situation were identified to

[98] International Commission of Jurists - *Kenya Report, 2005*: *Judicial Independence, Corruption and Reform*, April 2005< http://www.icj.org/IMG/pdf/Kenyareport> 17-18, accessed 5 April 2011: Fleming Commission Report, 1960; Pratt Commission Report, 1963; Miller-Craig Commission Report, 1967; Ndegwa Commission Report, 1971; Waruhiu Committee Report, 1979/80; Ramtu Committee Report, 1985; The Waruhiu Committee Report 1979/1980; Mbithi Committee Report, 1990/1991; Report of the Committee to Inquire into the Terms and Conditions of Service of the Judiciary, 1991-1992 (The Kotut Report); The Report of the Committee on the Administration of Justice, 1998 (The Kwach Report); The Report of the the Integrity and Anti-Corruption Committee of the Judiciary, 2003 (The Ringera Report); The Governance, Justice, Law and Order-sector wide Reform Programme, 2003; Report of the Sub-Committee on Ethics and Governance of the Judiciary, January 2006 (The Onyango Otieno Report); Report of the Committee on Ethics and Governance of the Judiciary, 2008 (The Kihara Kariuki Report); Vision 2030 Medium Term Plan 2008 – 2012; Kenya National Dialogue and Reconciliation Monitoring Project – Agenda Item 4 Longstanding Issues and Solutions, Draft Report – Status of Implementation January 2009; Multi-Disciplinary Task Force (chaired by Hon. Justice William Ouko), January 2009 - Case backlogs were singled out by many of the committees as creating a supportive environment for corrupt practices including the phenomenon manifested as the disappearance of files – where court files cannot be traced on matters listed in the daily cause lists of the judiciary, effectively frustrating the progressing of court hearings, as well as the disappearance of crucial court records.

include shortage of judicial staff and officers, inadequate number of courts and under-developed physical infrastructure, inappropriate rules of procedure, jurisdictional limits on magistracy courts and mechanical management of court records and proceedings.[99]

To the extent that these institutional weaknesses underwritten by corrupt practices persist within the Kenyan judiciary, it could be concluded that the integrity of financial contracts in Kenya, as far as enforcement goes, is uncertain. Chief Justices of the East African Community Countries recently admitted that the Region's justice system remained 'weak'.[100]

Another structural weakness undermining the reputation of the judiciary relates to law reporting. Kenya's law reporting history has been intermittent, and incomplete.[101] This creates a situation whereby legal practice cannot strictly speaking be said to be applying standardised judicial precedent around the country. This is also compounded by the infrastructural weaknesses of the Judiciary, with many places in Kenya not having a permanent High Court. Lawyer LX73, a leading commercial lawyer in one of Kenya's top 5 law firms, jokingly mused at interview:

> "The further you move away from Nairobi, the further you move away from the law."

This jocular statement startlingly captures the basic reality of the statement's meaning. Indeed, in *National Bank of Kenya Ltd V. Wilson Ndolo Ayah* [2009] eKLR, the Court of

[99] Republic of Kenya, 'Final Report of the Task Force on Judicial Reforms' (2010) 73 <http://www.kenyalaw.org/Downloads/Final%20Report%20of%20the%20Task%20Force%20on%20Judicial%20Reforms.pdf> accessed 24 October 2011.

[100] Benjamin Muindi, 'Region's Justice System Weak', *Daily Nation*,(8 Tuesday December 2009) < http://www.nation.co.ke/News/-/1056/818974/-/item/1/-/d20p8n/-/index.html >

[101] Kenya Law Reporting Council, http://www.kenyalaw.org/history/ - follow link for a Kenyan exposition on the doctrine of *stare decisis* as applied in Kenya.

Appeal noted obiter that there does exist a tendency by some judges in Kenya to not follow judicial precedent, a practice that it frowned upon. Quoting the reported case:

> *"…The Court of Appeal pointed out that there were many High Court decisions on the issue, some which followed* Obura v. Koome*, and some which did not. It was noted that those decisions which did not follow* Obura v Koome *were departing from the doctrine of precedent, as the High Court is bound by decisions of the Court of Appeal without discretion."*[102]

Drawing, therefore, from the generality of the foregoing, the following themes underpinning a reform agenda for the judiciary stand out: the challenge of adequate funding of the judiciary; the problem of infrastructure; the question of qualifications of judicial officers; the question of judicial independence; and the question of consistent law reporting. These are not new themes: they have been rehashed since the 1960s. It is valid to deduce that there appears to an entrenched problem of institutional inertia.

It was shown earlier that between 1960 and 2009, there have been established no less than 17 committees, commissions or task forces to look into the question of integrity, competence, efficiency and transparency in the Kenyan judiciary. A striking feature that has become recurrent is the rehashing of themes, the rehashing of recommendations, and pointless bureaucracy. This latter element is seen in the establishment of committees to evaluate how another committee's recommendations should be implemented. Most of the 17 reports are in fact self-contained: identifying the problems, identifying solutions, and recommending strategy. Yet in spite of this massive evidence base on how the judicial institutions should be reformed, there has been little evidence of implementation.

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[102] Kenya Law Reports, Issue 085, (11 December 2009) < http://www.kenyalaw.org/newsletter/ > accessed 15 December 2009.

These views support a deduction that there has historically existed a problem of institutional weakness to follow reforms through. Institutional weakness is the result of the absence of political will, which in turn could be the result of a mix of factors including the overall level of legal development in the country. To progress the agenda for a stable judicial doctrine, law reporting ought to be viewed as a fundamental development agenda, and perhaps prioritised in the nation's growth vision as articulated under Vision 2030.

8.7 Some Reflections on What the Findings Mean

From the empirical evidence around the themes underpinning this chapter, it emerges that Kenyan private equity practice places substantial effort and contracting emphasis on mechanisms other than courts and formal arbitration in the management of contract performance. It was noted in chapter 3 that private equity is a monitoring-based financial contracting strategy – this feature has been observed quite strongly in the findings in this chapter. It is a fact that fund managers place disproportionate faith in routine relationship management activities, and design the monitoring framework to pre-empt disputes ever getting grievously contentious. Selection bias naturally arises in relation to these deductions as investee companies were not engaged in the study. Nonetheless, the significance of the findings in this chapter support the proposition for continued law and institutional reform to strengthen contracting, even as more and more fund managers establish their businesses in Kenya.

In answer to the research question, therefore, whether the law is relevant to property rights, or indeed whether it plays any part in the occurrence of financial contracts, the answer – to the extent of the matters addressed in this chapter – must be 'yes'. But is the security of property rights the same as or commensurate with the efficiency of dispute resolution mechanisms in a country – both institutional and procedural? This is an important question to consider. In other words, what is it that makes property rights secure: is it the declarative principles in law that clarify what property is treated as secure in law or which proscribe and sanction certain human action for derogating declared precepts as to property rights, or does it proceed from the institutional ability of dispute resolving institutions to efficiently resolve disputes, including commercial disputes? Or, both?

The evidence led in this chapter support the notion that the ability of dispute settling institutions to efficiently determine commercial disputes turns on more than one factor. It would appear furthermore that some among those factors are more definitive than others. A basic principle of law is that compacts are to be observed (expressed in the Latin maxim *pacta sunt servanda*). Much of the wisdom in this principle lies in the faith that contract-based obligations are capable of extra-contractual enforcement, restitution or other forms of recompense. That faith in an external legal environment seems to be a powerful driver of contracting choices as they relate to dispute resolution. Law, particularly contract law, remains relevant to contract design, and so does the role and strength of legal institutions like the judiciary in supporting relational contracts.

8.8 Conclusion

In light of the foregoing discussion, several things are evident. Firstly, in financial contracting, the availability of extra-contractual mechanisms for the settlement of contract disputes, judging from the stated perspectives of private equity fund managers in Kenya, is essential. Where such availability is seen as elusive, contracts are designed to embed alternatives to local dispute resolution.

Secondly, in private equity contracting, choice appears to be an important factor. By "choice" is meant the availability of alternative options to choose from. Between litigation and arbitration in Kenya under Kenyan laws and litigation and arbitration extra-territorially, the overwhelming preference is to take disputes outside Kenya for investments undertaken in Kenya. Owing to their stated objections to dispute settlement in Kenya, 'choice' is unavailable to local fund managers. As a 'push' factor in jurisdictional attractiveness to the flow of private capital, this factor alone may not be deterministic. In combination with other country factors, however, it effectively contributes to making the investment environment less attractive – and sometimes sufficiently uncertain as to prevent entry.

Investors are quick to avoid a country deemed to carry too much 'risk', unless a particularly high rate of return can be guaranteed. In Africa, this closely follows the extractive industries (mining and manufacturing), meaning certain types of private capital flows will still be made available regardless of country risk profiles, but that capital will flow into specific industry types whose overall economic impact within the receiving jurisdiction may be limited. Taking the last notion a step further, Africa's experience is instructive. Some of the African recipients of the largest amounts of private foreign direct investment (such as Nigeria, Sudan, DRC) are not known for their strength of property rights systems, or as having efficient judicial systems. The private foreign investment into all three countries have been to their extractive industries (oil, minerals), and these are countries that have experienced decades of human conflict, low levels of human development, and weak banking systems. Would stronger systems for property rights protection motivate investors to diversify their investment interests into other economic sectors that promote deeper, more sustainable development for these countries?[103] This is an open question.

[103] Caution is necessary in interpreting these reflections since factors beyond investment sectors are responsible for under-development in any economy so classified.

Africa is not yet strong on technology innovation – the sector that drove private equity in all the more robust markets right from America in the early 1900s to Asia today.[104] It was shown in chapter 5 that African private equity is strong in the fast-moving commodity and lifestyle segments of the economy, and is increasingly specialising in agribusiness – arguably Africa's largest and most rapidly expanding economic sector. The role for the law is to define interests in property to facilitate the negotiation of financial contracts. this is especially important when Kenya's land-related property rights issues are taken into perspective.

The National Land Policy, adopted in 2010 contemporaneously with the new Constitution, is very closely aligned with chapter V of the Constitution of Kenya of 2010.[105] That policy documents that the land tenure system has made it difficult to establish interests in land, casting substantial doubt on the goodness of title where land-based financial investments are concerned. A huge swathe of agri-business, including private-equity financed agri-business, depends on a rational system for the clarification of land rights in such a way as to facilitate the creation of financial interests in land. This was the broad thesis in such works as *The Mystery of Capital* by Hernando de Soto, who argued for a law-based property rights system that facilitated the use of land rights as a means of economic exchange.[106] The National Land Policy (set out in Sessional Paper No.3 of 2009) affirms this thesis, arguing that investments in the land sector have historically been frustrated by the difficulty in establishing title. Previous inquiries and investigations into the land question documented patterns of executive abuse of power, the insidious impact of corruption in undermining the

[104] Ch 3, 88.
[105] Articles 60-68, Land and Environment, Cap 0, 2010
[106] de Soto, *The Mystery of Capital* (2000) (n 24) 36-68, 160-218

soundness of land titles as a negotiable instrument in commercial transactions, among other problems besetting landed property as a means to financial contracting.[107]

New reform programmes are currently underway to redress some of these systemic illnesses. They include the automation of the lands registry all over Kenya, the reissuance of land titles, the consolidation of land-sector laws, and the limitation of executive's ability to allocate land. The new constitutional paradigm therefore establishes the thesis that law and the security of property rights is essential to financial development.

Private equity financing is availed, this work has sought to argue, under conditions of extreme business risk. Within the context of this chapter, judicial risk can drive insecurity in financial contracts, and like it was deducted at chapter six, capacity constraints are pervasive across the private equity practice landscape in Kenya. The long-standing need for judicial reform, and the continuing limited implementation of judicial reforms, only add to that conviction, that institutional capacity constraints present some of the most pressing development challenges to an emerging economy like Kenya. Conceptually, this is a cross-cutting theme that emerges from this work.

It is thus deducible that in Kenya's case, there perhaps would occur wider investments in the agribusiness framework were the land tenure system rationalised, simplified and the integrity of interest in land made transparent and readily verifiable. Applying this to an enforcement framework yields interesting results. Where interests in land are not readily verifiable, financial contracts are not secure – since the possibility of third parties subsequently turning up to claim proprietary rights in the subject of a financial contract cannot be ruled out. Where the converse is true, investors more readily commit to financing

[107] Roger Southall, 'The Ndungu Report: Land and Graft in Kenya' (2005) 32(103) Rev. of African Political Economy 142

opportunities – on the basis that they can readily clarify what aspect of their contracts are open to breach, and how local dispute settlement systems are likely to resolve disputes.

In this illustrated sense, efficient dispute resolving institutions are essential for financial development in a country. That efficiency, the foregoing argument has suggested, turns on the law – a legal framework that permits contracting parties to clarify the content of the legal intentions they seek to create, and to clarify their fallback options should they find themselves standing in contractual breach.

In sum, two distinct patterns have emerged in the preceding review in this chapter as far as enforcement choices in private equity agreements are concerned. Among the few fund managers that are led by Kenyans, and which fundraise locally, their financial contracts demonstrated a preference for local arbitration and litigation before Kenyan courts. The converse is true for expatriate fund managers, who demonstrated a strong preference for foreign arbitration and litigation. Kenya, it has been shown, has a legal framework for the recognition of foreign arbitral awards and judgements, subject to statutory conditions for such recognition. Adopting a statistical measure of market trends reveals that the substantial majority of private equity companies operating in Kenya will not embrace local dispute resolution in the medium term – not until, perhaps, the judiciary's image as a tainted institution is altered. In this sense, legal institutions have been demonstrated to impact the design of private equity financing contracts.

9

CONCLUSIONS

9.1 Introduction

This work has grappled with the question whether the law is a useful and necessary tool in the quest to grow private equity markets in developing countries. The empirical chapters (4, 5, 6, 7 and 8) have focused on a study of a single country in Africa, Kenya, and have, sequentially, collated qualitative and empirical evidence around five key themes –

(a) Constraints to enterprise finance faced by Kenya's private sector;

(b) The structure and key features of Kenya's private equity industry;

(c) The regulatory framework for private equity in Kenya;

(d) The tax framework for private equity in Kenya; and

(e) The strength of contracts, property rights and efficiency of local commercial dispute resolution mechanisms in Kenyan private equity practice.

Within the context of those empirical chapters, a series of factual deductions based on the identified facts were drawn. This short chapter attempts to bring the empirical findings together through a concise and thematic analysis and evaluation of what those findings and deductions mean, reflecting on the main research question and the supporting statements thereunder (the secondary research questions).

This study's methodology proposed the employment of a financial contracting framework in evaluating this work, and the unit of analysis is the private equity contract: it was shown at chapter 1 (which stated the problem) and chapter 3 (reviewing the history and nature of private equity) how the private equity contract typically occurs at three levels (the '*private equity cycle*'): fundraising, investment and divestment. In bringing the study's findings together, this chapter evaluates the relevance (or potential irrelevance) of the law in private equity *fundraising*, commercial *contracting* and investment management (including the process of *divestment*). This chapter's inherent approach in engaging the empirical findings can thus be stated in three short questions, drawing from the study's core design:

(a) Is law relevant to fundraising for private equity in Kenya?

(b) Is law relevant to private equity financial contracting in Kenya?

(c) Is law relevant to improving efficiency in private equity divestment (or share sale transactions)?

The countervailing argument, of course, remains in this chapter as it was in chapter 1, that the law is irrelevant, that property rights are irrelevant, and that commercial transactions occur on a 'willing seller willing buyer' basis. When reflecting on these contested counter arguments at chapter 1,[1] it was proposed that in market transactions, there exist two sets of what we called 'country factors' necessary for private equity to grow: the 'external factors' and the 'internal factors'. The view was adopted at chapter 1 that law, and legal institutions, constitute the set of factors fitting within the 'internal' dynamics of private equity market development. It was proposed that the law and legal institutions constitute 'enablers' for the macroeconomic factors – that is, the 'external factors' that the 'willing buyer willing seller' paradigm promotes. The thesis argument at chapter 1[2] was that law and legal institutions are likely to be more influential than the macroeconomic factors, in a developing country context, in creating fortuitous conditions for private equity markets to grow. A central objective of this chapter is to explore the extent to which that claim is established in the empirical findings in this work.

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[1] S 1.2.1, 5-8
[2] ibid 6

Proceeding on the basis that this is a foundational study of private equity in Kenya, it seems fitting that the outcomes of this chapter's evaluations be translated into a series of law and policy implications. This is, in the end, a fundamental objective of "what it means to know"[3] what this study establishes on private equity in Kenya. It is thus that this 'ontological'[4] pursuit is contextualised in a set of the 'emerging legal and institutional issues' that this study gives rise to.

To achieve the foregoing objectives, this chapter is organised into the following five key emerging legal and institutional issues –

(i) Issues on the design of a law on private equity;

(ii) Issues on tax policy for private equity;

(iii) Issues on private equity fundraising;

(iv) Issues on capital market development for private equity; and

(v) Issues on the integrity of financial contracts.

Each theme is explored sequentially under the following five subsections. At section 9.7, a five-point law and institutional Private Equity Growth Model for Kenya is constructed, based on the evaluations in sections 9.2 through 9.6.

The chapter concludes at section 9.8 with a short statement on what future research aimed at expanding the frontiers of knowledge around Kenyan private equity might look like.

[3] Ch 2, 46,47

[4] ibid

9.2 Issues on the Design of a Law On Private Equity

The empirical findings in chapters 5,[5] 6[6] and 7[7] point to a policy inclination toward a defined, though still dispersed and incomplete body of law on private equity in Kenya. This deduction is grounded on the existence of detailed regulations under the Capital Markets Authority Act of 1989, the Registered Venture Capital Companies Regulations of 2007,[8] and income-tax specific regulations under the Income Tax Act of 1974. Organisational form for private equity is at the time of completing this study regulated under a separate piece of legislation (the Companies Act of 1962). In effect, the legal framework on private equity practice in Kenya remains a patchy framework.[9] Perhaps more significantly, the evidence finds a remoteness of relationship between market intermediaries and the regulator to exist, underwriting divergence between the law and market behaviour.[10]

Drawing from the experience of jurisdictions that have cultured private equity markets employing various legal tools (including the reviewed cases of the USA,[11] the UK,[12] Israel[13] Taiwan,[14] Spain[15] and Chile[16]), a law on private equity can be employed to do one or more of the following (whether that law is consolidated or dispersed) –

(a) Regulate dedicated organisational forms for fund management and venture capital investment services;

(b) Create structures around organisational vehicles that deliver tax efficiency (without negatively impacting the overall tax policy for the wider economy);

[5] Pp153
[6] Pp198
[7] Pp251
[8] Ch 4 (119), 6 (203), 7 (258)
[9] Ch 5&6, 159, 200, 247
[10] Ch 6, 235
[11] Ch 3, 69, 72, 77
[12] Ibid, 72
[13] Ibid, 75
[14] Ibid, 79
[15] Ibid, 78
[16] Ibid, 77

(c) Create frameworks for the making of institutional investments into private equity funds – as well as the regulation of certain institutional investments depending on the requirements of public policy (e.g. pension and insurance funds);

(d) Facilitate the provision of government programmes – e.g. government venture funds, or the channelling of capital into economically sensitive, but otherwise unattractive investment sectors;

(e) Lay down principles for the industry's regulation;

(f) Promote home-grown funds – e.g. creating competitive frameworks for onshore funds; and

(g) Provide a legal framework for efficient financial contracting – stipulating the forms of permissible investments, investment structures (capital structuring), as well as flexibilities around financial product innovation.

These objectives can be achieved through a single comprehensive law, or through targeted but dispersed legislative adjustments across a number of laws. Whether or not either option is advisable for Kenya is a subject over which there should be, in this study's perspective, focused regulatory debate in Kenya. Given the condition of the private sector, and the persisting attitude of indifference within the regulator toward private equity, it is deducible that legal development for private equity and alternative investments generally remains an ongoing need in Kenya.

The study's findings on the question of legal development do not support a categorical choice over either consolidation or dispersed regulatory framework for private in Kenya. The findings in chapters 5, 6 and 7, however, support the definite assessment that the legal framework for Kenyan private equity is under-developed and would benefit from a review that –

1. Expands choice over organisational forms available for private equity investment and advisory services;
2. Clarifies, expands and consolidates the law on private equity-specific tax policies;
3. Removes conflicts within the law on private equity investment options, e.g. over investment restrictions and the identified variances between capital market and bank sector legislations;
4. Clarifies the question of definitions under the Capital Markets Act of 1989;
5. Resolves the apparent division of the private equity market into regulated and unregulated intermediaries within the framework of Capital Markets (Registered Venture Capital Companies) Regulations, 2007;
6. Broadens the range of security instruments recognised in law for financial engineering (through amendments to the Companies Act of 1962 e.g. to include such options as convertible shares and enabling the full range of private equity contracting tools, including leveraged buyouts);
7. Progresses the evolution of the law on financial assistance through a careful and futuristic revision of section 56 of the Companies Act of 1962; and
8. Enables tax efficiency – a theme discussed in greater detail below.

The weight of the empirical findings supports the analytical deduction that the law is an essential instrument in the resolution of all or a number of the preceding issues – especially in crafting the basic country conditions necessary to support efficiency in private equity business formation, practice and regulation.

Issues (1) to (8) above, when placed within the analytical prism of this chapter, tend to have an impact on the financial contracting and divestment stages of private equity. Employing the law in achieving them is a practical choice: it would be difficult to attain those ideals through any other means.

9.3 Issues on Tax Policy for Private Equity

Tax incentives are a well-documented tool employed across many jurisdictions – as the cases of Taiwan, Spain, the United Kingdom, the USA, and Israel, cited above, evidence. Tax incentives, however, vary across jurisdictions, and within each jurisdiction, they are employed to achieve a predetermined policy-linked outcome.[17] This study established that tax policy tools can take any of the following illustrative forms –

(a) Exemptions – e.g. of dividends (earned from investments into private equity) from taxation;

(b) Deductibility of eligible expenses and losses – including limits to permissible thresholds;

(c) Reduced rate for capital gains taxation or complete exemption of capital gains from tax (usually subject to specified qualification requirements, e.g., stated minimum investment holding periods, or restrictions against redistribution of dividend incomes and capital gains income);

(d) Tax reliefs – for investments into private equity, or into SME-focused private equity funds (linked to a policy objective of bridging the 'funding gap');

(e) Incentives for research and development (which can take many different forms);

(f) Special treatment of employee compensation schemes such as stock options.

The objective of the foregoing tax policy tools is the same across jurisdictions: to increase fundraising for private equity.[18] Investors, faced with the promise of a reduced tax burden as a result of investing into private equity, are motivated to increase their exposure to private equity. A supportive tax policy for private equity in a developing country could therefore be

[17] Ch 1, 9

[18] Ch 7, 253

crucial to the mobilisation of capital, expanding sources and types of enterprise capital available to the private sector.

The evidence in this work demonstrates that in Kenya, there are very few tax-based incentives for private equity investing. Secondly, it has been shown that certain incongruities exist within the tax policy practiced in Kenya (e.g., the compensating tax). There exists a basis, therefore, to reflect that –

1. To promote local fundraising and investments into private equity, tax incentives might be valuable tools;
2. A small and medium enterprise tax rate targeted at key sectors that will drive and anchor the country's economic take-off might be valuable – this might unlock entrepreneur interest in research and development work, and there is every indication that Kenya's techno-innovations industry is priming for significant growth;
3. Promoting research and development as an economic activity is necessary – and tax policy could play a substantial role in driving this process. Taiwanese, Israeli, UK and USA experiences offer functional models from which to draw learning on targeting and structuring of incentives.
4. Tax incentives in compensation schemes are also warranted, especially now that the private equity industry is growing at a rapid pace. Evidence was led at chapter 7 on such compensation tools as ESOPs and Stock Options – rendering these compensation options tax-efficient will not only contribute to making them useful in talent attraction and retention, but will also drive deeper sophistication in overall economic management across shareholder-based companies in the country.

While tax policy clearly belongs among those factors this study calls 'external factors' (that is, a macroeconomic tool),[19] it is inevitably anchored in the law. It has been said that legal development reflects the dominant political reality within a country, a reality that shifts with time.[20] The expressed public policy in Kenya strongly supports enterprise and technology innovation – providing anecdotal evidence of congruence between this study's ideal for a private equity-efficient tax framework and the prevailing political will toward expanding sources of enterprise capital in Kenya.[21]

Placing these findings into an implementation framework supports the deduction that the law, and its supporting institutions, can be useful tools in the hands of policy makers when implementing improvements to the current tax framework for private equity practice in Kenya.

9.4 Issues on Private Equity Fundraising

The evidence (at chapter 5) shows that in Kenya, there exists a pool of substantial institutional funds (e.g. pensions, insurance, banks and high net-worth individuals) that could form substantial fundraising sources for Kenyan private equity investments.[22] All of these strategic fund pools are currently under-exposed to private equity. Lessons from other jurisdictions (the USA and the Netherlands, for instance) demonstrate that employing the law to trigger and consolidate institutional investments into private equity can support the growth and sustainability of local fundraising.[23] The law can be employed to –

[19] Ch 1, 5-9
[20] Mark J Roe, 'Strong Managers Weak Owners: The Political Roots of American Corporate Finance', (1994) Princeton: Princeton University Press; Luigi Zingales, 'The Value of the Voting Right: A Study of the Millan Stock Exchange', (2003) 7 The Review of Financial Studies 125 - 148
[21] Ch 1, 23-25
[22] Ch 5, 165-168
[23] Ch 3, 69, 74

(a) Set limits on the extent to which a closely regulated institutional fund pool can be exposed to private equity and similar alternative investments;

(b) Relax stringent regulation of certain types of institutional investors in order to allow larger exposure to private equity

(c) Create government fund pools to be employed in a targeted way to trigger desired market responses in capital mobilisation and dispersal.

Current law in Kenya permits, prima facie, limited pension, insurance and commercial bank exposure to private equity.[24] The evidence at chapter 5, illustrating reality within the pension funds industry, demonstrates that in fact, there remains limited take-up of alternative investments in the portfolio diversification strategies of most scheme fund managers – mostly stemming from Government Financial Regulations that require fund managers to invest only in government security papers.[25] The current policy on scheme fund corporate governance is directly responsible for the very shallow commitment of pension fund resources into unlisted equity.[26] Given stated government policy on restricting exposure of pension funds to such unlisted equity as private equity, it is proper to deduce that the question of corporate governance is a strong private-equity linked theme that merits separate focused exploration.

It does appear, on the strength of the foregoing analytical reflections, that beyond crafting an enabling legal framework for local institutional investments into private equity, political concerns over regulated fund pools will need to be addressed, alongside the corporate governance question. These are merely part-solutions, as additional work will need to be undertaken to build awareness and capacity among institutional fund managers on how to

[24] Ch 5, 165
[25] Ibid, 166
[26] Ibid, 167

undertake private equity investments. As reported in the empirical chapters, this process has began.[27]

More nuanced, and arguably the more delicate task (from a regulatory perspective) will be the creation of a framework for the various financial sector regulators to forge a joint approach towards private equity - including on information sharing protocols. The Dutch model (harmonisation of regulations around capital adequacy, solvency, disclosure standards and portfolio valuations) offers a useful starting point.[28] The last strand in the Dutch model is particularly relevant for Kenya, in light of the number of financial sector regulators operating technically independently. This relate to questions of valuation principles, financial accounting, authorisation and approvals as well as numerical ceilings.[29]

These are important issues for regulatory dialogue, and it does appear that to varying extents, a role for the law arises in aiding the creation of or improvements to a harmonious regulatory framework for institutional investments into private equity. In this sense, the law can become a fundamental tool in triggering and sustaining fundraising for private equity investments within Kenya.

9.5 Issues on Capital Markets Development for Private Equity

The findings at chapter 5 demonstrated that preferred exit strategies in Kenya include mainly trade sales and buybacks, but stock market exits would be more desirable.[30] A well-established theme in that chapter was the expression of difficulties around qualifying for a

[27] Ch 5, 167
[28] Ch 3, 74
[29] id
[30] Ch 5, 187

stock market listing in the main investment segment of the Nairobi Stock Exchange.[31] Chapter 4 reviewed the listing requirements.[32] It seems that to improve the investment exit frameworks for private equity in Kenya, developing alternative options is a desirable pursuit.

Over-the-Counter (OTC) markets and small and medium-enterprise (SME) capital markets trading platforms have been employed in a number of countries to promote avenues for enterprise growth and investing.[33] Taiwan, Israel and the USA, three of the reviewed models within this study, offer the more successful examples, while Chile, Spain and Brazil illustrate the less successful attempts in this regard.[34] These experiences offer mixed findings from a models transplant perspective.[35] The key lesson, it would seem, is that a country's strong experience with public equity markets can support the successful launching of such innovative fundraising techniques.[36]

It would appear that the law is a central tool in aiding the crafting of a formal OTC market and an SME trading platform in Kenya. Viewed differently, organised markets ultimately are a set of rules by which intermediaries play, and through which expectations are set, and against which conduct is judged. These are 'qualitative' elements. Key issues from a law and institutional standpoint relate to the general framework for disclosures and financial accountability, enterprise stability (from a business soundness or solvency perspective) and overall corporate governance standards and principles. While a code exists for corporate governance among listed firms,[37] the evidence adduced indicate three key elements –

(a) The level of compliance with financial reporting standards even among the listed firms remains low (and it was shown that the IFRS do not mandatorily apply to

[31] Ch 5, 187-188
[32] Ch 4, 119, 121
[33] Ch 4, 120, 122
[34] Ch 3, 69 - 80
[35] Ibid, 80
[36] Ibid, 81
[37] Capital Markets Authority, Corporate Governance Code, <http://www.cma.or.ke/Regulations/>

unlisted companies, suggesting the reality of a broad swathe of the Kenyan business sector implementing widely varied levels of corporate transparency);

(b) Regulatory capacity to discover and redress corporate governance crises and violations among regulated market intermediaries remains challenged; and

(c) Investor protection remains a challenge – judging from the series of distressed licensed market intermediaries, some of which have gone into liquidation, exposing investors to substantial losses because of an investment compensation fund that is yet under-capitalised.

The experience of failing licensees appears to have jolted the regulator into taking formative remedial action, in the form of proposing a number of new regulations to strengthen the regulatory oversight mandate – including the Capital Markets (Conduct of Business)(Market Intermediaries) Regulations 2011, the Capital Markets (Securities) (Public Offers, Listings and Disclosures) (Amendment) Regulations 2011, the Nairobi Stock Exchange (Nominated Advisors) Rules 2011 – to, respectively, clarify more stringently the qualifications and business conduct of licensees; create a framework for small and medium size enterprises listing on the Nairobi Stock Exchange under the SME Exchange or SMEx; and provide for the qualifications for listing, and the role of advisors in preparing SMEs for listing.[38]

The foregoing three key objectives relating to deepening of the capital markets require both legal and institutional instruments. The proposed regulations create a framework for the occurrence of market practice, while institutional factors promote ethical conduct, and deliver the public policy objective of investor protection.

[38] Capital Markets Authority, Proposed Regulations, <http://www.cma.or.ke/draftregulations/>

9.6 Issues on the Integrity of Financial Contracts

Proceeding from a financial contracting framework, the private equity process – anchored onto different but closely-connected contractual agreements – would appear to depend on a set of institutions for stability –

(a) Strong integrity of financial contracts (security of contracts)

(b) Strong respect for private property (strength of property rights)

(c) Strong tradition of truth-telling (corporate transparency and accountability, linked to financial reporting standards)

(d) Faith in third-party dispute resolving institutions (judicial integrity).

North (1991) views institutions as sets of recurring values, practices, standards and expectations, that acquire notoriety, constancy and predictability from repeated usage. [39] In other words, and within the context of this study, institutions are systems that acquire a reputational effect from regular usage, grounded in a sense of impartiality.

Fund managers in Kenya, it was documented at chapter 4, opined that financial disclosures for instance are not entirely reliable in Kenya,[40] and that private sector practices that reduce corporate transparency and accountability effectively lower firm value as investors practice what private equity terms 'price protection' – that is, the attitude of conservatively pricing their investments because of the uncertainty of latent liabilities not discoverable at the due diligence pre-investment stage.[41]

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[39] Douglas C. North, 'Institutions,' (Winter, 1991), 15(1) The Journal of Economic Perspectives, 97-112

[40] Ch 4, 138

[41] id

The theory behind financial disclosure is much agitated in disclosure literature.[42] Firstly, it is assumed firms hold private information. Secondly, it is supposed that where firms elect to disclose, they disclose truthfully. Thirdly, it is thought that firms attach importance to financial market valuation. However, any unverifiable statement in a financial statement could be indicative of untruthful disclosure, although if disclosure is an important entry deterrent (that is to say, suppresses the willingness of external parties to enter the firm context), there exists a structural motivation in favour of truthful disclosure.[43]

The disclosure literature adopts the basic assumption that disclosed corporate information is true, although it can be argued that the strength of the truth is higher in environments where anti-fraud laws are strictly enforced.[44] What this suggests is that 'truth telling' may not necessarily be a motivator to disclosure by firms: that is, firms disclose only so much information as is necessary to meet regulatory compliance thresholds, and no more.[45]

It has been argued that disclosure is good for firms – variously that it reduces the cost of equity capital, and fosters liquid and efficient capital markets.[46] It is also argued that disclosure reduces the cost of debt, enabling transparent companies to enjoy lower interest

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[42] Masako N Darrough, 'Disclosure Policy and Competition: *Cournot vs. Bertrand*' (1993) 68 (3) *The Accounting Review* 534, 537

[43] ibid

[44] Anat R Admati and Paul Pfleiderer, 'Forcing Firms to Talk' (2000) 13(3) in *The Review of Financial Studies* 479, 481

[45] The problem of 'truth': is financial reporting essentially about 'telling the truth', and do firms ordinarily tell the 'truth' about the financial standing of their business? Asked differently, is 'truth' integral to and essential in financial reporting? Even more complicated is the question of 'truth' from whose perspective, and whether 'truth' as a process or 'truth' based on morality. An interesting line of inquiry.

[46] Arthur Levitt, 'Importance of High Disclosure Standards' (*Inter-American Development Bank, Washington D.C.*, 29 September 1997) < http://www.sec.gov/news/speech/speecharchive/1997/spch176.txt> accessed 25 October 2007.

rates on loans.[47] But if it is so good for companies, why don't firms disclose fully and truthfully, without coercion? In practice, "firms are forced to talk."[48]

Mandated disclosure compels firms to disclose the types of information they would rather keep hidden. This directly upsets the natural inclination of a reporting entity to engage in 'happy reporting' – suppressing negative corporate results, disclosing only those aspects perceived to communicate positive financial performance.[49]

It would appear thus that North's construction of 'institutions' takes on an experiential quality for Kenya: owing to a prolonged period when the private sector's interactions with the formal economy was limited because of the structural barriers identified in chapter 4, it can be ventured that the doctrine of corporate transparency remains shallow out of its non-repetitive application. It is then defensible to presuppose that as the Kenyan private sector engages more in the formal economy, and as businesses transform, the doctrine will become more and more entrenched.

Yet as the disclosure literature indicates, firms are forced to talk. That compulsion proceeds from a legal instrument, and resides in that legal instrument. It is, in effect, the law. The practice of corporate transparency and accountability, however, becomes institutionalised in the practice of 'financial reporting', a term that in practice relates to the disclosure of the totality of a corporation's state of affairs.[50]

It would also appear that institutions are critical in the quest to improve the quality of the private sector – among others, to address negative business practices such as corruption, bureaucracy, inefficient regulatory practices, and widespread tax avoidance.

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[47] Partha Sengupta, 'Corporate Disclosure Quality and The Cost of Debt' (1998) 73(4) The Accounting Review 459, 549
[48] Admati and Pfleiderer (n 44) 479-483.
[49] Darrough (n 42) 534
[50] Interview with PM6, Regulatory Affairs, Ministry of Finance, Nairobi, Kenya, January 2010

In the context of financial contracting, the evidence supports a deduction that weak institutions tend to motivate contracting choices that introduce disservice to the local economy, e.g., taking disputes outside of the national jurisdiction reduces the opportunity for nurturing a local pool of talented dispute negotiators in complex financial transactions. It also removes from the local courts the opportunity to deepen judicial expertise around complex financial contracts.[51]

From the framework of the main line of inquiry, this thesis argues that the law, together with associated legal institutions, would be particularly useful to an emerging market like Kenya in resolving the issues discovered in this study. An efficient regulatory framework, it is easy to venture, would support the 'external factors' that drive macroeconomic activities within a legal jurisdiction. In fact, if countries were a construct, they would be a 'legal' construct, for states are juridical beings, defined by sets of laws and institutions that set them apart from other states. The implication of this latter proposition are substantial, and perhaps merit dedicated academic inquiry within the narrow context of financial contracting.

9.7 Synthesising Findings

The preceding reflections bring us back to the question, ultimately, whether laws and legal institutions are indeed relevant to the growth and expansion of private equity markets in Kenya? The foregoing analyses support an affirmative answer. But the inquiry line required a more nuanced evaluation: the secondary questions asked, in effect, which aspects, if the law is necessary, would be the most important? The foregoing analyses have attempted a drawing out of the main ingredients of the law and institutional paradigm for private equity growth in a country. These elements commend themselves closely to a country's individual

[51] Ch 8, 315-318

characteristics, especially the structure of its overall economy. The identified elements are used to inform the model proposed below

First, however, it is noteworthy that the evidence in this thesis support the further and bolder proposition that to more robustly expand Kenya's private equity industry - specifically, law and institutional instruments will be main tools in the hands of public policy makers.

Taking, therefore, the totality of the foregoing reflections and deductions, the following model for growing Kenya's private equity industry in the medium to long-term emerges. The model is styled "a Growth Model for Private Equity in Kenya." Its core elements include the following:

(a) Efficiency and choice of investment vehicles (fund structures)
(b) Tax efficiency in private equity investments
(c) Promotion of local fundraising
(d) Improvements to investment exit frameworks through capital markets development
(e) Strengthening the security of private property rights, including the strengthening of judicial and arbitral institutions
(f) Strengthening corporate transparency (more efficient and widespread adoption of international financial reporting standards
(g) Development and adoption of a national valuation strategy/standard for private equity portfolio assessments
(h) Strengthening the quality of Kenya's private sector.

These elements can be summarised in the following interdependent model:

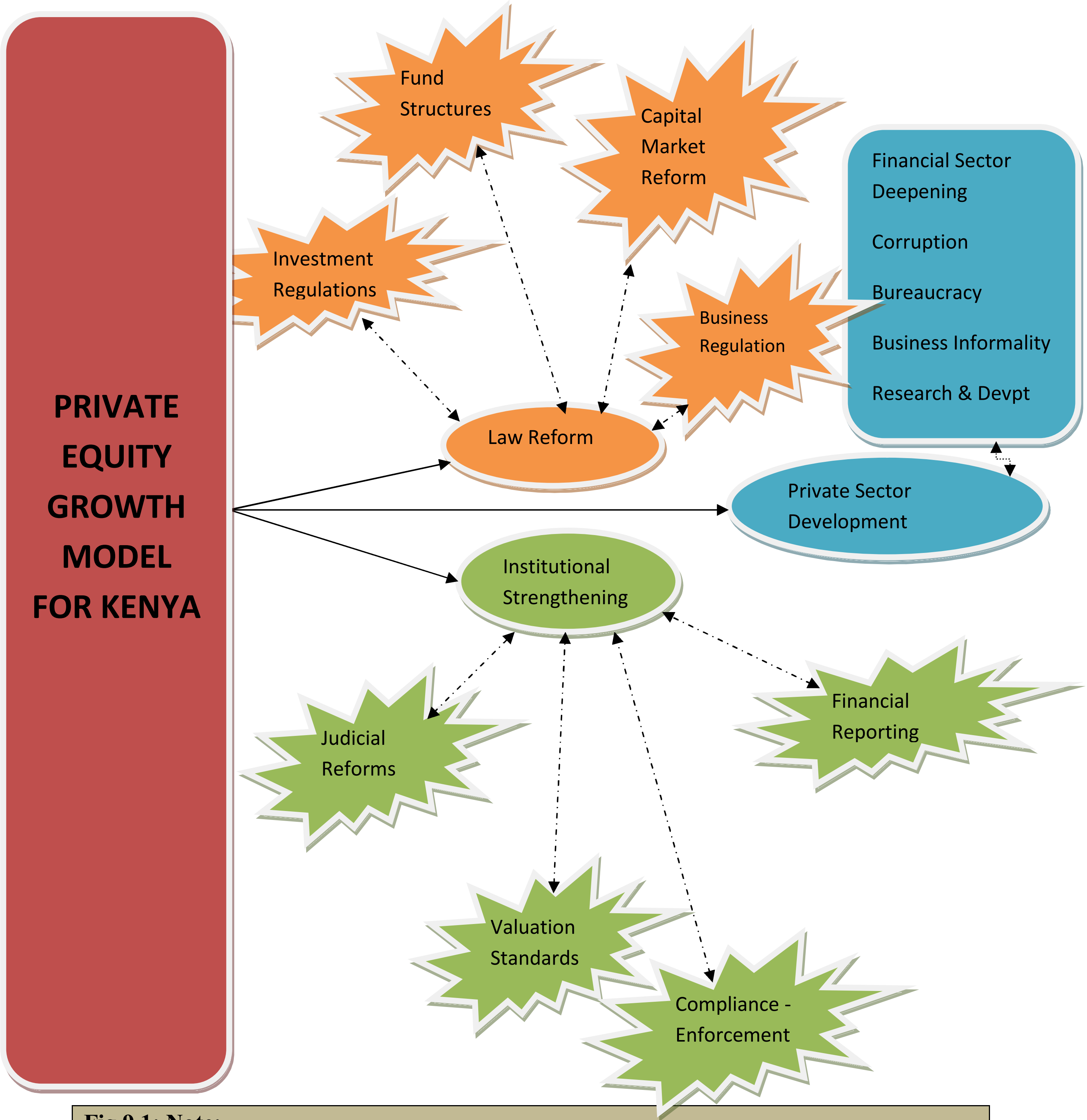

Fig.9.1: Note:

As the model illustrates, a multi-pronged approach to growing national markets for private equity would be essential. Each core element in the model is underpinned by a vortex of secondary strategies, and it is the submission in this work that pursuing one or two of the recommended options (like current disjointed practice shows) would not yield efficient outcomes, because of the inherent inter-dependence across all elements depicted therein.

9.8 FUTURE RESEARCH

As the pioneering study in this field in Kenya, this work has touched partially on the law and economics agenda, the financial regulation agenda, and the theoretical underpinnings to financial innovations and the law. These themes need more robust exposition and exploration, both empirically and theoretically. What this work has achieved is to create a baseline framework for future explorations of the multi-disciplinary nature of private equity.

Given Kenya's economic development stage, it is particularly crucial that future work look into the legal and institutional mechanics for the growth of a dedicated early stage venture capital programme for Kenya, especially one rooted in research and development. Financial innovation frequently mirrors enterprise innovation, which in turn mirrors a country's development ethic. Inquiry into these dynamics would expand the stock of local knowledge on how private equity and national development mesh together.

The vexed question on law and finance as a theoretical explanation to the provision of enterprise capital merits investigation within a developing country context such as Kenya. While the legal origins doctrine of the law and finance theory has largely been discredited around the world, the merits of the theoretical exposition of the link between finance, corporate governance and property rights warrant closer investigation in emerging markets. The value in theory is its ability to offer a prism for critical evaluation of knowledge, and an empirical testing of the claims of the law and finance theory in developing country contexts would be a valuable addition to knowledge.

Virtually everything known about private equity in the developed markets of North America and Western Europe remain largely unknown for African private equity – and there is justified merit in further work that tests and exposes assumptions about emerging markets private equity. Stemming from the intrinsic design of this work, an empirical approach to both theoretical and non-theoretical inquiries is favoured for future work in this area.

This work has only considered one face of private equity – two other 'faces' remain unexplored to complete the knowledge 'baseline' for Kenya's private equity commercial contracting. The experiences and the legal and institutional issues relating to private equity by venture companies on the one hand, and institutional investors on the other, needs to be undertaken.

There is a need to build a national baseline of empirical data on all aspects of the private equity industry. Collaborative work between researchers and the private equity industry in Kenya would yield valuable information that would form a critical first-line database for more robust empirical studies on Kenyan private equity, but also for policy makers seeking to evaluate public policy choices.

Finally, a persistent need has been identified throughout this work: the need for capacity development in Kenya, and, by extension, any developing economy. A key question that arises out of every empirical chapter in this thesis is what the role of government should be, and to what extent does the government discharge such role? Since private equity is a market process, it is reasonable to deduce that the role of codes of conduct would be central – giving rise to the question what codes are relevant to private equity? How should they be developed? Separately, do government agencies possess requisite supervisory skills and resources? How well-geared are they to discharge that supervisory mandate? What is the ideal balance for this purpose? On another level, what should the foundations of private equity be (a trade-off between fundraising, supervision and legislation)? Furthermore, in transplanting models, what should the ideal be: should developing countries model external realities, or adapt home-grown solutions? These are pertinent, unexplored issues.

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Appendix A

PRIVATE EQUITY IN KENYA – AN ANALYSIS OF EMERGING LEGAL AND INSTITUTIONAL ISSUES – A Doctoral Thesis Questionnaire

Dear …..,

I am a doctoral research student at Warwick University, England, studying the question how laws and institutions impact investments, financial contracting, and earnings. My special study economies are Kenya and South Africa. An important strand to my research is the state of the private equity industry in Kenya, especially the efficiency of financial contracts, security of property rights, and returns the local market supports. Your answers will not only illuminate the thesis, but will contribute directly to the formulation of policy options to be commended to relevant policy agencies of the government at the study's conclusion. This research is being conducted on the premise that efficient financial contracting is important to economic development, especially in deepening market confidence in the eyes of foreign investors, as well as engendering confidence in the financial markets by motivating and expanding the sophistication of business financing options to entrepreneurs.

This is therefore to request and invite you to kindly take a few minutes to answer the following questionnaire on the state of the private equity industry in Kenya.

The information you provide will be applied to a purely academic use, and will not be used for any other purpose. Your confidentiality as and individual and as an institution will be guaranteed, and all information will be desensitized before use in my thesis. This is my word of honour, and in keeping with my University's research ethics.

As I will be in Kenya from 30th December 2009 until 12th January 2010, I shall endeavour to collect the questionnaire in person from your offices.

Thank you for your kind cooperation.

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QUESTIONNAIRE COMPLETION INSTRUCTIONS

All questions are grouped around sub-headings. Kindly answer each question under each sub-heading by cycling or striking through a given letter-choice. You are very welcome to pen down your thoughts where you feel the choices offered do not speak to the reality as you know it. This questionnaire is designed to take no more than 30 minutes of your time. Please accept my sincere gratitude to you for accepting to participate in this important survey. The Survey Findings will be circulated to all participants promptly upon collation and analysis. Thank you.

QUESTIONNAIRE: PRIVATE EQUITY INVESTING IN KENYA

GENERAL ECONOMIC CLIMATE

During the next 12 months, I expect the overall economic climate to –
(a) improve
(b) decline
(c) remain the same

FUNDING

Over the next 12 months, we plan to raise a new fund
(a) Yes
(b) No

Over the next 12 months, we expect raising new funds for investment to –
(a) remain the same
(b) be less difficult
(c) be more difficult

If we intended to raise funds within the next 12 months, we would raise capital from the following source of third party funding –
(a) Governments and Development Finance Institutions
(b) Pensions and endowments
(c) Insurance
(d) Banks
(e) Private individuals
(f) Fund of funds
(g) Corporates
(h) Other

If we intended to raise funds within the next 12 months, we would raise capital from the following geographical source:
(a) Kenya
(b) Europe
(c) Africa
(d) USA
(e) Other

I expect the time it will take to invest my current fund to be:
(a) Less than 2 years
(b) 2-4 years
(c) more than 4 years

Currently, I feel that the understanding and attitude of institutional investors [locally] towards the PE/VC industry is –
(a) Improving
(b) Worsening
(c) The same

INVESTMENTS

Over the next 12 months, I expect to focus on opportunities in the following sectors –
(a) Financial services
(b) Info tech
(c) Health care
(d) Telecoms
(e) Retail
(f) Media
(g) Manufacturing
(h) Entertainment
(i) Services
(j) Other

I am currently looking at the following types of deals –
(a) Start-up and Early stage
(b) Seed capital
(c) Expansion and development
(d) Replacement and buy-out

At the present time, competition for new investment opportunities is –
(a) Increasing
(b) Decreasing
(c) Not changing

Over the next 12 months, I expect entry multiples on transactions to –
(a) Increase
(b) Decrease
(c) Remain the same

Over the next 12 months, I expect the volume of transactions to –
(a) Increase
(b) Decrease
(c) Remain the same

Over the next 12 months, I expect the average deal size to –
(a) Increase
(b) Decrease
(c) Remain the same

In the next 12 months, I expect to be a net buyer or net seller of businesses –
(a) Net buyer
(b) Net seller
(c) Purchases = Sales

I expect the availability of debt financing for transactions to –
(a) Increase
(b) Decrease
(c) Remain the same

EXITS

During the next 12 months, I expect exit valuations to –
(a) Increase
(b) Decrease
(c) Remain the same

During the next 12 months, I expect the volume of exits to –
(a) Increase
(b) Decrease
(c) Remain the same

During the next 12 months, we expect to exit investments by –
(a) Trade sale
(b) Sale to another PE firm
(c) Resale to management
(d) IPO
(e) Dividend payout
(f) Write down

I expect the average life-cycle (or hold-period) from initial investment to exit for investments made in 2007-2008 to be –
(a) Less than 2 years
(b) 2-5 years
(c) more than 5 years

PERFORMANCE

Over the next 12 months, I expect the relative financial performance of our investee companies to –
(a) Outperform expectations
(b) Perform in line with expectations
(c) Under perform expectations

12 months from today, I anticipate the combined valuation of all portfolio companies in which we are invested today, relative to current value, to be –
(a) Higher
(b) Lower
(c) Remain the same

OTHER

During the next 12 months, we expect to spend the majority of our time focused on –
(a) Raising new funds
(b) New investments
(c) Portfolio management
(d) Disinvestments
(e) Refinancing
(f) Other

INVESTORS

My current medium-term view is that PE/VC funds will provide returns that will –
(a) Outperform the appropriate NSE index
(b) Under-perform the appropriate NSE index
(c) Perform in line with the appropriate NSE index

My current medium-term view is that PE/VC funds will provide –
(a) Superior risk-adjusted returns
(b) Adequate risk-adjusted returns
(c) Inferior risk-adjusted returns

During the next 12 months, we expect our allocation (% of total funds) to PE/VC funds to –
(a) Increase
(b) Decrease
(c) Remain the same

Our current allocation to PE/VC funds are –
(a) 0 - 2.5%
(b) 2.5% - 5.0%
(c) Above 5%

I expect the following to be constraining factors during the next 12 months for investing in PE/VC funds –
(a) Lack of appropriate risk-adjusted returns
(b) Lack of liquidity
(c) Asset class not well understood
(d) PE/VC perceived as "exotic" products
(e) Other

I expect the sources of third party funds to be raised in 2010 to be –
(a) PE fund of funds
(b) Insurance companies
(c) Pension funds and endowment funds
(d) Banks
(e) Government, aid agencies and DFIs
(f) Private individuals
(g) Corporates

AGENCY ISSUES

Which agency problems do you face most in your investments in this market?
(a) Moral hazard
(b) Bilateral moral hazard
(c) Adverse selection
(d) Free riding
(e) Hold up

(f) Trilateral bargaining
(g) Window dressing
(h) Underinvestment
(i) Asset stripping
(j) Risk shifting

How are these ordinarily addressed/mitigated in the financing contract?

SECURITIES

Which of the following securities options do you most frequently employ in securing your cash-flow rights? (tick all that apply)

(a) Common equity only
(b) Preferred equity only
(c) Convertible preferred equity
(d) Preferred equity and warrants
(e) Convertible debt only
(f) Straight debt and warrants
(g) Straight debt only
(h) Warrants only
(i) Common equity and straight debt
(j) Common equity and preferred equity and debt (convertible or straight)
(k) Preferred equity and debt
(l) Preferred equity and common equity
(m) Common equity and warrants
(n) Other combinations
____(please specify)

Would you say your security design is mostly informed by –

(a) The nature of the regulatory environment
(b) A flexible contract environment
(c) An inflexible contract environment
(d) A desire to control for exit
(e) Tax advantage
(f) A poor exit environment

Would you say that your present contracting flexibility

(a) Allows for returns maximisation
(b) Negatively impacts returns
(c) Neither improves nor diminishes returns

EXIT ISSUES

Out of your _____ (total) investments up to July 2009, how many have you exited?

(a) None
(b) All

(c) Other ______________(please indicate number exited)

From the total investments exited, how many were exited via –

(a) Initial Public Offering _____________
(b) Acquisitions __________
(c) Secondary sales _________
(d) trade sales ___________
(e) Buybacks ___________
(f) Write-offs ____________

Do you control for exits in your investments by contract?
(a) Yes
(b) No

If yes, which of the following contractual provisions do you deploy for that purpose?

(a) Registration rights
(b) Super-majority clauses
(c) Demand rights
(d) Drag-along rights
(e) Warrants
(f) All of the above
(g) Other ____(please specify)

Would you say the prospect of exiting your investments is usually

(a) Difficult
(b) Uncertain
(c) Reasonably assured
(d) Always available

How would you rate the efficiency of your exit strategy?

(1) Highly profitable and very efficient
(2) Profitable/Efficient
(3) Average
(4) Unprofitable/Inefficient
(5) Mostly Disastrous

INVESTMENT HOLD PERIOD

On average, for the investments you made between 2002 and 2007, what is your investment hold period?

(a) 0-3 years
(b) 3-5 years
(c) 5-7 years
(d) Over 7 years

What would you say are the key explanatory variables/factors that determine/control the investment hold periods? (tick all that apply)

(a) A difficult/poor exit environment
(b) Slow firm-value certification process
(c) Slow turn-around time in value-addition
(d) Steep agency problems stemming from poor corporate governance
(e) Corruption
(f) High price protection
(g) Investment syndication
(h) Few buyers and sellers

Would you say a longer holding period (over 5 years) would:

(a) Lower returns at exit (as a function of increased transaction costs)?
(b) Facilitate complete exit (as opposed to partial exit)?
(c) Motivate lower price protection (as a function of firm-value certification)?

Which legal and institutional reforms in your view would increase efficiency in investment hold periods and promote more efficient exit strategies?

(a) Enhanced disclosure standards
(b) Improved corporate governance frameworks
(c) Reduced corruption

Would higher disclosure standards result in higher private equity valuations?

(a) **Y**es
(b) **N**o

How? (tick all that apply)

(a) By lowering the risk-adjusted return on capital
(b) By lowering transaction costs (excluding corruption-related costs)
(c) By lowering agency costs
(d) By lowering price protection (as a result of higher transparency)

COUNTRY RISK, SYNDICATION AND CO-INVESTMENTS

In structuring your investments in this market, what is the typical country risk premium that applies?

(a) 0-5%
(b) 5-8%
(c) 8-11%
(d) 11-15%
(e) Over 15%

How do you estimate the risk-adjusted hurdle rates for local investments (accounting for political risk, difficulties in converting cost of capital across currencies, difficulties of adjusting foreign proxy firm risk measures for financing packages in local currency, and difficulties in adjusting for financial and operational hedging policies)?

What are the preeminent determinants of your country risk profiling in this market? (tick all that apply)

(a) Contracting risk
(b) Agency costs
(c) Corruption
(d) Regulatory costs
(e) Exit risk
(f) Poor returns
(g) Macroeconomic and political instability

Do you syndicate your investments?

(a) Some
(b) All
(c) None

If you do, what are some of the key factors informing your syndication decisions in this market?

(a) Risk spreading/limiting fund exposure
(b) Deal size
(c) Country risk
(d) Cross-border investments/multi-jurisdictional reach
(e) Fund focus

Is corruption an important factor in your investment decisions for this market?

(a) Yes
(b) No

In your view, an auditor's report in Kenya

(a) Offers authoritative and exhaustive firm-level disclosure **(i) Yes (ii) No**
(b) Conforms with the true standing of firm operations **(i) Yes (ii) No**
(c) Is ordinarily not manipulated **(i) Yes (ii) No**
(d) Has a strong influence on the relationship between a corporation and its shareholders **(i) Yes (ii) No**
(e) Is open to manipulation and ordinarily does not provide complete disclosure in accordance with the demands of international financial reporting standards (IFRS) **(i) Yes (ii) No**

RETURNS

In the case of a targeted absolute return, which absolute return is your institution seeking to generate from private equity investments in Kenya?

Average ________
Median ________
Minimum ________
Maximum ________

In the case of a targeted relative rate of return, what level of over-return (in basis points) is your institution expecting from private equity in comparison to public equity investments in Kenya?

Average _________
Median _________
Minimum _________
Maximum _________

What discount rates do you (investors and non-resident funds) use to evaluate investment opportunities in Kenya?

What have been your overall portfolio returns on retired funds?

(a) 0-8%
(b) 8-12%
(c) 12-16%
(d) 16-20%
(e) 20-24%
(f) 24-30%
(g) 30-50%
(h) Over 50%

What has been your Average IRR on both realized and unrealized investments?

(a) 0-8%
(b) 8-12%
(c) 12-16%
(d) 16-20%
(e) 20-24%
(f) 24-30%
(g) 30-50%
(h) Over 50%

What has been your Median IRR on unrealized investments?

(a) 0-8%
(b) 8-12%
(c) 12-16%
(d) 16-20%
(e) 20-24%
(f) 24-30%
(g) 30-50%
(h) Over 50%

In this market, what combinations of factors best explain your returns performance?

(a) Number of deals
(b) Deal size
(c) Contracting in/efficiency (cross as it applies)
(d) Investment hold periods
(e) Market conditions (please specify)
(f) Exit in/efficiency (cross as relevant)
(g) Legal standards: poor/good (cross as relevant)
(h) Other ____(please specify)

CONTRACT ENFORCEMENT

In the enforcement of your property rights and financial contracts, would you make judicial enforcement (via local courts) your number one option?

(a) Yes
(b) No

If you answered 'no' to the preceding question, it was because you feel – (select all that apply to you)

(a) That the courts are corrupt and no fair or just outcome is ever guaranteed;
(b) The courts are too slow and there would be harmful delay in settling rights and claims;
(c) There are very few competent lawyers locally capable in complex financial contracts;
(d) The courts are not competent to handle complex financial contracts and disputes;
(e) The laws and procedures are cumbersome, opaque, unfamiliar and complicated.
(f) Other ____(please specify)

Where you cannot accept court-based dispute adjudication, would you accede to locally-based alternative dispute resolution mechanisms such as local arbitration, under local arbitration rules and procedures?

(a) Yes
(b) No

If you answered 'no' to the arbitration question, it was because you feel –

(a) The local law on arbitration is not adequately sophisticated to meet the complex needs of a private equity financing contract;
(b) The local law on arbitration has not yet been tested sufficiently for consistency in the application of legal principles and international standards of procedural conduct;
(c) There is not yet an established rich tradition of qualified and competent local arbitrators that inspire investor confidence in local mechanisms;

(d) Fund limitations exclude recourse to local dispute resolution mechanisms;
(e) Local arbitral rules and procedures are not as familiar as those of more familiar 'developed' overseas jurisdictions.

APPENDIX B
PRIVATE EQUITY IN KENYA – AN ANALYSIS OF EMERGING LEGAL AND INSTITUTIONAL ISSUES – A Doctoral Thesis

INTERVIEW SCHEDULE

The Earnings Question

1. There is thinking that transaction structures in many emerging markets evince investment syndication as a common practice, and that this partly explains why returns in such markets lag those of developed markets where syndication is more uncommon. Is it true that syndicating eats away at earnings? If so, in what specific ways for such investments in Kenya?

2. The investment hold period affords venture capitalists time to add value to an invested firm, yet there is a school of thought that longer hold periods negatively impact earnings – either because of increased transaction costs arising from managing the investment for longer, or because the market perceives assets held for long to be inferior of value, hence the longer certification process. Is any of these true? And does it matter to the bottom-line how long an investment is kept?

3. In what specific ways do higher disclosure standards translate to higher equity valuations?

4. In what ways is corruption an important issue in local private equity investments?

5. How do you estimate the risk-adjusted hurdle rate for local investments? [There is a school of thought that owing to the regulatory costs of operating as a venture capital firm in Kenya, the target return that would compensate for the regulatory costs has to be 25% minimum. Is this the case? Is it sustainable in this market?]

6. [Management in Kenya is paid management fees, but must pay VAT thereon. To secure full value on the management fee entitlement, then, fund managers are paid the management fee plus VAT, drawn from portfolio earnings. The implication is that the VAT indemnification from portfolio earnings eats away at the bottom-line. Industry logic is that the private equity business is not a vat-able service. The question then becomes why VAT is payable on management fees? Some secondary questions become whether scrapping VAT would be a significant factor for locating businesses within Kenya, and whether opening up or reducing the excluded sectors would make the local market more attractive to investments.]

7. There is research evidence that the choice of vehicle for exiting investments frequently determines how much the investors earn out of an investment – quite apart from the influence of the hold period, or syndication issues where the investment was syndicated. Is this true in your experience?

8. How do you adjust for inflation in private equity investments – which are not fixed-income contracts? [This is based on the premise that high inflation erodes the outstanding nominal value of contracts to the investor.]

APPENDIX C

PRIVATE EQUITY IN KENYA – AN ANALYSIS OF EMERGING LEGAL AND INSTITUTIONAL ISSUES – A Doctoral Thesis Interview Schedule

FINANCIAL AND ACCOUNTING STANDARDS IN KENYA

Dear …..,

I am a doctoral research student at Warwick University, England, studying the question how laws and institutions impact investments, financial contracting, and earnings. My special study economies are Kenya and South Africa. An important strand to my research is the state of financial reporting and disclosure standards in Kenya. The research is contextualised in the wider framework of the efficiency of financial contracting in African Emerging Markets. Your answers will not only illuminate the thesis, but will contribute directly to the formulation of policy options to be commended to relevant policy agencies of the government at the study's conclusion. This research is being conducted on the premise that efficient financial contracting is important to economic development, especially in deepening market confidence in the eyes of foreign investors, as well as engendering confidence in the financial markets by motivating and expanding the sophistication of business financing options to entrepreneurs.

This is therefore to request a very brief interview to consider 10 specific questions surrounding these issues, as set out below. I shall endeavour to wrap up the interview within 35 minutes.

I will be in Kenya from 30th December 2009 until 12th January 2010. I humbly request that you grant me an interview at any time during this period. A confirmation e-mail can be sent to my address below. I can also be reached on the mobile number detailed below.

Thank you for your kind cooperation.

Nathan R TUIMISING
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The Questions:

1. While taking cognizance of the fact that Kenya adopted international accounting standards nearly 2 decades ago, to what extent are international financial reporting standards (IFRS) effectively applied in Kenya (both in the public and private sectors)?

2. Both the Companies Act and the Accountants Act place a duty on companies to prepare accounts, but neither legislation specifically requires the application of IFRS to accounts preparations. Who under Kenyan law cracks the whip on IFRS, and on what regulatory basis?

3. Recently, publicly listed firms were compelled by the CMA to comply with the IFRS on financial disclosures, and most firms that attempted compliance were said to have fallen short of the detailed requirements under IFRS disclosure parameters. What are the regulatory sanctions for non-compliance with disclosure standards?

4. To the extent that the Companies Act, the Capital Markets Act and the Accountants Act do not directly legislate on the IFRS standard for accounts preparation, is it possible that Kenyan businesses are engaging in regulatory arbitrage to beat compliance?

5. A recurrent theme is that Kenya has far less qualified accountants to fully comply with the requirements of IFRS, with the result that most companies engage the services of accounting technicians with limited book keeping skills. Is it fair to observe, therefore, that compliance with financial reporting standards is below par in Kenya because preparers of financial statements lack the skills requisite for the job?

6. How many qualified accountants are in Kenya as of December 2009? What is the ideal number of qualified accountants needed for today's Kenyan economy?

7. How many qualified accounting technicians are there in Kenya as of December 2009? Does the corporate sector in Kenya have access to adequately trained accountants?

8. Is it correct to deduce that continued banking sector crises, including the recent spate of stockbroker and investment bank failures are the result of weaknesses in financial reporting and poor compliance with disclosure standards?

9. Does this mean that annual reports are open to manipulation by corporations?

10. What is the integrity of an auditor's report – as an auxiliary disclosure institution?

Annex D

PRIVATE EQUITY IN KENYA – AN ANALYSIS OF EMERGING LEGAL AND INSTITUTIONAL ISSUES

– A Doctoral Thesis

INTERVIEW SCHEDULE

The Judicial Question

1. If you were an investor in Kenya, why would you not use Kenyan courts to resolve your commercial disputes?

2. Since the early 1960s, we have seen a string of judicial commissions appointed to address the broad question of judicial capacity – and corruption, under-resourcing and related constraints have been repeatedly identified and recommendations for their resolution made: why in your view is there a persistently low threshold of institutional reform within the Judiciary?

3. Is the legal profession generally speaking partly responsible for the condition of standards within the judiciary? In the alternative, what role ought the legal fraternity play in changing the state of play?

4. In what ways is judicial corruption an important issue in local financial contracting?

5. For Judiciary: would you concur with the widespread belief that the Kenyan Judiciary is riddled with corruption? A former judge is quoted saying “The corridors of the high court have become a market place where justice is on sale to the highest bidder” – what are your views?

6. Commercial arbitration is not yet a widespread form of legal practice in Kenya – why do not more lawyers adopt it?