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Lessons from equity financing experience of Tanzanian SMEs

Donath R. Olomi
Neema Mori
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LESSONS FROM EQUITY FINANCING EXPERIENCE OF TANZANIAN SMES:

DRAFT REPORT

Prepared by

Dr. Donath R.Olomi and Dr. Neema Mori

Institute of Management and Entrepreneurship Development (IMED)

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SUMMARY

0.1 Background, Objective, Research Questions and Methodology

Access to affordable long-term finance is one of the biggest barriers to development of small and medium enterprises. Growth oriented small and medium enterprises face a momentous challenge of raising capital. Debt finance is not only expensive and difficult to get, but also inconvenient given the relatively short maturities of loans. Equity finance offers an opportunity for SMEs to raise capital, share risks, complement knowledge and skills, etc. Yet, it is grossly underdeveloped. The private equity industry has not sufficient adapted to the local institutional environment in developing economies like Tanzania. There are many policy initiatives to promote access to finance for SMEs, including equity in developing countries including Tanzania. There are also many individuals, enterprises and institutions, both local and foreign who are engaged in various forms of equity finance. Some institutions, such as the Dar es Salaam Stock Exchange are actively promoting equity finance. All these need locally relevant knowledge of equity finance. There is known effort done towards understanding and learning from experience of those engaged in this important form of finance.

The objective of the study was to generate lessons on the experience, successes and challenges of equity investments in Tanzania.

The specific research questions were:

i. What types of investees or firms have benefitted from equity investment and why? Are there investees or categories of firms that are more attractive than others for equity investment and why is it so. Does scale, ownership structure or sector matter?
ii. How do investors identify and select investees? How do investees identify and decide on investors? What criteria are used and what is the selection process? How do successful and unsuccessful investees differ?
iii. How do firms balance equity and debt? How does the tax structure or administration inform the choice between debt and equity? What intermediaries or facilitators exist and what role do they play in private equity placement?
iv. What challenges do investors and investees face and how do they differ by type of investor, ownership structure, background of investors and investees, size of investment, facilitation?
v. What is the balance between foreign and local investors?
vi. What exit opportunities are available to investors?
vii. What could be done to scale up equity investments in markets like Tanzania?

The study used an exploratory approach through literature review and repeated interviews with existing equity investors, SMEs that have sought and those which have received equity and stakeholders involved in facilitating access to finance. In total 20 SMEs, three private equity firms and five individual investors were interviewed. Of these, 10 cases were also documented, so that they can be used for teaching. The data was analyzed through a thematic approach, guided mostly by the research questions.

0.2 Key Findings

This exploratory study shows that the equity market is gradually developing in Tanzania. The dynamic and growing segment of SMEs is growing but little is documented about it. Investors are taking increasing interest in investing in Tanzanian SMEs. However, local investments in equity are largely confined to starting companies, in which a principal shareholder takes the lead and invites friends or acquaintances. Second stage external equity is still very much a preserve of foreign owned equity firms. Some of these have social mission driven sector focus (renewable energy, microfinance, community enterprises). However, most are primarily

interested in sectors and firms with high prospects of returns. Others exclude some socially undesirable sectors (alcohol, tobacco and mining). Scale matters for equity firms as it is seen as one of the indicators of viability, scalability and ability to absorb overheads associated with the investment. Family or non family ownership does not seem to matter.

How investors identify investees differ especially between the 1st stage (company creation) and the 2nd stage (growth stage). In the former case, the investors mostly know each other from previous interactions, and there is no need of due diligence. For later stage finance, investors and investees come to know each other through scouting visits by investors; reference by membership associations and consultants; and conferences.
Both investors SMEs founders prefer that the later maintains a majority ownership in the business. Equity firms appear to be ready to offer additional financing in the form of debt, to avoid over dilution of founder's shares. The tax structure is inconsequential to the ratio of debt to equity. Equity investors and SMEs get to know each other from consultants and associations. There are some linkage initiatives, but they are not yet quite effective.

Investors face many challenges, including difficulties in identifying good investee, slow communication from investees after investment and dishonesty. Investees sometimes spend a lot of time with investors without realizing investments. There are some exit opportunities for good SMEs projects in terms of other equity funds and the newly introduced 2nd tier window at the Dar es Salaam Stock Exchange
A key challenge facing both Tanzanian investors and investees is low awareness of the company law and reliance on informal arrangements. Investments are being made without having the requisite protections, including agreements, title to the company shares (share certificate), informed valuation, use of legal and finance expertise, etc. All these are contributing to conflicts and may be hurting the credibility of equity investments.

It is observed that the descriptions and policy measures for SME development do not recognize the most dynamic and growing section of the sector. In particular the opportunities, issues and challenges that face mid sized companies are almost not addressed in policy. It is noted in this study that some entrepreneurs who have managed to develop mid-sized companies face a momentous challenge in handling management and ownership succession, and there are no interventions in place to support them.

0.3 Recommendations

The pace of development of the equity market needs to be speeded by a number of policies measures. As well, investors and investees can improve the chances of success in equity investments by improving their practices based on the findings of this study.

Recommended policy measures

The low awareness and capacity of entrepreneurs to attract equity and for local investors to invest in equity successfully is attributed to limited opportunities for education and training in this area. It is therefore recommended to include equity investment in business studies curricula, providing opportunity for learners to be exposed to the form of finance. The training should make use of local case studies so that learners can learn from practice. Also, different stakeholders should introduce and promote short course focusing on readiness for equity finance

A key challenge in getting deal flow is lack of database on SMEs that have the potential or are interested in equity investments. It would be very useful for SME development organisations, including associations, the national small business development agency and investment promotion agencies to develop such databases. The database would be even more valuable if it could have information that reflects the credit rating of the SMEs.

The policy and institutional environment is insensitive to the existence, opportunities and needs of growing SMEs, particularly mid sized firms. There is need to conduct research and develop interventions that enable them to deal with challenges that come with size, including professionalization of management and ownership succession.

Recommendations to investors

Equity investors could take a number of measures to improve deal flow. One way is to establish a forum of equity investment stakeholders (potential and existing investors, investees, and equity promotion organisations) for learning, information sharing and networking. Equity investors are also advised to use networks of quality entrepreneurs and professionals, such as the Lions Club, Rotary Clubs and Business Network International (BNI) in sourcing deals, in addition to networks of consultants, associations and business challenge organizers.

In undertaking due diligence, it is recommended that equity investors should:

- Always follow the investment formalities and not take anything for granted. Investors should in particular be aware that prospective investees resisting or delaying compliance to a particular formality (signing an agreement or disclosure of some information) could be harbouring ulterior motives. All agreement should be signed as early as possible, and revised timely as necessary
- Check background and integrity of investee. The experience of some of the shareholders show that unscrupulous applicants may actually cheat about their identity or background
- Use convertible debt as a form of extended due diligence
- Evaluate the family, not just the lead entrepreneur – for character and ability, including willingness to share equity and information. It is clear that problems may arise due to the attitude or skills of the spouse or other investor, especially in the event of incapacity or death of the lead investor in the SME
- Investors should strictly demand and sign agreements at the earliest possible point in the relationship. Among others, agreements should specify roles, representation, protection of minority rights, exit and valuation. The lessons from the cases suggest that investors need to ask for an exclusivity agreement (investee not to invest in a competing business without agreement from investor)
- Investors should study and become more aware of the company law and demand share certificates immediately upon investing.

In terms of monitoring the investment, it is recommended that investors should have clear and unambiguous communication, especially for sensitive matters, such as bringing staff to the investee or any measures with financial implications. Also, problems should be sorted out quickly to maintain trust. Reporting should be simplified, and if possible automated, so that reports flow to the investor instantaneously as they are produced. Although participation in the investees' board meetings is expensive, investors should find low cost ways of participating, at least by proxy.

Recommendations to investees

On the other hand, SMEs that are interested in equity should formalize practice (record keeping, reporting, formal contracts, systems, governance, and compliance to government and tax regulations) at the earliest possible opportunity.

1. INTRODUCTION

1.1 Background

Access to affordable long-term finance is one of the biggest barriers to development of small and medium enterprises, which are the main source of jobs and incomes for the population of Tanzania. In the past four decades, innovations in delivery of microfinance have partly alleviated this problem among micro enterprise operators, especially in densely populated urban areas. However in many developing countries, growth oriented small and medium enterprises face a momentous challenge of raising capital. Debt finance is not only expensive and difficult to get, but also inconvenient given the relatively short maturities of loans.

Formal equity finance in these markets is grossly underdeveloped. Yet, it offers an opportunity for SMEs to raise capital, share risks, complement knowledge and skills, etc. Many reasons have been put forth to explain why it is difficult for SMEs to access and use equity finance from both local and foreign investors. Part of the problem is that the private equity industry has not sufficient adapted to the local institutional environment in developing economies like Tanzania. The venture capital model relies on expensive investment analysts and fund managers, which necessitates investment thresholds that are too high for virtually all small and medium enterprises. Traditional equity funders also expect a certain level of governance and managerial capacities in the investee, and a readiness to share business information and ownership with other investors. These attributes are not as developed in markets such as Tanzania.

1.2 Research Problem

There are many policy initiatives to promote access to finance for SMEs in developing countries. In Tanzania, the Bank of Tanzania (BoT) is leading the National Financial Inclusion Framework (URT, 2014) which among others, aim at facilitating development of wide range of long term financing products for SMEs. In 2013, Dar es Salaam Stock Exchange launched an Enterprise Growth Market window, which handles listing SMEs and start-ups that do not qualify for the main window. The entire network of service providers to this window, including stock brokers, DSE and the Capital Markets Regulatory Agency would benefit from knowledge of what works in that context. In addition, several private and social investors are promoting equity investments in Africa, including Tanzania. All these promoters, current and prospective investees as well as policy makers need knowledge of the drivers, experience and challenges of previous successful and unsuccessful equity investment initiatives in Tanzania.

There are a few cases of successful equity investments in SMEs, both from local and foreign investors. Yet, this experience has not been distilled to draw lessons for scaling up this form of finance. This study examined the experience of SMEs that have accessed or attempted to access equity investments and use it to draw lessons for scaling up this form of finance.

The objective of the study was to generate lessons on the experience, successes and challenges of equity investments in Tanzania.

The specific research questions were:

i. What types of investees or firms have benefitted from equity investment and why? Are there investees or categories of firms that are more attractive than others for equity investment and why is it so. Does scale, ownership structure or sector matter?

ii. How do investors identify and select investees? How do investees identify and decide on investors? What criteria are used and what is the selection process? How do successful and unsuccessful investees differ?

iii. How do firms balance equity and debt? How does the tax structure or administration inform the choice between debt and equity? What intermediaries or facilitators exist and what role do they play in private equity placement?

iv. What challenges do investors and investees face and how do they differ by type of investor, ownership structure, background of investors and investees, size of investment, facilitation?

v. What is the balance between foreign and local investors?

vi. What exit opportunities are available to investors?

vii. What could be done to scale up equity investments in markets like Tanzania?

1.3 Equity Finance in the context of SMEs

1.3.1 Nature and Types of Equity Finance

Equity finance[1] refers to the sale of an ownership interest to raise funds for business purposes[2]. In order to grow, any company will face the need for additional capital, which it may try to obtain through through debt or equity. If the company opts for equity, the owner sells a stake to others. During early growth stages of a company, especially when the company does not have sufficient equity financing can provide capital from investors who are willing to take risks along with the entrepreneur (Berger & Udell, 1998). Similarly, when a company has prospects of explosive growth, it can raise substantial capital through equity financing.

Various types of equity financing are available. Equity investors may combine equity with convertible debt or straight debt. This is done either as a form of extended due diligence, or to meet cash flow requirements while limiting dilution of the principal owner's shareholding. The most common sources of equity are presented below:

Principal owners and family equity

Most business are created and build through bootstrapping - with owners relying on personal savings, their own time and expertise (sweat equity), lowest possible operating costs, fast inventory turn around and a cash-only approach to selling. Grants and soft loans from friends are the second largest source of capital for start-ups (Mori, 2014). It is common for the principal owner to allocate equity to family members, even when they have not actually placed any cash into the company. The business is also typically directed by the founder, and other shareholders may only be asked to do what they must do by law, such as signing company documents. Business founders may also raise equity from family members, under which the later formally take a stake in the business. Ideally, these investments should be made with the same formality that would be used with outside investors (Cusmano, 2015). In practice however, close relatives do not always follow the formalities McKay, (2001), relying instead on prior knowledge family bonds and trust. This type of equity investment was not of interest to this study, because in practice, it does not differ much from sole proprietorship in terms of enabling access to finance and growth.

[1] Our study focuses on private equity offered to SMEs as defined by the Tanzanian SME Development Policy

[2] http://www.investinganswers.com/financial-dictionary/stock-market/equity-financing-1523

Individuals and other companies
The most numerous investors are individuals. All companies are established by at least two persons, who must invest equity in one form or another. Individuals who are unrelated to the founder may also invest equity in SMEs. This is the most common type of external (non-family) equity in SMEs. In some cases, founders jointly create a company from the beginning. This is the simplest form of equity investment. In other cases, individuals or enterprises buy shares in existing companies.

Angel Investors
Most angel investors (business angels[3]) are wealthy individuals who place equity in business that they believe have high growth and return prospects and are interested in supporting the entrepreneur and/or what they do (Ibrahim, 2008). Some invest on their own, while others invest as part of a network, syndicate or investment club. As experienced entrepreneurs themselves, angels often bring their own skills, knowledge and contacts to the company. Many successful large companies which attracted venture capitalists or public equity, relied first on angels (Ibrahim, 2008). Angels take significant risks when investing their own funds in startups with no operating history. It is estimated that angels provide 11 times the money invested by venture capitalists worldwide (Morrissette, 2007). Angels are more prominent in developed countries although they are starting to appear in emerging economies such as Tanzania.

Private Equity Firms
Private equity firms are owned by individual shareholders and they specialize in placing the capital contributed by the shareholders in other companies (OECD, 2015). The private equity model entails **active ownership**, often of minority stakes, in private businesses seeking not only capital but also enhanced governance or more professionalized management, over a period of several years (EMPEA, 2015). Private equity investors may be interested in staying as shareholders for the long haul, but may also decide to sell their interest to existing or new shareholders. They may be generalist or specialists in investing in specific segment of enterprises (OECD, 2015)).

Fund managers
Fund managers are companies that, like equity firms, place equity in other companies (Cusmano, 2015). Unlike equity firms, fund managers manage funds of other (large) investors, including mutual funds, pension funds and government funds. These funds are typically established for a specific period of time (e.g.10 years) and therefore placements in companies must be liquidated within the fund term. Fund managers may manage different funds at the same time. They place equity into other companies and provide strategy and governance support exiting in 5-6 years time by selling their interest to the existing or other shareholders. This might include listing the company in the stock market.

Crowd funding

Crowd funding is an emerging technique of raising external finance from a large audience, where each contributor provides a small portion of the funding requested (Cusmano, 2015). Conducted online, it allows a large number of investors to individually invest amounts of money ranging from $100 and $10,000 each into a business to help it reach its funding target. The crowd investors typically look for i) an investment requirement of less than US $200,000 ii) good seed or early stage development iii) potential for high return and iv) operating in a high growth sector, or where the investor has a personal interest in. This form of finance is not yet common in African economies although it has a potential to start and grow.

[3] https://www.nibusinessinfo.co.uk/content/sources-equity-finance

Venture Capital
Venture capital (VC) is financing from specialized companies for the purpose of supporting the business in its launch of new products/line of business or in expansion (Ernst & Young, 2010). VC investors typically invest larger sums of money and normally focus on creating an investment portfolio of businesses with high-growth potential and high rates of returns. While they take high-risk investments, they expect annual returns of 25 to 30 percent on their overall investment portfolio (ibid). Their objectives may sometimes conflict with those of their investees. They prefer businesses that have a competitive advantage or a strong value proposition in the form of a patent, a proven demand for the product, or a very special idea. VC investors often take a hands-on approach in their investments, requiring representation on the board of directors and sometimes the hiring of managers (Ernst & Young, 2010). They also can provide valuable guidance and business advice.

1.3.2 Equity finance for SMEs
SMEs financing motives and behavior are often different from those of large companies. Most SMEs owners have a strong desire for control and hence are averse to external equity finance (Oluwajoba & Oluwagbenga, 2005). SMEs also prefer debt to equity because they are much more familiar with the borrowing model (KPMG Consulting, 2002). In addition, external equity finance is limited especially for SMEs without strong growth prospects (Oluwajoba & Oluwagbenga, 2005). However, interest in upper-tier SME investment by other private equity has increased in recent years, as low interest rates have pushed investors to seek yields and diversification within their portfolios (Cusmano, 2015; (OECD, 2014).

SMEs are heterogeneous in terms of size; growth potential; formalization; stage of development; industry; and owners' motives, ability and sophistication and these affect their potential to access and work with different types of external financiers. Some equity investors have business models that are more suited to SMEs than others. For example, angel investors and crowd funders have much lower cost structures compared to venture capitalists. They meet SMEs through social networks and can easily follow them up (Cusmano, 2015). For this reason, they can invest in smaller businesses compared to venture capitalists. Venture capitalists have a high cost model that relies on highly paid experts to undertake due diligence and support the business, and are therefore more suited to larger businesses. Equity investment companies fall in between venture capitalists and angel investors in terms of the cost of their business model, and can therefore invest in mid sized enterprises. Table 1 below summarizes types/approaches that SMEs use in looking for of equity finance.

Table 1: Equity investors at the seed, early and later stages of firm growth

Informal Investors			**Formal Investors**	
Founders, family and friends	Crowd funding USD 10,000-200,000	Angel investors USD 25,000 -.5M	Equity firms USD 100,000-1M	Venture capital funds (typical investment size: USD 3-5M)
Seed Stage Investments	Early stage Investments			Later stage investments

1.3.3 Challenges in provision of Equity Finance to SMEs
The literature identifies limitations facing SMEs in accessing equity finance in four phases: Deal Flow; Investment structuring and monitoring and exit. ***Deal flow refers*** to the rate at which equity financers/investors receive business proposals/investment offers. Deals flow from entrepreneurs or companies in which the fund has previously invested; from other funds looking to syndicate a deal; and from other networks. Limited deal flows from SMEs investees arise from: i) Limited number of attractive investment opportunities due to stagnant economy and lack of enabling environment for businesses; ii) Inability of entrepreneurs to articulate business plans due to lack of relevant skills; iii) Low level of managerial and technical competence; and iv) Unwillingness of entrepreneurs to dilute shareholdings, preferring to be

'big fish in a little pond' rather being a 'smaller piece of a much larger pie' (Oluwajoba & Oluwagbenga, 2005).

Investment structuring is the stage where the investor and investees are in due diligence process and contracting. The challenges here are i) Low awareness of standard terms to private equity investing among SMEs ii) slowness in delivering needed information; iii) The problem of valuation of businesses, particularly due to lack of reliable historical financial information, meaningful financial projections; limited financial skills and industry data for valuations; iv) Obtaining sufficient information from the potential investee companies, during the diligence is time consuming due to lack of adequate records and/or documented procedures.

The third phase is ***support and monitoring*** the business after the money has been disbursed. A common problem here is resistance by the entrepreneurs' for the investor to monitor the business on an ongoing basis. It is also known that some entrepreneurs who were successful in bringing a business to a certain level might not be capable of taking the business to the next level of expansion and growth. In this case they may need additional support to ensure continued success of the business. In some cases, the founder entrepreneurs are not prepared to let other people to take charge of operations (Mori & Mersland, 2014).

The final phase is **exit.** Exit from equity investments in SMEs is often constrained by lack of a market for SME equity in many economies, as well as underdeveloped stock markets (van Zyl, Keet, 2014)..

1.4 Methodology for the empirical phase of the study

The study used a case study design. This entailed multiple interviews with actors who have been involved in or supported equity finance attempts and their operationalization. At total of 15 cases of local firms that have attempted to seek or accepted equity finance were identified. Out of these, 10 were chosen to represent successful and unsuccessful ones, foreign and local sources, diverse sectors and different geographical locations. The cases were picked from Dar es Salaam, Iringa and Tabora. The research team carried out multiple interviews with all relevant actors using dynamic checklists based on objectives and emerging questions. Data was collected included history of the business, age of the business, ownership structure, management structure, sub-sector, revenues and current available finance streams, other businesses operated by the founders. In addition to successful and unsuccessful equity investees and investors, interviews were also held with Dar es Salaam Stock Exchange (DSE), stock brokers and consultants in the equity investment space, focusing on their experience and knowledge of the issues under study, including options and ease of exit.

The final phase is exit where the investor sells his stake to other investors who might be the partner, new investors or the public through the stock market. The common challenge here are (i) lack of a developed market for companies and (ii) resistance from initial investors to bring others into the business (Ernst, & Young, 2010).

2. EQUITY INVESTMENT FOR SMES IN TANZANIA IN PERSPECTIVE

2.1 An Overview of Small and Medium Enterprises in Tanzania

The SMEs Policy (URT, 2003) defines MSMEs as business activities that meet four criteria: i) excluding agricultural production, animal husbandry, hunting, gathering and forestry; ii) entailing processing of agricultural outputs; iii) including both formal and informal activities; and iv) classified according to number of employees and capital. SMEs are defined as those employing one to 100 people with capital investment of a maximum of Tshs 800 million. They are classified as shown below.

Table 2.1: MSME definition in Tanzania

Category	Employees	Capital Invested in Machinery (Tshs)
Micro enterprise	1-4	Up to 5 mill
Small enterprise	5-49	5 mil to 200mill
Medium enterprise	50-99	200 mill to 800 mill
Large enterprise	100+	Over 800 mill

Source: URT (2003)

The most recent country wide survey of SMEs (URT, 2012) estimated that there are 2.75 million MSME owners with about 3.16 million MSMEs in Tanzania, contributing about 27% of the GDP and employing more than 5.2 million people. Of these enterprises, 97.1% were "micro" with 66.1% of the total being own account (one person) activities (URT, 2012).

The rate of graduation of micro enterprises to small, medium and large in Tanzania is very low, resulting onto most remaining micro in Tanzania (URT 2012) and a rarity of medium sized enterprises, a phenomenon referred to as the "missing middle" (Stevenson, & St-Onge, 2005). As well, a majority of SMEs are found in the trading sector with 55% being in wholesale, and retail trading URT, 2012). This might be a problem as it can suffocate innovation and growth of other sectors such as manufacturing sector (Young, 2010).

2.2 Historical Development of Equity Investing

Informal equity investment has a long history in Tanzania as most of MSMEs start with equity from personal savings, funds from family and Friends. Development of formal equity investment started in 1993 with the establishment of the first Tanzania Venture Capital Fund (TVCF) with a support of various development agencies. TVCF invested in 20 companies by 1998 but it failed due to various reasons including inexperienced management, location of investees and un-conducive business environment (Ernst & Young, 2010). In 1998, development partners started Fedha Fund with a capitalization of US$ 13 million. Similar funds were established in 2000 and include but not limited to Social Action Trust Fund (SATF), Southern Africa Enterprise Development Fund (SAEDF), Commonwealth Africa Investment Fund (COMAFIN) and Africa Enterprise Fund (AEF). All these operate as venture capital and they invest mostly in large businesses (Ernst, & Young, 2010).

In 1995, a number of prominent Tanzanian retired civil servants and entrepreneurs mobilized shares from a large number of local investors to create the National Investment Company Limited (NICOL), a collective investment scheme that was listed at the Dar es Salaam Stock Exchange (DSE). The money was then managed and invested in several companies, including some that were later listed at the Dar es Salaam Stock Exchange. NICOL has not been performing well due to reasons similar to TVCF and has been suspended from the stock exchange.

Since 2005, there has been increasing interest of local, regional and international equity investment SMEs in Tanzanian companies. This has been a result of the growing economy and competition in the traditional European and Asian markets.

2.3 Institutional Framework for Equity Investment in Tanzania

There are various policies and institutions that support development of equity finance for SMEs. The SME Development Policy of 2003 identifies access to various financial products, including short and long term debt and equity as one of the key means of improving the performance and competitiveness of the SME sector. The National Trade Policy stipulates that for trade to be effective, there is a need for enhancement of short and long term access to finance for SMEs. The long term finance in this case includes equity. Other policy frame works that emphasize issues related to access to finance for SMEs are the National Microfinance Policy (URT, 2000), the National Economic Empowerment Policy (URT, 2004), the Financial Inclusion Framework and the National Financial Education Framework.

In 1994, the government introduced a Capital Markets and Securities Act which was amended in 1997. The act led to the establishment of the Dar es Salaam Stock Exchange (DSE) which facilitates exchange of securities for traded companies. DSE is regulated by the Capital and Markets Securities Authority (CMSA) which also oversees and builds capacities of several brokers on financial markets. In 2012, the DSE established a special window called ' Enterprise Growth market (EGM) with the aim of supporting SMEs to mobilize funds to meet their capital needs. This window was received positively and currently four companies have benefited from it. Despite the supporting environment for public equity, private equity has not been very successful in Tanzania.

3. EQUITY INVESTMENT MODELS AND SERVICES IN TANZANIA

3.1 Type of Equity Investors in Tanzania

Equity investors active in the Tanzanian market include individuals, crowd funds, equity firms, fund managers and venture capital funds. There must be some form of angel investing going on, although not much is known or documented about these. The existing fund managers and their sector focus include the following:

Table 2.1 Equity Fund Managers Active in Tanzania

	Name of Fund or Firm	Sector Focus
1	Pearl Capital Fund	Agriculture
3	Persistent Energy Partners (PEP)	Energy
5	Progression Capital	Financial access
7	Match Maker Fund Management	SMEs
12	Grofin Tanzania	General

These funds offer equity, convertible debt as well as straight debt, often in combination. Except Grofin, the rest of the funds have a particular sector focus. Only one of the fund management companies has an SME focus.

There are also a few private equity funds active in Tanzania. Their models and sector focus are as follows:

Table 2.2 Private Equity Firms Active in Tanzania

	Name of Firm	Model	Sectors
1	Cheetah Development	$5,000 to $500,000 Crowd funding (3- 5 years maturity US $ 5000	Community enterprises
2	Fanisi Fund	US$50M fund, US $ 0.5 – 3M exit in 3-5 years	General
3	Mkoba Fund	US $ 300M fund, $1.0 to $15M investments, exit in 5-7 years	General
4	MTI Investments	US $ .1- $1M , no planned exit	General, but ethical
5	Tujijenge Africa		Microfinance
6	Grassroots Business Fund	$500,000 to $2.5M, exit 6 to 8 years	General
8	TBL Mirror Fund	$ .5 to $ 2M	General
9	Acumen Fund	$ .5 to $ 2M	General
10	Social Action Trust Fund (SATF)	Currently only buying stock of listed companies	None

Cheetah mobilizes investment funds from individuals worldwide through crowd funding. SATF was established by the government, mainly to address challenges facing certain groups, such as street children. SATF's source of finance is profit from investments that it does, which include providing equity and debt to private companies. SATF attempts to invest in SMEs have not worked well, and as a result most of its performing equity portfolio is in listed companies. It will be noted that except for MTI Investment and Cheetah Development, the rest of the firms have a minimum threshold of US $ 500,000, which is just too high for Tanzanian SMEs.

3.2 Type of SMEs Accessing Equity

There does not seem to be a particular segment of SMEs that is attracting more equity funds. The study was able to identify such firms in diverse sectors and geographical locations. However, there is an indication that agribusiness, construction and microfinance presents the largest opportunities for investors. The markets for products of firms in these sectors are large and growing, and this may explain why multiple firms could be spotted and included in this study from each of these sectors.

Table 3.1 Profile of SMEs included in the study

	Investee/Investor	**Sector**	**Source of external equity**	**Investee profile**
1.	KML Beverages Ltd	Agribusiness	Classmates at start-up, has received convertible debt from an equity firm	Team of University graduates, 10+years, upcountry
2.	BX Microfinance	Financial Services	Employees in same company at start-up, in discussion with equity firm	Mixed
3.	Mwandege Boys	Education	Classmates and friends, founders equity	Team of University graduates
4.	Construction Alliance	Construction	Two founding SMEs+ 6 individual subscribers	Graduates from the same University
5.	Treble Construction	Construction	Founders contribution, engaged in due diligence with equity firm, not successful	Workmates, all University graduates
6.	Limo Meat Ltd	Agribusiness	Has received convertible debt from equity investor	
7.	Coast Energy	Renewable Energy	Founders contribution, now looking for external equity, so far unsuccessful	Masters degree holders
8.	Moonlite Finance	Financial services	Was linked to equity firm by a creditor, has sold preference shares to an equity firm	A diploma holder
9.	TRONEP Investment	Financial Services	Created by teachers and their students and has mobilized equity from 5 investors	Degree holders
10.	Mselem	Agribusiness	A consultant invested equity to his client	Unknown

Eight of the 10 SMEs interviewed were founded and are led by University graduates, possibly because higher education prepares people better to meet the requirements of equity investors. A certain level of education is important for one to communicate ideas and plans and understand the complexity of structuring ownership, sharing risks and returns, etc. This implies that development of equity finance might be hampered by the fact that a majority of SME operators do not have much formal education.

4. EQUITY INVESTMENT PROCESS, CHALLENGES AND ISSUES

4.1 Investees motivation for seeking equity finance

From the interviews with the SMEs, there are four main motives for seeking equity finance. These are as follows:

(i) As a joint boostrapping strategy, to mobilize available resources from multiple investors so as to be able to create a business. Most of the people who jointly created a company did so because none of them could provide the money and or skills required to make the business a reality. In most cases, the founders had to put a combination of leadership skills, technical skills and a small amount of money to start a business. In all 10 cases, the SME was jointly created and it would not have been possible for the business to pay the market price of the founder and/or key technical staff.

(ii) As a source of a large amount of 2nd stage patient capital. Growing companies face the challenge of financing rapid growth, and given the high cost of debt, equity finance is seen as an alternative and more viable option. This is the case with all SMEs that already exit and are looking for growth finance

(iii) As a means to attract expertise and reduce dependency on the founders and hence enhance sustainability. Some of the companies, including Treble Construction and BML recognize that it is better for the founders to engage professional managers and a competent Board to steer the company. Some of the founders are even looking forward to retiring young.

4.2 Identification of Investees and Investors

From the experience of over 10 companies and interviews with different stakeholders, how investors and investees meet differs between by type of investee and investor. All start-up companies were established by people who have known each other for a long time, as students, work mates or clients Linkage to equity firm that comes later on also depends very much on networks of friends and relatives (see Table 4.1).

Table 4.1 How investors and investees identify each other

	Case	How investors came to know each other	
		At company founding	2nd Stage equity investors
1.	KML Beverages Ltd	College mates	Equity firm staff was a classmate of one of the shareholders
2.	BX Microfinance	Workmates	Equity firm staff is a friend of one of the shareholders
3.	Mwandege Boys	College mates and their networks	N/A
4.	Construction Alliance	College mates and their teacher	Equity firm staff is a relative of one of the shareholders
5.	TRONEP	Students with their teachers	Personal and professional network of initial shareholders
6.	Treble Construction	Work mates	Equity firm manager knows some of the shareholders
7.	Mselem	Consultant and client	N/A
8.	Limo Meat Ltd	Friends doing similar businesses	Reference by a challenge organizers
9.	Coast Energy	Students with their teacher	N/A
10.	Moonlite Finance	Work mates	A creditor introduced Moonlite to an equity firm

Other means by which investors and investees come to know each other are scouting visits by investors, conferences, consultants; and specialized organizations and projects that link investors and investees.

4.3 Investment process

Investors use different processes when making investment decisions. Those who invest with acquaintances tend to make the decisions quickly, based on the knowledge and trust of the investor or investee. There is no due diligence as such. For example, the investors in Construction Alliance were all young graduates working with the same employer. They knew each other very well, in terms of reliability and capacity. When they sensed a business opportunity, they consulted and decided without much thought to develop a business together. Treble Construction and Coast Energy were pioneered by students, who invited their former teachers to be shareholders. TRONEP was pioneered by teachers who invited their students to be shareholders. Moonlite Finance was established by former work mates. What is common among all these was the presence of a strong leader, who took the initiative to mobilize the others. It is also apparent that apart from the lead founder, most of the investors did not have to commit significant resources into the venture, and this made it easy for them to follow the leader in becoming shareholders. The experience of Mwandege Boys shows that lead founders must be sceptical of expressed interest to invest by minor shareholders. It appears that while many say that they are willing to become shareholders, very few are actually prepared to commit the resources (money, time, etc).

Equity firms are more methodical in their decision making. Even before settling on a company, they try to understand which sectors of the economy are likely to support rapidly growing firms. This is what all the equity firms interviewed did. They therefore choose these as their target sectors or they are at least more positively pre-disposed to invest in them.

The engagement process may start with a referral and/or a meeting of the investor and investee, where interest in equity investment is explored and expressed. Typically, the equity firm will ask for a business plan. If the business plan is interesting the investor and prospective investee may start negotiating for due diligence. Due diligence is preceded by the parties signing a Memorandum of Understanding, which stipulates general

terms applicable to the process and any conditions that either party would like to bring up early, so that they may not break the deal after investment in made in undertaking due diligence. This agreement also binds the two parties to keep all information accessed in the course of due diligence confidential and the prospective investee not to engage in discussion with another investor for a specified time. After due diligence, the parties may negotiate and contract the deal. This is followed by disbursement, support and monitoring (see figure 4.1)

Figure 4.1 Equity investment process

Step	Description
Step 8	Support and monitoring of the investment
Step 7	Disbursement may be in one or several installment
Step 6	Final negotiations, agreement and contracting, if due diligence confirms that the project meets the investor's criteria
Step 5	Due diligence, which includes evaluating the owners, legal, technical, market and financial issues
Step 4	Signing a Memorandum of Understanding with the entrepreneur. This covers exclusivity and confidentiality as well as other general conditions
Step 3	Meeting the entrepreneur, to have first hand impressions, get more insights into his/her ability and character, the business, the sector and the team
Step 2	Read a business plan to get initial ideas about the potential of the business, the owners and sector/sub-sector
Step 1	Exposure to the investee through a reference, pitching sessions, internet or meeting

4.4 Criteria used in selecting investees

All equity investors are looking for good return on their investments. The criteria used therefore link mostly to potential for scale up and profitability. The specific criteria used are centred on past performance, the ability and character of the owner, the management of the business and scalability of the business model.

The decision to invest or not to invest in a business is done in at least two phases. The first is initial screening, which leads to the decision as to whether to proceed with the second phase, which is detailed due diligence. The key issues that investors evaluate at the two stages are summarized as follows:

Table 4.1 Criteria used to assess prospective investees

Key questions	Initial screening	Due diligence
Do owners have the motivation, ability and character needed to grow the company	• First impression of owners • Owners' knowledge of the business (does he/she know his numbers?) • Readiness to share equity and control	• Track record of integrity • Success in building a team • Spouse character and readiness to accept equity
Is top management able to steer the business to grow?	• Skills and experience of top management • Top (below owner) management control of the business	• Skills and experience of top management • Top (below owner) management control of the business
Is the business managed in a way that can be scaled up through equity injection?	• First impression of the company and management • Quality of financial statements	• Financial management (record keeping, financial discipline) • Quality and functioning of team (profile, delegation, motivation, evaluation)
Is the business model scalable?	• Track record of profitability and positive cash flows • Current business size • Feasibility of the existing/planned business model or readiness of owners to improve a sub-optimal model	• Track record of profitability and positive cash flows • Debt/equity ratio •

Size of the business is an important consideration for equity firms. This is because, although they are using a low cost model, they need a certain minimum of size to absorb their cost. Size is also considered an indicator of viability and scalability. However, for local investors just starting, size is not an issue.

In addition, some investors take into consideration their own sector focus and institutional values. For example, some of the equity firms interviewed will not invest in alcohol, tobacco or mining. Others have a focus on financial services or renewable energy.

Despite these precautions, equity investors, including some fairly sophisticated ones, do not always get to know the investee or the business well before making the investment decision.

For example one of the equity firms interviewed reported that:

> *"Having been impressive by the personality of the founder, the rapid growth of the business, the huge potential market, and based on the audited financial statements, we decided to invest cautiously by buying preference shares and retaining 50% of the price of the shares until the due diligence was completed. To our shock, the due diligence revealed that the business was facing serious governance and control issues, and that while the audited financial statements had consistently reported profits, the company was losing money. Much of the reported growth was being financed through increasing bank loans a and it was unsustainable. We had to quit there and then, losing all our invested cash"*

Mselem invested his expertise and time in return for 10% equity in a company that he was initially working as a consultant. As part of the due diligence, he asked the owner to produce his certificates (he was known as a medical doctor). However, the entrepreneur argued that he did not think it was worth taking the trouble to get the certificates from his home region, while he was not looking for a job. Aftre the business grew substantially within a short period, Mselem's partners decided to defraud him, forgetting that it was his input that facilitated the growth. When Mselem was eventually kicked out of the business with nothing, he started digging deeper into the entrepreneur's past. He discovered that he had never attended any University, let alone a medical school.

For some entrepreneurs (investees), control is given a very big weight. For example, BX Finance founders insisted in maintaining majority control of the company despite investing little. They want capital, but still want to limit unrelated investor's share to 20%. Even when they invited "outsiders" they want these to be from their own circles.

4.5 How firms balance equity and debt

In Tanzania, debt is extremely expensive (17-40% interest per year). Long term debt is not available, and in any case it would be prohibitively expensive as a result of compounded interest. Yet, many SMEs find themselves financing growth through debt and hence becoming heavily leveraged. One of the reasons that SMEs are seeking equity is to limit leverage and to secure more patient and lower cost capital. For example, Limo Meat Ltd had a loan of over US $ 900 000 already at the time it was looking for an investor. Another debt would have seriously restrained the ability of the business to make profits and scale up. At the same time, the SMEs as well as investors do not want to over dilute the investee's interest in the SME. The investors would like to sustain the commitment and leadership of the founder (s). As well, the investees SMEs are concerned about losing control of the business. Investors are therefore happy to take a minority share in SMEs, and if the equity is insufficient, investors readily offer straight debt at terms that are more favourable than a commercial bank to a good business. This was done for KML as well as Limo Meat Ltd.

4.6 Tax structure and choice between equity and debt

Investees have the option of using debt, equity or a combination. The private equity investors and some SMEs are aware that debt (including convertible debt) attracts withholding tax on interest (5%) from the first repayment. This is an additional immediate burden, which the investor would normally pass on to the investee. However, the interest is tax deductible, compensating partially for the withholding tax. Dividends attract income tax at corporate tax rate (30%). Repatriation of profits for foreign investors attracts another 5% withholding tax. Eventually, the effects of tax on debt and equity may cancel out. In any case, the case for limiting equity ownership is so strong that marginally higher tax implications would not justify maintaining a lower debt/equity ratio. All investors and investees interviewed reported that they do not base their choice between equity and debt on tax implications. There was however one case where neither the investor nor investee were aware of the tax implications of debt vs. equity until the tax authority started demanding the withholding tax on interest.

4.7 Intermediaries used in equity financing

The experience from the case studies suggest that company founders who bootstrap equity to establish companies often know each other well before they decide to invest together. However, it is difficult for equity firms and SME investees to get important information on potential good partners. Different mechanisms exist to create awareness and broker the relationships between these two sides. These include the following:

1) **Consultants.** There are consultants that work for SMEs and SME development projects or programs. These tend to know some good SMEs. Equity firms looking for good prospects seek to among others, talk to these consultants in the hope that they can recommend some. There are also cases where the consultants help an SMEs to identify good equity investors. For example, Mselem supported his client to identify Ruwaichi, who brought in equity.

2) **Business Associations:** SME Business associations support their members by providing relevant information, including potential equity investors. Tanzania Private Sector Foundation (TPSF) is implementing a program that is promoting private equity and venture capital in Tanzania. Among others, the program brings together prospective investors and investees through an annual conference. Tanzania Chamber of Commerce, Industry and Agriculture also attempts to link foreign investors to their members by circulating emails about investors looking for investment opportunities.

3) **Diplomatic Missions:** Some diplomatic missions have a desk or program that links investors from their countries to Tanzanian investors. The Danish Embassy has a match making program called Business to Business (B2B) which has been operational for over 10 years, linking Danish with Tanzanian Investors. The Netherlands Embassy in Dar es Salaam also has such a function.

4) **Business Linkage portals:** Several organisations maintain portals that link SMEs with debt and equity finance. BiD Network Foundation (www.bidnetwork.org) has a portal that enables entrepreneurs to create business plans and develop them through a network of coaches towards an investment ready proposal. The Foundation has an office based in the Netherlands, with a network of over 300 angel investors ready to invest in high potential SMEs. Once they get an interesting plan, they bring it to the attention of potential investors, who then start engaging with the entrepreneur.

5) **Enterprise challenges and linkage programs.** There are a number of business linkage projects that have been operated, and some are still in operation. These usually start as enterprise or business planning challenges, whose winners are usually high potential companies. Potential investors seek information from the challenge organizers and challenge organizers pro-actively "market" good

companies to investors. In Tanzania, these programs currently include the Global Alliance for Nutrition (GAIN) Marketplace for Nutritious Products (promoting investments in high impact nutrition related companies), Africa Enterprise Challenge Fund (AECF) and the 100 Top SMEs Annual Challenge. AECF provides grants and interest free loans to SMEs with potential to grow rapidly. Among the interviewees, Limo Meat and Smart Money was identified by the investors from AECF.

6) **Banks.** There are a number of banks that are serving SMEs. These include CRDB Bank Plc, TIB Development Bank, Equity Bank, etc sometimes, these banks advise their clients to seek equity to finance growth in order to avoid excessive leverage.

7) **Investment forums and conferences.** There have been a few incidences of forums organized with the aim of bringing together equity investors and investees. A good example was a 2007 China Africa Forum conducted in Arusha by the Tanzania Investment Centre (TIC), United Nations Development Program in Tanzania and University of Dar es Salaam Entrepreneurship Centre (UDEC)

Despite the presence of these intermediaries, private equity investors appear to more often be connected to investees through networks of friends, family, classmates and workmates that these formal mechanisms. This may stem from the fact that equity investment demands a high degree of trust, and personal networks tend to have longer history and are trusted more.

Interestingly, none of the investors involved in the cases studies used networks of self selected entrepreneurs and professional those are likely to have high quality businesses and referrals. Such networks include local chapters of Business Network International (www.bni.com), Lions Clubs (www.lionclub.org), Rotary Clubs (www.rotary.org), Ys' men International (www.ysmen.org).

It is apparent from the discussion with SMEs and equity investors that little information is documented about growing SMEs, and mid sized firms in particular. The MSME survey of 2010, which is the most comprehensive profiling of enterprises, missed out the medium sized segment completely. Other than the few SMEs documented by the Top 100 SME Survey, there is no place where information about these companies can be accessed.

5. CHALLENGES AND LESSONS IN EQUITY INVESTING

5.1 Introduction

The literature identifies challenges and issues faced by investors and investees at the deal flow, structuring, monitoring and exit stages. The study has identified additional challenges from the experiences of investors and investees in Tanzania.

5.2 Experiences and challenges around deal flow

The equity investors interviewed report that one of the good things about investing in equity is that there are plenty of good business opportunities. There is also no shortage of good ideas and motivated and educated SME entrepreneurs. They also report that there are many SMEs that are willing to open up and share equity, while it is widely believed that they are generally unprepared. However, getting information about good quality investees is difficult, because there is little or no information available publicly about SMEs. Even information available about SMEs tends to concentrate more on the micro and small enterprises.

5.3 Experiences and challenges around structuring the deal

Investors' experiences

Investors involved in sweat equity had bitter experiences of the investees eventually denying the value of their investment. For example, Mselem invested years of his time and expertise to build a company in return for 15% equity stake but the founder later argued that it was not worth the shares he had initially agreed to give in return. Since Mselem had neither an agreement nor a share certificate to base his claim, he ended up losing his investment. This was contributed to by inadequate due diligence and not formally recognising the investment. Mselem was later to discover that the investee had cheated about his professional qualification (he had claimed to be a medical doctor), a fact which would have warned Mselem against entering into a shareholding arrangement. One of the equity firms invested in a company before doing due diligence. The decision was based on the audited accounts and the personality of the founder. They decided to invest in preference shares and withheld disbursement of half of the price of the shares until due diligence was complete. This turned out to be a big mistake after they realized that the business was facing serious control problems, and the accounts did not reflect the reality of the business.

Investors reported that it was sometimes difficult to get investees to sign agreements. In four out of the 10 cases, critical agreements were not signed in time. In one case, the parties moved to due diligence without signing an MoU. The prospective investee, Treble Construction insisted to start with the Investment Agreement which is longer and more complex than MoU. After spending over three months and a lot of expense on the due diligence they failed to reach an agreement on one condition (that the investee company transfers its shareholding in a mining operation to its individual shareholders). In two cases of sweat equity, the investees dilly dallied on signing any agreement, and the investors fell in the trap of investing without any documentation. The results were disastrous in both cases, as the investees ended up defrauding the investees of their shares. This shows the need to ensure all legal requirements are fulfilled on time and before proceeding to the next level.

Investees' experiences

Investees have had positive and negative experiences as well. Two of the 10 SMEs reported that the due diligence, contracting, disbursement were much faster than they had anticipated, having taken less than three

months. Four were pleased to have the opportunity to test the relationship through convertible debt. However six of the investees lamented that they had been frustrated by lack of communication and predictability from investors. In particular they had met prospective investors over long periods, sometimes years and ended up with no response or a negative response. In one case, an investor took six months to conduct due diligence in one SME. Even after expiry of the confidentiality and exclusivity agreement, the investor continued with the due diligence (without having renewed it). The SMEs felt that they had all that the investor needed and therefore were confident that the investor would invest. However, after the investor staff completed the due diligence, there was silence for nine months. During this time, the investor did not pick or return phone calls or respond to e-mails. In the meantime, the SME was approached by another investor, who quickly undertook due diligence and disbursed. When the funds from the new investor were about to be disbursed, the first investor turned up (after 1 year) saying that he was ready to invest.

5.4 Experiences and challenges around monitoring the investment

The three investors interviewed expressed frustration with slow responses or no responses from investees after investing. While prospective investees respond quickly and thoroughly during due diligence, they change after investment, sometimes not responding to call or emails, and almost always not submitting progress reports on time. They lament that even information that is routinely available in the company quarterly financial statements takes very long to be communicated.

Investors experience

Two investors who invested sweat equity in companies had very bad experiences. Mselem had installed a system that enabled him to receive daily performance report by internet directly. When he was away in the USA, the investee disabled the system. The investee also sacked the internal auditor that they had jointly appointed. In his absence, the Board of Directors (son, father and another investor) appointed the investee's son as Company Secretary without involving the Mselem. The company secretary proceeded to issue a share certificate to his father without the knowledge of Mselem. When Mselem came back to Tanzania, he was summoned by the Board of Directors and informed that he had no shares in the company. Since he did not have any document evidencing his stake, he was effectively defrauded of his shares.

Batende, who also invested his expertise and time also, had a bitter experience. After the company had grown more than 6 times, the investee and his wife and son secretly created a competing company and brand. Then they reported that the company was losing money and had to be wound up. Batende was left with worthless share certificates.

These experiences suggest that those who wish to invest sweat equity need to be extra careful. Rather than rely on in kind contribution, it is better to demand payment, which is then paid into the company account directly as share contribution. This might help to psychologically show the investee that value is being invested.

Investees experience

Some of the investees think that investors tend to be too demanding, forcing them to spend a lot of effort preparing reports to investors. Two of the investees also complained that the investors were arrogant, and that they thought their money entitled them to interfere and dictate things to the investees. In one instance, the investor was reported to be giving directions directly to middle managers. In one extreme case, the investor from abroad sent an expatriate manager to the investee company. As far as the investee was aware, he was to be Head of Finance and the investor was to pay him directly. However, when the expatriate reported, he said he had come to take over the management of the company from the founder and that his expatriate salary would come from the company. This led to a bitter row and near collapse of the company.

Experiences and challenges related to exit
The exit opportunities available include selling stock to other investors, including other equity firms and listing at the Dar es Salaam Stock Exchange (DSE). DSE established Enterprise Growth Market (EGM), an alternative listing window for SMEs and start-ups that do not meet the stringent criteria applicable to the main window. So far, four start-up companies (Maendeleo Bank Plc, Swala Energy Tanzania, and four have listed through this window. One existing company (Mkombozi Commercial Bank Plc) has also listed through this window. Others are in the process of listing as well.

Only one of the investors had attempted to exit. The reason for exit was to divest from business activity, since the investor is a development organisation. Because they were looking for an investor who can take the company forward rather than returns, they advertised the sale widely in the developing countries, shortlisted interested companies and eventually signed an agreement with one which undertook due diligence. This process is ongoing, and so far there have no major hitches.

6. CONCLUSIONS AND RECOMMENDATIONS

6.1 Conclusions

This exploratory study shows that the equity market is gradually developing in Tanzania. The dynamic and growing segment of SMEs is growing but little documented about it. Investors are taking increasing interest in investing in Tanzanian SMEs. However, local investments in equity are largely confined to starting companies, in which a principal shareholder takes the lead and invites friends or acquaintances. Second stage external equity is still very much a preserve of foreign owned equity firms. Some of these have social mission driven sector focus (renewable energy, microfinance, community enterprises). However, most are primarily interested in sectors and firms with high prospects of returns. Others exclude some socially undesirable sectors (alcohol, tobacco and mining). Scale matters for equity firms as it is seen as one of the indicators of viability, scalability and ability to absorb overheads associated with the investment. Family or non family ownership does not seem to matter.

How investors identify investees differ especially between the 1st stage (company creation) and the 2nd stage (growth stage). In the former case, the investors mostly know each other from previous interactions, and there is no need of due diligence. For later stage finance, investors and investees come to know each other through scouting visits by investors; reference by membership associations and consultants; and conferences.

Both investors SMEs founders prefer that the later maintains a majority ownership in the business. Equity firms appear to be ready to offer additional financing in the form of debt, to avoid over dilution of founder's shares. The tax structure is inconsequential to the ratio of debt to equity. Equity investors and SMEs get to know each other from consultants and associations. There are some linkage initiatives, but they are not yet quite effective.

Investors face many challenges, including difficulties in identifying good investee, slow communication from investees after investment and dishonesty. Investees sometimes spend a lot of time with investors without realizing investments. There are some exit opportunities for good SMEs projects in terms of other equity funds and the newly introduced 2nd tier window at the Dar es Salaam Stock Exchange

A key challenge facing both Tanzanian investors and investees is low awareness of the company law and reliance on informal arrangements. Investments are being made without having the requisite protections, including agreements, title to the company shares (share certificate), informed valuation, use of legal and

finance expertise, etc. All these are contributing to conflicts and may be hurting the credibility of equity investments.

6.2 Recommendations

6.2.1 Introduction

The pace of development of the equity market needs to be speeded by a number of policies measures. As well, investors and investees can improve the chances of success in equity investments by improving their practices based on the findings of this study

4.2.2 Recommended policy measures

The low awareness and capacity of entrepreneurs to attract equity and for local investors to invest in equity successfully is attributed to limited opportunities for education and training in this area. It is therefore recommended to include equity investment in business studies curricula, providing opportunity for learners to be exposed to the form of finance. The training should make use of local case studies so that learners can learn from practice. Also, different stakeholders should introduce and promote short course focusing on readiness for equity finance

A key challenge in getting deal flow is lack of database on SMEs that have the potential or are interested in equity investments. It would be very useful for SME development organisations, including associations, the national small business development agency and investment promotion agencies to develop such databases. The database would be even more valuable if it could have information that reflects the credit rating of the SMEs.

6.2.3 Recommendations to investors

Equity investors could take a number of measures to improve deal flow. One way is to establish a forum of equity investment stakeholders (potential and existing investors, investees, and equity promotion organisations) for learning, information sharing and networking. Equity investors are also advised to use networks of quality entrepreneurs and professionals, such as the Lions Club, Rotary Clubs and Business Network International (BNI) in sourcing deals, in addition to networks of consultants, associations and business challenge organizers.

In undertaking due diligence, it is recommended that equity investors should:

- Always follow the investment formalities and not take anything for granted. Investors should in particular be aware that prospective investees resisting or delaying compliance to a particular formality (signing an agreement or disclosure of some information) could be harbouring ulterior motives. All agreement should be signed as early as possible, and revised timely as necessary
- Check background and integrity of investee. The experience of some of the shareholders show that unscrupulous applicants may actually cheat about their identity or background
- Use convertible debt as a form of extended due diligence
- Evaluate the family, not just the lead entrepreneur – for character and ability, including willingness to share equity and information. It is clear that problems may arise due to the attitude or skills of the spouse or other investor, especially in the event of incapacity or death of the lead investor in the SME
- Investors should strictly demand and sign agreements at the earliest possible point in the relationship. Among others, agreements should specify roles, representation, protection of minority rights, exit and valuation. The lessons from the cases suggest that investors need to ask for an

exclusivity agreement (investee not to invest in a competing business without agreement from investor)

- Investors should study and become more aware of the company law and demand share certificates immediately upon investing.

In terms of monitoring the investment, it is recommended that investors should have clear and unambiguous communication, especially for sensitive matters, such as bringing staff to the investee or any measures with financial implications. Also, problems should be sorted out quickly to maintain trust. Reporting should be simplified, and if possible automated, so that reports flow to the investor instantaneously as they are produced. Although participation in the investees' board meetings is expensive, investors should find low cost ways of participating, at least by proxy.

6.2.4 Recommendations to investees

On the other hand, SMEs that are interested in equity should formalize practice (record keeping, reporting, formal contracts, systems, governance, and compliance to government and tax regulations) at the earliest possible opportunity

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ANNEX 1: CASE STUDIES (NOT FOR PUBLISHING OR CIRCULATION)

BX FINANCING LTD

BX Financing is a microfinance company established in 2013 by 15 shareholders all employees and serving or former directors of the Rural Enterprise Development Society (REDS). The history of BX dates back to 2002 when REDS established a "Loan fund" from which employees and non executive directors could take loans at a modest (10%) annual interest. In 2005, the Fund launched a special loan product for outsiders. In 2010, members of the fund resolved to transform the Fund to a microfinance company to take advantage of the growing demand for financial services. It was decided to dissolve the Loan Fund. Each member's net worth was determined, and members were given the option of either taking it or converting it into equity in the new company – BX. A business plan for the proposed company was prepared projecting to raise Tshs 300 million in the first two years from selling 300,000 shares of Tshs 1,000/ each.

It was decided that each shareholder could buy a maximum of 20,000 shares within the first year. Members decided to invite other shareholders not only to realize the targeted capital, but also to bring people with management and governance of financial institutions experience who could steer it at Board level. There was a strong feeling that only "like minded" people would be invited to invest in the company. To recruit new shareholders, each of the existing ones was asked to recommend credible individuals who would be invited to invest. However, some expressed concern about outsiders joining and taking over the company. Therefore existing investors decided to limit shareholding to Tshs 20 million per individual. However, only 3 new shareholders agreed to take equity in the new company. Even after two years of operation, only one shareholder had subscribed the maximum of Tshs 20 million. The response was far slower than it had been anticipated. Some of the high profile targeted shareholders expressed interest but are yet to actually buy shares.

The management of the company is under a part time CEO, who is also a former staff of REDS, a shareholder and a freelance consultant with an office in the same building and a part time consultant. The only full time person is a credit officer. In 2014, the management approached an equity fund to explore their interest in financing BX by buying equity. After just a brief discussion, the equity firm concluded that it was too early for it to invest in BX. They promised to come after 2 years to re-evaluate the status of the company.

COAST ENERGY LIMITED

This history of Coast Energy Ltd started in 2008 when Morris, then a sales officer with a multinational energy company, noted that their clients had difficulties getting someone to fix the solar equipment that they bought from his employer. Morris and his wife started a business called Sunny Sun, specialising in solar systems installation. Soon, Morris, MBA, an MBA decided to quit his job at an energy company to focus on Sunny Sun, which until then did not have an office. He realized that a solar installation business needed a more capital than he could raise and decided to look for other investors to raise funds. He approached three people and convinced them to buy equity in the business. The first was his MBA classmate, a Tanzanian who was working as a CEO of a company based in Dar es Salaam. He had known him as an entrepreneurial and honest person while they were studying together. The second was Morris's undergraduate college mate. They knew each other very well. The third was a high school classmate, working in Kenya. They also know each other well. Each of these took 20% of the shares. Morris and his Tanzanian wife took 20% each as well. When the first meeting took place, it was decided that a new company should be formed with its own name, office and assets. Morris therefore disbanded Sunny Sun.

Morris and the rest of the team realized they needed to have a certified electrical engineer in order to be registered with the Contractors' Registration Board. Since they could not pay an engineer's salary, they decided to find one who would accept to be a part time technical director in return for a few shares. Morris approached his former supervisor who agreed to be a part-time director for 1% of the shares. This left Morris's wife with 19% of the shares. They registered a company with 6 shareholders and 20,000 shares in July 2013, with the support of a lawyer. The shares were valued at Tshs 1000 each and therefore they realized total capital of Tshs 20,000,000. In December 2014 the shareholders contributed another Tshs 1000 per share, in order to raise money to buy a plot.

It turned out that the engineer could not spare time to attend meetings or undertake any activities of the company, other than signing cheques. They talked to the engineer, who confessed that he could not make time for the company's activities and agreed to cede his 1% shareholding back to the company. The company decided to find another engineer who would become its technical director. He was given 1% of the shares in return for the use of his name/expertise and asked to buy another 1% in order to have a meaningful stake in the company. He paid Tshs 2000 per share, reflecting 1% of the total equity. It was difficult to use any other approach because the directors did not know how to value the company.

Coast Energy is looking for funds to grow the business. At the moment, the debt/equity ratio is 1:1 and they are not planning to increase it. The directors are prepared to bring in new shareholders. However, since they have exhausted all shares, they are unsure of how to bring in a new investor. Coast Energy has never had a shareholders' agreement. Therefore, they do not have guidance on how to admit a new shareholder or how to handle exit.

CONSTRUCTION ALLIANCE LIMITED

In 2013, MAN Investments Ltd, building materials manufacturing company and MKS Consulting Engineers Ltd jointly formed Construction Alliance Ltd (CAL), a construction company. MKS is owned by two shareholders, both engineering consulting experts. Like Treble directors, they were formerly employed by the same company before they established MKS Ltd. Each of the two companies owns 30% of CAL. In order to mobilize capital and attract talent into the governance of the new company, the two companies decided to take only 60% shares in CAL sell the rest to other high potential individuals who could constitute a strong team. They however deliberately wanted to retain most of the interest within a close circle of relative and friends of existing directors. Management of MAN and MKS prepared a business plan with the assistance of a consultant and a relative, which they used to successfully mobilize friends, neighbours, relatives and other associates, who eventually bought 22% of the shares. They deliberately used a "closed" approach, given that they did not want to bring people who would prove to be difficult in their business. They thought a network approach to inviting subscribers would yield "like minded" investors.

Those who showed interest were given the business plan for the project by the person introducing them, and if they were interested, a meeting was arranged with one of the directors. An interview with those who bought shares revealed that they made their investment decision mainly based on the remarkable success of MAN and MKS. Two of the directors sold most of the shares, the reason being that they are very convincing.

However, since the company was established, no single meeting of shareholders have been held and therefore shareholders who are not part of the initial investors are not formerly informed of what is happening. The 1st meeting was scheduled for March 2015.

NARO MSELEM SWEAT EQUITY INVESTOR

Mr. Naro Mselem works as a consultant, supporting development of business plans and linking entrepreneurs to banks and equity investors. He started working with Roman Ngitu, the owner of Livefeeds Enterprises, a sole proprietorship making animal feeds, in 2006. Roman Ngitu introduced himself to Mselem as a medical doctor. Ngitu was supported by two casual labourers and for many years, annual sales did not exceed Tshs 30 million. Quality suppliers had stopped providing credit because they were not paid for years and the business relied on cheap, low quality raw materials. Mselem successfully convinced Ngitu to change the transform the business by attracting external investors to improve the business systems and to capitalize it. It was agreed to create a company which would be owned 55% by Ngitu, 30% by a new shareholder who would bring at least Tshs 50 million in cash and 15% by Mselem whose capital contribution would be by way of his expertise and time. The Tshs 50 million was based on valuation of the business on the basis of profitability projections made by Mselem.

Mselem managed to convince Naftali Ruwaichi, an auditor he had known from way back in 2004 as an auditor in companies that Mselem advised. Mselem reasoned that Ruwaichi would bring the money as well as the systems and oversight. Ruwaichi was asked to invest Tshs 50 million in return for 30% of the equity. This figure had no clear basis, as no effort was done to value the business. Mselem could not find any meaningful records to be used as the basis for valuation, and therefore used the profitability projections to convince Ruwaichi to agree to the Tshs 50 million for 30% of the equity.

Before committing to the relationship, Mselem undertook a due diligence, using a questionnaire and checklist he had acquired from his training and experience working with equity investors and lenders. He tried to check everything. However, the fact that Mselem knew he was dealing with a medical doctor made him a bit relaxed. For example, Ngitu was required to produce his school and college certificates as part of the due diligence. However, he successfully convinced Mselem that that it was unnecessary to incur the cost of following up these in the schools and colleges where he studied, while he had a passport and a Tax Identity and he was not looking for a job as a doctor.

The company was incorporated in 2010, with the three shareholders as company directors and Ngitu as its Managing Director and Ruwaichi as the Chairman of the Board Mselem was spending 4-5 hours at the business almost every working day.

After registering the company and opening bank accounts, Ruwaichi deposited Tshs 30 million in the company account. There was no formal recording of this money as having paid for shares and no share certificate was issued to any of the directors. Based on his experience and knowledge, Mselem drafted an Investment Agreement to be signed by all three of them. However, Ruwaichi and Ngitu did not sign. They always found an excuse to delay the signing. Ruwaichi was always busy with his audit firm, while Ngitu always tried to postpone the signing.

Mselem had consulted for another animal feeds company that had subsequently grown very rapidly and he understood the market quite well. He thus prepared a good business plan and put in place systems and controls for cash, human resources, sales and marketing and established relationship with credible suppliers, whose past debts were settled by the cash contributed by Ruwaichi. He also facilitated recruitment and placement of quality staff including 4 graduates (accountant, auditor, marketing officer, procurement officer) and a production supervisor with diploma in animal science. As a result of these measures, the business grew rapidly, with the turnover increasing from an average of Tshs 32 million in 2010 to Tshs 160 million in 2012.

Daily operations and financial reports were generated from QuickBooks and communicated directly to Mselem. Through the controls, he was able to establish that Ngitu was inflating raw material prices by a small margin. Ngitu had the authority to sign cheques worth Tshs 2 million without approval of the any other director. Mselem discovered that he was issuing multiple cheques in the same day, sometimes to the tune of Tshs 10 million. When Mselem asked why this was happening, Ngitu was very furious. Soon after that, Mselem went to the USA where he spent six months as part of his doctoral studies. While he was there, the daily reports stopped coming. He later learned that the MD ordered his staff to stop sending the reports. When Mselem came back, he found that the internal auditor had been fired.

In the next Board meeting, Ngitu and Ruwaichi informed Mselem that he was not a shareholder because he had not contributed any money to the company. Ruwaichi said that he had paid Tshs 50 million, while Mselem had brought nothing. When he reminded them of the expertise and time he had invested in the business and the impact on professionalism, sales and profit, they argued that each of them was born from a woman, and therefore had brains, and in any case, they had made all decisions together. Mselem resigned from the Board, and his resignation was formally accepted and dully filed to the Registrar of Companies. He estimates that he lost at least 100 million being 15% of the worth of the company at the time.

To his utter disappointment, Mselem learnt that Ngitu was not a reliable person. Among others, he discovered that Ngitu was a conman of a sort. For example, he did not have a medical. Ngitu had diverted money from the growing business and used it to build a house and buy a car. After 6 months, sales dropped to Tshs 50 million per month. Ruwaichi called Mselem to inform him that he had discovered that Ngitu is not a credible person, and regrets having trusted him with his money.

SWEAT EQUITY INVESTOR 2: RAYMOND BATENDE

In 2012, Batende, a business consultant, met Paul Maridadi, a retired accountant who looking for a good business in which he could invest. Batende had been advising some businesses that make concrete products and know that there was a large and growing market for such a business. He this advised Mr. Maridadi to consider starting such a business. Mr. Maridadi and his wife successfully pleaded with the young consultant to join them to form a company, since he had the right skills. Batende had learned that the couple were very religious and even operated an orphanage. This gave him a lot of confidence in them.

When Batende suggested that animal concrete product making was a very promising business, Mr. Maridadi took him to a large compound which he owned. In there were all the equipment and facilities needed for an such a business: a truck, go downs for materials, the machines, etc. The old man had unsuccessfully tried to operate the business while he was employed, and had closed the factory several years back. Batende suggested that they revive the factory. However, Batende, realising the risk of working from another person's premises, argued that they should set the business on another land. The old man and his wife argued that it would be insane to invest in another factory, while this one lies idle. Eventually Batende agreed that they revive the business.

It was verbally agreed that Maridadi's family would provide the factory plus Tshs 25 million for working capital, and the money would be paid back as a loan. The shareholding was agreed as follows: Mr. Maridadi (50%), Mrs. Maridadi (20%), Mathias Maridadi (their son) 15% and Batende (15%). Mr. Maridadi appointed his wife to be the director and his son a company secretary. It was agreed that Batende would be allocated Tshs 1 million a month as a salary, but this would not be paid for 20 months. It would constitute Tshs 20 million worth of shares, or 15% of the company. He immediately developed a business plan and started the process of incorporating a company, developing systems and facilitating recruitment of staff.

Soon after production started, Batende was taken aback when one day, Maridadi's son, who was the company secretary, warned him that his father was a difficult man, and he was surprised that he had agreed to invest in the same business with him. Batende became very worried, but then reasoned that it was too late to withdraw. Mr. Maridadi appointed his wife, who did not have any business background, as Director of Finance and Administration. Soon, her lack of business background led to a number of operational gaps. Later Batende's wife was appointed Director of Operations. With 18 months of its establishment, the business had 13 full time employees and an accumulated turnover of Tshs 1 billion.

However, despite this success, the business experienced a succession of problems, as follows:

(i) The couple maintained a go down at the compound where the business was operated in which they kept stocks of raw materials for sale to the company or another buyer. The go down caught fire . Batende did not manage to get to the sight immediately. A private fire tender was called in but it was too late, and the fire burnt down the entire stock and building. Maridadi claimed that Batende did not come to the site fast because he knew that the property under fire did not belong to the company. The family forced the company to pay for the cost of the private fire tender

(ii) Maridadi's wife wanted to build a structure at the compound, which would clearly have obstructed the business. When Batende objected, there was another argument

(iii) While Mr. Maridadi was not a board member, the wife insisted that he must attend board meetings. Batende objected to that, and the son said he could not attend board meetings without his father. It therefore became impossible to hold meetings

Eventually, the Board appointed an auditor without without consulting Mr. Batende. In one Board meeting, the auditors report was presented, showing that the company had made huge losses and was insolvent. When Batended objected, he was told by the other shareholders that he had not invested anything in the company and therefore he did not have any rights. Mr. Maridadi produced a share certificate and challenged Batende to produce evidence that he had a stake in the company. Maridadi's son who was the company secretary had issued the share certificate only to his parents and himself. Eventually, the Board (family) resolved that they were closing down the business because it was loss making. Later Batende learned that they had secretly created another company which had taken over the customer base that had been developed. Batende tried to consult lawyers, who informed him that in the absence of a share certificate or any formal agreement, they could not help him.

LIMO MEAT LIMITED (LML)

Limo Meat Limited (LML) is a meat processing business established in 2008. The company is based in Tabora, Tanzania and was started by Tanzanian entrepreneur Mr. Richard Limo. The business operated as sole proprietorship named Limo Trading & Supply up to 2011 when it was incorporated as a private limited liability company with an authorized capital of 100,000 shares of Tshs 1,000 each. The shareholders met during the course of doing business, they become friends and decided to join hand and form a new company. The shareholders are Mr. Richard Limo (70%), Mr. Deo Joseph (20%) and Mr. Daudi Paschal (10%).

After one year of operation, Deo Joseph decided to withdraw from shareholding and the company had to restructure shareholding to be as follows: Mr. Limo has (90%) and Daudi (10%). Limo and Daudi are siblings. The company has an active Board which directs and provides oversight. The board has five members including the three directors and two other practitioners of which one is a business expert and another is a scientist.

LML's processes different types of meat products including beef, lamb, goat, chicken and fish cuts which are produced to order. Major customers are mining companies and local hotels.

A recent market research by LML revealed a huge potential in Tanzania for meat products. In addition to the increasing investments in mining, oil, gas and hospitality sectors, urbanization is growing rapidly. The growing middle class would like to consume quality processed meat but cannot either find them in the market or are not aware of their existence. The company decided to build a modern meat processing plant of international standards to take advantage of this growing demand. The new plant was estimated to need US$ 4 million including construction key buildings, purchase and installation of plant and machinery, and initial working capital. To finance this expansion, the company looked for different sources of funds including private equity. They then participated in the African Enterprise Challenge fund (AECF) where they won a total of $ 200,000 grant and a $700,000 interest free loan. Through AECF network, the company was introduced to two different investment companies.

The first investment company started communication with LML in January 2013. The potential investors visited the company and did the initial due diligence. They showed interest of investing in the company but they were very slow in responding. At one time, the investment company promised to respond on the status of due diligence in two months. LML waited for three months without receiving any response. They started following it up but the investment company did not respond until after seven months. In their response, they apologized for taking long without responding and wanted to proceed with the process. At this point LML was no longer interested and had started discussions with NOS Ventures, another investment company.

NOS Ventures is a Danish company operating from Denmark. LML was introduced to NOS through AECF connect network. Discussions started in September, 2014 by both parties signing an MoU. Thereafter, NOS used various consultants to do financial, operational and legal due diligence. Following negotiations, the process was concluded in December 2014 by the two parties signing a contract which they call 'cooperation agreement'. The agreement stipulated that NOS will offer LML a total of $800,000 as a two year convertible debt with a possibility of turning it into equity with 20% share ownership offered to NOS. The agreement also stipulates that if there is a need, LML can get a commercial loan from NOS at a low rate. The loan will not be subjected to convertibility.

TREBLE CONSTRUCTION LIMITED

Treble Construction Company was established in 2008 by four shareholders, all of whom were young engineering graduates working with a construction company. Each owns 25% of the shares. Their initial investment was their sweat equity. They secured soft loans from family members. Later, banks loans have constituted up to 80% of their capital (mainly direct financing of projects). They chose each other from personal knowledge and good chemistry. They also wanted a team that could handle the technical and managerial aspects of the new business since they could not afford to pay high wages. One of the founders is the CEO, while the rest are heads of departments (projects, finance, operations). There has never been consideration of how one would exit, and none of them is contemplating an exit.

Treble Construction grew very rapidly from its establishment, increasing the number of full time employees from 6 at its establishment to 46 in 2015. Its annual turnover is over Tshs 9 billion. It is now a class 2 company (the highest is class 1), while it started as a class 6 company (the lowest is class 7). In the recent years it diversified into other types of businesses, including hotels, manufacturing of building materials and mining. The mining business is conducted under a subsidiary called Minerg Ltd.

In 2014, Scapita, an equity firm with a Scandinavian majority shareholding approached Treble Construction with an interest of investing. They identified Treble through a local consultant. Scapita also identifies prospective shareholder through referrals of Scandinavian Embassies and nationals living in Tanzania as well as through local consultants. Scapita indicated that they would only take a maximum of 30% of shares and were not planning an exit in the foreseeable future. In case additional funds were needed, Scapita was prepared to offer debt as well. What attracted this equity firm was the success of Treble Construction. Prior to that, Treble had only fuzzy idea of equity finance and had not given the idea of getting an equity investor much consideration. However, after being approached by Scapita, they thought the idea of getting an European Investor would enable them grow the company further and even hand over management to an independent professional team and retire while still young. They reasoned that a Scandinavian investor would contribute to governance and brand/credibility in addition to finance. In particular, the idea that they could even secure short term debt from the investor was very attractive, since they frequently face difficulties convincing banks to extend loans, given their already high gearing (debt/equity ratio) something that sometimes forced them to borrow from money lenders at exorbitant interest rates. Treble directors were not prepared to cede control to a company they knew so little about, and therefore they were happy with giving away only 30%. Tax implications of equity was not even considered.

After initial discussion and verbal expression of interest, Scapita proposed that they would sign a Memorandum of Understanding that would set the basic terms and conditions. In the draft MoU, Scapita indicated one of the conditions precedent was for Treble to transfer its shareholding in Minerg to individual shareholders, as Scapita's policy did not allow investment in mining activities. Treble directors decided to defer signing of the MoU and proceeded with other procedures, including due diligence. Scapita assumed that the directors had judged that the condition would not be a deal breaker. However, after the due diligence and six months of intensive negotiations on other matters, and after both sides had incurred travel and other expenses, they came back to the MoU. It turned out that the directors could not agree among themselves to transfer the shares in Minerg to individual shareholders. One of the four shareholders had all along been opposed to the condition and the other three believed that he would

eventually change his mind, something that never happened. The deal thus ended there. Directors of both companies (Treble and Scapita) were very much disappointed by this eventuality.

KML INDUSTRIES LTD

KML Industries was founded in 2013 by KML Limited (with 80% of shares) and KML Consultants Ltd (with 20% of shares). The history of KML Industries started in 2006 when three University graduates established a small juice processing business. They had noted that while there was inadequate supply of processed juices, a lot of fruits produced by small scale farmers in rural areas were being wasted for lack of transport facilities, organized market and processing companies. The founders had no cash, so they decided that two of them would take jobs or consulting assignments and support the nascent business, while one worked on it full time. They incorporated a company in which each had 33.33% of the shares. Mr. Gurumo Mpeho, one of the shareholders, became a full time CEO. They started juice production from the backyard of one of their parents, using very basic equipment, such as plastic containers and pots for pasteurization and simple plastic sachets for packaging. Later, they rented production premises in the nearby town and relocated their operations there.

Over time, KLM Limited gradually diversified into other types of businesses, including stationery, real estate, money transfer and business consulting. Between 2007 and 2012 the company grew rapidly through re-investing its profit and bank loans and invested in buying new machines and expanding operations. The annual turnover had growth to Tshs 1.5 billion and the number of full time employees had reached 16.

KML Limited found it necessary to get substantial amount of funds to finance its growth, given the huge market opportunity in the fresh juice market. Given that interest rates were very high, they thought the best solution was to find external equity investors. In the past, KML had been approached by a number of equity investors, but they were interested as they had not strongly felt the need for a major capital injection.

In early 2012, MKL Limited was approached by an investment firm from the Netherlands to whom they expressed readiness in negotiating for equity investment. They signed the Memorandum of Understanding in March 2012. The due diligence process took seven months. Finally, the investment company offered US $50,000 in return for 20% shareholding in KML Limited. KML Limited directors thought that the offer was just too low. They tried to negotiate for a better offer, but the investor would not change his mind. The directors decided to resort to debt (overdraft facility) to finance acquisition of machines. However, as they reflected on the very low offer they got from the equity investor, they concluded that mixing up the different lines of business was making it hard for them to properly track costs and performance of each and was rendering its valuation very complex. They therefore decided to register three different companies. KML Consulting Ltd was established to focus on consulting. KML Industries Limited was established to focus on food and beverage processing. KML Limited continued to be owned by the three shareholders in the same proportion. In turn, KML Limited owned 80% of shares in KLM Industries while KML Consulting took the remaining 20%. All three companies are however under the same management.

In 2014, KML Industries Ltd was approached by Swedish owned investment firm which was exploring equity investment opportunities in Tanzania. The company was referred to the Swedish investor by a consultant in SME development who also happens to be the KML founder and CEO's classmate.

KML Industries agreed to explore equity investment from the Swedish company. After signing the Memorandum of Understanding (MoU), the due diligence and negotiations started. This process took five months. During this process, both partners got to understand each other. The final decision was reached in August 2014 and the investment contract signed in September 2014. It was agreed that the Swedish company

was to invest Tshs 200 million as convertible debt (convertinble to 49% of the shares after two years), and Tshs 100 million as straight debt at an interest slightly lower than commercial bank. The rationale for a convertible debt was to give both sides more time to study each other and assess the business opportunity before the equity investment was made. The rationale for the Tshs 100 million debt was to avail the additional cash needed by KML Industries, without the Swedish investor eventually becoming a majority shareholder. It was agreed that the investment company would offer KML commercial loans at the same rate that was used in the convertible debt to meet cash flow needs in the future.

KML Industries is also getting advice from the investment company officials and other experts when needed. The Swedish investor had appointed consultants in Tanzania, who monitors performance of KML Industries on quarterly basis and represents the investor in Board meetings.

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London School of Economic and Political Science,
Houghton Street,
London WC2A 2AE

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