Lessons: Issues and Practical Considerations in Equity Financing in Nigeria

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Introduction

Profit making is the primary goal of business howsoever organised – whether a partnership, private or public (listed or unlisted) company, and this is duly recognised by law. One universally acknowledged way of increasing the prospects and quantum of profit is through growth and expansion. It is difficult (but not impossible) to increase profit without achieving growth. Often times (and all things being equal), size translates to profits because of bigger scale, larger market share, etc. This is why companies prioritise the pursuit of growth. A company can choose to grow internally and organically, or externally (by acquisitions). These two options present unique challenges and limitations. However, one common denominator to both options is the need for capital.

Thus, there is the temptation to finance growth through just any means possible. This is especially true for companies offering unique goods or services which are in high demand. The big question therefore is "how safe is this approach?" The debt/equity financing dilemma is as old as the invention of company itself. A choice between the two can decide the ultimate survival of a company. While debt financing has its own limitations and advantages, the choice of equity financing seems a lot more advantageous. But should a company embrace equity financing just because of its attractive rewards? Are there embedded dangers in this option? What protections are available for a company and for individual investors? This article takes a look at these issues.

Equity Financing v. Debt Financing: Making a Choice

Not all the expansion options available to a company are ideal. Companies offering unique product or services sometimes need to be wary of private investors who seek to exercise greater control over the business. Debt financing may be a better option for such companies. With debt financing, the owners' interest and control of the company usually remains intact because the lenders generally have no claim to equity in the business. Again, a lender is entitled only to repayment of the loan plus interest, and with few exceptions, he usually has no direct claim on future profits of the business.[1] When the company makes profit, the owners are entitled to more profit than they would if they had sold some of their shares in the company to investors in order to finance growth. More so, loan repayment and interest obligations are ascertainable amounts which can be planned for. Additionally, interest is deductible expense lowering the actual cost of the loan (from a tax point of view), to the company.

However, there are several factors which could make expansion through equity financing preferable over debt financing. For one, debt must be repaid unlike equity investment, being part of the company's capital with no repayment obligation. Again, debt financing is undesirable for start-up companies as it raises their break-even point. For older companies, high interest and debt servicing costs could restrict growth and increase the risk of insolvency. Bukky George, Founder and CEO of HealthPlus Limited which recently received an $18 million equity investment from Alta Semper Capital LLP (a UK based Private equity firm specializing in growth capital), summarized the experiences of entrepreneurs with debt financing as follows: *"On my journey, I have met several talented entrepreneurs whose potential cannot be maximised simply because of the punitive interest rates of debt from our financial institutions"*.[2]

Collateral requirement in debt financing further exposes a company. In some cases, shareholders or directors of a company are even required to personally guarantee loan repayment. Also, debt instruments often contain restrictive clauses which prevents a company from pursuing alternative financing options and non-core, but potentially lucrative, business opportunities. Again, a company with a large debt portfolio is rightly considered risky by lenders and investors alike, and would likely pay premium (higher interest), for additional debt. Accordingly, a company could be limited as to the amount of debt it can carry; in some sectors (like banking), debt-equity ratios are even regulated. These are serious considerations which could make equity financing more desirable in some transactional circumstances, especially in Nigeria.

Equity Investments: Practical Considerations

The decision to accept or reject equity investment is an important step which could

[1] Some debts are hybrids and entitles lender to participation in equity upside.
[2] *'Alta Semper Capital LLP invests $18m in HealthPlus', Business Day, 29 March, 2018.*

impact a company's future. It should only be taken after adequate consultation with professional advisers, including solicitors. Professionals are equipped to provide thorough and dispassionate analysis/ assessment that would be valuable input to investment decision making/evaluation process. They are also better trained and equipped to read and predict the market. Microsoft's bid for Yahoo in 2008 is a demonstration of the potential of an equity investment deal. Microsoft offered about US$45 billion to acquire Yahoo predicated on the assumption that by joining forces, the duo would be able to create a credible competitor to Google, the leader in internet search and ad market.[3] Yahoo rejected this offer as being too low.[4] Unfortunately, eight years later (in 2016), Yahoo was sold to Verizon for US$4.8 billion in cash[5] (although a deal like the one proposed by Microsoft in 2008 will be subject to Anti-trust regulations which is designed to promote and protect a transparent and competitive market from unjust and unfair business practices).

However, experiential reality is that many small and medium enterprises (SMEs) in Nigeria tend to pay scant attention to the implication of equity investments in their businesses. Often, they embrace the growth-at-all-cost mentality. As a business owner, there must be a thorough understanding of the available mechanisms for the company's protection before the choice of equity financing is made. The Investment documentations must be thoroughly reviewed and understood by the stakeholders: Directors and Shareholders. A case in point is Entertainment Highway Limited, owners of the now defunct HiTV. According to its CEO, Mr. Toyin Subair, in a recent interview,[6] HiTV collapsed essentially because of a clause in its original shareholders Agreement which allowed a group of founding shareholders, afraid of being diluted, but yet unable to inject equity capital, to block the company's admission of new shareholders.

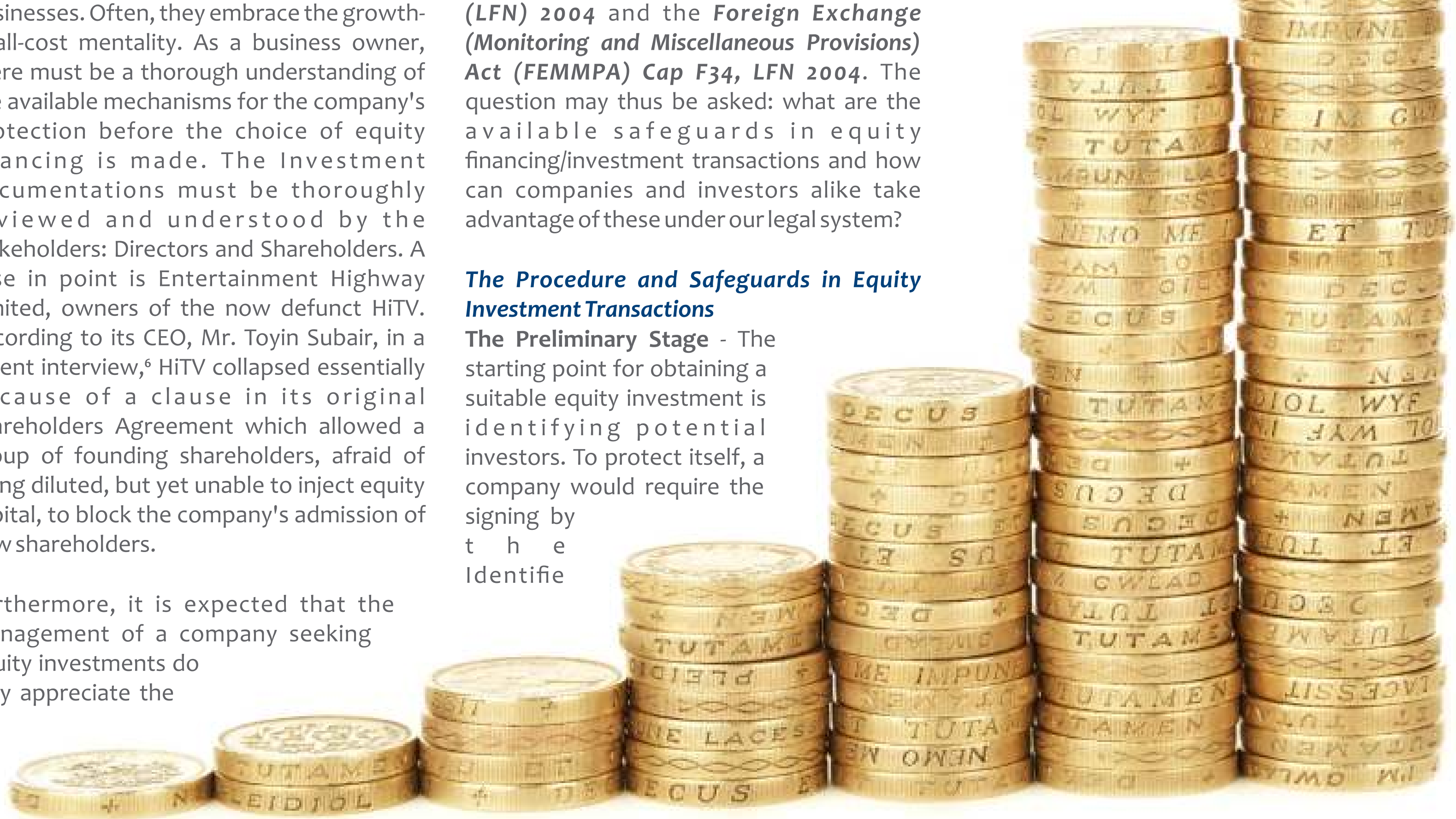
Furthermore, it is expected that the management of a company seeking equity investments do fully appreciate the regulatory landscape where the company operates. In Nigeria, equity investments (depending on their nature) are regulated by a combination of legislations. In addition to the ***Companies and Allied Matters Act (CAMA) Cap. C20, Laws of the Federation of Nigeria (LFN), 2004 and Investment and Securities Act 2007 (ISA) Cap 124 LFN 2004***, other sector specific laws exist. The aforementioned instruments however prescribe the broad framework for regulation of equity investment transactions. They establish the ***Corporate Affairs Corporate Affairs Commission (CAC)*** and ***Securities and Exchange Commission (SEC)*** respectively, to regulate the implementation of investment transactions, in line with public policy objectives. The ***Companies Regulations (CR) as amended*** and ***the SEC Rules and Regulations, 2013 (as amended, SEC Rules)*** provide the necessary supplemental guidelines for equity transactions in Nigeria.

Foreign parties are also free to make equity investments in Nigerian companies. However, foreign direct investments (FDIs) (not portfolio investments) are subject to provisions of the ***Nigerian Investment Promotion Commission Act (NIPCA) Cap N117, (LFN) 2004*** and the ***Foreign Exchange (Monitoring and Miscellaneous Provisions) Act (FEMMPA) Cap F34, LFN 2004***. The question may thus be asked: what are the available safeguards in equity financing/investment transactions and how can companies and investors alike take advantage of these under our legal system?

The Procedure and Safeguards in Equity Investment Transactions

The Preliminary Stage - The starting point for obtaining a suitable equity investment is identifying potential investors. To protect itself, a company would require the signing by the Identified investors of a Confidentiality Agreement (CA) before pitching its new product, expansion or business plan. This is followed by further discussions on the key financial elements of the prospective investment. The CA ensures that the business plan, business model and any other details of the investee's business are not disclosed to any other entity by the investor. In any event, it is important to ensure that a pitch is limited to the commercial aspects of the business, until a more definitive legal document is executed by parties. An example of such legal document is the Term Sheet (TS)[7] which is usually executed by prospective Investors who are interested in proceeding further with investing in the investee company (IC). The TS outlines the terms by which an investor may proceed to negotiate definitive agreements towards making a financial investment in a company.

Although TS are generally non-binding, it is possible to



[3] '9 Little-Known Facts About Yahoo' – www.gadgetsnow.com/slideshows/9-little-known-facts-about-yahoo/photolist/53394647.cms 26 July 2016.
[4] Miguel Helft and Adrew Ross Sorkin,'Microsoft Withdraws Bid for Yahoo' New York Times, 4 May, 2008: www.nytimes.com/2008/05/04/technology/04soft.html
[5] Brian Solomon, 'Yahoo sells to Verizon In Saddest $5 Billion Deal in Tech History', Forbes, 25 July 2016: www.forbes.com/sites/briansolomon/2016/07/25/yahoo-sells-to-verizon-for-5-billion-marissa-mayer/#4649911b450f
[6] Toyin Subair, 'Why HiTV Failed', Premium Times, 9 September 2016: www.premiumtimesng.com/business/business-interviews/210156-hitv-failed-toyin-subair.html
[7] Or Letter of Intent (LOI). LOI is more often used in merger and acquisition transactions while 'Term Sheet' is used in Venture Capital and Private Equity deals

specify binding clauses. For example, there should be a confidentiality clause requiring parties to keep transaction discussions confidential. This is an important safeguard for the IC. Investors may also insist on an 'exclusivity period' (EP), which usually prohibits the IC from approaching other investors within a specified period. This is equally important for an investor. The EP provides breathing space and room for robust negotiations. However, a letter of commitment may be executed alongside a TS to give a more binding effect to the latter.

Due Diligence Stage – After the execution of a CA and TS, the next step in an equity investment transaction is due diligence (DD). The importance of DD as a safeguard for an investor cannot be overemphasized. For instance, if the target company had been flouting regulatory requirements which is yet to be discovered or brought to public notice, the investor can be greatly affected. Or the target may have severe cash flow issues. DDs help to identify and minimize these risks, with DD findings shaping valuation and pricing discussions, if the prospective investor decides to proceed with the transaction, after considering the DD report.

Recently in East Africa, Emerging Capital Partners (ECP) pulled out of a deal to acquire Rift Valley Railway (RVR) after commissioning an audit firm to carry out DD on RVR's financial position.[8] The DD reportedly show that RVR had lost its biggest asset - its railway concession granted by the Kenyan government. However, more often, investors/acquirers ask for specific indemnities, representations and warranties to protect their investments. DDs can have many components: legal/regulatory, financial, environmental, labour, factory, technology, tax, etc. The nature of the DD being carried out and the materiality thresholds usually determines the scope of the DD, including period scope which in turn is influenced by limitation law.

Execution Stage – While the act of signing a TS or LOI shows the interest of an investor, it by no means secure the investment. A deal is not done until definitive investment agreements have been signed, and conditions precedent (CPs - pre and closing CPs) and conditions subsequent have been met. The execution stage denotes the signing of these definitive agreements. An equity transaction could be either or both of: (a) subscription for shares issued by the company, pursuant to which the parties sign Share Subscription Agreement (**SSA**); and (b) purchase of shares from existing shareholders who are exiting the company or selling down their stake to which the parties will sign a Share Sale and Purchase Agreement (SSPA) in addition to share transfer forms.

An SSA is usually between the investee company and an investor. It stipulates the number of shares that will be issued to the Shareholder, and the order and timing by which funds will be advanced. Subscription to fresh shares is what infuses the company with requisite funds, as proceeds from transfers goes to the selling shareholders. On the other hand, an SPA is an agreement which is used to transfer ownership of shares and which sets out the terms and conditions relating to the said transfer in a company. The SPA typically give warranties as to the ownership of the shares and absence of claims against the shares being transferred.

In ***Rajco International Ltd v. Le Cavalier Motels & Restaurants Limited,***[9] an investor allegedly made payment for acquiring shares in another company without executing an SPA or SSA. Nigeria's Court of Appeal held that the payment of money without the execution of an agreement and the fulfilment of other conditions as required by the Articles of Association of the IC will not be sufficient as proof of an intention of share subscription or transfer between the parties.

However, it is noteworthy that the rights of the investors as shareholders kick-in only after the subscription or transfer is complete. Thus, a Shareholders Agreement (SHA) is the legal document that stipulates these rights. It is part of the executed definitive agreements in an equity investment transaction and is usually amended at the entry of a new investor. SHA defines the rights, obligations and relationships of shareholders *inter se* in respect of the company and its management; often for enhanced effectiveness, the company itself is a party. It serves as another form of safeguard for IC and investors alike, in that it specifies the key terms of investment, rights over the shares issued to the investor, governance provisions, protections available to investors and specific exit-related rights.

Completion and Compliance Stage – After the signing of the investment agreements and the fulfilment of all CPs, the investors and the IC appoint a date within the specified timeline for 'completion and compliance actions'. This includes payment by investors, entering their names in the company's Register of Members in accordance with ***section 79 CAMA,*** issuance of share certificate to investors, , and filing of Return of

[8] Njiraini Muchira, 'Blow to Rift Valley Railway as Investor Pulls Out of Takeover Talks', The East African, 15 April 2017, www.theeastafrican.co.ke/business/ECP-pulls-out-of-RVR-takeover-talks--/2560-3890586-dqqsuaz/index.html

[9] (LN-e-LR/2016/53)

Allotments with the CAC, etc. This is crucial for the interest of an investor as it serves as conclusive proof of the acquisition of shares in the IC.

Irrespective of the mode of the equity transaction, requisite post transaction formalities or perfections must be undertaken. This primarily relates to filings at the CAC (*Form CAC 2A, Return of Allotments* is usually filed for both subscription and transfers, even though not mandated for transfers).[10] The other may be sectoral requirements – for example, ministerial consent needs to be obtained if the company is an upstream company, prior to the CAC filings. In such event, the transaction is inchoate until approval, hence perfection will only occur after consent has been received. All conditions precedents and condition subsequent are complied with at the completion and compliance stage. This may include due representation on the board and governance rights.

Conclusion

While it is apposite for every company to pursue growth, the bigger issue is the financing of the said growth. Expansion could mean the beginning of the end for a company if improperly financed. It could strain the cash reserves or cash flow of the company, which could have been put to better use. While expansion through equity financing can be tricky, it need not be laden with severe danger for both a company and an investor. Parties to an equity deal need not be too apprehensive of the consequence of investment once available safeguards are harnessed. Parties must therefore prioritize the engagement of experienced advisers to assure the prospects of successfully consummating, and optimally achieving their business objectives from the transaction.

[10] ***Section 129, CAMA***

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