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Mitigating Private Equity Risks:

A Commercial, Legal & Regulatory Perspective

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Private equity (PE)'s increasing global influence can be gleaned from the rise of global PE assets under management - US$2.49 trillion as at June 2016; whilst the 'dry powder' held by PE funds rose from US$755 billion in 2015 to US$820 billion in 2016, according to *2017 Preqin Global Private Equity & Venture Capital Report*. The *2017 Deloitte Africa Private Equity Confidence Survey* established that Kenya and Nigeria are the top investment gateways to East and West African regions. This is premised on Nigeria's stronger return from the 2016-2017 economic recession, and Kenya's positive economic outlook.

Significant PE activity in Sub-Saharan Africa (SSA), Gulf of Guinea and Nigeria have included fundraising by African resident or focused funds, international PE firms' entry into SSA, major investments and exits. Home grown firms (even if their funds are based outside Nigeria, most commonly Mauritius) include *African Capital Alliance (ACA)* (which recently closed and have been investing its US$570 million CAPE IV Fund), *Synergy* (manages US$65.9 million FAFIN Fund, committed to promote agricultural small and medium scale enterprises), *MBO Capital's* US$100 million MCM Growth Fund in microfinance and agro-processing, *Adlevo* an investor in technology-enabled companies like Solo Phone Holdings Limited, Paga etc.). Other Nigerian firms like *Verod Capital*, *Sahel*, *Alitheia* etc., are also making their marks.

African firms include *Convergence Partners* (promoted US$250

million CPCIF-an ICT fund aimed at developing telecommunication sector in West Africa); whilst International firms such as *Actis* (US$7.8 billion investment and realized US9.3 billion from 160 full and partial exits), *Abraaj Group* (which as at February 2018, manages US$13.6 billion assets in sectors like healthcare, clean energy and real estate), and so many others like - *TPG*, *Vectis*, *Helios Investment Partners*, *Emerging Capital Partners* etc. have made tremendous investment in the PE space.

Nigeria's recent recession and salient country risks have not deterred the PE industry. A recent transaction was *Helios* and *Vitol's* US$276 million acquisition of Oando's downstream business effective, July 2016.

Within this myriad of opportunities lies PE business risks - political, currency, operational and transactional risks - which could cripple investments. Preventing potential losses from these related risk exposure is therefore of major interest to PE firms, and this piece identifies and discusses these issues.

PE Investment Risks

Generally, businesses are prone to macro risks and PE funds enjoy no special immunity from such risk exposure. These risks - political, currency, market, operational, funding, and transactional - may arise at different phases of the deal namely: pre-investment evaluations, entry/operational (monitoring), and liquidity (exits). For instance, PE risk occurred during Nigeria's economic recession caused by the fall in oil prices, and the government's poor policy choices which negatively impacted exchange rate, resulting in massive Naira devaluation constituted PE risks. For

entrants, it may mean that assets can be purchased cheaply, whilst those seeking exits realize lower value in dollar terms. Also, investee companies become more challenged to deliver dividends at pre-recessions returns, and even to meet foreign currency obligations like debt servicing, payment of management fees, etc. Another is Political Risk (PR), which also constitutes a major threat for PE investments. Even developed countries such as the US are not exempted. For instance, after President Trump's election, many investors pulled out their investment from the US for fear of Trumps' 'America First' campaign. However, recent events including exceptional stock market performance and the pro-business tax reform legislation reflects or have engendered increased investor confidence in the economy. For instance, Nigeria's PR in 2017 was largely related to government and regulatory actions, like CBN's foreign exchange (forex) policy inconsistencies, but on the positive side, there were concerted efforts to improve ease of doing business. Political risks included sectarian and religious violence typified by Boko Haram insurgency and herdsmen/farmer clashes. There may also be heightened forms of 'distracted governance' as the 2019 elections approach. Other countries like South Africa, Zimbabwe, Egypt or Kenya, have their own PRs which investors have to factor into the calculations in taking near term, medium term and long term positions.

Preqin's Analysis of PE Risk/Return by Region-(May 2017) revealed that North America carry the lowest risk (14.6%) compared to Europe's 16.3%, Asia's 16.8%, and Rest of World (17.0%) vehicles. North America's favourable risk/return profile are due to the region's established capital markets, with a comparatively secure legal and regulatory environment that offers lower investment risk. This analysis was confirmed *by McKinsey's Global PE Review February 2017.* The challenge with emerging markets, especially in Africa, is how to facilitate both foreign and local investment by lowering the PRs.

Mitigating the Risks

An example of risks to mitigate is currency risk which can affect both entreprise value and net returns on investments. This can be achieved inter alia, by diversifying the revenue streams and investment portfolio (especially avoiding overconcentration on sectors prone to forex fluctuations), hedging investments (by using instruments in the market to offset the risk of any volatile prices), and buying insurance cover (transactional risk cover). For example, the Multilateral Investment Guarantee Agency (MIGA) provides political risk insurance and credit enhancement guarantees which help to protect investors' foreign direct investments against political and non-commercial risks in developing countries. Minimizing currency risk also involves reducing hard currency for PE deals.

The Federal Government (FG)'s efforts (through the Presidential Enabling Business Environment Council (PEBEC)) to champion reduction of business requirements stifling bureaucracies which has improved Nigeria's ranking in the *World Bank's 2018 Ease of Doing Business* (from 169th position to 145th out of 190 countries), is noteworthy.

PE investors in Nigeria can reduce PR exposure by avoiding or properly structuring deals with firms that have high government exposure especially if the firm's major client is the government or if it is highly regulated or otherwise exceptionally susceptible to control by the government.

Understanding the government's economic thoughts and political world view that underlies their policy decisions, actions and choices is also critical. This is with a view to being able to fairly anticipate/predict same, and having proactive responsive strategies in place. Having indepth understanding of the legal regulatory framework, the competitive (sectoral) landscape, and identifying the right local partners who are aligned with the firm are critical mitigating factors. Even challenges of infrastructure deficit represents investment opportunities to bridge the infrastructure gaps. An example is the Lagos Megacity initiative of the Lagos State Government (LASG) which provides a 'continuity backdrop' to prospective investors, given the erstwhile, current and potential future priority that successive LASGs has given, gives and will give to it.

Role of Legal Counsel

Engaging legal and other professional expertise is axiomatic when dimensioning PE risks. Legal counsel will assist in conducting legal regulatory, tax, and operational due diligence (DD), on the investee company. For instance, legal expertise is prerequisite for advising on optimal investment structuring. Should the investor be an SPV in a tax treaty country that also has bilateral investment treaty with Nigeria? What should be the capital structure: optimal mix of equity and debt? Should debt be foreign with sufficient tenor to enjoy tax benefits by way of withholding tax exemptions? How can the available incentives in the prospective investee company's sector be best leveraged? The DD report will provide an informed basis for taking the appropriate investment decisions, including valuation because of special circumstances/risks that may be applicable to the prospective target. An example is contingent liability from litigation or whether there is exposure to and quantum of statutory/regulatory fines.

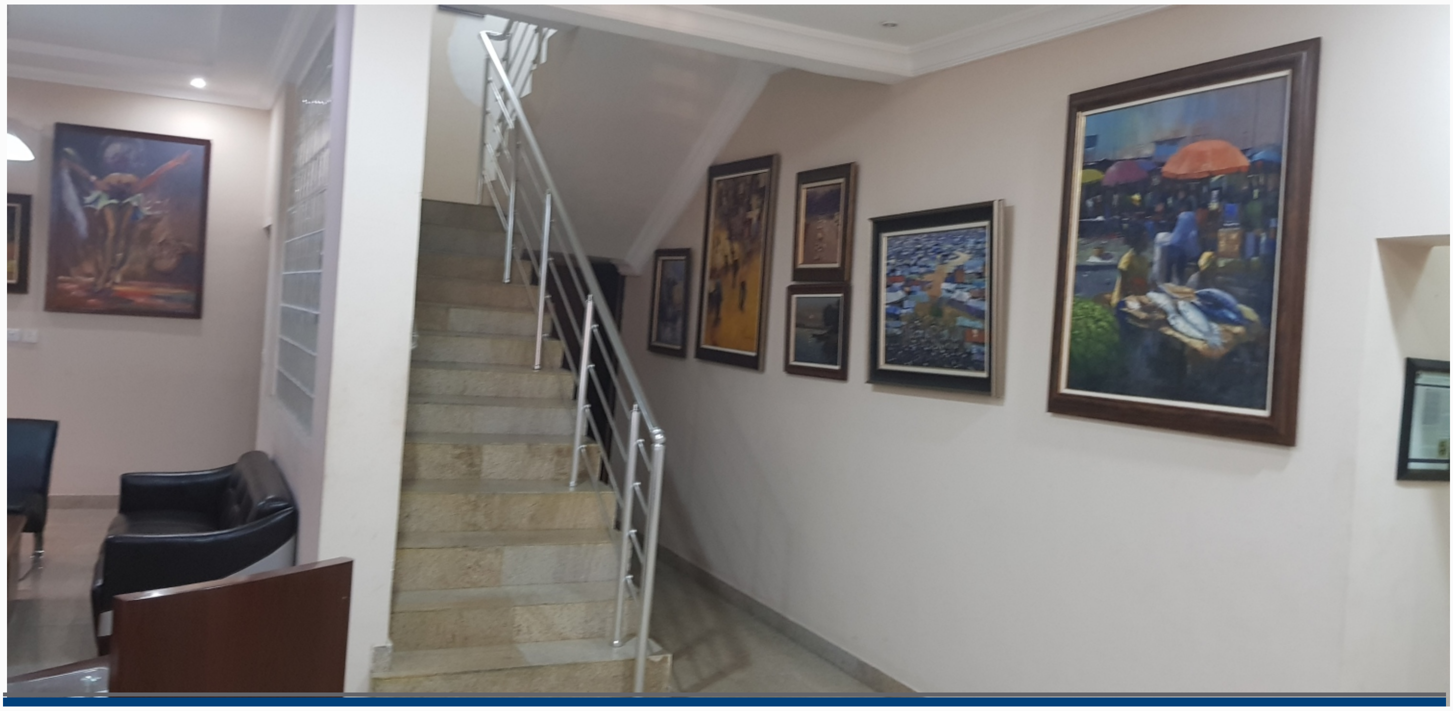
Also, legal expertise is required in deal negotiation (including fundraising), drafting and reviewing transaction documents

starting with the confidentiality and non-circumvention agreements, term sheets, and contract documents like the Investment, Loan, Subscription, and Shareholders' Agreements etc. The eventual language and import of some key clauses – valuation of stake and ratcheting structure, Right of First Offer/Refusal, exit or liquidity options (buy out, initial public offer, secondary sale to larger PE firms or third or third party investor etc.), fund lifecycle, internal rate of returns or the liquidity preference on investments, environment, safety and governance (ESG) considerations and business integrity, will impact rights and obligations. Consequently, it is apposite to have the backing of transactional astute counsel.

Legal expertise will also help with dispute resolution especially ensuring optimal protection vide contractual provisions on choice of law and mode of dispute resolution, pre-action steps etc. It is better to plan as if there will be disputes and have clarity about the process. A recent example was the dispute between *Helios* and *Telkom* which frustrated the proposed sale of *Multilinks* to *Visafone*; the sale would have prejudiced Helios.

PE Structures

Legal counsel assist in identifying legal regulatory gaps that can affect investment structure. For



instance, most PE structures involve engaging general partners (fund manager) and PE limited partnership (LP) (fund investors) who set up the funds.

In practice, PE fund vehicle must be registered under CAMA either as a business name or private limited company before it is registered as a LP or limited liability partnership (LLP) by submitting all requisite documents - LP name, registered address, partnership deed, limited and general partners' names designation etc. - to the Registrar of LPs/LLPs under the ***Partnership Law of Lagos State Cap. P1, 2003.*** Partnership laws are within the province of the States, and Lagos State has the most advanced because it has provided for regular, limited and LLPs. This should trigger regulatory competition amongst other States seeking to attract investments. Furthermore, although an LLP is registered in Lagos, it can transact business anywhere in Nigeria because it would also have been registered as a business name under CAMA, a federal legislation.

The ***Venture Capital (Incentives) Act Cap. V2 LFN 2004 (VCA)*** provisions–especially ***section 4 (b) VCA*** that exempts a venture capital company from capital gains tax (CGT) for disposing its equity interest is redundant due to ***section 30(1) CGTA*** provision that exempts sale of shares and stock from CGT. Generally, the ***VCA*** needs to be amended in light of, and to meet the current PE risk realities. This will boost PE investors' confidence.

Conclusion

PE business and legal risks can be daunting but are not insurmountable. In this regard, properly planned investment decisions leveraging robust risk management approach that draws from transaction seasoned multidisciplinary team, would help mitigate these risks. PE firms can also more actively influence policy directions as industry lobby (vide narrower PE association platforms and as part of wider private sector/FSI groups) towards achieving enhanced investment friendly policies/reforms to foster increased PE investment

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