FINANCIAL SYSTEM DEVELOPMENT IN UGANDA: ACCESS TO PATIENT CAPITAL

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Background

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- Growing amount of domestic medium to long term savings seeking investment in productive sectors (currently UGX 7.7 trillion with NSSF comprising 84% of this)
- Increasing interest from private equity funds seeking to invest in productive sectors for 5 – 8 years
- From UGX 915 in Nov.1991 to 3,600 in Nov.2016, the UGX has lost 5.63% on average to the USD
- Inflation has averaged 6.9% per annum for the past 16 years

Business growth (capital & challenges of growth)

1. **Growth needs capital**
2. **Sources of capital**
   - Savings/wealth; Family/friends; Business profits reinvested
   - Debt (high bank lending rates for medium sized companies)
   - Equity (Private, Public)
3. **Challenges of growth**
   - Management: reduction in direct management control
   - Formalization and visibility
   - Working capital – frequently underestimated (importance of 'visibility of demand')
   - RISK – complexity increases

Why capital markets – as an issuer?

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a) Source of patient capital (both debt & equity), so catalyzes entrepreneurship
b) Reduces cost of borrowing
c) Liquid shares provide quick valuation for business owners which can be a non-cash acquisition currency
d) Provides a liquid exit option for full or partial sell of business
e) Refinancing debt with equity increases a company's profitability
f) Secures customer, supplier, employee, stakeholder loyalty – boosts confidence.
g) Creates stakeholder goodwill amongst Ugandan citizenry (good for long term sustainability)
h) Provides a succession plan for founder managers of successful companies

How an Entrepreneur can benefit from Capital Markets

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- Owners of well managed companies have more options than ever before for growth capital, or an outright sale of their business.
- Selling a minority stake in your business can help you maintain ownership control and minimize your personal financial risk.
- Many business owners have a large percentage of their personal wealth tied up in their company.
- Selling a portion of the company enables owners like you to cash in on some of you hard work and re-invest the cash in more liquid investments that will be available for you and your family

Illustration

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- An entrepreneur starts a cottage industry with UGX 2 billion and produces goods which generate net profit margin of say 30% p.a., and business profit is growing at 10% p.a. over a 6-year period.
- Assume the business grows and attains a market value of UGX 12 billion within the first six years.
- The entrepreneur can opt to hold onto this growth trajectory or cash out a minority stake – let's assume 25% of the company and therefore recoup his/her initial investment while maintaining majority ownership.
- The entrepreneur can look for a buyer for 25% of his/her business from family, friends or even private equity funds, ***or go to the capital markets and place the shares on a stock exchange for the public to purchase them, OR sell to a private equity investor***. 25% of UGX 12b is UGX 3 billion.
- If the public likes the published financial performance of the company, the shares could be worth more than the entrepreneur imagined within a short time of floating the company. In this example, if the share price rises by 20% within a year of listing, the business will be worth UGX 14.4 billion.

Subsequent financing options

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- From our numerical example, the entrepreneur who listed his/her business now has several cheap and patient financing options available to him/her.
- Let's assume that he/she now needs to raise an additional UGX 2 billion to finance an activity or project that would generate more revenue for the company in the mid-term (3-5 years)
- Let's consider three financing options available to the entrepreneur that will not affect his controlling stake in the business

Option 1: Issue additional shares to existing shareholders (rights issue)

- Assume the company had 60 million shares at the time of IPO valued at UGX 200 per share thus valuing the company at UGX 12 billion as before.
- Share price increased to UGX 240 within a year of listing and company is now worth UGX 14.4 billion.
- To raise UGX 2.4 billion using a rights issue, the entrepreneur may issue an additional 10 million shares at a discount to existing shareholders including him/herself.
- This would raise UGX 2.4 billion
- The minority shareholders (25%) will need to raise UGX 600 million to avoid dilution (retain same proportion of shareholding).
- If they don’t participate in all the rights issue, the entrepreneur may raise part of this money and increase his or her shareholding to beyond 75%

Options 2 and 3: Issue new shares to the public and bank loans

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- The entrepreneur could issue an additional 17% of his/her company which is now valued at UGX 14.4 billion to raise the required UGX 2.4 billion and still retain majority shareholding.

- Alternatively, the entrepreneur could issue an additional 7% of his/her company which is now valued at UGX 14.4 billion to raise UGX 1 billion.
- The required balance of UGX 1.4 billion can be sourced from bank debt. Listed companies are usually given more favorable lending rates than non-listed companies owing to their better corporate governance and superior financial reporting standards.
- If the funding requirement was to bridge a short term working capital gap, then by all means, it would be advisable for the entrepreneur to turn to the bank for a loan.
- Again, the owner still has a controlling stake in his/her business.

- As time goes on, the value of the company could ultimately grow to UGX 30 billion plus, which creates more wealth for all the shareholders.
- Recall that our entrepreneur recouped his initial investment by offering equity and has used other sources of finance to grow the business and his wealth!

Public Vs Private Equity

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Public

- Greater brand visibility and public profile, customer & employee loyalty because of wider shareholder base including institutional investors
- Better prospect of price discovery because of liquidity of shares
- Relatively higher direct costs of public listing (5-8%) - Born by issuer (this is an investment).
- Additional capital can be raised through rights issues
- More than 100 shareholders
- Pressure to pay dividends
- Dilutive in nature

Private

- One or two shareholders to deal with
- Valuation of shares at entry and exit more rigorous
- Lower costs born by investor
- Technical capacity part of investment proposition
- Involves more extensive due diligence – direct costs born by investor, but time spent is an investment
- Repayment could be via royalties from turnover …. constraining
- Dilutive in nature

But, why the concerns …… ?

1) There is no loss of control in decision making if you remain the majority shareholder
2) The risk of losing your company to other shareholders as a result of failing to meet capital call requirements / rights issues etc. is low given the above.
3) Reporting to the public – publishing abridged financial statements is done twice a year & AGM is held once a year, increased public profile could attract unwarranted attention (e.g. from taxman)
4) The information published is historical not forward looking (no risk of losing competitive advantage to competitors because company information is “public”)
5) The cost of listing is negotiable (5-8% of issue size)

Thoughts for business owners before raising finance

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1) Is growing your business via own funds/bank borrowings increasingly looking difficult?
2) Are you willing to sell some of your shares in your business to raise more capital?
3) Does your business have a good or unique product/service?
4) Does your business have high growth prospects?
5) Does management have the relevant industry/sector experience, drive, vision? Who is in charge?
6) Is your business organized – books of accounts, good governance practices?

- *If your answers to 5 out of the above 6 questions is **"YES"**, equity is worth considering ….*

- Please visit www.cmauganda.co.ug for more information about an advisor to speak to.

Consider selling a minority stake in your company as a way of having your cake and eating it too.

THANK YOU