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RESEARCH NOTE SERIES

PRIVATE PLACEMENTS: CAN THEY BE A CATALYST FOR PUBLIC OFFERS IN UGANDA?

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INTRODUCTION

Private placements are a form of capital markets financing that usually targets a small number of high net-worth and highly sophisticated investors. Private Placements can take both the form of debt or equity. A typical issuer in the private placement market is usually a medium sized company or even a large company with limited information available in the public about its operations and the industry in which it operates. Such issuers are usually start-ups or growth companies or companies with complex structures or new products. These companies usually do not have an extensive track record or industry comparators which are critical yardsticks for evaluating an investment in a public market.

Given the complexity of private placement transactions and the high information asymmetry associated with them, they do not attract many investors as is the case with public offers. It is mainly institutional investors and very few retail investors. The retail investors are in most cases very rich individuals who have the capacity to evaluate high risk investments or they can hire financial advisors to undertake the due diligence on their behalf. In some cases institutional investors like pension funds may not be keen to invest in private placements given the high risks that may be associated with them.

However in Uganda's case the Uganda Retirement Benefits Regulatory Authority (URBRA) Investment regulations provide for up to 15% of the aggregate market value of total assets of funds of a retirement benefits scheme to be invested in private equity investments in the East African Community (EAC). This implies that retirement benefits schemes in Uganda can invest up to 15% of their assets in private equity placements so long as they are within the EAC.

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This research note seeks to establish whether private placements can be a catalyst to public offers in Uganda. One may argue that private placements can be a preparatory ground for companies intending to access the public capital markets as they expose the potential issuer to the rigors of engaging with external capital markets investors.

FIRM SIZE, INFORMATION AVAILABILITY AND CAPITAL RAISING

Mark Cary et. al. (1993)[2] provide a hypothesis on access to capital. In their hypothesis they argue that information availability is a very critical factor to accessing capital in the financial markets (See figure 1). In most cases small and medium sized companies with little or no track record and with scanty information about their operations and industry will have no access to the public capital markets. In the public market there is a diverse investor base in any particular company making it difficult for each of these investors to undertake comprehensive due diligence without sufficient information on both the company and industry.

In the case for Uganda, the minimum number of shareholders for any company intending to list on the Main Investment Market Segment (MIMS) of the Uganda Securities Exchange (USE) is 2000. Such a diverse investor base would require that sufficient information be available in the public domain about both the company and its industry. That is why the requirement of "a track record" is a very critical requirement of accessing the public capital markets because it's with "a track record" that a diverse investor base can analyze the suitability of an investment without much hassle. Small and medium sized companies with no "track record" and limited information about their operations and industry are thus left to a few investors in the private capital markets.

The private capital market ranges from the low end of the market where the companies can only access capital from their family, friends and founders' savings to the higher end of the market where these companies can issue bonds and equity in the private placement market (See figure 1). In between one will find the commercial banks that provide short to medium term capital. The high levels of information asymmetry and lack of track record inherent in such companies would require that the potential investors undertake intensive due diligence which in most cases would require specialized skills. In most cases it is commercial banks, venture capital funds, private equity funds, hedge funds and investment banks that have developed such specialized skills to undertake such in-depth due diligence. Pension funds rarely have the capacity to undertake such due diligence and as such rarely invest in such companies.

[2] Mark Carey, Stephen Prowse, John Rea and Gregory Udell (1994). The Economics of the Private Placement Market. Board of Governors of the Federal Reserve System. Washington D.C.

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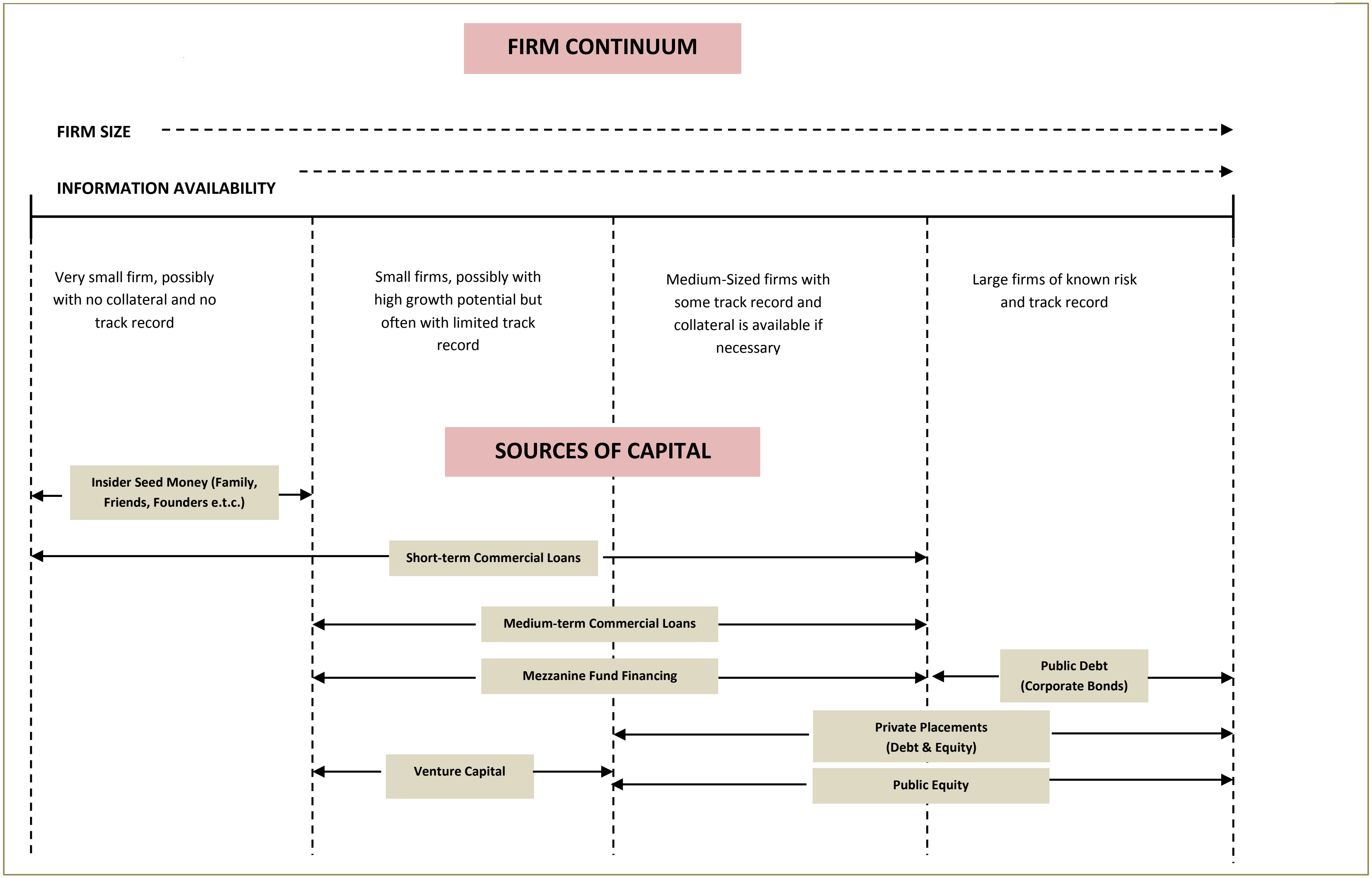
From the analysis above and the illustration in figure 1, it is clear that private placements cannot be a catalyst to public offers in Uganda. Private placements seek to address the challenges of information asymmetry inherent in some companies and industries by providing long-term risk capital to companies that would not ordinarily access the public capital markets. Therefore private placements are more of a substitute than a compliment to the public capital markets. Thus an increase in the number of private placements would not necessarily translate into more public offers.

However private placements can play a major role in bringing to the fore information on companies and industries previously not available in the public. As many more private placements are done investment banks leading these transactions can build a wealth of information on diverse companies and industries that could provide a foundation for future public offers of companies in those industries.

Therefore while private placements may not have a direct bearing on the development of public capital markets in Uganda, they can still play a major role in developing information databases on various companies and industries. This could ultimately place companies in these markets in pole position to access the public capital markets. In cases where venture capital funds and private equity funds exit their investments through Initial Public Offers, the private placement market can also play a critical role in developing the public capital markets.

Figure 1: Sources of Capital along the Firm Continuum



Source: Mark Carey, Stephen Prowse, John Rea and Gregory Udell (1994). The Economics of the Private Placement Market. Board of Governors of the Federal Reserve System. Washington D.C.