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**DEVELOPMENT VENTURE-CAPITAL FUND.**

**A PROPOSAL FOR MOZAMBIQUE**

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## **Index**

*Executive Summary*.....p. 4

### Section 1

Background, Justification and Potential Constraints.....p. 6

### Section 2

Lessons Learned from International Experiences.....p. 13

### Section 3

The Functioning of DVF and its Potential Impact.....p. 22

*Bibliographic References*.....p. 34

### Annex

Examples from other Countries' Experiences.....p. 36

# DEVELOPMENT VENTURE-CAPITAL FUND.

## A PROPOSAL FOR MOZAMBIQUE

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### **Executive Summary**

*The present document analyses and describes the possibility of introducing an innovative financial instrument to promote the development of competitive agro-business in Mozambique called "Development Venture-Capital Fund" (DVF). This instrument would work on the same guidelines of a traditional venture capital fund but would have some particular features that would make it an efficient "agro-business incubator" and would allow it to have a crucial impact on the development of the entire national agro-business sector in Mozambique.*

*The document is divided in 3 sections that will be briefly described below.*

*In **Section 1** the present situation with the constraints created by the lack of access to convenient and supportive financial services is presented together with a brief analysis of the main determinants of this situation. This section focuses on the justification for introducing the DVF and analyses the relative advantages of the venture capital model over other financial instruments (i.e. special targeted financial lines, guarantee fund, etc.). The main comparative advantages of an equity fund are identified as follows:*

- 1. It does not create a short-term expenditure burden on the firm*
- 2. it has greater "targeting capacities", i.e. it is more likely than other financial instruments to address specific situations*
- 3. It has a higher level of propensity towards risk taking*
- 4. It adopts a different approach to evaluate business opportunities (profit-oriented)*
- 5. It has the ability to leverage additional funds*
- 6. It does not only provide money but would act as a "business incubator" with a financial stake in the success of the invested company.*

*The section closes with an analysis of the possible constraints that the DVF could potentially encounter in Mozambique.*

***Section 2**, in light of various international experiences analysed, on the basis of secondary literature and direct interviews, focuses on lesson learned from international experiences in developing countries and in particular in Africa.*

*These lessons are grouped for simplicity in “reasons for success” and “causes of failures”. Two elements seem to clearly emerge from prior experiences:*

- 1. The crucial importance of the quality of the managing unit and the way the venture capital (VC) is managed*
- 2. The importance of avoiding to “over-design” and impose too many constraints (explicit and implicit because of political “intrusion”).*

**Section 3** *does explain in a more detailed manner what really a DVF is and how it should work in practice. Firstly, it describes a set of basic operating principles and the structure of this institution, including its necessary linkages with existing financial and non financial institution in order to create a “agri-business promotion consortium”. Our proposal is that a “consortium” of strategic and operating partners should be created to support the management unit; the managing unit should be linked to these other existing financial and non-financial institutions, which could play a role in outsourcing some of the activities for supporting the work of the DVF and strengthen the capacities of the financed agro-business. In this way the DVF will not duplicate the work of existing institutions (financial and non-financial) but will act as a catalyzer of existing capacities (nationally and internationally), introducing a new positive dynamics in the system supporting and promoting the development of productive capacities in the domestic agro-business.*

*It is important to underscore that in the authors’ analysis some basic principles emerged as necessary conditions for the success of this initiative:*

- 1. The need for independent and transparent decision-making*
- 2. The need for having clear and measurable targets*
- 3. The importance of recruiting appropriate human resources for the management of the DVF*
- 4. The need for reaching, after an inception phase, the self-sustainability of the fund.*

*The rest of the section focuses in a detailed manner on the composition, roles and responsibilities of the main actors managing the DVF (i.e. Board of Directors, managing unit and a possible committee of investors).*

*This section also presents a set of guidelines to address the investment process and the development of an investment strategy and management plan is also described.*

*Section 3 is closed by an analysis of the potential qualitative benefits of the DVF which is based on the analysis of both the Mozambican reality and the evaluation of the experiences of the existing and past VCs.*

## Section 1

### Background, Justification and Potential Constraints

#### **Background**

This section will address the following question: why a creative solution to financing SMEs is needed? And why it may be necessary to create an institution with a new investment model and way of operation?

One of the main constraints identified by previous analysis of the agri-business sector in Mozambique is the lack of access to healthy and supportive financing system<sup>1</sup>.

Three background aspects must be taken into account in order to explain the actual situation of low access to financial resources available to private sector:

- **The macroeconomic policy**, as a consequence of stabilisation program on which Mozambique embarked, is characterised by very restrictive monetary policy that implies high interest rates and constrained credit allocation. Furthermore, private sector and public sector compete for the same scarce resource and the high returns<sup>2</sup> paid from the Treasury on its bond crowd out private sector investments.
- **Inefficient financial system**. Due to high level of concentration the commercial banks act in a low competitive environment with high costs that are transferred to their clients mainly as high interest rates.
- **Low savings**. The deposits within the system reach 900-1000 million USD, which is about 30% of the GDP. Most of them are liquid deposits. This level of savings is unable to finance all the productive sectors and implies that there is a lack of financial resources. Therefore the sectors of agriculture and agro-industry, with relatively lower returns, higher risk and longer period of recovery are negatively discriminated in comparison with other sectors (i.e. commerce, services).

In addition to the analysis provided by secondary literature, this problem has been further analysed through field work interviews during the months of September and October 2002<sup>3</sup>. Below we synthesise the main findings:

- Commercial banks requirements appear excessively demanding and inconsistent with the development of agri-business sector based on competitive SMEs. The costs of commercial credit is too high and the access too low
  - Interest rate extremely high: about 30-35%
  - Real guarantees required too demanding: about 120% of the required loan in real assets

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<sup>1</sup> Carvalho Neves (2002), Carlos Nuno Castel-Branco (2002),

<sup>2</sup> At the present 28%

<sup>3</sup> See annex for detailed transcriptions of the interviews

- Fix co-participation to the investment: not less than 30% of the investment
  - Extremely high risk aversion that push them to exclude beforehand financing small and medium agri-businesses.
- It appears evident that commercial banking tend to avoid financing agro-industry
- Commercial banks claim it is a risky activity
  - The relative returns of agri-business versus other economic activities (i.e. commerce) makes it not attractive enough.

### **Existing institutions**

Commercial banks are not the only important actors. In Mozambique, there is a number of other financing institutions that must be considered because of their role in financing private sector in general and SMEs in particular<sup>4</sup>.

**GAPI** (Gabinete de Promoção para Pequena Industria): This is a development financing institution, probably the most active institution involved in financing SMEs. It has a portfolio of about 13 million USD and its average credit is about 35,000 USD. In the last few years it has been financing some agri-business and is willing to expand but is constrained by available financial resources and institutional capacities.

**PODE** (Programa para o Desenvolvimento Empresarial): Credit line of a World Bank's sponsored program targeted at promoting Mozambican entrepreneurs. PODE was activated in 2001 but so far very few projects have been financed because the funds are channelled through existing commercial banks that apply the same requirements applied to their own funds. During the interview with the director of PODE it has been referred that various agri-business projects have been presented but all rejected, despite of the fact that some of them appeared viable. There is an ongoing discussion about reshaping the PODE's credit line. The principle possibilities are:

- Introducing a credit line in dollars
- Converting the fund into equity
- Converting the fund into guarantee.

**AMODER**: This is a development financing institution initially financed by "Grupo de Solidariedade Sueco" that concentrates on "agricultural commercialisation"<sup>5</sup>. In Niassa AMODER administers a program called "Malonda" that aims at promoting entrepreneurs in rural areas through the creation of joint ventures<sup>6</sup>, with MALONDA concentrating on the financial administration and the entrepreneurs on core the business activity. So far the program has been in its pilot phase with good results<sup>7</sup>.

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<sup>4</sup> For a detailed list of the financing institutions in Mozambique see annex \*\*\*

<sup>5</sup> About 75% of its portfolio, about US\$ 1.4 million, goes to commercialisation

<sup>6</sup> The entrepreneur enter the joint venture with commercial and physical infrastructure, licences, work; MALONDA does enter with fresh capital and at the end of the contract gains or losses are equally divided between the participants

<sup>7</sup> So far 12 joint ventures have been financed (7 in 2001 and 5 in the first 9 months of 2002) with profit for each of the partners that exceeded 20% of the invested capital

**VENTURE CAPITAL:** There are in Mozambique two existing venture capital funds.

- MINCO: This VC has been operating in Mozambique for nearly 4 years, but has a limited numbers of investments (about 6-8 investments) and has never invested in “start-ups” or in “agro-business”. It is linked to AUREOS, an international finance company focused on providing VC in developing countries
- GCI: This VC has been in Mozambique for only a couple of years and is in an incipient phase with very few investments (2-3 investments). To the present no investments have been in done in agro-business. This VC it is linked to, and partially financed by BCI.

**FFA** (Fundos de Fomento Agrário): These are two funds of the Ministry of Agriculture and Rural Development aimed at promotion of agriculture that have performed poorly in the past with extremely high administrative costs and unsatisfactory performance<sup>8</sup>. Their role, aim and structure are currently under revision but the main idea is that these fund will not be providing credit directly.

In addition to existing institutions, there is a number of initiatives, mostly at the early conceptual stage, that are being discussed in order to address the problem of financing SMEs. The most relevant are:

- **Special targeted credit line:** This effort is being promoted in particular by GAPI and AMODER, among others, and aims at expanding and capitalising their past activities and experience in the area of financing SMEs.
- **Guarantee fund:** A proposal has been already put forward and publicly discussed with the aim of creating a guarantee fund with the objective of sharing the commercial risk of banks and creating an incentive for the existing commercial banks to finance agriculture related activities (i.e. agriculture commercialisation, agro-industry, services to agriculture).
- **Venture capital:** In addition to the existing funds TECHNOSERVE<sup>9</sup> made public and put forward the idea of creating a venture capital specialised in agro-business expansion.

### ***Justification for Introducing a Development Venture Fund***

The proposal aims at establishing, jointly with other donors and partner institutions, a Development Venture Capital Fund (DVF).

The aim of the DVF will be to finance viable agri-business ventures providing both equity for long term investment and loans for short-medium term financial requirements. The funds will be available either in dollars or in meticaís, this is needed because if funds were available only in meticaís then the export-oriented business would be negatively discriminated as they do

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<sup>8</sup> For a more detailed analysis of the FFA please refer to “*Refocussing the ‘Fundos de Fomento’*”, Internal Working Document, MADER

<sup>9</sup> Technoserve is an American NGO that specialises in support to private sector and agro-industry as instruments to reduce rural poverty in Mozambique

obtain their revenue in dollars and are able to pay the costs of financing in dollars<sup>10</sup>.

The relative advantages of a venture capital over other financial instruments (i.e. special targeted credit lines, guarantee fund, etc.) are multiple.

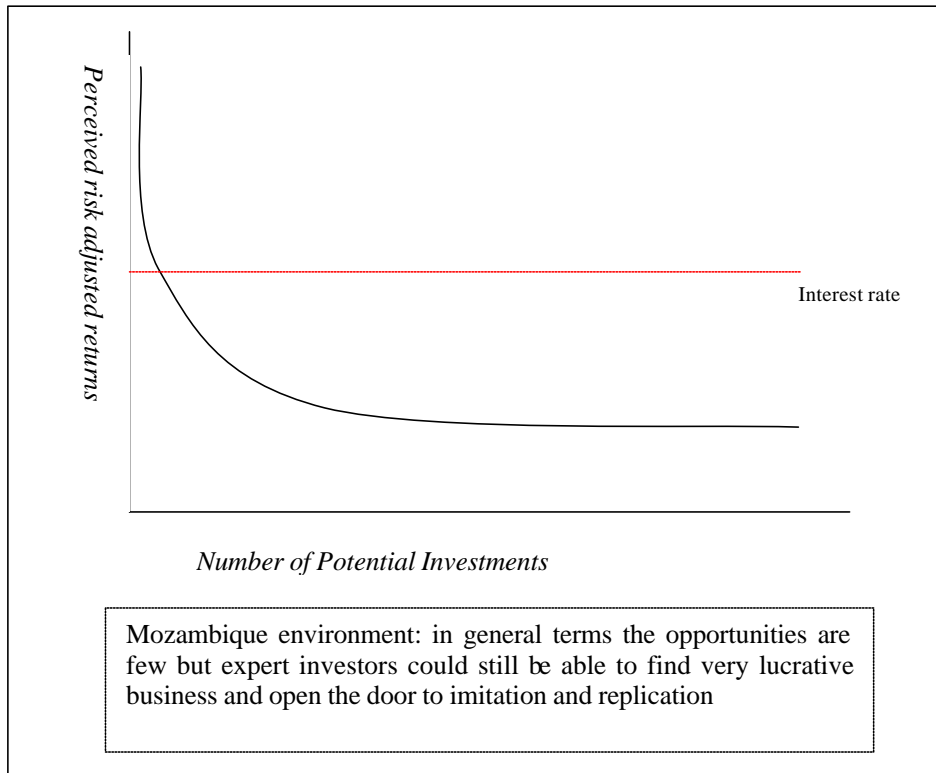
- i. **Equity funds do not create a short-term expenditure burden on the firms**, which is especially relevant for Mozambique where extremely high interest rates prevail and in the first phases of development when still full capacity and economies of scale cannot be reached. An important finding from a recent study<sup>11</sup> shows that businesses potentially viable are made unviable when a high level of investment is financed through commercial banks.
- ii. Many appoint the weak investment "environment" as one of the constraints for the existence of a developed financing system. As described by the image below the number of investment that can be financed<sup>12</sup> is in general low. However, individual investors tend to see this not as a generic issue, indeed many examples can be given of investors undertaking major initiatives under exceedingly unfavourable conditions, because they felt the potential returns warranted the risk. **The DVF would act as an investor and because of its "targeting capacity" could be able to find lucrative investments in an environment "in general" unfavourable on a case by case basis. Furthermore, if success in specific investments is achieved it is likely that this will allow others to imitate the success.**

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<sup>10</sup> It must be noticed that the spread between market interest rates in dollars and meticals is about 30 percentage points; therefore a firm able to pay its debt in dollar (i.e. export oriented firms) will have substantial savings.

<sup>11</sup> *Identificação de Opções e Viabilidade para a Promoção da Agro-Indústria Rural em Moçambique*

<sup>12</sup> (Risk Adjusted Returns) > (Interest Rate)



- iii. In a system where access to credit is extremely complex the DVF would **introduce a less conservative and risk averse alternative source for financial capital.**
- iv. DVF could reduce risk and its funds work as guarantee therefore **could have a leverage effect and catalyse other external funds** (i.e. commercial loans). The **reduction of commercial risk for the commercial banks** would happen because of 2 reasons:
  - (a) The funds would be used for investment in machinery and infrastructure. This could serve as real guarantee for commercial banks (for financing operative capital)
  - (b) The co-participation of the DVF would be a signal of better than average management and technical capabilities within the business, therefore create a more safe and convenient venture for the banks.
- v. An important element to be considered is that VC is able because of its own nature to handle and bear risk that other financial instrument simply cannot<sup>13</sup>. This is because of one principal reason: the VC does have access to insider information and can add value to the business which has two immediate effects: (a) reduce the information asymmetries between lender and borrower; (b) increase the chance of success of the project.
- vi. A crucial advantage of the VC is that **it does not provide only "money" as such, but it does strengthen the management**

<sup>13</sup> It is a basic principle of finance that risky endeavours should primarily be funded with equity resources, and only very safe investments (the traditional example is a public utility) should be highly leveraged with very low equity and high debt

**capacities** (financial but also technical when needed) of the firms participated<sup>14</sup>.

- This is extremely important considering that one of the main problems of Mozambican business ventures refer to their capacity and tradition of efficient management of the firm<sup>15</sup>.
- Furthermore, this would imply building “on the job” management capabilities among national entrepreneurs<sup>16</sup>.

In this perspective the **DVF would serve as a “business incubator”** in the sense that at the moment of the exit the entrepreneurs that have been working in partnerships would have developed management capacities, market access, capacity of dealing with clients, capacity of dealing with providers of services, raw materials and finance, etc.

The justification for the DVF to be publicly financed by donors, at least in its kick-off phase, is based on various reasons:

- Potential returns on investments in small and medium scale enterprises that require professional management and considerable support are not sufficient to attract private venture capital, and therefore virtually no such equity activity exists. It has been observed that technical support and capacity building for SMEs has not achieved the expected impact, at least in part due to the fact that no investment could be realised<sup>17</sup> (UNIDO, 2001)
- From the other side there many good opportunities in developing countries for investment in SMEs, but the weak financial system and shortage of long term capital work as powerful brakes on domestically driven industrial development<sup>18</sup> (UNIDO, 2001).

### **Potential Constraints**

This section aims at anticipating the potential constraints that will possibly surge in the future. While we cannot provide solutions for each of these problems, it is still important to consider them as “potential risks” for the success of the DVF.

There are two groups of constraints that is important to distinguish.

*Constraints that affect directly and specifically the venture capital:*

a. Lack of divestment options

- Exit strategy may be complex in a context where an active stock market is absent. This implies that the only concrete exit strategy is selling back the participation to the local partner-entrepreneurs, therefore this will

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<sup>14</sup> Venture capital funds provide more than just capital. An important part of the value added is the expertise in strategic/financial planning, marketing and accessing complementary financing that they bring to the companies in which they have invested. Those skills are especially valuable in transitional and low-income countries, where such skills are in short supply (Glen, 2001).

<sup>15</sup> This would impede that small management mistakes turn unviable business that are in reality lucrative, as well as would avoid mismanagement of funds

<sup>16</sup> The VC would serve as an “entrepreneurships development device”.

<sup>17</sup> UNIDO (2001)

<sup>18</sup> UNIDO (2001)

have clear monopsonistic power and strong negotiating weight<sup>19</sup>. The issue of exit is complex because there are competing interests simultaneously at stake<sup>20</sup>

- In the short term, the solution must pass through the use of creative instruments (i.e.: equity-debt swaps, consolidation<sup>21</sup>, strategic alliance<sup>22</sup>) and structuring the investment in an adequate form<sup>23</sup>. In the medium-long term other possibilities may be arising like the creation of a secondary stock market where the requirements for listing are less complex and demanding than on the primary market<sup>24</sup>
- b. Unsatisfactory legal infrastructure
- The problem of non availability of certain legal instruments can reduce the efficiency of the DVF<sup>25</sup>
  - The enforceability of the contracts can be an obstacle even if recently with the introduction of the “lei de arbitragem” the commercial disputes may be solved in a faster and more efficient way<sup>26</sup>
- c. Local entrepreneurial culture
- The acceptance of an external participation is normally problematic, entrepreneurs normally want capital but not to be controlled, and are unwilling to follow transparency requirements
  - It is crucial to diffuse and impose that idea that the external participation of the DVF does not mean negative control but is a way to improve their business through more transparent, professional and efficient management
  - The acceptance of local entrepreneurs is a crucial point for the success of the DVF, in fact the wider would be this acceptance the bigger would be the pool of potential “projects” that could be financed
- d. Involvement of investors (i.e. , Italian cooperation, others, etc.) must be handled with care because may determine the success or failure of this instrument
- Investors cannot be too close to decision-making but at the beginning this is most difficult, at least till a point trust is not developed between investors and managers
  - Since missed opportunities may be less costly than excessive concentration or bad investments, the most practical solution may be for management and some representative(s) of the investors each to have veto power over investments (IFC, 1993)

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<sup>19</sup> Where prospects for initial public offerings are uncertain, VCCs must negotiate from the outset alternative exit arrangements. Still, there has been the case of one the successful VCCs that was particularly effective in using creative instruments in an environment where prospects for initial public offerings were poor (IFC, 1993)

<sup>20</sup> From one side the owner of the firm willing to “get rid of” the VC and at lowest possible costs and from the other side VCC aiming at make a profit and reaping the results of the investment done. It is important to observe that not necessarily in the case of a successful investment (“good venture”) the exit is easier, on the contrary it can be very difficult because the interest at stake are higher

<sup>21</sup> Sell the firm to an existing competitor in order to create a stronger and more competitive national firm

<sup>22</sup> Sell the firm to an international firm that is complementary or similarly to it and is interested in expending in the national market or benefits of the national competitive advantage

<sup>23</sup> In the form of convertible loans, redeemable participating preference shares, or straight equity investments backed by put options

<sup>24</sup> Based on the interview with MINCO

<sup>25</sup> Based on the interview with MINCO

<sup>26</sup> MINCO affirmed has been taking advantage from this law

- e. Finding and training appropriate management<sup>27</sup>. And create the right incentives
  - This is a very crucial point as one of the reason of failure with some of the VC in developing countries has been the low level of managers<sup>28</sup>

*Constraints that affect indirectly the venture capital* as they are common to all the financial instruments and more broadly affect the productive sector and specifically agro-industry. The crucial point is that a constrained, underdeveloped and not dynamic productive sector does imply a clear even if indirect constraint to the efficient functioning of the DVF:

- a. Macroeconomic framework that discriminates against productive activities and is not conducive to business growth
- b. Weak infrastructure and high transport costs
- c. Problems at supplying raw materials and other inputs.

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<sup>27</sup> VCCs that were able to assist their portfolio companies effectively generally had staff with experience in managing ventures similar to those held, assigned a small number of companies to each experienced staff member, and generally operated within a geographically compact area

<sup>28</sup> Fox (1996)

## Section 2

### Lessons Learned from International Experiences

#### ***Analysis and Evaluation of Significant International Experiences***

The aim of this section is to draw some general inferences from international experiences in the realm of Venture Capital (VC) initiatives in developing economies.

In particular, we will focus on the results achieved by those programs that provided equity (instead of credit) support to firms, mainly targeting Small and Medium Enterprises (SMEs). We aim at providing a set of guidelines on how to successfully operate the DVF, in order to prevent some unfortunate situations already experienced in other circumstances.

It has to be noted, however, that while it is relatively easy to find thorough studies on the overall astonishing results achieved by private Venture Capital funds in developed countries<sup>29</sup>, it is much less so to retrieve reliable and systematic data relative to Venture Capital initiatives in the developing world; this is particularly relevant when, like in our case, we focus on projects backed by public financing.

Experiments of direct intervention in the form of public Venture Capital funds were first initiated at the end of the '80s by international and multilateral organizations, such as UNIDO and the World Bank through the IFC<sup>30</sup>, and quasi-governmental institutions, like the Industrial Development Corporation (South Africa), the Development Bank of Southern Africa, FMO (Netherlands), DEG (Germany), PROPARCO (France), the Commonwealth Development Corporation (UK) and others.

It is less common to find examples of direct state intervention: by the end of the '90s only a handful of Governments were launching programs that remind the DVF in their basic components; we have examples of such funds in Israel, the Far East<sup>31</sup>, India, Africa and in Latin American countries<sup>32</sup>.

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<sup>29</sup> As an example we could quote a recently published paper by the European Venture Capital Association, which presented some very interesting conclusions. A survey over 2,190 companies (SMEs with 10 to 499 employees in 74% of cases) across 12 European countries, in a period covering more than 10 years, showed that Venture Capital backed firms experienced on average 35% annual sales increases and 15% annual job increases, performing much better than the top 500 European companies. At the same time, VC backed firms sustained heavy investments in plant, property, capital equipment and in R&D, and experienced significant international development, mainly in the form of exports (+30% annually).

<sup>30</sup> Between 1978 and June 1995, IFC invested \$ 196 million in 49 venture capital funds, whose total capital was \$ 1.5 billion.

<sup>31</sup> Singapore, Taiwan, Malaysia, South Korea

<sup>32</sup> For instance, Tanzania, Uganda and Ghana sustained initiatives that were managed by foreign governmental institutions. Not all these initial efforts have proven successful over time.

Historically, the first institution to act as a pioneer in the field of public VC was the Government of the United States, the country where the Venture Capital phenomenon started<sup>33</sup>.

Between 1983 and 1997, the US Government run a program called SBIR (Small Business Innovation Research program), that awarded more than \$7 Billion to small high-technology firms. Even though we recognize the great differences between this program and the DVF, it is interesting to note that a research over a sample of 1,435 firms (both involved and not in the program) showed how awardees grew significantly faster than other firms in term of sales, revenues and employment (sales grew 4 times faster, employment 4.5 times faster).

Even more interestingly, companies involved in the program were able to attract more private financing. The latter is a particularly important finding for developing countries, where involving the private sector in the growth of the economy is paramount since one of the overarching goals of development projects is gaining independence from external assistance and being sustainable.

But how were such results achieved? Evidence seems to suggest a couple of possible answers that provide a first, tentative, justification for public intervention.

In the first place, public intervention supplements those additional financial resources that are extremely scarce in developing countries. These resources allow the selected firms to leap over the initial economic hurdles, and grow.

Less intuitively, though, public intervention seems to play an important role in certifying the quality of the selected firms<sup>34</sup>.

It is interesting analyzing how the process works: the governmental agency reviews candidates' applications/business plans/proposals and, on the basis of the guidelines of the program, awards those that it judges the best fit with the goal of the government. This way, by selecting certain companies rather than others, the government reduces the information asymmetries that often prevent investors from committing capital, and raises the level of confidence in the selected business ventures. This happens because public financial help is interpreted as long-term support, rather than opportunistic investing, and thus provides the additional guarantees needed by private investors that wish to invest in promising companies but seek reassurance on the likely existence of these companies in the medium term<sup>35</sup>.

More generally, interviews with entrepreneurs in both developed and developing countries show evidence that Venture Capital support brings, along

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<sup>33</sup> Venture Capital was first introduced in the United States. In 1946, a professor, an entrepreneur and a banker put together a fund, called ARD (American Research and Development) that took equity participation in Digital Equipment Company (DEC). In 14 years, the value of DEC grew by more than 5,000%, rising from \$ 70,000 in 1957 to \$ 355 million in 1971. Such an impressive result attracted interest from many sources, and led to a proliferation of Venture Capital organizations.

<sup>34</sup> Some of the companies financed by SBIR have gone a long distance, and are now well respected multinationals like Compaq, Intel, Federal Express, Apple.

<sup>35</sup> It is unlikely that the state will let go bankrupt a business it commits to. Banks are a typical example of the kind of private investor that intervenes with financial support when companies are supported by the state; banks seek assurance that funds they lend will be repaid. For this reason, funding from banks is usually hardly accessible to young and small SMEs.

with the 'certifying function' of public intervention and the availability of long term capital, many other valuable assets to the companies backed. Some of these, relevant to the DVF case, are:

- Relations to other sources of financing. Companies often become part of a network that allows them to obtain additional, private, resources. VCs are likely to introduce entrepreneurs to Banks, high-net worth individuals (Angel investors), or to other VCs that might be interested in sharing the risks of the venture.
- Business contacts and networks. Venture Capitalists are often former entrepreneurs or experienced professional managers, who provide useful business relations to the firms they support in terms of suppliers and potential clients.
- Expertise on several business issues. The experience matured by Venture Capitalists, often sitting on the Boards of the backed enterprises, is dispensed in the form of:
  - o Financial advice
  - o Assistance on Corporate strategy
  - o Sounding board for new ideas
  - o Technical oversight
  - o Mentoring and support
  - o Increased knowledge of the market
- Discipline and accountability. Venture Capitalists are very tough on follow-through. While difficult at times, this high accountability between the investment manager and the business manager is essential in ensuring that the investment maximizes returns and the company is run in accordance with sound economic principles.
- Increasing level of competence within the firm. Given the importance of the quality of human resources in SMEs, Venture Capitalists often take an active role in recruiting talents (especially in leadership and responsibility roles) and, again, their network and contacts can be of great use.
- Increasing level of technical know-how in the firm. Even in low-tech environments, there is often a perceived increase in the technical competencies of the firm, often manifest in an increase in the R&D spending, or in the growing ability to develop new products and manage the innovation process.

### **Comparative Learnings: Reasons for Success, Causes of Failure**

After an extensive review of the literature on VC and a focus on the experiences in developing countries in general and in Africa in particular<sup>36</sup> this

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<sup>36</sup> See annex 1 and annex 2 for a detailed description of this revision and for the presentation of two case studies on the "Ghana Venture Capital" and "Tanzania Venture Capital".

section presents the comparative learning and insights from this revision that are important to be incorporated in the design and functioning of the present DVF.

For simplicity the section is divided in two main complementary parts, the first focussing on the reasons for success and the second on the causes of failure.

### ***Reasons for success***

The International Finance Corporation (IFC) is probably the institution with the longest track record in financing developing countries. From its broad experience, it is possible to understand some of the key success factors helpful in managing the implementation of public Venture Capital funds in developing countries.

- **The Management of the VC.** The quality of the people involved in the management of the fund is the most important factor in a fund's performance. Therefore, a critical differentiating factor is the expertise of these people.

It is crucial to attract motivated and skilled resources, with prior experience in the industry. This can be achieved through a number of means, which might entail recurring to foreign managers and partners.

At the same time, managers must have some specific local expertise in the sector and the country, or at least in the region where the VC invests.

Strong hands-on support from the capital provider is the ideal model for developing countries: evidence suggests that direct support and control of entrepreneurial activities often facilitate the success of the ventures.

Ideally, managers should also have some of their money at risk. While this is difficult to achieve in a reality like the DVF, a coherent incentive structure might produce the same results (Linking total compensation to the performance of the investments would, in practice, putting Managers' compensations at risk)<sup>37</sup>.

The management of the VC plays a particularly crucial role in:

- *Investment decisions.* The Managing Unit (MU) must possess the knowledge and expertise to choose portfolio companies with convincing and viable business proposals
- *Structuring deals.* Having managers capable of making the right valuations and pay the right price for companies is crucial for the returns on the fund.
- *Managing early stage companies.* The MU has to have the ability to manage investments with the attention and care needed to nurture

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<sup>37</sup> The DVF will first go through an "inception or transition period", where the Managing Unit is contracted out through an international bid. After 3-4 years, it could be transformed into a fully fledged VC, with partners co-risking their money and managers' compensations tightly connected to clear and strong incentives.

potential into reality. It also has to exercise pressures to stimulate a relentless concern about profitability and cost control<sup>38</sup>.

- **The structure of the fund.** It helps defining the incentives for managers; typically, a two-tier structure has proven to be more effective. This means separating ownership and management of the fund: investors have veto powers, but most decision-making is delegated to the implementing entity, the Managing Unit.
- **The life of the fund.** Funds should have a limited life, 8 to 10 years, to provide incentives to managers to divest at the right time.
- **The quality of the investment environment.** It is necessary to have sufficient opportunities (business ideas/ plans) to choose from, in order to be able to discriminate.
- **The conditions of capital markets.** This is important in the exit phase, when the VC fund needs to collect the returns earned on its investments. Very often, in developed countries, this is done through an Initial Public Offering in the stock market, through an acquisition by a competitor or a foreign multi-national, or through a LBO/MBO by the managing team. The last two options seem the most viable in developing countries, at least in the short run.

### ***Causes of failure***

IFC, UNIDO, and USAID<sup>39</sup> provide interesting information also relative to cases in which VC initiatives did not obtain the hoped success.

The main reasons at the basis of failure of public intervention are related to the following facts, and represent interesting lessons for future projects:

- **Government bodies chose the wrong implementer.** This was the major cause of failure in most cases. It stresses again what we mentioned earlier: the importance of finding the right people to be in the Managing Unit.

A common mistake has often been that of selecting people without the needed previous experience as a Venture/Private Equity investor<sup>40</sup>.

It is important reminding that in the private sector operations start with the formation of a Management team, which then finds the money and the investments to run a fund.

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<sup>38</sup> Once the deal is in place and operating, it is still important maintaining a certain degree of control over execution. Successful VCs often take one or more Board seats in the companies they invest in. Managers who have previous experience in managing ventures similar to those held in their portfolio achieve the best results.

<sup>39</sup> In the period going from 1971 to 1989, USAID invested in at least 13 significant VC projects in developing countries, both in Latin America, Eastern Europe, and Africa. Most of these did not generate the expected results, and were forced to close before the forecasted expiration date.

<sup>40</sup> For instance, during the early 1980s USAID gave grant assistance to the Appropriate Technology Incorporated (ATI) Venture Capital Initiatives, 4 funds that were managed by non-profit organizations in Asia. All ended poorly. ATI concluded that non-profit organizations cannot successfully manage funds that have the purpose of being profitable.

What often happened in practice is that a limited HR budget (most money were put into the fund), coupled with a wrong structure of incentives, were not able to attract the best available managers to the fund.

- **Over-designed projects.** International agencies or governments are at times caught in the trap of setting too many goals for a single initiative. In particular, this resulted in missed objectives when great flexibility and a lot of initiative were required, elements not always straightforward and simple in developing countries.
- **Excessive constraints on the implementers.** Often Venture Capital firms were given very narrow mandates; for instance, they were allowed to invest only in very small businesses, or women-owned businesses. This proved to be critical in the sense that there were too few businesses to choose from: finding good investment opportunities in developing countries is difficult enough.  
It is necessary to focus the activities of a fund without limiting too much its scope.
- **Lengthy reviews of potential investments from public officials.** Bureaucratic and lengthy reviews made the Managing Unit lose the opportunity to invest in attractive deals. Quick decision-making is crucial: it is paramount to create an efficient process to manage the deal flow.
- **Unpromising country environments.** In addition to all the causes mentioned above, it is interesting noting that evidence suggests how the viability and success of Venture Capital funds also depends, to a certain extent, on the improvement of a number of 'external' environmental conditions, often beyond and above the direct control of the VCs<sup>41</sup>. Not surprisingly, Venture Capital funds had a hard time in countries where the business climate was uncertain and the prospects for expanding firms were poor.

Some of these conditions are<sup>42</sup>:

- o *A stable political environment*
- o *Basic Infrastructure:* airports, commercial ports, maritime lines, train network, roads and highways, public transportation system, telecommunications network, industrial zones, etc..
- o *A functional and reliable judicial system*
- o *An adequate educational system, able to provide the necessary pool of skilled labor.*

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<sup>41</sup> It is also to be considered the interest the entrepreneurial community might have in VC. An experience matured by USAID in Kenya suggests that when entrepreneurs are not ready to give up debt for equity, or are not willing to disclose their financial statements to potential investors, efforts duplicate and results are far from guaranteed.

<sup>42</sup> It is important to notice that these elements must not be understood as "joint necessary conditions" but elements that tend to 'facilitate' and make an environment more 'conducive' to the operations of a VC, furthermore it happens that some of these elements may be stimulated by the presence of a VC therefore creating a circular virtuous process.

- *An operative banking system*, allowing companies to effectively raise debt
- *Functional capital markets*, to facilitate divestments.
- *Respect and protection of private property*

It has also been noted that more general desirable macroeconomic conditions contributed to the success of public ventures in VC.

- *Economic growth*
- *A relatively stable currency*
- *Low inflation*
- *Low interest rates*
- *Export potential*
- *Existence of a dynamic private sector*

It is therefore important, in defining the characterizing elements of the DVF, to pay particular attention to the above mentioned facts. Ideally, a small and skilled Management Unit should be given a relatively broad scope of action with a few, clear, target objectives, and a few efficient and lean processes to follow when allocating resources.

As for the external risks involved in the operations of the DVF, we feel confident that Mozambique has, in recent years, proven to be moving on the right path, toward the creation of a friendlier environment for this kind of initiatives.

Mozambique has proven to be a stable democracy since Peace Agreements were signed in 1992. Even though there is still work to be done, major results have been accomplished in the last decade in terms of infrastructure development, and a number of initiatives are currently underway<sup>43</sup>. The recent trial of the murderers of Carlos Cardoso was internationally read as a meaningful change in the role that justice can play in Mozambique. When looking at education, we see that not only public schools are producing more and more graduates, but international aid has sponsored technical training in several circumstances<sup>44</sup>.

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<sup>43</sup> Rehabilitation of the internal transport system has been targeted as a priority for the transport sector through the roads and coastal shipping (ROCS) programme led by the World Bank. The costs of the required investments amounted to \$406m for the road programme over 1999-2001. The Government is planning to undertake periodic and routine maintenance of up to 28,000 km of roads through to 2003 and to rehabilitate a further 2,300 km of roads per year.

<sup>44</sup> The Government's decision to allow private investment in primary, secondary and higher education has led to a proliferation of private schools in the main cities (mainly Maputo and Beira). Quality has also improved because of competition. There are now a number of international schools (English, Portuguese, Swedish, Italian, and French) in Maputo and Beira.

Financially, it is important to remember that in 1978 all private banks operating in Mozambique were nationalized, and merged into two state institutions, the Banco de Moçambique (the central bank) and the Banco Popular de Desenvolvimento (BPD). During the 1980s and early 1990s the banking system operated virtually as an arm of the state budget, most credit being directed to assist troubled state enterprises.

After 1992, the Government's economic reform programme covered also the financial sector. Foreign banks were now allowed to invest in Mozambique, interest rates deregulated, and the regulatory and commercial activities of the central bank separated.

In October 1999, a stock exchange was inaugurated in Maputo – Bolsa de Valores

de Moçambique (BVM), with the support of the Lisbon Stock Exchange and the World Bank. Its activity is still mainly confined to secondary trading in treasury bills. Equity listings are planned but no date for a listing is yet known. Candidates for listing include the Government's remaining holdings in various privatized industries such as the main brewery, Cervejas de Moçambique, a cement factory and a Coca-Cola bottling company, as well as local banks and insurance companies. BVM will help to deepen financial intermediation in Mozambique, but it is not yet clear when operations will start.

On the macroeconomic side, Mozambique has recently experienced a tremendous growth. GDP has grown at a CAGR equal to 28% for the past 6 years<sup>45</sup>; after years of constant devaluation, the Metical has reached a partial of stability in relation to the dollar, which has endured since the summer of 2002. Inflation has also curbed down: from the hypes of the early 1990s (when it reached 53.1%), it is now at a much more acceptable rate (7.5% projected in 2003). Mozambique has recently reduced its trade balance deficit, showing an increased attention for exports, and prospects for the future look even more promising, once the full benefits of projects financed also by the IFC will be exploited (such as MOZAL and SASOL).

Still, it has to be noticed that the economy is getting skewed towards very big projects and this is a concern for the Mozambican Government that is committed to promote SMEs as a crucial devise for sustainable and equitable growth and job creation.

In terms of foreign investments, Mozambique has established itself in recent years as one of the leading FDI recipient countries in Southern and Eastern Africa. Foreign direct investment (FDI) in Mozambique – on an approval basis – reached a cumulative total of \$1.6 billion between 1985 and 2000. Despite the relative growth registered thus far, Mozambique has yet other unexploited business opportunities in areas such as food and beverages, tourism, telecommunications, energy, textiles, garments and leather. The country is poised to identify foreign partners with financial and technological capacity, business experience and quality assurance.

In addition to this fact, we would also like to stress that Mozambique has been granted the cancellation of about 80% of its debt within the framework of the

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<sup>45</sup> Notwithstanding the major setback due to the dramatic floods of the year 2000.

HIPC initiative as a consequence of its commitment to a five year Action plan for the reduction of absolute poverty, in which five fundamental areas of action are identified:

- Education
- Health
- Agriculture and rural development
- Basic infrastructure
- Good governance
- Macro-economic and financial management

These areas for action are considered *fundamentals* because they are absolutely essential for reducing poverty and stimulating growth, and the impact they produce is both deep and broad. They are also perfectly aligned with what is presented in this document.

We shortly presented a number of conclusions drawn from some very different international experiences we observed. We are aware of the fact that it is difficult to generalize, especially when considering developing nations, which differ along so many dimensions. We are nevertheless convinced that, although each country presents a unique situation, the factors we presented are crucial in every context.

## **Section 3**

### **The Functioning of DVF and its Potential Impact**

#### ***Purpose of this Section***

The purpose of this section is to explain what a DVF is and how it can function in practice.

The potential for economic growth and firm profitability in some specific projects in Mozambique is promising. With a stable, growing economy, plentiful natural resources, and a vibrant, even if still incipient, entrepreneurial private sector, there are numerous investment opportunities that could prove both profitable to investors and the economy overall. However, private equity investment instruments are inherently risky in any investment environment. This is especially the case in emerging economies such as Mozambique where formal markets are still in their infancy. As such, these conditions must be considered with even greater caution and planning. In this light, this section clarifies the structure and processes for ensuring sound fiscal and strategic management of DVF investments.

This section outlines operating principles in four key areas of the DVF:

- Organization and structure of the various teams involved in key decisions
- Roles and responsibilities at all levels of the Fund
- Investment rules and guidelines
- Investment process

These sections would allow the reader to understand how a DVF can work and function.

#### ***Basic Definition***

A DVF is a particular type of venture capital that focuses on certain specific sectors with 'developmental implication'. For developmental implications we understand objectives linked to development of certain particular sectors or areas that are particularly promising in terms of potential and impacts on the rest of the economy, but because of market failures are not able to mobilize the necessary capitals for their development.

In general a venture capital is a group of investors, either public or private, investing cash in non-listed business by buying a portion of the 'equity' (ownership) of the business. In general, venture capital is high risk, because no assets secure the investment, and high reward type of investment, because the growth of the business leads to higher company value.

Another typical characteristic of the venture capital is that characterize an active style of investment instead of a passive one because the investor tend to be involved, at different levels and in different ways, in the strategic management of the investee.

The literature tends to differentiate between venture capital and private equity depending on the stage of the companies in which they invest.

It is important that most of the proposals put forward in this chapter are normative rather than simply descriptive and are fundamentally based on the revision of the international experiences and successful benchmarks, taking into account the situation of the local social and economic environment of Mozambique.

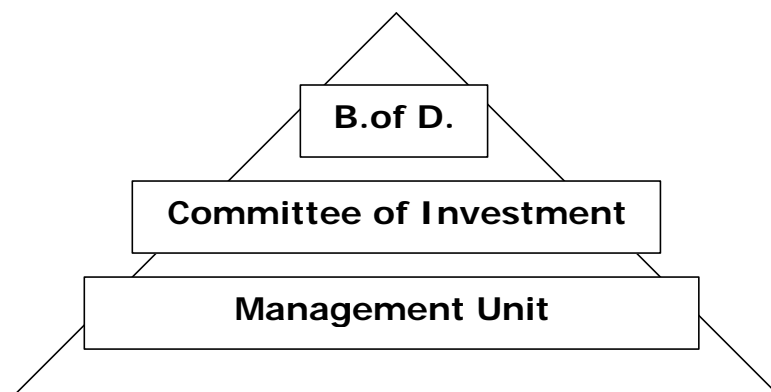
### ***Fund Operating Principles***

The key principles that should guide the operation of the fund are:

- Independent decision-making from government and large donor-institutions
- Transparent and accountable management decision-making
- Clear and measurable targets and performance metrics across a broad range of financial, economic, and social goals
- Management team with expertise in agrobusiness development and investment financing
- Human resources managed with private-sector compensation and incentive structures
- Self-sustainability of the operations after the initial start-up period (5 years)

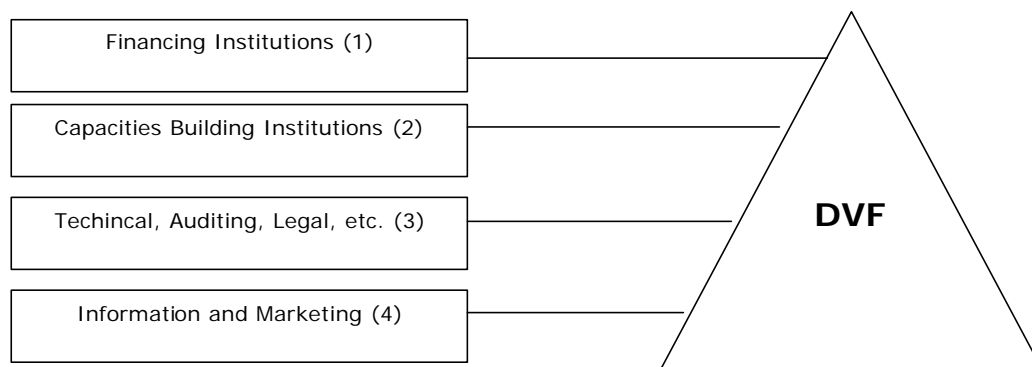
### ***DVF Organizational Structure***

The basic organizational structure for the Development Venture Fund should comprise: a **Board of Directors**, a **Committee of Investment** (the latter subordinated to the former) and a **Management Unit**.



In addition to the internal structure of the organization, the Fund will have structural mechanisms to manage and facilitate linkages with a consortium of key stakeholders such as:

- Institutions in capacity-building (universities, consultancies, etc)
- Agricultural marketing boards
- National Business Council, Chamber of Commerce
- Regional and International Partners
- Financing Institutions



- (2) Multi-lateral and bi-lateral financing institutions (World Bank, IFC, USAID, DFID); Investment Banks; Private Equity or Venture Capital Firms
- (3) Universities; Vocational Training Centers; Government Training Facilities; Local NGOs; International NGOs; Private Training Companies; Consultancies
- (4) Auditing Consultants; Attorneys and Legal Counsel; Technology Transfer, Installation, and Training
- (5) Regional Banks; National Business Council; Chamber of Commerce; Marketing Boards; Trade Unions

### ***Roles and Responsibilities of the Fund Actors***

#### ***Board of Directors***

The Board of Directors should:

- Define overall strategic direction of the fund (e.g., sectors/industries, regions, technologies)
- Set DVF governing objectives and investment guidelines that will prevail for investment decisions and performance evaluation
- Review the performance of the fund to ensure the governing objectives and targets are being achieved based on a quarterly report submitted by the unit
- Review and approve DVF Strategic Plan and Budget Annually
- Review and approve DVF Annual Report to be circulated publicly, including auditing procedures
- Approve decisions on compensation and remuneration policies

- Review staffing of the Management Unit (ie can dismiss the CEO if necessary)
- Review market opportunities and decides specific investments based on strategic direction set by the Board and investment proposals presented by the Investment partners
- Approve financing structure and conditions for investments based on recommendation submitted by Management Unit (timeline, minimum return, exit strategies)

The Board of Directors should meet frequently in the initial period of life of the fund in order to set the strategic direction of the fund and then on a scheduled basis thereafter (i.e. quarterly).

### ***Management Unit***

The roles and responsibilities of the Management Unit will include both core and non-core activities. The core activities must be owned and completed by the Management Unit directly, and the non-core activities may be outsourced if the capabilities are available in the market and DVF objectives are not compromised:

#### Core Activities

- Generate leads and identify companies as potential investments for the fund e.g. utilizes “local antenna” for diffusing information about its existence and its services among the target entrepreneurs and detect viable ventures worth financing<sup>46</sup>
- Screen business plans and evaluate risk of investment
- Present business plan / proposal to investor committee in conjunction with business manager
- Link with other financing organizations in Mozambique or outside to monitor overall trends in the agro-business sector
- Monitor the investment use (capital selection and maintenance)
- Provide on-going managerial assistance to business managers, e.g. diagnose and implement strategies for finding new markets and suppliers as well as developing management skills and technical knowledge of companies invested by the fund
- Make recommendations to Board of Directors on timeline of investment and exit strategies
- Write Annual Strategic Plan and Budget for Fund to submit to the Board of Directors
- Write DVF Annual Report in conjunction with the Board of Directors
- Communicate to key stakeholders the status and progress of DVF investments

#### Non-core Activities

- Work with other employees and management of the companies to prepare information required by the fund for a financing decision

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<sup>46</sup> This would avoid the need of financing local branch but would allow to get a direct link with business venture at provincial level

- Perform thorough and accurate investigations of potential investments to assess financial performance, competitive position as well as strengths and weaknesses of company management and operations
- Monitor and reports performance of the business
- Facilitate technical and managerial training to the investee companies

### ***Investment Principles and Guidelines***

Given the high levels of risk that will be managed in the fund, the Development Venture Fund need to adopt strong, clear investment guidelines that are grounded in sound financial investment theory.

Two groups of complementary criteria can be taken into account when considering how the DVF should define its investment guidelines: business criteria, which are to be considered as the basic necessary elements to be defined and taken into account, and the developmental criteria.

### **Business Criteria for Investment:**

- *Experienced business management team with market and technical expertise*  
An experienced, well-trained management team is the key to the Fund's success. The team will be selected based on extensive leadership experience in finance and agro-business.
- *Size of investment: \$25,000 – \$250,000*  
The fund will focus on start-ups and expansions of companies that are raising \$25,000 – \$250,000 USD in financial capital. Investments over \$250,000 will be considered, but only if there is another private investor also involved in the financing.
- *Type of project: Start-up and Expansion of Agricultural Businesses*  
The fund will invest in agro-business projects with special focus on value-added manufacturing and processing projects in Mozambique. The Fund will seek to serve as a catalyst for industrial growth by focusing investment in manufacturing and processing activities. Non-manufacturing activities will be considered; however, these projects will need to show strength in other investment criteria.
- *Type of investment: Long-Term Assets*  
The fund will primarily focus on projects requiring investment in long-term assets for which there are few other sources. Projects including technology transfer and physical capital investment will be targeted over investment in working capital. While financial support will be needed for human resource development, this support must be directly linked with technical skills development (i.e., training in specific technical skills).
- *Sound Indicators of Long-Term Profitability*  
Financial projections in the business plan must show evidence of:

- Operating profitability<sup>47</sup> within 3 years of investment and economic profitability<sup>48</sup> within 5 years of investment
  - Realistic, sustainable leverage and liquidity ratios<sup>49</sup>
  - Clear and demonstrated demand for the product or service
  - Stable and consistent raw materials cost base
  - Available pool of necessary human resources or clear plan for human resource development
- *Innovative approach to product / service development and delivery*  
The DVF will seek projects that bring an innovation to the industry leading to a step-change in industry efficiency. The DVF will target projects that have the ability to diffuse that innovation to the market through increased value to the customer, more efficient supply-chain management, and human resource development.
  - *Productivity Externalities*<sup>50</sup>  
The DVF will seek to support industry-wide efficiency gains unable to be realized by individual players in the industry. These externalities will create a positive feedback on overall sector productivity and competitiveness. (e.g. increasing returns on the cashew trees by introducing new cashew products creates incentives for farmers to take better care of the trees. This in turn, improving the productivity of the raw material, will have a positive effect on the sector through a pressure on the price/quality of raw materials)
  - *Share of ownership: 25% - 49%*  
The DVF will fund up to 49% of total company assets. Outside of DVF investments, there must be clear, accountable lines of ownership to the business management team.

## **Developmental Guidelines for Investment**

- *Social welfare objectives*
  - Job creation
  - Benefits dispersion (e.g., healthcare)
  - Human capital investment (training, technical education)
- *Health & Safety*  
The DVF will only invest in businesses that operate at the highest levels of health and safety standards possible in their sector. Governmental safety standards will be used as a benchmark for assessment; however, in cases where safety standards are non-existent, then the DVF will consult with field and industry experts to set the standards.

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<sup>47</sup> Operating profit defined as Net Operating Profit after Taxes.

<sup>48</sup> Economic profit defined as operating profit minus the cost of capital.

<sup>49</sup> To be defined by management team.

<sup>50</sup> E.g. increasing returns on the cashew trees by introducing new cashew products creates incentives for farmers to take better care of the trees. This in turn creates a positive feedback on sector productivity

- *Environmental*  
The DVF will use the World Bank Environmental Standards and Guidelines to ensure its investments uphold international standards whenever possible.
- *Business Integrity*  
Honest, transparent accounting is the backbone of a reputable, well-functioning private sector. The DVF management unit will work closely with the business managers to ensure that all DVF investments are managed with the highest degree of business integrity.
- *Social Issues – Impact on local community*  
In many cases, DVF investments will have direct impact on marginalised communities of farmers and factory workers. The DVF and businesses will work with the local communities, local government and non-government leadership to maximise positive externalities and minimise negative externalities to the communities.

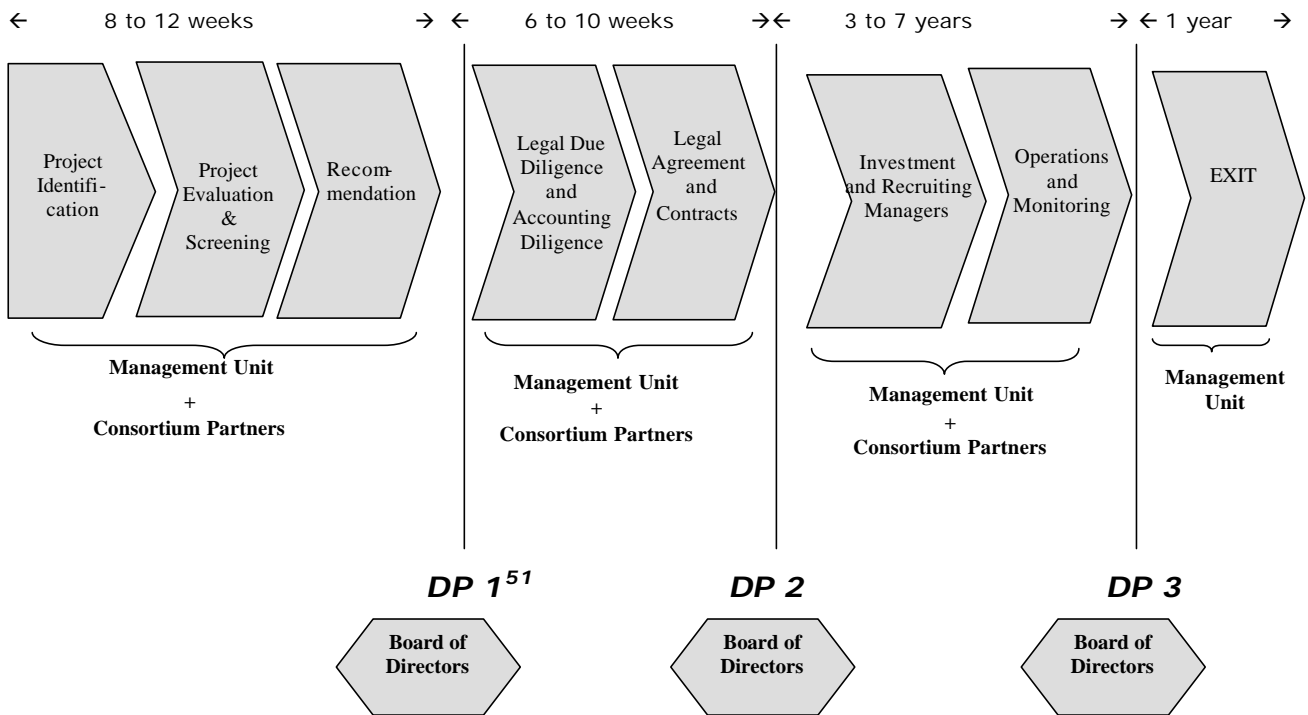
An important remark to be taken into account is that it may happen that some of the 'developmental criteria' are considered as stumbling blocs more than 'positive elements' because they are perceived to worsen the cost-competitiveness of business, especially in developing countries. Our opinion is that from one side these are general criteria that must be 'applied in conformity' to the local environment, therefore at different levels in different contexts and situations. On the other side, we believe that these criteria enhance the sustainability of business and therefore the profitability in the medium-long term and are in general associated to businesses that are not compelled to squeeze the costs to survive but focus on more elaborate and articulate competitive strategies.

## **Guidelines for Management of Investment**

In addition to the above investment criteria and social guidelines, the DVF will require investee companies to agree to full exposure to company accounts and decision-making processes under the following set of requirements:

- DVF has open access to all company accounts including bank accounts and compensation reports
- DVF publishes Annual report outlining state of the investments and the performance of the companies
- Management Unit required to document investment decisions and communicate reasons for investing or not investing
- Personal connections among DVF participants to be disclosed openly and in full at the beginning of a professional relationship through the Fund (e.g., Board member knows the owner of a recipient of DVF investments)
- DVF Management Team accounts to be managed like a private business for maximum return on investment

**DVF Investment Process**  
**Fund investments will be managed according to the following staged process:**



<b>Stage</b>	<b>Def.</b>	<b>Description</b>
1	Project identification	Identification of new projects with high potential (start-ups or existing businesses) in need of financial capital
2	Project evaluation and screening	Assessment of businesses identified (market potential, feasibility, financial risks, legal constraints, social impact), screening of projects identified, choice of projects to be presented to the Board of Directors
3	Recommendation	Final assessment of chosen projects, recommendation for Board of Directors
4	Legal due diligences and accounting diligences	Professional evaluation of legal and accounting principles for selected projects
5	Legal agreements and contracts	Draft, review and agreement of contracts containing all legal aspects
6	Investment in business	Transfer of money to the selected investee company and investment in required equipment
7	Operations and investment monitoring	Implementation of pre-defined strategies to meet expected results (i.e. training, changes in accounting systems, recruitment of new staff) - On going monitoring (four times per year) and corrective actions identified and implemented
8	Exit	Selling out capital shares according to agreed strategy

<sup>51</sup> Decision Point

## ***The Impact of the DVF: a Qualitative Assessment***

Without getting into a detailed quantitative assessment that a successful implementation of the DVF might bring to Mozambique, let's spend some time considering the qualitative benefits it could generate. These considerations are based on observations in similar environments, where injections of capital in various forms (credit and not only equity) from public sources fostered the development of SMEs, and impacted the life of the communities involved as well.

Of course these considerations are very general: they need to be adjusted to the current reality of Mozambique, and to the specific industry (Agribusiness) the DVF will support.

The underlying assumption is that, 10 years after its launch, the DVF will have funded several successful companies, created new jobs in the Agribusiness sector and possibly helped the growth of the Agricultural sector as a whole.

While poverty reduction remains one of the primary objectives to be achieved through the use of financial instruments such as the DVF, in this section we are interested in assessing which indirect effects could derive from a positive impact on the Agribusiness sector.

### ***General economic improvements***

The success of a few businesses located in a determined area would, in the first place, have an impact on the economic conditions of the local communities.

As a proven example, we would mention the case of a plantation of bananas in Cameroon, funded by a German VC, which created over 5,500 permanent jobs in a decade. The plantation also benefited upstream and downstream sectors such as cartilage for the shipping of bananas, local agricultural research, haulage firms, cargo handling in the port and small craft enterprises. The community as a whole experienced a beneficial impact: investments increased the number of cooperating farmers and the acreage of cultivated land by a large margin, which consequently created additional jobs.

From a purely economical standpoint, this meant higher disposable incomes, increased goods consumption, and better living conditions. The whole area was impacted by the change, and not just businesses related to the plantation of bananas.

### ***Financial implications***

As in a virtuous circle, there would be a trickle down effect: the capital injected into the economy would be transferred from the originally backed firms to their suppliers and to some extent to their clients (through lower prices, better trading terms, ...), allowing for new businesses to grow.

In principle, a successful DVF could even lead to an increase in the inflow of Foreign Direct Investments (FDIs). The impact of such a phenomenon would be seen in the long run and would be dependent from a number of other factors as well, of course. FDIs are driven by elements related to the political will of the government (and specific legislation introduced by the country), the stability of the macroeconomic environment, and the international attractiveness of the market, but a thriving sector in a developing country is often perceived as a good opportunity for entry from foreign investors.

Interestingly enough, there might be several important indirect implications for non-Agricultural businesses as well. As we mentioned earlier, the growth of Agribusiness companies would imply a surge in the use of financial instruments and, therefore, a more widespread adoption of credit financing. Other businesses might benefit from a more significant presence of commercial banks, coupled with a growing confidence in the business environment.

From the Government perspective, a more productive private sector would mean increased revenues in the form of taxes, both direct and indirect, and social security contributions.

### ***Impact on living standards***

Life expectancy in Mozambique is, today, 44.8 years, one of the shortest in the world, even if growing. An improvement in the agricultural output of financed companies would also impact on such kind of indicators.

It is difficult to determine to what extent increased wealth impact life expectancy or mortality rates, given the number of factors that come into play, but it definitely has a role under several dimensions.

For instance, the higher productive efficiency generated would lead to lower prices of agricultural goods and processed foods. This would constitute a major social benefit of the investment: more agricultural products at a cheaper price would actively contribute to fill a gap in the diet of local populations, this way increasing nutritional levels, quality of life, and life expectancy of local communities.

In Mozambique, where local key sectors involve growing tropical fruits, cashew and coconut, an increase in the productivity of companies would most likely induce trickle down effects on the communities involved in their production, packaging and distribution.

### ***Impact on education***

Venture Capital backed firms typically need skilled workers. This is true at all levels; in the case of the DVF and the agribusiness sector, there would initially be a great need for capable managers, while unskilled labor would find easy access to new jobs.

The need of managers would result in the DVF playing a substantial role in forming a new generation of skilled entrepreneurs/managers.

At the beginning such a process of transfer of knowledge usually implies an investment in education and training of executives and workers from the part of companies; however, increased education and need for skilled workers generally lead to some sort of public pressure to introduce whole, systemic education reforms, since people are encouraged and willing to acquire skills they will be able to use for earning their living.

This would be of particular significance in Mozambique, where the illiteracy rate is just above 43%.

In developed countries, in the medium-long run we also observe what is usually referred to as 'knowledge spillover': skilled workers leave their jobs in order to start their own small businesses, this way creating new potential wealth for the area. Such a process might take a bit longer in Agriculture in Mozambique, but it is likely to happen.

Overall, the impact on human capital of VC initiatives is substantial and very positive.

### ***New technologies and techniques***

A more skilled and educated workforce, backed by self-sustaining businesses, would gradually start introducing new technologies and techniques that would have beneficial impacts on the industry as a whole. The Agribusiness is probably one of the businesses most linked to traditional techniques, but the availability of capital and the pressures of competition would definitely foster change.

Change would mean:

- *Increased efficiency.* New technologies and techniques would allow for a better use of resources, and possibly lead to a reduction in the costs of production.
- *Productivity growth.* Agricultural output would also increase, encouraging trade and the creation of new companies.
- *Environmental impact.* New techniques could have a positive impact on the way the environment is perceived and treated. Moreover, participating in international markets would force companies to comply with stricter regulations.

### ***Psychological effects***

One of the most important positive outcomes of initiatives similar to the DVF is the 'demonstration effect' they have. As long as they succeed in creating new successful businesses in areas with traditionally high rates of unemployment, they also build confidence in local entrepreneurs and communities.

We cannot underestimate the role high, positive expectations toward the future play in the success of any economy. The example of Eastern-Asia countries is clear. In a span of very few years, several countries grew from being among the less developed in the world to having industries that compete with multinationals from Western nations. Local entrepreneurs would feel encouraged to start new ventures and try to replicate the successes they have witnessed.

Together with confidence, success builds reputation, another important aspect in business. This would be even more relevant if the DVF were able to encourage and promote the creation of small clusters, some sort of districts for the production of particular products, fostering the concentration of expertise and talent in the firm funded.

When such districts form, they are often the target for investments coming from foreign companies, which see the advantage of entering a reality where all the 'support services' to business are already in place.

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## **ANNEX**

### **Examples from Other Countries' Experiences**

In developing countries the role of VC has been, so far, relatively limited. The major problem has always been identified as the lack of potential investment opportunities (i.e. a large number of young enterprises with strong growth potential), while exit possibilities are usually restricted to the sell back to entrepreneurs.

There are, however, a number of development-oriented Venture Capital funds active in developing countries. One of these is the Small Enterprises Assistance Fund (SEAF).

#### **i. SEAF**

SEAF is an active fund manager based in Washington, DC, that has been dedicated since 1990 to equity and risk capital investments in SMEs in emerging markets. It started by investing in Poland in 1991, and in 2000 moved into Latin America (Peru and Bolivia). SEAF currently has operations in China, and is undertaking initiatives in India, Central Asia, and other Latin American countries.

SEAF typically provides companies with equity financing linked to technical and administrative assistance. One of its goals is that of generating commercial returns, in order to attract private capital and ensure the sustainability of the SMEs' risk capital industry in the long term. Lastly, the SEAF aims at promoting the creation of often underdeveloped capital markets for SMEs, in order to address the already mentioned problem of exit strategies.

- SEAF Experienced fund managers. People are the most relevant asset of SEAF.
- Significant and high quality deal flow. So to have enough options to choose from.
- Professional business managers. Entrepreneurs in developing countries need to acquire the skills necessary to administer growing businesses.
- Adequate deal size. SEAF originally funded a number of small deals. It later learned that only bigger investments produce interesting returns, and also that having too many small investments creates challenges for their monitoring, since partners have time constraints.
- Technical assistance. Together with training, mentoring and knowledge sharing, SEAF always provides help in securing successive rounds of additional financing.

SEAF manages 14 funds under its for-profit SEAF Management Company; each fund is generally operated with staff of about 5 investment personnel,

usually individuals with experience in the local markets where the fund operates. The profit orientation of the SEAF is seen as necessary to attract the right type of people to administer the funds.

In total, SEAF has done to date more than 160 investments of an average size of slightly more than \$300,000 per investment, usually corresponding to 35% of the equity capital of the company. It has already successfully exited 15 of these investments, with an average IRR in excess of 35%; its capital under management equals approximately \$140 M. First results make SEAF confident of the fact that SME risk capital investing can be profitable, by selecting promising, undervalued companies that need capital to grow.

In fact, hard data prove that as of the end of 2000, the average annual increase in revenues in portfolio companies within the SEAF network was 80%, and the funds' investments had generated 7,000 jobs.

SEAF has also grown able to attract capital from other international institutions, such as USAID, and regional and multilateral development banks<sup>52</sup>.

The key learning from SEAF experience, so far, can be summarized in the following critical success factors:

## ii. TVCF

Another interesting case is that of the first three years of operations of the Tanzania Venture Capital Fund (TVCF).

The idea of VC in sub-Saharan Africa was the brainchild of USAID; since it could not invest directly, USAID operated in partnership with Commonwealth Development Corporation (CDC<sup>53</sup>).

CDC would invest (alongside others) in the fund and supply seconded staff who would get the fund off the ground and head up the associated (local) management companies.

At the same time, USAID would provide grants to help with the initial start-up costs. Without a grant, CDC would never have done it themselves. The grant was required because the 3% management fee was not enough to pay for a properly functioning Management Company. Considering the cost of that at US\$450,000 per annum, the implied fund size should be US\$15m. In Tanzania, CDC started with US\$5.5m. It was crucial to cover the management costs during the initial 5-year period, while building up a track record sufficiently good to attract additional investors to get the fund up to US\$15m. This is why the grant was needed.

Eventually the CDC-seconded manager would hand over to a local, newly trained-up person.

Back in 1992, when the fund started, the whole project seemed, and probably was, very daring. The major concern was that a fund based in sub-Saharan Africa would never find investors and never find projects; and even if it did,

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<sup>52</sup> World Bank, International Finance Corporation, Asian Development Bank, African Development Bank, Inter-American Development Bank.

<sup>53</sup> The CDC is the private sector arm of the UK Government's aid program, and it's similar to the IFC and the World Bank.

since there was no stock market, it would never be able to sell the investments it did make.

It took one year to get the TVCF off the ground. Alongside CDC as investors, the fund got DEG and Swedfund (development agencies from Germany and Sweden), TDFL (a local bank) and NPF (a national pension fund).

The Government had to rule on various tax matters, the process to get all the necessary approvals was quite long, but eventually it was done, and the fund started in the autumn of 1993 with a small management company of 5 people. Together with a manager from the UK, two key assistants were taken from a local bank and Coopers & Lybrand respectively, while other two were a secretary and a "fixer" for getting approvals, permits etc. These four latter were young Tanzanians, nobody over 35.

The fear of lack of potential projects faded away as soon as the TVCF opened its doors: applications flooded. Even though most of them were not worth the effort, they were enough to get going. From the autumn of 1993 until June 1996, the fund made 16 investments, ranging in size from US\$50,000 to US\$500,000. They included, among others:

- *Tanzania Tea Packers*, the first private company to be listed on the Dar Es Salaam Stock Exchange which was set up during that decade. The US\$250,000 TVCF investment (50%) was floated at a value of US\$1.25m;
- *Precision Air*, currently the largest private airline in Tanzania;
- *Jupiter Communications*, the first public payphone operator in Tanzania.

The fund made profits and paid dividends in 1994 and 1995, and declared an interim dividend in 1996. Total dividends of US\$550,000 were paid during this time. It was important to pay out because the management company got paid 3% per annum + 20% of profits after the investors had got their money back. This was particularly important if profits were in Tanzania Shillings (TSh), and the TSh was depreciating against the US\$.

On the basis of this track record, DFID<sup>54</sup> decided to set up a second, local fund of US\$1.5m called Lake Zone Equity Growth (LAZER), catering to smaller businesses (i.e. investments from US\$ 20-50k) in Mwanza on Lake Victoria. Apart from the extra 3% fee, the attraction of this was that it would enable TVCF to open a second office in Mwanza, giving it three benefits:

- Some of those smaller investments would grow, and then become eligible for TVCF funding;
- The resident manager would be able to monitor better the TVCF investments the fund already had up north (important in a large country with poor communications and infrastructure);
- Running a smaller fund would be good training (basically, the Tanzanian who made a success of that would be the ideal candidate to take over from the English manager)

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<sup>54</sup> Department for International Development, the British equivalent of USAID.

DFID were very excited about this extension of the VC concept to smaller businesses outside the capital Dar Es Salaam. Unfortunately the management of that smaller Mwanza fund was contracted out to a local management consultancy company, which lacked experience in Venture Capital.

In 1996 the English manager abandoned CDC, and things started deteriorating. The reason has to do with incentives for management. The investee companies were horrified at what had happened, on an issue where they had not been consulted. 9 of them sent a joint appeal to CDC's CEO in London, asking for at least a 6-month handover period. In all 16 investments, the English manager was a main Board director. For all 16 owners, he was the main reason why they had gone into the project, in all 16 cases he had made a direct, positive contribution to the health of their business. In some cases, he had even become their personal friends. To have someone foisted on them (the new manager), someone who didn't turn up in Tanzania for some months, and someone who didn't speak Swahili (a number of the investees did not speak English, so it was important to speak Swahili well enough to conduct Board meetings) was an outrage.

Reported profits started to deteriorate, business conditions were suddenly "difficult". In at least two cases the original owner was able to buy the fund out for peanuts because he had persuaded them that the business was going bad.

The TVCF was operated along real venture capital lines in every respect, except two. The first exception was the need for an initial management subsidy. The second was the incentive issue. Despite widespread support for the principle of real incentives for management, it all got tangled up with internal CDC employment policies; and since CDC was, and is, state-owned, those policies were complicated and at times non-commercial. Its failure to set up appropriate incentives cost dear both the fund's investors and the investee companies the fund was designed to help.

In retrospect, this story provides evidence of at least three important elements for the success of a VC initiative in a developing country:

- It confirms the **centrality of the role of the Managing Unit**
- It stresses the importance of having a **smart system of incentives** to attract the best available candidates
- It shows that, **even in a developing country, a VC can develop an adequate deal flow** that will allow the fund to self-sustain.

### iii. The Ghana Venture Capital Fund (GVCF)<sup>55</sup>

A similar and interesting case is that of the Ghana Venture Capital Fund (GVCF).

GVCF was set up as a 10-year closed end local currency fund in 1992 to invest in Ghanaian SMEs. With total capitalization of \$5.8m, GVCF was the pioneer

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<sup>55</sup> This section of the document has been entirely developed by Mr. Jacob Kholi, Acting General Manager of Venture Fund Management Company.

venture capital fund in Ghana with specific developmental objectives in addition to providing high risk capital to business.

GVCF's 10-year life could however be extended by up to 2 years if agreed and approved by 75% of shareholders. In November 2002, on the recommendation of the Manager, shareholders extended the Fund's life by six months to June 30, 2003.

GVCF was promoted by CDC<sup>56</sup> and was the second fund to be established in the CDC funds family after Papua New Guinea Fund (1989).

GVCF was managed by Venture Fund Management Company (VFMC) under a management agreement signed in July 1992. CDC provided VFMC with management support from inception until 1999 when a Corporate Management Agreement was signed. VFMC is now owned by Aureos Capital (70%), SSNIT (20%) and InterAfrique Holdings (10%).

### Fund Objective

The objective of GVCF captured in the Management Agreement with VFMC was to "aim to use its investors' money to make and realize investments in new and expanding Ghanaian businesses, so as to give its investors a compound rate of return commensurate with the risks involved in equity investments". The required rate of return anticipated at the time was 20% in constant terms.

To facilitate the realization of this objective, GVCF was expected to:

- Invest in private sector companies in Ghana which had clear potential for achieving above average growth and profitability;
- Invest in companies which had the potential to make a positive contribution to the Ghanaian economy;
- Concentrate on providing capital for start-up and expansions and not aim to make substantial investment in turnarounds or buyin/buyout situations;
- Invest in companies whose owners and management had a clear track record of success in the relevant industry or a related one;
- Invest directly into companies and not generally purchase shares or securities from third parties;
- Not invest in companies whose activities were likely to have a significant negative social or environmental effect or were inconsistent with Ghanaian Government policy for development;
- Make additional investments in existing investee companies if such investments would contribute to growth of the investee company and would secure an acceptable return for GVCF;
- Join with other financial institutions to co-finance investments.

The investment policy directive of GVCF also provided the following framework:

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<sup>56</sup> Investors in GVCF were: CDC Capital Partners, DEG, Proparco, SSNIT, Barclays Bank Ghana Limited, InterAfrique Holdings, Merchant Bank Ghana Limited, Cal Merchant Bank Limited, and Ecobank Ghana Limited.

- GVCF's investment size would normally range between the Cedi<sup>57</sup> equivalent of \$100k to \$500k, although the Board in exceptional cases may vary these limits.
- GVCF would maintain a prudent mix between investments in start-ups and more mature companies;
- GVCF's investments would be by way of ordinary/preferred shares or unsecured loans. In exceptional cases, local and foreign currency secured loans may be made alongside equity type investments;
- GVCF would seek to realize its investments and disinvestments with 4-7 years or remaining life of the Fund, whichever was shorter;
- GVCF would where appropriate negotiate put options and encourage listing of investee companies on the Ghana Stock Exchange to facilitate its exit.

### GVCF's Operations/Results

GVCF made 13 equity and quasi-equity investments spread between the manufacturing (56% by value), food products (28%) and services sectors (16%). The investment portfolio consisted of one privatization, three private placements, two expansions, four start-ups and three rescues. (Appendix 2).

This financial performance should be viewed in the context of the rather volatile macro economic environment that prevailed during the period of the Fund. For instance the Cedi depreciated by over 1,631% between 1992, when the first call was made on investors (exchange rate of ₵496=\$1) and March 2003 (average exchange rate was ₵8,586); inflation peaked at over 70%. This clearly eroded any gains that the Fund made. Investee companies were adversely affected and therefore could not maximize the growth potentials.

GVCF's results in financial terms have been modest.

### Fund Returns

As at 31<sup>st</sup> March 2003, based on the realization cash flow schedule, GVCF posted a:

- Return of -2.5% in US\$ but 31% in local currency for its realized investments;
- Return on unrealized investments of -9.7% in US\$ but 15% in local currency;
- Combined return on all investments (realized & unrealized) of -11.2% in US\$ but 21.2% in local currency;
- Projected return at 30 June 2003 of -5.59% in US\$ and 27% in local currency.

### Investor Returns

The net projected return (after deducting fund expenses) to investors at 30th June 2003 was -11% in US\$ and 15% in local currency.

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<sup>57</sup> The currency of Ghana. In May 2003, US\$ 1 equals 8,258.50 ₵ (Cedi).

## Cash Returns

The fund posted a realized cash multiple of 0.91 times (91%) and unrealized cash multiple of 0.68 times (68%) giving a combined cash multiple in US\$ of 0.82 times (82%).

The local currency cash multiple was 3.13 times (313%) for realized investments and 1.59 times (159%) for unrealized cash multiple resulting in a combined cash multiple of 2.39 times (239%).

## Repayment of Shareholder Loans

By the end of its 10th anniversary, GVCF was able to fully repay shareholder loans (local currency equivalent) in accordance with the respective shareholder share subscription and loan agreements.

## Developmental and Social Impact

The Fund's activities had tremendous positive impact on the development and growth of the economy of Ghana.

These are some of the most significant results achieved:

- Sustainable direct employment created;
- Upstream and downstream economic multiplier;
- Direct foreign exchange inflows (especially in joint ventures with Swedfund, Nordic Development Fund, IFU, IFC etc);
- Increase in exports, especially non-traditional products (e.g. Voltic, PAF, Ghana);
- Development of entrepreneurial skills;
- Staff development and building of local managerial capacity (on and off the job training schemes);
- Knowledge/technology transfer, especially in joint ventures with technical partners;
- Capital market building (e.g. PAF on GSE);
- Legislative impact (Leasafric vs Leasing Laws, Non-Bank Financial Institutions Law, etc);
- Environmental risk impact (companies comply with environmental regulations);
- Health & Safety impact on employees (provisions of protective clothing, health care schemes, medical examinations/reviews);
- Local domestic savings conversion (provident fund & pension schemes, employee thrift and loan schemes, etc);
- Payment of taxes and contribution to national revenue generation (corporate taxes, VAT, excise duties, import duties, withholding taxes etc);
- Good corporate governance discipline
- Import substitution (thereby conserving forex)
- Investee companies social responsibility activities (sponsorships, community development, charity donations etc).

## Lessons Learnt

GVCF was set up at a time when the culture of Venture Capital was new to the Ghanaian economy. It was also new in the CDC family of funds and naturally served as a base for learning. With the benefit of hindsight and with new trend and products in the Venture Capital/Private Equity industry, lots of lessons have been learnt. These lessons are being applied in the structuring and management of new funds and the difference is already clear. The lessons include but are not limited to:

- Fund size. It should be ideal to support the expenditure base of the manager to attract and retain qualified and competent staff, pay for due diligence costs etc. GVCF size of \$5.8m was too small in this regard
- Deal size. Smaller deals tend to be unstructured and monitoring can be time consuming and expensive. Smaller deal range does not afford the fund the flexibility to provide round financing to maximize returns.
- Deal types. GVCF focused on start-ups which traditionally have high risks and high chances of failure unless there is a proven business model and experienced management teams. MBO and expansion deals have key structural advantages and high success rates while start-ups have a low success rate. Rescue and turnaround deals also have a low success rate.
- Deal structures. All GVCF deals were straight ordinary shares and loans and lacked important minority protection rights. Drag and tag along rights should be used to enhance exit prospects. Also deals should be structured such that the bulk of capital can be returned via redeemable instruments. The appropriate use of external gearing can enhance returns on risk capital;
- Quality of management of portfolio companies. It is crucial to the success or otherwise of the companies. The successful investment in the portfolio had better quality management teams that those which failed.
- Clear exit strategies from the on-set. It should be agreed with management and constantly monitored to ensure that the company stays on track.
- Longer investment holding periods. GVCF held on to its investments far too long than is ideal. This had the effect of diluting potential returns in the volatile environment that GVCF operated in. It is essential to constantly scout for exit opportunities throughout the investment period.
- Quality of due diligence. There should be no short cuts to due diligence citing lack of funds as the reason. Use should be made of appropriate expert opinions, comprehensive referencing and background checks etc.
- Regular portfolio valuation analysis and quality reporting. These are essential to focusing the management team and improving fund performance.

- Fund should be structured as flexible as possible. Capital should be drawn only as needed and necessary (to fund expenses and investments) so as to minimize the spread between gross portfolio returns and net returns to fund investors.
- Management should have incentives based on performance of the fund. Additional appropriate carry schemes to motivate them.

## Conclusion

Has the Fund achieved its objectives?

GVCF was unable to achieve its financial objective of providing investors with a compound rate of return of 20% in constant terms, which is commensurate with equity investments.

This rather below expectation performance should be viewed and evaluated in the context of over performance of the first generation of country funds in the CDC/Aureos family as well as the IFC's and other DFIs.

Key factors such as the hostile macro economic environment (over 1,600% depreciation of local currency against the US\$), its pioneering role, its associated teething problems and the focus on start-ups and rescues contributed in no small measure to the below average financial performance.

GVCF however made positive social and developmental impact on the economy of Ghana. A good level of awareness has been created for Venture Capital as a source of long term capital, lessons have been learnt in the management of funds, employment has been created, national revenue increased, health and safety and environmental awareness created or strengthened, technology transferred.

The GVCF is about to get to its legal closure and, at this stage, plans already exist about the future of Venture Capital initiatives in Ghana. In particular, a new Venture Company (AUREOS, owned by CDC and Norfund) has been set up to operate in 10 countries in Africa. Among these, there will be Ghana, Ivory Coast and Senegal.

The size of the fund is expected to be around \$50 million and, like the GVCF, the structure will be that of a ten year close end investment.

An important difference is in the principles behind this new venture: AUREOS is going to be more commercially driven and performance oriented, unlike its Ghanaian predecessor, which was more development driven.

As investment vehicles, AUREOS will most likely be using a mix of financial instruments that will principally cater for ease of exit and the maintenance of the value of the capital invested.

## **I Quaderni della Cooperazione Italiana**

Nº 1/2003

A. Carvalho Neves, *Alocação do Crédito como Factor de Desenvolvimento das PMEs em Moçambique*, January 2003

Nº 2/2003

R. Scuccato, G. Machatine, Mussa I. Hagy, J. A. Daria, F. Vio, G. Borgnolo, *O Impacto da Sida nos Serviços de Saúde em Moçambique. Resultados de um Estudo Preliminar*, August 2003

Nº 3/2003

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Nº 4/2003

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