
Private Equity Investments in Nigeria – An Overview



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INTRODUCTION

As the most important source of funding in the entrepreneurial marketplace, Private Equity (“PE”) refers to equity securities in private companies that are not publicly traded. A Private Equity Fund (“PEF”) as such is a Collective Investment Scheme (“CIS”) employed for making investments in various equity securities in accordance with a single investment model linked to private equity. PE funds are in a category similar to limited partnerships, involving a fixed time period of between seven to ten years, which can be extended on an annual basis. These funds are usually marketed to high net-worth institutions.

As a CIS, PEFs reduce the involvement of the investor and relieve him from keeping continuous watch on the stock market or looking for appropriate markets to invest. Usually conceived as closed-ended investments, investors in PEFs typically commit at the outset and afterwards cannot redeem their interests. The funds draw down the commitments from investors as necessary to make a considerable number of investments, and as investments are realized, the proceeds are received and distributed oftentimes without re-investment, thereby making the fund self-liquidating. The fund manager is usually obligated to issue quarterly or semi-annual reports of investments made to investors and inform



on other activities undertaken in the period under consideration.

In recent times, PE investments in Nigeria have witnessed considerable growth. Notable investments within the country include Actis Capital LLP's \$130 Million investment in Diamond Bank Nigeria Plc, its \$10.5 Million investment in the Palms Shopping Mall (it has since exited from same); Emerging Capital Partner's investment in Notore Chemical Industries Limited,¹ Oando Plc,² IHS;³ African Capital Alliance's investment in MTN Nigeria Communications Limited,⁴ the Associated Bus Company Plc⁵ and Swift Networks;⁶ as well as a host of others. Most PE deals in the country are hinged on management buyout and restructuring, unlike in developed economies where they consist mainly of leveraged buyouts.

The central theme from the foregoing has been the remarkably safe environment in which these investments have taken place. This newsletter discusses the available PEF structure within Nigeria and regulations guiding their investments. Further along, a comparative analysis of PEF structures in the United States of America is

undertaken towards appreciating the nature of PEFs.

PRIVATE EQUITY FUND STRUCTURES

The major consideration in structuring PEFs is averting the additional stratum of taxation (otherwise known as double taxation). Typically, the fund will be taxed when it realizes an investment or receives income, and likewise the investor upon the realization of investments in the fund or upon receiving income. For this reason most Nigerian-promoted PEFs are often set up in tax haven jurisdictions such as the British Virgin Islands and Mauritius.

PEFs are mostly set up as incorporated entities under the provisions of the Companies and Allied Matters Act (the "Act" or "CAMA").⁷ Where set up as a company limited by shares, such PEF (which is a Special Purpose Vehicle through which investments are made) is required by its Memorandum and Articles to state specifically the type of business that it intends to carry out. Where incorporated as a company under CAMA, such PEFs are liable to tax on company income tax. In Lagos state however, most PEFs are set up as limited partnerships under the Partnership Law of Lagos State.⁸ Under this structure, there is at least one general partner (usually the Fund Manager) whose liability for all the debts

¹ Under ECP Africa Fund II PCC

² Under ECP Africa Fund II PCC

³ Under ECP Africa Fund III PCC

⁴ Under CAPE I. It exited fully in 2008 through a management sale and private placement.

⁵ Under CAPE I. It exited in 2008 through an IPO.

⁶ Under CAPE II.

⁷ Cap C20, Laws of the Federation 2004

⁸ Section 46



and obligations of the Fund is unlimited, and other limited partners who are investors in the Fund, but are not liable for the debts and obligations of the Fund beyond their respective contributions. The fund manager manages the fund's business while the fund's investors as limited partners do not participate in the day-to-day management of the business, but may receive certain investment approved rights under the terms of their constituting documents. It must be noted that once the PEF is registered as a limited partnership under the Laws of Lagos State, such partnership can carry on business throughout the federation. Where however, the name of the fund does not include any of the names of its promoters, the provisions of CAMA requires that the name of the fund must be registered as a Business Name under part B of the Act.

SECURITIES & EXCHANGE COMMISSION RULES ON PE INVESTMENTS IN NIGERIA

Prior to the release of the 2011 SEC⁹ Consolidated Rules and Regulations (the "Rules") by the Securities and Exchange Commission ("SEC" or the "Commission"), there were no existing specific regulations on the establishment, management and operation of PEFs in Nigeria. Depending on the transaction and investment type, there are a number of specific rules that

⁹ Securities and Exchange Commission

must be complied with. The Rules subject PEFs operating in the country to authorization and registration with the Commission.¹⁰ Where Fund Managers intend to invest the assets of a fund in unlisted securities, they are required to have a minimum paid-up capital of N500,000,000 (Five Hundred Million Naira), unimpaired by losses or such amount as may be prescribed by the Commission from time to time.¹¹ Further, the Rules require the partners, principals and sponsored individuals to have been in the business of PE investment management for a minimum period of five years.¹² Investment in unlisted securities of a company is only permitted where such investee company has demonstrated compliance with the code of corporate governance; has consistently produced audited accounts for the preceding 5 years; and has a consistent history of profitability for at least the preceding 5 years.¹³

The Rules provide also that PEFs shall not solicit funds from the general public but have their funds sourced from qualified investors alone. They are also not allowed to invest more than 30% of the Funds in a single investment.¹⁴ It should be borne in mind however that the foregoing

¹⁰ Rule 550 (1) (c)

¹¹ Rule 535 (2) (a); Rule 552

¹² Rule 535 (2)(b)

¹³ Rule 535 (3)

¹⁴ Rule 553



provisions apply to all PEFs with a minimum investors' funds commitment of N1Billion.¹⁵

LOCAL INVESTMENTS IN PEFs

PEFs may solicit investments from target local investors such as high net-worth individuals, banks, insurance companies and pension funds. Investments by banks, insurance companies and pension funds are however strictly regulated by the Banks and other Financial Institutions Act ("BOFIA"),¹⁶ the Insurance Act¹⁷ and the Regulation on Investment of Pension Fund Assets 2010¹⁸ respectively.

Under BOFIA, banks are prevented from acquiring or holding any part of the share capital of any financial, commercial or other undertaking, subject to certain exceptions.¹⁹ Subject to the approval of the Central Bank of Nigeria (CBN), banks can invest in any company set up to promote the development of the Nigerian money and capital markets or improve the financial machinery for financing economic development. The CBN prudential guidelines for commercial banks,²⁰ however limits the type of investments that commercial banks can

undertake to those investments permissible under BOFIA.²¹ In line with CBN regulations, banks can acquire shares in small and medium-scale industries, agricultural enterprises and venture capital companies subject to the condition that the aggregate value of the equity participation of the bank in those enterprises does not at any time exceed 20% of the bank's shareholders funds²² and not more than 40% of the paid up capital of the investee company.²³

The Insurance Act regulates the capacity of insurance companies to invest in Nigeria by mandating that funds of insurance companies must be invested and held in Nigeria²⁴ in certain types of investments. It must be noted that the Act and regulations do not specifically prohibit insurance companies from investing in PEFs, even though they are not listed as permitted investments. Nevertheless, insurance companies have significant PE investments. These investments are required to be disclosed in periodic returns filed with the insurance industry regulator, the National Insurance Commission.²⁵

Prior to December 2010, only Legacy Pension Schemes (CPFAs²⁶ & existing

¹⁵ Rule 551

¹⁶ Cap B3, LFN 2004 (BOFIA)

¹⁷ Cap I17, LFN 2004

¹⁸ Issued in December 2010

¹⁹ Section 21, BOFIA

²⁰ CBN Scope, Conditions & Minimum Standards for Commercial Banks Regulations No. 1, 2010

²¹ Rule 4

²² Section 21(1)(d)

²³ Section 21(1)(c)

²⁴ Section 26, Insurance Act

²⁵ Section 21, Insurance Act

²⁶ Closed Pension Fund Administrators



schemes) had PE investments. However, the Regulation on Investment of Pension Fund Assets 2010²⁷ expanded the allowed investment instruments available to pension fund assets to include investment in alternative assets such as PEFs registered with SEC, Supranational Bonds issued by eligible MDFOs²⁸, Open/Close-ended/Hybrid Investment Funds registered with SEC and other instruments.²⁹

Before Pension Fund Assets can be invested in PEFs, such PEFs are required to have a well defined and publicized investment objectives and strategy; satisfactory pre-defined liquidity and exit routes.³⁰ Further, the Regulation requires that the PEF must have a minimum of 75% investment in companies or projects in Nigeria. Key principals of the Fund Manager (the CEO and CIO) are required to have at least ten years experience in PE investment. Pension Funds have a Global Portfolio Limit of 5% of assets under management in the PEF³¹ and such PEFs are required to have MDFOs as Limited Partners.

FOREIGN PEFs IN NIGERIA

Foreign investments are mainly regulated by the Nigerian Investment Promotion Commission Act ("NIPC Act")³² and the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act ("Forex Act").³³ Both legislation permit foreign investments by foreign investors in Nigerian securities either through the primary or secondary market, or by private placement.³⁴ The respective legislation also provide for the liberalization of foreign direct investment in Nigeria and permit foreign investors who intend to invest in Nigerian enterprises to do so without the need to seek approvals from numerous regulators.

As with any foreign investor, a foreign PEF (FPEF) – i.e., a Fund set up outside the country – is investing in Nigeria is guaranteed the unconditional transferability of funds through an authorized dealer, in freely convertible currency, of dividend and interest on profits attributable to the investment; payment in of foreign loans, as well as capital repatriation in the event of liquidation or divestment.³⁵ Upon importation of funds for investment in Nigeria, an authorized dealer (usually a license bank) through which the funds were imported is required to issue

²⁷ Issued in December 2010

²⁸ Multilateral Development Finance Organizations

²⁹ Regulation 4

³⁰ Regulation 5(2)(11)

³¹ Regulation 7(1)(8)

³² Cap N117 LFN 2004

³³ Cap F34, LFN 2004

³⁴ Section 26(2) Forex Act; see also section 21 NIPC Act and Rule 404 of SEC Rules

³⁵ Section 24, NIPC Act



Certificate of Capital Importation (CCI) to the foreign investor (CCI) evincing the amount of capital imported which is meant to be invested in the Nigerian company.³⁶ The CCI enables the PEF to repatriate the proceeds of its Nigerian investments without restriction, net of applicable taxes.³⁷ The provisions of CITA require an investee company to withhold tax at the rate of 10% as final tax on such proceeds at source (that is, dividend in the case of equity investment and interest in the case of loans), before remitting the same to the PEF.

While a FPEF does not require SEC notification before making investments in private companies, portfolio investments in securities of companies listed on the stock exchange require SEC notification and must be made through SEC-registered capital market operators or licensed brokers and/or dealers.³⁸

ACQUISITION OF SECURITIES

In structuring PE transactions, one of the first tasks of the fund manager is identifying an investee company. The nature of the Fund's investment in the investee company could be equity, debt, convertible debt or even a combination of two or more of these types of investments.

Equity investment makes it easier for the Fund to control and monitor the activities of the investee company since the Fund's equity will entitle it to vote at the general meeting of the company and usually participate on the board. The parties may enter into an Equity Purchase Agreement (EPA) to outline the terms and conditions for acquiring the investee company's shares and upon such acquisition, the Fund must ensure that its name is entered in the investee company's register of members. A common provision in the EPA is the delivery of share certificates by the investee company to the PEF.

Where the investment is a private investment in a public entity (PIPE), then attention must be paid to provisions of CAMA on the delivery of share certificates.³⁹ This is because the parties must take into consideration recent steps by the Nigerian Stock Exchange (NSE) to fully dematerialize share certificates of investors holding shares in companies listed on the exchange, through its clearing house, the Central Securities Clearing Systems Limited (CSCS). Shareholders are expected to open CSCS accounts through a stockbroker registered with the Securities and Exchange Commission (SEC) and obtain a CSCS Clearing House Identification Number.

³⁶ Section 15(2) Forex Act. See also Rule 406(1) SEC Rules

³⁷ Section 15(4) Forex Act

³⁸ Rule 408

³⁹ Section 146



Apart from just being entitled to vote at the general meeting, the Fund will also seek to protect its stake as a shareholder of the company. It could, by way of a Shareholders' Agreement where the investment is a private one, or a Subscription Agreement where the investment is a PIPE, ensure that there are share transfer restrictions and anti-dilution provisions. For example, rights of first refusal, rights of first offer, tag-along and drag-along rights. It is imperative that the Shareholders' Agreement does not contravene the provisions of the articles of association of the investee company, the CAMA and or any other applicable Nigerian laws or regulations.

In order to ensure maximum returns on its investment, the Fund will naturally be interested in the good governance and management of the investee company. The Fund would thus ensure that the powers of directors to manage the company are exercised in good faith and in the Fund's interests. Accordingly, the Fund would require that the Shareholders' Agreement provides that it has powers to appoint directors, thereby assuring its representation on the board of the investee company, especially on committees such as the finance and audit committees. It should be noted that this could pose a problem of conflict of interest as under CAMA the board of the investee company is expected to act in the

best interests of the company and not the Fund.

The Fund may also engage in loan investments. One of the advantages of loan investment by the Fund is a reduction on tax liability arising from the investment. This is because the interest payments that form a return on the Fund's investment will be deducted from the investee company's earnings before tax. Further, the Companies Income Tax Act Cap C21, LFN 2004 (CITA) grants significant tax exemptions (up to 100% depending on the tenor of the loan, including moratorium and grace period) on interest payments on foreign loans.

EXIT MODELS

The most common forms of exits for PEFs in Nigeria are a trade sale, an offer for sale and an initial public offering (IPO). The manner in which the sale would be carried out depends on the type of company and the terms prescribed in the company's articles. Where the articles provide for pre-emptive rights or other constituting documents in favour of other shareholders, the fund may sell its shares to other existing shareholders.

With respect to investments in private companies, the Fund may sell its equity holdings to other existing shareholders. Where the disposal is made at a profit, the profit will not be subject to capital gains



tax (CGT), due to the abolishment of CGT on the sale of shares. Upon the sale, the names of the new shareholders will be entered in the company's register of members.

Where the investment of the PEF is a PIPE, SEC Rules provide that a foreign investor shall divest its holdings in securities in public companies through the Nigerian Stock Exchange or on a recognized over-the-counter market with respect to shares traded on that market.⁴⁰ Divestment of holdings in securities in any other public company shall be done through capital market operators.⁴¹ The custodian is mandated by the Rules to notify SEC of the particulars of the divestment by the foreign investor within five working days of such divestment.

The Fund could also exit from private investee companies through an IPO. However, IPOs are extensively regulated by the SEC and the conversion of the investee company to a public company will be necessary before the IPO is undertaken. The NSE listing rules require that the company should apply in the prescribed form for listing of its shares on the NSE. Before making the application, certain requirements must be complied with. At least 25% of the share capital of the company having a nominal value of at least N250,000 shall be made available to

the public; the number of shareholders must not be less than 300 unless otherwise approved by the Council of the NSE; and the securities must be fully paid up at the time of allotment.

THE US APPROACH

The Limited Partnership ("LP") organized under the laws of the State of Delaware is the most commonly used fund structure in the United States ("US") with respect to domestic private equity funds. While an LP may be formed under the laws of any of the 50 states that comprise the US, Delaware is usually preferred due to its relatively flexible and highly developed laws on limited partnerships and other business entities.

The limited partnership structure for a fund usually comprises a single general partner⁴² and multiple limited partners that are investors in the fund. This structure effectively allows the limited partners to limit their individual liability to their commitments to the fund. Usually, the structure of any particular fund will be tailored to the fund's investor base, geographic focus, industry focus and a number of other factors that touch on various tax issues and regulatory concerns.

⁴⁰ Rule 410(a)

⁴¹ Rule 410(b)

⁴² Wikipedia available at

en.wikipedia.org/wiki/Private_equity_fund



In the majority of cases, the general partner exists as a separate legal entity owned by the founders of the fund. After setting up the fund, the founders are usually admitted as limited partners in the arrangement, while a limited liability company that is wholly-owned by the founders will be admitted as a general partner, possessing only a small economic interest in the general partner of the fund. In essence, this system accords the founders with limited liability and at the same time, allows them to receive their share of the general partner's carried interest through the limited partnership.

The fund is managed by a management company set up by the founders; and for each fund arranged by the founders, the management company undertakes the responsibility of the day to day operations of the funds. This allows the founders to centralize the management functions of the various funds in one entity. In order to shield the fund managers from liability, the management company is structured as a Delaware corporation or limited liability company.

PEFs that are structured as limited partnerships in the US are regulated by the Securities Act of 1933⁴³ which requires amongst others that the sale of securities must be registered with the appropriate

regulatory body, unless such offerings qualify for an exemption to the registration requirements.⁴⁴ Regulation S allows a number of non-US securities offerings to be deemed as occurring outside the US, which in essence allows them to avoid registration. This is only possible where the offer is regarded as an offshore transaction, in which case the offer must be made to non-US entities. The exemptions provided for under sections 3(c)(1) and 3(c)(7) of the US Investment Company Act 1940 provides US PEFs with the avenue to avoid the strict regulations of the Investment Company Act, which would normally require such PEFs to register with the Securities and Exchange Commission as investment companies and be subject to burdensome regulations.

The US Employee Retirement Income Security Act of 1974 as amended (ERISA) regulates investments made by ERISA Plans in PEFs as the fund's assets would be deemed to be assets of the investing benefit plan, thereby subjecting the fund to various onerous rules which typically, these funds have difficulty complying with. By imposing this fiduciary duty on the fund manager, they must then employ their best efforts to cause the fund to qualify for an exemption under ERISA.

⁴³ Regulation D allows issuers to avoid this registration process by offering securities on a controlled basis to accredited investors.

⁴⁴ This is usually referred to as the safe harbour requirement.



The four principal categories of investors in PEFs are non-US investors, US taxable investors, US tax-exempt entities and foreign governments.

CONCLUSION

PEFs are complex transactions, and no less is their structuring. No doubt the Rules has assisted in providing some form of guidance as to operations of PEFs in the country; nevertheless the contents of the Rules are such that they do not adequately address the growth of PE investments in the country. It is important that a country's PEF structure accommodates the needs of both domestic and foreign investors, as shortcomings in this area could lead investors to seek out alternative foreign structures, which in turn will diminish domestic investors' contributions to the funds in the country.

We advocate that limited partnership laws be promulgated in other states of the federation as they appear to be the most efficient PEF structure world over. Indeed, the most efficient tax mechanism for investments in PE is one based on tax transparency, which does away with double taxation. Tax transparency ensures that investors are only subject to tax in their home jurisdictions. Where this is not available, the attendant effect will be more funds being set up under a foreign

structure and investing in the country as FPEFs.

In today's economy, Funds are increasingly becoming accessible to foreign investors and often make investments in more than one country. This inexorably multiplies the complexities involved. Whereas PE investments in Africa are currently dominated by South Africa, Egypt, Mauritius, Morocco and Tunisia, Nigeria is expected to experience a boom in PE investments. Although Nigeria's private equity sector is not yet as vibrant as those of advanced economies, there is no doubt that further economic reforms will continue to make the environment attractive to PEFs. It is hoped that, as private equity transactions increase and the benefits become clearer, an even more conducive legal and tax environment will be created for the operations and establishment of PEFs in Nigeria.



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