## Financial Institutions and Services

# Private Equity Capital in a Less Developed Economy: Evidence, Issues and Perspectives

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**Abstract:** This study investigates the structure of the private equity industry and issues that impact on its development and growth in Zimbabwe. Studies conducted internationally have unequivocally demonstrated the importance of private equity investments in assisting firms at start/growth phase and decline phase. However there is a dearth of literature on how these financial intermediaries assist in unlocking firm value from an emerging markets perspective. The study uses the document analysis and an exploratory research paradigms to achieve the stated objectives. The study finds that the venture capital industry in Zimbabwe mimics similar industries in other countries except that it is constrained by market liquidity. Lack of regulation and viable business sectors coupled with excessive risks in the political economy narrows the scope of private equity operations. Several issues impacting on the development of the private equity industry are identified and evaluated. The study has policy implications for the development of regulatory framework to bolster the growth of the private equity industry in emerging market economies. This study provides new evidence and policy suggestions on the operations of the private equity industry in a liquidity constrained and less developed economy.

**Keywords:** private equity; venture capital; financial intermediation; start-up business

**JEL Classification:** G23; G24

## 1. Introduction

Globally, private equity funding is becoming the preferred source of finance for businesses amid growing shadow banking activities that compete head on with the banking sector. Private equity funds fall within the financial intermediation theoretical framework, which has received great attention since the work of Gurley and Shaw in 1956. Like any emerging market economy, Zimbabwe competes with other countries for capital, and as such, attracting private equity investments from both institutional investors and trade investors becomes paramount. The period

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between 1998 and 2008 saw a significant drop in capital investment in Zimbabwe (Zimbabwe Investment Authority, 2010). High inflation resulted in the destocking of the economy and loss of investor confidence (Mutengezanwa, Mauchi, Njanike, Matanga, & Gopo, 2012). Zimbabwe suffered industrial decline during the period 1998 to 2008 as the viability of companies was threatened (Mhlanga & Sibanda, 2013). However, the economic decline was substantially halted in 2009 when the government adopted the multiple currency system with the use of the United States dollar, the South African rand and the Botswana pula as its major currencies (Nakunyada & Chikoko, 2013). Consequently, after the adoption of the multiple currency system, companies regained their previous operational capacities despite the need for significant working capital investment (Mabhungu, B., Mhazo, & Chiriseri, 2011). The adoption of a multiple currency system brought revival and growth in the otherwise collapsed industries and, more importantly, the mushrooming of small industries and the emergence of venture capital companies and private equity funds.

Capital injection in either foreign direct investment or private equity is essential in improving productivity and company growth (Bender & Ward, 2009). To ensure domestic business remains competitive and relevant to the economy in a dynamic global economy, such businesses require significant investment in new equipment, technologies and contacts (Javorcik, 2004), which presents an investment opportunity in the private equity space. Private equity investment is important for the development of the country in that private funds are unlocked and become accessible to businesses that would generally not be able to access funds from the traditional banking institutions, which have very stringent lending practices owing to the level of risk associated with new businesses (Bender & Ward, 2009). Exacerbating the need for capital injection is the fact that the Zimbabwean working population depends on small enterprises for employment. The need for private equity finance to boost start-up firms and provide finance for leverage buyout transactions is therefore important. With limited access to bank debt due to insufficient trading history and the riskiness of cash flows, access to venture capital funds becomes pivotal (Bender & Ward, 2009). Venture capital firms can be engines of new job creation and a source of innovation as they support growing and innovative companies (Bertoni, Colombo, & Grilli, 2013; Harris, Jenkinson, & Kaplan, 2014).

Business and investment opportunities in Zimbabwe range across mining, tourism, manufacturing, transport, telecommunications and energy, among others. The Zimbabwean economy has been on the recovery path since the country adopted a multiple currency system in 2009 (Pindiriri, 2012; Nakunyada & Chikoko, 2013). Prospects of private equity investment therefore became entrenched in the country's instutions and investment climate. This study explores issues impacting adversely on private equity participation in Zimbabwe and provides further perspectives on promoting the private equity trajetory in an emerging market context.

Venture capital companies, by definition, focus on investing in the development of companies at the very early stages with the intention of exiting once the company has grown, thereby realising substantial financial gains (Altı, Kaniel, & Yoeli, 2012; Bender & Ward, 2009). Venture capital falls within the private equity framework. Five characteristics of venture capital finance are: the financial intermediary role; the active role in monitoring and assisting a company in its portfolio; return maximization through exiting in trade sales or initial public offerings; that they invest only in private companies; and that they invest to fund the internal growth of companies (Metrick & Yasuda, 2010). On venture capital and equity investment funds development in Zimbabwe, there has not been much attention, and the industry is still nascent as currently there is no regulation for this industry. The private equity firms are considered private investments because once the fund is registered as a company with the registrar of companies in terms of the Companies Act, private equity funds and venture capital companies begin to transact.

## 2. Literature Review

Start-up businesses have very high financial and business risk and only investors willing to bear this high risk invest in such companies (Bender & Ward, 2009; Metrick & Yasuda, 2010). Based on financial theory, only equity finance is appropriate at the start-up phase. hence the role of venture capitalists is essential at this stage (Bender & Ward, 2009). However, in some instances evidence shows that start-ups do not necessarily turn to private equity and venture capital because of their perceived level of risk, but use bank finance as a substitute for private equity and vice versa (Berger & Schaeck, 2011). Nevertheless, this has only been observed in continental Europe where bank finance is the major source of corporate finance (Levine, 2002; Demirgüç-Kunt & Levine, 2004). However, venture capital finance varies across regions and countries based on economic conditions and levels of formal institutional development (Li & Zahra, 2012). Although a thin line seems to exist between private equity and venture capital, the distinction between the two forms of equity finance is important. Private equity is mainly equity finance used in the acquisition of mature and established firms, while venture capital is equity used to finance start-up business or sometimes provide seed capital (Bender & Ward, 2009; Matthews, Giuliodori, & Mishkin, 2013).

Venture capital funds can thus be defined as “investments by professional investors of long-term, unquoted, risk equity finance in new firms where the primary reward is an eventual gain, supplemented by dividend yield” (Tyebjee & Bruno, 1984:158). Venture capitalists invest in new, unproven, high-risk, high-potential start-up businesses as they usually acquire control in the businesses they invest in and exit when they have realized significant returns, and in most cases they exit when the company goes public (Bender & Ward, 2009; Metrick & Yasuda, 2010). Venture capitalists are usually attracted to these new firms because of the skill they perceive themselves to possess (Tyebjee & Bruno, 1984). Instead of lending money, venture capitalists exchange capital for equity or an ownership stake in the companies they finance.

Private equity funds differ across countries with differences starting with organizational form. In countries such as the United States and the United Kingdom, firms are said to be organized as limited partners, while in countries such as France and Germany, they have a structure that involves banks (Lerner, Pierrakis, Collins, & Bravo, 2011). The management style of venture capitalists differs across countries as well, depending on the development of institutions (Lerner & Tåg, 2013; Lerner et al., 2011). Venture capital firms are actively involved in managing their investments by way of getting board representation and involved in the day-to-day management issues (Jääskeläinen, 2012; Metrick & Yasuda, 2010). This makes private equity and venture capital-owned companies better managed compared to those company funded by other sources (Bloom, Sadun, & Van Reenen, 2015).

Due to the fact that venture capital funds are private companies, it makes their accessibility limited to a few people with projects with the potential of generating returns (Bender & Ward, 2009; Li & Zahra, 2012). As a result, the poor remain unable to access funding from private equity funds due to the fact that they have no security and nowhere to start from. Consequently, access to funding becomes easy for the rich and those with potential to run successful businesses (Robb & Robinson, 2012). The key motivator for these investors lies in their ability to grow such businesses and present opportunities for venture capital and equity investment funds to exit the businesses (Bertoni et al., 2013; Metrick & Yasuda, 2010).

Very few studies have attempted to provide evidence of financing start-up businesses in Zimbabwe. One major study by Mhlanga and Sibanda (2013) provides a critical review of the mushrooming and growth of the banking industry from the 1990s to the end of the country's economic turmoil in 2008. What came out clearly in that study was the pivotal role played by venture capital firms in the establishment and growth of banks in Zimbabwe. Mabhungu et al. (2013) also conducted a survey on the determinants of financing used by small businesses in Zimbabwe though aspects of private equity were ignored. It is therefore important to provide a discussion on challenges and issues affecting private equity finance in an economic set-up such as Zimbabwe.

## 3. Methodology

This study employs document analysis and exploratory approaches to research. Venture capital information is obtained from private equity capital firms' websites and annual reports, investment bankers, and analysts' reports. In Zimbabwe the venture capital industry is relatively small as it is dominated by four big players, namely, Takura, Brain Works Capital, African Century and Masawara Capital. There are some small companies but their presence is insignificant. Venture capital funds are not regulated in Zimbabwe and they operate in the private space. The discussion is premised on the investment strategies of the private equity investors and the resultant issues affecting the industry.

## 4. Discussion

Valuation of the Zimbabwe private equity market is difficult as the industry is not regulated and firms do not have any association to which they submit returns for industry self-regulation. The industry comprises four major players, although institutional investors and banks actively participate in the private equity market. The following table shows the distribution of equity funds investments in Zimbabwe. Panel A describes the investment strategies while Panel B describes private equity transactions.

**Table 1. Summary of venture capital/ private capital activities**

| **Panel A: Investment Strategy** | | | |
|---|---|---|---|
| Fund | Target Internal Rate of Return | Sector/ industry distribution | Geographical Distribution |
| A | N/A | Technology | Not specified |
| B | 30% | Energy, financial services, hospitality, real estate | Not specified |
| C | 25% | Not specific but high growth firms, real estate, financials, technology, telecommunications in the portfolio | Not specified |
| D | 32% | Not specific but agribusiness, manufacturing, telecommunications, transport in the portfolio | No specified |

| **Panel B: Private equity transactions** | | | |
|---|---|---|---|
| Fund | Buyout Activity Reported | Venture capital activity reported | Exit Strategy |
| A | No | Several technology sector deals reported | Not reported |
| B | No | Cross-industry venture capital deals at greenfield or start-up level | 3-5 years holding period |
| C | Yes | Cross industry venture capital deals | Trade sales and listings |
| D | Yes | Few cross- industry deals reported | Not specified |

*Source: Authors' compilation using various companies' websites*

Table 1 shows that private equity firms in Zimbabwe are heterogeneous as they have different investment strategies. Some of the firms target specific sectors/ industries while others simply target high growth opportunities in various sectors of the economy in line with existing theory and evidence (see Metrick & Yasuda, 2010). Venture capital deals are in line with evidence in the literature relating to exit strategies via listings or trade sales within five years of commencing operations (Bender & Ward, 2009; Metrick & Yasuda, 2010; Mhlanga & Sibanda, 2013). High growth industries such as technology and telecommunications are the target investment destinations in line with assertions in the contemporary literature (Bender & Ward, 2009; Bertoni et al., 2013).

For the period between 2009 and 2015, seven delistings from the Zimbabwe Stock Exchange were private equity deals, while others delisted due to bankruptcy and viability reasons.

### 4.1 Factors Promoting the Growth of Venture Capital and Equity Investment Funds in Zimbabwe

Zimbabwe's prolonged, economic challenges have severely impacted negatively on the confidence of investors and the majority of the business community. However, the situation has presented opportunities for venture capital funds with high risk appetite, and in this section some of the factors that have promoted the growth of venture capital and equity investment funds are discussed. With many manufacturing enterprises having ceased operations due to viability challenges, and others having immensely downsized, private equity funds were presented with opportunities to make investments in different industries.

Inadequate availability of working capital for companies, stemming from hyperinflation between 1998 and 2008 at levels greater than ever experienced globally, and the demonetization of the Zimbabwean currency without compensation to those who were holding Zimbabwean dollars, resulted in many companies having to build their financial capacity from scratch. Unfortunately this void could not be immediately filled by the available financial institutions, which were also undercapitalized and had a low deposit base (Sibanda & Chikoko, 2014). Inability of existing companies to replace lost capital due to the limited financial resources in the banking sector compounded by exceptionally high interest charges on such limited, short-term funding, also promotes the existence of venture capital funds as they provide an alternative for funding companies.

Moreover, the development of venture capital funds is affected by the accessibility of new investment capital by firms to replace the capital lost due to the marginal monetary liquidity circumstances in Zimbabwe. Currently, there is a low investment appetite among foreign investors in Zimbabwe for fear of lack of assurance of investment security due to the unclear indigenization and economic empowerment policies and Zimbabwe's noncompliance with Bilateral Investment Promotion and Protection Agreements (BIPPAs), and perceptions of an absence of respect for property rights and law and order. This presents great opportunities for venture capital funds, which are keen to take risks in the high-potential start-up businesses and even existing businesses that have the potential of being turned around to profitability, which foreign investors are afraid to support. However, strong institutions remain paramount to the existence and growth of private equity investments (Lerner & Tåg, 2013; Li & Zahra, 2012).

### 4.2 Factors Hindering the Development of Venture Capital and Equity Investment Funds in Zimbabwe

Venture capital investments are meant to be long-term with periods ranging from three to five years (Bender & Ward, 2009; Puri & Zarutskie, 2012). However, due to the nature of the investment environment in Zimbabwe the development of the industry remains subdued due to a number of challenges hindering the development of the industry. The lack of development of venture capital and equity fund investment may be attributed to the following:

#### Poor Returns and Business Failures

Due to the difficulty of managing venture capital investments, most start-up businesses fail, hence making development difficult as most primary investors who invest in venture capital and private funds migrate towards investment in larger and well-established public companies. As demonstrated in Table 1, venture capital firms in Zimbabwe target an internal rate of return of above 25%. Private equity firms are selective in their choice of partners and always look for high-growth potential businesses where they can also take up a large shareholding stake in order to influence company decisions, hence profitability (Berger & Schaeck, 2011; Black & Gilson, 1998; Bloom et al., 2015; Croche, Steward, & Yermo, 2011).

**Lack of Recognition as an Alternative Investment Asset**

Institutional investors, pension funds and life assurance companies with huge balance sheets do not yet consider venture capital and private equity investments as alternative investments. Institutional investors are considered to provide more patient capital necessary for economic growth and development (Croce, 2012; Croche et al., 2011). With limited investment options in Zimbabwe, if these institutions would consider venture capital as investment options (alternative investments status) there will be great levels of development in the sector. This however has regulatory implications on the institutional investors and the governance of private equity firms.

**Knowledge Gap and Lack of Awareness**

The other factor hindering the development of venture capital and private equity investment funds is the knowledge gap in the country. Very few people focus on venture capital and equity investment funds, hence the level of development. Until a time when the knowledge about the sector increases, the level of development will remain low.

**Weak Business Environment**

Due to corruption and weak policies in the country, the government has created a weak business environment. Weakness in the business environment affects the development of private equity funds (Li & Zahra, 2012). For example, the indigenization and economic empowerment policies and the lack of the rule of law and respect for property rights, scare away investors and thus negatively impact on the development of the venture capital industry.

**Lack of Managerial or Technical Capacity**

The economic decline experienced in the country led to the migration of skilled labour to other countries in search of greener pastures. As a result there is a skills gap in the country and the country has extraordinary raw entrepreneurial talent with no capacity to build and manage an enterprise that can compete globally. The flight of skilled labour from the country resulted in the shortage of skilled personnel who are key to the country's developmental agenda. An estimated 25% of skilled Zimbabweans are living outside the country. Because of the need to train new staff it raises the costs that the venture capital fund has to invest in the business before getting their return on investment.

**Lack of Access to Capital**

Zimbabwe is experiencing liquidity challenges making long-term investments limited despite the attractiveness of the investments. Venture capital funds may have a portfolio of projects but get crippled by the shortage of capital to fund all the projects, and as a result focus on a few projects.

### 4.3. Possible Policies that will Make Venture Capitalists Work Better in Zimbabwe

In order to promote the growth of venture capital funds, the government needs to adopt policies that promote their growth by way of regulation and supervision. The following are some of the policies that the government could adopt for the viability and development of venture capital and private equity investment funds.

**Fund Allocation from the National Budget**

Venture capital funds are developmental as they promote growth of business entities. The government should promote their growth by allocating funds to the Ministry of Small- and Medium-Scale Enterprises and make it mandatory for the ministry to support venture capitalists who in turn will support start-up and growth industries.

**Prescribed Asset Status**

The government may also prescribe that institutional investors, pension funds, life assurance companies and asset management companies invest a certain percentage of their funds in venture capital funds, which in turn will invest in specific sectors of businesses with high potential so as to promote private equity investments. This will have a ripple effect in the economy as there will be growth in many industries that traditionally do not have access to funding from traditional sources of funding. Raising money from pension funds provides numerous advantages to the venture capitalist as the venture fund can quickly raise large amounts of investment capital by approaching a few pension funds. With proper legislation, many pension funds will be more eager to partner with venture capital firms.

**Venture Capital Funds Regulation and Reporting Standards**

The government could also regulate these institutions by way of legislation to eliminate the principal agent problems that they face between themselves and the providers of capital, and between themselves and the managers of the companies in which they invest (Acharya, Gottschalg, Hahn, & Kehoe, 2013; Bloom et al., 2015). Venture capital firms receive funding from various sources, each with its own objectives that need to be met, hence the importance of having regulations governing these firms so that they choose investments in line with the objectives of the fund providers. In turn, the venture capitalists need some protection from fund providers in case of unforeseen losses, because they take a lot of risk although they attempt to manage the risks involved in their activities. Regulations will improve the functioning of the private equity firms as there will be clear valuation procedures for reporting to providers of funds, because currently there is no standard procedure and no accepted valuation standards. It is the venture capitalists as agents who are responsible for valuations and on which their performance will be judged (Sahlman, 1990; Acharya et al., 2013).

**Increase Public Awareness and Encourage Public Listing of Firms**

There is need to promote the establishment of venture capital funds in the country due to the importance of the role they play. Black and Gilson (1998) argue that the health of the venture capital fund market depends fundamentally on the vibrant public market, which allows new firms to issue shares. Hence the success of venture capital firms is linked to the rise in initial public offering market activity, and it becomes important to increase public awareness by filling the knowledge gap that exists about private equity investment.

**Legal and Regulatory Environment and Respect for Property Rights, Law and Order**

An environment of absolute respect for property rights, law and order and human rights must be created and maintained as this will attract regional and international venture capital and equity fund investors. If laws are enforced, the functioning of the venture capital industry will be enhanced as investors will gain confidence in investing in the country. Different forms of protection of property rights induce different entrepreneurial behaviour. The success of venture capital funds also depends largely on the legal and regulatory environment, which is largely determined by public policy. Recent studies have shown the importance of legal and regulatory aspects (Lerner & Tåg, 2013).

**Linkages to Pure Commercial Markets**

Venture capital and equity investment funds should be encouraged to work closely with other local financial institutions to graduate their companies for later stage financing from commercial sources such as the banking sector, and co-investing at later stages of financing with banking institutions.

**Technical Assistance**

It is not enough to provide funding to small businesses without assisting with technical skills to run the business. Venture capital funds should help companies with management training, advice from experienced business people and insights on how to build the business. Since the investments that the funds make will be concentrated in a particular sector in which the firm has expertise, technical support to start-up firms will be highly beneficial as it will be based on best practice and what has worked well in the sector.

**Viable Exit Markets**

As a matter of policy, the government may come up with viable exit markets for venture investments as this increases the expected return to investors and entrepreneurs. Government policies that result in the creation of stock markets suitable for listing entrepreneurial companies are expected to increase the development of venture capital and equity investment funds.

## 5 Conclusion

This study investigates the structure of the private equity funds markets in Zimbabwe. Evidence, issues and perspectives are presented and discussed in the context of private equity investments. The study finds that the private equity market in Zimbabwe is subdued with only four big firms dominating the market. Lack of knowledge and market liquidity is identified as some of the challenges facing the private equity industry in Zimbabwe. In line with existing evidence, the study further reveals that the industry is adversely affected by political factors and lack of sound and transparent institutions. The findings further show that the investment strategies are in line with existing literature. The issues identified, together with evidence presented in this paper, have policy implications that could be leveraged to attract private equity investments and subsequently grow the targeted sectors of the economy. The study has limitations in that monetary data and values of private equity funds were not obtained. A survey of private equity firms could boost further research in this field.

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