

PRIVATE EQUITY

TYPES OF FUNDS



Private Equity (PE) in its simplest form refers to equity investments in private rather than public or listed companies. Viewed differently, it is the use of privately owned funds for direct investment into privately owned companies.

In the mid '80s PE emerged as mid-to long-term finance provided by an investor in exchange for an equity stake in potentially high growth unquoted companies. Initially PE concentrated on manufacturing entities, but has now leapt into services such as hospitality and infrastructural sectors, where it is more common today.

The Capital Markets Act defines a Venture Capital (VC) Fund as "a company approved by the Authority and incorporated for purposes of providing risk capital to small and medium-sized businesses in Kenya with high growth potential whereby not less than 80% of the funds so invested consist of equity or quasi equity investment in eligible enterprises".

VC is similar to PE, save for the fact that VCs tend to be associated with start-ups while PE investors look at investing in running businesses – though in ordinary parlance VC is commonly substituted for PE. Thus, traditionally, PE was split into VC funds and buy out funds. Buy out funds, as the name suggests, were used to buy out an entrepreneur's interest in the business that had

existed for some time.

PE and PE houses can be classified by stage, size, ownership, specialisation and purpose, among other bases.

BY STAGE

The two most common forms of PE by stage are Venture Funds and Buy Out or Leveraged Buy Outs (LBO's).

Venture funds are those that invest in early stage or expanding businesses that generally had or have limited access to other sources of funding. On the other hand LBOs invest in more mature businesses, usually taking a controlling interest and leveraging their equity investment with substantial amounts of third party debts. Thus in an LBO, a fund will inject a small amount in equity investment and take out loans, usually long term syndicated loans secured over the business's assets.

BY SIZE

Mega funds are established by more successful and established PE houses. Prior to 2007, the global PE industry saw several "mega deals" underwritten by banks, such as the Alliance Boots buy out of £11.1 billion. Mid market funds usually invest in lower value deals such as the Almatris Chemical business deal of US\$ 970 million.

Industry experts have, however, sounded an alarm bell over the increased reluctance of banks to underwrite big deals,

saying that their appetite for 'big ticket' deals has fallen. Investment banks were reportedly saddled with unsyndicated leveraged debts of US\$ 400 billion as at 2007.

On the flip side, mid market deals are enjoying a period of sustained growth, especially in emerging markets of Africa and Latin America.

BY OWNERSHIP

Under this category are captive and non-captive funds. Captive funds are established by and have strong links to a particular investor, such as a financial institution. Captive funds also tend to be limited in the investment choices they can make, i.e. they generally invest in one particular sector. Non-captive funds dabble in almost every industry and sector, provided the projected returns justify the investment.

BY SPECIALISATION

Funds may also be distinguished by the industry or sector in which they operate. These funds invest in portfolio companies in specific sectors. Examples include IT funds and real estate funds.

Under the Income Tax Act, Cap 470 of the Laws of Kenya, VCs are limited in the activities they can engage in. Specifically,

Vcs cannot trade in real property (i.e. land, banking and financial services) as well as wholesale and retail trade.

BY PURPOSE

Strange as it may seem, funds can also be categorised by purpose. Examples of such funds include feeder funds, fund of funds and secondary funds.

Feeder funds are specifically created to invest in a single PE fund. A common example of a feeder fund is a trust established by wealthy individuals where the terms of the trust direct trustees to invest all monies in a single fund.

Funds of funds are those which invest in other funds, principally as a means of managing portfolio risk. Therefore, a large fund will invest in several smaller funds that have diverse investments.

Secondary funds concentrate on acquiring interest in and assets of other funds.

Whatever the type or category of PE, the bottom line is that an investor puts in equity or quasi equity investment in a business for a period of time, within which he expects to have built value. At the expiry of the investment period, the investor will divest from that particular business and move on to the next investment.

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