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Venture Capital in East Africa: Is There a Right Model?

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Introduction

In its brief history so far, the venture capital (VC) and private equity (PE) industry in East Africa has attracted a sizeable number of active participants, and investment activity is on the rise (EAVCA and KPMG 2015). This has been driven partly by the overall trend toward positive sentiments about the viability of Africa as a whole as an investment destination (Roxburgh et al. 2010). The sustained positive economic growth of the continent over the past decade has generated some new-found interest in the continent other than as a recipient for aid. Indeed, by some estimates, the total dollar value of foreign direct investment (FDI) (UNCTAD 2013; UNESCO 2013; Lautier and Moreaub 2012; M'Amanja and Morrissey 2006), inflows to Africa now exceeds that of

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official development assistance (ODA). Sy and Rakotondrazaka (2015) observed that there were only two countries in Sub-Saharan Africa in 1990 that received greater FDI inflows than ODA—Liberia and Nigeria. In 2012, 22 years later, 17 countries were receiving more FDI than ODA.

Early-stage venture funding through VC and PE financing have been coming up as viable funding options for businesses alongside the traditional financing avenues through commercial lenders (Deloitte 2015). According to an East Africa Venture Capital Association (EAVCA)–KPMG survey (2015), 79 investment deals of this nature worth approximately USD800 million were reported between 2007 and 2014 across East Africa (EAVCA 2014). An Intellicap (2015) report noted that VC funds have committed USD93 million since 2012 and that since 2010 PE investors have USD862 million under management in Kenya alone (EAVCA and KMPG 2015).

What these statistics do not show is the fact that most general partners are in their first-round funds and are not sure if they will be able to raise second-round funds. That said, we naturally expect that some learning will have taken place among the general partners in the course of investing in the region over the time period they have been operating. We set out to interview a number of VC and PE players in the industry with the objective of getting a sense of the current state of the industry and how its future might evolve. Right from the beginning, we found our respondents constantly alluding to the idea that in their experience some of the key attributes of the venture funding model commonly used—that of structuring a fund based on a partnership model between the general partners (GPs) who run the fund and the limited partners (LPs) who provide the investment capital (Tawiri 2010; Zider 1998)—are not entirely suited to the East Africa context. Fund managers, for instance, thought the 7-to-12-year time span for a closed fund was not adequate and that the 2–3 % management fee was too low.

These realizations led us to formulate our research question: Is there a right model for VC funding in East Africa? Further, it emerged in the course of our investigation that this question cannot be considered in isolation. The right model has to be considered in light of two key realities for VC investors in the region: constrained deal flow, which is a function of the nature of entrepreneurship in the region (e.g., the tendency for entrepreneurship in the region to be driven by necessity rather than opportunity), and a challenging exit environment.

Literature Review

A 2010 report by McKinsey (Roxburgh et al. 2010) showed Africa's economy growing at an average pace of 4.9 % between 2000 and 2008. The East African Community (EAC) in particular—which comprises Burundi, Kenya, Rwanda, Tanzania, and Uganda—grew at an average pace of 6.2 % between 2004 and 2014 (Gigineishvili et al. 2014). Projections indicate that this growth is likely to be sustained in the short to medium term, because key economic indicators for the region, and the broader continent, are quite robust: a growing middle class and corresponding consumption patterns, rapid urbanization, stable (or stabilizing) governments, a large and growing proportion of youth who would provide labor, and so on. Efforts to integrate the EAC countries economically under a common market while doing away with inhibitive trade and investment barriers could create a unified market of more than 160 million potential consumers (World Bank 2012). Perceptions about doing business in Africa have also changed considerably over time, becoming much more positive (EY 2015a; Roxburgh et al. 2010).

It is in this general economic environment that PE and VC funding in East Africa have been developing. Buoyed by consistent growth and a favorable outlook, PE and VC in the region and the wider continent have developed progressively. Fundraising to invest specifically in Africa grew 24 % in 2014 over the previous year to USD4.1 billion (EY 2015b). About USD1.6 billion was raised by the PE sector for the East Africa region between 2007 and 2014—7.3 % of a total USD22 billion targeted at Africa. Most funds were sized in the USD10 to USD50 million or USD100 to USD500 million range. Of the 79 deals worth approximately USD822 million reported within that time, 63 % were in Kenya and 15 % were in Tanzania, including 27 % in agriculture, 14 % in financial services, 11 % in fast-moving consumer goods, 10 % in information and communications technology (ICT), and 9 % in healthcare. Seventy of the 79 were below USD10 million in size. There were 21 exits worth a combined value of USD260 million in the period, 43 % of them in financial services. As in other frontier markets, the majority of funds were sourced from development finance institutions and high-net-worth individuals. The investors were mostly foreign, those from Europe accounting

for about 50 % of the total. Local investors from the East Africa region were only represented as a minority (EAVCA and KPMG 2015).

VC funding specifically in the technology sector in East Africa is an even more recent development and has to a large extent been focused on Kenya, which has gained prominence over the past seven years as a rising technology hub known as the Silicon Savannah. Total invested capital in tech start-ups across Africa more than doubled in 2015 to USD26.9 million from USD12 million in 2014. The average capital secured per venture increased from USD129,348 to USD205,374 over the same period (VC4Africa 2015).

Earlier research (SAVCA-Monitor Group, SAVCA 2011) has shown that the cost of running a fund in Africa is generally quite high compared with that of other markets, a fact that has not been reflected in compensation structures, which have more or less been borrowed "as is" from other experiences of investing in developed markets. There is a shortage of skilled talent for funds. The operating environment is also characterized by high competition for viable investments and a shortage of deal flow. GPs mostly have to deal with founder-led firms that need significant business support from the investor to help them develop their governance, management, and operational capabilities to a level comparable to those that an investment-ready firm in the West would be adding to its cost base for funds and eating into its investment window. Furthermore, the deal intermediary and service provider ecosystem are relatively underdeveloped, meaning that GPs have had to do almost all the work, from sourcing deals to preparing them for exit.

Methods

In addition to secondary sources (i.e., industry reports and news articles) and the experiences of both authors in East Africa's investment landscape, primary data were collected from interviews with representatives of six investment funds (see Table 14.1 below). The six were selected for the fact that they were involved in investments across the region and in investment prematurity stage ventures. It should be noted that the six were selected purely for these reasons and for their availability to participate. We cannot claim that they constituted a scientific sample of the population of VC investors in the region. Data were collected by means of questionnaires administered through face-to-face interviews.

Table 14.1 Profile of interviewed investment funds

Fund	Fund size	Minimum investment	Maximum investment	Focus countries	Focus sectors
1	Fund I—USD12 M; Fund II—targeting USD55 M	Fund I—USD100 K Fund II—USD250 K	Fund I—USD1 M; Fund II—USD3.5 M	East and West Africa	ICT, consumer goods, healthcare
2	The fund for each country ranges from USD1–2 M	USD15 K	USD100 K	Kenya, Nigeria, and South Africa	Early-stage technology based start-ups
3	Several funds, up to USD750 M	N/A	N/A	Pan African, including Kenya, Tunisia, Nigeria, South Africa, Morocco, Senegal, and Cameroon	Late-stage, including transport and logistics, agribusiness, gas and petrochemicals, consumer products, power and water, financial services, and telecommunications and media
4	Accelerator program that provides funding and access to funding for start-ups going through the program	USD10 K	~USD100 K (amount has evolved over time)	Kenya	Renewable energy, agribusiness, financial services
5	USD50 M	USD50 K	USD15 M (Syndicated)	Eastern Africa	Agribusiness, healthcare, energy and natural resource services, retail and consumer, education
6	USD12 M	USD50 K (20 K for early-stage start-ups)	USD300 K (100 K for late-stage start-ups)	East Africa, preferably in Kenya, Uganda, or Tanzania	Media and information sector using mobile or online applications to provide content or services to consumers or businesses

We investigated the following aspects: fund structure and remuneration, team and roles, fundraising, deal sourcing and due diligence, investing, post-investment, and exit. Some of the investors invested as little as less than a hundred thousand dollars to start-up ventures, and others invested in the millions. In terms of their portfolios, several had investments across early-stage ventures through mature firms, where others were specialized. Moreover, our respondents invested in multiple countries and various sectors, including technology, healthcare, manufacturing, and financial services. The majority of the firms we spoke with are in the investment and early holding period of their funds.

Results

Four out of our six respondents stated that their funds were organized in the classic partnership structure. Two were organized as companies; one, a limited liability; and the other, limited by guarantee. The two limited companies were more focused on early-stage investing at the seed–start-up stages. All of the investment funds were incorporated outside East Africa, mostly in European countries. One of the companies was registered as a holding company in Europe with two separate entities in Kenya—a company limited by guarantee and a limited company. This was because the firm carried out both for-profit and not-for-profit activities. The other company was based in the Seychelles, "where it is easy to operate due to very low capital gains taxes and relative ease of set up," as one our respondents noted. Most of the respondents cited tax benefits as the main consideration in deciding where to incorporate. One fund incorporated in the Netherlands noted that the country has favorable legislation for funds; it is tax-transparent, meaning that individual investors are taxed instead of the fund.

Cost repeatedly came up as a major concern for industry players. This led to our asking about the remuneration of GPs. We found that the partnership-based funds, as expected, took the more or less standard 2–3 % management fee. However, all our respondents noted that operating expenses in East Africa have tended to be higher than average. One respondent went as far as suggesting that management fees should be in

the 5–6 % range. In addition, the partnership-based funds followed the standard ten-year (maximum) lifecycle from starting the fund to winding it down. Our respondents felt that finding suitable investments in this region took much more time and effort than average, calling the standard ten-year life of a fund into question. One of our respondents noted, for instance, that on average, it takes a year from identifying an opportunity to invest in and closing the deal. Another noted that the longest it had taken them from initiation to close was three years for one of their deals, explaining that "in the best case scenario, it takes us three to four months from identifying the opportunity to concluding an investment. In the worst case scenario it can be up to three years."

The respondents noted that, when it came to fundraising, the vast majority of investment funds in the industry were foreign—typically development finance institutions, as is the case in most frontier markets. The dearth of local capital, even from local pension funds, was a major concern. Koome and Kipanga (2013) note that at the time of their research, no local pension had invested in PE. However, more recently the PE firm Ascent Capital of Bangalore, India, managed to draw Kenya Power Pension Fund and Nation Media Group Pension Fund into their Sh8 billion fundraising (Gachiri 2015). It was noted that high-net-worth individuals in the region were mostly unfamiliar with the asset class and were more comfortable with traditional investments—real estate, shares, and bonds—that are perceived as being less risky. New legislation in Kenya (specifically the Retirement Benefits Authority [RBA] Act and the Insurance Act that govern the pension-fund and insurance industries), for instance, allows pension funds to allocate funds to alternative assets, although there is still low uptake among pension funds (FSD Kenya 2008).

Generally speaking, our respondents felt that the standard partnership-based fund structure was not well adapted to the regional context and boxed them in. However, we also noted that LPs are accustomed to this structure and that GPs have little chance of altering it. One respondent proposed that his firm would consider using an investment vehicle, such as a holding company, in the future instead of using the partnership fund structure. This would solve the problem of investment horizons and partly solve the exit issues, because the funds would exit only when good avenues arose instead of exiting in accordance with preset time limits. Additionally,

it would remove the need for explicitly set management fees based on the amount of funds raised, thereby also addressing the cost issue.

All our respondents reported that they maintained the smallest teams they could manage with (usually fewer than 10 members) in order to minimize operating costs. They tended to hire skilled individuals who had extensive work experience that could encompass multiple role expectations. One respondent said, “We have two people who are dedicated to sourcing deals. The same two need to be technical enough to sell the proposition,” referring to the fact that even the staffers doing work that ordinarily did not need technical skills still needed these skills in order to take on the additional tasks. As another noted, “Everyone on our team is involved in sourcing deals.” In addition to the typical functions covered in a fund (sourcing, selection, due diligence, valuation, and negotiation), we found two peculiar characteristics among our respondents: First, because of cost constraints, the funds (instead of the portfolio companies) had to do a large part of the work themselves to get a deal to its financial close internally. For instance, one of our respondents indicated that his firm handled all aspects of due diligence internally. Second, the funds tended to be highly involved in the operations of their portfolio companies. The reason given for this was that the GPs typically had to deal with founder-led firms that needed significant business support from the investor to help them develop their governance, reporting, management, and operational capabilities. Funds used a mix of in-house resources and external consultants to support their portfolio companies. One respondent said, “We sent experienced consultants to the different companies to help operationally. We also did a lot on the board.” In addition, to minimize costs, the funds preferred to have regional offices in one location rather than multiple offices. “Having satellite offices is hard. Teams tend to be small,” said one respondent. Another said, “You operate where you know best.” This ends up affect deal sourcing, as we shall see.

When it came to deal sourcing, the underlying theme across the spectrum was the highly relationship-based nature of the industry. As one fund manager said, “Right from deal sourcing, it’s a very network-sourced industry.” The funds relied heavily on social networks to source their deals and tended not to turn to intermediaries, such as investment advisory firms. “We don’t use intermediaries to source our deals. Most of them place

their own interests above those of the fund. They rarely give us what we are looking for," one respondent remarked. Another respondent noted that the quality of intermediaries was not as high as in more mature markets. In addition, the respondent felt that many times, deals that came through intermediaries had been "shopped around," that is, had already been presented to multiple investors in the same form. The clear preference among our respondents was to build strong personal networks by building trust (e.g., through information exchange, pro-bono work, membership in key associations, personal attendance of domestic conferences, and reciprocal action) and a good reputation (depending on multiple factors, such as the performance of investees, condition of investor–investee relationships, degree of embeddedness in the business community, and long-term interest in the region) such that deals could confidently be referred to the respondent. This kind of "social capital," however, takes significant time and patience to develop and can make things harder for new funds making their initial foray into a region. Some funds used the media to attract deals. One noted that one of their best marketing tools was contributing articles to newspapers or publicizing their investments, which would lead to potential investees contacting them.

On average, the funds ended up investing in only about one out of every hundred deal opportunities. The issue of time in getting deals to financial close was often raised. One respondent noted, "It takes long to build the first deal. You need time to network so that you can move; the first deal is a big thing in this case. People need to know if you are serious." The respondent proceeded to explain that although it is in the investor's interest to put in the work in order to help increase the value of the company ahead of the exit, entrepreneurs looked at this differently. The majority knew they needed help to build up their businesses and took this positively, but others perceived it as the investors meddling. As such, the respondent noted that the buy-in of the entrepreneur is critical from the start.

As for investment instruments, we found that investors used instruments similar to those used in developed markets—with several alterations. One of the accelerators we spoke with, for instance, offered training, coaching, business development, and support services to a cohort of ventures but did not take a stake upfront. Instead, at the end of the accelerator period, the investors selected the most promising ventures

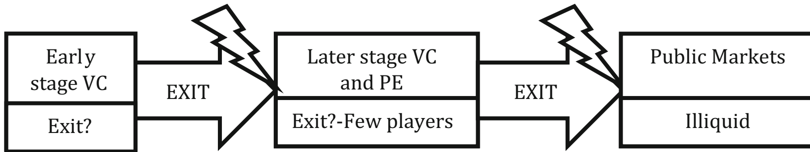

Fig. 14.1 Challenges in the current exit environment in East Africa

and converted the value of their support to a predetermined shareholding if the investee company was able to raise funds in a specified amount of time. Another interesting model we found was revenue-based financing, in which the investor took a royalty on sales as part of the return toward debt repayment until the debt and interest were paid off. Structures such as these ensure that in case the investment does not perform as expected, the funds can protect their downside risk to some extent.

As for deal flow, our respondents cited the exit as the most challenging aspect of investing in East Africa. Although trade sales and sales to strategic buyers were the most promising exit avenues in the market, it was pointed out that there were not many big firms locally that were in the market for acquisitions. Illiquid public markets have further added to the exit challenge, in the sense that without a final exit through public markets, the chain has no termination point for larger investors to harvest value—which creates a scarcity of buyers for VC projects (see Fig. 14.1 below).

Discussion

Venture funding in developed markets, particularly in the West, has several decades of history behind it (Gordon 2012; Hsu and Kenney 2004). VC and PE activity in East Africa, by contrast, is a very recent import and is still in its formative stages. The Western model has been refined, as it were, over the years and decades through the experiences of practitioners and other stakeholders, such as policy makers, to suit the context and characteristics of venturing in that context (Ferrary and Granovetter 2009). Further, the model has seen widespread uptake and been exported beyond the areas of its origins. However, its application in new contexts

is not guaranteed to succeed, given the new contexts' potentially unique dynamics, especially in terms of the nature of local entrepreneurship,[1] as we shall see shortly in the case of East Africa. Indeed as our respondents noted, there are substantial difficulties with the application of the Western partnership-based fund model in its strict form in the East African context. Compensation structure (Gompers and Lerner 1999; Litvak 2009) and fund life were particularly called into question.

We found that a lack of significant amounts of local participation in venture funding has been a major constraint for the industry. Probable local investors tend to prioritize for security and to be averse to risk and the unknown. Yet they have a much better grasp of local dynamics and could be of great value both on the investor side and the entrepreneur side. On the investor side, local investors can bring local know-how and understanding of the local norms and nuances of doing business as well as the long-term view needed for VC and private capital. Furthermore, they can add to the perception of the fund's local credibility, enhancing trust among local entrepreneurs. On the entrepreneur side, local investors, particularly those who have been successful in business in the past, can bring local market knowledge, contacts, and business linkages (Mäkelä and Maula 2008). This kind of support is especially critical for inexperienced early-stage founders and would be hard for a purely foreign player to match.

In contrast to US pension funds, East Africa's pension funds scarcely invest in VC. But it appears that commercial banks may be starting to dabble in it (Black and Gilson 1999). In the recent past, we have seen some commercial banks in Kenya getting involved in the tech start-up arena through partnerships (e.g., Chase Bank with the Nairobi Innovation Hub [iHub] [Jackson 2015a; Chase Bank 2015] and Barclays Bank, which has run an accelerator for financial technology start-ups in collaboration with a VC investor [Jackson 2015b]). We see this as potentially pointing to possible involvement in VC at some point, and we foresee that pensions will remain skeptical about VC in the short to medium term. Positive returns from the earlier-mentioned investment by two pension funds in Ascent Capital could, however, stimulate more interest by pension funds.

[1] See Bruton et al. (2004) for a similar study in East Asia.

Cost and ease of doing business in East Africa have clearly been impediments to VC funding. These factors vary quite significantly across the individual countries in the region. According to the 2015 World Bank Doing Business Ranking (World Bank 2015), Rwanda, Kenya, Uganda, and Tanzania ranked 62nd, 108th, 122nd, and 139th globally, respectively, in cost and ease of doing business. In terms of enforcing contracts, Tanzania ranked 64th, Uganda ranked 78th, Kenya ranked 102nd, and Rwanda ranked 127th. For investors hungry for deal flow and scouring the region to find deals, this situation can be daunting. Corruption presents itself as another major stumbling block, adding to the cost and complexity of doing business (Smarzynska and Wei 2000). Moreover, the East African bloc is a combination of five countries with different norms, legislation, and entrepreneurial cultures (Autio et al. 2013). This means that VC and PE focusing on firms in the region need to open local satellite offices or incur significant travel costs that further increase the costs of doing business.

The region's rather lengthy lag times between identifying and making an investment can be partly explained by a lack of trust and understanding of VC and PE on the part of entrepreneurs. In a market where investors—mostly foreign capital—are seeking local entrepreneurs, investors need to take time to "court" entrepreneurs and convince them to accept capital, not least because business owners in the region are more familiar with and accustomed to financing their work through commercial loans instead of VC. In addition, we have seen that a number of businesses that investors get involved in tend to need a lot of work to bring them up to standard in terms of effective operations and governance. The need for business support is a crosscutting feature of businesses in East Africa (Omidyar 2013), not just those that receive VC. However, with a lack of alternatives to provide such support, investors are placed in a situation where they have to take over this role in order to help develop the venture for future exit. This creates additional demands on the fund manager's time that could otherwise have been spent on other aspects of running the fund. It also requires a more active engagement by the fund manager in potential investees and a broader knowledge base to go beyond purely administering an investment fund. When the fund manager opts to bring in professional consultants, even more additional costs are incurred, further straining management fees.

The need for heavy post-investment involvement means fund managers getting in the market have to be prepared to play roles that go well above and beyond the call of duty for their typical role. They have to take on tasks related to coaching, mentoring, and training—becoming, in other words, enmeshed in the operational activities of their portfolio companies and significantly blurring the lines between investor and investee. This has an impact in turn on the composition of the fund's team. Compared with typical fund teams in mature markets, funds operating locally require people with operational business skills and immense contextual market knowledge; the alternative is to hire consultants. However, involvement in investee operations can create the potential for conflicts with entrepreneurs who are only interested in the fund's money, wishing to run their businesses as they see fit and to avoid the perception, especially among start-ups, that equity investors will take away their control in the firm—with the result that they become skeptical of VC.[2]

In our opinion, the lack of an exit avenue to public markets will remain the case in the short to medium term. According to data compiled by PricewaterhouseCoopers (2014), Kenya's stock market, the largest by market capitalization in the East Africa region, had only five initial public offerings from 2010 to 2014, raising a total of USD157 million; Tanzania had four, raising USD16 million; and Rwanda and Uganda each had only two raising, USD91 million and USD69 million, respectively. Some exchanges, such as the Nairobi Securities Exchange, have introduced market segments targeted at small and medium enterprises with lower and less stringent listing thresholds, but these have yet to really kick off and become vibrant enough as exit avenues. Liquid stock markets will draw in larger investors that will create demand from earlier VC (Black and Gilson 1999). As more multinationals seek entry into markets across Africa, investors that position themselves strategically through their holdings could find potential buyers (see Fig. 14.2 below).

On the other hand, VC is driven by the supply of high-quality entrepreneurship, creating a steady pipeline of deals for venture funders. The

[2] See De Clercq et al. 2006 for a fascinating overview of the VC's world through the lens of the entrepreneur, and Collewaert and Fassin 2013 on the possible conflicts in investor–investee relations.

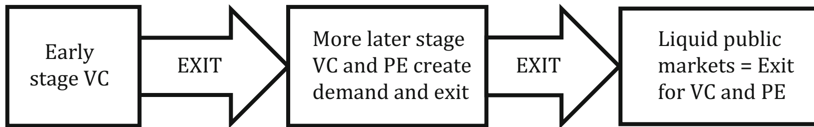

Fig. 14.2 A functioning exit environment

region is not lacking or behind the curve in entrepreneurial dynamism, as evidenced by Kenya's noted "hustling" culture, in which one can often have a full-time job and one or more other income-generating activities (usually not formally organized businesses) that are pursued on a deal-by-deal basis (Simons 2012). Much of the entrepreneurship that exists in the region (as in much of the rest of Africa) for those in "full-time" entrepreneurship, is characterized as necessity entrepreneurship (Giacomin et al. 2011), that is, as a means of survival and a way of earning an income, having failed to secure other means of making a living or supplementing one's income—as distinct from conventional entrepreneurship driven by the identification of an opportunity (Omidyar 2013). Muller and Amit (1995) referred to "push" versus "pull" entrepreneurship: Push entrepreneurs start ventures out of some kind of dissatisfaction with their current state, not as a result of their entrepreneurial spirit. Pull entrepreneurs are motivated by the attractiveness of the new venture in and of itself. Muller and Amit concluded that pull entrepreneurs are more successful than push entrepreneurs. The latter, thus, do not create opportunities as valuable for VC as intentional, opportunity-driven pull entrepreneurship does.

The problem of entrepreneurship supply is really about developing a culture of entrepreneurship, specifically the propensity for risk taking and a tolerance for failure. Nothing short of more and better-quality entrepreneurship will provide a lasting solution to the challenge of deal flow. This new kind of culture cannot emerge instantaneously. Cultures develop over time, and once entrenched are difficult to alter. The fact that entrepreneurship as a career seems to have gained general acceptance (Omidyar 2013) is encouraging. However, the hallmarks of entrepreneurship culture—again, the propensity for risk taking and a tolerance for failure—have yet to emerge sufficiently across the board. A larger and better supply of entrepreneurs will bring down costs for

investors as they have to expend less time and money to find suitable investees. Better entrepreneurship will also mean that investors will not need to be so highly involved in their investees' businesses, cutting costs further.

In a bid to bridge access to finance, governments in the region have taken initiative to create funds—usually subsidized loan funds such as Rwanda's Hanga Umurimo (meaning "create your own job") Fund, the Uwezo (meaning "enable") Fund in Kenya, and the National Entrepreneurship Development Fund in Tanzania—to support entrepreneurs. However, we feel that their efforts would better be directed at initiatives that provide entrepreneurs business support, emphasizing practical entrepreneurship skills in curricula and adapting education systems to develop entrepreneurialism in students from an early age. In fact, some have already questioned the possible role of such subsidy programs in eroding—rather than promoting—the entrepreneurial edge of beneficiaries.[3]

Thus, we find VC in East Africa in a dilemma: on the one hand, a limited supply of high-value deals and, on the other hand, a challenging exit environment. Compounding this dilemma are the issues of time, cost, and lack of local capital providers for VC investing. Figure 14.3 summarizes these challenges for VC in East Africa.

Recommendations

While the general idea of a partnership-based fund may still hold in East Africa, the specific characteristics of the partnership—the management fee percentage, carried interest, fund life, team composition, investment instruments, and so on—do not necessarily apply in the same way across different contexts. Nevertheless, this is the fund structure that foreign LPs, which constitute the main source of investment funds in the region, are familiar and comfortable with. Altering the modalities of the structure significantly might be desirable but is not feasible in the immediate term.

[3] See http://www.newtimes.co.rw/section/article/2014-09-18/181038/ for an intriguing recent article on whether government gives too much to start-ups.

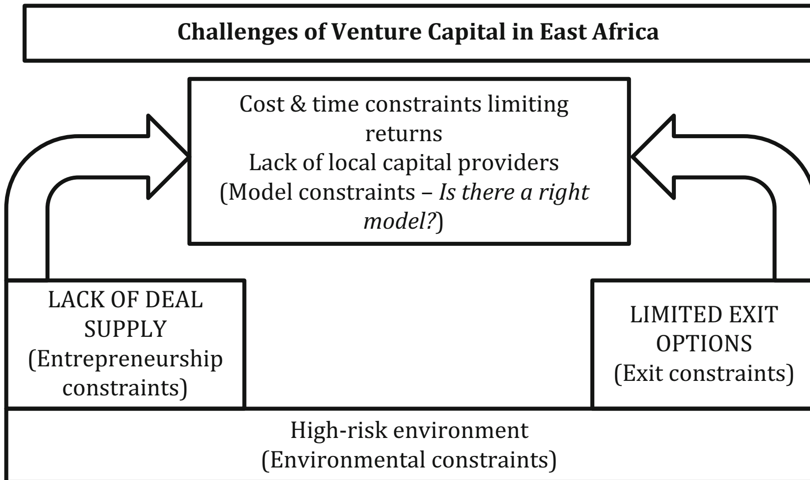

Fig. 14.3 The dilemma of venture capital in East Africa

As such, we recommend that fund managers *adopt a lean*, *start-up–like mentality of frugality* and maximize resources as best as they can to operate effectively in the region. Joint ventures between funds investing in the same sectors can increase their geographic coverage, split the burden in terms of cost and effort to find and make investments, and potentially help them get into bigger deals. This can be a good strategy for investors coming into the market for the first time, because it can help reduce the time it takes to close their first deal.

Fund managers should also *consider alternative structures*: evergreen funds where the fund has an indefinite fund life and a periodic inbuilt liquidity event to cater to LPs who would like to exit and to management, to calculate carried interest. Evergreen funds also have the advantage of keeping the gems in the portfolio within the fund while doing away with layered management fees that can be quite costly for the LP. Another structure that could be pursued to address the time issue is the setting up of investment holding companies in which capital providers can buy shares. As indicated earlier, there would be no management fees or exit stipulations. Fund managers would be remunerated as the company's agents, and the holding company would hold investments as long as it deems necessary and exit at the opportune time.

In terms of encouraging local capital, we see great potential in *bringing corporations into VC* either as suppliers of capital to funds or through in-house managed funds. As it stands, established firms in East Africa are not known to be very active in corporate venturing. Safaricom Limited in Kenya has been a pioneer in this direction, having set up its Safaricom Spark Fund that focuses on investments in tech start-ups.[4] We envision that established corporations investing in and working with young enterprises could bring in the rigor of administering an established enterprise. Furthermore, the enterprises could gain competitive advantage from being exposed to the corporation's internal resources and market. For the corporation itself, the innovation associated with start-ups could result in new product lines. Second, local savings and investment groups, known as chamas, could be another source of capital.[5] Some chamas command sizeable funds that could be directed to VC activity. The challenge with the majority of chamas is their lack of investment sophistication; most stick to the well-understood areas of real estate and stocks, security being more attractive to them than high returns. The long-term horizon of VC investments does not sit well with chamas either. That said, structuring funds as investment holding companies, as suggested earlier, could be attractive to chamas, because the idea of buying shares in a holding company is familiar, and in fact some larger chamas attract members by issuing shares in the group.

We see also two additional interesting avenues that could be explored to improve the entrepreneurship supply: *introduce venture builders and search funds*. Venture builders are outfits that create start-ups internally using shared resources, develop them, and then spin them off (as distinct from accelerators, which solicit external entrepreneurs and ventures). We are familiar with at least one venture builder—Brave Ventures—that is in its formative stages in Kenya.[6] Search funds, by contrast, have investors in the fund financially supporting an entrepreneur's efforts to locate, acquire, manage, and grow an existing privately held company. To our knowledge, there is only one active search fund in the region (Kolarova et al. 2014). However, these two avenues cannot really create new entre-

[4] See http://www.safaricom.co.ke/spark/ and http://disrupt-africa.com/2015/11/sendy-named-1st-safaricom-spark-venture-fund-investee/

[5] For a comprehensive review, see KAIG (2014).

[6] See https://braveventurelabs.com/ for more details.

preneurs at scale. Only a thriving opportunity-driven entrepreneurship culture will produce the kind of deal flow investors are looking for.

On the matter of exits: Funds could explore *weaving in self-liquidating securities*. A fund could, for instance, invest in a mix of high-interest-yielding loans and equity. This would ensure that the equity portion does not need to exit at significant levels for the target returns to be met (hence increasing the likelihood of exit) while at the same time, returning some cash to the investors before the final exit event. Gilson and Black (1999) suggested that a solution for the lack of active local stock markets for VC to exit to, while avoiding the time and effort needed to develop local markets, would be to turn to external markets in the way Israeli ventures have found an avenue through US capital markets. In the same manner, creating avenues for East Africa's ventures to *list on more mature stock markets on the continent*—such as the Johannesburg AltX—could be worth exploring.

In terms of future research, we feel that the cultural effects of investing in East Africa need further investigation. In particular, the Kenyan hustling culture described earlier has been a stumbling block to foreign investors, who feel that entrepreneurs should be ready and willing to drop everything else in order to focus 100 % on their venture—an obstacle that has also turned many entrepreneurs away from seeking investment, knowing that this would be required of them. (See Eskor John's chapter in this book on portfolio entrepreneurship.) The issue is further compounded by the fact that foreigners are quite active and getting more so over time in Kenya's start-up scene. This is inevitable in a globalized world. Foreigners come with a knack born out of experience for identifying and seizing opportunities and, through established networks, gathering the resources to launch and grow ventures—easily bypassing locals. If some of the stumbling blocks to the development of a vibrant start-up ecosystem are cultural in nature and changing culture takes time, how will local founders stack up against their counterparts who are coming in with the skills and experience?

Another area that could be investigated further is the intermediaries' space—that is, which aspects of VC are most in need of intermediation and how can this be developed? A strong intermediary network would, for instance, shorten the amount of time, effort, and associated cost

required by investors to source for deals. Yet another aspect that could be interesting to research further would be to benchmark the risk profile for investing in East Africa against that of other markets and those of the individual countries. Is it generally more risky to invest in Tanzania or in Uganda, for instance? And if so, why? And how can the risk be minimized? This can help investors better focus their efforts and help governments make better interventions to promote entrepreneurship and VC.

Conclusion

To summarize: We found that the high cost of operating a fund in the region and the length of time it takes to make an investment are the topmost concerns among fund managers. Further, fund managers are called upon to take on roles, such as acting as a mentor and business coach to investees, that are not typical of fund management. Fund managers have to expend their own time or that of their staff to support investees or spend money to hire consultants to do so. The dearth of local investors in VC stood out, and we noted that the industry would be better off with more of this. In addition, the surrounding issues of deal flow and exit were identified as being pertinent. These may not be exactly in the realm of the "right model" in terms of fund structures, but they inevitably have an impact on what structure works best. We also found that the industry is heavily dependent on social networks rather than intermediaries to source investments.

We conclude that the key aspects needed to increase the chances of success for existing funds and new classical partnership-styled funds making their initial foray into the region are the following: Fund managers need to adopt a lean, start-up—like approach to fund management and investing, gain a keen understanding of and take into consideration the nature of entrepreneurship in the region, and be ready to take on a far more active role in the business than fund manager typically do—while maintaining amicable relations with the founders and owners. Further, we recommend that fund managers explore new structures to circumvent cost and time constraints, such as investment holding companies and evergreen funds. To tackle the issues of deal flow, we propose that governments in the region should

focus on entrepreneurship education and business, instead of on providing subsidized loans. We drew attention to venture builders and search funds as having potential to create investment-worthy ventures. As to successful exits, we proposed opening up avenues to more liquid markets by way of external markets, much as Israeli ventures have found an avenue through US capital markets, as a way of circumventing illiquid regional markets.

In the end, then, *is there a right model for venture funding in East Africa*? Not yet. But we believe that it will emerge in the years ahead—as VCs continue to learn to adapt to the context and take into account the unique characteristics of venturing in the region.

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Conversation #14

Creating the PayPal Mafia of East Africa

Ben Lyon of Kopo Kopo

***Ben Lyon** co-founded Kopo Kopo in 2010 and sits currently on the Board of Directors. Earlier, he studied economics and international studies at Rhodes College in Memphis, Tennessee, where he specialized in informal economics and microfinance. Ben has served in various roles while at Kopo Kopo, from Head of Product to VP of Marketing and CEO. He has operational experience in multiple markets throughout Sub-Saharan Africa and Asia. Find Ben on Twitter @bmlyon, and check out his company at www.kopokopo.com.*

What is the story behind Kopo Kopo? And why did you decide to start in Kenya?

We—Dylan, Tom, and I—co-founded Kopo Kopo five years ago in Seattle, Washington, as a Delaware C corporation. Dylan and I moved to Nairobi in late 2010 and lived here for four years.

The reason we came here was because of the ubiquity of mobile money. Our background was all in microfinance, and we had a hunch there was a business angle and a microfinance angle in mobile money that hadn't been fully exploited. Today that's different, because almost all microfinance institutions (MFIs) in Kenya use mobile money for disbursement and collection to some degree.

In our early days, we wanted to help MFIs integrate mobile money with their core banking systems. We quickly found that this wasn't the best idea—the reason being that microfinance systems and processes aren't standardized. MFIs can take ages to make a business decision, and they are highly bureaucratic and risk-averse, so they don't change. Change is a frightening thing, so they are using lots of disparate legacy technologies, and there isn't a real understanding or desire to fundamentally change that technology to catch up with the times.

Would you say that's only typical for the MFI sector or for most SMEs in Kenya?

It'd be most SMEs. Fiber cables just came a few years ago, and so the Internet hasn't fully reached all businesses yet, but you do see this massive growth in Android devices and 3G connections. MFIs are not at the front of the adoption curve. They are not your early adopter. We found this quickly and pivoted to focus on retailers. By retailers, we mean a barber shop, a salon, a general trader, somewhere where you're paying for goods and services to the person in front of you.

In early 2012, we launched as the world's first merchant aggregator of mobile money services. In essence, we were to Safaricom's M-PESA what Square was to Chase Paymentech in the U.S.

Safaricom is the issuer of M-PESA (Kiswahili for "mobile money"), the largest mobile money service in the world. When we entered the market, the majority of Kenyan adults had M-PESA on their phones, but less than one percent of businesses formally accepted it. So imagine if you were walking around with a payment card in your wallet but you couldn't find anywhere to pay with it. The utility of that card would be diminished significantly. So we said to Safaricom, "Let us help you acquire merchants so people can pay for everyday goods and services with M-PESA." We were the first to do that in the mobile money industry, and we are currently the largest third party doing it.

Why did you decide to incorporate in the U.S.?

We incorporated in the U.S. because we are Americans and planned to raise money from U.S. investors. For tech startups in the U.S., you either incorporate in your home state, in the state of your investor(s), or in Delaware as a C corporation. For a U.S. technology investor, that's kind of the gold standard. So all lawyers in the U.S. are educated or taught on Delaware Case Law. C corporations can raise money from local and international investors. They have good board protections etc. So because we were raising money in the U.S., we incorporated in Delaware and have a branch in Kenya rather than a subsidiary. All of our shares are domiciled in Delaware, and that's again for investors. If we had a subsidiary, then we'd have shares sitting in Kenya, and that can complicate things in an exit.

The company was designed to be enticing and relatable to the investor and also kind of designed from the beginning as a technology company to be prepared in the event of an exit. So if someone wanted to acquire us, if we wanted to list on a stock exchange, that's how investors get their money back. If you want to get investment, you have to be prepared. It's not just what's the product, what's the opportunity, what's the problem you solve, or how big is it? It's also, how will I get my money back, and how long will it take, because they are not charitable organizations. So if they invest in you, on year three of their funds, they have seven years to get their money back. And so they are thinking in terms of an exit timeline from the very moment you shake hands. So you need to have a structure that accommodates that.

How about your employees? How do you engage them?

Building Kopo Kopo is a mission, not a job. And by mission, I mean a higher calling—something both important and meaningful that is greater than our individual selves. We wanted a compensation package that reflects that, and we wanted everyone to be aligned toward the same outcome. Every employee has a stake in the company's future—engineers, sales personnel, drivers, janitors, *everyone*.

The way it works is that every new employee signs an Employee Stock Option Agreement that entitles them to purchase shares at a strike price in the event of an acquisition or IPO. We also pay competitive salaries, so there aren't any real trade-offs. It's the best of both worlds.

Some time back I heard you talk about the "PayPal Mafia of East Africa." What makes it so valuable?

Silicon Valley is both ecosystem and mindset. The ecosystem is a function of mature capital markets, supportive institutions, and experienced entrepreneurs. It's common to see successful entrepreneurs in Silicon Valley become investors, and for good reason: They offer capital and, more importantly, empathy and expertise. Look for example at all of the consumer Internet companies you know today, the big ones, Facebook, Twitter, Foursquare, etc. Most of them have PayPal employees invested in them. So when PayPal IPOed, it made a huge number of millionaires, and now those employees are seeding entire generations of investment and starting new companies. You see it in 500 Startups, too. I mean, it's all over the place—Peter Thiel with Palantir, Elon Musk with SpaceX and Tesla. These are all PayPal people. We want to see that same ecosystem develop in East Africa.

Specifically, we talk about building the "PayPal Mafia of East Africa" because we want our team to become the first batch of entrepreneur-investors in the region. Their experience building a company and withstanding the ebbs and flows of entrepreneurship are a real and lasting asset.

What's happened here so far is that different parts of the ecosystem are developing parallel to one another. You have the incubators like iHub,

Nailab, iLab Africa, m:lab East Africa, and all the accelerators. You have angel investors starting to come from other markets. And this is all happening at the same time. What hasn't happened yet is there haven't been many successful exits from the technology community because it's so young. And because of that, you don't have many first-generation tech entrepreneurs that are wealthy enough to invest in the next generation. So we need a big exit, and then we need the members of that community to become the PayPal Mafia. That's the missing element.

Five years from now, I'd love to see our earliest employees behind the biggest startups on the continent. That's my personal vision of success.

How essential are investors from Africa to realize that vision?

I don't think it's about creating African investors or Silicon Valley investors or European investors. I think it's about learning a skill and paying that skill forward irrespective of region or nationality. We built a company from the ground up in Nairobi. That's what we know. As we've grown, we've seeded partnerships and cut our teeth throughout the continent. So I'm not on a mission to create "African investors"—I'm on a mission to create entrepreneur-investors that know their markets better than anyone else.

Should ICT ventures aim at becoming strategically valuable for a foreign buyout, reach for an international IPO, or simply not worry about it because other things matter? What is your strategy?

There's a saying that "companies are bought, not sold." I think that's true. Our main priority has been to build a big, defensible company. With defensible I mean that we're in the business of digging moats to protect our castle from attack. A company that is not defensible cannot withstand attack, or direct competition. In other words, to be defensible means that you have to capture a market segment quickly, patent some kind of unique IP, or jump over a material barrier to entry. Defensible companies are hard to replicate or attack.

We've made mistakes along the way in terms of prioritizing incorrectly. For example, we scaled prematurely. Specifically, we hired for the business

that our projections said we would have, not the business that our cash position dictated we actually had. We spent too much too quickly, and then we missed our targets. Another example is that we should have hired a chief financial officer or head of finance as early as 2013 or 2014 but only filled this role in late 2015.

In retrospect, I think we would have been more successful in the capital markets, if we had someone strong in the finance role. Despite these setbacks, our strategic goal has always been to build a big, defensible company. If you do that correctly, then there's a ready exit path.

How have you managed the tension between openness versus closed-ness when it comes to broadcasting information about your company?

We've probably been *too* open, insofar as we've always broadcasted our work. We've blogged about our work on the Kopo Kopo blog. We've also shared insights through industry blogs (e.g. CGAP, GSMA, and FSD Kenya). We've also talked about many of our insights and findings at industry conferences around the world. On the one hand, we've had a number of competitors try to replicate our ideas. On the other, the global industry knows and looks to our work. So it's hard to tell if our openness has been an asset or a liability. In general, though, it's who we are—it's in the DNA of our company.

What are some of the not-so-obvious risks you can get into when running a business in Kenya?

Risk is a relative term. It's important to understand the day-to-day context of your customers, employees, and partners. Growing up in the U.S., my idea of risk was relatively limited, and I mean this in the literal sense. We lost a friend in the 2013 Westgate Mall attack, and one of our board members was murdered in Nairobi in 2014. My wife and I also repelled or escaped repeated home-invasion attempts and a carjacking in 2014. As a result, I now think about security every single day. Growing up in the U.S., I never had to be so conscious of

physical security. We often talk about the relationship between risks and rewards. To be clear, there are real and significant risks to operating a business in an emerging market. Things don't often go south, but when they do, they go south quickly! That's a realization that inspires humility and patience.

Thank you, Ben!

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