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Survey of the Kenyan Private Equity and Venture Capital Landscape

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Abstract

This paper discusses the landscape for private equity and venture capital financing in Kenya. It provides an overview of the private equity and venture capital market in the country, describing key players, including funds, fund managers, investors, and public sector entities. The paper provides an analysis of key market drivers and impediments, as well as legal/regulatory/taxation drivers and impediments that affect Kenya's private equity and venture capital industry.

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Survey of the Kenyan Private Equity and Venture Capital Landscape[1]

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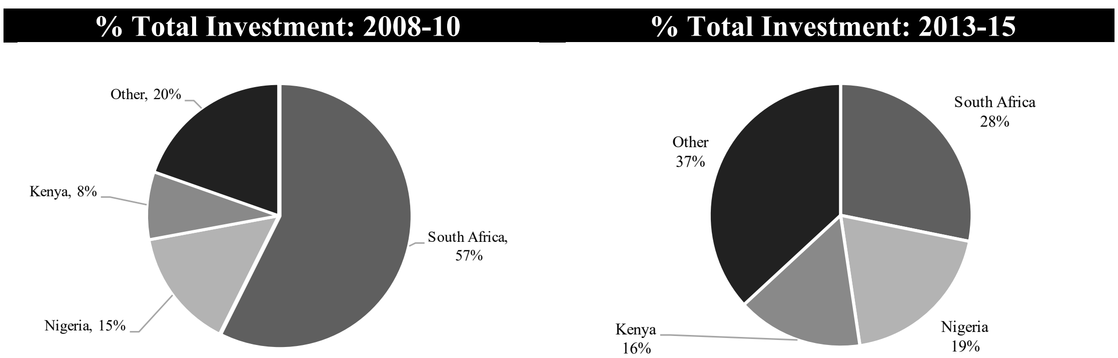
I. Recent Evolution of the Private Equity and Venture Capital Industry

A. Industry Overview: Kenya in Context

Less than a decade ago, the fledgling commercial private equity industry[2] in Africa was largely confined to and based out of Southern Africa. From 2008 to 2010, nearly 60 percent of investment in Sub-Saharan Africa was destined for South Africa, with regional hubs like Nigeria and Kenya trailing far behind in terms of both market share and mind share. Then, aided by continent-wide resilience in the aftermath of the 2008 global financial crisis, the region's growth story attracted an influx of private equity investors to Africa. These new entrants looked beyond the increasingly crowded South African market to explore other sub-regions and countries on the continent (Figure 1).

Figure 1: Distribution of Sub-Saharan Africa PE Investment by Value



Source: EMPEA

Within this context, East Africa, and particularly Kenya, has become an increasingly important destination for private equity investors. Beyond offering relative regulatory stability, Kenya has long been known for its private sector-led economy, and for the sophistication of the business environment, both in an absolute sense, but particularly relative to the other economies of East Africa. In addition, Kenya boasts a strong entrepreneurial class and benefits from a good supply of human capital, both local and international. Thus, when private equity interest migrated from South Africa into the rest of the continent, Kenya captured a disproportionate share of the activity, both in terms of deal flow and funds. Although it is just the third largest country in East Africa by population, and the seventh largest economy in Africa by nominal GDP, Kenya's standing in the alternative investment industry in Africa is notable. The country now ranks third behind South Africa and Nigeria in terms of private equity transactions in SSA: PE funds invested more than US$750 million across nearly 50 deals based in Kenya from 2013-2015.

[2] Note, for the purposes of this report, private equity, when referred to and discussed as an industry, is inclusive of venture capital as well.

Table 1: Sub-Saharan Africa Deal Flow by Country (2013-2015)

	2013		2014		2015		Total		Total	
	# of Deal	Capital Invested (US$M)	# of Deals	Capital Invested (US$M)	# of Deals	Capital Invested (US$M)	# of Deals	%	Capital Invested (US$M)	%
South Africa	24	368	22	418	25	586	71	21.3%	1,372	28.2%
Nigeria	14	176	17	614	20	159	51	15.3%	949	19.5%
Kenya	**15**	**629**	**22**	**22**	**11**	**104**	**48**	**14.4%**	**755**	**15.5%**
Ghana	7	25	15	179	8	6	30	9.0%	210	4.3%
Cote d'Ivoire	7	14	4	38	2	N/A	13	3.9%	52	1.1%
Other	43	715	45	631	33	187	121	36.2%	1,533	31.5%
Total	110	1,927	125	1,902	99	1,042	334	100.0%	4,871	100.0%

Source: EMPEA

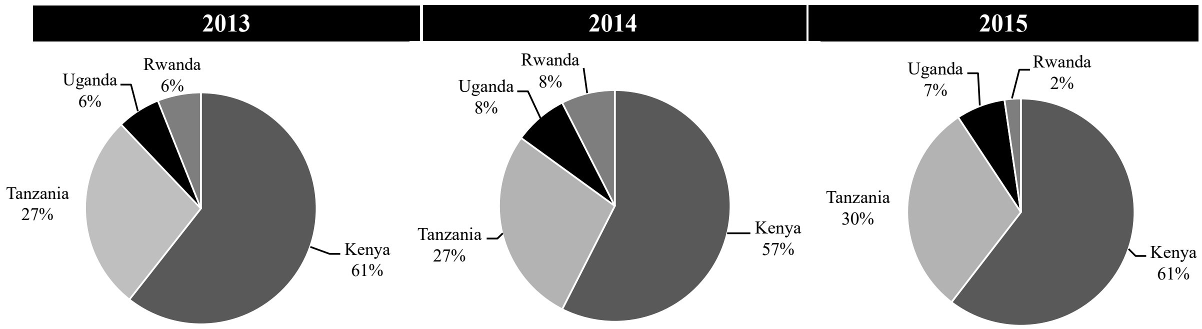
Kenya offers clear advantages for fund managers seeking to target East Africa. The country's capital, Nairobi, is viewed as the most attractive location in East Africa from which investors can establish offices and cover the region. This advantage makes the city the de facto alternative investment hub of East Africa, and places it alongside Johannesburg and Lagos as the investment capitals of SSA. Investors who choose to establish themselves in the city note that they have done so based on quality of life, a solid foundation of human capital, efficient transportation links, and a strong community of service providers such as accountants, lawyers, and consultants. For these reasons, Nairobi is also home to the East Africa Venture Capital Association (EAVCA), an organization that was set up in March 2013 to advocate on behalf of VC and PE investors.

Moreover, Kenya serves as a launch pad for investors to execute cross-border investments in companies that operate within the East African Community. The EAC, which comprises six partner states (the Republics of Burundi, Kenya, Rwanda, South Sudan, Tanzania, and Uganda) has pursued legal and trade harmonization in an attempt to support regional commerce and cross-border expansion by businesses in these markets. Given Kenya's membership in the East African Community, basing an investment firm in the country offers a fund manager the possibility of "regionalizing" local businesses and taking advantage of the EAC's cross-border regulations and commercial policies.

Pursuing regional integration also makes commercial sense. Although Kenya is the largest, most advanced economy in the region, it is easier to reach scale and attract the interest of strategic acquirers by building regional businesses that leverage the EAC market. While Kenya has a population of 45 million and a GDP of US$65 billion, the population of the EAC is estimated at 150 million and its GDP is US$146 billion. Many firms include regional aspirations in their investment theses when investing in companies that are already present in one part of the EAC region. Leveraging the political and economic links forged by the EAC to do so makes a regional approach even more compelling. At the same time, funds operating in Kenya must take regional legal and regulatory factors into account in addition to navigating those in Kenya. In this sense, Kenyan fund managers often operate within a regional legal and regulatory context.

With a significant population of investment firms resident in the country, Kenya sees more deal flow than elsewhere in East Africa. On a stand-alone basis, Kenya also benefits from secular trends - rapid urbanization, a growing workforce, ongoing technological evolution, and sustained consumer and business spending - that also support a Kenya-led private equity investment thesis. Kenya consistently captures the majority of deals in East Africa. As shown below in Figure 2, Kenya dominates the East Africa sub-region in terms of deal volume.

Figure 2: East Africa Deal Volume by Country (2013-2015)



Source: KPMG/EAVCA

As Kenya has taken a more prominent role in the African private equity landscape, the size of transactions has grown. Prior to 2007, there were no reported private equity deals with a ticket above US$5 million; from 2010 to 2014, however, there were 23 deals (29 percent) in which the investment amount totaled between US$5 million and US$10 million, while seven deals exceeded US$10 million. This increase in transaction size reflects a maturation of the market, the arrival of pan-regional players such as ECP and Helios that invest in much larger transactions, and investor confidence that they can find and fund regional champions that are based in Kenya.

The entrance of well-known regional or global players such as Emerging Capital Partners (ECP) and Helios is part of the ongoing growth in the number of private equity firms operating in Nairobi in the last five years. When the EAVCA was established in 2013, the group comprised just seven founding member firms. Today, it boasts 60 members (including service providers), of which approximately two-thirds have operations in Kenya.[3]

B. Industry Overview: Private Equity, Venture Capital, and Impact Investment

The funds that constitute Kenya's VC/PE industry can be divided into distinct groups. First, there are private equity funds. PE funds operating in Kenya may be classified based on their geographic targets: global (e.g. The Carlyle Group, Abraaj,[4] Actis), pan-African (e.g. Helios, AfricInvest, and ECP), and East African (e.g. Phatisa, Fanisi, Kibo). Second, there are venture and seed capital funds, such as Novastar and Safaricom Spark. Finally, there are impact investment funds, such as Grassroots Business Funds and Acumen Fund. The market for each of these investment types - private equity, venture capital, and impact investing - is profiled below.

Private Equity Funds

Private equity funds invest in businesses ranging from SMEs and family-owned businesses through to large

[3] This figure includes services providers such as lawyers and accountants.

[4] Following completion of this report, the Abraaj Group and its fund management business entered a court-supervised liquidation process in the Cayman Islands in June 2018. The appointed liquidators and investors are in discussions about the future of the Abraaj funds, including the potential entry of replacement fund managers.

pan-regional businesses that operate in Kenya, in East Africa, or across the continent. Global funds operating in Kenya are those firms that have worldwide operations (they are based-in and operate in geographies outside Africa), but also have dedicated teams and funds for Africa. Pan-African managers operate across SSA and may also have a presence in North Africa. East African firms typically focus their activities on member countries of the EAC (Burundi, Kenya, Rwanda, South Sudan, Tanzania, and Uganda) and often consider investments in Ethiopia as well. At present, there are no funds of note that operate solely in Kenya.[5]

Table 2: Representative PE Fund Managers Active in Kenya

Private Equity Fund Managers		
East Africa	**Pan-Africa**	**Global**
Ascent Capital Partners	Africinvest	Abraaj Group
Catalyst Principal Partners	Emerging Capital Partners	Actis Capital
Fanisi Venture Capital	Helios Investment Partners	The Carlyle Group
Centum Investment	Kibo Capital Partners	KKR
Transcentury	Phatisa Fund Managers	
BPI East Africa	Progression Capital Africa	
	TBL Mirror Fund	

Source: Primary Research

In addition to geographic focus, firms may also be classified in terms of the size of their typical investment in a target company, which in turn often correlates to the growth stage of the company that is receiving investment. The funds shown in Table 4 below target investments in the following ranges: investments of US$1-5 million (TBL Mirror Fund, Fanisi, GroFin), US$5-20 million (e.g. Catalyst, Ascent); and $20-100 million (e.g. Helios, ECP). Investments at the small end of the scale correspond to the lower end of the SME spectrum while larger SMEs or mid-market growth equity deals require investment tickets ranging from US$5 million to US$20 million. Investments above US$20 million correspond to large growth equity opportunities, regional roll-ups, buyouts or acquisitions of minority stakes in large and established businesses.

[5] Acacia, a locally-registered Kenyan schilling-denominated fund that was Kenya-centric was established in 1996 and wound up in 2017.

Table 3: Representative PE Fund Managers by Target Investment Size

US$1-5M	US$5-20M	US$20-100M+
	Private Equity Funds	
TBL Mirror Fund	Ascent Capital Partners	Abraaj Group
Fanisi Venture Capital	Catalyst Principal Partners	Actis Capital
	Kibo Capital Partners	Africinvest
BPI East Africa	Phatisa Fund Managers	Helios Investment Partners
		Kibo Capital Partners
		The Carlyle Group
		KKR
	Other Players	
	Familiy Offices	
	Chandaria Family	
	Listed Entities	
	Centum Investment	
	Transcentury	

Source: Primary Research
Note: AfricInvest also invests in the $5-20mn category

While many of the firms operating in Africa are generalist in nature, some managers have raised thematic funds focused on a particular investment thesis. Often, such funds are affiliated with established fund managers that are known quantities and leverage an existing track record as part of their fundraising story. AfricInvest raised its first generalist SME fund in 2004 and then raised the €61 million AfricInvest Financial Sector Fund in 2007. FMO served as the anchor investor for the fund with a €20 million investment. Other LPs including Proparco, Bio, the Lundin Foundation, and Desjardins, a Canadian Group, all joined subsequent closings between 2007 and 2014. The fund thesis included investments in less developed countries and post-conflict areas and encompassed greenfield and startup deals. Since these investments require greater time and flexibility than those included in a typical SME fund, AfricInvest expanded the fund's life from 10 years to 15 years. For the AfricInvest Financial Sector Fund II, a follow-on fund to be launched in 2017, AfricInvest has announced that it intends to raise a €100 million evergreen (i.e. permanent capital) vehicle.[6, 7] AfricInvest is also raising the French Africa Fund, in conjunction with Bpifrance, which will target SMEs in both France and Africa seeking to expand among and between these geographies. Investors include Proparco and the Central Bank of Kenya Pension Fund.[8] Another manager, Phatisa, has also raised two thematic funds, the US$151 million African Agriculture Fund, closed in 2010, and the US$42 million Pan-African Housing Fund, closed in 2014. The firm is also currently fundraising for a US$200 million successor fund to the African Agriculture Fund, the African Food Fund II, which will target primary agriculture, primary food processing, FMCG, retail, supply chains, agri-inputs, and packaging. Finally, in additional to its generalist PE funds, global investor Actis Capital has raised three real estate funds since 2006.

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[6] Permanent Capital Vehicles (PCVs) are investment entities that do not have a fixed fund life. They will be discussed in detail later in this report.
[7] Private Equity International (October 28, 2016).
[8] African Private Equity and Venture Capital Association (January 16, 2017).

Beyond the set of traditional private equity funds operating in the space, the Kenyan market includes an additional set of players that operate somewhat differently than traditional PE funds. Development finance institutes (DFIs), family offices and listed vehicles also execute private equity investments and may at times compete for deal flow with the traditional PE fund managers listed. DFIs have long been investors in private equity in East Africa. While they invest in many of the funds in the region as LPs, a number of these institutions, including large players such as the Commonwealth Development Corporation (CDC) and International Finance Corporation (IFC) also invest directly into companies, thus taking on the role of private equity investors themselves. This could pose some concern for PE funds that direct investment by DFIs may compete for deals or crowd out private capital in some transactions. However, the entry of DFIs as investors also introduces the benefits of stringent environmental, social and governance requirements. Beyond DFIs, there are two investment vehicles listed on the Nairobi Securities Exchange – Centum Investment, an East Africa investment company, and Transcentury, an investment and infrastructure company – that invest in SMEs operating in Kenya and East Africa. Additionally, family offices such as that of the Chandaria family, invest directly into both companies and PE funds. While both family offices and listed investments firms in Kenya typically invest in SMEs, they have greater flexibility than PE funds given the fact that they do not report to limited partners. They do not need to comply with requirements in terms of investment size or industry and they do not need to concern themselves with the returns timelines faced by fixed-life funds. Thus, for example, Centum Investments reports that it invests anywhere from US$1 million to US$30 million in a transaction and can hold investments for longer than its private equity peers.

Venture Capital and Impact Investment

Venture capital funds purchase minority stakes in early stage and fast-growing businesses and provide these businesses with capital to fuel continued expansion. They typically invest anywhere from US$250,000 to US2.5 million, often over several rounds. Given the high execution risks associated with early stage businesses, combined with the macroeconomic risks of operating in Africa, venture funds in Kenya are more specialized than private equity firms and there is less capital available vis-à-vis private equity. Still, the country is considered a hub for venture capital in Africa. This position is greatly helped by the fact that Kenya is home to mPesa and Safaricom, both of which are major African technology companies.

Firms operating in the early stage technology and VC space in Kenya include VC funds as well as accelerators. Safaricom Spark Venture Fund (managed by TBL Africa Tech Ventures) is a US$1 million seed fund sponsored by the telecom company Safaricom, which invests between US$50,000-US$200,000 in startups with a presence in Kenya. Novastar Ventures, a US$80 million venture capital fund, invests from US$250,000 to US$1 million per company. It operates a technical assistance (TA) facility financed by the Department for International Development (DFID) and has also received a grant from Dutch Good Growth Fund (DGGF) to fund its operations and ecosystem building exercises in Ethiopia. Notably, although Novastar invests at the bottom of the pyramid and does consider the impact of its investments on larger societal goals, it seeks purely commercial returns.

Kenya is also home to several accelerators that work with entrepreneurs at the earliest stage of their business plan to create and support investable companies. They invest small amounts of capital, provide hands-on mentorship, and facilitate access to potential investors and include: (i) Merck Accelerator, a health care focused affiliate of the global pharmaceutical company that invests up to US$30,000 in innovative companies operating in the health care sector, and (ii) Savannah Fund, a Nairobi-based seed investor and accelerator that invests US$25,000-US$500,000 in startups operating in East Africa and across the continent.

Table 4: Representative VC and Impact Investors Active in Kenya

Venture Capial and Impact Investors		
Venture Capital	**Impact Investment**	
Venture Capital Funds	Regional Funds	Global Funds
Novastar Ventures	Grofin Africa	Acument Fund
	Mango Fund	Grassroots Business Fund
Seed Funds and Accelerators	SEAF INVEST East Africa	
Safaricom Spark Ventures	ResponsAbility	Family Offices
Merck Accelerator		Lundin Foundation
Savvanah Fund		DOB Equity
		Blue Haven Initiative

Source: Primary Research

Impact investment firms typically invest less than US$5 million and focus on SMEs. They are distinct, however, in that they are willing to forego purely commercial returns to generate social and environmental impact alongside a financial return. Impact investment firms active in Kenya operate globally (e.g. Grassroots Business Fund, Acumen) or regionally (e.g. BPI East Africa, GroFin Africa, SEAF INVEST East Africa), and often have a technical assistance component as well. For example, the SEAF INVEST East Africa Fund, an agribusiness focused fund that seeks to promote intra-regional trade in East Africa, features a pre- and post-investment technical assistance facility funded by the US Agency for International Development (USAID) and MEDA.[9] In addition to impact investment funds, family offices such as Blue Haven Initiative, which hails from the United States; Lundin Foundation, a Canadian Foundation affiliated with the Lundin Group of Companies; and DOB Equity, a family office from Holland, are active in the space.

Acumen Fund provides a well-established case study of a long-standing participant in the East African impact investment space. The firm has been present in Kenya for a decade and started off making grants before moving into equity investing. It invests in agriculture, housing, power, and education, and has deployed over US$40 million into nearly 40 companies, typically in checks of US$250,000 to US$2.5 million. The firm's investments seek to bring transformational change to established industries in order to make those industries work better. They also create employment – Acumen's companies have created nearly 50,000 jobs in East Africa, of which more than 50 percent are in Kenya. As with some private equity funds such as AfricInvest, which raise industry funds, Acumen has chosen to invest via thematic funds, including: (i) Acumen Fund, which provides grants to support early stage and high-risk companies, (ii) Acumen Capital Markets I, which focused on proven technology and impact opportunities, and (iii) the Acumen Energy Fund. Although Acumen used to predominantly invest via debt structures, as the market has matured, the firm has adapted its style to favor equity or quasi-equity instruments.

There has been some convergence between the impact investment, early stage (VC) seed fund and SME private equity spaces over the last several years, considering the SME-centric nature of the Kenyan PEVC market. As there are funds of all kinds active in East Africa, the best companies attract interest from and are able to choose among SME private equity funds and impact funds. Acumen, for instance, has helped to drive this convergence between private equity and impact. As noted, the firm started out by providing grants

[9] MEDA website. http://meda.org/fr/about-meda, accessed June 11, 2017.

or debt investments to high-risk companies. Today, it invests equity or quasi-equity through a number of specialist or sector funds. While its investment activities are focused on the bottom of the pyramid (BOP) and take impact into account at all times, Acumen also seeks to generate commercial returns. In this way, it sits at the intersection of commercial and impact investing. Novastar Ventures is another entity that can pass as an impact and seed/VC player.

Beyond venture capital and impact investors, entrepreneurs who are looking for early stage or SME financing under US$500,000 must consider other, less institutional, sources of financing. These sources include: (i) friends and family, (ii) commercial lenders (which will expect collateral or guarantees), and (iii) chamas, or investment clubs run by family and friends that invest from pooled savings (although mostly in real estate). While angel investment in Kenya remains nascent, individuals or groups, such as African Garage,[10] are also a source of capital for early stage entrepreneurs. There are also firms that offer various forms of technical assistance to entrepreneurs: Open Capital Advisors, Victoria Ventures, the African Business Angels Network, Stanford Seed, and BiD Network prepare entrepreneurs to raise capital and help to connect them with funding sources. (*Providers of technical assistance are discussed in more detail later in this report.*) Finally, several grant-making organizations, such as the pan-regional Africa Enterprise Challenge Fund (managed by KPMG International Development Advisory Service) and DFID provide traditional grants or repayable grants.

C. Fundraising

Fundraising in Africa is dominated by global or Pan-Africa-focused funds that invest across the continent. Many of these firms have an on-the-ground presence in Kenya. Regional fund managers with offices in Nairobi include: Abraaj Group, Actis, AfricInvest, ECP, Grassroots Business Partners, Helios Investment Partners, Phatisa Fund Managers and Progression Capital Africa. As shown in Table 6, funds with a Pan-SSA orientation dominate the region with respect to capital raised. Such global or Pan-Africa funds tend to be the largest in the market and also tend to invest in larger companies or firms that are operating in a number of countries. In contrast, East African firms invest in smaller companies that operate with more limited geographic scope, such as within the EAC.

Fundraising by PE and VC investors across the Sub-Saharan region of Africa has fluctuated in recent years; in 2014 fund managers raised over US$4 billion, the largest annual fundraising total on record. Nevertheless, as many managers across the continent have now entered the capital deployment phase, fundraising fell by 20 percent in 2015 and declined further to US$724 million in 1H2016. That said, fundraising for firms focusing exclusively on East Africa (and by extension Kenya) has ebbed and flowed based on the sub-region's macroeconomic trends, such as the 2013 and 2017 general elections in Kenya.

Table 5: Sub-Saharan Fundraising by Fund Geographic Focus (2011-2015)

	Pan-SSA		Central and East Africa		Southern Africa		West Africa		
	Capital Raised (US$m)	% Capital Raised	Capital Raised (US$m)	% Capital Raised	Capital Raised (US$m)	% Capital Raised	Capital Raised (US$m)	% Capital Raised	Total Capital Raised (US$m)
2011	1,719	79%	268	12%	39	2%	157	7%	2,183
2012	1,202	52%	42	2%	1,032	45%	38	2%	2,314
2013	1,275	81%	3	0.20%	262	17%	40	3%	1,579
2014	3,823	88%	189	4%	97	2%	214	5%	4,323
2015	2,844	78%	65	2%	205	6%	524	14%	3,638

Source: EMPEA

[10] An innovation hub based in Nairobi which provides space and seed funding to early stage entrepreneurs.

Going forward, there are clear signs that the PE industry's assets under management (AUM) in Kenya will continue to grow. As private equity managers raise successive funds, it is common for these firms to raise ever larger funds based on their track records and their desire to generate incremental streams of management fees and carried interest. Thus, as the Kenyan private equity industry matures, funds under management will naturally increase. As shown in Table 7 below, there are seven PE fund managers with offices in Kenya that have raised multiple funds, most of them investing across Sub-Saharan Africa. Pan-African investors with third generation funds – Actis, AfricInvest, ECP and Helios Investment Partners – are also generally the most prolific fundraisers for the region. The largest of the funds with an office based in Nairobi is Helios Investors Fund III, which closed on US$1.1 billion in 2014. But even on the smaller end of the market, GPs like Kibo Capital Partners and TBL Mirror Fund have seen strong growth in fundraising from first generation funds to subsequent funds.

Table 6: Pan-African Fund Size Growth by Generation

	Fund Name	Fund Value	Ticket Size
Abraaj Group	North Africa Fund II	US$375 million	US$20-60 million
	Sub-Saharan Africa Fund III	US$990 million	
Actis Capital	Actis Africa Real Estate Fund I	US$154 million	US$15-100 million
	Actis Africa Real Estate Fund II	US$278 million	
	Actis Africa Real Estate Fund III	US$500 million	
Africinvest	Africinvest I	EUR€30 million	EUR€1-5 million
	Africinvest II	EUR€150 million	EUR€5-15 million
	Africinvest III	EUR€250 million	EUR€10-30 million
Emerging Capital Partners	ECP Africa Fund I	US$407 million	US$1-90 million
	ECP Africa Fund II	US$523 million	
	ECP Africa Fund III	US$613 million	
	ECP Africa Fund IV	US$750 million	
Helios Investment Partners	Helios Investors Fund I	US$305 million	n/a
	Helios Investors Fund II	US$908 million	
	Helios Investors Fund III	US$1.1 billion	
KIBO Capital Partners	The Kibo Fund I	EUR€29 million	US$4-10 million
	The Kibo Fund II	EUR€50 million	
TBL Mirror Fund	TBL Mirror Fund I	EUR€11 million	EUR€100,000-3.5 million
	TBL Mirror Fund II	EUR€50 million	

Source: Primary research

Within the Kenyan market, the primary sources of capital for PE and VC investors are foreign DFIs, HNWs, and foreign institutional investors. The strong participation by DFIs in the market is not surprising; DFIs have often been among the earliest investors in private equity in emerging markets worldwide and have been crucial to providing a demonstration effect for the industry. They also provide governance, environmental and social best practices and serve as a training ground for the human capital that is required to start and manage successful investment firms. In fact, two of the first commercial firms on the continent – Actis and Aureos (later Abraaj) – were both born as spin-outs of the Commonwealth Development Corporation (now CDC Group), the DFI of the Government of the United Kingdom.

DFIs have long been the dominant investors in Kenya VC/PE, whether investing directly or via a fund-of-funds. The most active DFI limited partners of funds in Kenya's private equity and venture capital industry include (partial list): IFC (investments in BPI East Africa, Catalyst, Fanisi, Helios, GroFin, ECP), CDC (Catalyst, Helios, ECP, Novastar, Ascent), Proparco (AfricInvest, ECP, Novastar), DEG (ECP, Catalyst), Swedfund, OPIC, FMO (AfricInvest, Novastar), Finfund, DFID (Novastar), BIO (AfricInvest), Norfund (Novastar), EIB (Novastar), the African Development Bank (AfricInvest, ECP) and the East African Development Bank (Catalyst).

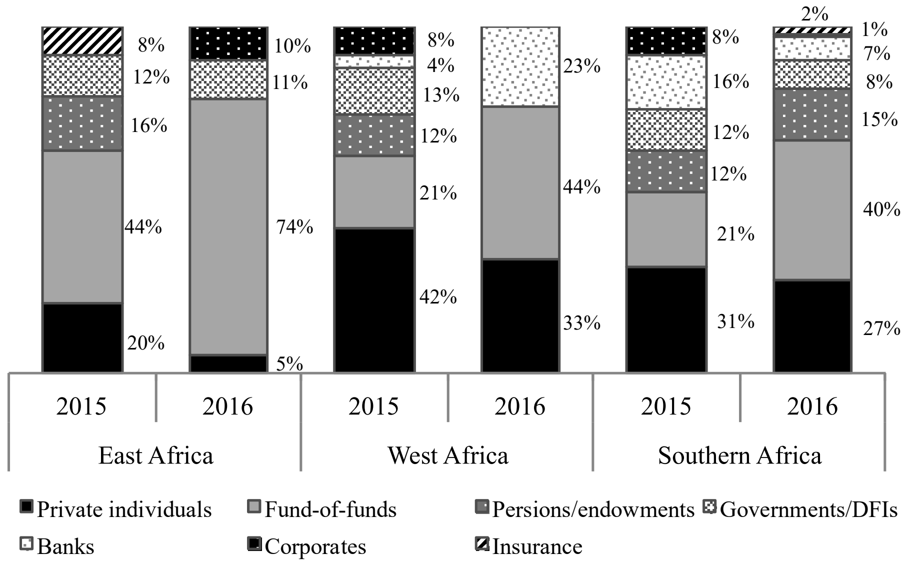
The most active DFIs in East Africa and the continent as a whole are the IFC and the CDC. Each of these players has long made both fund investments and direct investments as part of its overall investment strategy. Both are also adjusting their investment activities as the industry matures and changes with time. The IFC has invested approximately US$1 billion in approximately 50 African private equity funds, including pan-regional (i.e. Helios and ECP) and East African funds, including BPI East Africa, GroFin, Catalyst Fund, and Fanisi. The IFC has made a strategic decision to channel its interventions in the SME space through its own SME Venture Program. And the IFC is now focused on mid-market funds with proven track records that have the funds and the capacity to take control positions or actively manage their investees.

Like the IFC, the CDC has been at the forefront of fund investing, but has also adjusted its strategy over time. Following a strategic review, management sought to implement an approach that would allow the CDC to better monitor the direct impact of its activities. This led the organization to re-focus part of its efforts on direct equity and debt investments alongside its fund investments, with the goal of maintaining 33 percent of its activities in funds, 40 percent in direct equity, and the remainder in debt. A long-term investor in African funds (including Helios, Novastar, and Ascent), the CDC also is looking to push innovation in the fund space by exploring new types of fund structures such as permanent capital vehicles (PCVs) that allow for greater flexibility, especially for funds that invest in SMEs. PCVs, which are investment entities that have a longer fund life than traditional PE funds, will be discussed in detail later in this report.

For VC/PE funds, building relationships with DFIs, most of which have very deep pockets, portends significant fundraising opportunities from investors that are knowledgeable about and committed to the region. Moreover, private equity funds can look to DFIs as a source of co-investment capital when their ambitions lead them to large deals that they cannot fund themselves. Still, some fund managers in Kenya, especially those focusing on larger deals, sometimes consider DFI direct investment to be a potential source of competition. In Kenya, DFIs that invest directly in companies include the CDC, IFC, Proparco, Swedfund, DEG, FMO, and Norfund.

Although DFIs do increasingly invest directly in companies, they remain a major source of LP capital for funds operating in East Africa, especially relative to other, more developed regions of Africa. For example, Southern African funds are diversifying away from DFIs and expect to fundraise from commercially-oriented investors, such as pension funds and endowments. East Africa trails Southern Africa in this regard.

Figure 3: Investor Expectations for Source of Fundraising Over the Next Year



Source: Deloitte (2016)

High net worth individuals, also known as family offices, represent another important source of potential investment capital for private equity funds. Family offices have taken an increasingly active role in the global private equity sector, including in Africa, over the last decade and, as of 2015, HNWs represented approximately 8 percent of the US$4 trillion invested in private equity worldwide, up from 4 percent five years earlier.[11] As noted, in Kenya, these family offices are typically foreign in nature and may include investors who are seeking to combine their investment activities with broader impact-oriented objectives, such as investing at the bottom of the pyramid. While they are outnumbered by foreign family offices, some Kenyan families invest in funds as well, although the minimum investment of US$1 million usually required by private equity funds serves to limit the addressable market of family offices in Kenya. Kenyan HNWs include the Chandaria family, which is the owner of a large industrial conglomerate, among other businesses.

There is also some investment by sovereign wealth funds (SWF) and institutional investors, although their capital is largely directed toward Pan African rather than regional/national funds. Investors report that large SWFs that are active in private equity on a global basis such as the Abu Dhabi Investment Authority (ADIA) and Singapore's GIC have included Africa in their investment strategies. Specifically, GIC invested in Actis' Africa Real Estate Fund III in 2016. Meanwhile, institutional investors such as Santander Pension, GE Capital, and DGGF (Dutch Good Growth Fund), have also included asset allocations for African PE funds. In particular, the New York State Common Retirement Fund, announced in 2015 that it planned to invest up to 3 percent of its US$180 billion in assets into Africa in the coming years. To date, the Common Retirement Fund has already invested in pan-regional players such as Helios, while Novastar raised capital from JP Morgan Social Finance and Axa's impact investment group.[12] Finally, some Kenyan private equity firms, such as Catalyst, report receiving investment from US-based funds of funds. Unlike large pension

[11] Holman, Kelly (September 1, 2015).
[12] Africa Business Central (May 1, 2015).

funds or SWFs, funds of funds do not have to write large checks (i.e. US$50 million to US$100 million) and thus can consider investing in smaller SME funds.

While international investors and DFIs have been the most important LPs in Kenya, perhaps the most promising source of capital for PE and VC funds should be local domestic institutional investors, especially given their potentially catalytic role in terms of fundraising. There are some notable examples of institutional investors investing in local funds. For example, private equity firm Ascent Capital raised slightly more than $80 million for its debut Ascent Rift Valley Fund, with local pension funds such as Kenya Power Pension Fund and Nation Media Group Pension Fund contributing a combined $5 million.[13] Still, the paucity of local institutional investors remains a fundamental constraint to the growth of the VC/PE industry in Kenya. While local institutional investors, such as pension funds, often trail foreign investors in the private equity fund sector in some emerging market regions, they can become core investors in the asset class. Given their sheer size and their need to generate long-term returns, these local institutional investors can prove critical to scaling the industry and creating a domestic market for fundraising. For example, in Latin America, growth in VC/PE markets like Colombia, Mexico, and Peru has in no small part been propelled by increased involvement among local institutional investors.

Although there are more than 1,000 pension funds in Kenya that manage in excess of Ksh800 billion (US$7.7 billion), the vast number of institutional investors, such as those in the local pension fund industry, has not yet deployed meaningful amounts of capital into the VC/PE asset class. In theory, pension funds should be a large and attractive fundraising pool for private equity funds since they have sufficient capital as well as active investment teams. The largest pension fund, the National Social Security Fund (NSSF), is sophisticated, relying on five asset managers and an in-house team to manage its capital. Moreover, Kenya's other large pension plans, such as that of the Central Bank of Kenya, the Kenya Ports Authority, Kenya Railways, and Kenya Power and Lighting, all have in-house capacity to manage investment decisions. Smaller pension funds often hire asset managers such as Stanlib Kenya, PineBridge, Old Mutual, and GenAfrica to manage their capital. These external managers are familiar with the private equity asset class. Either directly or via asset managers, some pension fund companies – such as Brit-Am (into Aureos), Kenya Power (into Fanisi), and CFC Life Heritage (into Ascent) – have invested in private equity, but their participation represents just a small fraction of the assets that could flow to the industry. *The legal/regulatory section discusses the structural causes of pension fund lack of investment in PEVC.*

As will be discussed in detail later in this report, the Kenyan government has now adopted a series of reforms to allow pension funds to invest up to 10 percent of their portfolios in private equity and venture capital funds licensed by the Capital Markets Authority (CMA). Both investment firms and government sources expect that this regulatory regime reform will be meaningful in terms of its impact on fundraising. Nevertheless, even with the recent changes, discussions with fund managers, pension fund asset managers and the RBA reveal that critical obstacles will continue to hamper efforts to encourage pension funds to allocate capital to the space. These obstacles include a general lack of familiarity with the asset class, sensitivity to the high fees charged by alternative investment managers, and a lack of incentives for pension fund trustees to direct their funds into a new asset class.

As with the pension fund industry and other long-term oriented investors, insurance companies are also long-term investors that typically invest in VC/PE. Kenya is the largest insurance market in East Africa and its insurance companies have established subsidiary and associate companies within the region, with an asset base of KES 478.75 billion (US$4.6 billion). There are 51 regulated insurance companies and three reinsurance companies operating in Kenya.[14] Like pension funds, insurance companies have a clear

[13] PE firm Ascent raises Sh8bn for new fund, Business Daily.
[14] Insurance Industry Annual Report 2015 (July 2016), Insurance Regulatory Authority, xi. http://www.ira.go.ke.

need to generate long-term returns and to create diversified portfolios of investments. On a global basis, insurance companies that invest in private equity allocate 2.7% of their assets into the investment class.[15] In Kenya, however, the insurance industry is not yet a meaningful source of capital according to private equity funds that have raised capital domestically. In fact, they are less active in PEVC than pension funds. While private equity is not broken out by the insurance regulator, other investments, which is the category that would include PE, totaled 5.4% of assets as of 2015. [16] As of the end of 2015, 42.9% of the total industry investments was held in government securities. Moreover, they have shown a strong preference for investing in real estate, which has long been part of the portfolios of insurance companies. Only Catalyst reported that a local insurance fund invested in its first fund. This was achieved via a feeder fund, to circumvent the 5% restriction on foreign investment by insurance companies.[17] It is important to note that setting up feeder funds imposes additional costs that can affect returns. These complications make insurance companies a harder investor class to target vis-à-vis pension funds. *The legal/regulatory section discusses insurance company regulatory restrictions on investments in PEVC.*

D. Investments

Private equity and venture capital investments in Kenya generally follow the trends of the broader SSA region, with the fundamentals of the East African markets largely resembling those of the Southern and West Africa sub-regions. Fund managers interviewed, including those that invest across the continent, highlighted attractive characteristics in the market that mirror the favorable trends found in other sub-regions of Africa; namely, rapid urbanization, a growing workforce, ongoing technological evolution, and sustained consumer and business spending. Furthermore, the strategy of "regionalizing" investments in East Africa by launching them from Kenya - an approach popular among fund managers reviewed in this study - stems from opportunities and constraints similar to those found elsewhere in the SSA region, particularly West Africa. This kind of growth strategy is predicated on the relative openness of cross-border regulation and commercial policy, both of which are supported by Kenya’s membership in the EAC. It also reflects the desire to escape the growth constraints that are endemic to remaining in just one market in a region that is large, but still quite fragmented.

Within this context of regional interconnectivity, Kenya’s position as hub for East African investment has allowed it to capture the overwhelming portion of the sub-region's deal value in recent years. Between 2007 and 2014, the total value of the 79 deals in East Africa was US$822 million, of which Kenya accounted for just over US$517 million, or 70 percent. As Table 8 shows, Kenya made up a large share of total deal value for East Africa in 2014, 2015 and 1H 2016. Although Kenya-based investors indicate that other markets in East Africa offer appealing and accessible investment opportunities and will continue to do so in the future, Kenya is well positioned to capture a dominant share of East Africa's deal activity and value. This is partly due to the ease with which Nairobi-based investors can access opportunities without having to travel to source, negotiate, and manage their deals. It also reflects the importance of local networks, which allow funds to source attractive opportunities before they are widely shopped.

Investing locally in Kenya can also help a PE fund to build an investment case for local pension funds that are considering investing in private equity funds. PE Funds that have successfully raised capital from the pension fund community in Kenya, such as Ascent Capital Partners, note that having a portfolio with

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[15] Prequin, Prequin Special Report: Insurance Companies Investing in Private Equity.
[16] Ibid., 47.
[17] Under the Guidelines to the Insurance Industry on Management of Investment, insurance companies cannot invest more than 5 percent of their total assets into investments, private equity or otherwise, outside of their home market. See Kenya Insurance Regulatory Authority (November 2015). Guidelines to the Insurance Industry on Management of Investment. The feeder fund allowed it to overcome restrictions on overseas investment as Catalyst’s fund was domiciled in Mauritius.

Kenya-based success stories can be a powerful fundraising tool. Pension funds that see a PE firm investing in companies that are well known to them are able to better understand the industry, the role it plays in society, and the potential for PE firms to generate attractive returns.

Table 7: Deal Value by Geography (2014-1H 2016)

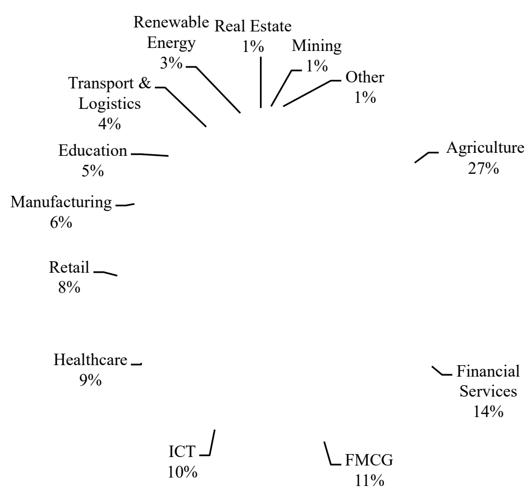
	Kenya		East Africa		Sub-Saharan Africa	
	Capital Invested (US$M)	# of Deals	Capital Invested (US$M)	# of Deals	Capital Invested (US$M)	# of Deals
2014	222	22	345	29	2,100	125
2015	104	13	273	27	1,300	99
1H2016	24	7	54	23	600	57

	Kenya as % SSA		Kenya as % of East Africa	
	% Capital Invested	% Deals	% Capital Invested	% Deals
2014	11%	18%	64%	76%
2015	8%	13%	38%	48%
1H2016	4%	12%	44%	30%

Source: EMPEA

PE investment in both East Africa and Kenya flows into a diverse set of sectors, ranging from basic industries and agriculture to industries such as FMCG and education that cater to the country's growing middle class. Between 2007 and 2014, five sectors accounted for 71 percent of a total of 79 deals logged by the KPMG/EAVCA survey in East Africa: agribusiness (27 percent), financial services (14 percent), fast-moving consumer goods (FMCG) (11 percent), information and communication technology (ICT) (10 percent) and health care (9 percent). In Kenya, where 50 of the 79 deals were consummated, the top five sectors were financial services (18 percent); ICT (16 percent); agribusiness (14 percent); retail (12 percent); and manufacturing (10 percent).

Figure 4: East Africa Deal Volume by Sector (2007-2014)



Source: KPMG/EAVCA

During the same period, Kenya was the only country with significant levels of PE investment in manufacturing, education and renewable energy. A sector such as education can attract both PE and VC, thus catering to businesses along very different points on the maturity curve. For example, Fanisi Capital invested in Hillcrest Investments Limited, a well-established secondary education company that operates schools catering to students from the rising middle class. Another prominent education deal, this time focused on the bottom of the pyramid, was the US$30 million raised by the startup Bridge International Academies[18] from Novastar Ventures, the IFC, and the CDC, as well as international VC and impact firms such as New Enterprise Associates, the Gates Foundation, and the Omidyar Network.

Over the 2007-14 period, 70 of the 79 deals recorded in East Africa had tickets of US$10 million or less, and were concentrated in agribusiness, FMCG, ICT and health care. This deal size is the focus of Kenya-based fund managers such as Grassroots Business Fund, Acumen Fund, Fanisi Venture Capital, Kibo Capital Partners, Novastar Ventures, Progression Capital Africa and TBL Mirror Fund. As Table 9 shows below, Kenya has the greatest number of deals at the larger end of the spectrum (i.e. US$10 million-US$50 million), which are primarily in the FMCG, financial services, manufacturing and energy sectors. Over the 2007-14 period, more than three times as many deals in this range took place in Kenya than in all other East Africa markets combined. This is the target range for managers such as AfricInvest, Ascent Capital Partners, Catalyst Principal Partners and Phatisa Fund Managers.

Table 8: East Africa Deal Volumes by Ticket Size and Geography (2007-2014)

	<US$1M	US$1-5M	US$5-10M	US$10-50M
Kenya	**10**	**28**	**5**	**7**
Tanzania	0	6	5	1
Ethiopia	0	2	3	1
Uganda	1	6	1	0
Rwanda	1	2	0	0
Total	**12**	**44**	**14**	**9**

Source: KPMG/EAVCA

The largest deals that have closed in East Africa have taken place in Kenya's oil and gas sector. The KPMG/EAVCA survey did not log any deals over US$50 million, but in 2015 there was one such deal in East Africa that was recorded by EMPEA: Helios Investment Partners made a US$100 million growth equity investment into Africa Oil Corp, headquartered in Vancouver, Canada, but with operations in Kenya. The largest known deal in East Africa since 2008 also involved Kenya's oil and gas sector, when Warburg Pincus made a US$600 million growth equity investment in Delonex, a global company based in London, but with a significant East Africa and Kenya presence. Kenyan fund managers that are capable of investing in excess of US$50 million per transaction include Actis Capital, ECP, and Helios Investment Partners. They tend to back large businesses with existing operations in East Africa or they invest in businesses with aspirations to expand into multiple markets in the region.

Although PE investors in Kenya and East Africa usually acquire minority equity stakes, they also employ debt instruments and quasi-equity securities. As shown in Table 10 below, most fund managers utilize a

[18] Bridge International Academies, which provides inexpensive education to children by leveraging technology, was founded in 2008. It now serves more than 100,000 children. Moreover, the company has expanded to Uganda, Nigeria, Liberia, and India.

range of financing instruments, tailoring deal structures to the needs of the company and the situation. That said, of the 79 deals in East Africa between 2007-2014, 61 corresponded to investors taking a minority equity stake of 40 percent or less.[19]

Table 9: PE Investors Active in Kenya by Target Deal Size and Instruments

	Target Deal Size	Instruments
Abraaj Group	US$20-US$60 million	Equity, mezzanine
Actis Capital	US$15-US$100 million	Equity, mezzanine
Acumen Fund	US$250,000-US$3 million	Equity, mezzanine, debt
Africinvest	EUR1-EUR30 million	Equity, mezzanine, debt
Ascent Capital Partners	US$1-US$15 million	Equity, mezzanine, debt
Blue Haven Initiative	US$500,000-US$25 million	Equity, mezzanine, debt
BPI East Africa	US$50,000-US$1 million	Equity, mezzanine, debt
Business Partners	US$50,000-US$1 million	Equity, mezzanine, debt
Catalyst Principal Partners	US$5-US$20 million	Equity, mezzanine
Centum Investment	US$2-US$20 million	Equity, mezzanine, debt
DOB Equity	US$1-US$5 million	Equity, mezzanine
Emerging Capital Partners (ECP)	US$1-US$90 million	Equity, mezzanine, debt
Fanisi Venture Capital	US$1-US$5 million	Equity, mezzanine
Grassroots Business Fund	US$500,000-US$2.5 million	Equity, mezzanine, debt
GroFin	US$100,000-US$1.5 million	Equity, mezzanine, debt
Helios Investment Partners	US$15-US$250 million	Equity, mezzanine
KIBO Capital Partners	US$4-10 million	Equity, mezzanine
KKR	US$20-US$100 million	Equity, mezzanine
Lundin Foundation	US$50,000-US$2 million	Equity, grant
MANGO Fund	US$5,000- US$50,000	Equity, debt
Maris Capital	US$5-US$20 million	Equity
MERCK Accelerator	US$1,000- US$15,000	Equity, grant
Novastar Ventures	US$100,000-US$6 million	Equity
Phatisa Fund Managers	US$2-US$24 million	Equity, mezzanine, debt
Progression Capital Africa	US$2-US$8 million	Equity, mezzanine
responsAbility	US$1-US$20 million	Equity, debt
Safaricom	US$50,000- US$215,000	Equity, mezzanine
Small Enterprise Assistance Fund (SEAF)	US$200,000-US$3 million	Equity, mezzanine, debt
TBL Mirror Fund	EUR100,000-EUR3.5 million	Equity, mezzanine, debt
The Carlyle Group	US$30-US$100 million	Equity
TransCentury	US$5-US$20 million	Equity

Source: Primary research

E. Exits

One of the biggest challenges for VC/PE investors in Kenya is the paucity of commercially viable exit options. Generating exits allows private equity funds to return capital to their investors, prove that their investment thesis is valid, and then return to the market to raise funds based on their track record of generating financial returns to their limited partners. If private equity funds can build profitable companies

[19] KPMG/EAVCA (June 2015).

and exit those companies successfully, new funds will be attracted to the market. Also, more companies and entrepreneurs will be willing to consider private equity and venture capital as a source of financing. However, in Kenya, exits have been challenging for various reasons.

While the public markets can provide an important path to liquidity, private equity investors in Kenya and East Africa have rarely accessed the public markets to generate exits. Given SMEs comprise a large number of investments, many of the companies in which they invest lack sufficient scale to consider filing for an IPO. Instead, the most viable exit strategies for PE and VC investors in Kenya and the East Africa region are buybacks, trade sales and secondary sales. While data for Kenya alone are not available, between 2007 and 2014, there were a total of 21 exits by PE funds in East Africa (totaling US$260 million). Of this total, 52 percent of exits were achieved via share buybacks.[20] Of the remainder, six exits came through sales to strategic investors, one was a sale to a financial investor and one resulted from a listing. The sole listing, executed by Actis Capital portfolio company Umeme, took place in Uganda.[21]

The paucity of IPOs in Kenya has not been lost upon investment managers. In general, private equity investors in Kenya expect to exit their investments via strategic investors, financial sponsors, or refinancing. A survey of private equity investors in East Africa over two consecutive years found that no respondents anticipated that they would exit an investment via an IPO in the next 12 months. Instead, they expected to exit their investments via a sale to a strategic investor, a secondary exit to another private equity player, or a refinancing. *A detailed discussion of the Kenyan capital markets and the environment for IPOs is provided in Section IV.B: Capital Markets Overview.*

Table 10: Exit Expectations of Private Equity Investors During the Next 12 Months

	2015	3016
Sale to a Strategic	85%	65%
Secondary Sale to Private Equity	8%	30%
Partial Exit via Refinancing	0%	5%
No Exits Expected	7%	0%
IPO	0%	0%
Total	100%	100%

Source: Deloitte

An emerging area of interest among PE funds in Kenya that could impact deal structuring is the advent of alternative fund structures, such as the PCV model. PCVs seek to address a fundamental tension that exists in private equity, especially one that is present when the asset class is adapted to emerging markets. Traditionally, private equity firms have operated with fixed fund lives of 10 years (that typically can be extended by two years). In such a case, a fund must deploy all its capital and exit all its investments within that time, with most investments requiring 3-7 years from investment to exit. While achieving this timeline is realistic in developed markets, is can be much harder to achieve in developing economies, where exits can be impeded by macroeconomic volatility and shallow capital markets. As a result, investors may need more time than a traditional fund structure can offer. A PCV is a fund that has a much longer fund life (for example, 20 years) or is even structured as an evergreen fund, meaning that it does not expire.

[20] KPMG/EAVCA (June 2015).
[21] Reuters (October 12, 2012). "Uganda power firm Umeme prices IPO at 275 shillings per share".

Although there are few examples in the region among PE and VC managers, Centum – an investment holding company that was originally founded by the Kenyan government - operates as a PCV because it is listed on the Nairobi Stock Exchange. Through this listed entity, Centum invests up to US$30 million per transaction. Moreover, both Phatisa and AfricInvest have indicated interest in using PCVs to mitigate some of the idiosyncratic challenges they face in Sub-Saharan Africa. Specifically, they highlight the agribusiness sector, one of the most popular industries for investors in East Africa, as an example of how the conventional private equity fund life may be too short. The long maturation period of certain crops alone would preclude a tenable return on investment (ROI) in the 3-7-year range. These kinds of sector-specific issues are exacerbated by endemic infrastructure challenges and the generally slow pace of legal processes and business transactions. Despite all the motivations for a fund to adopt the PCV model, however, structuring successful PCVs will require thoughtful design and time will tell whether investors wish to back such vehicles. First, the funds must contemplate exit mechanisms for limited partners at some point in the life of the fund. Second, they must adapt the traditional incentive structures for managers, such as carried interest, to this new approach. Finally, it remains unclear how managers would pitch perpetual funds to LPs that are long accustomed to investing in closed-end funds.

Industry Map

As the previous discussion of market dynamics in the VC/PE industry in Kenya suggests, the alternative investment management industry in Kenya resembles that of many other developing countries. Although the relationship between the stage of transaction and the size of an investment commitment is not rigid, fund managers focused on SME, venture, and impact investing, typically invest less than US$5 million while managers focused on growth capital deals dominate the industry, typically writing checks of between US$5 million and US$20 million. At the larger end of the spectrum, fund managers like Helios, ECP and Actis, target deals in which they can deploy more than US$20 million in a given transaction.[22] Figure 5 below provides a layout of Kenya's VC/PE industry in terms of investment type, fund size, and the players that are active within each market segment.

[22] As transaction sizes may require even greater amounts of capital, these funds can also look to their LPs to serve as co-investors or team up with other GPs in what are called club deals.

Figure 5: Market Map of the Kenya VC/PE Industry

Source: Primary Research

F. Business Environment: Doing Business and Global Rankings

Despite a thriving ecosystem of entrepreneurs and a private sector-led economy, Kenya has made a relatively mediocre showing in global investment climate rankings. Specifically, as shown in Table 12 below, the country has consistently ranked in the bottom half of both the World Bank's Doing Business Report and the Heritage Foundation's Economic Freedom Index. It has also ranked in the bottom quartile of Transparency International's Corruption Perception Index.

Kenya's ranking in Transparency International's Corruption Perception Index is worthy of note because it highlights the kinds of environmental challenges facing enterprises in Kenya. Widespread corruption can act as a leach on an economy and the companies within it, and SMEs lack the resources and networks to navigate the ecosystem of graft unscathed. Fund managers in Kenya actively screen for corrupt practices when conducting due diligence since irregularities exert both seen and unseen costs on businesses. Given that a meaningful part of the value-add of private equity firms is their focus on corporate governance, anything that detracts from these efforts can negatively impact the value of an investee company. Moreover, problems at investee companies can impair the operations and damage the reputation of the private equity firms that are shareholders, either minority or majority, in these businesses.

Kenya's poor ranking in the Economic Freedom Index is also of concern to foreign investors, as this suggests that businesses operating in Kenya must contend with burdensome regulatory regimes and legal systems. Specifically, Kenya performs worst on Fiscal Health, Government Integrity, Judicial Effectiveness, Property Rights, Financial Freedom and Business Freedom. Such indicators are meaningful to investment managers as they consider whether or not to register their fund in a given country. For example, Mauritius, where most VC/PE investors active in Kenya domicile their funds, has one of the best Economic Freedom Index rankings of any African nation (#21 worldwide in 2017). It performs particularly well in the Open Markets category.

In recent years Kenya has seen some notable improvement in its Doing Business ranking, which is perhaps the most important of the rankings for the purposes of VC/PE investors. Kenya has improved by 13 places since 2013, with a jump of 44 spots between 2016 and 2017. This improvement comes in recognition of recent advances with respect to reforms in business and property registration, electricity connections and access to credit.[23]

Table 11: Overview of Kenya's Global Rankings

	2013	2014	2015	2016	2017
Doing Business	**121** /185	**129** /189	**136** /189	**108** /189	**92** /190
Economic Freedom	**114** /177	**111** /178	**122/** 178	**115** /178	**135** /180
Corruption Perception	**136** /177	**145** /175	**139** /168	**145** /176	n/a

Source: World Bank, The Heritage Foundation, Transparency International

Among Doing Business categories Kenya ranks well on Enforcing Contracts and Getting Credit, which are of fundamental interest to venture capital and private equity investors and to a wide range of investee companies, from SMEs up to large corporations.

- Enforcing Contracts: Private equity investors see the rule of law as a critical environmental factor that can affect the ongoing operations of a business and its eventual valuation upon exit. They are unwilling to invest in a country where they cannot enforce contracts without enduring significant costs or lengthy conflicts. Improvements in the operation of the court system and the overall efficiency of overcoming disputes greatly improve confidence in the overall business climate.

- Getting Credit: This measure has a direct impact on the private equity sector as credit serves as both a complement to and a substitute for private equity. Private equity-backed companies benefit from access to credit since they can finance their growth less expensively than raising additional equity capital, which benefits all owners in the business. At the same time, bank lending competes with private equity to some extent. This dynamic has played out in Kenya in the wake of *caps on commercial lending rates that were introduced by the government of Kenya in August 2016*. The caps, which limit rates to 400 basis points over the Central Bank rate, have lowered interest rates, but have caused banks to curtail lending, especially to higher risk SMEs.[24] In the wake of these new limits on interest rates, fund managers interviewed for this report noted that this shift could drive businesses, such as family-owned companies, to substitute debt, which is now harder to come by, with private equity.

[23] Business Daily (October 28, 2015). "Huduma centres push Kenya up in ease of doing business index".
[24] Njini, Felix (May 11, 2017). "Kenya's Largest Bank Expects Rate-Cap Removal in Second Half".

In addition to these factors, Kenya's general improvement in various categories also positively impacts the market for private equity and venture capital. For example, the government has simplified the process of starting a business, which benefits startups by cutting costs and saving time as they seek to get up and running in Kenya. Moreover, improvement in insolvency laws benefits businesses at all ends of the spectrum by allowing them to reorganize and continue operating rather than face liquidation if they face business challenges.[25]

Table 12: Overview of Kenya's Doing Business Rankings

	2013	2014	2015	2016	2017
Starting a business	126	134	143	150	116
Getting credit	12	13	116	29	32
Protecting minority investors	100	98	122	112	87
Paying taxes	164	166	102	122	125
Trading across borders	148	156	153	107	105
Enforcing contracts	149	151	137	85	87
Resolving insolvency	100	123	134	140	92

Source: World Bank

G. Capital Markets Overview

As noted, private equity managers struggle to generate public market exits in Kenya and East Africa. This challenge persists even though Kenya's capital markets are the largest in East and Central Africa with a market capitalization of approximately US$20 billion[26], which makes the Nairobi Securities Exchange (NSE) the fifth largest stock market by value in Africa (after South Africa, the Arab Republic of Egypt, Nigeria, and Morocco).[27] Despite its size, however, the NSE ranks sixth with respect to IPOs, with just two companies – neither private equity-backed - raising less than US$50 million from 2013-2016. Moreover, companies raised far less capital in Kenya than in the other two regional hubs for private equity in SSA, South Africa and Nigeria.

Table 13: IPOs in Africa, 2013-2016

	2013		2014		2015		2016		Total	
	# IPOs	Raised (US$MM)	# IPOs	Raised (US$MM)	# IPOs	Raised (US$MM)	# IPOs	Raised (US$MM)	# IPOs	Raised (US$MM)
South Africa	4	261	9	742	12	658	7	823	25	1,661
Egypt	0	0	1	109	4	752	4	214	5	861
Nigeria	1	190	1	538	1	23	0	0	3	751
Tunisia	12	191	6	125	2	43	1	21	20	359
Morocco	1	122	1	127	1	74	1	195	3	323
Kenya	**0**	**0**	**1**	**7**	**1**	**35**	**0**	**0**	**2**	**42**
Rwanda	0	0	0	0	1	39	0	0	1	39
Tanzania	0	0	0	0	1	9	1	5	1	9

Source: 2016 Africa Capital Markets Watch, PWC

[25] World Bank (2017). Doing Business 2017: Kenya.
[26] Nairobi Securities Exchange (2016). Annual Report & Financial Statements 2016.
[27] Ibid.

Given the lack of IPOs, especially with respect to SMEs, Kenyan capital markets authorities have sought to open the market to more companies. In 2013, the NSE launched a junior board, the Growth Enterprise Market Segments (GEMS), to provide more options for SME finance. The GEMS operates under listing requirements that are tailored to SMEs. For example, the GEMS can admit companies that have been in operation for only a year. Also, the market does not impose a requirement for having turned a profit before listing. As of the end of 2016, six firms had listed on the GEMS, although one of those companies has since been suspended from trading. While the exchange has announced plans to increase this to 19 listings by 2017, and to 39 listings by 2023, the viability of this plan remains unclear.

Despite the lack of dynamism of the Kenyan GEMS to date, examples from other markets demonstrate that a junior board can serve as a meaningful tool in tailoring the benefits of a public market to the needs of SMEs. Since 2009, Jamaica has operated the junior market, which upon opening, rose rapidly to become a popular resource for Jamaican SMEs and a model for effective small business finance in the Caribbean region more broadly. Companies are permitted to list on the market for up to 10 years (split into two five-year stages), or until surpassing a maximum shareholder's equity capital capitalization of J$500 million (US$3.8 million), after which point they are required to list on the main exchange. As of June 2017, the junior market had 34 listed companies, including firms in sectors such as manufacturing, retail, financial services, tourism, culture, and logistics. According to interviews conducted with leaders at the Jamaican Chamber of Commerce and the Jamaica Stock Exchange, the junior market is considered to be a critical element of the stock market's future sustainability.

The main board of the Nairobi Stock Exchange also presents challenges to companies aspiring to execute on an IPO due to the poor performance of recent IPOs. The recent performance of companies that have debuted on the exchange has not been encouraging: Of the 12 companies that went public between 2000 and 2016, four are trading below IPO price as of 2017 and one has been delisted, while another has stopped trading pending completion of deregistration.[28] Moreover, the NSE has not performed well over the last six years, with its main index, the NSE 20, falling over 40% from early 2015 to the end of 2016.

Table 14: NSE Trends 2010-2016

	Year End						
	2010	2011	2012	2013	2014	2015	2016
NSE 20 Index (Points)	4,433	3,205	4,133	4,927	5,113	4,040	3,186
NASI (Points)	98	68	95	137	163	145	133
Equity Turnover (KSh Bn)	110.3	78.1	86.8	155.8	215.7	209.4	N/A

Source: Nairobi Securities Exchange

In addition to the poor performance of the NSE, investors also perceive listing on the exchange to be both cumbersome and costly.[29] In 2016, in response to these concerns, the Kenya Capital Markets Authority cut listing fees with hopes of encouraging more firms to list their shares. Companies now pay a maximum fee of Sh30 million (US$290,000), down from 0.15 percent of the total value of the offer.[30] While this reduction in fees could offer an incremental incentive for companies to consider the NSE, the performance of the market remains a hurdle.

[28] Alushula, Patrick (February 14, 2017). "Most new faces in Nairobi bourse drop below IPO price".
[29] Teche, Enos (June 29, 2016). "Firms reject IPOs, seek investors in divesture – study".
[30] Ibid.

II. The Business Enabling Environment: Private Equity and Venture Capital

There are five principal challenges to the growth of the private equity industry in Kenya. These challenges, which are discussed in detail below, correspond to sourcing investable deals, structuring attractive transactions, finding and retaining adequate human capital, generating exits, and fundraising. This section also discusses the use of technical assistance by investment firms in Kenya. Technical assistance can serve as a tool to address a number of the challenges that are inherent in the business enabling environment.

A. Sourcing

Many private equity investments in Kenya provide capital to SMEs or mid-sized family businesses. Given their size and/or ownership structure, such firms often lack the financial preparedness to successfully navigate the due diligence process with potential investors. Companies may be reluctant to reveal financial information, or their reporting and accounting systems may be weak, thus making it difficult for investors to accurately assess their financial performance. Moreover, SMEs may be unfamiliar with the types of analysis and requests that private equity firms require, so the entire process of due diligence can be slow and cumbersome. These problems can permeate the legal and governance considerations as well.

Even if investors find opportunities that meet their strategic objectives and that are "investable" assets, meaning that they have a sufficient level of financial and legal transparency to merit the costs of conducting due diligence, PE firms often contend with a lack of transparency, inadequate corporate governance, and insufficient knowledge about the requirements and expectations of private investors. To confront these challenges, technical assistance facilities are often used to help deploy VC/PE capital. As will be discussed later in this section, a number of funds tap into dedicated technical assistance facilities or access ad hoc technical assistance grants for pre-and post-investment capacity building for (potential) investees. Such resources are not widely available, however, so most firms must either invest considerable time, energy, or financial resources, to prepare potential investees to raise capital from them.

Investors also report that the shallow market can drive valuations upwards as capital competes for the relatively small number of deals in the market. Typically, in emerging markets, investment firms can counterbalance the operational challenges, macroeconomic risks, and inherent lack of exit opportunities, by buying into businesses at attractive valuations. When competition is high, achieving low entry valuations is more challenging. As noted, Kenya is an investment hub with a large number of private equity firms, including SME funds and impact funds that are increasingly encroaching on each other's territory. Thus, investment managers note that they feel the market is relatively crowded given the number of active deals at any time. Moreover, local family offices also compete for deals. Some investors, mostly those participating in the larger deals, also note that DFI direct investment can potentially compete with PEVC funds (although DFIs are important partners, since they also invest in funds as LPs).

Another important, and more recent, challenge facing VC/PE investors results from the government's decision to impose interest rate caps on bank lending. While this policy has ramifications for the financial services sector in a broad sense, it also specifically impacts the market for private equity. As previously mentioned, in August 2016, President Kenyatta signed a law capping commercial lending rates at no more than four percentage points above the central bank base rate. This has several ramifications, both positive and negative, for the PE sector. In terms of negative effects, the increased regulation makes the financial services sector less attractive for private equity investors. This is of critical importance since financial services has been the second most popular industry for investment in East Africa over the past several years. Now, however, the risk profile of the sector has changed since the government-imposed interest rate caps are directly hitting profitability and lending volume, as banks are unwilling to lend to riskier clients at artificially low interest rates. This development has spooked investors, with shares of Kenya's 11 publicly traded banks falling by as much as 33 percent in the six months after the regulation was imposed. Despite the challenges resulting from the interest rate cap, there may be positive side effects as well. First, although some companies will benefit from cheaper interest rates, others may find that banks are no longer willing to lend to them and will instead consider private equity as a substitute. Second, private equity firms may be able to leverage their financial strength and their relationships with banks to help the companies in their portfolios to take advantage of the lower financing rates offered by banks.

Given the challenging sourcing environment, private equity funds report that the clear majority of their deals are proprietary, meaning that private equity firms find these deals via their own networks rather than via banks or other intermediaries. While this approach allows firms to find deals while avoiding competition, it also requires time and resources and is difficult to scale quickly. Kenya, like many emerging markets countries, is not the kind of environment where private equity firms receive an ongoing stream of pitch books or participate in a large number of auctions for highly sought after assets. There are few international investment banks and the local advisors and brokers are of uneven quality. Instead of relying on third parties to bring them transactions, private equity investors in Kenya report that they must instead actively network in order to create meaningful relationships with family businesses. Building trust takes time, and firms must be prepared to strike when there is an opportunity to deploy capital. Such an opportunity might come with a change in generation or when a firm desires to grow, professionalize, or expand regionally. Although this approach works well for PE firms with deep networks, the long deal cycle and complications finding investible companies means that funds must invest significant time and energy to build their pipelines.

B. Deal Structuring

While the market has matured significantly over the last decade, multi-generational family businesses often continue to be reluctant to cede control to outside investors. Many of the best run and most promising Kenyan companies are family businesses. While such companies would be prime candidates for private equity investment (as is common in other parts of the world), these firms typically lack familiarity with the asset class and tend to be skeptical of investors, particularly if they are foreign in nature. Many SMEs are family businesses that are run by entrepreneurs who are control-oriented and thus these individuals may not perceive a clear value add from VC/PE investors. Local fund managers have found that personal networks and relationships can make a major difference when confronting these challenges. However, investment often comes in the form of minority participations, which means that investors will be partnering with the current owners rather than simply buying a majority or even all their shares and taking control. Thus, the private equity process is usually a long one, requiring months or even years of meetings and conversations to build trust between all parties.

C. Human Capital

In addition to the lack of resources for SMEs, the capacity of fund managers tends to be weaker in nascent markets. Although Kenya now has a growing league of experienced private equity firms (e.g. Helios, AfricInvest, Phatisa) that have raised follow-on funds, many of the firms operating in the market - especially SME funds - are first time fund managers. This reality is of critical importance since the private equity and venture capital businesses both require an apprenticeship approach whereby professionals receive training and gain on the job experience by working with more senior colleagues. In the absence of such experience – or learning by doing – investors lack the context to manage through the ongoing challenges that are part of the day to day life of investors in private companies. The remedy to this issue is to either: (i) grow capacity within the local investor base or (ii) attract experienced overseas talent to move to Kenya and add their talents to the industry.

It is also worth noting that since the average size of funds remains small, funds have limited management fees to cover their costs and pay salaries that will allow them to attract strong talent. PE and VC firms fund their operations by charging a management fee, usually in the range of 2 percent of funds under management. Thus, when a fund is small, there is very little budget to cover the actual operations of the funds from legal expenses and rent to salaries for professionals. This creates significant challenges for small funds. Most SME, impact and VC firms tend to be small, although their investments arguably require even greater hands-on management than the investments done by private equity firms. In Kenya, there is pressure (and clear incentives) for successful funds to move up to larger deal sizes, thereby allowing them to raise more capital, generate incremental management fees, and attract stronger talent.

Some funds also report that securing working approval for foreigners can be challenging. For private equity investors, this concern relates directly to hiring and retaining the requisite talent needed to manage the funds themselves. Some investors, such as pan-regional funds, often look to bring international talent to Kenya as they establish offices in the country, given the lack of seasoned investment professionals in the local market. They report challenges when securing work permits, particularly with regards to more junior professionals or when seeking to move African-nationals into Kenya. Given the very specific human capital needs in the tech sector, which is a favorite of VC investors in Kenya, as well as the small size of such target companies, migration concerns are particularly important to the venture capital industry.

D. Exits

Exit is another constraint common to VC/PE funds in developing countries, and Kenya is no exception. As noted, there have been few IPOs on the Nairobi Securities Exchange for several years and of the 12 companies that have gone public since 2000, only half are trading above their IPO price. This challenging market for IPOs, combined with the poor performance of the NSE has meant that the VC/PE industry must rely on sales to strategic players and self-liquidating instruments to facilitate exits. PE funds can also sell their stakes in companies to other investment firms.

Regardless of the IPO market, fund managers also frequently note that the maturation time for investments in Kenya and Sub-Saharan Africa is greater than in other parts of the worlds, even in other emerging markets. As noted, this longer gestation period, as well as the challenging exit environment, has pushed some investors in Kenya toward weighing the benefits of PCV models.

E. Fundraising

Although private equity and venture capital are not new investment classes in Kenya, most funds – with the exception of pan-regional funds - are still backed by DFIs and have not yet been able to diversify their base of limited partners to include robust participation from the private sector. Although pension funds are now considering private equity for inclusion in their portfolios, structural and cultural impediments to investment remain, including a lack of knowledge about the asset class and a lack of incentives to take risk on the part of the pension funds themselves. Meanwhile, insurance funds remain a large target market but there is no regulatory clarity with regards to their ability to invest in the asset class. Some level of trepidation is to be expected, as private equity as an asset class in Africa remains quite new, particularly with regards to East Africa. Other than the limited sub-set of large and established funds in the region, there are few firms that have managed a fund through the complete process of deploying capital and then exiting all the investments, especially in the mid-market, SME, impact, and venture capital spaces. Moreover, there is scarce data with respect to returns (i.e. IRRs) across the continent, especially outside of South Africa. Thus, while private equity is a known commodity in many regions of the world, there is a paucity of data on PE returns in many parts of Africa, which can lead to hesitance to invest capital.

F. Technical Assistance

PE investors in emerging markets face challenges that their counterparts in developed markets rarely encounter, which often translates into a need to integrate technical assistance (TA) into their investment activities. In developing markets like Kenya, even established businesses often lack critical business tools, from management and financial planning to technology and management systems, that are common in developed market businesses. These issues are even greater for SMEs, many of which lack the resources or the know-how to develop these systems and processes on their own. Even when support services are available, they may be expensive and difficult to procure. As a result, technical assistance can help to address these challenges. Specifically, the range of projects that can be considered under the rubric of technical assistance include: financial literacy training, resource planning and budgeting, business plan development, finance and accounting training, marketing support and market studies, strategic planning, legal support, operational and process improvement, facilitating access to international supply chains, and information technology support.

Technical Assistance (TA), when partnered with private equity, can considerably enhance the ability of SMEs in emerging markets to raise PE capital. First, technical assistance provides funding that allows investment managers to extend their reach to smaller companies since they can make necessary improvements without impacting returns. Second, technical assistance mitigates risk and increases the probability for success by implementing targeted operational improvements at investee companies. Since SME funds often lack sufficient scale to fund such projects themselves, dedicated technical assistance facilities financed by third parties such as DFIs, governments, or other parties, have emerged to fill this critical need.[31] Table 16 presents the primary sources of funding for technical assistance facilities both globally and in Africa. Unsurprisingly, the same DFIs that play a large role as LPs in the East African VC/PE space also actively fund technical assistance facilities.

While technical assistance provides significant benefits, particularly for SME funds, excessive technical assistance could also lead to a form of governance distortion that investors must guard against. When looking at projects where technical assistance is working in conjunction with PE, donors are often sensitive to ensuring that they are not simply "subsidizing" private investors. For instance, where technical assistance is provided, investors must ensure that the funding serves primarily to increase portfolio value and build capacity for investees rather than indirectly elevating management fees for the fund manager. The latter could potentially result in incentives for the fund manager being skewed in favor of management fees versus performance incentive, thus resulting in a governance distortion.[32] If technical assistance is unevenly applied – such as dedicated technical assistance facilities accessible to only some PEVC funds, creating an unlevel playing field – there is potential for market distortion.

Technical assistance practices among fund managers can generally be classified into two different groupings: Technical Assistance Facilities and Ad Hoc TA. The difference between these two categories is

[31] For more on this, please see April 2014 WB Policy Research Working Paper 6827, "Private Equity and Venture Capital in SMEs in Developing Countries: The Role for Technical Assistance" by Shanthi Divakaran, Patrick McGinnis, and Masood Shariff.
[32] Note: For more on lessons from the use of technical assistance in conjunction with PEVC funds, please see the following WB policy research paper.

relatively intuitive: the former represents more formally structured, permanent and consistently implemented technical assistance services, while the latter denotes a less structured, case-by-case approach. For the purposes of analytical coherence and utility, this report will focus on technical assistance facilities. The staffing and management of a technical assistance facility may be undertaken by donors, the PE fund itself, a third party administer, or a combination of these groups. For example, donors may elect to have a PE fund manage its own technical assistance facility. Alternatively, donors may hire a third party to manage the technical assistance facility. For example, Phatisa's Africa Agriculture Fund partnered with global non-profit TechnoServe for its technical assistance facility. Similarly, consulting firms such as Deloitte are equipped to administer technical assistance facilities. While contracting a reputable third party to manage the technical assistance facility is an option, it does present some challenges due to the high billing rates charged by these types of fully commercial firms.

Technical assistance facilities are the dominant form of technical assistance services associated with PE fund managers in Kenya, with most managers engaging in some kind of formalized, structured technical assistance with potential or current portfolio companies. The popularity of SME and Impact-focused investment strategies among VC/PE investors in Kenya and the broader East Africa sub-region can be understood as one of the primary reasons for the abundance of technical assistance facilities in the market. All these characteristics are, in turn, tied to the abundance of DFI and government funders as well. As noted, in some instances, technical assistance facilities are implemented by donors. Examples of this type of facility are Fanisi's US$2 million technical assistance fund operated by Norfund and AfricInvest's facility, which is administered by Proparco and the African Development Bank (ADB). Other firms utilize donor financing but rely on external service providers to implement TA. BPI East Africa runs a mentorship support services program that provides technical assistance to SMEs through outside consultants and experts who provide counseling, specialized assistance (e.g. accounting, IT systems, marketing), industry sectoral assistance and turnarounds.

Table 15: Funding Sources for Dedicated Technical Assistance Facilities by Geography and Type

Global TA Funders	Africa-Focused TA Funders
DFI/Government	**DFI/Government**
Agence Francaise de Developpement	African Development Bank
Bio	AGRA
COFIDE	CDC
EIB	KfW/DEG
EBRD	EIB
Finnfund	FMO
FMO	IFC
IFC	IFAD
KfW/DEG	Italian Development Corporation
OPIC	Norfund
Swedfund	Proparco
USAID	UNIDO
Omidyar Network	USAID
Foundations	**Foundations**
Conservation International	Bill & Melinda Gates Foundation
Ford Foundation	Elma Foundation
Gordon and Betty Moore Foundation	Gatsby Charitable Foundation
The Rockefeller Foundation	Maria Wrigley Trust
	Rockefeller Foundation
	Shell Foundation
Corporate-Related Institutions	**Corporate-Related Institutions**
Accion International	ASN Bank
Triodos-Doen	Doen Foundation
	JP Morgan Social Finance

Source: Primary Research

Table 16: Technical Assistance Practices Among PE Investors Active in Kenya

TA Facility	Ad Hoc
Abraaj Group	AfricInvest
Acumen	Ascent Capital Partners
AfricInvest	Blue Haven Initiative
BPI East Africa	DOB Equity
Business Partners	Grassroots Business Partners
Fanisi Capital	Kibo Capital
GroFin	Safaricom
Lundin Foundation	
MANGO Fund	
Novastar Ventures	
Phatisa Fund Managers	
responsAbility	
Small Enterprise Assistance Fund	

Source: Primary Research

A smaller yet not insignificant number of fund managers active in Kenya take a more ad hoc approach to TA. For example, Kibo Capital does not have a technical assistance facility per se, but when interviewed, reported that some 80-85 percent of their deals involved bringing in outside technical specialists (e.g. strategic consultants, lawyers) to help investees. Similarly, Grassroots Business Partners, DOB Equity and Safaricom's Spark Fund all rely on a combination of internal and external expertise to support and advise portfolio companies, yet they are not associated with any formal technical assistance facility. Although AfricInvest offers dedicated facilities through Proparco and ADB, the manager characterizes its technical assistance model for funds I, II and III, as ad hoc.

In addition to technical assistance facilities and ad hoc practices managed by or in coordination with commercial fund managers, there are a number of specialized companies in the Kenyan ecosystem that provide dedicated advisory, business support and capacity building services. The most prominent of these stand-alone technical assistance providers in the Kenyan VC/PE space are Open Capital Advisors and CrossBoundary. These entities play a unique role in the market: In addition to providing conventional technical assistance services (e.g. accounting support, Human Resources training), they also help advise companies on how to raise capital and make introductions to funders. Open Capital Advisors is the most prominent of this kind of players in East Africa, according to interviews with fund managers. The firm advises companies raising for rounds ranging from US$100,000 to US$10 million. It also provides consulting services to some fund managers, which enlist the firm's services to conduct due-diligence.

In addition to examining the differing types of TA, it is important to note whether a firm conducts technical assistance activities either pre-investment, post-investment or throughout the lifetime of an investment. Pre-investment technical assistance funds are disbursed prior to investing in any company. These funds can be used for projects such as market surveys or other types of research projects that can help to surface potential investment opportunities. For example, responsAbility describes its technical assistance facility as reducing risk and helping the manager "develop a more robust pipeline for the fund as well as a sounder basis for its investment decisions." The facility builds capacity with local promoters and financial institutions in the renewable energy market and supports potential investment projects, particularly in early development stages. In contrast, post-investment technical assistance occurs after a PE firm has closed an investment; such is the case for Novastar's technical assistance services, which include grants and third-party consulting. In general, most technical assistance funders show a strong preference for projects that focus on the post-investment phase because they provide technical assistance to portfolio investments rather than potential investments that may fall off the pipeline after due diligence. MANGO Fund is the only manager active in Kenya that explicitly markets its technical assistance facility as one that caters to the needs of businesses from the application period, through the procurement process and all the way until an investment is fully exited.

III. The Legal, Regulatory and Tax Framework for the Kenyan Private Equity & Venture Capital Industry

Increased global regulatory oversight of PE/VC

Since the 2007-08 global financial crisis, there has been a trend in increasing oversight of previously unregulated entities such as private equity funds and hedge funds. The G20's November 2008 summit was a defining point, leading to the decision that all significant financial market participants must be regulated to preserve financial stability and to protect investors. In line with this decision, the EU adopted the

Alternative Investment Fund Managers Directive (AIFMD) or Directive 2011/61/EU33 to regulate and supervise alternative investment fund managers (AIFMs) who manage alternative investment funds (AIFs), including PE funds, VC funds, hedge funds etc. operating in the EU. Similarly, the US Dodd-Frank Act, enacted in 2010, gave the US SEC greater purview over private funds.

Increased regulatory oversight of the asset class also engenders investor confidence. Institutional investors, particularly in markets where PE/VC is nascent, are less comfortable investing in an asset class which is unregulated. Thus, more oversight can increase the flow of capital into the asset class from such investors.

Overview of Kenya legal/regulatory framework for PE/VC

In Kenya, currently there is no overarching PEVC legislation/regulation, although the Capital Markets Authority (CMA) regulates the subset of venture capital funds within PEVC funds**.** The Capital Markets (Collective Investment Schemes) Regulations, 2001 ("CIS Regulations") does not provide a clear definition of collective investment schemes (CIS), but the thrust of the regulation is focused on CIS/funds offered to the public. In practice, therefore, the CMA focuses on CIS that meet the definitions of public offer in the Capital Markets (Securities) (Public Offers, Listings and Disclosures) Regulations ("Public Offer Regulations"). Given PEVC funds do not solicit funds from the public, they are not bound by the Public Offer regulations or, de facto, by the CIS regulations. Given the government's objective to promote venture capital investment in Kenya, venture capital funds benefit from a special taxation regime and are regulated under the Capital Markets (Registered Venture Capital Companies) Regulations, 2007 (or the CMA (VCC) Regulations) and the Income Tax Act. As defined by the CMA (VCC) regulations, a VC fund must be an LLC, incorporated under the Companies Act; registered with the CMA, with a minimum paid up share capital and fund size of Kenya shillings 100 million (~USD1 million). The fund manager must have a license from the CMA and the fund must have a board of directors, one third of which are independent. The VC fund's investees cannot be primarily involved in real estate; banking and financial services; or retail and wholesale trading. Furthermore, VC funds are eligible to tax benefits (*discussed below*) if they meet specific requirements per the Income Tax Act (Venture Capital Enterprise) Rules, 1997, most of which overlap with the CMA (VCC) regulations.[34]

In the absence of an overarching regulation on PEVC funds, an array of key legislations applies to PEVC funds that seek to be established or operate in Kenya. These include the Companies Act, 2015 ("Companies Act")[35], the Partnerships Act, 2012 ("Partnerships Act")[36], the Limited Liabilities Partnership Act, 2011 ("LLP Act")[37], the Income Tax Act, Chapter 470 ("ITA")[38], the Income Tax Act (Venture Capital Enterprise) (Amendment) Rules, 2008 ("Income Tax Rules)[39], and the CMA (VCC) Regulations.[40]

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[33] DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

[34] The VC Fund must be incorporated in Kenya, and must be set up for the purpose of investing in new or expanding venture enterprises companies; registered by the CMA; managed by a fund manager licensed by the CMA in Kenya; at least 75% of investable funds must be invested through equity or quasi-equity investment in venture capital enterprises; and the primary activities of the investees must be approved activities.

[35] http://www.kenyalaw.org/lex//actview.xql?actid=No.%2017%20of%202015.

[36] http://www.kenyalaw.org/lex//actview.xql?actid=No.%2016%20of%202012.

[37] http://www.kenyalaw.org/lex//actview.xql?actid=No.%2042%20of%202011.

[38] http://www.kenyalaw.org/lex//actview.xql?actid=CAP.%20470.

[39] http://kenyalaw.org/lex/sublegview.xql?subleg=CAP.%20470#KE/LEG/EN/AR/I/CHAPTER 470/SUBLEG/HC_9.

[40] http://www.kenyalaw.org/lex//sublegview.xql?subleg=CAP.%20485A#KE/LEG/EN/AR/C/CHAPTER 485A/SUBLEG/HC_9_V1.

To address why funds do not choose Kenya as a domicile, the CMA has undertaken a process to develop a broad framework for reform.[41] The team that is overseeing the reforms at the CMA is benchmarking Kenya against other markets – specifically Luxembourg, South Africa, Mauritius, Australia, and Singapore – to develop a sense of best practices in the industry. Moreover, the CMA is working closely with the East African Venture Capital Association (EAVCA) and its members to address and integrate feedback on its proposed reforms from the industry itself. Regardless of the proposed reforms that may be enacted by the CMA, it is highly likely that most PE funds operating in Kenya will continue to be registered in foreign jurisdictions due the importance of regional investing, the hard currency preferences of investors, and the efficiency associated with going offshore.

Although there is no overarching PEVC regulation in Kenya, available legal structures allow for onshore domicile of PEVC funds**.** It is critical for private equity funds to identify efficient vehicles and structures to pool capital from various domestic and foreign investors. Fund vehicles can be located either onshore (in-country) or offshore, depending on the level of flexibility of legal structures as well as investor location and preference. The legal form of a PEVC fund is also the principal basis for its tax treatment. The choice of fund vehicle has a direct impact on the taxes paid, and therefore, the returns earned by the fund investors. In Kenya, a PEVC fund, or its SPV, may be established onshore as i) a private company limited by shares, referred to as a Limited Company in Kenya (or an LLC, as in the United States); ii) a Limited Liability Partnership (LLP); or iii) as a Limited Partnership under the Partnership Act.[42]

However, there are currently no PEVC funds established onshore because of the perceived structural inefficiency of the available vehicles. Of the available legal structures, the Limited Company or LLC is not an attractive onshore fund vehicle for investors for several reasons. First, the LLC is taxed at the corporate tax rate of 30% on realized profits. Second, an LLC's distribution to shareholders must be made through dividends, which requires that the LLC maintain a Dividend Tax Account (DTA). The DTA, in turn, determines the amount of dividends that can be distributed without triggering compensating tax (*see discussion below*). Dividends paid to a Kenyan resident by an LLC are subject to withholding tax of 5%, and 10% for a non-resident person.[43] In addition, the seller of an LLC's shares incurs 5% capital gains tax.[44] Lastly, according to the Companies Act 2015, all limited companies are required to have share capital in KES, meaning that any onshore VCC registered in Kenya as a limited company would be required to have core capital in Kenya Shillings. This is unattractive to foreign investors, who typically prefer USD or euro funds. In contrast to the LLC, the LLP, which came into effect in 2012, is itself a tax transparent entity [45] -- instead, the investors are taxed on their shares or profits per their partnership deed. LLPs do not distribute dividends but rather share the profit between the partners. However, LLPs are still a relatively new concept,

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[41] As discussed in a meeting with the CMA during the World Bank mission to Kenya.

[42] The Partnership Act and the LLP Act establish two different forms of partnerships - The Partnership Act establishes limited partnerships and the Limited Liabilities Partnership Act establishes limited liability partnerships (LLPs). A limited partnership (LP) under the Partnership Act consists of one or more general partners each with unlimited liability and one or more registered limited partners each with limited liability. In an LLP formed under the LLP Act, all partners have limited liability. A PE fund may be set up as a limited partnership under the Partnership Act or as an LLP under the LLP Act.

[43] Dividends paid to a resident company holding at least 12.5% shares by a resident company is exempt from tax.

[44] If shares are sold in an offshore SPV that hold shares in Kenyan companies, then based on the current law, the gain will not be taxed in Kenya. However, this depends on the business activity of the Kenyan companies -- the 9th schedule (which deals with the oil & gas) taxes a disposal where there is an underlying change of ownership.

[45] Instead, the partners (individuals or corporates) are taxed on their share of profits in accordance with the agreed ratio as set out in the partnership deed. An LLP is a hybrid of a traditional general partnership and an LLC hence enjoying the benefits of both partnerships and LLCs. An LLP is considered to be a body corporate with legal personality separate from that of its partners, with perpetual succession and limited liability.

and the Kenya Income Tax Act has not been amended to make specific provisions for this structure, nor has it been tested sufficiently by PE funds to provide a conclusive analysis. In addition, the LLP structure may not be attractive to corporate foreign investors because non-resident partners in an LLP would need to setup a branch of the foreign company in Kenya since they are likely to create a "permanent establishment" [46] in Kenya (by holding a partnership stake in a Kenyan LLP). This may result in corporate foreign investors incurring corporate tax liability at the non-resident rate of 37.5%.[47] Individual non-resident partners would also be liable to income tax in Kenya on any income accrued in or derived from Kenya.[48] The Partnership structure is also tax transparent and similar to the LLP structure; non-resident partners, whether individuals or corporate entities would be subject to tax in Kenya on income accrued or derived from Kenya.

PEVC funds that invest in Kenya are therefore generally domiciled offshore; however, if the offshore fund were considered to be resident in Kenya, it would be subject to tax liability in Kenya. PEVC funds are generally domiciled offshore because these funds seek to raise capital in US dollars or euros since most of the limited partners that invest in Kenya are foreign (as discussed earlier in the report). Fund jurisdictions such as Mauritius have an established track record and offer investor safeguards, with PEVC funds that are regulated by the Financial Services Commission of Mauritius. Mauritian corporate law is sufficiently sophisticated to allow PE investors to structure deals flexibly. Mauritius is also an attractive offshore jurisdiction because it is only a 4-hour flight from Nairobi. However, despite being incorporated outside of Kenya, an offshore fund could be deemed resident in Kenya if at any time during the tax year, the management and control of the company's affairs are exercised in Kenya; or the Minister of Finance has declared the company to be resident in Kenya through a notice in the Kenya Gazette. Given the Act does not define "management and control," there is room for interpretation on whether an offshore fund is considered resident in Kenya.[49]

Fund Managers

Global trends on the regulatory framework of PE/VC typically focus on the fund manager rather than the fund, and particularly those fund managers that manage a large volume of assets. In general, the PEVC regulatory framework focuses especially on those fund managers that control assets above a certain threshold size, to guard against systemic risk. These regulations usually provide less stringent requirements for fund managers managing a smaller volume of assets, venture capital or social enterprises. Thus, for example, the EU AIFM Directive focuses on regulating the Alternative Investment Fund Manager (AIFM) managing above €500 million (unleveraged) or € 100 million (leveraged). Following the directive, in 2013 the EU issued regulation 345/2013 for VC funds -- the European Venture Capital ("EuVECA") regulation -- which essentially provides a marketing passport for VC fund managers across the EU in return for less

[46] A place of business which gives rise to a tax liability.
[47] The Income Tax Act does not deal with the taxation of LLPs and therefore tax practitioners have assumed an LLP will be taxed in the same way as partnerships. The Act does not deal with foreign partners and therefore, to be conservative the rate of 37.5% is often mentioned. It does not mean a capital gain will taxed at 37.5%, it impacts interest/management income.
[48] Section 3(1) of the Income Tax Act provides that "income tax shall be charged for each year of income upon all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya." The income tax rate applicable in Kenya is 30% charged on income in excess of KES 513,373.
[49] The Kenya Revenue Authority could be guided by international principles or "central management and control" tests adopted by other countries, which generally consider the physical location where the Board of Directors conducts key decision-making to be most important in determining where control is exercised.

onerous compliance regulations on investment portfolio, techniques, and eligible assets.[50] Similarly, in the US, fund managers for private funds with assets under management over $150 million are required to register with the SEC.[51] (*See Box below*)

Box 1: Less stringent requirements under the EU AIFM Directive for certain types of AIFS
The EU AIFM Directive provides for less stringent requirements for three types of AIF fund managers: In the first case, if the fund managed is below €500 million (unleveraged); or below € 100 million (leveraged), the regulatory requirements are less stringent; however, following the less stringent requirements does not give the manager a passport for EU-wide management or marketing (although the AIFM can opt-in if they want). The EU also issued a 2013 regulation (EU Regulation 345/2013)[52] on VC funds, which is part of a special proposal for managers of European Venture Capital Funds, complementing the AIFMD. Again, this is a regulatory initiative which is less onerous than AIFMD and seeks to improve access to finance for SMEs. These regulations provide a marketing passport for VC firms in return for compliance with rules on investment portfolio, investment techniques, eligible undertakings etc. and applies to managers of AIFs with Assets Under Management (AUM) below € 500million, unleveraged, closed-end AIFs[53] where at least 70% of capital commitments have to support young and innovative companies. EU VC fund managers are not required to follow this special regulation (in which case they would instead follow AIFM directive). The third case where the EU Directive provides less stringent requirement is for Social Entrepreneurship Funds with AUM below euro 500 million. This vehicle can be marketed across EU, but it is not compulsory to be set up under these regulations.

In Kenya, fund managers of any collective investment scheme, including PEVC funds, are required to be licensed by the CMA, if they are above a certain threshold. Fund Managers are defined under the CMA Act as "*a manager of a collective investment scheme, registered venture capital company or an investment adviser who manages a portfolio of securities in excess of an amount prescribed by the Authority from time to time.*" Fund managers incorporated in Kenya, or onshore advisors to offshore fund managers,[54] are taxed at the corporate tax rate of 30% on their advisory fees received. They charge standard VAT of 16% if their services are consumed in Kenya; and VAT of 0% if their services are consumed outside Kenya (deemed as exports).[55]

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[50] Applies to fund managers managing unleveraged closed ended AIFs below euro 500 million, who invest at least 70% of the portfolio in eligible VC undertakings.

[51] Fund manager managing a lower threshold of assets are usually required to register with the state, instead of the SEC.

[52] REGULATION (EU) No 345/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 April 2013 on European venture capital funds.

[53] Applies on a fund-by-fund basis.

[54] Most offshore funds use an investment advisory agreement to create an onshore fund advisor who serves as in-country service provider. They provide services such as i) identifying, procuring and evaluating opportunities consistent with the investment policy or policies of the Fund; ii) communicating advice and recommendations to the Fund Manager; iii) advising the Fund Manager on potential terms of an acquisition or divestment (formulating, but not undertaking any negotiation, of terms); iv) reviewing investments, periodically reporting to the Fund Manager and providing appropriate advice or recommendations to the Fund Manager; v) periodically monitoring, analyzing and reporting on the performance of the investments to the Fund Manager etc.

[55] Since the Fund and the onshore Manager are likely to be related parties, transactions between the two would fall within the context of transfer pricing rules in Kenya. ITA Transfer Pricing Rules, 2006, requires that related entities must establish a justifiable transfer pricing policy for cross-border transactions (that is, involving an offshore fund and an onshore manager), based on a benchmarking pricing exercise. Any such dealings should be conducted at arm's length (i.e. as would have been conducted between independent parties), otherwise the Commissioner is empowered to adjust/correct the prices as he deems appropriate and subject to any understated income to tax.

Key legal/regulatory issues for PEVC funds and investors

Kenya is a common law jurisidiction, with a legal framework based on UK law. In the absence of an overarching legal and regulatory regime for PEVC funds, the key legal/regulatory issues for these funds operating in Kenya are the structural inefficiency of the available legal forms described above; the time and resource burdens imposed by multiple competition regimes; and the regulatory and structural constraints to domestic institutional investment in the asset class. Given PEVC funds in Kenya generally invest in growth capital through minority stakes, buyout transactions – that is, when a PEVC fund purchases a controlling share in a company – are not common in Kenya. Regulations on buyouts, including buyouts by public auction, therefore do not yet exist in Kenya.

Competition Policy

Competition regulators have played a marked role for the PEVC industry in Kenya. Depending on the size, geographic scope, and nature of a transaction, private equity investors in East Africa overall must contend with several entities when filing for approval from competition authorities. Although PEVC investments are distinct from traditional mergers and acquisitions ("M&A"), they represent a form of business combination that could potentially change competition dynamics in a market. Thus, competition authorities globally take PE activity into account when regulating a market. However, for PEVC funds operating in Kenya, regulation of competition policy does not stop at Kenya's border. Regulatory bodies at the EAC, the Common Market for Eastern and Southern Africa (COMESA), and the sovereign level also impact private equity investors operating in Kenya and East Africa. The universe of potential bodies and laws from which an investor requires approval includes:

Table 17: Competition Regime in Kenya

	National Level (Kenya)	**Regional Level**
Law/Regulation	Competition Act, 2010, which came into force in 2011 (the Competition Act).[56]	COMESA Competition Regulations (2004) ("COMESA Regulations") East African Community Competition Act ("EAC Competition Act").[57] *The EAC regime has, however, not yet been operationalized although advanced plans are underway.* Tanzania Fair Competition Act (2003)[58] *Other members of the East African Community do not yet have national competition laws.*
Regulator	The Competition Authority of Kenya (the CAK), established under the National Treasury by the Competition Act	The COMESA[59] Competition Commission ("CCC"), which became operational in 2013.

[56] https://www.researchictafrica.net/countries/kenya/Kenya_Competition_Act_revised_2012.pdf.
[57] http://www.industrialization.go.ke/images/downloads/policies/eac-competition-act-2006.pdf.
[58] http://www.competition.or.tz/PUBLISHE_DOCUMENTS/FCA/fca_no_8-2003.pdf.
[59] COMESA comprises of: Burundi, the Comoros, the Democratic Republic of Congo, Djibouti, the Arab Republic of Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, the Seychelles, Sudan, Eswatini, Uganda, Zambia, and Zimbabwe.

		The East African Community[60] Competition Authority ("EACCA") Fair Competition Commission of Tanzania ("FCC")

The lack of coordination and harmonization between the various competition authorities results in PEVC funds undertaking multiple, time-consuming, and expensive approval processes, that include significant disclosure requirements. The CCC's mandate does not reflect the existence of the CAK or its role in regulating competition.[61] And vice versa, GoK has not yet amended the Competition Act to consider the existence of the CCC and allow, for example, applicants to only request CCC approval instead of both CAK and CCC approval. PEVC funds are therefore required to notify more than one regulator of a transaction, with each regulator applying different merger notification tests, timelines, procedural requirements and filing fees. In turn this leads to an accumulation of increased legal and filing fees – CAK fees can range between USD 5,000 to USD 20,000,[62] while the CCC can attract a filing fee up to USD 200,000. The lack of coordination can also lead to uncertainty about whether one regulator could approve a transaction, while another denies it. In addition, there could be delays in concluding transactions – the CAK is required to approve transactions within 60 days after receipt of a complete merger notification,[63] while the CCC normally takes between 90-120 days if the transaction is not approved in the first phase.[64] Competition authorities also typically require merger notification filings that can be both significant and burdensome.[65] PEVC funds may be required to disclose financial information for each of the companies in its investment portfolio, regardless of whether that company operates in an industry competitive to the investment target. In addition, if the PE fund holds shares in multiple SPVs in Kenya, they may need to disclose each SPV's portfolio of investments. In sum, PE funds may be required to disclose the entirety of their portfolios to the CAK, which can be considerable for large and pan-regional funds.

While harmonization initiatives are underway, there is no clear timing on such efforts to clarify the relationship between the CAK, the CCC, the prospective EACCA, or other national competition authorities in East Africa, such as Tanzania's FCC. Kenya is taking steps to harmonize its competition regime with that of COMESA. In June 2016, Kenya invited all competition authorities in East Africa to a summit to establish a rational policy for national, regional, or international level transactions. Such efforts, if successful, will create a stable policy environment, lower costs, eliminate conflicts and minimize the incentive to engage in jurisdiction shopping. However, there is no clear timing on the harmonization

[60] East African Community comprises of: Burundi, Kenya, Rwanda, South Sudan, Uganda and Tanzania.

[61] At the time of the creation of the CAK, the regulatory regime under CCC had not yet been promulgated. Thus, it was created without considering how the CAK would eventually interact with a supranational body such as the CCC.

[62] A filing fee of KES 500,000 (~USD 5,000) is payable where the turnover of the merging parties is between KES 500 million (~USD 5 million) and KES 1 billion (~USD 10 million). A fee of KES 1 million (~USD 10,000) payable where the turnover of the merging parties is between KES 1 billion (~USD 10 million) and KES 50 billion (~USD 500 million). The highest filing fee payable is KES 2 million (~USD 20,000) where the turnover is KES 50 billion (~USD 500 million) and above. Note that not all applications are subject to exclusion.

[63] Section 44 of the Competition Act provides that the CAK shall make a determination on a merger notification within 60 days. Although under law, the CAK can extend this timeline.

[64] While the Kenyan regime is "suspensory" – that is parties are prohibited from completing transactions without prior approval from CAK; the CCC regime is non-suspensory – that is parties can complete their transactions without awaiting CCC approval, but any issues that arise must be addressed post-closing. According to COMESA's merger guidelines, the first phase expires in 45 days if harm to competition is unlikely.

[65] Standard filing includes a merger notification form, to which the audited financial statements of the merging parties' copies of business plans and board resolutions are required to be annexed.

initiatives. Moreover, the situation will only become more complicated once the EACCA becomes fully operational.

A key issue affecting PEVC funds (which often acquire only minority stakes in companies) is that, unlike in other policy areas, competition authorities including both Kenyan and regional competition authorities employ a broad definition of mergers to include "change of control", rather than simply owning a majority of shares. As per international standard, Kenya's Competition Act defines a merger as a "change of control", which includes the acquisition of more than 50% of the firm;[66] but even if the investor acquires less than 50%, contractual controls -- such as veto rights or the ability to change the company's management -- can trigger "change of control."[67] This places investment funds on an equal footing to corporations – that is, if a Kenyan PE fund seeks to buy a minority stake in a local soft drink company, where the PE fund will have veto rights, it is held to the same series of regulations as a transaction in which Coca Cola® is buying the entirety of the same asset. This regulatory reality is significant for PE investors, as PE funds typically require a standard set of veto rights and often negotiate for the right to change management of the companies in which they invest. Thus, even if a PE fund acquires a minority stake in a company (as is common with growth equity or venture capital investors), the transaction is more than likely to require CAK approval. Similarly, the CCC must also be notified if a transaction involves a change of control.[68] Globally, notification requirements to the relevant competition authorities vary among jurisdictions, including with the FCC in Tanzania.[69] While competition filings in Australia and the UK are voluntary, filing in the US and European Union countries is mandatory if certain thresholds are met (*see discussion on thresholds below*).

Another key issue is whether the relevant competition authority applies financial thresholds to determine which mergers – and, therefore, which PEVC transactions – it must review. This issue is exacerbated if key terms -- such as "turnover"[70]-- used to determine financial thresholds, have not been clearly defined. The CCC, for instance, had originally set the financial threshold for mergers at zero, meaning that they had to approve all mergers that met the regional dimension test.[71] In 2015, these thresholds were revised, so the CCC had to be notified only if the combined annual turnover or assets (whichever is higher) exceeded USD 50 million; *and* the annual turnover/ assets (whichever is higher) of at least two of the parties exceeded USD 10 million.[72] Similarly, in Kenya, Section 42 of the Competition Act required all mergers within Kenya to seek CAK's approval. In 2013, however, the CAK published Merger Threshold

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[66] Competition Act Section 42(3) (a).

[67] Consolidated Guidelines on the Substantive Assessment of Mergers under the Competition Act, Paragraph 21.

[68] A private equity investor must notify the CCC when a transaction: (i) entails a change of control, rather than purchasing a simple majority, (ii) is regional, whereby both the acquiring firm and the target firm, or either the acquiring firm or target firm operate in two or more COMESA Member States, and (iii) exceeds certain financial thresholds.

[69] In Tanzania, all M&A where one party has the possibility of exercising "significant or decisive influence" over an entity or section of a business in Tanzania, involving a combined turnover/asset currently over TZS 800 million (or ~USD 360,000) must notify the FCC. "Significant or decisive influence" is widely interpreted by the FCC and a minority acquisition can be deemed to constitute a merger if the same is coupled with veto rights or reserved powers or a majority of the board. A merger is prohibited if it creates or strengthens a position of dominance – if market share is over 35%.

[70] Turnover is defined in The Exclusion of Proposed Mergers from provisions of Part IV of the Competition Act as "includes the value of the annual sales turnover for the merging parties within Kenya, based on the audited accounts of the holding company, the subsidiaries and other related companies for the preceding year".

[71] Whereby both the acquiring firm and the target firm or either the acquiring firm or target firm operate in two or more COMESA Member States.

[72] Unless each of the parties to a merger achieves at least two-thirds of its aggregate or assets in the same member country.

Guidelines ("Threshold Guidelines") to fast track the approvals in certain instances.[73] Generally, merging parties may request the CAK for an exclusion if the combined turnover of the acquirer and target is below KES 1 billion (~USD 10 million). This exclusion is normally granted within 2 weeks and does not attract filing fees.[74] In addition, the GoK has used different thresholds to attract PE Funds to markets like health care and carbon-based mineral sectors.[75] According to CAK's annual report for the 2014-2015 financial year,[76] 71 out of 148 notified M&A transactions were excluded from the provisions of the Competition Act, saving the applicants significant time and resources in the process. Offsetting the advantages of this simplified process, however, is that the Competition Act does not clearly define the term "turnover,"[77]which is key to determining thresholds as well as fees and disclosure requirements: the larger the turnover, the more the filing fees and the more the information required when seeking CAK approval. The 2016 amendments of the Competition Act allows setting a formal threshold for mandatory notification, but the rules for setting threshold value and defining elements to calculate "turnover" are yet to be approved.

In addition to the broad mandate defined by the competition law, if the regulator is (partially) required to cover its operational expenses through filing fees, this may incentivize broadened scope for reviews and higher fees, both of which can be burdensome to the PEVC industry. For example, while the CAK receives approximately 70-80 percent of its funding from the National Treasury, the remainder of its budget is covered by filing fees. The CAK has reviewed a growing number of transactions over the last several years -- 88 in the year ending June 30, 2014 (of which 4 transactions were PEVC related), increasing to 151 in the year ending June 30, 2016 (of which 10 were PEVC related).[78] Out of the 151 transactions in 2016, only 39 had a combined turnover of KES 1 billion (USD 10 million). Similarly, since becoming operational in 2013, COMESA's CCC uses its revenues to cover operational expenses. Given this pressure to generate revenue, the CCC initially charged a filing fee of 0.5 percent of the merging parties' combined annual turnover or assets (whichever is the higher), capped at USD 500,000. This high cost was revised downward in 2015 (concurrent with changes in the financial thresholds) to 0.1 percent, capped at USD 200,000. Competition authorities around the world charge fees for merger review to cover the administrative costs of undertaking a compliance check to ensure transactions do not harm competition, but these fees have to be proportionate to avoid discouraging efficient market development.

However, promising changes are underway. CAK recognizes the importance of the PEVC industry to attract capital to Kenya; and given the increasing number of PEVC transactions, as well as the time-sensitive nature of such transactions, interviews with CAK suggest they are developing simpler rules for PE investors. The CAK has indicated that, as part of its policies, it has determined that PE funds do not typically present concerns with respect to competition in an industry. Given PE funds' a priori bias against

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[73] While not legally binding, the Threshold Guidelines provide guidance to parties as to the circumstances under which a merger may be considered for exclusion and when a full merger notification is required.
[74] See Merger Threshold Guidelines, paragraph 4(a).
[75] In the health care sector, the thresholds for exclusion are between KES 50 million (approximately USD 500,000) and KES 500 million (approximately USD 5,000,000) while in the carbon-based mineral sector, the transaction may be excluded from notification if the value of the reserves, the rights and the associated exploration assets to be held as a result of the merger is below KES 4 billion shillings (approximately USD 4 million).
[76] Competition Authority of Kenya, Annual Report and Financial Statements 2014/2015.
[77] Turnover is defined in The Exclusion of Proposed Mergers from provisions of Part IV of the Competition Act as "includes the value of the annual sales turnover for the merging parties within Kenya, based on the audited accounts of the holding company, the subsidiaries and other related companies for the preceding year".
[78] Competition Authority of Kenya, Annual Report and Financial Statements 2014/2015/2016. Since June 30, 2016, 4 additional PE transactions were placed under consideration since 6/30/2016.

concentrating too much of their capital in any given sector,[79] the CAK has also indicated that it intends to "fast track"[80] approvals for PEVC investments. However, fast tracking of approvals is subject to interpretation and difficult to assess; and parties are prohibited from completing the transactions without prior approval of the CAK. In December 2016 the Competition Act was amended to allow CAK, in consultation with the National Treasury, to develop legally binding rules and regulations to set the thresholds to exclude certain mergers from requiring approval. However, the merger notification thresholds and the types of transactions (like PEVC) must be set in rules that are pending approval.

Legal and Regulatory Framework for Institutional Investors

Despite a large pool of pension fund assets that could be investable capital for the PE industry in Kenya, until 2014, PEVC investment could only be allocated under "Other Assets" with an overall cap of 5% investment; and pension funds required a "no objection" from the RBA to invest in the asset. After the Retirement Benefits Act of 1997[81] ("Retirement Benefits Act") was implemented, Kenya's pension market has been characterized by a large number of pension schemes. As of December 2014, there were almost 1,300 registered schemes of which over 450 were segregated (independently managed) schemes and over 800 were managed by fund managers and insurance issuers. In 2014, Kenya's pension fund industry assets were KES 788.15 billion (approximately USD 7.8 billion).[82] While large public pension funds in the US allocate an average of 7% to the PE asset class, [83] as of December 2014, PE accounted for less than 1% of Kenya's pension assets, compared to investments in GoK securities at 30% and listed equities at 23%. Until 2014, the pension industry regulator, Retirement Benefits Authority ("RBA") regulations did not provide a specific investment category to PE; instead, PE was included among the 5 percent (5%) "Other Assets" category. In addition, pension funds had to seek a "Letter of No Objection" from the RBA before committing to invest in a PEVC fund.

Currently, pension funds can invest up to 10% in PEVC. Actual allocation remains low, but there is clear recognition by the RBA that PE could become a more important component of pension funds' investment strategies going forward. In 2015, RBA amended the Investment Guidelines contained in the Retirement Benefits (Forms and Fees) Regulations to create a clear PE distinction and doubled the allowable investment threshold to 10%. Still, pension funds' exposure to PE remains low -- fewer than 10 pension funds invested in PE as of late 2016. However, the EAVCA expects an incremental US$50 million by the end of 2017 as funds avail themselves of the new regulatory regime and as pension funds seek diversification in their portfolios. This drive for a more diverse mix of investments reflects the challenging returns environment in Kenya with respect to other potential asset classes available to portfolio managers. For example, pension funds have been challenged by the poor performance of the NSE, especially considering that the NSE All Share Index decreased nearly 20 percent from the beginning of 2015 until the end of 2016. Pension funds that have been active investors in real estate have also seen the returns for those assets decline. Thus, they are looking to diversify and to invest in asset classes that can provide sustained long-term returns that are uncorrelated to the other investments in their portfolios.

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[79] PEVC funds seek diversification in their portfolios, and they are often governed by specific concentration limits in their investment documents that prohibit them from investing more than a given percentage of their capital - say 20 percent (20%) in a given industry.
[80] That is, faster than the 60 days permitted by regulations to deliberate before granting approval or denying a merger.
[81] http://www.kenyalawreport.co.ke/Downloads/Acts/Retirement%20Benefits%20Act.pdf.
[82] The largest pension fund in Kenya is the state-owned National Social Security Fund (NSSF), which internally administered over USD 600 million.
[83] https://www.preqin.com/blog/0/11528/us-public-pension-funds.

To increase pension fund participation in PE fund investments, a range of challenges must be addressed; and trustees play an outsized role in asset allocation of pension funds. First, the structure of the pension fund industry itself is a principal challenge. Kenya's pension system is remarkably fragmented, with roughly 1,300 different schemes, while pension funds' leadership (i.e. trustees) are generally unfamiliar with the VC/PE asset class and skeptical of offshore investors. Second, to raise capital from pension funds, VC/PE funds must work with several players, ranging from asset management funds and investment consultants to the trustees of the pension funds themselves. This adds additional time and complexity to the fundraising process. Finally, PE funds must convince pension fund trustees, who are the ultimate decision makers, to commit capital to private equity. Many trustees in Kenya rotate every three years – these limited tenures might encourage short term investment horizons and risk aversion. This poses a considerable challenge since, unlike investing in stocks or other listed asset classes, PE investments are long term in nature. As trustees are evaluated based on short term investment performance, the long-term nature of PE is less attractive to them (even if potentially beneficial to their pension funds). Trustees are also very cost conscious that PE investments are more expensive than other types of investments with regards to both management fees and performance fees.

In this environment, PEVC funds seeking pension fund investment must invest significant upfront time and effort. For example, one fund that successfully sourced local pension fund capital met with over 1,000 trustees and gave over 150 presentations to raise less than US$20 million of capital from the local market. Given this large investment of time and energy for a relatively small amount of capital (at least for the time being), some fund managers do not feel that it is worth the effort. On the other hand, some PE funds see local pension funds as a core part of their fundraising strategy. For example, Ascent Capital Partners was the first fund to raise local money, including US$4 million from Kenyan Power (both the Provident Fund and the pension fund), as well as investments from Zep-Re (PTA Reinsurance Company) and Nation Media Group. The firm is now seeking to raise as much as 20 percent of their next fund from local pension funds.

Even as pension funds build internal capacity and institutional knowledge to invest, there are questions that remain as the CMA considers its own role in the sector. The CMA hopes to have stakeholder consultations on the proposed regulations in 2017; these changes will require parliamentary approval. At present the CMA is preparing regulations that will require funds that are raising capital from local pension funds to register locally. While this requirement will likely be optional for all funds operating in Kenya except those looking to raise capital from Kenyan pension funds, the text of the proposed regulations is not yet available. As it prepares the text, the CMA is weighing a number of factors to combine effective oversight with a desire to create incentives, rather than roadblocks, to register locally. The CMA may, for example, create separate registration requirements for smaller funds vs. larger funds to accommodate the nature of each type of fund. In advance of stakeholder consultations on the regulation, the government has been working with the EAVCA on the filing of information notices under Section 30C of the Capital Markets Act (which relates to the information required when private offers are made) as well as the Retirement Benefits Act provision calling for the licensing of PE practitioners seeking to access pension funds. In particular, the EAVCA has proposed that regulations should largely be non-intrusive. This would mean excluding offshore funds with operations in Kenya that are not seeking to raise local capital from registration requirements with the CMA. In doing so, the Kenyan authorities would instead look to the fact that a fund is registered in an acceptable offshore domicile such as Mauritius and, as such, licensed and regulated by an appropriate foreign regulatory authority such as the Financial Services Commission in Mauritius.

Like pension funds, insurance companies also have a clear need to generate long-term returns and to create diversified portfolios of investments. Kenya PEVC market players note that it is more difficult to raise domestic capital from insurance companies than pension funds. The Insurance Act 1985 (the Insurance Act) requires that the assets of an insurer to be invested according to the the investment guidelines issued by the

Insurance Regulatory Authority ("IRA"),[84] currently the Insurance (Investment Management) Guidelines, 2017 ("Investment Guidelines"). The Investment Guideline set out the concentration limits[85] for investments in financial institutions,[86]shares in any institution or related companies, [87]property[88] and investments in related parties.[89] However, the Investment Guidelines do not specifically stipulate a maximum limit for investments in PE funds. They also do not specify how "concentration limits" would affect indirect investments by insurance companies, such as through PEVC funds. Although there is no specific policy for private equity investment as an asset class, the Insurance Regulatory Authority (IRA) does not allow insurance companies to invest more than 5 percent of their total assets into investments, private equity or otherwise, outside of their home market.[90] Insurance funds in Kenya have made some limited forays into the asset class, but to date have not been active, largely because most insurance companies are contracted to asset management funds that already have internal capacity to manage their own capital and therefore do not seek to invest through external PEVC funds. Moreover, as many PE funds are located offshore, such as in Mauritius, insurance companies must invest through dedicated feeder funds located within Kenya. Creating a dedicated vehicle for local investors who cannot, or do not want to, go offshore to Mauritius is, of course, more expensive and complex than working with investors in jurisdictions who can do so directly.

To encourage domestic sources of capital to invest in the asset class, improving capacity of domestic institutional investors is key. Given limited capacity within local providers of capital, pension funds, family offices and insurance companies should be encouraged to accompany experienced investors on due diligence assessments, to gain practical experience on how to select funds. Robust governance of local pension funds is important. And domestic pension funds could consider developing multi-year allocations to the asset class since one-off/ad hoc investments may not meet yield expectations, nor lead to the development of a sustainable investment program in private equity. The various sources of local capital also need strong financial systems to give confidence to fund managers that they can honor capital calls in a timely fashion over the fund life.

Other legal/regulatory issues for PEVC funds and investors

Minority Shareholder Rights

Given PEVC investment in Kenya are often minority stakes, PEVC investors seek minority protection provisions provided under the Companies Act. PEVC investor protections are usually exercised through contractual arrangements contained in the portfolio company's articles of association and in shareholder agreements (if the investee is a Limited Company); or a partnership agreement (if the investee is an LLP).[91]

[84] Insurance Act, section 48.
[85] Guideline 15.
[86] 10 percent (10%) of total assets.
[87] 10 percent (10%) of total assets.
[88] 35 percent (35%) of total assets.
[89] 10 percent (10%) of total assets.
[90] Kenya Insurance Regulatory Authority (November 2015). Guidelines to the Insurance Industry on Management of Investment.
[91] PE investors usually push for the following protections: i) non-compete provisions in the shareholders agreement to restrict the founders from investing in business similar to that of the target business; ii) veto rights for the PE fund in key decisions; rights to appoint directors to the board, and be counted for quorum for board meetings and shareholders meetings; and iii) the insertion of reserved matters, which are specified key decisions relating to the portfolio company that will be subject to specific approvals, such as unanimity, or more than 75 percent (75%) shareholder approval.

PEVC funds generally prefer to invest in a Limited Company so that they can own shares in a Limited Company instead of being a partner for an LLP. In addition, a Limited Company can be listed on a stock exchange, which makes exiting the portfolio company more convenient; and a Limited Company in Kenya also enjoys minority protection provisions[92] under the Companies Act,[93] which are not contained in the LLP Act. A PEVC fund would therefore need to neogtiate for wider protections in the partnership deed.

Corporate Governance of Portfolio Companies

In Kenya, a combination of the Companies Act of 2015 and a CMA issued Code on Corporate Governance provides a good basis for corporate governance within PEVC portfolio companies. The Companies Act of 2015 is still new, but is very clear on the duties and responsibilities of the directors: directors have a fiduciary duty, and duty of skill, care and diligence in exercising their responsibility to the company; and they may be held personally liable when companies are found guilty of committing offences under Kenyan tax and criminal laws. In addition, the Companies Act requires Directors to disclose personal interests in matters discussed by the board; and the articles of association may prohibit Directors from voting on such matters or being counted for quorum. The shareholder agreement may also require PE-appointed directors to disclose their appointments to the boards of other portfolio companies. In addition, the CMA published a new "Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015" ("Code") in March 2016. The Code, which applies to listed and non listed companies that are issuing securities[94] to the public, has robust and detailed corporate governance guidelines and incorporates global emerging trends in corporate governance.[95]

Property Rights

PEVC investors face due diligence challenges in Kenya when evaluating investment opportunities, particularly related to property. Property due diligence in Kenya is generally undertaken through title searches at the lands registry. However, land registries records in Kenya are in a precarious state, and there are documented irregularities which make it difficult to establish legitimate ownership; and ascertain if planning and environmental laws have been complied with, if diligenced properties are subject to multiple title allocations, or whether the records have been forged. On the plus side, most public services in Kenya are now available online, which has made service times more efficient as well as less susceptible to corruption.

Intellectual Property (IP)

PEVC investors in Kenya are assured of international standards of intellectual property (IP) rights protection because Kenya is a signatory to international IP treaties. Kenya is a member of the World

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[92] For example sections 22, 63, 393, 407 on changes to a company that require special resolutions, sections 398 and 780 on the rights of a member to make an application to court, section 34 on the right of a member to bring proceedings to restrain the acts of a director that are beyond the directors' power, section 277 on the rights of members to require directors to convene a general meeting and section 23 on the effect of an amendment to the articles of association on a member.
[93] The underlying principle under the Companies Act is that the affairs of a company are managed by its board of directors and that a majority of shareholders can pass most resolutions required to be passed by shareholders.
[94] "Securities" is defined in the CMA as including "debentures, shares, bonds, commercial paper, or notes issued or proposed to be issued by a body corporate".
[95] The Code is predicated on an 'apply or explain' principle. As such the portfolio companies isuing securities are required to either apply the Code fully or have to explain to the CMA, the reasons why the Code has not been applied in any particular circumstance.

Intellectual Property Organization (WIPO) and its various conventions and protocols, as well as the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), and the African Regional Industrial Property Organization. The Constitution of Kenya, 2010 Articles 11(2)(c) and 40(5) obligates the state to protect and promote intellectual property.

Framework for Insolvency and Creditor Rights

Kenya's insolvency regime was amended and consolidated with the new Insolvency Act No. 18 of 2015 ("Insolvency Act"), introducing also the concept of 'admnistration' or turning around distressed companies, which can be favorable for PEVC investors. The Insolvency Act repealed the previous insolvency regime consisting of the Bankruptcy Act (Cap. 53 Laws of Kenya) and certain sections of the Companies Act (Cap. 486), which contained provisions on insolvency of companies in Kenya. The Insolvency Act has introduced alternatives to banruptcy and the administration of companies – that is, imposing a moratorium that freezes creditor rights for 12 months while an administrator tries to rescue the business. Administration gives PEVC portfolio companies an opportunity to turn around, and in turn PEVC funds can recover their investment.

Investor liability

As an equity holder, a PEVC investor's liability in an insolvent portfolio company depends on the amount of equity that the investor has invested in the portfolio company. Courts may pierce the corporate veil and extend an insolvent portfolio company's liability to its shareholders (including a PEVC investor) if, for example, the insolvency is found to be a result of fraud, improper conduct or where circumstances warrant treating the company as an agent of its controlling shareholder. Directors appointed by PEVC investors may be liable for the liabilities of underlying portfolio companies if the portfolio companies are found guilty of offences under Kenyan tax laws or the Penal Code. In addition, to the extent that PEVC investors or other PEVC portfolio companies provide guarantees to secure borrowings by a portfolio company, the investors and portfolio companies of the fund may be found liable for the portfolio companies' underlying debts.

Contract enforcement

Given judgments through the judicial system can take a long time, alternative dispute resolution is becoming increasingly popular among investors in Kenya. For PEVC investors, and particularly foreign PEVC funds, the robustness of the judicial system is an important factor in deciding to invest in Kenya. However, factors such as corruption and lack of transparency mean that obtaining a judgment from the court sytem takes long. Arbitration is therefore the preferred dispute resolution method as it allows parties to flexibly choose the seat, law and arbitrator for their dispute.[96]

Foreign Investment and Exits

Foreign investors face minimal discrimination for inward investment and ownership in Kenya, although certain sectors have local content requirements. Foreigners cannot own land in Kenya but can lease it for

[96] In terms of enforcement, the authority of an arbitrator appointed by an agreement between the parties is irrevocable, except by leave of the High Court or unless a contrary intention appears in the agreement, i.e., that the arbitrator authority was not to be final. An arbitration award needs to be filed in court with an application for enforcement before it may be enforced. The arbitration award becomes enforceable as a judgment of the High Court once the High Court grants the application for enforcement. The parties may appeal a domestic arbitration award if there is express agreement between the parties. In the absence of express consent, the arbitration award can only be set aside by application to the High Court by one of the parties.

99-year periods; and only Kenyans are permitted to hold agricultural land. Certain sectors require a minimum percentage of local shareholding[97] – these are the aviation (51%), telecommunications (20%) and mining industries (60%). In addition, insurance companies have to have one third of their paid up capital owned by citizens of the EAC; and one-third of the members of the board of directors of an insurance company must be citizens of Kenya. Lastly, foreign investors qualify for GOK investment incentives and an investment certificate if they invest a minimum of USD 100,000, which may dis-incentivize small and medium enterprise investment, particularly in the services sector.

While Kenya does not have a formal exchange control regime in force, offshore PEVC investors and other foreign investors are subject to potential restrictions on remittances from Kenya, which have so far not been exercised by the CBK. Section 33I of the Central Bank of Kenya Act ("CBK Act"), CAP 491 allows the Central Bank of Kenya ("CBK"), in consultation with the Cabinet Secretary for the National Treasury, to impose restrictions on remittances from Kenya for the Government of Kenya under extreme circumstances, to meet its obligations under any international treaty. This "blanket" right has not been exercised by the CBK to date. Other than this, foreign currency is freely repatriable from Kenya provided the bank undertaking the repatriation is satisfied that it is a bona fide transaction. In addition, per Section 33H of the CBK Act, every payment made to, or from, persons outside Kenya must be made through a licensed Kenyan bank.

Key tax issues for PEVC funds and investors

PE funds usually set up a special purpose vehicle (SPV) as the legal entity that makes the investment in the portfolio company. These SPVs are usually incorporated as a private limited company or a limited liability partnership to ring-fence the Fund, its investors and the fund manager from liabilities arising from the investment. The key tax issues of PEVC funds operating in Kenya are: i) the reintroduction of the capital gains tax (currently 5%) in 2015, which applies to corporate restructurings and also to investments made prior to 2015; ii) the compensating tax, which is unique to Kenya and essentially offsets the capital gains tax regime by penalizing companies that have been taxed lower than corporate tax of 30% if they distribute dividends; and iii) a limited number of double taxation treaties to incentivize offshore investors.

Capital gains tax

Kenya recently reintroduced the capital gains tax (at 5%), after suspending it for 30 years, a key policy change for PEVC investors. Kenya's Finance Act 2015 reintroduced capital gains tax (CGT) of 5% effective January 1, 2015, on gains arising from the transfer of property situated in Kenya.[98] Per Paragraph 6(1) of the Eight Schedule to the ITA, if an SPV disposes its shares in a non-listed portfolio company in Kenya, this is deemed to be a transfer of property. Thus, the gains derived from this disposal would be subject to CGT.[99] A 5% capital gains tax regime is relatively low compared to neighboring economies such as Uganda, Tanzania, and Rwanda, which treat all gains, whether long term or short term, as ordinary income (that is, at a higher tax rate). However, it does constitute a key change in tax policy for PEVC investors. The East Africa Venture Capital Association (EAVCA) has therefore recommended that if there are any future increases in CGT, PEVC investors be exempt from this increase.

The CGT regime has also evoked other concerns: the sale of publicly listed equities is not currently subject to CGT, while private equity transactions are subject to a 5% CGT. The Finance Act 2015 exempted CGT on sale of listed securities, effective January 1, 2016, which means that while the tax no longer applies for

[97] Met if the entity is owned either by natural Kenyan citizens or by a Kenyan company owned by Kenyan citizens.
[98] "Property" is defined broadly to include shares in private companies, land and buildings, and other assets.
[99] On the other hand, if an offshore SPV invested in a portfolio company in Kenya and disposed the shares offshore at the SPV level, this would not be subject to CGT in Kenya.

publicly listed equities, it clearly still applies for private equity transactions. This disparity between capital gains tax on public versus private transactions creates an incentive to list companies on the stock exchange rather than sell them privately to other investors, effectively limiting the forms of exit for a PEVC fund.

In addition, the tax applies to the sale of PEVC investments made prior to January 2015 (when CGT was still suspended), thus impacting expected returns. The reintroduced CGT currently applies to the sale of securities on or after January 1, 2015, regardless of whether the purchase of these securities happened before January 2015. Since these investments did not factor in capital gains tax into the financial models, being required to pay the tax now impacts expected returns. Thus, EAVCA has suggested that PEVC investments made before January 2015 are not subject to this tax. In addition, there is no indexation of property costs (to factor in the effect of inflation) when computing capital gains tax liability, which can also lead to dampened returns for investors.

Moreover, Kenya does not currently exempt corporate reorganizations that see no change in beneficial ownership from triggering capital gains tax, making it costly for PEVC investors to structure efficient investments. PEVC funds often undertake corporate reorganization – such as consolidating several standalone investments into a group structure – for investment efficiency. However, in Kenya, corporate reorganizations trigger capital gains tax whether beneficial ownership has changed or not, unless the Cabinet Secretary of the National Treasury finds this reorganization to be in the "public interest." This is problematic because "public interest" is not defined; the principle has not been tested; and the exemption is at the discretion of the Cabinet Secretary. In contrast, the Stamp Duty Act of Kenya, Section 97, allows for corporate reorganizations without triggering stamp duty liability. Bearing an additional capital gains liability for reorganization makes target investments less attractive because the cost of the investment increases. Unlike Kenya, Uganda and Tanzania provide a "rollover" tax relief for corporate reorganizations.

Compensating Tax

Despite capital gains tax being a "final" tax, Kenya offsets the benefit of a capital gains tax regime through a "compensating tax" – unique to Kenya -- which penalizes limited companies that distribute dividends from income taxed at a lower rate than the corporate tax rate of 30%. PE funds typically register their local investment vehicles or SPVs as LLCs in Kenya. Kenya's Income Tax Act requires all companies to retain a Dividend Tax Account ("DTA") which matches dividends paid out by the company against incomes which have been subjected to income tax. The effective compensating tax rate can be as high as 42.86%. When the SPV disposes off its portfolio company investment, it first triggers a capital gains tax of 5%. However, since this 5% tax is lower than the corporate tax of 30%, the SPV must also settle a compensating tax[100] liability, as set out by Section 7A of the Income Tax Act, before the SPV can distribute capital gains through dividends to the PEVC fund. In essence, the PEVC fund ends up paying a total tax similar to what the company would have paid if a corporate tax of 30% has been levied --in effect not realizing any savings because of a capital gains tax of 5%.

In addition to offsetting the benefits of the capital gains tax regime (as described above), the compensating tax also offsets the benefits of accelerated capital allowances offered under the tax laws to allow investors to deduct 100%/150% of capital expenditures. When a target company incurs capital expenditure, Kenyan tax law allows an investment deduction allowance of 100% or 150% in the first year of use, which puts the target company at a tax loss position for several years. If the company distributes dividends during this tax loss period, compensating tax would be triggered given the company has not paid corporation or other tax. This limits the ability of investors to reap a return on their investments by benefiting from the incentive of accelerated capital allowances.

[100] Based on the ITA's formula, the maximum compensating tax is 42.86% (or 3070); and the potential liability is reduced by any taxes already paid on the income being distributed.

Thin Capitalization Rules

Like many countries, Kenya has thin capitalization rules which discourage the use of debt instruments to invest in foreign-controlled Kenyan limited companies; however, Kenya also has deemed interest provisions discourage interest free loans to foreign-controlled limited companies from non-resident investor. PE funds typically register their local investment vehicles as limited companies, or LLCs, in Kenya. Per the Income Tax Act,[101] a limited company is considered foreign-controlled if 25% of its shares or voting power is held by a non-resident. If a foreign-controlled company cannot maintain a debt to equity ratio of 3:1,[102] thin capitalization provisions are triggered.[103] These provisions mean that the foreign-controlled company cannot claim tax deduction for interest expense attributed to loans more than the 3:1 debt/equity ratio, and must defer any realized foreign exchange losses arising from the loans provided by non-residents until the thin capitalization status ceases. While thin capitalization rules are used in several countries; Kenya also has deemed interest provisions which penalizes investors for providing free investment. If the foreign-controlled limited company secures an interest free loan from its non-resident investor (or an associate of the non-resident), the ITA Section 2's deemed interest provision will deem the existence of an interest rate equivalent to the average 91-day Treasury Bill Rate. In addition, deemed interest payable by the foreign-controlled company incurs a withholding tax rate of 15%.[104] Thin capitalization rules do not apply for banks or financial institutions licensed under the Banking Act.

Double Taxation Treaties

In terms of mobilization of capital, Kenya has a limited number of Double Taxation Treaties (DTTs), making Kenya unattractive for an onshore fund relative to jurisdictions with a wide treaty network because of the possibility that investors will be taxed twice; limited DTTs with neighboring countries also discourages regional funds. DTTs help businesses that are conducted in different tax jurisdictions from incurring double taxation; they also help tax administrators to prevent tax evasion.[105] To encourage regional investment funds, Kenya should ideally actively conclude treaties with countries within East & Central Africa. An extensive African treaty network may mitigate withholding tax on dividends and interest and possibly allow for capital gains to be only taxable in Kenya. However, Kenya has only a handful of DTTS with countries such as Germany, Denmark, Sweden and the UK. Additional treaties with Mauritius, the EAC, Qatar and Kuwait have been ratified, but are not in force. Kenya has also only two tax treaties with its African trading partners – namely, South Africa and Zambia. This makes cross-border trading prohibitively expensive with other countries because income is taxed twice since the Kenyan Income Tax Act only provides tax relief for foreign taxes if a DTT exists between Kenya and the trading partner. Kenya is already seeking to expand its treaty network, given several treaties are under negotiation or are being prepared for negotiation. However, the challenge is to ensure the GoK speedily concludes pending negotiations. The easier option may be to amend the Kenyan Income Tax Act to allow for foreign tax credits irrespective of a DTT.

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[101] Schedule 2, paragraph 32(1).

[102] If the sum of all loans is over three times as high as the sum of revenue reserves and paid up capital in all classes of shares, the foreign-controlled company is considered thinly capitalized.

[103] Income Tax Act, Section 16(j).

[104] Income Tax Act, Schedule 3, paragraph 3 e (i).

[105] Kenya's Income Tax Act sections 41(5) and 41(6) provides DTT benefits will be available to a person who is resident in the other contracting state only if: 1. Over 50% of the underlying ownership of that person is held by individual(s) who are residents of that other contracting state; or 2) the resident of the other contracting state is a company listed on a stock exchange in that other contracting state.

In seeking to curb treaty shopping and the potential of tax evasion, the Income Tax Act section 41(5) only allows benefits of DTTs to be available to investors if a substance creation requirement is met – namely, 50% of the shareholding in the contracting state must consist of individuals that are resident in the contracting state; and the resident of the other contracting state must be a company listed on the stock exchange in that contracting state. This can be limiting because offshore structures are commonly used to attract global investors and are not necessarily conclusive evidence of an artificial structured set up to evade taxes. 50% requirement may be stringent to meet and it would therefore be prudent for the Kenyan revenue authorities to introduce other substance creation requirements in the other contracting state as sufficient evidence of a solid and commercially justifiable offshore structure.

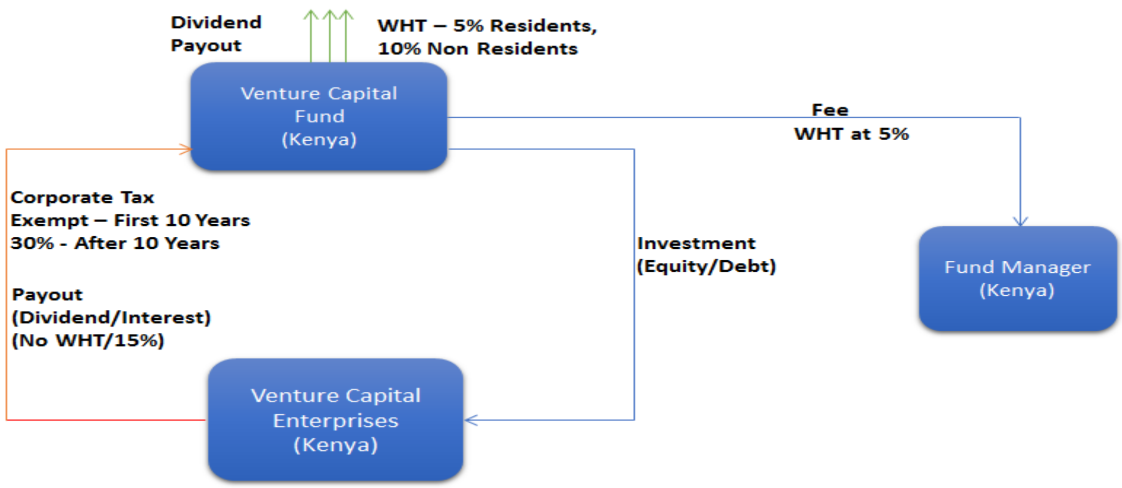
Venture Capital Fund Tax Regime

While Kenya currently does not have an overarching tax regime for PEVC funds, there is a tax incentive regime specifically for venture capital funds. As discussed in the earlier legal/regulatory section, Kenya's Capital Markets (Registered Venture Capital Companies) Regulations, 2007, allows for Venture Capital Companies, defined as "*a company incorporated under the Companies Act with the primary objective of providing substantial risk capital to small and medium size businesses in Kenya through equity, quasi-equity investments or other instruments.*"[106] To qualify for a special tax regime, the VC fund must be registered with the CMA, and also under the Income Tax Rules. The tax regime for such venture capital funds consists of three layers of incentives.[107] First, the Income Tax Act exempts the VC fund from corporate tax for the first ten years (from the date of its first investment) on any gains from sales of venture capital investees. From the 11th year onwards, the VC fund would have to pay corporate tax, is currently at 30%. Second, equity investment receives special incentives: dividends paid to the venture capital fund from its investees are exempt from withholding tax; on the other hand, interest paid to the fund by investees suffers a 15% withholding tax. Third, the Income Tax Act provides a specific exemption from the compensating tax, by allowing capital gains from sales of venture capital investees (which are tax exempt for 10 years from first investment) to be treated as dividends received, thus triggering no compensating tax liability. In addition, the VC fund withholds 5% tax for management fees rendered for onshore services for Kenyan residents.

[106] The VC fund must be an LLC, incorporated under the Companies Act, registered with the CMA, with a minimum paid up share capital and fund size of 100 million Kenya shillings100. The fund manager must have a license from the CMA and the fund must have a board of directors, one-third of which are independent. The VC fund's investees cannot be primarily involved in real estate; banking and financial services; or retail and wholesale trading.

[107] VC funds are eligible for tax benefits if they meet the following requirements per the Income Tax Act (Venture Capital Enterprise) Rules, 1997: They must be incorporated in Kenya, and for the purpose of investing in new or expanding venture enterprises companies; registered by the Capital Markets Authority (CMA); managed by a fund manager licensed by the CMA in Kenya; at least 75% of investable funds is invested through equity or quasi-equity investment in venture capital enterprises; and the primary activities of the investees must be approved activities.

Figure 6: Venture Capital Tax Regime in Kenya



Despite the enabling legislation being in place as well as various incentives having been offered, there has been little take-up for venture capital funds (VCFs) set up onshore because the incentive structure has not been holistically considered. In fact, Kenya's pioneer and only onshore venture capital fund, the Acacia Fund, is currently being wound up. There are various reasons for this: First, in addition to the VCF being registered with the CMA, to benefit from the tax incentives available, it must also register with the Kenya Revenue Authority (KRA). These processes of registration take a significant amount of time in addition to the regulations requiring high capitalization thresholds. This has, in the past, discouraged potential investors from using this form of vehicle for purposes of deploying funds. Second, investees under a VCF structure cannot trade in real property, banking and financial services, or retail and wholesale trading services. These restrictions significantly limit the success of VC Funds in Kenya, since these sectors present lucrative returns for investors in Kenya. Third, dividend distribution to investors does not receive special incentives – thus, while the fund itself is not taxed on capital gains for the first 10 years, upon distribution of gains, residents are taxed a withholding tax rate of 5%, while non -resident investors are taxed a withholding tax rate of 10% (the same as any other company). The incentive is therefore not holistically thought out, given an offshore fund would only be taxed 5% when selling shares of a Kenyan company. Lastly, VC funds can only receive benefits per the Income Tax Act if formed as a company under the Companies Act, and does not allow flexibility of legal forms such as LLPs etc. Hence investors prefer to forego the special tax regime for venture capital funds in favor of tax transparent vehicles such as Kenyan limited liability partnerships (LLPs) which are not taxed on revenues generated -- partners are taxed on their share of profits based on agreed profit sharing ratios captured in a partnership agreement. If LLPs were eligible to become venture capital funds, Kenyan institutional investors would find it easier to co-invest with foreign investors in a Kenyan fund. The CMA is indeed considering this reform. Tax incentives are also provided only for Venture Capital Funds that invest in Kenya, while most PEVC funds operating in Kenya make investments that are regional in scope. Lastly, thresholds in the Income Tax Act may not be in line with current economic realities. For example, a potential venture investment must have at minimum assets or annual turnover of KES 500 million, which has significantly diminished in USD value since the amendment was introduced on 13 June 2008.

In considering a new set of incentives to encourage venture capital, GoK could also consider a tax amnesty for SMEs that are moving from the informal sector to the formal sector. PEVC investments can often move informal businesses into the formal sector. However, a tax due diligence exercise on a target SME investment may identify significant liabilities that render the investment unattractive for a PE Fund. It would be useful for GoK to consider a tax amnesty in such situations, with the understanding that shareholders – both old and new – would ensure full compliance with tax laws going forward.

IV. Conclusion

As the main social, cultural, and economic hub of East Africa, Kenya has long been known for its private sector-led economy, strong entrepreneurial culture, and relative regulatory stability. Kenya's membership in the East African Community (EAC) allows it to serve as a launch pad for investors to execute cross-border investments. Kenya's position as the hub for East African investment has also allowed it to capture the overwhelming portion of the sub-region's recent deal activity. However, Kenya has a few structural flaws in the legal, regulatory and taxation framework for PEVC funds. Despite the attempts of Kenyan authorities to create incentives for investors to register their funds locally, private equity funds still prefer to register offshore rather than establish operations in Kenya. In fact, only one fund (the now defunct Acacia) took advantage of the local fund registration option. Instead, fund management companies register offshore, with Mauritius being the most common domicile of choice. Domiciling a fund in Kenya creates complications with respect to taxes and structuring inefficiencies. In the absence of an overarching legal and regulatory regime for PEVC funds, the key legal/regulatory issues for these funds operating in Kenya are: i) the structural inefficiency of the available legal forms; ii) the time and resource burdens imposed by multiple (i.e. regional and national) competition regimes; and iii) the regulatory and structural constraints to domestic institutional investment in the asset class, despite pension funds now being allowed to invest up to 10% of their assets under management in PEVC. In parallel, the key tax issues of PEVC funds currently operating in Kenya are: i) the reintroduction of the capital gains tax (currently 5%) in 2015, which applies to corporate restructurings and also to investments made prior to 2015; ii) the compensating tax, which is unique to Kenya and essentially offsets the capital gains tax regime by penalizing companies that have been taxed lower than the corporate tax of 30% if they distribute dividends; and iii) a limited number of double taxation treaties to incentivize offshore investors.

Annex I: Interviews Conducted

Mr. Dominic Rebelo, Anjarwalla Khanna (A&K)
Ms. Jordan Filco, The Abraaj Group
Mr. Duncan Onyango, Acumen Fund
Mr. Faisal Jiwa, AfricInvest
Mr. George Odo, AfricInvest
Mr. David Owino, Ascent Capital Partners
Mr. Biniam Yohannes, Catalyst Principal Partners
Mr. Suleiman Kigundu, Commonwealth Development Corporation
Mr. Brian Kiai, Centum Investments
Mr. Fred Murimi, Centum Investments
Mr. Luke Ombara, Capital Markets Authority
Mr. Francis Wang'ombe Kariuki, Competition Authority
Mr. Raphael Mburu, Competition Authority
Ms. Nonnie Wanjihia, East Africa Venture Capital Association
Mr. Paul Maasdorp, Emerging Capital Partners (ECP)
Mr. Christopher Kirathe, Ernst & Young
Mr. David Kinyanjui, Ernst & Young
Mr. Ayisi Makatiani, Fanisi Capital
Mr. Dennis Aluanga, Helios Investment Partners
Ms. Martha Mbugua, Hamilton Harrison & Mathews
Mr. Kevin Njiraini, International Finance Corporation
Mr. Christoph N. Evard, Kibo Capital
Ms. Sapna Shah, Novastar Ventures
Mr. David Loew, Open Capital Advisors
Mr. Rodney Carew, Open Capital Advisors
Mr. Yida Kemoli, Phatisa Fund Managers
Mr. Edward Odundo, Retirement Benefits Authority
Mr. Mick Murphy, VivaAfrica
Mr. Edward Mwachinga, VivaAfrica

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