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BUILDING WIN-WIN INVESTOR INVESTEE RELATIONSHIPS

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SHORECAP EXCHANGE

MESSAGE FROM EXCHANGE'S PRESIDENT

ShoreCap Exchange (“Exchange” or “SCE”), a non-profit sponsored by ShoreBank Corporation, was established to help build stronger local banks and microfinance institutions (MFIs) that serve the poor in developing rural and urban economies, primarily in Africa, Asia and non-EU Eastern European countries.

To achieve their goals, the ShoreCap companies bring together investment and capacity building for their partners. Exchange uses a blend of capacity building approaches to strengthen local banks and microfinance institutions (“MFIs”) including:¹TP

- ✚ Embedded technical assistance (TA) approaches (e.g. institutional needs assessment and TA planning, playing a role on bank boards, conducting evaluations);
- ✚ Direct one-on-one consulting services; and
- ✚ Banker to Banker Peer Knowledge Exchange Forums.

The Knowledge Exchange Forum activities among peer bankers are premised on our belief that entrepreneurs learn best from other entrepreneurs, and that providing opportunities for bankers at all levels to learn from their peers is a valuable, cost-effective and underutilized form of business services delivery.

In 2006 and 2007, ShoreCap Exchange conducted a series of in-depth interviews with banks, MFIs and international investors in order to obtain their perspectives on the definition of a “win-win relationship” between investors and investees. This effort supports and builds on the SCE mission to strengthen financial institutions in developing and emerging economies, particularly through communication and information exchange.

We hope this paper will be a useful guide in navigating investor investee relationships in a more proactive manner. Please note that this paper attempts to deal with the qualitative aspects of the process, rather than quantitative aspects such as valuation, pricing and terms of exit.

We would love to hear from you on any thoughts, comments or suggestions about this paper and our various endeavors (see email at bottom of page).

All the best,

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¹ Exchange currently focuses its one-on-one technical assistance exclusively on ShoreCap International’s investees. Exchange’s knowledge exchange activities and banker- to- banker peer forums are inclusive of peer MFIs and banks that have not have received an equity investment from ShoreCap International.

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Table of Contents

I. Executive Summary.....5

II. Approach.....7

III. Preparing for Investment: Understanding the Process.....9

IV. Evaluating Alignment between Investor and Investee.....13

 a. Understanding Investor Needs.....13

 b. Understanding Investee Needs.....17

 c. Defining Typical Terms and Conditions.....17

 d. Identifying a Misalignment.....19

V. Key Learnings and Examples of How to Manage an Investment.....21

VI. Conclusion.....22

I. Executive Summary

In 2006 and 2007, ShoreCap Exchange (“Exchange”) conducted a series of in-depth interviews with banks, microfinance institutions (“MFIs”) and international investors. The purpose of the research was to use the experiences of international investors and MFI/ bank investees to define the components of a ‘win-win’ investment relationship. What we learned was that interests converged at a point where each party understood its own needs and in turn, was able to determine what was suitable for the other party. This paper is an attempt to narrow the gap of understanding between investors and investees, in an effort to make the investment process more time-efficient and less painstaking than it has been in the past.

Many of the most obvious elements of a win-win relationship are the same factors that cause breakdowns in communications, inefficiencies, and unpleasant relations during the investment process. So, while these factors appear simple, ensuring that they are addressed takes careful planning and care.

A **win-win relationship** is established where:

- Interests of both investor and investee are aligned,
- There is agreement on clear objectives and the timeline for achieving them,
- Clear measurements are established for the achievement of agreed-upon objectives,
- Management buys into the agreed objectives and is suitably incentivized to achieve them,
- There is a clear separation of management and board roles and responsibilities,
- Boards operate with authority and do not refer to shareholders for decisions that boards should be making,
- Governance structures are in place to bring independence of board and establish respective accountabilities / responsibilities of management, shareholders and board,
- The board comprises suitably experienced and independent members acting on behalf of all shareholders and not only their nominating shareholders, and
- Legal documentation is clear, simple and comprehensive.

And investors

- Believe there is transparency and honest reporting,
- Indicate up-front what they are looking for by way of return on their investment, which can be a mix of financial, social, environmental and developmental returns,
- Be forthcoming about their investment time-horizon,
- Honestly communicate about what their approach is – passive or active. If the latter what this involves, and how it differs from micro-managing,
- Clearly spell out their exit requirements and put in place mechanisms for achieving the same without placing onerous pressure on the institution,
- Bring more than just financial involvement. In particular reputational enhancement, sources of technical assistance to build institutional capacity and global perspective / contacts can all make a positive contribution,
- Understand that when making an equity investment in a developing country, they are taking local currency risk and should be prepared to embrace such risk, and
- If entitled, appoint to the board suitably experienced individuals who understand their role as board members, rather than as representatives of the investor.

And investees

- Are prepared to communicate honestly and openly on a regular basis, sharing their vision and strategic direction,
- Are prepared to allow investors to contribute and improve governance – particularly through involving non-executive directors on the board and board sub-committees such as audit committee / risk committee,
- Provide regular financial and other information – particularly with respect to agreed measurement of clear objectives, and
- Exceed performance expectations.

Resulting in

A win-win relationship where difficulties facing the investee have been overcome,

- a) with the support of the investor,
- b) human capacity within the organization has been strengthened,
- c) a strong committed management team has been established,
- d) a performance culture has been created,
- e) expectations of performance have been met or exceeded,
- f) value has been created for all stakeholders,
- g) the business has performed better than had the investor not got involved,
- h) the timescale for achieving objectives has been met and
- i) there is a measurable return both in financial and other relevant terms.

II. Approach

The interviewing approach taken in this research was to speak with investors and investee companies across the globe to establish, based on their experience, what works and does not work in building successful investor / investee relationships.

The **types of investors** (defined by several different sets of criteria, sometimes overlapping) active in developing countries include:

- Commercial investors – looking primarily for a financial return probably with a yield.
- Social investors – interested in the impact on economic development, job creation, empowerment of women. Many social investors want some financial return.
- International investors – prepared to take cross border currency risk but looking for a hard currency return.
- Local investors – prepared to accept a local currency return.
- Development finance institutions – typically looking for both a financial return and a development return.
- Passive investors such as minority shareholders with no board seat.
- Active investors wishing to play a role in steering the institution and participate at board level.
- Stage investors – early stage investors are prepared to invest early on, including the start-up phase (venture capital), or later stage investors who will invest when an established business looks for expansion capital (private equity).
- Blended value investors, such as foundations looking for a financial and social return.

Types of investees considered in this paper include:

- Banks focused on small and medium sized businesses operating in developing and emerging economies.
- MFIs operating in developing countries.

Benefit to investors of a win-win relationship

Investors look for a good home for their money and in experience find it easier to place it than get it back. Building a win-win relationship with investees is critical if:

- The investment is to be managed effectively.
- Action is to be taken quickly where problems arise at the financial, political, management or governance level.
- Investors are to respond in a timely fashion to the needs of the investee e.g. the need for more capital, capacity building, interaction with regulators or lobbying for changes in legal framework or tax regime.
- Time is to be saved in the future. When an investment goes wrong investors can spend a significant amount of time trying to sort out the problem and rescue a portion of the money they invested.
- The chances of getting a good return on the investment are to be increased.

Benefit to investees of a win-win relationship

Investees look for suitable providers of capital for many reasons but primarily to:

- Strengthen the capital base of a financial institution where required to satisfy capital adequacy ratios or where regulators increase the minimum capital (as in Nigeria in 2006 and Rwanda in 2008).
- Finance expansion either organic growth or through acquisition.
- Enhance the reputation of the company through association. Having a triple-A rated investor in the liability or capital base provides some comfort that the financial institution is strong and robust. For banks this particularly helps with correspondent

banking lines, an improved credit rating, cheaper sources of funding and can increase access to other sources of funding. Moreover, local depositors (particularly institutional investors such as insurance companies) tend to see the investee financial institution as stronger and better governed if there are international investors in the shareholding.

- Lay the foundation for financing future growth. For a growing business where the need for further capital becomes critical, having a good relationship will increase the likelihood of further support from existing investors. Where sources of new capital are still required, a group of happy existing investors are more likely to provide comfort for a new investor to get involved. Thus building a win-win relationship is not only a valuable investment today but also lays the basis for future growth. Development financial institutions (“DFIs”) often come in on high-risk investments first and lead the way for commercial capital to follow, once the investee institution develops further.
- Provide an insurance policy where there may be systemic risk. A number of countries have suffered crises in the banking or MFI sector. Having support in difficult times from strong shareholders can protect the investee entity from a run on deposits. This can be particularly important where the investors are international and not subject to local circumstances threatening the domestic financial sector.
- The involvement of international investors that have a reputation for requiring good governance in an investee company can provide protection for the entity / management / board coming under undue pressure from powerful players in the economy, such as the government, wanting access to credit or other things the institution can provide.
- Gain access to additional capacity building and governance support from the investor. Oftentimes, investors are able to link investees with capacity-building resources, and themselves play an active role in the governance of the investee institution.

A financial institution in Asia attracted a DFI to invest alongside private investors in the early days of building the business. Purely commercial investors saw the investment as too risky at that stage. As the institution grew and expanded more DFIs invested and provided lines of credit. Over time, local institutional investors saw that the business was successful and started to invest themselves. The involvement of local institutional investors brought with it the opportunity for an exit by the DFIs who wished to sell and reinvest their funds in other early stage entities.

In the 1970s and 80s the management of an African financial institution came under pressure to finance businesses in which various politicians had an involvement. The Government was a significant, but not majority, shareholder in the bank. Loans were made, the businesses failed to perform and the resulting losses were suffered by the bank wiping out the capital base.

III. Preparing for Investment: Understanding the Process

Investors typically invest in one or a combination of the following asset classes:

1. Loans – denominated in US Dollars (USD), Euro, British Pounds (GBP) or local currency for terms of typically 3-10 years. Valuable for on-lending – particularly where the tenor meets the needs of the ultimate borrower.
2. Guarantees – typically provided by the investor to local financial institutions who, on the strength of the guarantee, lend in local currency to the investee entity. Has the advantage of avoiding a currency mis-match and utilizing excess liquidity in the financial system at country level.
3. Mezzanine / Quasi equity – convertible debt, preference shares and various other instruments, in hard or local currency, designed to provide finance to the institution but capture some of the up-side for the investor.
4. Equity – typically ordinary shares denominated in local currency whereby the investor may lose everything if the business fails or share in value creation if the institution is successful.

Many international investors prefer to share in the fortunes of an investee company through providing a loan in the first instance. This allows both parties to get to know each other, establish comfort levels and build trust. The advantage of debt is that typically the provider can call the amount if there is a default or adverse event - thereby ending the relationship. Such investor protection can be important to institutional investors entering new countries and relationships for the first time. However, the disadvantage of a loan to a young growing MFI or bank, especially at rates that many DFIs and others charge, is that it is expensive at a time when the institution is resource-constrained. What these second-tier financial institutions need is patient capital. There remains a gap in the market, even today with the flurry of funds in existence.

If the servicing of a loan plus the associated reporting requirements goes well the investor may in time consider investing equity or converting the loan into equity. Such an evolution is not uncommon and also allows the investee company to decide whether they also want the other party as a holder of equity.

It is primarily in the realm of equity that this paper is concerned given that the equity relationship tends to be riskier, deeper and longer than a purely lending relationship – and therefore more important for all parties to get it right.

Although different investors have their own approach and methodology when making investments the typical steps in the investment process are:

STEPS IN INVESTMENT PROCESS	
Origination	<ul style="list-style-type: none"> ▪ Introductory meeting / contact. ▪ The proposed investment is in a sector / country in which the investor invests. ▪ Unacceptable sectors could include: nuclear/military equipment, arms, pornography, gambling, and tobacco. ▪ Certain countries maybe unacceptable for historic, human rights or political reasons. ▪ Specific investment guidelines are met: for example, animal testing, countries' human rights records, and so on.
Screening	<ul style="list-style-type: none"> ▪ A rigorous screening process that eliminates “potentially bad” investments saves time and money. ▪ The investor is comfortable with the investment partners. ▪ The investment upholds the highest standards of integrity and honesty, operates in accordance with local laws and international best practice.
Due Diligence	<ul style="list-style-type: none"> ▪ Assessment of management, board, governance, historic financials, forecast financials, competitive advantage. ▪ Clear justification for use of funds. ▪ Legal, commercial, technical and environmental due diligence. ▪ In respect of business principles, check whether areas of non-compliance be addressed and is the sponsor prepared to ensure compliance over time. ▪ Negotiation of terms of investment and legal documentation.
The Investment Decision	<ul style="list-style-type: none"> ▪ Approval of the investment and terms. ▪ Setting of additional conditions. ▪ Drafting of announcement / press release if appropriate.
Portfolio Management	<ul style="list-style-type: none"> ▪ Regular monitoring based on management accounts, board meetings and ad hoc visits. ▪ If a pre-investment action plan is agreed, is the company meeting it?
Exit	<ul style="list-style-type: none"> ▪ Is the investor comfortable with the potential buyer, and is the equity stake being purchased with bona fide resources? ▪ Is the price acceptable? ▪ Is the return acceptable? ▪ Have other non-financial objectives been met?

Due diligence on an investment in a power station highlighted that significant work was required to improve the health and safety standards in order to reduce toxic emissions. The capital expenditure was assessed and incorporated into the financial projections. Commitment from the existing investors was obtained that the work would be carried out within an agreed time-frame.
Lesson: Due diligence findings, which could well have been a sticking point, were dealt with up-front and constructively by both sides, resulting in a positive outcome.

Timing & legal documentation

The time it can take from initial meeting / contact to actual investment can vary significantly, from less than 6 months to 2 years. Private investors tend to make quicker decisions than development finance institutions (“DFIs”) and appear to have a less complicated and less bureaucratic process.

The general perception from investees is that international investors and DFIs are slow, particularly when compared to local investors. Conversely, investors complain that investees do not appreciate the process required to get approval for an investment. Better communication from both sides and agreeing a target timetable, setting out what is needed by when at the outset may help everyone.

Once investment approval has been received legal documentation is required. The more standardized the documentation and the fewer the changes made, the easier and quicker the legal process. However, investees and investors need their own high quality legal advice (including local opinion) if they are to protect their interests and put in place the necessary protection in the event that things do not work out as intended.

Investors and investees need to be aware that the longer the time frame, the greater the risk of an investment not being made. Not only can the pricing of an investment change (possibly re-opening the whole negotiation) but also trust can be eroded to the extent that both parties walk away. After significant cost, time and effort have been spent such an outcome is in nobody’s interest and can possibly be avoided by all parties agreeing and sticking to a timetable.

An extreme example of taking an excessive time to make an investment decision in Africa involved European investors who took six years to make a decision on an infrastructure project. Extensive environmental impact studies were carried out as well as other necessary studies. However, when the investor communicated to the client that approval had finally been received to make the investment, they were informed by the African institution that the project had been completed with Chinese money.

Cost

Typically investors will expect the investee to pay an up-front fee to cover the costs of due diligence and sometimes legal documentation. Typically this is a percentage of the anticipated amount to be invested (e.g. 0.5% of a \$5,000,000 investment totaling \$25,000).

Agreeing the principle of such fees in the early days can avoid surprise / annoyance further down the line.

IV. Evaluating Alignment between Investor and Investee

Establishing both the attractiveness of a potential investment and the alignment of investee and investor needs are critical to achieving a win-win relationship.

Most investors commented that they would not make an investment, regardless of how commercially attractive it is, if the alignment of interest is not satisfied. Similarly, investees were quite prepared to decline a potential investor if they did not feel the investor understood their goals and plans and was not likely to be a supportive partner.

Determination of alignment is not easy to achieve. In practice alignment is an outcome of looking at the respective needs of investor and investee and making sure legal documentation reflects, as best as possible, the different positions. This means clearly setting out what will happen if conditions designed to achieve alignment are not met.. The more ‘face-time’ spent between prospective investors and investees, the greater the chance of understanding quickly whether alignment exists or not.

In one case, all the terms had been agreed upon in negotiations, except for the issue of senior management. The investors felt strongly that the current team needed strengthening if the growth projections were to be met. Existing shareholders, however, were quite comfortable with the current team and were not prepared to make any changes. Perhaps the bigger issue was actually how decisions were made and the matter of control. The existing shareholders were used to making all decisions and were perhaps not comfortable with another party being involved. Not able to reach agreement, the investment did not take place.

A tourism investment in the Caribbean went wrong within a few months of the investment. The due diligence and background checks had failed to pick up what reliance one could place on the local sponsor. The funds transferred to finance expansion of the hotel facilities were redirected in short order leaving the investor with very little other than the faded premises still waiting for a refurbishment. Building checks and balances into the terms of the investment could have been very useful in this case.

During negotiations, undertakings were given that funds invested in the financial institution would be used for certain geographies. Post investment, the funds were diverted to locations not agreed upon and contrary to the undertakings given. No legal documentation had been drawn up to indicate what action would follow if undertakings were not held to. As a result investors felt betrayed, the strategic direction they had supported was not followed and the investment had to be restructured at considerable cost of time and money.

a. Understanding Investor Needs

The criteria investors use to evaluate an investment clearly indicate that financial criteria is just one element - other factors such as mission/values and management capacity are also looked at closely, and often are as, if not more, important.

Investors typically are concerned about the following:

- Mission focus
- Values / institutional culture
- Management
- Sponsor reputation and background
- Size
- Location
- Growth/ Scalability
- Systems/ Processes
- Methodology
- Sustainability/ Profitability
- Legal structure
- Ratings
- Investment term
- Competitive environment
- Tax environment
- Legal environment
- Country risk
- Turnaround time where appropriate
- Return Required
- Development impact, environmental impact, social impact

The areas that investors stressed in Exchange's discussions were:

(i) Management quality and motivation

This is perhaps one of the most important considerations. If management is not of sufficient quality to realize the objectives it must be strengthened in order for the investment case to be robust. Agreement will need to be reached on this plus steps to be taken prior to making any investment. Trusting management to manage is key to ensuring investors do not interfere unduly in the running of the institution.

(ii) Governance

Clear separation of the board's role and management is key to the success of building a win-win relationship. The board should look to protect the interests of all investors and not one particular investor. The more independent the board members, the better the board functions. In particular this can help avoid conflicts of interest that can arise if a board member is only interested in looking after the needs of his shareholder.

A financial institution in need of capital could not make any progress as its institutional shareholders were not prepared to put in more funds. Although the company needed to inject capital, individual shareholder agendas dictated board member positions rather than a good governance outcome in which board members sought to make the best decision for the business and the shareholders as a whole.

(iii) Clarity of mission

The focus of the organization must be clear to shareholders, management and hopefully staff. The investor has to be comfortable with the mission and be able to support it.

(iv) Expected return

International investors will typically look for an equivalent USD returns and so the financial forecasts, post fluctuations in local currency versus USD, must deliver a base case acceptable to them. The minimum required return can vary significantly amongst investors.

Local investors are not as sensitive to exchange rate risk as they look for local currency returns. Moreover, they typically have a longer investment horizon.

It is critical that the investor accepts that they are taking local currency risk when making an equity investment in a local financial institution. If they are not comfortable with this, they should not invest. Most financial institutions in developing markets generate local currency returns. While this is a controversial view, it is often not appropriate, in Exchange's view, to burden such entities with hard-currency obligations (e.g. USD debt) or quasi-equity instruments that guarantee the provider a USD return.

(v) Growth potential and portfolio quality

For financial institutions, the areas of portfolio quality and credit control are critical. Credit is often the main activity of the investee and outreach a development goal of the investor.

Investors will look for a prudent and realistic approach in this area, which if not managed properly, can destroy banks and MFIs very quickly.

(vi) Role of investor

Ideally, the investor should be able to play a role beyond the provision of finance. Stipulating some of these, such as sourcing of management, technical expertise, lines of credit and other sources of capital to investees is key rather than leaving them undefined. All these 'capital-plus' roles that investors play add value and should enhance the return to all investors. Such investor activity strengthens a win-win relationship.

In the Far East an international investor promised many additional benefits when becoming involved in a local bank. Several years later none of the benefits had materialized.

In Africa a DFI provided technical assistance to strengthen the risk function within a local bank. This support preceded the provision of a local currency line of credit – the performance of which should in turn benefit from the bank having a better risk function. An equity investment in the bank was also envisaged as a third stage in the relationship.

Information requirements

In order to assess the above areas, investors require a significant amount of information and interaction. The documents / materials listed below seek to provide a useful insight into what typically is required by investors. In addition some investors will have their own additional requirements. If investors are not forthcoming with a well organized list of needed materials, investees should ask them for it early on. Otherwise, investees are faced with requests for materials in repeated iterations, which is not always efficient.

Typical Documents Requested During Due Diligence Process by Investors

Financial

- Audited accounts (and if audit report is clean) – last three years
- Management accounts - latest
- Budgets
- Business Plan for the next three years
- Expansion projections
- Portfolio Analysis
- Credit files
- Tax filings/ returns
- Auditor's management letter

Management

- Key managers with brief bio / CVs

Strategy

- Institutional presentation / profile
- Market information – market share and performance ratios of competition
- Country information

Capital

- Capital structure and rights of different shareholder classes
- List of major shareholders, donors and lenders
- Shareholder agreements
- Terms of any technical service or management agreements
- External Rating or evaluations

Operations

- Organization chart
- MIS description
- Operations information
- Products

Board

- List of board members with brief bios / CVs
- Board minutes
- Audit committee minutes

Legal

- All legal registration documents
- Banking laws
- Regulatory environment details including provisioning requirements and capital adequacy
- Inspection reports by any regulator

Due diligence

Investors will follow their own due diligence process. Often they perform the work themselves but at times they outsource aspects such as financial due diligence, legal due diligence and market due diligence. Investees can often research investors on their web site and become familiar with their investment process and goals. This should help educate the investee prior to any investment discussion.

b. Understanding Investee Needs

If the needs of the investor alone are met, but not those of the investee, the outcome is not a win-win relationship. Investees identified the following attributes of investors as most important during Exchange's discussions:

- Financial strength and capacity to invest including amounts involved.
- Compatible investment horizon and expected return.
- Good reputation and, therefore, reputational enhancement of investee company. Involvement of international investors tends to send a positive message to domestic markets.
- Influence of good governance / housekeeping.
- Shared goals and compatibility of objectives.
- Possible provision of capacity building support.
- Value addition through experience in banking, financial services and technology.
- Drawing on own networks and relationships to benefit the investee.

In Africa, an experienced banker was placed on the board of an investee bank as a non-executive director. Balance sheet structure was sub-optimal and the area of credit was in need of strengthening. Over several years, both areas were addressed with the non-executive director drawing on his wealth of experience to strengthen the bank to the benefit of the institution and all shareholders.

An investee company clearly summed up the need to align interests by saying, “We have to ensure that the relationship supports the achievement of our strategic business plan which we will have to clearly spell out to them. The partner therefore has to be able to share and believe in our destiny”

Increased alignment of investor / investee needs can be reinforced through appropriate incentives for senior management, clear performance measures designed to enhance shareholder value and the necessary oversight and strategic direction from the board. The use of share options or profit-share schemes or their equivalent can prove effective whereby senior management, and staff, are incentivized and participate in the value they help create.

c. Defining Typical Terms and Conditions

The legal basis for a relationship between investor and investee is typically set out initially in a term sheet, which is the precursor to full legal agreements. The term sheet looks to capture the framework within which the relationship will operate. The main purpose of defining terms is that it tests in black and white whether investors and investees can come to an agreement on terms and conditions. The earlier in the process agreement on terms can be reached, the more efficient the process and the greater the saving in time and costs. Additionally, a term sheet indicates in some way that the interests of all parties are clear and reasonably aligned. If agreement cannot be reached on terms then there can be no deal.

In Central America an investor insisted that the family owner no longer be Executive Chairman but rather become a non-executive director. When this was unacceptable to the shareholders of the investee bank, the deal fell apart, notwithstanding the other mutual benefits established. Five years later the bank collapsed.

An example of a term sheet is provided in Appendix 1.

Specific terms and conditions will depend on the individual deal, and typically are more difficult to design for start-ups. The major issues that need to be addressed and spelt out include:

(i) Pricing

Pricing poses a challenge in almost every investment. It may be simplified in existing entities, but is harder for start-ups and transformations because while the potential for substantial upside exists, there is far more risk. Also, the absence of comparable market transactions often makes the deal hard to price. Investees often believe their entity is worth top dollar whilst investors want to account for all the key risks they can identify. Many investors are conservative and prefer to buy at or below net asset value, in part because of the terms that they have, in turn, promised the investors in their fund. Pricing is linked to the valuation of the entity from the perspective of the investor and the investee. Pricing should always be a negotiation, rather than being investor-driven. The different views on pricing often become most evident when discussions are on the quality of the loan portfolio and impact of required provisions on net asset value and profit are under way. Pricing and exit strategy always pose the biggest problems because investees are often surprised by the connection between the two. Quite often, investors in MFIs tend to assign low values to price as they are taking into account limited exit opportunities (for example, if the institution has no plans of going public, or is not likely to become an acquisition target within the next 3-5 years, it is difficult to plan for an exit).

(ii) Exit

Exit strategy is important for most investors but is not always easily appreciated by the investee. Often, the investor wants to exit so the same money can be directed towards other investments down the road. Depending on the initial goals of the investee, they might be happy for certain investors to exit (for example, when there ceases to be a match with the objectives of the institution, or where there are new attractive investors on the horizon). Different investors often have different investment horizons which need to be established up front – a five-year exit horizon may not be appropriate for a growing financial institution where real returns will only come through in years eight to ten. Knowing the investment horizon of the investor enables the investee to plan for eventual recapitalization as required, and defining a timetable for the changes that works for itself.

Certain investors seek to address the exit strategy with a combination of timetable regarding:

- Put option (more a fall back position as this limits upside)
- Block sale agreement (can be of value where there are willing buyers)
- Initial public offering (is often difficult where capital markets are not developed and / or liquidity is low)

(iii) Social and environmental

These conditions are increasingly important and found in many term sheets. Specific measurables such as number of small businesses financed/ entrepreneurs assisted or jobs created can help bring clarity to this area.

Problems that have come up during a terms and conditions negotiating:

- Choice of jurisdiction – DFIs often want to follow UK, European or NY State Law and investees typically want to follow local law. This often leads to a conflict in how to make a final decision. Investees are entitled to point out that given the investor is prepared to take currency and country risk when investing; submitting to local jurisdiction is perhaps just an extension.
- Place of arbitration – investors typically prefer an internationally recognized place of arbitration.
- Management Shares/ Compensation related to performance – whilst there have been divergent views on this in the past, both sides are increasingly cognizant of the need to recognize the contribution by founders and managers. In practice, this is usually dealt with at board level and does not need to become a matter of terms and conditions in detail.

d. Identifying a Misalignment

Some of the major factors investors look at include the relationship between shareholders, management and board. If there is evidence of serious conflict / tension within the existing governance structure, the introduction of a new party may cause further problems.

In addition the degree of transparency and integrity is critical.

Some of the “red flags” that prevent investors making an investment include:

1. **Control issues (board/ shareholders/ management)** - if existing shareholders are not prepared to truly include other parties in decision making then there may be no basis for coming together.
2. **Overcapitalized leverage ratio** - if the entity is overcapitalized any additional capital may strengthen the financial institution’s balance sheet but may produce unattractive returns on equity that nullifies the investment case.
3. **Accounting irregularities** - raises questions over integrity of management and quality of earnings.
4. **Not regulated** - lack of oversight by a regulator raises the risks associated with an investment in a financial institution.
5. **Creative accounting** e.g. revaluation of fixed assets above market value, window dressing and other attempts to present a better picture than reality could be an attempt to get investors to fill a black hole.
6. **No risk management controls in place** (i.e. internal controls) - raises serious questions about quality of existing portfolio and alarm bells regarding future portfolio quality.
7. **Late or non- payment of taxes**-raises operational and integrity question marks.
8. **Poor portfolio quality** / high number of non-performing loans - raises questions over operational controls, credit methodology, management quality and capital sufficiency.

9. **Country risk** – currency / convertibility / political - the first two cannot be avoided with equity investments, the latter is a judgment call.
10. Questions over **source of funds / money-laundering** - if the source of money is deemed “dirty”, most international investors will not / are prevented from investing.
11. **No track record** - non-existence of a track record raises risk that plans will not be achieved.
12. **Reputation for not playing by the rules** - past misconduct in this area normally scares investors away.

Some of the “red flags” that prevent investees from accepting an investor include

1. At times foreign investors will demand **too much control** in return for their investment, stripping the institution of its ability to function independently.
2. **Unacceptable reputation** - most financial institutions look to protect their reputations in order to retain the trust of depositors and regulators. An investor with cash to invest but a reputation that could damage the entities own standing will often be declined.
3. **Onerous conditions** attached to the funding - some investors attach onerous conditions such as frequency of reporting, producing of additional reports, measuring certain outcomes etc. that distract management from running the business.
4. **Unnecessary conditions** preventing the investee servicing the market in a way that is driven by pure market demand. To protect their position some investors may require compliance with certain ratios, for example, tying up capital in a sub-optimal way.
5. **Cost too high** - if the cost of the funds is deemed to be too expensive it will be rejected. This can particularly be the case where investors seek to guarantee a minimum USD return.
6. **Know Your Customer** - with money-laundering practices in operation a failure in this area should prevent an investee accepting doubtful funds.
7. **Lack of transparency** or discovery of unethical dealings - negative impact on the investee of such findings would often make the investor unacceptable.
8. **Lack of openness** regarding intent - some investors adopt a Trojan horse approach and invest with ulterior motives such as obtaining market information prior to entering as a new competitor.

In practice, once an investor has committed to a deal and started working on it, they often do whatever they can to make it work. They would rather change a deal than walk away. For example, if there are control issues, the shareholder agreement can incorporate specific rights to protect minority shareholders. Where management quality is an issue, there may be a way to change the senior management. Where there are strategic differences, the investor may be able to work with the investee to re-think their business plan – attaching the final agreed version to the legal documentation as a clear record of what is being aimed for.

V. Key Learnings and Examples of How to Manage an Investment

Investors questioned by Exchange indicated that they prefer to see regular reporting from investee companies and more rather than less. While they want well-structured, clear, accurate and consistent financial statements and portfolio reporting, they do not just want to see numbers. They want to see achievements and challenges explaining the evolution of the company over time, which also gives them a better picture and an awareness of the ways in which they could help the investee more proactively.

Actions that lead to the relationship working when it comes to provision of ongoing information / performance include:

- Documents that regularly show the evolution of the investee company. This makes it easier to track progress and establish the quality of earnings. Meeting agreed hurdles gives confidence to all parties.
- Attendance of board meetings, particularly where there is a difference between types of board meetings e.g. a quarterly board meeting that is more strategic and lasts ½ or a full day compared with monthly or quarterly board meetings that are more routine and last for two-three hours.

It was normal practice for the international investor to send a variety of individuals to attend board meetings of the investee company. This provided no continuity and was not consistent with best practice (which recommends the non-executive director attends meetings in their own capacity and is personally responsible for fulfilling responsibilities as a director).

- Point of contact. When investees assign a point person in charge of an individual investor relationship, this can help significantly in managing the relationship. In particular it allows the investor to go to someone very quickly when a rapid response is required.
- Negotiating good legal documents at the beginning also provides guidelines to follow which helps build and maintain a good relationship.
- Equal treatment of all shareholders is of paramount importance.

In Africa, it had been decided that the international shareholders wished to exit as a block. One institutional shareholder, however, sought to make a side-deal with the proposed incoming investor. The board stepped into the situation to prevent a side-deal that would have not treated all shareholders equally.

On the other side of the coin, actions that cause problems and damage the relationship include:

- Non-attendance of board meetings, not taking up board seats or changing the investor board member frequently. All the above send a signal of lack of commitment / interest and adversely affect trust and good communication. Whilst an investment in a small bank in country X may be a small investment in a large portfolio, as far as the investee company is concerned, management and other shareholders want that particular investment to succeed. Neglect or indifference will not foster a win-win relationship, and is harmful for both parties in the long run.

- Incidence of fraud at shareholder level can be a major problem and if it occurs is difficult to fix.

The biggest mistake that was emphasized by all the investors was investees not following reporting procedures, not being transparent or keeping investors in the dark regarding important developments.

VI. Conclusion

Wrap-up

Both investors and investees agree that given that these relationships can be mutually beneficial, it is well worth making the effort to build win-win relationships. As in human relationships, there is often a need to work through disagreements and difficult patches. Both parties need to be able to look back at what the agreed objectives were at the beginning of the relationship can play an important part in keeping the investor / investee relationship on track so that it lasts for the intended duration.

Take-away snapshot for investors

- What is the mission of the entity? Is it focused on the things you are happy with e.g. development? What is the motivation of the founders?
- What is the financial situation of the company? Is it regulated? Is it profitable?
- What is the capital needs now and in the future? (Often former MFIs are overcapitalized) How efficient is the entity?
- What is the quality of management? What is their banking experience? What are the commitment / energy levels to build a successful institution?
- Is the business plan showing growth and appreciation of value of equity?
- Will the operations and procedures support the growth envisaged?
- When (ideally five-seven years) and how (management buy-out, put option, initial public offering) will the investor get an exit?

Take-away snapshot for investee companies

- Be careful whom you allow into the equity base, as alignment of vision is important.
- Investors should allow management to run the business, restricting themselves mostly to providing strategic input and if international, adding global perspective.
- Local and international investors each have a specific role to play at different stages of the development of the financial institution.
- Be careful with terms and conditions and avoid onerous ones.
- Investors should be flexible re dividends.
- Investors should add value: e.g. in areas of product development, governance and quality of reporting (housekeeping).
- Some investors can add value through providing strategic introductions and capacity-building support.

Appendix 1

DRAFT TERM SHEET FOR DISCUSSION PURPOSES ONLY

[NAME OF INVESTEE INSTITUTION]
Purchase of [TYPE OF SECURITY INTEREST]

1. Introduction [BACKGROUND TO PROPOSED RELATIONSHIP]
2. Shareholders' Agreement
The SHAREHOLDERS shall enter into a joint Shareholders' Agreement prior to the execution of the proposed investment. Such agreement shall establish, among other things, the purpose of the BANK, the rights and responsibilities of its Shareholders, governance procedures, share transfer restrictions, and an exit mechanism to be available to those SHAREHOLDERS seeking a return of capital within an [X] year timeframe.
3. Shareholders' Meetings
The BANK shall in each year hold a general shareholders meeting in addition to any other meetings in that year, and not more than fifteen months shall elapse between the date of one general meeting of the BANK and that of the next. The annual meeting shall be held at such time and place as the Board shall appoint. Written notice shall be given to all SHAREHOLDERS no less than [X] days prior thereto, specifying the agenda of the meeting. No resolution with respect to any matter may be put to any meeting of the Shareholders unless the notice of the meeting contains reasonable detail of the matter.
4. Voting Rights
A [X]% supermajority vote of the SHAREHOLDERS shall be required to approve all strategic or reserved matters to be defined in the BANK's Articles of Association, including but not limited to:
 - (a) Change of corporate purpose,
 - (b) Merger, amalgamation or spin-off of the BANK,
 - (c) Any capital increase, except by legal imposition,
 - (d) Acquisition of a new non-financial services business,
 - (e) Dissolution or liquidation of the BANK or discontinuance of its liquidation status or the authorization to managers to admit bankruptcy or to enter into composition with creditors,
 - (f) Other matters as agreed.

5. Board of Directors

The following SHAREHOLDERS [to be defined] shall have the right to appoint one Director and an Alternate Director to the Board of Directors of the BANK, subject to the [country] legal requirement that the majority of Directors shall not be affiliated with the SHAREHOLDERS. Each Director shall be entitled to one vote in the decisions of the Board of Directors. The Board shall consist of at least [X] and no more than [Y] Directors.

The Board of Directors shall meet at least [number of times] per quarter. Each of the Chairman or the Vice Chairman, or [X]% of the Directors, shall be entitled to call a meeting at any time upon written notice given to all directors no less than [X] days prior thereto, specifying the agenda of the meeting. No resolution with respect to any matter may be put to any meeting of the Board of Directors unless the notice of the meeting contains reasonable detail of the matter.

The Directors appointed by the SHAREHOLDERS shall receive a sitting fee of \$[X] per meeting and have actual out-of-pocket expenses covered with an annual travel allowance of up to \$[X] for attending Board meetings.

6. Tag along provision

If any of the SHAREHOLDERS of the BANK obtains a purchaser for its shares, then this shareholder prior to making such sale shall first obtain and offer to the other SHAREHOLDERS the same sale terms it has obtained for the sale of its shares, and at each of the Shareholder's choice will first arrange the sale of each of the shareholder's shares, on a pro rata basis. The terms of this tag along provision will continue until all of the following SHAREHOLDERS [to be defined] have completely divested their shares.

7. Right of first refusal:

In the event that the BANK offers new shares, all SHAREHOLDERS shall have a right of first refusal to purchase a pro rata percentage of shares of the new offering, based on each shareholder's percentage ownership interest in the BANK.

8. Affirmative Covenants:

The BANK will:

(1) maintain at least [X]% of its credit portfolio in credits to small businesses, micro-entrepreneurs or low-income individuals. "Low income" shall be determined by [definition]

(2) retain independent auditors as may be approved by the

Board of Directors provided that any auditor must be a firm of recognized international standing, and follow international accounting standards;

(3) authorize the auditors to communicate with the SHAREHOLDERS regarding the BANK's finances and financial statements if any individual Shareholder so requests;

(4) establish an Audit Committee of the Board of Directors to be comprised of Directors not representing management;

(5) use its best efforts to conduct its business with due diligence and in accordance with sound financial and business practices that are standard in the banking industry;

(6) keep its properties, business and assets insured with financially sound and reputable insurers against loss or damage as soon as such products are available in the [LOCAL COUNTRY] market;

(7) obtain Directors and officers insurance as soon as it becomes available in the [local] market;

(8) maintain and comply with internal procedures and controls and follow best international banking practices for the purpose of preventing the BANK from becoming an instrument for money laundering, the financing of terrorist activities, fraud or other corrupt or illegal purposes or practices;

(9) maintain generally accepted environmental, social, health and safety standards where prohibited activities shall include: Production or activities involving harmful or exploitative forms of forced labor / harmful child labor; Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements; Production or trade in weapons and munitions; Production or trade in alcoholic beverages (excluding beer and wine); Production or trade in tobacco; Gambling, casinos and equivalent enterprises; Trade in wildlife or wildlife products regulated under Convention on International Trade in Endangered Species of Wild Fauna and Flora; Production or trade in radioactive materials;

(10) grant access for all SHAREHOLDERS and their representatives to its premises, books and records during

normal business hours;

(11) prepare an annual budget approved by the Board of Directors;

(12) maintain its license with [CENTRAL BANK].

9. Exit:

Starting at the end of the third anniversary of the proposed investment, BANK management will present an annual capital strategy plan to the Board that addresses exit options for the following SHAREHOLDERS [to be defined], including options for selling shares to local or regional investors. If no suitable exit has been undertaken by the end of the fifth year, then the BANK will, under the direction of the SHAREHOLDERS, hire a third-party to seek a suitable buyer for a majority of the bank's outstanding shares. As minimum conditions, the sale will be for cash and at not less than book value.

10. Financial and Accounting Practices:

The BANK's reports will be prepared on a consolidated basis in accordance with generally accepted international accounting principles (IFRS) and be audited by independent auditors of the BANK, including the balance sheet and statements of income, retained earnings and changes in financial position, together with all supporting schedules and notes.

The BANK shall maintain accurate and complete books and records of all transactions, receipts, expenses, assets and liabilities of the BANK in accordance with generally accepted international accounting principles (IFRS), consistently applied as approved and adopted by the Board of Directors.

11. Reporting Requirements

The BANK shall provide the following to all SHAREHOLDERS:

- i) quarterly unaudited financials comparing actual results to budgets;
- ii) annual budget;
- iii) annual audited financials;
- iv) development impact report (format to be provided);
- v) asset quality reports;
- vi) risk management and ALCO reports;
- vii) annual environmental compliance report (format to be provided);
- viii) external audit reports;
- ix) [CENTRAL BANK] examination reports.

12. Legal Expense
- The costs of finalizing the legal agreements necessary to execute this investment shall be borne by the BANK up to a maximum of US\$XX per shareholder. It is anticipated that the SHAREHOLDERS can share legal counsel as a way of saving transaction costs.
13. Conditions Precedent to Closing
- (a) Completion of due diligence to the satisfaction of [INVESTOR] at their own discretion;
 - (b) Updated 5-year business plan for the BANK including financial projections and assumptions;
 - (c) Shareholder and Subscription Agreements in form and substance satisfactory to all SHAREHOLDERS;
 - (d) BANK Articles and Memorandum of Association in form and substance satisfactory to all SHAREHOLDERS;
 - (e) Legal opinion in form and substance satisfactory to [INVESTOR] confirming the approval, validity and enforceability of the transaction documents;
 - (f) Approval for the proposed investment by [CENTRAL BANK];
 - (g) Review and approval of the proposed IT system for the BANK to the satisfaction of all SHAREHOLDERS;
 - (h) Any other material issues to be discussed.
14. Closing:
- The SHAREHOLDERS will make best efforts to close on this investment on or before [date].

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