



**Zemen Bank S.C.**

## **Manual for the Administration of Advisors**

Advisors must notify Zemen Bank of their claim of compliance of the Advisor Code of Professional Conduct and claim of compliance on all sections. This Advisor Compliance Form [to be developed] is  for a communication and information-gathering purposes only and may not represent that Zemen Bank or Enterprise Partners engagement in enforcement or quality control of an Advisor Firm's claim of compliance.

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## **Provision of Advisory Services**

Advisor (“Advisor”) is an individual or a firm that advises a client (potential investee) concerning such matters that relate to financial and strategic matters of the client’s company, its subsidiaries or affiliates for a sole purpose of supporting an investment process, decision and action. The Advisor acts as interface between the client (potential investee) and investor to ensure all required activities are performed and the accompanying document is provided to investor. The main purpose of the Advisor is to help clients meet investment capital goal for their business.

Several countries around the world are introducing minimum standards for Advisors. For instance, in USA and Australia, a law is under way that would require:

- Compulsory education requirements for both new and existing Advisors;
- Supervision requirements for new Advisors;
- A code of ethics for the industry;
- An exam that will represent a common benchmark across the industry; and
- An ongoing professional development component.

Similar standards for certain aspects of Advisors are being introduced in the United Kingdom.

Due to lack of experience and industry practice in Ethiopia, Zemen Bank endeavors to provide overall guidance and set the minimum requirements for the conduct of Advisory work with client.

Since clients under the Zemen’s PCAF (learn more about PCAF at [www.zemenbank.com/privateequity](http://www.zemenbank.com/privateequity)) program will pay for Advisory services by drawing down on an interest free Advance Facility, Zemen Bank recognizes limited fiduciary duties in ensuring Advisors’ work meet expectation of client and the private equity firm that likely partner with the client.

### **Pre-Selection (Initial Screening) Criteria**

The Advisor must be registered and must have current business licenses under the relevant licensing laws of Democratic Republic of Ethiopia. The Advisor must have the credentials and/or must be affiliated with a licensed foreign investment Advisory firm.

1. Proven track record of capital raised on behalf of clients;
2. Copy of service agreement / service contract with the client seeking capital;
3. An alignment of service agreement with that of investors' requirement(s);
4. Two references from businesses whom the Advisor supported to raise capital;
5. Two references from institutional investors (be strategic or financial);

It is important to ensure an Advisor has a full-service offer for all the stages of the investment process either in house or in partnership with other professionals under a service partnership agreement. If the Advisor is providing full-service in partnership with other

service providers, these other service providers must be licensed under the relevant laws of Republic of Ethiopia and must be registered and have current business license.

Also it is important to note that the role of an Advisor is not an extension to the day-to-day operations or management of the client's business and does not include any of the services provided by financial officers, management or employees of the client's business.

Zemen Bank will compile list of the qualified investment advisors and introduce to potential clients.

### **Additional Requirement of an Advisor (Best Practice Activities)**

In order to be part of this list, an Advisor must submit a Brochure, which contains the following.

Provide a narrative "brochure" that includes in plain English disclosures of, among other things, the Adviser's business practices, fees, policies on conflicts of interest, and sector focus, if any;

1. Provide a "brochure supplement" that contains information about services offered and the service offerings and the person that heads service deliver to clients on a particular specialty e.g. financial or transaction or both, including educational background, business experience, other business activities, and disciplinary history.
2. Disclose of previous transactions, and a reference to the particular disclosed transaction. References must include name of the firm, full physical address of the company, license number, business owner or shareholder, full contact information such as business phone number, mobile phone and email address.
3. Ensure minimum qualification of all advising team, track record and performance history. Also, ensure there is a partnership agreement and profit sharing arrangement in place prior to selecting client;
4. Ensure the Advisor is able to provide the Advisory service throughout the stages of investment process in-house or through partnership arrangement with other service providers;

# Code of Ethics and Standards of Professional Conduct

(Adapted from the CFA Institute Code of Ethics and Standards of Professional Conduct and Asset Manager Code of Conduct)

Zemen Bank’s Advisor Code of Professional Conduct outlines the ethical and professional responsibilities of firms (“Advisors”) that advise clients. By adopting and enforcing a code of conduct for their organizations, Advisors demonstrate their commitment to ethical behavior and the protection of investors’ interests.

## General Principles of Professional Conduct

Advisors have the following responsibilities to their clients. Advisors must:

1. Act in a professional and ethical manner at all times.
2. Act for the benefit of clients.
3. Act with independence and objectivity.
4. Act with skill, competence, and diligence.
5. Communicate with clients in a timely and accurate manner.
6. Uphold the applicable rules governing businesses and investment in Ethiopia.

## Detailed Code of Professional Conduct

### A. Loyalty to Clients

Advisors must:

1. Place client interests before their own interests.
2. Preserve the confidentiality of information communicated by clients within the scope of the Advisor–client relationship.
3. Refuse to participate in any business relationship or accept any gift that could reasonably be expected to affect their independence, objectivity, or loyalty to clients.

### B. Investment Process and Actions

Advisors must:

1. Use reasonable care and prudent judgment when undertaking and managing client engagements.
2. Not engage in practices designed to distort transaction prices and values or artificially inflate valuation with the intent to mislead investors or clients.
3. Deal fairly and objectively with all clients when providing investment information, making investment recommendations, or taking investment action.
4. Have a reasonable and adequate basis for investment decisions.
5. When managing an investment process, recommendation and action to a client’s specific mandate, strategy, or style: 
  - a. Take only investment actions that are consistent with the stated objectives and constraints of the client

- b. Provide adequate disclosures and information so clients can consider whether any proposed changes in the investment style or strategy meet their investment needs of the client.
- 6. When providing investment advice or taking investment action on behalf of the client:
  - a. Evaluate and understand the client's investment objectives,  tolerance for risk, time horizon, liquidity needs, financial constraints, any unique circumstances (including tax considerations, legal or regulatory constraints, etc.) and any other relevant information that would affect investment decision.
  - b. Determine that an investment is suitable to a client's financial situation.

### C. Best Execution

Advisors must:

- 1. Not act or cause others to act on material confidential information  that could affect the value of a client's investment.
- 2. Give priority to investments made on behalf of the client over those  that benefits the Advisors' own interests.
- 3. Use client funds to pay for only  investment-related services that directly assist the Advisor in its investment decision-making process, and not in engagements of the Advisor with other clients.
- 4. Maximize client entry and exit value by seeking best execution for client transactions.
- 5. Establish policies to ensure fair and equitable allocation among client accounts.

### D. Risk Management, Compliance and Support

Advisors must:

- 1. Develop and maintain policies and procedures to ensure that their  activities comply with the provisions of this Code and all applicable  legal and regulatory requirements in Ethiopia are followed.
- 2. Appoint compliance officer responsible for administering the policies and procedures and for investigating complaints regarding  the conduct of the Advisor or its personnel.
- 3. Ensure that information provided to clients by the  Advisor is accurate and complete and arrange for independent  third-party confirmation or review of such information.
- 4. Maintain records for an appropriate period of time in an easily  accessible format.
- 5. Employ qualified staff and sufficient human and technological  resources to thoroughly investigate, analyze, implement, and  monitor investment decisions and actions.
- 6. Establish a business-continuity plan to address disaster recovery  or periodic disruptions of Internet communications.
- 7. Establish a firm-wide risk management process that identifies,  measures, and

manages the risk position of the Advisor and its client investments, including the sources, nature, and degree of risk exposure.

#### **E. Performance and Evaluation**

Advisors must:

1. Present past experience and service delivery information that is fair, accurate, relevant, timely, and complete. Advisors must not misrepresent the past experiences and service delivery of their firm to other clients.
2. Use fair-market prices to value client business and apply, in good faith, methods to determine the fair value of shares and any other securities for which no independent, third party market quotation is readily available.

#### **F. Disclosures**

Advisors must:

1. Communicate with clients on an ongoing and timely basis.
2. Ensure that disclosures are truthful, accurate, complete, and understandable and are presented in a format that communicates the information effectively.
3. Include any material facts when making disclosures or providing information to clients regarding themselves, their personnel, investments structured, or the investment process.
4. Disclose the following:
  - a. Conflicts of interests generated by any relationships with brokers or other entities, other client accounts, fee structures, or other matters.
  - b. Regulatory or disciplinary action taken against the Advisor or its personnel related to professional conduct.
  - c. The investment process, including information regarding lock-up periods, strategies, risk factors, tags, drags and use of derivatives and leverage.
  - d. Management fees and other investment related costs charged by investors, including what costs are included in the fees and the methodologies for determining fees and costs.

The amount of any soft or bundled commissions, the goods and/or services received in return, and how those goods and/or services benefit the client.

5. The performance of clients' investments on a regular and timely basis.
6. Valuation methods used to make investment decisions and value client holdings.
7. Shareholder voting policies.
8. Share allocation policies
9. Results of the review or audit of the fund or account.
10. Significant personnel or organizational changes that have occurred at the Manager.
11. Risk management processes.

## **Investment Advisor Association (IAA) Standards of Practice**

Since its' founding in 1937, the Investment Advisor Association has prescribed certain principles of conduct for investment Advisors. Over the years, the United States Congress and the Securities and Exchange Commission has used many of these principles as the basis for legislation and regulations governing the conduct of investment Advisors. The United States Supreme Court has used them in defining the standards of fiduciary conduct applicable to all investment Advisors.

In addition, the legal, regulatory and compliance, the requirements that relate to investment Advisors have dramatically expanded in scope and complexity. Accordingly, the IAA's Standards of Practice reflect changes that have occurred while continuing to emphasize an Advisor's core fiduciary duty.

### **1. Fiduciary Duty and Professional Responsibility**

An Advisor stands in a special relationship of trust and confidence with the client, and therefore is a fiduciary to, its clients. As a fiduciary, an investment Advisor has an affirmative duty of care, loyalty, honesty, and good faith to act in the best interests of its clients. The parameters of an investment Advisor's duty depend on the scope of the Advisory relationship and generally include:

- a) The duty at all times to place the interests of clients first;
- b) The duty to have a reasonable basis for its investment advice;
- c) The duty to seek best execution for client securities transactions where the Advisor directs such transactions;
- d) The duty to make investment decisions consistent with any mutually agreed upon client objectives, strategies, policies, guidelines, and restrictions;
- e) The duty to treat clients fairly;
- f) The duty to make full and fair disclosure to clients of all material facts about the Advisory relationship, particularly regarding conflicts of interest; and
- g) The duty to respect the confidentiality of client information.

### **2. Professional Qualifications**

To enable an investment Advisory firm to serve its clientele effectively, its investment and managerial personnel should be individuals of experience, ability, competence, and integrity.

### **3. Responsible and Ethical Business Practices**

An investment Advisor should run its business responsibly and ethically, including ensuring that its financial condition, operations, and compliance structure are appropriate to protect its clients' interests.

#### 4. Compensation for Services

The compensation of an investment Advisor for investment Advisory services should be fair, reasonable, and fully disclosed to the client.

#### 5. Communications with Clients and the Public

An investment Advisor's oral and written statements, including those made to clients, prospective clients, their representatives, or the media, must be accurate, balanced, and not misleading.

### **The Role of Professional Advisors**

The Advisor, lawyer and accountant have important roles to play in the private equity process, both for the entrepreneurs and business owners seeking finance and the private equity firm. It is often the case that the investment Advisory role and the role of the accountant performing investigatory due diligence are performed by different teams within the same organization.

#### **The Advisor's Role**

The primary role of the investment Advisor, for example in a private equity transaction, is to provide corporate financial and investment advice to either the management team or the private equity firm sponsoring the transaction. The investment Advisor will provide clients with impartial financial and investment advice, independent of the private equity firm and its own Advisors. The precise nature of the role varies from situation to situation but typically includes:

1. Undertaking an initial appraisal of client's financing proposition. □
2. Advice on client's business plan – critically reviewing and appraising client's plan to ensure that it includes □all the areas that are typically referred in a well written business plan and that the business plan is □framed and presented in accordance with the requirements of the private equity firms. □
3. Advice on valuation of the business and planning for the ultimate sale of the business (exit) and realization □of management and the private equity firm's investment. □
4. Undertaking financial modeling – carrying out sensitivity analysis on the financial projections to establish □that the forecasts make accounting and commercial sense. Checking that they have been prepared in □accordance with reasonable accounting policies and with due regard to publicly available information. □
5. Advice on the most appropriate capital structure to be used to fund client's proposal. □
6. Making introductions to appropriate sources of private equity with investment criteria that match □client's business proposition and a business style that should be right for the client. If the client's business is a highly attractive investment opportunity for private equity firms, this may include organizing an “auction” or a “beauty parade” of private equity firms to compete for the right to finance the client's company. The investment Advisor will need to ensure that the terms of the investment are properly complied. □
7. Making introductions to appropriate sources of debt and other finance to help to fund

- the proposal. □
8. Reviewing offers of finance – reviewing the terms of the deal offered by the private equity firms and other finance providers and assisting the client in negotiating the most advantageous terms from those on offer. □
  9. Assisting in negotiating the terms of the deal with the private equity firms and banks and with other vendors. □
  10. Project managing the transaction to minimize calls on management time and disruption to the business. □
  11. Providing other advice, at a later stage if required, on the sale of the client shares to the public, or their sale to another organization, or other such transactions. □

### **The Accountant's Role** □

The primary role of the accountant acting on behalf of the client in a private equity transaction for example, is to undertake investigatory due diligence. The precise scope of the accountant's role varies from situation to situation but typically includes: □

1. Reporting formally on projections. □
2. Undertaking financial and commercial due diligence – often a prerequisite to private equity □ investment. The accountant will also be able to make informal judgmental opinions on aspects of □ the plan to the benefit of both management and the private equity firm. □
3. Undertaking accounting treatment, IT or environmental investigatory work and due diligence. □
4. Providing audit, accounting and other Advisory services. □
5. Planning your tax efficiently – help client obtain the maximum benefit from the tax system, whether the aim is for a public flotation or to remain independent, and to minimize tax liability on any ultimate sale of equity. □
6. Valuing your company's shares – for tax planning and Inland Revenue negotiation. □

### **The Tax Advisor's Role** □

The tax Advisor will also help client to ensure that, where possible: □

1. Potential gains on the sale of equity are taxed as a capital gain and not treated as earned income. □
2. Capital gains tax (CGT) is deferred on the sale of equity. □
3. Tax indemnities provided by the company directors and shareholders to the private equity firm are reviewed. □
4. Advantage is taken of appropriate plant and machinery, industrial buildings and research & □ development and other investment related tax holidays. □
5. Corporate funding is structured to maximize tax relief. □
6. Due diligence procedures pertaining to taxes are properly carried out. □

### **The Lawyer's Role**

Usually there are at least two sets of lawyers involved in the private equity process; one representing the client team and one representing the private equity firm. Other parties,

such as bankers and other private equity firms, if acting as a syndicate, will each want their own lawyers are involved.

The private equity firm's lawyer is mainly concerned with ensuring that the private equity firm's investment is adequately protected from a legal standpoint. The lawyer will draw up the various investment agreements, usually including the following

1. Shareholders' or subscription agreements, documents detailing the terms of the investment, including any continuing obligations of management required by the private equity firm, the warranties and indemnities given by the existing shareholders, penalty clauses and the definition of shareholder rights.
2. Investors' rights agreement specifies the rights of the private equity firm with regards to the investment.
3. Warranties and indemnities that confirm specific information provided by the directors and/or shareholders to the private equity firm. If this information turns out later to be inaccurate, the private equity firm can claim indemnity against the providers of the information for any resulting loss incurred. An indemnity is a promise to indemnify, i.e. to reimburse the investors in respect of a designated type of liability if it arises.
4. Loan stock or debenture agreements including a statement of the terms under which these forms of finance are provided.
5. Service contracts
6. Documents that formalize the conditions of employment of key members of the management team.
7. Disclosure letter containing all the key information disclosed to the private equity firm on which the investment decision has been based. It is essential that the directors do not omit anything that could have an impact on that decision. The disclosure letter serves to limit the warranties and indemnities.

The client's lawyer will review the Offer Letter (or Term Sheet) from the private equity firm and, together with client's investment adviser, will help you to negotiate acceptable terms. The management team's lawyer will also, in due course, negotiate the investment agreements with the private equity firm's lawyer and produce the disclosure letter, as well as negotiating any loan documents with the banker's lawyer.

In the case of a new company, client's lawyer can incorporate the company and draw up the Memorandum and Articles of Association, which govern the constitution of the company, its permitted activities and the powers of its shareholders and directors.

## **Selecting and Targeting a Private Equity Firm**

Firstly, the client must decide whether or not to hire an adviser.

The most effective way of raising private equity is for both the client and the Advisor to select just a few private equity firms to target with the client's business proposition in mind. The key considerations should be to assess:

1. The stage of client's company's development or the type of private equity investment require;
2. The industry sector in which client's business operates;
3. The amount of finance the client's company needs;
4. The geographical location of client's business operations; and
5. The client and the Advisor should only select those private equity firms whose investment preferences match these attributes.

### **Stage and Type of Investment**

The terms that most private equity firms use to define the stage of a company's development are determined by the purpose for which the financing is required.

#### **Seed**

To allow a business concept to be developed, perhaps involving the production of a business plan, prototypes and additional research, prior to bringing a product to market and commencing large-scale manufacturing.

Only a few seed financings are undertaken each year by private equity firms. Many seed financings are too small and require too much hands-on support from the private equity firm to make them economically viable as investments. There are, however, some specialist private equity firms, which are worth approaching, subject to the company meeting their other investment preferences. Business angel capital should also be considered, as with a business angel on a company's board, it may be more attractive to private equity firms when later stage funds are required.

#### **Start-up**

To develop the company's products and fund their initial marketing costs. Companies may be in the process of being set up or may have been trading for a short time, but not have sold their product commercially.

Although many start-ups are typically smaller companies, there are an increasing numbers of multi- million dollar start-ups.

However, there are those who specialize in the start- up stage, subject to the company seeking investment meeting the firm's other investment preferences.

#### **Early Stage**

To initiate commercial manufacturing and sales in companies that have completed the product development stage, but may not yet be generating profits.

This is a stage that has been attracting an increasing amount of private equity over the past few years.

#### **Expansion**

To grow and expand an already established company. For example, to finance increased production capacity, product development, marketing and to provide additional working capital. Also known as "development" or "growth" capital.

### **Secondary Purchase and Second Rounds**

When a private equity firm acquires existing shares in a company from another private equity firm or from another shareholder or shareholders. When a company that has received private equity funding goes out to get additional investment from the same or different private equity firm.

### **Replacement Equity**

To allow existing non-private equity investors to buy back or redeem part, or all, of another investor's shareholding.

### **Rescue and Turnaround**

To finance a company in difficulties or to rescue it from receivership.

### **Refinancing Bank Debt**

To reduce a company's level of gearing.

### **Bridge financing**

Short-term private equity funding provided to a company generally planning to float within a year.

### **Industry sector**

Most private equity firms will consider investing in a range of industry sectors – if your requirements meet their other investment preferences. Where as, some firms specialize in specific industry sectors, such as fin tech, biotechnology, computer related, clean tech and other technology areas. Others may actively avoid sectors such as property or film production.

### **Amount of investment**

The minimum amount of foreign direct investment per project in Ethiopia is US\$200,000. The minimum amount is reduced to US\$150,000 for joint ventures and US\$50,000 for consulting and service firms.

Companies initially seeking smaller amounts of private equity are more attractive to local private equity firms. They can go to foreign investors if there is an opportunity for further rounds of private equity investment later on.

Incubation centers and business angels are perhaps the largest source of smaller amounts of equity finance, often investing amounts ranging between US\$ 10,000 and US\$ 20,000 in early stage and smaller expanding companies.

### **Geographical location**

Few private equity firms have offices in Ethiopia. Our neighboring Kenya hosts a much larger number of private equity firms. Most, if not all, of these private equity firms are eyeing Ethiopia as the next frontier for expansion in East Africa.

## **Business Plans**

## Essential Areas to Cover in Client's Business Plan

Many businesses fail because their plans have not been properly thought out, written down and developed. A business plan should be prepared to the high standard and be verifiable. A business plan covering the following areas should be prepared before a private equity firm is approached.

The executive summary is the most important section and is often best written last. It summarizes client's business plan and is placed at the front of the document. It is vital to give this summary significant thought and time, as it may well determine the amount of consideration the private equity investor will give to the client's detailed proposal. It should be clearly written and powerfully persuasive, yet balance "sales talk" with realism in order to be convincing.

It needs to be convincing in conveying your company's growth and profit potential and management's prior relevant experience. It needs to clearly encapsulate your company's unique selling point (USP) – why people should buy your product or service as distinct from your competitors).

The summary should be limited to no more than two to three pages (i.e. around 1,000 to 1,500 words) and include the key elements from all the points below:

1. The market
2. The product or service
3. The management team
4. Business operations
5.  Financial projections e.g. profit and loss, balance sheet, cash flow statements
6.  Amount and use of finance required and exit opportunities

## How Do Private Equity Firms Evaluate a Business Plan?

They will consider several principal aspects:

- Is the product or service commercially viable?
- Does the company have potential for sustained growth?
- Does management have the ability to exploit this potential and control the company through the growth  phases?
- Does the possible reward justify the risk?
- Does the potential financial return on the investment meet their investment criteria?

## Presenting Client's Business Plan and Negotiations

If a private equity firm is interested in proceeding further, the Advisor will need to ensure that the key members of the client's management team are able to present the business plan convincingly and demonstrate a thorough knowledge and understanding of all aspects of the business, its market, operation and prospects.

Assuming a satisfactory outcome of the meeting and further enquiries, the private equity firm will commence discussions regarding the terms of the deal with you. The first step

will be to establish the value of your business.

## Valuing the business

There is no right or wrong way of valuing a business. There are several ways in which it can be done.

Calculate the value of the company in comparison with the values of similar companies.

The key to this calculation is to establish an appropriate price/earnings (P/E) ratio for the client's company. The P/E ratio is the multiple of profits after tax attributed to a company to establish its capital value. Some private equity firms compare the P/E of client companies to similar companies in the developed world that are quoted in stock exchange. It is typical to expect an unquoted company's P/E ratio like the one we have here in Ethiopia will tend to be lower than a quoted company's due to the following reasons.

- Its shares are less marketable and shares cannot be bought and sold at will. □
- It often has a higher risk profile, as there may be less diversification of products and services and a □ narrower geographical spread. □
- It generally has a shorter track record and a less experienced management team. □
- The cost of making and monitoring a private equity investment is much higher. □

The following are factors that may raise an unquoted company's P/E ratio compared with a quoted company. □

- Substantially higher than normal projected turnover and profits growth. □
- Inclusion in a fashionable sector, or ownership of unique intellectual property rights (IPR). □
- Competition among private equity firms. □

### Private Equity Values Companies with Due Considerations to the IRR

Private equity firms usually think in terms of a target overall return from their investments. Generally "return" refers to the annual internal rate of return (IRR), and is calculated over the life of the investment. The overall return takes into account capital redemptions, possible capital gains (through a total "exit" or sale of shares), and income through fees and dividends. The returns required will depend on the perceived risk of the investment – the higher the risk, the higher the return that will be sought – and it will vary considerably according to the sector and stage of the business. As a rough guide, the average return required will exceed 20% per annum. □ The required IRR would depend on the following factors. □

- The risk associated with the business proposal. □
- The length of time the private equity firm's money will be tied up in the investment. □
- How easily the private equity firm expects to realize its investment – i.e. through a trade sale, public □ flotation, etc. □
- How many other private equity firms are interested in the deal (i.e. the competition

involved). □

Private equity firms also use other ways of valuing businesses, such as those based on existing net assets or their realizable value.

### **Pre money and post money valuations**

As the client and Advisor seeking private equity finance, you will be focused on the value of the company at the point in time that you are offering a stake in the company to the private equity firm in return for its investment in your company. This is the pre-money valuation, i.e. the value of the business or company before the particular fundraise round has been completed.

The post-money valuation is the value of the business after fundraise has been completed, i.e. after the private equity firm has made its investment. The private equity firm will be more focused on this than the pre-money valuation, as it is the post-money valuation that will be used as the benchmark for any subsequent rounds of financing or indeed for the eventual exit. To achieve the required return the private equity firm will be concerned at too high a post-money valuation.

## **Types of Financing Structure**

If a client uses an Advisor experienced in the private equity field, they will help the client to negotiate the terms of the equity deal. The client must be prepared to give up a realistic portion of the equity in the business if he/she wants to secure the financing. Whatever percentage of the shares client sells, the day-to-day operations will remain the responsibility of the client management team. The level of a private equity firm's involvement with client company depends on the general style of the firm and on what has been agreed with between them.

There are various ways in which the deal can be financed and these are open to negotiation. The private equity firm will put forward a proposed structure for consideration by the client and Advisor that will be tailored to meet the company's needs. The private equity firm may also offer to provide more finance than just pure equity capital, such as debt or mezzanine finance. In any case, should additional capital be required, with private equity on board, it is often easier to fundraise other forms of finance. The structure proposed may include a package of some or all of the following elements.

### **Classes of Capital Used By Private Equity Firms**

The main classes of share and loan capital used to finance Ethiopian limited liability companies PLCs and S.C.s are shown below.

#### **Share capital**

The structure of share capital that will be developed involves the establishment of certain rights. The private equity firm through these rights will try to balance the risks they are taking with the rewards they are seeking. They will also be aiming to put together a package that best suits client's company for future growth. These structures require the assistance

of an experienced qualified legal adviser.

### Ordinary shares

These are equity shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been satisfied. Ordinary shares have votes. In a private equity deal these are the shares typically held by the management and family shareholders rather than the private equity firm.

### Preference shares

These are non-equity shares. They rank ahead of all classes of ordinary shares for both income and capital. Their income rights are defined and they are usually entitled to a fixed dividend (e.g. 10% fixed). The shares may be redeemable on fixed dates or they may be irredeemable. Sometimes they may be redeemable at a fixed premium (e.g. at 120% of cost). They may be convertible into a class of ordinary shares.

### Loan capital

Loan capital ranks ahead of share capital for both income and capital. Loans typically are entitled to interest and are usually, though not necessarily, repayable. Loans may be secured on the company's assets or may be unsecured. A secured loan will rank ahead of unsecured loans and certain other creditors of the company. A loan may be convertible into equity shares. Alternatively, it may have a warrant attached that gives the loan holder the option to subscribe for new equity shares on terms fixed in the warrant. They typically carry a higher rate of interest than bank term loans and rank behind the bank for payment of interest and repayment of capital.

## The Offer Letter (Term Sheet)

Following the review and discussion of the business plan, initial investigation and enquiries, and negotiations on capital structure and other terms, and provided that the private equity firm is keen to do a deal with you, the private equity firm will send you an offer letter or term sheet. This sets out the general terms of the proposal, subject to the outcome of the formal due diligence process (see below) and other enquiries and the conclusion of the negotiations. The term sheet, without being legally binding on either party, demonstrates the investor's commitment to management's business plan and shows that serious consideration is being given to making an investment. The term sheet represents the private equity firm's preferred terms and not necessarily and indeed, unlikely at this early stage in negotiations, your preferred terms.

The private equity firm may change the terms as the due diligence process and negotiations progress, for example adjustments to the overall valuation, refinement of ratchets etc.

The terms in the term sheet will be incorporated into the shareholders' agreement at the end of the negotiation process. It is better for the term sheet to be as detailed and unambiguous as possible so that there are no surprises when the eventual shareholders agreement has been drafted for you to sign.

You can obtain an example of an indicative term sheet from the BVCA. Whilst there are no standard term sheets you can expect that the term sheet will cover the following areas all of which are briefly described below:

- Amount to be invested, instruments (eg. convertible preferred shares), valuation, capital structure; □
- Liquidation preferences, dividend rights, conversion rights, anti-dilution protection, redemption □rights, lock-ups, pre-emption rights; □
- Board composition, consent rights, information rights; □
- Warranties, vesting, option pool, milestones; □
- Confidentiality, exclusivity, fees, conditions precedent

## **The due diligence process**

To support an initial positive assessment of client business proposition, the private equity firm will want to assess the technical and financial feasibility in detail. The Advisor can also undergo the client through a mock (vendor) due diligence process.

External consultants are often used to assess the commercial and market prospects and the technical feasibility of the proposition, unless the Advisor has the appropriately qualified people in-house. References may also be taken up on the company (e.g. with suppliers, customers, and bankers) and on the individual members of the management team (e.g. previous employers). Advice may also be sought on the key commercial and structural risks facing the business in addition to assessments on the company's technology base and intellectual property rights.

Chartered accountants are often called on to do much of the financial, and sometimes other, due diligence. This will include reporting on the financial projections and other financial aspects of the business plan. These reports often follow a detailed study, or a one or two days overview and it may be all that is required by the private equity firm. The due diligence team will assess and review areas such as the following concerning the company and its management:

- Management information systems □
- Forecasting techniques and accuracy of past forecasting □
- Assumptions on which financial assumptions are based □
- The latest available management accounts, including the company's cash/debtor positions □
- Bank facilities and leasing agreements □
- Employee contracts. □

These due diligence reviews aim to support or contradict the private equity firm's own initial impressions of the business plan formed during the initial stage. If the private equity firm commissions their own external Advisors', it usually means that they are seriously

considering investing in your business. The due diligence process is used to sift out any skeletons or fundamental problems that may exist. Make the process easier (and therefore less costly) for you and the private equity firm by not keeping back any information of which you think they should be aware in arriving at a decision. In any event, the Advisor will have to warrant this in due course. □

## **And Finally... Completion**

Once the due diligence is complete, the terms of the deal can be finally negotiated and, once agreed by all parties, the lawyers will draw up Heads of Agreement or Agreement in Principle and then the legally binding completion documents. Management should ensure that they both take legal advice and have a firm grasp themselves of all the legalities within the documents. The legal documentation is described in the next chapter. □

## **Typical Credentials of Advisors**

The number of qualified Advisors in Ethiopia is extremely low. Many of the Advisors in the market possess a B.A. Degree in finance, accounting, business management or economics and some possess advanced degrees like MBA or M.Sc. in finance, investment, business or economics. Often, Advisors in accounting firms have accountancy qualifications; such as, ACCA, CIMA or ICAEW designations. While these educational backgrounds and accountancy designations equip Advisor with most of the body of knowledge and experience requirement to service clients, Advisors with specialized credentials and training are generally expected to deliver more tailored services to clients. Typical specialist Advisory credentials include:

### **CFA – Chartered Financial Analyst®**

The Chartered Financial Analyst ® (CFA®) charter is a globally respected, graduate-level investment credential established in 1962 and awarded by CFA Institute - the largest global association of investment professionals. There are currently more than 90,000 CFA charterholders working in 134 countries. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.

High Ethical Standards - The CFA Institute Code of Ethics and Standards of Professional Conduct, enforced through an active professional conduct program, requires CFA charterholders to: 1) Place their clients' interests ahead of their own, 2) Maintain independence and objectivity, 3) Act with integrity, 4) Maintain and improve their professional competence, and 5) Disclose conflicts of interest and legal matters.

Global Recognition - Passing the three CFA exams is a difficult feat that requires extensive study (successful candidates report spending an average of 300 hours of study per level).

Earning the CFA charter demonstrates mastery of many of the advanced skills needed for investment analysis and decision-making in today's quickly evolving global financial industry. As a result, employers and clients are increasingly seeking CFA charterholders; often making the charter a prerequisite for employment. Additionally, regulatory bodies in 22 countries and territories recognize the CFA charter as a proxy for meeting certain licensing requirements, and more than 125 colleges and universities around the world have incorporated a majority of the CFA Program curriculum into their own finance courses.

Comprehensive and Current Knowledge - The CFA Program curriculum provides a comprehensive framework of knowledge for investment decision making and is firmly grounded in the knowledge and skills used every day in the investment profession. The three levels of the CFA Program test proficiency with a wide range of fundamental and advanced investment topics, including ethical and professional standards, fixed-income and equity analysis, alternative and derivative investments, economics, financial reporting standards, portfolio management, and wealth planning. The CFA Program curriculum is updated every year by experts from around the world to ensure that candidates learn the most relevant and practical new tools, ideas, and investment and wealth management skills to reflect the dynamic and complex nature of the profession.

To learn more about the CFA charter, visit [www.cfainstitute.org](http://www.cfainstitute.org)

### **CAIA – Chartered Alternative Investment Analyst**

The CAIA Charter is the globally recognized credential for professionals managing, analyzing, distributing, or regulating alternative investments. The CAIA Charter designation is the highest standard of achievement in alternative investment education and provides deep knowledge, demonstrated expertise, and global credibility in alternatives.

Established in 2002, the CAIA Charter is a comprehensive program comprised of a two-tier exam process through which you may become a CAIA Charter Holder. The Level I exam assesses your understanding of various alternative asset classes and your knowledge of the tools and techniques used to evaluate the risk-return attributes of each one. The Level II exam assesses how you would apply the knowledge and analytics learned in Level I within a portfolio management context. Both levels include segments on ethics and professional conduct.

**MINIMUM QUALIFICATIONS:** (1) Successfully completing the CAIA program (passing both the Level I and Level II exams) and (2) becoming a member of the CAIA Association. To qualify for membership in the Association, you must fulfill all the following requirements: a) Pass the Level II exam within three years of passing the Level I exam, b) Hold a U.S. bachelor's degree or the equivalent, and have more than one year of professional experience, or alternatively have at least four years of professional experience,\* c) Submit payment for the annual CAIA Association membership fee, d) Agree on an annual basis to abide by the Member Agreement, and e) Membership is the final requirement for individuals who wish to use the CAIA designation. \*Professional experience is defined as full-time employment in a professional capacity within the regulatory, banking, financial, or related fields.

To learn more about the CAIA charter, visit [www.caia.org](http://www.caia.org)

### **CFP® - CERTIFIED FINANCIAL PLANNER™**

The CERTIFIED FINANCIAL PLANNER™, CFP® and federally registered CFP (with flame design) marks (collectively, the “CFP® marks”) are professional certification marks granted in the United States by Certified Financial Planner Board of Standards, Inc. (“CFP Board”). The CFP® certification is a voluntary certification; no federal or state law or regulation requires financial planners to hold CFP® certification. It is recognized in the United States and a number of other countries for its (1) high standard of professional education; (2) stringent code of conduct and standards of practice; and (3) ethical requirements that govern professional engagements with clients. Currently, more than 62,000 individuals have obtained CFP® certification in the United States.

To attain the right to use the CFP® marks, an individual must satisfactorily fulfill the following requirements: 1) Education – Complete an advanced college-level course of study addressing the financial planning subject areas that CFP Board’s studies have determined as necessary for the competent and professional delivery of financial planning services, and attain a Bachelor’s Degree from a regionally accredited United States college or university (or its equivalent from a foreign university). CFP Board’s financial planning subject areas include insurance planning and risk management, employee benefits planning, investment planning, income tax planning, retirement planning, and estate planning; 2) Examination – Pass the comprehensive CFP® Certification Examination. The examination, administered in 10 hours over a two-day period, includes case studies and client scenarios designed to test one’s ability to correctly diagnose financial planning issues and apply one’s knowledge of financial planning to real world circumstances; 3) Experience – Complete at least three years of full-time financial planning-related experience (or the equivalent, measured as 2,000 hours per year); and 4) Ethics – Agree to be bound by CFP Board’s Standards of Professional Conduct, a set of documents outlining the ethical and practice standards for CFP® professionals.

Individuals who become certified must complete the following ongoing education and ethics requirements in order to maintain the right to continue to use the CFP® marks: 1) Continuing Education – Complete 30 hours of continuing education hours every two years, including two hours on the Code of Ethics and other parts of the Standards of Professional Conduct, to maintain competence and keep up with developments in the financial planning field; and 2) Ethics – Renew an agreement to be bound by the Standards of Professional Conduct. The Standards prominently require that CFP® professionals provide financial planning services at a fiduciary standard of care. This means CFP® professionals must provide financial planning services in the best interests of their clients. CFP® professionals who fail to comply with the above standards and requirements may be subject to CFP Board’s enforcement process, which could result in suspension or permanent revocation of their CFP® certification.

To learn more about the CFP® certification, visit [www.cfp.net](http://www.cfp.net)

## **CPA – Certified Public Accountant**

CPAs are licensed and regulated by their state boards of accountancy. While state laws and regulations vary, the education, experience and testing requirements for licensure as a CPA generally include minimum college education (typically 150 credit hours with at least a baccalaureate degree and a concentration in accounting), minimum experience levels (most states require at least one year of experience providing services that involve the use of accounting, attest, compilation, management Advisory, financial Advisory, tax or consulting skills, all of which must be achieved under the supervision of or verification by a CPA), and successful passage of the Uniform CPA Examination. In order to maintain a CPA license, states generally require the completion of 40 hours of continuing professional education (CPE) each year (or 80 hours over a two year period or 120 hours over a three year period). Additionally, all American Institute of Certified Public Accountants (AICPA) members are required to follow a rigorous Code of Professional Conduct which requires that they act with integrity, objectivity, due care, competence, fully disclose any conflicts of interest (and obtain client consent if a conflict exists), maintain client confidentiality, disclose to the client any commission or referral fees, and serve the public interest when providing financial services.

In addition to the Code of Professional Conduct, AICPA members who provide personal financial planning services are required to follow the Statement on Standards in Personal Financial Planning Services (the Statement). Most state boards of accountancy define financial planning as the practice of public accounting and therefore have jurisdiction over CPAs practicing in this discipline; state boards would likely look to the Statement as the authoritative guidance in this practice area regardless of specific or blanket adoption of AICPA standards.

To learn more about the CPA certification, visit [www.aicpa.org](http://www.aicpa.org)

## **PFS - Personal Financial Specialist**

The PFS credential demonstrates that an individual has met the minimum education, experience and testing required of a CPA in addition to a minimum level of expertise in personal financial planning. To attain the PFS credential, a candidate must hold an unrevoked CPA license, certificate, or permit, none of which are in inactive status; fulfill 3,000 hours of personal financial planning business experience; complete 75 hours of personal financial planning CPE credits; pass a comprehensive financial planning exam and be an active member of the AICPA. A PFS credential holder is required to adhere to AICPA's Code of Professional Conduct and the Statement on Standards in Personal Financial Planning Services, when providing personal financial planning services. To maintain their PFS credential, the recipient must complete 60 hours of financial planning CPE credits every three years. The PFS credential is administered through the AICPA.

To learn more about the PFS certification, visit [www.aicpa.org](http://www.aicpa.org)

## **Risks and Mitigation Strategies on Delivery and Payment**

## **Client Agreement with Advisor**

The Fund Manager of Zemen Bank will ensure all Advisors meet the advisory service requirement as stated above and ensure delivery of Advisory services to the client that is acceptable to the private equity firm. It is important to develop a standard Client Advisor Agreement that clearly lays out the role, responsibilities, deliverables and payment structure.

The main job of the Fund Manager is to ensure risks pertaining to the relationship between Advisor and client are managed before, during and after the delivery of advisory services. Typical risks up on the relationship between client and Advisor under the sponsorship of Zemen Bank includes:

### **Service Delivery Risk**

Client faces the risk of Advisor not delivering the required services on time. The total cost of the Advisor services is borne by the client and the Advisor must deliver all required services for the success of the transaction. The Fund Manager will have to follow-up progress with client, Advisor and seek regular updates and provide regular feedback.

### **Transaction Risk**

In spite of all efforts put into the process to deliver the Advisory services, the investment may not happen due to reasons beyond the control of Advisor –the source could be the client or the private equity firm. The Fund Manager ensures the client pays the Advisor the basic (retainer) fees as per the agreement.

### **Contract Risk**

Early contract termination risk is where the investee terminates the contractual relationship prior to the transaction decision but after service is rendered. The Fund Manager ensures the client pays the Advisor the basic (retainer) fees as per the agreement.

### **Non-Compliance Risk**

Shareholders may change their minds and rather than terminate the contract, shareholders may not comply. The Fund Manager mediates between the client and the Advisor. The Fund Manager ensures the client pays the Advisor portion of the basic (retainer) fees for the services provided.

### **Non-Payment Risk**

Shareholders may refuse to pay for the service despite the fact that service is rendered and investment is achieved. The Fund Manager mediates between the client and the Advisor to ensure fees (both retainer and incentives) are paid as per the agreement. The Fund Manager explains the remedies available for Advisor to collect the agreed fees.

## Default Risk

Poor legal framework and lack of enforcement may render contracts useless in the event of default. The Fund Manager at Zemen Bank documents client satisfaction at each stage in the investment process to ensure defaults on the Advance Facility is maintained to the minimum.

## Recommended Advisory Service Delivery and Payment Schedule

ADVISORY SERVICE DELIVERY AND PAYMENT SCHEDULE				
<u>Investment process</u>	<u>Completion of work</u>	<u>Percentage of completion</u>	<u>Payment schedule</u>	<u>Payment schedule</u>
Review of Client Business	Understand the client - its challenges, opportunities, needs e.g. debt vs equity	10%		
Vendor Due Diligence	Perform due diligence on client - financial, tax, legal, marketing and operations	10%	20%	First payment - advance
Business Plan(s)	Write client's business plan or refine and fine-tune client's business plan	10%		
Data Room	Compile all client information in Data Room ahead of investor due diligence	10%	20%	Second payment
Financial Projections	Build a robust financial model or refine / fine-tune client's financial model	10%		
Valuation Estimates	Prepare valuation estimates of client's business - intrinsic (DCF) vs. relative	10%	20%	Third payment
Term Sheet(s)	Assist client in negotiating Term Sheet with Investor	10%		
Investor Due Diligence	Assist client during Investor Due Diligence process	15%	25%	Fourth payment
Final Agreements	Assist client in negotiating and concluding final agreements	10%		
Post Investment	Assist client in drafting strategic implementation of the first 100 days	5%	15%	Final payment
	Total	100%	100%	

**ZEMEN BANK S.C.**  
**ETHICS INITIATIVE PRINCIPLES FOR ADVISORS**

***Integrity:*** Act with honesty in all situations

***Trust:*** Build trust in all stakeholder relationships

***Accountability:*** Accept responsibility for all decisions

***Transparency:*** Maintain open and truthful communications

***Fairness:*** Engage in fair competition and create equitable and just relationships

***Respect:*** Honor the rights, freedoms, views, and property of others

***Rule of Law:*** Comply with the spirit and intent of laws and regulations

***Viability:*** Create long-term value for all relevant stakeholders