

# Minority investor perspective on Zambian capital markets

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Second Zambia Capital Markets Indaba

Sumeet Jain

Godfrey Mwanza, CFA

23 February 2023

*Walking the talk...*



**... today's dialogue between stakeholders is a reflection of the SEC's commitment to realize the CMMP**

## SUMEET JAIN

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- Internationally experienced professional with a track record of growing and investing in businesses in Africa
- Director of Pekanya, an agricultural services platform in Zambia
- Management consultant at Bain & Co., advising companies across Africa on corporate strategy
- Corporate lawyer at Shearman & Sterling, in New York City and London, working on a range of commercial transactions
- JD, Washington University School of Law
- BA in economics, University of Notre Dame
- Member, New York state bar

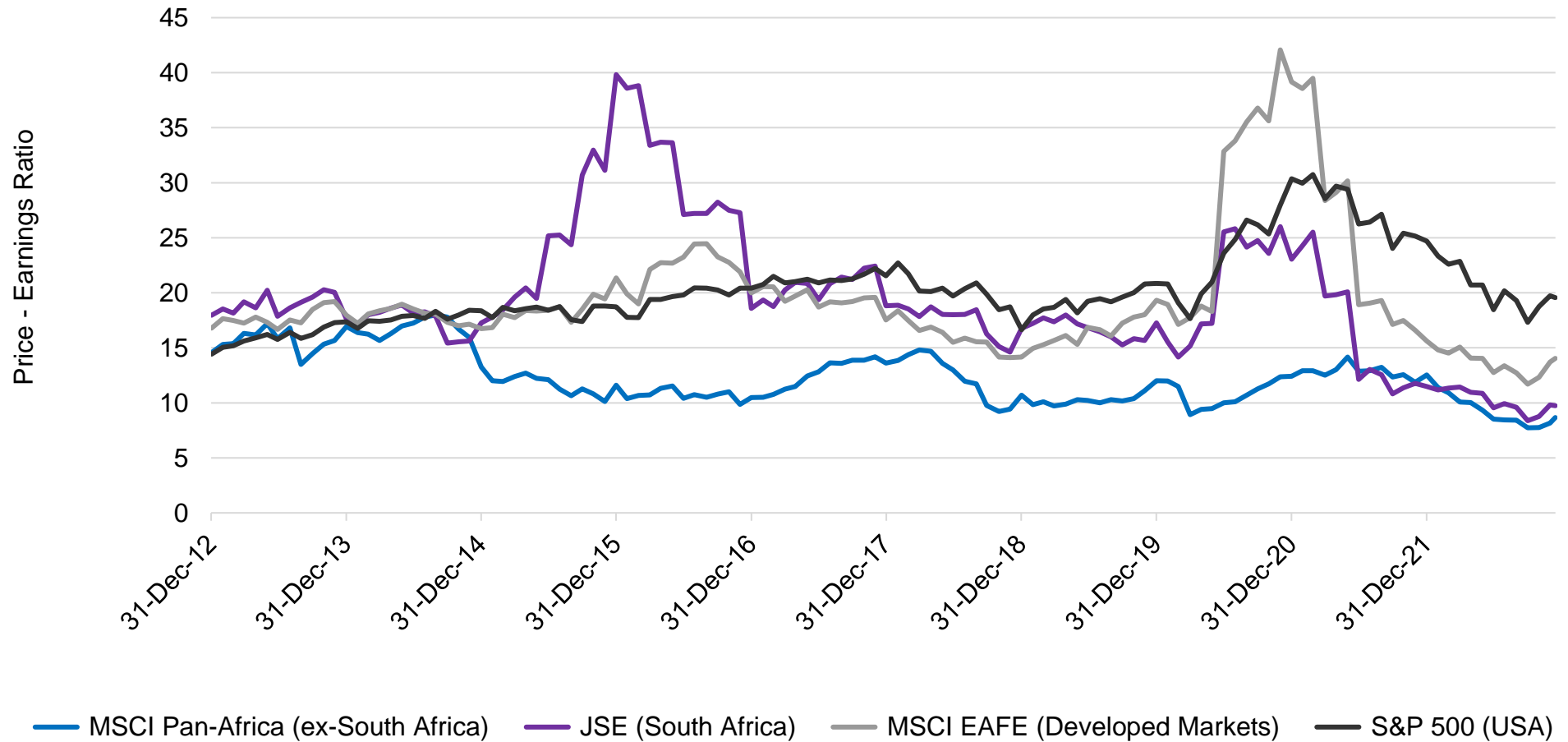
## GODFREY MWANZA, CFA

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- Over 15 years of experience working in African capital markets
- Head of Africa Equity Franchise at Absa Asset Management
- Portfolio manager of the Africa (ex South Africa) equities fund at African Alliance
- Investment analyst at Enko Capital, a multistrategy Africa-focused hedge fund based in Johannesburg, South Africa
- Corporate finance at Stockbrokers Zambia
- BSc in economics, London School of Economics and Political Science
- CFA Charterholder

# Deep value in African equities is, both, an opportunity and a challenge

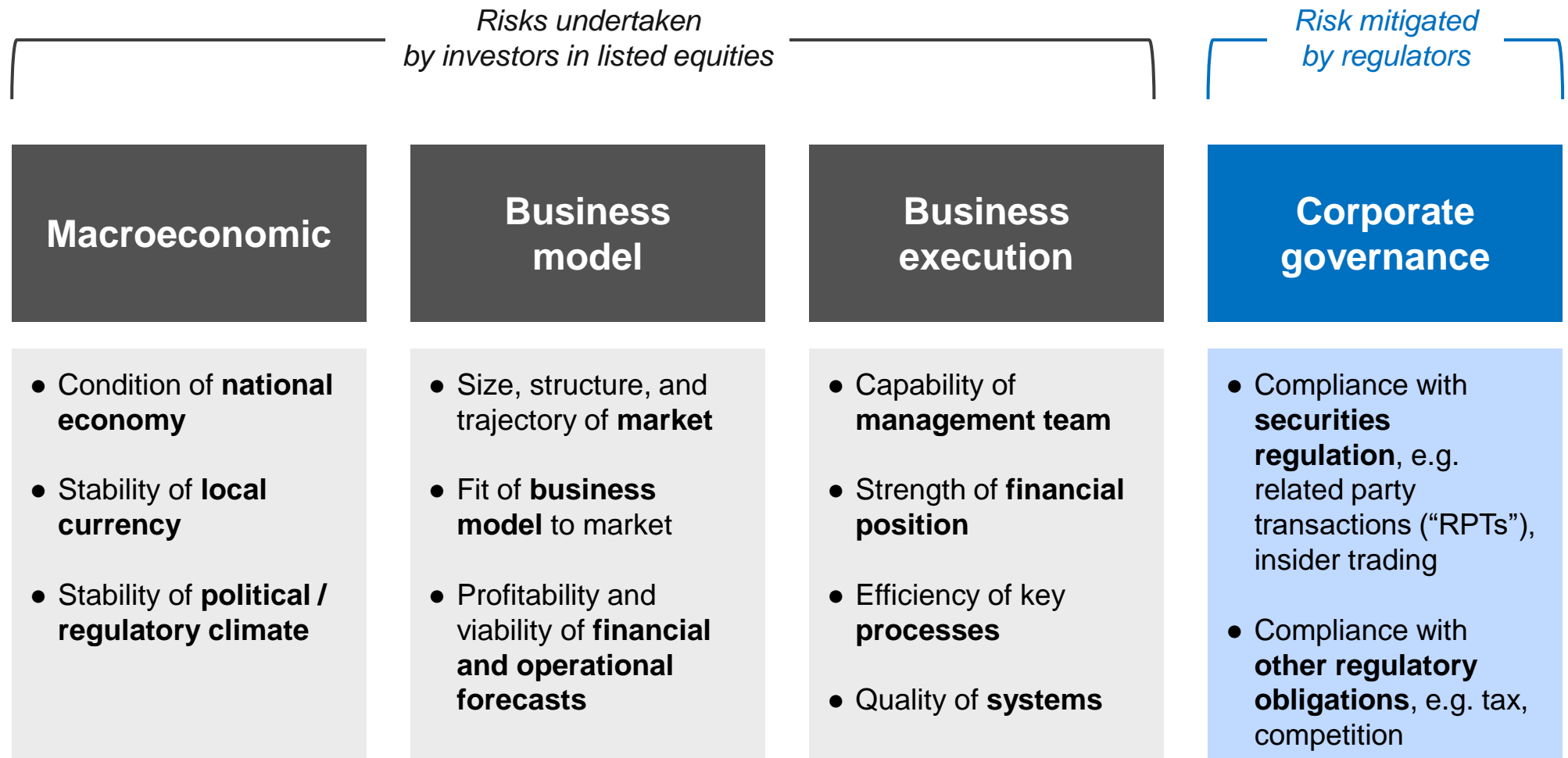


**Opportunity to buy robust cashflow and attractive dividend yields at discount**



**Challenge to realize sustained capital appreciation**

# African equities are discounted, in part, due to actual and perceived risks



# Effective corporate governance requires a range of moderating checks

“

Corporate governance is concerned with **holding the balance between economic and social goals and between individual and communal goals.** The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.

”

**Sir Adrian Cadbury**

Former Chairman of Cadbury Schweppes

Moderation of **controlling shareholders' conduct**

Restraints on **abuse of control** over issuer

Disclosure and approval of **RPTs**

Fairness of **director compensation**

Management of **conflicts of interest**

Restrictions on **misappropriation** of issuer's assets

Restraints on **abuse of information** about issuer

Restrictions on **insider trading**

Limitations on usurping **corporate opportunity**

# Enhancing corporate governance, including RPT governance, furthers the CMMP

| CMMP DEVELOPMENT AREAS  | CMMP BUILDING BLOCKS  | EFFECT OF ENHANCING CORPORATE GOVERNANCE |
|---|---|--|
| <b>Enhancing the government bond market</b>                   | Enhance primary market issuance and transparency              |  |
|   | Develop secondary market trade                                |  |
|   | Develop secondary market post-trade                           |  |
| <b>Enhancing other traditional security markets</b>           | Develop the corporate bond market                             |  |
|   | Enhance the equity market                                     | ✓  |
|   | Develop collective investment schemes                         | ✓  |
| <b>Development of new and innovative products / markets</b>   | Enhance the private equity, debt and venture capital markets  |  |
|   | Tracking and supporting of capital market developments        |  |
|   | Developing ETFs, REITs and retail bonds                       | ✓  |
|   | Developing securitization and mortgage refinancing            |  |
|   | Developing the market for green bonds                         |  |
| <b>Enhancing capacity building across the capital markets</b> | Enhance the capacity among regulators and stakeholders        | ✓  |
|   | Enhance investor education                                    | ✓  |
|   | Develop sustainable funding models across the capital markets |  |
| <b>Enhancing the capital market regulatory environment</b>    | Enhance regulation to empower regulatory oversight            | ✓  |
|   | Enshrine investor protection                                  | ✓  |
|   | Develop sound investing and reporting guidelines              | ✓  |



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# WHAT'S YOURS IS MINE AND WHAT'S MINE IS MINE

AN EXAMINATION OF THE HARM CAUSED BY  
NON-COMPLIANT RELATED PARTY TRANSACTIONS  
ON THE LUSAKA SECURITIES EXCHANGE AND  
A PROPOSAL TO MITIGATE THIS HARM

July 2022

SUMEET JAIN  
GODFREY MWANZA, CFA

## INDUSTRY PUBLICATION

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July 2022

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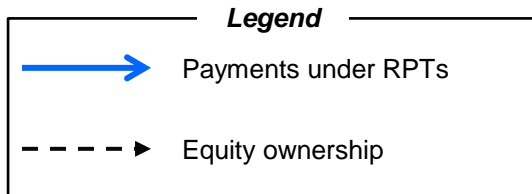
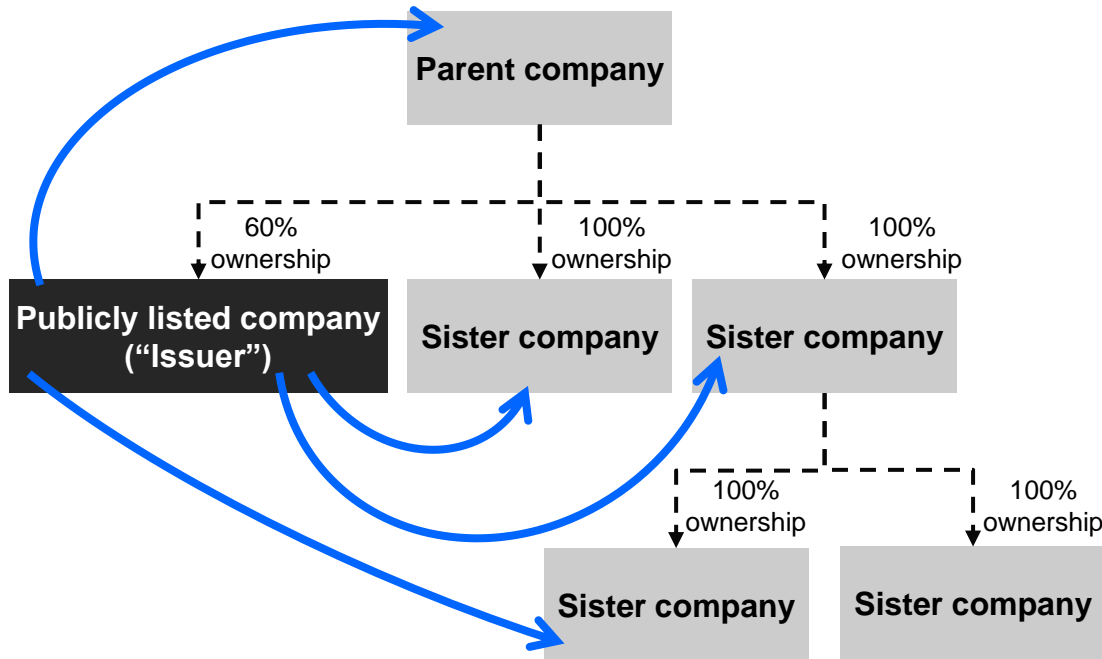


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RPTs are transactions where there “is a transfer of resources, services, or obligations between related parties” – IAS 24

**RPTs ARE TRANSACTIONS WITHIN A CORPORATE FAMILY**



**RPTs TAKE VARYING FORMS**



**Purchasing raw materials**



**Purchasing management services**



**Purchasing brand license**

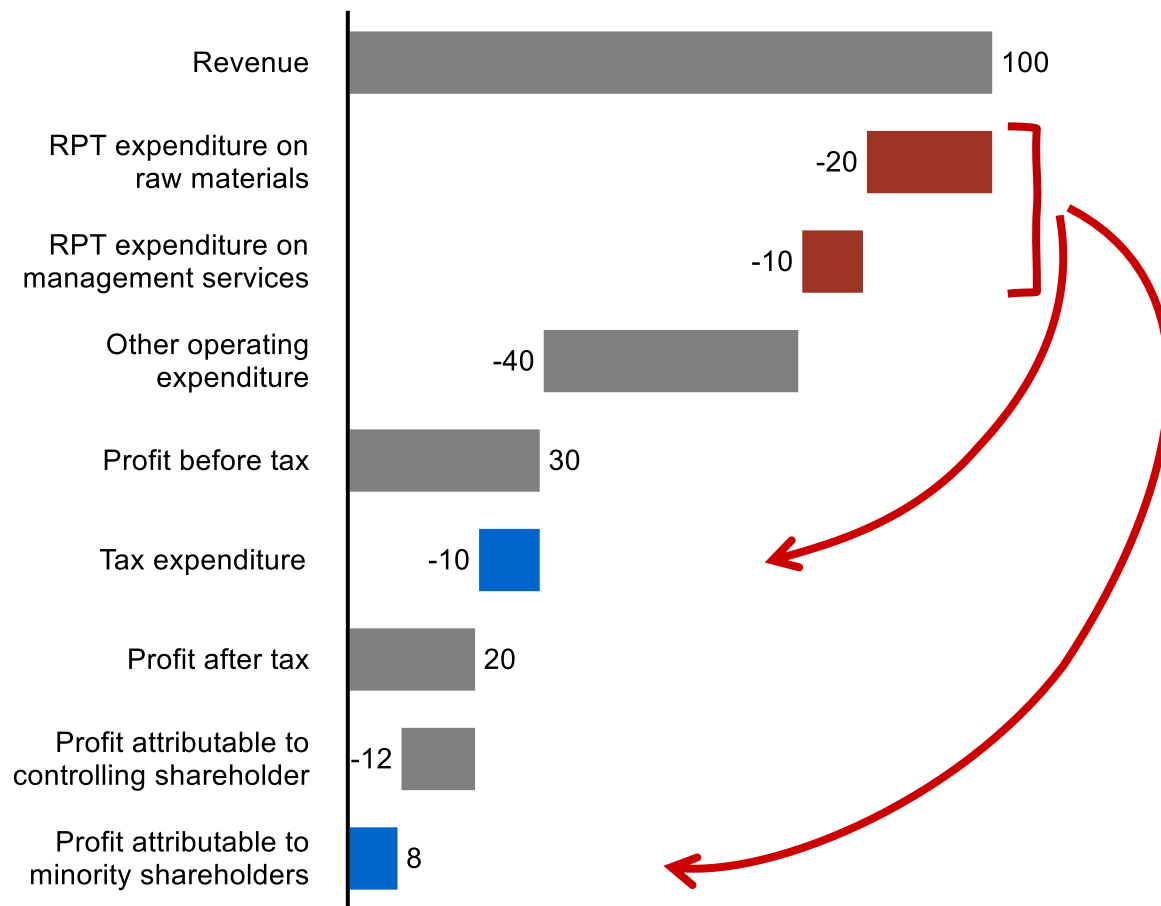


**Paying interest under financing arrangements**

# RPTs are prone to abuse in the absence of governance

- When abused, controlling shareholders force companies into **inefficient RPTs**, either at inflated pricing and / or to purchase superfluous goods / services
- Inefficient RPTs are used by controlling shareholders to show **excessive expenditure on a company's income statement**, with the aim of:
  - **Avoiding corporate taxation** through transfer pricing
  - **Usurping the investment returns** of minority shareholders
- Abuse of RPTs has wide-reaching impact across the economy
  - **Minority shareholders** are deprived of their share of earnings
  - **Revenue authorities** are deprived of taxable income
  - **Local suppliers** are displaced in procurement processes that favour issuers' related parties
  - **Stock exchange and brokers** are deprived of revenue due to suppressed share prices and trading volumes
- Mature stock exchanges around the world have **governance frameworks that limit inefficient RPTs**, while still permitting beneficial RPTs

## RPT EXPENDITURE MAY BE USED TO AVOID CORPORATE TAX AND USURP INVESTMENT RETURNS OF MINORITY SHAREHOLDERS



Illustrative Income Statement (ZMW, M)

# Zambian securities law provides a sound framework for governing RPTs

## BROAD DEFINITION OF RPTs

- **IAS 24 covers a range of transaction types, e.g.**
  - Purchases / sales of goods
  - Purchases / sales of assets
  - Purchases / sales of services
  - Provision of guarantees
  - Transfers related to financing
- **Section 10.1(b) of LuSE Regulations covers a range of counterparties, e.g.**
  - Material shareholder
  - Current or recent director
  - Current or recent adviser
  - Current or recent executive
  - Associate of a related party
- **Section 10.1(a) of LuSE Regulations extends to transactions involving members of the issuers' corporate group, i.e., an issuer or a subsidiary of the issuer**

## COMPREHENSIVE DISCLOSURE OF RPTs

- **IAS 24 requires issuers to make comprehensive disclosure of all RPTs, e.g.**
  - Amount of each transaction
  - Outstanding balance in each transaction
  - Terms, conditions, and guarantees of each transaction
- **Section 8.65 of the LuSE Regulations grants the LuSE discretion to instruct non-compliant issuers to publish information that the LuSE deems appropriate, and censure non-compliant issuers, following advice from a GAAP Monitoring Panel**

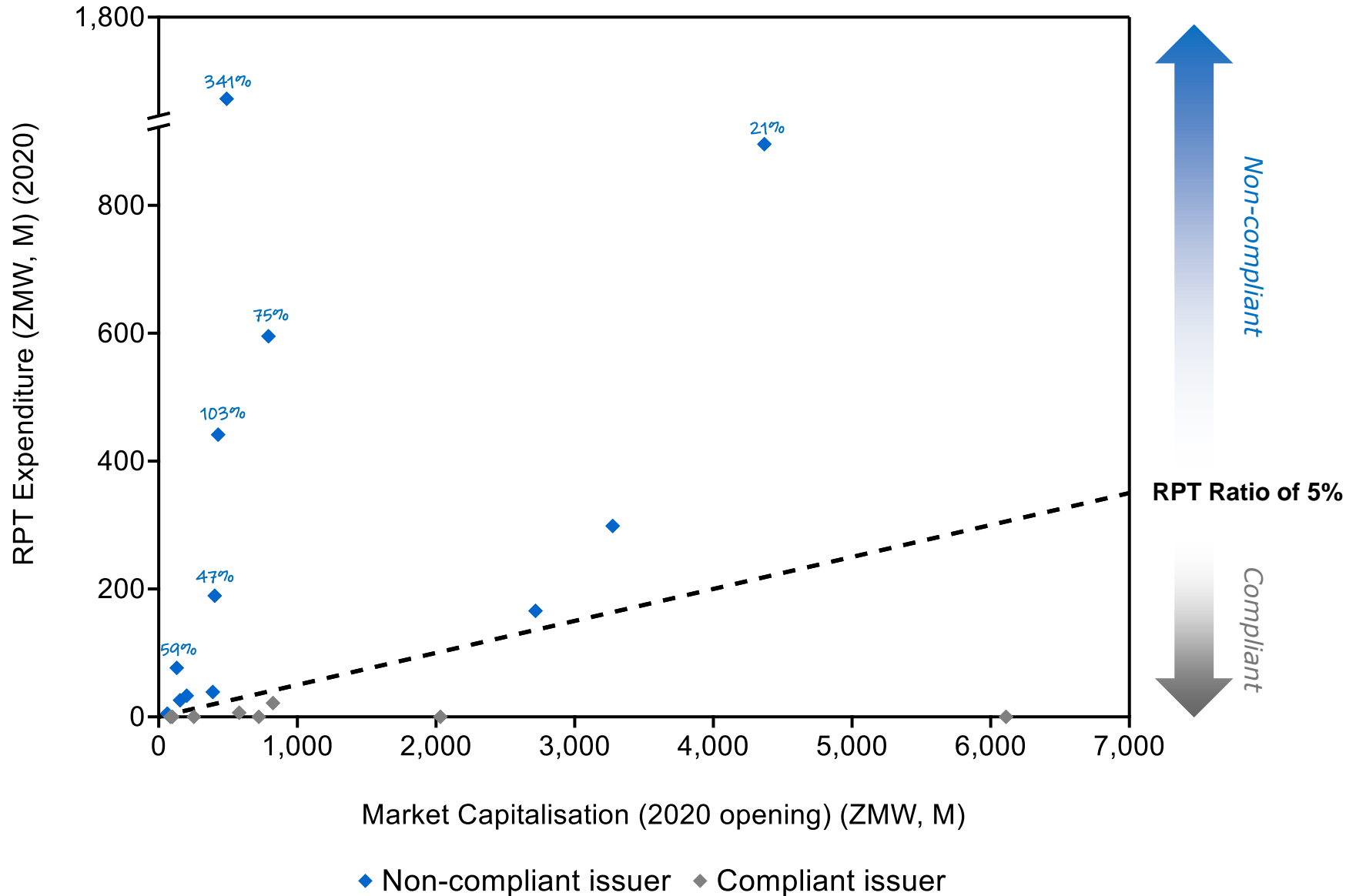
## FAIR APPROVAL PROCESS FOR ENTERING INTO RPTs

- **Section 10 of the LuSE Regulations instructs issuers to fulfil requirements before entering into RPTs.** The rigour and extent of these requirements vary based on the materiality of the RPT to the issuer

|            | LuSE Regulation | RPT Ratio | Key requirements before entering into RPT  |
|------------|-----------------|-----------|--|
| Exempt RPT | Section 10.6    | ≤0.25%    | <ul style="list-style-type: none"> <li>• None</li> </ul>   |
| Small RPT  | Section 10.7    | 0.25 – 5% | <ul style="list-style-type: none"> <li>• Provide LuSE with written confirmation from an independent expert that RPT terms are fair</li> <li>• Publish announcement containing details of RPT</li> </ul>  |
| Large RPT  | Section 10.4    | >5%       | <ul style="list-style-type: none"> <li>• Provide LuSE with underlying agreement of RPT</li> <li>• Publish announcement containing details of RPT</li> <li>• Provide a statement from the issuer's board confirming fairness of RPT</li> <li>• Distribute a circular to shareholders containing exhaustive details of the RPT</li> <li>★ Obtain approval for RPT from majority of all shareholders, excl. the related party and its associates</li> </ul> |

RPT Ratio = Consideration involved in RPT / Market capitalisation of issuer

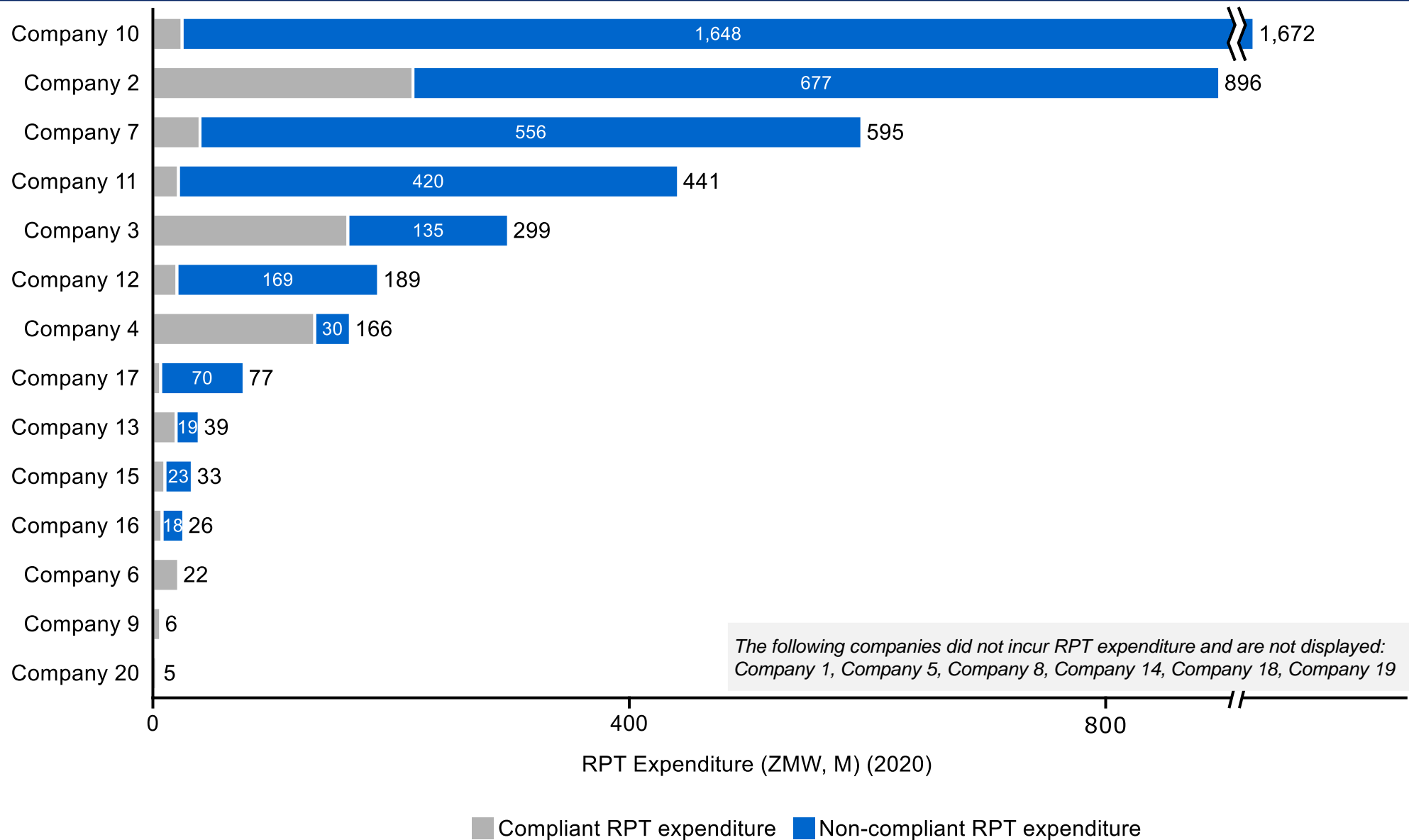
# Yet, many issuers listed on the LuSE engage in non-compliant RPTs



Source: Company annual reports (2020); LuSE trade summaries (2019-2020)

Note: Data for the following companies is based on their latest disclosure: Company 1 (2019), Company 16 (2018), Company 18 (2019)

# Total non-compliant RPT expenditure on the LuSE was ZMW 3.8B in 2020



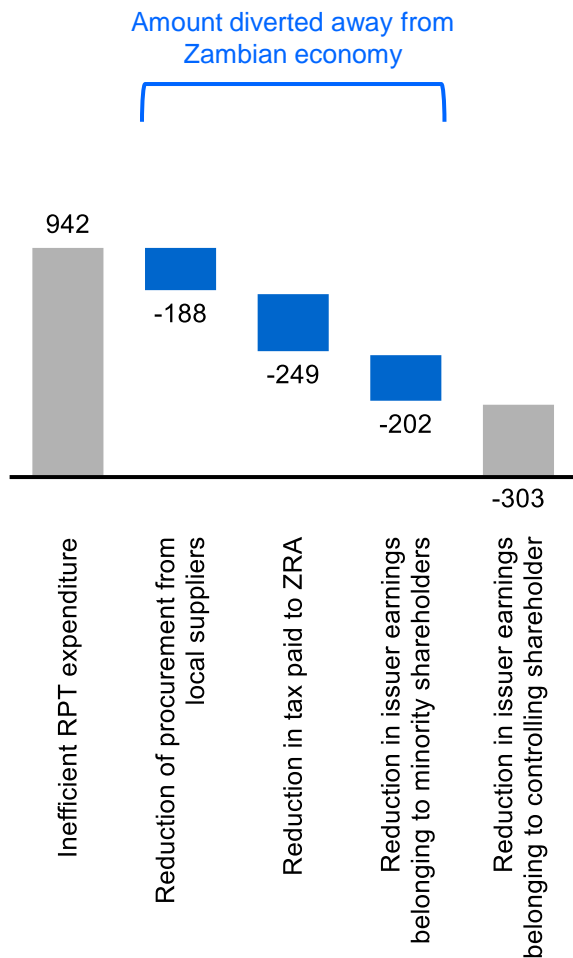
Source: Company annual reports (2020); LuSE trade summaries (2019-2020)

Note: Data for the following companies is based on their latest disclosure: Company 1 (2019), Company 16 (2018), Company 18 (2019)

# Inefficient RPTs divert an estimated K600M–1.9B from the economy each year

## LOW SCENARIO: ESTIMATED DIVERSION OF ZMW 0.6B

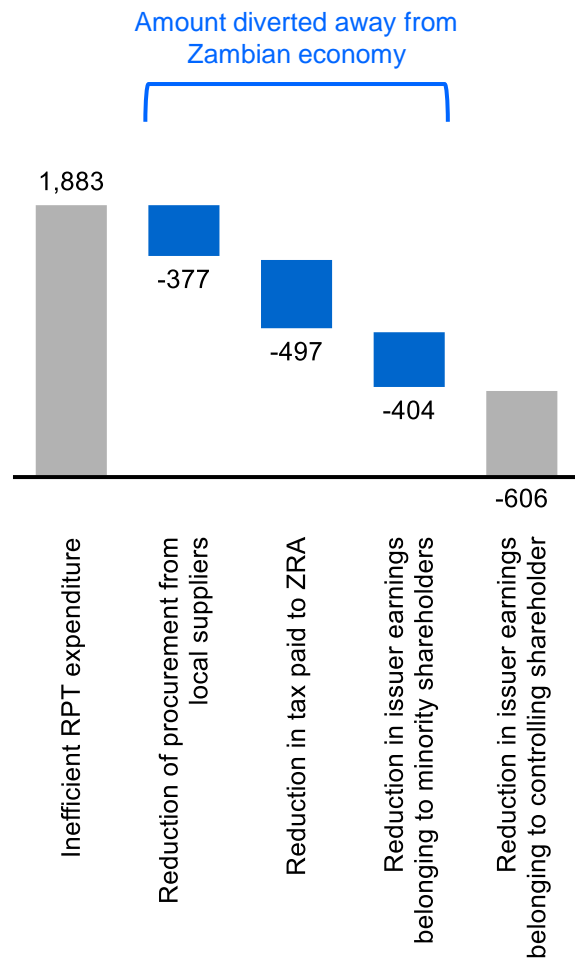
Amount (ZMW, M)



Assumes 25% of non-compliant RPT expenditure is inefficient

## MID SCENARIO: ESTIMATED DIVERSION OF ZMW 1.3B

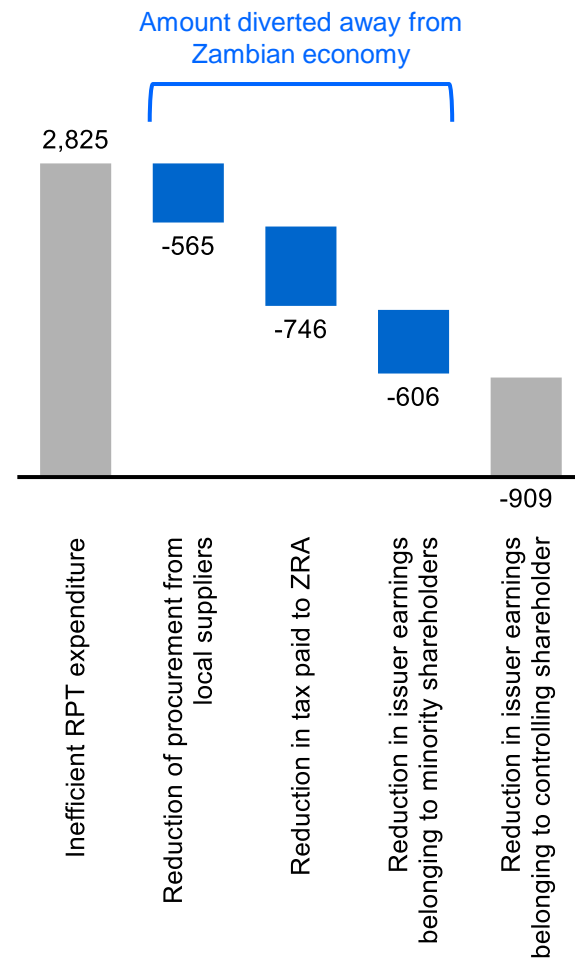
Amount (ZMW, M)



Assumes 50% of non-compliant RPT expenditure is inefficient

## HIGH SCENARIO: ESTIMATED DIVERSION OF ZMW 1.9B

Amount (ZMW, M)



Assumes 75% of non-compliant RPT expenditure is inefficient

# Addressing the harm of non-compliant RPTs requires a range of actions

|  | Role in capital markets        | Action required   |  |
|--|--------------------------------|---|--|
|  |                                | Redress for non-compliant RPTs in the past  | Deterrence of non-compliant RPTs in future   |
| <b>SEC &amp; LuSE</b>                    | Regulators of capital markets  | <ul style="list-style-type: none"> <li>Seek damages from non-compliant issuers on behalf of harmed shareholders</li> <li>Sanction management and directors of non-compliant issuers in extreme cases</li> </ul> | <ul style="list-style-type: none"> <li>Educate issuers' managers and directors on regulations governing RPTs</li> <li>Monitor disclosure of RPTs in issuers' annual reports</li> <li>Monitor issuers' RPT Ratios routinely</li> <li>Enforce compliance of issuers with disclosure and approval process for RPTs</li> </ul> |
| <b>Issuers' managers &amp; directors</b> | Fiduciary of shareholders      | <ul style="list-style-type: none"> <li>Create a plan to compensate harmed shareholders</li> </ul>   | <ul style="list-style-type: none"> <li>Develop an understanding of regulations governing RPTs</li> <li>Drive compliance of issuers with disclosure and approval process for RPTs</li> </ul>  |
| <b>Minority shareholders</b>             | Owner of invested capital      | <ul style="list-style-type: none"> <li>Seek damages from non-compliant issuers</li> </ul>   | <ul style="list-style-type: none"> <li>Monitor disclosure of RPTs in issuers' annual reports</li> <li>Monitor issuers' RPT Ratios routinely</li> <li>Advocate for improved compliance with regulations governing RPTs</li> </ul>   |
| <b>Proxy advisors</b>                    | Advisor to shareholders        |   | <ul style="list-style-type: none"> <li>Research equities in Zambian and other African capital markets</li> <li>Advise institutional investors on performance of equities, including RPTs</li> </ul>  |
| <b>ZRA</b>                               | Administrator of corporate tax | <ul style="list-style-type: none"> <li>Seek damages from controlling shareholders for lost corporate taxes</li> </ul>   | <ul style="list-style-type: none"> <li>Monitor issuers' RPTs routinely and regularly for possible transfer pricing</li> </ul>  |

## Addressing non-compliant RPTs will broadly benefit the national economy

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1. **Improving fiscal efficiency** by ensuring that the Zambia Revenue Authority earns appropriate corporate taxes from publicly listed companies
2. **Raising investment performance of pension funds and the IDC** by ensuring that minority shareholders in publicly listed companies receive their fair share of investment returns
3. **Promoting local manufacturers and service providers** by placing them on equal footing with related parties of publicly listed companies during procurement processes
4. **Attracting foreign investment** by giving confidence to investors that their investments will be treated fairly as prescribed by local securities law
5. **Restoring rule of law** by cultivating a track record of robust corporate governance on local capital markets