Cristal Advocates

Raising Capital for Business by Debt or Equity in Uganda
An Overview of the Commercial Considerations

Cristal Knowledge Series
June 2019

1. Introduction

Raising capital to start or expand a business is a strenuous task for most entrepreneurs. The decision on the mix of different types of capital eventually deployed is important as it influences the direction of a company for a lifetime. With an optimal mix, the cost of capital is reduced increasing economic returns and business value. For this reason, business owners ought to carefully evaluate their own circumstances in deciding their capital structure.

Capital represents the financial resources used to start, maintain or grow a business. It is one of the four factors of production considered by economists (the other three being land, labour and entrepreneurship) and takes three different forms. Fixed capital procures non-current assets that include though not limited to land and items of plant and machinery. Working capital funds the day to day operations of a business while growth capital supports a business to expand or change direction.

The primary sources of capital for a business may be categorised as either debt or equity. Debt is short or long term while equity includes ordinary and preference stock among others. There are also hybrid instruments that bear the characteristics of both debt and equity such as convertible debt that we explain further in section 4.

This publication outlines the forms of capital and a discussion of the commercial consequences for each.

2. Equity financing

Equity financing involves raising capital by selling a stake in a company to an investor who becomes its shareholder. Equity thus represents the value of shareholders' interests in a company. Equity is also referred to as risk capital because investors bear the risk of business failure. Unlike debt, equity is not repayable and for this reason equity investors demand for high returns commensurate with the investment risk undertaken.

An equity investor acquires a right to share in the annual profits of the company when dividends are declared. The investor likewise has a claim over the residual assets of the company at liquidation or winding up (i.e. after satisfying creditors' claims) as well taking part in the governance of the company subject to the terms of its constitutional documents.

The two main forms of equity are ordinary and preference shares. Hybrid financing instruments such as convertible debt too can qualify for classification as equity: see the discussion in section 4 of this publication.

a. Common stock

These are also known as ordinary shares and represent an ownership interest in a company. Ordinary shareholders are entitled to voting rights and annual dividends. They also have a residual claim on the company's liquidated assets after all liabilities and superior claims have been paid. Most companies have a single class of ordinary shares though it is possible to issue different classes with divergent rights.

b. Preference shares

These are also known as preferred shares. Preference shareholders have priority over ordinary shareholders in receiving dividends and claiming the residual assets of the company at liquidation or winding up. Despite this priority, preference shareholders typically do not have voting rights. Preference shares are issued with a par value which is the reference point of determining the dividends payable and the entitlement to the residual assets of the company at liquidation or winding up. Preference shares can be participating or non-participating, convertible or non-convertible, redeemable or non-redeemable and cumulative or non-cumulative.

- *Convertible or non-convertible preference shares*

Convertible preference shares are those shares which can be converted into ordinary stock after issue subject to the terms and conditions of their issue. Non-convertible shares cannot be changed to ordinary shares.

- *Participating or non-participating*

Participating preference shareholders are entitled to dividends prior to payment to ordinary shareholders but can also receive an additional dividend along with the ordinary stockholders. Non-participating preference shares do not have this right and are limited to the fixed priority dividends prior to disbursement of ordinary dividends.

- *Cumulative or non-cumulative*

With cumulative preference shares, investors are able to carry over to the following year any unpaid amount if the company does not have sufficient profits to pay the fixed annual dividends. Non-cumulative shareholders are unable to receive dividends that were not paid from a prior accounting period if none were declared because of unfavourable company circumstances.

- *Redeemable or non-redeemable*

A company has a right to buy back redeemable preference shares subject to pre-agreed terms. If preference shares are non-redeemable, then the shareholder is only entitled to the return of initial capital investment on the winding up or liquidation of the company. See our discussion under hybrid financing in section 4.

3. Debt financing

Debt financing involves a business borrowing funds that are repayable together with interest. Though borrowings do not dilute business ownership, they are shown as a liability on the balance sheet of a company. Within tolerable ranges, debt is less risky for the investor and therefore less expensive in comparison to equity because it is ultimately repaid back to the lender which is not the case with equity. Debt can be short or long term as explained further below.

- *Short term loans*

Short term loans are normally advanced to companies to meet their day to day working capital requirements and repayable within twelve months. Short term loans can take the form of lines of credit or the traditional bank loans.

Traditional bank loans can be secured or unsecured. A secured loan is one where the borrower's obligation to repay is secured by collateral. An unsecured loan is one where the bank disburses a loan without any pledge or specific collateral to support the loan in case of default.

- *Long term loans*

Long term loans are repayable over more than one year and mostly finance the acquisition of non-current assets. Long term loans are often secured by collateral and small companies face great challenges qualifying for them because of their weak balance sheets.

Instalment loans help businesses acquire fixed assets. A bank can disburse a loan covering the significant cost of the value of the equipment in return for a security interest in the same.

Terms loans are typically unsecured though some banks maintain the security requirement. Banks grant these loans to businesses whose past operating history suggests a high probability of repayment. Term loans usually impose covenants on the business decisions made by the company.

4. Hybrid financing

Debt and equity are at opposite ends of the spectrum and in the midpoint lies hybrid financing that offers investors and investees the benefits of both equity and debt. Though hybrid financing instruments possess the characteristics of both debt and equity, they must be classified as either debt or equity for accounting and tax purposes in accordance with the criteria set out under generally accepted accounting principles ('GAAP').

a) Convertible bonds

A convertible bond is a debt instrument that can subsequently be converted into equity. It will bear all the features of debt before conversion to equity acquiring the rights and rewards of company ownership. Convertible bonds can be structured variously with conversion occurring at the point set out in the bond terms.

If the bond issuer has an unavoidable contractual obligation to pay cash at the end of the bond term if the holder chooses not to exercise the conversion option, the inclination is classify this as debt under GAAP. If the bond issuer however has an unavoidable contractual obligation to repurchase the bond by issuing its shares, it would be preferred to treat this as equity. There are complex accounting rules on the classification, initial recognition and measurement of convertible bonds.

b) Redeemable preference shares

It is necessary to consider the substance of redeemable preference shares to decide whether they need to be presented as debt or part of equity. It is possible for tax authorities to contend that preference shares should be treated as a liability (debt) which can have an impact on the gearing ratios for tax purposes for most juridisctions.

The classification of preference shares as debt or equity is not straightforward. In general, where the holder of preference shares is entitled to cash, or if the preference shares are redeemable at a later date, these are treated as debt rather than equity. This is because there is a contractual obligation for the company to pay cash to the holder of the preference shares. This is however not absolute and preference shares can also be recognised as equity in certain situations. If the option to redeem the entity's preference shares has been granted at the discretion of the issuer, the shares are classified as equity. In this situation, the issuer has a right to pay cash to buy back the shares but not the obligation to do so.

c) Non-redeemable preference shares

Where the preference shares are non-redeemable, the classification depends on a careful analysis of the other rights attaching to them. If distributions to holders of the preference shares whether cumulative or non-cumulative are at the discretion of the issuer, the shares are equity instruments and expenses thereto dividends. If distributions are mandatory, the shares are classified as financial liabilities (debt).

5. An appraisal of debt and equity financing

As seen in the foregoing discussion, debt financing involves borrowing money repayable with interest while equity financing involves raising money by selling a stake in the company with a right to a future share of profits (i.e. dividends). Some of the commercial consequences of raising capital by way of debt or equity are as provided below.

Issue	Debt financing	Equity financing
Ownership	• Does not have an ownership stake in the business. Control is maintained though some term loans impose covenants on how to run the business until debt repayment	• Acquires ownership stake in the business. Dilutes ownership and control in a business.
Deductibility for tax purposes	• Interest payments are ordinarily allowable deductions for tax purposes.	• Dividends payments are not tax deductible expenses. They are payable out of the residual profits that remain after corporation tax has been paid.
Returns	• Earns interest and payment begins almost immediately. • The rate of interest on the loan should for related party entities should reflect the prevailing market conditions to be tax compliant.	• Earns dividends or capital gains on share disposal. There is no pressure to make early returns, but returns are generally higher than interest on debt to compensate for the higher risk taken by the investor.

Issue	Debt financing	Equity financing
Time value of money	• Interest accrues immediately the loan is disbursed depending on the terms of the loan agreement.	• Dividends are received only when the company has profits available to distribute.
Forex differences	• Forex differences arise if the loan is denominated and loan repayments are made in a currency other than the currency used to prepare the financial statements.	• The share capital of the Ugandan legal entities is denominated in Uganda shillings. Therefore no forex differences arise in the company's books on equity.
Stage of business	• Difficult to obtain for new businesses with a lean balance sheet	• Equity financing is the most common means of financing business at early stage
Stamp duty	• Stamp duty does not arise in relation to debt financing except on the loan agreement and security perfection documentation.	• Stamp duty is imposed on the authorised share capital of the company.
Accounting for withholding tax (WHT)	• WHT is payable to the tax authorities upon payment of interest unless there is an exemption.	• WHT is payable to the tax authorities upon payment of dividends unless there is an exemption.

6. Conclusion

The practice is for businesses to blend equity with debt. Within tolerable limits, secured debt offers the lowest cost of capital because of the lower return required by a secured lender and the tax deductibility of the interest payable. Too much debt however increases the bankruptcy risk to shareholders due to the cash required to service debt and the return on equity that they require. Thus business ought to find an optimal capital structure combining debt and equity that will lower the cost of capital increasing economic returns and business value. The optimum mix will vary from industry to industry and will be influenced by the conditions prevailing in the market where a company operates, for example companies in developing countries may be seen as intrinsically higher risk and therefore require high levels of equity compared to debt.

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At Deloitte, he lived and worked in Uganda, Kenya, Tanzania and the United Kingdom for over 6 years and subsequently became the firm's chief of staff for the Energy and Resources Industry Group seeing him play a lead advisory role in Uganda, Kenya, Tanzania, Mozambique, South Sudan, Somalia and Ethiopia.

Denis is widely published and a regular commentator in the local, regional and international media and speaker at various forums regarding the taxation and financing of energy projects as well as the protection of large capital projects within the framework of international investment law.

He holds a Master of Laws degree in Petroleum Taxation and Finance from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■

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Bill is a Senior Advisor with Cristal Advocates. He has concentrated on working with energy companies with a particular focus on cross border transactions and M&A since 1989 and is a leading global energy and tax practitioner with wide international experience. Between 1986 and 1998, he worked in London with the UK tax authorities and Big Four accounting firms. From 1998 to 2004, he was based in Kazakhstan working across the Caspian region with Deloitte. He was in the region at the time it was developing its infrastructure for crude oil production with international investment following the collapse of the Soviet Union.

From 2004 to 2008, he worked in Russia where he led Deloitte's oil and gas industry group and established Deloitte's office in Sakhalin. He moved to East Africa in 2009 leading Deloitte's energy and resources industry group in Uganda, Kenya, Tanzania, Rwanda, Ethiopia and Mozambique. He was initially based in Kampala, Uganda later relocating to Dar es Salaam, Tanzania. Bill returned to the UK in 2014 supporting Deloitte UK teams working on outbound projects investing in Africa and was a key member of Deloitte UK's energy and resource practice until his retirement from the firm in September, 2018.

Bill is a graduate of Oxford University and completed his inspectors' training with the UK Inland Revenue in 1989. ■

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John leads the public policy and advocacy practice at the firm and combines unique public and private sector experience.

Prior to joining Cristal Advocates, he had worked as a Private Secretary to the President of the Republic of Uganda. During this time, he participated in several public and private sector engagements that included advising and coordinating activities relating to oil and gas as well as infrastructural projects of national significance. John had earlier worked with the Post Bank Uganda Limited and Shonubi Musoke and Co. Advocates.

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Dickens leads the oil and gas practice at Cristal Advocates. He has an in depth appreciation of Uganda's oil and gas sector having served as the maiden Company Secretary of the Uganda National Oil Company (UNOC) and the Uganda Refinery Holding Company Limited (URHC). UNOC represents the Government of Uganda commercial interests in the oil and gas sector while URHC represents government interests in the refinery project as well as managing the petrol based industrial park.

Dickens was instrumental in UNOC's formation and initial period of operation and also served as its head of Contracts, Negotiations and Advisory until May 2018. Prior to joining UNOC, Dickens was Legal Counsel at the Petroleum Directorate of the Ministry of Energy playing key legal advisory roles on the negotiation and implementation of PSAs, Joint venture and other oil and gas agreements. He was also part of the team that shepherded the process of enacting the current Ugandan oil and gas Legislations and Regulations including the local content requirements.

He is a certified project control specialist (IFP) and holds a Master of Laws Degree in Petroleum Law and Policy from the University of Dundee in the United Kingdom, a Post Graduate Diploma in Legal Practice and a Bachelor of Laws degree from Makerere University. ■

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He joined Cristal Advocates from Kizza, Tumwesige, and Ssemambo Advocates. He previously worked with the Advocates Coalition for Development and Environment (ACODE). He also undertook a traineeship with the oil and gas division of Webber Wetzel in Johannesburg, South Africa.

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