NETWORK AFRICA

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CONCEPT PAPER

BY

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Network Africa, is a proposed chain of Internet cafes soon we plan to launch in South Africa and grow into the top 10 internet consuming countries of the African continent. The Lead Promoter is Munyaradzi Musamba. Our stores will be leased, fitted and operated on the principle of 'economies of scale'. Most stores will open 12 hours a day, 7 days a week, each with about 35 PC's. We hope to open our first store in the first quarter of 2010 in Johannesburg. We recognise that Network Africa's product offering has certain characteristics which are critical to consider at this stage that we seek to raise seed capital.

- We offer a highly perishable product (e.g. an hour of Internet access time, which cannot be put in inventory. Once an hour is gone, there was no way of reselling that hour of internet access time);
- Although our stores may be large, capacity will be limited;
- Internet access demand varies, not only by time of day, day of week, but also across other time and seasonal horizons;
- Incremental costs are next to nothing: it doesn't matter whether there is one person or fifty in a store, the bandwidth is already there.

Our product life cycle and other marketing strategies make a penetration pricing strategy ideal to build location and product awareness. The going rate for public internet access in Africa, is currently around USD1/hour. We intend to charge the same, but offer improved service, infrastructure and a trusted brand. Because of the fragmented nature of the internet café industry at the moment and within the foreseeable future, as we open more branches competitors will find it easier to match our price than take the battle to Network Africa because of our greater ability to withstand a price war due to our much larger capital base. We intend to offer a much better service to the consumer and forecast lower costs of customer acquisition and retention compared those of our competitors who are even bothered to monitor their customer retention. We will be located in areas with proven demand for internet cafes, where current Internet cafes are either thriving, and/or many internet cafes are located in that area such that the area has become a hub of ICT activity, among other critically assessed criteria. Customers have given price as the first reason for visiting an internet cafe, ahead of convenience, speed of access and other service/value factors, this is an excellent endorsement to Network Africa's business model. We will have a membership option for members which will be cost USD1/hour. All of our business will be on a prepaid basis.

Operational overheads will be kept low. Our management information system will be centrally managed and allow our customers to roam across all our stores, except across national borders until we are certain that it won't result in transfer pricing to the consumer's advantage at our loss. We will ensure that,

- The company leases property and ICT hardware and software in line with our expected revenue as these will be our longest term commitments.
- Stores are not too large – as economies of scale don't materialise if they are half empty.
- We don't purchase overly sophisticated and expensive information technology.
- Excess space in stores that are ideally located is sub-let before we commit to the lease.
- Unprofitable stores will be closed within 3 months.
- A franchising plan is researched and developed within our two years of operations.

We will continuously re-assess:

- If there is a sufficient number of customers who want to use an internet cafe? Today, X% of South African homes have internet access, and many others have (free or subsidised) access at their place of work or study etc.

- If there are new sites located in the right place to attract customers throughout the day and the whole week? City business centre cafes might attract people needing to keep in touch, but many city centres' are quiet in the evenings and at weekends.
- Smaller cafes, co-located alongside other retail outlets and busy places such as the airport lounges and check-in points, provide a good, steady income stream with very low overheads?
- There are real competitors charging a significant price premium or discount such that Network Africa customers actually feel they are getting a bargain or being ripped off, particularly 3@1, Postnet, Post Office branches, places of work and study, public libraries, unbranded internet cafes, etc.
- If it possible to introduce flat rate schemes of USDX per month for unlimited access? For a typical surfer using the internet for 2 hours per day, then USDX per month equals USDX per hour.
- How our product's performance compares? Is the performance as good, worse or far better? Is performance an issue? Probably not for accessing a few emails, but yes for on-line chat, web surfing and video conferencing.

Growth Strategy and Capital Structure

We intend to raise seed capital that will enable us to set-up a national presence and our management hub in Johannesburg, South Africa, where the national and regional strategy among other support services will be executed from. The fundamentals of the three capital structures we have considered are articulated below. The corner stone of our success is rapid replication of our concept across the African Continent. Only Zimbabwe and Ghana have presented opportunities for inorganic growth to date and we are interested in capitalising on these opportunities at the right price.

All factors considered, I believe a traditional exit is a possibility but is not a true option on which to rely. A dividend-based exit needs to be the other option, even though it is not optimal. The main idea is that, when allowed by the cash situation and the forecast for cash requirements in the coming years, dividends would be issued out of the company's bottom line. The actual amount of dividends disbursed would be a proportion of the cash requirement for the following year, so as to not cash-starve the business in the first years of development.

I would receive my share of dividends and be forced to use it to buy back the venture capitalist's shares until a 60% stake was bought. In other words the venture capitalist would have a put option on each of its shares that it could exercise every year in an amount equal to the dividends that I received for that year.

Several possibilities about how to structure the deal in this case are available; however, they differ in terms of how much downside protection and how much possibility to capture the upside, in case of major success, they offer. Below, I narrow them down to the three most attractive ones:[1]

a. Preferred shares with floating appreciation, fixed sweat equity

In this case, the capitalization of the company would be R100,000 from me and R900,000 from the venture capitalist.

A 15% sweat equity would be awarded to me upon disbursement of funds, increasing my company stake to 25%.

Every year at this point, the set level of dividends would be split between the venture capitalist (75% for the first year) and me (25% for the first year).

[1] For the purpose of illustrating the dynamics of the different structures I considered my company requiring a total capitalization of R1,300,000 of which R1,000,000 is in equity and R300,000 in debt. I also considered in all three situations that I would contribute to the capitalisation with R100,000

I would be obliged to use this amount to purchase back the venture capitalists shares at the new book value (i.e. taking into account the Retained Earnings from that year), provided that the venture capitalist is willing to sell (i.e. if the venture capitalist owned a put option on the shares).

For the next year the dividend split would be adjusted as a proportion of the ownership of the company's value from the starting value of 25% : 75%.

This option clearly exhibits benefits for me, the entrepreneur. Also, in case the company growth rate suggested a significant increase in value, the venture capitalist could choose to stay invested until the opportunity for a profitable exit through sale materialised.

The disadvantage of this option would be that it provides limited downside protection, i.e. should the book value of the equity remain contained, I, the entrepreneur would be able to buyout the venture capitalist at a relatively cheap price.

Regardless of these considerations, it would be essential to set the appropriate level of sweat equity, one that, on one hand, provided a beneficial deal to me, and on the other, would not overly dilute the venture capitalist's ownership.

b. Preferred shares with minimum appreciation

The capitalization structure for this case would be similar to the first. However, a minimum appreciation rate would be set for the venture capitalist's shares' value.

A sweat equity of 10% would be awarded to me upon disbursement of the funds, and an additional 10% would be allocated as a performance-related bonus for years 2 to 5 of the investment, divided into four trenches of 2.5% each.

The set dividend amount would be split between the venture capitalist and me, who would be forced to buy back the appreciated preferred shares. These shares could either be sold at the yearly book value appreciation rate or at the minimum pre-defined appreciation rate, whichever was higher.

The advantage of this option would be its guarantee of a downside protection in case the book value of the equity were to grow slowly.

However, the question of what would be a fair minimum appreciation rate, given the reduced protection from the downside compared to a pure debt instrument, has to be answered. At the same time, the reduced risk compared to an equity situation should be considered. One option would be to set this level at 20%, which would make the equity cost only slightly more than the debt instrument cost for this class of investment.

Similarly to the previous option, it would be essential to define an optimum value for the sweat equity. The difference would be that, in this case, two values (one for the initial sweat equity and one for the performance-related stake) had to be set and agreed upon.

c. Mix of preferred shares with fixed appreciation rate and ordinary shares

In this case, the capitalisation structure would be more complex, since the venture capitalist would be invested through R625,000 in preferred shares at a fixed appreciation rate and R275,000 in ordinary shares. I would receive 15% sweat equity in ordinary shares, thus owning 2/3 of the total ordinary shares, which would total 25% of the company value.

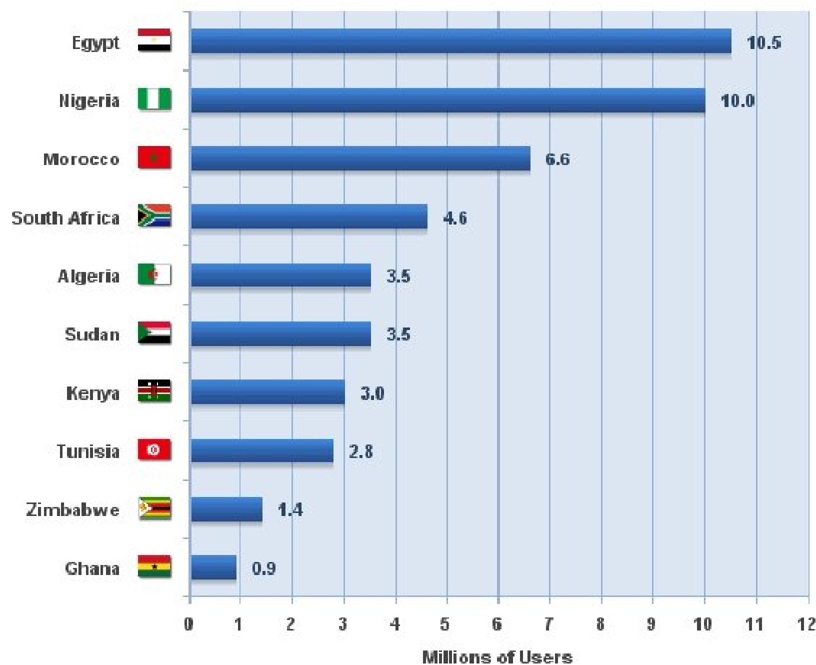
In order to allow me a faster buyout, each preferred share would only be entitled to half of the rights over the dividends that their value ownership would permit.

As with the previous cases, I would be forced to utilise my share of dividends to buy back the preferred shares. Once this operation had taken place entirely, the venture capitalist would own an additional put option on its part of ordinary shares, with a strike price equal to the book value.

The main advantage to this structure would be its allowance of some capture of the upside in case the company was very successful; it would also provide enough protection on the downside through the fixed appreciating element. With participation in both classes of shares, a more sophisticated control structure could be designed, which would give me more control over certain decisions (allocated to the ordinary shares) and leave the venture capitalist with more control over others (through the preferred element).

This structure's disadvantage would be that it would force the venture capitalist to define upfront how much to invest in preferred shares with fixed appreciation and how much to keep in ordinary shares with book appreciation. This could limit the amount of upside that the venture capitalist could capture.

As per the other options, it would be necessary to set the appropriate level of sweat equity to be awarded to me upon establishment of the company's constitution.



Source: Internet World Stats

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