The Economist | Corporate Network

A growth engine

Trends and outcomes of private equity in Africa

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Preface

A growth engine: Trends and outcomes of private equity in Africa is a report from The Economist Corporate Network (ECN). It is informed by interactions with leading private-equity advocates and actors who support the asset class in Africa. Prequin data for 2016 included reported transactions from January 1st to December 16th. Baker McKenzie sponsored the report. ECN performed the research and wrote the report independently. The findings and views expressed in this report are those of ECN alone and do not necessarily reflect the views of the sponsor.

Herman Warren, director of ECN Africa, was the author of the report. Gaddi Tam was responsible for layout. Wai Lam was responsible for the cover design. The cover is by iStock.

Special thanks are extended to all interviewees who shared their time, and provided data and perspective on this important topic.

March 2017

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Introduction

Private-equity (PE) activity in Africa has increased significantly in the last 30 years. From a dozen or so active general partners (GPs) in the region in 1990, there are currently at least 140 GPs active in Africa. Between 2010 and 2016, GPs invested around US$25.6bn across sectors that ranged from consumer goods to water and sanitation.

GPs' approach to investment in Africa is, in several ways, distinct from how the asset class functions in other parts of the world. For instance, PE fund raising and deal execution have a longer lead time in Africa than PE funds focused on other regions; the deal sizes are usually smaller; the average holding periods sometimes extend over eight years; and the exit options are weighted towards trade sales. Trade sales are associated with corporate buyers purchasing assets in their core line of business. PE, therefore, plays an important role in facilitating the presence and strategic expansion of corporates in the region.

Moreover, PE investment in Africa tends to focus on growth capital, helping investees to improve governance, and strategy, expand their footprint and (at times) contribute positively to the region's broader commercial ecosystem, for example by deepening capital markets and expanding supply chains. The focus on growth capital is the opposite of the financial-engineering accusations often directed at GP activities in other regions. Rather than buying a business, significantly increasing its debt levels, aggressively reducing costs and exiting after a short holding period, the GP approach in Africa centres on holding and scaling businesses with limited, if any, debt capital included in deal structures.

GPs operating in Africa have surpassed benchmark levels of return: between 2007 and 2015, they generated an average return well over 150% the MSCI Emerging Market Index. This notwithstanding, PE has low penetration relative to performance in other regions. Reforms have been enacted in some countries in the region in order to encourage Africa-based institutional investors to allocate capital to the asset class. However, more remains to be done to harness fully PE's potential to contribute to Africa's socioeconomic development. Each investment counts: every 0.01% in concluded PE transactions as a percentage of African GDP (US$2.1trn) translates to over US$200m of much needed incremental annual investment in the region.

The impact of private equity

> “Private equity in Africa is primarily used to support growth, whereas, in the developed world, it may have more of a financial structuring bias.”
> *Ngalaah Chuphi, executive director, Ethos*

Capital to grow

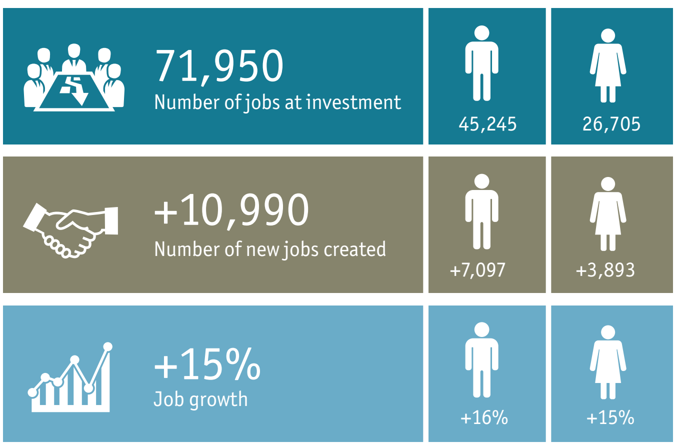
PE plays a catalytic role in Africa. The general shallowness of African capital markets and the high cost of debt finance mean that PE plays an important role in helping to unlock and grow the potential of individual companies and ecosystems. Unlike in other regions, where transactions may be driven by a financial-engineering objective, the asset class is primarily applied to fund enterprise growth in Africa. GPs generally approach transactions by assessing the potential to expand a targeted portfolio company’s market reach and/or combine it with a complementary business or service offering. “We play at the larger end of the PE spectrum. Investments start at US$50m and may go up to US$250m,” says David Cooke, partner at Actis, a GP that invests in emerging markets. “Baked” deals—those that are acquired at scale and run efficiently—are not as common in the region. “We find very few baked transactions. We may take a successful national business and expand it regionally; everything we do is around growth,” adds Mr Cooke.

Debt, when used in deal structures, is generally sparingly and judiciously applied. “We typically use a lot of equity, no more than one-third debt,” says Nhlanganiso Mkwanazi, director at Medu Capital, a Johannesburg-based firm. “In the mid-market space, we want to generate investment returns by growing the businesses. The businesses need to have strong balance sheets, not onerous structuring, to enable them to grow effectively,” adds Mr Mkwanazi.

Geographic expansion and job creation

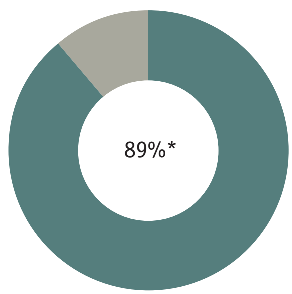
Various indicators point to the value of GPs’ involvement with their portfolio companies. For example, between 2009 and 2015, Africa-based PE investee companies grew their employment

Impact of private equity
(job creation and growth, 2009-15)



*Companies in the sample have different holding periods between 2009 and 2015
Source: AVCA, *Africa Sustainability Study: Job Creation.*

Share of new jobs created that were permanent



*Based on companies that provide permanent job data numbers by over 15%, according to The African Private Equity and Venture Capital Association (AVCA). One of Actis's South Africa-based investments, Food Lover's Market, is adding an average of five new employees daily.

Fanisi Capital, a Kenya-based GP, has had success growing smaller enterprises into national and regional enterprises. "We do early-stage investments, sometimes with a single entrepreneur, and help to corporatise them," says Ayisi Makatiani, managing partner at Fanisi Capital. He adds, "For example, we made an acquisition that had two pharmacies and helped to build it into a chain with 53 outlets."

"While the typical size of our PE investments is between US$50m and US$100m, we will look at anything from US$30m to US$200m. In terms of size, we care less about where we start out, and more where we can end up. Our focus is on the capacity to grow and develop a company into a market-leading business of scale," says Souleymane Ba, partner at Helios Investment Partners, a London-based GP that invests exclusively in Africa.

Improving environmental social and governance (ESG) performance

ESG is a generic term used by investors to evaluate corporate behaviour. GPs, and the limited partners investing in their funds, prioritise investees meeting acceptable ESG standards. These standards include financial and non-financial indicators geared to measure how well a company is performing and give an indication of its long-term prospects. Energy efficiency, staff training and qualifications, green house gas emissions and litigation risks, as examples, form part of a host of ESG factors. Often a GPs involvement in an investee results in a dramatic improvement in ESG performance.

"All of our portfolio companies in some way are making life better for people and businesses in Africa," says Dabney Tonelli, investor relations partner at Helios Investment Partners. "Through our investment activity we're developing the next generation of business leadership potential, enhancing lives through access to information and technology, creating financial security, increasing financial inclusion, improving environmental care and quality and improving governance standards," she adds.

"We put investment and growth first, before anything else."

Bruce MacRobert, chairman, Consol Holdings

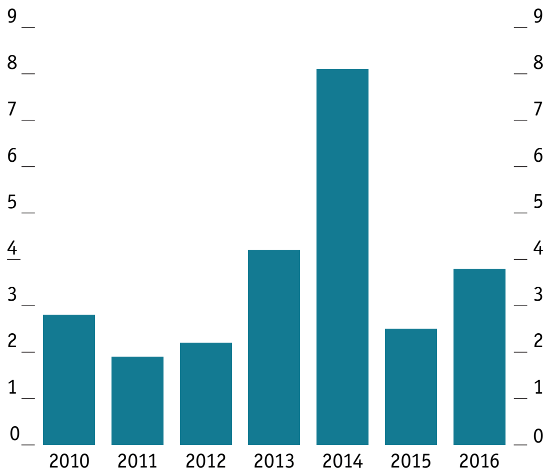
"Our Kenya-based restaurant business (Java House) had 12 restaurants when we first invested; we have grown it to 60 outlets, expanded their footprint outside of Kenya to Uganda, and there is still room for future investors to at least triple the number of outlets."

Hurley Doddy, managing director, ECP

Transactions: doing deals

Deal-value trends

Bumpy deal flow
(Africa-based private equity deals: 2010-16 in US$ bn)



Source: AVCA.

In 2010-16, around US$25.6bn of PE transactions were concluded. The annual investment level averaged around US$3.7bn. However, this figure does not tell the entire story. For example, 2013 and 2014 stood out within the period: over US$12bn, or 48% of total value, was invested in those two years alone. Three large telecommunications deals by IHS Towers, a company that builds and operates base stations, averaging around US$1.4bn each, and one US$630m deal by Helios Towers Africa, which also builds and operates base stations, accounted for around US$4.8bn of the total value of concluded deals.

Notwithstanding slower macroeconomic growth in the region, in 2016 the total amount invested by GPs was US$3.8bn or US$160m more than the average annual investment over the period 2010-16. For some GPs 2016 was their busiest year. “We do two to three deals a year, flowing from an annual pipeline of over 160 potential opportunities. In respect of transaction volumes, last year was our biggest year as a firm,” says Mr Ba.

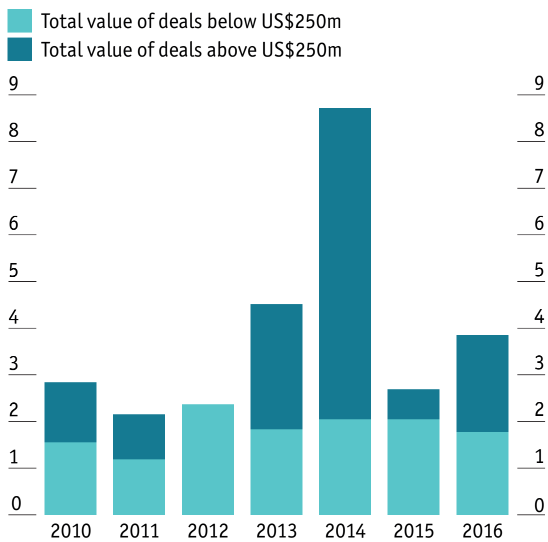
Out of 54 African countries, only five had a GDP that exceeded US$100bn in 2016, according to The Economist Intelligence Unit. Large PE transactions are, therefore, few and far between in the region.

Over the seven-year period, transactions greater than US$250m composed a little under half (US$12.5bn) of concluded deals. GPs biased towards larger deals generally do not conclude transactions that exceed US$250m. “The typical size of a deal is US$50m to US$100m,” says Ngalaah Chuphi, executive director at Ethos, a

“Transactions are being done across a range of industry sectors, particularly those that benefit from the emerging-consumer theme on the continent.”

Erika van der Merwe, CEO, SAVCA

Larger deals dominate overall, but not in every year
(deal mix by value, US$ bn)



Source: AVCA.

Johannesburg-based GP. In fact, in the period 2011-16, only around 3% of PE-transaction volume involved deals valued at US$250m or more, according to Prequin, a firm that provides data on the PE industry.

Deal mix

Regional focus

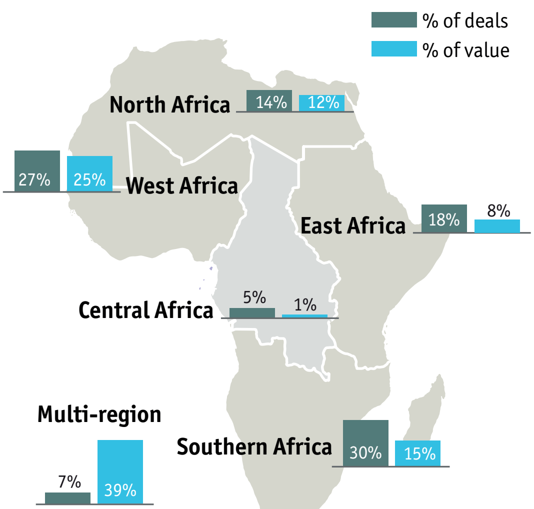
Over 1,000 PE deals were concluded between the beginning of 2010 and the end of 2016, according to data from AVCA and Prequin. Transactions that involved investees that operated across a single sub-region composed the largest share of deal value over the seven-year period. The Southern Africa region accounted for around 30% of completed transactions. South Africa is the largest and most sophisticated single PE market in Africa, accounting for around 22% of concluded transactions by volume and 13% of concluded transactions by value between 2010 and 2016.

West Africa contributed one-quarter of the capital invested in Africa PE transactions over the period, while accounting for around 25% of total transactions. The East Africa region contributed 18% of PE transactions, but just 8% of total deal value. Between 2011 and 2016, there may have been as few as seven concluded deals in East Africa valued at US$50m or more; other East Africa-based deals concluded over the same period averaged around US$8.5m per transaction, according to Prequin. The smaller average size of East African deals suited Fanisi Capital, a Nairobi-based GP focusing on transactions in the range of US$3m to US$5m.

"Africa is big, and it is complicated; that leaves opportunities for regionally based GPs like us," said Mr Makatiani. He adds, "The challenge has been that East Africa has become very popular. There is a lot of GP attention and competition here, particularly for deals valued at US$50m or higher. In the deal space we operate in, there is

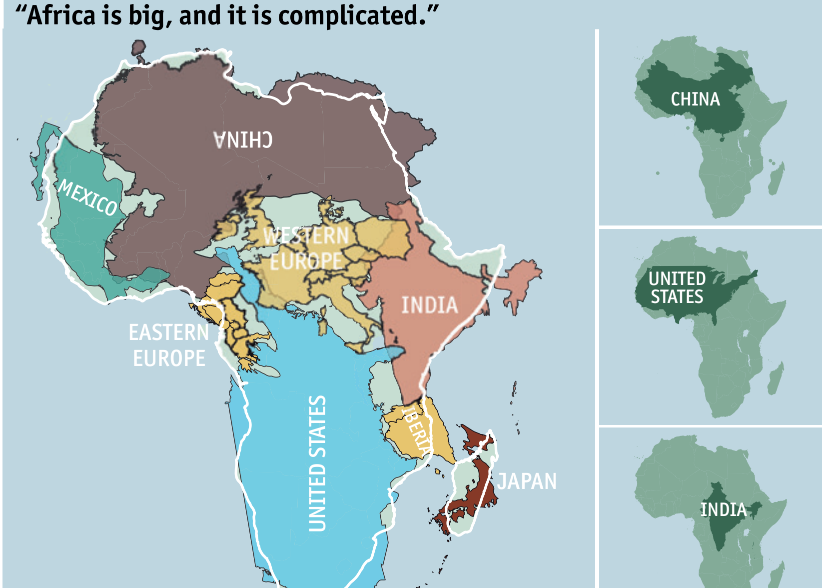
> "There is a growing base of consumers and opportunities to connect them to formal networks and service offerings."
>
> *Hurley Dodd, MD and co-CEO, ECP Investments*

Africa-based private equity deals, 2010-16
(% of total deals and % of total deal value over the period)



Sources: AVCA; Prequin.

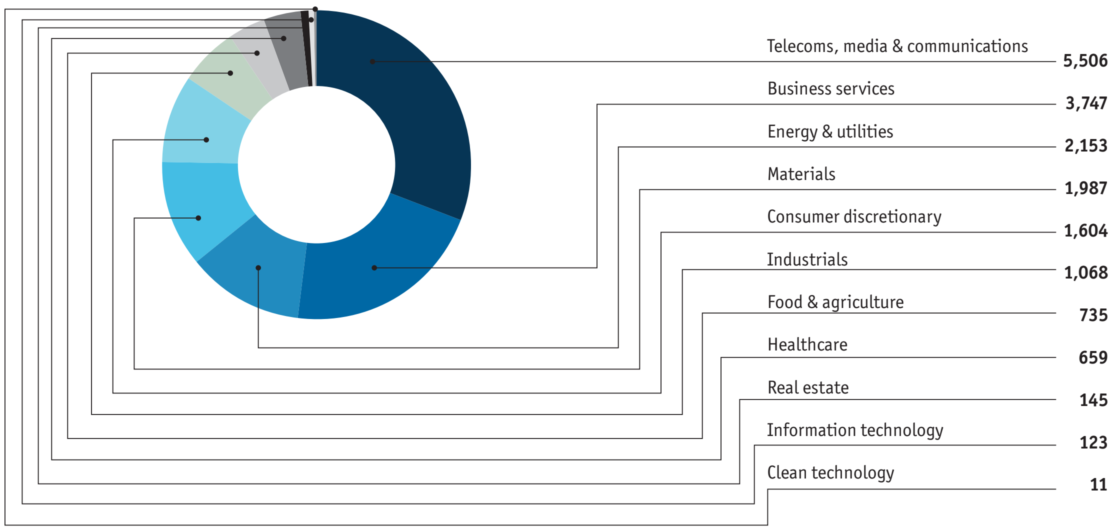
"Africa is big, and it is complicated."



Source: *The Economist.*

not as much competition."

Africa: private-equity deals
(industry sector mix: 2011-16; value of deals in US$ m)



Source: Prequin.

"We are not just sitting in hotel lobbies to do deals."

"A local office is as important to monitor your portfolio companies as it is to source deals."

Luc Rigouzzo, managing partner, Amethis Finance

Investment sectors

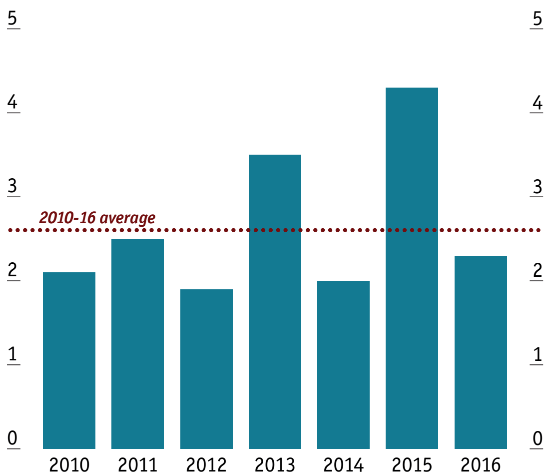
Local networks and credibility

Many of the companies targeted as investees have never worked with GPs and may have a limited understanding of the PE asset class. Moreover, given that many of the targets may be family-run or sole proprietorships, GPs must have an established network of contacts and a track record of working effectively with similarly structured businesses. Actis, a GP with a global presence, but an emerging-market bias, applies its broad experience and local networks to win deals in Africa. "We have over 60 years of legacy and experience to leverage. A lot of what we do is with family-owned businesses. We help investees think about what to do next to grow their businesses. We help with governance and setting the roadmap," says Mr Cooke.

Being based in a market or region where plenty of targeted deals take place is also helpful. "To do PE well, you have to be local. It's a local game," says Mr Makatiani. "We are local [Kenyans], and that is helpful. We are not just sitting in hotel lobbies to do deals," he adds.

Fundraising trends and challenges

Africa funds raised: outlying and average
(total value of private equity fundraising, by year of final close; US$ bn)



Source: AVCA.

In 2010-16 Africa-focused GPs raised around US$18.6bn to invest in the region. In 2015, even as the commodity cycle turned down and economic growth in Africa slowed, the level of fundraising peaked at US$4.3bn. In 2016 Africa is expected to have grown at its slowest pace in over a decade, but the level of PE fundraising was higher than 2014 when many commodity prices peaked, and economic growth was significantly higher in the region.

Despite the region-wide economic slowdown, Africa remains attractive to medium-to-long-term investors. A young population undergoing rural-urban migration; democracy firmly taking root; and strong economic growth potential in many countries are just a few of the factors in Africa's favour. In 2017 nine out of the twenty fastest-growing economies are expected to be in Africa. Importantly, even in those countries that have experienced slow growth (for example, South Africa) or recession (for example, Nigeria) there are still strong returns to be made, as Mr Chuphi, indicates, "You can still exhibit very attractive growth in a broader economic environment that may be subdued."

"Fundraising in Africa takes one to two years longer than in other regions," comments Paul Kokoricha, partner and chief investment officer at Capital Alliance Nigeria, a Lagos-based PE firm. Currency volatility also poses a challenge to fundraising efforts. "Investment returns in US-dollar terms have been negatively impacted by the strengthening of the US dollar against most currencies, but, in particular, against the major currencies in Africa. I expect that fundraising will be more challenging, especially from sources out of the US and Europe," says Mr Mkwanazi.

AVCA and The Southern African Venture Capital and Private Equity Association (SAVCA) actively promote the asset class to investors based in Africa and other regions around the world. "It's not easy. Africa is still relatively small and is not going to get the airtime that larger market opportunities may get," says Michelle Kathryn Essomé, CEO at AVCA. Despite the challenges, the number of GPs investing in Africa has grown to over 140 from a dozen or so in the 1990s.

Given the size of the Africa-based PE market, others caution against reading too much into recent fundraising trends. "The data for Africa appear a bit distorted because the industry is so small. There was a big spike in 2015 because a few large funds closed. The fundraising cycle will rise again when larger GPs go back out to the market," says Ms Tonelli of Helios Investment Partners.

Offshore sources of funds dominate

Most GPs based in East and West Africa expect to raise most of their investor funding offshore (primarily in the US and Europe), due to shallow pools of African institutional capital. “We have some Africa-sourced capital. We would like to have more and continue to speak to potential investors in Africa,” says Eduardo Gutiérrez, partner at Development Partners International, a PE firm operating in Africa.

Africa-based pension funds are growing fast—for example, the Nigeria-based fund segment is expanding by US$5bn per year—but remain a tiny fraction of a global pensions industry, which is concentrated in the US, UK and Japan and allocated over US$640bn to PE investments last year.

“Fifty percent of our commitments are sourced from the US; about 10% of our capital comes from Africa. Going forward, we’d like to raise more capital from Africa, and we expect to do so as Africa-based institutional investors become more familiar with the asset class,” says Mr Ba.

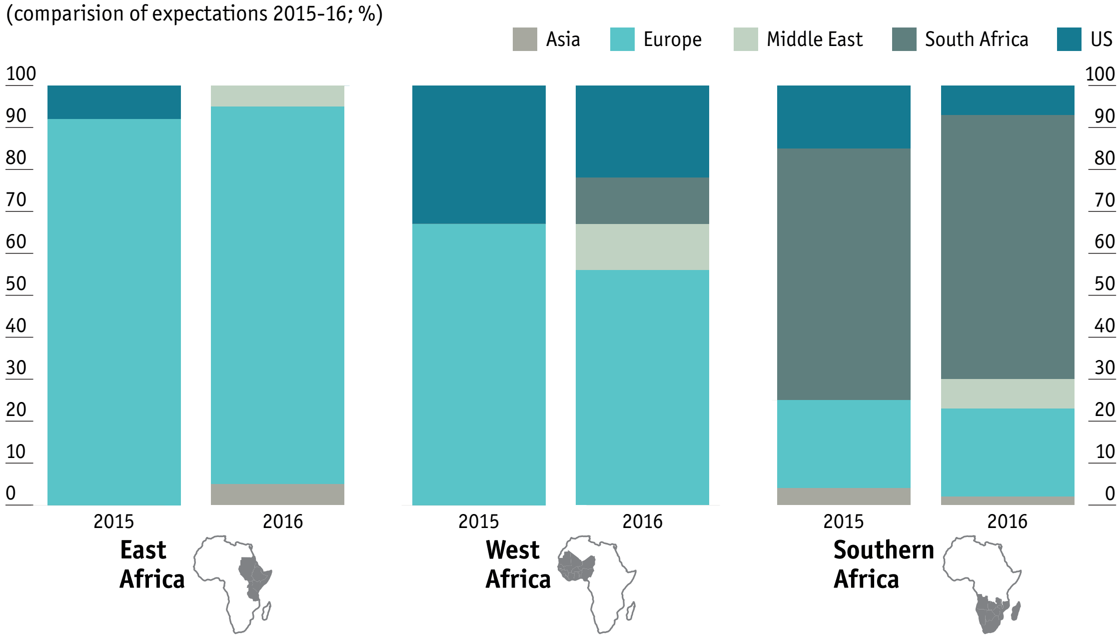
AVCA sees Africa-based institutions with capital as a big opportunity. “We have been educating a lot of Africa-based pension funds. We think it’s a great opportunity for them to invest in their own story,” says Ms Essomé. Indeed, pension reforms to encourage investment in the asset class have been enacted, for example, in South Africa, Nigeria, Kenya and Namibia. Nonetheless, not enough of the capital held by these institutions currently makes its way into the asset class. “If you want to raise over US$70m of PE capital, you have to go offshore,” suggests Mr Mkwanazi.

> “African pension funds have a key role to play as an additional pool of capital to grow the local PE industry.”

Track records matter

GPs active in the region with a strong team and a track record of generating investment returns remain best positioned to attract investor capital. In 2016, Actis, for example, closed a US$500m

Expected sources of capital
(comparision of expectations 2015-16; %)



Source: Deloiite, *2016 Africa Private Equity Confidence Survey.*

Sample of closed funds, 2010-16

Fund manager	Fund name	Reported final close (m)	Regional focus	Year of final close
Actis	Actis Africa Real Estate Fund III	US$500	Sub-Saharan Africa	2016
Investec Asset Management	Investec Africa Private Equity Fund II	US$295	Sub-Saharan Africa	2016
Verod Capital Management	Verod Capital Growth Fund II	US$115	West Africa	2016
The Abraaj Group	Abraaj Africa Fund III	US$990	Sub-Saharan Africa	2015
Helios Investment Partners	Helios Investors III	US$1,100	Pan-African	2015
Development Partners International	African Development Partners II	US$725	Pan-African	2015
The Carlyle Group	Carlyle Sub-Saharan African Fund	US$698	Sub-Saharan Africa	2014
Amethis Finance	Amethis Finance Fund	US$530	Pan-African	2014
AfricInvest	AfricInvest Financial Sector Fund	US$83	Sub-Saharan Africa	2014
Actis	Actis Energy III*	US$1,150	Pan-African	2013
Lereko Metier	Lereko Metier Sustainable Capital Fund	ZAR690	Southern Africa	2013
Adenia Partners	Adenia Capital III	EUR96	Sub-Saharan Africa	2012
Catalyst Principal Partners	Catalyst Fund I	US$125	East Africa	2012
Helios Investment Partners	Helios Investors II	US$900	Pan-African	2011
Emerging Capital Partners	ECP Africa Fund III	US$613	Pan-African	2010

*Actis Energy III invests in electricity generation and distribution businesses in Latin America, Africa and Asia
Source: AVCA.

fund. "We closed our third fund at the beginning of the year. There is a broad spread of investors willing to put their capital in the asset class," said Mr Cooke. The firm views the tougher economic outlook in many African markets, as well as political instability in the region, in a positive light. "When you see everyone running out of a burning house, we are the ones who run in to see what's worth saving," says Mr Cooke. Another GP seeing the tougher macroeconomic environment in a positive light is Capital Alliance Nigeria. "It's a good time to invest in Nigeria, given depressed asset prices," claims Mr Kokoricha.

"It's a good time to invest in Nigeria, given depressed asset prices."

Holding patterns and exit paths

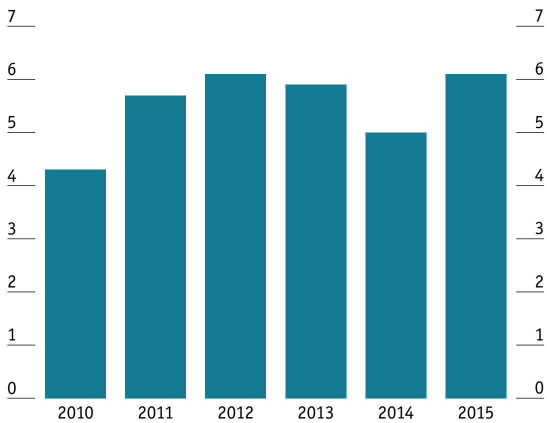
“We typically try to target a strategic buyer (50% of deals); financial buyers are also quite significant; then IPO markets open up for some investments, as well. Some of the South African companies we have, we sell to others, who want to use South Africa as a launch pad into the rest of Africa.”

Ngalaah Chuphi, partner, Ethos

“We have exited about 15 businesses. About one-third is trade sales. Around 20% is to co-shareholders. Around 20% to PE sponsors/financial buyers, and the balance falls into the broad ‘other’ category.”

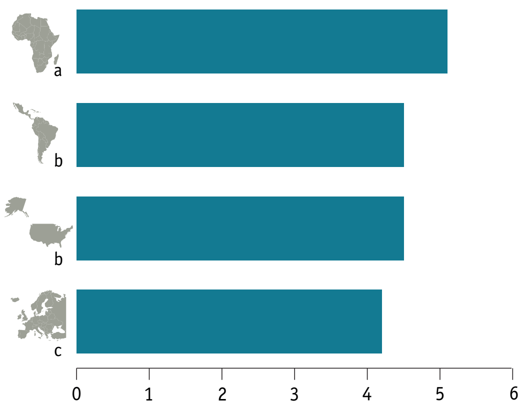
Nhlanganiso Mkwanazi, director, Medu Capital

Holding firm
(average holding period of Africa-based private equity investments, 2010-15)



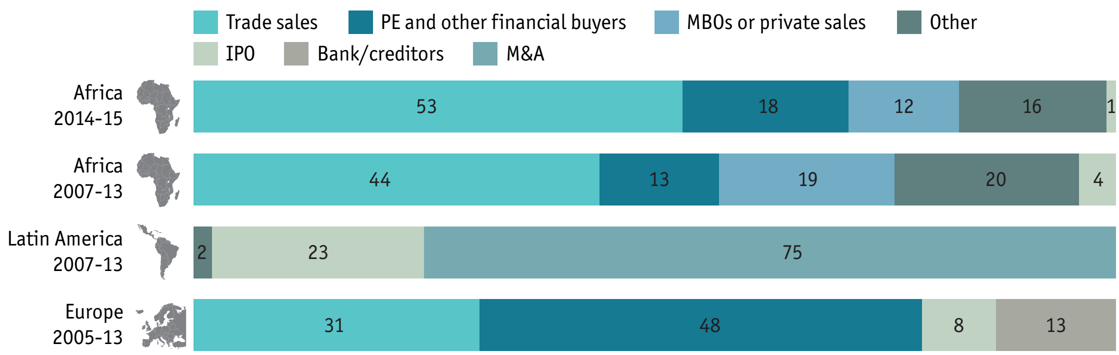
Sources: *How private equity investors create value,* Ernst & Young; AVCA.

Holding patterns
(average investment-holding periods by region, 2006-12)



(a) Africa covers exits for 2007–12. (b) Latin America and US cover exits for 2007–11. (c) Europe covers exits over 2006–12
Source: AVCA.

African exits biased towards trade sales
(exit route comparison by region, 2005-15, %)



Source: AVCA.

The holding period for which GPs invest in a single asset in Africa is longer on average than asset-holding periods in other regions. “The typical holding period is 5-7 years; sometimes we stretch it to eight years. At some point, we need to provide liquidity,” says Mr Chuphi.

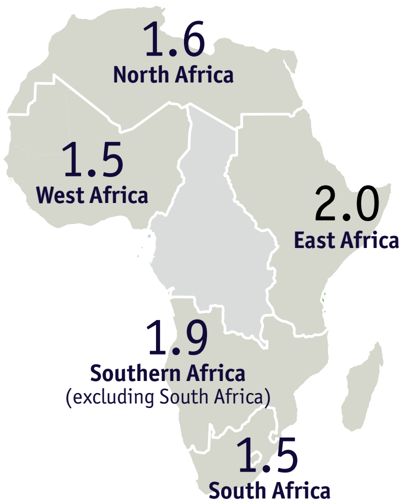
Africa-based capital markets are relatively shallow. At the end of 2015 African exchanges had a market capitalisation of around US$1trn—only 23% of this value resided outside of South Africa. The low capital-market base is one of the contributing factors towards trade sales’ being a dominate form of exit for PE investments in the region. In the period 2014-15, trade sales accounted for 53% of Africa-based exits, up from 44% over the period 2007-13. This notwithstanding, a growing category of exit in the region is sales to other GPs and financial buyers.

Investment returns: where the rubber hits the road

The average investment return achieved by GPs suggests that the relatively longer Africa-based investment holding periods are worth it. The asset class for Africa-based investments earned better returns than the MSCI Emerging Market Index over the nine-year period ending in 2015.

Even in tough commercial operating environments, such as Nigeria, GPs are generating above-average returns. Mr Kokoricha comments, "Our first fund delivered a 1,500% return. Fund II is partially realised and has already delivered a 100% return."

African exit returns vary by region
(private equity returns relative to MSCI Emerging Market Index, 2007-15)

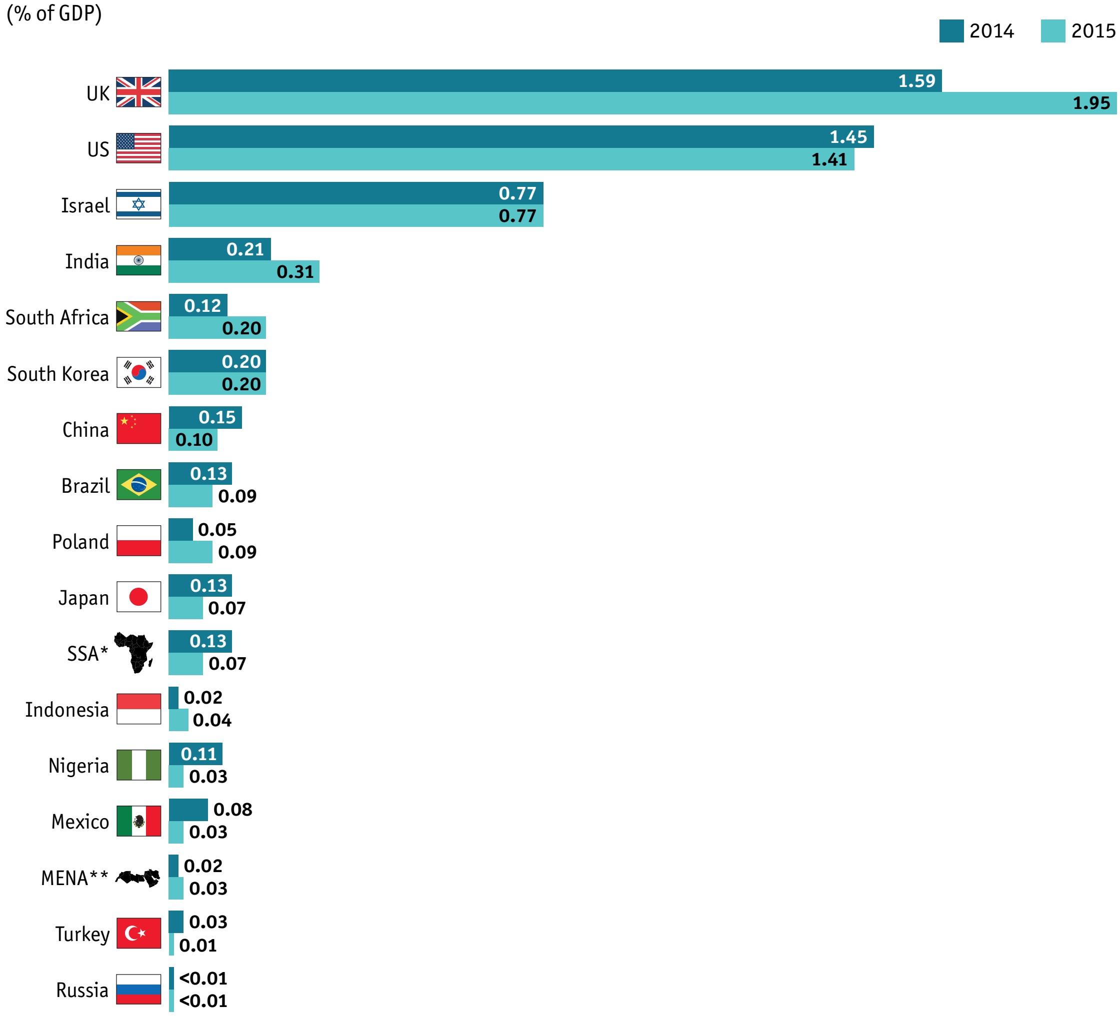


Sources: *How private equity investors create value,* Ernst & Young; AVCA.

Closing thoughts

The PE asset class stands out in Africa for its idiosyncratic execution, growth orientation, typical paths to exit, and long holding periods, as well as its successes, most pronounced, perhaps, in the growth of active GPs and the relatively high investment returns achieved. The asset class is both a bridge to and engine of sustainable commercial development in the region. GPs focus on equity-based growth capital has helped Africa-based businesses to scale within and beyond their domestic markets. Moreover, GPs drive to achieve financial returns is inextricably linked with an emphasis on sustainability, improved governance and the promotion of good corporate

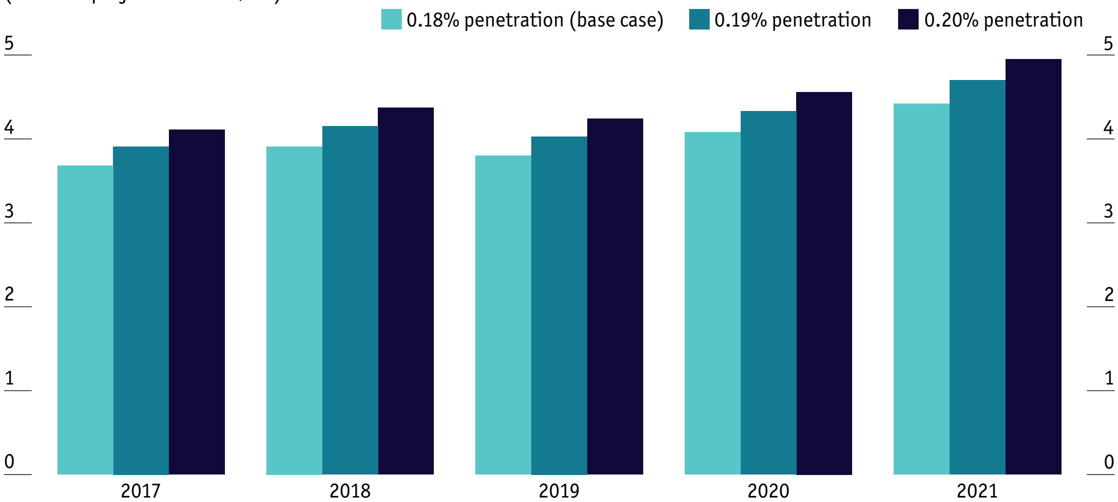
Private equity capital penetration, 2014-15
(% of GDP)



* Sub-Saharan Africa
** Middle East and North Africa

Source: *SAVCA 2016, Private Equity Industry Survey.*

Private equity in Africa: Impact of increasing asset-class penetration
(2017-21 projection in US$ bn)



Sources: The Economist Intelligence Unit; ECN analysis.

citizenship: ESG-related indicators are actively monitored and inform GPs' pre- and post-investment interactions with investees. In short, the benefits of PE in the region reflect win-win outcomes for investors and a broad set of societal stakeholders.

This notwithstanding, the level of penetration achieved by this asset class remains low as a percentage of GDP. There are exceptions within the region, such as South Africa. However, a case may be made that the full potential of the asset class has yet to be realized, even there.

Various countries (for example, South Africa, Nigeria, Kenya and Namibia) have enacted or plan to enact pension and other reforms to encourage investment in unlisted entities, but it is still early days. The question remains: how big a role could PE play in Africa and what may be holding it back? "It is a matter of time, as the industry spreads its wings to develop and mature, before it becomes a more notable player across Africa. The impediments include underdeveloped capital markets, regulatory constraints that slow down transactions and constraints on capital repatriation," says Michelle van der Merwe, CEO of SAVCA. She adds, "A notable constraint is the limited extent to which African institutional investors are deploying pools of capital from the continent for allocation to PE-fund managers."

In 2016 PE investment was only 0.18% of Africa's nominal GDP. Industry observers interviewed by ECN agree that the asset class in Africa is likely to grow in scale and importance in the near-to-medium term. However, it is difficult to arrive at a precise number for how large the asset class may eventually become. ECN analysis shows that every 0.01% increase in the asset class's penetration of Africa's GDP would inject an incremental US$1.1bn over the next five years: capital that Africa needs, and which GPs have demonstrated an ability to put to good use.

About The Economist Corporate Network

The Economist Corporate Network is The Economist Group's advisory service for senior executives seeking insight into economic and business trends in their key growth markets. Independent and thought provoking, The Economist Corporate Network provides clients with the information, insight and interaction they need to succeed. It is led by experts who share a profound knowledge and understanding of business issues. It has regional business groups across Asia Pacific, the Middle East and Africa.

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