Private Equity Investing in Africa

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Private equity in Africa dates back to the mid 1980s, with the emergence of the first South African based and South African focused funds. The footprint of private equity funds has evolved over time—from starting out in South Africa to now being located across most of Africa.

Economic growth projections for Africa are expected to remain relatively high, sparking intense interest among global investors. Investors are chasing the few available deals in Africa and expecting double-digit growth rates and super-returns on their investments.

A growing middle class, greater disposable income and lower oil prices are spurring the corporate and retail sectors. This, together with the need to invest in infrastructure—including transport, electricity, telecommunications as well as social and welfare infrastructure on the Government's side—is where investors or private equity funds see opportunities for real growth and sustainable returns.

Africa is definitely on the map and on the minds of many investors. Nevertheless, South Africa, which according to the World Bank is currently the continent's second largest economy, is expected to face a number of tough economic challenges going forward.

Some of the factors hindering the potential GDP growth of the South African economy are commodity prices, labour policies, electricity, rail infrastructure and the lack of a technologically advanced manufacturing sector.

Also, uncertainty in Nigeria—the largest economy in Africa—in the run-up to the pending elections as well as threats by Boko Haram, leakages in the economy and falling oil prices could have a major, negative impact on economic growth.

As governance structures and the regulatory environment improve, there will be a big push for private equity to plug the infrastructure gap in Africa. Infrastructure is seen as a high-quality asset for diversifying the risk and return profiles of funds.

How does private equity work in Africa?

Private equity funds in Africa typically follow a commitment and drawdown model, which means that investors commit a certain pool of capital at the launch of a fund and are only requested to transfer cash to the private equity manager as investments are identified or costs are incurred.

The track record and reputation of the manager enhance the capital-raising process.

Once the funds have been raised, the manager invests in specific portfolio companies over a period of five to ten years. After identifying and purchasing assets, the aim is to enhance the value of the company over a period of five to seven years and then sell the asset at a much better price than was originally paid. The targeted returns of funds are generally between 20% and 30% over the term of the fund. Some form of leverage is utilised to obtain capital efficiencies during this process.

These funds typically return capital during the course of the fund's life as investments are realised.

Private equity fund managers need to deliver a net return that compensates investors adequately for the lower liquidity and higher risk in the asset class.

Importantly, the private equity incentive model creates superior alignment between investors and fund managers. Fund managers only participate in the fund's returns after investors have received their capital back, plus a hurdle return. This means fund managers typically only start to share in the profits of a fund at the end of its life.

The combination of having to outperform liquid benchmarks over the long-term and incentive structures makes for an excellent ownership model that aligns investor, fund manager and portfolio company management interests around building portfolio companies into fundamentally better businesses.

State of the industry

South Africa

South Africa is no longer the destination of choice for private equity houses in Africa, with more funds going to Kenya and Nigeria.

The private equity industry in South Africa is increasingly more stable and established, but some of the portfolio companies are unable to match the expected returns in East and West Africa.

In fact, South African corporates are also going north in search of growth and returns. Certain private equity houses in South Africa are looking towards their investee companies to provide some traction and opportunities in the rest of Africa.

The returns provided by this asset class nevertheless remain higher than those on listed equities and bonds. Moreover, this is a sophisticated market that continues to offer opportunities for the private equity industry.

Another observation in South Africa is that fundraising once again seems to be going very well, and General Partners (GPs) are able to close their funds with support from local pension funds, insurance companies, asset managers and even global investors. Though it has taken them longer, General Partners with a good track record have closed their funds.

The challenge in the past 24 months has been the deployment of capital and identification of investments that offer value to both the seller and private equity houses. The private equity houses have not been able to get investments at asset spreads that made sense for them to do the deals. The price difference between buyer and seller has been too wide. This has improved in the last 6 to 12 months, and a few investments have been made.

The structure of deals and amounts of leverage are also more important to ensure value generation and growth in the investee companies. General Partners are now spending more hands-on time with investee companies to extract value in the longer term. They are looking to provide strategic direction, capital and growth opportunities to investee companies.

There is also more focus on infrastructure related assets. Larger pension funds are getting more sophisticated and are looking to support government initiatives for infrastructure growth and sustainable energy projects. Infrastructure bond and related money market assets are also attractive as an asset class offering good returns and security.

This is having a positive impact on investments in asset classes that will stimulate growth in sustainable asset classes and provide more active input in asset allocations.

Another interesting trend is the direct investments by Limited Partners (LPs) in certain investee companies. This has positive impacts in that there is a skills and experience transfer between GPs and LPs. LPs are building a skill set they previously did not have.

Funds and GPs are also looking at other ways to efficiently manage capital commitments and their own balance sheets and, at the same time, diversify their revenue streams.

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East Africa
New investments are increasingly targeting growth SMEs in consumer-driven sectors. There is activity across infrastructure, real estate, healthcare, agribusiness and green energy. Additionally, players are keen to see how the evolving regulatory space (especially in Kenya) will open access to pension funds as a source of capital. Private equity players have continued to stress the importance of having a professional association. Investors would like to have a unified voice and an avenue to share insights on the opportunities and realities of investing on the ground. One of the initiatives that have been put in place in this respect is the founding of the East African Venture Capital Association (EAVCA).

The current and expected growth in African pension funds with asset bases, due to rising incomes, will likely make these players look beyond traditional asset classes to diversify their portfolios. Given the long-term nature of private equity (the typical lifecycle of a fund being eight to ten years), this asset class is an obvious choice. The prudential requirements to safeguard members' assets and the confidence to manage risk, return and liquidity of private equity as an asset class will be important considerations when pension funds allocate funds to private equity houses.

In more developed markets, private equity and hedge funds are classified as alternative asset classes in the prudential regulations and given a much higher asset allocation than is currently the case in Africa.

Several countries in Africa have seen changes in pension fund regulations to allow a higher proportion of assets to be allocated to alternative classes of investments (e.g. Private Equity and Hedge Funds). We have also seen increasing regulation for the private equity and hedge fund markets.

Given the sophistication of most private equity houses in terms of fundraising, investment deployment, the provision of strategic guidance to investor companies, stringent mandates and adequate investment controls as well as due diligence, there is an opportunity to have some structure and reassurance in these asset classes. The positive spin-off for growth in these economies is evident, as it includes growth for the sectors in which investments are made, job creation, as well as other economic stimuli. An added benefit is the improvement in the skills and knowledge base, as private equity houses aim to enhance their brand and reputation for future funds.

In their search for higher returns and blended risk fundraising for East Africa, funds have been very successful and are expected to be more buoyant in the near future. Confidence in private equity houses and their ability to beat targeted returns has seen the number of funds increasing significantly year on year. Once the funds have been raised, the GP needs to identify and deploy investments.

Large companies have traditionally been owned by extremely wealthy families that receive backing from local banks. They have strong market insight and flexibility and the necessary relationships to do deals quickly. The opportunity for the GP lies in getting to know the market and environment in which it wishes to invest and attempting to use local expertise to support this. Investing in companies from afar will not work, as it is too easy to lose sight of the investments.

Proper due diligence covering financial, tax, regulatory and operational aspects of investee companies will be the safest way to deploy capital and then maximise investments.

Mauritius

Mauritius is still the preferred jurisdiction for investment into Africa. The South African International headquarter company regime, recently launched by the South African Revenue Service to compete with Mauritius into Africa has not been that successful, particularly in relation to private equity, as there are a number of restrictions on investments and shareholdings that are inconsistent with private equity.

According to statistics from the African Venture Capital Association, around 165 private equity funds are currently registered in Mauritius. The general view is that Mauritius has the most conducive enabling environment in Africa for private equity funds in terms of investment climate, perceived low political risk and availability of financial services providers backed by skilled professionals and enabling legal, regulatory and institutional frameworks.

Mauritius has emerged as an international financial centre due to its strong regulatory framework in line with international initiatives to fight money laundering and the financing of terrorist activities.

In addition, Mauritius has signed 42 double taxation agreements (DTAs) with both developed and emerging economies around the world. Six more DTAs, which are based on the OECD model, are awaiting ratification. Mauritius has become a reliable and competitive hub, where investments are structured and managed. It has positioned itself as the preferred jurisdiction for investing in Africa. Furthermore, the island has entered into Investment Promotion Protection Agreements (IPPAs), with 26 countries around the globe, in particular with eight African countries: Burundi, Egypt, Madagascar, Mozambique, Republic of Congo, Senegal, South Africa and Tanzania—thus opening a new window of opportunity. Moreover, agreements with 14 additional African countries await ratification, namely Benin, Cameroon, Comoros, Gabon, Ghana, Guinea Republic, Kenya, Mauritania, Nepal, Rwanda, Swaziland, Turkey, Chad and Zimbabwe.

Mauritius has established itself as one of the most successful financial centres because it has created a business-enabling environment that is internationally competitive and will continue to attract Private Equity Funds (PEFs) operating in Africa. The key features of this competitive, enabling environment include an established legal, regulatory, financial and institutional framework, as well as expertise in PEF administration. PEFs and other financial service firms focused on Africa are drawn to this, leading to a financial services sector that accounts for 10.5% of the country’s GDP.

To the **point**:

- There are many opportunities for private equity funds seeking superior returns in Africa.
- Funds need to understand the local markets and industry in which they would like to invest.
- Earnings growth will be the key driver of private equity investments in the next few years.

A client perspective: Rohan Dyer Head of Investor Relations, Ethos Private Equity

Ethos Private Equity is a leading private equity fund manager in South Africa.

What are the current issues affecting asset classes?
In South Africa, revisions to Regulation 28 introduced more flexible limits on retirement fund allocations a few years ago. This has widened investors' opportunity set significantly. Regulation 28 now stipulates that retirement funds can allocate up to 10% of assets under management to private equity. Many funds are still well below this limit.

Consequently, the industry is likely to benefit from substantial inflows in the coming years, as it is regarded as an attractive asset class in its own right. It is a productive contributor to the development of the local economy. In addition, diversification into private equity is a sensible strategy at a time of elevated valuations for listed markets.

What are your views on current returns?
Ethos is the most experienced private equity firm in our region. Established in 1984, we have made 102 investments since then and have exited 89 of them. We have a long track record of superior returns. The average internal rate of return on our realised assets has been 32% in dollar terms. We have achieved a 2.7x average multiple of cost on these investments, again in dollar terms.

What is the value proposition in private equity for Ethos?

Corporate social responsibility is a cornerstone of our value-adding model, especially as we operate in emerging economies. From day one of our investments, we build these elements into our investment thesis to drive the appropriate behaviour and goals within our portfolio companies. We do not view this as a box-ticking exercise; it makes good business sense, and it results in more sustainable, more attractive assets on realisation.

In South Africa specifically, we view Black Economic Empowerment as a deal enabler. It enhances our origination capacity. We have significant depth of experience and expertise in structuring and creating value for all stakeholders from such transactions.

What are your views on Africa?

The outlook for Sub-Saharan Africa (SSA) is optimistic, and growth is likely to surpass the global average by a good margin in the coming years. The IMF is forecasting GDP growth for SSA of 4.5% for 2015 and 5.1% for 2016.

There is a substantial amount of dry powder to be deployed by private equity firms across SSA in the coming years, which raises the likelihood of elevated entry multiples and disappointing returns for funds of this vintage. According to EMPEA's[1] statistics, fundraising in SSA totalled $4 billion in 2014, which was almost double the previous record year (2008).

The case for using South Africa as a gateway for investing in opportunities across SSA remains a convincing one. Although the local economy is not likely to grow as quickly as the SSA average in the next few years, it has significant advantages that compensate for that. The country is a hybrid of Developed Market corporations, financial institutions and infrastructure, with many industries exhibiting emerging market growth characteristics and return profiles. Furthermore, South Africa has a number of compelling private equity enablers: standards and execution capabilities are world class and access to debt and ease of exit both help to enhance returns.

In the 2015 edition of The World Bank report on 'Doing Business – Comparing business regulations for domestic firms in 189 economies', South Africa compared favourably with its African peers on the two criteria that we believe are the most important for private equity investors. Firstly, it ranked 43rd in the world on 'Ease of doing business', which was well ahead of Ghana (70th), Kenya (136th) and Nigeria (170th). Secondly, South Africa was 17th in terms of 'Protecting investors', which was also significantly higher than Ghana (56th), Nigeria (62nd) and Kenya (122nd).

A number of South African private equity firms are well positioned to take advantage of growth opportunities across SSA by growing the interests of their South African-based portfolio companies north of the border. Within South Africa, those firms with substantial value-add capabilities should be able to achieve good returns by enhancing portfolio company performance despite the macroeconomic headwinds.