

Guide to PE in Africa



Introduction

The African Private Equity and Venture Capital Association (AVCA) has a mandate to stimulate private equity and venture capital in Africa, and, since its inception in 2000, the association has worked tirelessly to deliver on this mandate.

Despite the current global uncertainties, the focus on Africa as an investment destination continues to grow, making AVCA's work as an independent voice increasingly vital. For this reason, AVCA is proud to present the latest edition of its acclaimed 'Guide to Private Equity in Africa' (Guide).

The Guide provides a broad overview of the private equity industry in Africa, covering the growth of the ecosystem from the Development Finance Institutions (DFIs) who began investing in Africa in the 1940s and played a crucial role in the development of private capital investment across the Continent, to the fund managers and investors whose emergence in the 1990s signalled

the advancement of the industry. Today, private equity in Africa has evolved into a complex and maturing landscape with numerous players and stakeholders.

The Guide also leverages the experience of AVCA members, providing insightful views on the evolution of private capital in Africa. In addition, the Guide provides a snapshot of some of the many opportunities attracting investors to Africa today.

Thank you to our members for their continued support in the development of this Guide, and special thanks to our contributors for lending their expertise to this important initiative.



In brief: what is private equity?

Primarily investment in unlisted companies

As an investment asset class, private equity predominantly provides investors with exposure to strategic investment in the private sector, in companies not listed on a securities exchange (*private companies* or *unlisted companies*). Often unlisted companies can offer significant growth prospects but need capital to be able to achieve their growth ambitions. As these companies are not listed on a securities exchange, they do not have access to public equity capital markets and need to obtain capital from other sources.

An alternative or complement to bank financing

Sources of capital for private companies can include banks or financial institutions for debt financing, or private equity firms, who provide equity or equity-like capital. For private equity firms, their interest in unlisted companies is one of a strategic nature across a typically short to medium-term (5-7 years) investment time horizon. To manage their investment, the private equity firm will adopt a formal strategic relationship with the company. This may include, for example, having representation on the company's board, and involvement in the company's strategic decision-making.

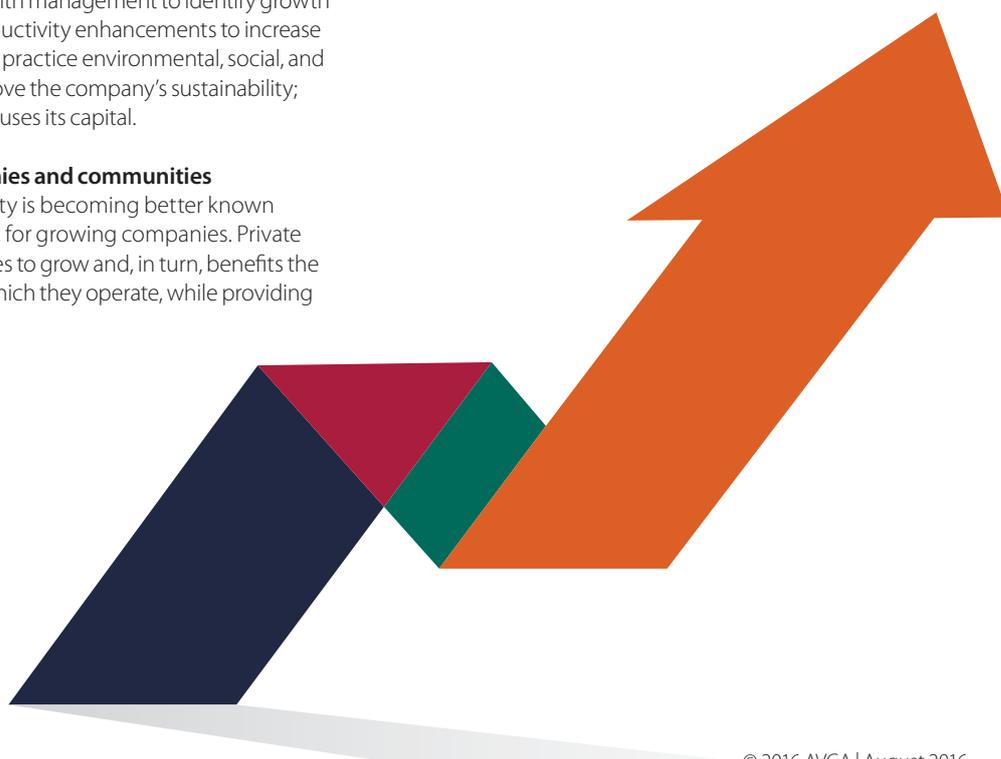
Private equity provides value-add, strategic management support

Private equity firms specialise in working with and investing in unlisted companies. The mandate of a private equity manager is characteristically based on the ability to add value to a company over-and-above what could have been achieved without their investment and strategic management support. This could be through a variety of mechanisms such as: working with management to identify growth opportunities; implementing productivity enhancements to increase profit margins; implementing best practice environmental, social, and governance (ESG) policies to improve the company's sustainability; and optimising how the company uses its capital.

A catalyst for change in economies and communities

In emerging markets, private equity is becoming better known as a source of value-add financing for growing companies. Private equity investment helps companies to grow and, in turn, benefits the economies and communities in which they operate, while providing financial returns for investors.

Often unlisted companies can offer significant growth prospects but need capital to be able to achieve their growth ambitions.



Guide to Private Equity in Africa

The evolution of private equity in Africa

A snapshot of the history of private equity in Africa

Private equity in Africa was pioneered by the Development Finance Institutions (DFIs), who had a mandate to invest in private sector businesses in developing countries. The DFIs aimed to stimulate economic growth, create jobs, develop better business standards and encourage commercial investors to also invest in these developing regions.

DFIs investing in African countries at this time included the African Development Bank (AfDB), the UK's CDC Group plc (CDC), Germany's Deutsche Investitions- und Entwicklungsgesellschaft (DEG), the European Investment Bank (EIB), the Netherlands' Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V (FMO), the World Bank's International Finance Corporation (IFC), France's Proparco, and Sweden's Swedfund, amongst others. The DFIs are strategically aligned: all investing in Africa to achieve a positive impact through building businesses, creating jobs and sustainably improving the lives of people in poorer communities.

Prior to the 1990s, DFIs predominantly supported African economies by providing loans, frequently in government-initiated development projects, then DFIs extended their activities to investing in private companies independent of government sponsored initiatives. Around this time, DFIs also shifted to providing equity capital to private companies in addition to the loans they had historically provided. This strategic shift resulted from the acknowledgement that equity investments better supported businesses to grow and prosper. More importantly, this shift provided greater alignment with the objectives of the DFI community.

Given their government ties, experience, and history in the region, the DFIs were in a good position to work with governments, policymakers and regulators. They were uniquely placed to educate these groups on the benefits of privatising assets and of private sector investment. They worked with governments to increase their openness to private sector development, reduce the legislative barriers to invest and create more enabling environments for both domestic and foreign investors.

Together, the DFIs went on to initiate the private equity industry in Africa. They introduced governments and businesses to the benefits of private capital and, by backing the pioneering Africa-focused fund managers, the DFIs created a real capacity for private equity practitioners to enter the market and build upon their achievements. While there were some early adopters, in the early 1990s, the DFIs were joined by the first wave of Africa-focused private equity firms, which largely emerged in South Africa.

By 1997, there were 12 private equity funds that had raised US\$1 billion collectively to invest in Africa. These funds were largely concentrated on investing in the South African market, but soon commenced investing in other parts of the continent including Botswana, Côte d'Ivoire, Ghana, Kenya, Mauritius, Zambia and Zimbabwe.¹

Today, there are over 140 private equity firms targeting Africa². Between them they offer an increasing array of sophisticated investment strategies varying from generalist or country-focused funds, to more sector or region specific funds, including pan-African funds. Increasingly these managers are now based around the world, with majority on ground in Africa.

DFIs continue to perform a critical role in the industry. They remain some of the largest investors in private equity funds today. They will often back first-time fund managers where others will not, which helps the manager to build a track record and supports the industry's growth.

The evolution of the industry has also increased the awareness of entrepreneurs, business owners and governments to the benefits of private equity investment in businesses, economies and communities. Sharing the success of this evolution has improved the perception of Africa and attracted a greater number of global institutions to Africa. Additionally, and importantly, this has translated into more Africa-based institutional investors investing in Africa, which is key to the ongoing growth of the industry and ultimately, the continent.

¹ How Can Sub-Saharan Africa Attract More Private Capital Inflows?
F Amar Bhattacharya, Peter J. Montiel, and Sunil Sharma, Finance & Development,
International Monetary Fund, June 1997 (Volume 34, Number 2)

² African Private Equity and Venture Capital Association.

1997 : 12 GPs

2016 : 140 GPs



What characterises private equity in Africa today?

It is primarily growth capital

Private equity investment in Africa is chiefly growth capital. There is little or no debt used in these transactions. This is in contrast to the more well-known strategies of the global leveraged buy-out private equity firms who operate in more mature markets.

In Africa, the dynamic combination of emerging industry and the demographic trajectory mean the strategies used by private equity firms to create value often focus on supporting sustainable expansion. These strategies may support the company to develop and capture more of the value chain of an industry, or to capitalise on increasing distribution channels and regional trade flows, or a combination of these factors.

It has a strong focus on environmental, social and governance standards

Globally, there is increasing recognition that strong environmental, social and governance standards are material factors in driving business value. This has long been the case in the private equity industry in Africa for two reasons. First, with strong historic and ongoing support from the DFI community, most fund managers in Africa have had knowledge, understanding and experience of improving ESG standards embedded in their operating model since inception. Second, in countries where local standards are poor or enforcement is lacking, a failure to understand ESG issues can have a significant impact on the prospects and ambitions of businesses.

Majority of fund managers consider ESG improvements integral to their approach and many have developed advanced systems and processes. These managers frequently tackle ESG issues as part of the investment strategy. This means identifying and prioritising opportunities for improvement, allocating resources and measuring and improving outcomes.

Minority stakes are prevalent

In line with the concept of growth capital, private equity firms in Africa tend to take minority stakes (less than 50%) in companies. This is typically alongside management, who remain majority shareholders.

Minority stakes in Africa are also common due to the developing nature of markets and the consequently shallow pool of executive talent. The shallowness of this pool makes incumbent management and effective successive planning important for success.

To protect their interests in a minority equity position, private equity firms typically implement contractual protections. This ensures they have sufficient influence on the portfolio company's major decisions, including its strategy and board composition.

Majority of investments are below US\$50 million

Given the stage of maturity of African economies and the significant role of private equity firms in financing the growth of small- and medium-sized enterprises (SMEs), most private equity investments in Africa are under US\$50 million in equity value. These investments are also largely unlevered.

According to proprietary research conducted by AVCA, under 80% of private equity investments in Africa were below US\$50 million, and they accounted for over 10% of the total value of investments in Africa.

We expect this level of investment to remain the norm for private equity in Africa in the short to medium term. However, as markets mature and governments continue to privatise assets, deal sizes will increase with the natural growth in the size of businesses and the need for investment in larger scale opportunities.

A place for patient capital

With the amount of hands-on support and strategic effort private equity firms in Africa apply to their portfolio companies, average investment hold periods are just over 5 years. Often businesses are not only building their operations, but also building the ecosystem to support the industry in which they are operating.

Provides exposure to sectors not represented in public markets

The private sector, rather than public markets, is the means by which investors can gain the greatest exposure to Africa's growth potential. Across Africa's 54 countries, there are only 23 securities exchanges, with around 1,500 publicly-listed companies collectively³. By comparison, the main market of the London Stock Exchange has 2,467 listed companies⁴.

To further illustrate the size of the private sector relative to public markets, in South Africa, there are an estimated 400,000 private companies compared to fewer than 400 publicly-listed companies on the Johannesburg Stock Exchange⁵.

In addition, public markets in Africa tend to be dominated by companies in mining, natural resources and financial sectors. As such, they do not fully reflect the range of industries that contribute to consumer-driven economic growth.

³ African Securities Exchanges Association 2014 Yearbook.

⁴ London Stock Exchange, as at 31 October 2014.

⁵ African Consumers: Driving the African Private Equity Opportunity, FMOFairview

According to proprietary research conducted by AVCA, under 80% of private equity investments in Africa were below US\$50 million. In terms of value, however, these investments accounted for over 10% of the total value.



Operating in Africa

Characteristics of successful private equity fund managers

Local presence and networks are key to generating value

Given the developing nature of the private and public capital markets in Africa (ex South Africa), there is limited market, sector and company research, or financial services and intermediary infrastructure. This makes understanding the market dynamics and sourcing potential investments more challenging than in markets with existing ecosystems. As a result, companies seeking capital often don't engage advisory houses to facilitate a formal auction process.

According to the AVCA and EY Africa private equity exits study, *Broadening horizons: How do private equity investors create value?*, 60% of the 207 exits surveyed were conducted on a proprietary basis, and a third were sourced via networks and relationships, with the remainder identified through company and sector tracking.

This demonstrates the imperative nature of private equity managers having a local presence and network. This will enhance their understanding of where the opportunities lie and assist in building relationships with potential target companies. Additionally, having local networks also enhances the ability to identify acquisition opportunities and exit options.

Know your team, know your company

Building relationships early with management, and conducting extensive commercial and operational due diligence is a key success factor in generating value.

Getting to know the company and its management takes time. Often SMEs and larger entrepreneurial companies don't have documented or clear strategies and business plans, making the process to evaluate performance more hands-on and time-consuming. To really understand these companies, considerable time needs to be spent working alongside management in the business.

Conducting extensive due diligence also enables a private equity manager to be better positioned to implement appropriate governance structures and operational improvements at the point of investment. This will enable it to add value to the company strategy with greater certainty of how these enhancements will likely impact company performance.

Implementation of best practice ESG standards

As noted earlier, the implementation of best practice ESG standards in portfolio companies is critical to generating and sustaining value through and beyond the deal life cycle.

The standard of ESG practices in portfolio companies in Africa tends to be high thanks to the DFIs who pioneered these practices, when they first began investing in Africa and who remain material investors in the industry today. Increasingly, best practice ESG policies and cultures are also being demanded by commercial Limited Partners (LPs), who are increasingly investing in Africa-focused funds.

ESG improvements put in place at a company will not only result in better standards for the company itself, but will also help raise the standards across the sector and impact communities.

In addition to the benefits of satisfying and attracting investors, General Partners (GPs) that value implementing transparent, accountable and productive cultures through ESG policies also achieve better financial outcomes.

Building relationships early with management, and conducting extensive commercial and operational due diligence is a key success factor in generating value.

Investing in Africa: The growing investor spectrum

As this Guide has discussed, the DFIs were pioneering investors in Africa and remain substantial investors in the industry today, through both direct and co-investments, and through investments in private equity funds.

Looking to the global LP investor spectrum, which includes family offices, multi-asset managers, funds-of-funds, endowments, foundations, sovereign wealth funds, and pension funds, amongst others, the attraction to Africa is growing.

Large global buyout firms are also setting their sights strongly on the continent and exposing their traditional investors to the growth opportunity in Africa.

In addition to the growing global institutional investor interest, Africa-based institutional investors are also increasingly investing in private equity in Africa. In the case of Africa-based pension funds, their ability to invest in private equity funds is being supported by changing regulations governing the investment asset allocation limits of pension fund assets. Kenya, Namibia, Nigeria, and South Africa have all recently made changes to the asset allocation rules of pension funds, allowing for investment, of up to 15% in some cases, of pension assets in private companies. As pension fund regulators and administrators become more familiar with the benefits of private equity, this will present a significant opportunity to increase the level of capital available to private equity funds and the private sector.

Looking to the global LP investor spectrum... the attraction to Africa is growing.



A practical view: the lifecycle of a private equity fund in Africa

Fund structures shaped by investor preference

Fund structures are predominantly based on the limited partnership model and most funds in Africa tend to be compliant with the Institutional Limited Partners Association's best practice guidelines. Fund structures typically involve a ten plus two-year term and a five-year investment period. Within these parameters, fund structures are shaped by investor preference, tax efficiency and regulatory requirements, and ensure limited liability for investors. Stable, tax efficient jurisdictions, such as Mauritius, the Cayman Islands, Cyprus, Jersey, and Guernsey, are common domiciles. Some DFIs require funds to be domiciled in Africa in order to comply with their investment criteria, which means Mauritius is a common jurisdiction to ensure funds can be supported by these DFIs.

Stronger alignment between fund managers and investors

Since the global financial crisis, investors have sought greater alignment with fund managers (also known as *GPs*) in fund structures. Compared to before the crisis, investors now have greater bargaining power on economic and governance terms, leading to a more granular ongoing review of GP performance.

Co-investments – helping to establish a track record

In addition to traditional, long-term fund structures, new fund managers or fund managers with little experience investing in Africa may seek to invest in a target portfolio company alongside an investor through a co-investment structure, or may also raise funds on a deal-by-deal basis. These structures are becoming more common for first-time fund managers, as they reduce the relative risk for investors when compared to the traditional fund structure. They can also often help build the fund manager's track record, investment reputation and investor relationships.

Investing: Some considerations

We have discussed the key elements of successful private equity fund managers in how they approach investments in Africa:

- **Local presence and networks are key to generating value:** having an on-the-ground presence favourably impacts the ability to source deals, buy well and generate value through the cycle and on exit;
- **Know your team, know your company:** conducting extensive due diligence on the company and management is a critical element of successful investments; and
- **Implementation of best practice ESG standards:** implementing transparent, accountable and productive cultures through ESG policies results in better financial and social outcomes.

These factors have been critical to driving value in private equity portfolios. Below we highlight some additional considerations that private equity managers tend to be conscious of when investing in Africa.

Between 2007 and 2015, the Exits Study recorded a total of 302 realisations by African private equity fund managers.

Investment structure flexibility will increase deal options

Private equity investment in portfolio companies can take multiple forms. In addition to simple equity, it can be structured to meet the manager's risk/return appetite and the strategic intentions of the target company.

Often SMEs may not be open to offering significant equity stakes, but would be amenable to debt-like growth capital to ensure they also have maximum exposure to the upside. In some cases, entrepreneurs want to hold on to what they have, and do not fully understand the growth potential a private equity partner could bring to the business.

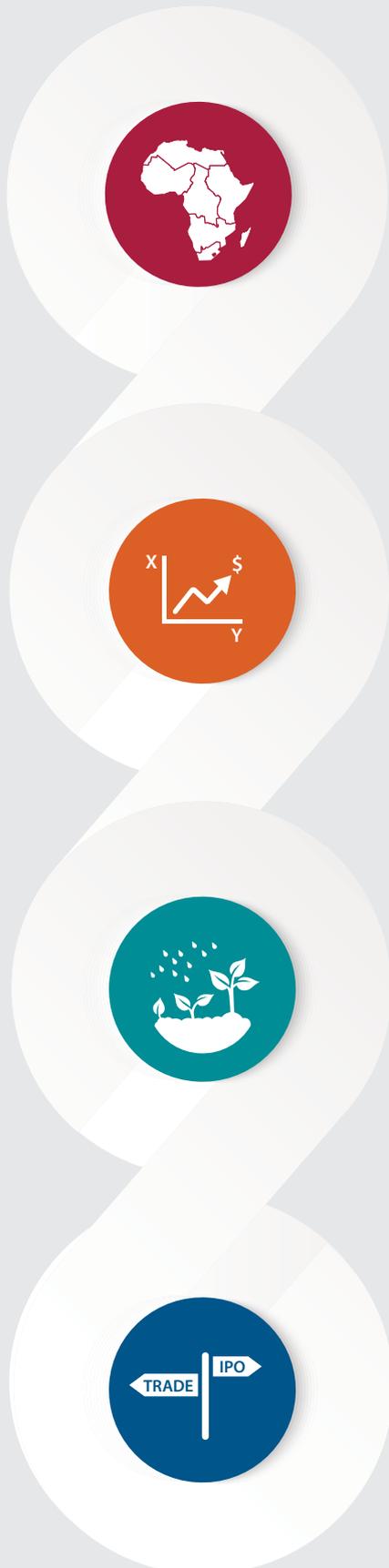
Preferential equity is a common investment instrument utilised by private equity managers in Africa. It ensures a regular profile of interest payments and has a higher ranking than common equity in the event of a default. Convertible notes are also prevalent for similar reasons, and can offer greater flexibility in the event that existing management and majority shareholders intend to remain major shareholders of the portfolio company beyond the private equity investment life cycle.

For a private equity manager, being able to work with a range and/or combination of different capital structures will provide a greater ability to review and execute on market opportunities.

Facilitate succession planning to enhance sustainability

We have highlighted the importance of knowing your team and the fact that the human capital pool is still developing in many African markets. As human capital is key to value creation, determining and facilitating succession plans, and management retention and incentive schemes are critical to creating a sustainable business and to maximising value on exit.

The most common way this is implemented is by aligning the interests of management with company value, through the retention of an equity stake, or by offering an equity incentive scheme. Simultaneously, putting in place retention mechanisms, such as "golden handcuffs" for a period post exit of the private equity firm, can add to buyer confidence.



Be aware of currency exposure in structuring funds and investments

The recent currency movements across Africa have put this issue on the center stage. Fund managers consider currency exposure and find natural hedging strategies to the extent that they can.

For private equity managers, effective structuring of the fund and the portfolio company returns to manage the currency risk is critical to retaining value. For this reason, most funds outside South Africa are denominated in US dollars.

Path to exit

Often a perception shared by those not doing business in Africa is to consider the developing nature of markets, stock exchanges, and regional trade, and conclude that private equity exits must be difficult to execute successfully. This was the genesis behind the development of the AVCA EY Africa Private Equity Exits Study, to provide the industry with empirical evidence on the exit environment in Africa, and the drivers that lead to success.

Between 2007 and 2015, the Exits Study recorded a total of 302 realisations by African private equity fund managers.

Growth in regional trade buyers

Significantly, the predominant exit route in the Exit Study's sample over this period has been to trade buyers, with trade sales accounting for 45% of exits. Increasingly, these trade sale partners are regional trade buyers, as companies seek to take advantage of the growth opportunities available from expanding across the continent.

The private equity secondaries market is nascent

With the increasing maturity of the industry, secondary buy-outs (sales to other private equity firms) have become more prevalent and accounting for an increased share of exits

As markets continue to broaden and deepen, and the industry continues to mature, more secondary buy-outs are likely to take place, and secondary-focused private equity firms are likely to enter Africa.

Entrepreneurs remain an exit option

A key experience to highlight is the number of portfolio companies exited through private sales. Under 20% of portfolio companies surveyed were exited via private sale. The majority of these were sales back to the entrepreneur. The terms of the sale back are often agreed upfront with the entrepreneur and detailed in the Shareholders Agreement, which increases optionality and reduces relative uncertainty for private equity firms.

Exits via stock exchanges: not yet material but having an impact

Exits via initial public offerings or stock sales on public markets are not yet material but are a viable exit option for quality businesses. Over 10% of all exits recorded were executed via this method.

About AVCA

AVCA: Enabling private investment in Africa

The African Private Equity and Venture Capital Association is the pan-African industry body which promotes and enables private investment in Africa.

AVCA plays an important role as a champion and effective change agent for the industry, educating, equipping and connecting members and stakeholders with independent industry research, best practice training programmes and exceptional networking opportunities.

With a global and growing member base, AVCA members span private equity and venture capital firms, institutional investors, foundations and endowments, pension funds, international development finance institutions, professional service firms, academia, and other associations.

This diverse membership is united by a common purpose: to be part of the Africa growth story.

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