AN UNTOLD STORY:

THE EVOLUTION OF RESPONSIBLE INVESTING IN AFRICA

African Private Equity and Venture Capital Association

APRIL 2018

Where ESG integration is concerned, African PE has been ahead of the curve compared with other markets, thanks to its origins.

FOREWORD

ESG and Impact have become significant parts of the investment landscape throughout the world today, with more and more General Partners (GPs) adopting an ESG policy and Limited Partners (LPs) from pension funds to family offices asking them to do this.

However, it is rarely understood or mentioned that African GPs have been doing ESG work to the highest standards for over 20 years. Our industry was started at that time by the development finance institutions ("DFIs") when private sector capital was not available, with a few exceptions, for African GPs.

This report, hopefully the first of several, highlights the basis of ESG work in Africa. It declares the fact that, where ESG integration is concerned, African PE has been ahead of the curve compared with other markets, thanks to its origins. As a GP, and on behalf of African GPs, perhaps I may be allowed to say that, while in the beginning, ESG and impact work and reporting seemed like an unwelcome cost centre, we have learnt about the commercial value of such work over the years. With good ESG policies, risks are reduced, and reputations are protected, usually resulting in higher valuations at sale. As a result, I thank the DFIs for their work in promoting ESG policies and their support of the African private equity industry.

With best regards,

Runa Alam

Chair

AVCA Sustainability Committee

PREFACE

An Untold Story: The Evolution of Responsible Investing in Africa

From the inaugural report in 2016, AVCA's Sustainability Studies have explored African private equity's adoption of Environmental, Social and Governance (ESG) standards in their portfolio companies, quantifying trends of job creation and job quality improvements in private equity-backed companies in Africa. On the back of the second edition of AVCA's Sustainability Study in 2017, which found that 80% of investee companies in Africa have ESG considerations in their process from the investment's inception, we are delighted to add further colour and detail to this narrative, by delving into the history and evolution of responsible investing and ESG policies in Africa. In so doing, we hope to show how patient capital has been, and can continue to be, a cornerstone for economic growth and sustainable development in Africa.

This report, which accompanies the 3rd edition of AVCA's Africa Sustainability Study entitled "Value Creation through Corporate Governance", charts the history of the Development Finance Institutions (DFIs) and their crucial role in popularising ESG policies in African investment. It also discusses the emergence of responsible investment strategies and, aided by interviews with industry practitioners, the different approaches found in the market. This extends from the simple adoption of ESG standards to protect value, to certain impact investing strategies that address societal challenges at the risk of below-market or non-existent financial returns. Finally, we provide an overview of the history of the African PE industry.

We would like to thank all of those who contributed to this report, particularly AVCA's Sustainability Committee's founding Chair, Runa Alam, and its members as well as Ben Zwinkels, Chairman of AfricInvest and a former long-time FMO investment officer, and Geetha Tharmaratnam, for their reviews, guidance and detailed comments. We are confident that this report, as part of AVCA's broader research programme, provides relevant and valuable insights into the African private equity industry.

Enitan Obasanjo-Adeleye

Director, Head of Research

AVCA

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An Untold Story: The Evolution of Responsible Investing in Africa

One of the more significant changes in the global investment industry over the past two decades has been the continuing rise of responsible investing approaches. This period also saw the establishment of the private equity (PE) industry in Africa, with the development finance community playing a key role as cornerstone investors. This has inevitably created an industry in which environmental, social and governance (ESG) practices have been ingrained, and which by its nature is more impactful than in other regions. For example, 87% of GPs that participated in AVCA's 2017 Sustainability Study survey reported incorporating ESG factors into the investment process for some or all of their portfolio companies. This can likely be attributed to the influence of development finance institutions (DFIs), which typically require the implementation of ESG standards as a condition of their participation as institutional investors in such funds. Whereas a 2017 survey by Greenwich Associates found that only 27% of North American Institutional investors currently use ESG principles, while a further 45% plan to do so.

This document explores the evolution of responsible investing in African private equity, while also mapping out the journey of the global private equity industry, and is intended to form a part of a series on the topic of Responsible Investing.

WHAT IS RESPONSIBLE INVESTING?

Responsible Investing (RI) can be defined as an investment strategy which seeks to generate both financial and sustainable value, and fully integrates environment, social and governance (ESG) factors into investment management. From what was once seen as a fringe interest, sustainability issues have gained prominence among global investors and across asset classes. However, it is still not tightly defined, both in practice and theory. A global definition is still to be agreed within the investing industry, although the UN's Principles of Responsible Investing, at least for the ESG part, is now being globally accepted.

ESG investing refers to a set of criteria which investors use in structuring their portfolios and assessing potential investee companies. Investors consider ESG factors when evaluating the sustainability potential in a company, and determining the risk and return on investments[1]. Increasingly, ESG standards are being seen as a key aspect of financial analysis and decision-making in the investment community as it is seen as mitigating certain types of risk and therefore helping commercial returns.

The environmental considerations include energy efficiency, recycling, waste management, pollution and emissions, and other factors of a company's operations that might have an impact on the environment. Social factors refer to issues such as community and stakeholder engagement, diversity and equality, human and labour rights, cultural heritage and conflict, among others. Finally, governance includes board structure issues, executive remuneration, and alignment of shareholder and management interests.

The broader concept of responsible investing also addresses investment approaches such as socially responsible investing (SRI), ethical investing, green investing, and impact investing. The UN's Global Impact Goals put this broader concept to the forefront, but given the many definitions and measurements of impact investing formulated by entities like the Aspen Network of Development Entrepreneurs (ANDE), the International Finance Corporation (IFC), the Global Impact Investing Network (GIIN), the German Investment and Development Corporation (DEG), and others (including the Global Reporting Initiative, IRIS, and so on), there is still discussion on a more global agreement on impact investing definitions.

It should be noted that with the exception of the DFIs named above, the formal impact investing industry emerged about 10 years ago (according to GIIN, which was founded in 2009 following a 2008 convening on the issue), while the DFI work discussed below, and especially their work in Africa, is at least two decades old.

Figure 1: ESG factors

ENVIRONMENTAL	Factors that relate to a company's interaction with the physical environment. Examples include air and water pollution, climate impact, greenhouse gas emissions, deforestation, water scarcity, energy efficiency, and site restoration
SOCIAL	Factors that relate to a company's practices that have a social impact on a community or socially. Examples include working conditions, labour relations, health and safety, human rights, impact on local communities, and child labour
GOVERNANCE	Factors that relate to how a company is governed. Examples include shareholder rights, executive compensation, board independence and composition, transparency, alignment of interests, and corporate ethics

1 UN Principles for Responsible Investment: https://www.unpri.org/about/what-is-responsible-investment

DEVELOPMENT FINANCE INSTITUTIONS:
Their History and Role in Private Sector Development

What are DFIs?

As described by the Organisation for Economic Cooperation and Development (OECD), national and international Development Finance Institutions (DFIs) are specialised development banks or subsidiaries set up to support private sector projects in developing and emerging economies. They are usually majority-owned by national governments and source their capital from national or international development funds, or benefit from government guarantees. This ensures their creditworthiness, which enables them to raise substantial amounts of money on international capital markets and provide financing on very competitive terms[2].

DFIs can be either bilateral or multilateral. Bilateral DFIs are either independent institutions, such as the Netherlands Development Finance Company (FMO), or part of larger bilateral development banks, such as the German Investment and Development Company (DEG), which is part of the German development bank, KfW. They are both among the largest DFIs worldwide. The main bilateral DFIs include: Agence Française de Développement/Proparco (France), Belgian Investment Company for Developing Countries (BIO, Belgium), BMI-SBI (Belgium), CDC Group (United Kingdom), CDP/SIMEST (Italy), COFIDES (Spain), Finnfund (Finland), FMO (Netherlands), IFU (Denmark), KfW/DEG (Germany), Norfund (Norway), OeEB (Austria), OPIC (United States), SOFID (Portugal), Swedfund (Sweden), Swiss Investment fund for Emerging Markets (SIFEM, Switzerland). Some agencies generally known for developmental work, such as USAID and the UK's Department for International Development (DFID), have from time to time done similar work to these DFIs.

Multilateral DFIs are the private sector arms of international financial institutions that have been established by more than one country, and hence are subject to international law. Their shareholders are generally national governments but could also include other international or private institutions. These institutions finance projects in support of the private sector mainly through equity investments, long-term loans and guarantees. They usually have a greater financing capacity than bilateral development banks, and act as a forum for close co-operation among governments. The main multilateral DFIs include: AfDB (African Development Bank), ADB (Asian Development Bank), EBRD (European Bank for Reconstruction and Development), EIB (European Investment Bank), IDB (Inter-American Development Bank), IFC, ISDB (Islamic Development Bank).

The current mandates of DFIs reflect the idea that the private sector plays a crucial role in fostering economic, social and environmental development. DFIs play a key part in promoting development in beneficiary countries by catalysing and supporting private sector investments. DFIs are particularly important in emerging market funds in that they often act as anchor investors to private funds or companies, providing the impetus for a first-close.

Increasingly, governments have been channelling aid funds through DFIs, which can use the money to address market failures and invest in private sector firms and funds in developing countries. According to the Overseas Development Institute (ODI), in 1990 there were hardly any investments of this kind, but by 2015 they had grown to US$65bn, equivalent to roughly half of global aid (US$132bn).

In part, the importance of DFIs has increased as the global pool of development capital has decreased. Most OECD governments now stress using aid capital in conjunction with private sector capital to increase developmental impact. One example of this relates to how DFIs (including DFID and USAID) have used their capital to seed funds, and serve as "first-in and last-out" capital, which catalyses further private capital.

2 http://www.oecd.org/dac/stats/development-finance-institutions-private-sector-development.htm

Sub-Saharan African economies have been the main beneficiaries of funding from the European Development Finance Institutions (EDFI), although the multilateral DFIs like the IFC and EIB are also investing in Africa. As of December 2016, EDFI's allocation to sub-Saharan African countries amounted to almost EUR12bn, nearly six times the value in 2005 (EUR2.4bn). Sub-Saharan Africa's share of EDFI's portfolio represents about a third of the EDFI's consolidated portfolio (compared with less than a quarter in 2005), representing the largest regional share in EDFI's total portfolio[3,4].

A brief history of DFIs

The concept of development finance emerged in the post-World War II period with the establishment of the Bretton Woods Institutions — the World Bank and the International Monetary Fund (IMF). Many European countries were in the early stages of industrial re-development and special financial institutions were set up to foster industrial growth. In the United States, DFIs came into existence for special purposes such as economic rehabilitation and to fill gaps in traditional finance. Several developing countries in Asia, Africa and Latin America have also established special financial institutions to hasten the pace of industrialisation and growth[5].

After World War II, vast areas of Western Europe had been destroyed and cities lay in ruins with millions of displaced people. Consequently, the USA launched its first major foreign aid programme, the Economic Recovery Programme, proposed by Secretary of State George Marshall. The Marshall Plan provided several billions of dollars of funding over four years in "recipient-friendly" terms, boosting the recovery in several European countries[6].

In 1956, the IFC was founded as an exclusively private sector focused affiliate of the World Bank with the goal of "fostering growth or productive private enterprise". In 1958, the EIB was established to mobilise capital to promote Europe's cohesion and modernise its economies. In the 1960s and 1970s, several bilateral DFIs were established by their governments, such as Germany's KfW, France's Proparco, OPIC in the USA and FMO in the Netherlands. These mainly provided concessionary loans to governments and public enterprises. The multilateral AfDB was also established in 1964 to promote economic and social development efforts in Africa. Between the 1970s and 1980s, some of these institutions set up subsidiaries dedicated to private sector development, providing both long term loans and equity, with typically the same ESG standards across instruments[7].

After the collapse of state socialism in Russia and Eastern Europe in the 1980s, economic and social institutions in the region were left weakened, causing DFIs to focus on strengthening both public and private institutions. However, accounting for only 1% of the economy, there was little or no private sector to strengthen; rather, the private sector had to be established, and it had to be done in an ethical manner. During this era, IFIs such as the World Bank and IFC focused on trying to create institutions, enable the private sector to operate in unregulated jurisdictions, and establish a baseline[8].

Many African nations gained independence in the 1960s and 1970s, with Africa's decolonisation concluding in the mid-1990s. After the fall of the Berlin Wall in 1989, and seeing the early results of liberalisation and privatisation in Asia, African governments, companies and DFIs established the private equity industry in Africa to grow the private sector and create jobs, driving GDP growth. As development in regions like Africa was, and still is, a key priority of DFIs, a method had to be found to provide not only money to the private sector companies but also management, technology and other such expertise. This method was through experienced private equity managers and investors who were engaged deeply with African corporates to help them get the skill sets needed to grow their companies.

What are the ESG standards that DFIs typically require?

Around the 1990s, DFIs began to consider that environmental standards should be implemented to ensure that investee companies were not contributing to pollution. At FMO, specialised employees were trained to confront these difficult new objectives. Investment Managers were slowly involved in taking environmental issues seriously within targeted companies, although creating awareness was a process of many years.

Nowadays, the IFC , CDC and FMO provide the sustainability frameworks that are most widely used by PE firms on the continent (AVCA's 2017 Sustainability Study found that 62% of portfolio companies had implemented an ESG framework using the IFC performance standards, and 28% had used CDC's ESG Toolkit).

3 https://www.odi.org/sites/odi.org.uk/files/resource-documents/11182.pdf
4 European Development Finance Institutions: EDFI Website: www.edfi.eu
5 The Indian Financial System: Markets, Institutions and Services)
6 Rethinking Development Geographies, Michael Power; Give and Take: What's the matter with foreign aid, David Sogge 2002
7 Source: Interview with Luc Rigouzzo, CEO of Amethis Finance, former Chair of EDFI and Head of Proparco
8 Source: Interview with Runa Alam, CEO of Development Partners International

The IFC's Sustainability Framework articulates its strategic commitment to sustainable development by promoting sound environmental and social practices, encouraging transparency and contributing to positive development impacts. The Sustainability framework consists of:

- The Policy on Environmental and Social Sustainability
- The Performance Standards
- The Access to Information Policy

The IFC Performance Standards are an international benchmark for identifying and managing environmental and social risk and has been adopted by many organizations as a key component of their environmental and social risk management. IFC's Environmental, Health, and Safety (EHS) Guidelines provide technical guidelines with general and industry-specific examples of good international industry practice to meet IFC's Performance Standards. IFC's Performance Standards offer a framework for understanding and managing environmental and social risks for high profile, complex, international or potentially high impact projects.

The IFC Performance Standards encompass eight topics:

- Environmental and social sustainability
- Labour and working conditions
- Pollution prevention and abatement
- Community Health, Safety and Security
- Land acquisition and involuntary resettlement
- Biodiversity conservation and sustainable resource management
- Indigenous peoples
- Cultural heritage

Where governance is concerned, the IFC also has the Corporate Governance Development Framework, which is now a common approach adopted by 34 DFIs towards addressing corporate governance risks and opportunities in investment operations in emerging markets.

In 2010, the DFI Toolkit on Corporate Governance was launched to assist in

i) assessment of the corporate governance in businesses;
ii) implementation of the Corporate Governance Development framework[9]

Like most DFIs, the IFC has very detailed ESG policies and processes, and its inclusion in a fund guarantees stringent ESG scrutiny, ensuring early identification of risks, and corrective action.

Although ESG standards are interpreted differently and emphasis is placed on different areas for each DFI, the EDFI ESG guidelines set out general principles and objectives for responsible and sustainable investment which the fund is expected to comply with, ranging from complying with all applicable laws, to minimising adverse impact on the environment and employees and stakeholders of investee companies, focusing on and continuously improving on aspects including management of the environment, social matters and corporate governance, applying international best practice standards and addressing E&S risks and realising E&S opportunities. Broadly, the EDFI ESG standards require that:

- Extensive management systems are implemented, including processes for analysing investments in accordance with ESG standards and categorising levels of risk;
- The general partner ensures compliance by portfolio companies with ESG standards where the fund has control or significant influence in portfolio companies in which funds are invested. Compliance with all legal and regulatory requirements, maintenance of high standards of business integrity and compliance with EDFI corporate governance standards is required;
- Although this only applies where the fund has control or significant influence, the general partner will need to ensure that it implements effective management and HR strategies, and remuneration standards in investee companies to ensure that the standards are adhered to;
- The fund and investee companies are required to work towards international best practice and standards in respect of environmental and social impacts. If negative environmental or social impacts are unavoidable, then they must be mitigated or compensated for;
- The fund is required to provide transparent and accountable feedback and information regarding ESG matters and is subject to ongoing monitoring; and environmental and social exclusions form part of the investment restrictions of the fund[10]. Generally this translates to an annual report to the DFIs and other LPs on a pre-agreed set of ES&G and impact criteria, including job creation, local taxes paid, etc.

As an example, the CDC's ESG toolkit is specifically designed for private equity fund managers operating in emerging markets to help integrate ESG issues into their investment process. The toolkit aims to:

- explore the business case for assessing and managing ESG risks and opportunities arising from investments;
- provide tools for integrating ESG analysis into investment decisions and investment management;
- help determine when specialist expertise is required;
- consider how to report to boards, investors and the public;

9 Source: https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/cg+development+framework/dfi+toolkit+on+corporate+governance)

10 http://www.kwm.com/en/uk/knowledge/insights/development-finance-institutions-and-their-role-in-sustainable-private-equity-investment-in-africa-20160101

- provide guidance on how to apply international ESG standards, notably those used by development finance institutions (DFIs).

The AfDB has been actively investing in Africa-focused private equity funds over the past two decades, recognising the potential of the industry in catalysing inclusive economic growth and social development. The Bank's investments in private equity funds are all subject to the Additionality and Development Outcomes Assessment (ADOA) as well as its environmental, social and governance safeguards, known as the Integrated Safeguards System (ISS).

Specifically, the ADOA is a decision-making tool developed by the AfDB to assist in the screening and selection of non-sovereign operations that the Bank could support. It provides an independent ex-ante assessment along two key dimensions: additionality and expected development outcomes. Additionality measures whether DFIs bring value added to the project that the market or commercial sources alone cannot or will not provide. The development outcomes assessment measures the adequacy of development outcomes expected from the project, including environmental, gender and social effects, among others. ADOA also plays an advisory role to improve project design, in order to strengthen DFIs' value addition and maximise the projects' development impact.

"The ESG learning curve within the DFIs has created further awareness in the key Private Equity players in Africa at present. For example, the AfricInvest Group is now operational in 25 African countries and is very active in implementing the ESG guidelines within their realised investments, showing and being examples for the future generation of Private Equity Companies.

It is proven that ESG compliance in investee companies creates not only substantially more value and better exits for Private Equity Funds, but a more sustainable private sector for the overall economy on the African continent."

Ben Zwinkels, Chairman of AfricInvest, with 30 years of prior experience at FMO

Interview with Luc Rigouzzo, Managing Partner of Amethis, former Chair of EDFI and former CEO of Proparco:

HISTORY OF EDFIS AND THEIR ROLE IN AFRICAN PE

What has been the experience of the DFIs with ESG over the years?

The ESG agenda became more relevant with the DFIs in the mid-1990s, with the adoption of a more structured and systematic approach. This trend began with the multilateral institutions such as the IFC and EIB, and then spread at the bilateral level. In 2000, Proparco worked with other bilateral institutions – FMO and DEG – to put tools in place for measuring impact. The IFC has always been at the forefront of the ESG agenda and continues to be so today.

In Europe, the three main bilateral DFIs – the French, Dutch and German – were on a similar agenda. The initial focus was on the "E", then the "G". The "S" tends to be more complicated, beyond the common factors, as each country tends to have its own nuances where social factors are concerned.

What have been some of the major achievements on ESG?

Over the last 20 years, there have been huge improvements by the DFIs in the assessment of ESG in general, such as the impact on government revenues, and the environmental impact, year-on-year. These are now reported in detail. Also, DFIs are now increasingly requesting KPIs to measure impact.

How has your prior experience as an LP influenced you as a GP?

The experience as an LP has ensured that as a GP, Amethis focuses on ESG Management Systems (ESMS) requirements that are realistic and achievable.

What are some of your key lessons learnt so far on ESG matters?

Some key lessons learnt are:

- Design the ESMS plan for the company with the objective of it being fully compliant within 18-24 months.

- There is a strong alignment of good ESG standards with financial performance – the two things are not contradictory or mutually exclusive.

THE RISE OF RESPONSIBLE INVESTING

Responsible investing has existed for as long as investments have been made, with religious organisations such as the Methodists and Quakers in the 18th century laying out clear guidelines to followers on appropriate companies their followers could consider for investments.

In modern markets, the practice became more formalised around the time that the mutual fund industry started to expand into widespread use. As the industry grew, activists recognised the opportunity that shareholders had to influence corporate behaviour. For example, the pressures placed on fund managers to avoid investing in companies operating in South Africa is identified as having played a part in bringing an end to apartheid. Responsible investing ramped up in the 1960s, when Vietnam War protesters demanded that university endowments stop investing in defence contractors, and gained momentum in the 1970s, with concerns on slavery, apartheid and fair trade. In the 1980s and beyond, environmental concerns gained more attention in the wake of disasters such as Exxon Valdez[11]. Following the issues that arose from a pipeline investment in Ecuador in the early 2000s, Citigroup established a committee of four banks including itself, WestLB, ABN AMRO and Barclays ("the Gang of Four") in 2002 to develop a framework for investing in the oil industry, initially in emerging markets. This led to the adoption of a set of principles using the IFC Performance Standards which came to be known as the "Equator Principles"[12]. From the mid-2000s, several African banks, mainly in South Africa, began to formally adopt the Equator Principles in their project finance transactions.

The grant-making approach to responsible investing began with the Ford Foundation in 1968, when it commenced making sub-market investments in compliance with its charitable purposes[13]. Investments of this type are now often referred to as program-related investments, as coined by the Inland Revenue Service (IRS) in the United States.

According to the United Nations Economic Commission for Europe (UNECE), the concept of "sustainable development" was first introduced in the 1987 report of the World Commission on Environment and Development (also known as the "Brundtland Commission"). The report defined sustainable development as "development that does not compromise the ability of future generations to meet their own needs", supporting strong economic and social development[14]. The World Bank has since formalised the concept of "sustainable development", to reconcile economic growth and environmental protection in developing countries. In 2006, the United Nations Principles for Responsible Investment (UN PRI) was released, leading to over US$60 trillion in signatories' assets as of 2017[15].

South Africa, the most mature PE market in Africa, has also been at the forefront of ESG issues. An example of this is the King Code on Corporate Governance, the first iteration of which was published in South Africa in 1994. It gained international recognition as the most inclusive approach to Corporate Governance, and the current code now forms part of the listing rules on the Johannesburg Securities Exchange. Key aspects of the King Code integrate social, environmental and social issues to include:

1. Good governance as being essentially about effective leadership
2. Sustainability as the primary moral and economic imperative of the 21st century
3. The concept of corporate citizenship[16]

In 2011, the Code for Responsible Investing in South Africa (CRISA) was launched, with principles that are aligned with those of the UN PRI. South Africa was the second country in the world, after the UK with its 2010 Stewardship Code, to formally encourage institutional investors to integrate sustainability issues such as environmental, social and governance factors into their investment decisions[17].

It is now increasingly debated in developed markets if ESG integration should be considered to be a fiduciary duty. The matter has resulted in guidance being issued for fiduciaries by the US Labour Department in 2015, and the United Nations Environment Programme (UNEP) recently stated that "it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them proper weight."

11 http://schroders.com/en/insights/global-investor-study/a-short-history-of-responsible-investing-300-0001/
12 When Principles Pay: CSR and the Bottom Line, Geoffrey Heal
13 Evolution of Sustainable/responsible investing, Russell Investments
14 http://www.unece.org/oes/nutshell/2004-2005/focus_sustainable_development.html
15 Source: Investopedia
16 Source: IOD Southern Africa, King Code of Governance for South Africa 2009)
17 https://www2.deloitte.com/content/dam/Deloitte/za/Documents/governance-risk-compliance/ZA_TheRelationshipBetweenCRISAAndRegulation28OfPensionFundsAct04042014.pdf)

A comparison of approaches to Responsible Investing: from ESG to Impact investing

Responsible investing approaches vary based on several factors which include geography, asset type, and investor type. These can range from negative screening (using selection criteria that screen out companies that have exposure to themes that are deemed to be unacceptable), to positive screening (which similarly seeks exposure to companies with desirable themes), to ESG integration, impact investing, as well as program- and mission- related investing. The specific ESG factors are typically dependent on the company, geography and/or industry-specific contexts.

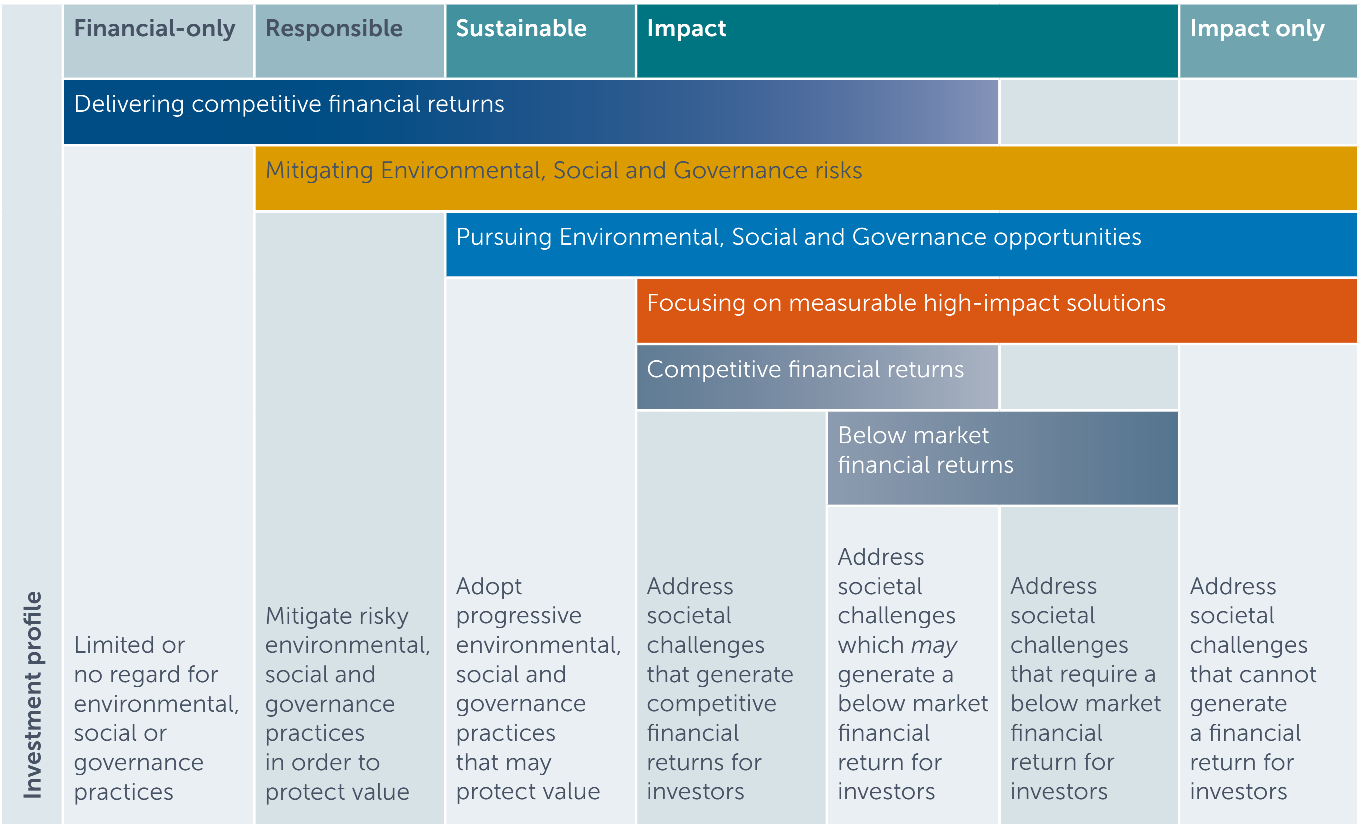
Impact investing targets investments in companies, organisations and funds with the intention to generate measurable social and environmental impact, alongside financial return. It is usually focused on themed investment strategies such as healthcare, microfinance, financial inclusion, job creation etc.

Mission- and programme-related investing typically relate to investments made by non-profit organisations that are in direct alignment with their missions and social beliefs[18].

While negative screening has been the dominant approach for investors implementing a sustainable investment programme in public markets of developed economies, this approach provides challenges for private markets in emerging economies. Although ESG integration is often thought of as risk mitigation, it also identifies significant opportunities for value creation. This approach of ESG integration has long been adopted in the African PE industry as a result of the involvement of DFIs.

A 2014 report from the G8 Social Impact Investment Taskforce, Asset Allocation Working Group provided an illustration of the investment landscape based on both financial objectives and impact objectives, which is presented in Figure 2 below.

Figure 2: The continuum of investment capital



Source: G8 Social Investment Taskforce, Asset Allocation Working Group (2014)

18 Evolution of Sustainable/Responsible Investing, Russell Investments

Interview with Edward Matsiko, Managing Partner, Pearl Capital:

IMPACT INVESTING IN AFRICAN PE

What is your approach to impact investing? How does it differ from what non-impact PE firms in Africa are doing?

We focus on measuring performance on two competing theories of return; social/environmental and financial. Hence, there is need to reach an optimal situation which we could deliver on a double bottom based return. In addition, our approach stresses the need for robust and continuous measurements of these returns in question, before opportunities can be scaled.

Can you provide an example that illustrates your impact-focused approach to responsible investing?

Our impact-focused approach can be defined as:

- Interface for smallholder farmers through either provision of market access or quality input distribution
- Employment creation
- Income growth

All investments would need to be suitable from an impact point of view based on the above metrics before further engagement.

Furthermore, impact-focused investment recognises the need to provide a foundation for growth and scalability which is necessary to attract additional capital. This foundation is mainly built around the gaps in portfolio companies by impact funds.

Do you see a trade-off between impact targeting and generating financial returns?

Not in general. In most cases, creation of viable commercial opportunities should generate substantial impact.

What are the specific challenges or opportunities of impact investing in Africa compared with non-impact funds?

Some characteristics of African businesses are: non-defined business models, weak institutions, weak management capacity, lack of capital discipline, lack of ESG standards and methods to measure ESG. Impact investing tends to find opportunities to mitigate these risks which non-impact investors do not have the risk appetite for. This is, in essence, the opportunity for impact investors.

What do you see as the future of impact investing on the continent?

The definition of impact investing will evolve depending on the stage of opportunity – start-ups versus refined business models.

Accordingly, impact measurement metrics will also evolve in line with the evolution of definitions of impact investing.

EMERGENCE OF THE MODERN PRIVATE EQUITY INDUSTRY

Though investors have been acquiring businesses and making minority investments in privately held enterprises since the time of the industrial revolution, private equity was then primarily an activity undertaken by wealthy individuals and families, such as the Rockefellers and Vanderbilts.

The early form of the modern private equity industry emerged after World War II, marked by the founding of the first two venture capital (VC) firms in 1946: American Research and Development Corporation (ARDC) and J.H Whitney & Company. ARDC was the first institutional PE firm that raised capital from sources other than wealthy families, and is also recognised as having had the first major venture capital success story with its US$70,000 investment in Digital Equipment Corporation (DEC) in 1957, which it took public in 1968 at over US$355mn.

In 1958, the Small Business Investment Act officially allowed the US Small Business Administration to license private Small Business Investment Companies (SBICs) to address the gap in the financing and management of small, entrepreneurial businesses in the US with the aim of facilitating the flow of capital to stimulate the US economy. The Act helped develop a pool of professional private equity investors by providing VC firms structured as SBICs or Minority Enterprise Small Business Investment Companies (MESBICs) access to federal funds that could be leveraged up to 4 times against privately raised investment funds.

During the 1960s and 1970s, the VC firms focused primarily on starting and expanding companies that were usually exploiting breakthroughs in technology, so VC became almost synonymous with technology finance.

The common form of PE funds used today, with the investment companies structured as Limited Partnerships, with limited partners putting up the capital and investment professionals as GPs, also emerged in the 1960s. During this era, the number of venture firms multiplied, with firms such as TA Associates (which made its first African investments in 2017) and KKR being formed. In the late 1970s and 1980s, the leveraged buyout (LBO) model focusing on more mature companies rather than VC investments in growth-stage companies gained prominence, marked by events such as the 1989 LBO of RJR Nabisco, which was the largest buyout transaction for nearly 17 years[19].

19 Source: Wikipedia

THE EVOLUTION OF PRIVATE EQUITY IN AFRICA

Having largely been established in the 1990s, the private equity industry in Africa has a relatively short history.

The first African PE funds were in South Africa, firstly with Ethos, which was formed in 1984 and originally named FirstCorp Capital Investors before being renamed in 1998, and Brait Private Equity, launched in 1991. Ethos's first fund was a US$100mn captive fund of First Merchant Bank which operated from 1984-1991[20]. Both funds were country-focused.

In 1995, FMO started actively working with local partners and commercial banks to create small SME Funds through the Seed Capital Fund from the Dutch Government. Interesting initiatives were undertaken in countries like Ghana, Cameroon, Tunisia, Zambia, Kenya, Côte d'Ivoire and even in Zimbabwe. Technical assistance was also made available in order to train local investment managers to later become experienced private equity fund managers.

One of the first multi-country funds was the New Africa Opportunity Fund for Southern Africa, a US$120mn fund that was launched in 1996 and sponsored by Overseas Private Investment Corporation (OPIC). It was taken over by Zephyr Management in 2000 and renamed ZM Africa Investment Fund (ZMAIF). OPIC also established the US$150mn Modern Africa Growth and Investment Fund in 1997, and the US$350mn New Africa Infrastructure Fund in 1999[21]. Early investors in the Modern Africa Growth and Investment Fund, which invested in East and West Africa, included Citicorp, Société Générale and Archer Daniels Midland[22]. Helios Investment Partners were selected by OPIC to co-manage the fund in 2004 and exited in 2007. Pioneering funds in North Africa include Egypt's Citadel Capital and Tunisia's Tuninvest-AfricInvest.

The first larger fund which generated equity returns for its investors was the AIG African Infrastructure Fund, which invested approximately US$350 million into Africa.

In East Africa, the Acacia Fund was founded in 1996, as a VC firm backed by AfDB, CDC Group, and Swedfund. The Acacia Fund was an early investor in AfricInvest and Emerging Capital Partners (ECP). Cauris Management launched its pioneering fund in Francophone West Africa, Cauris Investissement , in 1995 and African Capital Alliance, Nigeria's first PE fund manager, launched its first fund, CAPE I, in 1998.

Prior to the 1990s, DFIs mainly supported African economies by providing loans, frequently in government-initiated development projects. DFIs then 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 an advantageous 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.[23]

Pension funds investing in PE

Beyond the DFIs, pension funds have also been significant participants in African private equity. Since 2012, and ever more so today, global pension funds have been involved in ESG and some are now requiring ESG audits as part of their investment.

The Government Employees Pension Fund (GEPF) is Africa's largest pension fund, with over R1.6 trillion (~US$0.1trn) in AUM. The Public Investment Corporation (PIC) manages the bulk of the GEPF portfolio and works closely with GEPF on ESG issues. South African pension funds were limited to having no more than 5% of their holding in unlisted assets until 2011, when the limit was raised to 10% in private equity. GEPF's mandate allows PIC to allocate up to 5% of its assets to other African economies, with most of that allocation targeting private equity due to the limited liquidity in the stock markets. It first started investing on the African continent beyond South Africa in 2008. GEPF signed the UN PRI in 2008, setting an example to the South African retirement industry that responsible investing should no longer be a secondary investment consideration.

20 Private Equity in Emerging Markets: The New Frontiers of International Finance, D Klonowski.

21 Promoting US Investment in Sub-Saharan Africa, R. Hendrickson

22 http://www.panafricancapital.com/funds/

23 AVCA's Guide to Private Equity in Africa, 2016

Interview with Noel Eklo, Chief Executive Officer, Cauris Management:

HISTORY AND FUTURE OF ESG IN WEST AFRICAN PE

Which DFI investors were in Cauris Management SA?

The West African Development Bank (BOAD) and PROPARCO remained shareholders of the management company Cauris Management (CM) from its creation in 1997 to its acquisition in 2011 by the management team.

What was the influence of your DFI investor (if any) in your fund and portfolio companies from an ESG perspective?

ESG impacts from the DFIs led to the GP/Fund (i) setting up an Anti-Money Laundering and Combating the Financing of Terrorism Policy in 2009 and in 2013 to the development of an ESG risks management system; (ii) the appointment of an ESG staff who regularly participates in training. Deploying these systems/plans during pre-investment due diligence missions enables them to identify the ESG risks inherent to the potential companies likely to enter the portfolio, to make the sponsors aware of the consequences linked to the eventual realisation of these risks and the opportunities that may arise from their better consideration, and to implement an action plan to correct these risks.

Do you have examples or case studies that can illustrate the impact that ESG integration has had on your investments?

Yes, we have several. Eau Technologie Environnement (ETE) produces in mineral water in Benin under the Fifa de Ste Luce brand: CM has contributed (i) to the modernisation and upgrading to international standards of the production unit, (ii) to strengthening the information and management system. This unit is certified ISO 9001 version 2008.

Sodigaz, a bottling unit of butane gas in Togo: CM worked for the training of the workforce in terms of safety, maintenance of the production unit, and the implementation of administrative, financial and accounting procedures.

Azalaï Hotels, an African group of hotels chain: spurred on by CM, the group has developed a number of procedures allowing it to manage ESG issues (including hygiene and food safety, health and safety at work, code of good practice in terms of fight against money laundering and the financing of terrorism, etc.) and has equipped most of its hotels with wastewater and waste treatment facilities.

Cipharm, a pharmaceutical production unit in Côte d' Ivoire: CM worked for the realisation of the implementation study of a waste incineration unit, the upgrading of the unit of dry form, and closely follows the collaboration with a specialised operator for the treatment of waste and the consideration of fire safety recommendations.

AWI, a soap and table oil production unit in Côte d'Ivoire: CM monitors the implementation of the corrective measures identified in the context of the investment. This entails the assessment, management and control of ES risk and impacts in accordance to the ILO's best safety, security, quality control and working practices. The company has also installed a wastewater treatment system.

What has been your experience in terms of evolution of ESG practise in Francophone West Africa from Fund 1 to your current fund?

There is an increasing awareness of companies and their shareholders/leaders for the integration of ESG issues into the investment and management of their business. But this has a financial cost that can sometimes be a brake.

What is your view on the potential for ESG implementation and responsible investing to lead to strong financial returns?

We are convinced that better ESG risk management will ensure long-term and optimal return on investment.

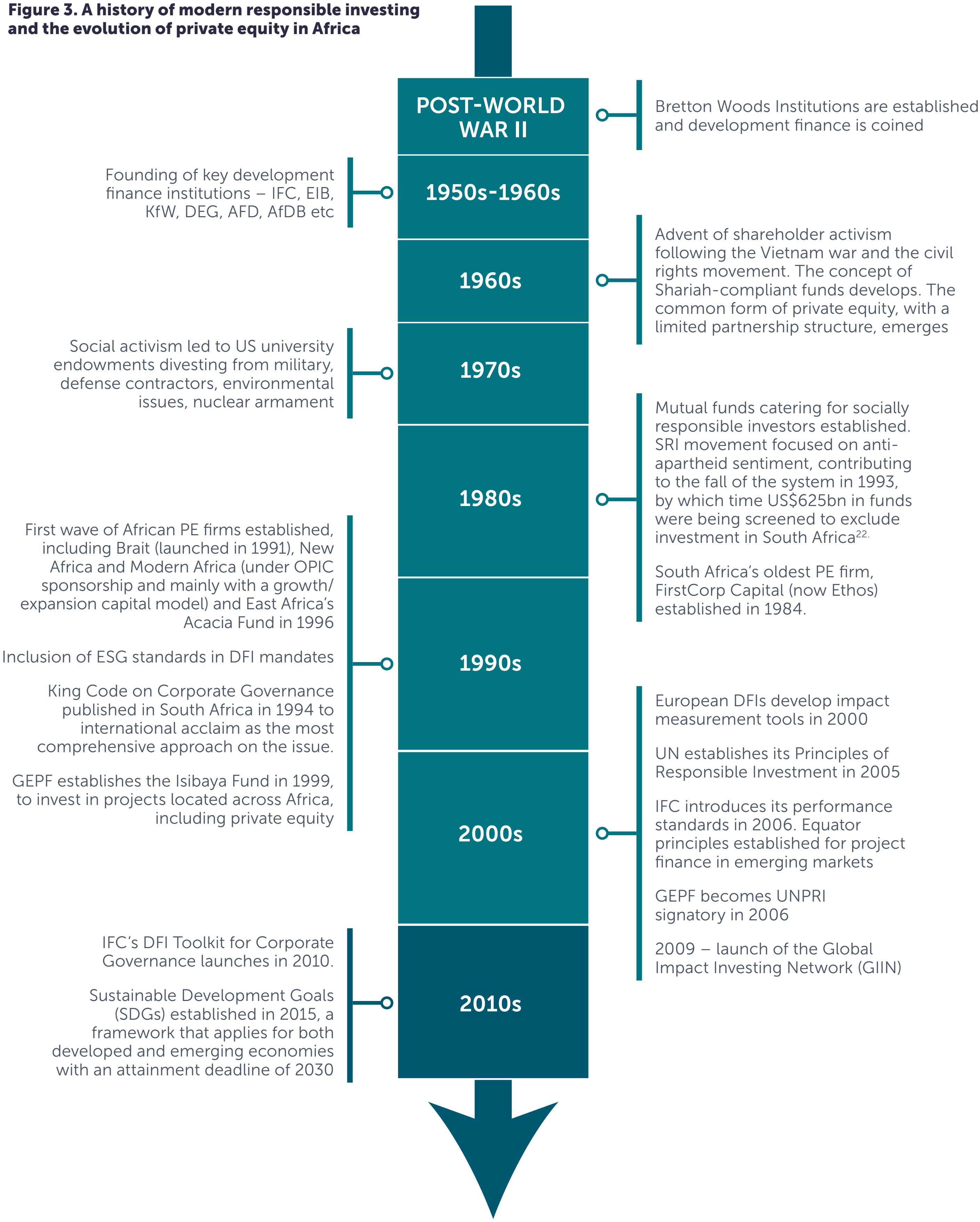
CONCLUSION

Due to its origins, fund managers in the African PE industry typically invest for development outcomes that encompass financial returns, economic impact, ESG performance, as well as for strengthening the private sector. Fund managers on the continent allocate more time and effort to ESG issues than in more developed markets, even for funds that are not explicitly impact focused.

This investment approach is a sustainable investing approach that imposes a long-term view that aligns well with the nature of the private equity asset class. In addition, private equity's activism enables the integration of these factors in portfolio companies in a way that is not possible with more passive investments, which can at best screen for, but not implement, ESG standards in investments.

Though the practice of responsible investing will continue to build momentum, a key barrier to its advancement is the perception that it is a trade-off for financial return. However, given its history, the African private equity industry can provide rich examples of ESG factors being the key driver of value creation.

Figure 3. A history of modern responsible investing and the evolution of private equity in Africa



22 "Evolution of Responsible Investment", UN PRI, April 2017

Interview with James Magor, Manager, Responsible Investment, Actis:

ESG IN PRACTICE IN AFRICAN PE

What is your approach to responsible and/or sustainable investing?

Over the last 70 years, Actis has gained a wealth of experience of investing responsibly in growth markets. At the heart of our responsible investing ethos is the idea that managing ESG issues is not simply about mitigating risk, but about creating value.

ESG challenges can be particularly acute in the growth markets in which we operate, but we go beyond risk mitigation and spotting cost savings opportunities. We have found that addressing ESG issues can set a company on track for achieving good, or even, best practice, and is a proven way of creating value, boosting returns and delivering strong financial performance for investors. It can also have a transformative impact on the workers, communities and markets in which our companies operate.

We are convinced that 'values drive value', and this underpins the way we select, manage and exit investments in all sectors in which we operate. With value creation as the goal, the key to success is identifying which ESG issues are material and focusing on these. We succeed because we have a deep knowledge of our sectors and regions which we combine with our in-house ESG expertise. This means we understand the ESG risk/opportunity profiles of our business, and we develop effective ESG value creation plans.

Before we invest, our due diligence process is designed to highlight any gaps in ESG management so that, if we decide to invest, we know how we can strengthen those areas of weakness. We also spend considerable time with management teams of potential portfolio companies, to ensure we agree on what needs to be done. This is key as it ensures we have alignment of mindset, and it secures senior support for embedding responsible practices across the business.

The responsible investment team has an important vantage point across all the Actis' companies and sectors, and we are highly focused on bringing this experience to bear when working with our companies. To codify our knowledge, we have developed toolkits and frameworks to help 'fast track' ESG improvements so our companies do not have to reinvent the wheel. We take a highly practical and commercial approach. We share our expertise of what constitutes industry best practice and develop detailed roadmaps to arrive at that outcome. We also share 'lessons learned' and connect companies so they can benefit from each other's knowledge and experience.

We seek to apply international standards to the businesses we back, many of which are in markets that lack strong regulatory frameworks with inconsistent enforcement. This means that adhering to rigorous international standards is vital for creating the right conditions for improvement. IFC standards, for example, are very exacting, and we believe that striving to adhere to these brings about sound management practices in our businesses – and that creates value for investors.

In your view, are ESG principles well-developed in African private equity?

As LPs, the DFIs have played a significant role in instituting core responsible investment principles within African, and Africa-focused, private equity fund managers (GPs). Historically, the DFI LPs have tended to place an emphasis on ESG management systems and process documentation but increasingly they are focussing on fund manager's ESG capacity, the quality of pre-investment ESG due diligence and the implementation of corrective action plans. This LP influence appears to have been the initial catalyst for the development of ESG principles in African private equity and, in the majority of cases, these elements – management systems, due diligence and corrective action plans – represent the basic foundations of responsible investment and the core ESG principles.

In terms of whether ESG principles are 'well-developed', there is a relatively wide recognition of material ESG risks and the essential ESG risk-management principles that must be adopted by GPs in order to raise capital from DFIs (typically the seed investors in new African PE funds) and, for GPs managing investments in infrastructure projects, there is a good understanding of DFI and Equator Principles lenders' ESG requirements. However, ESG principles in African private equity do not always extend much beyond these most fundamental risk management and capital raising requirements so, in that sense, they could be further developed. The integration of ESG issues into value creation strategies (as opposed to corrective action plans) is not yet uniformly adopted across the continent and ESG issues can often be seen as a discrete work stream, to be 'ticked off' once completed, rather than integrated into investors and company's business strategy.

What is your outlook on the evolution of ESG integration as the African private equity industry matures?

The message that ESG integration drives value is widely recognised to the extent that it has become the ubiquitous catch-phrase of presenters and panellists at ESG, Responsible Investment and Sustainability conferences. As the industry matures, I believe (and hope) that the African private equity industry will accept the 'ESG/value' link as an established truism, akin to the importance of sound legal advice and thorough commercial due diligence, and adjust the focus towards the identification of the material value drivers and implementation strategies.

CASE STUDY

VALUE CREATION THROUGH ESG INTEGRATION:
DPI & BIOPHARM

Development Partners International (DPI) is a pan-African private equity firm with over US$1bn of assets under management.

About the Company

DPI's fund invested in Biopharm in March 2013, taking the opportunity to partner with the leading local player in Africa's second largest pharmaceutical market, Algeria. Biopharm was established in 1991 as the Algerian pharmaceuticals sector was being privatised. Today, it is the leading indigenous pharmaceutical company in Algeria with an estimated 12% share of the pharmaceutical market.

ESG Achievements

During due diligence, DPI developed an ESG Action Plan, based on international best practices including the IFC Performance Standards, and following which key ESG-related milestones were set.

Throughout the life of the investment, DPI continued to work with the company on the improvement of ESG Standards as it carried out monitoring visits of Biopharm's head office and facilities in Algiers and reviewed performance against the ESG Action Plan.

In 2015, Biopharm became the first company in the market to receive accreditation by the French National Agency for Medicines (ANSM) for one of its production lines, allowing the company to export to France and the rest of the European Union.

Several other achievements were completed by Biopharm with the support of DPI, notably the installation of a waste water treatment plant for the main production facility, the first of its kind in Algeria. The plant allowed Biopharm to go above the mandatory environmental requirements and standards in terms of waste treatment.

Biopharm also started the implementation of a rigorous ESG management system, ISO 14001. The standard provides assurance to company management and employees, as well as to external stakeholders, that environmental impact is being measured and improved.

As ESG considerations are gaining increasing attention in Algeria and in the rest of Africa, Biopharm was able to create lasting value, with the support of DPI, thanks to its commitment to environmental protection and sustainable development.

DPI Development Partners International

بيوفارم Biopharm

ABOUT AVCA

Championing 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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