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Private equity in Africa

Context, opportunities, and risks

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Overview

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In many ways private equity - with its combination of capital and management expertise - is a perfect fit for Africa. As the scale of the Africa's potential has become recognised among the investment community, private equity has provided an opportunity for those who want to both contribute to, and benefit from, Africa's growth story. But on the ground private equity has also helped innovative and dynamic African companies, their ambition limited only by a lack of capital and experience, drive forward some of the most exciting new prospects and business leaders on the continent.

Africa's potential is clear, but the 'Africa Rising' story will face rigorous testing in 2015. Headline growth remains strong, but African markets are facing arguably the toughest macroeconomic environment since 2008, with falling commodity prices and a strengthening dollar presenting challenges for governments' fiscal management. Politics too will be scrutinised, with over a third of the continent's population going to the polls in 2015. While the Nigerian result has provided a resounding boost to democracy in Africa, investors across the continent will continue to watch carefully for the impact of politics on both stability and the business environment.

The arrival of big international funds is a sign of confidence in private equity in Africa, although obstacles for practitioners remain. These include: weak and evolving regulatory frameworks; shallow capital markets; and a scarcity of big deal opportunities. Overcoming these obstacles, and adapting to the demands of doing business in Africa is at the heart of the challenge. For those with the appetite to take it on, the focus on big markets - Nigeria and South Africa - and traditional sectors - energy and mining – are being bolstered and even overtaken by exciting opportunities in new markets in both West and East Africa, and a focus on telecoms, finance and FMCG as investors look to unlock the opportunity of rapidly rising disposable incomes.

While the complexities and variety of doing business on the continent is impossible to capture, this short document highlights some of the most important insights and most pressing questions for private equity in Africa.

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Macroeconomics

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Key themes and trends

After the debt cancellations of the mid-2000s African governments successfully employed counter-cyclical policy through the 2008 crisis, highlighting improved macroeconomic management. However, failure to tighten policy since then, in combination with widening current account deficits, has raised concerns about the vulnerability of the 'African Lions' to external shocks. In this context, falling commodity prices and a strengthening dollar will provide stiff tests of African macroeconomic resilience.

- Since the peak of 2011/12 prices for key African commodities have fallen significantly, not least oil which has approximately halved in price since July 2014. The impact varies widely; the damage to the five oil and gas 'mega-producers' who make up around 85% of the continent's output will be balanced by the majority of African nations who are net oil importers. The fall in the price of other commodities such as gold and copper have also been important, with the return of Ghana and Zambia to the IMF highlighting the dangers of overreliance on future commodity revenues.

- African economies will also be tested by the strengthening dollar which - driven by the unwinding of QE and strong US growth - has risen significantly against the continent's key currencies, especially those tied to commodities or pegged to the euro. For those African countries which have accessed international capital markets this threatens both higher debt service costs in domestic currency terms, and the possibility of higher interest rates. With the launch of the ECB's QE, Europe is replacing the US as the source of cheap money. New financing opportunities may arise, but a net tightening of global liquidity will make investors more discerning and may lessen risk appetite.

- African economies are arguably encountering their toughest macroeconomic environment since 2008. Headline GDP growth remains strong, although the IMF has cut its 2015 forecast for sub-Saharan Africa from 5.75% to 4.5%. Many governments' finances are less resilient than they were, and investors will be looking beyond headline growth figures to assess their state of health.

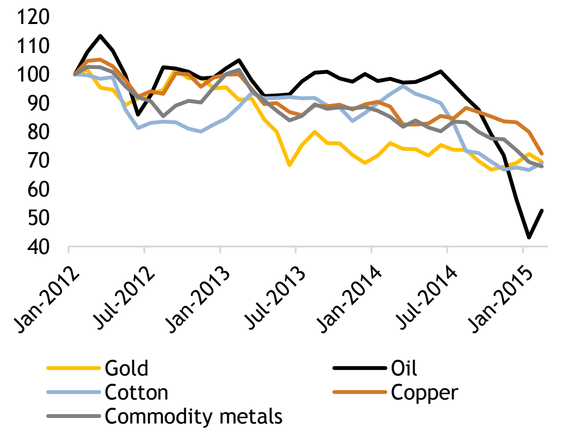
Limping lions?

Selected macroeconomic indicators (%GDP, 2014 estimates)

	Fiscal balance	Gross debt	Current account balance
Angola	-4.1	38.4	4.1
Ghana	-7.8	65.3	-9.9
Kenya	-6.0	44.7	-8.0
Mozambique	-9.2	51.4	-48.4
Nigeria	-1.7	10.6	3.7
South Africa	-4.9	47.9	-5.7
Tanzania	-5.0	42.1	-13.7
Zambia	-5.2	32.4	1.9

Falling commodity prices

Prices for selected commodities (index 100 = 1 January 2012)



Source: IMF, EIA, World Gold Council, International Coffee Organisation, National Cotton Council of America

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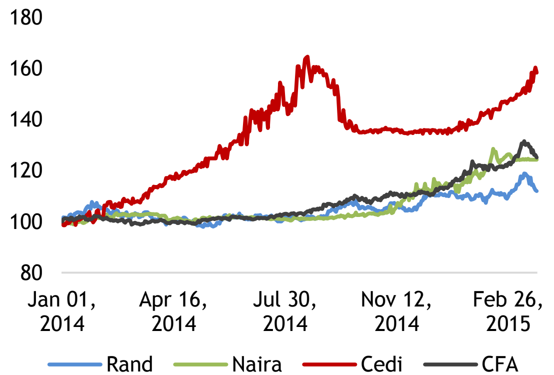
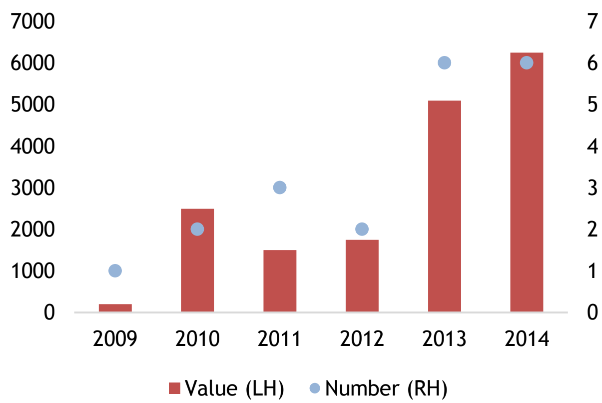
The strengthening dollar
Selected currencies against the dollar
(index 100 = 1 Jan 2014)



Sub-Saharan Africa sovereign bond issuances
Value ($mn), number by year



Source: Investing.com, ODI

Questions for private equity

- To what extent are African economies more vulnerable to external shocks than four years ago? Are Ghana and Zambia's recent return to IMF lending programmes country-specific, or do they tell us something more structural about macroeconomic stability on the continent?
- To what extent are we entering a 'new normal' for lower commodity prices and how are private equity strategies being directly and indirectly affected?
- What impact will the rapid growth in African sovereigns accessing international capital markets have for private equity funds and African economies more widely? Is this the next step for maturing African capital markets, or are governments exposing themselves to unnecessary downside risk?
- How are macroeconomic decisions elsewhere – particularly monetary policy at the US Fed and the ECB – affecting the environment for African investment and growth? What are the consequences for private equity funds coming to the market?

Politics and policy

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Key themes and trends

With approximately a third of Africa's population going to the polls in 2015, investors are focussing on politics and political stability. Nigeria's election was a landmark event for democracy in Africa, but raised questions over the sustainability of politics based largely on identity. For private equity investors who want to grow companies over the long term, the political and policy impact of increasingly youthful electorates will also be important to watch.

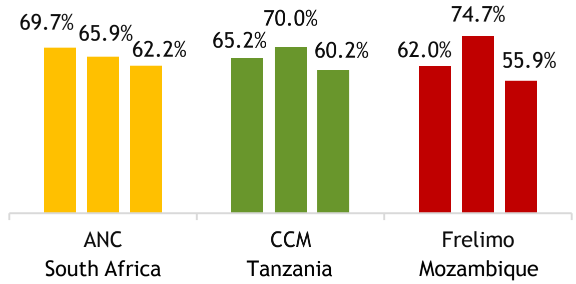
- Nigeria's peaceful handover of power was the most important event in the country's democratic history and gave the lie to predictions of post-election chaos. However, many within the APC are familiar faces, including president-elect Buhari and a cast of PDP defectors, raising questions over how transformative their victory will prove to be. After a 'policy-lite' campaign, investors will be watching Buhari closely for hints on his policy programme, particularly his cabinet appointments and approach to corruption.

- Africa's demographics are arguably the continent's most important political fact. After last year's ousting of Blaise Compaoré in Burkina Faso some even suggested the beginnings of an 'African Spring'. More widely it has been argued that youth populations with little invested in the status quo will cause instability where job creation cannot keep up. Broadly this has yet to emerge, but young Burkinabe demonstrated that youth can be a potent political force. They also pose difficult questions for parties who have dominated their nation's politics relying on loyalty derived from defining historical events – revolution, independence or civil war. With ever fewer having experienced these events first-hand, more and more voters may demand performance in job creation, service delivery and good governance as the price of their vote.

- Democracy in Africa has consolidated and even expanded over the last ten years, but politics in many countries remains dominated by regional, religious and tribal cleavages rather than ideology or policy. The resulting contest between groups for control of the resources of the state – the 'politics of patronage' – continues to undermine governance and foster corruption.

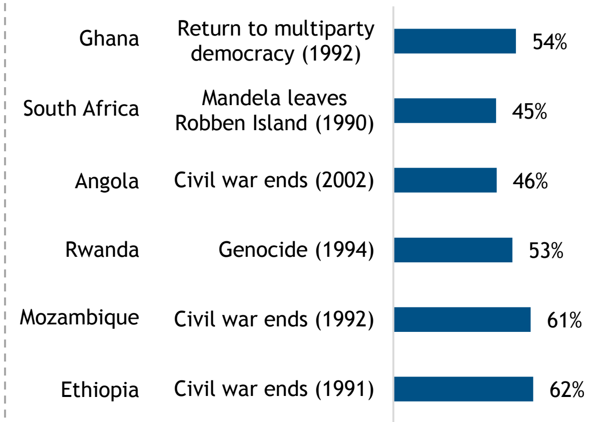
The erosion of dominant party support

% popular vote at last three elections



The shortening memory of African electorates

% population born after selected national events



Source: UN Population Division, GC calculations

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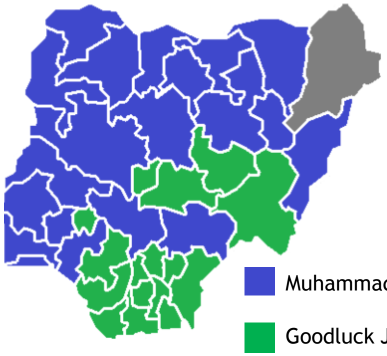
Buhari's Nigerian victory
Election result by state



Corruption remains a serious challenge
TI Corruption perception index (/100, Highly Corrupt = 0)

TI CPI	Countries
70 - 61	Botswana
60 - 51	Mauritius, Seychelles, Cape Verde
50 - 41	Sao Tome & Principe, Swaziland, Senegal, South Africa, Ghana, Rwanda, Namibia, Lesotho
40 - 31	Tanzania, Sierra Leone, Mozambique, Mali, Cote D'Ivoire, Malawi, Ethiopia, Djibouti, Niger, Liberia, Gabon, Zambia, Burkina Faso, Benin, Algeria, Egypt, Morocco, Tunisia
30 - 21	Zimbabwe, DRC, Chad, Republic of Congo, CAR, Kenya, Guinea, Uganda, Comoros, Nigeria, Cameroon, Madagascar, Togo, Gambia, Mauritania
20 - 11	S.Sudan, Eritrea, Guinea-Bissau, Angola, Burundi Libya
10 - 0	Somalia, Sudan

Source: INEC, Transparency International

Questions for private equity

- How important are politics and policy for private equity funds when they make investment decisions, beyond a basic requirement for political stability?
- How significant is the new APC government for Nigeria, the region, and the continent? What impact, if any, will the Buhari administration have on the investment climate in Nigeria?
- Will the dramatic demographic shifts on the continent threaten political stability? How are governments and political parties reacting in terms of politics and policy – and what is the likely impact on the investment climate?
- Can the big African markets such as Nigeria and Kenya move beyond the 'politics of patronage'? If not, what are the implications for doing business in terms of networks, political interference and corruption?

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The practice of private equity in Africa

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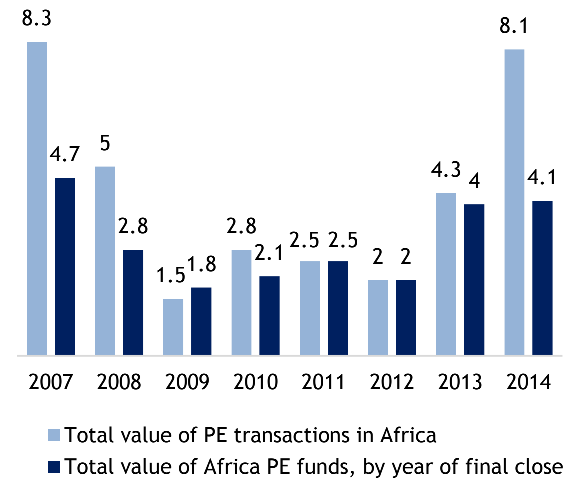
Key themes and trends

Private equity is an important source of growth capital and operational and management expertise, but General Partners continue to face barriers and challenges. These broadly fall into three categories: outsider perceptions of Africa and the African opportunity; regulatory and legislative barriers; and access to capital. Fundamentally these are the challenges of working in a private equity market which is still relatively young.

- The ‘Africa Rising’ narrative has gained traction in Europe and the US, but at $8.1 billion transaction values in Africa are only just reaching pre-crisis peaks. Ensuring that investors who are unfamiliar with Africa get comfortable with the market’s characteristics - a scarcity of large deals, longer holding periods, limited exit options, and relationship heavy transactions – can still be a challenge. For many international funds an important step in explaining the African opportunity has been establishing local presence and local expertise.
- Local regulatory frameworks can also be an obstacle as policymakers and regulators take time to become familiar with private equity. Multiple jurisdictions and restrictions on private equity operations, including access to local capital such as domestic pension funds, exchange controls, local content requirements and ownership restrictions are still a problem. Developed frameworks in Nigeria and South Africa could drive regional regulatory harmonisation, but progress is slow. International regulation too has increased funds’ liabilities with the passing of the UK Bribery Act and US Foreign Corrupt Practices Act, highlighting the importance of corporate governance.
- Shallow capital markets at the local level remains one of the most pressing operational problems for private equity in Africa. Corporate bond markets outside of South Africa and Nigeria remain virtually non-existent and stock exchanges are very illiquid. Regional integration could address some the problems, with progress for example being made in linking the stock exchanges of Nigeria, Ghana and the Ivory Coast under the West African Capital Markets Integration Council, but there remains a long way to go.

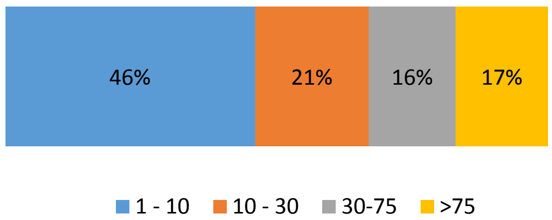
‘Africa Rising’ is slowing gaining traction

Value of Africa PE funds, PE transactions by year ($bn)



Deal sizes remain small

Exits by entry EV ($mn)



Source: AVCA, EY

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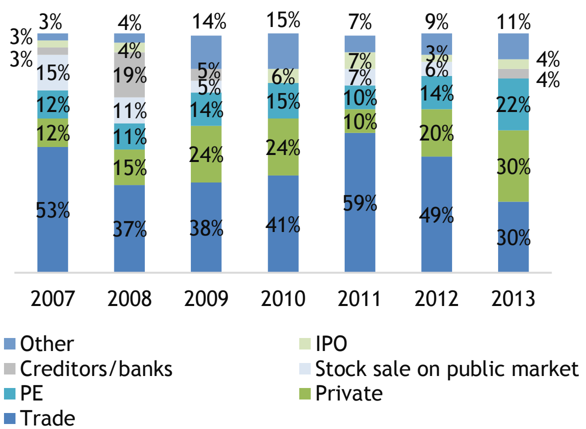
Questions for private equity

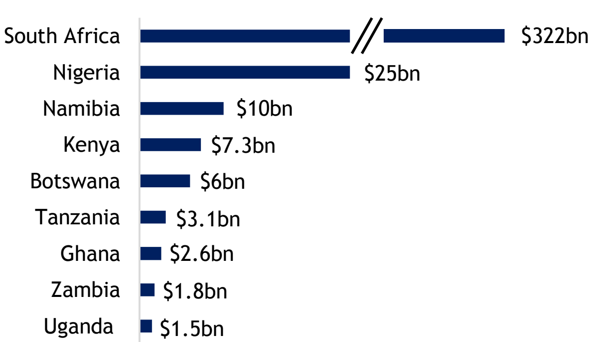
Exit strategies remain a strategic issue

Exit route, by year



Domestic pension funds on the continent

Pension fund assets under management



Source: AVCA,EY, EMPEA

- Is the 'Africa Rising' narrative still generating interest among investors? How do funds ensure that interest translates into actual investment – particularly given the scarcity of experienced fund managers in Africa?
- What are the biggest regulatory barriers which limit opportunity on the continent, and where are examples of 'best practice' emerging? Are private equity funds doing enough to engage with government and regulators to drive regulatory harmonisation? Are there alliances which could be built with local partners behind a policy and regulatory reform agenda in key markets?
- How important are relationships and local partners, and how does this contrast with the more traditional 'transactional' private equity model? How can relationships be leveraged to help develop private equity as an asset class in Africa, including with other private equity funds, DFIs, and local pension funds?
- How can international private equity funds best ensure that they are compliant with international anti-corruption legislation – is there a specific role for DFIs here?
- To what extent do private equity funds have to adapt their investment strategies specifically for the African market – particularly given the predominance of growth equity and paucity of exit options?

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Opportunities for private equity in Africa

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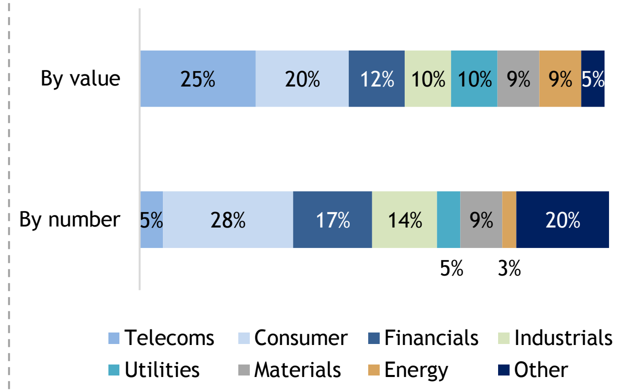
Key themes and trends

The arrival of big international funds has signalled a coming of age for Africa private equity. However, with increasing volumes chasing limited opportunities in favoured sectors – particularly the consumer and financial sectors – entry pricing has been driven upwards for larger deals. Geographic concentration in Nigeria and South Africa has also seen investors looking harder at opportunities in rapidly growing markets in East and West Africa.

- With the largest economies, most developed regulatory frameworks and deepest capital markets, private equity has long been focussed on South Africa and Nigeria. Investors are however increasingly looking at East Africa and other parts of West Africa, especially where there is potential for regional expansion. Whether this is a sign of confidence in new markets or nervousness about Africa's larger markets remains an open question.
- The rise of the African 'middle class' has sometimes been overstated, but rising disposable incomes in combination with Africa's dramatic demographics are compelling and as a result over half of all private equity investment since 2007 has been into telecoms, consumer and financial services. Investors have particularly seen opportunities in telecoms as the mobile phone becomes a platform for business. However, given the scarcity of these opportunities on the continent entry values for attractive assets have been pushed up. Private equity funds will be looking for the next big African story, with one of the biggest questions being whether Africa can follow East Asia through diversification into manufacturing for domestic and international markets.
- Many of the larger funds have been looking to acquire pan-African companies, seeking both scale and diversification of country risk. However, beyond financial services and energy there are few 'ready-made' pan-African companies and the challenge for most investors will be to identify regionally significant companies which have the potential for cross-border expansion. Where real pan-African opportunities arise competition is likely to be fierce, and potentially expensive.

Private equity investment by sectors

Private equity transactions in Africa 2007 - 2014



Private equity investment by geography

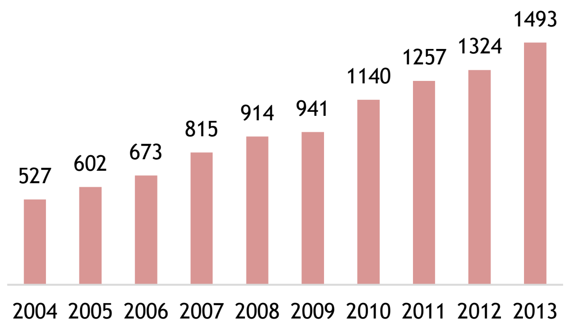
% share of transactions 2011 - 2014

Region	Share of transactions 2011 - 2014
West Africa	25%
South Africa	24%
East Africa	18%
North Africa	14%
Southern Africa	7%
Central Africa	5%
Multi-region	7%

Source: AVCA

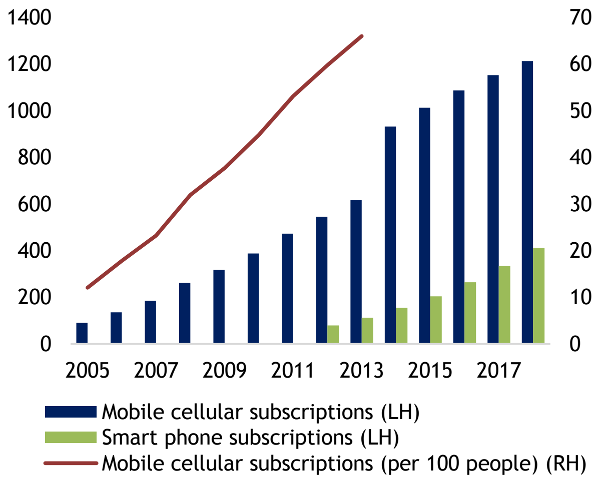
Household consumption triples in a decade

Africa household final consumption expenditure ($bn)



The mobile continent gets smarter

Subscriptions for mobile and smart phones



Source: World Bank WDI, Informa Telecoms & Media

Questions for private equity

- What are the implications of the concentration of private equity investment in Africa both by sector and geography? Are higher entry multiples causing investors to look outside the FMCG, financial services and telecoms sectors which have dominated investment to date? If so, where are the sectors which deserve more attention and where are the next opportunities for private equity emerging on the continent?
- How effective are sector-specific strategies across a continent which is so large and diverse? Are regional funds more likely to succeed given the importance of local knowledge?
- Are investors feeling more comfortable with markets outside of South Africa and Nigeria? What has been behind the recent investor attention on East Africa, and how sustainable is it?
- What can the development of private equity markets elsewhere tell us about the future for the African market, or will its development be unique?

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We advise on a range of policy issues - including trade policy, competition, financial regulation, mergers and acquisitions, sustainability and supply chain management - in a range of sectors – including financial services, TMT, energy and resources, and industry - and across markets in Europe, Russia, the Gulf, China, South East Asia and Africa. For more information, please visit www.global-counsel.co.uk

Our ambition at Allen & Overy is to help the world's leading businesses both maximise the opportunities that globalisation presents and meet the potential challenges. As our clients have sought new markets, so have we. We are continuing to invest in a growing network of international offices that covers Europe, Africa, Asia Pacific, the Middle East and the Americas. With 46 offices in 32 countries, our footprint is among the largest of any legal practice.

As a demonstration of our commitment to develop our presence in growth markets and our continued investment in Africa in particular, we opened an office in South Africa in 2014, building on the success of our launch in Morocco in 2011. Both our Johannesburg and Casablanca offices are key platforms for A&O's strategy in Africa, enabling us to build on our existing African business. In addition to our presence on the ground, we have a dedicated Africa group comprising over 100 lawyers from across our network of offices. Over the past 20 years, the group, together with selected local counsel, has advised clients on numerous large-scale international transactions across the continent, providing an integrated service for clients doing business in the region. For more information, please visit www.allenovery.com

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Notes

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