United Nations
Economic Commission for Africa

Ninth
African
Development
Forum

Private equity in Africa

Issues paper

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I. Introduction

1. What Africa has achieved over the past decade is noteworthy: average growth rates of 5 per cent and inflation in single digits. Moreover, an increasingly stable and predictable economic and political environment has lessened the risks for business investors, thereby giving companies more confidence to exploit profitable investment opportunities in Africa. According to a report published by the McKinsey Global Institute in 2010 entitled *Lions on the move: the progress and potential of African economies*, the rate of return on investment in Africa today, even adjusting for the real and perceived business risks, is higher than in any other developing region. In addition, Africa has vast reserves of natural resources, including platinum, gold, diamonds, chromite, manganese, phosphates, copper, coal, cobalt, iron ore and uranium. It is also home to about 12 per cent of the world's oil reserves, and has huge swathes of arable land and forests.

2. However, Africa should not only be seen as a source of natural resources. The continent's population of nearly 1 billion represents a burgeoning consumer market. Indeed, according to McKinsey, Africa's combined consumer spending power is projected to increase from $860 billion in 2008 to over $1.3 trillion by 2020, with the number of households with discretionary income set to soar by 50 per cent, to reach 128 million. Such growth is being fuelled by the rise of the middle-income group (it is estimated that the number of middle-class households will increase by almost 50 per cent between 2010 and 2020) and the high rate of urbanization in many countries. In addition, there is an increasingly large pool of well-educated, enterprising English-, French- and Portuguese-speaking workers. These demographic dynamics provide the potential for investments in areas other than natural resources, and private equity investors could easily tap into this huge market for consumer goods and services. In short, Africa is very much in the spotlight and affords tremendous opportunities for investors.

3. There are, however, some caveats to Africa's promise. First, although Africa is a dynamic and growing region, considerable challenges and risks remain. Second, the continent's growth is often couched in figures such as gross domestic product, but what really matters is how such growth is shared out. If growth is not inclusive and broad-based, people will not feel that they are part of Africa's promise. It is true that Africa's population is young and growing, but there are still large segments of the population that do not have enough money to cover their basic daily needs. Third, Africa's story is also about the continent's position vis-à-vis the rest of the world. The continent needs transformation, and with that comes competitiveness. Fourth, one has to be cautious about treating Africa as a single basket: countries vary from one to the other, and differences regarding education, the health system and rule of law matter. Lastly, Africa needs a strong political agenda in order to address challenges such as its infrastructure deficit.

4. What does all this mean for private equity investors? The following sections will attempt to answer that question by analysing the issue of private equity in Africa in terms of the trends, opportunities and challenges, and what Governments need to do to promote and enhance their role in support of national development efforts and Africa's transformation in general.

II. Understanding the asset class

5. Raising capital for investments is one of the biggest challenges facing many African entrepreneurs and economic operators due to, among other things, the very high and uncompetitive rates offered by commercial banks. Businesses traditionally get funding from banks and public equity markets (or bonds and debt markets), but private equity offers an alternative to

this. A company with growth prospects that needs funding can approach private equity players who will, after analysing the risk-return potential, provide a combination of debt (sourced from a bank) and equity (which they raise from institutional investors) to that company. The private equity investment horizon is anywhere between 5 and 10 years and at the end of that period, the private equity fund managers have to trade their equity shares, which is known as “exiting”. In more developed markets, exiting often happens by listing the company on a public exchange through an initial public offering. Private equity offers the potential, therefore, to fill the funding gaps currently holding back many local companies in Africa.

6. There is an urgent need for a massive capital infusion to finance a number of crucial projects in Africa in areas including infrastructure with particular emphasis on projects under the Programme for Infrastructure Development in Africa (including road and rail networks, energy and water), mineral resource exploitation, agrobusiness, industrial development and economic diversification in general. Investing in such opportunities could be a lucrative venture for private equity players and other investors, while also helping to create millions of much-needed jobs for Africa’s growing population and to lift people out of poverty. Agriculture in particular represents an enormous opportunity, because it is so important for Africa and brings in much of the continent’s wealth. Examples of possible agricultural investments include agricultural extension services to provide information and know-how, and storage facilities for farmers. Africa also needs impact investing. This is hugely promising because of the political pressure to provide basic services, which means that any group that wanted to support investments in this area would likely get the support of the Government.

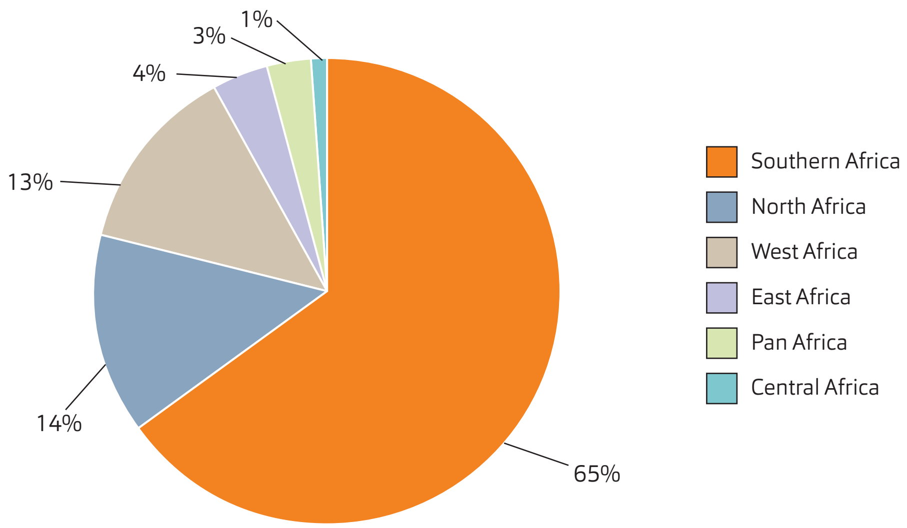
III. Private equity deals in Africa

7. About 8 to 10 years ago, the concept of private equity was not well-known in Africa. These days, we are seeing more and more capital coming to Africa, and private equity is being discussed in many forums, which shows that the industry is gaining traction. Data from leading firm Preqin, which tracks private equity trends, revealed that the second quarter of 2013 was one of the strongest private equity fundraising quarters of recent years, with 164 funds securing an impressive $124 billion in aggregate capital. Indeed, statistics from the past three years indicate that there are some significant investments being made in the private equity industry. According to the African Development Bank, investment deals in Africa are reported to have increased from $890 million in 2010 to $3 billion by 2011, an increase of some 30 per cent. Meanwhile, according to estimates by the African Private Equity and Venture Capital Association, $1.14 billion was raised from institutional investors in 2012 for Africa-focused private equity funds, and there are another 50 funds currently in the market that are targeting a similar aggregate amount. Ethos Private Equity alone (a South African fund manager) is reported to have raised some $900 million.

8. Figure 1 shows how private equity deals are distributed in Africa. In past recent years, Southern Africa has dominated, with about 65 per cent of private equity deals, followed by North Africa (14 per cent) and West Africa (13 per cent). Central Africa accounts for just 1 per cent of private equity deals.

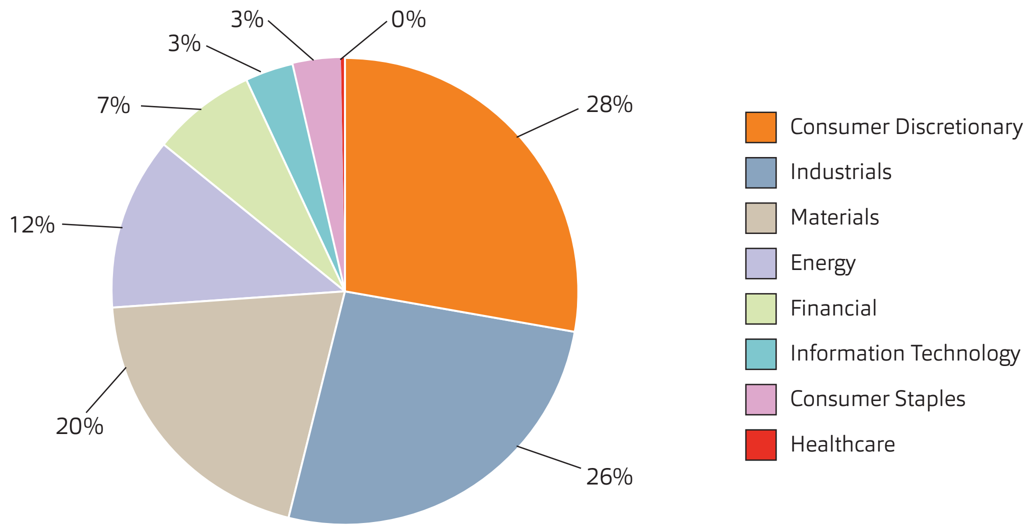
9. Not all sectors have attracted private equity investment. Investors have been very careful in identifying sectors that would easily grow and bring returns (see figure 2). For instance, investors are unwilling to put their money into the health-care sector because of the long term returns.

Figure 1: Private equity investments by subregion



Source: RisCura.

Figure 2: Private equity investment in Africa by sector, between 2006 and 2012



Source: RisCura.

IV. Challenges of private equity in Africa

10. Despite the positive narrative surrounding Africa as the "next frontier" for investments, investor perceptions in terms of the cost of doing business in the continent remain an area of concern. For one thing, the continent's sheer physical size, geopolitical fragmentation and weak infrastructure continue to make it an expensive place in which to do business. For another, fundraising in the private equity industry remains a major challenge. Foreign investors are always more comfortable when a funding team has managed to attract local money first, but there is a general lack of local investors in the private equity sector in Africa, with the possible exception of South Africa.

11. Deal-flow in Africa is mainly proprietary and generated by the personal networks of fund managers. Indeed, nearly half of all deals are sourced via networks or relationships, while one third are identified through company and sector tracking. Recently, however, there has been an increase in capital flows from general partners belonging to the African diaspora, whose remittances play an important role in the continent. Additionally, in South Africa, a change in the pension act has allowed local pension funds to quadruple their private equity allocation to 10 per cent, in line with more established public pension funds such as those of the United States of America and Canada.

12. Capital flow restrictions between African countries and the rest of the world represent another major challenge. Many countries are reluctant to open up their financial systems for fear of abuse, and most of the continent's financial systems are underdeveloped, making it difficult for capital to flow. In some cases, delays in processing paperwork and lengthy reserve bank approval procedures for moving funds further hamper the private equity industry. Other challenges include high borrowing costs (interest rates of up to 40 per cent in some countries); high taxation rates; a lack of experienced and proven African fund managers; and not enough institutional platforms for discussions between private equity players and Governments on issues affecting the industry. Indeed, many African Governments are not conversant about the industry and the scope of private equity operations, even within their own country.

V. Role of Governments

13. African Governments have a key role to play in promoting private equity as an important potential source of investment for national growth and development, and Africa's transformation in general. Policymakers have a multitude of levers available to make Africa a preferred destination for private equity capital, as opposed to competing regions such as Asia and Latin America, by enhancing the continent's investment attractiveness. The importance of private equity investment is underscored by the fact that those countries which have progressed the most are also those which have to date attracted the greatest share of private equity capital. The particular areas requiring government attention include the following:

A. Understanding private equity and its contribution to growth and development

14. Private equity on its own is not a driver of economic growth or upliftment, but it can be a catalyst and accelerator for growth, provided that there is already significant positive economic momentum.

B. Improving the legal and regulatory environment

15. First, the private equity industry needs policies and regulatory frameworks aimed at fostering its growth. In order to develop such policies, policymakers need a deeper understanding of the industry. Second, most private equity funds in Africa are currently registered in countries with favourable tax policies, good regulations and flexibility regarding the free flow of funds. No private equity player wants to set up a holding company in a country where there are restrictions about transferring funds in and out, and investment laws need to be improved to make it easier for private equity players to do business. Third, African investors cannot move around as easily as foreign investors, which deters investments; Governments should enact policies that encour-

age local investment as much as foreign direct investment. In this regard, implementing protocols on the free movement of people and capital throughout Africa will be key if the continent is to improve the private equity industry.

C. Building the talent pool

16. Private equity is effective only when managers are prudent in using capital to grow businesses sustainably. However, in Africa, the industry is still new and the continent lacks experienced fund managers. Governments should create an enabling environment for Africa to attract and retain more talent in the form of skilled managers with operational experience, in order to help the industry to grow.

D. Creating awareness among key private equity players

17. Some African Governments have very little knowledge about the industry. Policymakers need to understand what issues are affecting and impacting the industry, including political risk. Moreover, there is little or no engagement between private equity players and regulators, resulting in communication gaps.

E. Improving the availability of funds for the private equity industry

18. Finding adequate financial resources for the private equity industry remains one of the biggest challenges for many African countries. As a result, there is an urgent need to explore ways in which Governments could facilitate the flow of capital into the private equity industry. Despite the fact that pension funds are currently not invested in companies that are listed on African stock markets, let alone in those that are not listed, African Governments should be encouraged to explore investing pension funds into private equity. Governments should also be encouraged to explore co-financing and co-sharing opportunities with private equity investors, such as infrastructure financing in the energy, telecommunications, and water sectors.

F. Encouraging the investment of African capital into the private equity industry

19. In order to build the African private equity industry, the sourcing of local capital markets and funds needs to be accelerated. There is also a need to improve the knowledge of local African investors through education, a better understanding of the asset class, incentives and a regulatory framework. There are significant sources of local capital (such as pension funds, family offices, sovereign funds, high net worth individuals, diaspora Africans) that could be tapped both for the investment and exiting of private equity assets.

G. Encouraging more impact investments

20. Although assessing the impact of private equity on the welfare of people is not an easy task, a number of private equity firms are in one way or another investing in projects that have an impact on the lives of people. Adequate consideration should be given to investing in sectors that could change the lives of ordinary people, all while making decent returns. In this regard,

Governments should provide special incentives to encourage private equity firms to invest in sectors such as agriculture, which employ some of the continent's poorest people.

VI. Issues for discussion

A. Improving the availability of funds for the private equity industry

21. In the light of Africa's continuing funding challenge, there is a need to find ways for Governments to facilitate the flow of capital into private equity.

a. How can Governments encourage the use of pension funds for private equity investments?
b. How can Governments co-finance and co-share opportunities with private equity investors, such as infrastructure financing (in sectors such as energy, telecommunications, and water)?
c. How could development finance institutions get more involved in developing projects that are attractive and palatable to private equity investors?

B. Encouraging more impact investments

22. Impact investments that have direct and indirect positive effects on human well-being (education, health, employment, and the environment) are a necessary form of private equity that needs to be further encouraged.

a. How can private equity firms extend their investment portfolios by putting their money into key sectors such as agriculture?
b. How can private equity investment into small and medium enterprises (which is where most jobs are created) be encouraged?

C. Enhancing the role of Governments

a. African investors cannot move around as easily as foreign investor, which deters local investment. What policies should Governments introduce to encourage local investors as much as foreign direct investment?
b. What should Governments do to accelerate the implementation of protocols on the free movement of people and capital throughout the continent?
c. What should Governments do to accelerate African regional integration in areas such as trade facilitation and infrastructure networks, with a view to increasing the continent's investment attractiveness?
d. How can Governments encourage the private equity industry to support national development efforts?