Private Equity: The Outlook for Africa and Emerging Markets Part I

In this two-part interview, Knowledge@Wharton takes a look at the state of play in private equity in Africa and at prospects for emerging markets more generally, based on a conversation with Michael Rogers, EY's global deputy private equity leader, and Stephen M. Sammut, senior fellow and lecturer at Wharton. In Part I, Rogers notes that in Africa, "the PE ecosystem is beginning to mature. As that begins to improve, the capital markets improve, and I think that we'll see a very attractive environment for private equity over time." In Part II, Rogers notes that PE is one area where a slowing economy can also present opportunities because pricing plays such a key role in later performance. And Sammut says that while some economies are suffering at the moment, "things tend to change fairly quickly in the emerging markets. So things that look negative this year can very easily turn around in the next." An edited transcript follows:

Knowledge@Wharton: Welcome to Michael Rogers and Steve Sammut to Knowledge@ Wharton as they offer their views on private equity in Africa and other emerging markets. Michael is EY's global deputy private equity leader. And Steve is a senior fellow and lecturer at Wharton. He follows private equity closely and he's also active in the market.

Steve, you literally are just off a plane from Africa. I want to ask you for your latest impressions. And I want to give one bit of context before we start: Since 2000, the size of the sub Saharan economy has more than quadrupled.

Stephen M. Sammut: If you look at what's happened in Africa over the last 15 years, that quadrupling is visually apparent in most of the African cities that I've been to. I arrived last night from Nairobi. That was my fourth trip since May there. I run a program in health care management at one of the universities, Strathmore University. And I'm very tied in with the local private equity community, which has largely been using Nairobi as a hub. So I get reports on what's going on virtually everywhere else in Africa.

It's difficult to explain to someone who's not been to Africa just what's going on. Many of us grow up with very romantic visions of what Africa is all about. The African sunset has become a cliché almost in imagery and parlance. But I think what's really happening there is that most of those societies now have, for the most part, set aside conflicts and are in their nation-building phase.

They've seen the ravages of poor adherence to constitutions, they've revised their constitutions. They're trying to have much more democratic processes and elections. The banks have become much more disciplined and internationalized. In fact the American, European and Chinese banks have become active so there's a very positive flow of capital. That's great for the economics textbooks.

What that doesn't capture is the level of excitement and positive attitude that you find among most Africans, particularly the younger Africans, and there are a lot one of younger Africans. We're looking at many of these countries, half of their populations are under 18 years of age. And they are interconnected. Cell phone penetration is huge. Smartphones are now penetrating the market. This is a generation, or young generation, that knows what's going on in the rest of the world and they want to participate. As a consequence there's a high premium on access to education - parents value education in tremendous ways, make enormous sacrifices to send their kids to school. All the energy that you can imagine in a vibrant economy is there.

And while I was there on this trip, president Obama made a historic trip. And given his father's Kenyan ancestry, you can only begin to imagine the level of excitement. They even coined a term for it, Obamania. And it wasn't just Kenya, he went to Ethiopia as well and they basically put on a show as to what the future holds. And it's promising. And all of these things add up to extraordinary opportunity for the private equity sector and as well as an emerging venture capital sector.

Knowledge@Wharton: There's a new survey out by EY -- the "Africa Attractiveness Survey." It notes that the continent is currently the world's fourth most attractive investment destination. Back in 2014 it was actually the second most attractive. And one of the reasons that it slipped is because of oil prices. But what's interesting based on what Steve is saying is that only five years ago Africa was near the bottom of the list. It was number eight.

So some of the reasons as I mentioned for the step down are oil prices, some slowing growth in South Africa and also the slow down of China. So there's some commodity business there that has slipped. But I think the main point is that only five years ago Africa was near the bottom of the list and they're bouncing towards the top now. Would you discuss that and what that means for private equity in Africa?

Michael Rogers: Steve, having just gotten off the plane, gives a real sense of what's going on there locally. This was our fifth "Active Attractiveness Survey." There are obviously these long-term trends towards the consumerism … and the younger population. However, Africa did see some stronger headwinds over the last year…. Only 53% said the opportunity has improved there, versus 60% in 2014. So not a dramatic change, but it did dip down.

It's really still seen as one of the better places to invest. I think you mentioned it is number four on the list, had been as low as eight…. But [regarding] the historic perception of the political risk, some of the instability and corruption remains a significant barrier. The Ebola outbreak just put the breaks on some investment, possibly, and lowered demand for commodities. China's slowing down is really changing the mix on a global basis for the need for commodities. And given some of the countries are resource-intensive, that does tend to put a drag on the economy. Oil prices look to remain lower for some period of time here, right? So that's going to put a little bit of a cap on the driver growth in some of the faster growing economies.

But recent FDI [foreign direct investment] numbers show a mixed picture. There are still some countries that are receiving above-market, above-trend FDI. But others have shown some slowdown in that arena, as we've seen in many of the emerging markets. But particularly from a PE perspective, Africa's following a pattern we've seen in other markets, where the competition at the larger end of the deal spectrum is having impact on multiples. PE will have to be careful amid the excitement that Steve touched on not to get into the over payment mode. And I know that they're looking at that very closely.

And while we see a great deal of opportunity overall in PE in Africa, despite some growing pains, we saw KKR come into Ethiopia. Carlyle's been making a big presence there as well and importantly, there is the growing middle class. The PE ecosystem is beginning to mature. As that begins to improve, the capital markets improve, and I think that we'll see a very attractive environment for private equity over time.

Sammut: I agree with that assessment. And it is very much the case that we've seen some unprecedented capital formation just in 2015 with at least two, and quite possibly three funds at the billion dollar mark or greater than billion dollars. And whenever this has happened in other markets, it has foreshadowed challenges with valuation and pricing. So there will be stresses to be sure in private equity.

Knowledge@Wharton: There is another item from the EY Africa Attractiveness Survey, which was interesting. That survey is based on interviews with 500 international decision makers, two-thirds of whom have operations in Africa. It notes that nearly 70% of respondents expect Africa to improve over the next three years as a place for companies to establish or develop activities. Yet, opinions were diametrically opposed depending on whether one's company has operations in Africa or not. So companies that have operations in Africa found Africa to be the most attractive destination in the world. And those that did not have operations there found it to be the least attractive.

Sammut: I can give maybe more of a sociologic than statistical perspective on that. For the most part the media treatment of Africa has not been kind until very recently, even this past year with the Ebola outbreak as Michael had mentioned. There's plenty to be negative about: terrorist activity in Nigeria, as well as in Kenya; the ever-present problems in south Sudan; the restlessness in Somalia. These are things that the media seizes upon and it paints a picture of the continent that is not inexact, but emphasizes perhaps the wrong things.

What you don't hear about is the positive sides of urbanization. You don't hear about the improvements in education and in health care for the most part -- modest but nevertheless, improving infrastructural issues.

The things that make a region more accommodating to business just are not emphasized in the media. In fact, if you were to go back 15 years and just pick out covers from *The Economist* magazine you could put on a nice display showing how Africa was presented as, I'll use the term, a basket case, to now where there's, at least among people who are looking at it and taking the risk, very positive attitudes.

It becomes very difficult to shake those perceptions. And it doesn't take much to derail interest in Africa or a willingness to invest. And the other unfortunate aspect is Africa's a big continent. It's 1.1 billion people, or so, more than 50 countries on the entire continent. And what is true in one country is oftentimes far from the truth in another. So we haven't done a good job in the media and we really haven't helped the situation with a significant amount of solid academic research on what's going on in Africa to help change these perceptions.

Knowledge@Wharton: Some analysts have noted that when there's some political unrest in one emerging country, everyone starts to pull their money out of all emerging markets. But actually risks vary within a country, within an industry. And some companies could be in a very risky country and industry and still, that company itself might not have that much risk. Give us your take on this regarding Africa.

Rogers: We have continued to see emerging markets get bucketed a little bit. These countries many times couldn't be further apart in terms of their political process and their perception as global economic players. But they do sometimes get lumped into bigger groups.... And we definitely saw that a few years ago when everything was about the emerging markets. No one wanted anything to do with the developed world. They were taking capital from developed markets and moving it into emerging markets. Then it seems to have kind of reversed itself in some ways. We've labeled it as a rebalancing in that many are just looking for stable, consistent investment in places that over the long term that will make sense for their portfolio.... But there is a little bit of a knee jerk reaction to global geopolitical issues at times....

But to answer your question on how those who are [in Africa] seem to have a much more positive view than those who are not: Steve hit a number of the economic issues that you could look at and make business decisions on, but not until you go there and meet the people and see the excitement in their own view of the world, in their view of Africa. It's not lost on them that they have these challenges, that they've suffered over time and that they are in a sense trying to pull themselves out of those historic challenges….

What's amazing to me is when I meet the people there, and talk to the business owners and entrepreneurs on the continent about how much they really see the opportunity, and they see the chance to grow businesses, to attract capital, to improve the quality of life for people there. It's very difficult to do that from afar. You literally cannot sit in an office somewhere else around the world and make judgments about this. You have to be on the ground.

PE has the opportunity to bridge that perception gap. And in many emerging markets in particular, a lot of PE value, the primary value is around some of the intangibles -- things like professionalization and adding good governance; bringing in top management teams to work with entrepreneurs and families. And because of that, a company, which has spent the last several years being owned by PE, for example, is a lot more interesting to global strategic buyers, a lot more approachable than companies that haven't been known by PE. So the opportunity for PE here is to take advantage where the perceived risk is higher than the actual risk. And that's the beauty of being on the ground and being connected locally, and being able to touch and see the opportunities firsthand. And you really can't do that unless you're physically there.

Knowledge@Wharton: Fundraising for investments in Africa has significantly increased for two straight years according to EY's recent report called "Private Equity Round Up in Africa." In April, for example, Abraaj's Africa fund closed with nearly $1 billion in commitments. There have been several others like that, and these levels of funding are big and new.

Sammut: You can look at this in a variety of different ways. The good news or the facts that have aided funds in raising new capital, be it large or small amounts, is there is now an assembling track record in Africa. And the Abraaj Group is a good example [and I would disclose that I am on the advisory board of Abraaj's Africa health fund].

But what's happened is they [PE firms] now have a much stronger, more developed, more detailed and more persuasive story to tell the world of limited partners, that is to say the funds, the pension funds and others, that would invest in these private equity funds. So there's a foundation that exists now that really didn't exist seven or eight years ago in the first go-around of fund formation. That adds a dimension to the story that we frequently overlook.... And that has an impact, and at the same time the macro economic conditions are improving for all the reasons that Mike described.

Knowledge@Wharton: Mike, what is your view of this sort of significant bump up in fund raising levels?

Rogers: Clearly this speaks to the degree to which investors see significant long-term potential in the region. Africa is very high on investors' radar right now. And that's a function that Steve touched on of the LPs [limited partners] getting more comfortable with emerging markets investments in general, but also getting more comfortable in Africa and continuing to move out the risk curve in terms of the types of vehicles they're funding.

It's also a function of the maturation of the industry itself in Africa. The LPs now have a number of experienced and proven teams from which to choose when they look at the region -- certainly Abraaj, Helios, Ethos. I've had the opportunity to meet with some folks from Musa Capital, which is a smaller local fund that I think has sold onto some of those bigger funds that I mentioned. So not only has the opportunity bloomed over the last, call it decade, but the investability of the region has increased as well. So it's beginning to build a track record, that's what tends to draw and stabilize your LP base.

Knowledge@Wharton: Have investment themes in Africa changed in over the last couple of years? What are the interesting sectors or industries going forward?

Sammut: I'm not sure I would use the term "change," although we can talk about what some of the newer targets look like, as "intensified," and by that I mean the underlying themes of consumer driven economies, financial institutions, telecommunications, these have been present for several years. But it's only within the last two years that we seem to have hit many of the countries, this is not true in all of them, that we've hit a tipping point. And that's what I mean by intensifying -- more entrepreneurial activity, more of the companies that were ideas -- that got started three or four years ago -- are now investable from a private equity point of view. So the deal flow opportunities are certainly there. Anecdotally there is a growing interest in education ventures and health care ventures. These, I don't think, have statistically risen to the spotlight, but they will because these are things that the populations are demanding in no uncertain terms.

Rogers: I might step back because I think Steve did a nice overview of what we see in the themes. But we're seeing a broadening of the opportunity set. I think we see the firms still active in commodities and natural resources. But they've also become a lot more active in spaces like financial services, health care and technologies, consumer goods -- and [it's] almost an extrapolation from there in terms of the opportunities that definitely we'll see in the future.

That that's in contrast to just a few years ago where we saw much heavier representation in sectors like construction, natural resources and industrial. So we're definitely seeing a migration. And some of the research we've done around emerging markets has shown a couple, maybe simplistic facts, but the first thing we figured out is that when GDP improved and there was a rising middle class in many of these emerging markets, the first thing that improved was people eat better. And secondly, they tend to buy mobile devices and phones. And so if you think about the rising consumer goods market – and not only for food, beverages and the traditional consumer branded businesses -- that bodes well for folks moving into that space and interested in tapping into a huge market for those types of products -- and also the telecoms.

I find it really interesting how financial and telecom sort of blends together. If you think about what they've been able to do, since the banking industry was not very well established in Africa in many of the countries, they in some ways have skipped a generation of bricks and mortar banks. And so you have a rising usage of the phone, of smartphones, and at the same time more access to capital markets products and banking products. And so you've seen this jump to mobile banking. In fact, there have been a number of very successful entities on the continent that have moved directly into that business. So you see in some ways where they are able to adapt and move forward much quicker than in other countries around the world because they didn't go through the phase of setting up all the brick and mortar banks….

So there are some very exciting opportunities in some of those traditional businesses, maybe less so on the mining minerals and traditional infrastructure side. The exciting places in the future are going to be in the consumer space along with the migration in financials and technology.

Sammut: What you've described is what many classify as leap frogging. And many of these African economies have done just that. And they're aware that they're doing that. And they're looking for new ways to accelerate growth and not go through the capital-intensive phases that other industrialized societies have gone through.

And your example of mobile banking … this largely originated in Kenya through M-Pesa -- the mobile banking arm of Safaricom, which is one of the largest cell phone carriers in east Africa. And it's proven to be a platform for more than just managing your cash and having electronic wallets. It's working so well that a variety of other products that are very complex to administer, such as insurance products, are now being sold or being positioned to be sold and promoted and administered through mobile banking platforms.

Education, e-health, are all taking advantage of these things. In the west, in the U.S. in particular, we're actually lagging behind in many of these applications. It's a very interesting phenomenon. And many of these opportunities are inviting private equity investment in pretty substantial ways. ■