Private Equity Steps Up in Africa (Part 2)

The second part of a two-part podcast on the new face of private equity (PE) in Africa looks at the areas of the economy most ripe for growth, and also at some business models that PE firms are pursuing. With GDP growth in Sub-Saharan Africa at 4.4% in 2012 (and a third of the countries there growing at more than 6% annually), the amount of foreign direct investment in Africa has been gaining significant momentum, and interest has spread beyond natural resources to consumers, thanks to an expanding middle class.

Knowledge@Wharton spoke with three experts to learn about the private equity landscape in Africa:

- *Michelle Kathryn Essomé, chief executive of the African Venture Capital Association;*
- *Michael Rogers, global deputy sector leader for private equity at EY;*
- *and Stephen M. Sammut, senior fellow and lecturer at Wharton.*

An edited transcript of the podcast appears below:

Knowledge@Wharton: Mike, could you tell us which African countries are seeing the most private equity activity, and which will see increasing activity over the next two or three years?

Michael Rogers: It's interesting, because I think everyone's natural inclination is to migrate towards South Africa. And there's still certainly a lot of investment targeted there. I was in Cape Town a month or so back for the EY Strategic Growth Forum — we had entrepreneurs and leading business people from all over the continent. And [there was] a lot of discussion about South Africa, but … the interest levels are rising tremendously in places like Nigeria, Ghana, Kenya — Ethiopia even. And both the East and West Africa segments of the market are really attracting more interest. In fact, we saw what you might imagine: higher returns in some of those markets. And in some ways, I think that could be coupled with slightly higher risk that one must absorb in some of those economies that are still at the front end of emergence.

But I think that we're going to see much more interest and appetite moving into that part of the continent; there will still be investment in South Africa, but maybe not as much, and just redirected in some different ways. So, we see people really thinking about "where can we invest" from a geographic perspective, and then tying it back to the sector as well. We think that's really powerful.

The CEO of GE Africa was at the conference, and they are making a major push into East and West Africa — in fact, [they] have a big portion of their operations there. And the CEO of GE Africa resides in that part of Africa as well. So I think the future is going to hold a lot of opportunity for moving into that market.

Michelle Essomé: I totally agree with [that]. I think we're even seeing it on the GP (general partner) side. And I like that now we're looking at the continent in its entirety, not Sub-Saharan Africa and cutting off North Africa and lopping it with the Middle East. You'll see that with the GPs like Citadel Capital … who are really [positioning] themselves as "African investors." And I think the same thing is on the mind of South African GPs who've successfully raised and exited companies in South Africa: With the growth of South Africa changing … how do we intelligently tap into, or look, for investments on the rest of the continent? How do we partner with somebody locally in that region who has the knowledge and context? It's exciting that investors are looking at pan-African opportunities. That's the first point.

The second is, if you think of what we're doing in Africa: It's growth capital, so primarily equity; little or no debt; typically minority shares, but they've built in majority rights. And the goal is to take a fantastic domestic or regional company and make it continental. I don't think that GPs necessarily will think about a certain country or region; they're thinking of how they can make a good domestic or regional company [into] a great continental African one.

Rogers: Michelle, I would agree with that completely. And for some of the companies that we visited with over there, my immediate reaction as an international business person principally residing in the U.S. is to think: Can you take this platform business and do more with it internationally? And it was very interesting to hear the response from many of the entities. The first thing they're trying to do is take a small family business that gets, for the first time, professional management, professional capital and then an opportunity to grow and build their business — and solidify their local market by country, if they need to do that, and gel around a strategy within that local market. And then their next strategy is to follow, as you just pointed out, the pan-African strategy of moving products in and around Africa, which is still limited in many ways by weak infrastructure.

Last on their list is taking their capabilities on a global basis, because they really feel like there's so much opportunity — oftentimes within their own country first, and certainly on an African continent basis — before they even think about beginning to work more on the international trade side. So there's a lot of development on that front end, but clearly people are starting to think about not only "what can I do in my local market," but also is there a product or capability — or service — that is applicable for the rest of Africa?

Knowledge@Wharton: Steve, to the extent you can generalize, Michelle mentioned that deals in Africa are typically minority stakes with some majority rights. That sounds a bit like the Middle East. What is unique about Africa?

Stephen Sammut: Well, it is difficult to generalize, but I would point out that minority investing in emerging markets is actually fairly typical. In the U.S. and Europe, when we hear private equity, we think leveraged buyouts and we think control positions. But in the emerging markets, in many instances, the plays are so-called growth equity as opposed to total buyouts. That means the private equity funds are providing sufficient capital for the expansion of companies. And while they may not be content to not have control, they recognize that the existing owners and entrepreneurs really won't have it any other way. So they seek to compensate for that with other provisions in the contract: board seats and the like, reporting requirements. But it doesn't really concern me that the preponderance of deals in Africa are minority investments. That hasn't been a problem in other markets; it should not be in Africa.

Knowledge@Wharton: There is a perception that exits can be difficult in Africa. Michelle, can you comment on that and what the implications might be?

Essomé: We were always asked, "Is it possible to do an exit in Africa? Have there been any?" And I got tired of not having a reason or response. So when we had the opportunity to partner with EY that was really a gift. We have just launched this survey in which we were able to compile, as I said earlier, [results from] 118 [companies], and these are publicly available exits. There may be others that hopefully we'll uncover in future surveys. And I think that there's analysis on 79 of those. We collected the data via face-to-face interviews with the GPs.

A key takeaway is: Although this industry is relatively young, there's a lot of professionalism, and institutionalism and strategic thinking, thinking about the exits, entry, putting together really strong shareholder agreements, really spending a year with the founders before the investment. So I was just really blown away by what we heard back from meeting with the GPs.

Rogers: It's interesting: About half of the companies, I guess, were sold as strategic [buyouts]. And I think that the next wave possibly might be more of the opportunity flow from PE buyers to other PE buyers, from secondaries. I think as these companies do get professional management growing the business, and maybe a little bit improved financial reporting and transparency, they will become more attractive to the bigger private equity funds. You see that in the developed markets where smaller funds tend to be sellers to larger funds. And that ecosystem, I think, will develop over time. It's not quite there yet. But I think it bodes well for the future for exits, successful exits in PE in Africa.

Knowledge@Wharton: How do investors find companies in this region, or how should they go about finding companies?

Sammut: My observations, and these are born out actually in the study, is that unlike many other markets where transactions are brokered — that is to say there's an intermediary or an investment bank involved — in the case of Africa, most of the transactions are so-called proprietary. And that is to say they are identified and sourced by the private equity funds working through local networks, other organizations, building relationships, and really getting to know the entrepreneurial community and observing what's going on in business activity.

The fund that I'm involved with, the Africa Health Fund, which is managed by Abraaj, is focused as the name would suggest on health care. And effectively all of the opportunities that we have sourced and the transactions that we have completed have been proprietary. It's an enormous amount of extra work, but the good news is that things like valuation stay reasonable and you forge a much closer working relationship with the entrepreneurs, which comes back later in a more collaborative relationship. It contributes more to the ESG, the environmental, social, governance issues. And by and large, I think creates a very healthy platform for continued growth.

Rogers: But what we hear is that folks really have to do a lot of work around relationship building. It's the old model of meeting with entrepreneurs and family members and business contacts, and that bubbles up in the system. I think it creates a little bit more work that you have to do to find the opportunities, to uncover them. But when you do, and you find the right opportunities, obviously it can be very lucrative. And we've talked to a number of the — call it middle market — private equity funds there in Africa, and all of them have a different model for sourcing. But at the heart of it, it's much more relationship-driven and it has to do with really finding and unearthing those opportunities.

We think that the capital markets there, as they continue to evolve, will be more professional intermediaries that get involved in the sourcing and identifying and introducing of opportunity flow. But at this point, it's still in its fledgling state, I would argue. When you do find the right opportunities, they do tend to be very, very rewarding.

Essomé: We're speaking about a continent, but it's very much about relationships. So now, more than ever, it's a competitive advantage for a GP to have boots on the ground so you can hear about those deals and stay as long as he needs to…. I don't think [all the interest in Africa] is translating into higher entry prices or any sort of bubble. That's not what I hear from my GPs. But I think a real competitive advantage is where you have offices in a number of key regions, so that you're really on the ground fleshing out opportunities. As has been said, being on the ground, local networks and strong relationships are really going to be a strong competitive advantage for fund managers in Africa.

Knowledge@Wharton: Thank you everyone. Listeners can access past podcasts plus additional insights into private equity at our private equity website, at kw.wharton.upenn.edu/private-equity.