PRIVATE EQUITY | AFRICA

LP GUIDE TO PRIVATE EQUITY IN AFRICA

Part I – An Overview of PE in Africa

2013

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INTRODUCTION

The *Private Equity Africa LP Guide* is a special educational publication created to meet the informational needs of global private equity limited partner investors. The guide is a compilation of best-practice advisory articles and analysis from leading LPs, GPs, advisors and industry intermediaries.

The *LP Guide* seeks to address key LP concerns and misconceptions that slow capital commitment to the continent.

The first part, published here, will also be freely available in electronic form to LPs globally.

THOUGHT LEADERSHIP

This guide features thought leadership articles from industry experts.

The guide will be published in three parts:

Part I: *An overview of PE in Africa*
Part II: *African PE Risk Management*
Part III: *Selecting the right GP*

To contribute to Part II of the LP Guide, email gail.mwamba@peafrica.com.

PART I: AN OVERVIEW OF PE IN AFRICA

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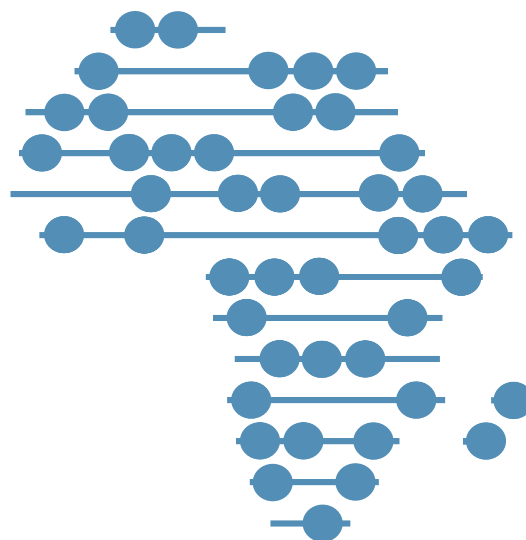

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Fundraising overview

Growth prospects are sky high for Africa, yet limited partners largely refrain from committing to the emerging market. However, some general partners are finding success with more targeted strategies

ALTHOUGH AFRICA'S high-growth prospects have made global headlines, very little of this has translated into actual commitments. Indeed, the continent has historically only managed to net between 3% and 6% of the total funds put into emerging markets, according to research from the Emerging Markets Private Equity Association (EMPEA).

The fortunes of African private equity fundraising reached their lowest ebb in four years in 2012, as fund managers raised $1.3bn for the continent, according to Preqin data (*see chart*).

The 2012 fundraising is only a quarter of the approximate $5bn raised by GPs for the continent at the height of industry optimism in 2007. The figure dropped to $1.2bn in 2008 as global financial turbulence dampened investor appetite.

The industry's optimists were vindicated in 2009 with a phenomenal upturn that saw figures double to $2.4bn, with this rising to $2.8bn the following year.

By 2011, fundraising commitments had reached $3bn, Africa's second highest fundraising year since 2000. There are currently about 55 managers seeking more than $11bn for the continent.

A mixed marquee

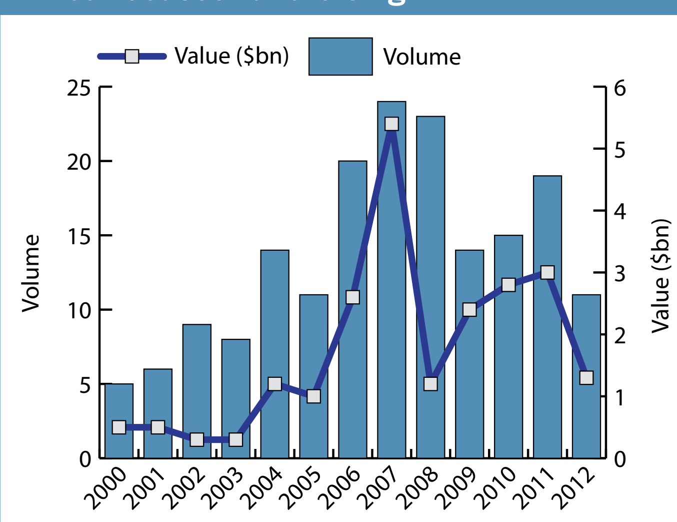
Although the bulk of fundraising African managers seem to have struggled to steer their funds to close, a few have managed to emerge as winners.

LPs appear to have favoured large funds such as the Helios sophomore pan-Africa vehicle, which closed at $900m – turning down additional commitments that could have taken it up to $1bn. Ethos also won favour with its $800m sixth fund – exceeding its original $750m cap.

In the mid to small fund space, LPs have plumped for the more focused strategies. In 2012, Vantage Capital closed its mezzanine vehicle at approximately $220m. Old Mutual Private Equity attracted $77m at the final close of its secondaries fund, while Decorum Capital Partners' mining pitch brought in $120m.

The year before, Adlevo Capital's technology focus had aided it in raising $100m for its maiden fund in 2011. Elsewhere, Aureos

Africa-focused fundraising



Source: Preqin

(now Abraaj), was able to bring in $105.4m for its Africa Health Fund (AHF) exceeding its $100m target.

LPs have also been smiling on regional plays, with Cauris Management closing its second West Africa-focused vehicle on target at approximately $75m in 2012. A regional focus also helped Catalyst reach a $125m final close for its East Africa-focused fund, exceeding its $100m target.

The funds were generally able to close in a shorter period of time than other similarly sized pan-African and generalist vehicles.

AS OF 2012, 115 fund managers oversaw approximately 158 private equity vehicles in Africa. The funds have an average size of $216.5m, with the bulk, 60%, below the $200m mark, according to Avanz Capital. Another 32% are in the middle market space, with a size of $200m to $800m. As of 2012, only six vehicles had fund sizes above $800m.

LPs warm up to Africa

After decades of being written off as a lost continent, Africa is now a hot discussion point for limited partners, with some mulling over firm commitments to the continent

PRIVATE EQUITY'S low penetration in Africa offers strong opportunities to investors. It is estimated that the asset class represents approximately just 1% of the continent's total gross domestic product (GDP). The vast opportunity is evident in the sheer number of private companies on the continent. South Africa alone has about 400,000 private companies, compared to 388 publicly listed corporations, according to research by Avanz Capital. The African opportunity is underpinned by a booming economic and middle class population growth story.

It is therefore not much of a surprise that perhaps for the first time LPs are beginning to take the continent seriously. Sub-Saharan Africa climbed to the number five spot on the Emerging Markets Private Equity Association's (EMPEA) emerging markets attractiveness index in 2012, from seventh place in 2011. The region was ranked eighth in 2010.

The interest in sub-Saharan Africa signalled one of the sharpest rises in interest, with Nigeria, Kenya, Ghana and South Africa taking the lead. About 20% of those surveyed plan to expand investments in sub-Saharan Africa, while 21% say they will begin investing in the region.

LPs' improved appetite for Africa is also seen in recent research from the Economist Intelligence Unit and Invest AD. About 66% of institutional investors surveyed saw African frontier markets such as Nigeria or Kenya as offering great opportunity. A good number of those surveyed said they plan to allocate more capital to the burgeoning continent (*see box on page 40*).

Meanwhile, GPs in Africa have increasingly been focusing their fundraising efforts on institutional investors based on the continent. The local institutions have in recent times seen healthy growth in assets under management and have been looking for opportunities to diversify risks.

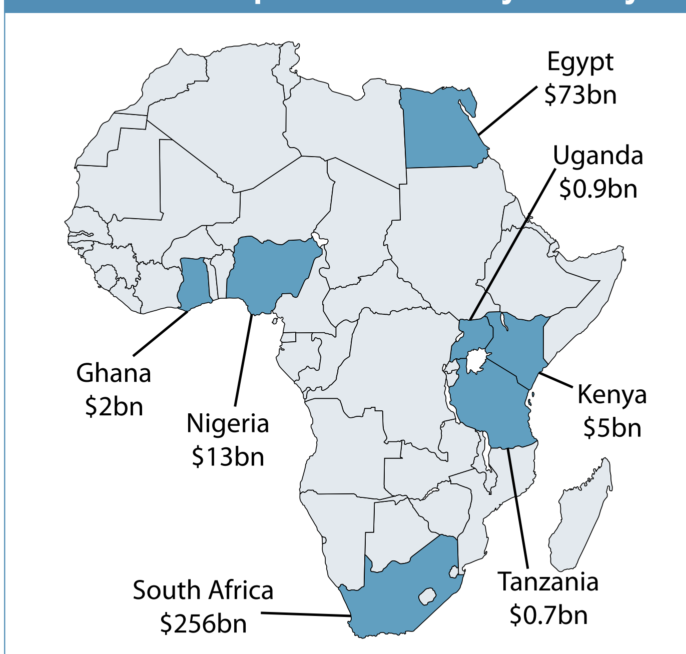
South African pension funds continue to take the lead in terms of allocating capital to private equity funds. The country's pension funds have a lion share of assets under management (AUM) in Africa, at $256bn as of 2012, according to Avanz's research. Egyptian pensions had about $73bn, while Nigeria was managing $13bn (*see map*).

Pension funds are expected to increase their allocation to the asset class on the back of recent regulations. For instance, South Africa's regulators in 2011 raised the cap on total pension fund exposure to alternative assets from 5% to 15%. According to the South African Private Equity and Venture Capital Association (SAVCA), local pension funds put more than $13.5bn into private equity in 2010.

Recent improved regulations have been underpinned by advocacy from development financiers, who have historically been the largest investors in African private equity funds.

The African Development Bank (AfDB) frequently invests alongside other development finance institutions (DFI). For every $1m the AfDB invests in private equity, a further $5m is invested by other institutions and individuals. Leading development financiers include the AfDB, whose private equity

Estimated total pension assets by country



Source: Avanz Capital

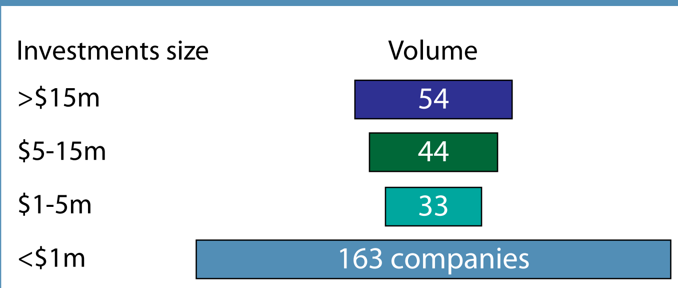
portfolio touched $1.09bn in early 2012. Of this, $836m was held in 37 private equity funds, invested across 294 companies.

The UK's CDC Group is also a top investor on the continent, with its African portfolio reaching £877m in 2011. In 2009, CDC generated about £126.3m in profits from sub-Saharan Africa alone.

The Netherlands Development Finance Company, FMO, has also prioritised allocating capital to the continent. FMO's African equity portfolio value stood at €609m in 2012, taking up about 68% of its €914m global equity portfolio. The DFI executed 35 contracts with fund managers focused on Africa during 2012, which contributed to raising the value of its African equity fund portfolio to €294m.

Other leading DFIs are the US International Finance Corporation, Germany's Deutsche Investitions-und Entwicklungsgesellschaft mbH (DEG) and France's Proparco.

However, some have criticised dependence of private sector fund managers on the DFIs, saying it undermines their long-term sustainability and demonstrates a lack of appetite amongst institutional investors. Some of the larger fund managers have in recent times worked to break away, increasingly attracting capital from private investors.



Source: AfDB

Helios Investment Partners' record-breaking $900m generalist fund, Helios II, received 72% of its commitments from private and institutional investors, while the rest was contributed by DFIs. Helios II, the largest Africa-focused fund ever raised, was oversubscribed, with demand exceeding $1bn.

Ethos Private Equity's recently closed $800m vehicle had attracted commitments from Europe, North America, the Middle East and Africa. Fund VI also featured Asian investors, whereas previous funds had no allocation from Asia-based LPs.

The virtue of patient capital

Africa's private equity industry still continues to be propped up by the developmental financiers, who have historically been catalysts to the growth of the industry

Traditionally, Africa's private equity industry has seen most commitments from the development finance community. Although the DFIs' primary goal is to advance the development of the continent and act as catalysts in the capital markets, commercial viability and adequate financial returns are usually high on their list of priorities. With the industry still in its early stages, the DFIs have committed to deploying patient capital – their strategy is to support fund managers until they are able to source capital from purely private limited partners, or from large domestic pension funds.

By acting as anchor investors, the DFIs help funds achieve a minimum threshold investment that gives other LPs confidence in the industry. The DFI commitment has had its rewards, with DFIs reaping fairly healthy returns (*see table below*).

AfDB sample of successful LP exits

Fund	Vintage	Fund size	AfDB's share	Volume of deals / (exits)	Realised cash proceeds	Realised net IRR
Acacia	1996	$19.3m	11%	16 / (16)	$29m	5.7%
ZVCF	1998	$12m	17%	12 / (12)	$15.8m	3.4%
IORF	2000	$11.1m	18%	4 (4)	$15.7m	5.6%
ECP I (AIG)	2000	$407.6m	12%	13 / (12)	$682m	22%
ECP II	2006	$453m	11%	18 / (6)	$135m *	n/a
Aureos Africa Fund	2008	$381m	8%	15 / (1)	$18.1m *	n/a

* Partial exits

Institutional investors' Africa sentiment improves

The Economist Intelligence Unit and Invest AD Institutional Investor survey findings

- Institutional investors see Africa as holding the greatest overall investment potential of all frontier markets globally. At an aggregate level, when asked to choose two regions out of five, two-thirds (66%) of investors with an interest in frontier markets see African frontier markets such as Nigeria or Kenya as holding the greatest opportunity. This puts the continent ahead of frontier Asian markets (selected by 44%) and Latin American ones (29%). Many economic forecasters predict the region's growth rate will outstrip all others in the five years up to 2017.

- Institutional investors plan to increase their asset allocation in African markets over the coming five years. Even among frontier markets investors, most are only just starting to explore African markets. One in five of those surveyed have zero allocation; among larger investors with more than $10bn under management, this is closer to one in three. Another one-quarter (24%) overall has less than 1% allocation, often as part of a pooled investment in global frontier markets. By 2016, however, all expect to have some exposure to emerging Africa, with nearly one-third expecting to shift at least 5% of their fund value there.

- Investors are moving towards longer-term investment strategies for Africa, rather than more speculative, short-term bets. Since 2004-05, Africa's capital inflows can be characterised in two waves: a pre-2008-crisis wave of low-cost capital in search of short-term yield, which evaporated at the collapse of Lehman Brothers; and a post-crisis emergence of more targeted country-specific investments. Nearly two-thirds (64%) of investors agree that market volatility, partly due to limited liquidity, now requires a longer-term investment approach.

- Africa's emerging middle class is catching investors' attention, ahead of commodities and natural resources. The continent's bountiful natural resources – from 10% of the world's oil to as much as 90% of its platinum group metals – has long made it a largely natural resources play. But it is its emerging middle class, which now numbers more than 300 million of Africa's total 1 billion people, that is increasingly catching investor attention. Four in 10 investors (39%), when asked to choose the top three out of 12 features, selected this as the most attractive aspect of investing in African frontier markets, ahead of high commodity prices (34%) or high growth rates (35%).

- Investors now worry more about technical concerns than about macroeconomic and political risks, at least in key markets. In some regards, Africa's biggest challenge is to overcome deeply entrenched perceptions. But a striking shift that can be observed among investors is a change in focus from macroeconomic and political worries towards more technical market concerns.

- Investors were asked to choose up to three main concerns out of a list of 15 challenges of investing in African frontier markets. Although bribery and corruption is the headline worry for investors (selected by 41%), concerns about weak institutions (40%) and illiquidity in capital markets (36%) are not far behind.

About the research

The above is an excerpt of a summary of findings of a report published by the Economist Intelligence Unit (EIU), entitled *Into Africa*.

EIU conducted a global online survey of 158 institutional investors on behalf of Invest AD. The respondents ranged from insurance and pension funds through to private banks, wealth managers, hedge funds and mutual funds. Investors represented firms with a range of sizes based on assets under management.

About half had up to $499m under management, while 22% have at least $10bn under management. Respondents were split roughly evenly between North America, Europe, Asia-Pacific, and the Middle East and Africa. All respondents indicated an interest in frontier markets, although not necessarily in Africa.

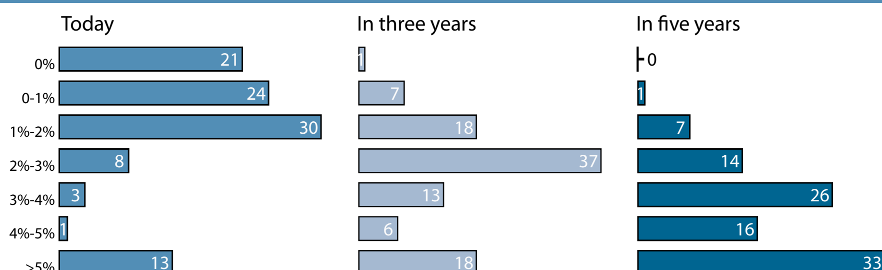
To complement the survey results, the Economist Intelligence Unit also conducted a programme of in-depth interviews with a range of experts and senior executives.

Source: EIU/Invest AD

Sample survey responses

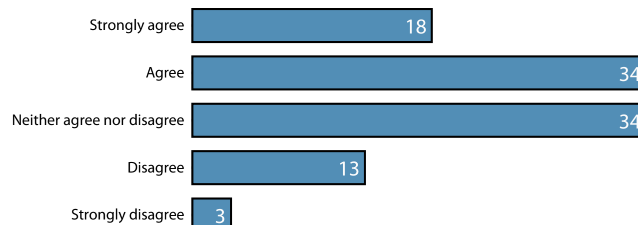
Survey question 1

What is your overall allocation to assets in Africa's frontier market, now and in three and five years' time?



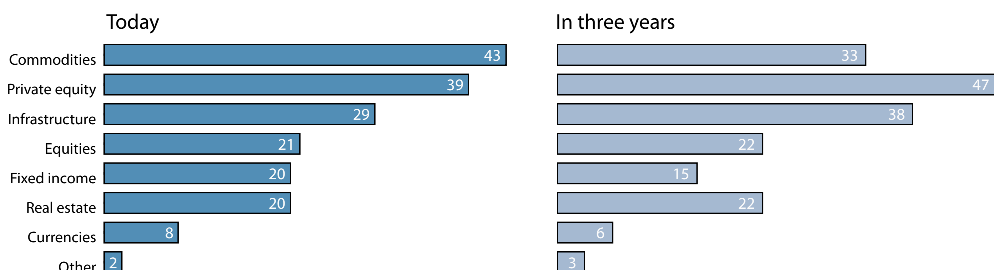
Survey question 2

Do you agree that Africa's frontier markets will offer the best prospects for investment growth of anywhere in the world over the next decade?



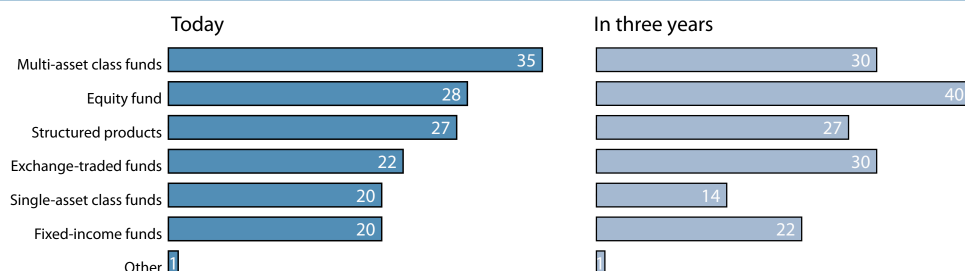
Survey question 3

Which of the following asset classes offer the best opportunities for investment in Africa?



Survey question 4

Which of the following vehicles currently offers the best opportunities through which to invest?



Source: EIU/Invest AD

Bigger is better

Dabney Tonelli, head of investor relations at Helios, discusses deal-making in the large-cap space – a strategy that has aided the investor in creating and investing in some of the continent's largest companies

AS THE world continues to struggle with growth, African economic activity remains strong, as evidenced by International Monetary Fund (IMF) growth forecasts. A strong surge is not only driven by global cyclical factors, but also Africa-specific elements such as economic liberalisation and a rise in technology-driven productivity. Demographics and urbanisation have also played a huge part in boosting Africa's prospects.

Africa's population growth over the next decade is expected to average 2.2%. By 2050, one in five of the world's inhabitants and one in four workers will be African. The rise in the middle-class also adds to the continent's attractiveness, with more than 300 million people now classified as middle class, up 27% from 2000.

Dabney Tonelli, Helios

These trends are strongly supportive of building truly significant African businesses over the next 10 to 20 years. However, as the rising tide does not necessarily lift all boats, the economic growth does not automatically translate into a rise in corporate earnings. The challenge lies not in the sustainability of the underlying drivers, but rather the operating business environment. Basic operating hurdles stand in the way of turning evident demand into sustainable profits and, ultimately, investment returns.

With this in mind, aiding investee companies address execution risks becomes fundamental to the role of a private equity fund manager. This can be achieved with a well-conceived investment strategy and an appropriate toolbox for executing it. A team comprising investment and operations professionals is the critical element of that toolbox, bringing complementary skills and diverse capabilities to bear in meeting these challenges.

Why size matters

In Africa, achieving scale is crucial. Size increases a company's ability to attract top-notch management and offers improved access to appropriately priced and structured bank funding. A larger company enables greater control over the often fragile value-chain of suppliers and customers.

Once growth targets have been achieved, larger companies also have stronger exit options. Exit prospects are likely to be far better for good-sized, cash-generative, growing companies that are market leaders in their areas of expertise. This rationale underpins Helios's investment strategy, ensuring that targets are, or have the potential to be, healthy, growing companies, with a leading position in their key markets.

In effect, companies must have the potential to achieve what we call "relevant scale". The term has two elements: an external market-facing one; and an internal fund-related one. The external aspect mainly refers to revenues and profits and must be capable of listing successfully on domestic and/or global stock exchanges, depending on the context.

Internally, the company must be of a scale to be significant, in terms of capital invested but, perhaps more importantly, in terms of the quantum of returns the investment is capable of generating. This is particularly so in the context of a concentrated portfolio of six to 10 individual investments.

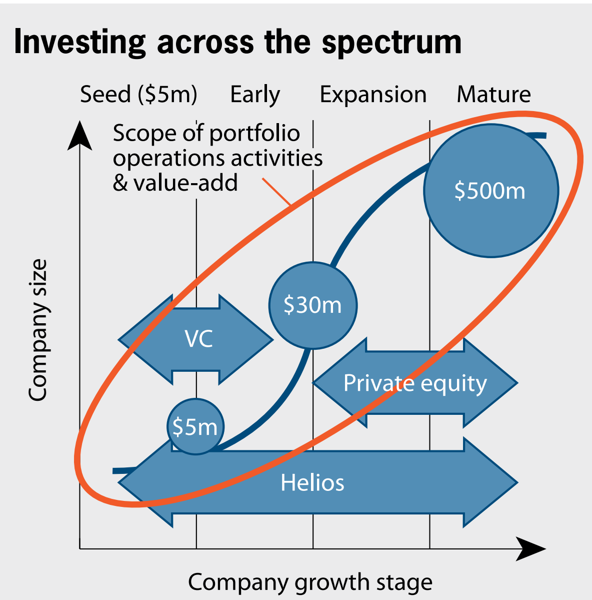
From vision to action

There are at least three kinds of companies that can meet such criteria. Investing in each requires a different transaction type, and investing across the spectrum of all three requires a full and diversified set of investment skills.

The first of these is a maturing business, one that has already achieved size and scale. Another strong target is one that is "taking off". Companies in this segment are relatively small and have already demonstrated some success in providing valued products or services in high-growth markets. These frequently require capital and operational assistance to achieve their full potential. The last type are conceptual businesses that offer start-up opportunities. The first two are more traditionally the domain of private equity funds (*see table*).

Investing in the third kind of company, the start-up, is less commonly a focus for private equity funds in developed markets. However, this is not so true in Africa where the majority of businesses are yet to establish themselves.

This is well illustrated in the financial services sector, where, for instance, only 24% of the continent's population has a bank account and 3% own credit cards. In the area of technology, internet penetration is 13%, while electricity consumption is 6% of the global average.



Starting from scratch

Among private equity firms operating in Africa, Helios is unique in developing and investing in start-ups. The criteria for such investments are, of course, stringent: the addressable market must be large and growing. In addition, the business must be modular, an aggregation of individually viable units with attractive unit economics. It also helps if the company is asset rich.

Another matter to consider is, the cost of discovery; that is, the capital-at-risk prior to achieving proof of concept, which must be relatively modest. In addition, operating leverage must be high, execution risks must be clearly identifiable and capable of being mitigated up-front. Our investments in telecom towers businesses are a good example of this.

Hands-on expertise

A critical element in achieving successful outcomes is to provide hands-on operational support and problem-solving capabilities to portfolio company management teams. At Helios, we have developed a group to do just that, led by operating partners with significant developing-markets expertise in senior management and board level positions. The goal in building such a resource is to support management teams as they develop their businesses, to share best practices across platforms, to encourage innovation, and ultimately to maximise investment returns at exit.

Our portfolio operations team comprises general managers as well as specialists, such as those with expertise in finance and human resources. Primarily, their role is to participate in investment due diligence and identify key operational risks to plan for value creation. A central part of their mandate is to also identify and monitor key performance indicators and develop 100-day plans, which includes establishing key milestones and management incentive plans.

Key target company types

	Maturing	Taking off
Growth prospects	Good, but not explosive, growth rates over the investment horizon	High growth rates that can either be materially enhanced or sustained longer
Value creation	Operational optimisation, leverage, growth and, ideally, multiple expansion, in roughly equal measure	Operational, through providing managerial support on strategy, new products and new markets in order to achieve market leadership and relevant scale by the end of the expected investment period
Transaction type	More traditional LBO structures	A broad range of structures, each tailored to suit the circumstances. Often, the initial capital investment (which could be as low as $10 to $15m) is expected to be followed by further rounds of funding, such that the initial outlay is not representative of the expected ultimate commitment
Helios examples	Vivo Energy, a landmark $1bn carve-out of Shell's downstream fuels businesses; now evaluating distribution opportunities	Interswitch, an electronic payments processing platform; now evaluating consumer goods and packaging opportunities

Going for growth

Satya Capital partner Samir Abhyankar argues the case for investing in Africa's medium-sized businesses

WHILE MOST of the headlines about sub-Saharan African private equity transactions tend to focus on the large deals, it's the corporate activity in mid-sized companies that gets us at Satya Capital most excited. The potential for growth for companies at this stage in the mid-life cycle can be highly seductive, even though the risk of converting that potential into reality can be considerable.

Investing in mid-sized African companies is fundamentally about supporting the growth of companies that are looking to occupy market segments characterised by under-penetration of goods and services. The numbers across many such segments are hugely alluring. For instance, Nigeria's entire local pharmaceutical manufacturing industry is about as large as a mid-size Indian pharmaceutical company.

In financial services, as of 2011 the total banking industry in Kenya had extended only 14,000 formal mortgage loans. To put this in context, one has to remember that banks in London on average approve approximately 40,000 mortgage loans per month. These and a good number of other under-penetration statistics are often cited as justification for investing in Africa. The revenue growth of emerging market leaders in these segments only reinforces the continent's allure.

Closely following the under-penetration statistics are the enviable demographics in most sub-Saharan countries. Africa is due to add an estimated billion people to the continent by 2050. Of these, 750 million of this addition will fall in the core age bracket of 15 to 65 years that drives consumer spending. When this is added to per capita income growth, the building blocks of revenue growth for consumer-facing companies become clear.

> *"To be effective, African GPs investing in mid-sized companies need to be able to understand how organizations work from the shop-floor up, as well as from the board-level down"*
>
> — Samir Abhyankar, Satya Capital

Growth for growth's sake

What is equally striking is a common disconnect between top-line growth and operational performance. Returning to the Nigerian pharmaceutical industry, top-line growth for some of the larger operators has been a healthy 15% to 20%. However, this has not translated into any material improvement in operating profit.

We see a similar story across listed mid-sized consumer goods companies in Kenya. This has to do with execution weaknesses. As long as you have the only fried chicken stall in town, making profits is straightforward. But what happens once the KFCs of the world show up? Based on our experience, this is when two problems start to become apparent – the lack of operational depth and organisational incompleteness.

Moving from individuals to organisations

Mid-sized African companies are usually centred on the founder and/or the chief executive officer. A period of rapid growth cultivates a culture where growing sales ends up becoming the singular focus. Typically these organisations are bereft of some fundamental capabilities and processes that are required to continue managing this growth.

For instance, you will find that a healthcare company has outsourced its finance function to consultants, while a telecoms services provider may have an entire sales team that is off the books and paid on commission. This can also be seen in a steel manufacturer, where the human resources function is managed by the chief executive's partner.

Rather than lofty boardroom strategising and nimble capital structuring, these companies need seasoned talent to come in alongside the founder. In addition, organisations often need to be built out with a focus on areas that are routinely downplayed such as human resources, collections, business planning, logistics and marketing.

While founders are typically reluctant to hire, or may feel threatened by such expensive resources, the improved know-how, reduced time to market and greater efficiency that comes with bringing in higher calibre people ends up far outweighing the short-term costs.

Based on our experience with Celtel and current portfolio companies, in order to deliver a successful exit it is imperative that an organisation operates with processes that are, or have the potential to be, in line with their eventual buyers.

Case in point is our investment in Chemi and Cotex Industries, a market-leading consumer goods company in East Africa that has placed quality control at the top of the corporate agenda. As such, it has rigorously been benchmarking itself against industry standards.

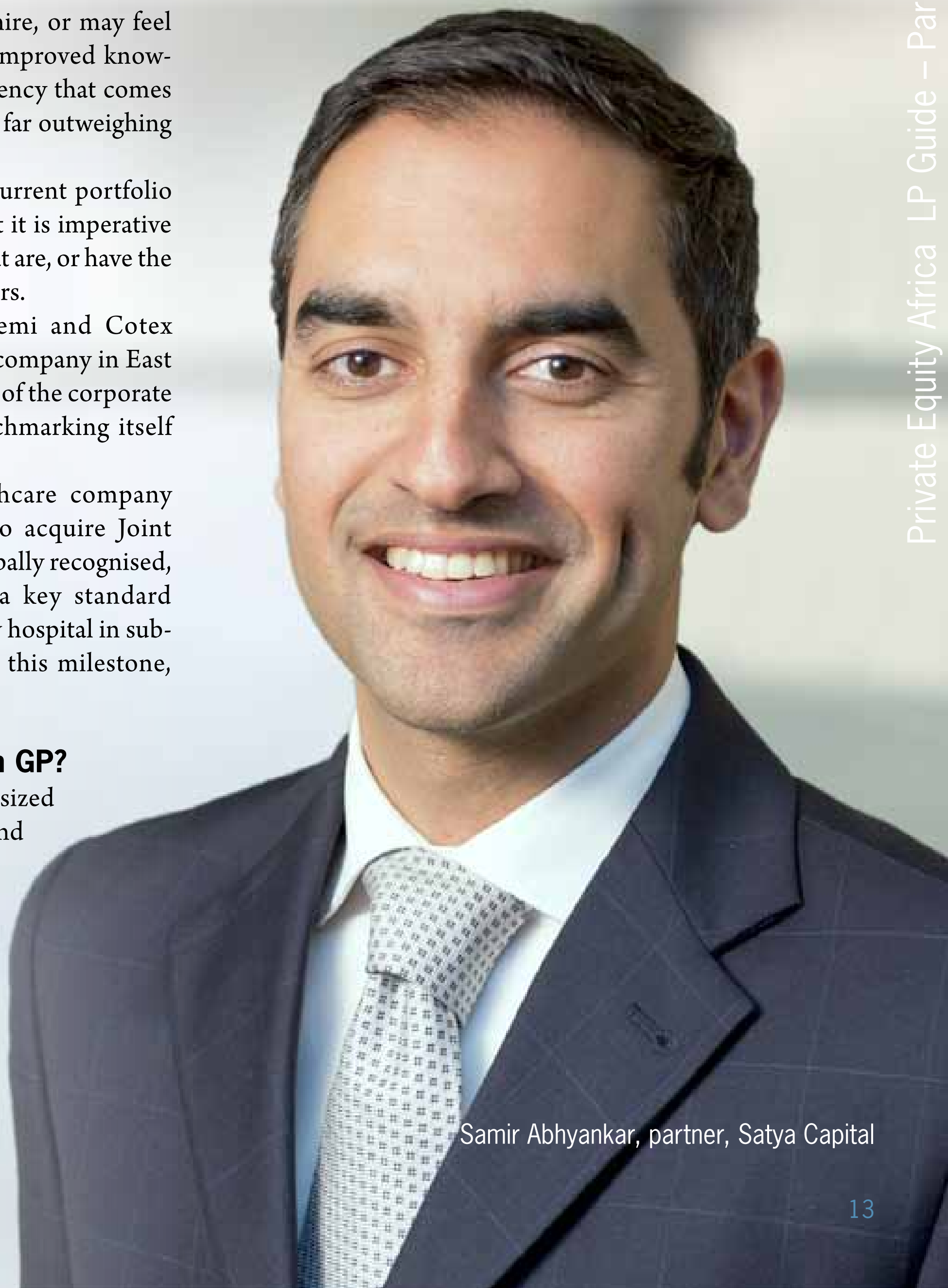
Similarly at Hygeia, our portfolio healthcare company in Nigeria, we have pushed the company to acquire Joint Commission International (JCI) status – a globally recognised, US-based healthcare accreditation. JCI is a key standard benchmark for hospitals and Hygeia is the only hospital in sub-Saharan Africa to have successfully achieved this milestone, outside South Africa.

So what does it mean for the African GP?

To be effective, African GPs investing in mid-sized companies therefore need to be able to understand how organisations work from the shop-floor up, as well as from the board-level down. This, in turn, has important implications for the make-up of the team.

Secondly, Africa is a relationship-driven world where the strength of networks are important determinants of success. GPs that have built and nurtured strong networks will be able to proactively source better transactions and support business development for portfolio companies. This is especially true today when even mid-sized companies in Africa have regional expansion ambitions and need hand-holding and relationship support in new markets.

Finally, and perhaps most importantly, the challenges of investing in this space will only be commensurate with the rewards if the GP has the ability to drive the required changes. This places a high premium on formal governance rights but equally, the informal softer skills of working with the founders and existing shareholders.



Samir Abhyankar, partner, Satya Capital

A clean proposition

Misa Andriamihaja, chief executive at Green Ventures Capital, gives insight into renewable energy investment opportunities in Africa

IT SHOCKS in the energy world, such as social unrest utions in North Africa and the Middle East and nuclear uncertainties in Japan, have brought to the fore the need ative sources of energy. Green Ventures Capital (GVC) capitalise on the momentum with proven technologies etitive edge as a first mover across Africa.

he past decade, Africa's gross domestic product (GDP) s averaged 5%, exceeding global average growth of 4%. ow one of the fastest growing regions in the world with of countries expected to exceed 7% by 2015.

gh this is good news for Africa, the boom is set to put n existing energy infrastructure, which has historically to meet both commercial and retail demand. Businesses e region frequently cite insufficient and unaffordable supply as a hindrance to operations.

ding to the United Nations, more than 600 million do not have access to safe and clean energy for daily nercial activities. Current access to electricity in a good f households across sub-Saharan Africa can be as low alling to bottom levels of 10% in rural areas, according orld Bank.

s therefore no wonder that industry experts predict explosive growth in renewable energy commercialisation. Investment in Africa's renewable energy sector alone is expected to reach $57bn by 2020, from about $3.6bn in 2011, according to a report by Frost and Sullivan.

A fresh approach

Governments have in the past attempted to meet energy demand through large-scale hydropower and fossil fuel programmes, often transmitted through centralised national grids. However, frequent droughts in recent years have made large-scale hydropower projects of little effect resulting in power cuts across some of the continent's major cities.

On the other hand, energy from fossil fuel plants – the burning of coal, natural gas or petroleum to produce energy – has been criticised for its negative environmental and social governance impact. Moreover, centralised grid systems tend to suffer frequent vandalism, further reducing energy services reliability.

Given this, a number of African governments have been rolling out plans for their nations to generate energy from safer and reliable renewable energy sources. This has been encouraged by the declining costs of deploying renewable energy technologies. In some cases, solar technologies have been found to be even cheaper than diesel or petrol generators. Tapping sources such as the sun and wind means that electricity can be locally generated, for industries and communities – significantly reducing power shortages due to vandalism.

Some of the strongest

Misa Andriamihaja, CEO, Green Ventures Capital

investment opportunities in this sector lie in Renewable Energy Feed-in Tariffs (REFiT). These are government initiatives to encourage investment in renewable energy – often by guaranteeing to buy and pay for all the electricity produced. The government commits itself to purchase the energy at a fixed rate and recovers the cost from the consumer – selling at a subsidised rate either directly or through third parties. Additionally, bonuses and feed-in-tariffs are given to operators of renewable technology.

Historically, development finance institutions (DFI) have dominated investments in this sector. Initiatives have primarily been led by the African Development Bank (AfDB), through its Renewable Energy Program in Low Income Countries scheme. The programme is funded from the Strategic Climate Fund , one of the two Climate Investment Funds. Global DFIs have also been present in the space, including the International Finance Corporation and the Dutch FMO.

Much to be done

Despite theses initiatives, the gap between present renewable energy production and targets continues to be wide, providing ample opportunity for investment in the sector. Kenya by 2030 hopes to produce 5,530 MW from geothermal energy, 1,000 MW from biomass energy, 2,000 MW from wind energy and 300 MW from small hydro energy projects. Mauritius also has an ambitious target for generating energy through renewable sources by 2030 (*see box*).

Recent times have seen more activity from private equity investors in this space. Citadel Capital has a significant renewable energy project under TAQA Power, Citadel's full-service energy distribution platform in Egypt. Denham Capital, through South Africa's Bio Therm, has committed to financing Dassiesklip Wind Energy, Aries Solar Energy Project and the Konkoonsies Solar Energy facility.

For private equity, the case for backing renewable energy deals in Africa boils down to getting superior risk adjusted returns. We have seen clean energy and technology deals posting indicative returns between 18% to 22%, based on external valuation and partial exits. In the broader private equity industry, investors have reported returns of 2.5x across all sectors. The new Cambridge Associates Africa Index shows 10-year annualised returns of 11.2% up to 2012, outperforming US venture capital and matching broader emerging markets.

GVC, through The Africa Cleantech Fund, will leverage its African, emerging and developed markets expertise to invest in solar, wind, hydro, geothermal, natural gas, bio-energy, energy technologies and environmental services. We believe the renewable energy space is the next wave of growth for African private equity – and for the continent as a whole.

African governments' clean energy initiatives

Algeria

Algeria adopted a renewable energy and efficiency development plan in February 2011 that aims to have 41% of electricity production coming from renewable energy by 2013. The country wants to add 12,000 MW of new capacity from solar generation. To attract investors, the country will give a bonus for each KWh produced, marketed or consumed. For electricity operated from solar or radiant-heat only, the bonus is 300% the price per KWh of electricity produced by the market operator. For electricity generated from facilities using solar thermal systems, the bonus is 200% of the price per KWh.

Kenya

Two projects are benefiting from the feed-in-tariff system. They are a 920 KW small hydro plant owned by the KIDA and a 5MW geothermal wellhead operated by Ken Gen. Due to the revision of policy as regards renewal energy generation in 2010, attractive tariffs are now applicable for small-scale hydro, biomass and wind power projects. Sixty of such projects have been approved.

Mauritius

The Mauritius government wants to generate 35% of its energy from renewable sources. Currently, the capacity developed under its feed-in tariff system accounts for only 1% of the country's total capacity. Mauritius experiences a 4% annual growth in electricity demand and the government is ensuring projects approved achieve production stage.

South Africa

South Africa's Renewable Energy Independent Power Producer Procurement programme has a target of 10,000 GWh of renewable energy. A 3,725 MW tranche of renewable energy is to be purchased from independent power producers. The government is also in the process of implementing its own 200 MW Sere Wind Farm and is investigating the implementation of a 5 GW solar park.

Policy makers are targeting energy efficiency improvement of 12% by 2015 and provide a number of incentives. In the first few bidding rounds, the government picked 28 projects, including some solar and wind projects.

Q&A Locally speaking

David Ashiagbor, previously economic advisor at the Commonwealth Secretariat and now at the African Development Bank, talks about local limited partners' participation in Africa's private equity industry

Why have African pension funds and sovereign wealth funds (SWF) been slow to embrace private equity?

A combination of a lack of awareness and knowledge of the asset class has largely underpinned the slow adoption of private equity among local investors in Africa. Many of the larger pension funds are state owned or controlled and so are therefore not as driven by the need to earn high returns as a private system would. This is because the state would normally pick up any shortfalls; there is therefore no pressure to increase returns.

Additionally, private equity is relatively young in Africa and only emerged about 20 to 30 years ago. Historically, investments in the asset class have been mainly led by the development finance institution (DFI) community. So, most local institutions don't know the asset class and are therefore unable to properly assess the risks and returns. We also have to remember that they have the option of other high-yielding assets, such as government bonds. Therefore, private equity really needs to make its case in terms of what it brings to the portfolio.

Which African local institutions have been early private equity adopters?

South Africa has been at the fore, especially as the regulations now allow for up to 10% allocation to private equity. Public Investment Corporation (PIC) and Government Employees Pension Fund have been looking at increasing allocation to the asset class. However, South Africa has close to 3,000 pension funds, the vast majority of which have never invested in private equity. So even with South Africa, there remains a lot of work to be done.

Nigeria is also an interesting case. The pension funds are able to allocate up to 5% to private equity under certain conditions. This amounts to a potential $1bn – not a lot today you might think, but pension assets are growing at 30% per annum. Some general partners (GP) complain about the regulation and the restrictions on private equity investment by Nigerian pension funds. But some GPs have successfully raised capital in that market. The key to success is in working together to understand each side's constraints and figuring out structures that make sense for everybody.

What have been the drivers of interest among local limited partners (LP)?

The recognition of the need to diversify has been behind a good number of the commitments to private equity. I have heard it said that it has become impossible for PIC to outperform the Johannesburg Stock Exchange (JSE) Index because the pension is already heavily invested in it.

That is a challenge facing many African pension funds. With pension assets experiencing double-digit growth in many countries, it is becoming increasingly difficult to find good quality assets. This is even more so where regulation limits choices. So, some look to private equity to diversify and manage risks, and also in search of higher returns.

What are the common investment strategies among local LPs?

The investment style is for the most part driven by regulations. Most regulation limits pension fund investment outside their country of origin. In Nigeria, for instance, 75% of any investment in a private equity fund must be invested within the country. This is to protect against capital flight and also for political reasons. So most pension funds would only invest in their country – and then maybe the region – before the rest of the continent. The

> *"There is an increasing realisation that Africa needs to play a bigger role in funding its own growth. With foreign investment and aid falling since the financial crisis, there are few options left"*
>
> — David Ashiagbor, Commonwealth Secretariat

notable exception is South Africa, where the regulation has an explicit allocation to investments in the rest of Africa. East African regulations are another exception, as they treat investments in member countries as local.

Even then, the challenge they face is how to deploy the allocation across so many different markets that they do not know too much about. However, with Africa being so vast, doing business in East Africa is, for instance, quite different from West Africa. African investors need to learn about other African markets just like any other investor.

Do you expect to see a rise in local LP commitments to private equity?

The momentum is in this direction. In addition to the need for diversification, there is an increasing realisation that Africa needs to play a bigger role in funding its own growth. With foreign investment and aid falling since the financial crisis, there are few options left. A good number of countries are reforming their pension systems, which is leading to more liberal investment regimes.

Having said all that, the biggest barrier to increased local capital is a lack of understanding of the asset class – not only by the pension funds, but by the regulators and policy makers – and in fact the whole ecosystem. Changing this takes time and hard work on both sides. It is not just up to the pension funds – they cannot do it alone.

What advice would you give to local LPs still not active in African private equity?

I think local institutional investors need to look at private equity a bit more closely, understand the risks and rewards, and decide whether it makes sense in the context of their objectives. Private equity has many advantages, but it also has risks. Having said that, I believe the private equity industry also has a role to play. The GPs need to get to know the African pension funds and understand what their challenges are and explore how they can work together to create structures that work for both sides. They should not assume that what would work for a DFI or commercial investor from outside Africa would be adequate for a local pension fund.

African pension funds regulations

South Africa: Under the new rules of Regulation 28 of the Pensions Fund Act, institutional investors can invest up to 10% of assets under management in unlisted equities. Investment limits in all alternative asset classes, including private equity and hedge funds, has been raised from the historical 5% to 15%.

Nigeria: Limits for private equity and alternative assets have been capped at 5% of assets under management. A minimum of 75% of funds need to be invested in companies or projects in Nigeria. Among other requirements, funds need to have multilateral development finance institutions as LPs.

Botswana: The country's largest pension fund, Botswana Public Officers Pension Fund (BPOPF), which has about $4.5bn in assets, has launched an alternative investment policy, with prudential limits for private equity set at 2.5%.

Kenya: With about $5bn of pension fund assets, Kenya has an allocation of 5% to unlisted equity.

Location, Location, Location...

As European investor interest in Africa-focused funds increases, general partners are faced with the question of where to domicile their fund to maximise fundraising potential with European limited partners. Karine Seguin, head of business development at Trident Fund Services, makes the case for Luxembourg

Karine Seguin, head of business development, Trident Fund Services

MAURITIUS HAS long been the domicile of choice for Africa-focused funds. However, the Channel Islands and Luxembourg both have very strong positions in the global private equity market, with Luxembourg the jurisdiction of choice when targeting the continental European Union (EU).

Reflecting the diversification of investors participating in the African market in the past year, at least half a dozen African private equity funds using a Luxembourg vehicle have been launched, mostly led by European or Swiss general partners (GP).

Luxembourg's appeal as a financial and investment fund centre is easily understood. It is both a financially

and politically stable EU member state with a long-standing commitment to the global investment funds industry. It is therefore no surprise that Luxembourg is home to investment funds housing about €2tn in assets under management, making it the second largest domicile.

It is important to note that Delaware and the Channel Islands are home to more private equity funds than Luxembourg. However, Luxembourg is the first choice for funds dealing with EU limited partners (LP), in particular those based in Germany, Scandinavia and France. Luxembourg has also achieved solid brand recognition in Asia and is particularly popular with investors in China.

Luxembourg has recently also been bolstered by incoming regulations under the Alternative Investment Fund Managers Directive (AIFMD). The AIFMD will be implemented in the national laws of EU member states in July this year, meaning funds marketed within the EU, including those domiciled offshore, will need to comply with its provisions.

However, EU-based managers of EU-domiciled funds that become authorised will be able to market on a cross-border basis within the region, using a single "passport". As such, it makes sense to have a fund located in the EU region, particularly Luxembourg.

Luxembourg's attractiveness has also been underpinned by institutional investment restrictions and perceptions, where, for instance, some institutional LPs and development finance institutions (DFI) are prohibited from investing in certain offshore centres. This has made it increasingly more challenging for offshore funds to market to EU investors.

This combination of factors is incentivising GPs targeting EU investors to set up in the EU rather than offshore. Although set-up and operating costs for an onshore fund are usually higher than for an offshore fund, the signs are that for funds targeting EU LPs, domiciling in the EU will eventually become the only viable option.

Luxembourg offers two main choices of vehicle for private equity fund managers taking this path. The first is the Specialised Investment Fund (SIF), which was introduced in 2007. The other is the Société d'Investissement en Capital à Risque (SICAR), a risk capital investment company, which has been available since 2004.

SICAR was designed with private equity and venture capital funds in mind, but has now been overtaken by the SIF regime, which is recognised as well-regulated, operationally flexible and fiscally efficient. It is believed all of the African private equity funds in Luxembourg that have recently launched have opted to use the SIF structure.

Karine Seguin works closely with private equity funds investing in Africa, and has guided funds in Mauritius, Cayman Islands and Luxembourg through their set-up period.

Key details of the SIF regime include:

- No more than 30% of the assets of the fund may be invested in the same security by the same issuer, although exemptions may be granted for a period of up to three or four years for private equity funds making their first investment.
- Minimum investment of €125,000, limited to well-informed investors. Investor eligibility is clearly set out in the SIF regime.
- Minimum capital/net assets of €1.25m must be achieved within 12 months.
- Tax exempt in Luxembourg, with the exception of an annual subscription tax of 0.01% of assets under management.
- Requirement for a Luxembourg-based auditor, depositary and administrator.

Funds domiciling in Luxembourg should pay attention to the following points:

- Investment management may only be delegated to a regulated entity, regulated either in the EU/EEA or in countries outside of the EU under legislation assessed as "equivalent". Mauritius-based GPs are unlikely to qualify.
- An adequate and independently controlled risk management system, either in-house or delegated to a third party, is required.
- There is an increased need for funds to demonstrate substance in Luxembourg.
- Time to market is longer than for offshore funds. Fund launches are currently taking between 3-6 months.
- The range of double tax-treaties between Luxembourg and African countries is limited. The inclusion of Mauritius GBC1 companies to channel the investments into Africa is likely to be required as Mauritius has the best range of DTTs and IPPAs with African countries.

Deal valuations

RisCura Fundamentals head Rory Ord discusses the findings of the firm's recent research, published in its *2013 Bright Africa* report, exploring private equity deal multiples in Africa

AFRICA'S IMAGE has come a long way since its portrayal as the "Hopeless Continent" by the *Economist* in 2000. Thirteen years later the *Economist* labelled the continent "Aspiring Africa", as the many benefits of more stable societies and booming resource prices have led to fast-growing economies with better living standards. These improvements have caught the attention of investors from around the world looking for growth in a post-financial crisis world.

African and global investors looking to tap into this growth are looking to the different investment alternatives offered on the continent and are weighing up the pros and cons of the available asset classes. African listed markets have markedly different levels of quality with low numbers of listings and low liquidity outside the largest exchanges of South Africa, and to a lesser extent Egypt.

RisCura's research suggests that investing in Africa's equity exchanges may not give investors the required exposure to the growth sectors of these markets. We covered the equity investment alternatives available to investors. This had a focus on transaction and quoted multiples as an indication of the relative price of African equity in comparison to other parts of the world and different regions within the continent.

Given the limitations of listed markets, investors with a long-term focus are looking to private equity to supplement their African equity exposure. While private equity has its own shortcomings, it has the great advantage of being able to access companies outside of the narrow confines of listed markets, giving investors a wider exposure to sectors and to companies at different stages of development.

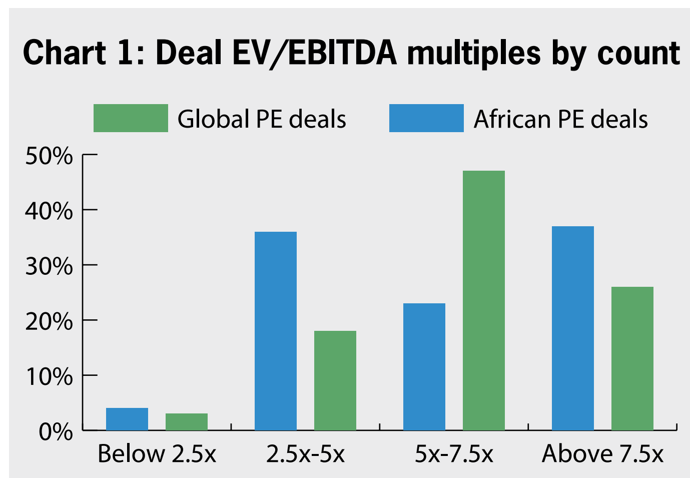
In general, African private equity deal multiples have been lower than those in other parts of the world, although there have been some exceptions to this rule. In 2010, several large deals took place on the continent where fairly high multiples were paid to secure these investments. The sample includes an average of 20 African private equity deals per year for the 2006 to 2011 period and is considered indicative of the level of transaction multiples paid over time.

The area where African deals differ markedly from other parts of the world is the use of debt as part of the financing of deals. African debt markets are relatively undeveloped with the exception of South Africa, which results in difficulty sourcing debt funding for deals. Consequently, African private equity deals use an average of approximately 2x EBITDA in debt financing compared to approximately 6x in the US and 4x in Asia. This very low level of debt means that these deals take on little extra risk through leverage and, therefore, do not rely on leverage for returns.

The use of debt in Africa was higher in 2007 when large deals were still being done with debt in South Africa. However, since then, debt levels have reduced and have not recovered. In contrast, debt multiples in the US have recovered significantly since the dip in 2009 and appear to be the main driver behind increased purchase price multiples in 2010 and 2011.

Deal multiples by count

An analysis of the number of deals falling into deal multiple groupings showed interesting results when compared to global private equity deals.



Source: RisCura Fundamentals, Pitchbook

Almost half of global deals take place in the 5x to 7.5x grouping, and a quarter in the greater than 7.5x grouping, leaving only 20% of deals happening at below 5x. In contrast, African deals predominantly take place in two groupings: 2.5x to 5x and above 7.5x (*see chart 1*). This leaves only 20% of deals taking place in the bracket where almost half of global deals take place.

One reason for this appears to be the number of high-growth medium-sized companies that fall into the 7.5x category to add to the leveraged buyout (LBO) transactions already in this category. Many more deals happen at lower multiples in Africa than globally, which may be a result of the higher risk assessment of investing on the continent and the higher required rate of return.

Deal multiples by company size

When deals are split by the size of the investee company, it is clear to see that African deals take place at lower levels than occur globally across all categories (*see chart 2*).

This appears to be a result of the higher level of return demanded in Africa compared to the rest of the world. On average, multiples across all categories are 12% lower than the global average. The data shows that in Africa the largest deals are generally the most expensive, likely due to the fact that they are the most competitive. This is a common scenario and is reflected in a similar finding in global private equity deals.

When looking at debt multiples only, it is clear that much lower levels of debt are used across all deal sizes in Africa, with the largest deals averaging only 2.27x (*see chart 3*). This is due to a number of factors including poor access to debt markets in parts of the continent, the relative risk aversion of South African banks and generally high interest rates across the continent.

The average debt use includes the fact that many deals do not include any debt in the capital structure. When these all-equity deals are excluded from the data set the debt/EBITDA ratio moves up to just under 3x. This is consistent with the levels at which South African banks say they will provide debt to deals.

Interestingly, the ratio of debt to equity used in African deals does not change much as the size of the deals change.

While there is certainly an upward trend in debt use as deals become larger, the rate of increase is far lower than that in global deals. Even deals involving companies with enterprise values of more than $100m are only 30% debt-financed compared to the global average of 60%.

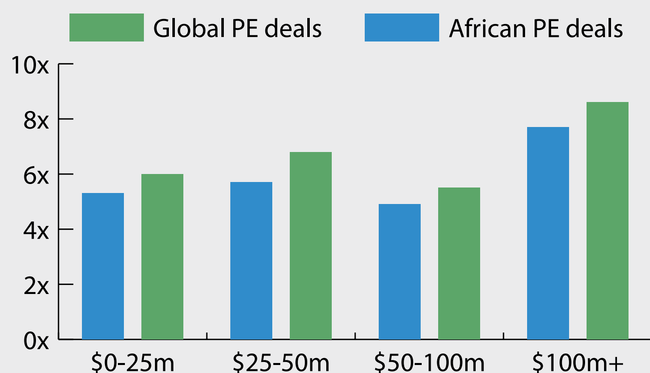
Deal multiples by region

When multiples are broken down by region, it is interesting to note that multiples paid in South Africa are the lowest on the continent, both in listed and private equity markets. One explanation for this is the lower growth expectations for South Africa as a significantly more developed economy than the other regions.

West African listed and private equity multiples are comparatively high, reflecting the growth expectations for the region compared to other parts of the continent. East Africa too reflects relatively high private equity multiples. However, it must be noted that the sample of East African deals was smaller than the other regions leading to reduced certainty in this as a strong representation of deal multiples in the region.

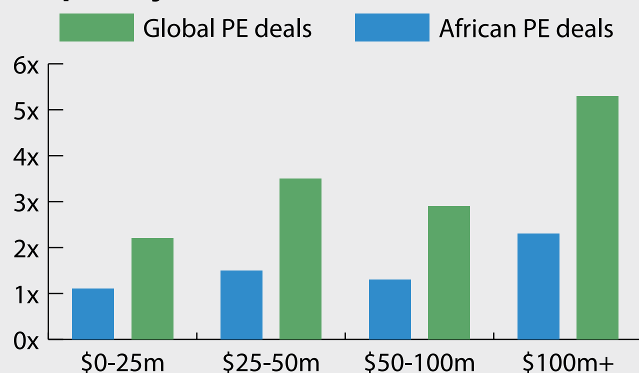
North African private equity multiples have been lower than those in West Africa, but above South Africa. Again, this is a representation of the growth expectations in the region relative to the additional risk. Overall, private equity multiples in South Africa averaged 6x, while those in the rest of the continent were 6.8x.

Chart 2: Average EV/EBITDA multiples by size



Source: RisCura Fundamentals, Pitchbook

Chart 3: Average debt/EBITDA multiples by size



Source: RisCura Fundamentals, Pitchbook

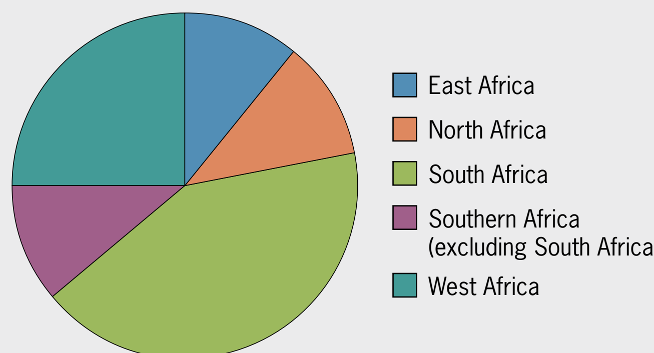
Exits on the rise

Global institutional investors have long cited Africa's poor exit record as one of the keys reasons for staying out of the continent. Recent times have, however, seen GPs find innovative ways out of deals, leading to a rise in exit volumes, according to a report by Ernst & Young and the African Venture Capital Association (AVCA)

AFRICA'S PRIVATE equity firms are clearly demonstrating a good capacity for finding ways to realise value. Between 2007 and 2012, Africa recorded a total of 118 exits by private equity firms. This figure is very encouraging and likely to be higher than many prospective investors and other market participants may have expected. And we know there are many more than these because many sales are completed privately, making it difficult to collate complete data. Also encouraging is the finding that these exits are not entirely centred around the more developed market in South Africa.

South African exits account for 42%, less than half of private equity exits. The remaining 58% were spread across all regions, where the industry is far younger than South Africa. West Africa accounted for the second-highest proportion with 25%, while the other regions – East Africa, North Africa and Southern Africa (excluding South Africa) – each accounted for 11% of exits (*see chart 1*).

Chart 1: Exits by region



Source: Ernst & Young, AVCA

This is a highly positive finding as it demonstrates that private equity houses across the continent cannot only source good investment prospects but also have a focused eye on the exit. Overall, as might be expected, the larger markets of South Africa, Nigeria, Egypt, Ghana and Kenya accounted for a large share of the exits, with 74%.

The year 2012 proved to be a good one for exiting private equity investments. Africa saw 22 realisations, up from 18 in 2011 and 20 in 2010. In fact, 2012 was the best year for exits by volume since before the global crisis in 2007, attesting to the resilience of Africa at a time of global uncertainty.

Trade sales dominate

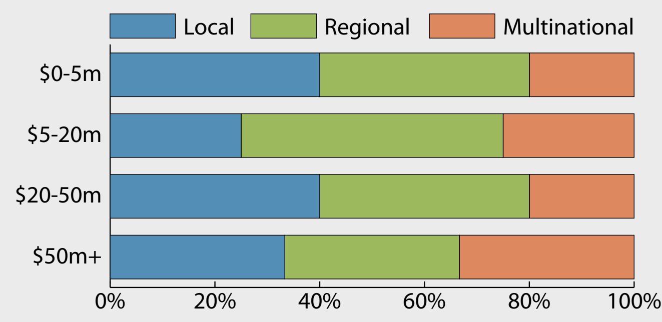
Sales to strategic buyers have been the most significant exit route in Africa, accounting for half of all exits. Indeed, they accounted for more than half of realisations in 2012. Of these buyers, regional and local companies have been the most active trade buyers in the six-year sample. However, between 2010 and 2012, regional buyers became the most prevalent type of strategic buyer, accounting for half of all trade sales (*see chart 2*).

This points to an increasingly pan-African market that is being driven by local players consolidating fragmented industries across the continent. The analysis suggests this trend is particularly notable in the financial services market.

Multinational companies, by contrast, make up a small proportion of trade sales – just 15% between 2010 and 2012, down from 31% between 2007 and 2009. This is perhaps a reflection of the cautious stance being adopted by global companies in their M&A strategies as economies in the rest of the world, including other key emerging markets, slowed in 2012.

However, it may also be a function of the size of deals that private equity currently targets in Africa. For those deals with

Chart 2: Trade buyers – local, regional & multinational by entry enterprise value



Source: Ernst & Young, AVCA

an entry enterprise value (EV) of $50m or more, sales to multinational companies account for a third of exits to strategic buyers. As fundraising numbers increase over time and deal sizes creep up, it seems likely that multinationals will become a more important source of exits in years to come.

Over half of the regional buyers were based in South Africa, with the rest evenly spread throughout the rest of the continent. This suggests that South Africa-based companies are becoming more active outside their domestic market and in other parts of Africa.

Back for seconds

Secondary buyouts were the second most important exit route in 2012, accounting for 23% of sales by private equity (*see chart 3*). This is a significant development: in 2007, secondary buyouts were just 12% of exits by number. The increase is suggestive of a maturing market, as more private equity funds become active in Africa and larger funds are raised. We would expect more private equity-to-private equity sales over the coming years.

Africa-focused funds are also using stock markets as an entry and exit point for portfolio companies. While some are able to take advantage of IPO markets in the relatively liquid Johannesburg Stock Exchange, private equity houses more commonly buy and sell minority positions in listed companies. In 2012, 9% of exits were via a stock sale on the public market. Meanwhile, the low incidence of leveraged transactions means that exits to creditors are few. While there were some in 2008 and 2009 (6% and 7%, respectively), other years saw none.

Outperforming public markets

African private equity firms are not just making excellent headway with generating exits, they are making strong returns in the process. This is highly encouraging for the future development of the industry in the region. Development finance institutions (DFI), which have largely been responsible for the creation of private equity in Africa, have clearly identified the private equity players with potential for generating positive returns. A greater level of commercial sources of finance – both domestic and international – should follow.

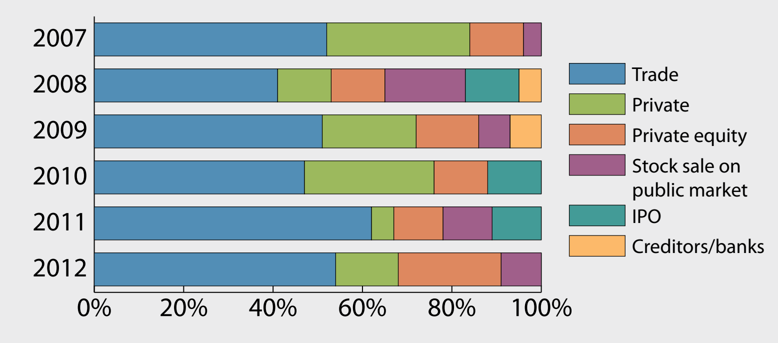
The analysis of the 62 exits for which we have an equity multiple return shows that private equity's strategic and operational improvement capability in Africa has led to a 0.9x multiple return over the JSE ALSI. As such, private equity in Africa has returned almost double to investors what they might have achieved on the public markets. This bears testament to African private equity's ability to create value by sourcing good investments, working closely with management teams to improve companies and finding the best available realisation route.

Unlike in many other markets, most of Africa's private equity investments do not use leverage so there is no return from leverage in the sample data. The investment model has been adapted by Africa's private equity investors to suit local conditions; the returns they have generated show that these adaptations work well.

By region, those markets that are arguably least mature in private equity terms – East and West Africa – generated the highest returns. This is possibly because private equity is able to make more improvements to companies in these markets in addition to taking advantage of multiple expansion strategies.

This article is an excerpt from Harvesting Growth, *a 2013 report on exits by Ernst & Young and the African Venture Capital and Private Equity Association.*

Chart 3: Exit route, by exit year & exit population



Source: Ernst & Young, AVCA