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SESSION II: PRIVATE EQUITY

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A NEW ECONOMIC PATH FOR SUB-SAHARAN AFRICAN COUNTRIES THROUGH PRIVATE IMPACT EQUITY

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EXECUTIVE SUMMARY :

Private equity investments are on the rise in Africa and, adjusting for economy size, are as important to the continent as for the average emerging economy. These investments are demonstrating profitability: Private equity deal multiples in Africa, based on performance over the past nine years, are estimated at roughly 8x. Equity investments can play an important role in resolving some of Africa's most pressing development challenges: solving the financing constraints facing African firms; meeting unsatisfied demand for goods and services among the continent's low-income households; and ushering in much-needed structural transformation for Africa's immature economies by improving firm competitiveness. Impact investors can be especially effective. Further growth of private equity depends on achieving economies of scale: transitioning away from small deal size and small size of funds. Governments can assist by providing financing (through Development Finance Institutions) and enabling regulation.

WHAT'S THE ISSUE?

The past several years have witnessed a boom in the economic growth of sub-Saharan Africa (SSA). The region has experienced an average 5 percent yearly increase in its real gross domestic product (GDP) since 2002, making it the world's second fastest-growing region behind East Asia.

This dynamic is changing perceptions of Africa. As perceptions evolve, so have international investment trends. The growing interest of investors in Africa is palpable: Foreign direct investment toward SSA increased fivefold between 2000 and 2011. There has also been a gradual

reorientation of local and international investments in the continent beyond traditional natural resource exploitation to infrastructure and indigenous corporations.

In this context, private equity is becoming a significant player. According to the Emerging Market Private Equity Association, private equity flows to sub-Saharan economies increased sharply between 2002 and 2008. The size of investment funds raised expanded fifteenfold while capital investments expanded 5.5-fold (to \$2.2 billion and \$2.9 billion, respectively).

The global financial crisis hurt private equity in emerging countries and flows are still recovering. Nevertheless, the share of private equity invested in emerging countries in 2012 devoted to sub-Saharan Africa rose to 4.9 percent in 2012 against 2.2 percent in 2010. Private equity in SSA as a percentage of GDP stands at 0.09 percent. This percentage is lower than in emerging Asia, but is equal to the average for emerging economies and only slightly lower than for the BRICs (Brazil, Russia, India and China).

The majority of investments continues to be below \$25 million in size and targeted toward South Africa, the Democratic Republic of the Congo (DRC) and Nigeria, which together represented 61 percent of the number of investments. Banking and financial services were the most popular sectors for investments in 2012, followed by agribusiness, industry and manufacturing. Private equity, in particular, gives investors a wider exposure to sectors and to companies at different stages of development that the few listed African markets cannot provide.

A minority but important share of private equity to Africa falls under the rubric of impact investment. The impact investment market is difficult to measure but, based on a recent survey (2013),¹ JP Morgan and the Global Impact Investing Network (GIIN) identified global impact investments worth \$8 billion in 2012, of which over \$500 million is devoted to sub-Saharan Africa. These investments are mainly targeted toward microfinance, housing, food and agriculture, and clean energy and technologies. These numbers describe a nascent and limited phenomenon when compared to the GDP, private flows and population of the continent.

Greater volumes of private equity to Africa should be encouraged in order to accelerate the continent's development. Private equity can help resolve the significant financing constraints Africa faces at multiple levels. African firms incur limited access to funding while African economies as a whole face massive financing needs.

African banking systems operate largely on a short term basis² (more than 80 percent of deposits are short-term deposits or deposits with a maturity of less than one year), have high intermediation constraints (loan-deposit ratios are 30 percent lower, on average, than in banks in other developing countries) and have high interest rate spreads and margins (interest margins in African banks are 44 percent higher, on average, than in the rest of the world). Non-banking segments of Africa's financial system show an even lower degree of maturity than banking. For instance, only 24 of the 53 African countries have stock markets, and only a few of these are liquid (Egypt, Morocco and South Africa). It is, therefore, the efficient allocation of financing as much as its level that serves as a constraint on African economic development.

¹ *Perspectives on Progress – The Impact Investor Survey*, JP Morgan 2013

² Data come from the book "Financing Africa: Through the crisis and beyond"

This problem is all the more acute as African economies have major investment needs in infrastructure, natural resources and agriculture. For instance, it is estimated that the continent requires around \$390 billion of infrastructure investments over the medium term, mostly for energy. This need is equivalent to around one-third of sub-Saharan Africa's GDP in 2012. In the long run, infrastructure needs can be counted in trillions of dollars. These volumes are far beyond what national governments or development finance institutions can realistically address.

Private equity, and impact investments in particular, can play a more fundamental role in ushering in much-needed structural transformation for Africa's immature economies.

Manufacturing industries remain very small in Africa, representing only 10 percent of its GDP—a share that declined by around 1 percentage point between 2006 and 2011.³ Indeed, manufactured goods represent only 23.5 percent of sub-Saharan exports, against 83.5 percent in Asia. African economies also have a very low level of diversification.

Africa's difficulty in developing its industry represents a broader failure to move toward more productive, value-added activities and to achieve more inclusive economic growth. Despite rapid economic growth, the creation of economic and social opportunities for the younger generation remains a crucial challenge for African governments. Indeed, the employment-to-population ratio⁴ has remained virtually constant over the last 20 years (from 59 percent in 1991 to 60 percent in 2011). Most African countries continue to have a high proportion of jobs in the primary sector. As a result, poverty has not reduced as fast as we could have expected given the pace of the economic growth.

The deficit of firm competitiveness, the consequence largely of institutional and geographical factors, explains why African economies have not undergone the same structural transformation as, say, Brazil or China. Infrastructure gaps and a difficult business climate contribute to increased direct and indirect costs for African companies. Frequent electricity shortages, high transportation costs, lack of financing and bribes are key challenges. African companies lose about 13 percent of their working time because of selective power cuts, compared to only 1 percent for Asian companies. Transport costs are more than double those in East Asia. Labor costs are higher than in other regions at the same level of GDP: Southeastern Asia labor costs are 40 percent lower than in Africa. Although business competitiveness has improved over the last couple of years as the level of human capital and governance progressed, sub-Saharan Africa's companies are the least competitive in the world, according to the Global Competitiveness Index.

Despite its steady economic growth, Africa suffers from an acute deficit in social and environmental development. The public sector still experiences difficulties delivering quality services. At the same time, the dearth of private companies explains why quality services are so expensive and restricted to the upper-middle classes. These private companies, especially the smaller ones, are generally insensitive to social, environmental and governance goals, or have neither the financial means nor the capacity to address those challenges.

By nurturing companies targeting unsatisfied demand for basic needs or by accelerating innovation, impact investing can precisely help African economies to address development challenges. For

³ *Structural Transformation and Natural Resources*, African Development Bank 2013

⁴ Measures the share of the working-age population in active employment.

instance, local generic medicine producers allow the sale of drugs at lower prices than if they were imported and contribute to improved health outcomes. Impact investment also contributes to sustainable development by fostering environmental, social and governance (ESG) practices in local firms. Respecting international standards can improve local companies' competitiveness and minimize negative externalities that spring from firms' activities.

Impact investment may also allow Africa to ultimately own its corporations. There is a risk that Africa's current economic model will result in foreign businesses dominating the supply of goods to its domestic market, as well as the continent's exports to the outside world, be they Chinese, European, American or Indian. Avoiding this outcome represents a social, political, cultural and economic challenge. Providing temporary equity and compensating for the current low level of savings on the continent will allow African entrepreneurs and companies to be part of the feast—and not just consumers.

WHAT NEEDS TO HAPPEN AND WHY?

How Africa has become more attractive for private equity

The phenomenon of private equity's expansion in Africa is inseparable from the broader story of the continent's improving economic performance.

The factors behind Africa's growth takeoff are numerous and contrary to commonly held assumptions. For instance, while the increasing exports of natural resources to emerging countries has been and remains an important cause—the African Development Bank evaluates this contribution at 35 percent since 2000—African countries with small natural resources endowments have also experienced much faster economic growth.

According to the International Monetary Fund regional economic outlook,⁵ the key to Africa's growth surge is the improvement of its institutional environment and economic policies. Over the last decade, the average inflation rate has halved, and public debt, including external debt, has decreased sharply, thanks largely to the Heavily Indebted Poor Countries initiative. In addition, the share of exports in GDP has grown at a two-digit rate, assisted by an improvement in the terms-of-trade (+77 percent between 2000 and 2011). Another factor is the rise of Africa's domestic (non-tradable) economy. Private household consumption increased by 61.5 percent between 2000 and 2011.

The improvement in Africa's macroeconomic conditions is particularly significant from an investor standpoint. For a long time, investors viewed Africa as a land of over-indebtedness, high inflation and volatile exchange rates—a perspective that is now changing, thanks to the strengthening of public administration and government capabilities.

Also significant from an investor's standpoint are microeconomic reforms to the business environment. For instance, the cost for starting a business decreased by 70 percent in sub-Saharan Africa between 2003 and 2011, and the time needed to register a property was divided by two during the same period (Doing Business 2013). While the business environment in Africa remains, on average, more difficult than in other emerging countries, the gap is smaller than imagined:

⁵ *Sub-Saharan Africa – Building Momentum in a Multi-Speed World*, International Monetary Fund, 2013

According to the Doing Business report, the average ranking of sub-Saharan African countries is 134th, compared to 116th for the BRICs.

According to a recent study by RisCura,⁶ African private equity deal multiples are estimated at roughly 8x based on performance over the past nine years. Although BRICs boast a better performance with an average multiple around 10x, this result is mainly skewed upwards by China with its two-digit multiple level (approximately 17x); by contrast, Brazil and India multiples average only 7-8x. These numbers should be treated with caution, as much of the information related to private funds is not disclosed; our experience suggests that true multiples are lower. Nevertheless, with multiples probably close to those for Brazil and India, sub-Saharan assets can be viewed as a good investment opportunity for venture capital companies, especially compared with the IRRs observed on mature markets.

Ongoing challenges for private equity

Even with the most assiduous attention to country and sector performance in determining investment choices, it is impossible to predict economic or political events. Investors have most control in executing business models. Active shareholders can play a significant role in the implementation of a company's business strategy. Potential internal failures can be overcome through active support from investment officers or capacity building.

The scarcity of high-skilled and experienced local staff makes the hiring of quality middle management difficult for investee companies. Local regulations in certain countries can preclude governance arrangements that might otherwise identify and overcome inefficient management. For example, the OHADA legal system, which covers all francophone countries in West and Central Africa, as well as some others, makes it difficult for minority shareholders to recover decision rights if the CEO performs badly.

Taxation is often a problem for private equity. African tax systems vary considerably, but more and more countries heavily tax profits on equity when investors exit. This is especially a problem in the absence of a taxation treaty between investor and investee countries: Double and excessive taxation occurs in these cases and represents an obvious constraint for investors.

Exits in sub-Saharan Africa are more complicated than in other emerging countries, especially given the scarcity of listed markets. With the exception of some IPOs (mainly in South Africa), the majority of exits in the last couple of years have been direct sales to strategic investors. Secondary exits remain rare due to the lack of sufficiently mature assets available for other financial investors. Investors have therefore often opted to invest in African companies throughout their entire lifecycle.

A focus on impact investment

According to the GIIN, "Impact investments aim to solve social or environmental challenges while generating financial profit." However, given the diversity of social goals pursued by impact investors on the one hand, and the wide variety of options to reach these goals on the other hand, classifying impact investment remains a work in progress.

⁶ *Bright Africa – A look at equity investment across the continent*, RisCura 2013

A key definitional question is how social/environmental objectives and financial objectives are weighed. While impact investment captures a range along the spectrum, a key point of impact investment is that the two concepts of maximizing profit and maximizing impact must somehow be harmonized. A useful distinction can be made here between impact investments and social businesses. “Impact investments” aim at optimizing financial returns with an impact floor, as opposed to “social businesses” which aim at optimizing societal impact within a financial floor.

This statement is nuanced by the different heights at which the impact floor can be set and the implications this has for financial returns. Impact investment “finance-first” vehicles expect close-to-market financial performance, and impact investment “impact-first” vehicles will accept a much lower financial performance and are therefore often indistinguishable from social businesses. Even the latter can reach acceptable financial returns in some cases.

	Standard profitable targets	Low profit targets
Standard profitable vehicles	<i>Market-vehicles</i>	<i>Finance-first vehicles</i>
Low profitability vehicles	<i>Impact-first vehicles</i>	<i>Impact-first vehicles/NGOs</i>

Financial vehicles that address standard profitable targets may also qualify for the impact investment category when, for instance, the cost of reaching out to those targets is excessively high. It is questionable whether a financial vehicle that sets standard profitable targets and gets standard financial returns can still be considered as part of the impact industry. Usually the answer is no, but one can imagine cases where the market would fail to address a specific target, and the financial instrument would have a clear and measurable social goal.

In every instance, what matters is that “impact investment” vehicles should have clear and measurable policy goals beyond, or in parallel to, financial targets. It is also important that these performances be assessed against these policy goals, be they environmental, social, cultural or ethical.

In many developing countries, impact investors cite a lack of investment opportunities as an important obstacle for growing business. This is generally not the case in sub-Saharan countries. Projects are numerous, and considerable dynamism exists in the business at the bottom of the pyramid.

Quality issues are more challenging: Many first-time or social entrepreneurs lack managerial skills and strengthening them is an unavoidable task and burden for investors. Technical assistance is often necessary to support this area.

Exits are also an important challenge for impact investors. Some investors are fortunate that entrepreneurs are willing to buy back their shares when an impact fund exits. In many cases, quasi-equity or debt-related structures offer a good alternative if valuation problems are too difficult to be solved.

RECOMMENDATIONS

A challenge of growth

There is growing recognition that existing financial resources are insufficient to address severe poverty, inequality, environmental destruction and other development issues in Africa. At the same time, a growing segment of the financial community recognizes that this situation also represents both business and impact opportunities. The growth of private equity, with a focus on impact investments, seems to have the potential to complement government and philanthropy by unlocking significant resources.

Given the imbalance between the amounts currently raised and invested in impact activities around Africa (probably no more than around \$300 million annually) on the one hand, and the size of the continent as well as its population (more than a billion people) on the other, the industry, as already highlighted, faces a challenge of growth. Private impact equity and lending economic models are mainly governed by three factors:

One is the *profitability of the targets themselves*. If one targets social businesses, returns may be low by nature. Even theoretically, profitable targets may return little money if they are located in politically unstable areas or address mainly startups with high-failure ratios or costly monitoring activities.

The second factor is the *size of the deals*. Even if one targets profitable activities, addressing smaller corporations will lead to small returns given that the fund business is mainly a fixed-cost business. This is the reason why venture capital is so rare, and small- and medium-enterprise financing has been abandoned by traditional market players.

Finally, a third factor is *the size of the funds*. The smaller funds are, the more expensive they are to run, since governance reporting and best financial practices represents a significant fixed cost.

There is little one can do and should do about the first two factors. Both the level of expected profitability and size of deals are part of the nature of the impact business. But the third factor is a very important reflection of the efficiency of this activity. Not only should we have more impact funds in Africa, addressing more challenges and active in more regions, but they should also be larger to diminish costs and to allow for better management.

The need for regulation and funding

There is much that governments can do to support the needed growth of this sector. The first area is regulation. In many countries, it is difficult to identify the appropriate legal regime under which impact investment activities fall. In some settings, funds may not be permitted at all. Financial corporations may be subject to major regulatory barriers making it difficult to develop small vehicles with limited financial means and modest teams. In general, financial regulations have tended to support the concentration of corporations and made it difficult for smaller vehicles to function, given that they lack the capacity to deal with onerous regulatory constraints, such as anti-money laundering rules.

Either in OECD or developing countries, specific frameworks should be created for impact investment activities. These frameworks would create a climate of confidence for impact investors and ensure that laws are appropriate to the size and the profitability of the sector.

A second area is funding. As we have seen, impact investment is still a very small sector. It has to compete with many “competitors” in accessing funding. Most impact investors don’t benefit from tax incentives. The bulk of the competition comes from the regular private sector and takes place especially in competition for funds from development financial institutions. The latter have so far contributed only modestly to funding impact investments, with a few bright exceptions. Many do not consider supporting impact investing part of their mandate, or deem impact investment not profitable enough. They are right: Many public institutions dedicated to supporting the private sector have been mandated over decades to demonstrate that investing in developing countries is definitively profitable and that more private investment should go into that direction.

It would be good and wise to start balancing the legitimate historical mandate of those institutions with more focus on social, environmental, cultural and poverty challenges. Moving into less profitable areas with higher impact on those dimensions is necessary. This would be a major shift for many DFIs, which are traditionally risk averse and focused on high returns. However, it is important that this shift takes place given that the traditional supporters of impact investment (family foundations, high net-worth individuals or industrial private firms) will probably reach their technical limits in the coming years.

Third, impact investment also needs more dialogue, more technical progress and more capacity building. Most firms are young; concepts are new. Proof of results is limited, and evaluation is only starting to be mainstreamed. Technical impact assessment is an area in which a lot of progress can be made. Thus, there is a lot of knowledge, capacity building and research to be supported both by foundations and governments. Investment firms, with their limited financial and human capacities, cannot be expected to fund or deliver these needs on their own.

Conclusion

Private impact equity is a new and exciting sector. We should address its agenda with enthusiasm and realism: Like any financial instruments, impact investment has its contribution, its limits and its risks. It needs regulation (please make it light and efficient, for once!), support, further thinking and, overall, more experience to understand better to what it can really contribute. Learning while doing is going to be very important—as it has been, for instance, in the area of microfinance.

Let’s embark on this new venture boldly, but with the right critical and learning frame of mind that can allow all stakeholders to move and progress. Hopefully, experience and theory will move us into more and more efficient ways of managing a great new way to address the challenges of sustainable development.