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PRIVATE EQUITY IN AFRICA: EMERGING TRENDS

 

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Private equity in Africa has come a long way since the early 1990s, which saw development financial institutions (DFIs) investing in government initiated development projects across the continent. The period that followed was characterised by the emergence of a limited number of South African focused PE funds, which over the next decade started to invest more widely across the continent. By 1997, there were 12 private equity funds that had collectively raised US$1bn to invest in Africa.

As we fast forward to 2017, the African PE ecosystem has significantly matured with over 200 PE funds managing upwards of US$30bn targeting Africa and unprecedented capital formation in 2014-2015 which saw over US$7bn raised to invest in Africa, including the first billion dollar sub-Saharan African funds, Helios Investors III and Equatorial Guinea Co-Investment Fund.

With the new narrative of 'Africa Rising' that pervaded the media from 2000 and in the aftermath of the 2008 economic crisis, PE funds increasingly turned to emerging markets for levels of growth that were unattainable elsewhere. Although certain countries on the continent have experienced headwinds in recent years, one thing we can be certain of is that African PE has significantly evolved over time. Many features typically reserved for PE transactions in Europe and North America are becoming increasingly prevalent in African PE.

Stronger exit opportunities

In the past, a key concern for PE funds and their LPs regarding African PE investments was the quality and availability of exit routes. Illiquid domestic exchanges and political and foreign exchange risk have historically contributed to a limited number of exit paths. However, with the maturation of the African PE market, the number and scope of exit opportunities have notably improved with AVCA reporting a record number of PE firms in Africa exiting in 2014 and 2015 (31 and 28 respectively). Furthermore, the majority of respondents in a 2016 Deloitte report expected the volume of exits in the next 12 months to increase or remain the same, despite increasing challenges in the debt funding environment.

Trade sales

Trade sales to strategic investors continue to be the most dominant exit route, constituting over 50% of exits in 2015. This is expected to continue to be the case in the next 12 months. A notable feature of the evolving market, is the increased prevalence of auction sales such as the sale of Brandcorp in June 2016 by Ethos Private Equity to The Bidvest Group. Given the strong fundraising by Africa focused funds in recent years and the competition for quality African assets, it is likely that auction processes will become increasingly common.

Secondary transactions

After trade sales, secondary buyouts (sales to other PE funds) such as the sale of Algeria-based manufacturer Cellulose Processing by Mediterrania Capital Partners to Abraaj in 2016, account for the next largest proportion of exits, at 18% of deals surveyed in 2015. With strong fundraising by domestic, international Africa focused and global funds such as Carlyle and KKR (who made their maiden African investments in 2014), we expect that secondary buyouts will continue to be a growing feature in the African PE market.

As the quality of assets and deal sizes gradually increase over time, we would also expect to see more sophisticated secondary transaction structures, such as 'portfolio' deals which package up several assets together to be sold to another fund, or deals which involve the breaking up of larger investments into smaller divisions for sale. Given that 75% of deals in the first half of 2016 were below US$250m, it may be some time before the market develops to such a point.

IPOs

Although public listings remain as one of the most attractive exit routes in the global PE industry, the converse has historically been true in African PE. Fragmented regulation, underdeveloped capital markets and low levels of market capitalisation compared to the developed world, result in low usage of IPOs as a PE exit route: only 1% of all 83 PE exits in Africa during 2014 – 2015 took place through IPOs.

The suspension of Nigerian fintech company Interswitch's IPO plans to raise as much as US$1bn, due to fears over the further weakening of the Naira and a shortage of foreign currency, is a good example of the challenges faced by African PE investors attempting to use IPOs as an exit route. While opportunities outside the Johannesburg Stock Exchange, Cairo and Alexandria Stock Exchanges and Lagos Stock Exchange remain limited, the Abraaj Group's exit of Unimed via an IPO on the Tunis Stock Exchange in May 2016 and Actis's exit of Ugandan electricity company, Umeme Ltd, via the Ugandan and Kenyan capital markets in December 2016 shows that viable options do exist.

A number of initiatives have been introduced to improve the listing of shares in African companies such as: (i) the East Africa Community (EAC) stock markets integration project, (ii) the introduction of the Growth Enterprise Market Segment by the Nairobi Securities Exchange (NSE); and (iii) new mechanisms to trade and settle ordinary shares of London listed or dual listed Nigerian companies. As such initiatives come to fruition, we expect that exit options on a limited number of exchanges will become more viable.

> *"Many features typically reserved for PE transactions in Europe and North America are becoming increasingly prevalent in African PE."*

International and domestic pensions funds as new sources of funds

Although DFIs continue to play an essential role in African PE, traditional institutional investors such as insurance companies and pension funds are becoming an increasingly common source of funds. More recently, global funds such as Helios and KKR have invested Western pension money in Africa.

Pension funds in 10 African countries have an estimated US$379bn of assets under management, of which $29bn could potentially be directed towards PE, according to the Emerging Markets Private Equity Association (EMPEA). Economist Charles Robertson of Renaissance Capital estimated that pension funds in the 6 largest sub-Saharan African markets will grow to US$622bn in assets under management by 2020 and to US$7.3 trillion by 2050. Such pension funds present a significant opportunity for alternative asset classes such as private equity.

Private equity is currently a rare feature of African pension portfolios, however, Africa's emerging pension fund industry could become a valuable source of funds for PE investments in the future. Pension reforms across the continent support this proposition: Nigerian pension regulations have been amended to include PE as a specified asset class for pension fund investment and in South Africa, the percentage of total assets under management that pension funds can invest in PE has been increased from 2.5% to 10%. Significant participation remains unlikely until African pension fund trustees become less risk averse and more familiar with this asset class, however, the opportunity in this area means that, like Western pension funds, we expect domestic pension funds to become a future source of funds for African PE.

Increasingly sophisticated features and capital structures

Equity and debt instruments

The illiquidity of domestic capital markets, as described above, presents challenges for companies seeking funding. The small size and conservative nature of many African banks, result in African PE deals being significantly less leveraged than equivalent deals in the developed world. As a result, the primary source of funding in African PE has historically been equity finance with a simple capital structure.

As the market matures and aims to close the funding gap, mezzanine debt is becoming a key component in the capital structures of African companies, and there are a number of dominant South African funds in the mezzanine debt market. While specific forms of 'mezzanine debt' in a European context are generally clearly defined, in African countries it refers more broadly to subordinated debt or unsecured senior debt.

A number of PE funds, such as Helios Investment Partners, Abraaj and TLG Capital, have raised credit funds specifically targeting these types of investments in Africa. Going forward, we expect to see an increasing number of such funds being established.

The challenges posed by the African funding market and the increased complexity of companies' investment needs, means that we also expect to see an increase in the use of tiered capital structures, with a broader range of share classes and debt instruments, including convertible instruments, loan notes, warrants, high yield instruments, and payment in kind (PIK) notes.

Warranty and Indemnity Insurance

Private equity has been a driving force in the increased use of warranty and indemnity ("W&I") insurance on global M&A transactions, particularly on the buy-side. Such policies are beneficial for buyers with limited recourse against sellers who have poor covenant strength. It also allows PE and institutional sellers to achieve a clean break and distribute proceeds to their LPs.

Historically, insurers' have been wary of emerging markets, however, AIG reports that this is a growing area. Before offering W&I insurance, insurers assess the legal, political and regulatory risks in the relevant jurisdiction, and reflect the level of risk through pricing and exclusions. We expect that the trend to take out W&I insurance, and the increased appetite to underwrite W&I policies on African PE transactions, will continue.

Contributors' Profiles

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