John Rowland, CFA
jrowland@whitelake-group.com
+44 (0) 7726302025

Ashok Parekh, CFA, CAIA
aparekh@whitelake-group.com
+44 (0) 7850080981

Patterns, Predictions and Profits: the Powerful Case for African Private Equity

According to the latest IMF forecast, seven of the 10 fastest growing economies worldwide over the next decade will be African. Couple this with the economic stagnation and market insecurity that continue to pummel the US and Europe, and it's no surprise that more and more investors are considering Africa as an investment destination.

At White Lake, we firmly believe that the time has come for global investors to embrace African private equity.

Over the past 10 years sub-Saharan Africa has grown on average 6% per annum in terms of GDP. Globally, only India and China have grown faster. The past decade's growth comes as the result of a wave of change that has affected populations, political institutions and infrastructure. Critically, many of the drivers behind this change are still in place and still propelling national and regional economies forward.

The drivers behind the African economic engine

The root causes of the change in African economic fortunes can be traced to the 1990s, when a commodity boom led by China prompted a surge of economic activity, and increasingly stable political institutions were able to weather the boom and profit from it. Other primary factors are communication improvement, notably the market penetration of mobile phones – an estimated half of Africa's 1 billion population has a mobile phone and an on-going widespread modernisation of agricultural and industrial techniques.

An ever-rising demand for commodities

African countries supply the world with many of the most valuable metals and certain critical soft commodities (e.g. cocoa). Most of the world's platinum and palladium comes from Africa, as does 18% of the world's uranium and 9% of the world's bauxite. Nigeria and Angola are among the top 20 oil producers in the world. The global appetite for these resources shows no signs of diminishing: indeed, the super cycle only looks set to continue in the face of China's un-abating growth.

Increasing commodity revenue across many African countries has indirectly boosted other sectors and led to an overall GDP boost. GDP per capita, however, is another matter: its comparatively slower rise indicates that inequality in wealth distribution persists in some countries, primarily those with a single commodity as the major source of income.

White Lake Strategic Advisory Group
35 Park Lane,
London, UK
W1k 1RB
www.whitelake-group.com

An increasingly stable environment for business and growth

Stabilising politics across Africa have led to unprecedented improvements in the ease of doing business. Africa has democratised at a significant rate since 1990. The number of absolute autocratic states has dropped to two (Eritrea and Swaziland), and while there are still certain countries with only marginal democratic systems, the continent's widespread democratisation using models of British and French law has proven invaluably helpful for business and FDI. Foreign investors need be less and less concerned about the risk of nationalisation or unhelpful regulatory changes that threaten their investments.

Atop this foundation of increasing political and economic stability, several secondary factors are contributing to Africa's appeal as investment destination.

Population growth and the rising middle class

Over the past five years, population growth in Sub-Saharan African has been 2.5% stronger than in any other BRIC country. Africa's total population now surpasses the 1bn mark, with more than 40% under 20 years of age. This is predicted to double to two billion people over the coming 50 years. Africa's labour force is also set to grow, and that means a key component of economic growth is assured.

As the African population grows and national and regional economies improve, more people will move into the middle classes – this in itself a hallmark of an increase in per capita GDP. As we have seen most recently in China, the newest members of the middle class wield discretionary spending power, further boosting market areas such as the fast moving consumer goods sector.

The shift towards urbanisation

The Chinese experience has shown that urbanisation boosts consumer spending firstly in grain and vegetables, and then in higher value goods. This same effect is now beginning to be seen in Africa, with figures showing that Africa is urbanising almost as fast as Asia.

According to UN data the African urban population is set to rise by 40% over the next ten years. African countries identified as having a particularly high rate of future urbanisation include Mozambique, Angola, Nigeria, Ghana, Tanzania, Kenya and Ethiopia. Urban populations of these countries are likely to follow the same patterns as urban populations everywhere: people will live longer and have fewer children.

Population growth in these urban centres will plateau over time, further contributing to sustainable economic growth. GDP growth will translate into higher earnings growth for companies as GDP per capita hits a tipping point and people enjoy more discretionary spending on branded higher value goods – goods which command pricing power.

The dimensions of the African PE opportunity

Taken together, these facts, patterns and predictions suggest that certain countries and sectors in the African market offer prime opportunities for investment. And in fact, many of the most exciting opportunities in the Africa are not listed on stock exchanges. For global investors, private equity serves as a route to market to take advantage of these fast-growing economies.

Although there has been increased interest in Africa as a private equity destination, actual investment has not yet made significant inroads into African economies. As such, while there is certainly increased competition for a few large notable deals among elite private equity players, there remains a huge untapped market where capital may be deployed. Africa offers investors a best-of-both-worlds scenario: while at any one time there are typically several sizeable transactions and infrastructure project that allow large deployment of capital, the market also allows private equity investors to gain significant or controlling stakes in companies with far more limited amounts of capital.

For investors looking to apply a social or ethical element to their investing activities, private equity also represents not only an opportunity to bring funding to Africa but also a chance to deploy significant intellectual capital into these economies. Private equity investors can provide strategic support to African entrepreneurs, in turn enabling them to grow their own businesses.

Sectors and opportunities

There are huge opportunities in the African market, we at, White Lake, we are highlighting infrastructure, SMEs, innovation and FMCGs – sectors where we see evidence of growth, stability and increasing profitability.

Infrastructure

The need for infrastructure in Africa remains huge, with a recent Africa Infrastructure Country Diagnostic (AICD) estimate suggesting that annual of investment of US $93 billion over the next ten years is needed just to close the gap between this region and other developing economies. Ports, railways, roads, airports, power are just some of the sectors that require upgrading in order for Africa to continue building upon its current economic momentum. Private equity can help bridge the gap between available public sector and debt funding. It is also an area where larger amounts of capital may be deployed.

SMEs

While large infrastructure projects and microfinance grab headlines, African SMEs are often ignored by Western investors. These companies have the potential for high growth but often have trouble getting lending from local banks. This presents an opportunity: a gap that private equity can fill.

Innovation

With its high number of less-developed countries and reputation for long-depressed economies, may be surprising for investors to think of Africa as a place where new and innovative ideas can easily be brought to market. However, investors would be wise to drop pre-conceived notions. For example, consider many countries' relative lack of fixed telephone lines: rather than this holding back progress, progress has simply found a way – straight to mobile. Africa has experienced a mobile phone revolution, with hundreds of millions of new users joining at rates unseen in more developed countries. This in turn has fostered new ways of applying mobile technology – such as mobile banking – which in turns leads to greater investment opportunities.

FMCGs

Along with rapid economic growth, strong population growth coupled with the rapid urbanisation of Africa brings a number of opportunities in the Fast Moving Consumer Goods (FMCG) sector. Higher income levels leading to increased spending points the way forward for the consumer goods sector. Investors who secure first mover advantage in this space will be in a position to reap increased returns.

Investment perspectives by country

Investors face a plethora of choice when targeting African markets. The larger, more established markets of South Africa, Nigeria, Kenya may be seen as the top emerging markets, while equally fast-moving but less defined Angola and Ethiopia may be seen as frontier markets.

White Lake showcases six key markets where we believe there is ample opportunity for private equity investors.

Nigeria

Nigeria is the continent's second-largest economy and it shows no signs of slowing down, having experienced sustained economic growth of averaging over 6% over the past five years. Nigeria's huge oil and gas reserves will continue to attract investment but there are other opportunities out there. Basic infrastructure of all kinds needs to be upgraded presenting plenty of opportunities, and the large domestic market is also creating opportunities in the communication, financial services and tourism sectors.

Tanzania

Tanzania is projected to have one of the fast growing economies in the world over the next five years. The stable macro economic environment, coupled with government incentives for foreign investors, leads to opportunities in the banking, tourism and mining sectors.

Ghana

Ghana has a sizeable resource base to support its fast-growing economy, and has recently been investing heavily in infrastructure and human capital projects. The Ghanaian government has opened up a number of sectors for foreign investors such as hydroelectric power, agri-business, chemical pharmaceuticals and IT.

Rwanda

Rwanda may be considered a frontier market by many investors, but since emerging from its painful civil war the country has placed considerable efforts in reforming its economy. Many investors rank Rwanda first for ease of doing business in Africa.

Kenya

Though Kenya does not benefit from the resources of many other African countries, its relatively well-educated workforce and position as a strategic trading hub in East Africa have made its economy relatively dynamic. Recently, considerable efforts have been made to make Nairobi an African tech-hub. Opportunities abound in targeting the mass-market sector.

South Africa

As the region's largest economy, South Africa cannot be neglected. It has a sizeable domestic market and a strong institutional environment conducive for private equity. Recent legislative changes have made South Africa more conducive for private equity managers.

Risks and mitigations

The aforementioned opportunities, while having the potential for high returns, do not come without risk. Some of this risk is ill-founded and based on out-dated paradigms: political unrest, war and famine. Like most generalisations, painting all of Africa's 54 countries with the one brush would be a mistake. Yet it would also be rash to make any investment decisions without examining in detail the political progress over the past ten years. Which risks still pose concerns for the informed investor?

Political risk

The major political risks include war, expropriation, unfavourable legislation changes for foreign investors, currency failure and breach of contracts (with governments). These risks are different for every country in Africa, though one of the main positive points (in comparison to China, for example) is that many African countries have French- and English-based legal systems. For investments involving governments as a counter party there are political risk insurance products available. These insurance products can also be applied to private equity funds and are worth exploring.

Outside of event-driven political risk, care must be taken to examine laws relating to each country's approach to taxation, repatriation of dividends, and capital gains.
You can also mitigate risk by co-investing with local investors or DFIs who have strong relationships with incumbent governments.

Lack of infrastructure

While Africa is a potentially huge market for many goods and services (mainly fast moving consumer goods) the lack of infrastructure (roads, rail, electricity, water) represents a major challenge for the distribution, storage and transport of goods to the consumer. With the lack of roads in Africa, coastal countries such as Ghana, Kenya and Madagascar currently have an advantage in importing and exporting.

As previously noted Africa will require US $90 billion of infrastructure investment per annum for the ten years. This is both an obstacle but also an opportunity for investors in countries where the economy has progressed sufficiently to support paying for infrastructure build out.

Corruption and corporate governance

For Western investors (both institutions and private investors), investing in businesses and projects that operate to a Western standard of business ethics is important. This includes avoiding investment in projects where there is bribery, unfair treatment of employees, and/or where environmental hazards are present. Though it can be time-consuming, it is important to carefully vet opportunities at the beginning of the investment process and to maintain this focus throughout the investment lifecycle. The key is the granularity of the due diligence approach on each investment, from examining how contracts were won, to looking at pricing versus the market.

Corporate governance is another area of concern for investors in Africa. Listed entities provide a certain level of transparency that a private equity investment does not necessarily provide. Implementing Western standards of shareholder reporting and audit procedures is vital. This is also helps render investments ready for exit, be it though IPO or a trade sale.

An underdeveloped market and a paucity of management talent

On one hand, the relative immaturity of the private equity market in Africa is a disadvantage, with a dearth of quality GPs with long track records. However, there's also a flip side: this young market offers huge opportunities for PE houses with an operational ability to cherry-pick quality assets and then to use their expertise to help grow these assets.

A longstanding talent gap at both PE GPO level and in senior management is also beginning to resolve itself, as a reverse diaspora brings many of those who have been educated abroad back home to invest. A new and dynamic generation of home-grown business leaders is emerging.

Lack of exits – detrimental or not?

The exit environment in African markets is the single most challenging area for private equity investments and will remain so for the foreseeable future. Funds such as Actis have exited 43 investments successfully in Africa over the past ten years.

The IPO market in Africa is set to slowly improve. Over the past 5 years a number of African companies have listed in London, prompting African exchanges to revisit their corporate governance listing guidelines and improve them to compete with London.

Another viable approach being taken by certain funds such as TLG Capital is to invest in strong cashflowing companies in a structure involving a coupon and payback period. This allows the investment and returns to be recouped in the lifetime of the fund without the pressure of looking for an exit, which may not be forthcoming. With corporates now looking at the growing middle class population in Africa as a major growth opportunity, trade sales will be more forthcoming for the right businesses.

There are also other factors: currency risks and inflation risk. Both of these risks have decreased over the past decade (with overall African currency appreciation and declining inflation), yet both still remain volatile and require careful consideration. Getting contracts or loans in hard currencies is one way to mitigate these risks.

Conclusion

From the analysis and discussion above, we at White Lake believe that for private equity investors willing to put the work in, Africa offers truly compelling investment opportunities. While this region requires a different skillset to ensure quality of investment origination, management and eventual realisation of the investment, it also offers an uncommon scale of reward. The potential is immense. Private equity in Africa now needs to be considered with enthusiasm.

White Lake is a spin-out of a Family Office PE team that has invested and managed >$500m in direct deals and also set up numerous PE funds worldwide including Africa.

White Lake assists investors (mainly Family Offices) in locating, negotiating, carrying out due diligence on direct investments and managing their Private Equity fund investments. We have a geographical specialism in African Private Equity – funds and directs.
www.whitelake-group.com

John Rowland is Managing Partner of White Lake

Ashok Parekh is Director of Private Equity Investment Services