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Can private equity boost African development?

Private equity divides opinion: for some it is a financial product like any other; for others it is an effective development tool. Can Africa afford to do without the financial opportunities it offers? This is the challenge.

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In just the last decade or so, private equity has carved out a new territory for itself in sub-Saharan Africa. For the region this is a fantastic opportunity to attract new investors whose funds are entrusted to specialist professional management teams. For many companies – from major corporations to start-ups – it is an opportunity to access not only the long-term funding vital for their growth but also close support in terms of defining their strategy, improving their governance and accessing international professional networks. To date private equity has remained over-focused on a few sectors and geographic areas – yet increasingly it is venturing into new terrain, via specialist funds, and developing innovative strategies.
However, this development tool attracts criticism on numerous counts. And indeed its impact, which is undeniable, should not overshadow the limitations of this investment model. Focusing on profitability – in itself justified, in terms of making the business sustainable and attracting investors – can lead fund managers to neglect particular sectors, and SMEs in particular. It can instil a short-termist bias. It can also lead some fund managers to distort the model by siphoning precious fiscal resources from national governments through aggressive tax optimisation schemes.
Yet what makes private equity effective is that it enables economic players to build long-term partnerships, selecting and supporting the businesses most capable of generating growth, employment and innovation.
The challenge is therefore to make private equity in Africa a virtuous tool of growth and development, creating wealth for the largest possible number of people while also enforcing rigorous standards of governance and accountability. —

The Next Chapter for Private Equity in sub-Saharan Africa

Private equity is well suited to the continent and is attracting an increasingly diverse spectrum of investors. It is true that its activities remain focused on a few markets, and that concerns remain regarding the reliability of local teams and that exit conditions are inadequate. Yet the process of diversification is under way, the region's image is improving and the prices are genuinely competitive.

Jennifer Choi

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As faith in the Western buyout model faltered during the financial crisis, emerging market private equity cemented its place in investor portfolios and received greater allocations. The riskier prospects of financial engineering, coupled with worsening views of sovereign risk, is prompting many investors to reconsider emerging markets. Sub-Saharan Africa is among the under-penetrated high-growth markets receiving more attention, boasting six of the 20 fastest-growing economies in 2010, with growth rates averaging 5%, compared with 3% in OECD markets (IMF, 2011).

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Private equity first took off in South Africa in the 1990s following a wave of multinational divestment and post-apartheid reforms. Over the last two decades the field has grown beyond South Africa, to more than fifty firms across the continent managing billions of dollars.

The scale of private equity in the region remains modest relative to other markets, and its growth slowed during the worst of the recent financial crisis. However, several new vehicles appearing in recent months – from niche strategies in frontier markets to sizeable pools of international capital managed by industry veterans – signal that sub-Saharan Africa is poised for significant growth in the medium term.

This article provides an overview of the sub-Saharan African private equity opportunity in the global context and touches on some unfolding trends in the fundraising and investment environment in the region, concluding with a commentary on the investment outlook.

Sub-Saharan Africa in the Global Context

As with private equity in developed markets, there was a buildup of activity in sub-Saharan Africa leading up to the financial crisis. Private equity capital raised for investment in dedicated sub-Saharan African funds between 2006 and 2008 totalled USD 6 billion (EMPEA, 2011).

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Even with dramatic increases compared with earlier years (sub-Saharan African funds raised only USD 2 billion between 2000 and 2005), the scale of private equity in the region is modest in global terms. Sub-Saharan Africa accounted for less than four percent of the USD 159 billion raised for all emerging markets between 2006 and 2008, and less than a half percent of the USD 1.4 trillion raised globally by private equity funds during the same period. Investment volumes during this same period across 47 markets in sub-Saharan Africa totalled USD 8 billion, compared with the USD 136 billion invested across all emerging markets, including the

FOCUS

The mission of the Emerging Markets Private Equity Association (EMPEA), an independent global membership association, is to catalyse private equity and venture capital investment in emerging markets. EMPEA's members include institutional investors and private equity and venture capital fund managers across developing and developed markets. It leverages a global industry network to deliver intelligence, promote best practices, and provide networking opportunities, giving members the edge in raising funds, making good investments and managing exits to achieve superior returns.

USD 59 billion invested collectively in China, India and Brazil alone. In 2010, sub-Saharan Africa's share rose to 6% of total capital raised for emerging market private equity – an all-time high, and growth is expected to continue (Figure 1).

When scaled to gross domestic product (GDP), however, private equity investment activity in sub-Saharan Africa is comparable across BRIC[1] markets and greater than other regions such as Latin America and Central and Eastern Europe. Between 2008 and 2010, private equity-backed investment in sub-Saharan African countries accounted for approximately 0.17% of GDP, versus 0.16% for China and 0.10% across Latin America (EMPEA,2011).

Fundraising Trends

After bottoming in 2009, private equity fundraising rebounded in 2010, with improving investor attitudes towards Africa translating into meaningful fund commitments. Fundraising for sub-Saharan Africa rose by 50% to USD 1.5 billion in 2010, thanks to a handful of sizeable regional funds. Industry veteran Emerging Capital Partners' third fund[2], which closed at USD 613 million in July 2010, was at the time the largest pan-African growth capital fund raised. Kingdom Zephyr Africa Management[3] captured USD 492 million in February 2010 for its second Pan African Investment Partners Fund, and pan-emerging markets investor Aureos Capital[4] raised USD 381 million in February 2010 for its latest Africa-focused fund.

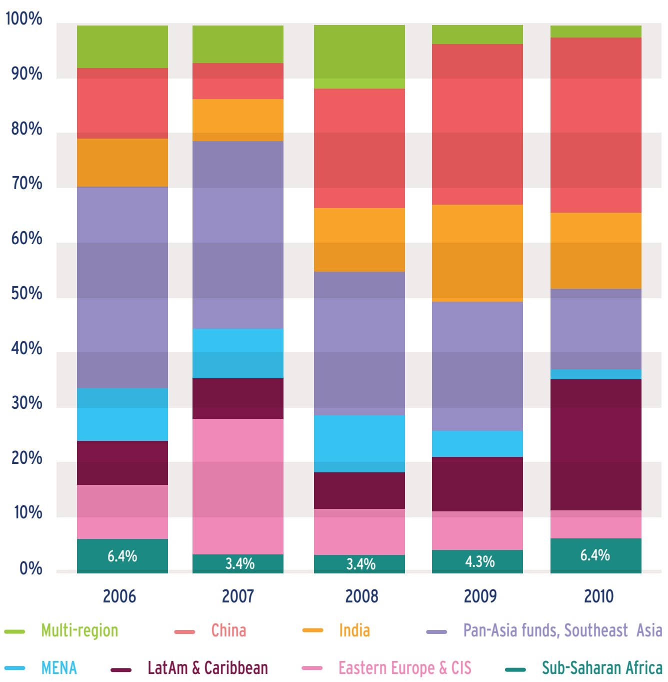
Recent developments point to the region's growing ability to attract capital from an increasingly diverse group of investors and the potential for eclipsing even pre-crisis fund sizes. The USD 900 million raised in June 2011 by pan-African investors Helios Investment Partners – the largest pan-Africa private equity fund ever raised – sources 70% of total commitments from outside the development finance community, traditionally African private equity's most stalwart investors. In the spring of 2011, global private equity house The Carlyle Group announced the launch of a fund dedicated to sub-Saharan Africa, targeting commitments of at least USD 500 million. South African private equity firms Ethos and Brait, responsible for two of Africa's largest funds, are expected to raise significant pools of new capital over the next 12 to 18 months. Additionally, a number of more discretely focused and modestly sized funds are currently in the market and lining up commitments.

Investment Trends

Deal activity in 2010 nearly matched 2008 levels with 48 transactions, although capital invested fell by 54%, pulled downwards by falling valuations,. the result of both a narrowing gap in expectations between buyers and sellers, and the disappearance of bank financing, which had previously made larger transactions possible. The largest disclosed sub-Saharan African private equity investment in 2010 was USD 151 million, versus USD 175 million in 2008.

A small number of markets continue to draw the bulk of investment activity, with South Africa, Kenya and Nigeria, drawing 27 of 48 deals in 2010. However, investments are becoming more geographically dispersed. South Africa's share fell from 56% of deals in 2008 to 21% in 2010 (EMPEA, 2011). In the last 18 months, private equity investors have backed companies in Benin, Congo, Ghana, Liberia and Madagascar and Tanzania. ▶▶▶

FIGURE 1: SUB-SAHARAN AFRICA'S PERCENTAGE OF EMERGING MARKET PRIVATE EQUITY FUNDS RAISED



Note: CIS: Commonwealth of Independent States (including Russia).
Source: EMPEA, 2011

[1] *BRIC refers to the group of Brazil, Russia, India and China, which are all deemed to be at a similar stage of newly advanced economic development.*
[2] *Emerging Capital Partners (ECP) is an international private equity firm focused on investing across the African continent. It is the first private equity group to raise over USD 1.8 billion to invest exclusively in African companies.*
[3] *Kingdom Zephyr Africa Management (KZAM) is a joint venture between Zephyr Management, L.P., a New York-based asset management firm, and Kingdom Holding Company, an investment vehicle headed by HRH Prince Alwaleed bin Talal Bin Abdulaziz Al Saud of Saudi Arabia. Both Zephyr and Kingdom Holding have been investing in African private equity for over 15 years.*
[4] *See the article by Kiriga Kunyiha and Davinder Sikand, p.10 in this issue of Private Sector & Development.*

Can private equity boost African development?

▶▶▶ The private equity model is particularly well matched to the African context, appealing to an increasingly international and diverse class of investors. Equity markets offer an alternative to institutions who might otherwise prefer to invest directly in companies but are deterred by market opacity. Most African exchanges are concentrated in a few companies and sectors, e.g., financials and natural resources, with minimal exposure to the growing middle class, a fundamental growth driver for the region that forms the core of most private equity fund strategies.

While the banking and extractive industries figure prominently in the private equity space, more than half of transactions in 2010 were in other sectors, such as food and beverages (e.g., South Africa's Dewcrisp and Foodcorp), healthcare (Liberia's Snapper Hill Clinic and Nairobi Women's Hospital) and media/telecommunications (Kenya's Wananchi Group) - EMPEA, 2011. As the asset class matures, fund strategies are becoming more specialised, with niche strategies emerging, such as agribusiness (Phatisa, Chayton Capital, Silk Invest Food Fund), cleantech and renewable energy (Inspired Evolution One Fund), healthcare (Aureos Capital Health Fund) and mezzanine finance (Vantage).

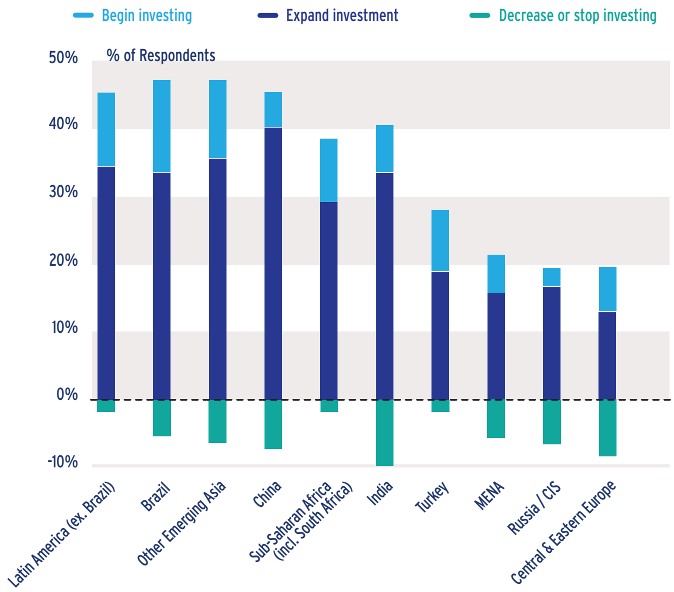
Outlook and challenge for Investors in sub-Saharan Africa

EMPEA's most recent research on Limited Partner (LP)[5] appetite gives evidence of the region's brand improvement, with 67% of LPs surveyed viewing Africa as attractive in 2011 and 39% planning to begin or expand their investments in sub-Saharan African funds (Figure 2) – Coller Capital and EMPEA, 2011.

Concerns – chiefly about the depth of the fund manager pool – remain, as do residual concerns related to political risk. Investors without exposure to the region indicated in both the 2010 and 2011 EMPEA/Coller Surveys that a shortage of experienced fund managers inhibited their willingness to invest in Africa (Table 1). Yet, over the last decade, the number of fund managers active in Africa has grown fivefold.

Fund managers cite the human capital deficit – professionals to develop, screen, structure and execute deals – as limiting their ability to exploit opportunities. The pool of skilled management within portfolio companies, particularly CFOs, is also shallow. Yet another constraint facing fund managers is the absence of a robust intermediary network – advisors, bankers, brokers and data providers – making sourcing and evaluating opportunities labour-intensive. Because most deal

Figure 2: Planned changes to LP emerging market private equity strategies, next 2 years



Note: CIS: Commonwealth of Independent States.
Source: EMPEA/Coller Capital Emerging Market Private Equity Survey, 2011

flow is sourced on a proprietary basis, management talent is all the more important. Encouragingly, the financial crisis may result in many Western-trained African professionals returning home to fill this void.

An exit environment is another hurdle to attracting more capital. Apart from a small number of private equity-backed public listings, primarily in South Africa, trade sales accounted for the bulk of exits in 2009 and 2010. Exit activity remains sluggish in 2011, but signs of an improving exit environment are emerging. Recent examples include the July 2011 listing of Ethos-backed sporting goods retailer Holdsport on the Johannesburg Stock Exchange, and the sale of Aureos Capital's stake in Nigerian biscuit manufacturer Deli Foods to South Africa's Tiger Brands. Secondary sales remain rare due to the small field of assets ripe for transfer between financial sponsors.

African fund managers hope for a larger and more diverse ecosystem coupled with a deeper pool of mature private equity-backed companies, translating into more options for exiting, including secondary transactions.

Pricing and Performance Expectations

One positive by-product of Africa's thin domestic private equity market, whether due to shallow talent pools or challenging exit environments, is more competitive pricing. Assets in sub-Saharan Africa – with

[5] Limited Partner is one of the co-owners of a business organized as limited partnership who does not participate in the management of the firm.

entry multiples in the high single digits compared with double-digit multiples in markets such as China and Brazil – are considered bargains by many investors. Prices are expected to rise, yet most fund managers believe that good deals abound.

According to the 2011 EMPEA/Coller Survey, investors with exposure to assets in sub-Saharan Africa expect higher returns than do LPs without exposure, suggesting confidence in the abilities of experienced fund managers to anticipate and manage the risks of investing in these comparatively nascent private equity markets. While returns data on the whole of sub-Saharan Africa is not available, a 2011 study by RisCura and the South African Venture Capital Association showed that South African private equity outperformed UK and US private equity funds over three-, ten-, and five- year horizons, with South African funds delivering pooled net internal rates of return of more than 20% over a ten-year period, versus roughly 13% in the UK and 8% in the US (RisCura and SAVCA, 2011). Two of the most active investors in the region - the International Finance Corporation (IFC) and the UK's CDC Group - report that their African funds have outperformed relative to emerging markets benchmarks such as the MSCI Emerging Markets Index[6] (CDC), or to their emerging markets private equity portfolios overall (IFC).

"The pool of skilled management within portfolio companies, particularly CFOs, is also shallow."

Private equity in sub-Saharan Africa is not new, but the region is certainly under-penetrated. In fact, the nascence of African markets may mean a greater upside for investors. Many African economies are less correlated to the volatility wrought by debt in developed markets. Much of the forecasted growth will come from domestic drivers such as consumption and investment in energy. Private equity offers tremendous additionality to capital-starved companies at saner prices than are commanded elsewhere in emerging markets. While the data is not present to enable definitive claims about performance prospects, optimism surrounding the trajectory for private equity is by no means misplaced. •

[6] An index created by Morgan Stanley Capital International (MSCI) that is designed to measure equity market performance in global emerging markets. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI EM Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey, as of May 30, 2011.

TABLE 1: DETERRENTS TO INVESTMENT, LIMITED PARTNERS' VIEWS, NEXT 2 YEARS

	Limited number of established GPs	Scale of opportunity to invest is too small	Entry valuations are too high	Weak exit environments	Challenging regulatory/tax issues	Political risk
China	7%	7%	45%	14%	31%	24%
India	14%	0%	58%	14%	8%	11%
Other Emerging Asia	38%	19%	4%	35%	12%	19%
Russia/CIS	25%	12%	2%	17%	30%	63%
Turkey	28%	23%	5%	12%	7%	12%
Central & Eastern Europe	19%	16%	5%	27%	11%	16%
Brazil	11%	3%	31%	11%	11%	3%
Latin America (excl. Brazil)	32%	19%	16%	10%	10%	23%
MENA	39%	33%	2%	14%	12%	32%
Sub-Saharan Africa	47%	24%	2%	14%	12%	39%

Note: CIS Commonwealth of Independent States.
Source: EMPEA/Coller Capital Emerging Market Private Equity Survey, 2011

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Profitability and development hand in hand

A question frequently asked is whether profitability is the only criterion to be taken into consideration when private equity is evaluated. By itself, profitability is not an adequate basis on which to assess the effectiveness of private equity. The questions surrounding investment funds go beyond merely securing the required profitability: private equity can also mobilise additional investments and play a key role in developing local economies. But alongside this tangible and quantitative impact, private equity also has a qualitative impact, and while it is not yet systematically measured, it represents an opportunity to make private equity a tool for development in Africa.

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The arguments against private equity and investment funds follow a well-trodden path: its critics argue that this funding mode is geared solely to securing short-term returns for investors at the expense of the entrepreneurs. This means, the argument goes, that investment funds actually create instability for businesses and also facilitate tax evasion, since the funds are frequently based offshore.

It is, however, no coincidence that private equity and investment in funds form an integral part of the range of tools available to development finance institutions (DFIs). DFIs see them as a way of boosting the impact of their funding, by providing indirect support to large numbers of businesses, and as a means of influencing the governance and strategy of these businesses. Beyond its function as a simple funding mechanism, private equity can help develop long-term local economic networks and support the transition to inclusive and sustainable business models.

Analysing PROPARCO's equity portfolio in sub-Saharan Africa will help to quantify these impacts and identify ways of maximising them (see Box).

The sine qua non of profitability

Profitability is a sine qua non of developing private equity. The assumption that it plays only a limited role has long acted as a brake on the development of a mode of funding that has become more prominent over the past few years. The debate has, however, moved on: African private equity, long provided by development finance institutions, now holds its own with other funding mechanisms.

Measuring the yield from equity is, however, particularly difficult in sub-Saharan Africa, since analysts use indicators from the developed world that do not yet, unfortunately, reflect the situation in developing countries. It may, therefore, be helpful to consider the portfolios of three development finance institutions that have historically been active in sub-Saharan Africa – CDC in the United Kingdom, FMO in the Netherlands, and France's PROPARCO. The global internal rates of return (IRRs, both

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There, she developed evaluation and advisory services for the social and societal performance of businesses based in developing countries.

After five years spent working in investment banking (with Rothschild&Cie) and in strategic consulting (with LEK Consulting), Aglaé Touchard joined the French development agency AFD in 2006. After initial experience in the Risk Department, she has for the past three years been involved with capital investments within the Private Equity Division of PROPARCO, focusing particularly on the renewable energy sector. She has qualifications from three prestigious Paris-based institutions, the Institut d'études politiques (now Sciences Po), the École supérieure de commerce (Paris School of Management), and the Université de Paris IX-Dauphine. She has also been lecturing at Sciences Po since 2006.

[1] It is very difficult to compare the internal rates of return of different investors because the reported figures cannot be verified and there is substantial variation in methodology (in particular in terms of: (i) the scope of equity held, either in the investment phase or liquidated, (ii) inclusion of the remuneration of the manager as a gross or net IRR, and (iii) the method used to assess latent added value).

FIGURE 1: QUANTITATIVE IMPACT OF BUSINESSES BENEFITING FROM INVESTMENT FROM PROPARCO'S FUNDS EQUITY PORTFOLIO IN SUB-SAHARAN AFRICA

Sub-Saharan Africa	Number of funds	Number of businesses receiving funding	Number of jobs preserved or created	Average annuel growth in turnover (in %)	Contribution to state revenue (million euros)	Average annual growth in earnings before interest and taxes	Average annual growth in employment (in %)
PROPARCO (2010)	25	229	50 000	+16,54%**	230*	+ 12%**	+ 11%**

**EUR 230 million represents the contribution to state revenue over the last financial year by the 87 businesses in the sub-Saharan Africa portfolio which had reported this figure as at 31.12.2010.*
** * Analysis of 53 businesses in the sub-Saharan Africa portfolio as at 31.12.2010 for which historical data are available.*
Source: PROPARCO, 2011

actual and potential) on sub-Saharan Africa funds are good at between 14% and 23%.[1] In fact, their average profitability is better than in France, where – according to figures produced by the French Private Equity Association AFIC[2] – the net internal rate of return at end-2010 was 9.1% (AFIC/Ernst & Young, 2011). Since 2004, IRRs in France reported by AFIC have ranged from 8.3% to 14.7%.
In terms of the average multiple,[3] another profitability indicator, PROPARCO's portfolio in sub-Saharan Africa yields 1.8x on equity being managed or dis-invested, a higher multiple than that achieved in other PROPARCO intervention zones (1.5x in Asia and 1.2x in the Middle East and North Africa region). While the creation of long-term value is greater in sub-Saharan Africa, though, investments are also held for longer than elsewhere, particularly since the African markets are less liquid than, for example, those in Asia (Figure 1).

"Equity has an economic, social and environmental impact on local economies."

This demonstrated profitability is beginning to attract a growing number of private and local investors. For example, the Development Bank of Southern Africa (DBSA) has noted that the contribution of development finance institutions to the equity they finance declined from 54% between 1995 and 2000 to 36% between 2005 and 2009 (Mamba, 2010). The DBSA also notes that local investors, too, are contributing more to the funds in which the Bank has invested, their share rising from 30% between 1995 and 2000 to 52% between 2005 and 2009. This growth is a good sign: Africa's image is improving and it is becoming more attractive to the potential capital investors its businesses need.

The economic and financial impact

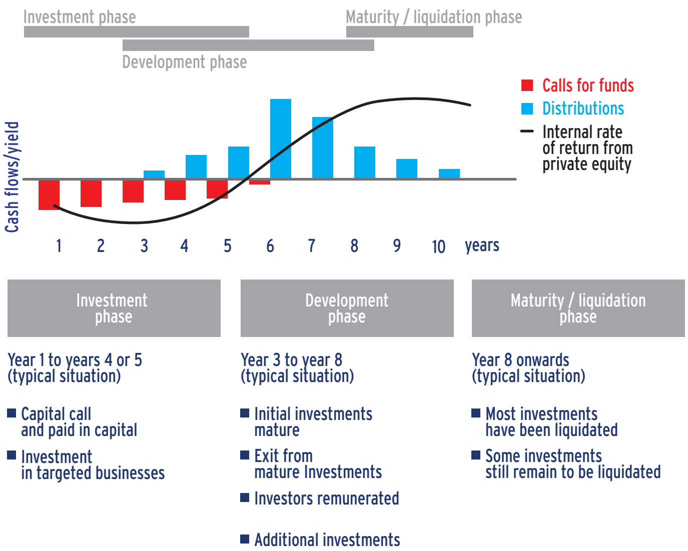
One of the key roles played by equity funds is their ability to bring with them a wide range of investors keen to spread their risk. This enables development finance institutions or sponsors to act as catalysts by mobilising additional sources of capital, particularly from foreign investors. CDC has calculated, for example, that for every pound sterling invested in equity, the same amount is invested by other development finance institutions, while a further GBP 2.70 is contributed by private investors, increasing the initial investment to a total of GBP 4.70 per pound (CDC, 2010).
For businesses in sub-Saharan Africa, private equity is an invaluable source of finance: although local financial markets are constantly improving, access to finance – and particularly to equity, which is the key to ensuring growth – remains a major issue for African businesses.

The quantitative impact on local development

Private equity also contributes to develop local economies. To gauge its impact, PROPARCO has strengthened funds portfolio monitoring with a systematic reporting of the results of funds' investees companies. To do this, it uses quantitative indicators relating to non-financial issues (Table 1). Its ▶▶▶

[2] Based on a survey of 475 funds with total assets of EUR 38.6 billion (between 1988 and end-2010).
[3] The average multiple on invested capital measures cash inflow against cash outflow but does not take into account the temporal dimension of IRR.

FIGURE 1: TYPICAL LIFE CYCLE OF A PRIVATE EQUITY FUND



Source: HSBC

▸▸▸ analysis shows that the 229 businesses funded by its private equity funds portfolio in sub-Saharan Africa employed 50,000 people for both skilled and unskilled labour. For those companies that reported data, workforce grow by an average of 11% a year.

In terms of economic activity, average annual growth in turnover has been 16.5% and the average growth in earnings before interest and tax (EBIT) 12%.[4] The pattern and scale of growth in these businesses varies according to the stage they have reached in their development, the country in which they are located, their size, and the sector within which they operate. Higher turnover is noted in the countries of East Africa, for example.

"Private equity meets a specific funding need that neither the banks nor the equity markets nor microfinance institutions are currently satisfying."

This twin growth – a higher pay bill and a higher level of economic activity – also means businesses make a more substantial contribution to state revenue: the 87 businesses in the sample providing this information contributed more than EUR 230 million in taxes to domestic governments in the countries in which they were based during the last fiscal year.

Comparison with other geographical regions, including France, highlights the greater impact that private equity has in Africa than in Europe, where businesses have been harder hit by the economic and financial crisis.[5] The added value of a management team in sub-Saharan Africa is also felt both in increased earnings and in improved business profitability. In more mature markets, such as the French market, by contrast, the added value tends to focus more on financial leverage or bargaining on the purchase or exit price.

The qualitative added value of management teams

Beyond these quantitative benefits on local economic development, though, private equity also offers an effective lever for value creation within a business. As shareholders, management teams can instigate good management practices, good governance arrangements, more appropriate organisation, more transparent financial reporting, and more efficient human resources. This added value is particularly marked in sub-Saharan Africa, where businesses frequently still operate informally or are based on family structures. Some management teams are instigating financial reporting arrangements geared specifically to improving corporate governance, including such measures as increasing the number of businesses subject to auditing, setting up committees to monitor activity, establishing performance indicators, or monitoring budgets. The impact is even greater where the investor has a majority shareholding or where he is investing in a start-up that is still structurally underdeveloped. In such cases, the investor can boost development of the business, for example by putting forward key managers from within his own networks.

The presence of development finance institutions means that investment is increasingly being used as a vector for improving environmental and social (E&S) performance. Before they make their investments, management teams assess each business's main E&S risks, identify ways in which they can be mitigated, and set out action plans for helping the business reach compliance with national and international standards. These improvements also act as levers for boosting performance in other areas: acquiring certification can, for example, open up new markets, while reducing energy consumption helps to drive down overheads.

How can the impact of private equity be maximised?

If private equity is to make a greater contribution to developing the continent of Africa, then high-quality management teams need to be convened and consolidated that are able not only to structure and support businesses but also to embed the development criterion as a key objective for investment.

Ultimately, however, the tried-and-tested criterion of profitability is based on the quality of the management team. A good team should have good operational skills. Creating value in sub-Saharan Africa takes place largely through the lever of growth, unlike in European markets, where it relies heavily on the lever of debt and on cost rationalisation. The organisational skills of the fund manager therefore become more important than skills in banking syndication, which are more highly valued in more mature markets. The local profile of fund managers is also particularly vital for success in sub-Saharan Africa, given the greater significance of informal networks there than in other parts of the world. Finally, it is also important to be able to form partnerships with investors, entrepreneurs and other parties involved.

[4] *EBIT reflects net turnover minus operating costs, such as salaries, social security contributions, materials, energy, and so on.*

[5] *AFIC, study by Ernst & Young 2010: as at 31.12.2009, 848,954 jobs in the 1,268 businesses receiving investment funds from 213 private equity funds. The dynamic analysis of growth in the labour force and in turnover carried out in France between 2008 and 2009 highlights a 5.9% decline in turnover in France and a 1.8% contraction in numbers employed over the period.*

A high-quality team is also a team able to support good governance and improvement in a business's environmental and social performance. As a result, some funds make technical assistance envelopes available to businesses to strengthen specific aspects of their management or organisation. 43% of the investee companies surveyed within PROPARCO's sub-Saharan Africa funds portfolio had their compliance with international environmental and social standards evaluated before investment was made, and all these businesses reported that they had received support to improve their performance in these areas.

Where local development is considered as important as financial indicators, it shifts to being one of the main objectives of investment. A number of specific development objectives need to be defined and assessment tools need to be developed in order to evaluate results transparently through a reporting standard or by means of an external evaluator. Governance should also be structured to achieve these objectives.

There are a growing number of examples of this happening. The Africa Health Fund, for example, which was set up to develop high-quality and affordable health care for populations in sub-Saharan Africa, especially those at the bottom of the income pyramid has linked fund managers' remuneration to achieving this specific objective. Governance has been supported by external evaluation of the targets for populations affected by the businesses.

Effective measuring of impact has become one of the key issues involved in boosting the effects of private equity in sub-Saharan Africa. Reporting of indicators has limitations and does not by itself ensure that all the relevant qualitative data are taken into account, such as type of business, level of maturity of the business (start-up, growing business or turnaround, for example), quality of employment, integration of populations excluded from economic opportunities, or sectors affected (for example, social sectors).

Moreover, there are still no standardised tools for measuring such impact, which may be reported in very different ways by management teams. For example, one of the first projects carried out by the Global Impact Investing Network,[6] through the 'Impact Reporting and Investment Standards' initiative, involves defining a standard for measuring the social impact of an investment on the investor.

In contrast to their public image, private equity funds can be major vectors for development in low-income countries. Impact on development and financial profitability are certainly not mutually exclusive. The opposite is true, in fact: profitability enables sustainability of business and means that the reach of development can be maximised but also that new investors can be recruited. Development organisations have a greater part to play than ever in terms of promoting environmental and social performance and boosting the transition to sustainable and inclusive economic models. They also need to fulfil the function of catalyst to cover sectors and countries that investors have neglected, sometimes because they do not know the area and consider it still to be a risk.

"The 229 investee companies funded by the PROPARCO's sub-Saharan Africa funds portfolio have contributed to create or preserve more than 50,000 jobs."

[6] *The Global Impact Investing Network (GIIN) brings together about 20 organisations, including banking institutions (such as JP Morgan and Citigroup), alternative investment funds (such as Acumen), and philanthropic foundations, including the Bill & Melinda Gates Foundation and the Rockefeller Foundation.*

ANALYSIS OF EQUITY IN THE PROPARCO PORTFOLIO

The 25 funds making up PROPARCO's and FISEA's[1] portfolio in sub-Saharan Africa as at 31 December 2010 provide capital for 229 businesses. Four main characteristics can be identified. First, most of the businesses benefiting from investment are mature: the average investment is EUR 5.3 million, which shows that development of these businesses is well advanced. Second, however, this average figure conceals a wide diversity, spanning everything from large companies and infrastructure projects to micro-businesses (for example, three funds have an average investment of EUR 250,000). Accordingly, each of the businesses benefiting from investment employs an average of 300 people. Third, the geographical location of the businesses highlights their concentration in the English-speaking countries. 75% of the businesses benefiting from investment are located in just ten of the 29 countries of intervention[2] (excluding multi-country investment): in descending order of value of investment, these are Nigeria, South Africa, Kenya, Ghana, Rwanda, Tanzania, Uganda, Ivory Coast, Cameroon and Senegal. Moreover, just under half (47%) of the businesses funded are located in the first four of these countries. 47% of the business funded are located in poor countries. Finally, analysis of the portfolio reveals a sectoral concentration. The businesses funded operate mainly in growth sectors, such as financial services – banking, insurance and leasing – and in distribution, services to business, the agrifood sector, and transport. However, sectors, such education or healthcare, are also represented.

[1] *FISEA is an investment fund making equity investments in sub-Saharan Africa and was set up in 2009. With EUR 250 million in funds, it is held by the Agence Française de Développement (AFD) and managed by PROPARCO.*

[2] *The countries covered by funding are: Benin, Botswana, Burkina Faso, Cameroon, Chad, the Comoros, the Democratic Republic of Congo, Djibouti, Gabon, Ghana, Guinea, Ivory Coast, Kenya, Liberia, Madagascar, Mali, Mauritius, Namibia, Niger, Nigeria, Rwanda, Senegal, South Africa, South Sudan, Tanzania, Togo, Uganda, Zambia, and Zimbabwe.*

REFERENCES / **AFIC/Ernst & Young, 2011.** *Performance nette des acteurs français du Capital Investissement à fin 2010*, study, 1 June. // **CDC, 2011.** *Annual Review 2010*, report. // **Mamba, G., 2010.** *The Changing Profile of Investors in African Private Equity*, EMPEA Insight, Special Edition, Private Equity in sub-Saharan Africa, November. / **Wilton, D., 2010.** *A Comparison of Performance Between First Time Fund Managers & Established Managers Moving Into A New Market. How Important Is Track Record?*, IFC, 15 September.

PE Funds Improving Corporate Governance and Investor Climate

While fund managers may influence public policy geared towards improving the investing environment, they make a more significant impact by improving portfolio companies' governance standards. This is because the resulting improved performance is transmitted to other corporate entities and entrepreneurs emulating them to replicate success. With increasing acceptance of private equity capital, the probability of best practices being adopted greatly increases.

Davinder Sikand et Kiriga Kunyiha

Deputy CEO, Aureos Capital
Kenya Investment Principal, Aureos Capital

An improved investment climate is viewed as a key component of fostering economic growth and reducing poverty. Studies have demonstrated the positive correlation between good governance and economic growth. "Accelerating growth and poverty reduction requires governments to reduce policy risks, costs, and the barriers to competition facing firms of all types – from farmers and micro-entrepreneurs to local manufacturing companies and multinationals" (World Bank, 2005). While reducing public sector governance risk in developing countries is important, private sector governance cannot be underplayed. The destabilising effect of deficiencies in corporate governance is counterproductive to economic development. The decisions, conduct and operations of private sector entities have serious implications, as observed in the 2009 global financial crisis.

The private sector's role is increasingly viewed as a critical component of the development of emerging economies. Lobbying local authorities and improving corporate governance contributes toward improving the investment climate. Private equity funds, as a key component of a diversified financial environment, also play a vital role. As providers of capital to businesses in emerging markets, private equity funds play an active role. They work towards improving governance standards to optimise the management of and return on investments made, which, in turn, fosters greater investment flows to the economies concerned.

The Reform Dividend in Challenging Environments

As seen in Table 1, from the 2011 World Bank Doing Business Survey, sub-Saharan Africa pose challenging operating environments.

However, this snap shot hides the true picture of the trend on the continent. After implementing structural adjustment programs in the 90s, governments today acknowledge that while a stable macroeconomic environment is necessary to accelerate growth, it is not sufficient. Governments recognise the role played by the private sector and have, as a consequence, become more receptive to creating business-friendly environments. Evidence can be seen in countries like Rwanda, a global leader in business regulatory reforms as recorded by Doing Business in 2008/09, which attracted around USD 1.1 billion in investment, 41% more than in the previous year, in the midst of the global economic crisis (World Bank, 2011). Despite such improvements, substantial progress still needs to be made to transform the continent into a preferred investment destination.

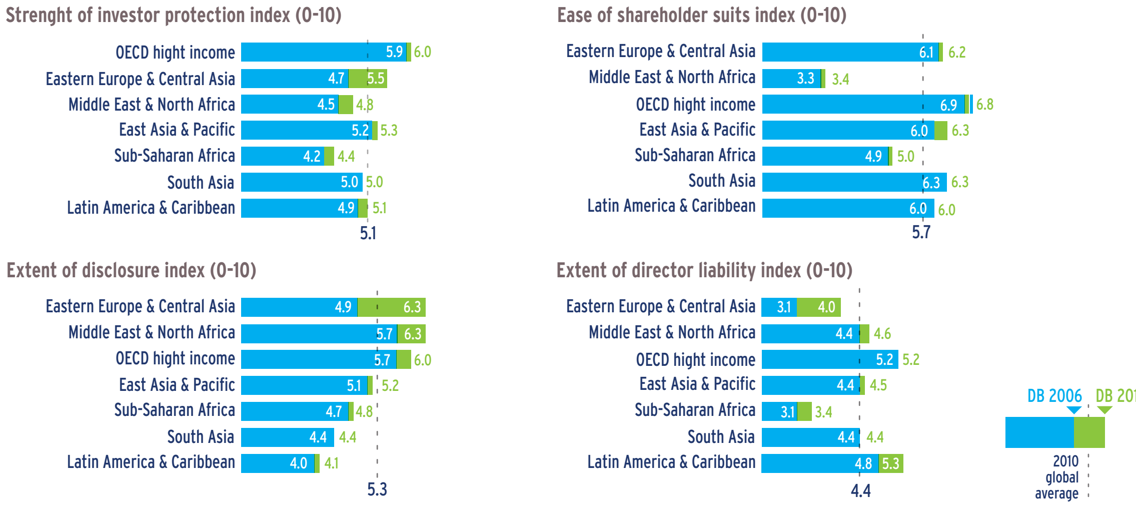
While funds may be limited as catalysts for influencing change in public governance, they are beneficiaries of the changing environments, as evidenced by new and renewed investor interest in funds

DAVINDER SIKAND ET KIRIGA KUNYIHA

Davinder Sikand is Aureos Capital Deputy CEO and Regional Managing Partner for Africa. He has been with Aureos since its inception, 2001, having 25 years of private equity and investment banking experience. Previously, Mr. Sikand worked at Drexel Burnham Lambert, Financial Security Assurance and PricewaterhouseCoopers. He holds a Masters in Business Administration (MBA) from the Kellogg Graduate School of Management, Northwestern University (USA).

Kiriga Kunyiha is an Investment Principal based in Nairobi. He joined Aureos in 2003 and has over eight years private equity experience, focusing on deal origination, structuring, execution, monitoring and exit facilitation in East Africa. He holds a BSc. in Economics from Queen Mary and Westfield College, University of London.

TABLE 1: REGIONAL AVERAGES IN PROTECTING INVESTORS INDICATORS



Note: The data sample for DB 2006 (2005) includes 174 economies. The sample for DB 2011 (2010) also includes The Bahamas, Bahrain, Brunei Darussalam, Cyprus, Kosovo, Liberia, Luxembourg, Montenegro and Catar for a total of 183 economies
Source: World Bank – Doing Business, 2011

dedicated to the region. According to the Emerging Markets Private Equity Association (EMPEA), between 2006 and 2008 sub-Saharan private equity funds raised USD 6.2 billion and invested USD 7.7 billion, which was substantially higher than at any point in history, showing further evidence of the reform dividend (EMPEA, 2010).

Further, private equity funds can significantly impact the investment landscape within an economy through their activities. This can happen either directly through consultation with stakeholders, through portfolio companies or indirectly as members of private sector groups, like the African Venture Capital Association.

The Acacia Fund[1] experience illustrates improved local regulations through consultations with stakeholders. It formalised private equity in Kenya by obtaining government recognition for private equity as a distinct financial instrument. This formed the basis of new regulations for venture capital, introduced by the Kenyan Capital Markets Authority.

Moreover, as mentioned, private equity fund managers can also improve quality standards through lobbying via a portfolio company as experienced in Kenya, where legislation governing building codes and standards was positively influenced and changed. An area where safety standards had not been adequately addressed was the sale of structural steel for buildings. Prior to 2009, the sale of structural steel was done “by piece” and not “by weight”. Without a defined safety standard policy, the weight consistency would vary, and some manufacturers would deliberately undersize, compromising the structural integrity of the steel. Athi River Steel Plant, a steel recycling company that is part of Aureos East Africa Fund’s portfolio, along with a number of concerned sector participants, lobbied authorities to change the selling method. In 2009, the Kenya Bureau of Standards gazetted the new standard of selling by weight.

Private Sector Governance Leading the Way

“The governance of companies is more important for world economic growth than the government of countries”. These words of James Wolfensohn, president of the World Bank 1995-2005, emphasise the importance of the governance of corporate entities in today’s world. Over and above, the macroeconomic consequences of failures such as Lehman Brothers,[2] the private sector plays a larger role in our economies than ever before. Globalisation and deregulation have opened up growth opportunities for companies but also increased complexity and risks. These opportunities and risks are not limited by size or geography. African businesses are also subject to the same reward/risk issues, with small- and medium-sized enter- ▶▶▶

[1] Established in early 1997, with a total committed capital of USD 19.6 million, the Acacia Fund made equity and quasi-equity investments in well-managed Kenyan SMEs which demonstrated strong potential for growth. By the end of January 2003, the fund had invested USD 15.6 million in 18 companies. The fund has taken minority stakes in businesses across a diverse range of sectors.
[2] Before declaring bankruptcy during the financial crisis, in September 2008, Lehman Brothers Holdings Inc. was the fourth-largest investment bank in the USA.

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Aureos Capital is a private equity fund management company specialising in expansion and buy-out capital for small to medium size enterprises in Asia, Africa and Latin America. Since 2001, Aureos has increased its funds under management to USD 1.3 billion, managed by over 90 investment professionals in its 28 offices worldwide. Investors include financial institutions, development finance institutions, pension funds, sovereign wealth funds, fund of funds, family offices, and high-net-worth individuals.

Can private equity boost African development?

▸▸▸ prises from Kenya to Senegal yearning to expand from a single-country presence to regional/pan-regional operations. As a result, management of these operations has become even more complex and can no longer be the preserve of a principal/owner.

The key feature of sound governance is that it produces better resource allocation outcomes as a result of better management of resources. This reduces corporate risks, increasing access to finance, and attracts larger investments into these companies. Many research projects have shown that sound governance practices are essential to establishing an attractive investment climate.

The Leadership Role of PE Fund Managers

Fund managers play a vital role in the governance culture of investee companies, as they are an important aspect of the value creation process. While most fund managers understand the importance of strong governance, this should not be taken for granted. Empirical evidence from emerging markets has shown that investors place a high premium on well-governed companies, resulting in better exit values. Fund managers are especially interested in governance because it promotes value creation, which otherwise could not occur.

The other point to note is governance, only forms the "G" in Environmental, Social and Governance strategy. There also has to be a strong emphasis on environmental and social practices in order to build great businesses, lower risks and reduce potential liabilities throughout the life of the investment, right through to exit.

Good Governance, Beyond the Words

"No process of box ticking will overcome the fundamental dysfunctionality of a board of directors flowing from inadequate expertise on the part of directors, an over-compliant board, or an excessively dominant chairman or CEO. The functionality of a board cannot be achieved solely through prescriptive rules, but requires the right mixture of personalities, expertise, commitment and leadership" (Robins, 2006). Being on a Board of Directors of the investee or establishing a sub-committee in itself does not constitute improvement. Well-known governance failures at WorldCom,[3] Enron[4] and Lehman Brothers all occurred with company boards in place.

Sound governance involves more than compliance with a set of rules. It is about taking steps to ensure that the organisation enhances efficiencies. To illustrate, given the nature of risk facing a bank, numerous specialist board sub-committees are required to assess and manage each risk factor. A general services business does not face the same level of risk, so it would not require the same level of oversight. Striking the balance between practicality and effectiveness is the key. Having worked with numerous businesses across various sectors, fund managers are well positioned to know what works given the business and market conditions. So as companies commence their journey of scaling up, fund managers can match internal controls and governance structures with the complexity of the business. Good governance is about going beyond the basic measures required to sustain success. It is about paying real attention to building the organisation's culture and capability. It is about ensuring that the leadership has all the modern managerial disciplines in place, and that a clear, concise strategy has been developed and agreed by the board, and is implemented by management. Progress must be monitored and measured against a set of well-defined and agreed matrices.

Technical Resources for Staying on Track

Improvement is nothing if it cannot be measured on an ongoing basis. In addition, performance indicators also have to capture more than just financial indicators. To steer a company in the right direction, the board needs to ensure that there are processes in place enabling relevant disclosure on matters such as adequacy of internal controls or assessing the level of risk a company is taking.

The increasing complexity of managing businesses means that a larger amount of information is required to ensure correct and timely disclosures. This has serious implications for how data is gathered and processed. To remain relevant, companies have to look at enhancing their management information/reporting systems and align them with the performance and sustainability objectives of the business. The cost implications and skill requirements may be out of the reach of typical medium-sized firms in Africa, which is why fund managers utilise dedicated technical resources to fill the gaps that may exist in portfolio companies. This gives portfolio companies' access to cost-effective and appropriate solutions. ●

[3] On July 21, 2002, telecommunications giant WorldCom filed for bankruptcy protection in one of the largest bankruptcies in United States history, after Executives perpetrated accounting fraud. The WorldCom scandal is regarded as one of the worst corporate crimes in history, and several former executives involved in the fraud faced criminal charges for their involvement. Most notably, company founder and former CEO Bernard Ebbers was sentenced to 25 years in prison.

[4] At the end of 2001, it was revealed that Enron Corporation, an American energy, commodities, and services company based in Houston, reported a financial condition that was sustained substantially by institutionalized, systematic, and creatively planned accounting fraud, known as the "Enron scandal".

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Living with an investment fund – the company perspective

From the decision to open up its equity capital to the withdrawal of the private equity fund four years later, step by step SOMDIAA reveals the four stages of this marriage of two worlds, and shows how a family business operating in Africa for more than 40 years changed its culture and adopted a more professional approach at the instigation of a financial investor. A report by the company's chairman.

Alexandre Vilgrain

Chairman, SOMDIAA

At the beginning of the 21st century, SOMDIAA decided that it wanted to open up its capital to external investors. SOMDIAA is a French company that has been established in sub-Saharan Africa for over 40 years and holds majority interests in sugar-production complexes and wheat flour mills. An unusual feature of the company at the time was that it was owned by just one family.

The challenge for this key player in Africa's agribusiness sector – in particular in the CEMAC region[1] and in UEMOA[2] – was to bolster its own resources and build the capacity to develop the business further. In addition, the company needed to improve its operations and consider new working practices. Because of its history (based in Africa, family-run, etc.), the company had trouble breaking moulds and old habits. It has a large number of long-term employees who have been working in Africa for decades. Although not openly opposed to change, they nevertheless proved somewhat resistant. One of the reasons for involving financial partners is to remove constraints and break down barriers.

The initial idea was to list the company on the stock exchange, but in the end SOMDIAA decided to open up its capital to a private equity fund at the beginning of 2003. This experience, which proved to be an enriching one, but also traumatic for the company and its managers, can be broken down into four phases: the due diligence process, the decision to invest, day-to-day life with the fund and, finally, the exit.

ALEXANDRE VILGRAIN

Alexandre Vilgrain began taking on responsibilities within the subsidiaries of the family's agribusiness group in France, Africa and the Indian Ocean in 1979. In Asia he set up a network of French-style café bakeries called Delifrance Asia, which was then listed on the stock exchange.
In 1995 he succeeded his father as Chairman of SOMDIAA. He also holds various positions within other companies, including that of observer on the Proparco board of directors. He was appointed Chairman of the French Council of Investors in Africa (CIAN) in 2009.

Phase 1: Due diligence checks provide a jolt

The first stage is the most important. In the course of due diligence checks, the potential investors – in this case the private equity fund – strip the company to its bones, question its managers, and visit the industrial sites with the management team. During this period, the company's entire strategy and organisation are called into question. Looking back, this phase was by far the most crucial for restructuring.

Effectively, the workforces and managers see the company anew from a different angle, and modify and improve certain practices, approaches and working methods. Moreover, for a group like SOMDIAA, which was 97% owned by a single family, the due diligence phase marked the start of a real change of mindset. Because of its history, the company was finding it hard to enter the modern age. It was chugging along, mired in old habits. Some longstanding employees were resistant to change. The main topic of conversation within the company became 'why change?' The fund's teams were quick to supply the answer.

"The due diligence phase was by far the most crucial for restructuring."

The fund's impact was a salutary shock. Private equity funds are staffed by young people who speak English and move in another world – the world of ▶▶▶

[1] *The Central African Economic and Monetary Community (CEMAC) is an international organisation covering Cameroon, the Central African Republic, Chad, Equatorial Guinea, Gabon and the Republic of Congo.*
[2] *The West African Economic and Monetary Union (UEMOA) is an organisation working to achieve economic integration of its member states (Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo) by strengthening economic competitiveness through open, competitive markets and the rationalization and harmonization of the legal environment.*

Can private equity boost African development?

▶▶▶ international finance. This means that they look at the company through fresh eyes, unimpeded by the company's history, traditions and genes. They dissect the company professionally and impassively, and shake up its routines – reaching right into the heart of Africa. Their financial approach proved extremely valuable.

Discussions, debates and – most of all – changes

This approach led to the professionalisation of a large number of practices, which have now become firmly established, including regular reporting from every subsidiary. SOMDIAA struggled to publish its monthly results and half-yearly accounts quickly. By visiting the subsidiaries with representatives from the investment fund during the due diligence phase, it was possible to have people from outside the group explain that these procedures were commonplace in many other companies. This challenge to employees' pride meant the practices were implemented. And they are still in place today, with monthly figures available no later than the 10th of the following month, and consolidated half-yearly; similarly annual accounts are produced and audited within a very short time frame.

"The presence of a fund is one way of professionalising African businesses."

In the same way, the investment fund, which had social and environmental responsibility commitments to its investors, asked the company's board of directors about this issue. This was another area in which the fund's teams introduced changes and professionalism during the due diligence phase. Since then, the SOMDIAA Group's corporate values have been promoted through a network of foundations.[3] In every country where the group operates, the foundation's mission is to optimise the social and charitable activities that the group has been running for decades, and to manage the financing of development projects. The first foundation was set up in Chad at the beginning of March 2010. Today there are eight foundations in six countries (Cameroon, the Central African Republic, Chad, Congo, Côte d'Ivoire and Gabon). There is also a Health and Safety at Work Committee on each of the group's sites. On the environment front, the SOMDIAA Group has introduced a proper policy based on ISO 14001 to improve the way it manages its impacts on the air, soil and water, to reduce its resource consumption (energy and water) and to establish a plan for the treatment of waste from the various subsidiaries. In a similar approach, since 2002, the group's sugar factories[4] have been striving to develop a consistent quality procedure based on ISO 9001. It aims to find the optimum quality level for every product: products for industrial customers, for skilled tradesmen, for traders and for end customers.

All these changes were made possible by the presence of an external financial partner who was able to get messages across by opening the company up to the outside world and to the modern age.

Phase 2: The decision to invest

Once the due diligence phase was over, it was time for the final negotiations on the value of the company. For the company chairman, this stage was the most stressful and the most intense. The honesty and transparency with which he responded during the audit phase now seemed to backfire on him.

A private equity fund is not just another shareholder. These young people, with their fresh (and above all, financial) perspective, are not entrepreneurs. Neither are they familiar with the environment of the company which they are reducing to figures. The fund has a clear objective: to get a 'good deal' when it invests in the company, with the investors convinced that the 'good deal' will be when the fund pulls out.

Having come this far, the management team does not really want to call into question all the work that has been done, or start the whole due diligence process again with another fund. And, of course, there is money at stake!

The fund's involvement in the group's capital was linked to an exclusivity agreement with the SOMDIAA Group for business opportunities in the sugar and flour sectors on the African continent. The group hoped that the deal would enable it to use the fund's network to access other development opportunities, as well as providing a cash injection.

Finally, the arrival of an external shareholder was a good thing for SOMDIAA's image and reputation in the business world. A number of banks did not think that the group would be able to raise funds. This too created a sense of pride within the workforce.

Phase 3: Day-to-day life with an investment fund

For the fund, the most important moment in the life of a company is the that of the budget and results. The fund's aim is to check that its investment is profitable. Represented on

[3] Each foundation in the SOMDIAA Group is financed by a subsidiary, which delegates to it all activities that are not linked to the group's industrial and agricultural operations.
[4] Compagnie sucrière du Tchad (CST), Société sucrière du Cameroun (SOSUCAM), Société agricole de raffinage industriel du sucre (SARIS Congo), SUCAF Côte d'Ivoire, SUCAF Gabon and SUCAF RCA.

the board of directors, the fund also keeps an eye on the group's global strategy. Otherwise, it generally behaves like a financial shareholder, leaving the management team to do its work, which is a very comfortable arrangement for the company chairman. This marriage between the worlds of business and finance did not cause any friction or generate any particular problems. On the other hand, this attitude is still quite disappointing, when compared with the due diligence phase. For its part, SOMDIAA put in place during this period everything that had been decided during the due diligence audits: the social and environmental policy, reporting systems, etc.

"For the company's managers, the fund's exit felt like a divorce."

However, life with a private equity fund does not only boil down to this. It also sends a very strong message both to the workforce and to the outside world and introduces a new negotiating partner, who acts as a shield for the board of directors as they improve the company's working methods. This is vital in the regions where SOMDIAA operates. In sub-Saharan Africa the group generally has two negotiating partners: its employees and national governments. Having a 'financial' partner sent a strong message to the group's African partners (generally governments), facilitating and improving the company's relations with them and, above all, providing them with a structure. The presence of a fund is one way of professionalising African businesses and bringing them into the modern age. Everything that was put in place while the fund was involved is still there today.

Phase 4: The exit

For an entrepreneur, the withdrawal of an investment fund never comes at the right time. It is always either too early or too late. Above all though, once the decision has been taken, there is no going back. Once the fund has confirmed its intention to pull out, it will do everything possible to extricate itself. And the decision is a quick one. The exit arrangements are not written down and the exit date is not known in advance. Everything that was said about long-term strategy during the due diligence phase and in board meetings no longer exists. Only one thing matters: getting out. The fund's exit proved difficult and very stressful for SOMDIAA, quite apart from the fact that the fund did not do the company any favours. After the fund pulled out (at the end of 2007), the company no longer existed for the fund. That phase was over and they had no regrets.

More generally, for the company's managers, the fund's exit felt like a divorce. A divorce of vision first of all. The board (the entrepreneur) realises that the fund is there only to make a profit – the best profit possible – and not to help the company do well. The fund achieved its goal: it pulled out after four years having doubled its investment. This psychological aspect is very important, but is often ignored. It is a kind of trauma and it shocked the workforces at all the group sites. Over time, the fund and its representatives had become part of the group, part of the family... and then they broke off all contact overnight! It was as if the adventure (because the experience was indeed an adventure) was no longer of interest to them.

Did the withdrawal of the fund mean that the group's strategic choices changed? It is clear that from the moment a company requests help from a private equity fund, its very nature is changed, especially in the case of a family owned business. Of course in theory, when a fund pulls out, a company is no longer the same size, which was the case with SOMDIAA. And it no longer operates in the same way, which was also the case with SOMDIAA. This means that the life of the company changes dramatically and its future strategic choices will naturally be different as well.

Although the fund's withdrawal was traumatic, a year later the business was back on its feet. For a family firm operating in a somewhat complicated geographical region, life with a private equity fund is something to be experienced – provided one invests as little emotion and as much professionalism as possible.

A marriage of these two worlds is possible, as long as those involved remember that they are poles apart. The fund is aiming to make a healthy profit, while the business is using the money invested by the fund to leverage its development. If this is kept in mind, both sides will benefit from the arrangement. •

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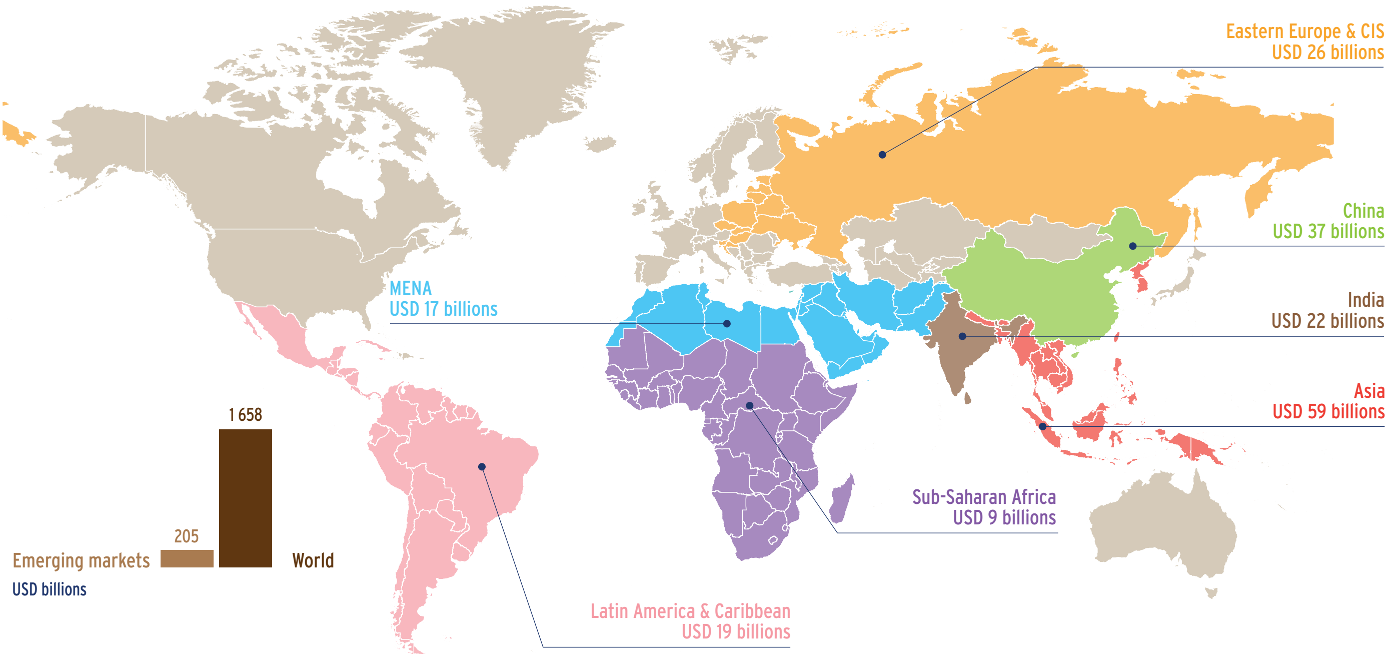
SOMDIAA *(Société d'organisation de management des industries alimentaires et agricoles)* is a holding company that has been providing services to the agrifood industry in Africa for over 40 years. It has a turnover of EUR 400 million and employs 20,000 people. As a major economic player in Africa (Cameroon, the Central African Republic, Chad, Congo, Côte d'Ivoire and Gabon), SOMDIAA focuses primarily on developing activities in the sugar, wheat, animal feed and poultry farming sectors.

Can private equity boost African development?

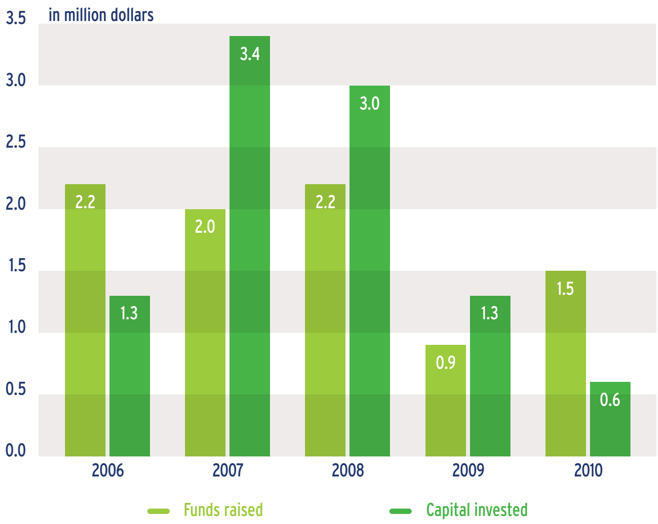
Although private equity has expanded at a rapid pace in sub-Saharan Africa in recent years, it still remains relatively modest in scale here compared with other emerging markets. Investments tend to be too concentrated in a few countries and in the traditionally more dynamic sectors: diversification would help to meet the needs of African growth and the financing requirements of SMEs.

Private equity fundraising in emerging markets, 2006 – 2010



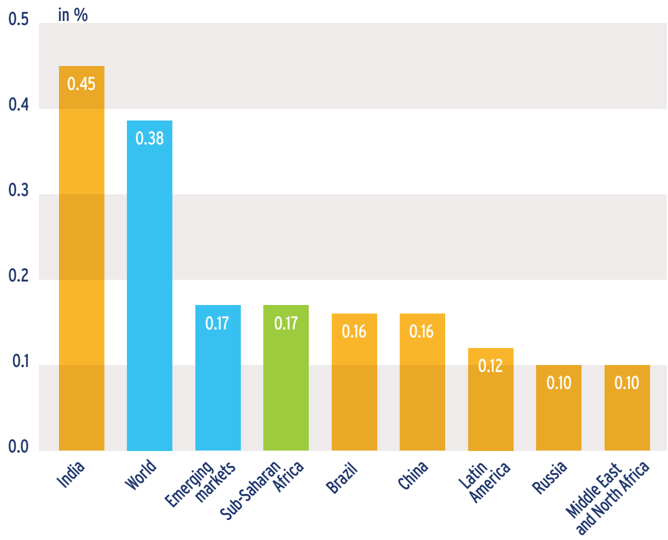
Note: CIS: Commonwealth of Independent States; Asia: excluding Japan, Australia and New Zealand
Source: EMPEA/ PROPARCO-Private Sector &Development, 2011

Private equity funds raised and invested in sub-Saharan Africa



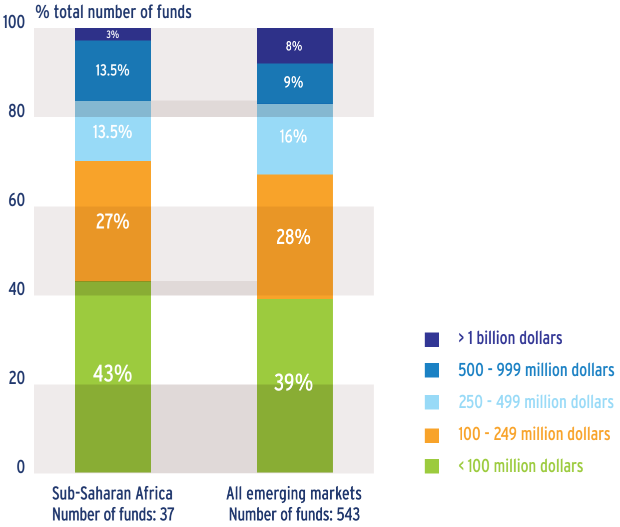
Source: EMPEA, 2011

Private equity investments as a percentage of GDP, 2008 - 2010



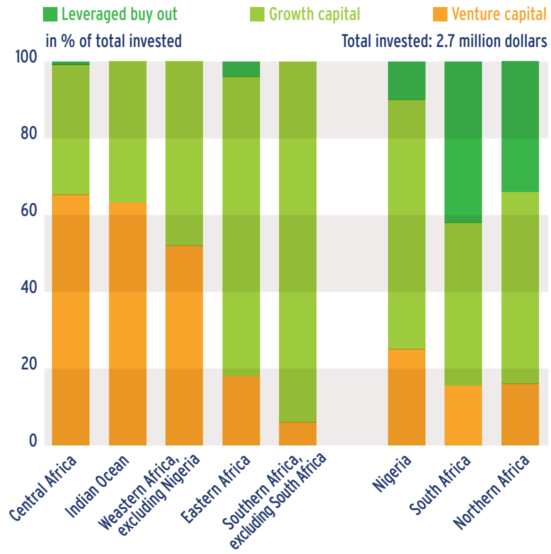
Source: EMPEA, 2011

Breakdown by size of funds raised between 2006 and 2010



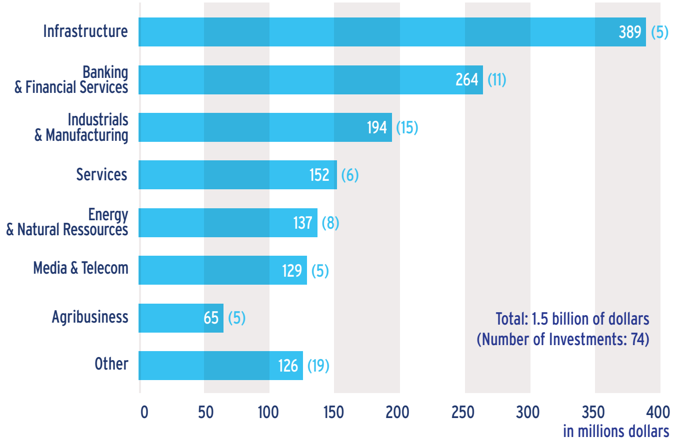
Source: EMPEA, 2011

Funds stage by geographical area, 2007



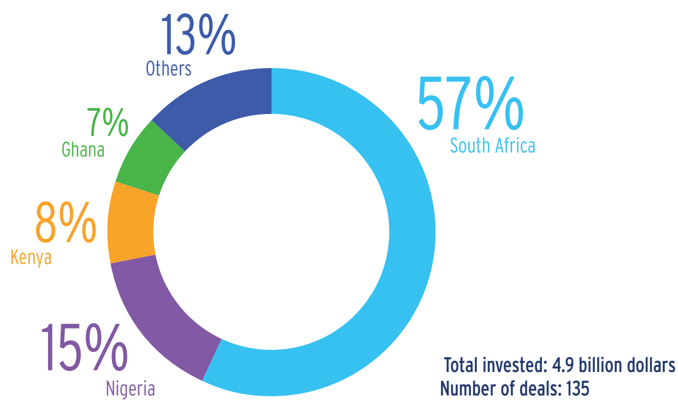
Source: Geiss R., Hajdenberg J., Renchon M. L'Afrique, terre d'investissement: le private equity en Afrique, réussites et nouveaux défis. CAPafrique, 2008.

Breakdown by sector of private equity investments in sub-Saharan Africa, 2009-2010



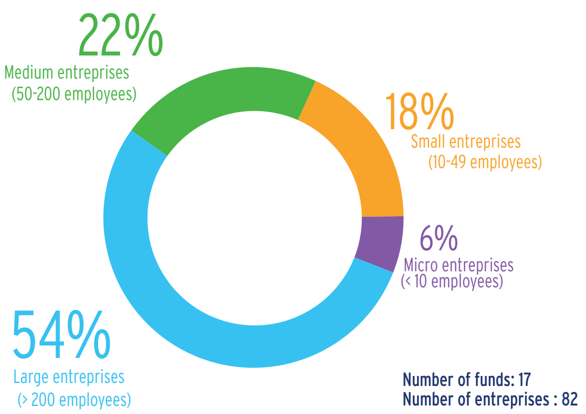
Source: EMPEA, 2010

Geographical breakdown of private equity investments in sub-Saharan Africa, 2008-2010



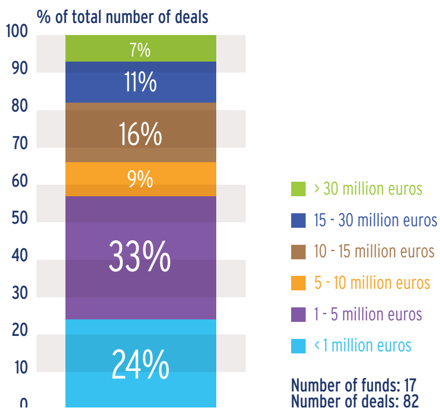
Source: EMPEA, 2011

Size of PROPARCO's portfolio private equity funds' investees, 2004-2010



Source: PROPARCO -Private Sector & Development, 2011

Ticket size of PROPARCO's portfolio private equity funds' investments, 2004-2010



Source: PROPARCO -Private Sector & Development, 2011

The transparency challenge facing private equity

When hedge funds are set up in offshore centers, they benefit from favorable conditions when investing in Africa. Their investments may spur economies, but short-term profit targets, the lack of transparency and tax evasion do not contribute to the development of the continent. Enhanced tax controls, transparency and traceability of funds will help private equity investment become a full-fledged player in Africa's development.

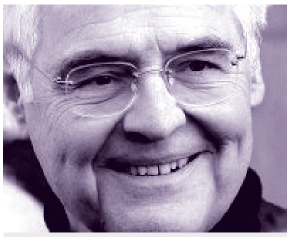
François d'Aubert

General Delegate of the fight against tax havens

Private investment (direct and portfolio) has been gaining impetus in Africa since the early 2000s, in line with the "Washington Consensus".[1] In 2010, it had a stock of some USD 150 billion of assets and is gradually taking over from international finance institutions. The capital is mainly American, French and British, but Chinese and Indian investments, those from Gulf countries and inter-African investments (South Africa, Libya) are growing at a rapid rate.

Multinational investments in oil and mining countries continue to take the lion's share. However, there is a certain degree of diversification which does serve the interests of non-mining sub-Saharan African countries and benefit certain local small- and medium-sized enterprises (SMEs). The sectors include telecommunications, transport infrastructure, the textile industry, agriculture, tourism and the hotel industry and, last but not least, financial services.

Experts forecast that investment flows in Africa will be in the region of USD 150 billion by 2015. The bulk of these investments (80%) will continue to focus on the mining, metal, oil and gas industries, as well as natural resources exploration, driven by China's high level of demand for raw materials. The tourism and hotel industry are expected to receive 15%, while major sectors such as infrastructure and industry may each only obtain 4%.



FRANÇOIS D'AUBERT

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Tax and legal arrangements adopted by private equity investors

Private equity investment features prominently in a new political-economic model that is coming into being in developing countries. What attracts it to Africa are both the positive prospects for economic growth and the high returns on investments, which are above those in other world regions, with the exception of Asia and emerging countries. The range of funds, investors and operators interested in the continent is expanding and diversifying and is helping certain countries such as Egypt, Kenya and Nigeria reach the "status" of "emerging countries", which is already the case for South Africa.

Investors exercise a high level of selectivity: political and government instability, the low level of security, wars in certain regions or the lack of transport infrastructure can be discriminating factors which penalize countries with rich mining potential. This is, for example, the case for the Democratic Republic of Congo and a handful of other countries.

"Fund strategies are often based on extremely high profit targets against a risk that is not always controlled."

Other negative factors such as corruption are often deplored, but very rarely put off potential investors. The different private equity-friendly tax incentives and exemptions implemented by numerous African governments under the International Monetary Fund and World Bank Tax Consensus are viewed positively by operators. However, the lack of transparency

[1] The "Washington Consensus" presents a set of standard measures applied to economies facing difficulties as a result of their debt. It was designed by the World Bank and International Monetary Fund (both based in Washington) and is named after an article by the economist John Williamson, who in 1989 defined ten recommendations closely modeled on the ideology of the Chicago School. Its recommendations include financial liberalization, trade liberalization, market deregulation and the privatization of State-owned companies.

in the terms under which they are generally granted is an obstacle to establishing a climate of confidence. They do, however, make it easier for fund managers to keep their promises of ambitious returns on investment – often over 25% – and to interest funds with alternative strategies, even hedge funds.

These funds very often operate via legal entities registered in Mauritius, the Caiman Islands, the British Virgin Islands and Bermuda, or from the offshore[2] financial centers where they are established (Delaware in the United States, Luxembourg, Singapore, Switzerland and the United Kingdom). The different tax exemptions, particularly on capital gains and valuation gains, make this situation highly advantageous for them. In addition, these jurisdictions offer the possibility of maintaining funds' resources in convertible hard currencies. While most sub-Saharan African countries have non-convertible currencies and legislations that do not authorize offshore companies, they also make it possible to enhance risk coverage on currencies and deals and, in principle, to keep in check the real value of financial assets.

Short-term returns, lack of transparency and tax evasion

It may be a win-win situation for investors, but this is unlikely to be quite the case for countries. Admittedly, private equity investment does play a positive role by supporting job creation and the emergence of new projects; it provides existing businesses with capital for their development, helps stimulate emerging financial markets and create and modernize infrastructure. However, operating conditions in certain mines or agricultural sectors in which funds invest are also criticized for not complying with basic social imperatives and minimum environmental standards.

Although the increasingly active involvement of private equity funds generates a growth process which can create jobs and wealth in the African countries they target, it also raises three types of problem. First of all, their strategies are often based on extremely high profitability targets against a risk that is not always controlled; the consequences can prove disastrous for the host country: projects permanently halted, bankruptcy, disappearance of debtors, cost overruns, fraud, etc. The recent participation of hedge funds and speculative funds in pan-African investment vehicles (with capital raisings worth several hundred million dollars) shows that the target of high short-term returns has a strong influence on the tax and financial strategies of investors and fund managers. Private equity funds can consequently be tempted to take control of a local business merely to make a quick profit. This is made easier by a tax system which facilitates equity distributions and reductions during the first years. And yet local businesses generally require access to long-term equity and need to be able to rely on a stable shareholding structure. Africa has often attracted financial speculation, particularly in the mining industry; it is hoped that the arrival of private equity in other sectors does not lead to a similar result.

The lack of transparency in unregulated private equity investment poses another problem with its financial and tax arrangements in which funds are active players. It is based on the extensive use of offshore jurisdictions and financial centers where the funds, in addition to the tax facilities they benefit from or organize, are largely outside financial regulation and prudential standards. They are major players in shadow banking[3] for which tax havens are most typically used. Funds registered in tax havens have practically no transparency and information obligations vis-à-vis the market or regulatory authority in terms of the identity of their owners or debtors, changes in their share capital distribution, their accounts or their level of debt, their strategies or their results. This lack of transparency also concerns the offshore debt of new entities, which are encouraged by the possibility of being able to deduct interest and are not submitted to any external control. It can be practical for investors and operators seeking discretion for political reasons to make use of the lack of legal and financial transparency of certain non-cooperative jurisdictions – whether they are from sovereign funds or the instruments used to take over raw materials reserves. But they can also be screens for the interests of Mafia figures or fraudsters seeking to geographically and sectorally diversify ▸▸▸

"Africa has often attracted financial speculation, particularly in the mining industry; it is hoped that the arrival of private equity investment in other sectors does not lead to a similar result."

[2] *The term offshore is used to describe the creation of a legal entity in a country other than the one in which the activity is conducted in order to optimize taxation (tax haven) or financial capital management.*
[3] *Shadow banking is a banking activity conducted by entities that do not receive deposits and, as such, are not regulated as banks.*

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▸▸▸ their investments and take advantage of host countries' needs for fresh capital in order to launder dirty money.

The third type of criticism concerns tax evasion, which is at the core of the system, with tax optimization arrangements that are often aggressive and combine exemptions in host countries with those offered by third-party non-cooperative jurisdictions. Transfer pricing manipulations on exports (particularly raw materials), which involve one or several tax havens between the exporting country and the actual importer, are one of the main reasons for local tax base erosion. This tax evasion is also fostered by loan interest deduction mechanisms, which have long benefited multinationals in the mining and trading sectors. They have even more strategic advantages for companies financed by private equity with strong leverage.[4] All of this naturally undermines host countries' tax bases, weakens the local impacts of investments and encourages local authorities to "make up the difference" with parallel revenue systems. In the end, several tens of billions of dollars leave developing countries. This represents more than the amount of international aid.

"It is a priority to fight against tax evasion, the main victims of which are the public finances of most developing countries in sub-Saharan Africa."

Enhancing the impact of foreign investment flows

The crisis has revealed a pressing need for financial and prudential regulation from which financial "ecosystems" linked to Africa must not be exempt. By reducing the scope of unregulated areas and financial products and dependence on offshore banking,[5] the virtual detour that investment funds make via tax havens would become less attractive. It would also limit the negative impacts of excessive leverage and investments in derivative products.

International finance institutions should also undertake not to provide their expertise or support to private equity fund projects that transit through *non-cooperative jurisdictions*.[6] They may do so by referring to the criteria, recommendations or standards of the Organization for Economic Co-operation and Development (OECD), the Financial Action Task Force[7] (FATF) and the Financial Stability Board[8] (FSB).

It is a priority to fight against tax evasion, the main victims of which are the public finances of most developing countries in sub-Saharan Africa. This requires fighting against illicit capital outflows from host countries. They often stem from endemic corruption, circumvented exchange controls and fraudulent remittances of interest and dividends (linked in particular to private equity investments) towards tax havens.

The arrival of private equity investment must not mask the need for a more equal sharing of revenues between investors and States, within a balanced legislative and tax framework, that is investor-friendly and preserves the interests of local communities and States. The latter must, as certain emerging countries do, at the minimum provide for transactions concerning movable and immovable property in an investment operation (acquisitions, sales and capital gains) to be taxed where they are located and not where the platform company is domiciled. More generally, it involves fighting against aggressive optimization schemes aiming to artificially reduce local tax bases and reduce charges in order to locate the highest possible amount of profits in tax havens where they are tax exempt.

Tax transparency must also be made mandatory, notably to avoid abusive transfer pricing; sums paid by mining companies, revenues received by governments and expenditures made must all be disclosed. In addition, the fiscal relationship between the host country of the investment and the offshore center must be based on equitable rules and conventions on the exchange of tax-related information in compliance with the OECD standard. This must also be the case for the relationship established between the offshore center and the investor's country. It is advisable for the network of tax conventions, which has expanded significantly over the past two years with offshore centers, to be strengthened with new conventions. They must provide for the exchange of tax-related information to the OECD standard and must be signed between the offshore centers and the African countries receiving the foreign investments. Today, only five Afri-

[4] Leveraging involves borrowing liquidities in order to increase the actual size of the portfolio (initially only made up of funds provided by investors).

[5] Offshore banking rapidly developed in the mid-1960s, thanks to the growth and liquidity of global financial markets. The range of services offered by offshore banks includes all deposits, transfers, credit facilities and investment management. They handle administrative procedures and provide all these services on a confidential basis.

[6] Non-cooperative jurisdictions are areas which do not apply internationally adopted standards for transparency and the exchange of tax and financial information.

[7] The Financial Action Task Force is an inter-governmental body with a mission to develop and promote national and international policies to fight against money laundering and the financing of terrorism.

[8] The Financial Stability Board is an informal economic group set up during the G20 meeting in London in April 2009. Its objectives relate to cooperation in the field of supervising and monitoring financial institutions.

can States (Botswana, Ghana, Mauritius, Seychelles and South Africa) are members of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes.[9] Moreover, a number of offshore centers that serve as a hub for investments in Africa (British Virgin Islands or Hong Kong for example) do not always have relevant bilateral conventions which would allow an effective exchange of information with sub-Saharan African States.

Host countries of investments must build sound tax bases. This is essential for numerous African States. States must introduce tax base, collection and control systems for both corporate tax and capital gains tax on the businesses in which funds invest, and better regulate the different tax exemptions concluded between the authorities and operators. This also requires acquiring expertise in tax matters.

The need for transparency and traceability

Funds' use of investments based in offshore centers to invest in projects and businesses in Africa contributes to the lack of transparency which affects global financial circuits. Introducing greater transparency is essential in terms of ethics and good governance. But it is also the key condition for foreign capital flows towards Africa to truly support the development of countries targeted by investors, without, however, causing operators to lose interest.

This transparency requirement concerns all public stakeholders in investment: both the States that receive the investments and the offshore financial centers that often carry them. The international community expects them – particularly those affected by drug trafficking – to rapidly comply with FATF recommendations for the fight against money laundering in order to avoid any pollution of private equity investment. Transparency is also needed from operators, investors and direct beneficiaries – the identity of which must be known by tax authorities (under countries' adherence to the OECD standard) and by bodies dedicated to the fight against money laundering.

"Only five African States (...) are today members of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes."

Initiatives for greater transparency are also expected in the mining and oil industry, with businesses undertaking to disclose their country-by-country results, the tax they pay locally (notably corporate income tax) and the dividends paid by a subsidiary. Increasing international involvement aims to foster good governance practices, such as the Extractive Industries Transparency Initiative (EITI),[10] the main tool used in recent years to promote better governance of revenues from natural resource exploitation in producing countries. In order to promote the sustainable economic, social and environmental development of the sector, Africa must establish good governance practices at the national, regional and international levels. •

[9] *Since 2000, the Global Forum on Transparency and Exchange of Information for Tax Purposes has been the multilateral forum within which over 90 jurisdictions work. It is in charge of the in-depth monitoring and peer reviews of the implementation of standards for transparency and of the exchange of information for tax purposes.*

[10] *The EITI is a coalition of States, businesses, civil society groups, investors and international organizations. It establishes an international transparency standard for the oil, gas and mining sectors. This standard is based on the publication of both amounts paid and collected by businesses and States.*

Private equity and SMEs: an instrument for growth

Stabilising growth in Africa – growth which is real but fragile – depends partly on the dynamism of SMEs, which receive little in the way of private equity support. Funds' profitability can be enhanced, in particular by developing local teams. The levels of funding invested need to be scaled up and the full spectrum of technical support resources should be utilised. Finally there needs to be considerable emphasis on additional investments targeting social objectives.

Jean-Michel Severino

Chairman of Investisseur & Partenaire pour le Développement

We're hearing it everywhere: Africa is back on track; its time has come. Growth rates prove it, and the impressive forecasts are stacking up. A booming population combined with GDP increases look set to propel the continent to the equivalent of China's current position, measured in terms of absolute economic value, by 2050. And you can almost hear what comes next: development has happened, aid can be scaled back, case closed – Africa must now become private-sector terrain. A good deal of this description is indeed accurate – the recovery in African growth rates is raising hopes of a renaissance. A middle class is emerging. Civil society is transforming, and exhibiting increasingly democratic values.

JEAN-MICHEL SEVERINO

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Yet this growth is both fragile and unevenly distributed. Fragile, because the African economies are still small, vulnerable to external turbulence, confronted with immense environmental challenges. Their public finances are exceedingly constrained, as evidenced by the recent return to state indebtedness. Unevenly distributed, because not all of the continent's regions are reaping the fruits of this growth to the same extent; nor do the different social categories have fair access to the same opportunities. Africa will struggle to contend with these constraints and challenges on its own.

An ecosystem of responsible SMEs for sustainable growth

Achieving sustainable growth in Africa partly depends on developing responsible small and medium-sized African enterprises (SMEs). Expansion in this sector – in terms of the number and size of the companies involved – is in itself a driver of growth. A dynamic SME sector has a balancing effect on society through the "middle class effect" it brings about; it creates jobs, spreads wealth, and anchors economic activity locally. Of course it is also necessary that these SMEs genuinely promote sustainable growth – environmental issues are especially crucial here: SMEs are less able to bear the costs involved in managing environmental impacts and their social practices can prove to be less beneficial than those of large corporations.

> *"Achieving sustainable growth in Africa partly depends on developing small and medium-sized enterprises."*

Nonetheless the role of SMEs is widely celebrated and growing this sector features among the official objectives of all the bilateral and multilateral cooperation programmes. Many development banks have set up ad-hoc programmes and European financial development institutions have been intervening in this area on a regular basis for many years. Even so the support systems in place for SMEs have remained unambitious in number and limited to a handful of instruments: comprising on the one hand public technical support (or "upgrading") programmes, on the other refinancing or guarantee instruments offered to the primary banks. These instruments are useful and important and should be reinforced. Yet however impressive they sound, they do not provide a means of tackling the endemic problem of capital financing for SMEs.

This problem has been so well known for so long that most countries in the Organisation for Economic Cooperation and Development (OECD) have set up dedicated state support schemes benefiting their own SMEs in order to address it. In the vast majority of cases these SMEs find themselves in a tight situation in terms of their equity capital: they can be suffocated by their own growth, limited by their owners' financial capabilities or effectively barred from accessing the long-term external financing typically provided by the private equity industry. In France for example, there are schemes to support innovation (FIPs[1]), and local SMEs (FCPIs[2]) – all supported by fiscal expenditure. Then there are OSÉO's[3] interventions in the form of quasi equity and debt, backed by the substantial funding available to this financial institution and facilitated by the triple-A rating it owes to its public status.

Africa's private equity boom has not benefited the continent's SMEs. International and continental funds have focused mainly on the telecommunications sector and major infrastructures (primarily energy), and have concentrated on the more highly developed nations to the north of the continent and on South Africa. This trend is even more pronounced for small SMEs (with fewer than 100 employees). And the situation is even worse for start-ups – companies established within the last five years, which play a key role in driving economic dynamism. It is these newly formed, small-scale SMEs that constitute the core of future development: they will be the engine driving African growth in the future, its central ignition system. And yet they are entirely neglected, absent from collective concerns – and from the interventions of private equity.

Improving investment profitability

Low levels of savings, the inadequacies of the banking system and the limitations of the entrepreneurs themselves make the challenges of accessing private equity familiar to SMEs in other parts of the world even more acute in Africa. The same is true with regard to accessing private equity funds. We might assume that investment funds' lack of interest in small companies derives from their lower profitability compared with that of large corporations. However, neither claims levels nor profitability differentiate the potential performance levels of instruments dedicated to large corporations or to SMEs. What makes the difference is management costs. In Africa, front-end and management costs are exceptionally high compared with the unit values of the transactions, in an industry where fixed costs are the rule. This has an automatic knock-on effect on net profitability for investors. Moreover, when the investment objectives are innovative profitability may be limited – resulting in extended investment periods or higher losses compared with the portfolio average. Which explains investors' relative disinterest in this target category – and, in consequence, the low number of management teams dedicated to this sector.

The profitability of equity or quasi equity investments in African SMEs could improve given two scenarios: more local teams operating with lower charges within a local market; or the development of teams of a significant size capable of industrialising the process and spreading their structural costs over a substantial portfolio. The former scenario is realistic and is already starting to happen. Yet the process is very slow, because of the low levels of human resources available (which are therefore expensive) and the scarcity of local capital – which means that these teams need to find international backers, who are difficult to identify and persuade.

"Building African teams focused on small businesses is an objective in its own right."

The second scenario is also possible, taking as a basis the international teams already in place or some national teams – like those currently emerging in South Africa or north of the Sahara, for example. Yet here too the process will take time; the market's natural processes will not of themselves offer any shortcuts. Developing a strong SME sector certainly involves the provision of more long-term financing, among other things; yet it also requires a dedicated programme of initiatives. This needs to be one of the general interest objectives of development policies if we wish to accelerate the growth process in a meaningful way.

Promoting the growth of private equity

As was the case for microfinance, accelerating the growth of private equity to benefit African SMEs involves deploying a range of complementary strategies. First of all the funds made available to private equity teams targeting SMEs need to be increased. Too many public finance institutions supporting the private sector continue to have exces- ▶▶▶

[1] FIPs (Fonds d'Investissement de Proximité – local investment funds) were created by the Dutreil Law in 2003, supplementing the SME support system already provided by FCPIs (Fonds Communs de Placements dans l'Innovation – innovation investment funds).
[2] FCPIs (Fonds Communs de Placements dans l'Innovation – innovation investment funds) were created by the 1997 Finance Law to support the growth of high-potential innovative companies.
[3] OSÉO is a French state-owned company whose primary objective is to help SMEs and medium-sized businesses secure funding, supporting their ability to drive innovation and growth.

▶▶▶ sive financial requirements with regard to this category. Like FISEA, the Investment and Support Fund for Businesses in Africa set up by the *Agence Française de Développement* (AFD), it is important that bilateral or multilateral private-sector finance institutions establish "patient investment" categories which can benefit social business[4] in general and SMEs in particular. Some bilateral co-operations could take on the role of subsidising the instruments with the most socially beneficial objectives.

Private individuals also represent significant potential contributors. They could be further encouraged, in France, by extending the fiscal measures relating to income tax and the solidarity tax on wealth ("*impôt de solidarité sur la fortune*" or ISF) which benefit the FPI and FCPI schemes – and by equivalent measures in other countries. These tax schemes' yield in development terms could prove significantly higher than that of traditional tax-funded development aid. Admittedly these tax schemes are not very popular in France, but these investors could be given additional or alternative encouragement by insuring their investment risk using a mechanism like the ARIZ scheme[5] or by setting up schemes to cover initial losses. The fact that such mechanisms incorporate an element of indirect subsidy should not be a deterrent, if the aims and outcomes of these funds do serve the general interest and if the returns achieved by investors are clearly below market expectations: what is happening here, effectively, is the co-financing of public policy. The same arguments can apply to the final category of potential investors: industrial and financial businesses implementing a social and environmental responsibility strategy involving the creation of investment funds designed to have an impact.

The second category of resources needing rapid deployment is technical support. Small and very small businesses have only very recently started to gain access to this resource. Private equity funds can use this instrument efficiently to benefit the companies in which they are investing. The larger the intervention the greater the tangible impact it can have: alongside ad-hoc technical expertise it is also possible to finance medium-term management positions during the start-up phase, to provide training and to facilitate evaluations. This final point is very important: capitalisation, formalisation and feedback are crucial to drive progress in a sector which is feeling its way forward, laying down new pathways for development policy. It is also important to help the fund management teams themselves progress: often young and facing significant professional challenges, almost all of them need strengthening, particularly in relation to the quality of environmental and social management. Building African teams focused on small businesses is an objective in its own right, involving a commitment to developing this profession and taking the risk of supporting emerging, relatively inexperienced teams. There must be a willingness to accept potential losses – relatively easy here because the sums involved are limited – and to support training in universities and higher education institutions.

Greater environmental awareness

Supporting African SMEs, it must be emphasised, involves more than just developing a private equity industry adapted to the context. The legal and fiscal business environment, the quality and cost of infrastructures and essential services, the availability of human resources, openness and the international commercial context, the performance of public services, etc. are all factors which can boost – or impede – the dynamism of SMEs.

Nonetheless the development of *impact investment* – using financial instruments which combine social objectives with targeting a financial return – will play a crucial role in the major battle to stabilise African growth which has been under way for a decade or so, following the long and depressing period of structural adjustment. In order to ensure that this era is firmly consigned to the past it is vital that sufficient energy and resources are devoted to this objective, especially by public organisations and private development institutions. ●

[4] This new kind of business was defined by Nobel prizewinner Muhammad Yunus: an enterprise which devotes its profits to reducing costs and producing social benefits, returning no more than the initial investment to investors.
[5] ARIZ is a guarantee scheme created by the Agence Française de Développement to make it easier for private SMEs and microfinance institutions to access financing.

FOCUS

Investisseur & Partenaire pour le Développement **(I&P)** is a private finance company established in 2002. It provides financial and managerial support for microfinance institutions and medium-sized companies in Africa – organisations which cannot access bank financing and for whom microcredit is insufficient. Its interventions take the form of equity investments and, in some cases, loans.

Pioneer role of DFIs in sub-Saharan Africa

Growth in emerging markets is currently leading the financial development institutions (FDIs) to re-focus their efforts on low-income countries – bringing sub-Saharan Africa to the fore once again. FDIs can play a driving role here by facilitating access to the private equity market, particularly as private operators are turning away from SMEs – assessing them as too risky. How to turn theory into practice.

Yvonne Bakkum and Jeroen Horsten

Director Private Equity, FMO
Evaluation Officer, FMO

Starting in the early 90s, Development Finance Institutions (DFIs) played a catalytic first-mover role in making emerging markets more accessible to hesitant commercial investors. They have been pivotal in developing the proper infrastructure for the private equity industry, by promoting domestic and pan-regional private equity associations and educating governments on the barriers imposed by legal and regulatory frameworks.

Over the period 2005 to 2009, the percentage of emerging market private equity deals has more than doubled to 30% of deals worldwide (Liechtenstein and Meerkatt, 2010). At present, most of the capital is geared towards the BRIC-countries.[1] According to the Emerging Markets Private Equity Association's (EMPEA[2]) latest Annual Fundraising and Investment Review, funds dedicated to BRIC accounted for 51% of total capital raised – USD 23.5 billion – in emerging markets in 2010 (EMPEA, 2011).

The impressive economic growth of many emerging markets has put pressure on the role of DFIs in terms of their additionality to commercial investors, which lies at the core of the missions of DFIs. Consequently, DFIs have exited certain countries. Dutch development bank FMO, for example, decided to discontinue new investments in Brazil, Russia, Mexico and Kazakhstan due to their investment grade and upper-middle income country status,[3] and is striving to increase its exposure in lower-income countries. Recently, CDC, the United Kingdom's DFI, announced in a radical new business plan that it will exclusively focus its activities on the low and lower-middle income countries[4] in sub-Saharan Africa and South Asia, where 70% of the world's poor live (CDC, 2011).

"Barriers to investment include a lack of institutional quality fund management teams, limited access to market information, and poor corporate governance."

DFIs, gateway to SME funding in sub-Saharan Africa

The sub-Saharan African region is now a focal area for most DFIs, mainly due to the presence of many low-income countries (according to the 2011 World Bank list of economies, 26 out of the 47 sub-Saharan Africa countries currently have a low-income status). In spite of sub-Saharan Africa's gross domestic product (GDP) having grown consistently over the last decade, with output growth expected to accelerate to more than 5% over the next five years (IMF, 2011), interest from commercial private equity investors in ▸▸▸

YVONNE BAKKUM AND JEROEN HORSTEN

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[1] *BRIC refers to the group of Brazil, Russia, India and China, which were all deemed to be at a similar stage of newly advanced economic development.*
[2] *See the article by Jennifer Choi, p. 2, in this issue of Private Sector & Development.*
[3] *Upper-middle income countries defined by the World Bank as countries with a gross national annual income per capita of USD 3,976-USD 12,275.*
[4] *Low-income countries are defined by the World Bank as countries with a gross national annual income per capita of USD 1,005 or less; lower-middle-income countries, with a national annual income per capita of USD 1,006-USD 3,975.*

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▶▶▶ sub-Saharan Africa is still low.[5] Barriers to investment include a lack of institutional quality fund management teams, limited access to market information, and poor corporate governance. Consequently, investment flows into sub-Saharan Africa end up mainly in the larger and more established companies in the main economies. Small and medium enterprises (SMEs) still find it hard to access capital.

According to the 2007 Finance for All report from the World Bank, increasing access to finance for SMEs can accelerate economic growth and reduce poverty (World Bank, 2007). However, World Bank surveys have revealed that these firms, especially in lower income countries, still consider lack of access to finance a major obstacle to their development. Many are considered too risky by local banks, and they are seen as too small to justify extensive due diligences studies. They may also need investor guidance and experience to develop further.

"With its private equity experience, South-Africa could be an important investor hub on the continent."

DFIs target this gap among SMEs – which local banks are in many cases not equipped to address – by using local private equity funds as intermediaries. Also, DFIs provide local banks with dedicated funding to grow their SME lending programs. In some cases, DFIs have created separate programs, often supported or initiated by their own national governments, to make sure that funds are reserved for this higher risk segment. Examples are the FISEA[6] (*Fonds d'investissement et de soutien aux entreprises en Afrique*), investment fund funded by *Agence Française de Développement* (AFD) and managed by PROPARCO, International Finance Corporation (IFC) SME Ventures, and FMO's Massif program.

Private equity investing requires fund managers who have the ability to identify, grow and exit firms. This ability is developed with experience, and to this end, DFIs – with their knowledge of the dynamics of private business and the barriers to entrepreneurial development – actively support first-time managers in sub-Saharan Africa. They offer these managers much needed help: to seed the fund, find the right legal structure and optimise their investment strategy, among others, and they provide them with access to their global networks.

The concerns of commercial investors about the returns of first-time funds are often not justified. The IFC showed in a recent analysis of its fund portfolio performance that first-time funds in emerging markets matched and sometimes exceeded the returns achieved by experienced fund managers: for the period from 2000 through 2006, 46.2% of the top-quartile of performers in the IFC's data set were first-time funds (Liechtenstein and Meerkatt, 2010).

With its private equity experience, South-Africa could be an important investor hub on the continent. Yet, the number of South-African fund managers that have invested in countries north of their borders is fairly limited. This is because of unfamiliarity with local conditions – creating uncertain price-risk trade-offs – and the abundance of attractive deals in their home market. An exception is global asset manager Investec, which started building a pan-African investment team in 1997 with the opening of its offices in Botswana and Namibia. In 2004, they started investing in public equity markets across Africa. Their strong track record in this new environment laid the groundwork for the launching in 2008 of Investec's first pan-African private equity fund, the Investec Africa Frontier Fund.

Despite Investec's good reputation and attractive market conditions at the time, there was still limited appetite among other investors to invest in private equity in Africa. FMO was the first investor to deliver a final commitment, matching the USD 25 million investment of Investec. Ultimately, the fund managed to raise USD 155 million, including investments from several South-African pension funds and a fund of funds. In Zimbabwe, Investec sourced an interesting opportunity in the retail sector. To properly assess the potential of the opportunity, Investec was looking for external expertise. Through their extensive network, FMO introduced Investec to the ex-CEO of two leading multinational food retailers. He was able to provide Investec with the knowledge and expertise that they needed and now functions as a non-executive director on the investee company's board.

Another example of the roles DFIs play in sub-Saharan Africa is the Africinvest Financial Sector Fund (AFS). FMO and long-time strategic partner Africinvest joined forces in 2007 to start this fund, which focuses on early stage and small financial institutions, espe-

[5] According to EMPEA's latest Annual Fundraising and Investment Review (2011), sub-Saharan Africa accounted for only 6% of total funds raised for emerging markets in 2010.
[6] FISEA is an investment fund that makes equity investments in businesses, banks, microfinance institutions and investment funds operating in sub-Saharan Africa. It is a public limited company set up in Paris on 20 April 2009, held by the Agence Française de Développement (AFD). PROPARCO, AFD's private sector arm, is in charge of appraising and managing FISEA operations.

cially those located in post-conflict and less-developed countries. The fund is managed by Africinvest Capital Partners (ACP), who have a dedicated investment team and are able to use resources from a network of local partners, located in countries like Ghana, Togo and Cameroon. To prevent a time-consuming fundraising exercise causing delays with a highly uncertain outcome, FMO decided to take a 100% share in the first closing of the fund (EUR 20 million). In early 2010, the second and final close took place, resulting in a total fund size of EUR 31 million, due to commitments from AFD/PROPARCO, through FISEA and a private investor. To enhance corporate governance, FMO not only appointed two members to both the advisory committee and the investment committee, but also has a position on the board of directors.

Walking alongside locals

When FMO started to make equity investments in the 90s, this involved mostly direct investments in a wide range of sectors and countries. Soon it was realised that an in-depth sector knowledge and local presence were essential to apply hands-on management and create added value. In the early 2000s, FMO adopted a co-investment strategy: besides investing in funds, where required, it co-invested alongside these funds. This provides the fund manager with a flexible source of funding for closing deals. FMO limits its direct investments without local partners to the financial institution, energy and housing sectors.

The Bank of Africa (BOA) provides a good example of the role a DFI can play in a direct deal. When it was still a small group with only two subsidiaries, FMO became a shareholder by converting technical assistance (TA) funds into equity. In addition to their financial support, FMO, PROPARCO and other DFI's also participated in the capital of several subsidiary banks. In most cases, the DFIs were founding shareholders and participated in several rounds of capital increases. Through board seats and by providing further TA, they helped BOA improve its corporate governance and company structure.

DFIs are able to allay investor concerns and assist funds and companies to meet their criteria through playing linking and partnering roles. To attract a broader array of (commercial) investors to the sub-Saharan African region, one has to know the criteria of potential limited partners,[7] such as pension funds and insurance companies, in selecting private equity funds. A study by Groh and Liechtenstein found that historically track record is prioritised (Groh and Liechtenstein, 2011). Unfortunately, little data are publically available on returns achieved in the sub-Saharan Africa private equity market. For example, Africa does not feature in Cambridge Associates' Private Equity & Venture Capital Index and Benchmark Statistics Report, which provides (historical) return data. DFIs and fund managers could fill this role by jointly providing data, consequently lowering the threshold for commercial investors.

"DFIs are able to allay investor concerns and assist funds and companies to meet their criteria through playing linking and partnering roles."

Hence, the role of DFIs is essential in the sub-Saharan African private equity market. With their continued support, a growing number of sub-Saharan African private equity fund managers have been able to successfully raise a second or third follow-up fund. This is a positive development, as growth in the industry requires success stories or demonstrated effects.

Ultimately, this generates a cycle entailing resources moving into private equity investing, critical mass being attained faster and more entrepreneurs being willing to take risks. DFIs will continue to lead the cycle, making the sub-Saharan African private equity markets more accessible.

[7] *Limited Partner is one of the co-owners of a business organized as limited partnership who does not participate in the management of the firm.*

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Lessons in this issue

BY BENJAMIN NEUMANN EDITOR IN CHIEF

Sub-Saharan Africa, long perceived as terra incognita, is now recognised as fertile territory for private equity. A few figures illustrate this trend: fund-raising between 2006 and 2008 totalled USD 6 billion, compared with USD 2 billion between 2000 and 2005. Although Africa remains, nonetheless, a relatively minor market in this respect – accounting for less than 4% of funds leveraged across all emerging markets between 2006 and 2008 – the continent now constitutes a "new frontier" for private equity.

Sub-Saharan Africa is now attracting increasingly diverse investors – private investors, local investors – in a sector supported to date mainly by the financial development institutions. Highly concentrated in geographic terms (South Africa, Nigeria, Kenya) and focused on particular sectors (mining and energy, banks), private equity is gradually expanding its sphere of operation. In 2010, 21% of transactions were conducted in South Africa, as compared with 56% in 2008, while more than half of the transactions were in sectors like food and beverages, healthcare and media/telecommunications.

Nonetheless several factors are impeding the growth of private equity in sub-Saharan Africa: political risk, a lack of experienced fund managers, the small scale of the investment opportunities available, high entry valuations, challenging exit conditions, an unfavourable legal and regulatory environment, challenging operating conditions, etc.

However – and contrary to popular belief – private equity funds can play a key role in Africa's development. Firstly they are an important source of capital, assisting with start-ups and the growth of existing businesses. As a shareholder, a high-quality management team can instil good management practices, good governance, a more effective organisation, more transparent reporting, and improved efficiency in human resources terms. It can also support the company in improving its environmental and social standards, particularly through technical assistance programmes.

Finally, the funds have a strong impact on employment and economic activity – and therefore in terms of fiscal revenue for governments – quite apart from creating a favourable climate for investments: all key factors in promoting economic growth and reducing poverty. Investment funds' profitability – frequently decried – should on the contrary be seen as signalling this sector's growth prospects in sub-Saharan Africa: it is this profitability that encourages more, and more diverse, players into the market.

This form of financing is indeed often reduced to the pursuit of short-term profit for investors, at the expense of business stability; it is also accused of participating in tax evasion, with what can be aggressive tax optimisation schemes combining exemptions in the host country with the exemptions offered by offshore jurisdictions. While investors may benefit from fiscal transparency and legal security, this is too often accompanied by opacity and lack of supervision on the private equity side.

Private equity needs to answer these challenges, in order to make a greater contribution to the continent's development. Multilateral organisations have a key role to play in supervising this sector, in order to achieve greater transparency. Financial development institutions, meanwhile, need to continue their pioneering role in Africa by intervening in the areas and sectors neglected by private investors, and by providing more support for the SMEs which are crucial to achieving sustainable growth in Africa. —

In our next issue

What are the growth prospects for the private agro-industrial sector in sub-Saharan Africa?

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