Huge potential to tap - The Banker

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Huge potential to tap

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The allure of private equity might have faded in developed markets, but Africa is providing golden opportunities for funds that are willing to swallow a bit more risk. *Charlie Corbett* reports.

The 18th century satirist and poet Jonathan Swift once wrote: "So geographers, in Afric maps, With savage pictures fill their gaps, And o'er uninhabitable downs, Place elephants for want of towns." Mapmakers' ability to chart Africa has come a long way since those words were penned in 1733, but in many ways popular perceptions of the continent have not. More often than not, when referring to Africa, people in developed countries fill their mental image with Swift's "savage pictures" and "uninhabitable downs".

It is not hard to see why. Press coverage of the continent is dominated by negative news. Strife, war, famine and corruption dominate the headlines, whereas little is said of the great strides that some countries have taken towards political and financial stability.

It was a geographer, George Kimble, who best summed up Western perceptions two centuries after Swift when he said: "The darkest thing about Africa has always been our ignorance of it."

This is just as true among the financial community. Risk-averse Western investors have traditionally avoided Africa, citing the high political and economic risk that goes with investing there. Just mention Rwanda in the UK and people will probably think of genocide and murder rather than the current political stability or the leaps and bounds taken by Rwandan banks.

The attitude to Africa, however, is evolving. Changed perceptions have been driven in part by a series of funds that have been investing in Africa for many years but are only now attracting the world's attention. The credit crunch in global markets has left investors with little choice but to search for returns in emerging markets, and in particular in Africa. The impact of the credit crisis on Africa has been limited. Countries such as Nigeria do not have developed credit markets or over-leveraged homeowners. What they do have is enormous potential at a time when the rest of the world is hurtling towards recession.

Ready for business

Investors across the globe are beginning to rethink their risk profile and asset allocation, says Simon Harford, a senior partner in African private equity specialist Actis, which has $1.5bn invested in 15 African countries. "Over the past few years, Africa has been delivering some fantastic returns, both in terms of the public markets and private markets," he says. "Global investors are realising that risk comes in lots of different forms. They've got risk in developed markets that they had not appreciated fully, and they've got less risk in a place such as Africa than they thought."

Actis signed one of the biggest deals in Africa last year when it led the R8.4bn ($1.2bn) management buyout of South Africa's biggest retirement fund administrator, Alexander Forbes. That followed shortly after US private equity firm Bain Capital's R25bn buyout of Edgar's Consolidated Stores, South Africa's biggest retailer, in February 2007.

Both deals reflected the huge demand for African investment. This was echoed in an Emerging Market Private Equity Association study, which showed that the number of limited partners surveyed in Europe and the US "opportunistically investing" in Africa leapt from 3% in 2006 to 19% in 2007.

Mawuli Ababio, the managing director of the African Venture Capital Association (AVCA), tells The **Banker** that $2.35bn was raised by Africa-focused private equity firms in 2007, up from just $1bn in 2005. "Africa has become flavour of the month. Over the past 10 years, some fundamental changes have taken place across the continent from the political, social and economic perspective. Africa is ready for business: With better democratisation and good growth, people are realising that the rule of law prevails and business can be done."

Sub-Saharan attraction

It is easy to focus on more sophisticated markets, such as South Africa, when it comes to writing about private equity in Africa, but the real beating heart of venture capitalism on the continent lies in sub-Saharan Africa and its small and medium-sized enterprises (SMEs).

"There is a whole stream of mid-cap deals... these are the heart of African private equity. Not these big high-profile deals, but the medium-sized deals. They are the guts and the heart of private equity in Africa," says Richard Laing, the chief executive of CDC, a UK government-owned development financier that invests in African private equity. "Private equity firms are putting in new management and building these businesses up."

The figures speak for themselves. An International Finance Corporation report for the fiscal year ending 2007 showed that private equity investments in sub-Saharan Africa had increased to $1.37bn from just under $500m two years previously.

Aureos Capital is one fund that focuses on SMEs across Africa. It recently announced that it was raising $400m to invest in firms with a market cap of between $10m and $20m. Davinder Sikand, the firm's regional managing partner in Kenya, says that the fund sees opportunities across the continent.

"We now have eight offices in Africa and an active pipeline. We see similar trends across the continent. Construction, housing, logistics, financial services, technology are all sectors we are looking at," says Mr Sikand. The firm has made 34 investments in Africa in the past five years across a host of sectors, and plans to make many more.

Mr Sikand's advice to people considering making an investment in Africa is: "Don't wait, tap in. There is a lot going on. If you want to be in Africa, come in now because in five years it will have changed."

Post-conflict potential

Private equity firms and venture capitalists are investing in parts of Africa that many Western investors would have baulked at just a few years ago. There is a focus on post-conflict countries, such as Sierra Leone, Liberia and, in particular, Rwanda.

All of Rwanda's local banks were purchased by foreign investors in the past four years, including by Actis, which owns an 80% stake in the country's second largest bank, Banque Commerciale Rwanda.

US-based fund Thousand Hill Venture Capital (THVC) has set its stall in Rwanda and plans to raise up to $45m alongside local investors towards a second Rwandan fund. Robert Fogler, co-founder of the Colorado-based THVC, tells The **Banker** that the Rwandan government is doing a good job of creating a friendly investment environment. “There is no functional corruption from a foreign investor’s perspective and the government has a strong commitment to the private sector,” he says.

Mr Fogler stresses local people’s desire to partner with foreign investors, both inside and outside Africa, with the aim of connecting to global markets.

He also points out that many Rwandans are returning from overseas. “The talent in the diaspora that has been working abroad, in some cases for decades, is returning home to participate in the growing economy,” he says.

As for Western aversion to investing in African, he agrees that it is evolving. “The US economy is not what it was... so people are looking to diversify in countries that are not so heavily correlated to ours. Ever since 9/11, people in the US are more focused on what is going on around the world and so they’re more studious about what’s happening in developing economies,” says Mr Fogler.

Middle Africa rises

The opportunities for private equity in Africa are being driven by a growing middle class. According to AVCA’s Mr Ababio, it is a section of society that needs to be serviced. “Populations that have money and are looking for services are booming,” he says.

This is particularly true in west Africa. Nigeria’s economy is forecast to grow by up to 9% next year as a result of soaring oil prices. It has paid off its external debt and now holds more than $55bn in foreign reserves. Its banking industry has benefited enormously from a Central Bank of Nigeria inspired consolidation that reduced the number of banks from 89 in 2005 to just 24 today. These 24 have greatly enlarged capital bases and have, during the course of consolidation, attracted huge investments from foreign funds. In February, Actis paid $134m for a 19% stake in Diamond Bank – the biggest private equity investment in the country.

Although Nigeria is still a largely cash-based economy, local banks are looking towards servicing a new generation of wealthier individuals who want credit cards and lease facilities for cars and household items. Tapping into that huge potential source of wealth is a prime attraction for many private equity and venture capital funds.

Another positive sign is the growing band of highly educated Africans returning home to set up their own private equity funds. Helios is just one example of an Africa-focused private equity fund set up by Africans to exploit the new-found opportunities. It was founded in 2007 by Babatunde Soyoye and Tope Lawani, former employees of US private equity giant Texas Pacific Group. Helios raised $300m for its first fund, which will be one-third invested in African start-ups.

“In Africa, we see a greater volume of business opportunities than companies we can actually invest in. That means we sometimes need to create the company to take advantage of the opportunity,” says Mr Soyoye.

Political risk

Despite the raft of opportunities appearing across African countries and sectors, the risks involved in investing in the continent remain high. The ongoing troubles in Zimbabwe, and more recently in Kenya, provide a sobering reminder of how easily even the most stable countries can descend into anarchy and violence. In a country such as Kenya, which has no mineral wealth and relies almost entirely on agriculture and tourism, the troubles following the disputed re-election of Mwai Kibaki had a devastating effect on the economy.

But the Kenyan story also provides hope. The politicians managed to resolve their differences and cobble together an agreement that shares power between opposition leader Raila Odinga and Mr Kibaki. As a result, many now believe that the economy will be back on its feet by year-end.

Mr Sikand says that a number of Aureos' businesses were set back during the troubles but he is upbeat about the future. "Tourism was hit hard and some of the businesses had a rough January, but most of them are coming back now," he says. "I think by the end of the year most of them will have caught up on their budgets. It has forced many of them to look at their costs quite closely and to take the option to get leaner. Many of them have accelerated their regional expansion plans. It acted as a kick-start for some."

Inflationary risk

Inflation is another dark cloud threatening to dampen the economic growth of the continent. Although many nations have benefited from soaring commodity prices, it is the escalating cost of food that could undermine growth.

CDC's Mr Laing is cautiously optimistic: "These countries are on average growing 6% to 7% per annum in real terms... there is tremendous opportunity there, but high commodity prices and particularly high food prices could absorb a lot of that disposable income."

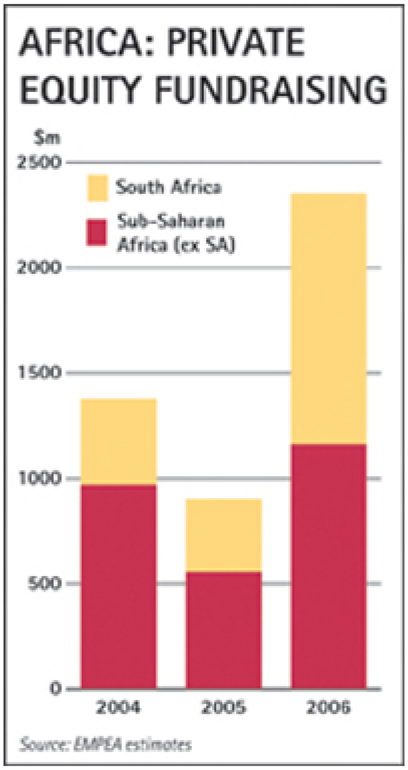
Private equity funds face challenges, not least the high cost of doing business in multiple African countries with underdeveloped legal systems and unreliable infrastructures. There is also a tangible lack of local know-how. "The dearth of talent is one of the key issues," says Mr Ababio. "One of the roles that AVCA intends to play is in training fund managers. [Private equity] doesn't just require an effective network but also the technical skills to be able to realise the kind of returns that investors want."

Land of opportunity

African growth will be driven to a large extent in the near future by private equity and venture capital funds investing in SMEs. At the moment, it remains a continent that consumes what it does not produce, and produces what it does not consume, according to Jean Louis Ekra, president of the Cairo-based African Export Import Bank. "We eat bread and rice most of all – and yet it is produced elsewhere. We produce coffee and tea and yet we are not big coffee or tea consumers," he says.

Mr Ekra agrees that private equity has a role to play in changing this, but has yet to make a true impact on Africa's internal economy. "Private equity funds, particularly those that have come into the stock markets in Africa or are buying companies, have limited themselves to certain sectors such as telecoms, electricity or banks. But in the SME area, it has not happened as much," he says.

Looking ahead, Africa faces huge challenges, not least when it comes to fixing the continent's woeful infrastructure. It is a land that screams potential, and a growing band of venture capitalists want to tap into that. They are not concerned with Jonathan Swift's "savage pictures" but instead focus on the bright opportunities in those "uninhabitable downs". There will be troubles along the way but, as one African proverb puts it: "Smooth seas do not skilful sailors make."



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