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A new era for private equity in Africa

- Juan Coetzer
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Over the past two decades, private equity (PE) in Africa has emerged as an expanding asset class, both in funds raised and capital deployed. By Juan Coetzer for Ashburton Investments

According to the African Private Equity and Venture Capital Association (AVCA), a total of US$6.5 billion has been raised for African PE from 2011 to 2016, with a total reported deal value over the same period of US$ 22.7 billion for 919 deals. In 2016 alone, 145 deals were reported, totaling US$ 3.8 billion.

The evolution of PE in Africa has been underpinned by the enduring commitment of development finance institutions (DFIs), as well as local and international development banks. Favourable population growth trends, steady increases in disposable income and diverse, expanding economies have also played a role. Despite the challenges, like political uncertainty, foreign currency shortages, exchange rate volatility and cyclical commodity-exposed businesses, African PE continues to present attractive investment opportunities.

The lack of developed listed exchanges might mean one less exit route for PE fund managers, but it presents opportunities for investors to gain access to high-potential, privately owned businesses in those markets. Many industries on the continent are also supported by strong macroeconomic fundamentals – like rapid urbanisation, increasing consumer needs, and an expanding middle class – which will continue to attract investors from across the globe.

In the 1990s and early 2000s, major local and regional players saw themselves mainly as capital providers; taking a more passive role in portfolio management compared to today. The tradition was to take a seat on portfolio company boards, drive good governance, and guide sober financial decision-making.

But things changed and a new approach was needed.

According to Bain & Company, PE firms in Africa need to ramp up value-creation efforts if they are to keep delivering attractive returns amid a challenging macro environment. Over the last five years, several have transformed their investment strategy and portfolio management model accordingly, requiring a bigger investment of human capital into their own in-house portfolio management team. There has also been a conscious shift towards appointing skilled portfolio partners (marketing, sales, engineering, technical, logistics), supported by in-house transaction, finance and ESG teams.

Stronger competition for ticket deals north of US$ 25 million, macroeconomic and political headwinds, operational challenges, limited management resources, and constrained levers for liquidity events in Africa, required local fund managers to put greater emphasis on value creation to continue delivering attractive returns. The pure skill of buying well and implementing organisational and/or financial innovations to drive returns was no longer the sole distinguishing factor. More funds competing for the same deals and greater access to well-priced debt, meant that managing portfolio companies to a successful exit became more than just financial engineering.

Portfolio management (boots-on-the-ground) is playing a pivotal role as a key value addition tool. For example, as recently as February 2017, Phatisa {link: http://www.phatisa.com/}, a sector-specific African PE firm, announced the appointment of two additional portfolio partners with strong industry and pan-African experience to bolster their team. Ashburton Investments has identified Phatisa as an outstanding African PE fund manager with whom we have been building a close working relationship. We're assisting Phatisa with fundraising for its Phatisa Food Fund 2 as we do not currently have a similar investment offering for our investor base.

Many mid-cap companies in Africa (turnover between US$ 10 million and US$ 25 million) are run by the original founders or their families, with some reluctant to relinquish control to new investors. Others have children who are either ill-equipped, working abroad, or not interested in taking the helm. The common thread is a lack of succession planning to prepare the business for the founder's ultimate exit.

Active fund managers can bridge the gap, as a team member, to optimise the value of the business for exit and longer-term growth. Changes can include a hands-on advisory role in marketing and production; building routes to market; attracting and retaining professional management teams through appropriate incentive; skills transfer; guiding the company's board; and improving overall efficiencies through focused interventions. Portfolio partners may even assume a middle-management role to achieve specific improvements.

The focus on active portfolio management has translated into a measurable component of PE returns. EY stated in their 2013 report *Global Private Equity Watch*, that for exits between 2006 and 2012, 50% of total cash return for the portfolio companies was driven by PE strategic and operational improvements. Operational engineering is likely a key contributor to this outperformance for the foreseeable future.

On a continent where lack of skills and education remain problematic, and in a world where the unexpected seems to be the norm rather than the exception, the approach to African PE investing has to change to unlock its full growth potential. African PE managers need to turn their attention to undervalued investment sectors, engineer and launch new purpose-built, non-traditional investment vehicles and strategies, with portfolio management playing a larger role than ever before.