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The developmental difference of African private equity

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Economic development efforts in Africa have traditionally been the purview of foreign aid agencies, local and international NGOs and publicly-funded multilateral finance institutions. African governmental spending has also played a central role. Private-sector funded economic development, while existent, has been much less present and visible.

This situation, however, has been steadily changing over the past 15 years, and the growing Africa-focused private equity (PE) community has a unique opportunity to play its part in what is becoming a symbiotic development relationship. African economic growth has created opportunities for PE firms to create value and get returns, and, at the same time, PE is good for African economic development: it helps to create a robust and healthy business sector, which promotes job creation and political stability, and takes pressure off governments to be universal problem-solvers. At its core, African growth equity hires, while leveraged-buyout-style private equity in development markets fires.

African private equity is maturing as an industry. Since the 1990s, the number of funds has grown from around a dozen Africa-focused PE firms, managing about $1bn, to more than 200 firms with some level of focus on Africa, managing more than $30bn. In the past five years, firms raised over $16.2bn and invested across a variety of sectors and in every region of the continent.

A significant amount of that money has been concentrated in the dozen large funds that manage over $500m. This high end of the market – which targets larger, more established African companies – is important in keeping the PE ecosystem running but is heavy with dry powder in search of big deals. The next wave of African private equity will need to invest in the middle market, in the 10,000-plus companies with revenues of $10m to $100m throughout Africa.

These are the companies that have ample room to grow, and they would be well served by growth-focused private equity capital and the expertise and discipline it can bring. Small and medium-sized African companies are far better suited for growth capital investments than for US or European-style leveraged buyouts, which generally look for larger deals that provide ways to create synergies, cut costs, and maximize efficiencies through financial engineering. The majority of African businesses are also family businesses – estimates of the percentage of family businesses range from 65 per cent in South Africa to 90 per cent in agricultural regions of East Africa – who want partners who share their optimism for growth and support their plans for expansion, not financial gurus looking to carve up their hard-built companies.

PE funds and their investors are already making a significant impact. In a study of 200 African companies backed by PE between 2009 and 2015, the African Venture Capital Association (AVCA) found that companies generated a net increase of 10,990 jobs. FMO, the Dutch development finance institution (DFI), backed PE funds and companies across development countries that created 858,000 direct jobs in 2015. Its UK counterpart, CDC, reported creating over a million new direct and indirect jobs in Africa and Asia. More jobs, especially for women, increase health and educational attainment and contribute to the overall sustainable development goals.

Environmental, social and governance (ESG) requirements that PE firms embed into their investment terms upgrade operations at portfolio companies and improve internal governance. In its Guide to Private Equity in Africa, AVCA notes that DFIs, which catalyzed commercial PE investment in Africa, maintain high standards for ESG in Africa and have diffused the practice throughout the PE industry.

Environmental policies that require firms to upgrade how they manage waste products, for example, have a positive impact on public health. For example, Phatisa, an Africa PE fund focused on housing and agriculture, invested in an egg producer in Zambia in 2012 called Goldenlay. With Phatisa's investment and guidance, the company installed a full-service onsite incinerator resulting in the reduction of toxic emissions and new treatment tanks to treat waste water from the chicken houses.

The advantages of good ESG are double. As FMO notes: "Experience has proven to us that those who incorporate sustainable environmental, social and governance practices into their business have enjoyed stronger financial results and long-term viability." By placing value on transparent and accountable and productive cultures, ESG policies also contribute to better financial outcomes overall. In the absence of PE investment, the adoption of enhanced social and environmental practices would be significantly slower.

Given the economic development aspects of PE investment in Africa, the industry needs to ensure that it has the right operating methods to scale up rapidly in African markets. Specifically, there needs to be creative hybrid of skills within management teams. Because of its fundamental differences with PE in developed markets, African PE requires soft skills in addition to the traditional hard skills of modeling and valuation. Soft skills, such as managing complex relationships, building trust with family business founders, engaging with a broad group of stakeholders and forging working ties with regulators, can be a source of competitive advantage. Getting the mix of general partner skills right will be essential to ensuring that PE can have an even far greater development impact in the years to come.

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