ADDLESHAW GODDARD

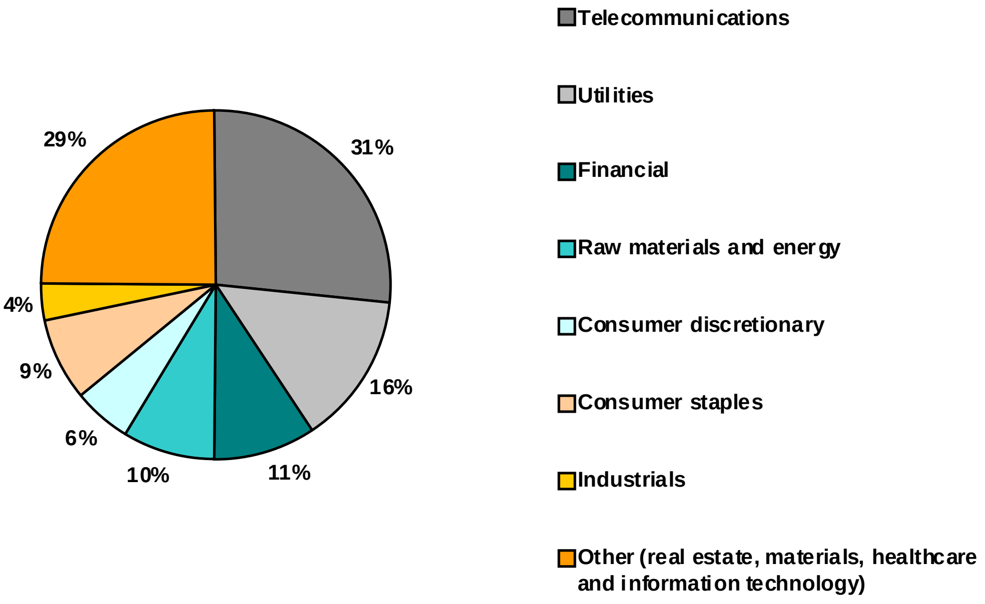
Private Equity in Africa – thoughts and comparisons from the Middle East…

Much has been written in the press recently about the growth of private equity in Africa. The Economist speaks of private equity being "warmly welcomed" in Africa and Forbes observes "heady times" for the private equity industry in the region. Clearly there is a buzz of excitement as investors look to emerging economies to seek higher returns to offset stagnant returns in more mature markets. And much of this positive sentiment has been articulated about private equity in the Middle East amidst record-breaking levels of investment (USD 6.6 billion of private equity-backed acquisitions was carried out in the Middle East during 2015 according to a study carried out by Bloomberg).

Darren Harris and **Ben Sims**, both of Addleshaw Goddard's Dubai office, outline some of the common characteristics between the landscape in the Middle East and that in Africa, investing in Africa from the Middle East and the challenges facing the landscapes.

Where are the deals coming from?

According to the African Private Equity and Venture Capital Association (**AVCA**), of all funds invested by private equity houses in Africa between 2010 and 2015:



A similar story emanates from the Middle East with key sectors such as consumer, industrials, healthcare and education sectors driving private equity deal volumes across the region.

The AVCA note that, regionally, West Africa dominates with around 25 per cent of all African private equity deals focussing on this region, with Nigeria taking the bulk of that portion of investment. South Africa, previously the leader of the pack, is now in second place with 24 per cent of such deals. In the Middle East, the focus has been on the United Arab Emirates and Saudi Arabia with the world watching to see how the opening of Iran will impact the region's deals.

Use of Middle East Investment Platforms

Why the Middle East? Middle East-based private equity funds are more adaptable to the local environment in Africa. As Reuters have put it: "Due to the constraints in their home markets, Middle East investors are more familiar with Africa's challenges." Infrastructure, the scarcity of a highly trained workforce and the lack of liquidity in capital markets are cited as common characteristics. Geographical location is also a factor with investors operating across the Middle East and Africa from locations such as Dubai and Abu Dhabi to attract the best professional talent, the close proximity to the Middle East and African markets and the ease of doing business in the United Arab Emirates.

Another key advantage of using a Middle East-based platform for investments into Africa is the availability of bilateral investment and double taxation treaties between numerous African nations and key investment hubs such as the United Arab Emirates. There are also broader treaties such as the OIC Agreement and the Arab League Investment Agreement for those eligible under those treaties.

Challenges: Supply and Demand and Increasing Returns

One of the challenges facing private equity funds investing in the Middle East and Africa is competition from each other. The Wall Street Journal noted in a recent report that purchase prices for potential investments in Africa are being inflated due to simple supply and demand principles with the excess of private equity funds for which suitable investment is being sought and the relatively small number of companies which are capable of absorbing such international investment.

Judith Tyson of the Overseas Development Institute (**ODI**) notes that "The region is suffering from an 'overhang' of unused capital because of the lack of suitable companies for investment. Firms are too small, lack human capital and are often within underdeveloped sectors".

An interesting area of research has recently come from The Boston Consulting Group (**BCG**), which shows 39% of private equity deals completed in the Middle East between 2010 and 2015 were part of a buy-and-build strategy to generate growth through synergies, to internationalise a business or extend it across the value chain. BCG's figures highlight an average IRR of 23.1% for standalone deals compared to exits where a buy and build strategy has been implemented which generate an average IRR of 31.6%. It seems logical that such a theme will continue to spread across the Middle East and Africa as a means of scaling up businesses and increasing returns to investors. Private equity investors may find an answer to the supply and demand challenge through smaller value "bolt-on" acquisitions.

OTHER CHALLENGES TO PRIVATE EQUITY INVESTORS ACROSS BOTH REGIONS INCLUDE:

- political instability and sanctions;
- insufficient management expertise to take businesses to the next level;
- local regulatory frameworks and foreign capital controls; and
- currency fluctuations.

What is next for Africa?

The ODI see there being five key policy priorities for national governments and bilateral agencies in the coming years to encourage further capital flows to Africa:

- being more proactive at an earlier and smaller level of enterprise development;
- adopting a more holistic policy to develop 'eco-systems' for sectors and industries;
- taking a more sophisticated and well-priced approach to risk mitigation that is more closely aligned with investors needs;
- more effective capital flow management to manage risks to financial stability, especially from mutual funds and exchange traded funds; and
- achieving universal, but pragmatic, standards for responsible investment tailored to the sub-Saharan African context especially for energy, healthcare and education.

With one third of Africa's population having gone to the polls in 2015 and the recent drops in oil prices putting pressure on government finances, market uncertainty is rife. However, in times of market uncertainty, opportunities arise. As Shaun Zagnoev, a partner at Ethos Private Equity in Cape Town has commented "During periods of uncertainty there's often increased deal opportunity". Marlon Chigwende, Carlyle's African fund manager commented "Valuations are lower and getting lower over time. This is presenting interesting opportunities over the medium-term, as we see sound businesses attracting softer valuations."

The Middle East and Africa private equity markets are proving popular areas to generate returns but the private equity industry can also help infrastructure, employment (particularly youth employment) and increasing international standards across both regions. We can expect more to be written in the press…

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