The Resilience of Private Equity in Africa

As investors continue to look to emerging economies seeking higher returns to offset weakening returns in more mature markets, Africa as the second largest continent by land mass and population is a natural home for such investment inflows.

Darren Harris and **Ben Sims**, both of Addleshaw Goddard's Dubai office, comment on private equity activity in Africa, developing trends and emerging sectors and what the future holds for African private equity.

Private equity activity

According to the EY and African Private Equity and Venture Capital Association, there were 48 exits recorded in 2016 and the signs are that 2017 will be a strong year. The number of exits continues to grow year on year. The data has to be put in an appropriate context of a lack of recording and so the number of exits are in reality likely to be higher in any given year.

Private equity secondary transactions and trade sales account for the largest proportion of exits. The growing number of Africa focused funds will mean that the number of private equity secondary exits will increase year on year - this reflects an increasingly mature private equity landscape in Africa and is a very positive sign for future years.

Despite the growing trajectory of exits relative to more mature markets, they remain difficult to achieve. There is much excitement about private equity investments across Africa (and particularly the East Africa region) with the growing number of Africa focused funds leading to more competition for quality assets. Exits have increased year on year for the last 5 or 6 years. 2016 was a strong year for private equity and 2017 has continued to set the pace for another strong year.

Exits remain difficult due to illiquid domestic capital markets, a nascent (but growing) secondary private equity market and deal execution risks. However, the position is changing rapidly and the increased number of exits year on year points to a very positive picture in key markets on the continent.

Returns in East Africa are on the rise. The East Africa Venture Capital Association reported an average of 19% internal rate of return in 2016 and 2015 with Kenya accounting for the majority of deals across the East Africa region. The rise in affluence in East Africa, a growing focus on Tech and Fintech sectors (sectors that tend to achieve higher returns than more traditional sectors) and the currency problems experienced in other regions on the continent have all contributed to increased returns in East Africa - a trend likely to continue. The increase in accelerators and incubators in Nairobi is an exciting development for young entrepreneurs and SMEs in the region. The number of exits in South Africa remains relatively strong but we are not seeing, across the board, the level of returns that are being achieved in East Africa.

Developing trends

Factors affecting exits include:

IPOs still challenging

Domestic IPOs in certain countries in Africa have been expected to rise for the last few years but challenges remain. Complex and fragmented regulation continues to be a key obstacle for businesses looking for an exit by way of an IPO. A large proportion of businesses are still family-owned and need more time to go to capital markets to realise their value. In more mature markets, capital markets and private equity funds have worked in conjunction with each other to increase exit opportunities – private equity will play its role in the development of businesses and preparing them

for IPOs if higher returns are achieved through IPOs. East African stock markets are at near multiyear lows, listings are less attractive, which means companies are more open to private equity deals.

Smarter financing

The primary shift has and will be from public to private financing, largely due to the dramatic fall in oil and commodity revenues and the inherently weak financial markets across the continent.

Better fiscal discipline

Macroeconomic stability must underpin the entire system: particularly borrowing rates and inflation. In 2017, it is likely that Africa's fundamentals will remain settled. Even in nations that have suffered extensive financial damage from the slump in oil and commodity prices, stability has been ensured through central banks use of currency controls, interest rates and fiscal restraint (Angola is a good example of this).

Trade sales

A notable feature of the evolving market is the increased prevalence of auction sales such as the sale of Brandcorp in June 2016 by Ethos Private Equity to The Bidvest Group. Given the strong fundraising by Africa focused funds in recent years and the competition for quality African assets, it is likely that auction processes will become increasingly common.

Higher level of Foreign Direct Investment in Africa

Foreign Direct Investment (FDI) in Africa may also experience an uptick in 2017 because of sluggish growth in the EU and uncertainties surrounding the economic approach of the new administration in Washington; which will add financial strength to the region.

Secondary transactions

Secondary buyouts (sales to other PE funds) such as the sale of Algeria-based manufacturer Cellulose Processing by Mediterrania Capital Partners to Abraaj in 2016, account for the next largest proportion of exits. As the quality of assets and deal sizes gradually increase over time, one would also expect to see more sophisticated secondary transaction structures, such as 'portfolio' deals which package up several assets together to be sold to another fund, or deals which involve the breaking up of larger investments into smaller divisions for sale. Given that 75% of deals in the first half of 2016 were below US$250m, it may be some time before the market develops to such a point.

International and domestic pensions funds as new sources of funds

Although development financial institutions continue to play an essential role in African PE, traditional institutional investors such as insurance companies and pension funds are becoming an increasingly common source of funds. More recently, global funds such as Helios and KKR have invested Western pension money in Africa.

Pension funds in 10 African countries have an estimated US$379bn of assets under management, of which $29bn could potentially be directed towards PE, according to the *Emerging Markets Private Equity Association (EMPEA).*

Private equity is currently a rare feature of African pension portfolios, however, Africa's emerging pension fund industry could become a valuable source of funds for PE investments in the future. Pension reforms across the continent support this proposition: Nigerian pension regulations have been amended to include PE as a specified asset class for pension fund investment and in South Africa, the percentage of total assets under management that pension funds can invest in PE has been increased from 2.5% to 10%. Significant participation remains unlikely until African pension fund trustees become less risk averse and more familiar with this asset class, however, the

opportunity in this area means that, like Western pension funds, we should expect domestic pension funds to become a future source of funds for African PE.

Equity and debt instruments

As the market matures and aims to close the funding gap, mezzanine debt is becoming a key component in the capital structures of many African companies, and there are a number of dominant South African funds in the mezzanine debt market. While specific forms of 'mezzanine debt' in a European context are generally clearly defined, in many African countries it refers more broadly to subordinated debt or unsecured senior debt.

A number of PE funds, such as Helios Investment Partners, Abraaj and TLG Capital, have raised credit funds specifically targeting these types of investments in Africa. Going forward, we expect to see an increasing number of such funds being established.

The challenges posed by the African funding market and the increased complexity of companies' investment needs, means that we also expect to see an increase in the use of tiered capital structures, with a broader range of share classes and debt instruments, including convertible instruments, loan notes, warrants, high yield instruments, and payment in kind (PIK) notes.

Warranty and Indemnity Insurance

Private equity has been a driving force in the increased use of warranty and indemnity ("W&I") insurance on global M&A transactions, particularly on the buy-side. Such policies are beneficial for buyers with limited recourse against sellers who have poor covenant strength. It also allows PE and institutional sellers to achieve a clean break and distribute proceeds to their LPs.

Before offering W&I insurance, insurers assess the legal, political and regulatory risks in the relevant jurisdiction, and reflect the level of risk through pricing and exclusions. It is expected that the trend to take out W&I insurance, and the increased appetite to underwrite W&I policies on African PE transactions, will continue.

Emerging sectors

Financial services, industrials, consumer goods and services continued to attract the highest number of PE exits between 2007 and 2016. Exits from the healthcare and industrials sectors continued to increase.

Key growth sectors in 2017 and beyond are likely to be natural resources, transportation, energy, housing, healthcare, technology, fintech, education and hospitality.

Capital investment in these rapidly expanding industry sectors is playing an important role in addressing the needs of Africa's growing population; in job creation, innovation, skills, exports and a robust and diverse value chain. Therefore, these are sectors which to some extent offer a greater defence from global headwinds and offer solid long-term returns.

The *EY annual report, Private Equity Roundup Africa*, suggests that 'Growth is being driven by investment in infrastructure, a robust services sector and strong agricultural production, especially in the region's lower-income countries.' Hospitality is a sector that offers significant opportunities for private equity investors because of its role as business-critical infrastructure. QG Africa Hotel LP, for example, announced its acquisition of the landmark Mövenpick Ambassador Hotel Accra from Kingdom Holding Company (KHC) in January 2017. The hotel has demonstrated outstanding growth through the highly-rated and reliable delivery of world class hospitality facilities to its international and local customers.

In infrastructure [*particularly power generation and distribution*], 2017 is almost certainly going to present investors with even more interesting opportunities. As well as seeing major investments in national infrastructure through Public-Private-Partnerships (PPP's). For example Angola has the country's first deep-water port in the northern province of Cabinda: a project worth hundreds of billions of dollars in the form of a public-private-partnership. This grand-scale project forms an

entirely new logistics corridor that enables Angola to position itself as the new west coast gateway to the continent. We are also seeing an appetite for renewable energy investment following Denham Capital's $250 million investment in GreenWish Partners this year.

What does the future hold for African Private Equity?

Private equity in East Africa has shown considerable growth and have potential to grow further - Kenya, Uganda, Tanzania and Ethiopia are seen as strong growth markets for private equity and therefore funds are increasingly attracted to businesses that have the potential to grow in scale across these countries and the East Africa region more generally. Nairobi, in particular, is seen as a hub for the region and will therefore continue to be a focal point for private equity investors, particularly as investors look to off-set volatility in commodity prices (and perhaps political instability) in other regions on the continent. A good example of such growth is the recent acquisition of Java House, East Africa's largest chain of coffee shops by Abraaj Group's growth market fund from US based Emerging Capital Partners for an undisclosed sum (TPG and Carlyle were previously amongst the pack of potential suitors will to offer as much as USD 100 million for the chain).

Darren Harris is a Corporate M&A Partner at Addleshaw Goddard's Dubai office (d.harris@aglaw.com)

Ben Sims is a Corporate M&A Associate at Addleshaw Goddard's Dubai office (b.sims@aglaw.com)

Addleshaw Goddard is a premium international law firm with 1,200 lawyers across 11 offices.