CURRENT DRIVERS AND DYNAMICS IN THE AFRICAN PE MARKET

With global world events seemingly unfolding on a daily basis, the effect of macro-economic, political and financial matters on the private equity transaction landscape in the emerging markets of the African continent are worthy of consideration.

There have been a number of particular features and dynamics affecting the PE market in Africa over the past twelve months which stand out above the others. Foreign currency volatility has had a major impact on in-bound capital and for those sponsors seeking to deploy reserve currencies into many of the countries on the continent, managing this risk both financially and structurally has been challenging. South African and Nigeria have been particularly affected in this regard, not only because their monetary systems have seen particularly heavy value falls, but additionally due to the sheer size of their economies in an African context. Until only a few weeks ago, the government of Nigeria was still refusing to allow the Naira to "float freely", causing further uncertainty in the market. Since the removal of the artificial peg, the currency has seen further dramatic falls. Other countries have faired somewhat better, particularly many of those in East Africa, being effective net oil-importers, such as Kenya. Lower dependency on overseas monetary receipts for this key commodity have clearly helped limit local currency fluctuations to an extent.

It is self-evident that investing at the wrong point in the foreign currency cycle, on an unhedged basis, could be extremely dilutive to returns for an overseas investor. Financially, hedging such exposure over the life-cycle/hold period of a typical private equity investment often does little to improve the economic outcome - most sponsors have rather sought to manage this exposure operationally, by taking a platform approach to investment and seeking a reasonably wide spread of economies/geographies in any one investment - a general hallmark of African private equity activity on the continent.

On the other side of the coin, the foreign currency issues mentioned are also driving potentially tremendous value opportunity. As stakeholders in local assets and foreign investors begin to bridge the valuation gap which, in many instances, has been driven by foreign currency impact, capital overhang is starting to ebb, and the flow of overseas funds in to local assets, to drive long term growth, seems a very positive sustainable trend.

With so many private equity investments being in the consumer and consumer-facing space-banking/financial services (including fintech), FMCG/Retail, Telecoms/Internet - it is important that the long term impact on local economies, driven by commodities, a potential weakening in the growth rates of key trading partners (discussed later in the article) and the currency issues already mentioned, will not stifle or inhibit the inherent, burgeoning and increasingly middle-class populations of the continent, and the businesses and enterprises which service their growing needs. However, assuming that such value-based matters can be adequately and properly "priced-in" to a transaction, the deal-flow pipeline would appear to be robust and well set.

It should also be noted that a loosening of monetary policy in many of the world's largest economies, driven at least in part by the recent Brexit vote in the UK, has delivered some positive short-term and immediate effects to emerging markets in general. While the long term impact of such a decision is one which will no doubt be awaited for the next many months and years, and particularly its effect on trade, I think it is fair to say that the last macro-economic event which provided a significant boost to Africa was, in some ways ironically, the world economic crisis in 2008 - it was at this time that the phrase "Africa Rising" was coined. Capital will always flow to markets where it can generate the best returns. Post 2008, it became apparent that the level of equity returns being generated in many of the traditional money-centres (not least due to material and adverse effect on levels of transaction leverage) were not likely to be seen again, and that they had very much been "right-sized". It was at this time that a significant number of more traditionally developed market focussed sponsors began to turn their attention to Africa, and the tremendous long-term value proposition it potentially presented. I think therefore that it is equally fair to say that while conditions in such markets remain challenging, potentially for a sustained period of time - all other things being equal - levels of private equity activity in Africa will remain strong.

Lately, the pricing of key mineral commodities has also seen tremendous volatility. This has had a negative effect on local economies which are heavily dependent on such assets. The slowdown in certain of the economies which fuelled huge demand in this regard (China in particular) has been a major driver of the depression of commodity prices in general. However, there are some important positives - once again, with lower commodity prices, comes value opportunity. While the up-stream has never been the traditional comfort-zone of the private-equity/sponsor community, as pricing becomes increasingly compelling we are beginning to see a certain level of evolution with respect to investment focus. This is equally true in the oil and gas and infrastructure sectors. Economies which have traditionally been over-reliant on minerals/oil and gas are finally feeling the pressure to diversify. The role private equity can play in financing such diversification, particularly in the consumer-facing sectors, clearly presents further potentially phenomenal opportunity.

Another aspect of the market worth mentioning is what has come to be referred to as "the Rise of the Strategics". Deal flow in the private equity/sponsor community in Africa is very much on a proprietary basis. It is extremely contact driven, and is in many respects dominated by those sponsors who have been serially active in the market, and may well be raising, or investing, their third of fourth dedicated continental fund. We have seen more and more co-investing, between funds with long and successful African track records and either new entrant funds or strategic/corporate investors - the marriage of capital, opportunity, management, experience and exit opportunity. Of these, management teams/experience and exits are of the greatest significance. The importance of finding and retaining a strong management team is critical to any private equity funded transaction - but particularly so in an African context. The genesis of a transaction often starts with finding the right people rather than finding the right enterprise. The talent pool available is, in many respects, disproportionately smaller than it would be in other markets. The deep industry experience of a strategic investor, combined with the appropriate management talent and a compelling African growth story can be of huge value.

Not least due to the generally lower levels of leverage in African private equity investments (challenges with "debt push down", security and cash extraction), returns on African private equity transactions are generally driven by not overpaying for an asset and then improving and growing it. The latter aspect is largely dependent on the strength and quality of the management team.

African capital is often described as "patient capital", which is true in a number of respects. However, for present purposes, the lead time involved in executing a transaction, and the path to exit are particularly apposite. To have a strategic or corporate investor in the capital structure from the outset of a transaction can make the exit process significantly more straightforward (recognising that the "secondaries market" in Africa is still relatively nascent). While there are a number of notable exceptions, the lions share of sponsor exits in Africa have been by way of trade sale. The effectiveness and liquidity of many local capital markets and the comparatively smaller asset sizes can make access to the international capital markets more challenging. Knowing who the exit-partner is likely to be from the outset addresses many of these critical issues for sponsors, and makes their liquidity and value realisation eminently more achievable.

Sponsors who source long term growth opportunities, and management teams growing developing and transforming those enterprises to take to full maturity on a truly international platform, supporting the development of businesses and economies across the continent in many ways captures an important aspect or role played by private equity in an African context.

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