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Pioneer role of DFIs in sub-Saharan Africa

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Growth in emerging markets is currently leading the financial development institutions (FDIs) to refocus their efforts on low-income countries – bringing sub-Saharan Africa to the fore once again. FDIs can play a driving role here by facilitating access to the private equity market, particularly as private operators are turning away from SMEs – assessing them as too risky. How to turn theory into practice.

Starting in the early 90s, Development Finance Institutions (DFIs) played a catalytic first-mover role in making emerging markets more accessible to hesitant commercial investors. They have been pivotal in developing the proper infrastructure for the private equity industry, by promoting domestic and pan-regional private equity associations and educating governments on the barriers imposed by legal and regulatory frameworks.

Over the period 2005 to 2009, the percentage of emerging market private equity deals has more than doubled to 30% of deals worldwide (Liechtenstein and Meerkatt, 2010). At present, most of the capital is geared towards the BRIC-countries.1 According to the Emerging Markets Private Equity Association's (EMPEA2) latest Annual Fundraising and Investment Review, funds dedicated to BRIC accounted for 51% of total capital raised – USD 23.5 billion – in emerging markets in 2010 (EMPEA, 2011).

The impressive economic growth of many emerging markets has put pressure on the role of DFIs in terms of their additionality to commercial investors, which lies at the core of the missions of DFIs. Consequently, DFIs have exited certain countries. Dutch development bank FMO, for example, decided to discontinue new investments in Brazil, Russia, Mexico and Kazakhstan due to their investment grade and upper-middle income country status,3 and is striving to increase its exposure in lower-income countries. Recently, CDC, the United Kingdom's DFI, announced in a radical new business plan that it will exclusively focus its activities on the low and lower-middle income countries4 in sub-Saharan Africa and South Asia, where 70% of the world's poor live (CDC, 2011).

DFIs, gateway to SME funding in sub-Saharan Africa

The sub-Saharan African region is now a focal area for most DFIs, mainly due to the presence of many low-income countries (according to the 2011 World Bank list of economies, 26 out of the 47 sub-Saharan Africa countries currently have a low-income status). In spite of sub-Saharan Africa's gross domestic product (GDP) having grown consistently over the last decade, with output growth expected to accelerate to more than 5% over the next five years (IMF, 2011), interest from commercial private equity investors in sub-Saharan Africa is still low.5 Barriers to investment include a lack of institutional quality fund management teams, limited access to market information, and poor corporate governance. Consequently, investment flows into sub-Saharan Africa end up mainly in the larger and more established companies in the main economies. Small and medium enterprises (SMEs) still find it hard to access capital.

According to the 2007 Finance for All report from the World Bank, increasing access to finance for SMEs can accelerate economic growth and reduce poverty (World Bank, 2007). However, World Bank surveys have revealed that these firms, especially in lower income countries, still consider lack of access to finance a major obstacle to their development. Many are considered too risky by local banks, and they are seen as too small to justify extensive due diligences studies. They may also need investor guidance and experience to develop further.

DFIs target this gap among SMEs – which local banks are in many cases not equipped to address –by using local private equity funds as intermediaries. Also, DFIs provide local banks with dedicated funding to grow their SME lending programs. In some cases, DFIs have created separate programs, often supported or initiated by their own national governments, to make sure that funds are reserved for this higher risk segment. Examples are the FISEA6 (Fonds d'investissement et de soutien aux entreprises en Afrique), investment fund funded by Agence Française de Développement (AFD) and managed by PROPARCO, International Finance Corporation (IFC) SME Ventures, and FMO's Massif program.
Private equity investing requires fund managers who have the ability to identify, grow and exit firms. This ability is developed with experience, and to this end, DFIs – with their knowledge of the dynamics of private business and the barriers to entrepreneurial development – actively support first-time managers in sub-Saharan Africa. They offer these managers much needed help: to seed the fund, find the right legal structure and optimise their investment strategy, among others, and they provide them with access to their global networks.

The concerns of commercial investors about the returns of first-time funds are often not justified. The IFC showed in a recent analysis of its fund portfolio performance that first-time funds in emerging markets matched and sometimes exceeded the returns achieved by experienced fund managers: for the period from 2000 through 2006, 46.2% of the top-quartile of performers in the IFC's data set were first-time funds (Liechtenstein and Meerkatt, 2010).

With its private equity experience, South-Africa could be an important investor hub on the continent. Yet, the number of South-African fund managers that have invested in countries north of their borders is fairly limited. This is because of unfamiliarity with local conditions – creating uncertain price-risk trade-offs – and the abundance of attractive deals in their home market. An exception is global asset manager Investec, which started building a pan-African investment team in 1997 with the opening of its offices in Botswana and Namibia. In 2004, they started investing in public equity markets across Africa. Their strong track record in this new environment laid the groundwork for the launching in 2008 of Investec's first pan-African private equity fund, the Investec Africa Frontier Fund.

Despite Investec's good reputation and attractive market conditions at the time, there was still limited appetite among other investors to invest in private equity in Africa. FMO was the first investor to deliver a final commitment, matching the USD 25 million investment of Investec. Ultimately, the fund managed to raise USD 155 million, including investments from several South-African pension funds and a fund of funds. In Zimbabwe, Investec sourced an interesting opportunity in the retail sector. To properly assess the potential of the opportunity, Investec was looking for external expertise. Through their extensive network, FMO introduced Investec to the ex-CEO of two leading multinational food retailers. He was able to provide Investec with the knowledge and expertise that they needed and now functions as a non-executive director on the investee company's board.

Another example of the roles DFIs play in sub-Saharan Africa is the Africinvest Financial Sector Fund (AFS). FMO and long-time strategic partner Africinvest joined forces in 2007 to start this fund, which focuses on early stage and small financial institutions, especially those located in post-conflict and less-developed countries. The fund is managed by Africinvest Capital Partners (ACP), who have a dedicated investment team and are able to use resources from a network of local partners, located in countries like Ghana, Togo and Cameroon. To prevent a time-consuming fundraising exercise causing delays with a highly uncertain outcome, FMO decided to take a 100% share in the first closing of the fund (EUR 20 million). In early 2010, the second and final close took place, resulting in a total fund size of EUR 31 million, due to commitments from AFD/PROPARCO, through FISEA and a private investor. To enhance corporate governance, FMO not only appointed two members to both the advisory committee and the investment committee, but also has a position on the board of directors.

Walking alongside locals

When FMO started to make equity investments in the 90s, this involved mostly direct investments in a wide range of sectors and countries. Soon it was realised that an in-depth sector knowledge and local presence were essential to apply hands-on management and create added value. In the early 2000s, FMO adopted a co-investment strategy: besides investing in funds, where required, it co-invested alongside these funds. This provides the fund manager with a flexible source of funding for closing deals. FMO limits its direct investments without local partners to the financial institution, energy and housing sectors.

The Bank of Africa (BOA) provides a good example of the role a DFI can play in a direct deal. When it was still a small group with only two subsidiaries, FMO became a shareholder by converting technical assistance (TA) funds into equity. In addition to their financial support, FMO, PROPARCO and other DFI's also participated in the capital of several subsidiary banks. In most cases, the DFIs were founding shareholders and participated in several rounds of capital increases. Through board seats and by providing further TA, they helped BOA improve its corporate governance and company structure.

DFIs are able to allay investor concerns and assist funds and companies to meet their criteria through playing linking and partnering roles. To attract a broader array of (commercial) investors to the sub-Saharan African region, one has to know the criteria of potential limited partners,7 such as pension funds and insurance companies, in selecting private equity funds. A study by Groh and Liechtenstein found that historically track record is prioritised (Groh and Liechtenstein, 2011). Unfortunately, little data are publically available on returns achieved in the sub-Saharan Africa private equity market. For example, Africa does not feature in Cambridge Associates' Private Equity & Venture Capital Index and Benchmark Statistics Report, which provides (historical) return data. DFIs and fund managers could fill this role by jointly providing data, consequently lowering the threshold for commercial investors.

Hence, the role of DFIs is essential in the sub-Saharan African private equity market. With their continued support, a growing number of sub-Saharan African private equity fund managers have been able to successfully raise a second or third follow-up fund. This is a positive development, as growth in the industry requires success stories or demonstrated effects.

Ultimately, this generates a cycle entailing resources moving into private equity investing, critical mass being attained faster and more entrepreneurs being willing to take risks. DFIs will continue to lead the cycle, making the sub-Saharan African private equity markets more accessible.

Footnotes

[1] BRIC refers to the group of Brazil, Russia, India and China, which were all deemed to be at a similar stage of newly advanced economic development.

[2] See the article by Jennifer Choi, p. 2, in this issue of Private Sector & Development.

[3] Upper-middle income countries defined by the World Bank as countries with a gross national annual income per capita of USD 3,976-USD 12,275.

4 Low-income countries are defined by the World Bank as countries with a gross national annual income per capita of USD 1,005 or less; lower-middle-income countries, with a national annual income per capita of USD 1,006-USD 3,975.

5 According to EMPEA's latest Annual Fundraising and Investment Review (2011), sub-Saharan Africa accounted for only 6% of total funds raised for emerging markets in 2010.

6 FISEA is an investment fund that makes equity investments in businesses, banks, microfinance institutions and

investment funds operating in sub-Saharan Africa. It is a public limited company set up in Paris on 20 April 2009, held by the Agence Française de Développement (AFD). PROPARCO, AFD's private sector arm, is in charge of appraising and managing FISEA operations.
7 Limited Partner is one of the co-owners of a business organized as limited partnership who does not participate in the management of the firm.

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