Private Sector & Development

A blog coordinated by Proparco

Equity investment to bring SMEs to scale: An interview with two African fund managers

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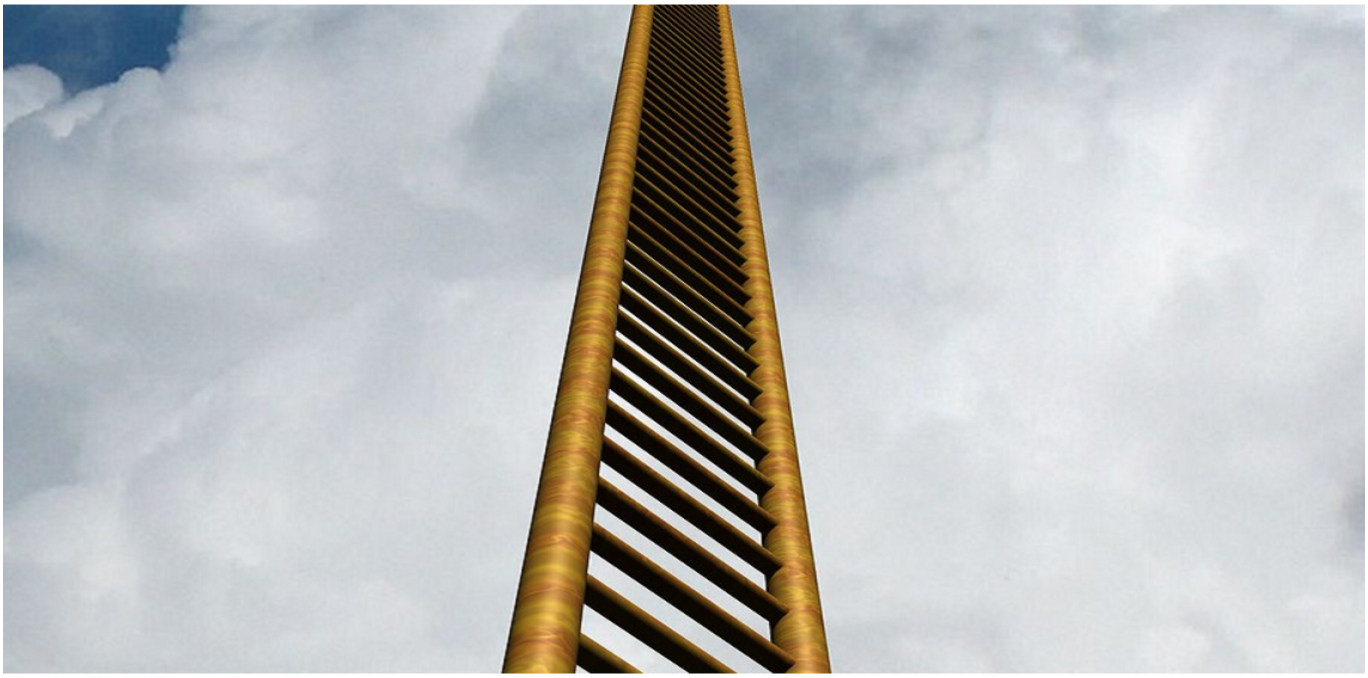
October 23 2019



SMEs in Africa remain heavily reliant on internal resources and traditional bank debt. A lack of appropriate forms of finance – especially of the equity type – limits market entry, long-term investment, expansion and innovation. Ascent Capital and Metier are two successful fund managers who have managed to overcome the usual obstacles to providing equity to SMEs in Africa. For this issue, they discuss how equity capital can be used to bring SMEs to scale and describe the practicalities involved.

JEUNE AFRIQUE

This article was published by Jeune Afrique on 9 October 2019, available on the website

PROPARCO: PLEASE COULD YOU DESCRIBE THE MARKET OPPORTUNITY, AS YOU SAW IT, FOR AN SME STRATEGY IN YOUR RESPECTIVE SUB-REGIONS?

Lucas Kranck :We operate in economies that have relatively infant companies with limited or no track record insofar as corporate governance and investor-ready metrics are concerned. One actually has to build these companies; de-risking them, thereby giving them gradual value uplift. SMEs are usually family-owned enterprises where decision making is centralised and informal. Most institutional investors shy away from the risk of bringing such firms to formalisation and professionalism. It is this gap that has allowed us to develop our strategy which derives much of its value from developing systems and processes that allow for more fluid and dynamic decision making, as well as greater transparency

J-P Fourie : The typical investment drivers in Sub-Saharan hold true: population growth and urbanisation; a rising middle class driving consumer growth; a growing workforce and improving social conditions; rising investment in infrastructure; demand for the skills and expertise increasingly required; under-serviced markets needing essential goods and services. In addition to the lack of formalisation, other impediments that SMEs face can be viewed as opportunities. For instance, inadequate infrastructure is a major obstacle to SME competitiveness in Africa. Therefore, Metier has pursued opportunities in alternative resource-efficient energy, downstream transport and logistics, cold storage, etc. From a geographic standpoint, we see South Africa as a gateway to regional growth, as it plays a leading role in intra-regional trade and investment.

WHAT MAKES YOUR STRATEGY STAND OUT COMPARED TO OTHER FIRMS OPERATING IN THE SAME SPACE?

J-P.F : JPF: Metier's investment style is characterised by an active approach to value creation. We implement transformative investment theses that address regional themes. Our goal as a fund is to create market leaders or at least niche leaders. This can be achieved by enhancing distribution networks, corporatising businesses (making them ready for scale), enhancing supply chain management, carrying out vertical integration, optimising capacity, developing own brands, etc. If necessary, we enlist the support of experienced outside managers, advisers or specialists. Platform building is a particularly effective strategy. It involves consolidating businesses within an industry to increase the companies' combined value. The goal is to foster further, organic growth and scale benefits (such as volume rates on business services and raw materials, pooling working capital resources and sharing distribution channels). A good example is Metier's investment as early as 2005 in Libstar, a prepared foods company. Libstar subsequently acquired controlling stakes in more than 20 South African FMCG manufacturing and distribution businesses, prior to Metier's exit in 2014. Metier saw the potential in South Africa, as a growing middle class and changing spending habits were fuelling an increase in consumption, while increasing urbanisation was driving more out-of-home eating, for example, as well as greater interest in health and wellness brands. Meanwhile, brand owners with a core competency in marketing were outsourcing their manufacturing activities to contracted producers. The private-label market for its part showed potential for rapid growth as consumers looked to value alternatives to national brands.

L.K : We have offices in all our focus countries with local staff who have strong ties to the community. This enables us to see unique opportunities before other firms and instil confidence in the entrepreneurs that we understand the markets in which they operate. Most of our team members have themselves been entrepreneurs and have successfully started and run organisations. They have a first-hand understanding of the challenges that sponsors face, so a true connection is established in most cases. The sponsor can discuss business with Ascent's staff, not just from a technical perspective but from an operational one too. Local offices give easy access to the team should they require support (which SMEs frequently do).

EQUITY TICKET SIZES IN AFRICA ARE OFTEN TOO LARGE FOR SMES, SHUTTING THEM OUT OF

THE MARKET. IS OPERATING UNDER THE RADAR – BELOW A CERTAIN TICKET THRESHOLD – AN OPPORTUNITY FOR FUNDS WHO ARE WILLING TO TACKLE THE SME SPACE? OR IS A LACK OF INVESTABLE COMPANIES A CHALLENGE?

L.K : Interestingly, investment opportunities in the missing middle are plentiful. Over the past five years we have screened at least 960 deals (this does not include deals that were too small to be recorded) across the three focus countries (Kenya, Uganda, Ethiopia). Private equity capital is available in Africa, but it rarely reaches the SME segment. This means that investments can still be made at reasonable multiples especially if one is willing to look in countries such as Ethiopia and Uganda – or in Kenya outside of Nairobi.

SMES CONSISTENTLY RATE ACCESS TO FINANCE AS THE TOP BARRIER TO GROWTH. DO YOU AGREE?

L.K : A lack of funding is probably the main barrier to SME growth. In Ethiopia, this is especially the case when it comes to funding in foreign currency required to procure machines and raw materials. It is true even in Kenya, the most developed country in East Africa, where the interest rate cap has severely limited the banks' willingness to lend to SMEs. In Uganda financing is available, but interest rates (greater than 20%) are too high for entrepreneurs.

> *Regulations do tend to make it costly to be an SME – unlike small companies who generally ignore regulatory hurdles.*

J-P.F : Fundability is a major underlying cause. All too often we see the need for introspection by entrepreneurs on their business model, team, market, strategy, etc. before they can access finance.

OTHER REASONS ARE OFFERED TO EXPLAIN A LACK OF FORMAL SMES: DEMAND FOR DIFFERENT, LESS PROFITABLE KINDS OF GOODS,[1] COSTLY BUSINESS ENVIRONMENTS WITH HIGH TAXES AND RESTRICTIVE REGULATIONS, ETC. HOW DO THESE EXPLANATIONS HOLD UP IN PRACTICE?

L.K: It is true that regulations do tend to make it costly to be an SME – unlike small companies who generally ignore regulatory hurdles by staying informal and large companies who have the necessary economies of scale to bear the additional cost. SMEs do not necessarily face a lack of demand for their goods and services, but rather increased competition from local players, as well as from imported goods (often imported with no duty paid). It is particularly hard for local businesses to compete with cheap import, sometimes after establishing the local demand and market themselves.

WHAT ARE THE MAIN BARRIERS TO INVESTING IN SMES IN YOUR OPINION? HUMAN CAPITAL, FOR INSTANCE, IS OFTEN CITED AS A MAJOR CONCERN.

L.K : : Human capital is an issue especially outside of Kenya. For example, hiring experienced CFOs in Ethiopia is a time consuming and expensive exercise. Also, many countries (like Tanzania) limit the opportunity to bring talent in from abroad. But in our opinion, the main barrier to investing in SMEs is a lack of reliable information, be it the financial records of the business or market/industry data. The cost of institutionalising the business is another key barrier. SMEs tend to have nimble operations that suit their level of revenue thereby letting them earn some profit. However, when a private equity fund comes in, more often than not operational costs go up, but the business remains on the same revenue base – at least for the first year or two. This can put off both the promoter and the fund manager as the company no longer looks as attractive as before. Furthermore, the time to return to profitability often takes longer than planned.

J-P.F : The challenge is to bring a company to a sufficient size, in order to offset the cost of institutionalisation and to reap the rewards, such as facilitating acquisitions or the exit of the investment

THE PRIVATE EQUITY INDUSTRY IN AFRICA HAS MATURED OVER THE PAST DECADE, WITH THE NUMBER OF FIRST-TIME TEAMS DECREASING AND THE NUMBER OF SUCCESSOR FUNDS INCREASING. LARGER FUNDS MEAN BIGGER TICKET SIZES, POTENTIALLY WORSENING CAPITAL SCARCITY FOR SMES. HOW CAN FUND MANAGERS GROW WITHOUT FORSAKING THEIR SME APPROACH?

L.K : This is a difficult balancing act that we feel does not have a straightforward solution. One way for fund managers to achieve growth and maintain an SME focus is to have sector-specific funds. This allows for consolidation and bolt-on acquisitions that ordinarily do not require individual large ticket sizes. Another way set aside a portion of the fund for these VC-type deals. The idea would be to have one or two assets of that nature rather than an entire portfolio
J-P.F : Metier has now started to raise sector-specic funds in renewable energy and clean infrastructure. We agree that platform investments allow for entry into markets where it is otherwise not possible or appropriate to deploy large sums of capital in a single investment – a challenge often encountered outside the larger African economies.

LASTLY, THE THEORY BEHIND SUPPORTING SMES IS THAT SMALL, INNOVATIVE COMPANIES (‘GAZELLES’) HAVE A DISPROPORTIONATE EFFECT ON JOB CREATION. ARE THE COMPANIES YOU TARGET PARTICULARLY EFFECTIVE IN TERMS OF NET JOB CREATION?

> *The challenge is to bring a company to a sufficient size, in order to offset the cost of institutionalisation and reap the rewards.*

J-P.F : Yes, they are. Metiers’s SME investments have created 2,657 jobs since 2015 to the end of 2018. The workforce totals 6800 people, of which 47% are women.
L.K : Ascent’s eight portfolio companies created 359 additional direct jobs in 2018. This was in addition to 1,364 direct employees at the end of 2017. The number does not include temporary employees or jobs created by suppliers.

1 : Engel effects skew the demand mix towards simpler products with low start-up costs, e.g. baked foods, footwear, apparel and metal products