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# Chazen Society Fellow Interest Paper

## Private Equity in Africa: Impact of the Financial Crisis on Global Investment's Last Frontier

SAWA NAKAGAWA MBA/MIA '09<sup>1</sup>  
Columbia Business School  
Columbia University School of International and Public Affairs

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### Introduction

In the first half of 2008, U.S. private equity firms saw a decline in fund-raising activity for the first time since 2003, while emerging-market private equity funds maintained their strong performance. Private equity funds focused on emerging markets raised US\$35.3 billion, a 68 percent increase compared to the same period in 2007. One of the strongest areas of growth came from Africa, where private equity funds grew by 113 percent and raised US\$1.2 billion.<sup>2</sup> There was a prevalent view among investors that Africa would be immune to the volatility in the U.S. market and that growth would continue—until the financial crisis hit.

As the U.S. credit crunch transformed into a global financial crisis, and most likely into a global economic crisis, many began to question Africa's resilience in the face of a global downturn. While the S&P 500 lost 33 percent of its value by the end of October compared to the beginning of 2008, shares listed on the Johannesburg Stock Exchange in South Africa declined 28 percent. During the same period, the Kenyan Stock Exchange and the Nigerian Stock Exchange lost 35 percent and 38 percent of their value, respectively. While African markets performed better compared to those in the BRIC countries, which declined by 41 to 70 percent, the long-held view of Africa's low correlation to the rest of the markets does not seem to hold in periods of crisis.<sup>3</sup>

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<sup>1</sup> The author would like to thank J-P Fourie of the South African Venture Capital and Private Equity Association, Thomas Gibian of Emerging Capital Partners and Jacob Hinson of Actis, as well as Professor Laura Resnikoff and Professor Paul Tierney.

<sup>2</sup> Emerging Markets Private Equity Association, *Emerging Markets Private Equity Fundraising on Course to Beat 2007 Totals: US\$35 Billion Raised through June 2008* (Washington, D.C.: July 30, 2008).

<sup>3</sup> Bloomberg.com, "Investment Tools," Bloomberg L.P., [http://www.bloomberg.com/invest/index.html?Intro=intro\\_investment](http://www.bloomberg.com/invest/index.html?Intro=intro_investment).

Having seen the dismal stock performance, some investors predict that growth in African private equity will come to a halt in the midst of declining investor confidence. But others argue that factors unique to Africa, such as higher rate of economic growth, will help preserve Africa's growth and encourage investors to engage in African investment activities.

Often referred to as the last frontier by the investment community, Africa represents an attractive destination for many international investors who are looking for significant returns simply not available elsewhere. More important, private equity in Africa has the potential to support private-sector development and fuel the economic growth that is much needed in the continent. How is the global financial crisis going to affect private equity in Africa in the short run and in the long run? Can African private equity continue to grow and attract investors?

### Recent Growth in African Private Equity

Before the current crisis, Africa was becoming an increasingly attractive destination for private equity investors. "Emerging market was the flavor of the day," said J-P Fourie, executive officer of the South African Venture Capital and Private Equity Association (SAVCA).<sup>4</sup> African private equity funds certainly took advantage of this opportunity, raising more than US\$2.3 billion each year in the past two years, compared to US\$791 million in 2005 (see table).<sup>5</sup>

Table: Emerging markets private equity fund-raising by region, 2003–2007 (US\$)

Year	Emerging Asia*	CEE / Russia	LatAm & Caribbean	Africa	Middle East	Africa / Middle East**	Multi-Region EM	Total
2003	2,200	406	417			350	116	3,489
2004	2,800	1,777	714			545	618	6,454
2005	15,446	2,711	1,272	791	1,915		3,630	25,765
2006	19,386	3,272	2,656	2,353	2,946		2,580	33,193
2007	28,668	14,629	4,419	2,340	5,027		4,077	59,161

Source: Emerging Markets Private Equity Association.

\* Emerging Asia excludes funds focused primarily on Japan, Australia and New Zealand.

\*\* EMPEA reported Africa and Middle East together in 2003–2004.

<sup>4</sup> J-P Fourie (executive officer, South African Venture Capital and Private Equity Association), telephone interview by the author, October 20, 2008.

<sup>5</sup> Emerging Markets Private Equity Association, *Emerging Market Private Equity 2007: Fundraising Review* (Washington, D.C.: April 2008).

There were several key drivers that contributed to the growth of African private equity over the past decade. As some parts of the continent began to enjoy more stable macroeconomic and geopolitical environments, investors' attitude shifted: limited partners (LPs) surveyed by the Emerging Market Private Equity Association (EMPEA) in 2008 assigned a risk premium to Africa of 6.7 percent, down from 8.9 percent in 2006—equivalent to the risk premium for Latin America.<sup>6</sup> Many investors became aware of the potential for high growth rate as Africa's gross domestic product (GDP) growth rate averaged 6.2 percent between 2004 and 2007, compared to 2.9 percent in the United States and 2.3 percent in Europe during the same period.<sup>7</sup> Others found the historically low correlation to developed markets an attractive way to diversify their portfolios.

As a result, institutional investors' interest in Africa grew dramatically, with 52 percent of LPs surveyed in 2008 estimating they would be investing in Africa in five years' time, versus only 4 percent actually invested in 2006.<sup>8</sup> According to Jacob Hinson, director of Actis, a leading private equity fund investing exclusively in emerging markets, significant interest started to flow in from U.S. pension funds and other institutional investors in the United Kingdom and the Middle East before the crisis.<sup>9</sup> As a result, there was a proliferation of new local fund managers, as well as direct investments by major international private equity players, such as Bain Capital and Kohlberg Kravis Roberts & Co. The US\$3.5 billion investment made in 2007 by Bain Capital and Absa Capital in South African retailer Edgars Consolidated Stores was the country's largest private equity transaction ever.

Africa's private equity industry first took shape in South Africa toward the end of the apartheid era in the late 1980s and early 1990s with the emergence of fund managers tapping into a number of multinational divestments and management buyouts. Development finance institutions (DFIs), such as the International Finance Corporation (IFC), the private-sector arm of the World Bank, and CDC Group, a UK-government-owned fund of funds, helped to catalyze the industry throughout the continent by backing first-time funds investing beyond South Africa.

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<sup>6</sup> Emerging Markets Private Equity Association, *EMPEA Insight: Sub-Saharan Africa* (Washington, D.C.: October 2008).

<sup>7</sup> International Monetary Fund, World Economic Outlook Database, October 2008, <http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/index.aspx>.

<sup>8</sup> Emerging Markets Private Equity Association, *The 2008 EMPEA Survey of Limited Partner Interest in Emerging Markets Private Equity* (Washington, D.C.: May 2008).

<sup>9</sup> Jacob Hinson (director, Actis Johannesburg), telephone interview by the author, October 20, 2008.

These DFIs subsequently raised a series of successor funds and supported the creation of new private equity funds across the region.<sup>10</sup>

South Africa, the economic hub of the continent, continues to account for the majority of private equity activity in Africa. Within sub-Saharan Africa, South Africa has drawn as much as 76 percent of the region's investment total to date.<sup>11</sup> Interestingly, however, much of the future growth in the region is expected to occur outside South Africa, as its market is seen to be relatively mature. South Africa, which was the focus of 50 percent of funds raised in 2006, accounted for only 24 percent of the total funds raised in 2007.<sup>12</sup> Several of the established fund managers have raised or are in the process of raising capital for their pan-African funds, including Emerging Capital Partners (US\$1 billion), Kingdom Zephyr (US\$500 million) and Aureos Capital (US\$400 million).

### Challenges: Testing the Resilience of African Private Equity

Just as momentum built up for the next phase of African private equity, the global financial crisis began to rock the continent. The industry now faces several challenges related to each stage in the life cycle of the private equity business: fund-raising, investment activity and exit.

#### Fund-raising

As investors are becoming more concerned about the world economy, they might prefer to put their money in safer assets. Limited partners may be reluctant to take on the additional risks, such as political, macroeconomic and legal issues, that are more prevalent in emerging economies. While Africa was able to attract investors with its phenomenal growth, the continent may now experience a withdrawal of capital.

Many funds have seen the portion of alternative assets increase beyond their allocation limit because of a reduction in the value of publicly traded assets, forcing the funds to sell alternative assets to limit their exposure. As more capital from international investors helped to fund African private equity, raising capital in the current economic environment poses a serious challenge. However, experience and track record might make a difference in this tough market. Tom Gibian,

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<sup>10</sup> Emerging Markets Private Equity Association, "Markets and Sectors: Sub-Saharan Africa," [http://empea.net/pubs/markets\\_sectors.shtml](http://empea.net/pubs/markets_sectors.shtml).

<sup>11</sup> Emerging Markets Private Equity Association, "Sub-Saharan Africa," *EMPEA Insight*, October 2008. [http://www.empea.net/pubs/insight\\_africa.shtml](http://www.empea.net/pubs/insight_africa.shtml).

<sup>12</sup> Ibid.

CEO of Emerging Capital Partners, said that there will be “more of a delay” than a complete halt in his firm’s fund-raising activity, while he expects newer funds to face a tougher time.<sup>13</sup>

### **Investment Activity**

As fund sizes grow thanks to their fund-raising success in the past couple of years, investors will demand to see that African markets present sufficient opportunities to absorb the capital already raised, putting pressure on general partners (GPs).

Africa has benefited from a boom in the price of such commodities as oil and minerals, boosted by very high demand from the rapidly industrializing economies of India and China. But if the current crisis brings a global recession, there is a risk that demand could fall drastically, decreasing foreign-exchange earnings for many African countries. Oil prices dipped under US\$70 a barrel at the end of October 2008, down more than 50 percent compared to the peak price earlier in the year.<sup>14</sup> The price of copper has been tumbling, which will sharply affect such countries as Zambia and Congo. It will be more difficult for private equity firms to find attractive opportunities in the resource sector as such businesses become less profitable. In addition, high food prices and inflation will affect consumer spending, which is one of the growth factors in Africa. In the short run, GPs are likely to spend more time looking for investment opportunities that would satisfy the returns required by LPs.

### **Exit**

The continent has seen a considerable growth in the number of initial public offerings (IPOs) in recent years, fueled by a series of banks going public on the Nigerian Stock Exchange and raising more than \$10 billion since 2005. Just as the U.S. market is unlikely to see many IPOs in the near future, the global financial crisis will make IPOs more challenging and less attractive in African markets. Financial or strategic buyers who are looking for an entry into African markets may still continue to show some interest, though they are likely to push the valuation down.

Major African currencies took a massive dip in October, with the South African rand down more than 40 percent against the U.S. dollar since the beginning of 2008. The rand has not been seen at this level since 2002. This decline was caused by the flight of capital from emerging markets, particularly in Africa, as investors fear the level of current account deficit (7.25 percent

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<sup>13</sup> Thomas Gibian (CEO, Emerging Capital Partners), personal interview by the author, October 14, 2008.

<sup>14</sup> FT.com, “Markets Data,” Financial Times Ltd., <http://markets.ft.com/markets/overview.asp>.

of GDP in South Africa in the second quarter of 2008) and reduced economic indicators.<sup>15</sup> The immediate impact of the currency depreciation on African funds has been a decline in the projected dollar-denominated returns.

### Opportunities: Unique Growth Drivers Remain

Despite the risks and challenges caused by the global financial crisis, Africa may be able to turn adversity into opportunity. Emerging markets are emerging for a reason, and volatility is to be expected.

### Attractive Long-Term Growth Outlook

Recent growth in African economies has largely been fueled by rising commodity prices. Private equity funds were able to stimulate the growth by providing much needed capital, which was previously unavailable in many parts of the continent. While rising commodity prices drove much of the economic growth in the region, further growth for private equity is expected to come predominantly from consumer-led industries. The emergence of a growing consumer class is likely to continue to make the telecom, banking and infrastructure sectors particularly attractive to investors. According to EMPEA, a number of GPs evaluating their 2008 pipelines indicate healthy deal flow in Africa, particularly for those markets in which private equity is more nascent, where access to capital has historically been more limited and where deals are financed primarily by equity rather than debt.<sup>16</sup>

Officials of the IMF have said GDP growth in Africa will be lower than previously predicted, averaging about 5 percent in 2008 and 2009.<sup>17</sup> However, a 5 percent growth rate still provides an attractive opportunity, particularly compared to the revised projected growth rates for advanced economies of 1.4 percent for 2008 and -0.3 percent for 2009.<sup>18</sup> Investors in the United States and Europe are likely to seek growth opportunities in emerging markets, including Africa.

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<sup>15</sup> International Monetary Fund, "IMF Executive Board Concludes Article IV Consultation with South Africa," public information notice (PIN) no. 08/137, October 22, 2008.

<sup>16</sup> Emerging Markets Private Equity Association, "Sub-Saharan Africa," *EMPEA Insight*, October 2008. [http://www.empea.net/pubs/insight\\_africa.shtml](http://www.empea.net/pubs/insight_africa.shtml).

<sup>17</sup> International Monetary Fund, "Rapidly Weakening Prospects Call for New Policy Stimulus," *World Economic Outlook Update*, November 6, 2008. " <http://www.imf.org/external/pubs/ft/weo/2008/update/03/pdf/1108.pdf>.

<sup>18</sup> Ibid.

## Limited Leverage

In general, private equity funds in Africa are not dependent on a high level of debt, in contrast to many funds in other parts of the world. Private equity transactions in Africa outside South Africa are not highly leveraged because these deals are mainly growth capital-focused and are generally funded by equity. Unlike many of the buy out firms that came to a halt due to lack of financing, African growth capital funds are largely unaffected.

Although leveraged buyouts tend to be the norm in South Africa, the leader in private equity in the region, the typical level of gearing does not surpass 60 percent. As a result, the current level of distressed assets is fairly low. "There is risk aversion towards debt in South Africa . . . , [which is] borne out by banks being overcapitalized," said Hinson. "While credits are still available, banks are taking a cautious approach in lending to be prudent, with limited loan amounts and tighter covenants."<sup>19</sup> Debt will be scarce in South Africa, though the negative impact resulting from the scarcity of debt is not as significant as it is in other parts of the world.

## Better Value for Money

Both private and public markets in Africa saw increases in prices over the past few years. This bubble caused increasing competition among private equity firms and led to a risk of overpaying for deals. Following the global financial crisis, asset prices have come down in the African public markets, providing more "fair value" for investors. Prices in private deals are likely to follow suit.<sup>20</sup> When the prices in the private market come down, "there are opportunities at GP and company level to cherry-pick opportunities," said J-P Fourie of SAVCA.<sup>21</sup>

## Countercyclical Role of DFIs

Development finance institutions, such as IFC and CDC Group, continue to fill some of the remaining investment gaps in Africa. Eighteen percent of the third-party funds raised in South Africa up to December 31, 2007, were from government, aid agencies and DFIs.<sup>22</sup> That these institutions are willing to provide funds despite poor macroeconomic conditions may limit the negative impact on fund-raising activities for some African private equity funds.

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<sup>19</sup> Hinson, telephone interview.

<sup>20</sup> Ibid.

<sup>21</sup> Fourie, telephone interview.

<sup>22</sup> Southern African Venture Capital and Private Equity Association, *KPMG and SAVCA Private Equity Survey 2007* (Johannesburg: May 2008).

## Conclusion

The current financial crisis demonstrates that Africa is not isolated from the global financial system: while the theory of low correlation may hold in normal times, Africa's correlation to international markets increases in periods of crisis. In the short run, African private equity is likely to see limited capital flows because of international investor sentiment, weak investment activity caused by a decline in commodity prices and high inflation, and fewer opportunities for exits that would result in attractive returns on investment. In the long run, however, the continent's low correlation to the rest of the world is likely to hold as the market normalizes, and such unique factors as the high growth potential, limited leverage, attractive valuation and availability of funding from DFIs may help to grow the private equity industry in Africa. Furthermore, the challenges posed by the crisis can be opportunities for the future, creating incentives to invest in African entrepreneurs who can provide exponential growth in return for much needed capital.

Africa will continue to be an important region for global investors given its higher growth forecast, and some fund managers are prepared to stay for the long haul. If the funds have good management and investment track records, they are likely to be well positioned to take advantage of the current market in the long run. "We have seen this before, and we are less likely to overreact. It is the nature of the market," said Hinson.<sup>23</sup> Gibian seemed to concur, saying, "Private equity doesn't need to be Switzerland."<sup>24</sup>

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<sup>23</sup> Hinson, telephone interview.

<sup>24</sup> Thomas Gibian, panel discussion, 7th Annual Social Enterprise Conference, Columbia Business School, New York, October 24, 2008.