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Africa Current Issues

Africa Private Equity: Impact of Covid-19 on fundraising, valuations and exits

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Private Equity in Africa

This report traces the development of the private equity industry in Africa and explores recent trends in this financial subsector. It then examines the current impacts of the COVID-19 pandemic. The article closes with insights into post-pandemic opportunities for stakeholders.

The Emergence of an African Private Equity Industry

Development Finance Institutions (DFIs) pioneered private equity (PE) in Africa. Until the 1990s, DFIs with mandates to invest in the private sector in developing countries supported economies mainly through loans. These often funded government-initiated development projects. DFIs later extended their activities to investing in private companies. Around this time, DFIs began to provide equity capital to private companies in addition to loans. This shift resulted from the realisation that equity investments would encourage businesses to grow and prosper.

DFIs contributed to the first and second generation of African funds. However, they gradually surrendered market share to more traditional, larger institutional investors, including pension funds, insurance companies, and endowments. The resulting mix of fund types presented an array of offerings that targeted more sophisticated investment strategies. These varied from generalist and country-focused funds to sector-specific funds, including pan-African funds.

By 1997, twelve PE funds had US$1 billion to invest in Africa. While these funds initially focused on investment in the South African market, they soon moved to support other parts of the continent.[1] Today, PE firms manage upwards of US$30 billion in Africa.[2] Research by Asoko Insight and Africa Capital Digest reveals that by the final quarter of 2018, 215 PE investment firms operated from 307 offices based in 27 sub-Saharan African (SSA) markets.[3] According to the Asoko report, South Africa leads the pack with 39% of such PE offices, followed by Kenya with 14% and Nigeria with 12%. The Southern African Venture Capital and Private Equity Association (SAVCA) sizes the South African private equity industry at US$12 billion in managed funds by end 2018.

Africa remains attractive for PE investment. For years, plenty of PE capital flowed into the continent despite the challenges. In South Africa, for instance, PE capital inflows have grown at an average compounded growth rate of 9.3% per annum from 1999 to 2020. This growth is expected to continue, as local institutional investors increase their exposure to the asset class to a level in line with current global allocation. Additionally, with the onset of the Africa Continental Free Trade Area (AfCFTA) agreement set to increase intra-African trade, more global PE funds are likely to increase focus on the continent. The AfCFTA is expected to stimulate and facilitate intra-African trade volume to reach 50% from 18% currently.[4] With global dry powder estimated by Preqin at US$2.5 trillion as of end 2019[5], there is little doubt that Africa is likely to continue experiencing increased allocation in the coming years.

But despite its successes, the industry faces many headwinds. These include currency risks, foreign currency shortages, exchange rate fluctuations and illiquid exit markets. The 2019 Emerging Markets Private Equity Association (EMPEA) Global Limited Partner Survey ranked Africa as the least attractive emerging market for realisations, with 40% of investors citing its weak exit environment as a deterrent.[6] These factors have an impact on the PE sector in Africa. Its assets under management are a mere 0.1% of GDP compared to Western countries where PE assets are approximately 1% of GDP. High exit barriers may also explain why, although Africa accounts for 3.1% of global GDP, only 0.9% of global PE funds focus on the continent.[7]

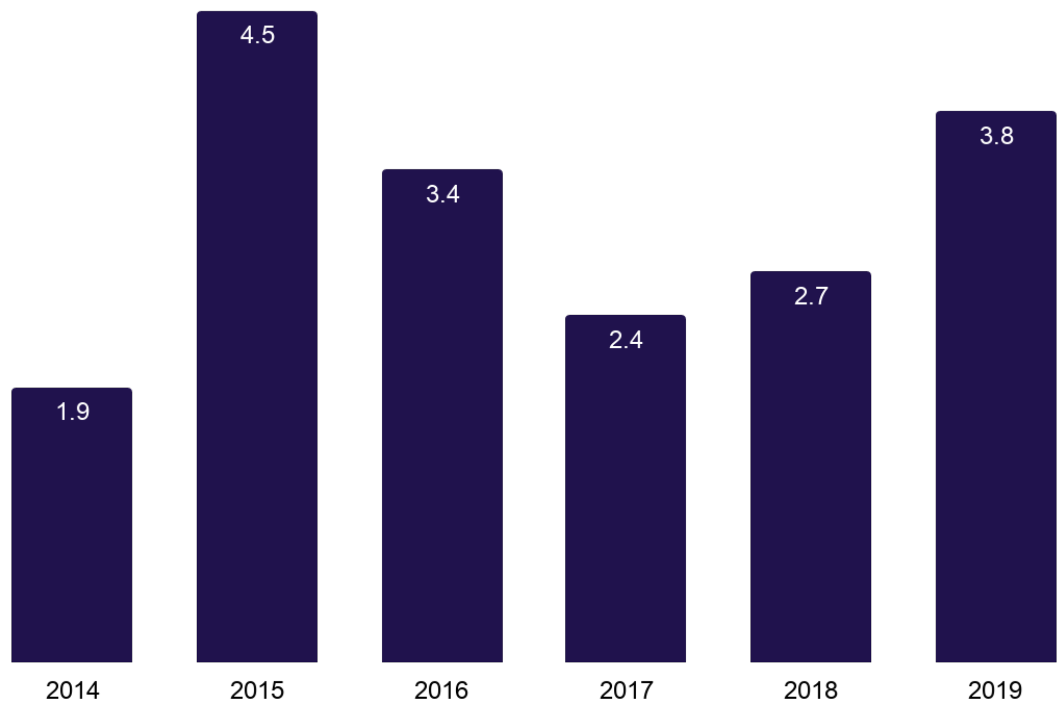
Key Trends

Private equity investment in the continent receives increasing investor attention. Key drivers for this trend include better business environments, fiscal reforms, sound economic policies, advances in technology, regional integration and improved cooperation between the public and private sectors. PE increasingly provides access to opportunities overlooked by publicly traded equities to support its growth. The Johannesburg Stock Exchange (JSE) accounts for close to 90% of Africa's stock market capitalisation. Since 1994, half the publicly traded domestic companies on the JSE have delisted. This trend resulted in under-represented industry sectors on the exchange. Over the same period, South African PE grew to become the largest and most highly developed capital market in Sub-Saharan Africa. Of course, this success does not apply equally across the continent. The PE sector emerges in different forms as indicated by three key trends; fundraising, exits and valuations.

- **Fund Raising**

Deal flow on the continent continues to respond to strong investor interest in and commitment to the region's growth (see Chart 1). The 2019 Annual African PE Data Tracker published by the Africa Private and Venture Capital Association (AVCA) reports the total value of PE fundraising in Africa as reaching US$3.8b in 2019, recovering from its slowdown over the three prior years. Although total deal value since 2015 tracks downward, the total number of PE deals reached its highest since 2014, at 198 deals.

Chart 1: Total value of African PE fundraising, by year of final close, (US$ Bn)

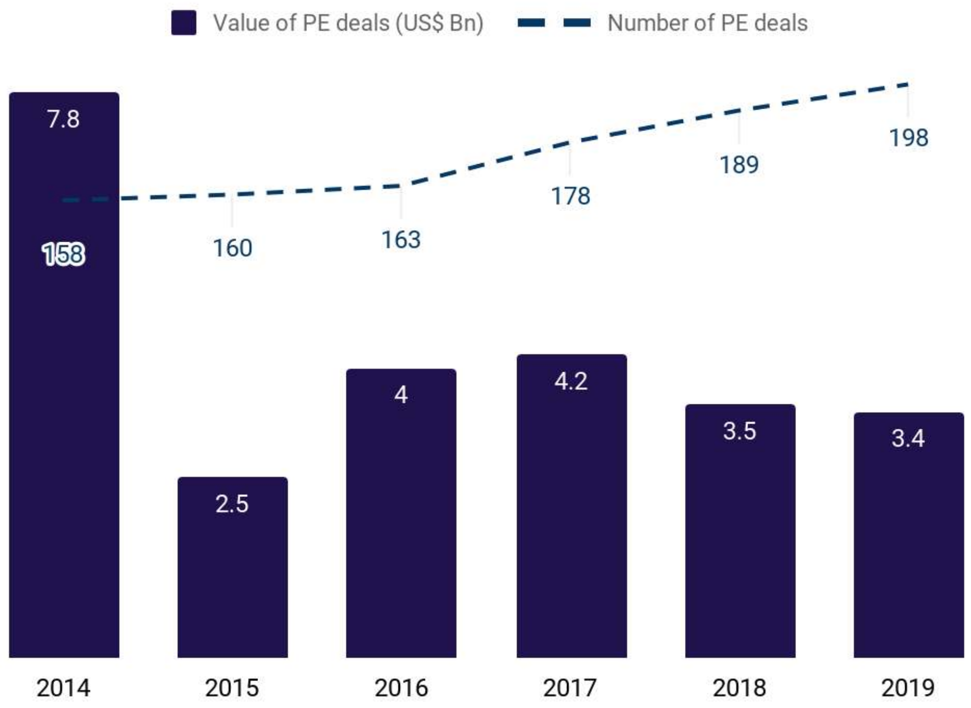


Source: AVCA 2019 Annual African PE Data Tracker

- **Valuations**

Valuations in SSA's private markets compare favourably, both to its public markets and global markets. The value of reported African PE deals from 2014 to 2019 totalled US$25.3 billion. The number of documented African PE deals in the same period totalled 1,046, according to AVCA (See Chart 2). Rising demand and attractive valuations seem likely to generate steady investment flows. The healthy competition and high global valuations are likely to provide General Partners (GPs) with opportunities in Africa to meet the expectations of their Limited Partners (LPs)

Chart 2: Number and Values of African PE deals by year

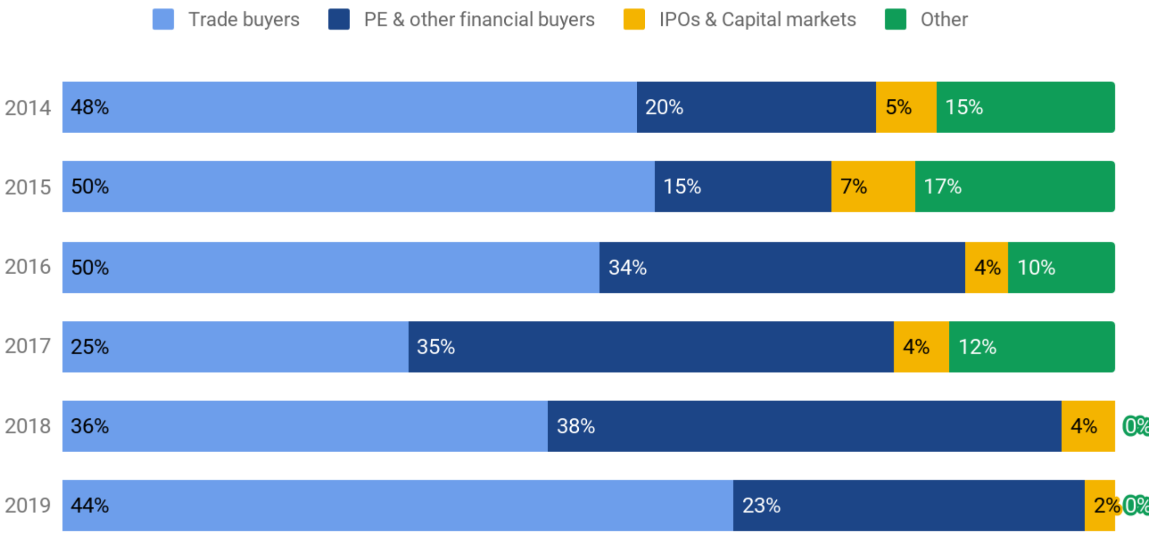


Source: AVCA 2019 Annual African PE Data Tracker

- **Exits**

Exit markets on the continent are diversified and, despite their many problems, growing. These issues include political and economic instability, currency and commodity price fluctuations and ongoing infrastructure deficiencies. Some capital markets saw questionable governance, as in many emerging and developing markets. Chart 3 below traces exit routes between 2014 and 2019 as reported by AVCA. Inactivity in African capital markets (2%) led to alternatives such as trade (44%) and secondary sales (23%) emerging as dominant exit paths for PE investments.

*Chart 3: Share of exit routes, 2014-2019**



*Source: AVCA 2019 Annual African PE Data Tracker. *investments recorded as exited once fully or majority divested by the PE firm.*

The EY and AVCA exit study "*From origination to exit how much value can your capital create?"* illuminated recent growth patterns. The study reported on 403 exits from 111 PE firms over the ten years ending in 2017.[8] 2016 was a record year for exits with 50 exits recorded compared to 34 in 2007. The exit market showed steady growth up from 22 in 2009. The report shows the greatest number of exits in the industrial sector, followed by consumer staples. (See Table 1).

Table 1: PE exits by sector

	2016-2017	**2007 - 2017**
Industrials	22%	19%
Consumer staples	15%	13%
Materials	13%	11%
Consumer discretionary	12%	12%
Financials	12%	19%
Utilities	10%	4%
Information technology	5%	5%
Telecommunication services	5%	6%
Health care	4%	7%
Real estate	1%	4%
Energy	0%	1%

Source: EY & AVCA study; 2018. "How private equity investors create value."

Covid-19 effects: Impact of the pandemic on PE fundraising, valuations and exits

With the onset of the Covid-19 pandemic, the PE momentum seen in recent years is likely to suffer. Most observers agree that in response to the pandemic, the global economy will enter recession in late 2020. Projections by the International Monetary Fund (IMF) in April of 2020 confirm this bleak picture. World growth is projected to contract by 3% in 2020[9], a downward revision of 6.3% from January 2020 estimates. The major developed economies can be expected to contract between -5.2% and -9.1%.

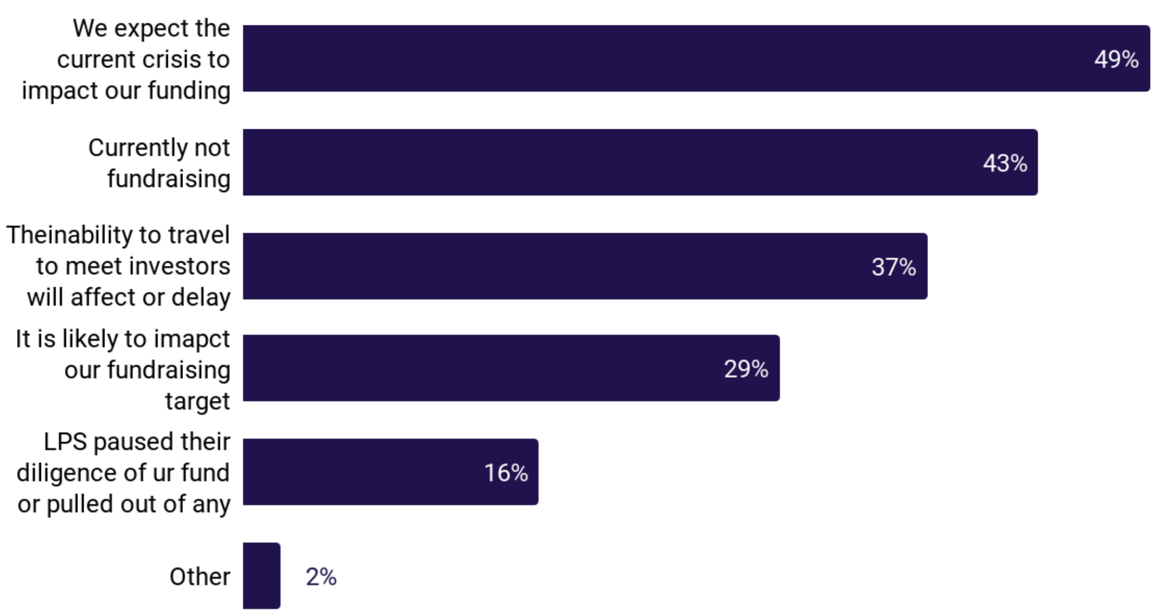
The IMF expects economic activity in Sub-Saharan Africa (SSA) to contract by some 3.2%. This forecast reflects a weaker external environment and the impact of measures to contain the COVID-19 outbreak. Growth is expected to recover in 2021 to 3.4%, subject to the continued easing of restrictions and, importantly, whether the region can avoid the epidemic dynamics that have played out elsewhere.[10]

Without doubt, the pandemic created a level of uncertainty rarely faced by PE firms. This impact is likely to persist over the next several years. Many firms operating in the private equity market will likely see changes in 2020 –in strategy, operations, or investor demand. Given the wide variety of potential outcomes stemming from the crisis, PE players must plan for the worst case, even while they hope for better. In the short term, country-specific measures such as restrictions on movement and travel can be expected to affect fundraising, exits and valuations.

- **Fundraising**

PE fundraising initiatives can expect many adverse impacts as a result of Covid-19. A Covid-19 survey published by AVCA in April 2020 reveals the extension of many fundraising timelines, with delays ranging from six to 12 months. The uncertainty triggered by the pandemic makes many LPs hesitant to commit funds. As a result, almost half (49%) of GPs say that they expect the pandemic to affect their fundraising timelines, with 29% expecting impacts on their fundraising targets (See Chart 4). Two-thirds of respondents to the AVCA Covid-19 survey reported their expectation that a depressed funding environment will be a challenge in the near to medium term, even after the end of the pandemic.

Chart 4: If you are currently fundraising, how have or will your plans be affected?



Source: AVCA Covid-19 GP Survey Results

Commercial LP actors are understandably cautious. Until the pandemic ends, African PE fund managers must tap into support from DFIs and other international investors. DFIs, in particular, are likely to play an even more crucial role during the next two years. Both have the capacity to take a longer-term view, plus experience operating in Africa during previous crises.

- **Valuations and Exits**

The health crisis restricted liquidity and placed stress on companies. Consequently, deal-making fell sharply in the wake of a sudden and unpredictable demand shock. Businesses considering the sale of assets are now likely to focus on protecting employees, managing supply chains and understanding and planning to mitigate business risks over the short to medium term. Sellers will undoubtedly be reluctant to part with assets given the steep drop in equity values. Falling valuations will result in delayed sales until asset valuations recover.

The recent Covid-19 survey confirms the impacts on the exit market following the disruption of deal flow. Fifty-seven per cent of survey respondents cited uncertain asset valuations as one of the most significant challenges resulting from the pandemic over the near-to-medium term. Only 12% of GPs surveyed view limited investable opportunities as a challenge. Moreover, 43% of the respondents report changes to deal terms due to the crisis. About two-thirds expect decreased returns.

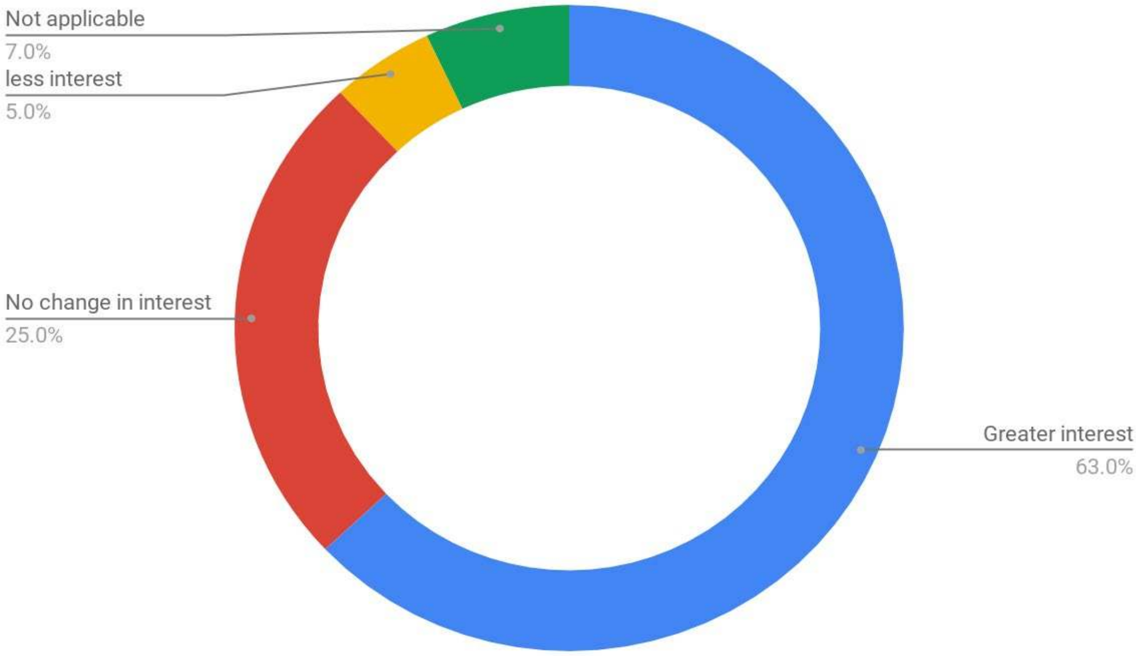
Post-Covid-19 opportunities in the Africa PE market

As the pandemic fades, not only businesses but entire economies must face the transition from their immediate response to the pandemic to putting in place the levers needed for recovery. As stakeholders prepare for the "next new normal," opportunities for private equity investors will emerge. Cash flow pressures on companies during this period may lead some firms to seek private equity investment. The bottom line: with few sectors untouched by the pandemic, many opportunities will appear for those fast-moving private PE investors that do their homework and take the right approach to sustainable investment.

- **Distressed opportunities**

The Covid-19 crisis dealt a hard blow to businesses. The pandemic also raised interest in distressed funding strategies. Fund managers can now acquire certain assets cheaply amid the downturn. The industries that face challenges and offer good opportunities for buyers include education and hospitality. Indeed, PE firms with dry powder in the Covid-19 era will benefit from depressed valuation levels. As PE firms seek opportunities to help businesses emerge from the financial impacts of the lockdowns, we can expect more PEs to set up distressed debt funds (See Chart 5).

Chart 5: How do you anticipate your interest in distressed debt or special situations investment strategies to change over the next six months in light of Covid-19?



Source: Private Equity International's Covid-19 Study

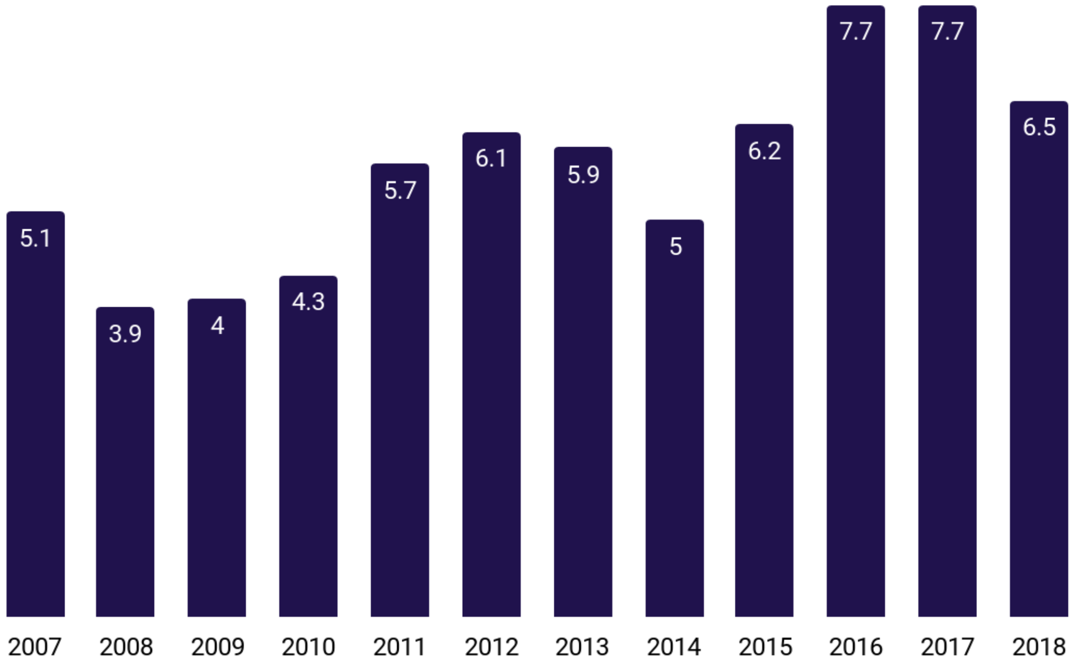
The PE industry is supporting existing portfolio companies through the pandemic. Some fund managers unveiled initiatives to invest in new assets in need of capital as they navigate the storm. In South Africa, particularly badly hit by the coronavirus, Ninety One launched its Ninety One SA Recovery Fund in association with Ethos Private Equity. Vital Capital, which has invested in Africa since 2011, set up its Impact Relief Facility to provide loans of up to US$1 million to companies in sub-Saharan Africa.

Across the region, the healthcare and electronic commerce sectors attract investors due to their essential roles throughout the crisis. Similarly, lockdown measures accelerate the adoption of online technology across several verticals. Businesses that can accommodate the demand for online services benefit significantly from these recent shifts in consumer behaviour.

- **Specialist secondary-Market Funds (Liquidity Providers)**

Post Covid-19 exit strategies will be crucial. Many sellers will wait for conditions to improve before exiting the market. However, the rebound may be quicker than in a "normal" economic recession, with a flurry of exits surfacing as conditions begin to improve. This scenario presents opportunities for unique PE players: secondary market PE funds. Such funds offer investors liquidity and can help investors rebalance their portfolios. Many funds may need to hold their investments a little longer due to the pandemic. This scenario is not new to the industry. Holding periods increased over the 2008 to 2016 period, from less than four to nearly eight years (See Chart 6).

Chart 6: Average Holding Period by Exit Year



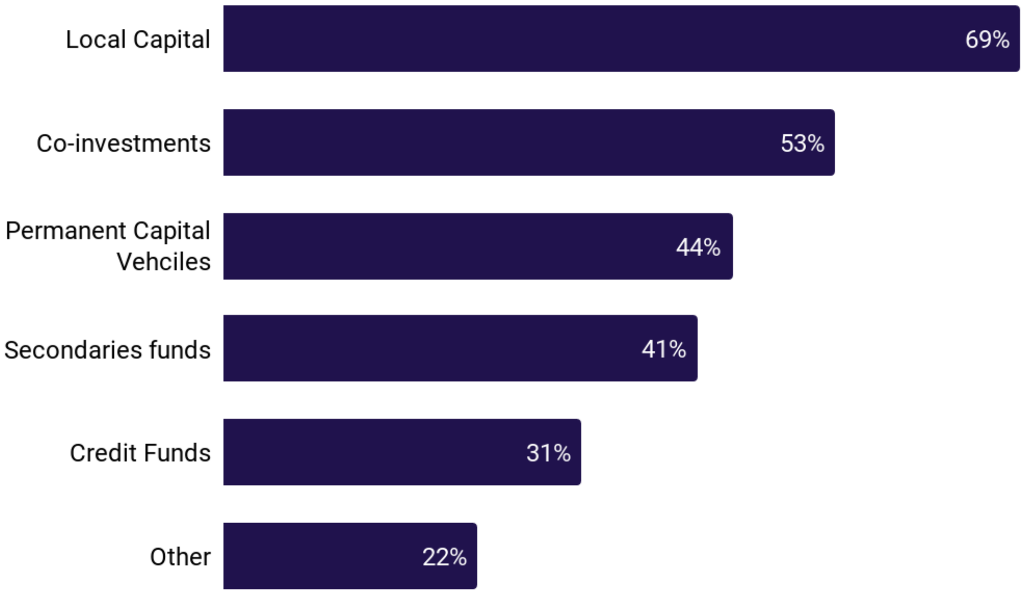
Source: EY & AVCA

Also, secondary market players are now awash with capital. According to a recent survey by Preqin, the secondary market has been flooded with record levels of cash, as investors seek to capitalise on what they see as a buyer's market for private equity stakes. Eleven secondary-market funds that closed in the first half of 2020 raised US$44 billion — far surpassing 2019's full-year total of US$26 billion raised across 26 funds.[11] This trend is partially motivated by the expected impact of Covid-19, as 89% of those funds closing in H1 2020 secured capital above their initial targets — a sure sign of stable investor demand. Those fund managers plugged into local networks will be able to unearth choice assets from the secondary market.

- **Co-investments**

Co-investment is expected to trend upward. The challenging fundraising environment brought on by the Covid-19 crisis is likely to push most PE funds to consider co-investing with other funds. Even before the crisis, PE funds sought increased co-investments, as reported in the 2020 African Private Equity Industry Survey. Over half of LPs (53%) expect co-investments to play an essential role in Africa over the next three years (See Chart 7). Of these LPs, 71% co-invested alongside an African GP in the last five years, while 94% seek a co-investment option when investing in an African GP. The proportion of LPs seeking co-investment when investing in PE in Africa increased to 87% in 2020, up from the 70% reported in a similar survey in 2018.

Chart 7: LPs expectations on developments that will catalyse the PE industry in Africa



Source: AVCA

As co-investment strategies become widely adopted, they will help funds navigate emerging fundraising challenges.

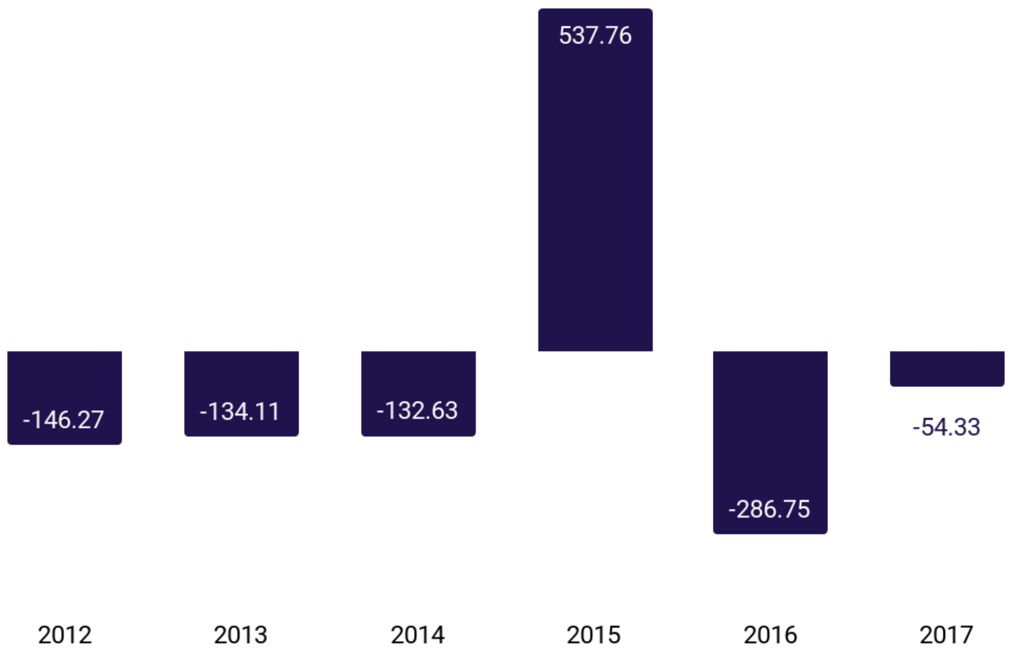
Action

Partnering with established Africa-focused funds will lower access barriers to private equity. The international funds (and even funds of funds) and other institutional investors seeking to invest in Africa may receive a helpful boost from the implementation of the AfCFTA.

- **Increasing allocation to Africa-focused Private equity**

Africa's access to private equity remains inadequate. As a proportion of gross domestic product (GDP), private equity across all African countries is far lower than Asian and OECD countries. Even in South Africa, the largest and most developed private equity market in SSA, allocated capital represents only 0.8% of GDP. Unfortunately, Africa-focused fundraising consistently failed to hit its targets in recent years (See Chart 8). This poor record means that African companies are likely to face continuing challenges in raising capital from private equity.

Chart 8: Amount raised by Africa funds compared with targets



Source: Private Equity International

Funds have many reasons to think about raising their allocation to the continent. Most of Africa's fundamentals remain solid. Since 2010, its consumer sector grew at a compound annual rate of 3.9%, reaching US$1.4 trillion in 2015.[12] The sector expects to reach US$2.1 trillion by 2025, and US$2.5 trillion by 2030.

- **Riding the wave of the African Continental Free Trade Agreement (AfCFTA)**

By 2030, assuming an adequately implemented AfCFTA, a single continental market for goods and services will offer corporations multiple points of entry to the continent, and access to a market of 2 billion people. This market is growing, with more than half the global population growth between now and 2050 expected to occur in Africa.[13] Despite its risks, Africa remains one of the world's most significant growth opportunities for private equity.

Conclusion

Africa is fast becoming a strategic private equity market. Despite Covid-19 and the subsequent economic crisis, the region provides the most attractive opportunities of any emerging market in 2020. The current economic challenges will require that agile investors navigate volatile and distressed environments, but are expected to present many investment opportunities. Given the proven track record of private equity investors being adaptable and resilient, the asset class has a vital role to play in the post-Covid-19 recovery and rebuilding in the continent. Besides, this asset class has a proven track record for outperforming other asset classes during periods of weak economic growth and market volatility, as demonstrated in recent years in South Africa.[14]

The dynamic West African economies offer investment opportunities across several subsectors. These include fintech (particularly mobile money and e-commerce), healthcare and related support service, and in Nigeria, Fast Moving Consumer Goods (FMCG). Beyond the current use of technology in the fight against Covid-19, the onset of the Fourth Industrial Revolution (4IR) will provide innovative investors with opportunities to deploy capital effectively in Africa during the recovery. Recent survey responses from private equity practitioners across East, Southern and West Africa, revealed that over the next 12 months they would focus on manufacturing, food and beverages, agriculture and financial services.[15]

Distressed assets were severely affected due to the difficult economic environment. However, this creates potential opportunities for savvy investors to purchase high-quality assets at attractive prices across the continent. Africa-focused funds will have opportunities to pivot and ride those megatrends positioned to emerge post–Covid-19. One trend will be restructuring global supply chains to increase their resilience. This will involve localisation in strategic sectors and diversification of the supply base for products with complex value chains. Other trends to watch will be accelerating digital transformation (driven by increased digital adoption by businesses, the rise of the digital urban consumer, the uptake of digital platforms and innovative digital business models). These trends present strategic investors with many opportunities for co-investments with sector-focused funds already in Africa. The increasing appetite for impact-oriented investments will lead to more opportunities to invest in impact-driven funds. The AfDB reports that the direct impact of the pandemic on the more than 23 million already vulnerable workers in Africa would drive the total number of people living in extreme poverty to 463 million in the worst-case scenario.[16]

Resolving the crisis created by the pandemic provides numerous opportunities to generate adequate returns. The post-crisis period is an opportunity for investors to make a long-lasting, meaningful impact on millions. Rebuilding economies will create opportunities across the spectrum of private equity investors. The resilient PE business model is well-suited to help navigate companies out of economic crises. PE firms can become partners in rebuilding Africa by reducing equity funding gaps and leveraging their strategic and operational know-how to support structural changes across businesses.

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