AFRICA: THE OPPORTUNITY AT HAND

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EXECUTIVE SUMMARY

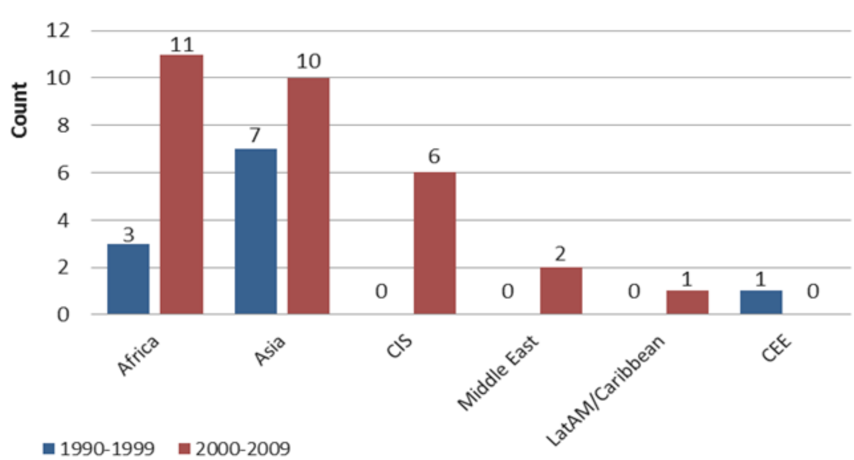
In contrast to developed and highly competitive markets like the US and Europe, where private capital is often used to finance the exchange of equity interests in companies, private capital in Africa more typically supports growth initiatives for underlying companies. Africa has the most attractive economic growth prospects of any emerging markets territory, and local governments and regulators continue to take steps to encourage and support private investment. This has resulted in a positive structural shift in Africa's private equity market that has improved investors' ability to effectively unlock value in the region. And while heightened interest in the continent has led to greater capital inflows, the private equity market remains very inefficient, meaning there is still significant opportunity for investors to capitalize on.

WHAT IS DRIVING THE OPPORTUNITY IN AFRICA?

1) Rapid Economic Growth

Africa contains seven of the 10 fastest growing economies in the world, and it has experienced close to 5 percent annual GDP growth over the past decade. A large reason for this growth has been the rise of the African middle class, which grew from 126 million people in 1980 to 350 million people in 2010 (African Development Bank, 2014). Figure 1 shows a comparison across regions of the number of countries that grew GDP by over 7 percent per annum, broken down by decade for the past 20 years. As the graphic shows, Africa only had three countries that fell into this category between 1990 and 1999, but this increased to 11 countries between 2000 and 2009. In the latter decade, Africa had the highest country count, even surpassing Asia. This trend should continue, particularly if foreign direct investment in the region continues at a strong pace.

FIG. 1: NUMBER OF COUNTRIES THAT GREW GDP >7% PER ANNUM



Source: Renaissance Capital, IMF

With this growth has come a significant increase in urbanization—Africa's urban population nearly doubled to 401 million people between 1990 and 2010 (Ernst & Young, 2013), and by 2030, Africa's top 18 cities are projected to have a combined spending power of $1.3 trillion (McKinsey & Company, 2010). In addition, this growth has fueled Africa's labor force, which is expected to double by 2020 to over 1 billion people, surpassing both China and India (AfricInvest, 2014). Since higher employment translates into greater aggregate income and demand, this growth in the labor force will help perpetuate GDP growth in Africa.

Figure 2 shows a snapshot of Africa as it stands today, and compares this to what Africa is expected to look like in the future. This figure truly speaks to the continent's growth prospects, and shows how much economic potential Africa still holds.

FIG. 2: AFRICA TODAY VS. AFRICA TOMORROW

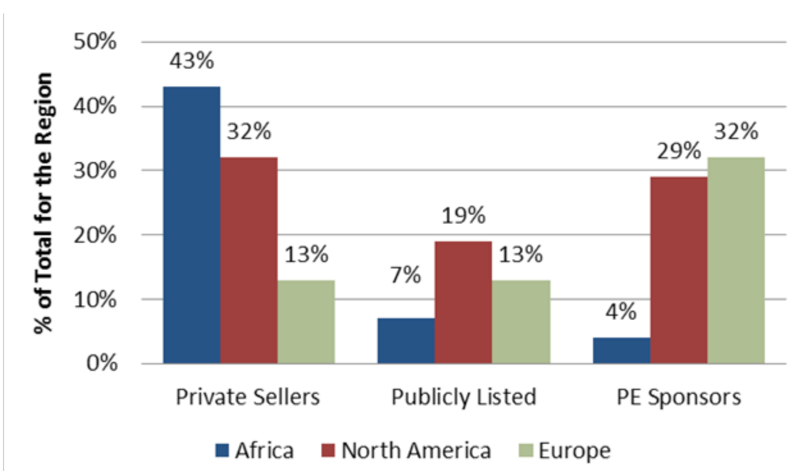
	Africa Today	Africa Tomorrow
Population	1.05B (2011)	2.3B (2050)
Dependency Ratio	78% (2010)	59% (2050)
GDP	$1.9T (2011)	$2.5T (2020)
Household Expenditures	$716B (2011)	$1.4T (2020)
Foreign Direct Investment	$42.7B (2011)	$150B (2015)
Urbanization	39% (2010)	58% (2050)

Source: Population Reference Bureau, United Nations, Ernst & Young research, UNCTAD

2) Inefficient Markets

Despite its rapid economic growth over the past decade, Africa remains a very inefficient market. It has a nascent public equity market, which makes comparable pricing difficult and decreases the viability of one of the primary exit routes (IPOs) chosen by US and European private equity firms. Africa also lacks the infrastructure seen in developed markets, which means that information can be hard to access and hard to leverage on a widespread basis. This means that private equity on the continent is highly relationship-driven, with the majority of deals happening without an intermediary. Figure 3 shows the effect that inefficiency in Africa has on private equity deal sourcing. In Africa, 43 percent of the deals sourced come from private sellers, versus only 32 percent and 13 percent in North America and Europe, respectively. Conversely, only 4 percent of deals in Africa are sourced through other private equity sponsors, compared to 29 percent and 32 percent in North America and Europe, respectively. Sponsor-to-sponsor transactions are more common in mature private equity markets, and they tend to result in the least attractive pricing. Privately-sourced transactions are harder to consummate and require deep relationships. However, they typically result in better pricing (lower entry multiples) and greater potential for operational value-add, both of which translate into better back-end returns.

FIG. 3: PRIVATE EQUITY DEAL SOURCING



Source: Ernst & Young

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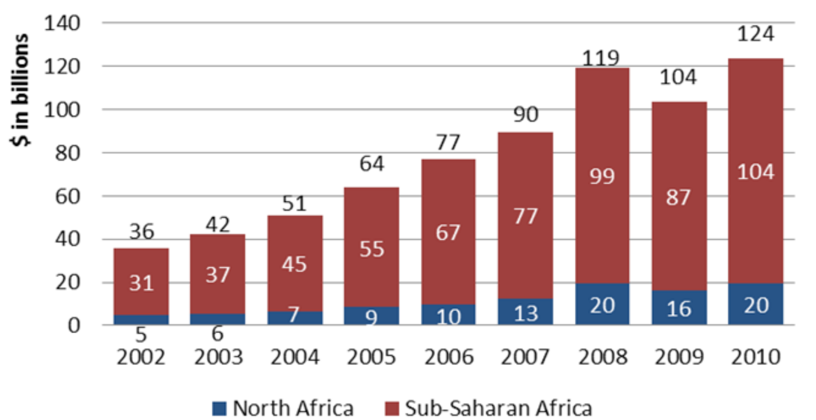
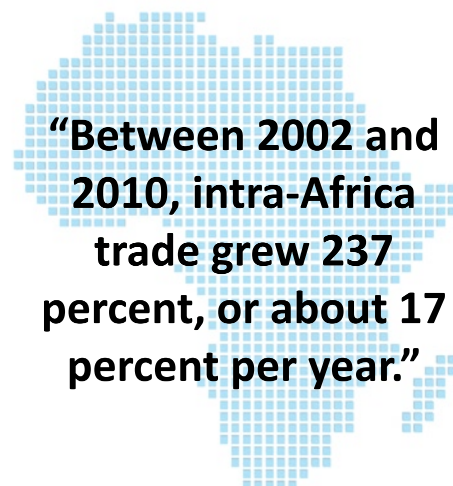
3) Regional Integration

As its economy has grown and domestic consumption has increased, Africa has experienced a high level of regional integration. Political efforts to sustain the continent's economic growth have assisted in promoting intra-Africa trade and have resulted in a large number of regional trade pacts being signed over the past 10 years. The trend has also partially been driven by the global financial crisis, which resulted in stagnant growth in developed markets and forced Africa to turn inward for demand. Figure 4 shows the growth in intra-Africa trade between 2002 and 2010. Over this time frame, intra-Africa trade grew 237 percent, or about 17 percent per year. This growth in domestic trade has led to increased cooperation among countries, improved transparency and coordinated economic policies. It has also created a means for dominant local companies to achieve greater scale through regional expansion, which has both supported the companies' own growth and allowed them to create value in lesser developed areas of Africa. These elements are all positives for the African economy, as they result in a more cohesive economic structure, improved governance and a more equitable distribution of wealth across the continent.

FIG.4: INTRA-AFRICA TRADE (2002-2010)



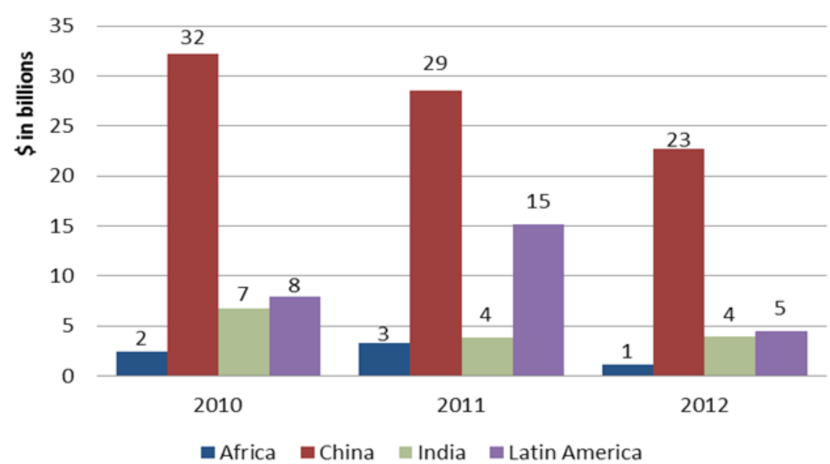
Source: AfricInvest



4) Favorable Private Equity Dynamics

Compared to other emerging markets, private equity remains an underutilized investment approach in Africa. As Figure 5 shows, private equity fundraising in Africa is less than half the level seen in India and Latin America, and is significantly below the level seen in China. Based on the anticipated growth of the African economy, fundraising levels will naturally increase as private capital comes into greater demand. However, the market is so underpenetrated that modest inflows should not have a material adverse effect (in the short run) on the opportunity set for private equity investors.

FIG.5: PRIVATE EQUITY FUNDRAISING

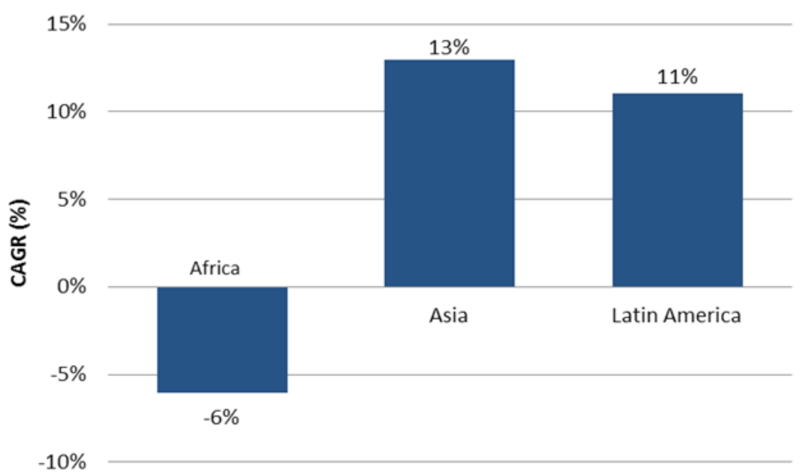


Source: Preqin, Venture Intelligence and Factiva

Despite the much lower levels of fundraising in Africa compared to other emerging markets, African private equity firms have deployed a higher proportion of their committed capital than firms in Asia and Latin America. As Figure 6 shows, dry powder in Africa decreased 6 percent annually from 2008 to 2013 but increased 13 percent and 11 percent annually in Asia and Latin America, respectively, over the same time frame.

When a market is less developed and less saturated, there is naturally going to be more room for capital deployment. However, capital deployment in Africa is being driven by structural elements that should allow the current pace to persist. For one, governments in Africa are encouraging development in order to address the continent's infrastructure needs and to accommodate the growth in middle class wealth. This means governments are focused on providing a better operating environment for private capital, primarily by working to improve governance. In addition, regulatory changes in Africa have freed up domestic capital that can now be allocated to private equity. As an example, certain regulatory bodies in Africa have raised the eligible allocation that domestic pension funds can make to private equity. Since these funds are seen as a primary source of domestic private equity capital—and in some ways, their dollars are a necessary precursor to attracting more capital from outside of Africa—the regulatory changes should result in even stronger capital flows into African private equity.

FIG.6: PRIVATE EQUITY DRY POWDER (2008-2013)



Source: Preqin

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CONCLUSION

The surge in economic growth that Africa has experienced over the past decade should continue, and with it should come continued opportunity for private equity investors. The market remains underpenetrated relative to its economic potential, which should provide a floor for expected returns and help them remain higher than in other emerging markets. Africa does have its risks, such as country-specific political risk, a potentially difficult exit environment due to nascent public exchanges, and the possibility that too much capital flows into the market, outstrips deal flow and leads to inflated entry prices. However, these risks can be mitigated by selecting managers that know the continent well and intelligently deploy capital. In the end, Africa currently offers the most attractive market dynamics for emerging markets private equity. Coupled with the geographic diversification that investors gain from allocating to the region, Africa presents investors with a significant opportunity.

ABOUT THE AUTHORS

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Dan Pogue joined Summit Strategies Group in 2013 as a Research Analyst on the Private Equity team. His responsibilities include assisting with client reporting and performing research and due diligence on private equity managers. Dan graduated magna cum laude from the University of Missouri, receiving a BSBA in Business Administration with an emphasis in Finance. Dan is currently a Level II CFA candidate.

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