Private Equity: Value Creation in Africa

As private equity matures in Africa, a greater focus on alpha is required to deliver attractive returns.

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Bain & Company is the leading consulting partner to the private equity industry and its stakeholders. PE consulting at Bain has grown fivefold over the past 15 years and now represents about one-quarter of the firm's global business. Bain maintains a global network of more than 1,000 experienced professionals serving PE clients. The firm's practice is more than triple the size of the next largest consulting firm serving PE firms.

Over the past decade, African private equity (PE) has emerged as an attractive asset class, underpinned by favourable fundamental trends. However, stronger competition for deals, recent macroeconomic headwinds and operational challenges in Africa are requiring PE funds to put greater emphasis on value creation to continue delivering attractive returns. We review some of the archetypal approaches to value creation used globally and examine how they are being deployed in the African context.

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The emergence of African private equity

Africa has long been seen as the last frontier for investing, and since the turn of the millennium, the continent has become increasingly attractive for PE investors.

The emergence of African private equity as a popular asset class has had much to do with Africa's compelling economic fundamentals. Sub-Saharan Africa's real GDP has grown by an average annual rate of about 5% since 2000, according to the Economist Intelligence Unit. This rapid economic growth has been supported by a growing population, greater market liberalisation and increased macroeconomic stability.

As a result, Africa has seen rapid growth in the number of PE funds operating on the continent—from 12 funds in 1997 to more than 200 funds today, based on data from the African Private Equity and Venture Capital Association (AVCA). Predominantly local PE funds that have operated in Africa for decades (such as Ethos in South Africa or African Capital Alliance in Nigeria) have grown their fund sizes while regional funds (such as Actis, Helios and the Abraaj Group) have also expanded their African presence; Abraaj alone has made 14 investments in sub-Saharan Africa since 2012. Major global players have entered the market as well: In 2014, The Carlyle Group raised a nearly $700 million dedicated fund and KKR made a $200 million investment in Ethiopian flower company Afriflora.

Challenges for African investors

PE investors in Africa, however, are facing some very real challenges, including greater competition for a limited number of attractive assets, renewed macroeconomic headwinds and distinct local operational challenges.

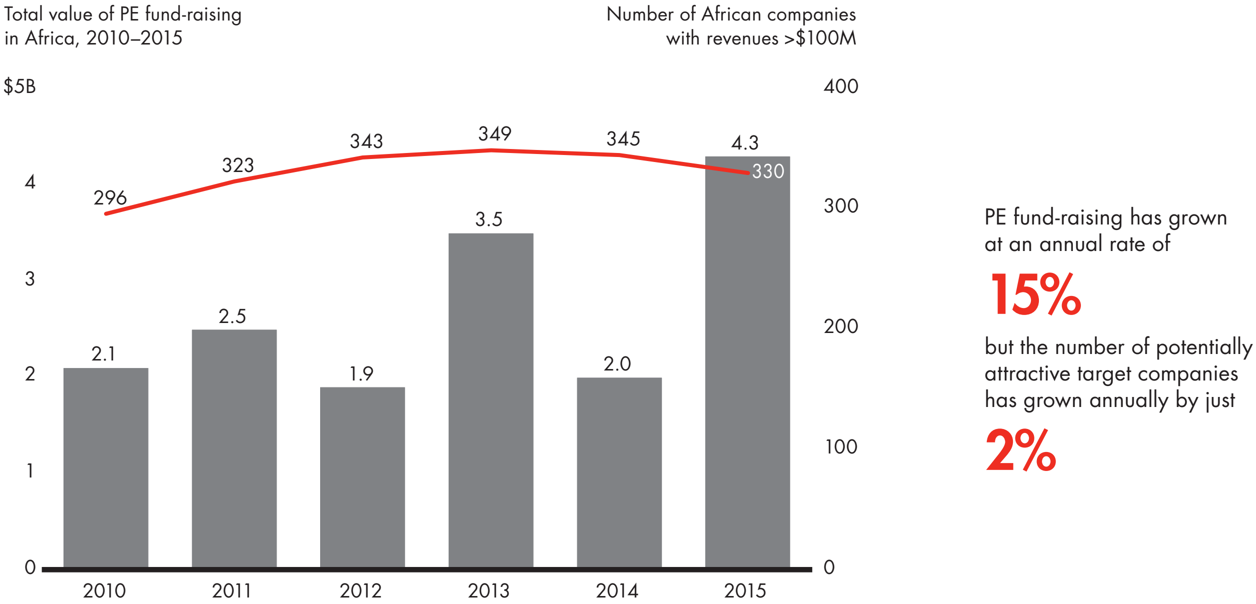
According to AVCA's Annual African Private Equity Data Tracker, PE fund-raising in Africa grew at an annual rate of 15% from 2010 to 2015, while the number of companies with more than $100 million in revenues (typical PE target companies) grew annually by just 2% during that period (*see Figure 1*). This has led to a large increase in competition, raising valuations and multiples being paid for assets. A recent report by investment advisory firm RisCura shows that between 2009 and 2013, more than half of African PE deals were priced below six times earnings before interest, taxes, depreciation and amortisation (EBITDA), but by 2015 this share had declined to less than one-third.

Recent years have also brought renewed macroeconomic challenges. The brisk decline in key commodity prices since 2014 has negatively affected the many African countries that still rely heavily on the export of natural resources. That has been compounded by recent political uncertainty across Africa, including in three of the largest African markets: South Africa, Nigeria and Kenya. This economic and political uncertainty has resulted in the rapid depreciation of many African currencies. Over the past three years, the South African rand and the Nigerian naira have depreciated about 40% against the US dollar, while the Ghanaian cedi depreciated about 50%.

Lastly, PE funds are also facing some very real operational challenges in Africa:

- **Working with owners and founders.** In Africa, many companies are still run by their original founders or their families, with many afraid to relinquish control to new investors.

Figure 1: PE fund-raising in Africa has significantly outgrown the number of attractive African assets



Note: Data for number of companies includes only parent companies and excludes subsidiaries
Sources: African Private Equity and Venture Capital Association's 2016 H1 African Private Equity Data Tracker; S&P Capital IQ

- **A limited talent pool.** There is often limited depth to the management skills and capabilities in African companies; this is particularly true below the top management level.
- **Opaque business practices.** In many African countries, some businesses are still reliant on informal practices such as providing "gifts" to obtain an import licence.
- **Indigenisation trends.** Many African governments encourage local economic empowerment by limiting the extent of foreign ownership. South Africa's proposed bill for 51% local ownership of private security companies is one example.

Faced with these challenges, African PE funds are increasingly looking to promote value creation in their portfolio companies to be able to deliver compelling returns for investors.

A global private equity shift towards value addition

Since the global financial crisis, PE funds around the world have benefited from market beta—underlying economic growth, rising equity values and readily available low-cost debt—to help deliver attractive returns. With these passive forces now waning, PE firms are having to further develop the strategic and operational skills needed to create alpha in their place through active value creation.

Based on Bain & Company's extensive global experience, we have outlined four archetypal approaches to creating value at portfolio companies *(see Figure 2)*:

The adviser-led model. PE firms that adopt an adviser-led approach typically take a less interventionist approach to their portfolio companies. They will selectively lean in on particular investments to help shape the management team's goals and supply resources to help deliver

Figure 2: There are four archetypal approaches to value creation at portfolio companies

Light-touch intervention ⟷ Highly interventionist approach

Adviser-led model	Functional playbook model	Maestro model	General-activist model
• Fund adopts a **less interventionist** approach to its portfolio companies • Fund will **selectively lean in** on particular investments • Fund has **no dedicated portfolio team**, but rather uses **external experts** as needed	• Fund takes a **hands-on prescriptive approach** to value creation • Fund employs **full-time experts** to implement a dedicated playbook to **deliver operational** improvements	• Model places **considerable emphasis on engagement** with portfolio management, but is well suited for **funds that lack resources** or desire to staff expensive **in-house teams** • Fund designates a **seasoned leader** in-house to coordinate **external resources** to implement **value-creation plans**	• Fund has **dedicated multi-disciplinary** teams that bring a **high level of engagement** to each portfolio company • These teams **work closely** with newly acquired companies to **support and promote value creation**

Source: Bain & Company

on those goals. Adviser-led value creators typically eschew dedicated portfolio teams and instead assemble a network of external experts who can address specific needs.

The functional playbook model. Some activists take a more hands-on prescriptive approach to creating value in portfolio companies. PE funds that adopt the functional approach typically employ full-time experts who implement a dedicated playbook with initiatives that improve business processes, reduce costs or deliver other operational improvements.

The maestro model. This model places considerable emphasis on early, high-level and continuous engagement with portfolio management, but is well suited for PE funds that lack the resources or the desire to staff expensive in-house operating teams. PE funds that adopt the maestro approach typically designate a seasoned leader within the firm to coordinate a flexible team comprising deal team members and external resources to develop and implement value-creation plans.

The general-activist model. Some larger PE funds build portfolio activism into their DNA. Their multidisciplinary operating teams bring a high level of engagement to each investment. These dedicated multidisciplinary portfolio groups work closely with the newly acquired companies to provide deep strategic analysis, support the development of value-creation blueprints and help management teams put them into operation.

Examples of African PE value addition

Increasingly, leading African PE firms are recognising that it is only by generating alpha through active portfolio management that they can deliver sustainable, attractive returns. In the African context, funds may use different value-creation models for different investments, with the chosen model depending on the extent of control funds have over the portfolio company. Where funds have minority stakes, direct value addition is considerably harder, and softer skills such as influence become key.

Despite Africa's distinctive investment climate, Bain has observed the archetypal global approaches being applied by funds across the continent.

CDC Group, the UK's Development Finance Institution, has largely embraced the maestro model. The fund specialises its deal teams by industry—financial institutions, consumer businesses, industrial businesses and so on—and selectively leverages expertise in these teams, as well as a growing sector-specific network of senior advisers, to create value in its portfolio companies. Furthermore, across investments, CDC also utilises the functional playbook model in deploying its in-house expertise to enhance a company's environmental, social and governance standards.

A balance should be struck between developing dedicated expertise in-house—either through specialising deal teams or developing dedicated value-addition resources—and flexibly leveraging trusted external resources with a track record of delivering results.

Meanwhile Ethos, the South African-based PE fund, also often utilises the maestro model, whereby a senior leader coordinates members of the deal team to add value in its portfolio companies. In other situations, where the fund sees more scope for value addition, it will deploy a broader general-activist model using its dedicated in-house value-add team, supplemented with external qualified advisers where relevant. This core team consists of five professionals, who actively engage with the portfolio companies and bring institutionalised excellence.

Practical considerations

In summary, we believe that Africa is an attractive investment destination for PE funds, but it is becoming increasingly clear that these funds cannot rely on market beta alone. Rather, they require a greater emphasis on portfolio value creation to generate alpha and attractive returns.

Bain believes that any properly structured approach to value creation should flow organically from a PE fund's unique size, strategy and values, and depends on the fund's philosophy (its objectives for value creation), its engagement model (how and when it will intervene) and its organisation (what internal and external talent it needs). In general, a balance should be struck between developing dedicated expertise in-house—either through specialising deal teams or developing dedicated value-addition resources—and flexibly leveraging trusted external resources with a track record of delivering results.

Finally, given the challenges inherent in investing in Africa, it is critical that PE funds continually adapt and innovate their value-creation models to react to local market conditions, by examining where and how they can achieve the highest returns on their costly investment in portfolio management resources.

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