PRIVATE EQUITY AFRICA Awards 2019
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MBUYU CAPITAL

"This is Africa" deconstructed

African Private Equity Returns, Risk and Potential in a Global Context

SUMMARY REPORT

Mbuyu Capital

Mbuyu Capital has the experience and is uniquely placed to access and manage successful investments in Africa.

We work with thoughtful investors to create and manage bespoke strategies and funds to achieve attractive returns and real, measurable impact.

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Executive summary

- Africa's large 1.3 billion population is forecast to almost double to 2.5 billion between now and 2050, to account for 25 percent of the global population. Africa is also forecast to have the largest urban population, 37 percent higher than China's.

- Africa is expected to have the largest labour force, 83 percent higher than China's, and the only labour force still expanding, owing to the young age demographic, with the potential to throw off significant dividends in terms of growth and GDP.

- There are increasing foreign direct investment flows into Africa, from a low base, and focused on key economies. Africa's mobile infrastructure and innovative companies have made it a global leader in mobile payments. These opportunities are reflected in strong venture capital flows into Africa with fintech and agritech the two leading verticals.

- Developed market private equity returns have been declining while fundraises have increased, as have entry valuations and the use of leverage. Despite much lower leverage and valuations, and comparable risk, African private equity flows are a fraction of global flows and below relative GDP.

- Gross returns from African private equity investment are comparable to those from developed markets, but for private equity funds African median net IRRs are closer to 5%, compared to 14% for developed market private equity fund net IRR over the last 10 years (although future expectations are nearer 8%). However, as developed market private equity returns continue to decline and risks increase, African private equity should warrant attention if the gap between gross and net returns can be addressed. This paper has highlighted a number of ways of achieving this, which could result in a more than 4 percent improvement in net returns, putting median African private equity performance ahead of expected global private equity median returns:
    - The use of capital call facilities and recycling of proceeds by private equity funds in Africa;
    - A much stronger focus by GPs on shortening investment holding periods to below five years, from a median of over six years currently;
    - The further development of intermediaries and platforms to present investment-ready opportunities.

- The predominance of international development finance institutions (DFI) in the African private equity investor base dampens median returns through a "strategy effect". DFIs' focus (understandably) on the developmental aspects of investments results in a higher tolerance for investments requiring extended holding periods and a resistance to the use of developed market practices such as capital call facilities and recycling of proceeds. It has also resulted in limited appreciation by GPs of the importance of IRRs (rather than multiples) for attracting commercial investors. It also results in a higher tolerance for investing with fund managers who would not have been funded by commercial investors, impacting the median return statistics.

- An investment strategy using developed-market return enhancing techniques, selecting deals with clearly-defined exit potential and seeking shorter-term opportunistic investments is likely to deliver returns more comparable to developed market private equity returns. This approach will be necessary if African private equity as an asset class is to attract commercial capital. Good availability of co-investments in Africa also makes a co-investment approach with a commercially-minded fund manager a potentially attractive way of achieving superior returns.

- Africa also offers significant opportunities to contribute to the UN's Sustainable Development Goals as part of a responsible investment strategy.

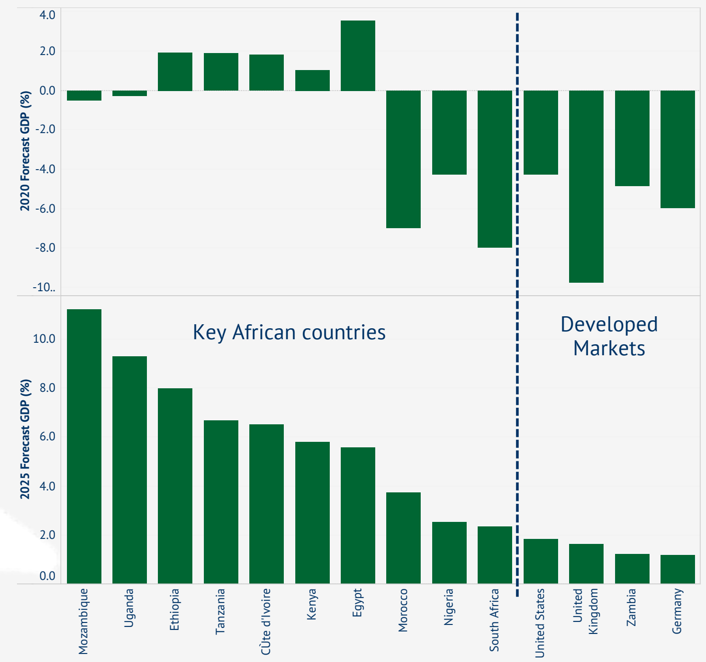
Macro backdrop

Growth and trade

Africa continues to show strong growth prospects, with an expectation of a significant rebound from COVID, which has also affected African growth less than for developed markets. Its population is also expected to exceed that of North America, Europe and Latin America combined, at 2.5 billion by 2050 and a 25 percent share of the global population.

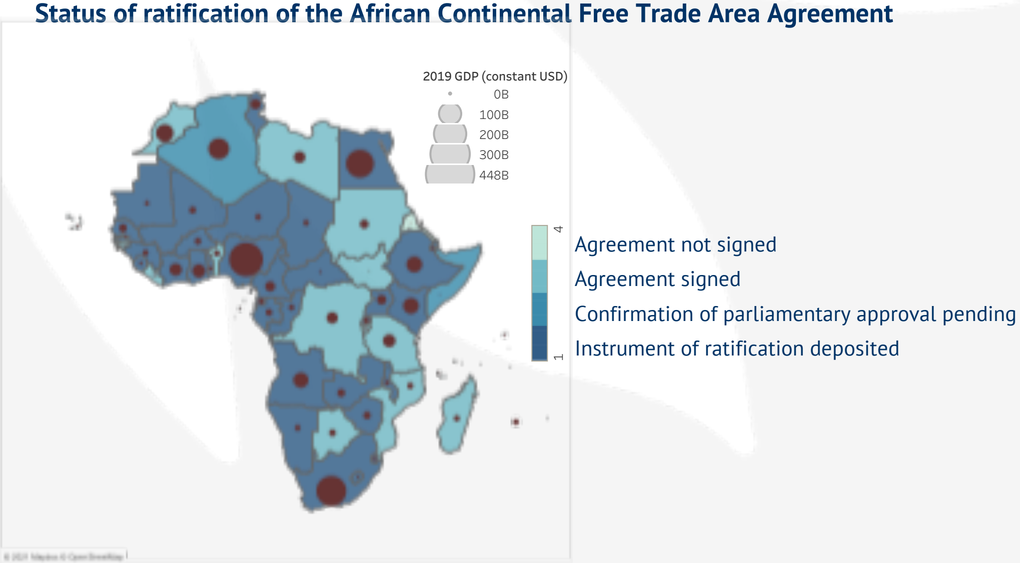
The landmark African Continental Free Trade Area (ACFTA) agreement among 49 countries came into effect on 1 January 2021 and should further support growth. The free trade area will create a single market for trade in goods and services among the African countries. This is expected to be accompanied by co-operation on investment measures, intellectual property rights and competition policies, to support innovation, competitiveness, and trade diversification. The largest economies by GDP have ratified the agreement. It is estimated by UNCTAD that full liberalisation will lead to a 1-3 percent increase in GDP and a 33 percent increase in the value of intra-African trade.

Forecast GDP at constant prices



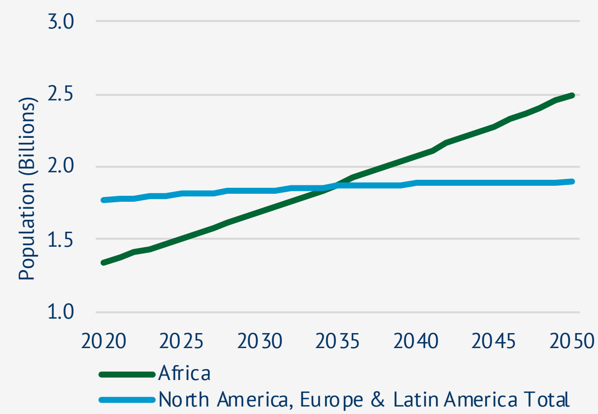
Source: IMF October 2020 Dataset; Mbuyu Capital analysis.

Status of ratification of the African Continental Free Trade Area Agreement



Source: TRALAC, as at 15/3/2021 (ACFTA status); World Bank Databank (GDP data).

Africa Population Projection vs North America, Europe and Latin America



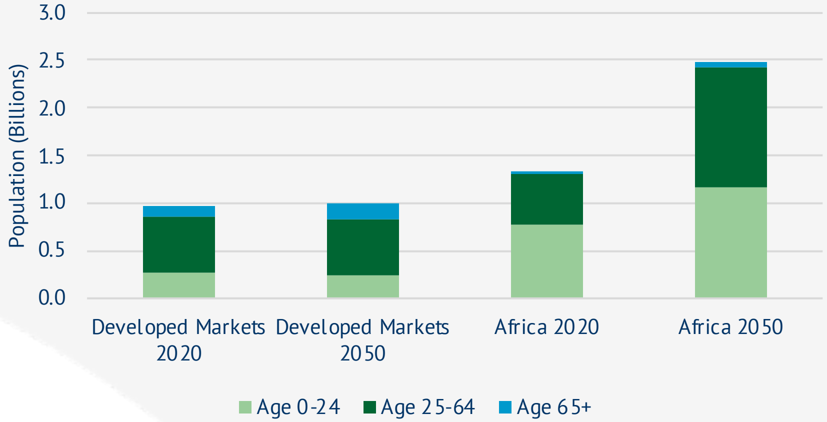
Source: United Nations, Department of Economic and Social Affairs, Population Division (2019).

Demographics

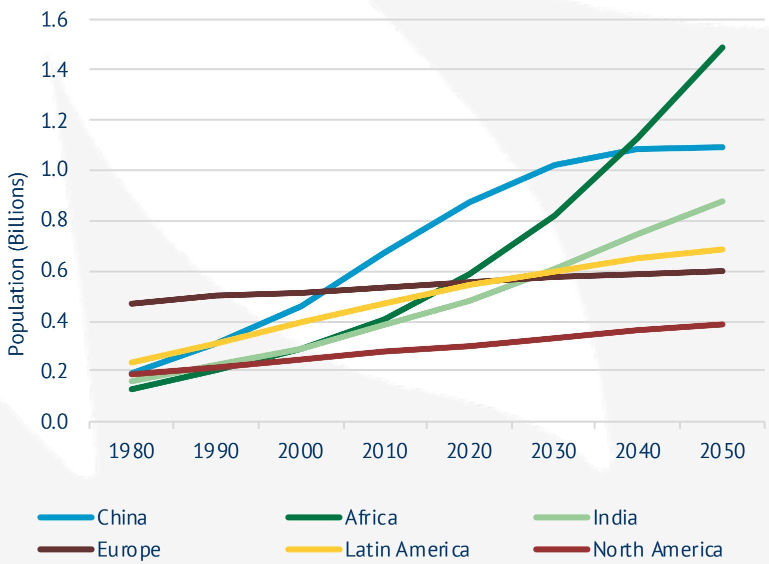
Africa's population will also be young and the corresponding workforce growth could lead to dividends for African economies:

- Boosting economic growth by increasing the effective labour supply, improving the annual growth of GDP per capita by up to half a percentage point at constant output per worker;
- Increased activity ratio (proportion of the working-age (15-64 years) population relative to the dependent-age population aged under 15 and over 65. A favourable change in activity ratio can accumulate savings, investments in physical and human capital, and productivity gains;
- Associated urbanisation can increase these effects on economic growth. Rapid urbanisation brings opportunities to create new markets and improve productivity;
- Africa's labour force is expected to exceed China's this decade and Africa's urban population is forecast to exceed China's in the next decade.

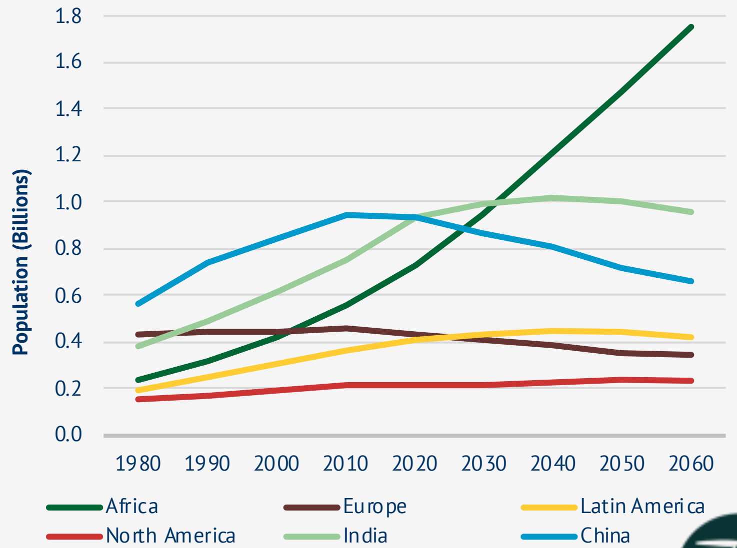
Population and growth projection to 2050, by age group



Urban population forecast



Labour force growth forecast



Source: United Nations, Department of Economic and Social Affairs, Population Division (2019).

Investment

Foreign direct investment (FDI) to top African urban markets is also increasing. An estimated 83 percent of all jobs directly created by FDI between 2003 and 2014 were located in cities.

International investment plans and programmes to promote investment in Africa support growth potential given the link between FDI and GDP. The 2019 G7 Summit agenda highlighted the importance of developments in Africa as a global priority.

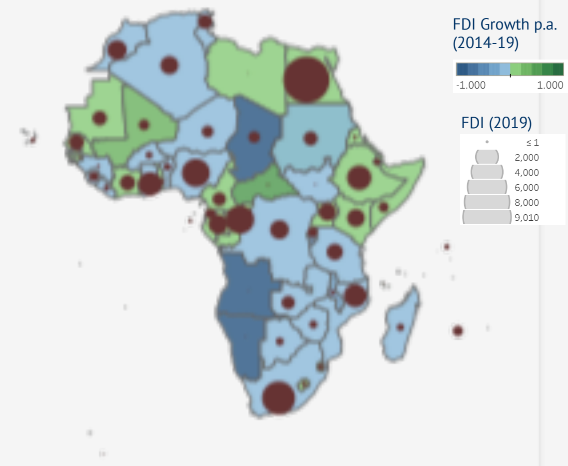
Recently announced and renewed country initiatives include:

- United States - Prosper Africa initiative
- France - Choose Africa programme
- Germany - Africa Connect
- India - Longstanding trade/investment with new free trade agreement being considered
- China - Belt and Road initiative
- Japan - 2019 Tokyo International Conference on African Development and related plans
- United Kingdom - Partnership for Investment and Growth in Africa.

Africa represents an immense opportunity to invest and promote the achievement of the United Nations Sustainable Development Goals. Although approximately 12 percent of the USD 12 trillion of global investment opportunity available to target advancement toward the Goals is based in Africa, given the continent's earlier stage of development, there is significant low-hanging fruit across many Goals. Of the global job creation potential, estimated at 380 million jobs before 2030, 21 percent could be achieved in Africa. Africa also possesses great potential for increased food production, possibly by 65 percent by 2050, to feed the rapidly growing population worldwide. Improving agriculture-related logistics could reduce food waste in Africa, estimated at as much as 40 percent of production, through basic storage and logistics.

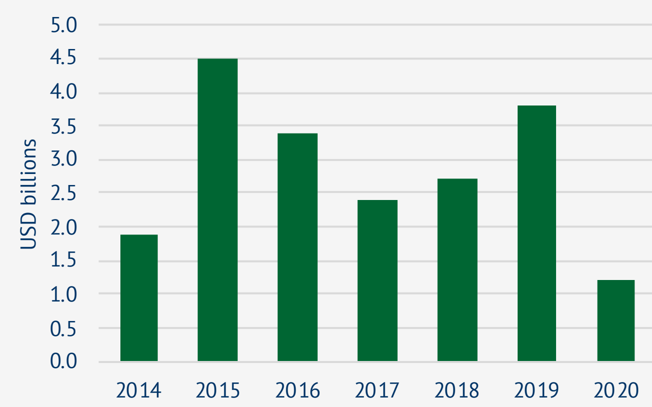
Currently the majority of private equity investment in Sub-Saharan Africa ex South Africa is from outside the Continent and only represents a fraction of the capital required.

Africa inward FDI Flow; 2019 (USD millions, current prices)



Note: FDI flow of -1 equals -100 percent p.a. and flow od 1.0 equals +100 percent p.a.
Source: UNCTADSTAT, Mbuyu Capital analysis.

Africa private equity fundraising 2014-20



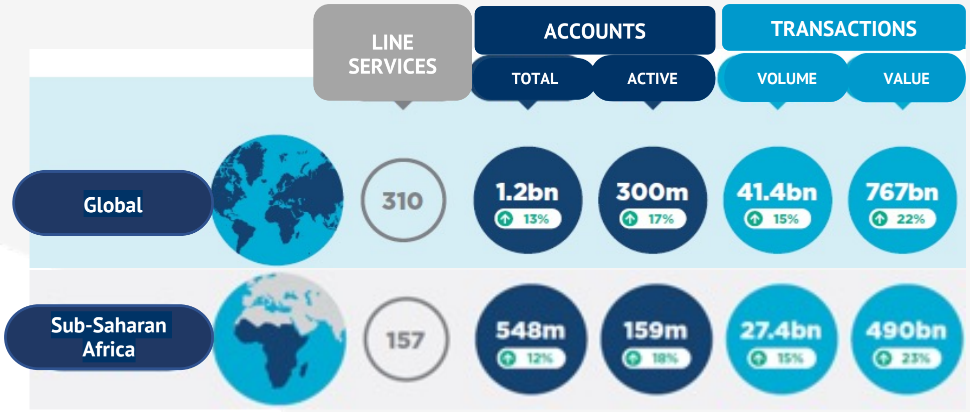
Source: African Private Equity and Venture Capital Association, 2020 Annual African Private Equity Data Tracker, March 2021.

Opportunities for innovation and disruption

Sub-Saharan Africa leads the world in access and use of mobile payments platforms. North Africa is seeing a large increase in registered accounts in absolute terms as a result of new and renewed efforts by industry players and government support. Access enables opportunities to provide additional information and financial services.

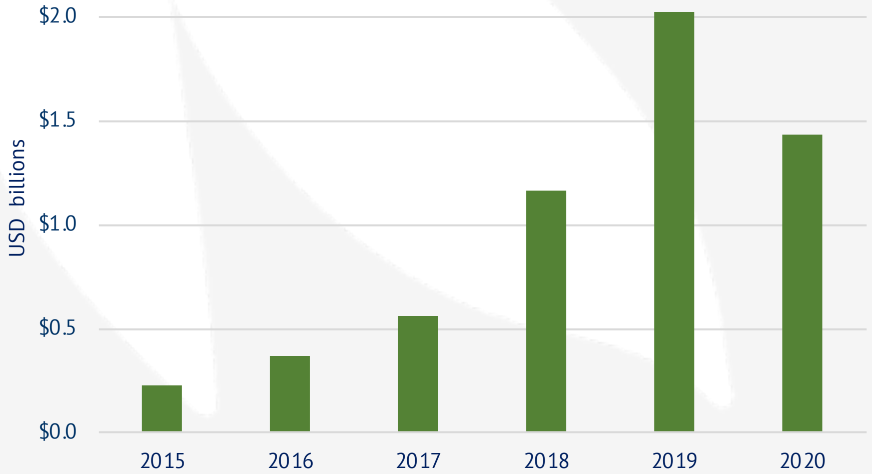
This has enabled the development of an active venture capital sector in Africa, much of which is driven by mobile phone and other digital infrastructure. Investment into the venture capital sector exceeded private equity fund investment in 2020 and was c. 50 percent of USD 3.8 billion private equity fundraising for all of Africa in 2019.

Regional mobile payments growth; 2020



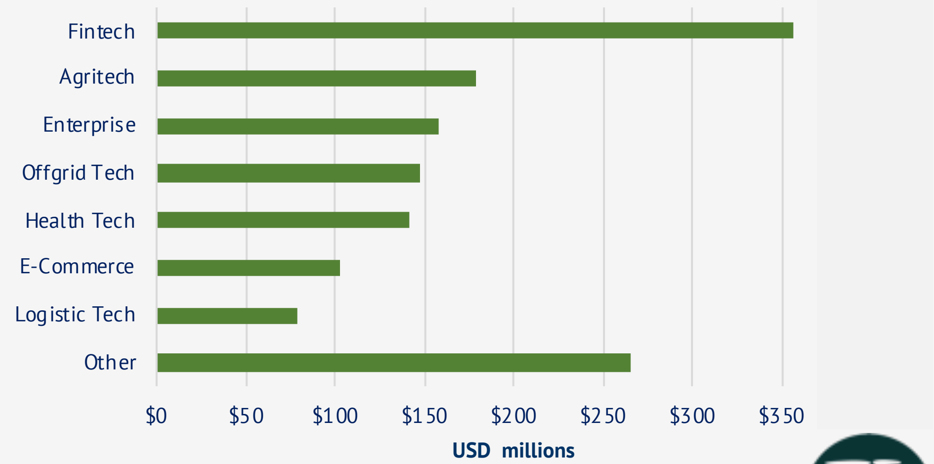
Source: GSMA; 'State of the Industry Report on Mobile Money 2021', March 2021.

Total equity funding of venture companies in Africa; 2015 – 2020



Source: Partech Africa Report 2020.

Equity funding by technology vertical; 2020



Source: Partech Africa Report 2020.

Private equity in Africa and developed markets

Potential returns from African private equity

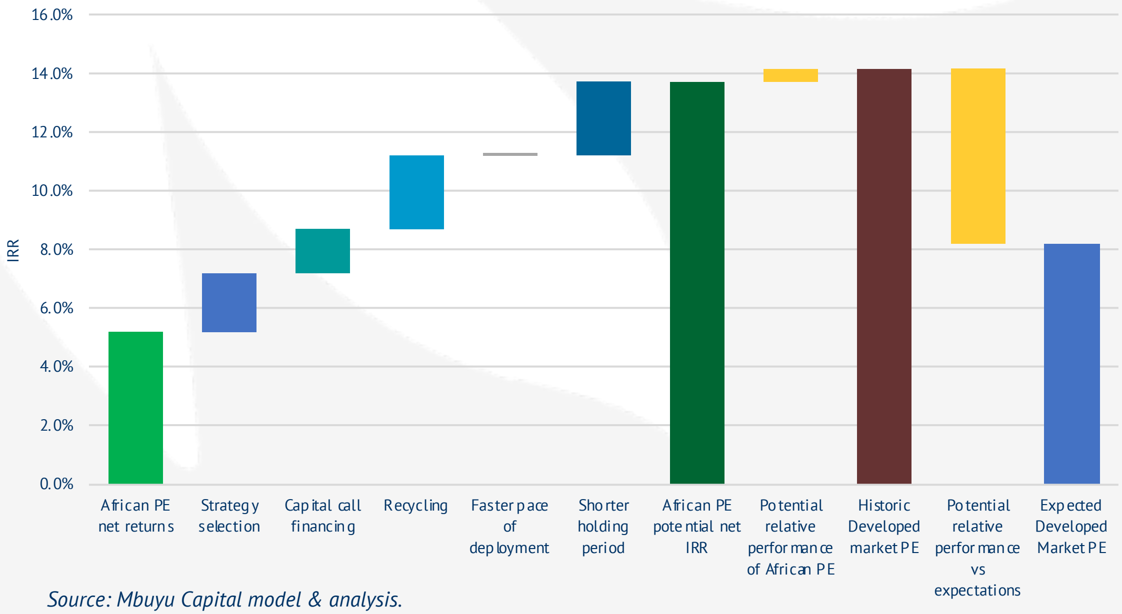
African private equity managers do not generally employ certain techniques which are common in developed markets, in particular capital call financing or recycling of proceeds during the investment period, both of which mitigate the J-curve and therefore reduce the gross-net gap.

A faster pace of deployment and shorter holding period without compromising on MOIC is clearly less straightforward. However, in our experience there is significant scope for shortening holding periods in ways such as:

- Investment appraisal focused on the ability to achieve target MOIC in 3-5 years.
- Making exit decisions when target MOIC is expected to be achieved rather than holding on for some further upside, at the expense of IRR. In our experience taking the “bird in the hand” is important in African private equity as currencies generally depreciate against the USD and there may be macro risks around the corner.
- An absolute focus on detailed and readily-executable 100-day plans to be implemented immediately post acquisition to maximise the speed of business improvement and shorten the time to target MOIC.
- A focus on either having the right management in place and the ability to change management readily.
- Making opportunistic investments with an expected short (1-2 year) holding period through, for example, secondary purchases.

A challenge of African private equity appraisal is the short supply of investment-ready opportunities, which in developed markets have been prepared by the companies themselves or by intermediaries. Recent initiatives of creating virtual “deal rooms” such as those managed by Asoko Insight and Orbitt are a step in the right direction.

Potential IRR enhancement for African private equity



Source: Mbuyu Capital model & analysis.

Our analysis suggests that there is significant scope for IRR enhancement for African private equity, levelling up return potential to that of developed markets at a time when developed market private equity return expectations are falling to below 10%[1].

African private equity has had a similar historic risk profile to that of developed markets, while increasing use of leverage and rising acquisition multiples suggest forward-looking risk may not be fully reflected in developed markets’ historic return data.

Note: (1) 8%, according to eVest, see page 16.

For the full report and further information please contact:

Michiel Timmerman
Managing Partner
e mtimmerman@mbuyucapital.com
t +44 20 8133 2600

David Donahue
Partner
e ddonahue@mbuyucapital.com
t +44 20 8133 2600

Mbuyu Capital Partners Ltd
Michelin House
81 Fulham Road
London SW3 6RD
UK

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