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US development agency should take a lead in Africa

Finance corporation has the chance to help launch a new cadre of middle-market PE funds

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African private equity funds continue to struggle to raise capital compared with their global peers, despite operating in an unrivalled market of untapped and underserved opportunities. African PE raised only $1bn in 2017, less than 0.2 per cent of the $453bn total raised globally. In comparison, China and India, both with similar populations to Africa, accounted for roughly 14 per cent and 1 per cent, respectively.

With the passage of the Build Act and establishment of the US International Development Finance Corporation (USIDFC), the US has a unique opportunity to lead development finance institutions (DFIs) in streamlining the fundraising process to provide increased, broader capital to African markets, helping African businesses and diversifying US portfolios.

DFIs have long played a critical role in Africa's private equity industry, and continue to act as catalysts and early investors for nearly 50 per cent of the continent's funds. Given the real and perceived risk of investing in Africa, DFI investment can provide needed legitimacy to young private equity firms given its embedded strict environmental, social, and governance (ESG) requirements.

Yet, the fundraising process remains long and costly, preventing many potential managers from bringing their talents and energy to African PE.

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The PE industry in Africa is following global trends of increased capital concentration, While the number of funds in Africa has grown from just a dozen in the 1990s to over 200 firms today, 10 GPs accounted for 70 per cent of capital raised in 2014 and 2015, concentrating Africa's PE industry in too few funds.

Furthermore, 43 per cent of capital raised between 2014 and 2017 accrued to funds over $500m. The opportunities for large deals over $250m are not as widespread in Africa as in other regions. However, Africa has more than 10,000 companies with revenues between $10m and $100m.

These small and medium-sized enterprises (SMEs) have the ability to substantially impact Africa's development and create needed jobs on a continent with rising unemployment.

But today's mismatch between LP commitments and the underlying investments opportunities is leading to a vacuum of funds that can provide capital to SMEs. The new USIDFC has the opportunity to help transform the fundraising process, thereby democratising the industry and launching a new cadre of mid-market fund managers by:

1. Reducing Time and Cost

The average private equity firm takes over three years to raise money. Much of this time is spent travelling around to pitch to two dozen main DFIs each requiring different application processes and niche predilections. Each DFI has its own checklist reflecting political preferences. Some like post-conflict countries and others feel overweight Nigeria and Kenya.

The International Finance Corporation (IFC) often focuses on infrastructure and climate change funds, while FMO, the Netherlands' DFI, prefers funds focused on financial institutions and energy.

With its new ability to make equity investments, USIDFC should work with the leading DFIs to re-engineer the fundraising process to be more efficient and accessible for small to medium-sized fund managers. This could include requiring standard, universal pitch information and conducting panel-type interviews to avoid the repetitive nature of the current pitch process. This would allow funds to focus a greater percentage of time on building out their pipelines and post-investment value addition plans. Additionally, implementing a co-ordinated due diligence process with shared data and tech-based screening, DFIs can reduce transaction costs and increase the speed at which investment decisions can be made.

2. Accepting First-Time Fund Manager Risk

As a young and small industry, few African PE funds have lengthy, if any, track records. Many institutional investors are reluctant to back first-time funds given the increased risk and uncertainty. Yet there is a substantially higher number of first and second-time funds in Africa compared with other regions. In 2014, 78 per cent of funds holding final closes in sub-Saharan Africa were first-time funds.

While DFIs played a central role in creating Africa's PE industry in the 1990s, the IFC and others are increasingly investing in third and fourth-time funds of some of the largest PE firms instead of focusing on seeding new managers. DFIs' continued support of smaller, new funds is essential to grow Africa's private equity market and create more opportunities for public and private global limited partners.

Beyond investing in first-time funds, USIDFC can play a critical role in developing new and diverse managers. While many institutional investors have emerging manager programs, they are often focused on the US. DFIs should support emerging manager programs for African markets to help to cultivate the next generation of diverse PE managers.

3. Experimenting with Structure

While institutional investors will continue to follow tried and true investment strategies, DFIs are well placed to experiment with non-traditional structures that may be better suited to smaller markets, smaller funds, and a broader range of industries.

PE firms specialising in buyouts are often structured with three-to-five-year holding periods. However, in the African market where exit opportunities are more limited, and African SMEs are often in need of transformational organisational level change, DFIs should include more patient structures such as longer holding periods and permanent capital vehicle structures. This flexibility will allow funds to raise capital as needed instead of being limited to the traditional one to two-year fundraising period.

DFIs can further experiment with structure by supporting local currency debt funds. Given the high cost of local bank debt, external debt funds can provide much-needed working capital to growing SMEs. Many sectors critical for African economic development — agriculture, education and infrastructure — often require more patient capital as returns cannot be generated as quickly as in other sectors or in developed markets

The relative immaturity of the African PE industry affords USIDFC the unique opportunity to strengthen its future. USIDFC should lead in facilitating an environment where mid-market and first-time funds can actively and efficiently compete for capital. This will require close partnership with other DFIs and a willingness to be open to new managers with new approaches, and to look beyond traditional investment structures.

Just as they did in the 1990s, DFIs can once again play a pivotal role in shaping the future of the PE industry and the role it plays in Africa's economic development.

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