

VOLATILITY AND UNCERTAINTY: HOW PRIVATE EQUITY IN AFRICA NAVIGATES THROUGH TURBULENT TIMES





By launching this new research initiative, we hope to provide further enlightenment on investing in Africa and ultimately encourage greater capital inflow to the continent.

FOREWORD

We are delighted to present this inaugural edition of AVCA's special research reports, which explores how the African private equity industry remains resilient amidst currency volatility and unpredictable political environments.

Despite the hurdles faced by fund managers as a result of challenging macroeconomic conditions, private equity firms continue to identify ways to transform their portfolio companies and deliver long-term value, taking advantage of the opportunities presented by a growing consumer market amongst other trends.

AVCA's mission is to educate and equip stakeholders with valuable insight on the African investment landscape through our proprietary research. By launching this new research initiative, we hope to provide further enlightenment on investing in Africa and ultimately encourage greater capital inflow to the continent.

A better understanding of the strategies fund managers can employ in navigating currency and political risk should give more confidence in their ability to successfully withstand periods of turbulence.

We are grateful to our members and all participants who supported this important project by giving their time and sharing their perspectives.

We hope to continue deepening AVCA's research and driving Africa's growth story.

Kind regards,



Abi Mustapha-Maduakor

Chief Operating Officer
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Volatility and Uncertainty: How private equity in Africa navigates through turbulent times

This special report presents an exploration of the effects of currency volatility and political uncertainty on the African private equity industry, and provides insights into the strategies adopted by fund managers active on the continent to address the risks and capture the opportunities involved. It features views and experiences collected through a survey and interviews conducted with industry practitioners.

Key findings from our survey and case studies on political and currency risk in Africa:

- Our political risk survey highlights that 63% of GPs view currency and commodity price volatility as having been the most important macro factors in Africa over the past three years. 45% of GPs consider geopolitical risk to be the biggest macro risk over the next three years, while sector-level political risk involving regulatory change is of greatest concern to 52% of respondents.
- Most GPs (67%) consider political risk management when constructing their portfolios. GPs favoured diversification (55%) and the avoidance of risky locations (33%) as the main ways of managing political risk.
- Our political risk case studies show that macro-level risks can be weathered by investing in market-leaders in resilient sectors and by adopting expansionary strategies.
- While our survey respondents do not favour purchasing political risk insurance, it provides an alternative option for GPs. Providers such as MIGA, OPIC and ATI can insure against a wide variety of risks, and may offer dispute resolution services between investors and governments, which is useful for mitigating sector or company-level risk.
- Our currency risk survey highlights that most respondents (90%) perceive currency risk as being either important or very important. 78% of GPs claim that currency risk has increased in Africa, and 75% claim that it has had a detrimental impact on their realised investments.
- 73% of GPs see investing in resilient businesses as the most important strategy for countering currency risk. GPs consider Consumer Staples (55%), Healthcare (43%) and Energy (38%) to be the most defensive sectors in this regard.
- Finally, our currency risk case studies show that FX volatility can be weathered by focusing on the quality of business operations, expanding revenue streams, passing increased costs on to consumers, and reducing the need for hard currency by sourcing inputs locally.
- While traditional derivatives are unsuited to hedging multi-year investments, organisations such as TCX and some commercial banks can provide risk hedging solutions for investors at critical points of the investment cycle.

INTRODUCTION

Despite the declining macroeconomic conditions experienced in major African economies in recent years, the private equity industry on the continent has shown continued growth.

The total value of PE deals reported in Africa in 2016 reached US\$3.8bn (up from US\$2.5bn in 2015), with US\$2.3bn raised by African PE funds in 2016, following a record US\$4.3bn total raised in 2015, amidst declining global commodities and weakening local African currencies. However, investors typically cite concerns over political unrest and macroeconomic instability as major factors deterring their investment in emerging markets generally, and Africa specifically. For example, in AVCA's 2017 Annual Limited Partner (LP) Survey, 69% of LPs cited currency risk as the biggest challenge faced when investing in African PE, while 42% cited political risk. In this report, we unpack the nature of political and currency risk, noting how they can impact private equity investment, and outline how private equity fund managers can exploit, and have responded to, these risks.

Political risk, broadly referring to losses caused by the exercise of political power (or lack thereof), is identified as being of increasing importance to global markets, given the shifting political landscapes in many Western economies. With epoch-making events such as Britain's exit from the European Union, or the United States' election of President Trump in 2016, which were both largely unpredicted by pollsters, a revision of the traditional view of Africa's unpredictability relative to more developed markets bears consideration.

While political uncertainty will continue to be a major issue for Africa-focused investors, the continent's political situation is not uniform. There are distinct and distinguishable types of political risk. Firstly, there are those risks relating more broadly to the political outlook for a country (that is, its stability, including the prevalence of terrorism, and changes within the composition or policy focus of the government). Secondly, there are risks pertaining to individual sectors (including regulatory changes, or cuts in the prices that companies can charge, or the interference of vested interests or political actors, potentially resulting in nationalisation). Finally, there are risks pertaining to individual companies or projects of national importance (such as the unilateral renegotiation of existing contracts by new governments). One example is the termination by the Kenyan and Ugandan governments of PE-backed Rift Valley Railways' concession in 2017, due to its alleged failure to meet the terms of its contract.

It is worth noting the differing impact political risk can have on those investing in public markets, where investors often

have a shorter-term focus and are thus more sensitive to volatility, as opposed to those investing in private equity, where General Partners (GPs) can select superior companies according to long-term secular themes and manage them through short-term turmoil.¹ GPs can typically deal with political risk by avoiding deals in heavily regulated or risky industries or countries, by diversifying their risk, by investing in a range of sectors and geographies, or by purchasing insurance for terrorism or political risk. Though not yet widely used, the latter is becoming increasingly popular. For instance, since 2011, the Overseas Private Investment Corporation (OPIC), the US Government Development Finance Institution, has provided insurance for investors against the risk of losses caused by expropriation, currency inconvertibility, and political violence². Indeed, investors purchased US\$1.04bn of Sub-Saharan African risk insurance from the Multilateral Investment Guarantee Agency (MIGA) in the year ending June 2017. This was down from the US\$1.76bn purchased in the previous year, which was a record high for the continent³.

Importantly, GPs have historically invested successfully in locations where long-term economic development has been interrupted by intermittent periods of political instability

Importantly, GPs have historically invested successfully in locations where long-term economic development has been interrupted by intermittent periods of political instability, as we explore in our examples from our case studies. The Ethiopian political crisis that began with protests in 2014, and which saw the government declare a state of emergency in late 2016, has shaken some investors. However, 3 private equity deals were completed in both 2015 and 2016 in Ethiopia (compared to the average of 2 per annum from 2010 to 2014). Moreover, GPs continue to fundraise in the country, attracted by its positive economic

1 City A.M., 2017. Why is private equity surviving the storm? (<http://www.cityam.com/259786/why-private-equity-surviving-storm>).

2 OPIC, 2011. New OPIC Political Risk Insurance will cover investments by Private Equity Funds. (<https://www.opic.gov/press-releases/2011/new-opic-political-risk-insurance-will-cover-investments-private-equity-funds>).

3 Private Equity Africa, 2017. Africa risk hedging drops. (<https://privateequityafrica.com/africa-risk-hedging-drops/>).

fundamentals, which should help to create a more stable political environment in the long-term⁴. In fact, the country was ranked by LPs as the third most attractive country in Africa for PE investors in AVCA's 2017 Annual LP Survey. Similarly, despite the political upheaval of the Arab Spring, the number of deals (excluding multi-region deals) completed in North Africa remained stable, rising from 16 in 2010 to 21 in 2011, before leveling off at 18 in 2012. Also, total deal values for North Africa rose from US\$118mn in 2010, to US\$127mn in 2011, to US\$393mn in 2012.

There are some noteworthy events on the African political calendar. Kenyans headed to the polls in August and October 2017, while Nigeria is due to hold its next presidential election in February 2019. In South Africa, the African National Congress (ANC) will be holding its elective conference from the 16th to the 20th of December 2017, at which a new ANC President will be elected to contest the general elections of 2019. Nonetheless, political risk can be surmounted by experienced regional investors with well-developed local networks, who can identify superior companies benefiting from attractive long-term macroeconomic themes that trade at good valuations.

Looking beyond the impact of political risk on investment returns, currency risk has become increasingly important for investors in Africa, particularly with the backdrop of the collapse of commodity prices from 2014 onward, and the impact that this has had on the economies and currencies of commodity exporters on the continent, especially Nigeria and South Africa, Africa's two largest economies. The Nigerian Naira, for example, fell by 30% against the USD to NGN280 after the Central Bank of Nigeria removed its currency peg (fixed at NGN197 against the USD) in June 2016, in an attempt at redressing the country's foreign exchange reserve shortage. The currency has since declined further, trading at around NGN356 against the USD in early November 2017. The Egyptian Pound has also suffered steep falls, halving in value against the USD after the currency was floated in November 2016.

The impact of currency risk on private equity investment can take different forms. During the commitment period, LPs face the prospect of the amount of capital they commit increasing if the foreign currency that the fund is denominated in appreciates against the LP's home currency between the commitment and drawdown date. During the investment and distribution periods, LPs and GPs both face the prospect of hard-currency returns being reduced by any depreciation in the local currency, discouraging investment in non-exporting companies whose sales are primarily in local currency. Formally hedging currency exposure over the multi-year holding period of a PE investment, however, is generally too costly and difficult to achieve, given the unpredictability of the cash flows involved and the illiquidity of many African currencies. Hence, most investors have sought to hedge only by diversifying investments across geographies, although many free-floating African currencies have become more correlated in recent years.



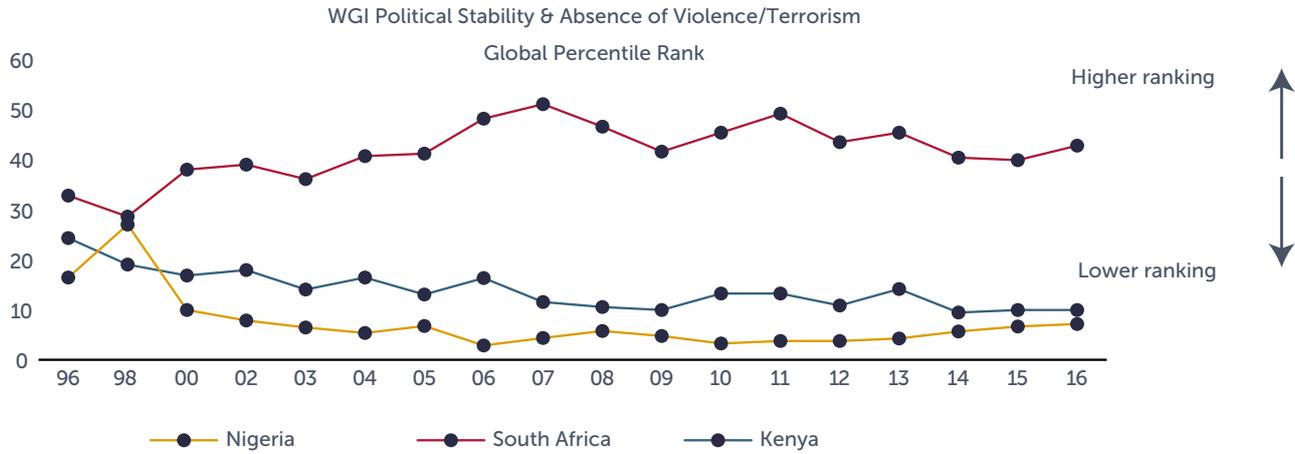
Looking beyond the impact of political risk on investment returns, currency risk has become increasingly important for investors in Africa, particularly with the backdrop of the collapse of commodity prices from 2014 onward

The oil-importing nations of East Africa, however, have seen slightly better local currency performance, in comparison.

Nonetheless, currency volatility can help foreign investors by creating opportunities for purchasing quality assets at reduced prices, with export-driven local companies becoming more attractive in this environment. The best time to make long-term private equity investments, after all, is not at the top of the market. In any case, the continent's growing consumption, and Africa's rapid rate of urbanisation, continue to provide compelling investment opportunities for PE investment in sectors that are relatively insulated from the immediate economic headwinds created by the declines in commodity prices and local currencies. In closing, what is perhaps of greater concern than political and currency risk is the perception of risk that investors have regarding Africa. As the examples presented within this report will illustrate, skilful investors can effectively navigate and surmount volatility and uncertainty in African investment. The focus for investors, then, should be on improving their understanding of the risk profile of each country and each opportunity under consideration.

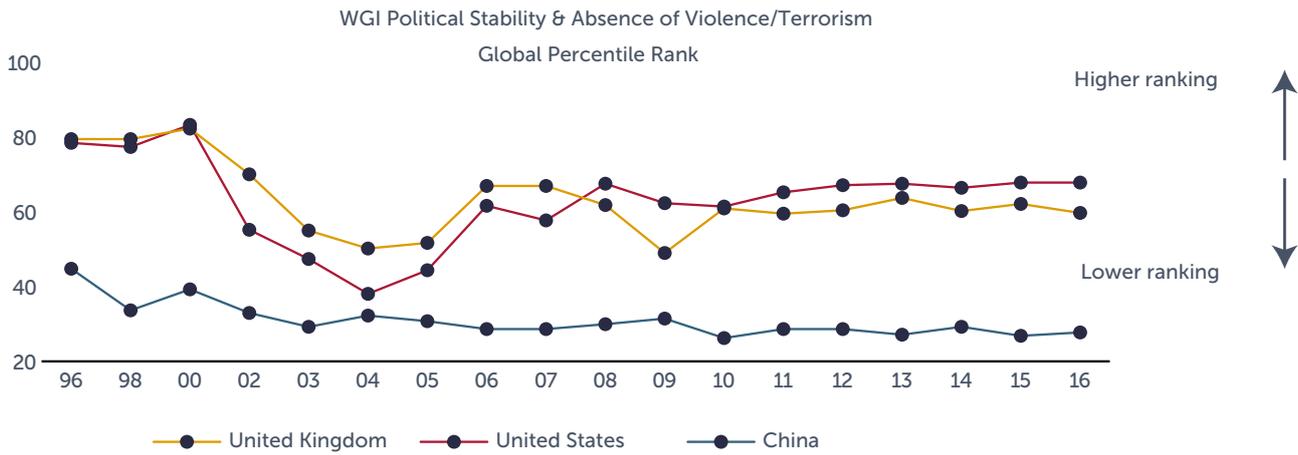
⁴ African Business Magazine, 2016. Ethiopia: Investors rattled by unrest, considering options. (<http://africanbusinessmagazine.com/region/east-africa/ethiopia-investors-rattled-unrest/>).

Figure 1: Political Stability in Major African Economies



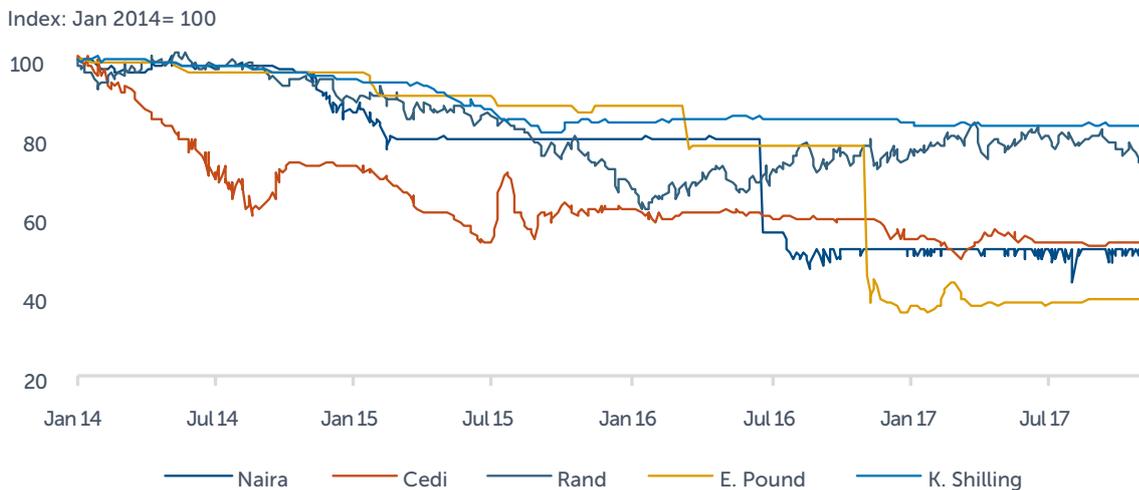
Source: World Bank (World Governance Indicators Database)

Figure 2: Political Stability in Major Global Economies



Source: World Bank (World Governance Indicators Database)

Figure 3: African Currencies Against USD, 2014-2017



Source: www.investing.com



POLITICAL RISK AND
AFRICAN PRIVATE EQUITY

Importance of Political Risk

For most GPs (63%), currency and commodity price volatility are the macro factors that have had the largest impact on their portfolios over the past three years, a period in which commodity prices, from oil to copper to iron ore, fell to their lowest level since the financial crisis of 2008 (see Figure 4). However, looking forward on a three-year time horizon, geopolitical risk was perceived to be of much higher importance: 45% of respondents identified it as the most critical macro risk that will impact their portfolios. This could be explained by the general elections in Nigeria and South Africa in 2019, and by doubts over the likelihood of further large commodity or currency falls, with several major African currencies looking more fairly valued compared to recent years.

In any event, the prospect of an emerging markets hard landing or central bank interventionism were not seen by most respondents to be of high significance to the performance of past or future portfolios. For example, only 29% of respondents chose an emerging markets slowdown as one of the top two factors that are likely to impact their portfolios in the future, with only 10% doing so for central bank activity.

Political risk was either important or very important for 69% of respondents (see Figure 6). As Figure 7 shows, sector-level risk, involving topics such as regulatory changes affecting certain industries, was most concerning to 52% of respondents, compared to macro-level risks involving issues such as mass civil unrest (38%). There is a slight difference in the profile of GPs identifying different levels of political risk as most important. Amongst respondents, 38% of those choosing macro-level risks as the most important had country-specific funds, whereas amongst those saying that sector-level political risks were most important, only 5% had country-specific funds.

Figure 4: Which macro factor had the biggest impact on your portfolio over the last three years?

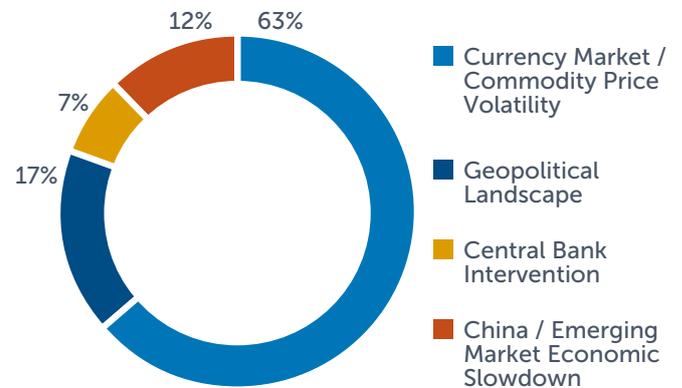
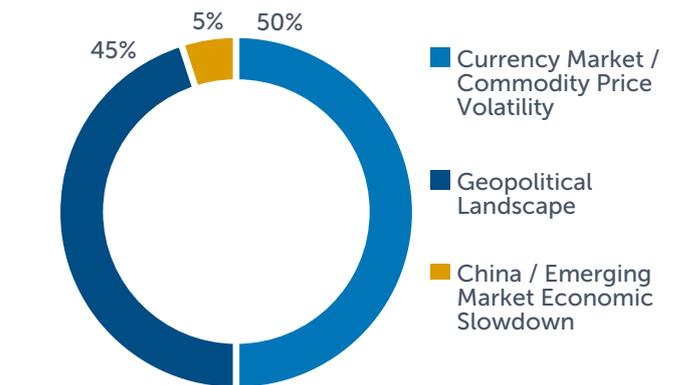
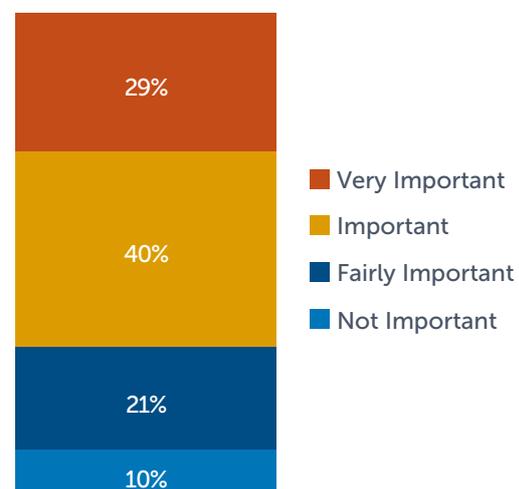


Figure 5: Which macro factor do you expect to have the biggest impact on your portfolio over the next three years?



(Central Bank Intervention: 0%)

Figure 6: Beyond a basic need for political stability, how important is political risk to your firm?



Note: Due to rounding, some percentages presented in this document may not add up to precisely 100%

Impact of Political Risk

GPs were divided on whether political risk in Africa had decreased over the past three to five years (40%) or had stayed the same (43%). Regional funds were more likely to see political risk as having decreased. Amongst those stating that political risk had decreased, 59% had funds focused on specific regions. This figure falls to 12.5% amongst GPs claiming that political risk had remained stationary. Conversely, Pan-African and Sub-Saharan African (SSA) funds were more likely to see political risk as having remained the same. Amongst those stating that political risk had decreased, 29% had SSA funds and 6% had Pan-African funds. Amongst those stating that it had stayed the same, 44% had SSA funds, and 25% had Pan-African funds. Respondents were also split on the question of whether political risk in any investment

geography had precipitated a change to their plans for exits (it had for 48% of respondents, and it had not for another 48%). The heterogeneity of political risk across Africa could explain the direction and impact of this broad divide. Improvements have been seen in countries like Côte d'Ivoire, Egypt and Morocco, which have emerged from either from civil war, mass civil unrest or revolution, while other countries, such as Ethiopia or South Africa, have faced headwinds, and others have seen relatively few developments.

For most GPs, political changes either had no effect (29%) or a negative effect (38%) on their realised PE investments (Figure 10).

Figure 7: Which form of political risk is your biggest concern as an investor in Africa?

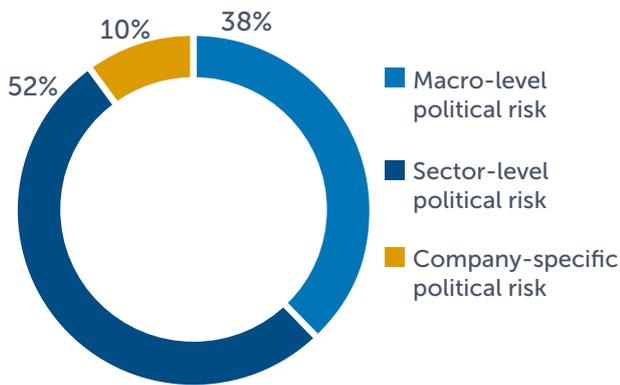


Figure 9: Has political risk in any of your investment geographies caused you to amend your exit plans?

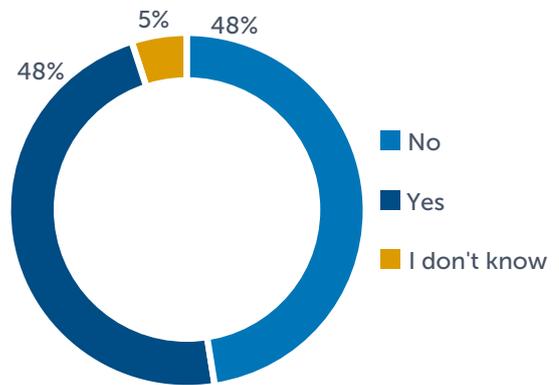


Figure 8: How has political risk in Africa changed over the past 3-5 years?

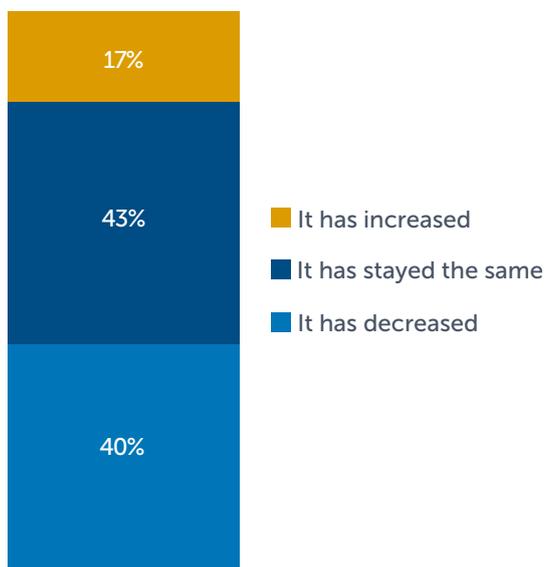
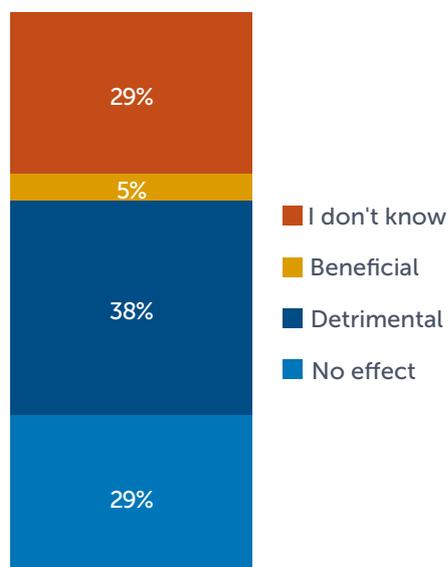


Figure 10: What effect have political changes had on your realised investments?



Managing Political Risk

Moving on to the mitigation of political risk, two-thirds of GPs include political risk management as a specific aim when constructing their portfolios, while one-third do not (Figure 11). Figure 12 shows that diversification across countries or sectors (55%) was the most important method for managing political risk. This is followed by simply avoiding or withdrawing from locations with high political risk (33%). Of course, there are unique suggestions. For example, within the 'Other' category, one respondent representing a single-country, single-sector fund, highlighted diversification across national regions as its preferred approach. Another respondent within the 'Other' category emphasised the importance of building relationships with policymakers to facilitate closer monitoring of political developments.

Furthermore, the global political risk insurance industry has matured in recent years. According to OPIC⁵, the industry now writes over US\$1.5bn in annual insurance premiums for political risk, and by providing protection against risks like political violence and civil disturbance, expropriation and confiscation, transfer restrictions or currency convertibility, it has stimulated the growth of FDI across emerging markets. However, purchasing political risk insurance is not a popular strategy amongst the GPs surveyed. Figure 12 shows that purchasing insurance was not the main mitigatory option

for any respondent, and, as Figure 13 shows, only 10% of GPs have purchased it. 39% of GPs went further by claiming that it is unnecessary, given that the risk can be managed in other ways (through diversification or outright withholding of investment, for example). Finally, 22% of GPs claimed that it is too expensive, while another 22% stated that they were unfamiliar with the suite of political risk insurance products that are available (see Figure 13).

Figure 11: Do you include political risk management as a specific aim when constructing your portfolio?

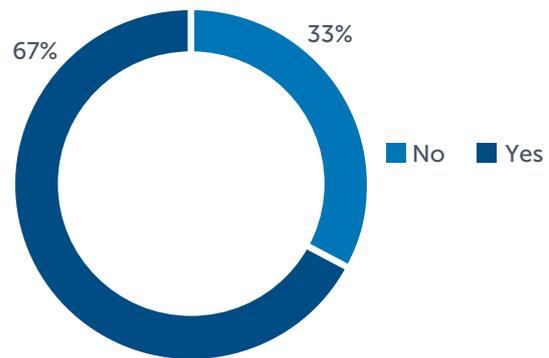


Figure 12: What is the main strategy that you adopt to manage political risk?

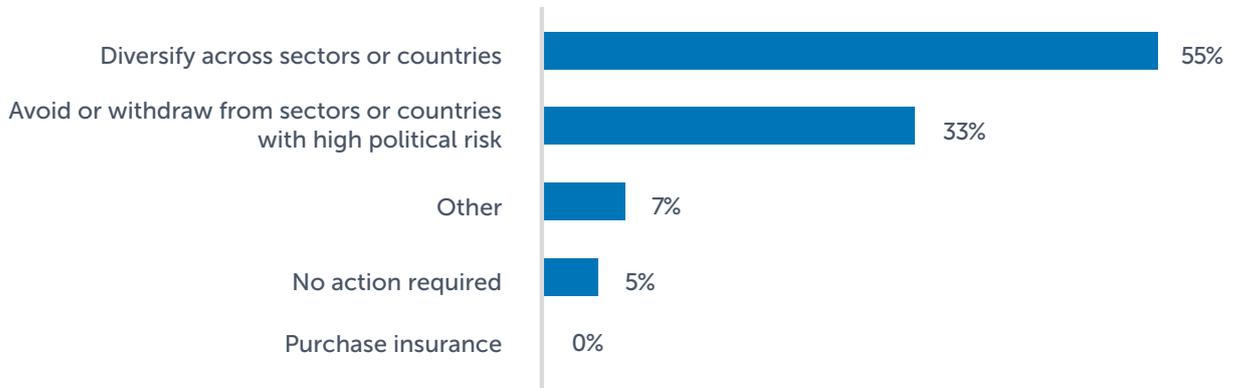
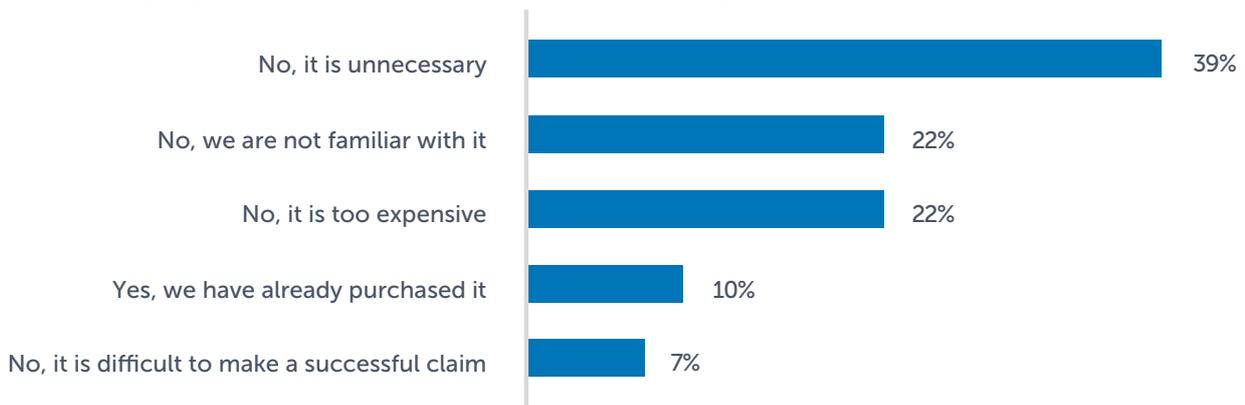


Figure 13: Have you purchased political risk insurance? If not, why not?



⁵ OPIC, 2016. Why Political Risk Insurance is critical to the global economy. (<https://www.opic.gov/blog/uncategorized/why-political-risk-insurance-is-critical-to-the-global-economy>).

Case Studies: Strategies Adopted by African Fund Managers to Mitigate Political Risk

This section presents a discussion of the diverse strategies adopted by GPs to manage various kinds of political risk, informed by conversations with GPs and providers of political risk insurance.

Political risk mitigation starts at the pre-investment stage. A sector-focused GP noted that part of their protocol involves screening for and avoiding shareholders or sponsors with political backgrounds, to avoid complicated or damaging conflicts, or a potential scenario in which funds with an unclear source have also backed a company that they have invested in. Considering the relationship between existing shareholders or sponsors and the current government also forms a part of the due diligence process. Once political risks have been factored into investment forecasts and the investment has been made, political issues, such as unexpected changes in sector regulations or ineffective implementation of government policy, are then generally shouldered by the investment company. Liaising with political actors and lobbying governments can also improve the environment in which investment decisions are made or in which investment companies operate. For example, a regional GP noted that, by engaging with intelligence agencies and political actors, they could assess the likely direction of political events and make well-informed decisions.

Once a political event has occurred, concentrating on the consumer and the quality of business operations is important for withstanding the turmoil. For example, in 2008, **Adenia Partners** invested in Newpack, a leading cardboard manufacturer in Madagascar. The Madagascar political crisis that began in early 2009 with widespread protests and a coup drove GDP per capita to record lows and harmed local consumption. Nonetheless, from 2008 to 2014, Newpack's exports as a percentage of sales rose from 2% to 30%, revenue increased by 55%, and EBITDA increased

by 132%, due to the company's focus on business and product development⁶. Similarly, **AFIG Funds** noted that geographical diversification is always key to mitigating the impact of a political event overall on an investment. For example, in the complicated aftermath of the disputed 2012 Ghanaian election, AFIG Funds expanded RMG Concept, a leading distributor of crop protection products, into several other countries (currently 16).

"We invested in Mali's agricultural sector in the early 2010s, and were confronted by a coup d'état in 2012. However, we were relatively unaffected, due to the sector's natural defensiveness and a drought in 2011 that increased demand for industrially produced seeds, with sales improving that year"

Jerry Parkes, Injaro Investments

Another example is the **Actis** investment in Edita Food Industries, the leading branded snack food business in Egypt and North Africa, in June 2013. This deal was completed on June 24th, 2013, shortly before the mass protests that broke out in Egypt on June 30th, which eventually resulted in the removal of President Morsi from power on July 3rd, 2013. Actis stated that the main lesson learned was the importance of "holding their nerve". They knew that they were purchasing a well-positioned and fast-growing business, and were backing a top-notch management team. These factors enabled Edita to trade well through the riots and the general upheaval. Actis had originally planned to exit Edita in 2018, but due to its strong performance, they were able to exit the investment in stages between 2015 and 2017, including a heavily oversubscribed IPO in 2015.

"Expanding the investment company into new regions is always central to our thesis and helps us in times of political uncertainty"

Kelechi Okoro, AFIG Funds

⁶ Adenia Partners. Case Studies. (<http://www.adenia.com/case-studies/>).

Exit timing is another facet of political risk management, with GPs often seeking to time their exits around election periods. For instance, **Injaro Investments** also invested in a seed production company in Burkina Faso in 2013, for which the government was one of its largest clients. They structured their exit to be achieved gradually ahead of the next elections planned for 2015, so that by the time of the failed coup d'état in September 2015, they had exited 60% of the investment.

As illustrated in the case studies above, the use of political risk insurance is not very widespread. GPs have relied on diversified investment strategies to mitigate political risk. Some GPs that were interviewed argued that the potential for high insurance premiums, the difficulty in making a successful claim given a high number of exclusions, and their own expertise in navigating difficult markets, prejudiced them against using political risk insurance.

However, as the number and level of sophistication of African investors has been increasing over time, driving a search for a competitive edge, so has the use of insurance to mitigate political risk. The **Multilateral Investment Guarantee Agency** (MIGA) is an organisation focused solely on providing political risk insurance and credit guarantees in emerging markets. Along with other insurance providers such as the **Overseas Private Investment Corporation** (OPIC), and the **African Trade Insurance Agency** (ATI), MIGA pioneered the African political risk insurance market. A variety of political risks are typically covered. These range from insurance for political violence and civil disturbances, to insurance for assets and shares expropriated by the government, to insurance for contracts breached by the government, to insurance for when investors are unable to access hard currency for making dividend and loan repayments due to FX restrictions.

According to MIGA, typical coverage sizes in the consumer sector range from US\$10mn-US\$20mn, whereas coverage for the infrastructure and energy sectors can run into hundreds of millions of dollars.

Also, out of about 850 projects that it has supported over the years, MIGA has paid out 9 claims, of which 7 were related to political violence, and has successfully resolved disputes between investors and governments in over one hundred cases. MIGA's pricing is market based and comparable to private insurers', although in more challenging countries in Africa, it may have greater appetite than the private market as it does not amend its tenors to mitigate risk - its tenors are generally always between 15-20 years. MIGA also syndicates reinsurance from the private market for additional capacity when a certain exposure is reached on a project. One example of MIGA's political risk insurance coverage is the Azura-Edo Independent Power Producer (IPP) project in Nigeria, for which MIGA provided guarantees totalling

"Stronger businesses are better able to cope in times of turmoil, and can displace weaker players that tend to fizzle out in difficult circumstances"

Sherif Elkholy, Actis

US\$492mn for equity investors and lenders in 2015. Also, in 2014, **Actis** used MIGA to cover a US\$300mn exposure in the Cameroonian company AES Sonel, insuring against war, civil disturbance, expropriation, and other factors⁷.

Finally, an intermediary firm that brokers political risk insurance, working with both public and private risk insurance providers for Africa, also reported increasing use of their services for political risk advisory purposes to support PE fundraising activity, and general increasing uptake and interest from PE firms on the continent.

7 Private Equity Africa, 2014. Actis gets \$300m Sonel risk hedge. (<https://privateequityafrica.com/actis-gets-300m-sonel-risk-hedge/>).



CURRENCY RISK AND AFRICAN PRIVATE EQUITY

The Importance and Impact of Currency Risk

In the context of some of the historical difficulties faced by emerging market currencies, which came under pressure in recent years from falling oil prices, a stronger USD, and concerns over Chinese growth, it was unsurprising that 90% of respondents highlighted currency risk as being either important or very important to their firm (Figure 14). Additionally, 78% claimed that currency risk in Africa has increased over the past 3-5 years (Figure 15), and 75% noted that currency volatility had had a detrimental impact on their realised PE investments (Figure 16). Also, there was close to an even split amongst respondents as to whether currency risk had led them to amend exit plans (Figure 17).

Figure 14: How important is currency risk to your firm?

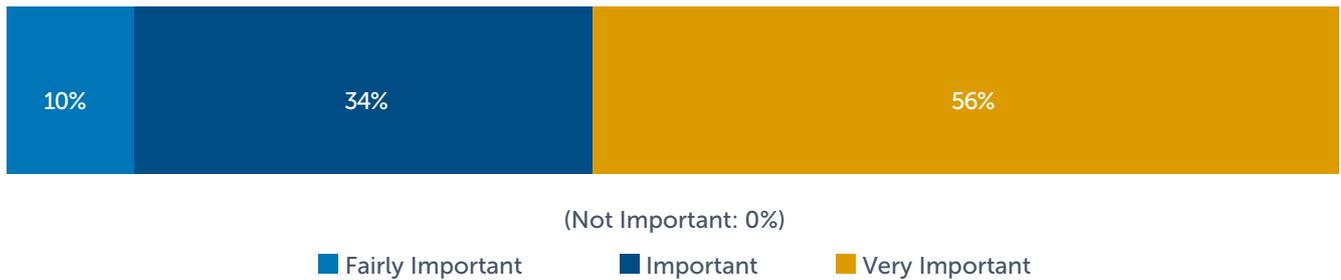


Figure 15: How has currency risk in Africa changed over the past 3-5 years?

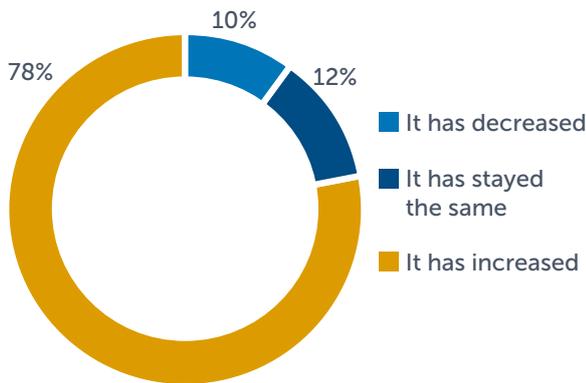


Figure 17: Has currency risk in any of your host countries caused you to amend your exit plans?

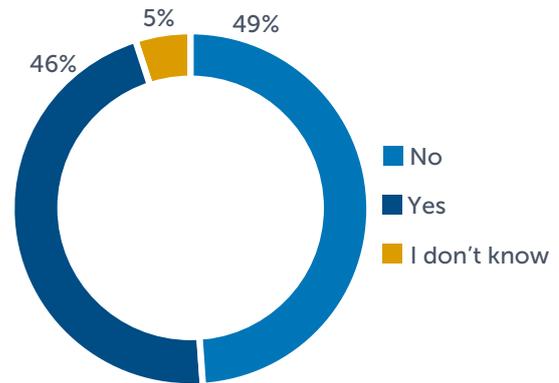


Figure 16: What effect has currency volatility had on your realised PE investments?

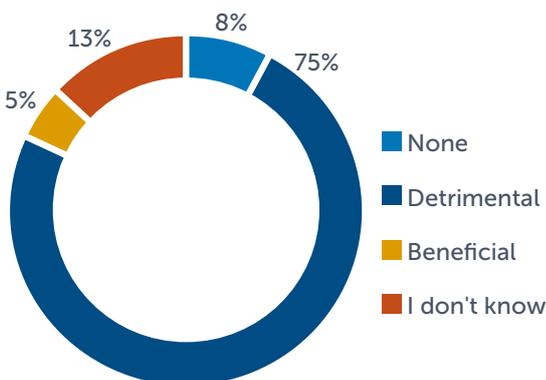
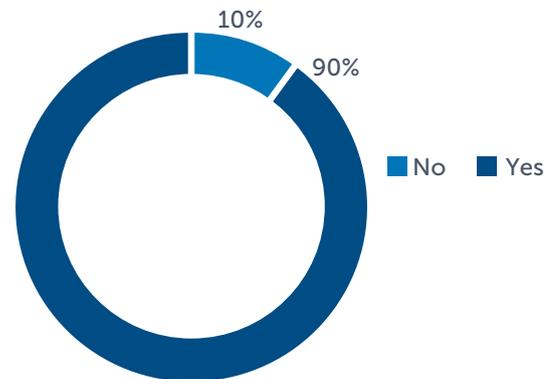


Figure 18: Do you include currency risk management as a specific aim when constructing your portfolio?



Managing Currency Risk

GPs often construct their portfolio with currency risk mitigation as an explicit objective, both in investment selection and in deal structuring; as Figure 18 shows, currency risk management is a specific aim of 90% of respondents in portfolio construction.

Regarding the strategies adopted to manage currency risk, investment in businesses resilient to currency weakness is a key theme. Exporters whose hard currency revenues hedge their local currency costs can potentially benefit from local currency weakness, while local currency revenue earners with sufficient pricing power can pass currency falls on to consumers through higher prices. Alternately, market leaders can gain market share by keeping prices low to drive out competition. Of course, revenue growth in local currency terms may be high enough to still constitute an attractive investment for foreign GPs.

Overall, investment in resilient businesses was highlighted by 73% of GPs as the most important strategy for managing currency risk (Figure 19). As Figure 20 shows, the sectors

seen as having underlying businesses most resilient to currency weakness were Consumer Staples (55%), Healthcare (43%), and Energy (38%). Meanwhile, Utilities (10%), Materials (13%) and Consumer Discretionary (13%) were ranked as the least resilient sectors by respondents. Portfolio diversification is another option for PE investors seeking to hedge FX risk; 71% of GPs chose diversification as the second most important strategy (Figure 19).

Finally, traditional derivatives for hedging, such as FX options and FX swaps, are unsuited to hedging multi-year PE investments. TCX, a DFI-backed organisation that provides FX risk hedging solutions to investors in Africa, noted that most of the activity that they witness amongst equity investors is concentrated on hedging exposure only at entry and exit. Accordingly, 93% of GPs selected hedging with financial instruments as the least important strategy for managing currency risk (Figure 19).

Figure 19: GPs' ranking of the importance of strategies used for managing currency risk

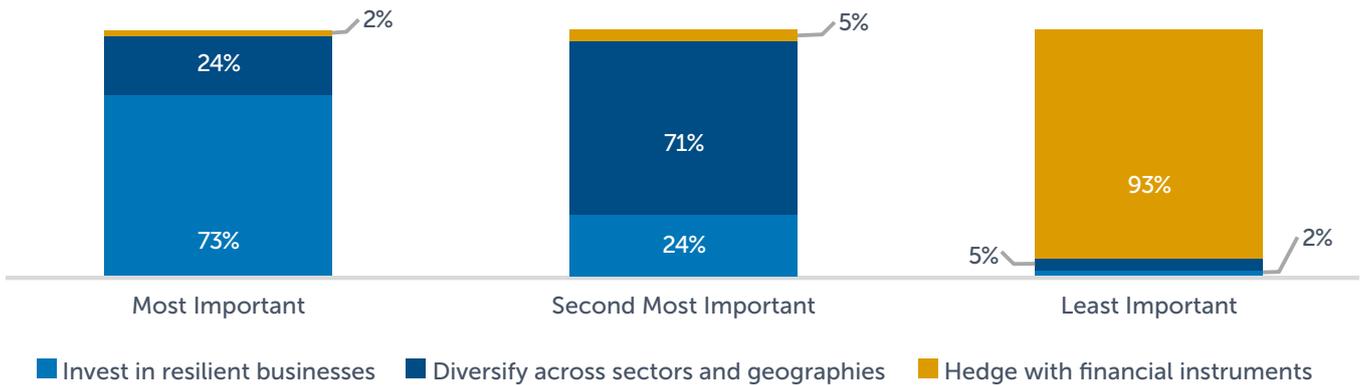
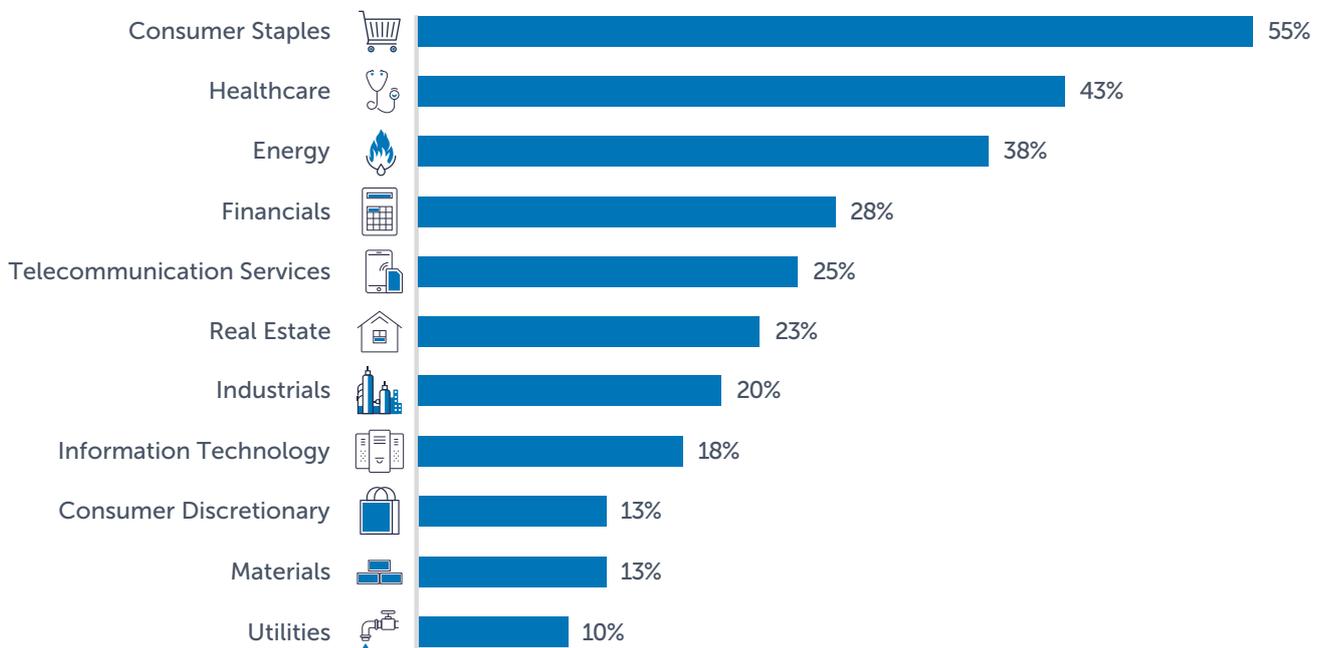


Figure 20: GPs' selection of the top three sectors most resilient to currency weakness



Case Studies: Strategies Adopted by African Fund Managers to Mitigate Currency Risk

In this section, we present some examples that show the diverse ways in which GPs have planned for and reacted to currency volatility in Africa.

AFIG Funds and FSDH Merchant Bank

AFIG Funds' investment in 2016 in FSDH, a leading merchant bank in Nigeria, illustrates the options considered by GPs to reduce currency risk at the pre-investment stage. AFIG Funds, as manager of USD-denominated funds, faced a scenario where, following the precipitous decline in the value of the Nigerian Naira, there was a 70% divergence between the official and parallel market rates, suggesting that an official devaluation was likely. Given that, as an equity investor, AFIG Funds would have to invest in FSDH in local currency, it would be exposed to significant FX risk, immediately recording a loss on their investment in USD terms if the feared official NGN devaluation occurred.

In their pre-investment planning, AFIG Funds therefore sought to disburse their investment to FSDH without taking an immediate local currency risk. They also wanted the structure of the hedge to provide optimal flexibility to minimise the downside in any scenario, given that the timing of the devaluation and the process by which it could be carried out (phased or one-time) was unknown.

Response

AFIG Funds considered a number of options. It initially assessed the use of structures that would enable it to raise money in local currency, either through a bank loan, fully backed by hard currency assets, or the issuance of notes to be subscribed to by a local asset manager, again backed by hard currency assets. The debt or notes would then be redeemed in the event of a devaluation, from conversion of the hard currency instrument serving as security for the loan or notes.

These options would have been effective strategies for a non-banking investment, but due to uncertainty on the compliance of this approach with regulatory requirements and a desire to err on the side of caution, they were eventually rejected in favour of more traditional hedge approaches, such as futures, forwards, and swap contracts, with a preference for futures due to lower cost and counterparty risk.

Eventually, due to the relatively short tenor of the traditional hedges, AFIG Funds opted to construct a more tailored solution in agreement with the investee company.

Adenia Partners and DDP Outdoor

Adenia Partners' 2014 investment in DDP Outdoor (DDP), an outdoor advertising firm based in Ghana, illustrates some of the strategies employed by GPs operating in difficult FX environments. DDP enjoyed a leading market position in outdoor advertising, a large and growing market in Ghana, high profitability margins, a cash generative business model, and potential for further value creation through improvements in financial reporting, operational planning and environmental, social and governance (ESG) measures.

Prior to the investment in 2014, DDP had no specific protocol to manage currency risk. In 2014, the Ghanaian Cedi experienced a significant depreciation against other major currencies, losing around 37% of its value against the dollar, and finishing the year as the worst performing African currency. This heavily impacted the overall economy, significantly reducing consumer spending, and led companies to cut back on their discretionary marketing expenditure.

Response

The decline of the Cedi limited DDP's revenue potential during the period. Post-investment, to

mitigate the impact of the falling Cedi, Adenia Partners regularly reviewed customer prices and margins and passed on any cost increases, albeit with a time lag as customer agreements could only be adjusted every 6-12 months, and at the expense of lost sales. This helped to maintain profit margins and lower cash flow volatility. Additional measures were taken to reduce the cedi-denominated cash reserves to dollars.

However, since the currency stabilised in mid-2015, the overall economy has rebounded. Strategies now in place to reduce currency risk at DDP include import substitution – increasing the proportion of raw materials sourced domestically without impeding quality; pass through of cost increases caused by a falling currency; geographical expansion to other African countries like Senegal; and building out new complementary revenue streams to increase its earnings potential.

As a key take-away, Adenia Partners learned that it was better to maintain prices in hard-currency, taking a short-term hit in sales, rather than maintaining sales volume by not raising prices. This successfully increased sales at DDP by approximately 27% in the 2 years following the investment.

Development Partners International (DPI) and the Company

During the Naira's decline in 2016, DPI's management of the Company, an operator of consumer food retail outlets in Nigeria, is indicative of the measures that can be adopted post-investment to counter FX volatility. DPI invested in the Company to access a high growth sector, driven by a consumer market with rising disposable income and changing consumption patterns. There was significant upside potential from supply chain improvements, product and brand extensions, franchising and technology improvements. However, the Nigerian Naira (NGN) declined against the USD on the parallel market from around NGN268 at the end of 2015 to around NGN495 at the end of 2016. This led to food inflation of over 40%, as well as severe FX scarcity. The devaluation and subsequent imported inflation placed severe strains on the Nigerian consumer and led to a recession in the broader economy.

"We have weathered Ebola, elections, currency crises, supply challenges and constant power outages, and yet we have continued to grow. In part, this is down to management below the CEO not spending too much time worrying about macro issues, and constantly focusing on the customer and on operational excellence"

The Company's Managing Director

Response

The Company had already launched an affordable value meal package aimed at attracting and retaining the emerging middle class in January 2016, partly due to expectations of a challenging economic climate. In parallel, it aggressively localised its supply chain, significantly increasing the share of local purchases within 12 months, limiting the impact of price inflation and its foreign currency needs. The Company aggressively cut back on expatriate management from 6 to 2 employees to limit foreign currency salary costs. It negotiated extensions to payment terms in partnership with suppliers in recognition of harsher economic realities.

The Company had always closely monitored FX needs and stress tested the budget. However, the 2016/2017 devaluation fell outside almost all market expectations. While the devaluation created a valuation headwind in USD terms, the business drove strong transaction growth by offering a quality product at a very affordable price point in troubled times, and gained market share. Additionally, it developed a significantly improved local supply chain and permanently substituted a significant portion of previously imported goods.

Over and above the actions mentioned above, the Company is now following a franchise model to expand outside Nigeria to diversify revenue streams beyond NGN. In future, DPI stated that it is necessary to stress test the budget harder against currency swings. Overall, they attribute their success in driving transaction growth in African markets challenged by recessions, currency swings, elections, and constant power outages, to a relentless focus on the consumer and the quality of their business operations.

"In times of currency weakness, only leaders in their markets which command some pricing power vis-à-vis their clients can maintain their margins"

Antoine Delaporte, Adenia Partners

Currency Risk Hedging

While our survey showed that the use of insurance to mitigate currency volatility was not widespread amongst respondents, it does provide an additional option for concerned investors.

For frontier currency-hedger **TCX**, Africa is the core business. Established in 2007 by a selection of development finance institutions, including the African Development Bank, and with the German and Dutch governments as first loss providers, TCX offer FX risk hedging solutions in areas historically neglected by traditional banks. Over the past decade, TCX has grossed over US\$5bn of hedging transactions across frontier currencies. Provided with over US\$170mn of first-loss coverage by the German and Dutch governments, TCX has provided hedging solutions

in countries such as Kenya, Madagascar, Malawi, Nigeria, Sierra Leone, Tanzania, and Uganda, providing only linear products such as FX forwards and FX swaps (but not options). Accepting that for GPs to hedge FX risk across their entire investment horizon might jeopardize their returns and their promises to LPs, TCX argue that their services could be most appropriate in the current environment when investors have set an exit date for the near future, to protect their exit return. Near-equity investments that have predictable cash flows can also be suitable for hedging.





CONCLUSIONS

Conclusions

Political and currency volatility will continue to be a part of investing in Africa. High profile events like the repeated general elections in Kenya in 2017, or the devaluation of the Egyptian Pound and Nigerian Naira in 2016 after attempted defences of capital controls, will occur on occasion and capture the attention of the world's media. Meanwhile, events of a lower profile, such as the renegotiation of a government tariff, or difficulties in sourcing hard currency, will continue in the background. However, the case studies presented in this report illustrate that skilful investors with advanced regional knowledge can successfully invest in African companies despite macro headwinds.

Looking forward, how will improving living standards and economic development affect political and economic volatility in Africa? Broadly speaking, longer-term improvements in Africa's business environment are likely to reduce political volatility, while shorter-term macroeconomic instability, often involving currency volatility, can feed through into political instability⁸. For example, while Brent crude has stabilised over the past few months to trade in the low-US\$60s as of November 2017, further declines in the price of oil could lead to reinstated currency controls, regulatory crackdowns or increased taxes in a bid to raise revenues, or social unrest due to the damage caused to key economic sectors.

While the long-term march towards economic development and political stability in Africa is likely to experience occasional setbacks, Africa's wealth is expected to rise over the next few decades, with increasingly urbanised populations, and larger middle-classes with better access to technology and information. Better educated and wealthier populations will increase demands for accountable government.

However, continued urbanisation will intensify the strain on housing and public services and raise competition for jobs. This could potentially magnify popular dissatisfaction

and the appeal of populist movements⁹, compounded by technological change that can undermine traditional, labour-intensive sectors but also enable the rapid spread of social unrest. As shown historically by the Arab Spring uprisings in North Africa in 2011, the changes in government seen in Nigeria and Tanzania in 2015, or the protests and upheaval in Ethiopia in 2016, popular demands for accountability and transparency in government in Africa will have ramifications that investors must consider. Such concerns are, however, not unique to African investors. Moreover, private capital can pre-empt these issues by investing in sectors that support economic diversification (thereby mitigating natural resource-linked currency volatility), and advance social welfare by improving urban infrastructure and creating jobs. Private capital will thus have a key role to play in fostering a more stable economic and political environment in Africa.

Overall, we hope that this study has provided some useful insight and will stimulate dialogue in the industry on managing, mitigating and navigating the macroeconomic headwinds that are part and parcel of long-term investment on the continent. We expect this to be a subject worth revisiting and welcome feedback and comments from readers.

⁸ Global Risk Insights, 2015. What to expect in 2016 in Africa. (<http://globalriskinsights.com/2015/12/what-to-expect-in-2016-in-africa/>).

⁹ Democracy in Africa, 2017. The future of African politics. (<http://democracyinafrica.org/future-african-politics/>).

Participant Demographics

AVCA surveyed 42 respondents in August and September 2017, from PE firms headquartered globally.

Figure 21: In which region is your head office located?

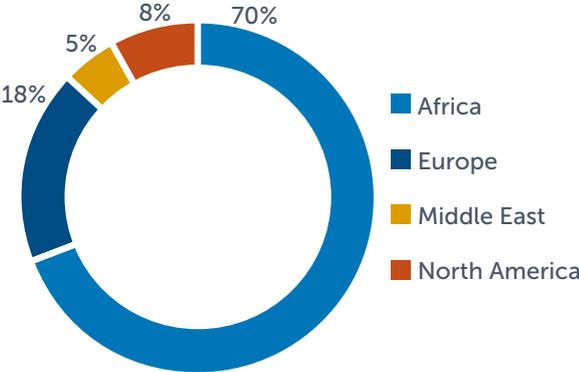


Figure 22: What are your total African assets under management?

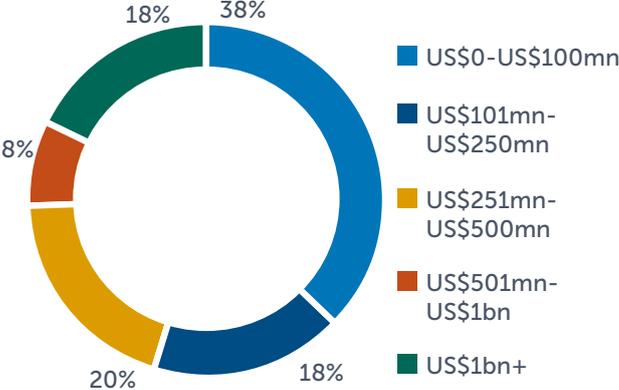
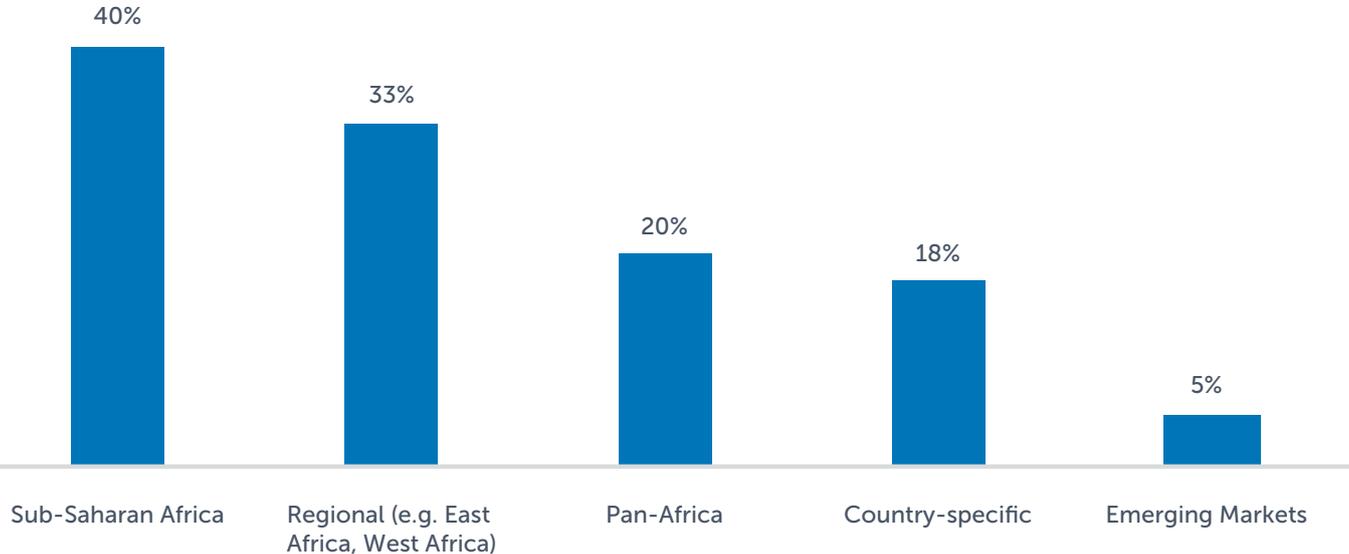


Figure 23: What is the geographic remit of your PE funds? (Please select all that apply)



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