

Currency Risk Management Practices in African Private Equity and Venture Capital

March 2022



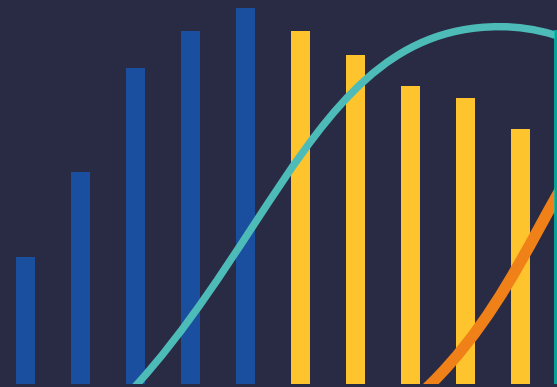
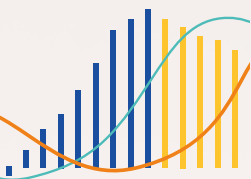


Table of contents

Currency Risk Management Practices in African Private Equity and Venture Capital

Foreword	3
Executive Summary	4
Introduction	6
Importance and Impact of Currency Risk in African Private Equity and Venture Capital	11
Currency Risk Management and Hedging Practices in African Private Equity and Venture Capital	18
Ask the Expert	28
Participants' Profile	38



Foreword

The African Private Equity and Venture Capital Association is pleased to present the *Currency Risk Management Practices in African Private Equity and Venture Capital Report*, produced in collaboration with The Currency Exchange Fund (TCX) and MFX Solutions (MFX). The second of our special report series on navigating volatility and uncertainty in Africa's investment landscape, this report exemplifies our commitment to providing topical, independent, and thoughtful research to the industry.



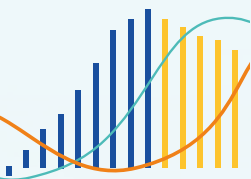
Abi Mustapha-Maduakor

Chief Executive Officer, AVCA

Amidst an increasing appetite for private capital in Africa, concerns related to currency illiquidity and volatility remain significant barriers to growth. As Africa's innovation ecosystem continues to expand, and investor interest in the boundless opportunities on offer multiplies, the demand for timely, reliable and competitively-priced sourcing of currency will only intensify. So too, will the demand for contextually relevant currency risk management strategies and sophisticated hedging products catered to the unique needs of African fund managers. AVCA's research partnership with TCX and MFX is an exploration of this pressing challenge for businesses and investors alike in Africa. The report provides data and insights on how limited and general partners operating in Africa can successfully address currency risk on the continent and manage their FX exposure whilst capturing the opportunities in the African private equity and venture capital industry.

At AVCA, our mission is to champion private investment in Africa, educating and equipping stakeholders within our industry with valuable insights to support the investment ecosystem. In that vein, this report is an exposé of the importance and impact of currency risk, offering strategies for currency risk management and hedging practices, as well as an overview of the challenges accompanying currency risk management in African Private Equity and Venture Capital.

We would like to extend our sincere appreciation to the fund managers and limited partners that participated in this report by giving their time and sharing their perspectives, as well as to the AVCA members that supported this important initiative. We look forward to continuing our bespoke research on the nuances of investing in Africa, and in so doing ultimately encourage greater capital inflow to the continent.



Executive Summary

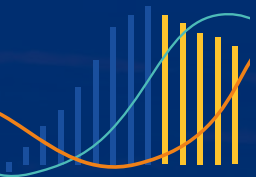
The *Currency Risk Management Practices in African Private Equity and Venture Capital* report convenes survey results from 37 GPs and 26 LPs engaged in African private equity. It assesses their views of the importance and impact of currency volatility, as well as their strategies for evaluating and managing the same. The survey respondents represent a broad cross-section of investors by type, size and location.

The study begins with an overview of the nature of currency risk in private equity, analysing the key market drivers that contribute to increased currency volatility on the continent. Foreign exchange volatility and foreign currency shortages remain some of the biggest challenges facing private equity investors in Africa. Exemplifying this, 64% of **LPs** and 86% of **GPs** surveyed **perceived currency risk as important** or **very important** when investing in African private equity, with over half of each cohort going further to maintain that currency risk **has slightly** or **significantly increased** in the last 2-4 years. Of note, the survey illustrates that although currency risk is present throughout the investment process, it **was most impactful for both fund managers and limited partners at the time of portfolio exit**.

Having established the pertinence of currency concerns to African investors, the study proceeds to investigate how the industry navigates this risk. GP respondents gave higher credence to the importance and necessity of adopting currency risk management strategies than LP respondents. This is evident in the **increasing proportion of fund managers with a formal written policy for managing currency risk** in place (53%), up from just (29%) in 2017. From the **LP** perspective, over half that participated in the survey **require a comprehensive FX scenario analysis** when onboarding an African fund manager, although over a third also report not having any specific requirements related to the management of currency risk. That said, a significant majority of **both GPs and LPs** surveyed **favoured natural hedges** (specifically portfolio diversification different sectors and geographies) as a strategy for managing currency risk in Africa, with only a minority of both cohorts favouring **hedging with financial instruments**.

Although the importance of hedging currency exposure in some form is unanimous, the survey respondents were also cognisant of a number of challenges related to the mitigation of currency risk in Africa. An overwhelming majority (94%) of GPs that participated in the survey cited the **high cost of hedging facilities** as the main factor preventing them from making use of them. Cost was also the largest concern for LP respondents, although to a slightly lesser extent (only 50% identified this as a barrier).

To address some of these key concerns raised by survey respondents, the report concludes with an “Ask The Expert” collaboration with The Currency Exchange Fund (TCX) and MFX Solutions (MFX). This expert commentary responds to key questions raised by both limited and general partners on currency risk management strategies and hedging practices unique to Africa’s investment landscape. In this section, TCX and MFX identify relevant hedging products on offer to international equity investors in local African currencies. It also provides an overview of FX Options and FX Forwards, their relevance and applicability in the African context; and finally, guidance on how both limited and general partners should think about risk across the various stages of the investment lifecycle.



Introduction

As private equity markets have become more integrated and limited partners invest in private equity funds across the globe, currency risk presents growing challenges for both limited (LPs) and general partners (GPs). The problem of currency volatility, which has long been of concern to investment professionals, became a particularly pressing issue in the last two years as the global economy grappled with the Covid-19 pandemic. At the height of the global pandemic, African economies witnessed capital flight from concerned investors and downgrades by credit rating agencies to below investment grade. Foreign Exchange (FX) markets were also significantly impacted by the Covid-19 pandemic, which in turn affected the balance sheets, valuations and financial reporting for financial institutions globally.

Managing currency volatility is arguably inherent to the practice of private investment more generally; with this base risk only amplified or diminished by the relative maturity of the market of investment. Exchange rates fluctuate, especially over the longer holding periods typical of private equity investments. This is more acute in emerging markets, where foreign exchange markets are not as mature or liquid comparative to developed markets. As such, foreign exchange risk is not unique to the African context. Private equity fund managers that invest their capital on a global basis and engage with multi-national companies will continually encounter and be exposed to FX risk. Nevertheless, African economies (and correspondingly their currencies) are vulnerable to exogenous shocks, including collapses in commodity prices, (un)foreseen political instability, and unsustainable sovereign debt.

Contextualising Currency Volatility in Africa

Currency volatility and the depreciation of African currencies in recent years has resulted from a number of wider global trends. The first is fluctuations in the international demand and price for commodities. The performance of African economies with a high dependence on a single commodity for export earnings are contingent on commodity price cycles and global trade patterns. Commodity exporters, particularly of

oil, have historically experienced significant currency depreciation following contractions in global demand and commodity prices. African economies heavily reliant on commodity markets such as Angola, the Democratic Republic of Congo, Equatorial Guinea, Nigeria and South Sudan are vulnerable to currency swings related to prices for their primary export, often creating a structural imbalance between the supply and demand of foreign exchange.

Political uncertainty (i.e. risk or losses caused by the exercise of political power, or lack thereof) also contributes to currency volatility in Africa. Seven African countries will undergo presidential elections in 2022 – five of which are scheduled to take place following disruption by attempted political coups or armed conflict¹. A history of troubled elections and uneasy power transitions have contributed to highly volatile electoral exchange rate cycles in most African economies. The result is a general pattern of local currency divestment in favour of the acquisition of more stable global currencies, thereby creating short term illiquidity and the depreciation of local currencies around electoral cycles.

The general domestic economic health of Africa's economies also plays a role in the likelihood of currency volatility across the continent. Significant changes in a country's current account² can cause fluctuations in exchange rates for local currencies relative to widely-traded currencies. Cases where a country's current account is

Currency volatility and the depreciation of African currencies in recent years has resulted from a number of wider global trends.



operating at a deficit (such as Mozambique, Sudan and Sierra Leone, for example) or where it consistently operates at a trade imbalance, can place downward pressure on local currencies. Domestic fiscal policy (over expenditure, corruption losses, poor tax collection etc) as well as monetary policy (the Central Bank's ability to maintain independence and fiscal normality) are other contributors to the general health of local currencies, and correspondingly the likelihood of currency volatility or weakness.

Finally, sovereign debt is another factor that contributes significantly to currency volatility. Inflated and unsustainable government borrowing can place pressure on local currencies, evidenced in Mozambique's "hidden debt" financial crisis in 2016. The Mozambican Metical lost a third of its value in the same year, and in the last decade has depreciated by a further 60%³. Foreign-currency denominated debt is predominant in Africa,

1 Specifically, Chad, Guinea, Libya, Mali and Somalia.

2 Also referred to as a country's balance of payments (i.e., the inflow and outflow of goods, services, investment incomes and transfer payments, including aid).

3 Reuters, 2019. [Factbox: Mozambique Debt Crisis - What Does the Country Owe, And To Whom?](#)

accounting for two thirds of the continent's external debt⁴. African governments are often the largest local consumers of foreign exchange (in the servicing of their foreign debt obligations) and thus face significant unhedged foreign currency liabilities. Presently, 24 African countries now surpass the 55% debt-to-GDP ratio recommended by the International Monetary Fund, driven by a surge in public financing by governments to mitigate the socioeconomic consequences of the pandemic⁵. The result, however, is an over exposure to swings in global market conditions, leaving currencies vulnerable to collapse in the event of unforeseen crises.

Compounding the volatility of many African currencies, a further concern for investors surrounds the restrictions placed on foreign exchange movements by some intra-country governments, which can affect the repatriation of income from investments. Beyond official exchange controls, liquidity shortages in foreign exchange markets often create parallel markets. This disparity between central bank rates and "real" or "on the ground" rates available in the market is more acute in illiquid markets with weak local currencies. An example is the Nigerian Naira, which in November 2021 was priced significantly higher against the dollar on the black market (₦572) compared to official exchange rates (₦413)⁶. Illiquidity and competing official vs. parallel foreign currency exchange rates can amplify entry and exit risk for private equity fund managers.

Currency Risk in Private Equity

Private equity and venture capital investors often bear significant currency risk. With multi-year investment horizons and illiquid assets, finding suitable mechanisms to hedge this exposure is of critical interest to limited and general partners alike. Although some private equity fund managers factor currency depreciation into their internal risk management processes, sudden currency devaluations similar to that witnessed in Nigeria (where the Central Bank has devalued the Naira three times since March 2020) can eclipse returns from otherwise profitable investments.

The AVCA 2021 Annual Private Equity Industry Survey found that 56% of LPs view currency risk as a key challenge when investing in African PE, while 44% of GPs identified short-term macroeconomic risks (such as currency and political instability) as a significant challenge facing fund managers operating in Africa's PE industry⁷. Similar concerns were raised by respondents in the 2021 World To Africa Survey led by Standard Bank, which surveyed 225 global investors and their intermediary providers⁸. Specifically, 50% of new investors and 30% of existing investors cited FX liquidity and restrictions as a key obstacle "blocking" them from being fully invested or optimised in key African markets. However, a pressing challenge for private investors in Africa is the dichotomy between existing hedging

products and the unique needs of African fund managers. A wide range of sophisticated FX hedging products on offer to investors in developed markets are simply unavailable in sub-Saharan African markets.

56%

56% of LPs view currency risk as a key challenge when investing in African PE, while 44% of GPs identified short-term macroeconomic risks (such as currency and political instability) as a significant challenge facing fund managers operating in Africa's PE industry



4 Coulibaly, B., Gandhi, D. and Senbet, L., 2019. [Brookings Africa Growth Initiative Policy Brief: Is sub-Saharan Africa Facing Another Systemic Sovereign Debt Crisis?](#)

5 African Development Bank, 2021. [Debt Dynamics and Consequences](#).

6 The Africa Report, 2021. [Nigeria Needs to Clear Dollar Backlog to Avoid Further Devaluation](#).

7 AVCA, 2021. [2021 Annual Private Equity Industry Survey](#).

8 Standard Bank, The ValueExchange, BNY Mellon, MIDA, AVCA, SAVCA and Global Custodian, 2021. [The World To Africa](#).

Types of Currency Risk Facing Africa-Focused Private Equity Fund Managers⁹

Pre-investment or Entry Risk

USD-based investors are exposed to the risk of USD depreciation and/or local currency appreciation upon the identification of an investment opportunity until its conclusion (i.e. between signing and the completion of the acquisition).

Portfolio Risk

Currency volatility can have an (un) favourable effect on the purchase or sale price of assets. As such, any local valuations of a private equity firm's portfolio will need to be converted and revalued in the fund's base currency.

Transaction Risk

Throughout the lifecycle of a private equity fund (the adding of new portfolio companies, providing follow on financing, and exiting other investments), there will be marked changes to the aggregate FX exposure of the fund.

Closing or Due Diligence Risk

Exchange rates can fluctuate in the time it takes to approve a transaction, call capital or deliver funds.

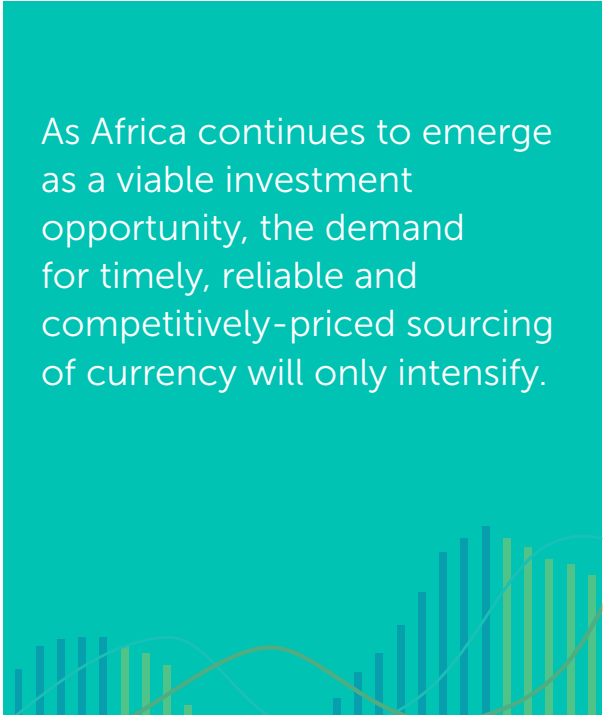
Operational FX Risk

- Movements in FX rates for private equity funds holding foreign assets can have an impact on the Net Asset Value (NAV) of the fund.
- FX risk also exists if a private equity house receives management fees in a different currency to the base of the fund.

⁹ J.C. Rathbone Associates Limited, 2017. *Hedging Foreign Exchange Risk in Sub-Saharan Africa*.

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 that invest in hard currencies also risk the value of their investment returns being reduced, should there be any depreciation in the local currency. This exposure tends to discourage 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 perceived to be too costly and difficult to achieve, given the unpredictability of the cash flows involved and the illiquidity of many African currencies. Consequently, most investors have sought to hedge by diversifying investments across investment stages, vintage year, sectors, and geographies.

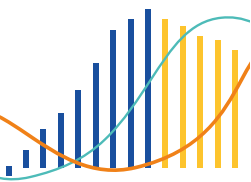
In closing, as Africa continues to emerge as a competitive investment opportunity, the demand for timely, reliable and competitively-priced sourcing of currency will only intensify. This report provides data and insights on the importance and impact of currency risk; strategies for currency risk management and hedging practices; and an overview of the challenges accompanying currency risk management in African Private Equity and Venture Capital. The report concludes with an "Ask The Expert" collaboration with The Currency Exchange Fund (TCX), and MFX Solutions (MFX). This section addresses key questions and concerns raised by limited and general partners on currency risk management strategies and hedging practices unique to Africa's investment landscape. In so doing, our hope is that this special report will offer investment professionals practical support on how they can effectively navigate and surmount currency volatility in African investment.



As Africa continues to emerge as a viable investment opportunity, the demand for timely, reliable and competitively-priced sourcing of currency will only intensify.

**Currency Risk
Management Practices
in African Private Equity
and Venture Capital**

Importance and Impact of Currency Risk in African Private Equity and Venture Capital



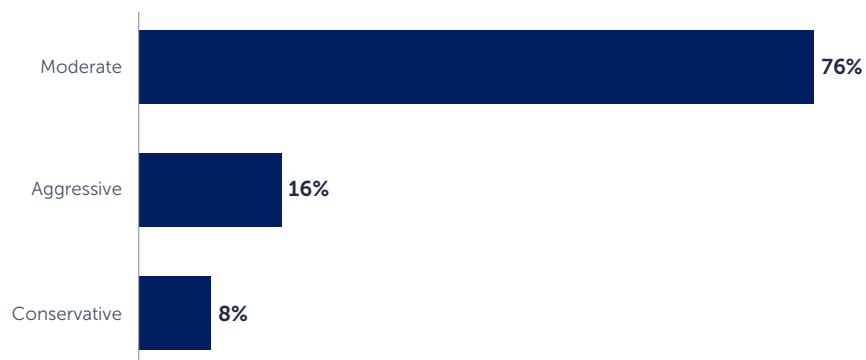
1.1. Importance of Currency Risk

GPs rated the importance of currency risk in Africa at **4.3**, placing a greater emphasis on its importance than the LPs surveyed, whose average score of the same was 3.8

Figure 1 – Importance of Currency Risk in Africa to GPs and LPs



Figure 2 – LPs' risk appetite



Understanding and managing currency risk has become an increasingly important concern for both limited and general partners, as global private equity markets have become more integrated. Exchange rates often fluctuate over the long holding periods that typically characterize private equity investments. This overall trend is more so accentuated in Africa where FX markets have experienced increased volatility in recent years.

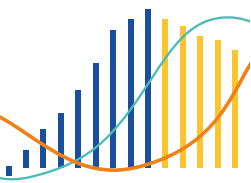
When questioned on the importance of currency risk, General Partners (GPs) and Limited Partners (LPs) both opined that the risk is crucial for their organisation.

GPs rating the importance of currency risk in Africa to their organisations recorded an average score of 4.3 on a scale of 0 to 5. For almost 90% of surveyed GPs, currency risk in Africa has been particularly important to their organisations, with 56% of them stating that it has been very important.

Although the importance of currency risk for GPs is no longer in doubt, it seems to be correlated to their level of experience within the industry. Indeed, GPs that started investing relatively recently placed more importance on currency risk, compared to those with more experience. GPs that first started investing between 2010 and 2019 scored an average of 4.6, while the ones who first started investing between 2000-2009 and before 1999 scored 4.1 and 4, respectively.

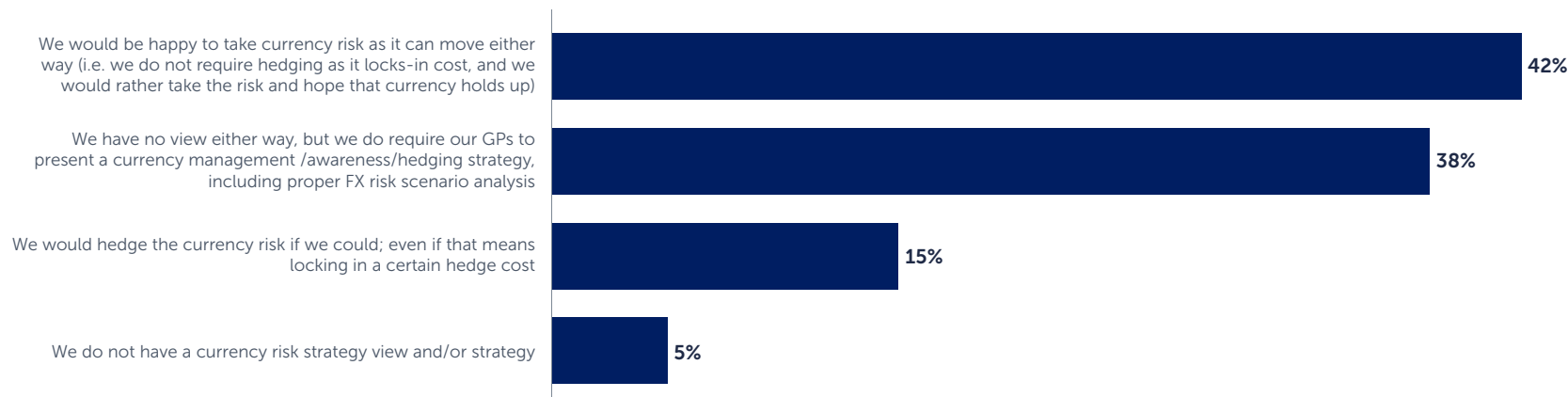
On the other hand, LPs recognize the importance of currency risk, but their risk appetite is a key driving factor in the determination of their risk management strategy.

They recorded an average score of 3.8 out of 5 when rating the importance of currency risk in Africa, with most (76%) describing their risk appetite as moderate. Moreover, nearly half of the LPs (42%) would prefer taking currency risk as it is with the hope that currency will hold up instead of hedging with financial instruments. Another 38% say that they have no preference but do require their GPs to have a currency management strategy in place. This indicates that although LPs recognize the importance of currency risk, their risk appetite is determinant in their risk management strategy. Some are willing to accept it as a risk they are willing to take, and other prefer a tangible risk management strategy.



Three quarters of LPs surveyed have a moderate risk appetite, with a slight majority exhibiting a preference for taking currency risk as it is, with no hedging or management requirements in place for fund managers

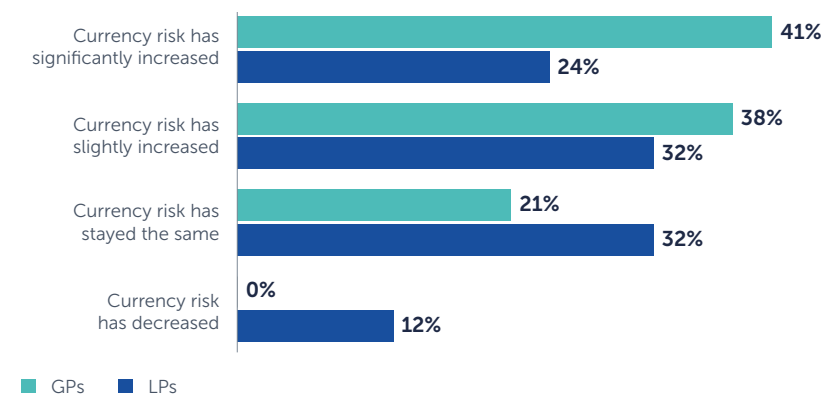
Figure 3 – LPs’ views on currency risk based on their risk appetite

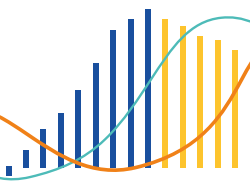


GPs recorded a bleaker account of the evolution of currency risk in Africa: **41%** believe currency risk has **significantly increased** in the last 2-4 years, compared to just 24% of LPs who share this view

Given the highly uncertain environment surrounding currency volatility in Africa, it’s not surprising that the fund managers and limited partners surveyed express greater concerns about the FX market volatility. 79% of the GPs surveyed noted that currency risk in Africa has slightly or significantly increased compared to the last 2-4 years.

Figure 4 – GPs and LPs’ views on the evolution of currency risk in Africa





Overwhelmingly, the GPs stating that currency risk in Africa has slightly or significantly increased have identified two main factors behind this sentiment. 90% view African countries' economic performance as a significant contributor and nearly three quarters (72%) of fund managers cited the macroeconomic instability caused by the COVID-19 pandemic as a key factor. They also cited African countries' political instability (52%) and a global macroeconomic downturn (41%) as causal factors behind the recent increase in currency volatility.

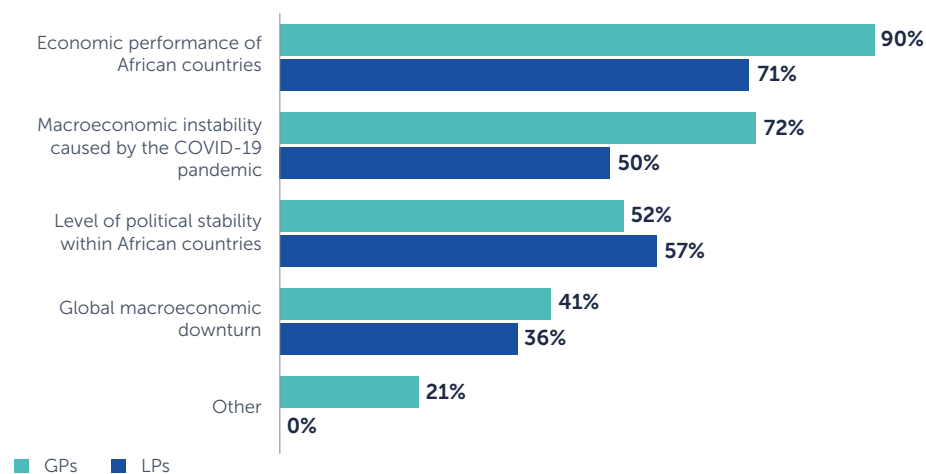
Within the 'Other' category, respondents also identified factors such as trade imbalances, ineffective monetary policies, and limited economic support provided by African governments as significant factors behind the increase of currency risk in Africa over the last 2 to 4 years.

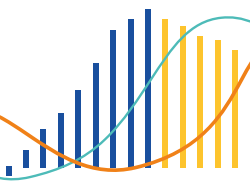
Furthermore, just over half of the limited partners (56%) believe that currency risk has slightly or significantly increased on the continent compared to the last 2-4 years.

A majority (71%) of the LPs that hold this view consider the economic performance of African countries as a main factor explaining the increase in FX market volatility. Political instability was the second most popular factor identified by the LPs (57%) as explaining the currency volatility in Africa. At 50%, the third key factor cited by the respondents was the macroeconomic instability caused by the COVID-19 pandemic, while the global macroeconomic downturn was viewed by most non-African LPs (83%) as another significant factor that contributed to the increased FX market volatility in Africa. This confirms that political uncertainty and other short-term macroeconomic risks remain significant challenges for fund managers operating in Africa's PE industry, and thus for LPs.

Africa's economic performance, the macroeconomic instability caused by the COVID-19 pandemic, and the **overall level of political stability** within African countries were identified as the main contributors behind the **increasing currency volatility** in Africa by the largest proportions of both GP and LP survey respondents

Figure 5 – GPs and LPs' views on the main factors behind the increase in currency risk in Africa over the last 2-4 years

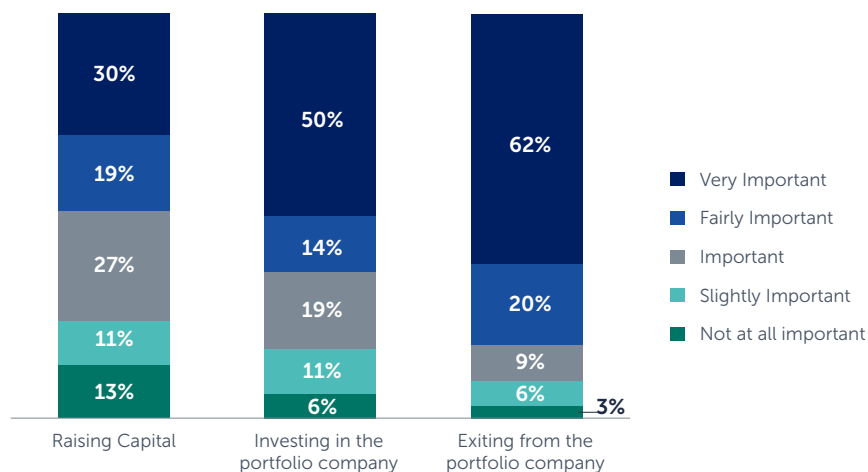




1.2. Impact of Currency Risk

Currency risk was most impactful for fund managers when exiting their portfolio, with **62% of GPs** surveyed describing said impact as **“very important” at the time of portfolio exit**

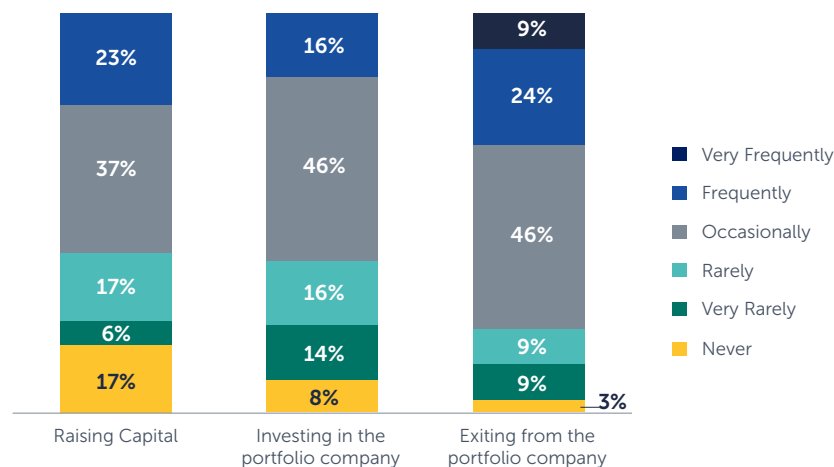
Figure 6 – GPs’ views on the importance of currency risk on the different stages of the fund lifecycle



Although currency risk is present throughout the investment process, the relative impact of currency volatility is heightened at certain stages of a fund’s lifecycle. Both during the commitment period where LPs may face a change in the amount of capital they commit, and during the investment and distribution periods, where both LPs and fund managers may face a reduction in hard-currency returns.

Most General Partners (83%) state that the impact of currency volatility on exiting their African portfolio companies has been either fairly important or very important. Of these GPs, 85% state that hard currency funds constitute a vast majority of their total number of funds raised (75% to 100%). It is to be noted that when exiting their African portfolio companies, 33% of GPs frequently or very frequently experience a delay due to currency volatility.

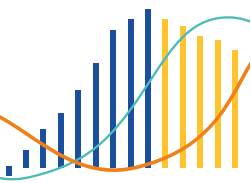
Figure 7 – GPs’ views on the frequency of delay due to currency volatility in Africa



The impact of currency volatility on investing in African businesses has been very important for 50% of fund managers, with 16% of this cohort experiencing frequent delays when investing.

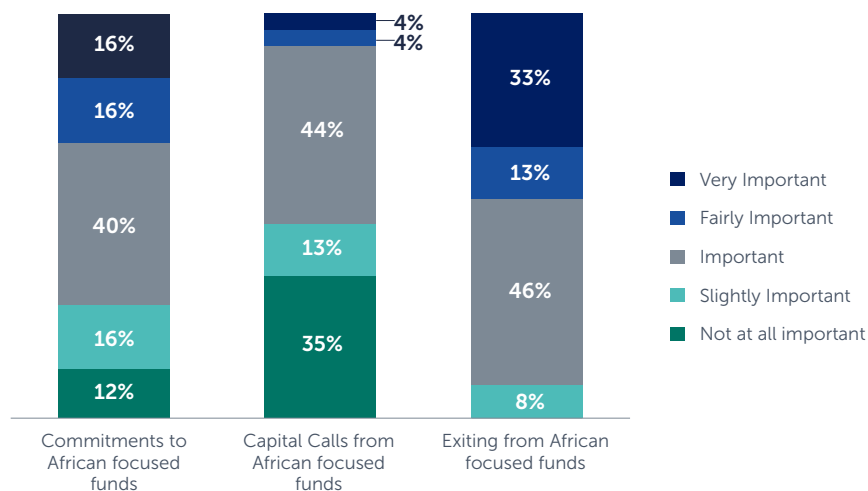
When it comes to fundraising, the percentage of fund managers that view the impact of currency volatility on their process of raising capital as very important falls to 30%, and only 23% of them frequently experience a delay when raising capital.

In short, GPs experience more negative impact of currency risk at the time of the exit, compared to the time of fundraising and investing in the portfolio company. This amplifies the double challenge related to exits for African private equity fund managers, given the nature of the asset class - unpredictability of the cash flows involved and the illiquidity - and the specificities of the African market, including the strong volatility of the FX market.



Delays resulting from currency risk when servicing capital calls from Africa-focused funds are regarded as “slightly” or “not at all important” by close to half (48%) of the LPs surveyed, with a similar proportion (46%) elevating the importance of currency risk to **“important” when exiting** from Africa focused funds

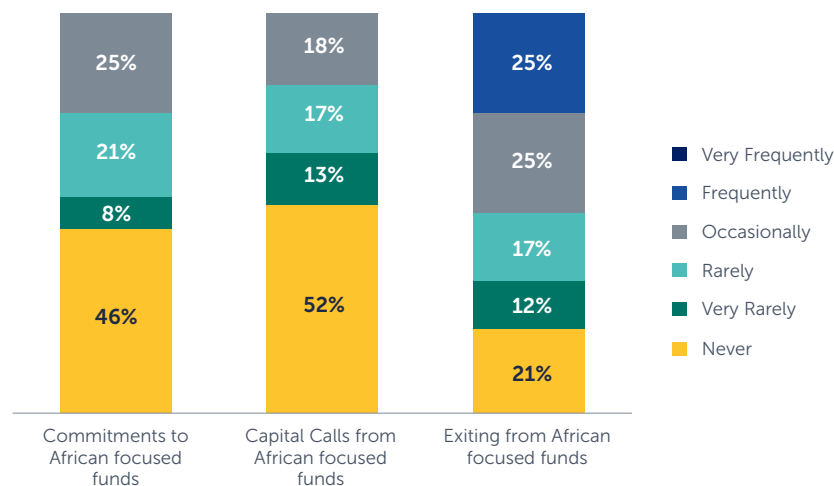
Figure 8 – LPs’ views on the importance of currency risk on different stages of the fund lifecycle



Turning to the Limited Partners’ perspective, they confirm that currency volatility is a determinant variable on committing capital and exiting from Africa-focused funds. Close to three quarters of LPs (72%) say that the impact of currency risk on their capital commitments to African focused funds has been important, fairly important and very important.

This percentage further increases when LPs assess the impact of currency risk on exiting from African focused funds. Specifically, the vast majority of LPs (92%) state that the impact of currency volatility on exiting their African PE commitments has been important, fairly important or very important.

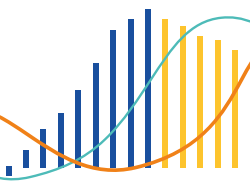
Figure 9 – LPs’ views on the frequency of delay due to currency volatility in Africa



Most of the LPs that only deemed currency risk important at the exit instead of fairly or very important have invested in only hard currency funds (63%), while 100% of which said that currency risk is very important when exiting from African focused funds have invested in local currency funds.

Most LPs state that they never experience a delay in committing capital to African focused funds or in capital calls from African focused funds due to currency volatility.

However, when it comes to exiting from African focused funds, one quarter of LPs say that they frequently experience a delay due to currency risk in Africa.



As previously mentioned, currency risk matters at various stages of the investment process, but even more during the distribution periods where both Limited Partners and General Partners may face a reduction in returns. Both LPs and GPs are doubly exposed to currency risk, both at the individual portfolio company level as well as at the level of the fund's returns.

Almost two thirds of GPs (65%), state that currency volatility had a negative impact on their African PE returns, including 41% for which the impact was significantly negative.

Meanwhile, 8% state that currency volatility had a marginal positive impact on their African PE returns. All these fund managers have raised sector-specific funds focused. Only 5% of GPs state that currency volatility had no impact on their African PE returns.

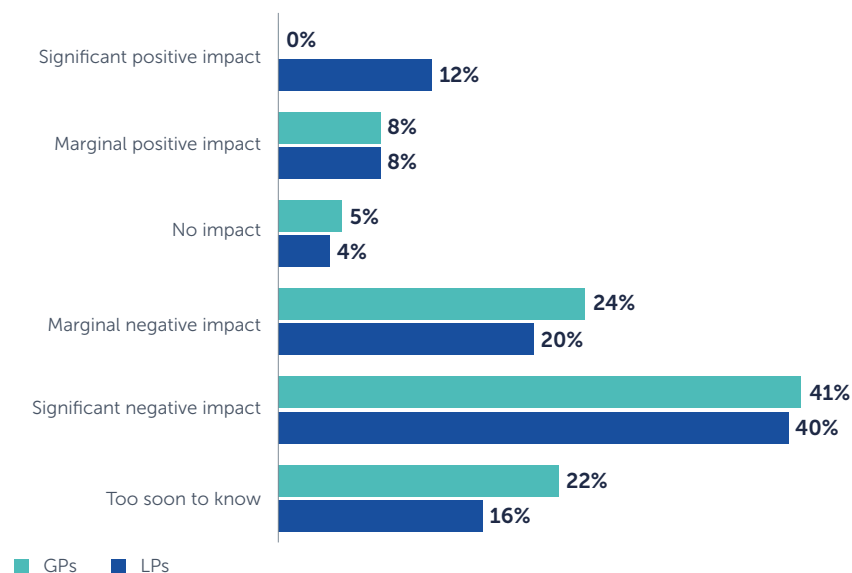
Unsurprisingly, it was more difficult for some to express their views given their more recent investments.

More than half of LPs (60%) state that the currency volatility had a negative impact on their African PE returns, including 40% for which the impact was significantly negative.

For a minority of them (20%), the impact appears to be either marginal or significantly positive, noted that 80% of these LPs are pension funds - mainly based in Africa – who are primarily invested in hard currency funds in Africa.

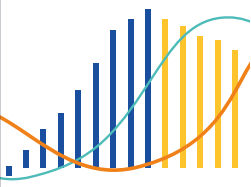
Similar proportions of LPs and GPs surveyed reported experiencing a **significant negative impact** on their African PE returns caused by currency volatility

Figure 10 – Impact of currency volatility on GPs and LPs' African PE returns



**Currency Risk
Management Practices
in African Private Equity
and Venture Capital**

Currency Risk Management and Hedging Practices in African Private Equity and Venture Capital



2.1. Importance of Currency Risk Management

GPs gave higher credence to the importance and necessity of adopting a currency risk management strategy than the LPs that participated in the survey.

Figure 11 – Importance of the adoption of a Currency Risk Management Strategy to GPs and LPs

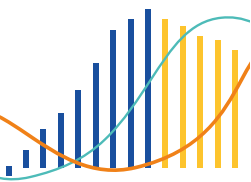


Greater concerns from the GPs (79% of GPs) and LPs (56% of LPs) about the FX market volatility compared to the last 2-4 years, have led to adjustments in risk management practices, although there is still room for changes in behaviour.

Rating the importance of a currency risk management strategy on a scale of 0 to 5, GPs scored an average of 4.3. Specifically, half of them consider the adoption of a currency risk strategy as very important when they construct their portfolio.

Meanwhile, the LPs assign an average score of 3.8. The ones who invest only in hard currency funds scored an average of 3.7, and inversely, those investing in only local currency funds rated on average a 5.0. This exhibits the greater importance the latter associate to the adoption of a currency risk management strategy, and further accentuates the trend that local currency denominated funds are more impacted by currency volatility than hard currency denominated ones.

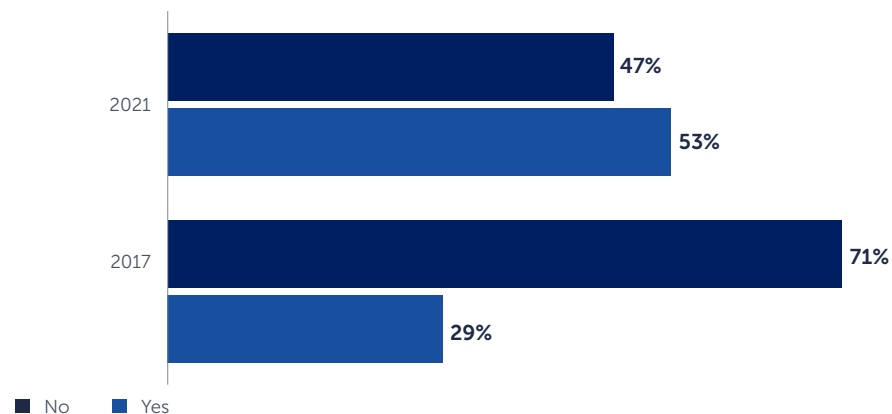
Turning to experience investing in the African landscape, the LPs who are looking to make their first investments identified an average score of 3.5, while the ones who are more familiar with the African market and started investing in Africa before 1999 scored on average 4.0. Even though LPs who are looking to make their first investments associate importance to the adoption of currency risk management strategies in this new environment where currency risk is perceived as one of the biggest barriers to entry, the latter seem even more to prioritize adopting and strengthening FX risk management frameworks, based on their long-term experience navigating currency in Africa.



2.2. Currency Risk Management Infrastructure

Fund managers have prioritized **strengthening their FX risk management frameworks** in Africa over the last 4 years. A **slight majority** of fund managers surveyed have a **formal written policy** for managing currency risk in place, although only a minority apply quantitative or statistical methodology to measure currency risk

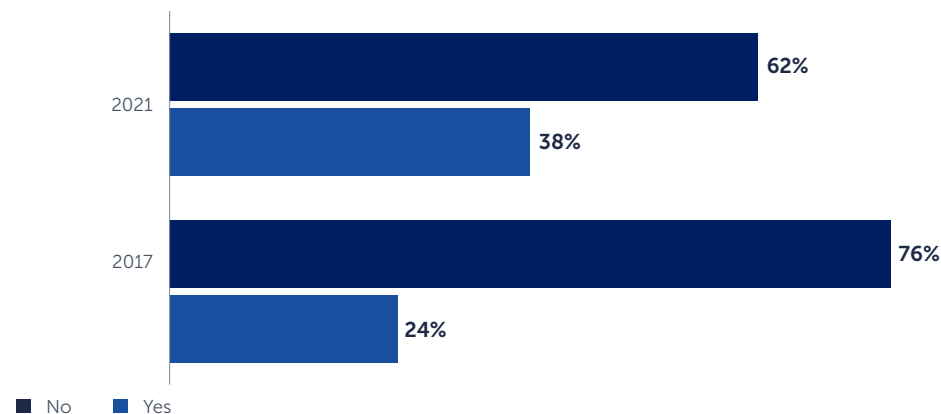
Figure 12 – GPs' adoption of a formal written policy for managing currency risk



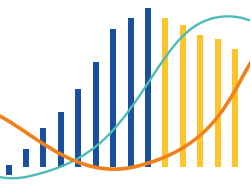
With increased concerns about FX market volatility, Limited and General Partners have adjusted their hedging strategies over the last 4 years. They appear to have prioritized strengthening their FX risk management frameworks. The survey shows a sizable increase in the percentage of respondents having a formal written hedging policy, and an uptick in the use of quantitative analysis to measure risk – crucial elements of effective FX risk management strategies.

Over half of fund managers (53%) state that they have a formal written policy in place within their organisation for managing currency exchange risk in Africa. This constitutes a significant increase when compared to 2017, where only a minority of fund managers (29%) used to have a formal written policy within their firm for managing currency risk on the continent. It is to be noted that African fund managers have changed their behaviour: in 2021, 50% of African GPs have a formal written policy for managing exchange risk, compared to only 32% with the same in place back in 2017.

Figure 13 – GPs' quantitative or statistical methodology to measure currency risk



Although only 38% of GPs state that they currently have a quantitative or statistical methodology to measure currency risk within their organisation, they appear to have prioritized strengthening their FX risk management frameworks. This percentage was even lower in 2017, when only a fifth of GPs (24%) said that they had such methods to assess currency risk within their organisation.

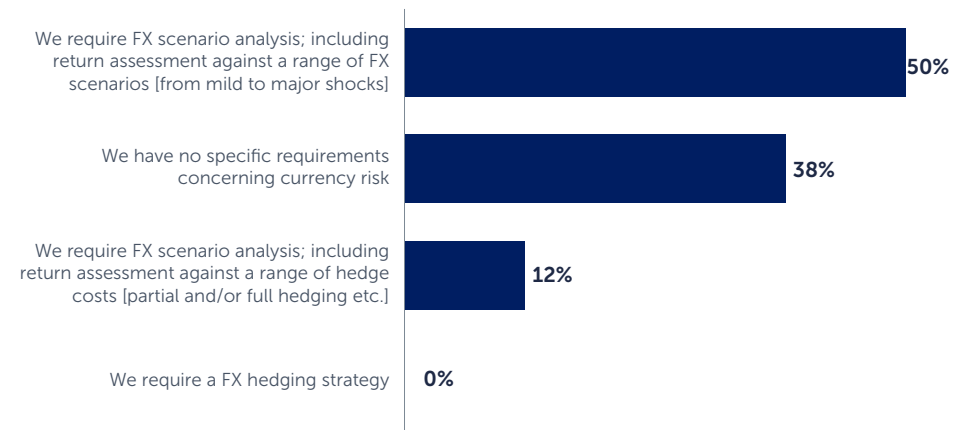


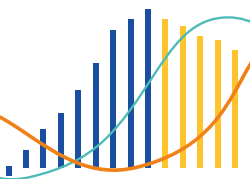
Although **half of the LPs** that participated in the survey **require a comprehensive FX scenario analysis**, none require a formal FX hedging strategy from fund managers – suggesting a **desire for an awareness** of the potential risk currency volatility may pose, but a **willingness to proceed** without formally hedging currency exposure

Half of the LPs state that they require an FX scenario analysis which includes a return assessment against a range of FX scenarios when they onboard an African fund manager. Of these LPs, 77% describe their organisation’s risk appetite as moderate.

Over a third of LPs (38%) say that they have no specific requirements concerning currency risk, and 60% of them select the diversification across sectors and geographies as a main method that they adopt to manage currency risk on the continent. Diversification enables LPs to not require specific FX scenario analysis as diversification mitigates currency risk.

Figure 14 – LPs’ requirements in terms of currency risk assessment when onboarding an African GP





2.3. Currency Risk Management Strategies and Hedging Practices

Natural hedges such as **portfolio diversification across different sectors and geographies** was chosen by the largest proportion of **LP** respondents as their preferred strategy for managing currency risk in Africa, with Swaps and Back to Back structures being the most favoured options amongst the minority that opt to hedge with financial instruments

Formally hedging currency exposure over the multi-year holding period of a private equity and venture capital investment can be costly and difficult to achieve, given the unpredictability of the cash flows involved and the illiquidity of many African currencies. Consequently, most investors have sought to hedge only by diversifying investments across investment stages, vintage year, sectors, and geographies. Portfolio diversification is thus a very important strategy in currency risk management given the long-term, illiquid, and cyclical nature of private equity and venture capital investments.

The majority of LPs (69%) state that the diversification of their fund investments across different sectors and geographies constitutes a main strategy that they adopt in order to manage currency risk on the continent. Fund managers' track record of investment through to exit was selected by two thirds of LPs (65%) as another significant method that LPs use in order to mitigate the effects of currency volatility on the continent. This is followed by fund managers' knowledge of target countries and sectors (54%). Only 15% of LPs hedge with financial instruments to cope with currency weakness in Africa.

Of this minority of LPs hedging with financial instruments, 50% use Swaps and Back-to-back structures, and only 25% hedge with Forwards, Options, and Internal cash reserves.

Figure 15 – Strategies that LPs adopt for managing currency risk in Africa

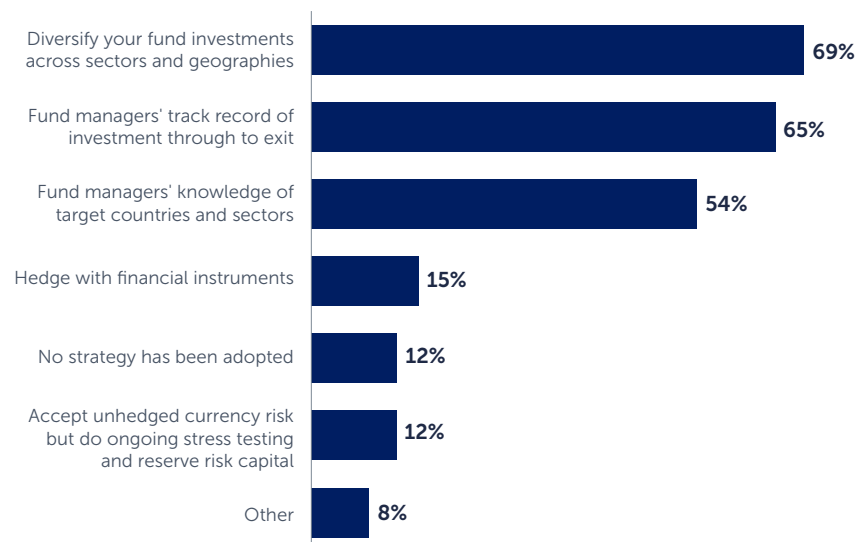
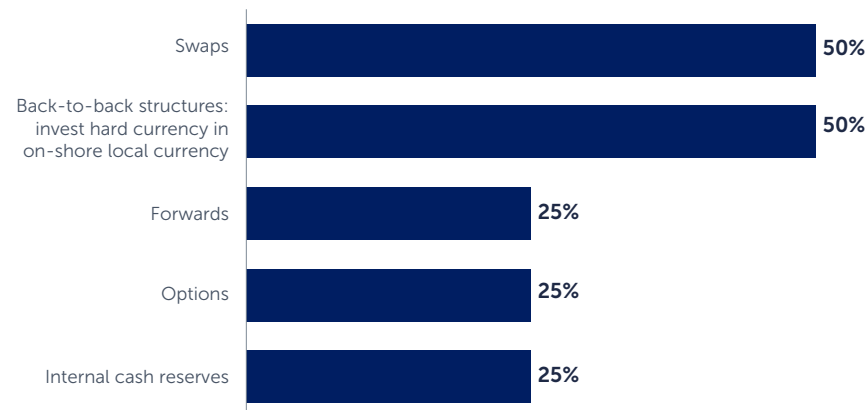
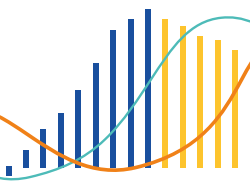


Figure 16 – Main instruments LPs adopt for managing currency risk when hedging with financial instruments

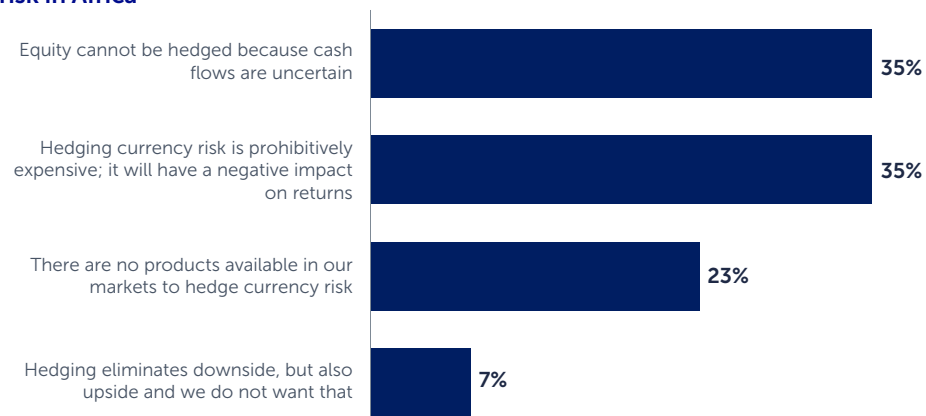


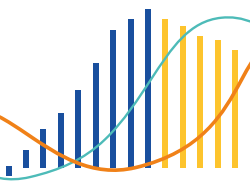


35% of LPs jointly maintain that **equity can't be hedged** given the unpredictability of the cash flows involved, and where possible, hedging currency risk is viewed as prohibitively expensive in Africa

LPs' views on hedging with financial instruments to manage currency risk in Africa are rather mixed. One third of LPs (35%) believe that equity can't be hedged given the unpredictability of the cash flows involved, while another 35% express the view that hedging currency risk is expensive and will therefore have a negative effect on returns. It should be noted that, among the LPs who view hedging currency risk as prohibitively expensive, 75% said that currency volatility in Africa has already had a marginal or significant negative impact on their African PE returns. In addition, a fifth of LPs (23%) highlighted the lack of hedging products available in the markets of their operations.

Figure 17 – LPs' views on hedging with financial instruments to manage currency risk in Africa



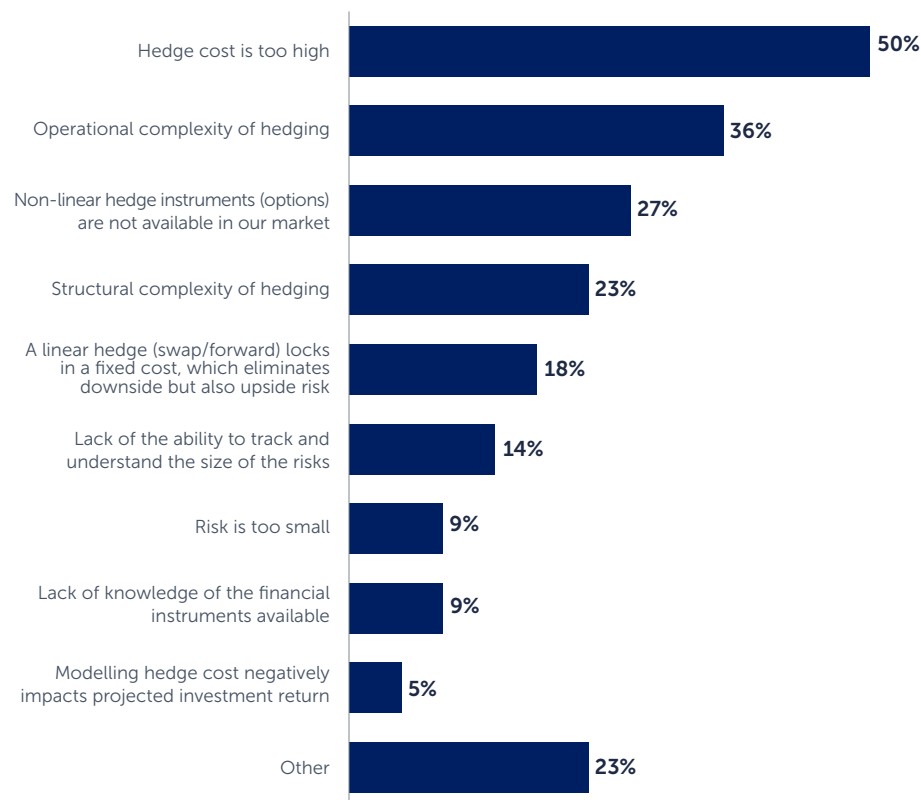


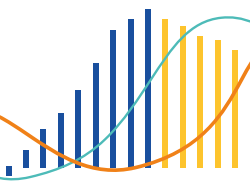
The **cost of hedging** and the **operational complexities of hedging** were the two most important factors identified by **LPs** surveyed preventing them from using financial instruments to hedge currency risk in Africa

These views are further accentuated when we analyse the factors preventing LPs from hedging with financial instruments. For half of LPs (50%), the main factor preventing them from using financial instruments to hedge currency risk in Africa is the high cost of these hedging facilities. The operational complexity of hedging (36%), the lack of non-linear hedging instruments in their markets (27%), and the structural complexity of hedging (23%) are selected by LPs as other significant factors preventing them from hedging with financial instruments. It is to be noted that the majority of LPs citing the structural complexity of hedging, legal documentation, collateral requirements (80%) are located in Africa, while the majority of those stating the operational complexity of hedging, valuations, margin calls, settlements (63%) are located in Europe.

Within the "Other" category, LPs have also stated the nascent nature of hedging facilities available in their markets, their organisations' internal policy, and the difficulty associated with hedging private equity investments because of the unpredictability of exits as other factors that prevent them from using financial instruments to manage currency risk.

Figure 18 – Factors preventing LPs from hedging with financial instruments





Natural hedges such as **portfolio diversification across different sectors and geographies** was also chosen by the largest proportion of **GP** respondents as their preferred strategy for managing currency risk in Africa, with **Back to Back structures** the most favoured options amongst the minority that opt to hedge with financial instruments

Figure 19 – Strategies that GPs adopt for managing currency risk in Africa

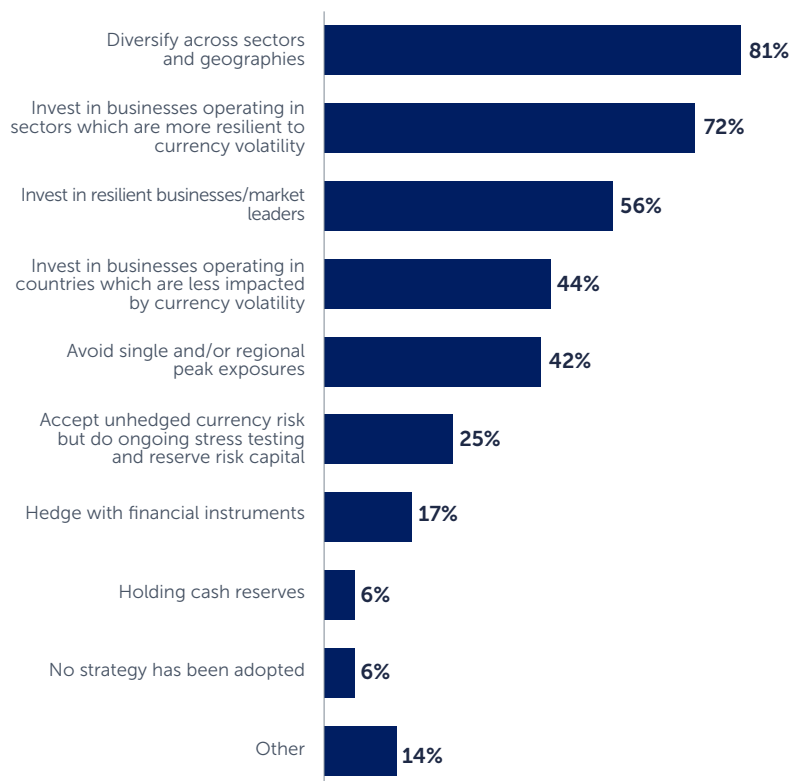
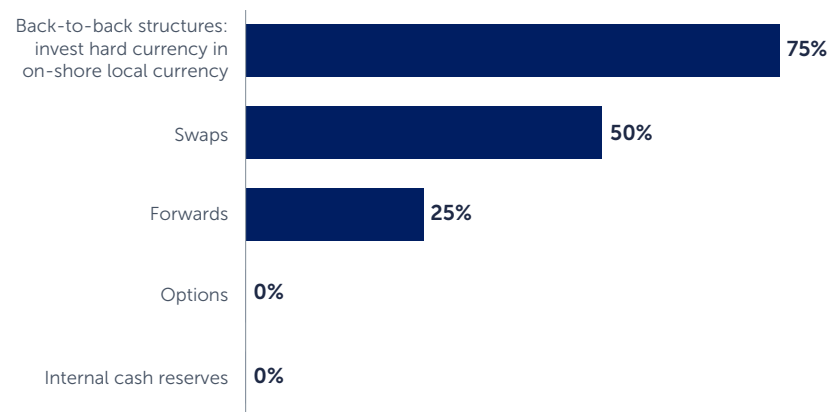


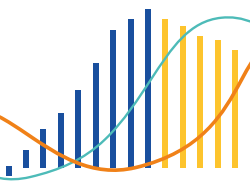
Figure 20 – Main instruments GPs adopt for managing currency risk when hedging with financial instruments



Unsurprisingly, most fund managers (81%) have selected diversification across sectors and geographies as a main strategy that they adopt to manage currency risk on the continent. This is followed by investing in businesses operating in sectors more resilient to currency volatility (72%), and by investing in resilient businesses and market leaders (56%).

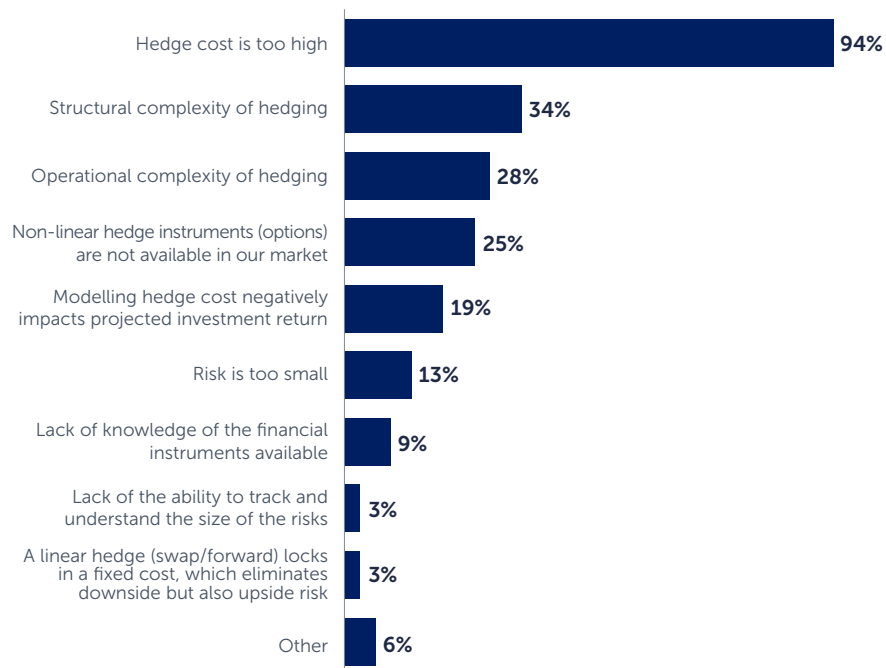
Only 17% of fund managers hedge with financial instruments to manage currency risk on the continent.

Of the minority of GPs hedging with financial instruments, 75% use Back-to-back structures, 50% use Swaps and only 25% hedge with Forwards. The Options are not used by any of the fund managers, which is not surprising as in Sub-Saharan Africa FX Options are not, or very rarely, available.



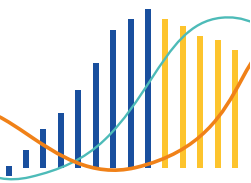
Echoing results from the LP Survey, the **cost of hedging** and the **operational complexities of hedging** were the two most important factors identified by **GPs** surveyed preventing them from using financial instruments to hedge currency risk in Africa

Figure 21 – Factors preventing GPs from hedging with financial instruments



For most GPs (94%), the main factor preventing them from hedging with financial instruments in Africa is the high cost of these hedging facilities. Of these fund managers, 83% state that they diversify across different sectors and geographies to mitigate currency risk on the continent.

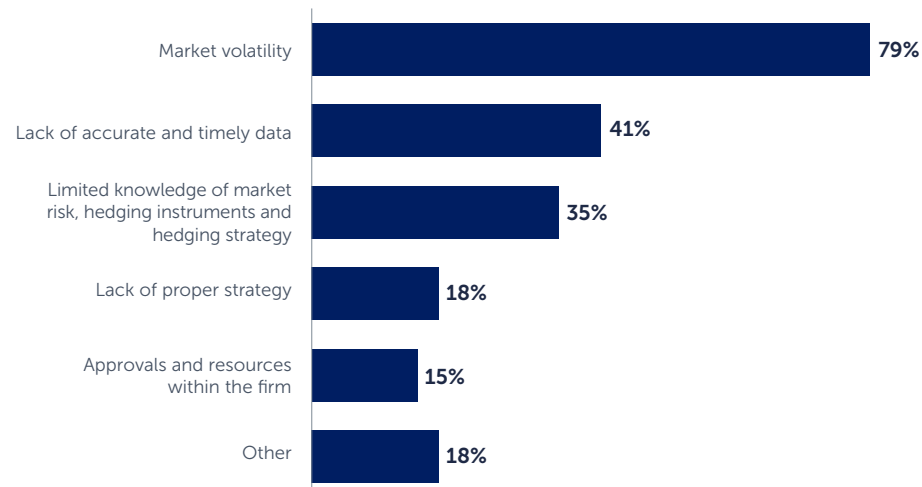
Other main factors that prevent GPs from using hedging instruments in Africa include the same ones quoted by LPs, namely the structural complexity of hedging (34%), the operational complexity of hedging (28%), and the lack of non-linear hedging instruments in their markets (25%).



2.4. Currency Risk Management Challenges

The views of LPs and GPs converge: both name **market volatility** as the biggest challenge associated with currency risk management in Africa, with a similar proportion of each also viewing a **lack of timely and accurate data** as another key challenge

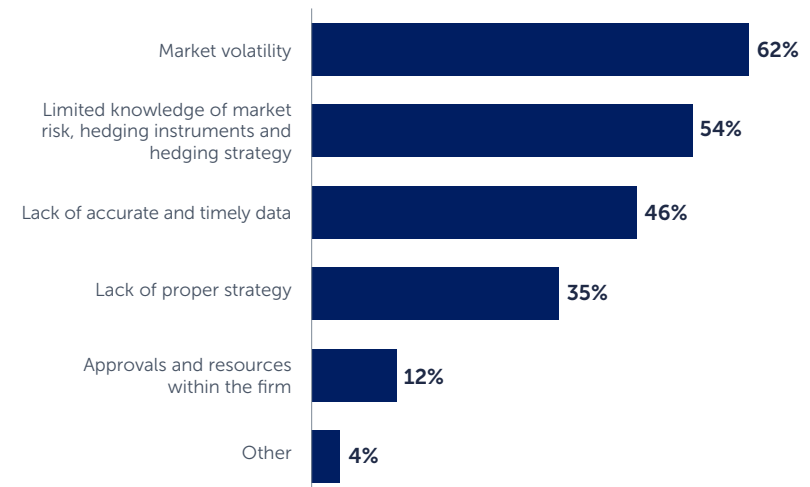
Figure 22 – GPs’ views on biggest challenges associated with Currency Risk Management in Africa



The biggest challenge accompanying the management of currency risk in African private equity and venture capital is the continent’s market volatility. Identified by the majority of GPs (79%) and almost two-thirds of LPs (62%) as the most important challenge, this long-standing concern to investment professionals has been accentuated over the past two years with the Covid-19 pandemic.

Other important challenges cited by the GPs are the lack of accurate and timely data (41%), the limited knowledge of market risk, hedging instruments and hedging strategies (35%).

Figure 23 – LPs’ views on biggest challenges associated with Currency Risk Management in Africa



Within the ‘Other’ category, GPs have also stated the regulatory volatility in African markets, the limited number of available hedging instruments, and the fact that funds in Africa are raised in hard currency rather than local currency as other important factors that make the management of Africa’s currency volatility challenging.

As for the LPs, the limited knowledge of market risk, hedging instruments and hedging strategies (54%) and the lack of accurate and timely data (46%) are cited as being other significant challenges when managing currency risk in Africa.

Within the “Other” category, LPs expressed the view that equity investments are intrinsically or by nature difficult to hedge.

Ask the Expert

In the following “Ask the Expert” commentary, The Currency Exchange Fund (TCX) and MFX Solutions (MFX) jointly contextualise currency volatility in Africa: addressing some of the key questions and concerns raised by limited and general partners on risk management and hedging strategies applicable in Africa’s unique investment landscape.



Ask the expert: how can investors navigate currency volatility in African Private Equity and Venture Capital?

Context

A hard currency equity investor that invests in a business in an African country, will in principle be exposed to the local currency of that country. While in emerging and frontier markets, and most of Africa, currencies tend to always depreciate over time, the direction of that exposure can differ. When the local currency depreciates, an investment in a business with local currency expenditure and hard currency revenue will gain value, while an investment in a business with local currency revenues and hard currency expenditure, will lose value. Currency risk can be mitigated using i) natural hedging strategies, such as investing in exporting companies to protect against depreciation, or through portfolio diversification; ii) back-to-back structures, where a local bank takes currency risk on the back of a hard currency deposit, against which it will disburse local currency to the investee or iii) derivatives, such as FX options, cross currency swaps and FX forwards.

FX options and FX forwards are the hedging products which are generally considered most suitable for hedging currency risk associated with equity investments. A swap covers multiple cash flows and has multiple settlements and is therefore the preferred instrument to hedge debt, while forwards covering just a single cash flow with a single settlement, are more suitable to hedging equity. We briefly describe options and forwards below and explain the reason why forwards are the most available instruments in African markets.

A **FX option** allows users to protect themselves against a loss of value below a certain level due to currency depreciations, against payment of a premium. For example, an investor purchases a put option that gives the right to “sell” local currency and “buy” USD at a future date, at a certain fixed exchange rate (known as the “strike price”). If the currency drops below that level, the investor can exercise the option and be paid out (in hard currency) the difference between the strike price and the actual value of the currency at the strike date. An option maximises the investor’s loss, at a level that depends on the strike price and the premium paid. The premium will be a function of volatility of the relevant currency and of the difference between the strike price and the spot price at execution. For a put option, the lower the strike price is relative to the current spot rate, the lower that premium will be. When the strike price is below the current spot rate, the option is said to be “out-of-the-money”. Options can protect against a loss below a certain level but will still allow the investor to benefit from an opposite and beneficial movement in the currency the investor is hedging; in that scenario the investor will not exercise the option, realize the FX upside, and only incur the cost of the premium.

A **FX forward** is a contract to exchange two currencies at a future date, the maturity date of the forward, at a fixed agreed exchange rate (known as the “forward rate”). Forwards to buy hard currency in the future against an emerging or frontier market currency, will typically have a forward rate that is higher than the spot rate at execution. The spread of the forward rate

over the spot rate reflects the expected (risk of) depreciation of the local currency against the hard currency. Technically, the forward rate is determined by the interest rate differential between the two currencies.

Forwards with an onshore bank to buy one USD for a certain fixed local currency amount, will have an actual exchange at the maturity date of USD versus local currency (the currencies are “delivered”). The product that international banks and TCX offer, is a “non-deliverable” forward, which does not have an actual exchange of USD for local currency at the maturity date. Instead, only the difference between the agreed forward rate and the actual (official) exchange rate at the maturity date, is settled between the parties. That settlement will be negative to one party, positive to the other, depending on whether the actual exchange rate at maturity is above or below the forward rate. This settlement payment, calculated over the full amount hedged, will be made in hard currency.

For the investor the forward effectively replaces a probable but uncertain annual cost of future depreciations, with a certain, fixed, “locked-in”, annual cost of the forward. The forward

Currency risk can be mitigated using i) natural hedging strategies, ii) back-to-back structures, iii) derivatives

therefore eliminates downside risk (if the local currency exchange rate at maturity is worse than the forward rate) but also upside risk (if the local currency exchange rate at maturity is better than the forward rate).

According to our experience, equity investors generally favor using options over forwards, because an option eliminates unacceptable downside risk but preserves upside risk at the cost of only a one-off premium, while a forward, by locking-in an annual cost eliminates downside, but also upside risk. Specifically, if the local currency does not depreciate as expected (or even strengthens), the investors will in principle still have to pay the locked-in fixed annual cost.

Another distinction between options and forwards, is that with an option the full required cash outlay is known upfront, while the settlement amount of a forward will depend on the actual local currency exchange rate at maturity. This means that the investor must either have the liquidity to make a settlement if required or, alternatively, “roll the settlement forward” into a new forward. Depending on pricing and liquidity, the hedge provider can incorporate the settlement value into the pricing of the replacing forward, thereby extending the hedge without any payment made. Forward strategies also generally require posting of collateral - by and to the investor - which can create unwanted liquidity draws during the life of the investment. However, equity investors can generally avoid collateral arrangements by transacting with MFX Solutions, a partner of TCX, that can intermediate between investors and TCX and/or banks, with zero-collateral terms.

Currency hedging products in African currencies that are relevant to international equity investors are, in varying degrees and forms, offered by:

- i. international banks like ICBC Standard Bank, Société Générale, Standard Chartered, each with quite good coverage, and JPM, Goldman Sachs and others, in selected larger African markets;
- ii. major regional banks with head offices in South Africa, and local offices in many Sub-Saharan Africa countries, including FNB, Stanbic and ABSA; and
- iii. TCX acting additionally to the collective banks. In other words, TCX will only make its hedging products available if the banks do not offer the required product, or if parties in need of such products cannot get proper access to the banks. For example, TCX is rarely active in South Africa because the country is well covered by commercial banks.

Equity investors generally favor using options over forwards, because an option eliminates unacceptable downside risk but preserves upside risk

Banks can only offer hedging products like options and forwards if they can manage the risk they take, which generally depends on their access to the underlying domestic spot and financial markets and on the liquidity of those markets. Because such access and liquidity in many African markets is poor, and because of other commercial, capital and risk considerations, the bank- offer of hedging products in those markets is (very) slim.

The current situation in Africa is that commercial banks:

1. rarely offer FX options, and always subject to liquidity. However, these options are only available in a few markets (e.g. South Africa, Egypt, Nigeria, Kenya, Morocco) and generally for only short tenors of less than a year (with the exception of South Africa and Nigeria, for which the tenor may be longer).
2. cover many/most African markets with forwards, but always subject to liquidity and generally only in tenors ranging from 12 to 36 months, with occasional exceptions (e.g. 5-10 years in Nigeria).

The shallowness of the bank-offer is exactly the reason why international DFIs created TCX; to supplement the banks’ offer. The TCX risk model deviates from that of banks and is specifically designed to take currency risk of any tenor on its own balance sheet (meaning TCX does not need to hedge itself). That unique model allows TCX to supplement the banks’ offer of forwards, with forwards of any tenor in all African currencies. TCX also offers roll-overs, and with its partner

MFx Solutions, can also provide investors/funds with zero-collateral terms, which mitigates the uncertainty around liquidity that is normally associated with forwards.

Despite the limitation in product offer, there are nonetheless multiple considerations that justify not only having i) a sound currency risk management framework without considering the use of hedge products but also ii) a hedging policy that, given certain circumstances and conditions, does consider the use of forwards to mitigate currency risk.

1. Are there any currency trends within African countries that make you particularly optimistic or pessimistic?

Accumulating debt loads in African countries is a cause for pessimism. The debt of low- and middle-income countries in Sub-Saharan Africa increased to a record USD 702 billion in 2020, compared to USD 305 billion in 2010 (source: World Bank). Hard currency debt service requires the sale of local currency, while local currency debt fosters inflationary pressure. Both impacts push currency weakness.

A positive trend is Central Banks letting their currency float more. The IMF generally favours FX flexibility. A free-floating currency reflects the macroeconomic reality better than a managed or pegged currency and is less prone to currency shocks. The flipside can (but not necessarily

A positive trend is Central Banks letting their currency float more. The IMF generally favours FX flexibility. A free-floating currency reflects the macroeconomic reality better than a managed or pegged currency and is less prone to currency shocks

will) be greater short-term volatility than with a heavily managed or pegged currency. The West and Central African monetary union continues to represent a major block with a pegged currency (XOF and XAF are pegged to the EURO). However, the downside of heavily managed and pegged currencies is that when the FX rate or the peg becomes unsustainable, a sizable and very painful adjustment is usually necessary. For example, in 1994 the XOF was devalued from 0,02 to 0,01 French francs, a 50% depreciation in local currency terms.

2. How would you contextualize currency volatility in developed markets versus emerging markets over long-term periods?

Volatility is generally higher in emerging and frontier markets and the trend is for all emerging and frontier market currencies to depreciate over time versus hard currencies like the USD, EURO and YEN. This is mostly due to the inflation differential. Inflation in emerging and frontier markets tends to be higher due to weaker fiscal and monetary policy and weaker institutions, resulting in more inflationary money printing. However, depreciation in an emerging and frontier market can be less than the inflation differential when productivity growth in the emerging and frontier market is greater. It should also be mentioned that we often see a currency strengthen in the short term, happening right after an interest rate hike (to respond to higher inflation), but that the longer-term trend is in line with the inflation differential with developed markets and the country's trading peers.

For frontier markets, their limited integration in the global economy can sometimes be an advantage, for example when a global economic crisis hits. These markets and their currencies are then somewhat isolated. For this reason, adding frontier market currency exposure to an investment portfolio can increase diversification and lower correlation.

3. What trends related to the treatment of FX risk/volatility has TCX Fund observed in emerging and frontier markets? Which of these trends (if any) are long term and why?

TCX was created in 2017 to facilitate local currency investment by impact investors and has since supported over USD10 billion of local currency investments globally. We have witnessed growing awareness with borrowers and lenders of currency risk and of the hedging possibilities that now exist. Hedging policies are standard among lenders while borrowers increasingly demand local currency alternatives. A resulting trend is a deepening of hedging supply, meaning more active banks and a wider product offering.

With **equity investments**, the trend is flat. TCX and MFX frequently engage with equity investors looking to mitigate their currency exposure, but hedges are rarely executed. The considerations

We have witnessed growing awareness with borrowers and lenders of currency risk and of the hedging possibilities that now exist

are familiar; investors prefer (preferably cheap, “out-of-the money”) options to hedge downside risk while preserving currency upside. In Sub-Saharan Africa options are not, or only very rarely, available. Most investors seem to back down from alternative hedging strategies involving forwards, for example to manage specific risks and situations like currency over-exposures and exits.

The trend to carefully assess currency risk and to consider adequate risk-mitigation strategies is irreversible as the offering of hedging products and the number of hedging suppliers grow, and as investors demand sound hedging strategies and the use of available hedging instruments when appropriate.

4. From your experience, what effect has currency volatility had on the overall performance of PE & VC funds operating in Africa? Are there any differences between groups that have used currency hedgers like TCX Fund and those that haven't?

We are not in a position to make such comparisons, but we do have anecdotal evidence of gains made eroded and losses suffered, due to some of the severe FX shocks that have occurred in the past decade. These examples include Egypt (2016; ca. 50% FX loss in USD terms), Nigeria (2016; 40%), Ghana (2014; 30%), Mozambique (2016; 40%),

Zambia (2015; 45% and 2020; 50%), Uganda (2015; 30%) and Tanzania (2015; 30%). In hindsight, some of these losses could have been mitigated using forwards, especially in cases where the shocks occurred when exits had already been planned and hedging could have prevented loss of exit value. Note that irrespective of (the size of currency) losses incurred, FX volatility will have a continuous impact on a fund's P&L, annual returns and net asset value, which may blur visibility on portfolio performance, impair planning, trigger covenants and complicate reporting generally.

5. Which countries within Africa have financial hedging facilities?

Onshore hedge markets are generally underdeveloped, with only few banks offering hedges (forwards only), and usually these hedges are of limited volume and tenors. Such onshore markets are generally less relevant to international PE/VC investors; they will instead mostly rely on offshore hedging sources, such as major international banks and TCX/MFX. As mentioned previously, the banks and TCX/MFX together offer forwards in any African country and without any limit on tenor or volume. Moreover, the unique intermediary role of MFX, allows investors to transact hedging instruments offered by TCX and the banks, without (cash) collateral mitigation being required.

Q&A focused on LPs

1. How should LPs think about currency risk?

Considerations of currency risk, and subsequently how to manage it, are quite similar for both LPs and GPs. LPs should treat currency risk as a very significant return factor that can easily outweigh an investment's intrinsic value growth that is inherent to investing in emerging and frontier markets. For example, if an investee's revenue growth is at pace with domestic inflation, then, if all other things remain equal, it is possible and even probable, that the same inflation will drive currency depreciation, cancelling out the investor's gain in hard currency terms. And then of course there are all the emerging and frontier market idiosyncrasies that lead to much greater volatility than in developed markets.

LPs should perform and/or require proper and conservative scenario analysis, including shocks and hedged and unhedged scenarios to have a realistic range of return projections. LPs should have FX risk management and hedging strategies at LP level and require the same at GP level. These strategies should reflect the LP's risk appetite.

Currency risk management strategies may require portfolio composition and diversification criteria across i) geographical regions and countries ii)

floating and pegged, FM and EM currencies iii) commodity exporting and importing countries iv) sectors with low and high FX vulnerability (exporters versus non-exporters) v) across high-risk high growth investees and low risk steady-growth investees; etc.


The risk management strategy should also include (derivative) hedging strategies, which may include i) only not hedge if certain portfolio conditions are met; ii) hedging short-term cash flows during an investment period and/or when approaching exits; iii) hedge throughout investment periods, across the portfolio or only in specifically volatile environments or to hedge out peak-exposures to one or more currencies iv) hedge dynamically to benefit from favourable hedge rates; etc. A strategy may even consider proxy hedging; for example, buying put-options on oil to balance out a possible currency shock in a non-diversified oil-producing economy. The hedging strategy should also consider the liquidity implications of hedging, both rollover settlements and potential collateral calls. If sources of liquidity are not available during the life of the investment, the strategy should consider solutions that limit those factors, like working with hedging intermediary MFX.

Awareness, realism, and pragmatism may drive an LP's approach towards currency risk.

2. At the pre-investment stage, where and when should LPs expect PE/VC managers to hedge FX risk?

A hedging policy should consider if hedging is possible and suitable in all relevant circumstances, including i) post-commitment, pre-investment to sustain a match between commitments, calls and investment volumes ii) during holding periods to avoid peak-exposures in certain single currencies and/or to take advantage of anomalously low hedge rates and/or because the LP's risk appetite requires elimination of (a portion of) downside FX risk and iii) prior to exits to prevent value-leakage due to sudden FX shocks that cannot be recouped.

GPs must be aware of the products available. The absence of options in most African markets implies a need for bespoke hedging strategies. The GP hedging strategy should reflect the LP's risk appetite and liquidity constraints.



Awareness, realism, and pragmatism may drive an LP's approach towards currency risk

3. In what cases is currency risk un-hedgeable for LPs? Is there a way to answer this question without resorting to banking intermediaries?

It is practically complex for an LP investor in a fund with a granular equity portfolio across multiple currencies to hedge that investment at LP level. The GP however should have an LP approved hedging policy at fund level. Access to hedging products, which in most African countries are limited to forwards, requires access to commercial banks and/or TCX/MFX.

4. In what cases is the cost of hedging unjustified for LPs?

The “cost” of a hedge reflects the FX risk covered by it. Only in hindsight can it be determined whether that “cost” was positive or negative.

A distinction must be made between options and forwards. Options - generally not available in Africa - offer protection against losses beyond a certain level against payment of a premium (the deeper “out-of-the-money” a put-option is, the lower the premium will be). This fixes the cost while allowing for upside currency risk and does not create subsequent liquidity uncertainty. Forwards replace uncertain future losses due to FX volatility by a certain, fixed, risk-reflective annual cost, that eliminates FX downside risk and FX upside. Forwards “lock-in” an annual certain cost that is a proxy for the cost of currency depreciation that the investor is exposed to without the hedge.

The “cost” of a hedge reflects the FX risk covered by it. Only in hindsight can it be determined whether that “cost” was positive or negative

The price of the forward “exposes” the currency risk on the investment. Whether that “cost” is justified upfront, is entirely a function of the investor’s risk appetite and willingness to speculate.

5. When does it make sense to put FX hedges on post- investment in longer-term strategies? How might that be structured to manage costs of the hedge - especially for investors who are typically not FX specialists?

If an investee’s long-term revenue growth in local currency terms is unlikely to match domestic inflation and currency depreciation, then that may be an indication to hedge (a portion of) the investment during the holding period. Other reasons to do so, may be projected volatility and an investment’s relative (over)exposure to the currency concerned.

An investor that is unwilling or unable to take full FX risk can hedge the investment using short-term

forwards with a roll-over and layering approach, with long-term forwards or using a mixture of short and long-term forwards. The trade-off of using forwards is between eliminating downside FX risk but accepting the replacing fixed hedge cost. If the investor does not want to lock-in such fixed hedge cost because of the risk that the locked-in value exceeds the actual cost of depreciation, he can consider hedging partially, or only highly volatile currencies and/or only peak-exposures. Such dynamic hedging strategies, require access to hedge providers like banks and/or TCX/MFX and in-house hedging capacity and/or external hedging support.

6. Should LPs expect currencies of countries with high relative interest rates to depreciate/ appreciate over time?

In principle, emerging and frontier markets currencies depreciate against hard currencies due the inflation differential between emerging and frontier market currencies and hard currencies. All other things remaining equal, higher inflation in currency A than in currency B, will result in currency A depreciating against currency B.

Domestic base interest rates are a function of inflation expectations. The risk-free interest rate in a country is the rate at which the government borrows in its own currency. It is risk-free as the government can always pay back local currency debt by printing local currency. High (risk-free) interest rates therefore (should) reflect only high

inflation expectations. When interest rates and correlated inflation (expectations) are greater than in hard currencies, the local currency should be expected to depreciate. This is model theory, and of course reality comes with many distortions, but the trend is nonetheless clear and actual. It should also be mentioned that monetary authorities can raise interest rates to combat inflation leading to a temporary strengthening of the currency.

7. What advantages would LPs obtain by working with currency-hedgers like TCX Fund and its partner MFX Solutions?

While TCX and MFX offer the same hedge products as commercial banks, and in principle on comparable terms, there are many differences. TCX and MFX do not have a profit maximization objective but a development mandate, which is to promote and facilitate development finance flows, free of exchange rate risk. That mandate requires that TCX and MFX will in principle always endeavour to find a solution to mitigate FX risk, irrespective of currency, volume, sector, or counterparties concerned. It is also reflected in a constant search to optimize product offering, product pricing and access to products and services. Besides hedging products, TCX and MFX offer any interested party access to their macro/FX knowledge and FX risk management expertise.

High (risk-free) interest rates therefore (should) reflect only high inflation expectations. When interest rates and correlated inflation (expectations) are greater than in hard currencies, the local currency should be expected to depreciate

Trading-access to TCX can be obtained directly (through the execution of an International Swaps and Derivatives Association contract with TCX with customary cash-collateral counterparty credit risk mitigation structures), or indirectly through TCX's principal intermediary partner MFX Solutions (through similar contracts but generally without cash collateral requirements). Costs for trading directly with TCX or through MFX are generally comparable. MFX can also offer collateral mitigation on hedge products offered by commercial banks.

Q&A focused on GPs

1. In PE & VC where the exit date is not pre-set, is there a hedging mechanism possible for PE/VC fund managers besides natural hedge or depositing dollars and borrowing local currency to make an investment?

Yes. Besides alternative risk management strategies, any equity investment can in principle be hedged. As mentioned above, in African markets, FX options are generally not available, but forwards of any length are.

For an equity investment without fixed cashflow projections, forwards cannot result in a perfect hedge, but they can be used to hedge a (substantial) portion of investment value, either over the full holding period (using a forward roll-over/layering approach) and/or at commitment/investment and exit stages.

2. What are the best hedging mechanisms for PE/VC fund managers currently operating in Africa?

In the absence of FX options, investors must rely on (a combination of) i) portfolio diversification, natural hedging (investing in exporters or in businesses with ability to increase pricing with inflation), proxy hedging, and ii) having access to

banks and/or TCX/MFX. What is best, will depend on investment mandate, risk appetite, portfolio composition, liquidity constraints and actual macro-economic conditions.

Please refer to Question 1 (Q&A focused on LPs)

3. What is the cost of currency hedging tools? Are there any attractive alternative solutions?

FX options, where the cost to cover downside risk is a premium sized to reflect volatility in the currency and the "in-the-moneyness" of the option, are generally not available in African markets (with few exceptions like South Africa). The forwards offered by banks and TCX/MFX reflect the risk they cover (plus in case of the banks, the bid-ask spreads that they charge).

The "cost" of forwards, expressed as an agreed fixed exchange rate at which two currencies are exchanged in the future, is a function of the interest rate differential between the two currencies. The interest rate differential and the corresponding "cost" of a forward can vary (wildly) across currencies and over time. Forwards eliminate downside and upside risk. The greater the interest rate differential, the greater the risk that the forward covers and the greater its "cost" expressed as the forward rate. The flipside to eliminating high risk by using forwards, is that the risk of missing out on FX upside - if the currency does not depreciate or even appreciates - is also greater. Whether a FW price is perceived to be

In the absence of FX options, investors must rely on (a combination of) portfolio diversification, natural hedging, proxy hedging, and having access to banks and/or TCX/MFX. What is best, will depend on investment mandate, risk appetite, portfolio composition, liquidity constraints and actual macro-economic conditions

attractive, depends entirely on the investor's risk appetite and its willingness to speculate on the local currency holding firm.

4. For how long can a hedging mechanism such as a forward be in force?

Forwards offerings usually cover (only) the larger African markets and are generally limited in tenor up to 12, 24 or 36 months with rare exceptions for longer tenors (for example 10 years in Nigeria).

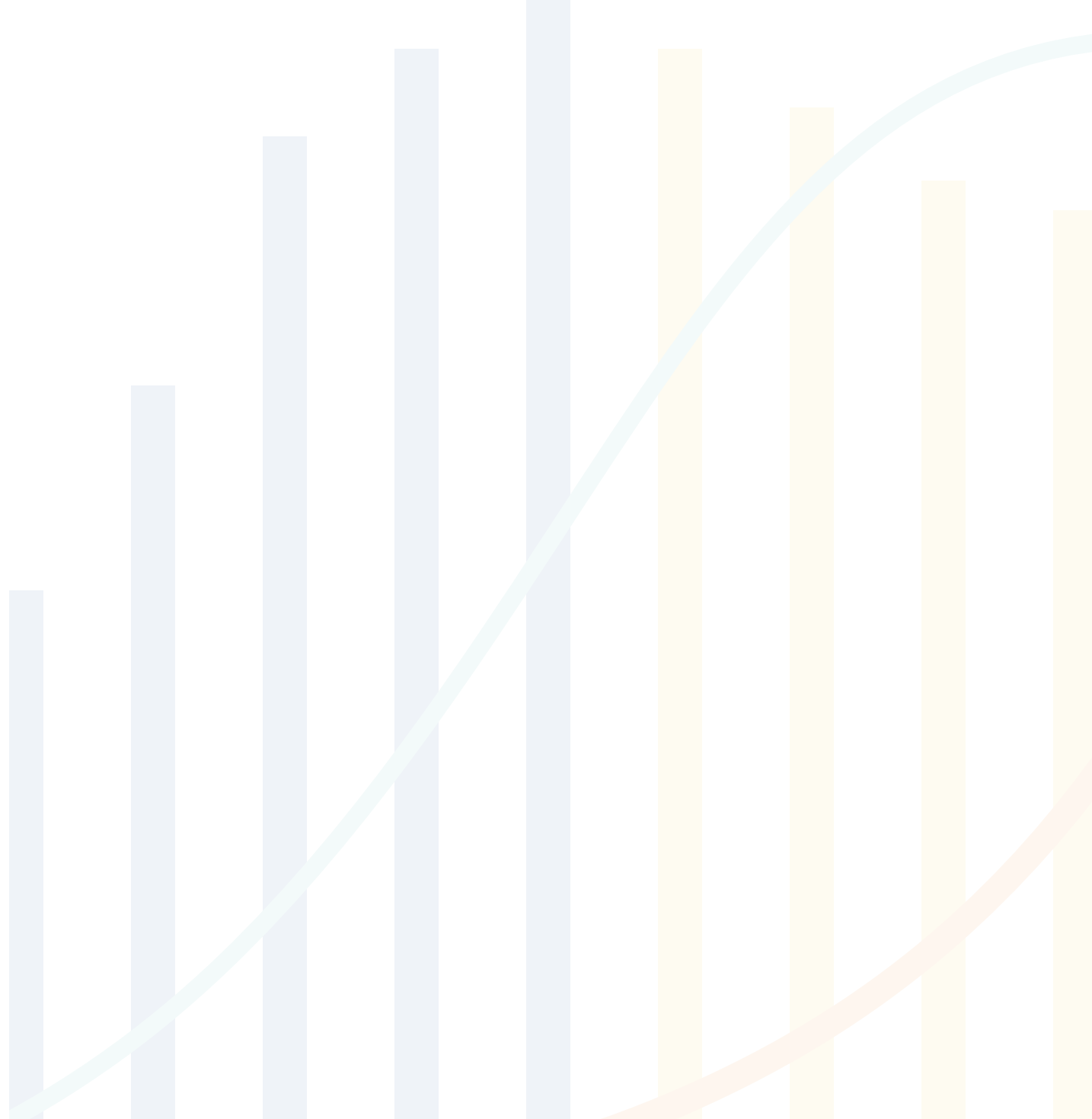
5. In which cases is currency risk un-hedgeable for GPs?

In principle, currency risk can always be hedged. A currency risk management strategy should consider alternative hedging methods including natural hedging, portfolio composition and diversification criteria to mitigate currency risk and include a hedging policy using hedging instruments.

6. In which cases is the cost of hedging unjustified for GPs?

The "cost" of a hedge reflects the FX risk covered by it. Only in hindsight can it be determined whether that "cost" was positive or negative.

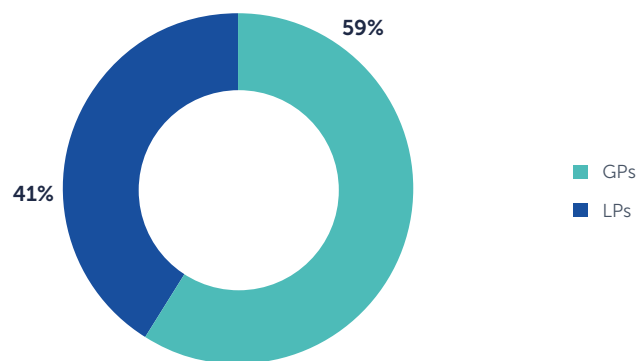
Please also refer to Question 4 (Q&A focused on LPs)



Participants' Profile

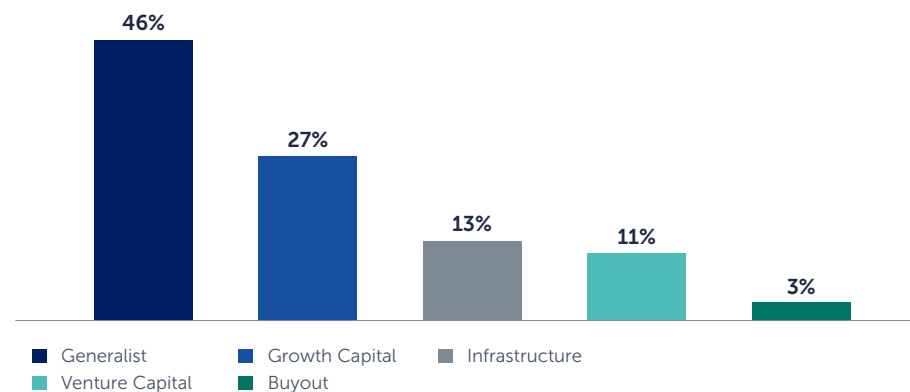
AVCA surveyed 37 GPs and 26 LPs between November and December 2021. The survey was undertaken via an online questionnaire and the questions were designed to provide insights into the effects of currency volatility on Africa's PE & VC industry and examine fund managers' and Limited Partners' views and practices for managing currency risk on the continent.

4.1 Survey Respondents



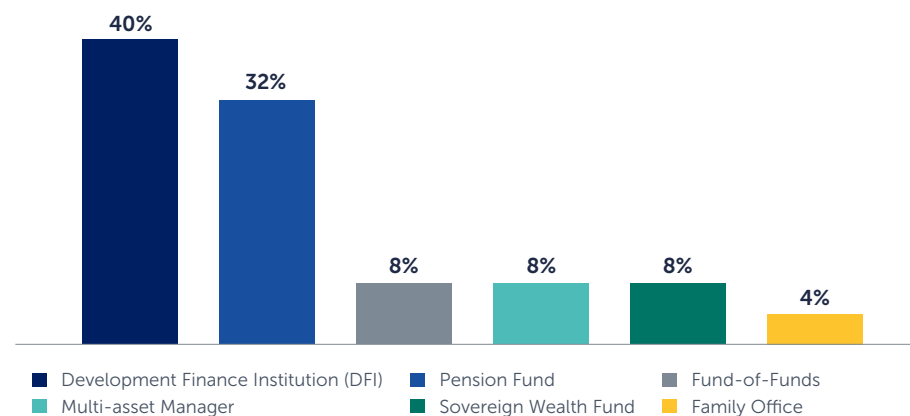
4.2 Type of GPs and LPs

GPs' Type



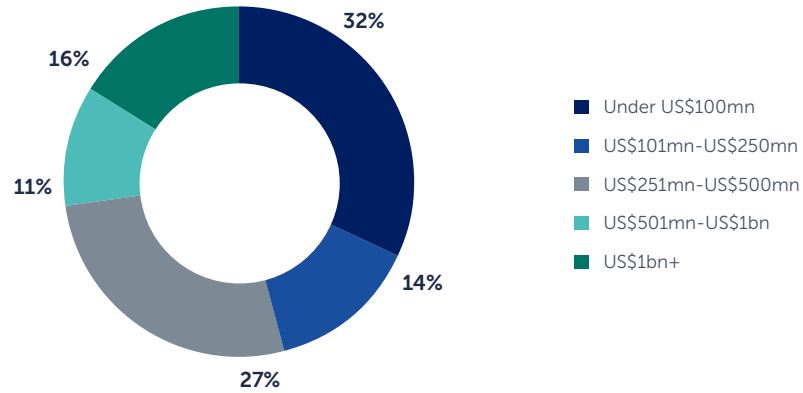
A generalist GP is a fund manager investing with more than one investment strategy.

LPs' Type

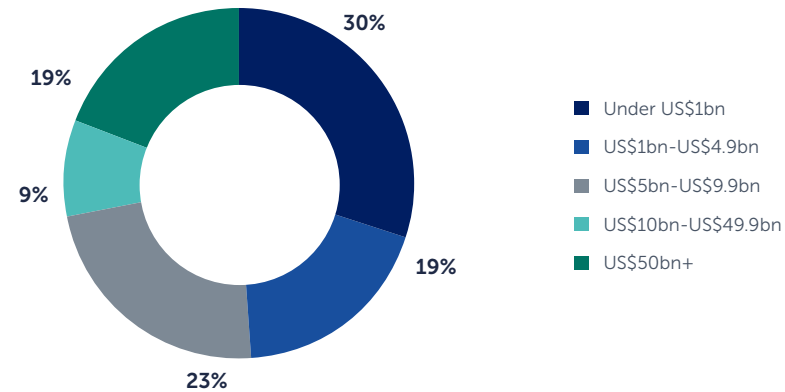


4.3 Assets Under Management

GPs' Assets Under Management

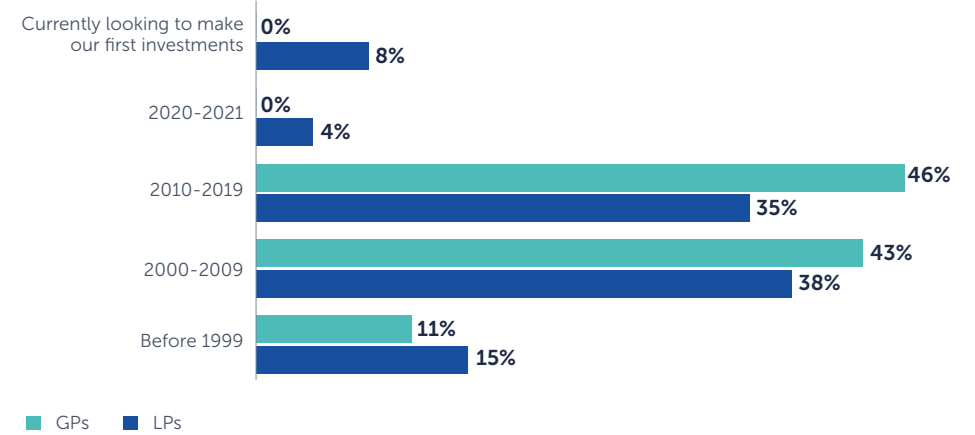


LPs' Assets Under Management



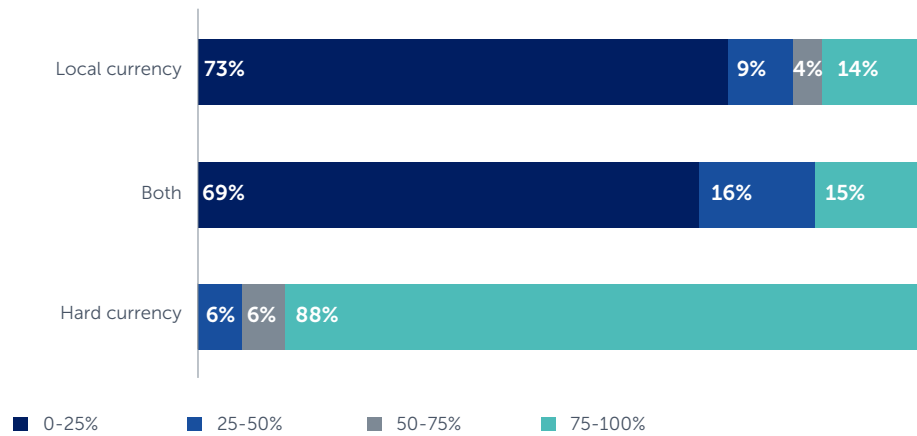
4.4 Experience in the industry

Year Organisation first started investing in Africa PE & VC

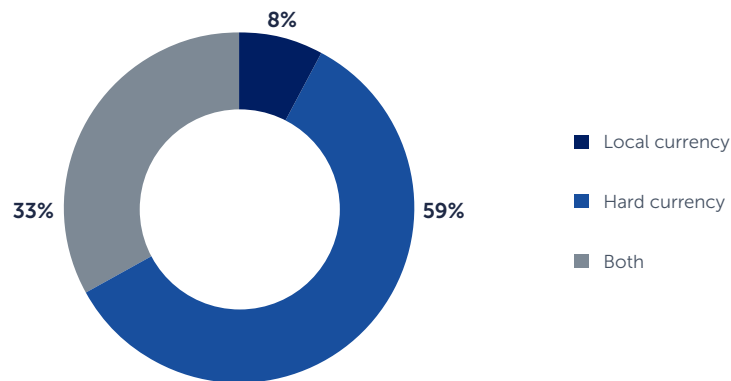


4.5 Portfolio by currency type

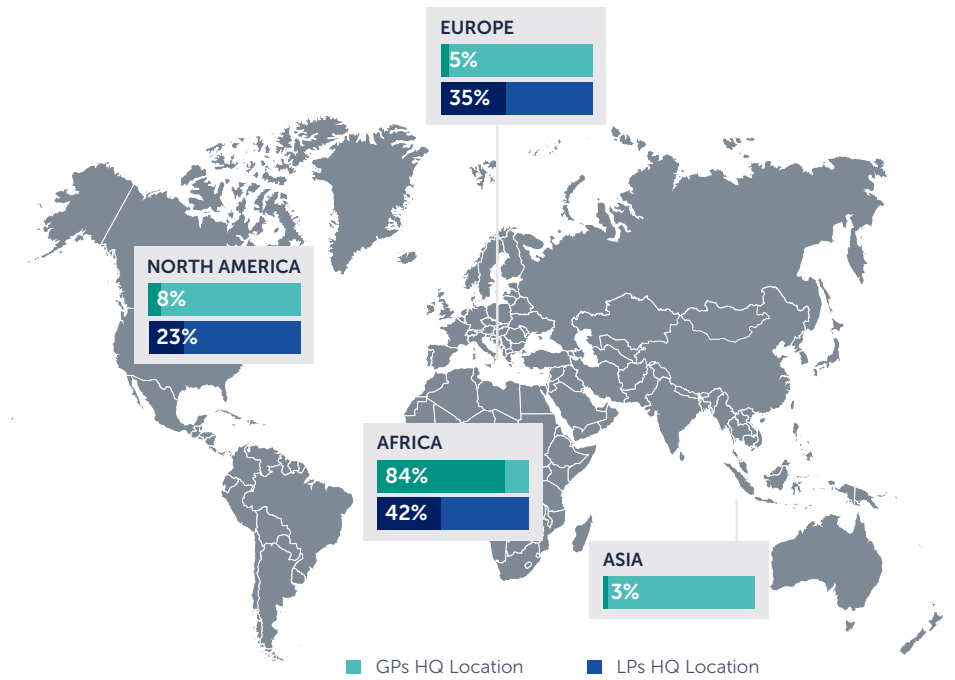
Share of GPs' portfolio by currency type



Share of LPs' portfolio by currency type



4.6 Regions





African Private Equity
and Venture Capital
Association

Contact AVCA

37 North Row
3rd Floor
London W1K 6DH

E avca@avca-africa.org
W www.avca-africa.org
C www.avcaconference.com
T +44 (0)20 3874 7008

Championing Private Investment in Africa

The African Private Equity and Venture Capital Association is the pan-African industry body which promotes and enables private investment in Africa.

AVCA plays an important role as a champion and effective change agent for the industry, educating, equipping and connecting members and stakeholders with independent industry research, best practice training programmes and exceptional networking opportunities.

With a global and growing member base, AVCA members span private equity and venture capital firms, institutional investors, foundations and endowments, pension funds, international development finance institutions, professional service firms, academia, and other associations.

This diverse membership is united by a common purpose: to be part of the Africa growth story.



Contact TCX

The Currency Exchange Fund N.V.
Mauritskade 63
1092 AD Amsterdam
The Netherlands

E info@tcxfund.com
T +31 20 531 4851

TCX Fund is a Netherlands based development finance initiative backed by a wide range of development finance institutions and government agencies. The fund's mandate is to eliminate currency risk associated with impact investing. TCX for that purpose offers swaps and forwards without any tenor restrictions, to hedge emerging and frontier market currencies globally. Since TCX started operations in 2007, it has supported USD 10+ billion equivalent of local currency investments in 70+ currencies. TCX actively trades with some 150 impact investors globally, in large part indirectly through its principal intermediary MFX.



Contact MFX

1440 G St NW
Washington DC 20005

E Corina@mfxsolutions.com
T 202 809-9635

MFX Solutions contributes to currency risk elimination by ensuring that impact investors can effectively access the hedging products that TCX, and commercial banks, offer. MFX can transact without collateral thanks to government guarantees that backstop its clients' credit. Hedging through MFX can eliminate the cost of holding liquidity for, and the operational complexity and uncertainty of, margin calls. MFX trades with TCX to hedge the least liquid currencies and with several commercial banks for other currencies. Since 2009, MFX has transacted USD 3.8 billion of hedges in 60+ currencies for some 75 impact funds. Of that, USD 2 billion was hedged with TCX, and the rest with banks.

