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When Investing in Africa, Fortune Follows the (Moderately) Brave

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Any discussion of why it makes sense to invest in African companies, or to pursue mergers and acquisitions ("M&A") there, must begin by confronting all the negativity that historically has surrounded the continent.

Companies and investors in Africa have had well-founded concerns about political instability; endemic corruption; and regulations that have been loose, difficult to follow or constantly changing. Potential investment or acquisition targets often have been notable for poor corporate governance and a lack of financial and operational transparency. In 2000, The Economist labeled Africa "The Hopeless Continent," pointing to political chaos and violence in nations like Sierra Leone and Liberia, as well as the regular recurrence of natural disasters such as floods and famines, as reasons for a persistent lack of economic progress in the region.

Yet today, there are encouraging signs. The Sierra Leone and Liberian governments are more stable than they have been in decades. The recent, peaceful political transition of power in Nigeria particularly is significant, given that the country has a growing economy and is increasingly perceived as the gateway to Africa, rivaling South Africa. On the other hand, Africa continues to suffer hard luck. The 2014 Ebola virus outbreaks in West Africa gave investors a new reason to shy away.

In this article, we mostly address sub-Saharan Africa, as the countries of North Africa are more closely associated with the Middle East, and the political and economic issues there are different and currently roiled. South Africa stands apart as a nation with a more developed economy, featuring bankers and corporations that weigh investments and M&A opportunities in the rest of the region in much the same way as their counterparts in other areas of the world. Because of slow growth in South Africa's own economy, investors and businesses there seeking expansion opportunities are looking elsewhere in Africa.

Those who see opportunity in sub-Saharan Africa point to its underserved population, an emerging middle (or, at least, consumer) class, and its rich pool of human and natural resources. The region's economy is one of the world's fastest growing, with gross domestic product projected to rise an average 4 percent to 6 percent annually for the next several years.

Given that, there should be opportunities in Africa, especially for retail and consumer products businesses, and we believe that smart investments in and acquisitions of African companies can pay off. But finding the right strategy will be tricky. What is required is not simply money — but executive leadership that sets an example for improved corporate governance that will lead to sustained success.

First, the Good News

The opportunity to profit from Africa's growth is real. On average, the continent's economies will grow 4.5 percent in 2015 and 5 percent in 2016, according to the 2015 **"African Economic Outlook" report** by the Organization for Economic Co-operation and Development, the African Development Bank ("ADB") and the United Nations Development Program.

Private investment from abroad will grow to $55.2 billion this year, the report predicts, more than 10 percent higher than last year. But the figure continues to be significantly lower than the $66.4 billion invested in 2008, a sign that foreign interest in investment in Africa, while rising, still has not fully recovered from the blow of the global financial crisis.

One of the greatest traditional *concerns* about Africa — its burgeoning population — also represents an *opportunity*. Sub-Saharan Africa's population is expected to double by 2050, and, unfortunately, many of those people will be born into poverty, according to the Population Reference Bureau. On the other hand, the African Development Bank reported in 2014 that a stable African middle class (**defined by the ADB as people spending from $4 to $10 a day**) already has grown to 313 million, or 34 percent of the total population. A larger middle class means greater demand for improved infrastructure, especially considering how many Africans lack access to basic services such as banking and telecommunications. As seen in Figure 1, communications infrastructure is where the vast majority of business leaders see investment increasing significantly (96 percent).

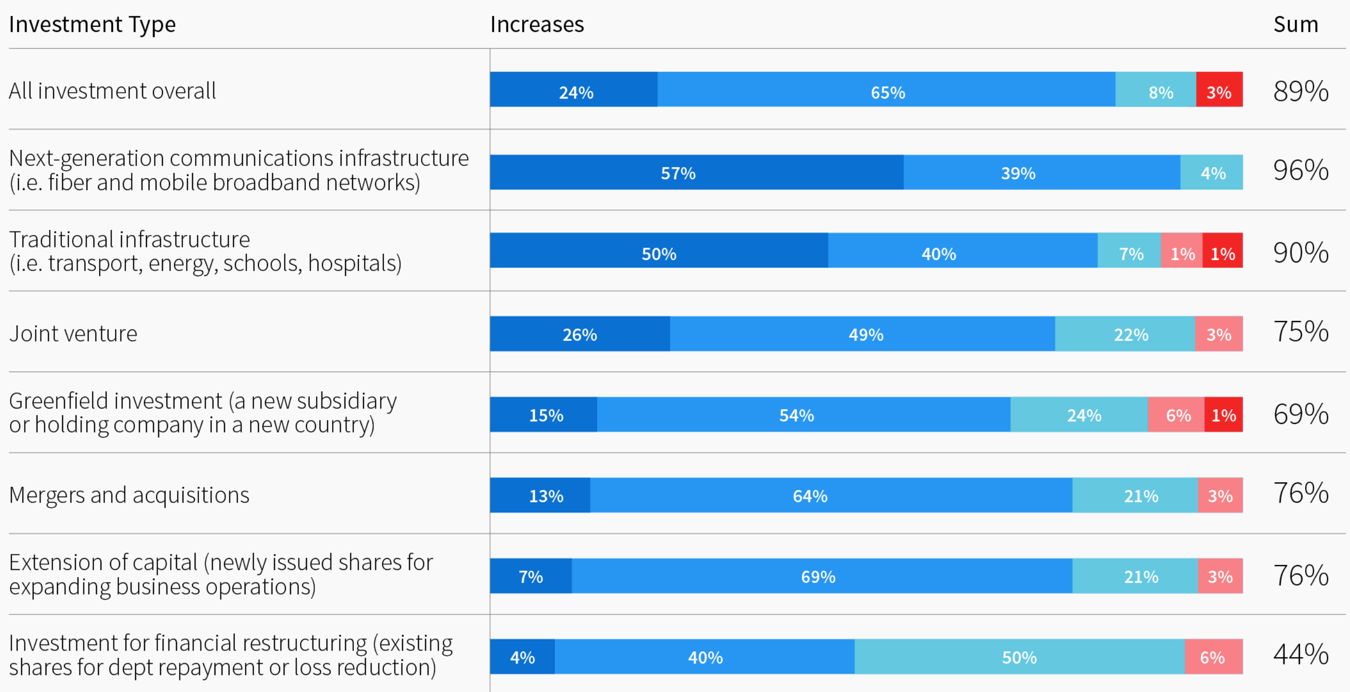
In addition, we're seeing an explosion in demand for healthcare, as a higher percentage of the population begins to suffer from middle class diseases like diabetes. At the same time, an expanding middle class might make greater use of birth control, thus limiting population growth to a more manageable rate.

The recent peaceful transfer of power in Nigeria (the first in its history) has given rise to optimism about the potential for political stability in the region. In March 2015, former President Goodluck Jonathan conceded the national election to Muhammadu Buhari, who was inaugurated in May. If the leaders of other African countries see that a more democratic political climate leads to a better economy, they may be motivated to follow Nigeria's example.

Robert Diamond, Jr., the former Barclays CEO now focusing on African investment as CEO of Atlas Merchant Capital, cited

Figure 1: The Changes to Investment Types

Q. Which of the following types of investment into Africa are expected to change over the next 12 months?



Base: (2015) n=78 opinion leaders on Africa ■ Encourage investment ■ Neither encourage nor discourage ■ Discourage investment ■ Don't know

Note: all numbers have been rounded to the nearest percentage

Nigeria's peaceful political transition as one of the major reasons for his own optimism. Speaking as part of an FTI Consulting panel discussion at the World Economic Forum on Africa 2015 this past June, Diamond said, "Nigeria is a very big part of the [sub-Saharan Africa] growth story, [as] one in three of GNP [gross national products] comes from Nigeria and one in five Africans is Nigerian."

Throughout the region, urbanization and population growth "will demand services [that don't exist today] and infrastructure that is still to be built," said Rick Menell, a senior advisor to Credit Suisse and a mining industry veteran, speaking at the same event. "Public-private partnerships are necessary, but they need a regulatory framework that satisfies both the profit motive of investors and the broader mandate of governments."

In other words, businesses are looking for governments with whom they can work. Dealing with African governments can be difficult, but the challenge is starting to look more manageable. Given a sufficient appetite for risk and a properly diligent approach to risk mitigation, investors and companies interested in investments, as well as mergers and acquisitions, should be optimistic about Africa's potential.

What Business Leaders Are Thinking

In June 2015, FTI surveyed business leaders at the World Economic Forum conference in South Africa. About half labeled investment in Africa "important but risky." Despite the perceived high level of risk, 88 percent said the overall investment for outlook is positive, with the greatest opportunities in East Africa (91 percent positive) and West Africa (89 percent positive).

As shown in Figure 2, key criteria that would encourage investment are:

- Government support for investment projects (88 percent)
- Availability of public-private partnership opportunities (83 percent)
- Market accessibility, size and growth prospects (80 percent)

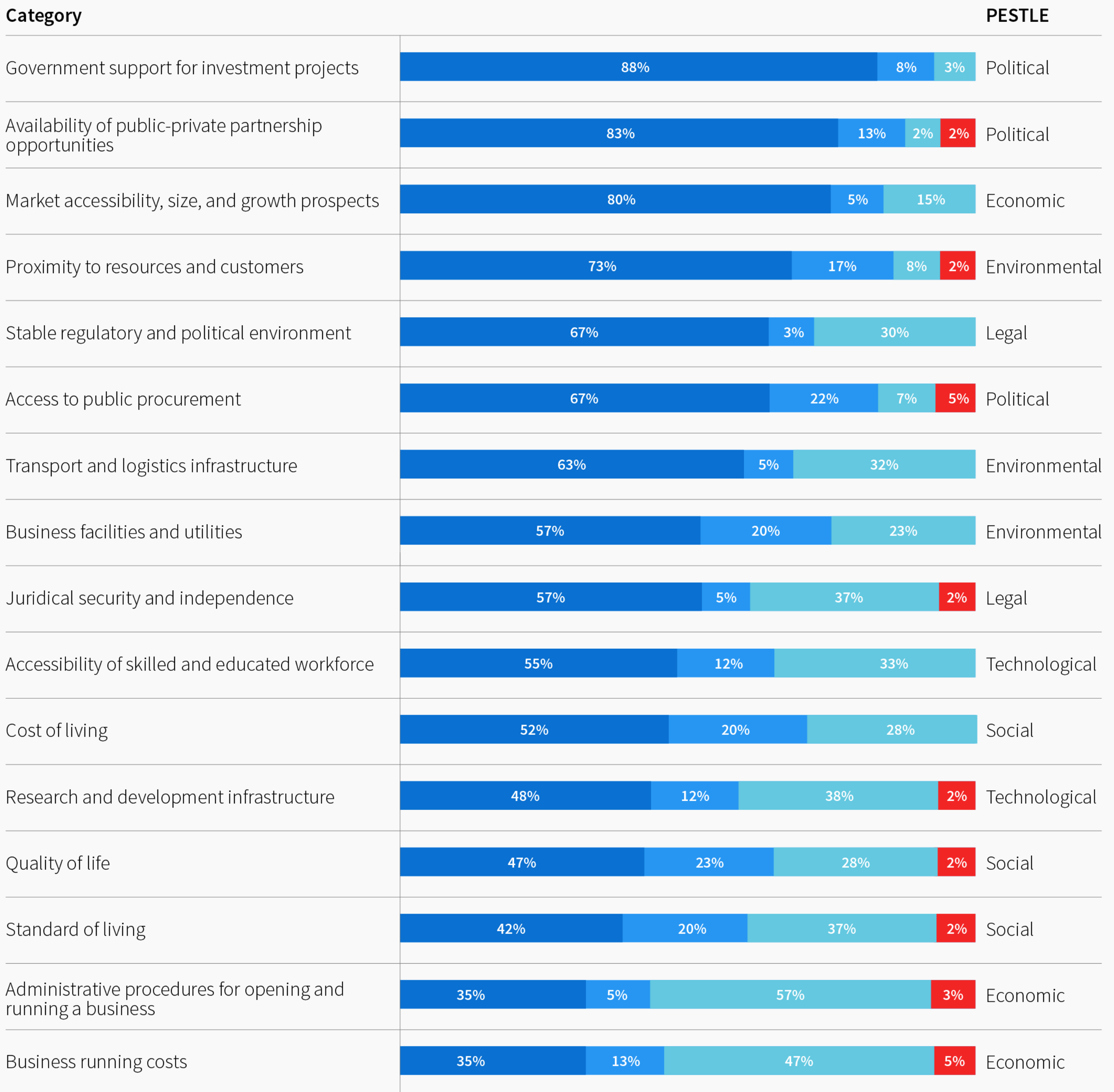
However, administrative procedures for opening and running a business (57 percent) and business running costs (47 percent) stood out as factors most likely to discourage investment.

The survey also confirmed as shown in Figure 3 that Nigeria is emerging as the new gateway to investment in Africa (76 percent), eclipsing South Africa (60 percent). This reflects a much improved impression of Nigeria's stability and business climate.

Also as shown in Figure 1, M&A activity in Africa will increase, according to 76 percent of participants, with 76

Figure 2: Factors to Encourage or Discourage Investment into Africa

Q. Which of the following do you believe would either encourage or discourage investment into Africa?



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percent expecting this to originate from multinationals outside Africa and a further 50 percent believing it will come from intra-African activity.

Within our panel of business leaders, 89 percent expect an overall rise in investment, with 96 percent expecting the greatest increase to occur in communications infrastructure and 90 percent expecting it to show up in traditional infrastructure (transport, energy, schools, hospitals). Additionally, 74 percent said the sector where they would most like to see additional investment is in agriculture and farming.

Short-Term Actions for Long-Term Success

We believe Africa is poised to more fully realize its economic potential.

An improved climate for M&A makes it easier for investors to make back their

money without the necessity of an initial public offering, which still is relatively rare for firms born in developing nations.

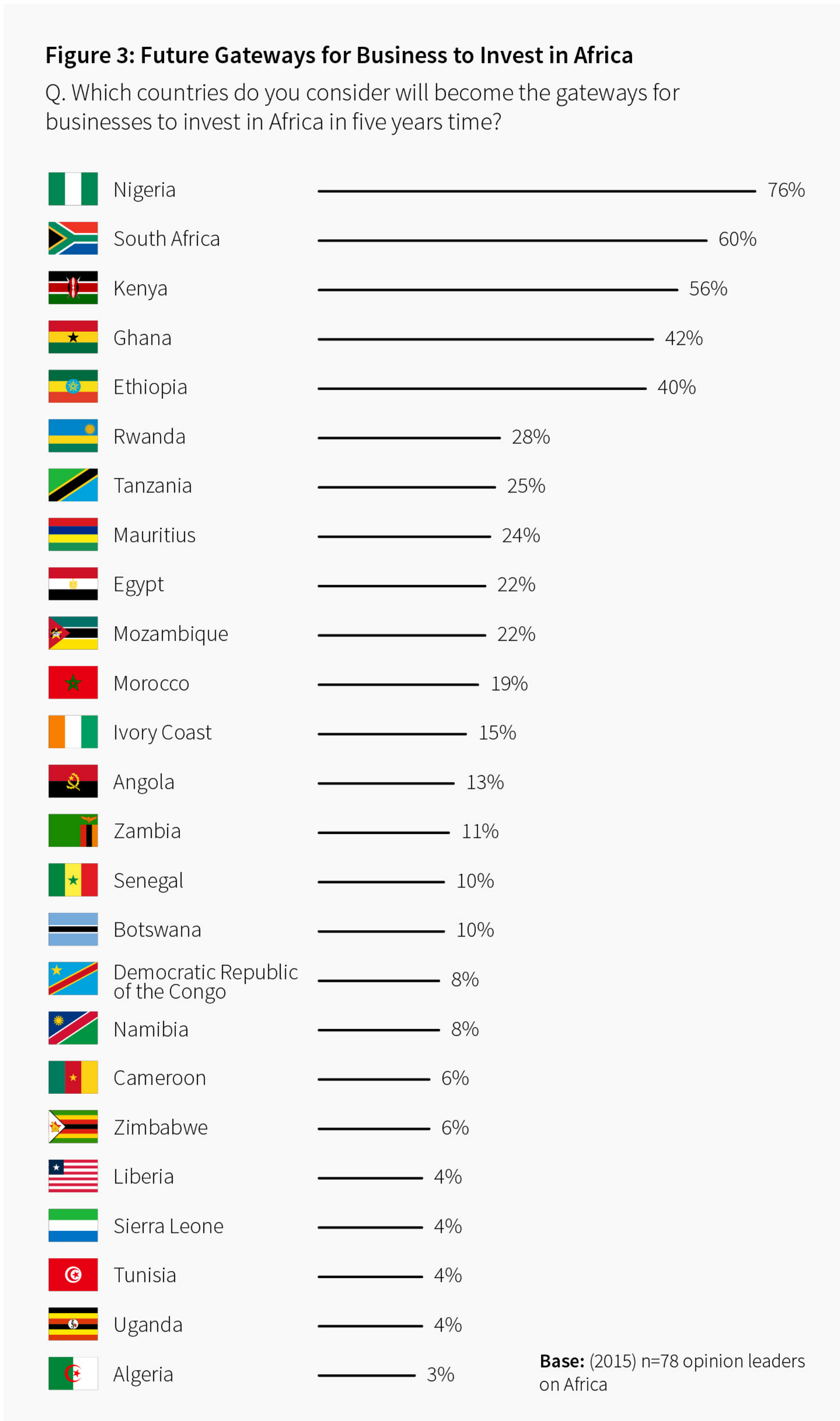
Examples of successful acquisitions include Wal-Mart's 2012 purchase of 51 percent of African retailer Massmart for $2.4 billion. Massmart is Africa's second largest distributor of consumer goods, operating in 12 countries. Wal-Mart is among the most prominent examples of a U.S. company seeking to gain a first-mover advantage by capitalizing on the higher demand for consumer goods from a growing African middle class, although the American giant faces stiff competition from South African retailers like Shoprite Checkers, which also is expanding aggressively throughout Africa.

Acquisitions continued in 2014. Marriott International became the largest hotel operator in Africa with the purchase of the 116 hotel Protea Hospitality Group for approximately $200 million.

A study commissioned by the **African Private Equity and Venture Capital Association** found that private equity investors have been more and more successful in finding exits, including sales to other private equity investors. The results revealed a record year for private equity exits in 2014, with 40 transactions concluded. This represented a 38 percent rise over 2013 and the largest total since 2007 (pre-crisis), when there were 34 exits.

This is an encouraging sign. Investors that put money into African companies increasingly have been able to retrieve a profit. At the same time, buyers need to be aware that seemingly promising acquisitions in Africa can go bad.

Bain Capital continues to struggle to make back its $3.5 billion purchase of Edcon, a fashion retail conglomerate. This was partly a matter of bad timing: Bain leveraged the business with offshore debt just before the financial crisis hit. Post-acquisition, Edcon needed to invest in store remodeling and other expenses that further hurt its balance sheet. Edcon's business in South Africa benefited from an economic surge due to heightened interest in soccer in general and of the country's hosting of the World Cup in 2010, but the boost in the national economy since has tapered off — and growth elsewhere in Africa has yet to make up for Bain's original investment.



In 2012, South African consumer packaged goods firm Tiger Brands paid nearly $200 million for a 63 percent stake in Dangote Flour Mills. Since then, the subsidiary's performance has been so poor that Tiger Brands is carrying Dangote as an asset of essentially zero

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value — and, worse, the performance of Tiger’s stock price suggests investors see Dangote as having a negative value.

Once Dangote’s founder and members of the former management team left after the acquisition, the qualities that had attracted Tiger Brands swiftly evaporated. Integration issues, including the retention of key managers, are the bane of many acquisitions, and that is at least part of the story here. The lesson — especially in Africa, where the management layer may be relatively thin or immature — is that companies need to be especially diligent in assessing the depth of management talent at acquired companies, as well as the need for robust retention and training initiatives.

That’s the short-term lesson. In the long run, investors must be patient.

Speaking at the FTI Consulting panel discussion, Tiger Brands CEO Peter Matlare said the lesson he had learned is that investors “can’t become skittish at the first sign of trouble.”

Firms embarking on M&A in Africa must be prepared to persist through business cycles. That means investments should be made for the long term. Beyond the purchase price, successful development of an acquisition target is likely to include putting money into improving operational capabilities, infrastructure and management training.

While conducting in-depth due diligence on an acquisition target always is a good practice, it is doubly important in Africa. Solid management is a rare commodity. To address this, it’s essential to engage with management before making or even considering an acquisition in order to gauge the strength of the company’s governance. This engagement should go beyond the organization’s top leaders to its line managers.

Savvy investors may best be advised to make a minority investment first, secure a seat on the board and learn about the organization thoroughly before committing a large sum of capital. Some of the most successful foreign investments have been in the banking sector, where oversight from European financiers has pushed institutions such as Nigeria’s Access Bank, Diamond Bank and First Bank of Nigeria to improve their governance, knowing that they now will be audited at a much higher level of scrutiny.

And, in a virtuous circle, as these banks raise their game, they attract more foreign investment. For example, in 2008, Diamond Bank became the first African financial institution to have its global depository receipts listed on the London Stock Exchange. In November 2014, The Carlyle Group, a U.S. investment firm, announced a $147 million investment in Diamond Bank.

Success begets success.

An African Investment Strategy

Investing in African companies, whether through M&A or equity investments, still calls for a great deal of caution. The best strategy may be to engage with a potential acquisition target first through an equity investment, evaluating and working with it to strengthen the depth of its management and the quality of its operations.

The opportunities in Africa are real, but the investors that profit most will be those that take the time to completely understand what they are buying or investing in.

By definition, capitalism is good for business. It’s particularly good for business in Africa. Smart foreign investment improves the governance of African businesses, which, in turn, increases opportunities for other businesses, both within and outside the continent.

The message from investors is (and ought to be): “We’re not going to give you money unless you behave like a real business.” Investors have the right to insist that the African businesses they put money into meet the same standards of management and governance they would expect from companies anywhere else in the world.

By setting high standards, investors and acquirers cannot only capitalize on an *improving* economic climate in Africa — but they also can *accelerate* it.

Research methodology:

This research was conducted online by the Strategy Consulting & Research team at FTI Consulting from 15th to 20th May 2015, involving n=78 opinion leaders on Africa attending the World Economic Forum, South Africa in June 2015.

For more information on the research methodology: dan.healy@fticonsulting.com

Please note that the standard convention for rounding has been applied and consequently some totals do not add up to 100%.

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