



Africa: Maximizing Investment Opportunities While Mitigating Risk

African markets, boasting 10 of the top 20 fastest growing economies in the world and five of the world's top 10 reformers in 2012 according to the World Bank's Doing Business rankings, hold exceptional promise for private equity investors. However, the lack of transparency and underdeveloped legal systems and institutional infrastructure in many African markets make assessing potential investments difficult.

In Kroll Advisory Solutions' most recent annual survey of global senior executives on the subject of fraud risk, Africa scored highest on a comparative regional basis for six of eight types of fraud-related loss, ranging from conflicts of interest with management to corruption and bribery (see Exhibit 1). Interviews with these executives revealed several key themes in the real and perceived challenges related to operating and investing in Africa:

1. Overlap between public and private sector
2. Difficulties in conducting due diligence – availability and reliability of information
3. Aggressive regulatory frameworks that deem Africa to be high risk

A panel of EMPEA Members—industry experts including Melvin Glapion from Kroll Advisory Solutions, Bayo Odubeko from Norton Rose, Ralph Keitel from the International Finance Corporation, Davinder Sikand of Aureos Capital and Gerben Dijkstra of Investec Asset Management—enumerated approaches to these challenges during an EMPEA Professional Development Webcast on 26 September 2012, highlights of which are featured here.

Overlap between the Public and Private Sector: Managing Exposure to Government Influence

A defining feature of regulation in many African markets is the high degree of overlap between the public and private sector, as well as levels of government supervision over investment generally exceeding those in developed markets. Bayo Odubeko, a Partner with Norton Rose, observed that "investments that would be seen as routine in many developed markets may require a multitude of approvals from various government bodies within select African markets." For example, Nigeria requires investments in public but unlisted companies to be approved by the Securities and Exchange Commission (Nigeria), while in most jurisdictions outside of Africa such approval would only be necessary for investments into listed companies and/or investments that involve some change in control. In Ghana, all transactions involving government-owned entities entail Parliamentary approval. Across the region, added levels of approval are time consuming to obtain and compound the difficulty of completing deals.

In African markets, challenges around navigating governmental involvement and enforceability of contracts are compounded by legal systems that are highly varied, as well as regulatory structures and legal procedures that may be under-developed or fall outside the norm of the investment process in other jurisdictions. The variety of legal systems present across the continent follow colonial patterns, with the Anglophone countries of the former British Empire

Exhibit 1: Comparative Vulnerability to Select Fraud Risks, by Region



Source: Kroll Global Fraud Report, 2011/2012 with EIU; poll of 1,265 senior executives worldwide June–July 2011.

using English common law, former French and Portuguese colonies using civil law, and much of Southern Africa using Roman-Dutch law. Exhibit 2 shows the distribution of legal systems within Africa.

In many African markets, indigenization and local economic empowerment initiatives also shape the investment environment. In such jurisdictions, control transactions are impossible; foreign ownership is either limited to a maximum of 49 percent, particularly in industries deemed strategically important such as the Nigerian oil and gas sector, or proscribed altogether as in the financial services sector in Ethiopia. To meet the “local content” requirements, which may afford investors with access to a more favorable fiscal regime and/or priority consideration when bidding for government contracts, private equity firms must ensure that their investments are structured through a locally-owned entity, and that local ownership of that entity remains intact. A change in the ownership of the pre-approved local entity may trigger a required divestment by the private equity investor.

Furthermore, in highly regulated industries such as banking and insurance, private equity funds investing above a prescribed threshold may be required to register themselves with the government as controllers or owners of an entity. In such jurisdictions, regulators may require “looking through” the fund, meaning that the fund may be forced to disclose a list of their limited partners in the fund.

Gerben Dijkstra, an Investment Principal with Investec Asset Management, noted that many general partners concerned with the public sector’s level of involvement in the private sector take the simple approach of avoiding such conflicts of interest in the first place.

“Being that we’re part of a large platform, we take an institutional approach to risk management. We only invest in

private companies with limited or no government shareholding. We prefer to deal with retail-facing companies doing a large number of transactions with a large number of private clients rather than business-to-business where you may have few clients and government may be one of them,” said Investec’s Dijkstra. “We avoid certain sectors where tenders are involved, material licenses have to be renewed and government approvals have a repeated and significant impact on the business.”

Ralph Keitel, a Principal Investment Officer with IFC’s Private Equity and Investment Funds Department, endorsed this approach, noting that IFC is generally reluctant to allow its funds to invest into natural resources deals, for example, unless it’s a private equity manager with a proven track record managing both the risks related to government supervision as well as the inherent environmental, social and corporate governance (ESG) risks involved.

Confronting Due Diligence and Transparency Challenges

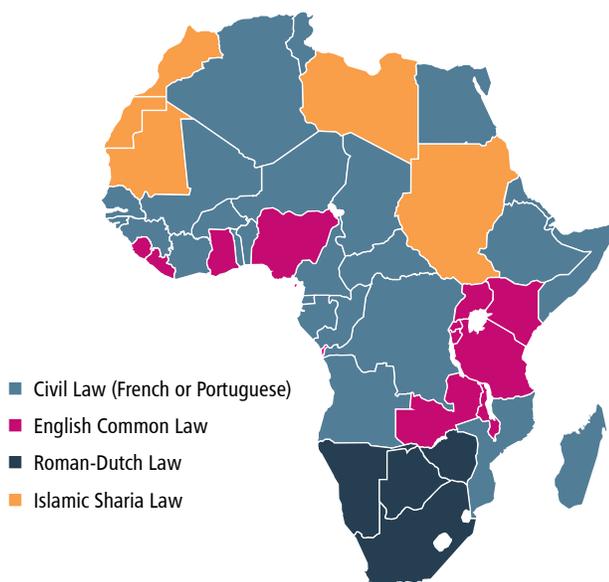
Transparency challenges aren’t unique to Africa, and the panellists agreed that prudent use of external legal, financial and sometimes technical advisors is a must in any private equity deal. In emerging markets, however, private equity is more often about backing entrepreneurial founders and managers and not buying out mature businesses, making diligence into the people involved all the more crucial.

“The problem isn’t that the data or information doesn’t exist, but that it is not as readily available as it might be in more developed PE markets or may not be as reliable as you’d ordinarily expect. The best way to overcome such uncertainty is to do as much homework as possible,” noted IFC’s Keitel.

For IFC, notes Keitel, this means more diligence on a company’s sponsors, shareholders and management. “The thing that would cause us to walk away, even late in a deal, is when we see opaque structures, where there may be undisclosed beneficial owners,” said Keitel. “Unless we are convinced otherwise, we have to assume that at the end of the line there is a beneficial owner that wishes to remain unknown, either one deemed to be a politically exposed person (PEP), such as a high-ranking government official or a member of the ruling family that we don’t wish to deal with, or someone involved in some sort of criminal activity such as corruption or money laundering. The reality is that these two issues—politically exposed persons and criminal activity—sometimes go hand in hand. The overruling principle for any investor, including IFC, is that we don’t want to see our names in the headlines of the newspaper in a negative context.”

Investec’s Dijkstra agreed that diligence in African deals should be aimed at developing trust in and with the people involved. “When you’ve developed a good relationship, you can sit across from them and ask the hard questions and flesh out your ability to influence or change the business sufficiently to invest. But ultimately, if you encounter

Exhibit 2: Legal Systems of Africa (as of November 2012)



a system of payments or procedures that you can't change or you can't get comfortable with—even if it's a good company and even if they can make a case on the merits—you must be willing to walk away.”

Aureos' Senior Partner for Africa Davinder Sikand underscored the primacy of diligence into the people involved: “It's all about referencing. It's about understanding who we're dealing with, whether we can work with these people, whether we can trust them. It's only once we've rated our trust in the team that we look at all the other aspects of the investment opportunity, the company's position and plan and so on.”

But Norton Rose's Odubeko countered that investors must put issues around transparency into the appropriate context and not assume anything out of the ordinary is a sign of untoward behavior. “For example, you may find in certain countries that there are contracts that haven't been signed or dated or haven't been registered with the relevant authority. These contracts may indeed be operational, and there may be valid reasons for why a contract hasn't been signed or registered that have to do with very significant tax implications of a signed document. That doesn't necessarily mean that those documents are invalid or that the parties involved do not believe they are bound by them,” explained Odubeko.

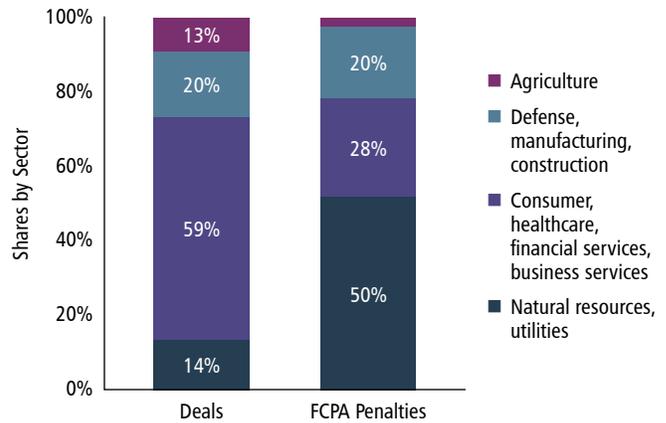
Aggressive Regulatory Frameworks Deem Africa to Be High Risk

Whether these risks are real or perceived, the fact remains that under the anti-corruption and anti-money laundering statutes with which many private equity investors must comply in the United States and the United Kingdom, African markets are generally deemed higher risk. As a result, investors must be able to demonstrate an elevated level of diligence in the forensic accounting process, anti-bribery compliance, employee screening, and supplier and customer vetting. There is in fact a correlation between corruption-related prosecutions and highly regulated sectors, such as natural resources, in those countries with a high degree of government involvement. Exhibit 3 shows the distribution of investments in 2011–2012 by sector in Sub-Saharan Africa, and a corresponding distribution of penalties imposed under the United States' Foreign Corrupt Practices Act of 1977 (FCPA). Whereas natural resources and utilities represented 13 percent of total investment transactions between August 2011 and July 2012, the sector accounts for 50 percent of all FCPA penalties imposed by United States authorities since 1977.

Legal Remedies and Mitigants

There are a number of standard mitigants, such as warranties or indemnities, that investors can avail themselves of in the sale or investment documentation. “What we often see in the documentation in Africa are pledges of the sale of the sponsors—in the event of any material breach, the PE fund has the ability to exit by the pledge and be made whole for any losses,” noted Norton Rose's Odubeko.

Exhibit 3: Investment and FCPA Penalties, by Sector (Africa)



Sources: EMPEA; FCPAmap.com.

Note: Deal data based on number of deals by sector, Jan. 2010–Dec. 2011; FCPA data based on value of penalties in U.S. Government FCPA cases since 1977.

Government involvement in many African markets alters practices that are otherwise standard for private equity funds globally. In some jurisdictions, warrants and preferential shares may be precluded from capital structures. In Sharia-compliant regulatory regimes, the payments of interest or dividends to investors may also be proscribed. In Ethiopia, the government requires that transaction bylaws be written according to a specifically prescribed format, limiting private equity firms from incorporating necessary minority investor protections and “tag-and-drag” provisions that are otherwise common practice in most negotiated transactions.

Odubeko also advised that, where permissible, investors may want to consider put and call options that enable a private equity fund to price their shares at a premium to that of the sponsor. Noted Odubeko, “PE funds are generally reluctant to allow sponsors to exit and take money off the table, and therefore transactions tend to be structured to ensure alignment, so that sponsors aren't getting rich just as you're coming into the investment. The idea is that everybody is in the investment together.” ●

On 26 September 2012, EMPEA co-hosted a Professional Development Webcast with Kroll Advisory Solutions on *The Appeal of Africa: Maximizing Investment Opportunities While Mitigating Risk*, with perspectives from Norton Rose, Aureos Capital, International Finance Corporation and Investec Asset Management. A replay of the webcast can be accessed through the EMPEA website at www.empea.org/events-education/webcasts/.

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