Private equity is an asset class in common use by institutional and private investors around the world. In its simplest form it involves the purchase of equity stakes in enterprises that are not listed on any stock exchange, with the capital raised by the company used to fund expansion through organic growth or acquisition. Rather than invest directly into businesses, most institutions prefer to use fund structures, which allow for a more efficient use of capital and a diversification of risk.

A number of institutions and private individuals invest into a fund run by a professional management company. The fund manager is known as the general partner (GP), and deploys the pooled capital into a number of enterprises, making investment decisions on behalf of its investors, known as limited partners (LPs) within a set of restrictions set out in the initial agreement with the LPs. Typically these restrictions attempt to reduce the overall risks of the Fund. They are likely to include elements dictating the sector, geography and minimum and maximum size of business that the fund may invest in.

The fund structure allows for a more efficient management of investment risk, as the GP can participate in a wider range of businesses while still investing enough capital to have a meaningful effect on their growth. The LPs have exposure to the underlying growth of the portfolio without having to take too much risk on a single business or spread their investments too thinly.

The GP invests the capital over a specified time period, typically around five years, and then seeks to exit the investments by selling them to another company, known as a trade sale, by listing them on a stock exchange or by selling to another private equity fund. They then return the capital to their LPs, taking out a management fee and a percentage of the profits.

Private equity is considered relatively high risk, but has high returns. It is often used by institutional investors to add index-beating “alpha” growth to their portfolios. The returns are typically higher than those delivered by fixed income or equity funds, but attract a higher management fee.

In emerging markets, which may have less developed capital markets and less liquid stock exchanges which cannot accommodate large investments, private equity is being increasingly used as a proxy for the growth of the underlying economies.
The African Private Equity Industry

- Developed strongly over the past decade, but small in global terms
- Fundraising peaked in 2008, then fell during the financial crisis
- Sector rebounded well in 2011, and in 2012 to date

African economies’ high growth rates over the last decade have proven attractive to investors all over the world. However, outside of the largest regional economies, many lack liquid stock exchanges and internationally-traded fixed income products. This means that some investors have struggled to find ways to gain access to that growth. Private equity has become an important avenue for both public and private sector investors to enter African markets, and over the course of the past few years several major specialist players have appeared, and other large fund managers have begun to operate Africa-focused funds.

The years up to the financial crisis in the West showed a sustained growth in fundraising in Africa, peaking at $2.6 billion in 2008 before falling back to $933 million the following year, according to statistics compiled by the Emerging Markets Private Equity Association (EMPEA). Since then, fundraising has rebounded faster than most other markets. However, despite the strong performance, the absolute amount of investment into the asset class in Africa is marginal compared to the amount that is invested worldwide. In 2011, more than $262 billion was invested into private equity funds, according to Preqin, a research house.

How Does Private Equity Support Development?

- Invests directly into centres of growth and job creation
- Builds management skills and supports entrepreneurship
- Improves environmental and social governance

Private equity has a direct and measurable impact on individual businesses in the developing world, improving their ability to expand and giving benefits in terms of revenue and job creation to their country’s domestic economy.

As Line Picard, Chief Private Equity Officer at the African Development Bank, says: “Investing in private equity supports development directly with the capital it brings to the companies which have a meaningful growth potential but have not yet been able to secure financing from financial institutions.

“The private equity fund managers bring the know-how, the networks and the required strategic technical assistance to guide those companies with their growth in addition to the much needed capital. Often, the investee companies benefit much more from the support they receive from the fund managers than the cash itself.”

As well as improving the commercial prospects of businesses in Africa, private equity investors have a large role to play in improving the corporate, social and environmental governance of their portfolio companies. When investing, they can demand additional conditions mandating that their portfolio businesses implement standards to limit negative impacts and enhance positive ones.

The Bank’s total portfolio size is now US$1.09 billion, of which US$836 million is in private equity Funds and a further US$253 million in direct equity. As of 1 March 2012, 37 private equity funds had been approved, investing across a broad range of sectors and geographies.
Why Do DFIs Invest in P.E. Funds?

- To diversify risk and improve efficiency
- To allow access to a broader range of companies and sectors
- To support development objectives
- To unlock global private sector capital

For every $1 million the bank invests in private equity, a further $5 million is invested by other institutions and individuals. By helping to create and sustain this industry, the African Development Bank Group can unlock capital from other private and public sector investors around the world.

Development financial institutions (DFIs), like the African Development Bank, have been expanding their presence in private equity funds for some years. The benefits for DFIs are similar to those of purely financially-driven investors. The fund structure allows the institution to put its capital into centres of growth and job creation in an efficient way across a variety of sectors and geographies, using the private sector expertise of the fund manager to meet development objectives, while also spreading its risk.

DFIs have been key actors in the creation of the private equity industry in Africa. The African Development Bank, like other players, believes that active and growing private equity players on the continent will be a significant contributor to its economic and social development. However, there remains a perception amongst many international investors that the risks of these markets outweigh the potential benefits, and in a difficult global economic climate, these institutions – which hold a significant proportion of investable capital worldwide – are still hesitating.

This capital needs to be unlocked if the many financing gaps in Africa are to be filled, and if the continent wishes to deepen and broaden its economies by building domestic and regional enterprises with international standards and ambitions.

These institutions, however, require that managers and asset classes can demonstrate track records of successful growth before they consider investing. Since private equity requires long time horizons – usually 10 to 15 years – the industry in Africa is still very much in its early stages and needs support to reach the point where it will be able to expect to raise capital from purely private limited partners, or from big domestic pension funds.

By helping to seed an industry, DFIs, like the Bank, can have a multiplier effect. As much as $5 of additional capital is invested alongside every $1 invested by the Bank into funds.

The African Development Bank Group has a portfolio of US$ 1.09 billion in private equity investments, with commitments to 37 funds. The Bank believes that the asset class is an effective way to strengthen Africa’s economies, create jobs and drive development.