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Investment Opportunities in Sub-Saharan Africa

Bridget Sproles | Benjamin Robins | Sharcus Steen
Melanie Bunke | Greg Moessing | Miriam Schmitter
Lisa Miller | Kyle Anderson | Yichang Chen | Henry Kegan

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Executive Summary

- As developed economies continue to face the risks of muted economic growth, widespread deleveraging, and subpar market returns, opportunities further afield, including Frontier Africa, are worth studying. The challenges investors face are manifold, including political risk, illiquidity, inadequate regulation, volatile currencies, and the fundamental economic headwinds that may result from impoverished, poorly educated, and rapidly growing populations. On the positive side, Frontier Africa offers the opportunity to invest in some of the world's fastest-growing economies, driven by rich endowments of natural resources, young populations, and increasingly supportive political and economic policy. Valuations are generally reasonable and where capital is scarcest pockets of pronounced cheapness can be found.
- Over the past ten to 15 years, six key factors have set the stage for resurgence: improved governance; a notable decrease in the level of violence; rationalization of economic policy; both well-established and recently discovered natural resources; a demographic dividend; and increased wealth in China and other emerging markets. However, investors are unlikely to realize attractive long-term returns unless these promising political and economic developments take root—evidence points toward a change, but these are still relatively recent developments—and investors in capital markets are able to benefit from the improving economic backdrop.
- Among public markets, South Africa stands out as the most liquid, regulated, and advanced. However, because the South African stock market is highly correlated to other emerging markets, as well as natural resources stocks globally, we find that the diversification benefits are strongest with Frontier Africa. In addition, Frontier African public markets offer reasonable valuations and strong cash flow. These opportunities vary from country to country and sector to sector, rewarding active and experienced stock pickers.
- Information is harder to come by in frontier markets, which allows for inefficiencies that active managers should be able to exploit over time. Therefore, hiring an active manager to maneuver through the best risk/return options may enhance returns, especially since the limited passive options are highly concentrated and not necessarily reflective of the domestic growth opportunity. Active managers' returns have exhibited high dispersion in the space. As in other asset categories, managers experience cyclical performance patterns, adding value net of fees in some periods and losing value in others. All managers display very high tracking error, as we would expect.
- The key to capitalizing on Africa's opportunities is partnering with the right asset management team. Although the universe is expanding, there are few well-connected and experienced managers in the space and fees can be high.
- The hedge fund industry in Africa is small compared to its global counterparts in Europe and the United States. Outside of South Africa, private equity and long-only funds are far more prevalent than hedge funds. South Africa is where most of the hedge fund investment talent resides, the regulatory framework is in place, and the stock market is robust and liquid. Northern Africa and Frontier Africa should not be overlooked, although most managers operating in this space are long-biased hedge

funds. The hedge fund industry in Africa is still in its early stages of development, and therefore we recommend that most clients continue to evaluate this area over the coming years. For those clients with mature emerging markets or hedge fund portfolios seeking niche opportunities, we have conducted due diligence and become more comfortable with a small number of South African long/short hedge fund managers.

- Frontier Africa does represent a higher risk/return strategy than traditional emerging markets equities, making it important to rebalance the exposure after earning significant gains. Investors must be prepared to weather significant periods of decline or stagnation.
- Some investors may choose to take a small position in a new region, such as Frontier Africa, with the goal of learning more about the opportunity by placing assets there and growing the exposure over time. Another approach may be to invest as part of broad exposure to frontier markets using a more diversified approach with investments in both Africa and other smaller markets. In a frontier portfolio, the exposure to pure African holdings will vary. Historically, frontier managers have held 0% to 40% (averaging 20%) in Africa. A frontier manager with knowledge of the continent provides an attractive, diversified exposure to Africa or an investor may combine a frontier manager with a dedicated Frontier Africa manager.
- Private equity competition in Africa remains limited relative to many other emerging markets, which, along with improving exit avenues, supports private equity's increasing role in the region. Private equity investors gain exposure to industries and sectors they could not in Africa's public markets, including smaller family-owned business that benefit from the region's increasing private consumption. Most private equity investments are minority positions in closely held companies. Control positions and buyouts also occur, and are often corporate spin-offs from multinationals or pan-African conglomerates. The ability of private equity teams to select the right business partners is crucial, particularly given the occasional difficulty of enforcing the rights of minority investors. Local private equity firms remain reliant on well-cultivated relationships to source and execute deals. Other challenges for private equity in the region include corruption, political instability, relatively short track records of most general partners (GPs), and a lack of experienced portfolio company management talent. Nonetheless, Africa may offer an attractive risk/reward trade-off for investors—if they can identify and invest with high-quality GPs.
- Subject to standard best practices of manager selection, a portfolio approach that selects sub-Saharan Africa private equity investments with varied geographic and deal positioning would be appropriate. One or two pan-sub-Saharan Africa funds focusing on mid-sized and larger deals could be complemented with one or two local funds where local investment networks are key to sourcing investments in family-run businesses.
- Opportunities certainly exist in both the public and private markets in Africa; however, we find the private market opportunity set marginally more interesting for institutional investors with a large asset base due to the illiquidity in Frontier Africa's public markets. ■

Introduction and Background

Between 2001 and 2010, six of the world's ten fastest-growing economies were in sub-Saharan Africa (Figure 1). After two decades of economic stagnation and political instability, a significant turnaround began on the continent during the 1990s. African nations have set about rebuilding their dilapidated infrastructure, rationalizing economic policy, and establishing a more stable political order. This recovery has been funded in no small part by substantial reserves of energy and minerals. Though many countries on the continent still struggle with the typical issues developing nations face, Africa's recent growth is noteworthy. Several nations have enjoyed economic growth in the high single digits over the past decade. As a resource-rich continent with potentially attractive demographics, a burgeoning middle class, a high degree of economic diversity, and improving governance, Africa offers strong potential returns for investors willing to provide much-needed capital. However, those considering African investments must remain aware that many of these nations continue to face substantial challenges.

With a population somewhere close to one billion spanning 54 nations (Figure 2), Africa is the world's second most populous continent. Five of these countries— Democratic Republic of the Congo, Egypt, Ethiopia, Nigeria, and South Africa—collectively account for roughly half of Africa's citizens. Africa remains the poorest and least urbanized continent, with only 41% of the population living in cities and a larger percentage living in extreme poverty (on less than US$1.25 per day) than on any other continent. Nonetheless, roughly 400 million Africans are categorized as middle class by the World Bank, meaning they have some disposable income, some assets, and the potential to form a large indigenous consumer base.

Not surprisingly, Africa reports the lowest life expectancy of any continent, at 54 years for men and 56 years for women. Other vital statistics such as infant mortality and literacy rates paint an equally grim picture. While these statistics speak to a profound need for development, they also underscore the potential for economic growth and need for investment.

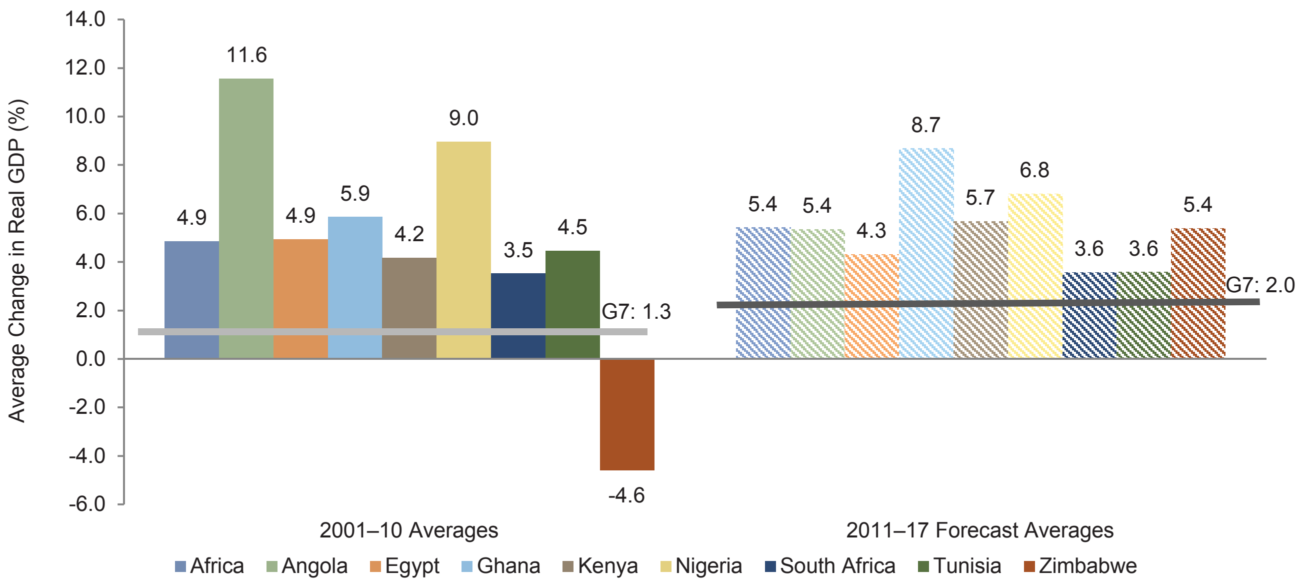
Africa can be divided along a number of geographic, economic, and cultural lines. However, from an investment standpoint, the regions that appear most meaningful to us are:

- **North Africa.** Includes French- and Arabic- speaking countries with close ties to the Middle East and represents some of the larger and more established economies on the continent. Despite recent political upheaval, North Africa remains not only a potential investment destination, but also a source of investment capital for the rest of the continent as North African businesses look south to expand.

- **South Africa.** The continent's largest economy, representing 22.2% of Africa's GDP, and among the richest nations on the continent with GDP per capita of US$8,000 per year. Other measures, ranging from capital market sophistication to secondary school attendance and cell phone penetration, reflect South Africa's position as the most industrialized economy in sub-Saharan Africa.[1] Although the country

[1] Definitions of sub-Saharan Africa vary. We use this term in a geographic context to reference countries south of the Saharan desert. Sudan is often an exception. We follow the definition used by the United Nations and include Sudan with North Africa. However, its stock market is small and illiquid and is not included in any of the indices we reference in this paper.

Figure 1. Historical and Forecast Average Growth Rates
2001–17



Source: International Monetary Fund - World Economic Outlook Database, October 2012.
Notes: Estimates for Zimbabwe begin in 2010; Ghana, Kenya, and South Africa in 2011; and G7, Angola, Egypt, Nigeria, and Tunisia in 2012. GDP figures for Africa are calculated by averaging the eight listed individual nations. Horizontal gray lines show G7 GDP growth over each time period.

Figure 2. True Size of Africa

Source: *The True Size of Africa,* Kai Krause.

faces significant economic and political challenges, it remains a source of capital and expertise as South African companies look to expand into growing markets to their north.

- **Frontier Africa.** Finally, the polyglot remainder of "Frontier Africa" is an enormously diverse set of countries broadly characterized by the factors discussed below. In our view, some of these nations offer the best investment opportunities in Africa as rapid demand growth intersects with scarce capital. Regional leaders such as Kenya and Nigeria play a key role in coordinating trade and, among the smaller frontier nations, are leading destinations for investor capital.

In this report, we discuss Africa's political and economic changes over recent decades and how this changing landscape may offer improved investment prospects. Specifically, we address the key opportunities and risks associated with public (long-only and hedge funds) and private market investing in sub-Saharan Africa, with an emphasis on Frontier Africa.[2]

The Good News and the Bad News

Despite its large population, attractive demographics, and abundant endowment of natural resources, Africa, in its entirety, accounts for less than 3% of nominal global GDP (Figure 3). At a broad level, the continent's economic output is reasonably well diversified; however, on a country-by-country basis, many African states are beholden to a handful of industries, often associated with resource extraction and agriculture. Africa's approximately US$1.8 trillion of nominal output places it somewhere between Spain and California in terms of economic heft. Frontier Africa's economic output is smaller still, at US$806 billion. This disparity between population, resources, and economic output lies at the heart of our investment thesis for Frontier Africa. Frontier Africa asset managers will often focus their efforts on nations where a dearth of capital coincides with adequate governance, functional markets, and strong fundamental economic growth. Botswana, Ethiopia, Ghana, the Ivory Coast, Kenya, Nigeria, and Tanzania stand out as examples.

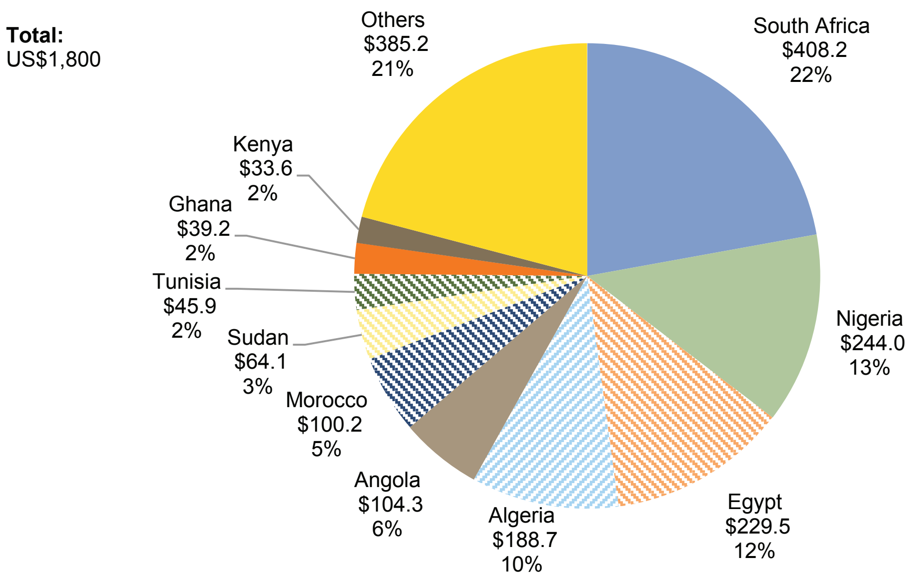
A relatively recent confluence of factors has created a climate in which this gap between Africa's economic potential and economic reality may begin to close. A litany of ills characterized the post-independence period (roughly 1970 to 1995) in many sub-Saharan African countries—flat to negative per capita GDP growth, endemic violence, the HIV/AIDS epidemic, heavy dependence on foreign aid, high debt levels, heavy-handed economic regulation,[3] and rampant corruption. This rather grim picture shaped a lasting image of the continent, scaring off many private sector investors well into the 21st century. While all of these issues remain challenges, those who continue to hold a truly Malthusian view of the continent are increasingly mistaken. Over the past ten to 15 years, six key factors have set the stage for a resurgence:

- **Improved governance and the end of the strongman.** Many Western or Soviet-backed authoritarian regimes lost support with the end of the Cold War, ushering in a new generation of leaders more attuned

[2] For a discussion of Northern Africa, please see our May 2011 Market Commentary *MENA Equities: Is There an Opportunity?*

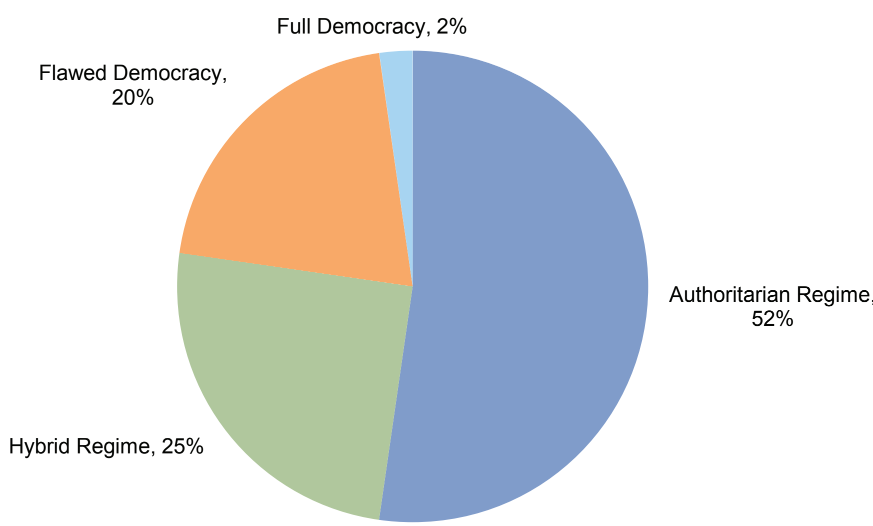
[3] Need to support currency controls, etc.

Figure 3. African GDP by Nation
As of December 31, 2011 • U.S. Dollar (billions)



Source: World Bank.
Notes: Patterns indicate North African countries. Figures do not total to 100 due to rounding.

Figure 4. Sub-Saharan Africa Government Types
2011

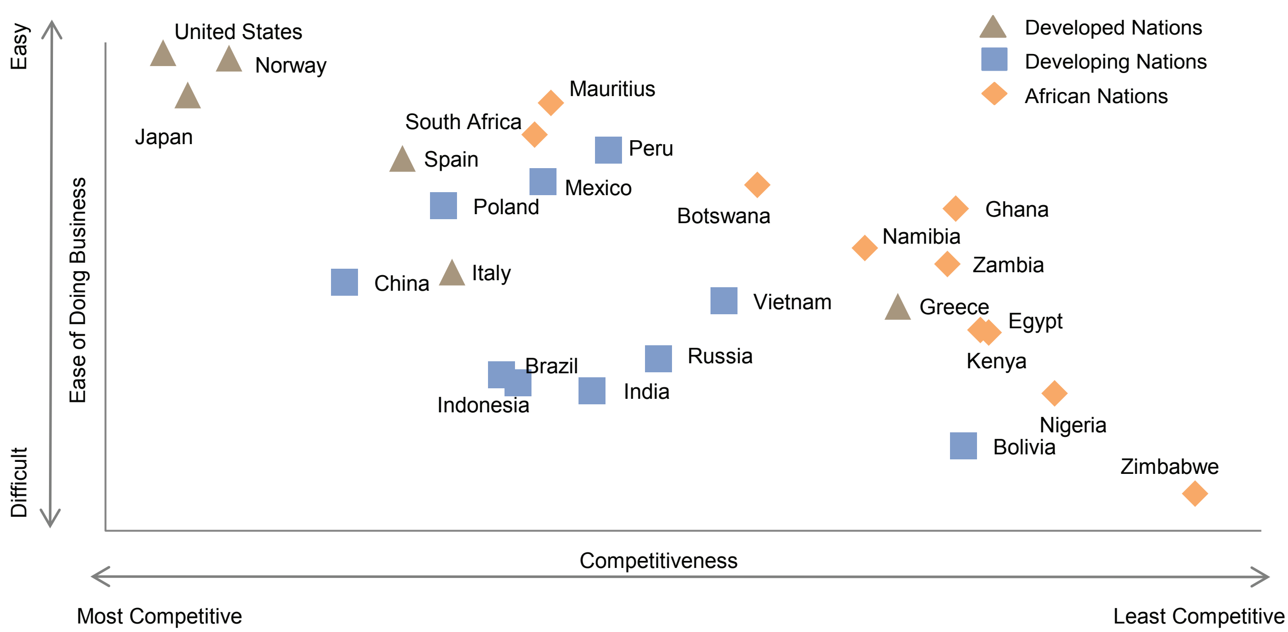


Source: The Economist Intelligence Unit.
Notes: Authoritarian regime is defined as states where political pluralism is absent or heavily circumscribed; hybrid regime as states where elections have substantial irregularities that often prevent them from being both free and fair; flawed democracy as states where countries have free and fair elections and, even if there are problems (such as infringements on media freedom), basic civil liberties will be respected; full democracy as countries in which basic political freedoms and civil liberties are respected, and also tend to be underpinned by a political culture conducive to the flourishing of democracy. Figures do not total to 100 due to rounding.

to the importance of good governance. According to Freedom House, Frontier Africa has gone from three democracies in 1989 to 19 today. Still, only about 25% of its nations have either full or flawed democratic governments and many have a long way to go (Figure 4). Many of these democracies are young and continue to face growing pains. While corruption may have declined with increased international and domestic scrutiny, it remains an issue. With a handful of exceptions—Botswana, Namibia, and Rwanda—Transparency International ranks most African countries toward the bottom of its index of public sector corruption, and while a few countries, like Ethiopia and Nigeria, have risen in the rankings, many have remained at the bottom or fallen in the last five years. IFC ease of doing business and competiveness indices show an equally varied picture, with African nations scattered from good to bad. Perhaps more importantly, according to these measures, African countries appear no more or less problematic than many of the other emerging markets that investors have embraced, including the BRIC nations (Figure 5). Investors in the region note that corruption tends to be concentrated in agriculture, extractive industries, and other heavily regulated sectors that rely on government spending or licensing, giving them some ability to steer clear of questionable business relationships. Governments have also grown more cognizant of the need to control corruption to encourage foreign investment.

- **Return to peace.** The level of violence in Frontier Africa has decreased notably over

Figure 5. Ease of Doing Business and Competitiveness: Africa Relative to World



Sources: World Bank and World Economic Forum.
Notes: Ease of doing business data represented by the June 2012 World Bank Ease of Doing Business Index. Competitiveness data represented by the 2012–2013 World Economic Forum Global Competitiveness Index.

the past 15 years and the rule of law has gained a solid foothold in most nations. While there remain some areas of war and civil unrest—Democratic Republic of the Congo, Somalia, and the Sahel region—these conflicts are the exception rather than the rule, and tend to be less severe and more short lived than past strife.

- **Rationalization of economic policy.** The past 15 years have also seen widespread improvements in economic policy, and improving conditions for direct foreign investment, trade, and capital markets investors. Notably, nations have reformed exchange controls, price controls, and tariffs and have increased private participation in key industries. In addition, many African countries have professionalized central banking, with data becoming more available and central bankers developing a growing appreciation for the need to communicate their intentions to the market. Once endemic, inflation has been largely brought under control[4] and national balance sheets have been cleaned up. Widespread debt relief under the IMF and World Bank's Heavily Indebted Poor Countries[5] program also paved the way for more balanced government budgets and increased domestic investment. Some nations have also rationalized tax policy, focusing on lower tax rates and improved enforcement.

- **Natural resources.** Although clearly a mixed picture, the continent's substantial endowment of natural resources has the potential to be a powerful engine for development. Along with well-established energy and mineral resources in countries such as Angola, Democratic Republic of the Congo, Nigeria, South Africa, and Zambia, new oil & gas deposits have recently been discovered in Ghana, Kenya, Mozambique, and Uganda. Africa also possesses the world's largest repository of fallow, arable land. Assuming that the global demand for food and energy continues to grow apace, these resources will provide a sustained tailwind to African economic growth. Unfortunately, historically, much of Africa's natural wealth has been squandered, enriching kleptocrats and fueling armed conflict. However, if well invested, natural resource wealth could be used to improve the continent's decrepit infrastructure and provide education and health care, creating a base of future economic growth. Corruption appears to be declining, as the populace becomes more vocal about the distribution of resource wealth and multinational companies' business practices in Africa come under closer scrutiny.

- **A demographic dividend.** Africa has the fastest-growing population of any continent in the world, with a fertility rate more than double those of Asia and Europe. It is also one of the youngest parts of the globe, with 62% of the population under the age of 25. Although fertility rates have fallen across the continent since 1990, Africa is far from experiencing the sharp declines in population growth that some Asian countries have seen over the past several decades. In other regions, slowing population growth has tended to accompany economic development, establishing a virtuous cycle. At

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[4] According to International Monetary Fund (IMF) data, average sub-Saharan debt to GDP fell from 99% in 1990 to 31% in 2012.

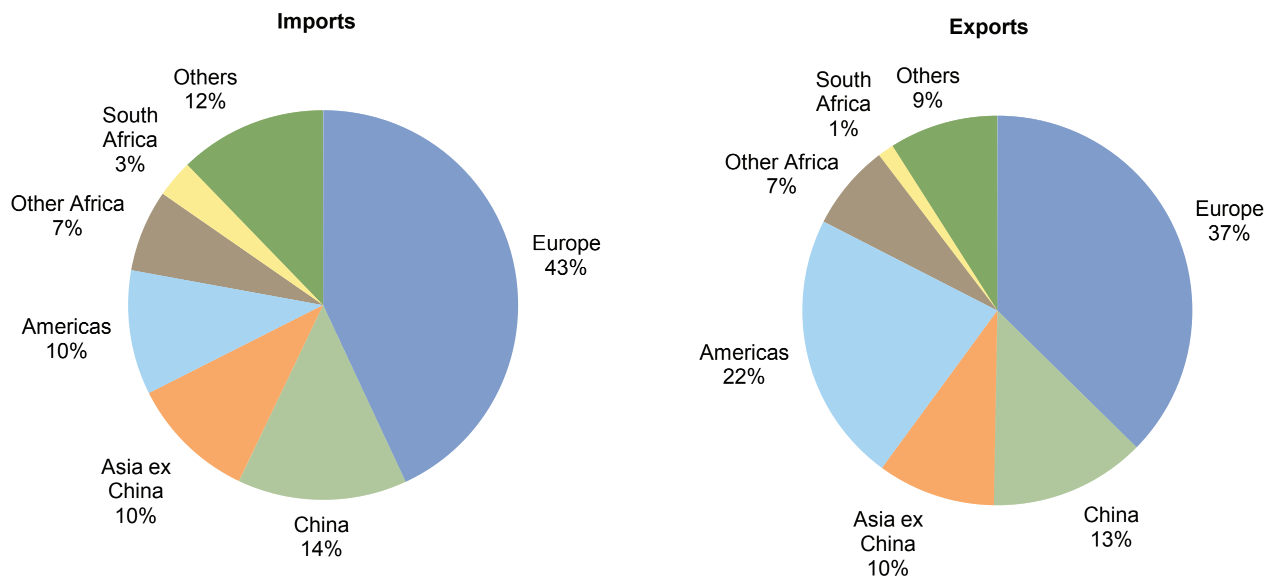
[5] Debt burdens have also declined through other programs such as the IMF and World Bank's Heavily Indebted Poor Countries Initiative, which reduced debt service across 34 African countries from 3.2% of GDP in 2001 to 0.9% in 2010.

this point, it is unclear whether Africa's demographics will prove a gift or a curse in terms of the region's economic prospects. A young and growing population offers a ready supply of labor if it can be educated and employed. However, rapid population growth can result in high unemployment, environmental degradation, food shortages, and political unrest. Over the past 20 years, slowing population growth has mirrored economic development, with the largest declines in population growth appearing in North Africa, while the population in the poorer parts of Frontier Africa has grown at a high, but decreasing rate.

- **Increased wealth in China and other emerging markets.** While Europe accounts for approximately half of Africa's trade, the so-called South-South trade has also created a strong demand for Africa's resources as Asian economies have industrialized (Figure 6). According to the OECD, developing nations accounted for approximately one-third of Africa's 2009 trade, up from 18% in 2000. Although the data vary, China is likely Africa's largest single trade partner, accounting for 10% of trade. While a smaller trade partner, India is also increasing economic ties with Africa, particularly in East Africa, where a large Indian population has been resident for several generations. The lion's share of African exports to other emerging markets is in the form of raw materials and energy, with finished goods playing a small role. In exchange, Africa primarily receives machinery and consumer goods.

Asian nations are also increasing their foreign direct investment (FDI) in Africa. For example, China has made US$1

Figure 6. Africa's Trade Partners
2009



Source: OECD.
Note: Figures do not total to 100 due to rounding.

billion to US$2 billion per year of direct investment in Africa over the past decade. Renaissance Capital estimates that these FDI flows will average US$5 billion per year by 2015. These direct investments have centered on mining (30%), manufacturing (22%), and construction (15%), as China makes an effort to maintain and diversify its sources of raw materials. Agriculture is also an area of increasing investment. This relationship provides Africa with much- needed manufacturing infrastructure and knowhow and a ready source of cheap consumer goods for its burgeoning middle class. A dramatic slowdown in China or developing markets more broadly would likely reduce demand for African exports and stem the flow of capital and goods to Africa. As emerging markets come to represent a larger and larger share of Africa's trade, the continent's susceptibility to a hard landing in the developing world grows. Conversely, should emerging markets continue to grow rapidly, Africa is likely to be a sustained beneficiary.

These developments helped Africa's real GDP grow at an average of over 5% per year between 2000 and 2010. After accounting for population growth, per capita GDP increased at 2.5% annually. As a general rule, this growth has been most pronounced in Frontier Africa, where several countries have enjoyed rapid economic growth off an admittedly small base. Although the continent's more liquid capital markets sold off in 2008 and 2009, the fundamentals of African economies have remained surprisingly insulated from the global economic slowdown of the past four years.

At this point, a compelling case can be made that the continent has turned the corner and the fundamentals are in place to unlock Frontier Africa's economic potential, offering the type of returns that are rare amid widespread deleveraging and anemic economic growth in the West. More specifically, we see opportunity in Frontier African public markets, where valuations look reasonable and cash flow is strong. These opportunities vary from country to country and sector to sector, rewarding active and experienced stock pickers. The private markets facilitate investment in sectors not well represented among listed companies, including agribusiness, consumer goods, infrastructure, and manufacturing.

While valuations in Frontier Africa may look reasonable and capital is scarce, investors are unlikely to realize attractive long-term returns unless:

- The promising political and economic developments discussed above have truly taken root. In our view, the evidence points toward a sustained change; however, these are still relatively recent developments for many African nations.
- Investors in the capital markets are able to benefit from Africa's promising economic backdrop. Historically, GDP growth has not necessarily translated into investment gains. Market-friendly policies are necessary, as is a degree of political and economic stability. With these factors in place, investors in Frontier Africa may enjoy rapid earnings growth that, coupled with a re-rated market, generates strong long-term returns.

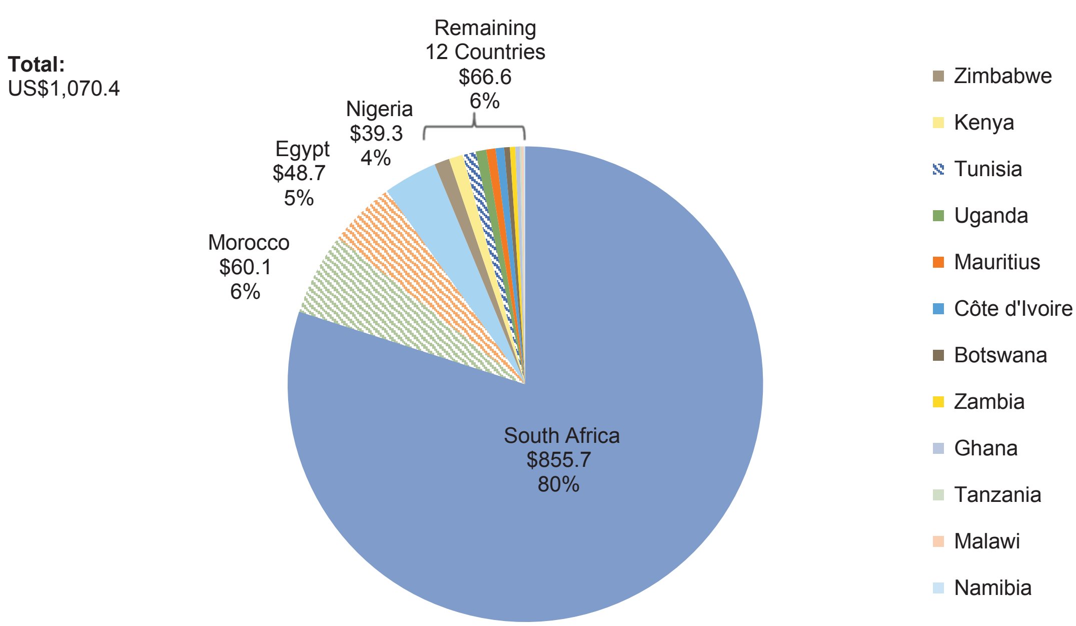
Opportunities in the Public Markets

The array of African countries boasting stock exchanges as well as the number of listed companies expands each year. In 1989, only five stock exchanges existed across the continent. Today, 29 exchanges span 38 countries (some exchanges are regional rather than country-specific and some indices do not show all exchanges as seen in Figure 7). In addition, some African companies or multinational companies dominated by revenue from the continent choose to list overseas. Approximately 30 to 40 African companies are listed on exchanges in developed markets.

Today, the continent has over US$1 trillion of market capitalization in publicly traded companies, about 80% of which is found in South Africa. By way of contrast, the market capitalization of the world markets is roughly US$47 trillion. There are over 1,000 publicly traded companies across the continent, almost half of which are in North Africa and South Africa. Excluding North Africa and South Africa, the total market cap of the remaining Frontier Africa falls to approximately US$100 billion. Within Frontier Africa, Nigeria is the largest market, with a US$39 billion market cap, followed by Zimbabwe and Kenya, both at roughly US$10 billion. Together, these three countries account for over 63% of Frontier Africa's market capitalization (Figure 7).

In Frontier Africa, there are few large, liquid, publicly traded companies and many small, illiquid public companies. Of the 572 listed

Figure 7. African Market Capitalization by Country
As of December 31, 2011 • U.S. Dollar (billions)



Source: Standard & Poor's Emerging Markets Database.
Notes: Legend shown for remaining 12 nations only. Patterns indicate North African countries. Figures do not total to 100 due to rounding.

companies in Frontier Africa, most money managers consider about 100 investable based on liquidity, acceptable reporting, and corporate governance.

Among the public markets, South Africa stands out as the most liquid, regulated, and advanced. Its stock market has been in operation since 1887, with listings of domestically oriented companies as well as companies taking advantage of the growth opportunities across the continent. South Africa also offers sufficient liquidity for large-scale institutional investment, with approximately US$2 billion of daily trading volume. As a result, South Africa has a well-established and sophisticated domestic asset management industry, eliminating some of the inefficiencies seen in less developed African markets. Because the South African stock market is highly correlated to other emerging markets, developed markets, and natural resources stocks globally (Table 1), we find the diversification benefits are strongest with Frontier Africa. At the same time, South Africa represents roughly 8% of the emerging markets universe as defined by the MSCI Emerging Markets Index. Therefore, many investors will already have exposure through their dedicated emerging markets manager(s).

Should Investors Simply Focus on South Africa?

Some investors may decide that the regulatory and liquidity risks in most of Frontier Africa are beyond their comfort level and ask whether one can invest primarily in South Africa and still benefit from the continent's attractive growth opportunities. South Africa's economy is expected to grow at a much slower pace than the rest of the continent, return on equity (ROE) is lower than Frontier Africa, and the valuations are on par with Frontier Africa. A case could be made that many well-established South African companies are seeking growth from the dynamism of the rest of the continent. However, managers have indicated that, on average, of the top 40 stocks on the Johannesburg Stock Exchange (JSE), less than 10% of company value might be ascribed to

Table 1. Index Return Correlations

December 1, 2002 – December 31, 2012 • U.S. Dollar

	MSCI Emerging Markets	MSCI EAFE	MSCI World	S&P 500	MSCI China	MSCI South Africa IMI	S&P Africa Frontier	S&P Global Natural Resources
MSCI Emerging Markets	1.00							
MSCI EAFE	0.90	1.00						
MSCI World	0.89	0.98	1.00					
S&P 500	0.81	0.90	0.97	1.00				
MSCI China	0.86	0.73	0.71	0.64	1.00			
MSCI South Africa IMI	0.86	0.82	0.80	0.72	0.75	1.00		
S&P Africa Frontier	0.28	0.29	0.26	0.21	0.26	0.23	1.00	
S&P Glob Nat Res	0.86	0.83	0.81	0.72	0.77	0.78	0.24	1.00

Correlation > 0.66 | 0.66 >= Correlation > 0.33 | 0.33 >= Correlation > 0.00 | 0.00 >= Correlation

Sources: MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Total returns for MSCI Emerging Markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

Africa outside of South Africa. That number is expected to grow over time.

Sector Exposure

Although the South African stock market is fairly diverse, it has significant (over 25% of the market cap) natural resources sector exposure. In Frontier Africa, stock markets are concentrated in financial services (Table 2), particularly in the more liquid markets of Kenya and Nigeria. Financial stocks tend to be tied to GDP growth since they lend to growing businesses and households across the region. Although most African banks posted very strong returns up until 2008, they have suffered since then due to large non-performing loan exposures. Most of these institutions already have, or are in the midst of, cleaning up their balance sheets, and share prices are slowly recovering.

Local subsidiaries of consumer-related multinational corporations are another significant component of Frontier African public markets. Many managers find these holdings attractive given the high governance standards imposed by multinational parents, strength of brand, high free cash flow, rapid growth rates, and high dividend yields; however, some of the parent companies only float a small percentage of their subsidiaries and then dividend back sizable cash flows to headquarters, making many of these securities relatively illiquid and difficult for an investor to obtain.

Liquidity in Frontier Africa

Liquidity is a real challenge in Frontier Africa. The smaller exchanges only trade approximately US$1 million per day, which means investors must be patient in buying and selling.

Table 2. African Equity Benchmarks: Sector Breakdown
As of December 31, 2012

	S&P Africa 40	S&P Africa Frontier	S&P Pan Africa	MSCI FM Africa	MSCI FM Africa IMI	MSCI EM + FM Africa ex South Africa	MSCI EM + FM Africa ex South Africa IMI	MSCI EM + FM Africa	MSCI EM + FM Africa IMI
Number of Constituents	40	112	319	23	59	34	86	84	195
Sector Allocation (%)									
Energy	29.8	2.1	6.2	---	2.5	---	1.8	7.8	6.9
Materials	30.9	4.0	15.3	4.5	4.8	2.6	4.7	16.3	16.3
Industrials	3.6	1.9	5.7	---	2.6	10.6	10.7	4.9	5.8
Consumer Discretionary	5.6	1.8	15.1	---	1.0	---	1.0	15.6	15.1
Consumer Staples	1.2	26.4	10.3	41.6	36.7	23.7	22.3	9.3	10.6
Health Care	---	0.4	4.0	---	0.6	---	0.3	3.5	3.4
Financials	18.1	59.4	32.4	51.0	48.5	51.5	48.7	29.1	29.4
Information Technology	---	---	0.4	---	---	---	---	---	0.4
Telecommunication Services	10.8	2.9	10.5	2.9	2.3	11.6	9.9	13.5	11.9
Utilities	---	1.0	0.1	---	1.0	---	0.6	---	0.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: FactSet Research Systems, MSCI Inc., and Standard & Poor's. MSCI data provided "as is" without any express or implied warranties.
Note: Percentages may not total due to rounding.

Illiquidity also means investors face large bid/ask spreads when they trade (as much as 4% in roundtrip trading costs). This illiquidity reduces expected returns and limits the ability for investors to add to or redeem from their investments. Therefore, investments in the public markets must be fairly long term in nature, and intended as strategic rather than tactical positions. Illiquidity also forces investors to consider managers' liquidity terms relative to the stocks in which they invest. Funds with accommodative liquidity terms may be forced to invest in a small subset of the names purely to allow for investor liquidity. It is worthwhile for investors to consider tolerating limited liquidity to invest with the managers that have the broadest opportunity sets.

Most long-only funds in Frontier Africa tend to manage very small assets. The median fund size in our database is US$69 million. Given the illiquidity in these markets, a smaller asset base is appropriate for funds to access their best investment ideas. However, this small asset base requires managers to charge high fees and/or have thin staffs. There are a few funds managing close to US$1 billion, but they are the exception within the universe of options. Some larger fund organizations have created small Africa-dedicated funds and are absorbing the associated costs while the asset base grows.

Disclosure and Regulatory Oversight

In addition to analyzing liquidity, investors must also understand the regulatory environment companies listed in Africa face. Once again, the South African exchange stands out as offering investors a high standard of reporting, corporate governance, and disclosure. Other, newer exchanges are evolving but have varying degrees of oversight. Financial disclosure is mixed, varying from country to country. Larger companies generally use the "Big Four" international audit firms and may be more conscious of the benefits of high-quality financial disclosures. Some countries have rolled out international accounting standards, but they will take several years to become pervasive.

Active versus Passive Investment

There are at least 14 indices covering Africa, but most are dominated by South Africa and consist of fewer than 50 stocks (Table 3). As is the case for many frontier markets, none of the available indices offers a single, balanced, and investable reflection of the universe. There are, however, a few passive options for investors to consider, some covering pan-Africa, some Frontier Africa, and some South Africa. Although index options are varied, they show consistent themes in sector and country exposure and concentration.

Today, the growth prospects for many African companies and economies are compelling, while valuations based on major indices offer a reasonable entry point. Valuations vary by country and sector, suggesting active managers have an opportunity to add value through careful stock, country, and sector selection. Based on MSCI indices, which are concentrated and not fully representative of the investment opportunity set, Frontier Africa appears roughly fairly valued. Over the trailing 12 months ended February 28, 2013, the MSCI Frontier Markets Africa Index returned a remarkable 73%, with heavyweights Kenya and Nigeria up 70% and 85%, respectively. Still, given that the index began the period with depressed valuations, the market, while no longer cheap, remains reasonably valued. Relative to emerging markets and across

Table 3. African Equity Benchmarks: Country Composition
As of December 31, 2012

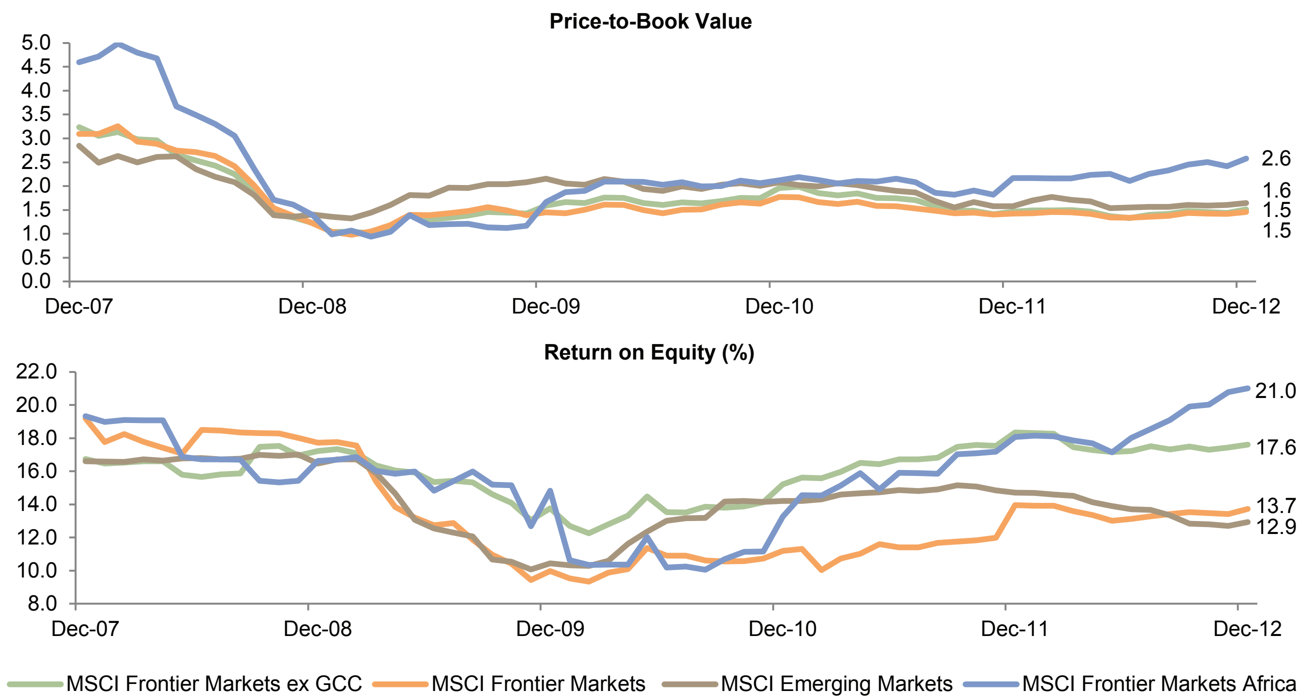
	S&P Africa 40	S&P Africa Frontier	S&P Pan Africa	MSCI FM Africa	MSCI FM Africa IMI	MSCI EM + FM Africa ex South Africa	MSCI EM + FM Africa ex South Africa IMI	MSCI EM + FM Africa	MSCI EM + FM Africa IMI
Number of Constituents	40	112	319	23	59	34	86	84	195
Country Allocation (%)									
Botswana	--	3.4	0.3	--	--	--	--	--	--
Burkina Faso	6.3	--	--	--	--	--	--	--	--
Cameroon	0.4	--	--	--	--	--	--	--	--
Congo	0.7	--	--	--	--	--	--	--	--
Egypt	11.5	--	3.7	--	--	34.1	34.0	3.6	3.8
Eritrea	1.0	--	--	--	--	--	--	--	--
Ethiopia	1.8	--	--	--	--	--	--	--	--
Gabon	5.9	--	--	--	--	--	--	--	--
Ghana	9.3	2.6	0.3	--	--	--	--	--	--
Ivory Coast	--	3.0	0.3	--	--	--	--	--	--
Kenya	--	14.0	1.3	16.9	15.2	9.6	8.8	1.0	1.0
Mali	7.5	--	--	--	--	--	--	--	--
Mauritius	--	7.7	0.7	4.7	5.3	2.7	3.0	0.3	0.3
Morocco	1.8	--	2.5	--	--	9.0	8.0	0.9	0.9
Namibia	--	1.2	0.1	--	--	--	--	--	--
Nigeria	9.5	66.7	6.4	74.6	73.5	42.5	42.7	4.5	4.8
Sierra Leone	1.5	--	--	--	--	--	--	--	--
South Africa	30.6	--	83.7	--	--	--	--	89.5	88.7
Tanzania	4.1	--	--	--	--	--	--	--	--
Tunisia	--	--	0.5	3.8	6.0	2.2	3.5	0.2	0.4
Zambia	8.1	1.3	0.1	--	--	--	--	--	--
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: FactSet Research Systems, MSCI Inc., and Standard & Poor's. MSCI data provided "as is" without any express or implied warranties.
Note: Percentages may not total due to rounding.

frontier markets today, Frontier Africa is slightly expensive (Figure 8). Excluding the GCC,[6] frontier markets are undervalued on the whole—at year-end they traded at a price-to-book (P/B) ratio of 1.5 (up slightly to 1.7 at February 28) and a normalized price-earnings (P/E) ratio of 9.2 (10.0 at February 28). Frontier Africa, in contrast, trades at a P/B of 2.6 (3.0 at February 28) and a normalized P/E of 16.1 (18.7 at February 28). Interestingly, Frontier Africa has strong ROE, which may justify elevated valuations. However, it is not clear whether these high ROEs can be sustained. The challenge across these markets is their short histories, which makes it difficult to use our standard valuation methodologies; rather, one must value these markets like "growth stocks," relying heavily on future earnings

[6] The countries in the Gulf Cooperation Council.

Figure 8. MSCI Index Valuations
December 31, 2007 – December 31, 2012



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

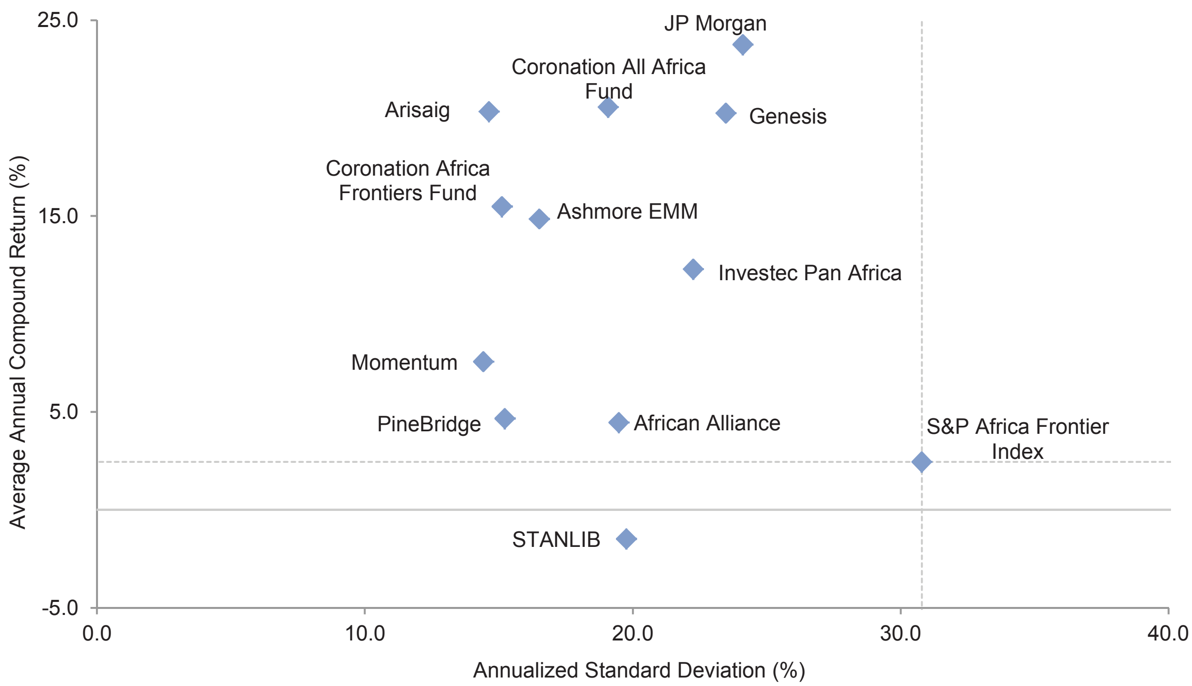
growth estimates. Given the less liquid nature of these stocks, price and valuation swings can be wide due to changes in growth expectations. As a result, a more active approach may be in order, perhaps one including Africa as part of a broader frontier equity mandate that allows flexibility to increase/decrease Africa exposure based on relative valuations. In other words, Africa seems fairly priced on a longer-term horizon, but perhaps a bit pricey today compared to other frontier opportunities, at least for the larger, relatively more liquid markets and stocks tracked by the MSCI indices, recognizing this is not the full opportunity set.

Information is harder to come by in these markets, which allows for inefficiencies that active managers should be able to exploit over time. Therefore, hiring an active manager to maneuver through the best risk/return options may enhance returns, especially since the limited passive options are highly concentrated and not necessarily reflective of the domestic growth opportunity. Active managers' returns have exhibited high dispersion in the space. As in other asset categories, managers experience cyclical performance patterns, adding value net of fees in some periods and losing value in others. All managers display very high tracking error, as we would expect.

The key to capitalizing on Africa's opportunities is partnering with the right asset management team. Although the universe is expanding, there are few well-connected and experienced managers in the space, and fees can be high. Cambridge Associates' database

Figure 9. Risk/Return Analysis: Africa-Focused Long-Only Equity

January 1, 2009 – December 31, 2012 • Four Years



Annual Total Returns (%)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Managers										
African Alliance	---	---	---	---	---	-45.9	1.3	28.9	-27.3	25.6
Arisaig	---	---	---	---	27.3	-35.9	17.0	33.3	-4.7	41.1
Ashmore EMM	80.9	48.8	43.2	51.9	68.8	-44.6	36.0	22.6	-18.4	27.9
Coronation Africa Frontiers Fund	---	---	---	---	---	---	26.2	26.5	-13.6	28.8
Coronation All Africa Fund	---	---	---	---	---	---	46.9	35.6	-17.5	28.6
Fulcrum	---	---	---	---	---	---	---	---	-31.5	37.1
Genesis	---	---	---	---	---	-66.4	49.0	56.0	-23.8	18.0
Investec Africa Opportunities	---	---	---	---	---	---	---	---	---	20.8
Investec Pan Africa	---	---	---	23.6	75.9	-45.9	35.7	30.5	-30.8	29.8
JP Morgan	---	---	---	---	---	---	69.5	39.6	-21.4	26.1
Momentum	---	---	---	---	---	-33.1	9.1	14.4	-19.8	33.7
PineBridge	---	---	---	---	---	---	-4.9	21.1	-10.3	16.1
SQM	---	---	---	---	---	---	---	---	-20.5	28.8
STANLIB	---	---	---	---	---	-58.1	-1.0	17.3	-32.5	20.3
Sustainable Capital	---	---	---	---	---	---	---	14.4	-25.2	15.3
Visio Metsi Fund	---	---	---	---	---	---	---	20.2	-18.8	30.2
Nile Capital	---	---	---	---	---	---	---	---	---	39.7
Index										
S&P Africa Frontier Index	-5.4	12.5	21.8	77.5	52.9	-52.1	-21.9	24.0	-22.0	45.8

Sources: Cambridge Associates LLC Investment Manager Database and Standard & Poor's.
Note: Calculations are based on monthly data, net of fees.

includes approximately 34 Africa-focused public equity funds[7]; Morningstar follows approximately six (including exchange-traded funds). Many of the long-only funds charge hedge fund–like fees and require long lock-up periods. The average fee for long-only products is 1.4%, often accompanied by a performance fee of 10% to 20% of profits (more than half of the funds in our database charge performance-based fees). Even with the hefty fee structures, many managers have added a value net of fees over time (Figure 9). As time progresses, a growing number of funds will have longer track records. Today, many institutional investors are conducting due diligence, making plans to invest, or starting to gain exposure.

Fixed Income Opportunity

Some investment managers in the space have the latitude to purchase fixed income instruments, which have been an attractive source of returns for investors (Table 4). The lion's share of issuance is concentrated in South Africa, the Ivory Coast, and Nigeria, with nearly 92% of sub-Saharan Africa's current outstanding debt in those countries (Figure 10). Although a significant portion of the outstanding debt is sovereign, financial institutions are the leading issuers of debt (over 40%) (Figure 11). Debt issues are highly rated for the most part, with nearly 75% with a rating of BBB- or above (Figure 12). Foreign investors find the high quality and return potential of fixed income in sub-Saharan Africa attractive; for example, foreign investors have purchased nearly 30% of debt in Ghana and South Africa. However, all debt issues are not the same; the yield and demand for US$-denominated debt issuances and local currency debt is bifurcated. The

[7] Based on fund level holdings above 50% exposure to Africa at September 30, 2012, or December 31, 2012, reporting periods.

Table 4. Fixed Income Benchmark Characteristics

As of December 31, 2012

	EMBI Global					
	Weight (%)	Div Index Wt (%)	Yield (%)	2012 Rtn (%)	Maturity (Yrs)	Duration
Africa	4.3	6.8	4.3	19.0	9.4	6.8
Angola	0.2	0.3	4.3	---	4.7	4.0
Gabon	0.2	0.3	3.2	14.0	4.9	4.2
Ghana	0.2	0.3	4.6	13.7	4.8	3.9
Ivory Coast	0.4	0.7	6.6	89.1	13.0	8.6
Namibia	0.1	0.2	3.7	15.7	8.8	7.1
Nigeria	0.1	0.2	3.9	20.9	8.1	6.4
Senegal	0.1	0.2	5.7	29.0	8.4	6.2
South Africa	2.4	3.4	3.2	12.5	8.7	6.8
Zambia	0.1	0.2	5.3	---	9.7	7.6

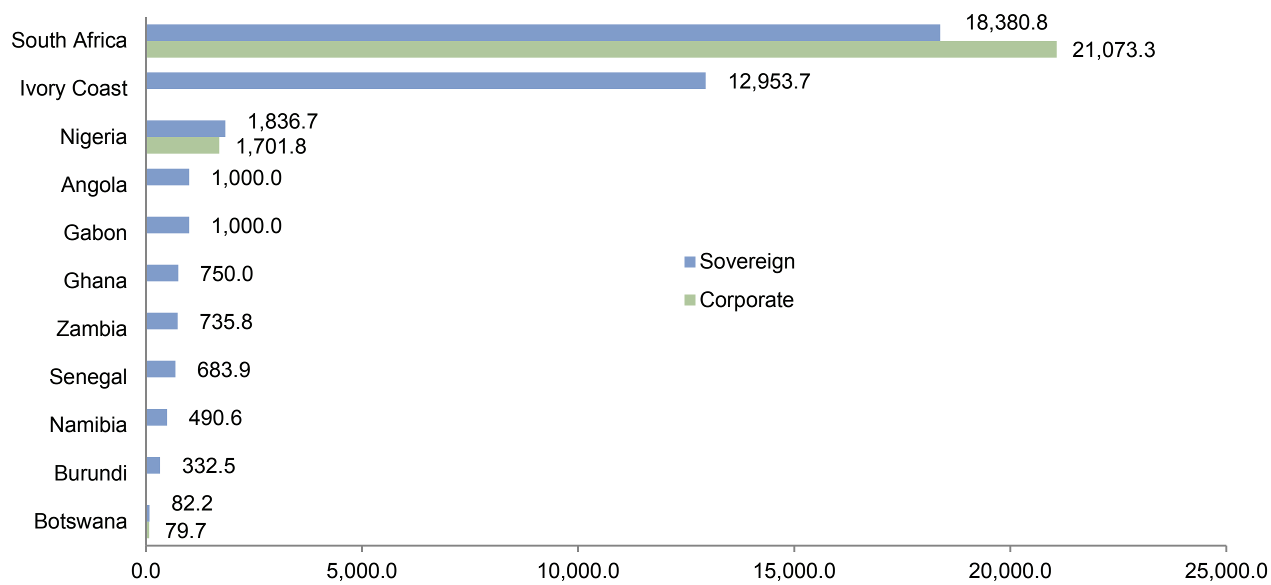
	NEXGEM				
	Weight (%)	Yield (%)	2012 Rtn (%)	Maturity (Yrs)	Duration
Africa	25.2	5.7	32.9	9.3	6.2
Angola	3.1	4.3	---	4.7	4.0
Gabon	2.6	3.2	14.0	4.9	4.2
Ghana	2.4	4.6	13.7	4.8	3.9
Ivory Coast	5.9	6.6	89.1	13.0	8.6
Namibia	---	---	---	---	---
Nigeria	1.7	3.9	20.9	8.1	6.4
Senegal	1.7	5.7	29.0	8.4	6.2
South Africa	---	---	---	---	---
Zambia	2.1	5.3	---	9.7	7.6

	CEMBI					
	Weight (%)	Div Index Wt (%)	Yield (%)	2012 Rtn (%)	Maturity (Yrs)	Duration
Africa	2.0	3.2	4.6	17.5	7.0	5.7
Angola	---	---	---	---	---	---
Gabon	---	---	---	---	---	---
Ghana	---	---	---	---	---	---
Ivory Coast	---	---	---	---	---	---
Namibia	---	---	---	---	---	---
Nigeria	0.4	0.6	4.9	23.8	3.2	2.8
Senegal	---	---	---	---	---	---
South Africa	1.6	2.6	4.5	15.5	7.9	6.4
Zambia	---	---	---	---	---	---

	GBI-EM Global					
	Weight (%)	Div Index Wt (%)	Yield (%)	2012 Rtn (%)	Maturity (Yrs)	Duration
Africa	---	---	---	---	---	---
Angola	---	---	---	---	---	---
Gabon	---	---	---	---	---	---
Ghana	---	---	---	---	---	---
Ivory Coast	---	---	---	---	---	---
Namibia	---	---	---	---	---	---
Nigeria	0.7	1.1	11.9	30.4	6.0	3.7
Senegal	---	---	---	---	---	---
South Africa	8.8	10.0	6.9	15.8	10.1	6.1
Zambia	---	---	---	---	---	---

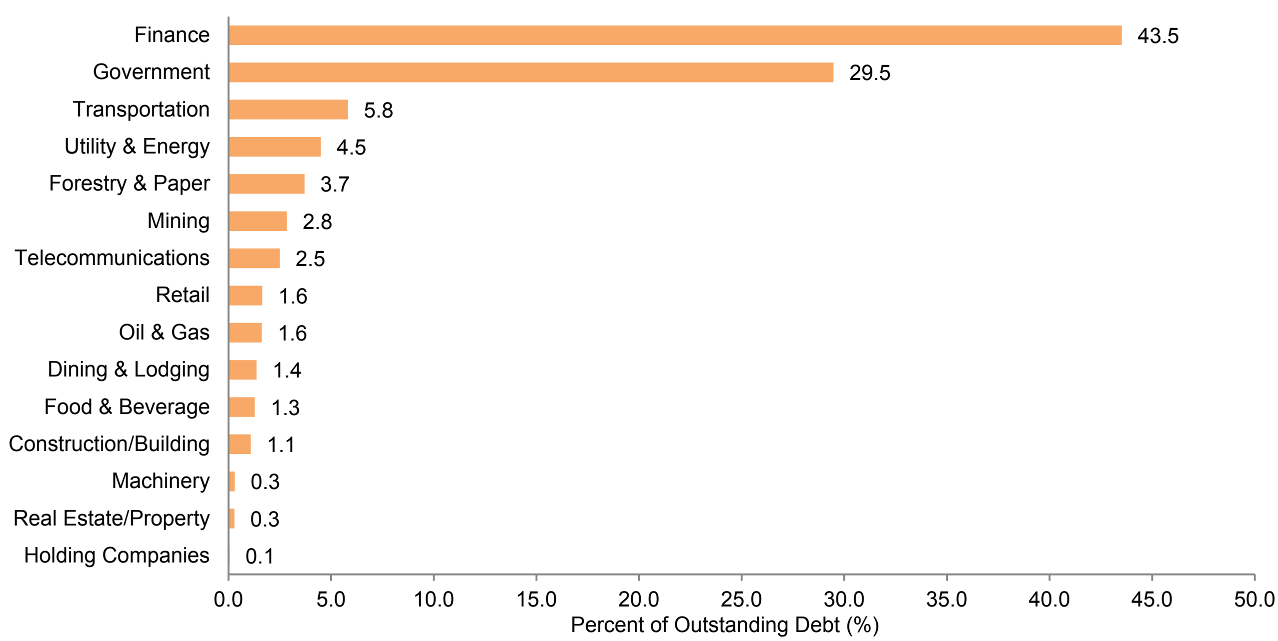
Source: J.P. Morgan Securities, Inc.
Note: Div index weight represents the country's weight in the diversified version of the index.

Figure 10. Sub-Saharan Africa Outstanding Debt: By Nation
As of December 31, 2012 • U.S. Dollar (millions)



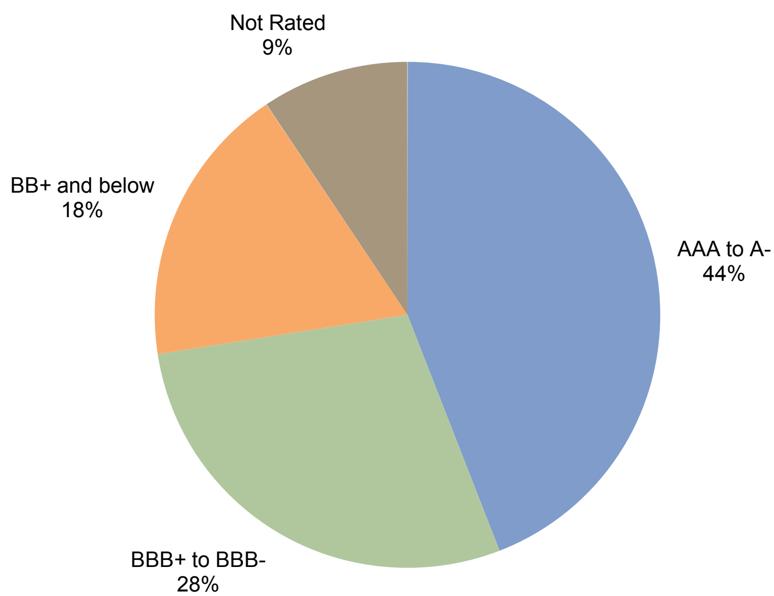
Source: Dealogic.

Figure 11. Sub-Saharan Africa Outstanding Debt: Sector Breakdown
As of December 31, 2012 • Percent (%)



Source: Dealogic.

Figure 12. Sub-Saharan Africa Outstanding Debt: Ratings Composition
As of December 31, 2012



Source: Dealogic.
Notes: Ratings determined by ratings at launch. Percentages do not total to 100 due to rounding.

difference in yield is prevalent in emerging markets, but is especially pronounced in currencies perceived as riskier. Today, yields across Africa are very low, suggesting they will not adequately compensate investors for the various imbedded risks.

Hedge Funds

The hedge fund industry in Africa is small compared to its global counterparts in Europe and the United States. Political risks associated with civil strife, corruption, currency risk, and less market regulation tend to keep hedge funds concentrated in more mature markets like South Africa. Short selling is not commonly practiced in African securities markets and is only widely available in the more developed markets, such as the JSE. Outside of South Africa, private equity and long-only funds are far more prevalent than hedge funds.

Though still small by international standards, the African hedge fund industry includes over 70 management companies offering more than 100 funds with discrete mandates, according to HedgeNews Africa.[8] South African hedge funds had just over US$4.1 billion in assets under management as of June 2012, representing an all-time peak for the industry.[9]

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[8] Based on management companies that reported assets under management and performance data to HedgeNews Africa as of December 31, 2012. While the data are thorough, they are not exhaustive, and likely understate the true investable universe of African hedge funds.

[9] Based on the 2012 South African Hedge Fund Survey from Novare Investments, which sends a questionnaire to managers that classify themselves as managing hedge funds. In the most recent survey, Novare received

The South African hedge fund industry continues to mature and attract significant foreign direct investment. Within South Africa, equity long/short and equity market-neutral strategies make up the majority of hedge fund assets (~59%), though other strategies such as multi-strategy, fixed income arbitrage, and macro-oriented investments are becoming more common.

While not a focus of this paper, it is worth noting that historically the North Africa region has not been associated with hedge fund investment. The ability to short is currently limited to synthetic positions with five or six main counterparties (investment banks). Inventory for shorting—whether in single names or indices in Egypt, Morocco, or the GCC markets—can be limited and unstable.

Hedge Fund Investment in Frontier Africa

Hedge fund managers have been attracted to the robust growth in Frontier Africa. However, Frontier Africa also suffers from many of the liquidity and hedging issues that exist in Northern Africa and it is difficult for hedge fund managers to play the market. As hedge fund manager Renaissance Investment Management pointed out in an interview, "shorts on single names in sub-Saharan Africa are few and far between." This is due to country-specific regulations or a lack of liquidity, including locating stock to borrow. Further, the costs of trading—for both local and foreign investors—are still relatively high across most of Frontier Africa, and significantly higher than in South Africa.

It is worth noting that we have encountered a small handful of multi-strategy hedge fund managers that invest predominantly in Frontier Africa. Broadly speaking, these managers have open mandates, with the flexibility to invest in equities (including pre-IPO placements), corporate debt, sovereign debt, and currencies. While these managers typically cannot short single stocks outside of South Africa, they can use other instruments to express a negative view on certain areas of the market. These instruments include American depository receipts, exchange-traded funds, currency non-deliverable forwards, forwards, futures, equity options, and swaps. Hedge funds focused on Frontier Africa generally have limited track records and low assets under management (of less than US$100 million), and as such are likely not yet appropriate for most institutional investors. However, their emergence underscores the increasing attractiveness of and potential alpha within Frontier Africa, and we will continue to monitor their development as frontier markets deepen.

In September 2012 the Nigerian Stock Exchange approved a market-making program that will allow for securities lending and short selling. While implementation is in its early phases and stock borrow is scarce, hedge fund managers may increasingly evaluate investment opportunities in Nigeria in the coming years given its status as Africa's third-largest exchange (behind South Africa and Egypt) and as the major economic hub of West Africa. Potential developments in other countries including Botswana, Ghana, and Kenya will likely create positive headwinds for African hedge funds to engage in short selling over the medium to long term.

At present, South African hedge funds often have mandates that allow Frontier African investments to compose a portion of their long portfolios. A number of these hedge funds have

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responses from 62 managers that collectively manage in excess of 106 different mandated funds.

expressed eagerness to short in Frontier Africa as the markets deepen. In a recent interview, a South African long/short equity manager quipped that his team has "probably identified about half a dozen completely fictitious businesses [in Africa excluding South Africa] and so [they] are quite eagerly awaiting a short-selling capability throughout the rest of Africa."

Notably, some South African hedge funds will short American depository receipts or equities listed on other exchanges that have predominantly African operations. For example, mining stocks in Frontier Africa are often dual-listed on the London, Sydney, or Toronto stock exchanges.

Hedge Fund Investment in South Africa

Although many places across the continent have some investment opportunities, the African hedge fund industry is mainly confined to investing in South Africa, where markets are more liquid and, as a result, more efficient. In South Africa, the hedge fund industry is still in its infancy, but has shown tremendous growth in recent years, both in terms of assets under management and proliferation of funds. Unlike global hedge fund peers that were primarily seeded by high-net-worth individuals, demand from pension funds was a key driver of the creation of the South African hedge fund industry, with funds of hedge funds as the "key allocators." Data from Novare Investments show that assets under management in South African hedge funds increased from US$320 million in 2003 to approximately US$4.1 billion by 2012. That said, the local hedge fund industry is still very small when measured against the total market capitalization of the JSE and the assets of the local unit-trust industry.

Unlike their counterparts in Northern Africa and Frontier Africa, South African hedge fund managers are regulated under the Financial Advisory and Intermediary Services Act. This act regulates the rendering of advice and intermediary services for certain financial products for clients in South Africa. Those that render advice and intermediary services to South Africans must register with the Financial Services Board and meet certain "fit and proper" requirements. Hedge fund managers are also required to have appropriate qualifications and demonstrate to the Financial Services Board that they have a suitable track record for their strategies. The existing requirements extend to demonstrating knowledge, skills, and competency in managing the instruments making up the fund portfolio.

Historically, the majority of hedge fund assets within South Africa are managed in equity long/short and equity market-neutral strategies. According to Novare Investment's June 2012 survey, funds of hedge funds form the backbone of the South African fund industry, composing 66% of the industry's estimated US$4.1 billion in assets under management.

While hedge funds in South Africa are less transparent than their long-only counterparts, information certainly flows between institutional investors and those managers entrusted with a portion of their assets. Further, the combination of sound regulation and self-regulation in the South African market warrants mention:

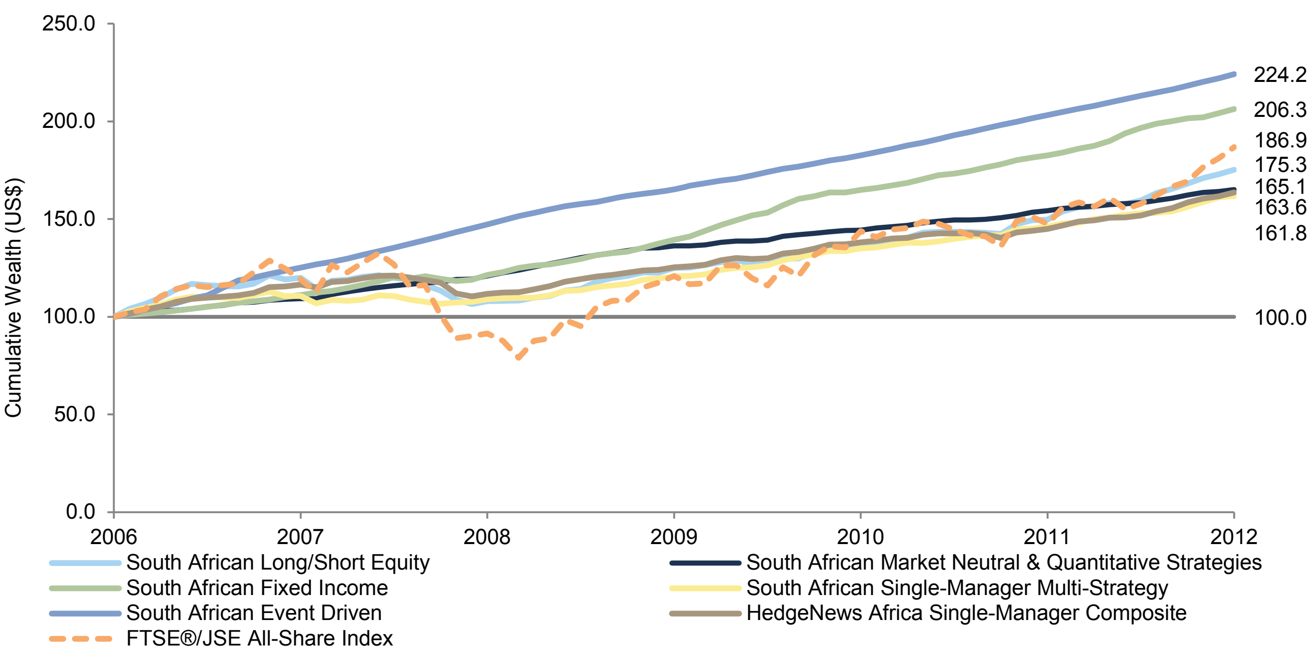
- South Africa did not ban short selling during the turmoil that roiled international markets in 2008. South African regulatory authorities recognized early on that the dangers of "naked" (not owned) options are very different from those of "covered" options, and South Africa only allows covered short sells (sellers have to borrow stock from a third party if they want to sell short). South African markets have not been susceptible to wild swings as lenders temper short selling.

- The National Credit Act introduced in 2007 is designed to prevent domestic banks from the sort of zealous overlending seen in the United Kingdom, the United States, and other economies in the 2000s.
- South Africa also has relatively low exposure to the retail market. Retail investors can increase market volatility by chasing performance on the upside and making emotional withdrawals from investments on the downside.

This combination of sound regulation and self-regulation in the South African market shielded hedge funds from the turmoil in international markets and overreaction by regulators in 2008–09. And despite negative returns on an absolute basis and a few hedge funds shuttering their doors, one could argue that the impact of the global financial crisis on the South African hedge fund industry has been considerably less than the shockwaves felt across the international industry. In South Africa, local equities performed poorly, with the FTSE®/JSE All-Share Index losing 23.2% in 2008. However, South African hedge funds preserved capital on a relative basis in extremely difficult conditions by falling 7.7% in 2008, based on the performance of the Eurekahedge South Africa Hedge Fund Index. Local long/short hedge funds returned -10.0%. Market-neutral hedge funds performed far better than their long/short counterparts during a volatile 2008,

Figure 13. South African Hedge Funds: Cumulative Wealth of Various Strategies

January 1, 2007 – December 31, 2012 • Rebased to 100 at December 31, 2006



Sources: HedgeNews Africa and Thomson Reuters Datastream.

returning 10.5%. Local fixed income arbitrage hedge funds returned 9.2% in 2008 (Figure 13).[10] Although 2008 saw the South African hedge fund industry record its first year of net outflows (US$135 million), fund launches put on a strong showing, with 20 new hedge funds coming to the market, the majority started by established management companies.

Hedge Fund Strategies

In South Africa, data from Novare Investments as of June 2012, show that about 45% of assets are managed in equity long/short funds, compared to nearly 80% in 2005. Equity market-neutral funds make up 14% of all local hedge fund assets, and other strategies such as fixed interest hedge funds (19% of the industry total), multi-strategy hedge funds (10%), volatility arbitrage (4%), and structured finance funds (1%) continue to gain in popularity and size, offering investors a healthy blend of strategies to invest in that are less reliant on market direction.

Globally, one of the problems of including hedge funds in investment programs has historically been the lack of transparency that hedge fund managers provide their clients. In South Africa, the vast majority of hedge fund managers provide position and transactional data to investors and third-party risk managers. For context, as of June 2012, 60% of South African hedge funds allowed investors to view their funds' underlying holdings on a daily basis, and 31% allowed the same level of transparency on a monthly basis. Such transparency allows investors to accurately and exhaustively analyze hedge funds and invest with more confidence, as well as to more accurately assess the degree to which managers generate alpha.

[10] These returns reflect the substrategy index returns from HedgeNews Africa.

Concentration of Industry Assets

In South Africa, the ten largest asset management companies of local hedge funds manage in aggregate just over half of all industry assets. According to Novare Investments, hedge fund managers with an excess of R1 billion under management (~US$120 million) managed 79% of all industry assets. A further 15% of assets are managed by hedge fund managers with total assets under management between US$25 million and US$120 million. Only 6% of industry assets are managed by hedge funds with less than US$25 million under management across all of their hedge fund products.

The majority of South African hedge fund managers possess short track records, which would be expected in a rapidly developing market, but track records are beginning to lengthen as a meaningful percentage of managers have demonstrated staying power. Approximately 32% of all industry assets are in hedge funds with track records of more than eight years; roughly half of these funds are closed for investments, recognizing the strategic advantages of a smaller, more nimble asset base. Also encouraging is that 84% of total industry assets are managed by funds with track records over three years, according to Novare Investments.

For South African local hedge funds, funds of hedge funds remain the largest investor group, managing approximately 66% of all assets according to Novare Investments. These funds of hedge funds exert their influence by requiring a high minimum level of transparency and reporting standards from the funds in which they invest. High-net-worth individuals represent the second-largest identifiable investor grouping, at 16% as of June 2012. Pension funds investing directly into hedge funds composed just 6% of industry assets as of

June 2012. However, most pension funds prefer to invest via funds of hedge funds.

Notably, in July 2011 the South African legislature enacted Regulation 28 of the Pensions Fund, which states that local pensions can invest up to 10% of assets in alternative investments (i.e., hedge funds). This regulation initially created a negative headwind for the industry, as South African pensions that had already established exposure to hedge funds often had more than a 10% allocation, and were forced to reduce their exposure. Nevertheless, Regulation 28 may attract an increased amount of capital over the long term. South Africa's Public Investment Corporation (PIC), a large government-owned entity that oversees the Government Employees Pension Fund, has not yet established a significant allocation to hedge funds. Should the PIC expand into hedge funds, many smaller union pension funds would likely follow suit. Increased foreign interest in South Africa's hedge fund industry could also diversify and expand current industry assets.

Hedge Fund Attractions and Considerations

A key question for investors interested in Africa is whether hedge fund strategies constitute a better option than long-only strategies and/or offer a differentiated return stream. One of the desirable attributes of hedge fund investing is a manager's ability to reduce downside volatility while still capturing much of the upside and allocating capital in a better risk-adjusted manner.

Facing the global economic meltdown in 2008, the South African hedge fund industry held up extremely well. Fixed interest arbitrage and equity market-neutral funds posted positive performance, and on average, local hedge funds easily outperformed the FTSE®/JSE All-Share Index. Even more encouraging is that this outperformance has been achieved with considerably less volatility, in most cases.

Up until the global crisis of 2008, local equities in South Africa enjoyed a four-and-a-half-year bull run, albeit not nearly to the same extent as in other emerging markets. The total size of the South African hedge fund industry as a percentage of local equity market capitalization is still less than 1%. Nonetheless, a number of South African hedge fund managers see significant scope for growth. Given current market conditions and the pool of skills and opportunities, the local hedge fund industry could potentially double in size.

Investment Attractions

- Locally domiciled South African hedge fund managers should have greater expertise in their local markets than global managers in London or New York trying to keep tabs on every emerging markets country. Locally domiciled managers are also likely to get more one-on-one company meetings with both top- and mid-level management, as well as participate more abundantly in the local network. That said, managers outside of South Africa do have competitive advantages, including perhaps a more global, less myopic industry view.
- Most South African hedge fund managers have been educated at leading local institutions and have worked at global investment banks. As a result, they have a level of sophistication and training comparable to that of managers in any developed country.
- South Africa and a few countries in Northern Africa have a robust regulatory environment that covers both traditional equity and hedge fund managers. Thus, concerns about widespread corruption, market manipulation, or unrest are misplaced.

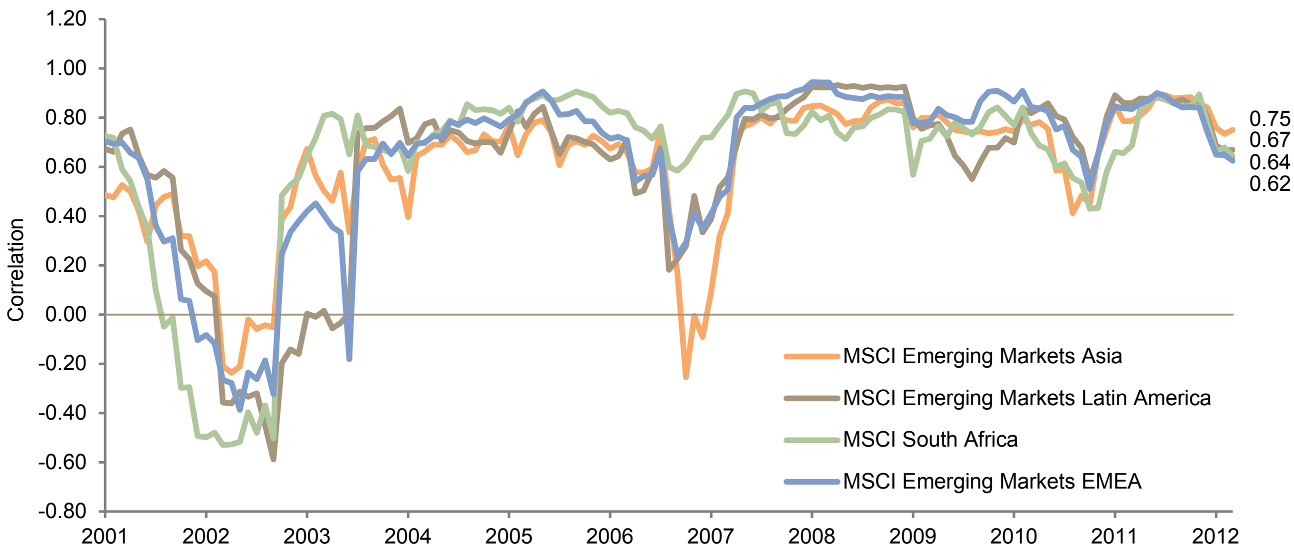
- The vast majority of South African hedge fund managers provide transparency by giving position and transactional data to investors and third-party risk managers.
- In South Africa, investors seeking greater liquidity might find locally domiciled hedge funds with monthly liquidity a better option than global managers. South African hedge funds have shorter lock-up periods and redemption notice periods.
- The deepening of capital markets across Africa, in addition to Regulation 28, should positively impact South African hedge funds over the medium to long term.

Considerations

- Hedge fund investing is concentrated in more mature and regulated markets like South Africa.
- Apart from South Africa and a few countries in Northern Africa, Africa's markets continue to develop, but remain somewhat limited for hedge fund managers to operate.
- The investable universe for South African hedge fund managers is somewhat efficient.
- South African hedge fund managers have limited historical track records, averaging nearly seven years of fund manage-

Figure 14. Rolling 12-Month Correlation of Emerging Markets Indices with South African Hedge Funds

November 30, 2000 – December 31, 2012 • U.S. Dollar



	South African Hedge Funds	MSCI EM Asia	MSCI EM Latin America	MSCI South Africa	MSCI EM EMEA
South African Hedge Funds	1.00				
MSCI EM Asia	0.48	1.00			
MSCI EM Latin America	0.49	0.82	1.00		
MSCI South Africa	0.47	0.74	0.76	1.00	
MSCI EM EMEA	0.52	0.81	0.86	0.90	1.00

Sources: Eurekahedge PTE LTD., HedgeNews Africa, and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

Notes: Graph represents 12-month rolling correlation to South African Hedge Funds. South African Hedge Funds are represented by Eurekahedge South Africa Hedge Fund Index from November 2000 to December 2006, and by HedgeNews Africa South Africa Hedge Fund Composite Index from January 2007 to present.

ment experience, according to Novare Investments.

- The majority of local hedge fund managers in South Africa are leanly staffed. Portfolio managers tend to be overextended since they also need to conduct research, manage risk, and market the firm and product to prospective clients.
- The most common concerns about investing in Africa, including general governance risks and specific event risks, especially political elections, apply to hedge funds as well.
- In South Africa, fees tend to be high. A 2% management fee and 20% carried interest fee structure is common in local hedge funds.

Summary

At this time, we believe the hedge fund industry in Africa is still in its early stages of development, and therefore recommend that most clients continue to evaluate this area over the coming years. For those clients with mature emerging markets or hedge fund portfolios seeking niche opportunities, we have conducted due diligence and become more comfortable with a small number of South African long/short hedge fund managers. These skilled, fundamental managers have a demonstrated ability in generating long and short alpha, and are supported by a growing history of strong risk-adjusted performance. In terms of diversification and lower correlation with global markets, South African hedge funds may provide an opportunistic source of return in addition to a mature global long/short hedge fund program (Figure 14).

Apart from South Africa and a few countries in Northern Africa, hedge funds are limited on the continent, as most African stock markets, which are relatively small and immature, are still nascent in their development. Not surprisingly, then, any discussion of the African hedge fund industry necessarily focuses almost entirely on South Africa. South Africa is where most of the investment talent resides, the regulatory framework is in place, and the stock market is robust and liquid. Northern Africa and Frontier Africa should not be overlooked, although most managers operating in this space are long-biased hedge funds.

As the market in Africa continues to broaden and more companies become public, the playing field for long/short hedge funds should gradually improve. Hedge fund managers,

Table 5. S&P Africa Frontier Country Correlations

January 1, 2009 – December 31, 2012 • U.S. Dollar

	Botswana	Ghana	Ivory Coast	Kenya	Mauritius	Namibia	Nigeria	Zambia
Botswana	1.00							
Ghana	0.01	1.00						
Ivory Coast	0.64	0.10	1.00					
Kenya	0.41	0.17	0.46	1.00				
Mauritius	0.46	-0.04	0.36	0.58	1.00			
Namibia	0.56	-0.08	0.48	0.36	0.29	1.00		
Nigeria	0.17	0.01	0.28	0.11	0.21	0.28	1.00	
Zambia	0.27	0.01	0.26	0.24	0.50	0.14	0.47	1.00

Correlation > 0.66 | 0.66 >= Correlation > 0.33 | 0.33 >= Correlation > 0.00 | 0.00 >= Correlation particularly in South Africa, will then be better positioned to extract greater alpha and mitigate substantially more volatility—skills many managers in the region demonstrated in 2008.

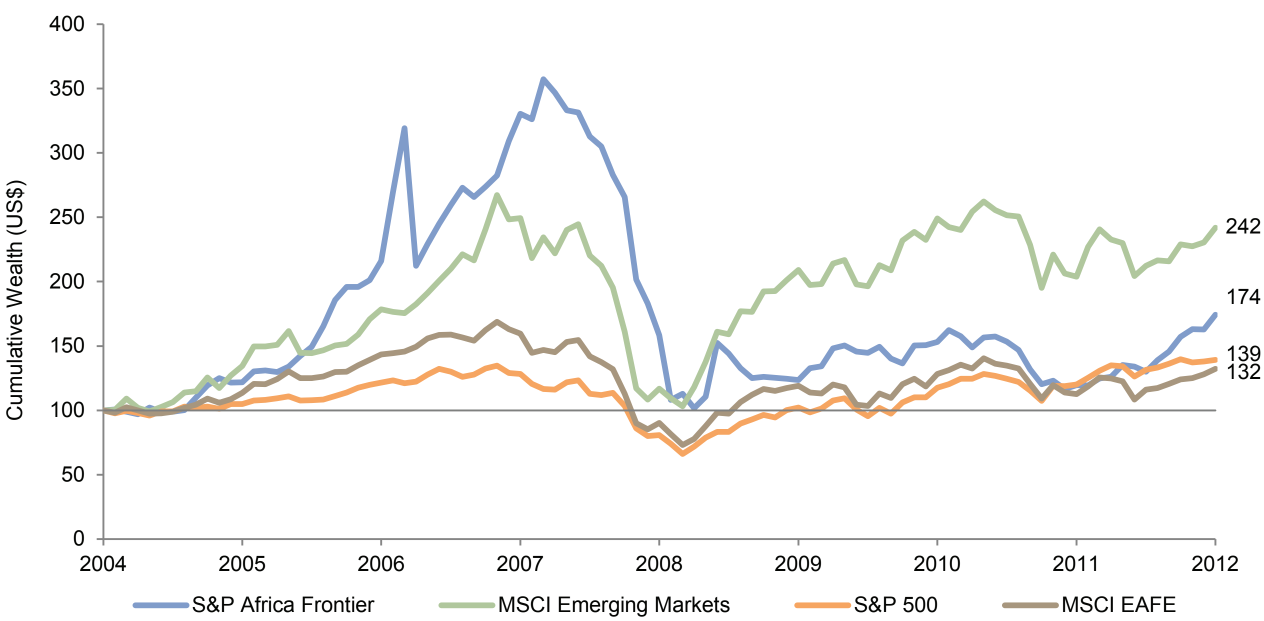
Public Market Portfolio Positioning

Most investors seeking exposure to Frontier African public equities will do so for diversification from the broader global equity markets, to tap into higher growth than that available in developed and other emerging markets, and to educate themselves about the markets with an eye to growing the exposure over time as the markets mature.

Investors will expect to benefit from Frontier African markets' relatively low correlation to the MSCI World and S&P 500 indices. Most of these markets have exhibited low correlations to the developed equity markets and emerging markets as well as to one another (Table 5). Frontier Africa does represent a higher risk/return strategy than traditional emerging markets equities, making it important to rebalance the exposure after earning significant gains. Investors must be prepared to weather significant periods of decline or stagnation (Figure 15).

Some investors may choose to take a small position in a new region, such as Frontier Africa, with the goal of learning more about the opportunity by placing assets there and growing the exposure over time. Other inves-

Figure 15. Cumulative Wealth of Developed and Emerging Markets and S&P Africa Frontier
January 1, 2005 – December 31, 2012 • Rebased to 100 at December 31, 2004



Sources: MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Total returns for MSCI Emerging Markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

tors may decide to gain exposure via "Middle East and North Africa" mandates as some managers combine African holdings and Middle Eastern stocks. However, investors must be aware that those mandates tend to hold larger positions in the Middle East and may have minimal exposure to Frontier and South Africa. A third approach may be to invest as part of broad exposure to frontier markets using a more diversified approach with investments in both Africa and other smaller markets. In a frontier portfolio, the exposure to pure African holdings will vary. Historically, frontier managers have held 0% to 40% (averaging 20%) in Africa. A frontier manager with knowledge of the continent provides an attractive, diversified exposure to Africa or an investor may combine a frontier markets manager with a dedicated Frontier Africa manager.

Private Equity

The evolution of private versus public markets in Africa has not mimicked that of the Western nations. In particular, private deals in Frontier Africa often had backing from development finance institutions (DFIs) and may have preceded the establishment of public markets in certain countries. The industry started to form in the 1980s in South Africa, with some pioneering firms investing in private equity, mostly through buyouts and growth investments. Many funds originated within local banks. For example, South Africa–based Ethos Private Equity, one of the first private equity fund managers on the continent, established its first fund in 1984 as part of the First Rand National Bank, using the bank's own capital. In the 1990s, consistent with the trend in the United States and Europe, South Africa also started to see a small number of bank-captive managers gain independence and raise first-time institutional funds. Over time, regional or Pan-African funds were established and funds dedicated to individual countries other than South Africa were raised. The industry has seen strong growth in recent years with fund raising achieving record levels amid a maturing market environment.

Despite the industry's recent growth, private equity competition in Africa remains limited relative to many other emerging markets, which, along with improving exit avenues, supports private equity's increasing role in the region. However, challenges remain, among them corruption, political instability, relatively short track records of most general partners (GPs), and a lack of experienced portfolio company management talent. Nonetheless, Africa may offer an attractive risk-reward trade-off for investors—if they can identify and invest with high-quality GPs.

Who Is Investing?

The vast majority of investment professionals working in African private equity are African nationals, as firms, even those based outside of Africa, prefer to cultivate and maintain teams mostly made up of professionals with links or origins in the region. Outside of South Africa, a significant proportion of investment professionals still join the private equity industry with no previous private equity experience, coming from Big Four accounting firms, banks, or operating companies with experience in the region. According to the 2011 Coller Capital Emerging Markets Private Equity Association (EMPEA) Limited Partner (LP) survey, the limited number of established GPs was likely to be the single biggest factor deterring respondents from investing in Frontier Africa over the next two years. However, as the market matures, we expect to see more and more experienced private equity investors with substantial experience and established track records.

The majority of firms have teams on the ground, often based in and focusing on Eastern, Western, or Southern Africa. Some pan-African or regionally focused firms operate from an office(s) in Europe, usually London or Paris. In these cases, the majority of investment professionals are still typically African nationals. Larger African deals are often transacted through and financed in London or Paris, and some managers argue that it is more convenient to travel to some African countries from London than from within the continent. For example, there are many more airlines flying from Europe to Lagos, the capital of Nigeria, than from Johannesburg. A base in Europe can also mitigate talent constraints, since managers can recruit internationally and reduce costs on expatriate living allowances. However, this approach could still disadvantage firms in establishing relationships with prospective local sellers well in advance of sales processes. For funds focusing on smaller deals in Frontier Africa's sub-regions, an on-the-ground presence is essential.

In 2003, the South African government started to introduce the Black Economic Empowerment (BEE) scheme to address inequality by giving the previously disadvantaged black population economic opportunities formerly unavailable. The scheme encourages companies to be 26% black-owned, train black employees, support and procure from black-owned companies, and follow other affirmative action measures. The impact of BEE on private equity in South Africa is relevant at the GP and portfolio company level. Private equity firms have sponsored funds owned by black investment professionals and restructured their ownership to incorporate BEE elements. BEE-focused funds could see some differentiated deal flow as companies restructure ownership to comply with the scheme. A scorecard system was introduced to the BEE scheme in 2007 using seven pillars to measure BEE compliance, with ownership contributing 20% to the total score. However, in recent conversations with South African GPs, the practical relevance of BEE seems to be less than originally anticipated when the program was introduced in 2007.

Fund Landscape

Figure 16 shows the landscape of the major funds in the sub-Saharan Africa region. According to Cambridge Associates and African Venture Capital Association data, there are approximately 50 institutional-quality non-infrastructure private equity firms operating in Africa, although only a small subset of these would be suitable for return-focused international LPs. Together, these 50 firms have raised 83 funds since 1991, representing in excess of US$19 billion of total commitments. Helios Investors II, at US$900 million in 2011, is the largest sub-Saharan Africa private equity fund closed to date. Helios is focusing on larger-sized deals across the sub-Saharan Africa region. Reflecting the higher degree of market activity and socioeconomic stability, most private equity fund activity takes place in Kenya, Nigeria, and South Africa, though private equity firms seeking to transform their portfolio companies into regional or pan-African leaders will often make add-on investments in other countries. Participants within these regions are segmented into two broad groups: locally focused GPs and pan-African firms. Private equity firms that operate locally within these regions include Brait, Ethos, and Medu in South Africa; Catalyst

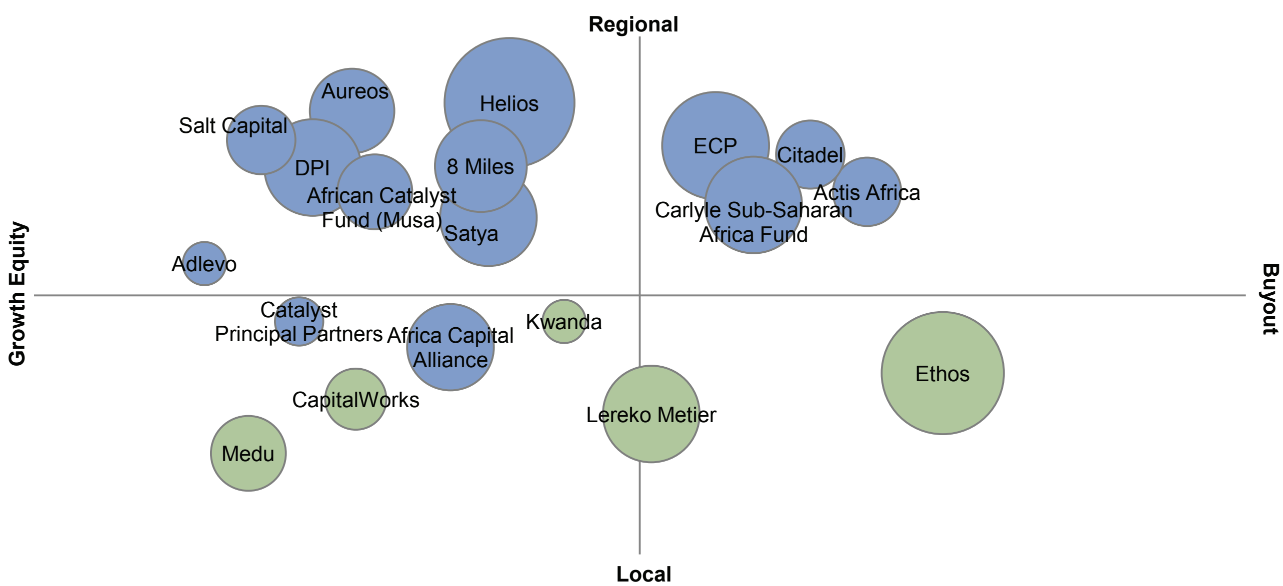
Principal Partners in Eastern Africa; and Africa Capital Alliance in Western Africa. Pan-African firms include Actis, Aureos, and Emerging Capital Partners.

Historically, private equity funds-of-funds devoted solely to Africa were rarely seen, due to the limited universe of institutional-quality managers and the emerging nature of the private equity universe in the region. However, with the market maturing and growing investor interest, a rising number of private equity fund-of-fund managers have raised inaugural funds in the past two years. Examples include Kuramo, at a proposed fund size of US$300 million; South Suez Capital, at US$280 million; and Sango Capital, with a goal of US$200 million. As a result of the relatively small universe of private equity managers in the region, funds-of-funds in Africa tend to aim at a higher co-investment percentage compared to such funds in developed markets. Some managers target multiple asset classes, also investing in public debt and equity, such as Kuramo. Fund-of-fund managers in Africa typically focus on the similar sectors to direct managers: consumer, energy, infrastructure services, and natural resources services.

Strategy

While Frontier African markets continue to develop, capital to fund growing private enterprises remains limited and private equity penetration in the region low. Most private equity investments are minority positions in closely held companies. Control positions and buyouts also occur, and are often corporate

Figure 16. Africa-Focused Private Investment Fund Landscape
As of December 31, 2012



Source: Cambridge Associates LLC Private Investments Database.
Notes: Blue bubbles show Pan-Africa or ex South Africa–focused funds, green bubbles show South Africa–focused funds. Manager positions shown are based on Cambridge Associates' qualitative analysis of institutional-quality funds. Size of bubble determined by size of most recent fund raised by the manager.

spin-offs from multinationals or pan-African conglomerates.

The continued lack of financing alternatives for small, but growing, private businesses outside of South Africa has made providing growth capital the dominant investment strategy, making up the majority of total private equity activity by invested capital. In accordance with the low private equity penetration and often modest capital needs of African companies, private equity investments in Africa are often relatively small compared to other developed and emerging markets, with deals typically sized under US$100 million.

The South African economy is much more developed than the rest of Africa and includes more mature businesses that are suitable buyout targets. Private equity–backed buyout transactions in South Africa also benefit from the country's sophisticated banking system, which provides leveraged financing for buyouts quite readily. Management buyouts, corporate carve-outs, family transitions, and secondary buyouts are among the types of buyout deals seen in South Africa. According to a KPMG and South Africa Venture Capital Association (SAVCA) survey, 32.1% of private equity investments in South Africa in 2011 were buyouts, compared to 23.1% in 2010 (based on capital invested).[11] However, even firms largely focused on buyouts such as Brait and Ethos often also invest in the growth equity space.

Larger-sized, pan-African-focused GPs typically concentrate on acquiring significant minority and controlling positions in companies with enterprise values in excess of US$100 million. Equity investments are typically sized between US$50 million and US$100 million, and in larger situations co-investors—including other private equity firms, local development institutions, and the fund's LPs—may invest alongside the GP. Target companies often have leadership positions within their sector and region and seek to use investment proceeds to expand their geographic reach before ultimately being sold to an African or global strategic acquirer or pursuing a public listing. Company valuations vary widely based on region and industry; however, anecdotally, deals are typically priced in excess of 6 times enterprise value (EV) to EBITDA, with deal-level target returns and holding periods in excess of 20% gross internal rates of return (IRRs) over a four-year period.

Pan-African managers investing across Africa include Actis, Aureos, Emerging Capital Partners, and Helios Investment Partners. Actis and Aureos, both spin-offs from the Commonwealth Development Corporation, the U.K. government's DFI, are pan–emerging markets managers with dedicated Africa-focused funds. In addition, some global players such as Bain Capital and Warburg Pincus have also invested in the region through their global or Europe-focused funds. The continent has also recently attracted the attention of Chinese private equity investors. For example, Hony Capital, a China-focused growth equity investor, committed up to US$100 million in the Madagascar-based Soalala Iron Ore Project in 2011.

By volume, the sub-Saharan Africa private equity market is mainly driven by the needs of local, family-controlled businesses trying to expand, either in their domestic market or across the continent's segmented regional economies. Small- to mid-cap regional managers typically focus on acquiring significant minority or controlling positions in companies

[11] KPMG and SAVCA, "Venture Capital and Private Equity Industry Performance Survey of South Africa," June 2011.

with enterprise values under US$150 million. Investments are often sized between US$10 million and US$25 million. Target companies are typically family- or entrepreneur-owned with limited focus on institutional corporate governance. For these smaller deals, entry pricing is typically more reasonable (generally priced in the range of 4 to 6 times EV/EBITDA), with deal-level target returns and holding periods in excess of 30% gross IRRs over a four-year period.

Private equity managers have uniformly stated that selecting the right entrepreneur and managing exit expectations are critical since it is often difficult to enforce legal agreements in a timely and consistent manner across the region's diverse legal landscapes. Notwithstanding the importance of selecting the right investment partner, private equity managers typically structure standard investor protections similar to those in other emerging economies, especially in minority situations, including drag-along clauses, ratchet mechanisms, and puts that allow the private equity investors to sell back the company to the founder.

Corruption and political influence within certain industries continue to be issues in sub-Saharan Africa. Private equity firms will often make efforts to avoid companies operating in industries prone to corruption and/or heavy political influence including agriculture, extractive industries, and other heavily regulated sectors that rely on government spending or licensing. The investment team's ability to bring strong forensic accounting capabilities and rely on its personal network to fully vet its partners are crucial components in operating in sub-Saharan Africa's private equity arena.

GPs routinely say that hiring experienced and strong company management is a key bottleneck in sub-Saharan Africa. Given the shortage of indigenous, mid-level management, GPs are often heavily involved in managing the strategic direction and supervising operations of their portfolio companies. Private equity firms with dedicated portfolio support teams, often seen among the global and pan-regional players investing in Africa, could differentiate themselves in this respect.

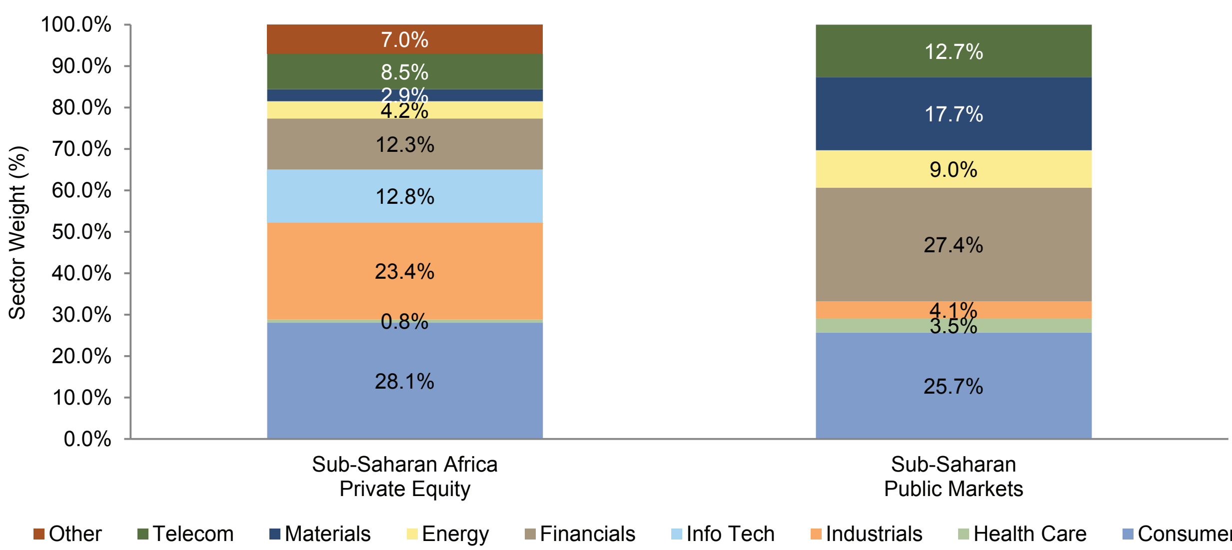
Investments and Exits

According to EMPEA data, private equity investments in sub-Saharan Africa, including those made by non-African-focused GPs, totaled US$14.7 billion from 2002 to 2011, compared to a total of US$149 billion invested in emerging Asia and US$33 billion invested in the Caribbean and Latin America during the same period. Private equity penetration in 2011, measured by private equity investments as a percentage of GDP, was 0.12% in South Africa, the most developed private equity market in Africa, compared to 0.14% in China, 0.33% in India, and 0.98% in the United States. Private equity investments in Africa peaked in 2007 with a total of US$3.4 billion invested, primarily driven by Bain Capital's US$3.5 billion acquisition (including debt) of South Africa's fashion retailer Edcon, one of the largest deals in Africa to date. South Africa is clearly the largest investment destination in Africa, accounting for 72% of the total capital invested in sub-Saharan Africa from 2002 to 2011. According to the KPMG and SAVCA survey, the infrastructure sector accounted for the largest proportion of capital invested in South Africa in 2011 at 39.1%, followed by manufacturing and retail at 6.4% each. Despite being a region well known for its rich natural resources, private equity investments so far have limited direct exposure to the mining or natural resources sectors.

Private equity investments allow LPs to gain exposure to industries and sectors that are not accessible through Africa's public markets, including smaller family-owned business that benefit from the region's increasing private consumption. Sub-Saharan African public markets are dominated by financials (27.4%) and consumer-oriented companies (25.7%) that together make up over half of market capitalization (Figure 17). Private equity investments to date have been dominated by consumer-oriented companies (28.1%) and industrials (23.4%) that together compose half of the private equity investments in our performance database. South African companies represent the majority of public market exposure, making up over 90% of sub-Saharan Africa's public market capitalization. Although listed companies should benefit from the region's continued development, local and pan-regional private equity funds provide investors with the option to gain a wider geographic exposure to investment opportunities outside South Africa.

The exit environment, one of the main concerns for LPs investing in sub-Saharan Africa, has improved in recent years. Through the growing presence of exchanges in sub-Saharan Africa, equity capital markets have deepened significantly. In addition to the continent's largest and most-liquid exchange (JSE), the Nairobi and Nigerian Stock Exchanges have also grown in terms of the number of listed companies and market capitalization, although liquidity in most of the other stock markets remains an issue. There have been a few notable private equity–backed initial public offerings (IPOs) in Africa recently, including

Figure 17. Private versus Public Market Exposure in Sub-Saharan Africa
As of September 30, 2012



Sources: Cambridge Associates LLC Private Investments Database, FactSet Research Systems, and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

Notes: Private data show companies headquartered in Africa (excluding Algeria, Egypt, Morocco, and Tunisia) in non-U.S. buyout and growth equity funds. Exposure based on net asset value + cumulative realizations. Public market data show emerging and frontier African companies as determined by MSCI (excluding Algeria, Egypt, Morocco, and Tunisia). The consumer sector combines both consumer discretionary and consumer staples sectors.

the US$680 million IPO of Life Healthcare Group Holdings in 2010, which was backed by a consortium of investors including RMB Ventures and Old Mutual Private Equity, and the oversubscribed dual listing of Wilderness Safari, an ecotourism company backed by Brait Private Equity, on the Botswana Stock Exchange and the JSE.

Trade sales will benefit from growing interest from international players and local firms. As Brazil, China, and India saw increased demand for natural resources fuel their rapid growth, strategic sales of African resource companies to international buyers have started to play a more important role. According to the KPMG and SAVCA survey, until 2007, sales to financial buyers had been the main exit route based on proceeds received. Recent years have seen a more balanced trend, with the rise of IPOs and trade sales.

As a result of the still-developing exit environment in the region, private equity investors sometimes structure deals with exit options built in from day one. As noted earlier, deals are often structured to allow private equity investors to put the company back to its original owner or sell back shares as a back-up exit option in the event they are unable to realize an exit via traditional routes like an IPO, trade sale, or sale to financial buyers.

According to the KPMG and SAVCA survey, private equity investments in South Africa from 2002 to 2011 returned total proceeds of R96.3 billion (approximately US$12.5 billion), compared to total capital invested of R107.7 billion (approximately US$14.0 billion). Exit to financial buyers has historically been the main exit route, based on proceeds generated, although exits through trade sales and IPOs have also been meaningful. In 2011, exits through IPOs and trade sales each accounted for 13% and 12% of total proceeds received, compared to 69% through sales to financial buyers.

Investing in the Region

Subject to standard best practices of manager selection, a portfolio approach that selects sub-Saharan Africa private equity investments with varied geographic and deal positioning would be appropriate. One or two pan-sub-Saharan Africa funds focusing on mid-sized and larger deals could be complemented with one or two local funds where local investment networks are key to sourcing investments in family-run businesses.

Environmental, Social, and Governance Framework. A key feature of African investing is the support that private equity funds receive from DFIs. As a function of their support, GPs are often required to have a comprehensive environmental, social, and governance (ESG) framework for investment. At a high level, the GP may require portfolio companies be assigned to an ESG risk category, conduct a gap analysis for compliance, perform ongoing ESG monitoring, and upon exit ensure that potential buyers/owners adhere to the same strict standards. As a result of the ESG mandate imposed by some DFI-supported funds, LPs with socially responsible investing mandates may find African investments appealing from both a returns and investment mandate perspective. While socially responsible investing benefits may be obvious, a significant, but less obvious benefit of working with DFIs is the potential for portfolio companies and funds to enjoy more favorable lending, which results in a lower cost of capital.

Summary

Sub-Saharan Africa's nascent private equity landscape continues to develop. The relatively limited private equity competition, as well as improving exit avenues, supports private equity's prospects in the region. Private equity investors gain exposure to industries and sectors they could not in Africa's public markets, including smaller family-owned business that benefit from the region's increasing private consumption. The ability of private equity teams to select the right business partners is crucial, particularly given the occasional difficulty of enforcing the rights of minority investors. Local private equity firms remain reliant on well-cultivated relationships to source and execute deals.

Conclusion

As developed economies continue to face the risks of muted economic growth, widespread deleveraging, and subpar market returns, opportunities further afield, including Frontier Africa, are worth studying. The challenges investors face are manifold, including political risk, illiquidity, inadequate regulation, volatile currencies, and the fundamental economic headwinds that may result from impoverished, poorly educated, and rapidly growing populations. On the positive side, Frontier Africa offers the opportunity to invest in some of the world's fastest-growing economies, driven by rich endowments of natural resources, young populations, and increasingly supportive economic and political policy. Valuations are generally reasonable and where capital is scarcest pockets of pronounced cheapness can be found. In our view, Africa has turned the corner and the good news will win the day. The handful of managers that possess the ability to navigate this difficult terrain warrant serious consideration as they may stand to earn returns that will be hard to come by elsewhere. While opportunities certainly exist in both the public and private markets, we find the private market opportunity set marginally more interesting for institutional investors with a large asset base due to the illiquidity inherent in Frontier Africa's public markets. ■