PRIVATE EQUITY AND RESPONSIBLE INVESTING:
Trends and Opportunities in Sub-Saharan Africa
About KudosAfrica

KudosAfrica is a value capture platform for unlisted African businesses. KudosAfrica has developed a unique and practical rating methodology that incorporates international best practice in the assessment of sustainability of companies in emerging markets. Our goal is to increase investment into responsible and sustainable African enterprises by encouraging companies to improve their environmental, social and governance (ESG) performance. We are a passionate, dedicated team of experienced industry specialists with a common mission to inspire and influence responsible business innovation and investment.

About this report

This report presents an overview of the growth of private equity in sub-Saharan Africa in the context of the emergence of sustainable and responsible investment (SRI). It considers the dynamics behind these markets and barriers to growth. The report reviews third-party surveys on the motivations for SRI and considers whether integrating ESG factors into investment decisions can lead to outperformance.

Finally, it provides companies looking to improve sustainability and attract responsible investors with some steps they can take toward integrating ESG factors into their businesses.

The report was authored by Mike Davies, an experienced analyst with specialist knowledge of environmental, social and corporate governance issues in sub-Saharan Africa.

Glossary

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<th>Acronym</th>
<th>Definition</th>
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<tr>
<td>AVCA</td>
<td>African Private Equity and Venture Capital Association</td>
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<td>DFI</td>
<td>Development Finance Institution</td>
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<td>ESG</td>
<td>Environmental, Social and Corporate Governance</td>
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<td>GP</td>
<td>General Partner</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>LP</td>
<td>Limited Partner</td>
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<td>PE</td>
<td>Private Equity</td>
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<td>SAVCA</td>
<td>Southern African Venture Capital and Private Equity Association</td>
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<td>SRI</td>
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Executive Summary

There has been a steady growth of interest in investing in the sub-Saharan African region in the past decade. This is most clearly demonstrated in the private equity sector. The total value of private equity deals in the region spiked in 2014, while the number of deals and the number of exits both hit record levels in 2015.

This interest has persisted despite the significant dissipation of the “Africa Rising” optimism. In 2015, Africa-focused private equity funds raised over US$4.3bn – more than a quarter of the total raised in the five years between 2010 and 2015. By comparison, in 2005, only US$800m was raised. Helios Investors also closed the first billion dollar fund in 2015.

The growth in private equity (PE) in Africa is now raising some challenges. According to the UK’s development finance institution CDC there are less than 3,200 Africa-based companies with annual revenue of over US$50m, half of which are in South Africa. With the billions being raised in PE funds chasing very few deals, there are concerns that this could stimulate a bubble. However, it also highlights the opportunities available for companies needing additional funding to accelerate their growth plans.

Although PE is often associated with financial engineering and cost-cutting leading, in Africa the focus of private equity has been on value creation through active ownership. Value creation lends itself to the integration of sustainability, or environmental, social and corporate governance (ESG) factors, into investment decisions as part of a sustainable and responsible investment (SRI) strategy. The involvement of development finance institutions at an early stage of the growth of PE in the region, and their requirement that private equity firms regularly account for performance, has supported this approach.

Various surveys highlight the fact that private equity investors believe that sustainable investment or integrating ESG factors will lead to outperformance. According to the Principles for Responsible Investment’s (PRI) 2016 Report on Progress: Private Equity for example, more than 60% of respondents supported the view that ESG integration helped identify risks and/or opportunities for value creation. Sustainable investment can lead to cost reduction through improved water or energy efficiencies, or reduced risk through improved environmental compliance; it can stimulate revenue by opening new market opportunities or enhancing productivity gains from more loyal employees; and it can encourage brand loyalty. It can also reduce reputational risk and ensure that interests are aligned with other stakeholders.

Although there are challenges to integrating ESG into PE investment decisions, such as comparable ESG data and the costs of ESG due diligence, the PRI underlined the even greater costs that can result if ESG issues are not managed. A quarter of respondents said ESG issues had affected the price paid for an investment, while 45% said that ESG concerns had led to a potential investment being abandoned.

KudosAfrica believes the drive by private equity to invest in good companies across the continent represents a major opportunity for both investors and companies. Companies wanting to take the next step should start working towards systematically integrating ESG factors across all business activities, from product design to sales, and ensuring that sustainability is embedded into the culture of the organisation.
Sustainable and Responsible Investing (SRI), which involves incorporating environmental, social and corporate governance factors into investment decisions, has seen considerable global growth in the ten years since the UN-backed *Principles of Responsible Investment* was launched. The number of PRI signatories has grown from 100 to almost 1,500, managing over US$60 trillion in assets. SRI, which has roots partly in the campaign for divestment from apartheid South Africa, has also grown in sub-Saharan Africa. There are now eight sub-Saharan asset owner signatories, including the largest pension fund on the continent, the South African Government Employees Pension Fund (GEPF), and 44 investment manager signatories from the major investment markets including South Africa, Nigeria, Mauritius, Ghana, Botswana and Namibia.

The interest in prospects for growth of investment in sub-Saharan Africa has also increased in recent years. The post-Cold War move towards democratic states, reduced levels of conflict and globalisation provided an initial boost to Africa’s fortunes. Demand for resources from many of Africa’s resource rich countries fuelled faster growth and gave rise to an emergent middle class. However, after the heady optimism of the “Africa Rising” narrative, there is now a more measured picture of both the risks and opportunities. The fall in commodity prices has particularly exposed the economic imbalances of several resource-dependent countries, such as Nigeria and Angola. Consumer-driven markets have performed better, but expectations have moderated as country-specific political risks, such as electoral violence and corruption, regulatory interventions and infrastructure concerns continue to make the business environment challenging.

Private equity investors flocked to Africa during the zenith of the “Africa Rising” narrative. The *May 2013 EMPEA Global Limited Partners Survey* found that the Africa region was a more attractive destination for private equity compared to other emerging markets for 70% of respondents.\(^1\) Similarly, the 2014 Riscura report *The search for returns: Investor views on private equity in Africa*, found that over two-thirds of respondents believed that Africa was more attractive than other emerging markets, with 85% of the 48 Limited Partners surveyed (representing a mix of pension funds, insurers, development finance institutions and others) expecting to increase their exposure to private equity investments in the region in the next 24 months.\(^2\) This shift was motivated by the potential earnings growth, which respondents expected to outperform other emerging markets over the next 10 years.

However, recent developments affecting the continent have changed the perspective of some investors. EY’s *Attractiveness survey: Africa 2015*, for instance, found in 2015 that investor perceptions of Africa reached their lowest level since 2011 as it slipped from the world’s second most attractive investment region to the fourth.\(^3\) *The 2015 African Private Equity and Venture Capital Association (AVCA) Limited Partner Survey* found that only half of the 68 Limited Partners (LPs) surveyed viewed Africa as more attractive for PE compared to other emerging markets and only 50% of respondents planned to increase their allocation to PE in Africa over the next three years.\(^4\) Nonetheless, indications are that the appetite for investing in sub-Saharan Africa remains strong.
Private equity is under-represented in sub-Saharan Africa and, as a result, it provides an opportunity for investors. In 2014, PE deals in Africa accounted for under 1.5% of the global total of $438bn. Of the $53.3bn of capital investment in sub-Saharan Africa between 2008 and 2013, 19% of the total was from private equity while listed equity accounted for 64%. Recognising this potential, a number of large international PE firms, such as the Carlyle Group, KKR and Blackstone, have entered the African market since 2014. In 2015, Helios Investment Partners became the first fund to close a fund over US$1bn when it raised US$1.1bn.

According to AVCA, there were 823 private equity deals across the continent between 2010 and 2015 worth a total of US$21.6bn. Southern and western Africa accounted for 49% of the number of deals during this period. The total value of deals peaked in 2014 at US$8.1bn. Although the value of deals below US$250m in 2015 was roughly the same as in 2014, deals valued over US$250m fell sharply.

Despite the 69% drop in the total value of deals in 2015, the appetite for private equity in Africa remains strong, with a large majority of industry players believing that PE will outperform listed equity in the next decade. This interest is reflected in the fundraising activity. According to AVCA, the total value of PE fundraising in 2015 was US$4.3bn or more than 25% of the US$16.2bn raised between 2010 and 2015.

Only US$800m was raised in 2005. Although more than 140 private equity funds have raised capital, it is highly concentrated with six funds raising two-thirds of the total between 2008 and mid-2015. AVCA suggests that with a number of large funds achieving final closes in 2015, fundraising will be lower in 2016.

While domestic fund managers accounted for the majority of total capital raised for most of the years between 2007 and 2013, "Prequin Private Equity Online’s data" suggests that the dominant proportion of total capital raised has shifted strongly towards international fund managers. In 2015, 81% of total Africa-focused private equity capital was raised by international fund managers.
Development Finance Institutions (DFIs), such as the World Bank’s International Finance Corporation (IFC), the UK’s CDC and the Dutch FMO, were instrumental in the early years of PE capital raising for African markets. One report from 2011 suggests that DFIs account for around 9% of total PE investment in Africa. This is compared to an average of 1.5% in other regions and is likely to be significantly higher in less developed markets and if South Africa is excluded. While the relative size of DFI funding in the PE sector is expected to decline as more private sector funding enters the market, DFIs will remain an important component, especially considering the developmental needs in many sub-Saharan African countries.
Sectors of interest

According to AVCA’s Annual Private Equity Data Tracker, as shown below, consumer goods and financials were the dominant sectors of interest in terms of the number of deals between 2010 and 2015. However, in terms of value, telecommunications and utilities were the major sectors.

**NUMBER AND VALUE OF PE DEALS IN AFRICA, BY SECTOR, 2010 - 2015**

<table>
<thead>
<tr>
<th>By number</th>
<th>By value</th>
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<tr>
<td>Consumer Staples</td>
<td>Industrial</td>
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<tr>
<td>Financials</td>
<td>Real Estate</td>
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<tr>
<td>Consumer Discretionary</td>
<td>Information Technology</td>
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<td>Industrial</td>
<td>Materials</td>
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<tr>
<td>Real Estate</td>
<td>Utilities</td>
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**SOURCE: AVCA ANNUAL PRIVATE EQUITY DATA TRACKER**

EY’s Private Equity Roundup 2014 shows a similar pattern, with foreign direct investment (FDI) in the continent focused on consumer-facing industries, rather than the extractive sectors. Over 50% of FDI in 2014 flowed to technology, media and telecommunications (TMT), financial services, and consumer goods. This is compared to 3.3% for coal, oil and natural gas, and 5.3% for industrial products.

Given that the investment case across many sub-Saharan African markets is built on dynamics such as urbanisation, youthful populations, and a growing middle class, supporting demand for consumer goods and essential services, this trend looks set to continue. The 2015 AVCA survey found that 76% of LPs view consumer goods as the most attractive sector for PE over the next two years. This was followed by financial services with 46%, infrastructure and real estate with 42%, agribusiness with 32%, and telecommunications with 25%. While the extension of goods and services to communities and consumers is clearly valuable, it is also important to recognise the dire need for additional capital in other less glamorous sectors. According to the World Bank, for example, an extra US$90bn is needed annually to fund infrastructure backlogs in power generation, road networks, irrigation, and water and sanitation. The Southern African Venture Capital and Private Equity Association (SAVCA) believes this is an opportunity for private equity investors, as infrastructure projects on the continent still offer private equity returns and opportunities greater than those available in other sectors.18
Barriers to private equity

As in other emerging and frontier markets, there are a number of challenges to the growth of PE in sub-Saharan Africa. General Partners (GPs), which manage the investments of a private equity fund, will face many familiar risks of investing in emerging markets. Although many African economies have shown attractive economic growth in the past decade, according to the World Economic Forum’s Africa Competitiveness Report 2015, 15 of the 20 least competitive economies in its study are from Africa. The report highlights weak institutional frameworks, which are reflected in high levels of insecurity, poor governance and low levels of government efficiency.19

The private equity sector, frequently negatively associated with radical financial engineering, cost-cutting and restructuring, also needs to overcome some misperceptions if it is to fulfil its potential contribution in the region. In January 2015, in an article on the growth in interest in Africa among private equity investors, The Economist highlighted comments by founder of East Africa-focused Catalyst Principal Partners, Paul Kavuma, that business owners were offended by the suggestion he would invest and improve operations.20 The owners felt this reflected badly on the financial position of their businesses. Others viewed an exit as a loss of confidence in the business. Fortunately, the traditional private equity model of loading an acquired business with debt is seen as more difficult in Africa due to much higher borrowing rates.21 In sub-Saharan Africa, the more prevalent private equity model is value creation through active ownership.22 The greater focus on extracting value by boosting revenue and increasing efficiency should mean that PE can avoid the most negative attributes associated with it elsewhere.

Positive social impacts of private equity can also potentially reverse some of the negative associations. In April 2016, AVCA released its first Africa Sustainability Study on Job Creation. The study found that 199 companies, which accounted for 23% of PE-backed companies between 2009 and 2015, created almost 11,000 additional jobs.48 Of these 89% were permanent. Over half of the new jobs created were in the financial sectors. The study found that the majority of PE firms implemented initiatives such as leadership training, team-building and environmental, health and safety standards to improve job quality.

For LPs, there are a number of other challenges. According to the 2014 Riscura, AVCA and SAVCA report The search for returns: Investor views on private equity in Africa, LPs believe that the three biggest barriers to private equity in Africa are the limited number of established GPs with the requisite track records, a weak exit environment, and political risk factors.23

While the exit environment presents a challenge, exit activity continues to increase. In time this will grow the number of GPs with credible track records. As can be seen below, according to the most recent EY Private Equity Roundup Africa data24, exit activity peaked in 2015 with 45 disclosed exits. Of the 83 recorded exits in 2014 and 2015, 53% were through trade sales, but secondary transactions to other PE players are growing. Around 40% of the 302 exits recorded between 2007 and 2015 were in South Africa. Exits through listings are relatively rare; only 4% of exits between 2007 and 2013 were made through IPOs. This figure dropped to 1% in 2014 and 2015. The low number of IPOs is partly due to challenges relating to the small size and illiquidity of local stock exchanges.25
BIGGEST CHALLENGES TO INVESTING IN AFRICAN PE

- Limited established GPs
- Regulatory / tax issues
- Too competitive
- Weak exits
- Lacking opportunities
- Political risk
- High entry valuations

SOURCE: RISCURA, AVCA AND SAVCA, 2014. THE SEARCH FOR RETURNS: INVESTOR VIEWS ON PRIVATE EQUITY IN AFRICA

PE EXITS (2007 - 2015)

SOURCE: EY/AVCA, 2016, HOW PRIVATE EQUITY INVESTORS CREATE VALUE
The limited number of deal opportunities is frequently cited as both a challenge and a risk for PE in Africa. The sub-Saharan African corporate market is characterised by a relatively small number of large, multiregional groups. As a result, GPs are required to invest in regionally-focused companies across the fragmented regions. The Overseas Development Institute has argued that the unused excess capital raised by PE funds represents an “overhang” due to the limited number of investable companies, and that this could contribute to an emerging market bubble.\(^{26}\) The extent of the problem is evident if one considers the claim by Diana Noble of CDC, speaking at a private equity event in 2014, that there are only 3,187 African-based companies with revenue of over US$50m, of which almost 50% are in South Africa.\(^{27}\) With many private equity firms only looking for deals over US$100m, it is uncertain how long it will take for the funds raised to be invested.

One effect of this competition for deals is higher PE multiples. Riscura’s Bright Africa research found that while less than 20% of PE deals took place at an earnings multiple of over 10x between 2009 and 2013, in 2014 and 2015 over 30% of transactions were at a multiple of over 10x.\(^{28}\) Similarly, at the lower end, between 2009 and 2013 more than 50% of PE transactions were at a multiple of less than 6x, but in 2014 and 2015 less than a third of transactions took place at this level. The consumer sectors attract the higher multiples, again reflecting its attractiveness to investors. Riscura notes that the energy sector attracts fewer deals, which are much larger transactions and at a lower cost factor.
In addition to the growing PE interest in the Africa region, another significant development over the past decade has been the emergence of responsible investing, both in listed equities and, more recently, in PE. One indication of a recent surge in interest is that in 2012 around 50% of private equity firms had a responsible investment policy, but by 2015 this figure had increased to 83%. PwC’s Bridging the Gap 2015 survey found that 97% of respondents undertook an ESG assessment of a GP’s responsible investing approach before allocating funds. There are now over 200 GPs and 75 LPs that are signatories to the PRI.

Compared with other regions, the integration of ESG factors in the PE sector in Africa happened at an early stage. This was largely due to the early support provided by DFIs, which required that GPs demonstrate their ESG credentials in order to satisfy the concerns of their domestic stakeholders. With ESG factors being viewed as at least equally important to private equity investors in Africa as in other emerging markets, with even greater importance given to governance issues, this trend is expected to continue.

Motivations for integrating ESG

There are a number of reasons why incorporating environmental, social and corporate governance factors into private equity investment decisions is viewed as being valuable. Integrating ESG factors is increasingly seen as part of the fiduciary duty of LPs. This is the case in South Africa where Regulation 28 of the Pension Fund Act, which imposes limits on the investments of retirement funds, was amended in 2011 to support responsible investment as follows:

“A fund has a fiduciary duty to act in the best interest of its members whose benefits depend on the responsible management of fund assets. This duty supports the adoption of a responsible investment approach to deploying capital into markets that will earn adequate risk adjusted returns suitable for the fund’s specific member profile, liquidity needs and liabilities. Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund’s assets, including factors of an environmental, social and governance character. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment.”

The need to fulfill their fiduciary duty means LPs have increased their scrutiny of GPs’ responsible investment practices. In 2013, for example, when asked about their motivation for implementing responsible investment practices, 85% of GPs said “at least some of their investors, or Limited Partners (LPs), had shown interest in responsible investment”. 

Private equity and sustainable investment
In addition to the regulatory issues, 83% of PWC’s Bridging the Gap responding LPs believed that improving management of ESG issues would either improve returns or reduce risk. Returns could be improved by stimulating revenue through new opportunities opened through ESG analysis; productivity gains with the support of more loyal employees; encouraging brand loyalty; or by reducing costs by implementing energy or water efficiency measures or waste management programmes across product lines or in the supply chain. Risk can be reduced by ensuring regulatory compliance, minimising liabilities and avoiding reputational damage relating to ESG factors.

This reasoning is supported in a March 2015 report titled Global Insights on ESG in Alternative Investing by investment consultants Mercer and LGT Capital Partners that surveyed 97 pension funds and other institutional investors from 22 countries. Although it did not include South African or other African respondents, it provides a number of valuable insights. The survey found that 76% of respondents, which included private equity, real estate, hedge funds and infrastructure, incorporate ESG criteria into their investment decisions.

**WHAT IMPACT DOES INCORPORATING ESG CRITERIA HAVE ON RISK-ADJUSTED RETURNS?**

Motivations included:

- **Improving risk-adjusted returns:** 57% of respondents “believe incorporating ESG criteria has a positive impact on risk-adjusted returns, whereas only 9% think that it lowers them.” The strongest consensus that ESG criteria increase risk-adjusted returns was seen in Australia and New Zealand, while in Asia there was a fairly even split between respondents who saw positive risk-adjusted returns and those who felt ESG criteria had no effect.

- **Reducing reputational risk:** Overall, 70% of respondents believed that incorporating ESG criteria into investment decisions reduced reputational risk, while 81% of European respondents took this view.

- **Stakeholder pressure:** 69% of respondents felt that their stakeholders were either very concerned or somewhat concerned about the integration of ESG criteria. Only 9% believed stakeholders were not at all concerned.

**SOURCE:** MERCER AND LGT CAPITAL PARTNERS, 2015. GLOBAL INSIGHTS ON ESG IN ALTERNATIVE INVESTING
• **Industry initiatives, ethical objections and regulation:** These factors were listed by investors in certain regions as other drivers for the inclusion of ESG criteria.

Given the list of motivating factors for ESG integration, it is unsurprising that the failure to address or the mismanagement of ESG factors will have consequences. PWC’s *Bridging the Gap* report found that 71% of the 60 LPs interviewed in 14 countries would decline to participate in a GP’s fundraising or refuse a co-investment on the basis of an ESG assessment that found, for example, a history of investing in unethical sectors. Furthermore, 18% of surveyed LPs have withdrawn from an investment or withheld capital due to concerns over ESG issues. 38

The PRI’s *Report on Progress: Private Equity 2016* also reported that 45% of its respondents had abandoned a potential investment on ESG concerns. 39 In fewer cases, ESG issues also affected the price offered or price paid for the investment or the terms of the Special Purchase Agreement. However, over 60% of respondents reported that ESG issues helped to identify risks and/or opportunities for value creation.
ESG and private equity: positive returns?

Despite the logic behind the motivating factors for integrating ESG issues into investment decisions, there is still a great deal of scepticism within the wider investment community over the possible implications of doing so, especially for investment returns. However, there is growing evidence that integrating ESG factors into investment decisions can lead to outperformance.

Recent examples include the following:

- A June 2012 Deutsche Bank report that found that 89% of the 100 academic studies, 56 research papers, 2 literature reviews and 4 meta studies it reviewed showed that companies with high ESG ratings saw market-based outperformance. Strong evidence was also found that companies with high ESG ratings have a lower cost of capital, implying that they are lower risk.

- A 2015 Oxford University and Arabesque Partners meta-study that showed that 88% of over 200 sources found companies with “robust sustainability practices demonstrate better operational performance, which ultimately translates into cash flows” and 80% of studies showed “prudent sustainability practices have a positive influence on investment performance”.

- A 2015 Morgan Stanley Institute for Sustainable Investing report that found that, on both an absolute and risk-adjusted basis, the performance of sustainable investments “usually met, and often exceeded, the performance of traditional investments”.

But these examples largely refer to listed equity. There is less direct evidence supporting the investment case for incorporating ESG factors into investment decisions in private equity. As PWC’s Bridging the Gap report notes, despite the strong belief in the value added through responsible investment practices, there is a “lack of hard evidence [and] uncertainty around the quantification of the benefits of responsible investment…” This is partly due to the differences in these investment classes. Listed equity lends itself to the type of modelling required to demonstrate the investment case, whereas private equity deals, with or without ESG integration, cannot easily be back-tested.

Nonetheless, some studies have shown positive indications resulting from the adoption of sustainable business practices. In a 2014 Harvard Business School study, Robert Eccles, Ioannis Ioannou, and George Serafeim found that a group of 90 companies identified as “high sustainability” due to their early voluntary adoption of environmental and social policies significantly outperformed a matched sample of 90 other companies that had adopted virtually none of these policies.

This outperformance was both in terms of stock market performance and, importantly for PE investors, in accounting performance. The study also found that in “high sustainability” companies, a formal stakeholder engagement process was more likely to have been established and more ESG data was measured and disclosed.

Private equity, with its longer term investment horizons and strong influence over boards and management due to substantial shareholdings, lends itself to ESG integration and management. This is particularly true in Africa where PE aims to create value. However, the PE investment case for ESG integration still needs to be strengthened beyond anecdotal and survey-based evidence.
It is difficult to accurately estimate the current proportion of the sub-Saharan African private equity market that integrates ESG factors into investment decisions. The 2012 IFC *Sustainable Investment in sub-Saharan Africa* briefing paper found that out of the US$24bn total assets under management in the private equity market, US$11.9bn was ESG-branded or ESG-integrated. South Africa was the dominant market with US$7.4bn of the US$14.2bn total managed under some sort of ESG strategy.46

More recently, *The African Investing for Impact Barometer 2015*, which assessed US$721bn of assets in the “investing for impact (IFI)” market in Kenya, Nigeria and South Africa, found that 70% of the funds managed in South Africa implement at least one IFI strategy.47 This is compared with 48% in Kenya and 23% in Nigeria.

In South Africa, the size of assets managed by asset managers, who mostly invest in listed equities, far outweighs the assets managed by private equity or venture capital across most IFI strategies. For example, US$462bn of a total US$480bn assets managed according to an “ESG integration” strategy are held and managed by asset managers. Private equity is only dominant in the thematic investment category.

In Kenya and Nigeria, the opposite is true. Private equity and venture capital are the dominant players in the IFI space. In Kenya more than two-thirds of assets under an “ESG integration” strategy are held and managed by private equity or venture capital. In Nigeria, this figure is close to 100%. Furthermore, private equity and venture capital are dominant across all IFI strategies identified in the report.

There is minimal information available on whether this shift toward responsible investment is being driven by local or international investors. It is likely to be a combination of both. Regulatory drivers are present in South Africa and developed markets. These are ensuring that GPs adopt best practice on ESG integration.

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“ESG is particularly suited to private equity because of its inherent long-term characteristics”  
– Jesse de Klerk, Investment director, Robeco Private Equity - 2012

**Market size**

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While the market for responsible investment has undeniably grown, there are questions over the extent to which various PE firms are implementing ESG practices. Many PE investors highlight the way in which they already employ certain aspects of ESG strategies; however, they do not have systems in place to manage these issues. This is reflected in the PRI’s *Report on Progress: Private Equity 2016* which found that while GPs use responsible investment practices to market themselves, few make formal agreements in fund formation contracts.\(^{49}\)

The PRI suggests three practices that GPs should employ to integrate ESG factors within the organisation\(^{50}\):

1. **Commit to ESG integration**: this should involve a formal commitment from leadership and include the provision of resources; the appointment of a person or team responsible for ESG integration; training for employees on the motivation and practices of ESG integration; and linking ESG objectives to employee evaluation.

2. **Set ESG objectives**: objectives should be set and communicated, and portfolio companies should be monitored by an operations group or consultants.

3. **Engage with stakeholders**: engagement should include participation in initiatives such as industry associations and dialogue with LPs to better understand their requirements.

The PRI further suggests ways ESG practices should be integrated into the various stages of the investment process.

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<th>DUE DILIGENCE</th>
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<th>INVESTMENT AGREEMENT</th>
<th>OWNERSHIP</th>
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<td>ESG checklist</td>
<td>Inform investment committee on ESG due diligence</td>
<td>Share ESG objectives, policies and practices with portfolio company</td>
<td>Establish ESG programme</td>
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<td>Screen for controversial industries or countries</td>
<td>Include ESG findings in investment memorandum</td>
<td>Incorporate ESG issues into deal documents</td>
<td>Conduct site visits</td>
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<td>Desk research</td>
<td>-</td>
<td>Draft 100-day plan for ESG issues</td>
<td>Engage portfolio company executive and board ESG issues</td>
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<tr>
<td>Site visits</td>
<td>-</td>
<td>Develop 3-5 year roadmap with benchmarks</td>
<td>Collect and monitor ESG data using reporting templates</td>
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<td>Ensure that ESG issues are on board agenda</td>
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<td>Discuss ESG issues during annual review meetings</td>
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SOURCE: ADAPTED FROM PRI, JUNE 2015. INTEGRATING ESG IN PRIVATE EQUITY
The PRI report did not deal with integrating ESG factors into the exit process. However, as noted above, the disclosure of ESG factors is viewed as increasingly important in the PE sectors. Exiting a portfolio company with an ESG programme and a history of ESG data is likely to ease the due diligence process if the exit is to another PE firm. With regional stock exchanges joining the Sustainable Stock Exchange Initiative, ESG disclosure for listed equity is also expected to increase. As a result, addressing ESG factors early on should facilitate PE funds’ route to exit through an IPO.

There are a number of tools available to PE investors aiming to integrate ESG factors. These include:

- **ESG Disclosure Framework for Private Equity**: launched in 2013 after a 16 month consultation process with 40 LPs, 20 private equity associations and 10 leading GPs, the ESG Disclosure Framework should be the benchmark ESG tool for the sector. It includes eight objectives relating to fund due diligence and disclosure.

- **IFC’s Environmental and Social Performance Standards**: the latest version of the IFC Performance Standards was released in 2012. The Standards cover material environmental and social performance aspects for emerging markets, including Labour and Working Conditions, Resource Efficiency and Pollution Prevention, Biodiversity Conservation and Sustainable Management of Living Natural Resources. These aspects are assessed throughout the lifecycle of the investment.

- **FMO’s ESG Risk Management Tool for Private Equity Investment**: an Excel-based tool based on the IFC Performance Standards.

- **CDC’s ESG Toolkit for Fund Managers**: an updated version was released in June 2015. It provides practical guidance to fund managers and others on ESG risk management.

- **Environmental Defense Fund’s ESG Management Tool**: according to non-profit EDF, which released its tool in 2012, it was the first to define the practices needed to build a successful ESG management programme.
**ESG barriers**

These tools are all potentially useful ways of assessing ESG risks and opportunities and developing management programmes to improve performance. However, challenges remain. The PWC *Bridging the Gap survey*, for example, found that 69% of respondents did not use the ESG Disclosure Framework. Reasons for the low take-up included challenges in analysing large volumes of ESG-related data and the potential burden placed on fund managers by reporting requirements.

This underlines that, despite the growing interest, there are a number of barriers to SRI and ESG integration. These include:

- Collecting comparable ESG data
- Assessing ESG data across investments, industries and geographies
- Quantifying non-financial data
- Expense of undertaking ESG due diligence, whether in-house or through ESG consultants, particularly for smaller GPs
- Lack of common reporting standards or best practice guidelines
- Limited knowledge or skill of analysts to assess key ESG topics
- Internal opposition to ESG programmes

However, these challenges should not prevent investors and companies from taking steps towards ESG integration. As the PRI notes, GPs might complain about the cost of hiring an ESG consultant to undertake due diligence, but they should reconsider given the savings in avoided risks and legal bills.
The growth of the private equity market represents a significant opportunity for companies in the region looking to access capital to fund the next stage of development. However, the increasing focus on sustainable and responsible investment practices means that companies performance on sustainability factors will come under increasing scrutiny. Forward-looking, responsible companies that have started to take steps toward addressing the negative impact they have on the environmental and communities and position themselves in a resource-scare world will be best positioned to maximise this opportunity.

Companies looking to embrace the business value of sustainability and attract responsible investors can adopt an "integrated value" approach, which sees continuous improvement in social impact and environmental performance as a critical driver of innovation and long-term business value creation. This approach sees the systematic integration of ESG factors across all business activities, from product design to sales, and ensuring that sustainability is embedded into the culture of the organisation. These include the following:

1. **Measure, verify and monitor** – As noted above, collecting comparable ESG data is a major challenge for investors. However, this is an important starting point for businesses. Without data on relevant ESG issues, such as energy usage, water efficiency or health & safety incidents, it is impossible to track progress or monitor results from a sustainability programme. Where possible, data should be consistent and verified.

2. **Set targets** – In order to drive performance, it is important to set targets. Although clichéd, a useful approach is to set targets that are SMART – Specific, Measurable, Attainable, Relevant and Timely – or some similar variation.

3. **Start early, look to the long term** – It is far more difficult to retrofit sustainable business practices into a company than it is to incorporate them into the thinking and culture at the beginning. So start early. But sustainability is a process and quick-wins are infrequent. As a result, it is important to keep focus on the long-term results.

4. **Show commitment** – There are numerous ways in which commitment towards sustainability and ESG can be demonstrated. This can include putting in place the right policies, demonstrating leadership, and improving transparency and disclosure. It is essential that management supports this commitment and that resources are allocated for implementation. Governance structures should reinforce this commitment.

5. **Link to strategy** – A commitment to sustainable business strategy and systems is often seen as being a reflection of management quality as it requires taking a holistic view of a business. However, in order for this to be the case it is necessary to move past a box-ticking approach and link sustainability to corporate strategy. It should ideally be a consideration in all aspects of the business, including product development. Furthermore, there should be a feedback mechanism that supports continuous learning in order to maximise performance gains.

6. **Improve efficiencies** – Focusing on the cost savings that can be found from improving efficient use of scarce resources such as energy or water is an excellent and practical starting point for any company wishing to become more sustainable. New technologies, especially in the energy sector, are continually driving change and reducing costs.
7. **Apply throughout supply chain** – There is growing recognition that ESG management has to extend beyond the portfolio company and incorporate the supply chain. The supply chain is often where many ESG factors, such as labour rights, resource scarcity, waste management and pollution, and corruption, have the potential to affect a company’s performance. They also have the potential to damage the company’s reputation. Companies are increasingly using audit and supply chain management tools to ensure sustainability risks are effectively managed through their supply chains.

The systematic integration of sustainability is clearly a lengthy and comprehensive process. However, these are some principles that companies wanting to make a start can implement if they wish to take steps towards integrating ESG factors into their businesses.
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