# *Fifteen years Fifteen lessons from Africa*

INVESTISSEURS & PARTENAIRES

# 1 *Lesson of Strategy*

1. Lesson n°1: Africa is one continent, but a diverse one
2. **Lesson n°2: The business environment is improving, but in a gradual and disparate way, which engenders integrity risks for firms**
3. Lesson n°3: The African middle class is shaking up market dynamics but has not closed the debate on growth patterns

## 2 Lesson n°2:
## The business environment is improving, but in a gradual and disparate way, which engenders integrity risks for firms

Global rankings such as Doing Business[1] or Mo Ibrahim's Index[2] are a good measure of the constant improvement of what is now called African governance. Among the notable points to recognize, the increasing weight of OHADA[3] regulation in Francophone countries represents a big improvement in the context of business and an important protection for investors. Nevertheless, two important issues for the SMEs and start-ups with which we collaborate are present in this operational context.

**First, dealing with the State and public companies remains a risk to consider and accept in a large number of countries.** Very few companies can escape the generation of outstanding payments that can lead, in many cases, to bankruptcy for the creditor firms that often lack liquidity and/or have no access to debt refinancing from banks. Despite our precautions, several of the firms we support were trapped in situations where no solution could be found. Alas, in most cases public companies do not represent a lesser risk than the State itself. The situation is even more disturbing because, first, the increasing weight of the public debt in Africa tends to generalize and intensify the challenge, and second, the resolution of a crisis becomes a pretext for corruption. Indeed, public administration agents regularly bribe firms before agreeing to transfer the needed outstanding payments from public firms.

**Also, the fight against corruption evolves unevenly between countries**. Some countries, like Senegal, have experienced a very positive evolution toward better governance. In many other cases, the situation is stagnant or is becoming worse. In some of our countries of operation, the phenomenon is systemic. It is, of course, a characteristic of the public sector. In such cases, corruption affects all contact opportunities with public administrations (taxation, customs, regulatory agencies, technical ministries) and concerns not only tax management but any situation requiring the delivery of an approval, an authorization or a license.

*1. World Bank, "Doing Business Regional Report", updated annually*

*2. Ibrahim Index of Good Governance: http://mo.ibrahim.foundation/*

*3. OHADA stands for "Organisation pour l'Harmonisation en Afrique du Droit des Affaires" which means the "Organization for Business Law Harmonization in Africa".*

In certain "country/sector" duos, paying taxes has also become counterproductive, generating fiscal sanctions and creating the conditions for powerful unfair informal competition: only informal business can allow economic activity to carry on. This phenomenon also concerns the private sphere: it happens in situations where a firm's employee acts as a prescriber (in insurance companies, for instance) or in purchasing divisions (in tender procedures within construction or retail industries), which generates frequent opportunities for briberies. Such situations are even more dramatic as the possibilities for legal recourse are uncertain. Avoiding a legal dispute is, therefore, a priority, although certain legal courts do function acceptably.

## *Zoom: I&P portfolio*

We observed that companies operating in the financial services sector, specifically in the microfinance space, faced huge pressures from public sector representatives seeking personal gain from unethical and unauthorized transactions. These situations were difficult to handle and generated misunderstandings, delays, as well as significant costs for our portfolio companies. In the majority of the cases, shareholders' coordination, reputation and lobbying capacity were crucial in withstanding these unethical initiatives, to enable their companies maintain good governance principles.

**As a result of our experience, analyzing the governance environment has become a priority for all investments.** Such analysis can be done in a very concrete manner for a specific "country/sector", duo and even sometimes in "city/sector" duos, depending on what players are involved the institutional configuration. A governance analysis can provide us with information that leads us to renounce very interesting investments that can only be driven if the firm remains informal or that bear substantial financial and legal hazards that cannot be accepted.

*Analyzing the governance environment has become a priority for all investments*

Despite an increase in public investment for the 2000-2015 period that would be denied after the collapse of public budgets in oil-producing countries, this situation is harmful from a macroeconomic perspective as the collective effort to build equipment to support demographic growth has been largely insufficient. This has led to dramatic deprivations in many sectors, including the energy, water, and transports, as well as health, sanitation and public order, affecting the whole population and the poor in particular. Thus, the state and local governments' legitimacy is often precarious, and constitutes a major flaw in the consolidation of democracy.

## Managing integrity, a comprehensive challenge

The African context is characterized by integrity risks that are especially high in comparison to markets in industrialized countries. We have already noted that corruption is widespread, although disparately through the countries and sectors, and affects both public and private business. Fraud risks also concern the inner workings of the firm. In a high-poverty environment, and in a context of social pressure affecting employees that typically have large families to support, temptation is great and so are the risks for the firm. This phenomenon can affect both African and foreign firms. The companies that I&P supports frequently face difficult situations and sometimes have to bear substantial costs due to integrity problems.

**With no magic bullet for such situations and risks, we have developed a series of rules during these 15 years to help us better manage these situations.**

**Rule number 1: Prioritize Human Resources above everything else.** Indeed, integrity risks inside the firm are first and foremost risks linked to people. Reducing these risks requires maintaining a global vision of the firm, as well as a specific vision for all employees, requires a first-rate human resources policy. In the African context, the HR function is key to managing human resources risks, and is as critical as the financial management of a firm. For big enough firms, the HR Director plays a fundamental role in the enterprise and thus, his or her hiring and control deserve special attention. The HR Director should help the CEO to build a human-resources based policy that will foster employee adhesion to the company, aligning employee interests with the firm's, and that will create transparency. Concerning companies that are not big enough to develop an HR department, the CEO's awareness of and attention to these issues is critical. Where there is mistrust and feelings of exploitation on the part of employees, corruption and fraud are more likely to occur. In addition, HR guidelines must ensure that no clan, based on ethnicity or anything else, manages to create a situation where they would control essential internal processes, or financial functions such as payment or billing.

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**Rule number 2: Always implement strict procedures.** The management culture in France is not necessarily strict on procedures. It rather relies on the employee's motivation, through target setting, and, when possible, letting collaborators use their autonomy to define the means to reach the ends. The African context is, so far, less suitable to this method. In some cases, the employee is incentivized by his/her environment to take a steal from the company without this necessarily being perceived as immoral. In any case, it is better for the firm to create situations where, no matter how strong the employee's motivation to commit fraud, it is de facto impossible for it happen. The African managerial context should establish clear, precise and detailed rules, describing both the means and the goals to be fulfilled, and permitting frequent controls and formal audits and limiting decision making at the bottom of the hierarchy. The design of these processes should take into account the fact that not all auditors are trustworthy that collusion between employees and other firms and even the company's bank is also possible. Therefore, it is key to ensure that an effective system of checks and balances over clients, providers and bankers is in place.

**Rule number 3: Always monitor cash flows.** The need for control over cash flows is more fundamental in Africa than elsewhere. While most documentation and billing systems can be falsified, cash flows -both within revenues and expenses- represent high vulnerability zones that must be eliminated or monitored obsessively. In this regard, the spreading of mobile payment technology is a wonderful opportunity.

**Rule number 4: A business must always remain or become formal.** Informality is a key component of the African economy. Escaping it is difficult because, for instance, customers want to pay only in cash to avoid VAT. Many suppliers may also want to stay outside of the formal banking system. When it is not possible to do otherwise, cautious controls on cash flows are necessary, as we have just outlined. However, it is important to fight systematically to redirect informal flows into a formal channels, even if this entails certain costs. The use of informal circuits can represent substantial risk in the accounting, integrity or fiscal areas, and reducing these risks is imperative.

*Our second lesson for investing in Africa deals with the management of weak governance over the continent and the integrity risks that this situation places on a firm. We have noted that contact with the state and other public entities should be avoided as much as possible in favor of purely private businesses, on the customer side as well as on the supplier side. This general rule may suffer a few exceptions that must be cautiously analyzed and justified before investing. A comparative approach to investment opportunities should include the fiscal and customs situations of the sector. Current and future competition with the informal sector must be carefully assessed, especially when the domestic market is heavily protected with customs barriers or subjected to VAT or various taxations (in particular for B2C businesses). The dependency on customers or providers is also of special interest and requires additional investigation that will clearly establish and measure the integrity risks, which are still relatively high in the African context. Harnessing these risks is a managerial imperative that the entrepreneur shares with the investor. Risk reduction can be achieved following the four rules: prioritizing HR guidelines above everything, imposing strict procedures, closely monitoring cash flows and adhering to or imposing a process of formalization.*