Fifteen years
Fifteen lessons from Africa

INVESTISSEURS & PARTENAIRES

4 *Investment Lessons*

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Over the last fifteen years, capitalizing on European know-how and methodology, I&P has made 70 direct investments in African startups and SMEs, gaining valuable exposure to the specificities of an emerging economic fabric. This experience has led us to evolve in our expertise as an investor in many ways and we want to share some achievements, as well as some questions on three topics we feel have been important in our work. The first concerns the financial arrangements which raise universal issues that are practically linked to the African situation. The second is related to the management of corporate debt, which leads us to a more specific question on banks in the region. The third concerns the time available for an investor to prepare a business for investment and the significant improvements we have observed over the past years made on the entrepreneurial ecosystem, particularly in East Africa.

10 Lesson n°10: Structuring a deal, but how?

In I&P's first years in business, operational priority was to focus on the very business of the companies in which we invested. **Over the years, the formalization of investment conditions became increasingly necessary**: the hazards encountered on exits, such as the probability of misunderstanding or disagreement with our partners, and the entry of a growing number of investors in I&P's funds required greater formalization of our funds management and led us to specifying more and more precisely at the time of investment, the conditions of entry, management and exit terms. The financial structure negotiations were becoming increasingly time consuming and tightening on a limited number of options.

For an investor, the choice of legal arrangements in an African SME is dictated by the acceptability of the options it has to offer in the cultures where it operates. We have observed that it is particularly difficult for the SMEs we invest in to accept the entry of third party capital into their business at the maturity stage. In almost all of our investment experiences, our investment funds have been the first capital to be injected into the partner company, necessitating us to train our partners on the methods of equity investment. This leads our partner companies to prefer mezzanine or convertible bonds over more intrusive securities like equity investment, even those appended with clauses allowing participation on the board of directors, consultation or even veto powers on certain strategic decisions made by the board.

In reality, the use of equity-linked debt is neither desirable or systematically possible: the debt is indeed paid back by the company, which can lead to unsustainable financial situations, especially when companies are in strong growth mode and have significant working capital and investment needs. A creditor, even one in equity-linked debt, is also in a less comfortable position than a shareholder to provide support in the management of the company. Lastly, the expectation of return is greater as a shareholder than as a creditor; even for equity-linked debt, entrepreneurs tend to compare the conditions of indebtedness with the conditions offered by the banks, and sometimes have difficulty accepting rate differentials that are perfectly sensible economically. Finally, the tax treatment of the interest on these debts is sometimes very unfavorable.

These considerations have led I&P to prefer to invest capital in partner companies as much as possible when shareholders are in agreement. However, even in these cases, two factors can constrain returns and weigh on the arrangements.

The preservation of their majority position is often a primary concern for our partners

First, our experience has led us to have controlling interest only when it could not be avoided, while the preservation of their majority position is often a primary concern for our partners. This has also led us to put a cap on the amount of capital I&P can bring and once it is reached to use additional funding in the form of debt, sometimes convertible debt, while we would have more appetite for equity.

Secondly, the possibility of buying back our shares at the end of the investment period is often a priority for our partners. This constraint can also lead to putting a cap on the amount of the equity contribution or to making some arrangements that can affect the investment's value.

A complementary difficulty affects numerous arrangements: investing in start-up companies where markets are difficult to predict but highly promising in terms of growth, **it is often challenging for us to value the companies in which we invest**. Typically, the high expectations of entrepreneurs, based on very ambitious business plans, appear to us very excessive, and coming to an agreement can be difficult. Possible negotiated solutions may lead to a delay in the recognition of the value of entry ... At the exit, if the business plan has been followed; mechanisms to upgrade share values or set a minimum guaranteed IRR can be put in place, for example. In all these cases, such clauses, however, make the arrangements and the writing of legal terms more complex.

In addition, arrangements are constrained by the legal specificities of each country and system. Thus, until recently, it had not been possible in OHADA law to use the mechanism of convertible bonds. In practice, the differences between European law and the British common law used in English-speaking Africa, preclude the use of uniform arrangements for all countries and firms, even when fund situations are comparable.

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All of these considerations have led I&P to evolve toward the use of three major types of formula. The first category involves negotiating, at entry, capital multiples for exit, with put and call mechanisms, and the disposal of I&P's shares to a third-party. In the second category, the arrangements are made up of a mix of participating and/or convertible stocks whose accrued yields must provide an IRR target. At maturity, the promoter may redeem the fraction of capital held by I&P on the basis of the targeted IRR. This creates a strong incentive for the promoter to exceed the performance objective. The sale of the capital to a third party is, of course, always possible if both parties agree. Finally, a third category is based on the principles of "venture": based exclusively on capital, with a forecast of successive capital injections in rapid terms; this category offers the early investor "privileges" in subsequent valuations that pay for the risk taken. Around these broader categories, a large number of variations take into account the psychology of our partners, as well as the particular situation of the company and the country concerned.

This is the tenth lesson of Africa: Despite increasing attention to the setting up of investment arrangements and an increasing formalization of the process, there is no standard, "one-size-fits-all" investment arrangement. While general arrangement categories can be distinguished, due to the wide variety of psychological, business and economic profiles of our partners, the disparate but generally weak maturity of the intervention of third-party investors, and the varying laws applicable in different countries, it is impossible to implement standard arrangements , even though the small size of investments in SMEs would seem to justify simple and uniform formulas. The combination of capital contributions and participatory debt in varying proportions, however, would appear necessary in many cases.