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INSIGHTS

Scaling Platforms Needed in Africa

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*By: **Tom Jamieson** **Gordon Stewart***

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Introduction

Africa is often touted as the land of opportunity for private equity. However, private equity players looking to deploy capital in the market require scale in order to achieve the desired return levels for their investors. This is challenging, particularly in the renewable energy space, with relatively small projects, increased competition for new capacity driving down the power purchase prices and the currency risk associated with the fragmented nature of the markets on the continent. This challenge may be successfully overcome by aggregating energy assets into scalable regional or multi-jurisdictional platforms.

The Land of Opportunity

As early as the turn of the 21st century, commentators had hailed Africa as an extraordinary growth opportunity. The main driver behind this is human capital – an increasing population, and with it, increased levels of migration from rural to urban cities, strong economic growth and political stability. This continues to be the case today.

According to experts, the population of sub-Saharan Africa is growing at 2.7% a year, which if it continues at its current rate of growth, means the population will double by 2050 representing more than a quarter of the world's population.***[1]*** The African Development Bank has estimated that the proportion of this group in the middle class, the segment of the population with the most spending power, is expected to grow to 1.1 billion by 2060.***[2]***

Further, an increasing proportion of this population are migrating from rural to urban cities in search of better living conditions, education and economic opportunities. According to the African Development Bank, the urban share of Africa's population has doubled from 19% to 39% over the last 50 years and by 2030, it is expected that the urban populations will increase by an additional 350 million people.***[3]***

This is driving economic growth. Real GDP growth, estimated at 3.4 percent for 2019, is projected to accelerate to 3.9 percent in 2020 and to 4.1 percent in 2021.***[4]*** The continent already encompasses 700 companies that have annual revenue of more than $500 million with 400 companies that have reached over $1 billion.***[5]***

Alongside this, public infrastructure is maturing and the political landscape is increasingly becoming more stable. According to the World Bank's 2019 Doing Business index, half of the most progressed countries exist in Africa and one-third of all reforms recorded globally were in sub-Saharan Africa.

These factors are driving development, investment, innovation, skilled labor and higher incomes which in turn, provides immense opportunities for the establishment and growth of businesses in various sectors including consumer goods and retail, energy, financial services and healthcare across Africa.

Renewable Energy

Africa requires energy to fuel this growth. A majority of countries in Africa are still experiencing power shortages and many households have no electricity at all. If Africa does not achieve wider access to reliable and affordable energy, economic growth and development on the continent will slow.

Africa is richly endowed with natural energy sources. However, a continued reliance on oil and gas along with traditional biomass combustion for energy sits uncomfortably alongside the need to both manage the cost of power and meet the ever increasing regional and global pressure to transition to a sustainable future, as reflected in the United Nations 2030 Agenda for Sustainable Development and the United Nations Paris Agreement on Climate Change.

This is driving a firm policy commitment to renewable energy. Governments across Africa are increasingly seeing the provision of clean energy to the grid as something which will bring not only environmental benefits, but will also help boost economic growth by encouraging innovation in new technologies and driving employment. Countries like Egypt, Kenya and South Africa are leading this effort, while others such as Cape Verde, Djibouti, Rwanda and Swaziland have also set ambitious renewable energy targets.

However, the financial requirements of increasing renewable energy generation far exceed most countries' public finances. Therefore, greater volumes of private investment will be critical to the effort to expand and improve electricity supply. The primary vehicle for such private investment is the independent power project (IPP) structure which is, and will likely continue to be, the principal investment structure for privately financed power projects.

The Challenge – Achieving Scale and Diversity Required to Develop a Track Record

Activity in the private equity space highlights the opportunities presented by Africa. The number of private equity houses investing in Africa has grown to over 140 from a dozen or so in the 1990s***[6]*** and remains strong today. According to the African Private Equity and Venture Capital association, US$1 billion of funds were raised in H1 2020 with 81 PE deals reported during the same period totaling US$0.7 billion.***[7]***

Notwithstanding the relatively high and promising levels of activity in the PE space in Africa over the past couple of decades, generally speaking, the level of activity remains low as a percentage of GDP.***[8]*** Further, the proportion of private equity activity attributable to renewable energy investment, while promising, is relatively small. Therefore, a case may be made that the full potential of renewable energy private equity activity in Africa has yet to be

realised.

One of the key challenges faced by PE houses looking to realise the full investment potential of Africa is that "ready-made" deals i.e. those that are acquired at scale are rare in the region. This is particularly pertinent in the renewable energy space where the interplay between relatively small projects, increased competition for new capacity driving down the power purchase prices and the currency risk associated with the fragmented nature of the markets on the continent contributes to the relative scarcity of such "ready-made" deals.

Generally, the size of individual renewable energy projects are small. For example, the typical range of African wind power projects is smaller than 150 MW and of the 350 African solar PV projects reviewed by Global Data in 2015, a majority only have production capacity of between 10 MW and 100 MW, with capacity factors from as low as 11% to as high as 33%.***[9]***

As the largest IPP program of any African country, the South African REIPPP program demonstrates the downward pressure on power prices over the course of a decade. In the three rounds since the first round in 2011, average bid prices have fallen relative to the previous round by 21.5%, 26.9% and 20.9% for wind; 40.4%, 46.4% and 25.2% for PV; and 6.5%, 41.9% and 16.2% for CSP respectively.***[10]***

In addition, although depreciation assumptions are typically priced into a deal, sudden currency devaluations such as those in major African economies over the last few years can devastate returns (usually denominated in USD) from otherwise profitable investment. For example, the local currency in Nigeria depreciated as much as 16% (against the USD) in 2017-18. A further concern for investors is that many governments in Africa place restrictions on foreign exchange movements and withholding taxes add additional cost to cross-border currency movements. This can be seen in countries such as Zimbabwe, where dollars are both scarce in the market and difficult to repatriate.

The combination of these factors pose a real challenge for private equity houses looking to deploy capital in Africa's renewable energy sector to achieve the scale required in order to deliver the desired return levels (usually denominated in USD) for their investors. This is further compounded by the fact that track records matter – private equity houses active in the region with a strong track record of generating investment returns are best positioned to attract investor capital.

The Solution - Aggregating Energy Assets into Scalable Platforms

This challenge may be successfully overcome by aggregating energy assets into scalable regional or multi-jurisdictional platforms. This approach enables private equity houses to package a series of relatively small individual renewable energy projects into a single platform with considerably larger combined generation capacity and thereby, higher revenue. Further, by building a diverse portfolio of projects in such platforms, private equity houses are also able to address the currency risk by, for example, offsetting profits in one operating or project company with foreign exchange losses in another to optimise tax exposure.

This model also combines flexibility with strong return outcomes for investors. It is flexible in that it enables not only traditional project finance to be obtained but also a range of additional finance solutions such as holdco financing and portfolio financing which can be tailored for each

type of technology and the platform as a whole to optimise the cost of capital, leverage levels and support the recycling of capital in order to deliver a successful exit.

In addition, with such platforms, private equity houses have the flexibility to deliver an exit in any manner considered desirable (e.g. whether partial or full, at any level, whether project level, holding company, platform or fund level) in order to enhance competition for the business and thereby maximise the return to its investors at the relevant time. As the number of successful exits delivered increase, so too does the strength of the private equity house's track record and thereby, its fund raising capability.

Examples of such platforms include Globeleq, which has been realised by private equity house, Actis. At the time that Actis exited Globeleq, which was launched in 2002, it operated a portfolio of assets with a total of 1,234 MW of generating capacity across more than 7 countries across Africa. This platform was in a fund managed by Actis which achieved US$750 million close in late 2009. Other Actis energy platforms include Azura Power, Lekela Power and BioTherm Energy. These platforms were established using capital from funds managed by Actis which raised a total of US$1.14 billion in 2013 and US$2.75 billion in 2017.

African Infrastructure Investment Managers (AIIM) has also established platforms such as AIIM Hydroneo, a hydro power platform and BBOXX, an off-grid utility platform. These platforms were established using capital from a fund managed by AIIM which raised a total of US$399 million in 2019. Others that can be seen adopting this approach include Helios Investment Partners, Denham Capital and Harith General Partners.

Conclusion

A growing number of private equity houses are aggregating energy assets into scalable regional platforms in Africa. This approach enables them to overcome the challenges associated with the renewable energy sector as well as providing them with the flexibility to deliver successful exits and thereby, the desired level of return for their investors. This then provides such private equity houses with a strong track record that enables them to attract the private capital that the continent requires to further develop. Establishing, building and realizing value from these platforms, regardless of size, requires legal as well as financial and tax advisers who are adept at navigating the nuance and complexity of these structures.

[1] The Economist Special Report, 28 April 2020, available ***here***

[2]Africa in 50 Years' Time, The Road Towards Inclusive Growth, African Development Bank, Tunis, Tunisia, September 2011

[3] The African Development Bank, last accessed on 22 February 2021, available ***here***

[4]African Economic Outlook 2020, last accessed on 22 February 2021, available ***here***

[5] See footnote 1.

[6] See footnote 1.

[7] The AVCA 2020 H1 African Private Equity Data Tracker, 30 September 2020

[8] See footnote 1.

[9] Africa 2030: Roadmap for a Renewable Energy Future, International Renewable Energy Agency, last accessed 22 February 2021, available ***here***

[10] AIP Conference Proceedings 1734, 110002 (2016) published online 31 May 2016, available ***here***