Sub Saharan venture capital: a new frontier for MENA investors

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With over $2billion invested in venture capital financings in 2019, Sub-Saharan Africa has been the centre of growing interest from tech investors and has seen an influx of venture capital in the past few years both from within and outside the region.

Despite the impact of the coronavirus, venture financings remained strong in 2020 with a significant increase in the number of deals and only a slight reduction in total fundings reflecting macro trends including the COVID-19 pandemic. Venture financings are only expected to accelerate and diversify from the current fintech focus in the coming years, with enterprise software, e-commerce, health tech, and agritech gaining momentum.

The potential for start-ups to build proof of concepts in single countries such as Nigeria, Kenya, Ghana, or South Africa and later expand to neigbouring markets makes the region particularly attractive and creates excellent possibilities of returns. Investors are seeing the gigantic potential of companies supporting the development of the African continent and are warming up to the idea of funding those leading the change.

A fast-growing market ripe with opportunities

Home to over a billion people already, Africa’s population is projected to double over the next thirty years to reach over two billion. In addition to demographic growth, Sub Saharan Africa is also a major hub of urban growth. Cities such as Lagos, Dar Es Salaam, and Luanda will solidify their position as regional powerhouses and be linked with a wide network of smaller cities hovering around the one million population mark.

The new distribution of population characterised by the urban concentration will create unprecedented needs in logistics, transportation, e-commerce, financial inclusion, and health services. Moreover, the population boom will create new challenges linked with education, agriculture, and the need for clean energy.

As an example of challenges requiring new approaches, the majority of the population of Africa currently owns a mobile phone, but the tendency trends towards ownership of traditional phones rather than smartphones, forcing a rethink of the mobile application mentality of many founders. Even though the smartphone market penetration grows every year, there is a breadth of underserved people who will benefit from accessing services through text messages. This creates unique opportunities for some companies offering services through text messages and creates a barrier to entry for foreign companies coming from smartphone-dominated markets trying to port their products to this new market.
Success for start-ups in Sub Saharan Africa is dependent on both the understanding of the current market and the capacity to evolve alongside its changing characteristics.

The challenge of segmentation

Despite the wide variety of opportunities, start-ups in Africa all come to face a similar challenge. After developing a product in a country, they will need to expand to the surrounding ones and adapt to the local needs and specificities. Replicating the success of a start-up in neigbouring countries can prove to be a very difficult task even though both markets may seem to present similarities at first. Local customs and habits can make it a necessity to rethink a product entirely or change its presentation. The fragmentation of the Sub Saharan African market is a challenge, but can also prove to be a fantastic opportunity for investors from the MENA region.

Factoring outside risks

As is often the case in frontier markets, the Sub Saharan markets' great promises come at the expense of having to accept risks. In Sub Saharan Africa, political risk and market risk are the two main sources of outside uncertainty for start-up investors.

Sub Saharan Africa's growth in the past three decades has unfortunately been accompanied by a history of armed conflicts and political unrest. Some countries are significantly more stable than others, and many citizens and organisations ranging from local groups to international NGOs are working towards a path for peaceful resolution. However, the current reality is that investors must take into account both the international political risks, such as armed conflicts or border disputes, as well as the internal political risks, such as coup d'etats, in each individual country while making the decision to invest.

Furthermore, the overall performance of the region will make or break some start-ups. Political risk is only one factor of this and in many cases, investors cannot protect themselves by diversifying their investment. A downturn in the economic prospects, tensions between countries and central banks, violations of human rights accusations, unexpected meteorological conditions leading to insufficient agricultural production, or natural disasters are all unpredictable factors contributing to market risk. As those events will have a ripple effect through the region and in many industries, diversification often fails to mitigate market risk. An advantage of MENA investors is that by investing in two regions of the world, some of the market risk is absorbed as certain events might see their consequences constrained to one region. Moreover, a string of successes in a region might allow investors to deploy capital in the other to weather some storms.

The value of MENA investing experience

As the world comes to realise the potential of the region for investing, available capital will increase to a point where promising start-ups become the scarce resource over which investors are fighting. This reality is starting to take shape and start-ups are looking beyond the financial opportunities offered by potential partners. Start-ups are looking for advice and experience as well as financial support.

Coming from a market where, similarly to Sub Saharan Africa, it is currently necessary for a start-up to be a regional player to hope to join the ranks of African unicorns such as Jumia, MENA investors are used to guiding emerging companies through their international expansion. This experience and know-how of retaining the core values of a company and the strengths of its products while adapting them for the new markets will be a strong asset. When competing for deals with other international and local investors, MENA venture capitalists and angel investors will be well positioned to be the partner of choice of Sub Saharan African start-ups. Furthermore, they can leverage their previous successes in North Africa and in reaching the Arabic-speaking market through Egypt to try to replicate this formula to expand out of a major market in Africa.

A structured ecosystem

Lately, the Sub Saharan entrepreneurial ecosystem has seen acceleration in the development of its structure. There are new incubators, accelerators, venture funds, mentoring opportunities, and educational content catering to founders being launched every month. This can be an advantage for MENA investors as navigating an ecosystem spread over multiple countries will be easier for them than for other international investors used to single markets. MENA start-ups will typically focus on one country before seeking capital to expand to neighbouring markets, providing experience to investors in helping start-ups adapt their products and business strategies.

The necessity of legal protections

Even though the Sub Saharan market offers excellent potential rewards and a familiar investment structure through offshore entities, it comes with risks, and MENA investors might be reluctant to enter uncharted territories despite being well placed to do so. Solid legal advice is required to navigate the complex process of deploying capital in emerging and frontier markets.

On the due diligence side, this means taking extra care to understand the cleanliness of corporate structures that will invariably involve local operating entities and also the reliability and enforceability of employee obligations and IP rights as well as the effective ownership of IP.

On the cap table side, we have seen instances where African start-ups may have relied on alternative sources of funding such as crowdfunding or ICOs before turning to more traditional venture capital, or they may already have investors from a wide variety of countries. In any case, it is imperative for MENA investors to understand the legal obligations of the companies and the specifics of the operating environment in the country in which they are investing.

The legal protections awarded to venture investors in the MENA region are based on negotiated market standards and practices. In our experience, those standards regularly borrow from international VC markets although regional specificities mean that one region (East Africa) may borrow more typically from the BVCA playbook while North and West African markets may borrow more from the practices of the French VC ecosystem. In all cases, we have seen substantial adaptation and a substantial adoption of offshore vehicles used to house equity investment and intellectual property (see next section).

In outbound international deals involving parties from a wide range of countries it is indispensable to understand the expectations of all parties. In our experience, MENA investors take their lead on economic, governance, and information rights from BVCA or NVCA market standards and are not always used to the pushback they experience in Sub Saharan African deals. However, as long as there are no fundamental issues that arise in the diligence process, investors should maintain their confidence and find the right balance between demanding market-standard protections from the US, UK or MENA playbooks and acommodating regional market standards to get an allocation on an attractive deal.

A tried and tested investment structure

In addition to the legal protections awarded for their relationships with the investee companies, investors can take further reassurance in the fact that they are familiar with investment structures. In order to guarantee legal security, investments are made through common-law regulated offshore entities. Those entities will typically be in Mauritius, the British Virgin Islands (BVI), or the Cayman Islands and, if the company expects to raise funds from US-domiciled funds, Delaware. Additionally, and due to double tax treaties (which are beyond the scope of this article) we have also seen other structures such as Dutch SPVs utilised for holdco level entites.

Nevertheless, MENA-based investors should be aware that Abu Dhabi Global Market (ADGM) and Dubai International Financial Centre (DIFC) vehicles could also be very suitable domiciles for holdcos. Whether or not such entities will be suitable will depend on a range of matters including the tax environment, economic substance considerations and the willingness of co-investors to accept such entities. However, when advising clients on such deals we have often recommended that DIFC or ADGM holdco entities are utilised as part of a pre-investment re-domiciling and have seen a degree of acceptance by companies (and co-investors) who recognise the value that MENA investors can bring to the table in terms of post-investment value-creation

Smart money from experienced and daring investors

In conclusion, investing in the Sub Saharan market can prove to be an excellent opportunity for MENA investors. The combination of available capital and experience in a market facing similar barriers paired with the will to replicate successes and tackle new challenges makes MENA investors extremely attractive to Sub Saharan African start-ups. MENA investors have the means to deploy smart money, meaning capital tied with support and advice, and will need to be supported by proper legal advice to ensure both confidence in the deals and protection as they foray into this new market.

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