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Investing in Africa: How to Do It Right

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By William Looney [1]
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There are two ways that Africa presents itself to the world. There is the untapped growth model, where the region is positioned as a future global economic powerhouse; and the troubled, post-colonial legacy profile, of a “dark continent” mired in poverty, corruption and the toxic mix of ethnic and religious rivalries that perpetuate civil conflicts—a civilization at war with itself. In healthcare, statistics on public health show Africa posting major gains against infant mortality and life expectancy. But this is balanced by a huge demographic challenge—Africa is literally running out of space for its people—along with poor infrastructure and a woefully disconnected network of trading relationships.

Another imbalance is that between the desire of major equity investors to find investment targets of a suitable size, quality and depth and the impact of depreciating local currencies

Les Funtleyder

and slower economic growth. The latter tends to deflate such opportunities and push investors to smaller projects with lower returns and much longer time-frames to cash out.

Which of these dueling perspectives will prevail is a critical strategic question for big Pharma investors seeking potential returns from Africa’s storehouse of raw, unlocked assets—assets that create new opportunities and a better life for patients. To help answer that question, *Pharm Exec* talks with our Editorial Advisory Board member Les Funtleyder, portfolio manager for New York-based E Squared Capital and consulting partner to Blue Cloud Investments, a private equity investor focused on midmarket opportunities in the sub-Saharan region of Africa.

PE: ***How do you see the current status of the continent as a place for healthcare investments? Is the global biopharma community discounting the potential opportunities in Africa from a favorable demographic of young, highly productive workers interested in improving their health status?***

Funtleyder: There is no simple answer, because Africa is not a monolith. Prospects vary significantly by country. In some countries, healthcare—and access to it—is improving. In others, the trend is in the opposite direction. There are 54 sovereign states in Africa, more than any other continent. Efforts to align these countries around a single universal platform for health provision, investment and financing have not moved forward. In addition, the economic model throughout Africa is focused largely on extractive resource industries like mining and oil—“get rich quick” projects that add little of substance to the local economy, especially given the collapse of global commodity prices in the last three years.

Finally, healthcare infrastructure is uneven by country and is not connected across the region. That leads to major delays and uneven care for patients. My firm is supporting a local investment in a central diagnostics lab, which is a big precedent for the region since in most African countries there is no such venue.

PE: ***What you are saying is that Africa lives and dies by shifts in the global prices of key minerals and other commodity assets. Why is this approach to investment different than in healthcare?***

Funtleyder: Healthcare is not a good, but a service highly dependent on human capital. This is a problem for the region, because even if the health system has the necessary physical infrastructure, such as out-patient clinics, hospitals and pharmacies, you still require highly skilled people to make it function properly. What the region needs is a strong network of medical schools to turn out physicians, nurses and also the technicians to manage the technology that keeps it all running.

On the positive side, Africans are quite good at building out capabilities in mobile technologies developed for other sectors and applying these to healthcare. I travel to Africa frequently; I often run in to Facebook executives looking to find commercial applications around social media and the growing Internet community. The region also has a truly advanced mobile phone culture. Some countries, like Ghana and Rwanda, have proven adept at leveraging this high level of mobile penetration to address health access problems. Telemedicine is a good example.

PE: ***According to the International Finance Corporation (IFC), an affiliate of the World Bank, the total healthcare market in sub-Saharan Africa today is approximately $35 billion. That's a relatively modest sum—equivalent to just half of J&J's annual revenues as a single company. How big will the market be by 2025?***

Funtleyder: This number is not as small as it seems, especially given the double-digit annual growth rate for the sector. That means, in 10 years, the healthcare market will have doubled—at least. We know this from data showing that sales of healthcare products and services tend to rise faster than GDP.

PE: ***How would you assess the current state of health infrastructure in Africa. Which countries are leading the way?***

Funtleyder: Africa does not carry the burden of the costly, aging physical plant associated with large healthcare systems in the US and Europe. The industrialized world is grappling today with a lot of redundant facilities that should be mothballed. Defects in the health supply chain require multiple interventions, which are wasteful. Hence, Africa has the luxury of digesting these learnings and starting anew. And that requires a lot of investor money, loans and creative financial assistance, which is good for firms like mine. In Africa, healthcare is all about compiling the capital to grow and then deploying it wisely.

A big element is philanthropic and donor aid, particularly from multilateral agencies like the World Bank and NGO powerhouses like the Gates Foundation. An interesting trend is how big private equity investors tied to the extraction industries are moving to diversify by investing in healthcare projects. Their interest is in supporting projects valued in excess of $50 million. Smaller firms are following their lead, taking part in projects worth less than $20 million. My firm, Blue Cloud Investors, is one of these; we focus on projects that are already up and running, but need to expand their range. We call this brown field investing. Our expertise is with the middle market of healthcare in Africa. Generally, we see ourselves moving up the value chain rather than down it.

PE: ***Can you provide an example of that?***

Funtleyder: An example of a brownfield project is when a pharmacy chain in Ghana with five pharmacy outlets wants to expand this network to 10. Blue Cloud is helping to make this happen. We also focus heavily on the due diligence process, looking for management that follows standard Western business practices, such as GAAP.

Three challenges

PE: ***What are the pitfalls, lapses and problems that you encounter when seeking attractive investment candidates in Africa? Are there strategies to help mitigate exposure to these challenges? What are the key elements of a "best practices" list to ensure successful investing in the African market?***

Funtleyder: The essential issue is the quality of governance. Management practices, the business plan and accounting standards must be reviewed and certified air tight. Information that is taken for granted in the US, like articles of incorporation, are not always evident in the African context, which often relies on little more than a handshake between parties. That is not enough.

The second issue of note is you can never assume that an investment relationship will culminate in an exit path. There is no guarantee that someone will acquire your stake or that the initial deal will culminate in an IPO and eventual status as a public company. Capital markets in the region, outside South Africa, are too small and immature to accommodate the desire to put business development on a stable path to growth. Be ready, instead, to invest in a debt instrument of some kind, such as a revenue participation note, to ensure there is a financial return without having to wait for an IPO or acquisition that may never happen.

The third challenge is handling currency fluctuations, which can gyrate wildly in Africa and affect the bottom line. Hedging strategies are important.

One widely cited problem I would discount is political uncertainty. We have been investing in the region for many years and it has not surfaced as an impediment to our plans.

Putting all these factors together, I believe the safest, most reliable "best practice" markets in the region are the English-speaking countries of West Africa, led by Ghana, and, of course, South Africa and Botswana. Angola is a country with significant assets, and, hence, opportunity in healthcare, but it does have its share of governance problems, not to mention the language barrier. We have yet to consummate any deals in East Africa, but we are actively exploring the investment landscape. There is a lot of untapped potential there, in Ethiopia (where demographic projections show a population of 178 million by 2050), Kenya, Tanzania and Rwanda. Conversely, most of central Africa is a conflict zone.

PE: ***What do you see as the current strategy of the big Pharma players in Africa? Is the commitment to the region real or overstated?***

Funtleyder: Most of big Pharma looks at Africa as a sidebar in their overall strategy for emerging country markets. I am not saying it's invisible; just an area that they keep monitoring to identify opportunities over the long-term. Some companies have organized internal VC units that invest selectively in projects in the region. This gives them exposure to a market with minimal investment risk. It's an excellent way to survey the lay of the land. Companies with a more advanced view are promoting joint ventures with local partners, which gives them a front-row seat in evaluating strategies on key topics like supply chain management, pharmacy distribution and who the competition is among local pharma players.

Overall, the perception is Africa will eventually be a serious market with add-on growth potential. It's a big, diverse continent of mainly young people with middle-class aspirations, all of whom are ready to consume medicines that lead to better health. Partnering is the way to obtain a full understanding of the potential opportunities while building a reputation for local engagement and trust. The strategy is to put a few small stakes on the ground and then see what happens.

PE: ***What are the "no-go" issues and areas?***

Funtleyder: US companies have to be eternally vigilant about the reach of the Foreign Corrupt Practices Act (FCPA). Business and even personal staff activities in Africa must be constantly monitored from HQ. The UK has a tough extraterritorial anti-corruption statute, too.

There are cultural pitfalls as well, which are not limited to US investors. Chinese-backed investments in Africa have created friction with the locals, suggesting that political winds in the region can shift from one extreme to another. Once greeted as a generous rich uncle, China is now viewed more dubiously, although its presence in Africa does give governments leverage against traditional US and European donors.

PE: ***How does the cultural dynamic play out?***

Funtleyder: First off, every country in Africa is different; there is no single script to address the culture difference. Generally, that first hard-charging, get-to-the-facts meeting agenda is not going to win points among African partners. Trust is paramount in relationships and that takes time to establish. Being 100% transparent is actually not appreciated in most African countries. You have to allow for some nuance. What must be remembered is that Africans like to cultivate relations while US executives are comfortable with a return-driven, transactional mindset. But if you meet the Africans halfway, the payoff can be substantial. You need to find and then rely on a cadre of reputable local contacts to build reputation as a good corporate citizen. One bad apple can create a crisis and lead to a costly disinvestment.

It's also true that foreign drug multinationals present in Africa are all partly motivated by a desire to demonstrate to African partners there is a social impact from their investments. This is a non-economic factor that we often underestimate as a source of good will in growing the bilateral relationship.

PE: ***How ingrained is social investing—that mix of profits and philanthropy—in the business strategy for investors in Africa?***

Funtleyder: My view is that profitability always comes first. If the business is not an ogoing concern, then it is a charity. A sustainable, profitable business has room for doing good precisely because it makes money. There is some interest in Africa in social investing, particularly among big European companies. US drugmakers are a bit behind on this indicator, but more companies are actively considering it. Unfortunately, however, there is no metric that might define what social investing is. There are some useful proxy measures. One example is if a company succeeds in the marketplace by increasing patient access to medicine or adding capacity to health infrastructure, then that action carries a social benefit that people want.

PE: ***Can you identify industry players that are "doing it right" in the Africa region?***

Funtleyder: Hospital operators are well-positioned to benefit from the demographic surge in Africa. That's because most care is delivered in acute rather ambulatory settings. Devices and diagnostics based on "frugal innovation" are another. Biopharma has a specific set of challenges, including a complex pricing dynamic and distribution channels that tend to get complicated at that crucial "last mile" to the patient. Even medical device companies are beginning to dip their toes into the African market. But I caution we are in the early innings of the investment game in the region. The analogy is with China in the

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1980s. There is so much development yet to come.

I believe in the notion that change provides a tremendous opportunity for profit. And there is certainly a lot of change taking place in Africa. What is cool about this region is it serves as a template for new approaches to technology. There is a demand for reliable, durable and very cheap technologies with mobile applications that transcend geographies. For example, unmanned drones to replace gaps in transportation infrastructure may be poised to flourish in Africa, earlier perhaps than in the industrialized countries. “Smart” technology with the ability to overcome supply chain or service barriers could put Africa in the lead on logistics innovations, proving them equally relevant to the market’s needs in North America and Europe.

PE: ***Can you identify a potential disruptor coming from Africa that might impact healthcare markets here in the West?***

Funtleyder: We are already observing interesting ideas at work on the distribution of drugs to remote or rural settings—I mentioned the drone example. Africa’s experience is also useful in advancing reliance on do-it-yourself diagnostics, using telemedicine’s data retrieval technologies. Cold storage vaccine facilities powered by solar energy cells is another. Each of these can be done at less cost than the conventional approach. It’s frugal science at work; the more this happens, the more it disrupts the big Pharma business model.

PE: ***What do you reserve as your biggest criticism of the way big Pharma companies invest and operate in Africa?***

Funtleyder: Africa is admittedly a long-term play. But for big Pharma, everything is about short-term performance. That’s the heart of the problem. The majors see Africa as presenting good long-term rewards countered by significant short-term risk. In our view, the best way to balance the two is to start small and gradually work your way up the investment pole, relying on partnerships to hedge any liabilities. Starting small also enables investors to learn about the local climate for business, which is always an asset for reputation over the long-term. The final element is a CEO or someone in senior HQ management who cares enough to declare a vision for the company that expressly includes Africa—a vote of confidence in the market.

Les Funtleyder is a Healthcare Portfolio Manager at E Squared Capital. He can be reached at les@esquaredasset.com [2]

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