Financing of Investments

19

Accepting Challenges, Recognising Opportunities Opportunities, Use Financing Offers

Klaus Helsper and Jan Müller

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Abstract

The German Mittelstand stands for innovation and internationality. Nevertheless, German companies are rather cautious in their investments in African markets compared to international standards. This caution also results from the fact that many cannot accurately assess and evaluate the risks associated with such an investment. An experienced financing partner can help here. From the investment decision to the structuring of the tailor-made financing solution to the improvement of the sustainability strategy, institutions like DEG have been reliable partners in Africa for the German

K. Helsper (✉) · J. Müller
Köln, Germany
e-mail: Klaus.Helsper@deginvest.de

J. Müller
e-mail: Jan.Mueller@deginvest.de

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Mittelstand for years. Appropriate financing under sustainable conditions promotes investments and contributes to improving living conditions locally.

19.1 Missed Opportunities

The German Mittelstand stands for innovation and internationality. The latter is not only limited to the high export quota: countless German pioneer companies have invested in emerging—and challenging—international markets over the past decades. Often it is family-run companies from the Mittelstand, so-called "Hidden Champions", who open up the global markets from the German provinces and compete with innovative, high-quality goods in the worldwide, international competition.

The investment activity of German companies is particularly focused on Asia, in addition to industrialized countries. Recently, less than 1% of German direct investments were made in Africa. This quota is not only low—it has also remained almost stable over the last 20 years. In comparison, not only companies from the United States, France, Great Britain and China, but also those from the Netherlands, Italy and Singapore, for example, are more heavily invested in Africa *(UNCTAD—United Nations Conference on Trade and Development, 2019. World Investment Report 2019. Geneva)*. This is compounded by the strong regional focus of German investments, for example on South Africa and Egypt.

Many countries and regions of Africa are still not sufficiently considered in the location decision of German companies. For example, many North African countries offer ideal conditions for a production location to supply the European market. For example Tunisia: the country has proven to be relatively politically stable since the Arab Spring and has continuously improved investment conditions. Well-trained workers and geographical proximity to Europe make Tunisia an ideal alternative—or at least a supplement—to the "classic" production locations in Asia and Eastern Europe. The regional dependence for companies has shown to pose significant risks, especially during the Corona pandemic. Africa is ideally suited for diversification in this regard.

In addition to the comparatively well-developed countries in North Africa, there are many dynamic economies in Sub-Saharan Africa with increasingly attractive investment conditions and considerable sales markets. These include, for example, the economic heavyweight Nigeria with a very young population (the median is 18 years), which already generates a gross domestic product of more than USD 400 billion today and is likely to double this value by 2025. Already today, about 200 million people live in Africa's most populous country—this number is expected to double by 2050. Nigeria will then have the third largest population in the world after China and India. *(Data and forecasts: IMF)*.

The growth dynamics of African economies are impressive, despite all problems and challenges. Today, most of the world's fastest growing economies are located on the African continent. The markets of Asia and Latin America, which are well-known territory for many German companies, viewed as more safely due to long-term presence and experience, may appear more attractive than the unknown regions of Africa. However, it

is wise to recognize and take advantage of the opportunities offered by many economies of this impressive continent.

19.2 Special Challenges

Investing in an unknown market is a special challenge for any company—this applies regardless of the size and strength of the individual company. Foreign cultures, unknown customs, a different language, unknown laws, often associated with the unpredictability of their application, slow grinding bureaucratic mills, corruption, state arbitrariness but also lack of security, exchange rate volatility, conversion restrictions and patchy infrastructure can make an engagement in a new country a special challenge. Large, globally active companies usually have both the necessary financial resources and the personnel capacities to successfully meet these challenges. And yet, even the global players repeatedly fail in their attempt to open up new markets. It is even more difficult for medium-sized companies, whose resources and capacities are naturally more limited, to manage the challenges and risks of foreign engagement in such a way that opportunities are successfully exploited.

For many German companies, most of the 54 African states are still unknown territory. The risks and challenges for investments are real. Nevertheless, more companies should start dealing with the opportunities and soberly analyzing the risks. This assessment often falls too often to the disadvantage of an investment in Africa—often because reliable information is difficult to access and the perceived risks are greater than the real ones. This first step—dealing with opportunities and risks—requires careful preparation, an experienced partner and a sustainable financing concept.

19.3 Success Factor Financing

The three most important factors for a successful investment are the same in every new market: careful preparation, careful preparation and careful preparation! The greater the degree of challenge, the more this maxim applies. Each of the 54 African states presents foreign investors with significant challenges and an investment decision requires the best possible preparation.

But not only the basic decision to invest in an African country must be well prepared, the financing of such an investment must also be very carefully and tailor-made selected. Sustainable financing concepts, which focus on long-term, joint success, plan for contingencies and adequately consider risks, form the necessary, strong and reliable basis for successful new investments.

Family businesses in particular tend to finance investments that appear to be high-risk from the equity capital of the German parent company. Often the long-standing house bank comes on board, providing liquidity, usually in euros or US dollars. Since the house

bank relies on the creditworthiness of the well-known, long-standing customer in Germany, it usually offers him financing at very attractive conditions.

But especially in companies that are not in the saturation phase, but in an investment and growth phase, one must ask whether it is really sensible to finance investments in challenging new markets, such as the emerging countries of Africa, exclusively or at least predominantly on the creditworthiness of the German parent company? Isn't it more far-sighted, in terms of profitability and risk aspects, not to finance the new investment in Tunisia, Nigeria or Kenya predominantly from own resources?

A strong equity base is a must for many German family businesses and indeed it can cushion market uncertainties and crises as a comfortable buffer. However, it is important to distinguish: What works well in Germany, in the Eurozone and in other industrialized countries can easily become an expensive (wrong) decision when engaging in an emerging or developing country. An example: If the Nigerian Neira devalues by 20%, the value of the Nigerian subsidiary in the balance sheet of the German parent company also melts by 20%. If, due to the fall in oil prices, US dollars and euros become scarce in the Nigerian state treasury, dividend-eligible profits of the local subsidiary cannot be converted. The cash reserves grow—but unfortunately only in local currency and it continues to devalue year after year. A good investment decision can become a wrong decision in such a case, which is quite relevant in practice, due to a suboptimal financing solution.

Financing concepts that are specifically tailored to the special challenges of direct investments in Africa and that flexibly respond to the changing needs and conditions in the life cycle of the investment have significantly better chances of success. With such a financing solution in the background, difficult situations as well as unpleasant surprises can be mastered and, by the way, foundations for sustainable returns and further investments can be laid.

19.4 Financing Partners

The classic way to finance usually leads the CFO of a company to his house bank—and that's a good thing, because with a high probability he will be offered the fastest and cheapest financing option here. However, as described above, this solution is not necessarily the best.

An alternative to the classic house bank are local banks. Especially when the planned investment not only serves the purpose of producing at low cost for the international market, but also serves to open up the local market. Financial institutions in the investment country usually have an extensive network, great know-how and can in principle provide loans in domestic currency. Financing in local currency leads to a "natural hedge": if income in local currency is generated as a result of the investment and these income are offset by bank liabilities in the same currency, foreign currency risks can be eliminated.

However, the path to a local bank is often rocky for foreign investors, as they are not familiar with local customs, while local credit institutions find it difficult to assess the creditworthiness of a customer from abroad. Even with a guarantee from the parent

company, it is often not possible for medium-sized companies to access local financing resources at attractive conditions. The aspect of term is also often a stumbling block for local financing—terms beyond two to three years are simply not common in many African markets.

A good alternative—or supplement—to the house bank and a local bank are so-called development banks (or "Development Finance Institutions", short DFIs), which are often state-owned. DFIs specialize in the long-term financing of sustainable investments in developing and emerging countries. As specialist institutes that have focused exclusively on this segment for decades, they provide companies with individually tailored financing—from long-term loans to equity—at market conditions. In addition, they support their customers with special funding and can be a valuable sparring partner for the entrepreneur who is considering an investment in Africa due to their many years of work in challenging markets.

DFIs often secure their financing in the fixed assets of the investment company, thus preserving the liquidity and creditworthiness of the company. In addition, they offer long-term financing that allows terms of over 15 years depending on the investment project, which also enables project financing.

The circle of development banks includes, among others, the DEG—Deutsche Investitions- und Entwicklungsgesellschaft based in Cologne, the other European Development Finance Institutions (EDFI) (EDFI, 2021), regional development financiers, such as the African Finance Corporation based in Nigeria or the Development Bank of Southern Africa from South Africa, and multilateral development banks, such as the International Finance Corporation (IFC), which, as a subsidiary of the World Bank, is committed to promoting the private sector in developing and emerging countries. In complex financing projects, several development banks often engage together in structuring and providing larger financing volumes.

When it comes to accompanying investments by German companies in the challenging markets of Africa, the DEG is a good first point of contact. As a subsidiary of KfW, it has felt particularly committed to supporting German companies for more than 60 years. With local branches in Johannesburg (South Africa), Lagos (Nigeria) and Nairobi (Kenya) and an employee in Abidjan (Cote d'Ivoire), the DEG accompanies companies from preparation to long-term investment in Africa. The focus is on the German customer as well as the permanent improvement of living conditions in the investment country.

19.5 From Idea to Optimal Financing

Development banks support and accompany companies that want to engage in Africa with a comprehensive range of services that follow the life cycle of an investment. At the beginning of every investment is an idea—the idea of exploring a new market and then successfully opening it up. In this early stage, as already mentioned, the necessary information is often lacking to make a sustainably successful investment decision. Foreign

languages, unknown regulations, laws and customs, lack of knowledge about market opportunities and conditions, insufficient information about the availability of raw materials, water, energy and last but not least, labor and their level of education make a well-founded investment decision initially seem almost impossible.

19.5.1 First Steps

In Germany, DEG offers the private sector financial support for feasibility studies (DEG, 2021) in the form of a non-repayable grant to assist on the path to a sustainably successful investment decision. From market and location analysis to the technical assessment of legal conditions to questions around the topic of "Human Resources", many aspects can be illuminated that may later prove to be decisive for the success or failure of the investment. The costs of such a feasibility study can be funded up to 50% and a maximum of EUR 200,000 under certain conditions. A well-founded feasibility study not only makes the investment decision plausible, but often also forms the basis for the design of the later financing.

19.5.2 Exports as a Door Opener to New Markets

Medium-sized companies often do not start market entry with a comprehensive investment in production in the target country. Before this step, which would tie up financial and human resources on a large scale, market preparation through exports of the produced goods to the corresponding markets is usually the first step. Tailored and innovative export financing solutions are in demand here. If the export goods are plants or machines worth several million euros, the buyer's required buyer financing can usually be covered by a state export credit insurer. German exports are supported by the federal government, for example, through guarantees from the mandated Euler Hermes. These state guarantees are an important part of export financing, especially for deliveries to challenging markets. However, due to their complexity, they are only used for large-volume exports. Financing exports with values below a threshold of approximately EUR 5 million is much more difficult and repeatedly poses challenges for companies. The German Desks—Financial Support and Solutions (DEG, 2021a) can help in these cases. German Desks are a cooperation between DEG and the DIHK—German Chamber of Commerce and Industry, the local German Chamber of Commerce Abroad (AHK) and a local bank in the respective target country. The German exporter, whose local buyer wants a tailored financing solution, finds the previously missing offer to close cultural, linguistic and financial gaps with the German Desks. The German-speaking German Desk managers have excellent networks in their respective banks as well as contacts with local authorities and institutions. They are customer-oriented enablers for the export activities of German companies. German Desks—Financial Support and Solutions are available in Africa—as of December 2020—in Accra (Ghana), Lagos (Nigeria) and Nairobi (Kenya). Another German Desk is expected to open in Abidjan (Ivory Coast) in 2021.

19.5.3 AfricaConnect: Lean Financing in Challenging Markets

If an export market develops to the satisfaction of the company, the question of local production to optimally serve demand arises at some point. Often the next step towards further market penetration is a smaller investment, especially to limit the risks associated with engagement in a challenging market. If the step of a local production facility fails despite the best preparation due to unforeseeable events, this failure must not endanger the existence of the parent company. For this reason, a financing structure that does not rely on the balance sheet of the core company is recommended. Such investments require a lean financing instrument that supports companies uncomplicatedly and expertly.

In 2019, the Federal Ministry for Economic Cooperation and Development (BMZ) initiated AfricaConnect (Africa Connect, 2021). The program is operationally implemented by DEG and aims to support German and other European companies entering African markets with attractive loans tailored to their needs. In addition, subsidiaries of European companies already operating in Africa can finance their expansion investments with AfricaConnect funds.

AfricaConnect offers long-term loans from EUR 0.75 to 5 million at particularly attractive conditions and flexible use of funds: from greenfield investments to site expansions and operating financing to COVID-19 response loans for companies that have run into liquidity problems as a result of the pandemic. The financings are implemented as leanly and quickly as possible. However, this does not come at the expense of expert support: the program draws on the networks and decades of experience of DEG with investments in Africa. Investments are not only financed, but the companies are accompanied in a partnership over the entire investment period. A special feature is that investments are usually financed without collateral. Neither local assets such as buildings or machines are ordered as collateral—which in turn gives local banks the opportunity to secure themselves accordingly and act as complementary financing partners. Nor are guarantees from the European parent company required.

Since the start of the program in autumn 2019, 19 financings have already been successfully implemented with AfricaConnect (DEG, 2021b). In total, the funds have helped the financed companies to create about 2500 new jobs and secure over 5,000. Companies in Burkina Faso, Ivory Coast, Ghana, Kenya, Morocco, South Africa, Senegal, Tunisia and Uganda have been financed. The industries range from chocolate production to solar power leasing and sustainable agriculture to logistics. The seemingly high-risk financings are only possible because the companies are intensively advised by the responsible experts at an early stage and the investment projects are thoroughly examined. In order to be sustainably successful with the first investment in an African market, in our experience, the fulfillment of the following three criteria is the basic prerequisite:

- Management and Partners: A new operation in an African market cannot be managed from Germany. Local management presence often proves to be the key to sustainable success. Whether this is ensured through a joint venture partner or excellent employed

managers, each company must answer for itself. Presence, network and local knowledge are essential in any case.

- Tested Business Model: Even if it is the first investment on the African continent—the business model must be tested and successful. Ideally, investments have already been made successfully at other locations, for example, production facilities opened and market entry successfully carried out. The challenges are individually different. However, experience with the operational setup of a facility—ideally in a developing or emerging country—is enormously helpful in mastering these.
- Long-term Horizon: To be successful in African countries, a long-term perspective is helpful. This requires both a comfortable financial cushion that allows delays and setbacks to be overcome, and a long-term corporate philosophy. Family-run medium-sized companies often combine both qualities.

The advice to AfricaConnect customers is not limited to credit technical analysis and market and country expertise. As with all DEG financings, a comprehensive environmental and social audit is also carried out within the framework of AfricaConnect. Potential risks and need for improvement in the investment are identified and an Environmental and Social Action Plan is agreed upon. During the later implementation of the Action Plan, the companies receive technical advice and additional financial support.

If the cooperation between the company and AfricaConnect is sustainably successful, the investment will usually experience further expansion stages due to growth at a later date. This usually also involves a larger financing requirement.

19.5.4 Sustainable Investments—Long-term Financing

Tailored long-term financing solutions are often offered by the aforementioned DFIs. Whether the right financing is a long-term loan, a mezzanine structure or an equity participation is determined by the company and the responsible financing expert together. Mezzanine financings are special forms of financing that are located on the continuum between debt and equity depending on the individual design. These are, for example, loans that are subordinate to service. The associated higher risk is reflected in the costs, which usually consist of a fixed interest rate plus a profit-dependent component. This disadvantage of such a financing form is offset by the advantage of stabilizing the equity structure. The financing goes—analogous to the AfricaConnect financing—directly to the African subsidiary and does not have to be passed on via the European parent company. This direct financing has a decisive advantage over the internal transfer: the often complex processes of registration, conversion and transfer of foreign exchange are accompanied by the experts of DEG.

Companies that want to spread their risks across multiple shoulders and in particular want to use the “political escort function” of a state development bank invite them to a classic equity participation in their foreign subsidiary. This most expensive form of financing has a high signaling effect and often enables the mobilization of external funds

from commercial banks. It is often used to create a balanced shareholder structure, for example in joint ventures with local partners.

In addition to these different financing structures that arise in the life cycle of a foreign investment, DFIs offer additional funding (DEG, 2021c) in addition to the above-mentioned funds for feasibility studies. Due to the often low local level of education, almost every company investing in an African country is faced with the challenge of designing training programs that convey the necessary technical knowledge. Such measures, which improve the chances of finding long-term employment in the local labor market, can also be promoted by non-repayable grants.

19.6 Sustainability and Development Policy Impact

Sustainability is no longer a niche topic. If German companies apply their high environmental and social standards to their investments and productions in Africa, all parties involved can benefit. DFIs support their customers in this and actively demand compliance with international standards (DEG, 2021d; IFC, 2021). It is not just about reducing reputational risks. Due to their presence and relevance for customers, buyers, suppliers and the public, sustainable investments and resource-saving production are essential for long-term business success.

Successful investments in Africa not only benefit the companies themselves, but also contribute to long-term value creation on site. Successful companies create qualified jobs and income and thus help people in developing countries to develop perspectives. Many German medium-sized companies actively promote the training and further education of their employees and promote the transfer of technology and know-how to the target countries. With their investments, they expand local value chains and improve the supply of goods and services in the country. Their tax payments and export revenues contribute to improving state and foreign exchange revenues—funds that are needed for investments in infrastructure, education and health.

19.7 Outlook

Despite all the challenges, many markets in Africa will continue to grow dynamically. Demographics, innovative power and political will, as recently demonstrated in the creation of the African Free Trade Agreement AfCFTA, clearly speak for such a development. The question is whether the German Mittelstand will benefit from this dynamism. Although many companies have fundamentally recognized the opportunities in Africa and the opportunities have been highlighted in public discourse for several years, investments from Germany have so far hardly increased. The Corona pandemic offers many companies the opportunity to rethink their international structure. Perhaps a good opportunity to invest in Africa.

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Klaus Helsper heads the "German Economy" department at DEG—Deutsche Investitions- und Entwicklungsgesellschaft mbH, Cologne.

After training as a bank clerk and studying international business administration in Utrecht (NL), he was CFO of Paul Jost GmbH in Mülheim/Ruhr. He gained banking experience from 1989-2007 in senior positions at National-Bank AG in Essen.

His specialty is the international financing business of medium-sized companies. With his team, he is the contact person at DEG for German companies with economic involvement in developing and emerging countries, as well as for the initiatives "German Desk—Financial Support and Solutions" and "AfricaConnect".

Jan Müller is a graduate economist and works at DEG—Deutsche Investitions- und Entwicklungsgesellschaft. There he heads the AfricaConnect program, which supports European companies with their investments in African markets with loans using funds from the Federal Ministry for Economic Cooperation and Development.