Value Chains and Value Creation in Africa:
The Role of Private Investment

A Conversation with David Rice

FLETCHER FORUM: *How did the Africapitalism Institute get started, and what makes its economic approach unique?*

RICE: The Africapitalism Institute was started a little over two years ago by Nigerian banker and philanthropist Tony Elumelu. Elumelu is quite unique in that he was born, raised, educated, and then worked in Nigeria. He's now part of the elite on the continent, but, unlike many other successful emerging leaders in the public or private sector in Africa, he wasn't born into privilege: he didn't go to Oxford, work at a Swiss bank, and then come back home after earning his chops in the private sector. That gives him a unique perspective on what Africa's challenges are. After Elumelu transitioned from his role as CEO at one of one of Africa's largest banks, he wanted to give something back. He'd seen how providing access to capital to entrepreneurs and small businesses can transform whole communities. Because he's also an economist, he wanted to convince policymakers in

David Rice *consults, writes, and teaches about African economic development, governance, and policy. He previously served as Founding Director of the Africapitalism Institute, a pan-African think tank based in Lagos, Nigeria, that conducts rigorous, applied research on the critical role of the private sector in driving broader economic growth and social development across the continent. Rice was also the Africa advisor to the Milken Institute and an adjunct professor at New York University; he spent the summer of 2013 as a visiting faculty member at the University of Nairobi in Kenya. He is also the senior managing director of Development Equity Partners, a consulting firm advising investors and corporations on how to invest in emerging markets to maximize both profit and regional prosperity.*

Africa to think about the role of the private sector differently—as an engine of growth, job creation, and innovation, and not just tax revenue.

Traditionally, government in Africa has been top-down. Most African countries have planned economies in which the government owns and operates the largest industries. These state industries have been neither efficient nor innovative, and they've had challenges bringing in private sector practices and private capital. As a result, these countries have certainly suffered: Nigeria is one example. To address these challenges, Elumelu launched a pan-African think tank that uses quantitative research to demonstrate how the private sector can transform economies and societies. Eventually, these societies will have to train a labor force for human capital, create physical infrastructure, and develop a policy environment that makes it easier for the private sector to thrive.

At the Institute, we focus on the structural challenges within African economies. One of the biggest issues we looked at was the absence of local value creation. For example, in Nigeria, 95 percent of oil is exported as crude and then refined in Louisiana or other parts of the world. Nigeria then has to buy this oil back at ten times its original price because it's buying a finished product. This is what Nigeria's economy is going through right now; despite having oil for many years, Nigeria is facing a massive trade imbalance and currency crisis because the process of turning crude into a finished product occurs elsewhere. We emphasize this a lot to governments: they need to develop policies and spend public money on resources that will eventually allow African economies to evolve and move up the value chain so that they are capturing more value of resources—whether these are mineral, human, or otherwise.

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FLETCHER FORUM: *Where does the capital for these projects come from?*

RICE: It all comes from the private sector. The typical resource model in Africa starts with human capital, which often needs to be imported. In Nigeria, the government maps offshore oil, and then blocks are auctioned off to international oil companies like Shell. The government takes part ownership through selling 60 percent of the oil block to Shell and collecting 40 percent of the revenue, but Shell captures 60 percent of the value of the crude oil as a refined product because it is controlling the value chain. The private sector furnishes capital for this: the government doesn't directly run anything in the oil sector, but instead manages relationships with private companies. We're starting to see some indigenous companies emerge, but there aren't many that are purely Nigerian; many are joint ventures instead. An obstacle to the emergence of indigenous companies is that it takes a long time to grow the necessary talent—and, frankly, talent is a bigger challenge than capital. If there is a marketable opportunity, the money will find its way to you.

FLETCHER FORUM: *Given the prevalence of multinational corporations, how would we reshape that model in a way that maximizes value for Nigeria and encourages those local companies, but is still attractive to investors?*

RICE: One of my first projects when I started at the Institute a few years ago was to look at incentives. The problem with incentives, especially in Nigeria or other parts of Africa, is that the government is not adept at managing stakeholders. The bureaucracy isn't very efficient, and it's not getting information in real time. This means that companies can often exploit this lack of oversight. Sometimes, the regulations just aren't robust. Other times, they may be commensurate with European or other Western countries, but enforcement is so weak that companies can get away with a lot, or even bribe an official if they do something wrong. So, despite a good policy framework, the execution side still has a lot of holes. You have companies that enjoy the benefit of a tax incentive, for example, but are terrible corporate actors. The government is getting less and less value from what it has foregone in tax revenue as the company's presence in the country proves not to be a net benefit.

So, to address this challenge, we put forth a proposal to reverse the process of governments just giving tax holidays to companies. In our plan, when the government negotiates, for example, with an oil company the price of a license to operate an oil block, the government also would offer the company a 25 percent discount on the royalty fee if, over the next ten years, the company invests in training local staff and using local contractors for equipment or delivery systems. Over time, the company should demonstrate that it's investing in the value chain of the country and its human capital, and we should see the labor force transitioning from foreign to local. We call this proposal performance-based tax incentives.

There was a time when African countries were so starved for global companies and foreign investment that governments were offering companies anything to come and do business. That has changed. The African continent is seen as a difficult but potentially very lucrative place to do business, and so governments need to get out of the mindset that they need to offer everything under the sun in order to attract business. These governments are in a position of much greater leverage when they establish operating conditions on these companies that go beyond just taxes and royalties, because these companies are competing with each other for access to those opportunities.

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FLETCHER FORUM: *With this change in leverage and competition, how have investors' perception of risk shifted in different places in Africa?*

RICE: The perception problem with respect to Africa is very real; in some ways, there is a long way to go to combat misperceptions. Yes, the infrastructure is poor, there are still severe power outages; and the water supply is non-potable. There's a lot of corruption as well. Most of these stereotypes are real to some degree. However, stubborn misperceptions surrounding risk make it hard to persuade people that there are a lot of good things happening as well, because those stories don't get told. The fact that my boss's bank is greatly successful in nineteen countries doesn't hit the news like Ebola does.

Perceptions of risk are so skewed that they keep many investors away, giving a huge advantage to any investors who do their homework and actually engage in effective market research. It's not that there aren't risks, or that capital doesn't exist where there is risk, but that smart investors know how to price risk accurately. Whether it's corruption, human capital that isn't fully developed, or poor infrastructure, all these challenges can be managed as long as investors fully understand the costs associated with them.

FLETCHER FORUM: *So, how should investors approach this market research, especially when taking risk into consideration accurately?*

RICE: Investors need to change their approach when it comes to Africa. Let's say an investor wants to invest in the Kenyan horticulture sector because fresh flowers out of Kenya are dominating the market. Those flowers are much cheaper, and because of efficient air travel, within three days, consumers in New York can have flowers from the edge of the Serengeti on their kitchen tables.

So, the way to invest in Kenyan horticulture is not just to invest in a farm, but also in the entire value chain. Investors have to invest in the farm, the distribution company, and the distribution point at the airport, because there are weaknesses in these various value chains. There is a lot of unpredictability because of these weaknesses—bad roads, corrupt police, and vehicles that aren't properly maintained. When investors only look at one element of the value chain, they are actually bearing all the risks associated with other elements of the value chain that are not yet completely reliable.

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Investors have to think about the entire value chain as opposed to one segment of it. That way, they're going to manage risk and build capacity throughout the value chain. That's what investors don't understand; it's a new way of thinking, and understanding the value chain and the approach to it have to be holistic.

FLETCHER FORUM: *What's the most effective way to understand and approach value chains?*

RICE: It depends. As with anywhere, local conditions in African countries vary greatly from place to place and sector to sector. My former employer and I are publishing a report on agriculture and entrepreneurship soon, and one of the interviews we did was with a former Silicon Valley venture capitalist. He said that he came to South Africa because he knew there were opportunities in the agricultural sector, and so he started investing in maize. But he then realized they were losing money, not on the production side, but on the distribution side. His company had off-taker contracts, but then these would disappear, or wouldn't show up, or run out of money. They were left with all this supply that was rotting with nowhere to sell it. They were scrambling to sell it quickly, so they were selling it at a loss.

Different markets will have different challenges. Investors can't play this game from their desk; they have to get on the ground, because one of the continent's biggest challenges going forward—in addition to physical infrastructure and the policy environment—is information. There is a shocking lack of information about what is happening in these economies. The World Bank, IMF, and others will admit that they have poor data and that they don't fully understand it. A year and a half ago, Nigeria reassessed its economy, and it was twice as big as they had estimated because the method they had used to measure GDP hadn't been updated in twenty years. The method wasn't right twenty years ago, and I'm not sure that it was a year ago. There isn't a lot of confidence in the statistics being released, even in the official ones. That's a huge problem, because investors can't make decisions about whether they want to enter a market if none of the available information about that market is bulletproof. It's expensive for investors to gather their own data and do their own market research.

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This information gap will be difficult to tackle. Even in a developed economy like the United States where the methods of gathering data are sound, the data itself is not always predictive. Now imagine trying to make decisions in an economy where investors can't rely on information at all. Investors are going in blind; that's a big problem.

FLETCHER FORUM: *Related to this problem of data, you mentioned that you rely on a lot of quantitative research for your own work and for the Africapitalism Institute. Could you discuss how you conduct that research?*

RICE: The Institute is fully embedded in the Tony Elumelu Foundation, and the Foundation has started a pan-African entrepreneurship program. Elumelu has set aside USD 100 million of his own money, with plans to give away USD 10 million every year for the next ten years to 1,000 entrepreneurs across the continent. In the first year of the program, we received 20,000 applications from fifty-three countries, and these applications are our source of data. Our dataset is narrow, in that those who apply are entrepreneurially-minded and self-selecting, but we have data on their location, income, education, and gender. The research that we did in the last year was based almost entirely on questions we asked applicants about their businesses, communities, and governments. With that qualifier, we do have reliable information because we are gathering primary data. Big banks and others think that some ventures, like the cell phone companies, for example, are successful because they are all gathering primary data. That's the only way to get credible information, and that's why we have confidence in the research we put out.

FLETCHER FORUM: *Which of your industries are powered by that primary data, and which industries do you have the most confidence in?*

RICE: The consumer-facing industries are gathering the best information, particularly because they are the ones closest to the mass-market decision-making process. Unilever, for instance, needs to know what kind of soap people want to buy, and so Unilever has the best information about that segment of the market. The consumer class is a very fast-growing class, and consumer-facing industries may not understand that very well.

In addition, there is a demographic explosion happening, which also poses big risks. If this explosion in the working-age population doesn't have any real opportunity, we will see in African countries the kinds of things that are happening in the Arab world. People have often said that sub-Saharan Africa could experience its own version of the Arab Spring. A very real concern is that this great emerging success story of the continent could be in jeopardy if this growth is not inclusive.

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FLETCHER FORUM: *Can the private sector provide opportunities for inclusive growth?*

RICE: Yes, but the process has to be deliberate. The nature of the private sector is about maximizing shareholder value, and this is a legal obligation for a company's board members. Companies realize that corporate social responsibility is about risk management and reputational risk, and a lot of industry-, NGO-, and UN-led responsible investment initiatives are raising awareness and forcing conversations between these different stakeholders. We looked at this, and we noticed that the largest private employers across the continent are foreign companies, but there is also an emerging African private sector. It's in everybody's interest to make sure that the private sector continues to be able to grow, and in order to do that it needs to be secure and stable.

As a way to manage this potential risk, we had a three-day retreat with eminent African academics from the continent and from the diaspora. We had a discussion about values that companies should adhere to, and one ideal we agreed on is employing locals over foreign citizens. That is a value we want companies to aspire to. We discussed these values as a way to tell the private sector that it is in its own long-term best interest—and in the interest of shareholders and stakeholders—if the private sector and society at large continues to grow, evolve, and thrive. As companies, they have a role to play, whether they want to or not. ***f***