SECTION 01 CHAPTER 05

DUE DILIGENCE IN AFRICA

By Oliver Gorton and Adrian Stones, Alaco Ltd, UK

Introduction

Ouagadougou is not a common jurisdiction for due diligence. Few Western financial institutions have the place in their sights. Burkina Faso has some gold, admittedly, but it is bereft of the mineral wealth that is a draw for so many investors currently showing an interest in sub-Saharan Africa. Cotton does not seem to attract investment banks. The country's thriving market for mobylettes (the small-engined mopeds that remain the favoured mode of transport) is all about dealerships, not deals.

Yet Burkina Faso is as good an example as any of the challenges faced by international investors looking to understand the local market. Public record information is hard to come by. International credit rating agencies rarely scrutinise local firms. Company directorships are not posted in online databases. The media is partisan, either overly respectful or wildly scurrilous – either way, not a reliable benchmark by which to judge integrity and reputation. Political exposure is a given in a country with a President who has been in power for 20 years, taking the reins of the country in a coup which saw the 'accidental' murder of his predecessor. Clan ties figure significantly and make an understanding of the links between business and politics all the more complicated to outsiders. From afar, Ouagadougou is hard to penetrate.

Such local dynamics can, however, be an aid to intelligence gathering, not an obstacle. The business community is well networked. It is a small world and there are few secrets. Whatever the public pronouncements of a company, or more often the individual behind it, context and background will be known to many. With the right sources, the story can be told more comprehensively than would ever be the case in London or New York.

The potential obstacles to an investigation

A recent investigation is a case in point. The subject, a local Burkinabe businessman, oversaw a disparate but significant range of businesses across the Burkina Faso economy. His name appeared in a few French-language local media stories, not picked up by the international media monitoring services but accessible through some judicious online research. Several references linked him to a major business scandal, long-running but apparently never resolved. He was either a saint or a sinner, depending on whose pamphlet one read. Court records did not exist.

An investigator went to Burkina Faso. He was a Francophone African, more likely to pass unnoticed in a country with relatively few international businessmen. Even this was not straightforward. He had to make his way from Conakry, where he had been assessing the likely impact of a potential regime change on another client's mining concession. Shooting in the streets, martial law and a general strike had complicated his travel itinerary. He got out in a private light aircraft, then zigzagged his way across West Africa by regional airline. His luggage is still in Côte d'Ivoire.

Once on the ground, he was quickly able to establish a profile of the subject. The individual was involved in the companies that desk research had suggested, together with a good many more. His name was spelt five different ways in as many documents and no date of birth had been officially recorded. He was from a poor background and had made his own way in life. He had started by selling lottery tickets on the street outside state offices, where he made valuable contacts among government officials. Though he shared a surname with many leading members of the country's Cabinet, he was not in fact related to them.

This had not stopped him from trading on his name to open doors and peddle influence. He had become a wealthy businessman – hence the interest from investors. The circumstances – and likely consequences – of the scandal identified in the media were made clear. Face to face with government officials, local businessmen, clan members and a couple of the country's few truly independent journalists (a dangerous profession in Burkina Faso), it was possible to paint a comprehensive picture of the subject's history, reputation and scope of activities.

These enquiries did not go entirely unnoticed in Ouagadougou. The city's chief of police warned him to stop asking questions. African logistics added further complications. Unable to file a report from Ouagadougou, the investigator went to ground for several days. Then there was radio silence. He had gone down with malaria, which he had contracted in Conakry. When he recovered, the few flights out of Burkina Faso were fully booked for a week. Thankfully, the client was sympathetic, the deadline flexible – it was familiar with 'Africa time'.

The challenges of due diligence

Africa is not alone in its lack of transparency. Nevertheless, conducting due diligence in the region does present its own unique challenges.

Some form of official public records is usually available, although do not expect to be able to access them electronically. A local source might pay a visit to the relevant state register of companies, if such exists, but often official records are spread across a variety of ministries and state buildings. They may be held on a card index in a provincial capital or at the state governor's office. Along the way, the relevant card may have been damaged or 'lost'.

Sometimes there simply is no information. A recent investigation into a proposed mining venture in the Democratic Republic of Congo (DRC) found no public records. A local media article confirmed that the concession had been awarded, but the venture was still too new for any corporate structure to have appeared on the radar. The businessman behind the venture was a Congolese who had been living in exile abroad. He had no known track record. His joint venture business partner, however, was an established Asian energy company whose credentials were sound and experience relevant. Although the local partner had no history, sources in DRC identified no known material issues surrounding him, either. No news was, in fact, good news. They were also able to confirm that the venture had the full backing of the President, whom the partner had lobbied hard. It was understood that that President's interest in the venture was 'covered' by the businessman. The mining concession was genuine and the opportunity was real. The President's backing suggested that the political risk was low. It was up to the investor to decide whether the other reputational risks were acceptable.

The effect of Black Economic Empowerment policy

Black Economic Empowerment (BEE) legislation can often introduce an element of the unknown into a company's compliance credentials. Part of the BEE strategy is to increase black ownership of businesses, which means that many companies will have shareholders there primarily to fulfil the company's BEE obligations. Often the BEE share of a business will comprise many small shareholders grouped together in a BEE entity. These shareholders frequently play no active part in the company and often keep very low profiles. Finding out about their activities, associations and reputation can be difficult and time-consuming.

A mining company in Southern Africa is a typical example. The company was part-owned by the government but an additional 15% stake was held by a local company, regarded as a BEE organisation. Research revealed that the BEE company in turn had 51 separate shareholders, 10 of which were unknown local companies, with the remainder comprising local individuals. According to one source, the shareholders register read "like a Who's Who in the Zoo" of the ruling political party. Sources all agreed that the company was essentially an investment vehicle for serving members of the government. A couple of the names on the list were prominent political figures, but the rest had no footprint.

With so many different shareholders, the BEE element of the mining company would always remain something of an unknown quantity. A definitive picture of the associated risks, either now or further down the line, could never be guaranteed. This was not necessarily a deal-breaker; but it did help focus the client's attention on what issues to monitor.

Such mixtures of politics and business are never far away in sub-Saharan Africa. Opportunity and expediency combine in an immediate shared interest between the two sides.

In some cases, the causes are rooted in history. The shift from colonial rule to indigenous government created new monopolies in countries such as Zimbabwe. During its independence struggle, a minority of European businessmen in the country supplied the rebels with equipment. As the guerrillas became office holders, so those businessmen formed partnerships with the new leadership. Ministers signed contracts without the need for competitive tenders and those same Ministers acted to protect the businesses in which they had an interest from regional and even domestic competition.

In this way, contracts such as the supply of equipment to the army, airline catering and major infrastructural projects fell under the control of the ruling party and the small number of businessmen who made those businesses work. Only recently have these relationships begun to unwind.

Foreign influence

Similar long-standing relationships between the ruling party and Western businessmen dominate large portions of the African economy. Almost uniquely in today's emerging markets, there exist several powerful and well-established foreign businessmen who are able to wield enormous influence in the spheres in which they operate. Such figures dominate the extractive industries sectors of several African countries.

When a review of mining licences was announced by the government in Guinea, one leading investor remarked that it amounted to little more than going through the motions to ensure that Western aid continued to flow. His particular enterprise had nothing to worry about – his people watered the President's lawn.

Not all international companies have such useful ground-staff. In DRC, following last year's elections (attempts to level, or at least to regulate, the playing field are often launched after a round of elections), a London-listed client found itself on the wrong end of a judgement about how some of its licences had been acquired. The concessions had been granted in the Mobutu era and were now being found invalid. Further investigation revealed, lurking in the background, the vested interests of a competitor with close links to the current government. The manner in which the competitor acquired its licences, however, is unlikely ever to be subject to similar scrutiny.

Dealing with corruption

Corruption is an emotive word but it is certainly an integral part of the business landscape. It probably comes as no surprise that Transparency International's (TI) respected Corruption Perceptions Index lists most sub-Saharan African countries in the lower orders of its index. Not every country can be tarred with the same brush, though. Botswana, for example, appears 37th in TI's index (Finland is 1st, Haiti is 163rd), slotted neatly between Bahrain and Oman, countries well within most financial institutions' comfort zones.

Western investors will rightly be wary of any possible association with corrupt practices, but they also need a certain degree of pragmatism if they are to do much business in the continent. Corruption comes in many shades and hues and varies not only by country but by sector. As with any emerging market, context is everything. Government involvement will usually be the price to pay for a licence to extract a country's natural resources. The fact that a few individuals connected to that government stand to benefit personally from the concession is the reality of most government contracts in Africa.

The African playing fields are not level and they will not be level any time soon. Elections in Africa are expensive. State funding is not always available or available in sufficient measure. There are rarely mechanisms in place to limit donations to a particular party or to a particular candidate. Donations are made to which strings are attached. Those strings might subsequently deliver an unusual amount of access to a decision-maker or firmly close doors that competitors had been expecting to open.

The reasons to continue research

Africa should not be viewed universally as a continent where 'anything goes', however. Standards of compliance are as varied as the geography. African financial institutions clearly carry out their own due diligence and many are as rigorous as their counterparts in established markets – some are more so.

A recent pre-initial public offering (IPO) due diligence in Southern Africa throws up a refreshing example. The company had been due to list locally and negotiations were well under way. However, the local bank pulled out because of a perceived lack of transparency. No material issues had been discovered but the bank decided that the potential risk to its own reputation in the region could be compromised if things did not work out in the longer term.

There was no question that the deal, had it gone ahead, would have made a lot of money for all the advisors involved. But many of the assets had once been part of another company which had gone through the same process and many local institutional investors had been badly burned. The Chief Executive of the local stock exchange agreed: his countrymen, he said, "had long memories".

A listing is now going ahead on AIM. Perceptions of risk in London were clearly different to those held locally.

Much comes down to the character of the organisation commissioning the due diligence. Appetites for risk vary. Hedge funds may seek it out. Banks might be more cautious. Those with greater experience in Africa will have broader comfort zones than those stepping into the market for the first time. For every banker pushing a new relationship, there will be executives in compliance, corporate communications, marketing and corporate social responsibility seeking to make sure that this will not come back to haunt them.

With the right research and the right resources at one's disposal, investors can mitigate these internal struggles. Sub-Saharan Africa is porous as far as information is concerned. Where the region lacks easily accessible official public records, it makes up for it in the likelihood that, somewhere out there, informed sources will probably be able to give chapter and verse on a company or individual. This is off-balance sheet due diligence. It can paint as revealing a picture as any spreadsheet.

Ultimately, the general rule for due diligence in Africa is the same as for any other emerging market: do it. There are no prizes for being poorly briefed.