The Africa Sessions, Q1 2014

Africanisation: Local content and the evolving investment reality

Buoyed by competition for access to African natural resources and African consumer markets from a diverse group of potential investment partners, African governments are increasingly able to dictate the terms of engagement. Front and centre of these terms is often a requirement for foreign investors to develop 'local content': to create jobs, open equity to local partners and invest in local supply chains. The national objective is clear: the transfer of knowledge and value to the local economy and to indigenous companies. The incentive for business should also be clear: businesses that can develop talent, procure inputs and market goods and services locally should be able to develop better operating margins and to protect long-term license to operate. Unfortunately too often government policy and regulation has been inadequate or inappropriate. Business has responded with caution and often sought to circumvent or avoid rather than to comply. The result is a complex, varied local content landscape across the continent, which is difficult to navigate.

To unpick the thorny issue of local content Africa Practice and Pinsent Masons gathered a panel of industry experts and participants from the African mining, banking, consulting, investment and energy sectors for the first of The Africa Sessions, 2014. The key question: are local content policies effective in achieving national development objectives and how should investors approach national participation?

PANEL

- Rolake Akinkugbe, Ecobank
- Bernard Obika, Roughton
- Douglas Brew, Unilever
- Akshai Fofaria, Pinsent Masons
- Thomas Wilson, africapractice

Evolving reality

The panel had one unanimous opinion: local content legislation is here to stay and those companies that fail to recognise this evolving investment reality will fall quickly behind.

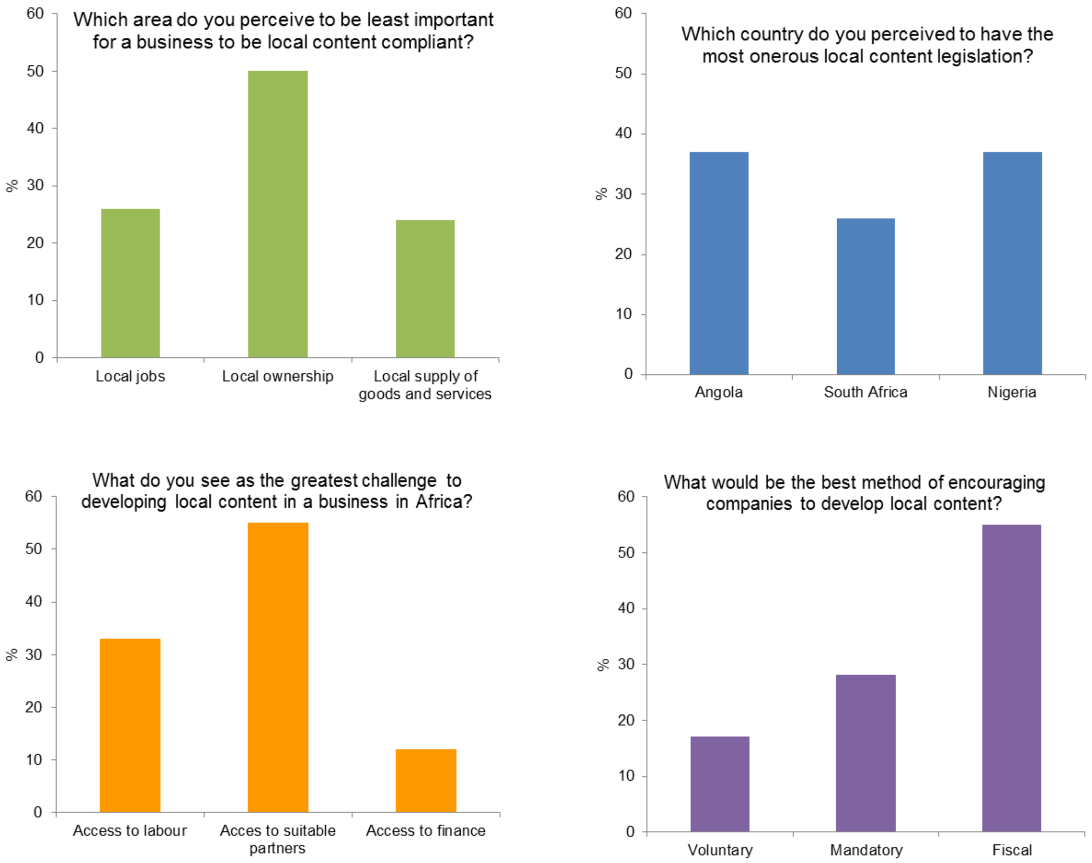
A combination of political, market and socio-economic forces mean that every country in Africa is pursuing local content development in some shape or size. Democratic reforms have been remodelling politics across the continent, slowly rendering governments more accountable to their electorates. In this environment, governments increasingly recognise that jobless economic growth and strong government revenue is not enough to sustain political power. With the African population growing exponentially - **Nigeria** will have a population of over 200 million by 2020 - and the emergence of a younger, better educated, job-hungry generation, government must create jobs and economic opportunities for all if it is to maintain a popular mandate.

At the same time economic shocks such as the global financial crisis, subsequent economic slow-down in Europe and periodic commodity price collapses are driving home the need for sustainable, self-reliant, economic development for resource and non-resource economies alike. African leaders are increasingly cognisant of the need to harness the potential industrial multiplier effects of oil or mining revenue sooner rather than later. In agriculture Africa lost its status as a net exporter of agricultural products in the early 1980s. The value of agricultural exports from Thailand, which has less than 10 per cent of the population of sub-Saharan Africa, is now greater than the whole of sub-Saharan Africa. Inspired by the rapid economic development of the Asian tigers and now China, Africa wants to follow suit, address these inconsistencies and invest in local production and local manufacturing.

Finally other subtler forces on the ground are rendering local content development viable. The return of better educated and trained diaspora with strong professional experience is building the local human capital able to fill the jobs and create the businesses needed to meet local content requirements. This diaspora is also returning with robust financial resources and a sophisticated understanding of international finance. At the same time domestic banking sectors are improving, increasing access to local finance while international banks and financers, frustrated by poor growth rates and returns at home and more confident of investment prospects in Africa, are making more foreign capital available.

The drivers for local content development are there: the question is how to accelerate local economic development; how to develop the local financing structures, workforce and supply chains needed to create diversified local economies; how to bridge the gap?

The Africa Sessions survey



The charts above show the results of a series of multiple choice questions we posed at The Africa Sessions to assess audience perceptions of different local content issues in Africa. Interestingly the audience felt that a regulatory system that offered fiscal incentives for compliance with local content requirements would be the most effective way to bridge the gap.

Bridging the gap

It is not an African phenomenon: every economically developed or developing country has faced the challenge of how to develop local capacity and as a result, vacillated between periods of protectionism and liberalism. However, because it has happened before does not make it easier to manage. Local content legislation seeks to artificially increase levels of local participation in an industry beyond levels that local capacity is currently able to meet. It is by definition aspirational. As a result, at the point of promulgation it is generally impossible to comply with.

This has been acutely clear in a number of African markets where achieving the balance between local content requirements and an enabling investment environment has proven difficult, creating an inherent conflict between local content requirements and local operating realities. For example, most investment codes, mining codes and model Production Sharing Agreements now include a reference to local content but rarely is local content properly defined or regulated. In November **Tanzania** published a new model Production Sharing Agreement, which tightened local content provisions obliging companies to '*maximise their utilisation of goods, services and materials from Tanzania*' and giving priority to nationals. This vague wording is typical. It is left to industry to create mechanisms and strategies to drive local content development, or in some cases, to circumvent local content requirements.

> *"Government often has the authority to grant a waiver if companies fail to meet local content requirements. However, individual discretion is easily abused and can quickly create an uneven playing field."*
>
> Akshai Fofaria, Pinsent Masons

In **Angola** local content legislation is clearly identifiable but different laws govern different areas of local content and there is no single institution to supervise enforcement. Various stakeholders, sometimes with conflicting agendas and responsibilities, govern different aspects and compliant status is not achieved at one time: Sonangol takes local content compliance into account when evaluating bids; the Petroleum Ministry (*Ministério dos Petróleos*) demands annual reports on training and succession planning; while the Labour Ministry (*Ministério de Administração Publico, Trabalho e Segurança Social*) enforces the 70:30, national to expatriate rule and inspects work locations.

Where local content requirements are clear, for example on the subject of employment quotas, capacity shortfalls mean that compliance can be extremely difficult. If governments want companies to comply with exacting quotas in technical sectors they must work hard to bridge the gap by improving standards of secondary and tertiary education, aligning curriculums with the technical requirements of important sectors and creating opportunities for public private partnerships in education.

Understanding local content: conclusions

If the rationale behind investing in the development of local content is sound and well understood, how to achieve the effective development of local content is clearly more challenging. Government knows what it wants to achieve: a diversified economy powered by indigenous companies servicing all parts of the economy to generate jobs and economic stability. How to intervene with incentives, regulations and penalties to artificially alter the local economy and how business should respond is much more difficult to define.

Here we offer ten important conclusions to shape the way companies should understand and approach local content compliance.

1. **Beyond oil & gas:** Local content is well established as a principle in the oil and gas and mining sector. Local content requirements are already being extended into the finance sector: expect requirements to be extended into most if not all sectors in due course.

2. **No one-size fits all:** There is no single approach to local content development and international business should not seek a consolidation and replication of regulation across multiple markets. Local content policies need to reflect the political and commercial realities of the local environment. Government cannot take on market forces: efforts to develop local content in sectors where the country has no competitive advantage are likely to fail. Successful local content policies will identify sectors where due to specifics of geography, climate, human capital, natural resources or market access, the local content development makes sense.

   "Different countries take different approaches. In Botswana, a leader in local content regulation, the government undertook a sophisticated analysis of local capacity in the infrastructure sector before setting out its local content policy.'

   Bernard Obika, Roughton

3. **Beyond local ownership:** Early local content requirements focussed heavily on local ownership. The most forward thinking governments are now recognising that local ownership can be the least important element. Just because a business is locally-owned does not mean that it will succeed and create local manufacturing capacity or local jobs. In many cases foreign investors have used creative legal structures to impose limits on profit sharing and take effective control of joint ventures through shareholder arrangements, which mean that a locally-incorporated entity with a politically connected shareholder is anything but an active indigenous business.

   "In the past local content has been enforced through a focus on equity ownership and job creation. However, governments have been undecided about the benefits that these criteria have delivered.'

   Rolake Akinkugbe, Ecobank

4. **National vs local content:** Defining local content can be contentious. Although normally understood as national content, in some jurisdictions there is an increasing focus on the 'local' element. In the **Nigerian** oil and gas sector, operators in the Niger Delta are increasingly under local pressure to ensure that local content policies reflect state-level political and ethnic realities: i.e. operators in Rivers State should employ staff and procure goods and services from Rivers State; Nigerian content alone is not adequate. Within increasingly decentralised governance models being tested in a number of countries, such as **Kenya**, local content may increasingly be defined in such narrow terms.

5. **Embracing local content:** With local content here to stay and local content requirements only likely to tighten those companies than put local content front and centre of their investment strategies will fare better. Companies that can link their businesses more closely to the local environment through local equity ownership, local supply and local job creation will find it easier to monitor, mitigate and manage risk, and build compeitiive advantage.

   "Local content development should not be treated with suspicion; local content should be embraced"

   Douglas Brew, Unilever

6. **Incentives:** Brazil has demonstrated that interventionist local content polices can drive industrial growth by offering industry-specific incentives and exemptions. Critics argue that such policies undermine efficiency, distort competition and deter investment in other sectors. On the other hand companies prepared to invest in local content will be able secure incentives if they are prepared to be first movers. In our Africa Sessions audience survey, 55% of participants responded that fiscal incentives would be the best method of encouraging compliance with local content regulations. Fiscal incentives were preferred to voluntary or mandatory regimes.

   "By providing guarantee facilities to SMEs, governments can encourage local content where it would otherwise fail. But such guarantees can only work with state-level involvement"

   Rolake Akinkugbe, Ecobank

7. **Regionalisation:** Increased levels of regional cooperation should make local sourcing, manufacturing and recruitment more viable, if – and it's a big if – national governments are willing to accept regional solutions to local content. Investors have historically been reluctant to invest in capital intensive manufacturing, preferring to import, due to the small size of domestic markets

and the difficulty of achieving scale. If barriers to regional trade continue to be lifted, the business case for local manufacturing will improve. Similarly, the improved movement of skilled labour between African markets should help meet capacity shortfalls: again this requires national governments to invest in regional cooperation and look beyond short-term national agendas.

"Tariff issues that used to hold back regional manufacturing have largely been resolved but other non-tariff and logistical hurdles still need to be overcome to optimise regional trade."

Douglas Brew, Unilever

8. **Supply chain optimisation:** Where possible, developing robust, competitive local supply chains will have commercial benefits beyond local content compliance. The largest soap factory in Africa imports palm oil from Asia to keep it running. If the owner could source palm oil locally and competitively, production time, supply chain security and profitability would all improve. Creative solutions that allow for the establishment of successful, sustainable local supply chains will become increasingly important.

9. **Local capital markets:** Local ownership no longer needs to mean a local, politically-connected, 51 per cent shareholder. The development of local capital markets is creating opportunities to raise capital locally and to allow for genuine local equity participation, making local ownership more inclusive.

10. **License to operate:** Democratisation and increased access to information continue to increase the number of stakeholders interested in or with an influence on any investment in Africa. In this context maintaining social licence to operate is a complicated exercise of identifying, engaging and satisfying an increasingly diverse number of different actors across all levels of society. An effective local content strategy can help to maintain license to operate by more closely aligning local and project interests.

The Africa Sessions is a series of high-level conversations on African business hosted by africapractice and Pinsent Masons.

The first event - *Africanisation: local content and the evolving investment reality* - will be followed by future events in London and Dubai.

Next events:

London
- 14 May 2014
- 10 September 20134
- 9 December 2014

Dubai
- 19 March 2014

To attend future events contact aahmed@africapractice.com or lucy.wilson@pinsentmasons.com