Chasing Outliers

Why context matters for early-stage investing in Africa

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Kinyungu Ventures is an East African venture firm on a mission to catalyze resilient businesses for local intergenerational prosperity. Based in Nairobi and Chicago, Kinyungu Ventures strives to do three things well:

- Context: Provide wisdom in crucial moments
- Connects: Leverage trusted relationships
- Capital: Invest in great businesses

Foreword

When I began the journey to become a fund manager for early-stage African ventures, I was excited and anxious to tackle the complicated problem of getting the “right” capital to the right companies in the right way. As an entrepreneur at heart, I embrace the marvelous chaos, the impossible trade-offs, and the crafty experiments required to find product/market fit.

Along the way, though, a wise mentor warned me that “venture fund product/market fit” is different. I can’t just run a few experiments, get quick market feedback, and pivot the way a tech company does in five weeks. As a fund, the quality of your investment decisions is often revealed slowly. Deciding to pivot a fund doesn’t take five weeks—it might take five years. What if I deployed large amounts of misdirected money today? In five years, I’d be very wise—and very broke.

I realized that while my thinking isn’t restricted by history, I am also very keen to learn from its lessons. How do I squeeze 15 years of learning into one? This desire to learn from those who have gone before me is the genesis of this research. And my hope is that the lessons learned from the first chapter of African venture capital will lead to more resilient, stronger start-ups, venture funds, ecosystems, and economies across the continent. While the challenges are many, I believe that humans always rise to the occasion with resourcefulness and ingenuity.

Tony Chen
Co-Founder, Kinyungu Ventures

Executive Summary

> **There are multiple mismatches between key characteristics of Silicon Valley VC and African markets.**

Chasing Outliers: Why Context Matters for Early Stage Investing in Africa explores what drives outcomes for early-stage startups and investors in Africa. The first section tackles the assumptions that drive venture capital (VC) investing norms and how well they apply in Africa, while the second section addresses how founder, team, and investor behavior; communication; execution; and alignment influence startup success or failure.

This report makes a case for why African market realities (which are distinct from other markets' realities), and startup characteristics (in which key variables may be similar but context affects how they're experienced on the ground) create a set of operational norms that influence how startups and funds behave. The existence of this unique "operational code" should inform how early-stage investing is practiced in Africa.

WHY SILICON VALLEY VC CLASHES WITH AFRICAN REALITIES AND HOW FUNDS AND STARTUPS RESPOND

There are multiple mismatches between key characteristics of Silicon Valley VC and African markets. These mismatches influence how startups and funds maneuver as well as what results they expect and produce.

- **African market characteristics.** African markets are large, but also fragmented. They comprise consumers with limited purchasing power who are likely to be utility- and price-sensitive. Additionally, these consumers are difficult and expensive to acquire and retain, partially because they don't tolerate fully digital modes of distribution.

- **Returns potential.** Silicon Valley VC, which is designed to support high-growth companies, requires outsized returns that African markets can't necessarily provide at the same scale due to the market dynamics described above. Yet founders and investors seek strong growth, and returns can still be compelling.

- **Capital availability.** Funding hypergrowth companies requires a lot of capital, particularly when the costs of building infrastructure and navigating external conditions are considered. Capital in Africa is scarce, however. Because of this, pursuing a "growth at all costs" strategy where capital pools are shallow can endanger companies.

- **Deal-flow availability.** To the extent that a "spray and pray" strategy characterizes the volume of opportunities required to find unicorns, deal flow scarcity can make them harder to find. Investors who hold unrealistically high returns expectations, crowd into deals that meet those expectations, or focus on specific sectors may reduce their deal flows.

Fund structures. African startups take a long time to generate returns due in no small part to challenging market conditions. As a result, general partners (GPs) may benefit from flexibly structured funds that limited partners (LPs) are unlikely to support without strong business cases and compelling results.

Because of these incongruencies, startups and funds have adjusted their operating models to better align with market realities. More specifically, startups have done this by tackling problems in foundational sectors such as agriculture, building infrastructure, pursuing mass markets, and leveraging their local knowledge and presence.

- **Tackling big problems.** Africa-focused founders are often trying to solve large, foundational problems that could improve the lives of countless people. In many cases, this means that they are motivated not only to stimulate economic development, but to use technology to increase value creation for agricultural producers, improve education, and create access to finance, health services, and jobs.

- **Building infrastructure.** To deliver a product or service, a venture often has to build the infrastructure or fix the supply chains required to do so. As well, sometimes, a company may also set out to fix one element of a supply chain, such as providing affordable internet service, only to realize that it also has to build towers and generate power.

- **Pursuing mass markets.** In the African context, small and fragmented markets, poor and difficult-to-reach consumers, and hefty infrastructure costs all constrain returns. Serving the majority of African consumers represents a massive opportunity under certain conditions, however: Although African consumers have limited purchasing power, they are numerous. Consequently, startups can build robust businesses that are based on high volumes, small margins, and lean operations.

- **Leveraging local presence and knowledge.** Nuances in consumer behavior, cultural norms, and business practices affect how startups operate. As a result, it's critically important for founders to live where their businesses are based and to truly understand the environment.

Funds have responded similarly to startups in terms of investing in solutions to big problems and prioritizing local presence and knowledge. They have also focused on risk assessment and mitigation, as well as strategic decision-making.

- **Solving big problems through investing in solutions.** Many investors see massive, profitable opportunities in creating the backbones of African economies, which means investing in building blocks such as human capital, financial services, infrastructure, and real assets. Technology can be used to reach customers more cheaply and easily by defragmenting and organizing markets, reducing customer acquisition and distribution costs, and increasing efficiency. In other words, delivering products and services that fix market failures in largely uncontested markets can be a lucrative opportunity.

- **Prioritizing local presence and knowledge.** Generally speaking, VC is a local business where investors fund startups in relatively close proximity because they want to understand the problems and markets involved. In Africa, the need for such understanding is more acute given the challenging conditions and fragmented markets. As a result, fund managers acknowledge the benefits of having an on-the-ground presence and context familiarity.

- **Assessing and mitigating risk.** Given the lack of data on startups, consumers, and markets, investors try to assess and mitigate risk by tracking multiple types of risk, using the due diligence process to understand founders, and charging premiums to compensate for the risk they assume.

- **Making strategic investment decisions.** To navigate tough terrain, investors seek to make strategic investing decisions that improve outcomes, such as investing in companies after product-market fit has been achieved, investing primarily in business-to-business (B2B) companies, re-investing in companies that are performing well, and diversifying their portfolios geographically as well as by sector, stage, and age of investment.

WHY PEOPLE, EXECUTION, AND ALIGNMENT MATTER

While the first part of this report outlines characteristics of early stage investing in Africa that are distinct from those that define Silicon Valley VC, a number of other factors that aren't explicitly Africa-specific also affect startups. These factors include how founders, teams, and investors behave, create relationships with one another, execute and measure performance, and contribute to success (or failure), irrespective of where the founders and investors are operating.

Founder, Team, and Investor Characteristics

Although founders drive company success, the "ideal entrepreneur" archetype is nuanced. Investors seek founders who can execute and who are passionate, committed, and highly intelligent. These founders possess unique insight into the problems they're solving, communicate transparently, and are deeply experienced.

Strong founders must also be supported by a strong team, however. Funds invest in visionary CEOs as well as their ability to attract other talented people who co-own the execution of that vision. Good teams are analytical, determining how and when to take action as well as what worked, what didn't, and how to create value going forward. Despite the importance of strong teams, however, it can be very difficult to hire, cultivate, and retain top talent.

Investors also have an impact; founders appreciate investors who have built businesses, understand markets, and adapt well to the inevitable shifts in a startup's trajectory. They also seek investors who will lead investments, provide good advice, actively support their business, or remain supportive yet passive. Ultimately, founders prefer investors who prioritize their interests as well as their own.

Execution, Relationships, Communication, and Alignment

The challenging market conditions in Africa make superior execution indispensable. In fact, execution quality can distinguish teams with comparable resources, separate novice teams from mature ones, and transform mediocre ideas into successful businesses. For founders and investors alike, execution is about translating strategy into actions that produce results for the company. It involves determining what steps are required to achieve a goal, using data to determine what is or isn't working, learning from failure, and using insights to change the business model or strategy. To assess the quality of their execution, companies use a variety

> **Despite the diversity of funding sources, the investor ecosystem remains immature, undifferentiated, and saturated, with investors not yet coalescing around specific niches.**

of key metrics. However, unit economics are often emphasized, because strong unit economics increase the margin for error, while poor unit economics are difficult to correct. As a result, many African companies prioritize profitability at earlier stages in their life cycles.

Again, although execution is a key driver of outcomes for African startups, the ways in which founders and investors interact is also critical. Founders and investors build healthy relationships by cultivating trust, openness, and transparency. Similarly, strong communication characterized by transparency and openness contributes to strong relationships. Notably, communication approaches often reflect founder and investor preferences as well as the needs and stages of the companies involved. Good communication and relationship building also creates a foundation for alignment, or owning shared goals and processes. From an investors' perspective, alignment can be achieved by sharing goals and building relationships, and agreeing on deal structure and desired outcome expectations. Similarly, entrepreneurs try to achieve alignment by agreeing on goals and strategy, as well as through fostering good relationships and communication.

The Case for Context

Reflecting on the mismatches and adaptations identified earlier alongside the intensive people, relationship, and execution dynamics, one could erroneously conclude that the case for investing in Africa is tenuous and fraught with caveats. However, a more measured perspective is that significant, profitable opportunities exist despite, and arguably *because*, of the challenges previously highlighted, for three reasons:

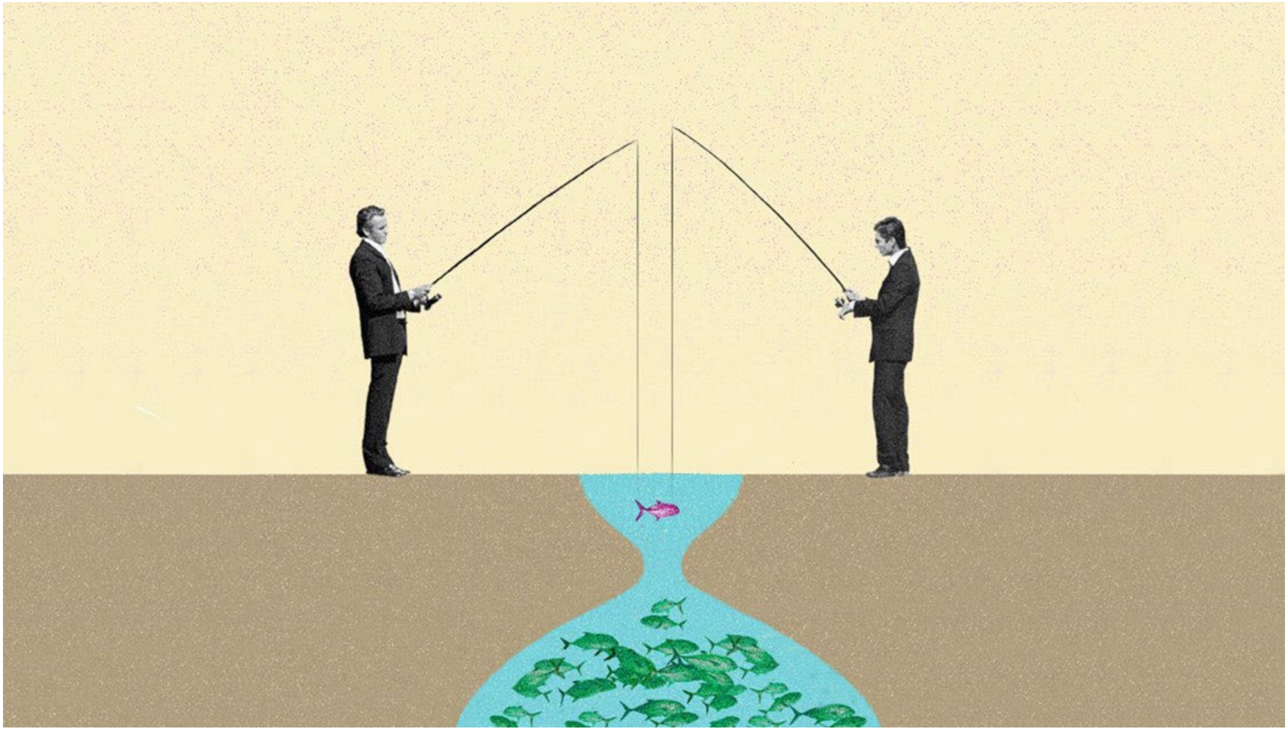
1. **There are still large, unexploited markets to serve in Africa.** Despite conditions that seemingly limit the size of addressable markets, key indicators of robust consumer markets and enabling startup environments, including a growing, young, middle-class population; increasing mobile and smartphone penetration; high-tech adoption; and an increase in entrepreneurship activity, talent, and support structures are still valid. Additionally, the same challenging conditions that increase friction also reduce competition and increase the size of unserved populations.

2. **Many of these opportunities will be discovered through experimentation and exploited through stellar execution.** In many cases, large, profitable opportunities in Africa are more likely to be created by deploying well-understood business models in poorly understood markets, rather than relying on frontier technology and innovation. As well, many African startup ecosystems are at the stage of development in which companies whose models reflect deep market knowledge, and whose operators possess the muscle to execute them, will enjoy a larger opportunity space.

3. **African startups are building infrastructure to create new markets while digitizing**

analog use cases. Leveraging technology to defragment big markets and serve consumers better sounds like a typical VC opportunity. In African markets, however, companies are leveraging mobile infrastructure and nuanced local knowledge to digitize and organize analog markets.

In essence, the core message from this discussion is that African startup ecosystems should



For those who know how to go deeper, there are still large, unexploited opportunities within African markets.

adopt norms, structures, and processes that reflect the realities of operating in Africa. As highlighted in the alignment discussion above, goals, priorities, expectations, and strategy all need to coincide to drive the desired outcome: cultivating African startups in a way that is rooted in, and respectful of, context.

Arguably, multiple points of leverage can stimulate change, including markets, ventures, funds, LPs, and startup ecosystems. Markets will evolve and startups will adapt out of necessity, which leaves funds and LPs as a potentially rich area of focus.

This research suggests that funds should consider adopting other structures and pursue focused investment strategies. General partners need flexible structures that better enable them to respond to market-level changes. Using alternative instruments and structures, such as debt or permanent capital vehicles (PCVs), is one approach. The open-ended time frame that characterizes PCVs is a notable benefit, allowing companies to fully realize their growth potential. Nonetheless, some would argue that time horizon and liquidity preferences are difficult to reconcile within PCVs. Limited partners want to see a return of capital within a defined period of time, usually 10–15 years within a typical fund structure.

Using focused investment approaches is another way to circumvent the challenges of African markets. As with alternative investment structures, there are a number of options for funds, including focusing on B2B investments, moving upmarket to invest in more mature companies, and cross-subsidizing a portfolio. A fundamental enabler of these and other shifts is the willingness of more LPs to reconsider their assumptions, norms, and preferences, however.

Time will tell which investing structures and operational variables matter most. What is clear now is the need to respect the context in which funds and startups operate and use it as a foundation to develop appropriate fund and company building norms.