Investing in Africa

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Investors have broadly ignored Africa as political instability, poor corporate governance and insufficient liquidity have forced investors to turn elsewhere for investment returns. This is quickly changing, as surging commodity prices and a relatively benign external environment have led to rising foreign direct investment and robust domestic demand. Yet, despite its wealth of natural resources and strong forward-looking growth prospects, African capital markets are still nascent and investors must tread with caution.

The investment outlook: why investors are finally taking notice of Africa?

As with most frontier market economies, Africa has been the beneficiary of strong absolute performance and largely uncorrelated investment returns. For those of us operating in the region, it comes as no surprise to hear that Middle Eastern and North African equity funds had experienced positive investor inflows every week this year according to consultancy firm EPFR Global. Yet, while the macroeconomic theme of «global decoupling» has been adopted as the explanatory vehicle underlying recent emerging market outperformance, the fundamental drivers for Africa are far more compelling and form the foundation for our bullish outlook on the region.

Global growth convergence & improved fiscal and monetary prudence.

Africa is the second largest continent in terms of both population and land mass. Yet, at USD 1.75 trillion, Africa accounts for less than 2.5% of world aggregate GDP. As the region becomes more tightly integrated into the broader global economy, African GDP is likely to exhibit considerable potential for upside. Moreover, with African GDP rising from such a low base, the ancillary impact on local economies provides a hugely positive backdrop for continued foreign investment.

Africa has displayed fiscal and monetary prudence as evidenced by improving current account balances, expanding FX reserves and deteriorating debt. African nations have benefited greatly from the Heavily Indebted Poor Countries (HIPC) program and some (e.g. Nigeria) have managed to eliminate outstanding London and Paris Club debt. Should African nations remain focused on improving their economic fundamentals, country risk premium will likely compress and the region will more readily attract additional investment.

Democratization of Africa & increased rate of urbanization

In 1985, 45 out of 53 African nations were considered undemocratic. Today, more than 70% of African countries hold regular democratic elections which are deemed free and fair. Events in Kenya and Zimbabwe notwithstanding, such developments have resulted in reduced political risk, diminished incidence of corruption and improved conditions for future investment.

Africa's rate of urbanization is well above the global average with the continent exhibiting a 3.2% growth rate versus 2.0% world average. Strong urban growth rates have positive implications for business investment including increased demand for infrastructure, more highly efficient resource use and improving environmental consciousness. Urbanization has also contributed to shifts in domestic expenditure, including rising shelter costs and increased protein consumption.

Continued resource strength & rapid technological advancement.

Rising commodity prices have led to dramatic growth in resource-rich countries with many African nations reaping the benefits of higher energy prices. According to the World Bank, GDP growth among Africa's oil exporters rose from 5.7% in 2006 to 8.1% in 2007. Furthermore, GDP growth among oil importers rose to a 10-year high in 2007 as price gains across non-oil commodities (i.e. metals, grains, softs, et al.) buoyed overall performance. As stated previously, rising commodity prices have served as the primary catalyst for foreign direct investment into Africa. While this theme is largely bullish for Africa, we have grown increasingly cautious as per capita real income growth has failed to keep pace with rising food and energy prices.

Increased access to information has dramatically improved the quality of living for African citizens. Mobile telecommunications has leveled the economic landscape, and led to the rapid growth of mobile banking and internet usage. Improved access to information has had profound economic impacts such as more highly competitive pricing, increased worker productivity and business models geared toward less wealthy segments of the population.

In Search of Alpha: The opportunity in Sub-Saharan Africa

When examining Sub-Saharan Africa, there are two distinct avenues though which a portfolio manager is able to consistently demonstrate skill and generate alpha: structural arbitrage and information arbitrage.

Structural arbitrage refers to a manager's ability to capitalize on any number of structural inefficiencies which may exist within the marketplace. Presently, Sub-Saharan Africa ex-South Africa consists of nearly USD 300b in aggregate GDP spread unevenly across 46 individual countries and 710 million people. The region presently houses 20 national stock exchanges with more than 900 tradable stocks totaling USD 880b in total market capitalization. As such, a manager with intimate working knowledge of the African capital markets can effectively capitalize on trading inefficiencies across individual jurisdictions, exchanges, brokers, custodial banks, et al. In addition, managers with sufficient tenure are typically able to capitalize on long-standing relationships and gain preferential access to individual markets and exchanges. Benefits include access to buried pools of liquidity and greater transparency with respect to pricing and trade flow.

Information arbitrage refers to a manager's ability to capitalize on greater access to corporate data. An information edge may be derived from having preferential access to management, government officials, banks, brokers, et al. Information arbitrage opportunities typically result in more reliable security valuations and highly astute economic forecasts, including country risk premiums, availability of credit and investor sentiment.

Portfolio managers are faced with numerous issues and challenges when attempting to invest across the region. Perhaps the single greatest challenge to investors is an overall dearth of sufficient market liquidity. Although average daily trading volumes are rapidly improving, most exchanges are operating at levels which are far from optimal. At present, the Nigerian Stock Exchange is the most liquid exchange in all of Sub-Saharan Africa ex-South Africa with an average daily trading volume of USD 107m. To put things in perspective, the New York Stock Exchange exhibited average daily trading volume of nearly USD 89b over the same period.

Another risk to portfolio managers operating in Sub-Saharan Africa is an overall inability to hedge individual beta and FX exposure. Because shorting listed equities is prohibited in most jurisdictions, managers must look elsewhere for short beta exposure. Opportunities include, but are not limited to, stock/borrow agreements, contracts for difference and exchange-traded funds listed abroad. On the FX side, currency hedging is available, but extraordinarily expensive. Costs typically range from 8 – 10% of notional, and pricing is far from transparent. Although transparency across the African currency markets is improving and transaction costs are declining, a manager ought to have a firm conviction on the underlying currency before putting the requisite FX hedge in place.

Looking ahead: country & sector themes

Admittedly, listed equities are prone to market-driven movements which often reflect such issues as investor sentiment, liquidity and exchange/regulatory considerations, among other factors. As such, we prefer to review macroeconomic themes by both country and sector with an eye toward identifying individual companies which stand to profit across Sub-Saharan Africa.

Ghana – Near-term risk, long-term reward. Ghana has profited nicely from economic reform and successful macro stabilization although energy shortages and rising fuel consumption are driving above-trend import growth and pushing inflation higher. The economy has benefited greatly from debt relief schemes such as HIPC and MRDI, and was the first post-HIPC/MDRI country to raise financing from the private sector via its 2007 eurobond issue. The country remains a large exporter of gold, cocoa and timber although oil imports will likely outweigh export receipts over the medium-term. Even so, we are willing to trade medium-term balance of payment weakness for the promise of export riches and oil-related revenue.

Inflation remains a one-way street and with the Ghanaian cedi depreciating -16.2% year-to-date, investor appreciation for attractive equity market valuations is currently being tested. We remain wary of continued cedi weakness as the preference for holding foreign currency deposits appears to be gaining momentum. Although increased privatization (i.e. Ghana Telecom, SIC Company, et al) and greater domestic banking penetration are likely to support cedi strength over the medium-term, Ghana does not yet have the FX reserves necessary to defend its currency over prolonged periods. In addition, uncertainties surrounding the December 2008 elections will likely force investors to the sidelines although we do not foresee a situation similar to Kenya.

We expect GDP growth to remain well above trend as strength in agriculture, construction and mining are likely to exceed expectations. Better cropping techniques and investment in agri-finance projects such as Cargill's cocoa processing plant have greatly expanded Ghana's capacity for additional agricultural supply. International and domestically-funded infrastructure development (e.g. World Bank RIAS, NEPAD, PACITR/WAEMU, et al) aimed at improving roads and transit lines to land-locked West African nations will increase regional trade and yield greater production efficiencies. Finally, rising commodity prices have resulted in new investments across the mining sector with output levels expected to increase considerably. As such, we are encouraged by the nation's prospects and anticipate attractive buying opportunities in the months ahead.

Namibia – Beginning to uncover its true potential. Namibia has been one of the best performing growth stories in Sub-Saharan Africa. The country boasts stable GDP growth on the order of 4.5% y/y with low indebtedness and well diversified export base driven by manufacturing and mining. Rising unemployment, high levels of poverty and increasing income disparity remain issues, but the country is marked by wonderfully rich economic freedoms and is ideal for continued investment. Should the promise of unproven oil reserves be realized, Namibia's potential for forward-looking growth is significant, to say the least. With a population of just under two million and its generally high degree of economic freedom, we feel Namibia is fertile ground for future growth. Still, inflation remains a concern with surging food prices weighing heavily on consumer sentiment. In addition, households have become increasingly stressed with restrictive monetary policy leading to tighter private sector credit. Nevertheless, we are confident that the nation's heightened fiscal prudence and diversified export base will prove resilient as the country attempts to unlock its full potential.

Mozambique – An emerging economic force. Mozambique has successfully emerged from a state of civil war and is looking to capitalize upon its rich history of economic reform and post-conflict reconstruction. The nation continues to exhibit robust economic growth although its nascent capital markets make it difficult for managers to convert expanding multiples into profitable investment opportunities. Change appears to be on the horizon as increased privatization and emergence of the Bolsa de Valores de Maputo (BVM) will provide investors with fresh opportunities for investment. In fact, the BVM is expected to soon serve as home to two new listings in the form of state-owned enterprises CMH (natural gas production) and M-Cel (wireless telecom). Generally speaking, we view Mozambique as an infrastructure play with excellent upside as the economy is coming off a very low base. The nation is presently a net exporter of electricity, the Cabora Bassa Dam has 2,400 MW of installed capacity, 70% of which is exported to increasingly power-starved Southern Africa. In addition, Maputo's emerging port system provides an alternative trade route for landlocked nations such as Zambia and Zimbabwe.
Mozambique's importance as a transport conduit is further solidified by recent road infrastructure initiatives, including World Bank approval of a USD 100m credit facility for continued development. We are further encouraged by growth in the nation's mining sector as recent investments by Compania Vale do Rio Doce and Kenmare Resources have proved both profitable and sustainable. Risks to the outlook include a high level of poverty, increased vulnerability to natural hazards (e.g. cyclones, floods, drought, et al), food & energy price inflation and uncertainty surrounding the nation's first provincial assembly elections. Nevertheless, Mozambique offers an overwhelmingly positive risk/reward profile for those managers in search of deep value opportunities.

Consumer Markets – The rise of the middle class. Although developed economies have historically exhibited widening income inequality, we find the opposite to be true in Africa. Within many African nations, income distribution is narrowing and middle class formation appears to be accelerating. As such, we are fond of consumer-driven sectors such as breweries, household products and food producers. Far from being a defensive sector, consumer shares had been trading at unsustainably high P/E multiples only a few months back. Yet valuations have corrected sharply and current multiples are much more sustainable. Risks to the outlook include margin pressure from rising input costs, affordability issues tied to declining disposable incomes, and spillover effects from slowing economic growth. From an operational perspective, we will continue to monitor sales volumes as they follow two years of above-average pricing. From an investment perspective, earnings expectations remain high and share prices may be prone to downside risk.

Wireless Telecommunications – Still a growth market. Our research implies mobile penetration in Sub-Saharan Africa is currently between 15 – 20% tele-density. Over the next five years, penetration rates are expected to more than double before leveling off in the 40 - 50% range, implying an aggregate subscriber base of more than 400 million individuals. Subscription growth will continue to be driven by cheaper handsets, declining infrastructure costs, and growing acceptance of SMS technology as vital to everyday life. Note that SMS technology has fueled significant productivity gains across the region as the rise of mobile banking and data services has led to greater household efficiency and improved access to information. Risks to the outlook include deterioration in mobile ARPU as rising inflation continues to weigh on household purchasing power and EBITDA margin erosion due to regulatory issues / increased competition. From an operational perspective, we will continue to monitor usage levels in Nigeria and Kenya as these two nations account for roughly half of Sub-Saharan Africa's total mobile telecom revenue. From an investment perspective, we will look for opportunities to participate in regions where subscriber penetration is set to rise from an abnormally low base (e.g. Ethiopia, Malawi, Rwanda, et al).

Conclusion

From a macroeconomic perspective, the case for investing in Africa is overwhelmingly bullish. In truth, we are unable to identify a region whose underlying opportunity set carries more positively-skewed risk/return profiles. From a diversification perspective, the case is equally compelling as the region exhibits low correlation to both developed and emerging market asset classes.
Nevertheless, the African capital markets are still immature and carry significant operating risk.
As such, investors looking for direct market exposure are wise to invest alongside locally-based portfolio managers with a strong track record and experienced management team. In addition, we would look to enlist managers who maintain diversified country risk and whose investment edge remains independent on the commodity «super-cycle».
After all, the investment themes which are more likely to prove sustainable over the long-term are those which take advantage of structural, economic and political improvement across the region.