African Intelligence Report

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Sub-Saharan Africa

After a very strong April, May was rather more subdued. There was a decline of 3% for the MSCI Africa ex South Africa index. This index is now down by over 16% in US dollars over the past twelve months. Looking at some of the markets in US dollars over the past year, we note that Kenya was up by 3%, Botswana by 2.2%, whilst Nigeria was down 30% (22% being currency), Mauritius fell 19%, Morocco fell 14%, Zimbabwe by 12% and Zambia by 7%.

Buhari was finally sworn in as President of Nigeria at the end of the month. As we write, there has yet to be an announcement of his cabinet or advisors. Rumours suggest that he might take on the role as Minister responsible for the oil sector himself. Two weeks ago Nigeria ran out of petrol and diesel which all but stopped the economy in its tracks. Since Nigeria generates so little electricity, businesses rely on generators which of course need petrol and diesel! Domestic airlines were grounded whilst international flights had to fly via other international airports to load up with aviation fuel. We would therefore expect that the second quarter will see a sharp slowdown in revenues and profits for many companies in Nigeria. We are looking beyond short term earnings trends however and as such would rather focus on the reform agenda of the new Government going forward and how successful it might be. This will ultimately determine the direction of revenues and earnings in the years to come.

The Kenya shilling came under pressure during the month, falling by 3.6% against the dollar. Up until recently, the shilling was devaluing only to a small extent relative to the US dollar implying a sharp appreciation against the Euro, the currency of its main trading partners. At the end of April the shilling had devalued by 8% against the dollar but had appreciated by 15% against the Euro. The Central Bank recently left its interest rates unchanged but has since brought forward its next MPC meeting, we suspect to review the decline in the currency. They will want to avoid the experience of 2011 when the currency fell sharply forcing them to raise rates aggressively to deter the speculators. We would expect to see rates rise as a result. That said we believe that the Central bank will be happy to see some depreciation against the Euro in the months ahead but in a controlled manner. President Kenyatta also announced his nomination for the new Central Bank Governor to replace the current one whose term expired in March. His nominee has worked with the IMF for the past twenty years, most recently for the deputy MD so should be well qualified for the post. Parliament will need to ratify the nomination.

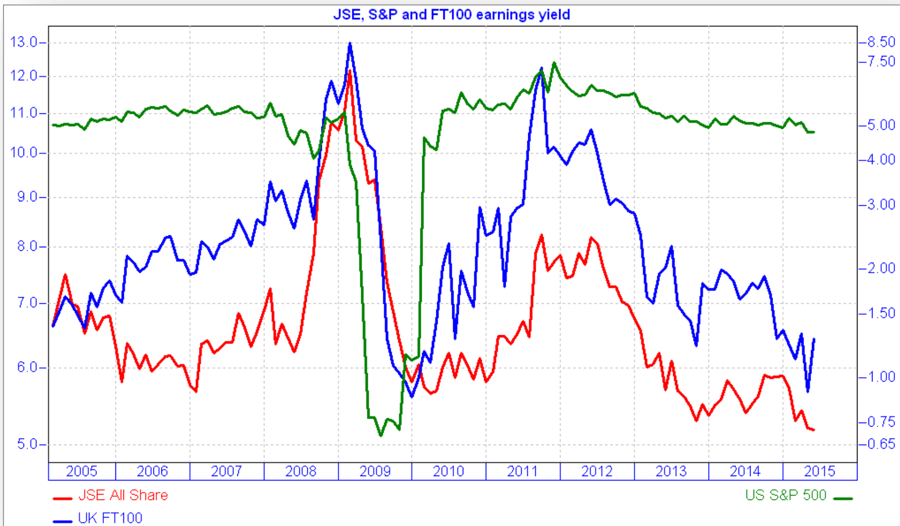
In Egypt, CIB announced very strong first quarter numbers with net income rising by 38%, well ahead of expectations. This was primarily driven by higher loan growth of 25% together with growth in fee income. They increased their loan loss provisions to be conservative. Analysts have revised their earnings. CIB is now on 10x 2016 earnings with a high ROE of 28%.

We will be visiting Zambia this month which should be interesting from both a micro and a macro viewpoint.

South Africa

The search for yield is likely to continue for now

Monetary policy is creating market overshoots on a global basis as investors continue to search for yield. The overshoot is particularly acute in equity markets



Source: I-Net Bridge

due to negative real long bond yields in developed markets.

Local bonds and equities remain at record levels owing to continuing strong support from foreign buying because of attractive local yields relative to developed markets. This is unlikely to change anytime soon as there is little pressure for both the FED and the SARB to start hiking rates in the short term. But, interest rate hikes will eventually materialise, albeit gradually, and a correction in asset prices is highly likely nearer to the event.

As can be seen in the chart above, the gap between the earnings yield of the JSE and long bond yields has widened to 2.6% after being as low as 1.4% in the beginning of the year mainly due to a sell-off in local bonds following comments by the FED that asset prices are inflated. The equity risk premium for local equities compares to 3.2% for UK stocks and 2.8% for US stocks making us relatively more expensive. The gap could well narrow (bond yields declining) in the short term if US economic data continues to disappoint and the FED decides to postpone interest rate hikes.

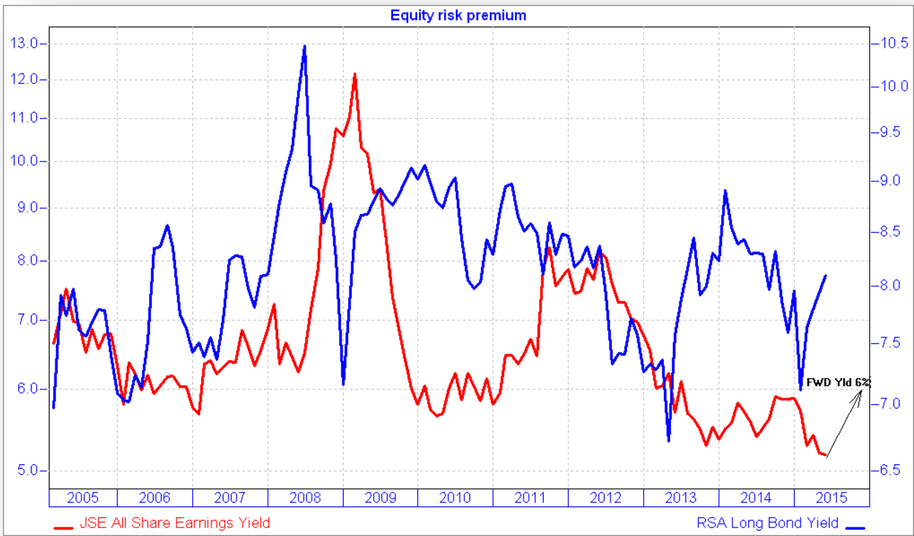
Despite local equities trading at record low yields (record high PE's) it's likely that our market will remain elevated in the short term as foreigners continue searching for yield. Approximately 40% of the JSE and local bond market are owned by foreigners.

Comparing the JSE earnings yield with those of the UK and US markets, the local market appears more expensive that the UK market but slightly less expensive than the US and interestingly is more correlated with the UK market, likely due to the large number of our dual listed mining and industrial counters.

The JSE currently trades on an earnings yield of 5.2% compared to yields of 6.5% and 4.8% respectively for the FT100 and S&P 500. It is worthwhile pointing out though that expected earnings growth for the local market is higher than the UK and the US. So, on a forward basis, valuations do not appear that onerous, particularly if rand weakness sets in again, as far as earnings growth is concerned.

Uncertainty about what is priced in around an interest rate hike by the Fed has caused heightened volatility in equity markets globally and is likely to continue in the near term.

The latest decision by the SARB to leave interest rates unchanged was accompanied by a more hawkish stance on the outlook for inflation and the timing of rising interest rates locally. In its comments, it now seems certain of a FED hike this year and is expecting a potential fallout in markets and the local currency (thus higher inflation) when this happens due to foreign disinvestment flows. It now seems that the SARB is willing to act on the strong assumption of a hike by the FED instead of acting after the event, in order to prevent a sell-off in the currency and markets as well as to thwart a vicious inflationary spiral.



Source: I-Net Bridge

To quote opening remarks from our latest MPC meeting: "*The challenges facing monetary policy have persisted, and, as expected, the downward trend in inflation which was mainly attributable to the impact of lower oil prices has reversed. Headline inflation is expected* *to breach temporarily the upper end of the target range early next year, and thereafter remains uncomfortably close to the upper end of the target band for most of the forecast period. The upside risks have increased, mainly due to further possible electricity price increases. The exchange rate also continues to impart an upside risk to inflation as uncertainty regarding impending US monetary policy continues. Domestic demand, however, remains subdued while electricity constraints continue to weigh on output growth and general consumer and business confidence".*

Nigeria

The MSCI Nigeria Index fell by 1.0% and 1.1% respectively in US dollar terms. The Naira was stable at around N200 to the US dollar.

President Muhammadu Buhari was sworn in on May 29th so it remains too early to gauge the nature of any new administration. Various names have been mentioned as potential cabinet ministers but no one has been confirmed. The current rumour is that the president himself will take on the role of oil minister presumably as part of a hoped-for reform programme. However, there is no denying the uphill battle that Buhari faces despite winning power in 20 of the 36 states partly because the opposition governors control the oil producing areas. A crippling strike by oil marketers demanding payment of subsidies brought the economy temporarily to its knees this week and adds to the sense of crisis caused by the fall in the price of oil. Banking and phone services stopped for example as offices/telecom towers are all powered by generators. An early removal of the petrol subsidy is being urged and this may possibly have more success than Jonathan's attempt in 2012 which was met with riots now that the scale of the corruption associated with it is understood. [Essentially, petrol is imported at subsidised rates then re-exported to neighbouring countries – on an industrial scale.] There is also a general expectation of a devaluation to around N230 (from N200). Economic growth was 3.9% in Q1 2015 vs. 6.2% y-o-y.

As part of an offensive against Boko Haram, the president's first move, even before forming a cabinet, has been to announce the re-location of Nigeria's military command centre to Maiduguri in Borno State (in the North East) from Abuja. He is also currently visiting Niger. Rather curiously, Buhari suspended Order 79 (1) of the Senate Standing Orders which requires that Bills must pass three readings on the Senate floor before being passed. The Senate then passed 46 bills into law in less than 10 minutes mid-week. Whilst we all wait to see what has been passed, the implication is that President Buhari is going to rule with an iron fist.

Unilever Plc is bidding for 25% of Unilever Nigeria at N45.5 per share to add to its existing 50.1%. This bid was made when sentiment about oil, the Naira and the election was at its lowest ebb so although the price was at a premium to the then share price of N34, N45.5 is actually the average price over the period since January 2012. 2012 was also a good year for Unilever until the petrol price hit consumer demand and Unilever's earnings for six. What price can be justified? Slotting peak 2012 margins into our model and assuming the 10 year bond yield returns to its pre-oil price fall level, then our calculated fair value is about the same as Unilever Plc's bid price. This model assumes a long term growth rate of 8% - which sounds high but is the same as inflation i.e. there are no real price increases and no wealth effect caused by the emergence of the middle classes – people might brush their teeth twice a day rather than once, for example, or use other products in the Unilever range. A big uplift in fair value comes if any of the components of the weighted average cost of capital are changed. If the equity risk premium for example is changed, fair value rises quite quickly. Why would we want to change the equity risk premium? The risk premium is the return required to compensate for risk above a risk free rate; it could be reasonable to argue that a brand like Unilever (listed in Nigeria since 1973) is lower risk than holding government paper. The sell-side arbitrarily uses a 5% risk premium; at 2.5% we derive a value above N55 per share and at zero ie looking at Unilever Nigeria as a perpetuity, a value of N75 per share. DCF valuations can be greatly abused as fair values are very sensitive to the discount rate as we have shown above, but overall, our view is that the price Unilever Plc is paying reflects the cyclical recovery to come but ignores the potential of the parent pumping a much greater part of its product range through Unilever Nigeria's extensive distribution channel as the middle classes develop.

Zimbabwe

Another quiet month characterised by very low turnover once again. The ZSE index fell by 2.1%. Whilst the month witnessed low volumes a number of companies reported either at AGMs or at results announcements. Masimba which is a construction company, a manufacturer of plastic piping and a property developer, sought and gained approval to unbundle its Proplastics division by means of a dividend in specie that will be listed on the Stock Exchange. That will then enable that company to raise new capital from a technical partner to expand production to serve both Zimbabwe and the region utilising new more effcient machinery. There is no doubt that demand for plastic piping for irrigation, municipal upgrades and residential use will remain strong in the years ahead. Meanwhile the construction business will assist the property development until such time that large scale construction projects become a reality. The stock rose by 25% but remains at a considerable discount (over 50%) to its net asset value.

At Edgar's AGM, the Chief executive gave a trading update that was remarkably upbeat given the tough consumer environment in Zimbabwe at the moment. Retail sales are up 8.8% over the first four months of the year whilst unit sales are up by 12%. This is on the back of an increase in credit sales in their stores which is significantly boosting financial income of the company. Profits after tax are up 212% on the previous year which is well ahead of expectations. The stock trades at a PE of under 6x so remains cheap.

On the other hand, Zimbabwe's largest supermarket chain, OK Zimbabwe, announced its annual earnings to March that reflect the weak consumer environment for cash sales in the formal sector, as against the informal sector that continues to grow. Revenues fell by 4% whilst profits after tax declined by 22%. Their own internal pricing models suggest that they have been experiencing deflation since July 2013 and over the last year deflation has amounted to 3%. Operating expenses were up 3% but entirely driven by higher depreciation as new stores and refurbishments are completed. EBITDA was down 10%. The supermarket sector is becoming increasingly competitive with new entrants into the formal market, combined with the informal market seeing a growing number of street vendors, often in close proximity to the shopping centres. On historic and depressed earnings per share, the stock trades at under 15x and yields 3.5% which is low relative to the region.

Dairibord management also gave a better than expected report back at their AGM, despite the difficult operating environment. Revenues for the first quarter increased by 6% on the back of a 22% increase in volumes, mainly coming from their beverage division. Operating profits were up 1%. In 2013/2014, management took some large one-off restructuring costs in order to improve efficiencies. Costs remain under control in a deflationary environment.

Delta reported their year end results which were anticipated given their now quarterly trading updates. Volumes overall were down 2% but revenues fell 4% as consumers shifted from the higher margin lagers to sorghum beer which saw volumes rise 8%. Attributable profits fell by 13% but cash generation remains strong enabling the Board to approve a higher payout ratio and hence an increased dividend for the year. Lager volumes are off 600,000 hecto litres from their peak just two years ago so when demand recovers profits should recover rapidly on a more effcient cost base. Delta trades on 14x historic earnings, yielding 3.5%, a large discount to regional peers.

Finally Econet reported poor figures thanks to increased excise duty on airtime (attempting to tax the informal sector) and a forced reduction in call rates by the regulator (35%) which did not result in more usage. Growth in data softened the blow but still net profits declined by 40% although EBITDA was down only 14%. The stock is on an historic PE of 10x, yielding 2%. Cheap by regional standards.

East Africa

The dollar remained buoyant, backed by strong economic indicators in the US that bolstered the case for the Federal Reserve to raise interest rates later in the year, the Euro weakened further owing to persistent woes in Greece and signs of fatigue with austerity among the Spanish public. Except for the Rwandese Franc, which strengthened by 1.7%, all other regional currencies weakened against the USD. The Kenya

Shilling, Mauritian Rupee and Uganda Shilling declined by 3.1%, 2.4% and 1.4% respectively.

After a 3-month wait, Kenyan President Uhuru Kenyatta nominated International Monetary Fund (IMF) advisor, Patrick Njoroge, as the next Governor of the Central Bank of Kenya (CBK). Other nominees to substantive positions at the CBK include Harun Sirima, current Deputy Governor, and Sheila M'Mbijiwe, a banker and former member of the Monetary Policy Committee (MPC), as deputies, and Mohammed Nyaoga, a seasoned lawyer, as CBK board chairman. The nominations come at a time when the steady weakening of the Kenya Shilling vis-a vis- the US Dollar (7.2% YTD) had seen the CBK step up its monetary operations to intervene in the foreign exchange market and bring the periodic MPC meeting forward by one month to 9th June 2015. The MPC, which meets bi-monthly to discuss the monetary policy stance, held its last meeting on 6th May 2015 and retained the Central Bank Rate (CBR) at 8.50%, citing lack of demand-driven inflation and a stable shilling. Meanwhile, an IMF mission noted that the country's gross international reserves, equivalent to USD 7.3bn as at end of May, remained adequate.

The weakening shilling continued to take its toll on the Nairobi Securities Exchange (NSE), as foreign investor portfolio outflows continued to dominate trading activity. The FTSE NSE-15, FTSE NSE-25 and NSE-20 indices dropped by 9.1%, 3.1% and 8.9% respectively, all in USD terms. Year-to-date, the indices have respectively declined by 7.6%, 1.9% and 13.1% in USD terms. Equity Bank commenced implementation of its 10-country Pan African expansion strategy by announcing the acquisition of a controlling interest (79%) in ProCredit Bank DRC. ProCredit Bank has been in operation since 2005 and had total assets, shareholder funds and profit after tax of USD 213 mn, USD 26m and USD 2.6 mn respectively in FY14 and market share by total assets of 4.7% in 2013. Meanwhile, Centum Investments received regulatory approval for listing of its USD 62 mn bond through issuance of fixed-rate and equity-linked notes at the NSE. The notes will be senior unsecured fixed rate bonds (13% p.a.) and unsecured equity linked notes comprising a fixed rate component at 12.5% p.a. and a variable component with an upside of up to 10% of the redemption price-subject to a 25% increase of Centum's NAV at maturity. In positive news for East African Breweries, a new law now grants a higher excise duty waiver of 90% for beer made from sorghum, millet or cassava grown in Kenya. The new rate is a significant increase from the current excise tax waiver of 50%, and should result in improved sales for the company's low-end product, Senator Keg, which prior to June 2013 (when the excise duty waiver was reduced from 100% to 50%) accounted for 15% of total beer sales. The lowering of the tax waiver had resulted in a steep price increase and massive reduction in beer volumes.

The IMF expects Uganda's economy to expand by 5.8% in FY15/16, up from 5.3% the previous year, boosted by scaled-up public investments and a recovery of private consumption supported by stronger credit growth. The government is at various stages of implementing several multi-billion US Dollar infrastructure projects, including hydropower dams, a refinery, express highways and a railway line. The Treasury estimates economic growth of 5.3% in FY14/15, from 4.5% in FY 13/14. As with prior trends, the looming 2016 General Election remains a major source of concern, with the IMF noting that it was crucial for the country to contain spending pressures. Last month, core inflation increased to 4.6% from 3.6% in March but is likely to remain within the Central Bank's medium-term target of 5%. In April, the monetary authority raised the policy rate to 12% from 11%, in part to slow the rise in inflation and support the Uganda Shilling, which YTD is down 7.5% to the USD. The country is expected to start pumping crude oil from its oil fields in 2018 and will leverage these projects to maximise benefits from the burgeoning oil industry and accelerate the pace of industrialisation.

In Mauritius, higher exports resulted in the narrowing of the country's trade deficit by 3.4% from a year earlier, to US$ 151 million in March. The value of exports increased by 18.3% while imports rose by a smaller margin of 9.2%. The United Arab Emirates was the main buyer of goods from Mauritius, accounting for 22.5%, while China supplied 20.4 % of the nation's imports.

Rwanda continues to receive plaudits for upholding prudent economic policies and implementing reforms that have delivered satisfactory economic performance. Following the third review of Rwanda's economic performance under the 3-year Policy Support Instrument (PSI) program (which is designed for low-income countries that do not need or may not want financial aid to boost their balance of payments) the IMF noted that the country's economic outlook was stable with strong economic performance expected in 2015. The IMF singled out the 2015/16 budget framework for prioritizing public investment in line with available resources, including measures to improve domestic revenue mobilization, protect priority spending and limiting the crowding out of credit to the private sector.

Resources

The MSCI World Commodity Index fell 4.3%. The pullbacks largely nullified last months' exuberance as subsequent economic data provided no hint of a sustained turnaround in global infrastructure expenditure. We believe that the 'commodity world' is overly reliant on China and that production cutbacks by miners are necessary to rebalance demand/supply across most commodities.
It is four years since commodities and resource share prices peaked in May 2011. The ongoing pressure on commodity prices has seen the worldwide mining industry refocus on operating practices and skills. Miners are desperate to squeeze out efficiencies and lower costs just to survive. As part of the survival process, companies are also reducing capital and exploration expenditure and unfortunately retrenching staff. As we have indicated in previous monthly communiques, such actions are necessary to rebalance the demand/supply equation. We suspect that these survival tactics will continue for most of 2015.

Mysteel reports that over the past month the all-important Chinese steel market softened as local prices for major steel products fell further and capacity utilisation dipped to 86.6%. This has obvious negative implications for the prices of steel inputs: metallurgical coal and iron ore. Already Chinese met coal imports for January to April are down 25% and the global iron ore supply market looks like a war-zone: Vale has just reported record Q1-2015 production of 74.5mt; Rio Tinto will add another 55mt to global seaborne supply in the coming months and BHP Billiton will add another 50mt by 2017; Anglos' Minas Rio will add 11mt this year and another 14mtpa in 2016; and Roy Hill mine in Australia is projected to add 55mtpa from late 2015 onwards. The only conclusion is that the over-supply of iron ore will persist unless the price falls significantly from the current level of around $62/t. Some good news is that Chinese iron ore production for January to April reduced by 11.8% or 52mt.

The plight of many global miners is no better illustrated than by where the South African gold mining industry currently finds itself; add the old platinum miners on the western limb to that list as well. From peak annual gold production of 1,000 tonnes (32,2mozs) in 1970, South Africa will only produce around 160 tonnes in 2015. Many of these deep, narrow seam old gold and platinum mines fight a daily cashflow battle to survive. The reality is that most of these mines are 30-50 years old. With the benefit of hindsight it is fair to say that the industry has over-relied on a model of low-cost / low-skilled, migrant labour for too long. The narrow ore seams (<100cms) of the gold and platinum mines proved difficult to introduce new equipment and technologies. However, the great lesson for all businesses is that you fail to embrace technology at your peril. If the rand gold price does not increase timeously, there is a risk that towns such as Welkom, Klerksdorp, Carletonville and Westonaria will turn into ghost towns within the next five odd years.

Over the past two years Baobab Mining (20 – 1.2%) has tried desperately to raise funding for its pig iron plant in Mozambique, but has eventually succumbed to an offer from the African Minerals & Development Fund. Lack of support from traditional long only equity investors is allowing private funds to snap up opportunities such as Baobab.

Randgold Resources (8 – 4%) reported a 35% year-on-year fall in earnings for the March quarter on the back of flat gold output at 280kozs, higher exploration and corporate expenditures and a 6% fall in the gold price. Total all-in costs increased 3% to $708/oz due to tight controls. However, more importantly, cash from operations increased by 50% to $102m. For us the most encouraging news is that after years of planning, Randgold is now a step away from mining underground using remote surface controls at its Loulo Gold Mine in Mali.

Aureus Mining (20 – 0.9%) was formed in May 2011, announced a DFS gold reserve of 860kozs in May 2013 and poured its first gold last week at its New Liberty Gold Mine in Liberia. All of this whilst the country was ravaged by Ebola! The $175m equity/debt funded project is forecast to produce about 120kozs per year for the first six years of the expected eight year life of mine. The project has an expected 3.7 year payback and a NPV10% of $250m, which compares to the market capitalisation of $165m.