IMARA
Asset Management

Investment Note
African Equities – An Investment Opportunity

Date: **January 2016**

Issued by: **Imara Asset Management Limited**

Powerful investment themes are driving the African markets:

» **Growth**
» **Reform**
» **Socio-political improvement**

Combined with the fact that African equities:

» **Look cheap after a sharp bear market**
» **Have a low correlation with other equity markets**

Executive Summary

1. Corporate management in Africa is often already world class, which means they are able to take advantage of the improvements to the inefficiencies that exist in infrastructure, political leadership, economic management, productivity, and the rule-of-law.

2. Structural reform can be a powerful investment theme; investment opportunities exist when economic stewardship improves.

3. Global equity markets are currently in turmoil, but Africa and the Emerging Markets (EM's) have been in a bear market for some time.

	PE 2016	PE 2017	Dividend Yield 2016
MSCI Africa ex-SA	8.6x	6.9x	5.0%
MSCI Emerging Markets	10.6x	9.1x	3.3%
MSCI World Index	15.0x	13.4x	2.8%

Source: Bloomberg, January 2016, estimates. Actual results may differ from estimates

Africa now trades on about half the rating of the Developed Markets (DM's) and nearly twice the yield. African equities look cheap compared to the EM's.

4. Africa ex-SA equities have a low correlation of around 0.40 using 3-year monthly data with the EM's and 0.25 with DM's[2].

5. A strong US trade-weighted dollar is a hostile environment for EM equities because of high levels of debt. This is not so for African markets because of lower foreign debt levels.

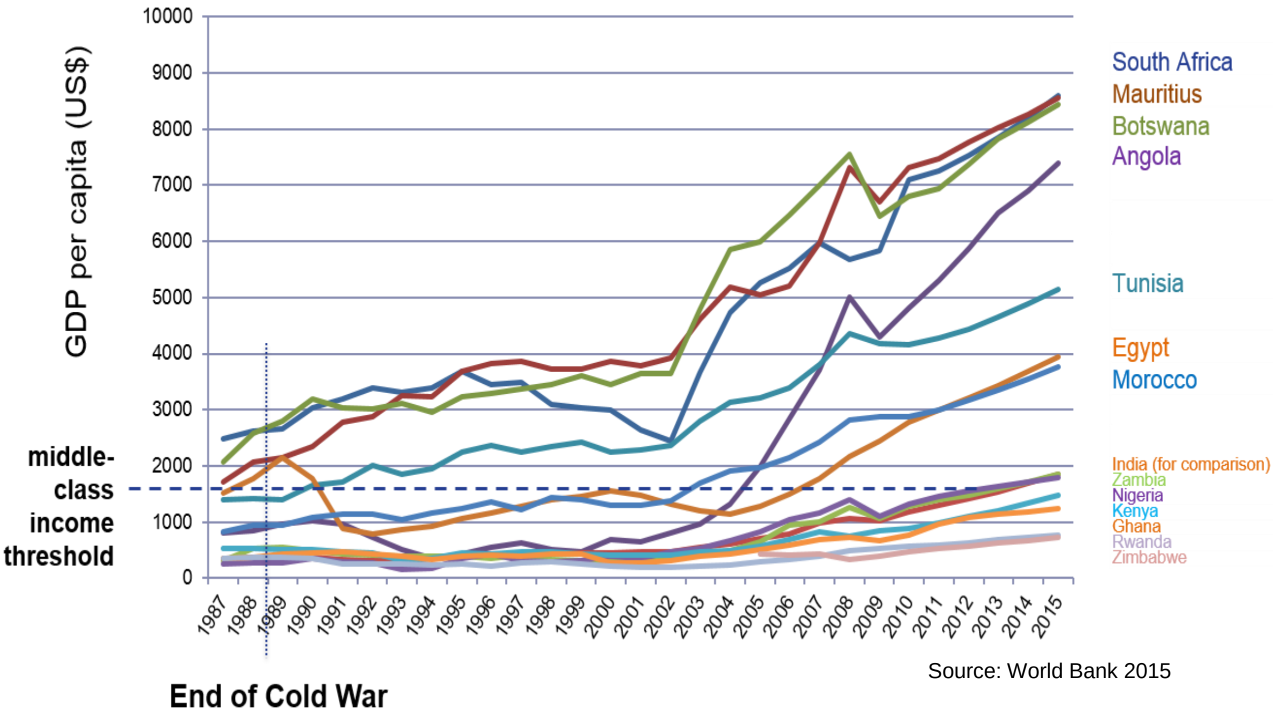
IMARA
Asset Management

1. **The end of the Cold War, in 1989, led to better economic management in sub-Saharan Africa: fiscal deficits fell, inflation fell, interest rates fell, economic growth rose, investment rose and debt fell.**

   After 1989, following the fall of the Berlin Wall, the United States and Russia were no longer willing to support corrupt Governments which forced many African regimes to accept the economic reform programs demanded by the IMF in exchange for financial support.

2. **Economic growth then accelerated from the early 2000's onwards**

   Africa has achieved an average growth since 2000 of 9%, compared to 5% for the World and 3.7% for the High Income OECD[3]. This graph shows the GDP per capita growth of various African economies since 1989 as well as India for comparison.



Source: World Bank 2015

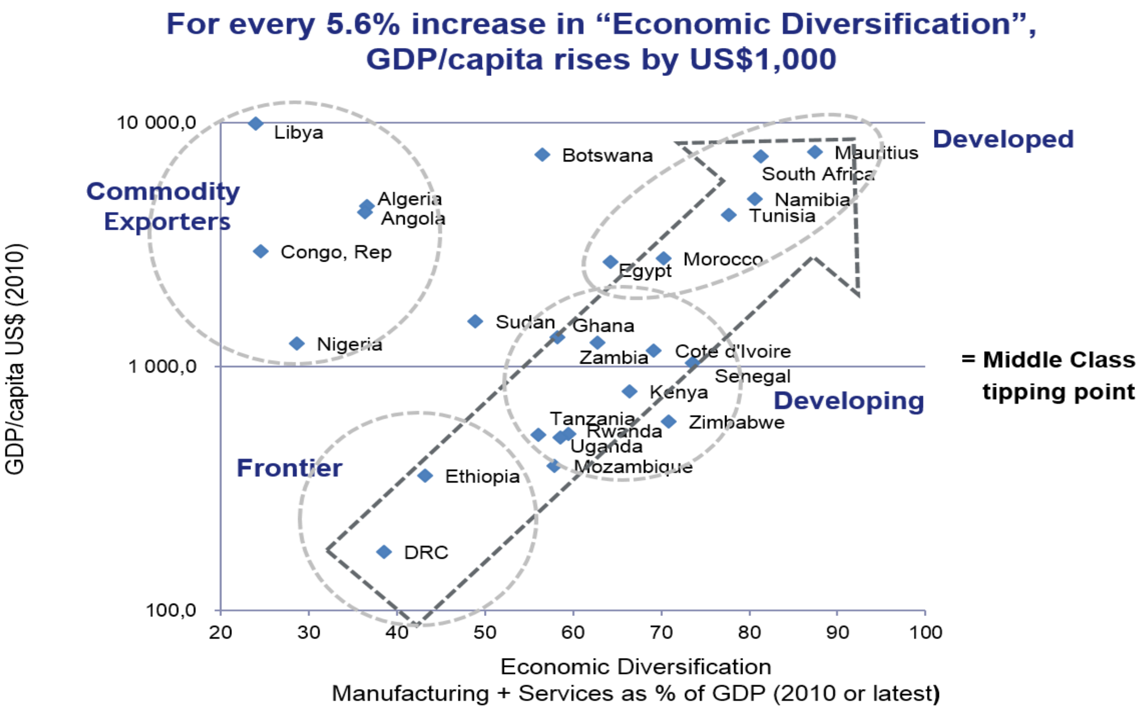
3. **Economic diversification and industrialisation is driving higher income**

   As the graph below shows, many countries in Africa have moved away from being dependent on commodities with their GDP growth being driven by manufacturing and services. 18 countries out of the 54[4] have over 50% of their GDP coming from manufacturing and services. Only 6 countries in Africa are still heavily dependent on commodity exports.

   For example, Tunisia is now among Europe's top ten suppliers in electrical wiring systems used in auto components[5]; Morocco has a growing car manufacturing industry

(PSA Peugeot Citroen); Al Arafa, a large Egyptian luxury garment manufacturer, has a 14% market share of the UK suites market[6].

In our view many of these 18 countries offer some of the best investment opportunities.



Source: McKinsey, World Bank 2013

4. The Wealth Effect - where consumption rises faster than average income as the Middle Classes develop - is starting to be a powerful theme in Africa

The middle classes and disposable incomes are growing, and with this growth an appetite for consumer goods (cars, insurance products etc).

Placing a number on the size of the middle classes in Africa is tricky, estimates range from 15m to 313m[7].

However, the middle classes are measured, three factors are clear:

» Demand for middle class items is growing: as people become richer they demand a greater variety of goods.

» The public sector is an important constituent of the middle classes, so better economic management since 2000 has been important.

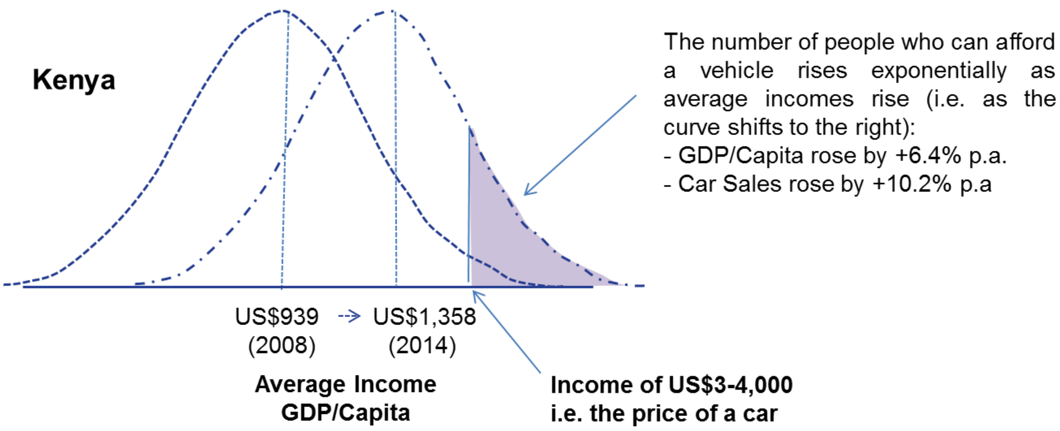
» A large proportion of the population lives on the fringes of the middle classes; one shock – such as a bad drought – can have painful consequences. The growth of the middle classes is best seen as oscillations around an upwards-trending line.

Car ownership in Nigeria is 31 per 1,000 people[8] compared to 17.6 per 1,000 people in India (excluding 2 wheelers). Egypt has 46.9 cars per 1,000 inhabitants whilst Zimbabwe has 113. China by comparison has 170 per 1,000 people.

Guinness sales in Nigeria overtook those in Ireland in 2013[9].

The insurance market in Kenya grew by 20.4% last year and by 20.3% the year before[10].

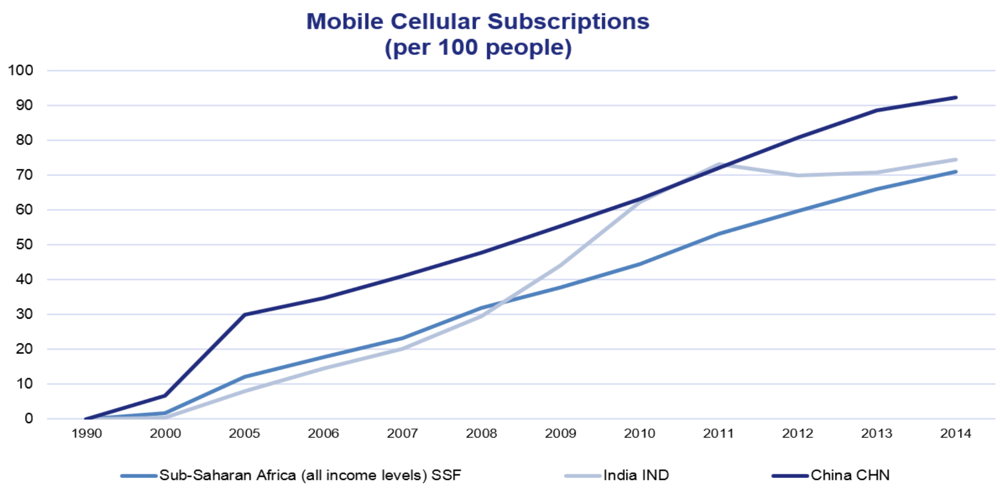
This graph demonstrates the Wealth Effect in Kenya.



Source: World Bank Group, Kenya National Bureau of Statistics 2015

5. **In Africa, leapfrogging old technology increases productivity and is helping countries to develop and industrialise**

Mobile phone usage has grown by 34% compound since 2000. There were 683m mobile phone users in 2013, most of the adult population[11]. 19% of the population are internet users[11].



Source: World Bank 2015

Companies that benefit from leapfrogging technology are likely to produce strong earnings' in the medium term.

6. Socio-economic reform creates opportunities for significant equity returns, similar to Latin America in the 1990s

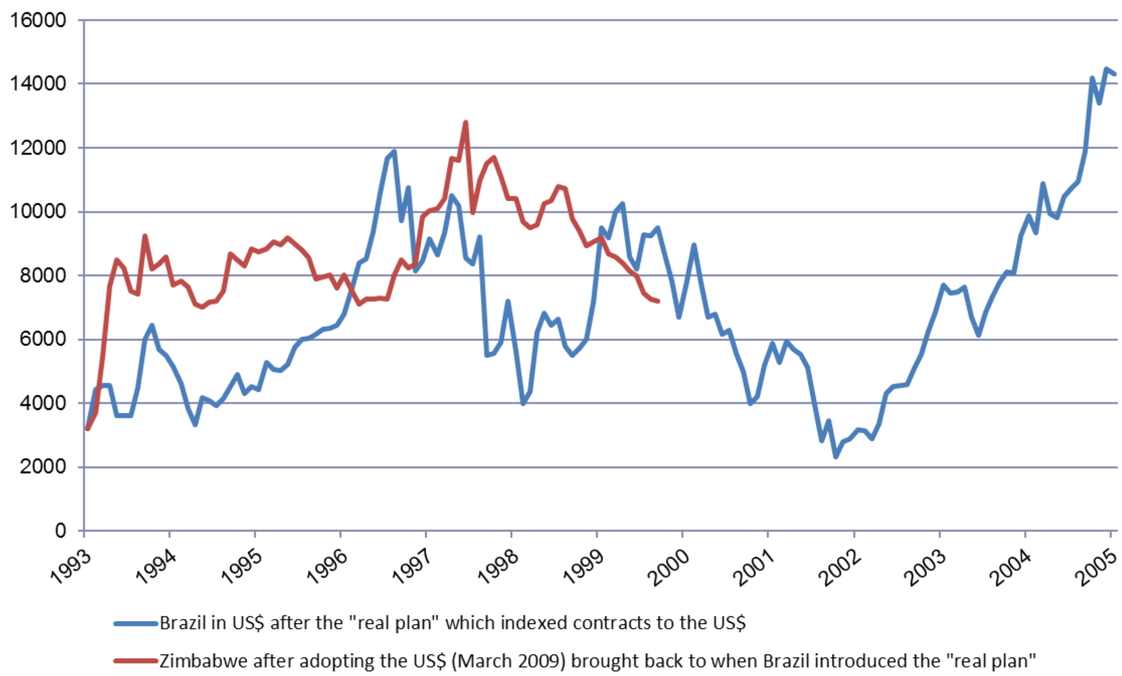
Following the implementation of the *real Plan* in 1994, Brazilian equities rose by 3 times over the following 3 years (see graph below).

Zimbabwe and Nigeria have the potential to offer these similarly high returns as a result of reform – Zimbabwe from political reform while Nigeria will benefit from reform to its industrial sector.

Zimbabwe dollarized in February 2009, which was a significant reform as the population suddenly had a currency that was not only a means of exchange but also a store of value. For example, despite people receiving "lower" wages they could now save to buy a car - evidenced by worsening traffic jams. As well as removing currency risk, it has also meant that the Government has had to run a balanced budget.

There are growing signs that the extremely difficult political environment is changing and that the IMF/World bank will restructure Zimbabwe's debt combine this with the fact that Zimbabwe is the only African country with the US dollar, should create, in our view, an environment for strong returns.

This graph shows the performance of the Brazilian stock market after the implementation of the *real Plan* (1994) compared to Zimbabwe after dollarization (data shown from March 2009 – November 2014). Zimbabwe has the potential to replicate Brazil.



Source : Bloomberg January 2015

Nigeria's new president is looking to implement a number of industrial reforms:

The Oil sector – up-stream (restructuring the NNPC, Nigeria's regulator and oil company), down-stream (potentially changing the subsidy system), and mid-stream (e.g. encouraging fertilizer, refining of oil and natural gas).

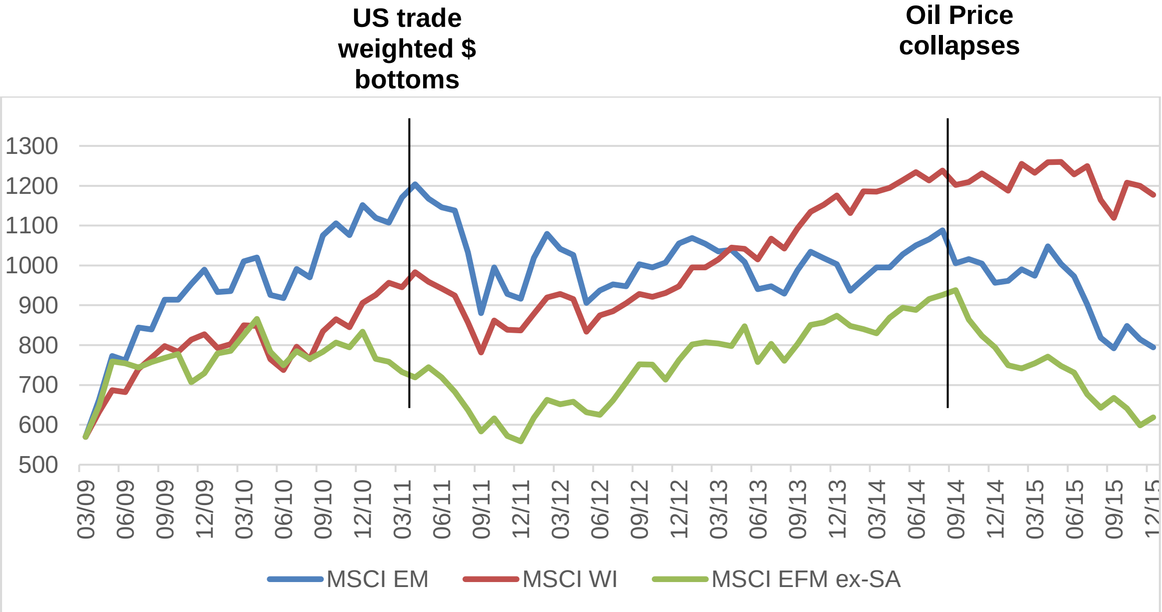
Electricity – roughly 80% of Nigerians rely on alternative source of power[12], mostly diesel generators. A regular supply of electricity from the grid should reduce costs throughout the economy by 40% based on the cost to generate power by a diesel generator vs. conventional gas or coal fired power plants.

Agriculture – by re-establishing the value chain in a range of commodities in which Nigeria has strong competitive advantages. These value chains were destroyed historically as government involved itself in pricing i.e. providing subsidies to farmers for gerrymandering purposes. Nigeria has already started exporting Palm Oil for the first time in years.

7. African equities, unlike EM equities are resilient to a strong US dollar

EMs have historically suffered during periods of a strong US dollar because most of the EMs have high levels of US dollar debt. Since the US dollar began strengthening in early 2011 EMs have been flat or down.

However, after an initial fall, African markets rose thereafter in line with the DMs, until the oil price collapse at the end of 2014. EM's remained flat (see graph below). This is because Africa has much less US dollar denominated debt than EMs. African Governments had not built up large deficits pre-2008; companies and individuals had not borrowed significantly. African countries have debt levels up to 50% of GDP whereas in the Developed world it is often significantly in excess of 100% of GDP.



Source: Bloomberg Jan 2016

8. African share prices have however responded negatively to the failing oil price, now making African equities particularly cheap (see green line in graph above)

The Africa ex-SA index has fallen by 34%[1] since June 2014 when the oil price began to fall because 40% of the index is Nigeria. This is despite the fact that African economies in general have benefited from the falling oil price as most are net oil importers. **This index is now close to the low set in March 2009; a moment of extreme stress and panic.**

We feel many high quality stocks, with low leverage, strong earnings forecasts, good dividend yields and high quality management are trading at significant discounts to their fair value.

9. Conclusion

African equities are currently cheap, and because of their low correlation should provide good diversification in your portfolios.

Harry Wulfsohn
Director
Imara Holdings Limited
January 2016

For more information please visit www.imara.com or contact Harry Wulfsohn on harry.wulfsohn@imara.com

IMARA
Asset Management

Note on Imara Asset Management

Imara Asset Management is an African long-only equity fund management business with assets under management of approximately USD500m from a range of institutions and high net worth investors in Africa, Europe and the USA. We offer a number of funds as well as manage bespoke segregated accounts covering Africa ex-SA and Pan-Africa. The key messages being:

» Ten-year track record (one of the longest)
» Fundamental, bottom-up, high-conviction investment style
» On the ground offices in 7 African countries giving us a competitive edge
» Experienced and stable senior investment team
» Fund Managers are invested in the Imara funds

Sources

All Index returns are in US dollars

1. Bloomberg, January 2016
2. Bloomberg, January 2016, under normal conditions
3. World Bank national accounts data, and OECD National Accounts data files. GNI per capita in current US dollars using the World Bank Atlas method, divided by the mid year population.
4. Or 55 depending on the classification of Western Sahara
5. Rouis and Tabor; Regional Economic Integrations in the Middle East and North Africa, World Bank Publications
6. Arafa Holdings H'15 Investor Presentation
7. The African Development Bank estimates 313m (based on a daily consumption of $2-20 - i.e. moving away from a more standard definition of around $4,000). Standard Bank estimates a much lower 15m (based on a Living Standards Measure, which looks at ownership of electrical good and cars etc). McKinsey on the other hand project that by 2020, the number of households with discretionary income will rise from 85 million today to 130 million.
8. Macro Economy Meter; World Bank – World Development Indicators
9. The guardian business section - www.theguardian.com/business/2007/aug/30/9
10. Association of Kenya Insurers
11. World Bank; International Telecommunication Union, World Telecommunication / ICT Development Report and database. Internet users are individuals who have used the Internet (from any location) in the last 12 months.
12. NOIPolls – who partner with Gallup USA