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Investment note - September

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Executive Summary

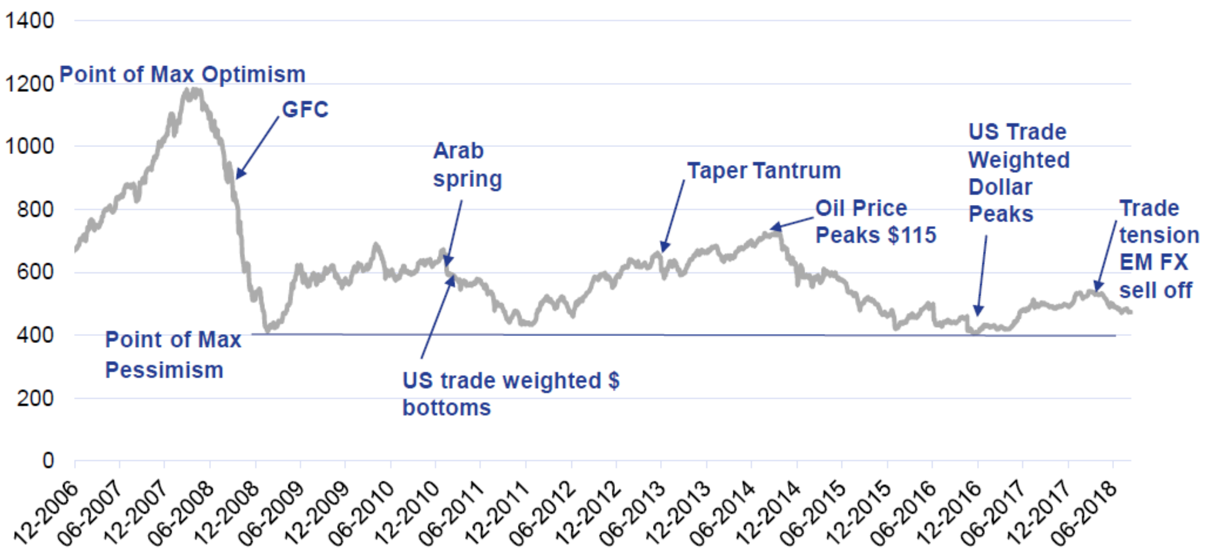
It is important that Africa is viewed through the right lens or it risks being consistently dismissed by international investors. Africa is a youthful, frontier story that has a long runway for growth which is uncorrelated to the rest of the world. The real story is the fortune at the bottom of the pyramid. This market is there right now and it doesn't depend on politicians, commodity prices or even a growing middle class, it depends on finding the right corporate that is sensitive to the consumers' needs and through a multi-year investment in brand equity, route to customer and technology can tap into this with similar economics to their mainstream or premium products due to scale and local sourcing of inputs.

African markets are trading significantly below 2008 and 2014 peaks and near 2008 lows

African markets are trading significantly below 2014 peaks and even further below the 2008 peak, see graph below. If we call the trough reached in 2008 after the GFC the point of maximum pessimism and look across to where the market is trading now, you can see that we are close to this bottom and yet underlying company fundamentals have improved significantly since then, resulting in attractive valuations. There has also been significant currency reform in our two biggest markets Nigeria and Egypt.

Since the beginning of the year MSCI world markets are up +5.3% (mainly US), whilst MSCI Africa is down -4.5%, MSCI frontier -12.4% and MSCI emerging markets -6.9% (as at the end of August).

MSCI AFRICA exSA (USD)



Source: MSCI, Imara 2018

Company fundamentals have improved but Africa still trading at a discount to EM and world peers

Valuations are at attractive levels relative to the world and emerging markets, see the following table:

MSCI (USD)	P/E	P/E + 1	Div %	ROE %
Africa	12.2	10.5	4.8	18.4
EM	13.8	11.3	2.6	12.2
World	19.5	15.6	3.3	12.7

Source: MSCI, SBG Securities, Imara

The fast-growing domestic pension fund industry

Domestic pension assets to GDP ratios are still low at 29% compared to an average of 50% in developed markets (Riscura Bright Africa, 2018). Countries like Kenya and Nigeria have a skew towards fixed income allocations, yet these are youthful populations with labour forces that have an increasingly young demographic. In Nigeria for example 47% of RSAs are less than 39 years old (Pencom 1Q18 report) and less than 10% of the pension fund industry is invested in equities. To meet pension obligations in the long term the allocation to equities should grow, providing domestic support for the equity markets and reducing market volatility.

Africa's young demographics

The African demographic is skewed towards the young, the population pyramid is short, fat and flat. The urbanisation rate is also higher than any other region, this means that there is a young aspirational population that is growing at a faster rate than the rest of the world. With a progressive leadership this can fuel sustainable GDP growth. If the jobs are created to match this urbanisation rate, then in absolute terms the consumption numbers are significant no matter what sector you look at, rising urbanisation means more beer and beverages, more food, more white goods and more data. This kind of thinking is what lends some multinational companies for example ABINBEV to invest aggressively on the continent. ABINBEV calls Nigeria the "jewel of Africa" with an LDA population of 22,7m and an average age of 17,9, there is a long run way for growth. In their most recent investor presentation they estimated the size of the market at 20mhl and it poised to grow in the next ten years to 30m hl.

	Median Population (Age)	Urban (%)	Urbanisation rate (%)
Africa	19.0	40.5	3.6
Middle East and North Africa	25.6	52.0	2.2
Latin America and Caribbean	27.4	80.7	1.3
Asia	26.8	49.9	2.2
Europe and North America	39.2	82.2	1.0

Source: UN, Department of Economic and Social Affairs, Population Division (2018)

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The other exciting thing about this demographic is that it hasn't voted yet. Africa has an age-gap disconnect between the median age of its leaders and its population. You have the average age of leaders being 62 and yet the median population age is 19, an age-gap of 43 years! If you look at the table on the next page you can see that the age gap between leaders and the population is much smaller in other regions. This observation is particularly interesting to us, because not only does the average African not have a vote yet, but he has a very different life experience and world view to the leader that has been chosen for him. The decisions and actions these leaders took were shaped by a liberation struggle, fighting to get freedom from a colonial power. Their voter base reflects this and to an extent they are deeply scarred by colonisation and are likely to vote along communal lines (they follow the vote of their Chiefs), they aren't holding leaders to account as you see in other democracies, they just don't want a return to the colonial past. The youth however, born after the winds of change swept through Africa, have "generational amnesia" or born-free as some people call it, they want jobs and economic liberation. They can't fall back on subsistence farming, they want jobs and they will hold their leaders to account. If I use the example of my daughters, they certainly won't be holding anyone else to account other than me. This is a very powerful backdrop for policy formation that shapes the future.

Age	Leader	Median Population
Africa	62.3	19.0
MENA	65.8	25.6
Latin America	59.8	27.4
Asia	58.3	26.8
EU and North America	55.2	39.2

Source: UN population division, RMB

At a minimum we expect to see policy convergence in some of the younger democracies where parties are aligned in their view that job creation and wealth generation are of paramount importance. Because of the tendency of politicians to manipulate the voice of the poor there will be some speed wobbles along the way, but long term we believe that progressive leadership will emerge. We saw the impact of this recently in Zimbabwe's close election. The policy convergence between Zanu PF and MDC is uncanny!

The underlying bottom-up stories

We mentioned some broad themes above, but what we spend most of our time doing is researching the underlying companies. Investing into companies that are well structured and can tap into buoyant consumer demand for their products. This demand is driven by either new customers in underserved markets, or, offering new products to an existing customer base by taking advantage of brand loyalty, innovation and extensive distribution networks. This demand should be mostly immune to global and country specific macro-economic developments. These companies are in sectors that are growing faster than GDP and are the fastest growing companies in their sector. This virtuous cycle repeated over many years has given these businesses strong barriers to entry and an ability to generate stable ROIC through market cycles.

Africa is at a much earlier stage of development than for example Asia. The biggest opportunity in Africa is the transformation of the informal sector to the formal. Up to 70% of African's operate in the informal sector whether home brew beer, grey goods, subsistence farming, loose milk or cash under the mattress, the theme is the same, capture these revenue pools and both corporates and governments gain. The companies that are sensitive to this consumer at the bottom of the pyramid are the most exciting to us. They are selling affordable products at the right price point and convenience to attract this previously underserved consumer, for example to start buying beer as opposed to making it at home or to start using mobile money instead of cash. Technological leaps, particularly in banking, in places like Kenya, is allowing low cost deposit mobilisation that wouldn't have been possible before with a conventional branch network because of the remoteness of certain locations. This drive to serve the "wider economy" is aligned with government as they look to formalise the informal sector to boost their revenue collection. Estimates of the size of the informal and illicit market in Africa range from as low as 25% in South Africa to as high as 70% in Nigeria (IMF). The challenge is not that the opportunity does not exist but that the companies serving these consumers need to adapt to the local nuances of the African markets. Affordability is important as it opens the consumption of products and services to a group of consumers who previously could not access them, enabling the companies to realise the returns they are expecting from Africa.

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