Asset Management

Investment note – September 2019

Date: 25 September 2019

Issued by: Imara Asset Management Limited

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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 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 company that is sensitive to these consumers' needs by delivering a product that is good quality, offers convenience and at the right price point. In this note, we unpack our thinking behind such companies as well as the current mega-trends driving growth.

We favour 'Corporate Champions'

We are looking for companies that are Masters of Circumstance as opposed to Victims of Circumstance – 'Corporate Champions'. Africa is a difficult place to operate but some companies consistently do well despite the environment. We built an in-house system for identifying these companies. This was not easy. We learnt from our mistakes, taking good attributes from our winners and stripping out bad attributes from our losers. Over time, we built a scorecard that allows us to rate the quality of a business. These quality companies are well structured and can tap into buoyant consumer demand for their products. This demand is driven by:

- **new customers** in underserved markets by being sensitive to the needs of this new consumer at the 'bottom of the pyramid' 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 navigate through market cycles with an ROIC above the domestic cost of capital. They survive policy errors, recessions, depressions, hyperinflation and political shifts.

A question we get asked a lot is how do you define quality? For us, quality is a collection of metrics both quantitative and qualitative, designed to capture superior business models. Our quality criteria are informed by quantitative metrics that measure Profitability, Capital Structure, Cash Flow and Earnings volatility. Qualitatively we focus on identifying talented management teams by interrogating managements pattern of decision making, understanding their strategy and governance. For example, we ask: Do you trust management? Does management have a track record of success? How competent do you think the management team is? Is management promiscuous with equity? What is the growth strategy of the company? Does the company sell an essential/highly valued product? Has the company revised targets or failed to deliver? These qualitative metrics are minimally explored on the continent. You can always run the numbers for quantitative metrics but having met some of these companies over the past 15 years we have in-house data that makes it easier to connect the dots for the qualitative aspects.

These Corporate Champions are trading at reasonable valuations

Typically, quality is associated with companies that trade at a premium. However, in Africa you can find quality companies that are trading at attractive valuations. We spend most of our time trying to identify these types of opportunities. The end result is a style-agnostic portfolio that is quality first and then has companies that are either growth and/or value depending on the opportunity. Quality alone is not enough, quality is a filter, because you can still lose money if you pay too much for a quality company that is trading at a premium or a quality company that is not growing. Having learnt the hard way, we have become better at identifying and avoiding mistakes.

For valuation, we seek to pay a reasonable price, below intrinsic value. We use two methods, a discounted cashflow to calculate intrinsic value and then we look at relative and historical multiples to get a feel for the range, buying a company at the low-end of its range shifts the odds in our favour and gives a margin of safety.

For growth, we look at book value growth for banks and cashflow and operating income growth for other sectors. Growth drives price. A growing company justifies a faster rerating of the price multiple.

The snapshot below shows the PER multiples for the MSCI indices compared to our flagship Imara Africa Fund class A. Our portfolio trades at a discount to MSCI Frontier (FM), Emerging Market (FM) and World indices and has a higher ROE and dividend yield. There have been times when this discount between Africa/EM/FM has closed and Africa has traded at a premium to EM and FM. Broadly speaking this usually happens during periods of USD currency weakness, African equities have a negative correlation to the USD, rallying when the USD depreciates and falling during periods of dollar strength. Easing in the US will be supportive of risk assets such as Africa.

	PER	DY %	ROE %
MSCI World (DM)	18.1	2.5	13.2
MSCI EM	13.2	2.9	11.9
MSCI FM	12.4	4.2	14.8
IAF CLASS A	**12.2**	**6.0**	**30.0**
MSCI Africa	10.6	5.2	20.4

Source: MSCI, SBG Securities, Imara Asset Management

Tailwinds for Corporate Champions – Africa's mega-trends

There is a lot of literature on mega-trends in Africa. We have identified 4, which are driving growth on the continent currently:

1) **Demographics.** A youthful population, with a median age of 19, the population pyramid is short, fat and flat. This means potentially larger customer lifetime value, if you capture this customer early, you can capture him/her for a long time.

2) **Urbanisation.** The urbanisation rate is the highest in the world, higher than Latin America or Asia. This is making it much easier (and cheaper) to deliver products and services. It is also fast-tracking network effects and increasing aspirations for the African consumer. The challenge is creating the jobs to match this burgeoning youthful population.

   In absolute terms the consumption numbers are significant no matter what the sector. Rising urbanisation means more beverages, food, white goods and data demand. This is what drives 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 and wide runway for growth. In their West Africa investor presentation, they estimated the size of the Nigerian market at 20mhl and is poised to grow in the next ten years to 30mhl.

	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)

3) **Politics**. The first two trends feed into the 3rd - political change. A young voter connected and urbanised votes for jobs and opportunity. He suffers from what we call generational amnesia, he wasn't born in the colonial era. The politics of the stomach is more important to him than the politics of liberation. This is important because the types of leaders they vote for are pursuing business friendly policies that can attract capital and create jobs. The median age is 19, so we are yet to see the full impact of this voter, but we are encouraged by the increase in student voter registrations in both the recent Zimbabwe and Nigerian elections.

4) **Formalisation of markets.** This is a natural evolution from traditional methods/informal markets to modern markets. This is by far the most important trend and explains why Africa is an opportunity now and not in the future. This is a domestic, consumer theme. There is a market right now that is underserved and underpenetrated. 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 (source: IMF). Historically, this was a market that was perhaps overlooked by some during the colonial period. Post-independence however, it is a market that is getting a lot of attention. With the diaspora returning home to play a key part in management and directing local solutions and innovation we are seeing a lot of exciting products that address the needs of this segment. The companies that serve this market with quality, convenience and affordable products have a large revenue stream, with economics that can match conventional premium or mainstream markets. You are talking cash displacement technologies, formalisation of retail, subsistence to commercial farming, raw/loose milk to processed milk, home brews to packaged opaque beer. We devote most of our time to finding such companies that can turn this revenue into profit. Companies that can do this have a long runway for growth.

Imara's investment Beliefs

Having discussed what we look for and the megatrends, this leads us to our beliefs:

1) **Companies that are sensitive to the trends I mentioned will outperform** because they will grow faster than their sectors and the economies they are in. Why? Because if they are exploring the blue ocean potential in the traditional or informal markets and serving a customer that their competition isn't serving, they are adding a revenue stream that has limited competition. They also obtain a head start, acquiring the customers trust and gaining brand loyalty. They obtain data that none of the competition have because the segment was informal and they understand the consumer behaviour

better. The acquisition costs are high initially, but over time economies of scale kick in and the economics of this value segment starts matching the mainstream or premium segments.

We have seen this with products like MPESA (Safaricom, East Africa mobile payments/cash displacement), Ecocash (Cassava, Zimbabwe mobile payments/cash displacement), Chibuku (Delta/ABinbev, opaque beer/displacing home brewed products and illicits) and IDH (Egyptian diagnostics for a population that is undertested for chronic illnesses). All of these companies have limited or no competition and have a market to attack that is bigger than the formalised market. We believe there is a logical sequence that builds momentum and manifests in high ROIC and cash generation when you have a company that has a robust business model and is sensitive to this fortune at the bottom of the pyramid. The first mover advantage and reinvesting the cashflows whilst sustaining high ROICs/ROEs, creates a long term runway for growth.

2) **Deep and rigorous research is essential.** Building networks and having a data-driven and methodical approach to research is essential. For this you have to travel, kick the tyres and do your own research.

3) **A quality overlay mitigates much of the risk of investing in Africa.** We have robust data to support the view that using a quality overlay captures most of the upside and less of the downside. A well-constructed portfolio of quality companies is additive no matter if it is growth or value. You capture most of the upside and more importantly less of the downside.

4) **Building a concentrated, high conviction, index agnostic portfolio** is the best way to capture this opportunity. There aren't many of these opportunities that meet our quality criteria, trading at a reasonable valuation and growing. When we find them we allocate aggressively.

Craig Bandason, Portfolio Manager

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