African Intelligence Report

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Sub-Saharan Africa

The quarter ended on a subdued note, the MSCI Africa ex SA index is down by 8% since the beginning of the year and was 3.1% down over the quarter. In the currency markets, the Zambian Kwacha fell by 4% whilst the Kenya shilling declined by 1.8%.

Mauritius Commercial Bank released strong results for their third quarter ending March which were far better than expected. EPS rose by 32% year on year as their regional growth continues to positively impact profitability. The stock rose by 7.5%.

We visited a number of companies in Zambia in June, the first such research trip since the new President Edgar Lungu was elected in January following the death of Zambia's previous President, Michael Sata, in October last year. Most agree that Sata was good for the people following generally populist policies but was bad for business and the mining sector. Indeed a number of his policies were overturned after they resulted in a loss of confidence in the Kwacha in early 2014. His last major initiative was to impose a high royalty tax (20%) as a means to tax the mines to benefit the people. Unfortunately such a large tax on revenues together with a number of other measures made mining even less viable following the decline in commodity prices in 2014. Indeed Barrick Gold which had invested in its first venture into copper mining announced that it would put its mines into care and maintenance by April this year should the Government not rescind the royalty tax. Fearing job losses the Government recently reduced the tax to 9% which arguably is still high.

Lungu only has a year in his position when he has to stand again, as Sata's original term ends in 2016. As a result he does not want to take any risks with policies which might lose him votes in 2016. He is therefore continuing with the country's infrastructure programme. With a high fiscal deficit, Zambia is talking about issuing a $2 billion Eurobond following on from those issued in recent years. It will be interesting to see the current appetite for such a bond after the previous ones were heavily oversubscribed.

Despite the high deficit, we found it interesting to hear from both the breweries and the tobacco companies that their markets had been flooded by illicit imports. This was the direct result of Government increasing excise taxes on beers and cigarettes to very high levels that immediately encouraged smuggling of similar products across the border to be sold ex tax. What has been strange is that Government, faced with declining tax revenues has been reluctant to stamp out this illicit trade and we can only speculate that this might be unpopular in an election year! By contrast in Zimbabwe, the Government reduced excise duties in order to make the products more attractive thereby hoping to boost volumes and their own tax take! This is arguably a better way to make smuggled imports less attractive. We came away sensing that Zambia is in a holding pattern as the elections approach and hence tough decisions are not being taken. Encouragingly that is not stopping the private sector (ex the mines to some extent) from investing and new shopping malls being erected!

We still await the appointment of Nigeria's Cabinet, now three months after the Presidential elections took place. President Buhari has fired the entire Board of the State oil company, NNPC which is a good start! Investors are however beginning to lose patience with the lack of progress in his appointments and setting policy

South Africa

Let's not be so negative

It is very easy for South Africans to be overly negative about our country given all the bad news around labour, politics and of course Eskom, amongst other things.

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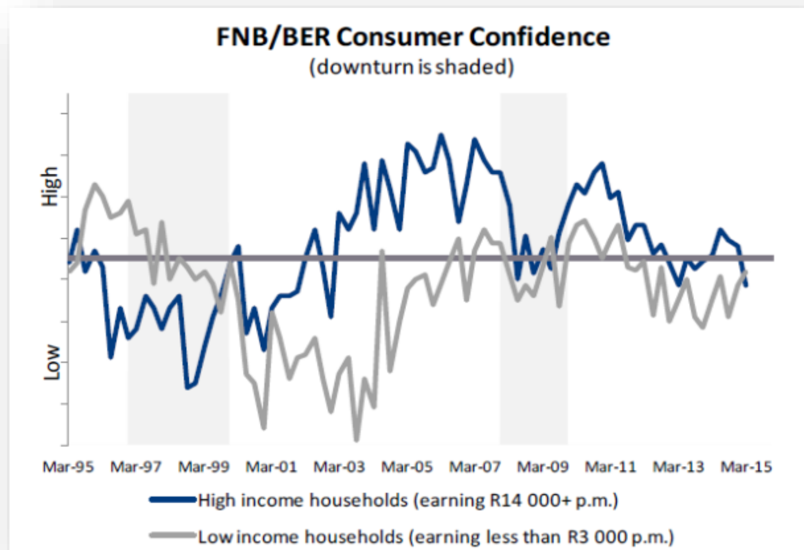
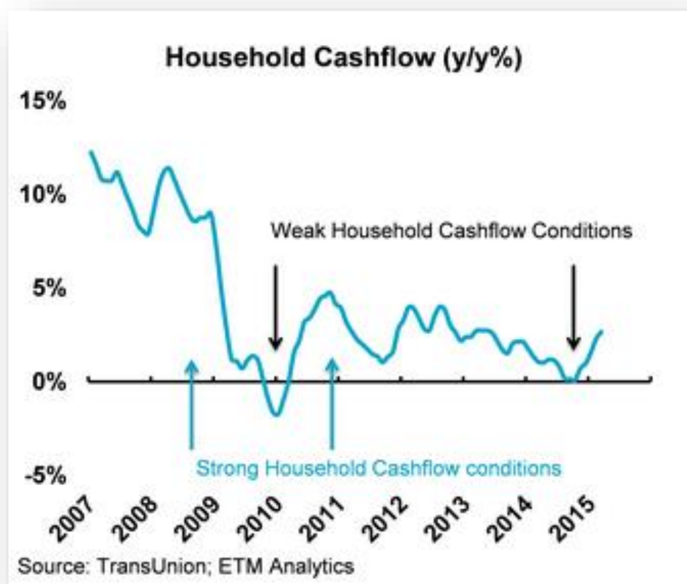
Despite our structural problems, in all likelihood the economy will still grow and quality businesses will still make profits and provide returns to shareholders. We as investors need to understand, like our corporates have, that there are always opportunities that can be exploited despite all the obvious headwinds. Take for example the highly successful growth we have witnessed in private education and healthcare companies listed on the JSE as well as the potential for private companies to sell power into the electricity grid in due course ,to name just a few. Moreover, because of our structural issues more and more companies are expanding operations offshore to ensure continued growth. Returns to shareholders will also benefit from a weaker rand exchange rate over time.



Source: BER



Source: TransUnion; ETM Analytics

Near term negative factors for the local economy remain heightened inflationary expectations and a hawkish Reserve Bank with most economists now expecting a hike in the repo rate of 25bp in July, despite deteriorating economic growth. Consensus GDP growth for 2015 is 2.1% with inflation expected to average 4.9% in 2015. Forecast risk for inflation is high due to the potential impact the proposed additional Eskom price increase of 12.6% and its negative effects on inflation; exacerbated by a weakening rand. The rand should remain on the back foot due to tightening capital flows into emerging markets when the FED makes its first move around hiking interest rates later this year or very early 2016.

The lower oil price in February and March provided a short term boost to consumer confidence and expenditure but has recently deteriorated again as the higher fuel taxes since the budget have begun to impact.

Appetite for consumer credit is also showing signs of weakness and a looming interest rate hike is most likely to negatively impact consumers spend. Household cash flows (see chart alongside) have improved somewhat after reaching a low in December last year mainly due to a lower rate of borrowing but is at risk as the cost of existing debt will go up after a move by the SARB.

We cautioned in previous communications that volatility in markets was likely to increase due to expectations around a move by the FED and geopolitical risk particularly around Greece and a potential exit from the euro. This has been the case. The JSE all share has declined by 5% after reaching a high in May this year but is still up 5% (coincidence) year to date and is up 2% year on year. Foreign buying and selling remains fairly volatile with net buying in favour at the time of writing. The accompanying chart indicates the increased volatility and the market appears to still be in an upward long term trajectory and is trading just above its long term support line. Further volatility cannot be ruled out once the SARB and the FED strut their stuff!

Source: INet Bridge

At sector level, resource stocks remain out of favour due to poor macro variables and slowing growth in China despite appearing inexpensive. It's likely that this sentiment will prevail for some time still. Industrial rand hedges appear expensive but the weaker rand (we expect more weakness over the medium term) is supporting valuations on a forward basis which appear more reasonable.

We potentially foresee opportunity in the financial sector due to a likely negative reaction in share prices when interest rates change. Rising interest rates have historically been positive for banking profits as lending margins increase but could eventually cause deterioration in bad debts and slower loan growth.

Nigeria

The MSCI Nigeria Index fell by 3.4% in US dollar terms. The Naira remained stable at around N200 to the US dollar although the parallel rate fell to N225 representing an expected devaluation of 12.5%.

Although Muhammadu Buhari was sworn in as President on May 29th everyone is still waiting for him to announce a cabinet. Rather unsettling has been reports of fights between APC members in the House of Representatives over key positions. The APC was formed from the main opposition parties to un-seat Jonathan so it is perhaps not surprising to see unholy squabbles in the election's aftermath. To date Buhari has inaugurated the National Economic Council (NEC) – which comprises the governors plus the central bank governor – to advise on economic policy. He has also dissolved the board of the NNPC, Nigeria's oil company, ahead, hopefully, of deep-seated reform.

The Central Bank published a list of 40 items that foreign exchange will no longer be provided for, such as the import of rice, textiles, poultry products and private jets. The full list demonstrates just how much damage the "curse of oil" has done with products such as toothpicks on the list, as too are products derived from palm oil and rubber (such as margarine, soap, and rubber products) which Nigeria used to be the world's top producer of. Quite whether the building sense of crisis is a deliberate softening blow against the NNPC or the public with respect to petrol subsidies is hard to tell; Buhari has made several references to the treasury being virtually empty, high debt levels (which are in fact quite low on a global comparison) and a range of articles about unpaid federal and state workers have appeared. It has always been the case that reform

has followed the politically feasible path in Nigeria (e.g. agriculture), with reform attempts slowing when the vested interests have proved too strong (e.g. electricity, petrol subsidies). It has also been true that the bigger the crisis the deeper the reforms, hence the extensive reform of the banking system from 2010 which saw some bankers go to jail. The NEC recently revealed that the NNPC has spent US$19bn without approval in the past 3 years which seems to have been confirmed by the PwC audit and by the Presidential Committee on the Verification of Fuel Subsidies. These reports suggested that the NNPC was deducting as much as 46% of oil receipts to meet expenditure before sending the balance to the Consolidate Revenue Fund. Perhaps President Buhari intends a big-bang approach to reform, tackling both the NNPC and petrol subsidies while the sense of crisis persists.

There was little corporate news during the month. The bid for Unilever Nigeria by Unilever Plc at N45.5 per share has now closed and the price of Unilever Nigeria has held steady at this level after the close of the bid. Most brokers and agents for Unilever Plc were fairly confident the price of Unilever Nigeria would collapse back to its former level but all the bid has done is to remove any weak holders of the stock.

Unilever Plc is bidding for 25% 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 increase hit consumer demand and Unilever's earnings for six. What price can be justified? Slotting peak 2012 margins back 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 weak month characterised by very low turnover once again. The index fell by 3% with a year to date 8.8% decline in the index. Over the quarter the index fell by 6.2%. Over the month only Seed Co of the blue chips managed a gain rising by 5.6% whilst many other counters once again were unchanged. Delta fell 3.9%, whilst OK and Econet fell by 11%. Turnover has been so low which supports rumours that employees of some stock broking firms have not been paid in months!

We met with the local representative of the IMF this month. The IMF's offices were re-opened in September 2014 having been closed for ten years when Zimbabwe defaulted on its loans. He confirmed that the various multi-lateral agencies are working hard to find a solution to Zimbabwe's debt arrears so that they can resume lending once again. Whilst the IMF loan is only $150million or so, that of the World Bank is $1.2 billion but Zimbabwe has to repay both before the IMF and the World Bank can consider a new lending programme. The problem for the Government is that it has no money to play with as they continue to struggle to pay their own workers. Further, Zimbabwe is not eligible for a Heavily Indebted Poor Countries style debt write-off because ironically the debt is not

high enough to warrant it being low relative to GDP and in terms of its export earnings. It therefore remains a case of trying to square the circle. The IMF's view is that this conundrum can be solved with the goodwill of the IMF members and the Zimbabwe Government. As far as the latter is concerned, positive progress is being made and the required policies to enable a turnaround in the economy are accepted by an increasing number in Government. To implement them however requires the political will to do so. The next World Bank/IMF meetings will be held in early October at which Zimbabwe's debt will be discussed on the sidelines. We hope that this brings with it a much needed solution. The IMF still hopes to move forward from the current Staff Monitored Programme to a Structural Adjustment Programme. The former ends in December of this year. The IMF representative confirmed our belief that the donor community in general holds much goodwill toward Zimbabwe and has the funds lined up. Frustratingly, there appears little political will from the top in Zimbabwe to move forward with the all important reform measures or at least that is how it appears from the outside.

Indeed the politics remains the country's bugbear. Since the upheavals in Government created by December's ZANU-PF Congress that resulted in the dismissal of Vice President Joyce Mujuru and her perceived supporters, there has been no let up in the factional fighting within the Party. This all stems from the "succession" issue that is gripping the party. Since there is no appointed successor to the President should he die in office or retire, various factions are battling to be in prime position should that occur. The President does not want to appoint a successor which would likely reduce the growing fighting within the Party, for fear that the successor could turn on him. The net result is the economy remains of little importance to those looking to position themselves in this political soap opera. Encouragingly though, the donor community is moving forward anyway righly taking the view that the politics will eventually sort itself out.

Foreign investors on the otherhand remain on the sidelines although there again, the diplomatic community has been hosting a growing number of trade delegations to Zimbabwe from their respective countries, looking at potential opportunities for trade and investment. This would include the UK and the USA. This again is encouraging and far from the dark days of 2002 to 2009.

There has been little in the way of corporate news to report but we should expect to hear from those companies with June full year or interims over the coming months. Innscor meanwhile issued a cautionary to inform investors that they are looking to spin off, by way of a dividend in specie, the fast foods division of the company. The aim is to improve shareholder value and allow the company to grow on its own two feet. It also follows in the footsteps of Masimba/Proplastics last month where the market cap rose above the original level of Masimba.

East Africa

The sustained weakening of regional currencies continued to drive foreign portfolio investors away from the local equity market. Meanwhile, turmoil in the Eurozone ahead of the Greek referendum further weakened the Euro vis-à-vis the US Dollar ('USD'). In line with the trends in global markets, all regional currencies weakened against the USD. The Uganda Shilling, Rwandese Franc, Kenya Shilling and Mauritian Rupee declined by 7.5%, 3.4%, 1.6% and 0.6% respectively. In Kenya, the Monetary Policy Committee (MPC) raised the Central Bank Rate (CBR) by 150 bps to 10%, the first increase in 26 months, citing the rapid depreciation of the shilling against the USD.

June is Budget Month in East Africa. A key highlight of the budget proposals simultaneously read out by the East African Community (EAC) Finance Ministers on 11th June was the harmonization of new taxes (common external tariffs - CET) on both exported and imported goods and removal of some sensitive goods from the duty remission and exemption schemes. The measures appear aimed at providing incentives for manufacturers to expand capacity and enable weak industries withstand competition from outside the region. The regional economies are also looking to external borrowing to bridge large and growing budget deficits.

Kenya's banking sector is set for further transformation after the Finance Minister proposed a significant increase in the capital requirement for commercial banks. In the 2015/2016 Budget proposals, the minimum core capital for lenders will increase from US$10.1 million to US$ 50.54 million in the next three years. This move, which is intended to create strong and stable institutions that can compete regionally and have the capacity to lend more at lower interest rates, should trigger a wave of capital-raising (both equity & debt) as well as an increase in mergers and acquisitions. In the same breath, the paid-up capital for insurance firms conducting general business has been doubled from US$ 3.03 million to US$ 6.06 million, while the same for life insurance business increases from US$ 1.51 million to US$ 4.04 million.

At the Nairobi Securities Exchange (NSE), the market reported lacklustre performance, driven by continuing net foreign outflows attributable to the depreciating shilling, capital gains tax (now replaced with a securities transaction levy of 0.3% in the 2015/2016 Budget) and investors seeking returns in other markets. The FTSE NSE-15 and FTSE NSE-25 indices dropped by 0.9% and 7.4% respectively, while the NSE-20 index rose by 0.8%, all in USD terms. Year-to-date, the indices have respectively declined by 8.5%, 9.2% and 12.4% in USD terms. Centum Investment reported strong FY15 performance, posting a 160% year-on-year EPS growth that was primarily driven by the sale of its 13.75% stake in UAP Holdings (an insurance group) at almost double the balance sheet value. The company also announced plans to recapitalize the newly acquired K-Rep Bank (controlling stake of 68%) and develop new platform companies in healthcare and education.

Uganda's Finance Minister raised spending for FY 2015/2016 by 71%, which heightened investor concerns about heavy pre-election spending and subsequently drove the local currency to a record low. The Uganda Shilling has depreciated by 17% year-to-date. In response to the weakening currency, the Bank of Uganda tightened monetary policy by raising the policy rate further, from 12% to 13%, to curb anticipated inflationary pressures and ensure medium-term inflation converges around the policy target of 5% in 2016/2017. Based on developments in the global and domestic economy, the revised monetary policy stance was necessitated by changes in the Central Bank's conditional inflation forecast. Annual core inflation is projected to rise to 8 – 10% by the end of FY 2015/2016, an increase of 200 bps compared to the April 2015 forecast, with most of the rise in core inflation attributable to currency depreciation due to global conditions and a weak balance of payments position. The current account deficit is projected to widen to 10.3% of GDP in FY 21015/2016 from 8.4% in FY 2014 owing to higher imports relating to the non-oil private sector and public infrastructure, lower personal transfers and weak exports due to subdued global commodity prices and lower aggregate demand in key export markets.

In Mauritius, GDP growth is forecast at 3.8% in 2015, up from 3.5% in 2014, with the main contributors being "Financial & Insurance activities", "Manufacturing" and "Wholesale & retail trade; repair of motor vehicles and motorcycles". On the growth rate by industry, ICT is expected to register the highest growth rate of 7.0%, up from 6.4% in 2014, followed by accommodation and food service activities at 5.4%, based on a forecast of 1,100,000 tourist arrivals.

Bucking the trend across the region, Rwanda's budget deficit for FY 2015/2016 dropped to 4.6% of GDP, at US$ 406.2 million, down from 5.2%, at US$ 414.1 million, in FY 2014/2015. The country seeks to raise US$104.9 million through domestic borrowing and US$ 301.4 million through external borrowing with 34% of the US$ 2.58 billion budget financed through external borrowing and funding. A new surcharge of 1.5% on goods imported from outside the EAC (an infrastructure levy already charged by Kenya and Uganda) will raise funds for regional infrastructure projects, with priority given to funding the country's portion of the 2000-km Standard Gauge Railway (SGR) that will connect the Kenyan port of Mombasa to Uganda and Rwanda and significantly reduce the cost of freight and doing business within the region.

Resources

The MSCI World Commodity Producer Index by 5%. The overall weak performance was driven by the relentless negative sentiment towards resource stocks being

fuelled by poor news out of China and a lack of growth elsewhere in the world. More time is needed to balance demand over supply across a range of commodities.

On the ground in China, Mysteel reports that steel prices fell further this past month and that “mills lowered capacity utilisation on weak demand, rapidly rising inventory and widening losses”. Also, the increasing losses being reported by the Chinese steel mills suggests that it won’t be long before large-scale maintenance shutdowns are effected. Whilst this might prop up steel prices, it will reduce demand for feedstock inputs such as iron ore and coking coal.

In a trading upgrade Pan African Resources has indicated that earnings to June 2015 will be down by 43% to 63% from £1.47p. At the time of the acquisition of Evander Gold Mines (EGM), management had warned that its mining operations would transition through a low-grade zone. This fall in gold output, together with a primary crusher problem at its Barberton Gold Mines (BGM) plant and a flat gold price are the major reasons for the indicated fall in earnings. Whilst these negatives were being overcome, the R175m Evander Tailings Retreatment Plant was constructed and is currently ramping up to 10k ounces per year. This follows the successful BGM Retreatment Plant. Other projects being considered are the Elikhulu recycling project to treat 12mtpa of the 165mt (1.5mozs) of surface slimes at EGM and the Evander South project – a potential new shallow gold mine at EGM (21.7mt @7.7g/t). Finally, subject to certain conditions, PAR will acquire the 26mt Uitkomst colliery for $16.5m.

On a positive note, Tiger Resources reported that after 12 months of operations, output at its SXEW plant exceeded capacity (25ktpa of copper) by 10% in May. Furthermore, management believes that by debottlenecking the plant in certain areas and by adding extra electro-winning cells, monthly production could increase by as much as 30% for a very modest capital outlay. Such initiatives are both complementary and independent of the previously mentioned 25ktpa Stage 2 expansion of copper cathode output at the Kipoi mine in the DRC.

Maya Gold & Silver has reported progress from the first ever, systematic 6000m drilling campaign to be performed on its Zgounder silver mine property in Morocco. The objectives of the drilling programme are to validate whether widespread mineralization occurs across the known deposit and to explore lateral extensions to the east and north and also at depth. Early results from drill-hole No. 12, aimed to evaluate a sub-parallel mineralized trend north of the main Zgounder zone, returned an average silver grade of 1098 g/t over a true width of 8m. Guy Goulet, CEO of Maya says: “this is a very exciting result for Maya at the beginning of this drilling campaign and this initial result brings a new perspective and insight to the Zgounder Mine”.

Since the start of hot operations in mid-February 2015 at its new Kansanshi copper smelter in Zambia, First Quantum Minerals reports that a daily average concentrate throughput of 3000t has been achieved, with periods in excess of the 3500t nameplate capacity. Benefits are being derived from the processing of 60kt of concentrate inventory and the production of 180kt of sulphuric acid; this is manifest in C1 cash costs that have reduced to around $1.30/lb, from $1.77 at the end of Q1-2015. For the first time in several years, the mine is able to operate without the constraints of limited availability and widely-fluctuating sulphuric acid prices and the lack of smelter capacity in Zambia. Phillip Pascal, CEO, says that “the achievement of over 100% of nameplate capacity in the first three months from startup, is unprecedented and that commercial production is expected to be declared in the third quarter of 2015 – ahead of the previous expectation of the first quarter 2016”.

During the month Nevsun announced exciting results from a new Volcanogenic Massive Sulphide discovery at the grassroots Asheli project, about 20km southwest of the Bisha Mine plant. Management reports that “with over 4kms of untested strike length with similar geology the potential for further discoveries on this trend looks very promising”. Nevsun also recently announced two, successive quarterly dividends.