IMARA
Asset Management

African Intelligence Report

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Performance Review:

Global equities rebounded from the weak third quarter but Africa continued to weaken. The MSCI World index rose by 5.5% and even the Emerging Markets index gained 0.7% over the quarter. African markets were impacted by fears over the Chinese economy, currency volatility and commodity price weakness. The majority of African currencies outside of South Africa either stabilized or recovered somewhat against the dollar having been weaker earlier on in the year.

Commentary:

The big issue currently facing the Emerging economies is that the Federal Reserve has started a new tightening cycle: “never fight the Fed!” was the pre-2008 adage. However, the small rise in US interest rates may be less important for emerging economies the fact that the strong US dollar has actually been tightening liquidity in peripheral markets since mid-2011 - as borrowers of US dollars have sought to repay dollar debt. The trade weighted dollar has risen by 38.6% since 2011 and by 24.0% since mid-2014 alone; this is the largest move in the dollar since the very large Plaza/Louvre Accord distortions of the 1980’s and is the same magnitude as the move that preceded the Asian Crisis in the late 1990’s. A further large move in the US dollar therefore seems unlikely. The Emerging Market indices have as a consequence undergone a profound bear market since the dollar started to rise, falling by 38.2%. This compares to the 54% falls in both 1997 and 2008 which were both times of extreme economic and equity market stress. The more modest reaction to the strong dollar this time round is possibly due to a greater awareness of the damage foreign denominated debt can do. Africa, by contrast, has generally low levels of corporate debt. The fundamentals are therefore good yet the African indices have also performed dismally. Africa ex-SA has fallen by 41.2% in recent months and is now actually only a mere 1.3% above the low set back in the dark days of March 2009. The Emerging Markets, by contrast, are still 44.8% above this low water mark. Overall, we feel Africa has been thrown out with the bath water.

Whilst the markets have been unsettled, we believe it is important to maintain our programme of country and company visits not least to separate the impact of global sentiment changes (i.e. noise) from real-life business operations. We visited Nigeria and Kenya during the last quarter.

For many developing countries, and especially in Africa, secular reform (for example the gains to be had from better infrastructure, less corruption and the leapfrogging of old technology) can sometimes have a greater impact than cyclical developments even when, like Nigeria, the price of its main export, oil, halves. In Nigeria, the new government is demonstrating a reformist zeal which has all the hallmarks of being hugely beneficial for the stock market - at a time when the equity index itself is moving in lock-step with the oil price. We think that when oil prices stabilise, the beneficial impact of reform will start to be reflected in equities. It took six months for President Buhari to announce his cabinet but when he did it was clear he meant business with regard reform, not only by cutting the size of Government but in appointing new private secretaries to support technocratic ministers. He has come down hard on corruption too which has resulted in the arrest of the former defence Minister. Key areas of reform will be to boost power generation by privatising the energy sector and to continue to promote local production of raw materials such as palm oil, rice, sorghum and maize. Eliminate theft and corruption, get the lights on, focus on import substitution and agriculture, and the collapse in crude oil prices could easily be offset. Petrol subsidies look like they will be phased out too. Indeed the budget presented by the President in December was commendable and realistic and signalled a more orthodox return to macro-economic policy with a devaluation finally on the cards. President Buhari’s first target on coming to power this year was the Nigeria National Petroleum Corporation (the NNPC). Emmanuel Ibe Kachikwu, who was general council for Exxon Mobil, was appointed just after the election and the latter’s first move was to sack the corporation’s entire board. His second was to initiate the publication of provisional monthly data on the finance and operations at the NNPC. He is now focussed on other areas that need changing. These include the contractual arrangements with buyers of Nigeria’s oil, and Nigeria’s gas industry. Gas is mostly flared - and has been for decades despite reserves that are some of the most plentiful in the world. Nigeria’s gas is also some of the cheapest in the world yet the gas-fired power stations often suffer from a lack of gas due to poor infrastructure. Nigeria's oil refineries are also an obvious target; their current annual production is precisely zero; these are likely to be privatised. Finally, the Petroleum Industry Bill looks like it could split the NNPC into two. An oil company and one for holding other assets.

From a stock market perspective we believe the Nigerian market is close to a bottom, although the volatility in the oil price may affect the recovery. Three pools of money tend to focus on the Nigerian equity market: foreigners, domestic pension funds and the retail public. Foreigners have been selling for some time having been spooked by the falling price of oil, the announcement by JP Morgan that they were dropping Nigeria from their bond index, the fear of a further devaluation and fears that US interest rates might start to rise. Evidence suggests South African investment funds have also been large sellers of Nigeria. That said Unilever PLC and Diageo on the other hand have recently made bids to increase their stakes in their local subsidiaries to around 75% suggesting that these insider's believe current valuations to be at their cyclical low.

The Nigerian pension funds have around US$26bn under management vs. a total stock market capitalisation of US$49bn. This is equal to 5% of GDP which is low by any standards. The weighting to equities is around 9-11% and historically these funds have bought and held government bonds (the average 3 year Nigerian Government Bond yield has been 13.5% since the start of 2013) but these rates have now fallen to 9.2% as a result of the cut in the commercial bank's cash reserve ratio after peaking at 16% in September. Pension funds may therefore have to start looking at the equity market once again. In any case, assuming historic rates of growth in funds under management of over 20% and a constant asset allocation, these pension funds would be buyers of about one third of daily volume on average. The expected 2016 dividend yield in the equity market is 4.5% for consumer stocks (which are at a cyclical low) but 9-11% for banks like GT Bank and Zenith. We would argue that as these dividend yields are now the same as bank deposit rates the stock market looks to be fairly close to a bottom.

We also visited Kenya during quarter. A new Central Bank Governor has taken charge; a priority is to improve bank regulation and supervision so bank provisions could rise as property collateral is correctly accounted for. We have been concerned for some time that local bank's provisioning has been too low and hence profits are over inflated as compared with the more conservative multinational subsidiaries. Interest rates are falling sharply as a problem caused by poor treasury planning unwinds; we expect a Treasury Management Office to be set up. Safaricom continues to deliver strong growth at around 1.5x GDP. As expected, voice revenue growth is on the decline in favour of data growth which for the foreseeable future will continue, particularly given all the various initiatives which the company is looking at. M-Pesa continues to build a strong network effect and as one analyst put it 'people will put money into their M-Pesa account before buying food. People look at you strangely if you don't have an M-Pesa account'.

The New Year always bring volatility, the product of all the investment committee meetings that take place making decisions because its investment meeting time rather than because of fundamentals. This year the mood seems to have decided the developed markets are a sell and nothing is a buy. On top of the falls in both equities and currencies last year, Africa now looks cheap.

Jon Chew, January 2016