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EMERGING MARKETS REPORT

Investors in Africa seeking undervalued names, diversification

Funds head south of the Sahara as banking and telecom sectors expand

By Polya Lesova, MarketWatch
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NEW YORK (MarketWatch) -- Where most investors see a continent plagued by underdevelopment and conflict, others recognize Africa as the next frontier, whose accelerating economic growth and long-term potential are creating compelling investment opportunities.

"We're convinced that the perceived risk in Africa is greater than the actual risk for disciplined and focused investment," said Thomas Gibian, chief executive of Emerging Capital Partners, which manages more than $1 billion in five private-equity funds focused on African companies. See video interview with Gibian.


Reuters
Worker examines diamond particles at a cutting factory in Botswana's capital Gaborone

"We thrive on diversification -- across regions in Africa, across currencies, across sectors," he said.

After decades of colonialism, violence and poverty, some African countries, particularly those south of the Sahara Desert, are experiencing an economic renaissance, propelled by more than rich deposits of natural resources. The banking and telecom sectors are luring foreign investors, who are now hunting for deals in smaller countries including Ghana, Botswana and Zambia, not just South Africa. Certainly, significant challenges remain, including ongoing conflicts in some countries, corruption and HIV infection.

"Optimism is what separates people today," said Lawrence Speidell, co-manager of the Frontier Market Select Fund, L.P., a $4-million, long-only hedge fund that invests in frontier equity markets, most of them in Africa.

"If you read the newspaper, you're very worried because a lot of news is bad news," Speidell said. "If you take a step back and you take a look at the patterns that are in place in the world, you'll see that there's a long-term movement of the world toward democracy and peaceful settlement of disputes."

Optimism is one of the four pillars on which Speidell bases his investment philosophy; the others are history, risk, and globalization.

Sub-Saharan Africa posted economic growth of 6% in 2006 and is expected to grow by 6.7% this year, making it one of the fastest-growing regions in the world, according to the International Monetary Fund. In contrast, between 1980 and 1999, the region lagged far behind global growth -- its GDP grew by about 2% on average. China, with its insatiable appetite for commodities, is becoming a key destination for African exports.

"While key oil exporters like Angola, Equatorial Guinea and Nigeria are expected to enjoy some of the fastest growth rates in Africa in 2007, they are not the only countries enjoying rapid economic growth," said John Orford, South Africa-based strategist at UBS Investment Research, in a June research report.

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"Indeed about 18 oil importers will enjoy growth rates of 5% or higher in 2007," Orford said. "A number of factors -- better macro management, lower inflation and rising savings and investment rates -- are supporting higher growth across the continent."

Some countries in Africa have made partial progress on implementing economic reforms, specifically when it comes to monetary, regulatory, trade, fiscal and financial policies, Orford said. Barriers remain, however, in areas like property rights, investment freedom and corruption.

Inflation in sub-Saharan Africa, with the exception of Zimbabwe, is forecast to fall to about 7.1% from 7.2% in 2006 and 8.1% in 2005, according to IMF figures quotes by UBS. Investment-to-GDP ratios are still very low, but rising.

External debt has declined and foreign private capital flows are increasing. Net foreign direct investment in sub-Saharan Africa excluding South Africa climbed to $18 billion in 2006.

Attractive sectors

"We have been able to identify many investment opportunities where there are near-monopolistic environments," said Gibian of Emerging Capital Partners, the pan-African private-equity firm.

The companies he invests in "operate with preferential access." For example, if it's a natural resource, the company has the rights to the mineral or energy source that they are developing.

Emerging Capital Partners has made more than 35 investments in 30 African countries. In some deals, the firm takes a controlling position, but as a rule it always acquires a seat on the boards of the companies in which it invests.

"We look at businesses where Africa has historically had a comparative advantage -- in energy businesses, because that's where the oil and gas is, in mining, in agriculture, even in tourism," Gibian said.

One such company is Anvil Mining Ltd. (CA:AVM: news, chart, profile) (AU:AVM: news, chart, profile) , a copper and silver producer that is listed on the Toronto and Australian stock exchanges. The company operates several mines in the Democratic Republic of Congo.

Another example is Artumas Group Inc. (DE:A0J34E: news, chart, profile) (NO:AGI: news, chart, profile) , an energy producer that operates hydrocarbon reserves in Tanzania and Mozambique.

"We also look at businesses where Africa has lagged -- in terms of banking, telecommunications, distribution -- these are not areas where historically Africa has held itself up as an example of efficiency," he said. "Our track record is the most complete in the area of telecommunications and now in the area of financial services and financial institutions," he said.

Among the firm's investments are Celtel International, a mobile telecommunications company; Continental Reinsurance Plc, Nigeria's largest reinsurance company, which was recently listed on the Nigerian Stock Exchange; Intercontinental Bank Plc, the fifth largest banking group in Nigeria; and Ecobank Transnational Inc., one of the largest regional banking groups in sub-Saharan Africa and a company that is listed on stock exchanges in Ivory Coast, Nigeria and Ghana.

"There has been tremendous investment in Africa -- look at Air France, Exxon, Shell, De Beers etc. -- but investment in Africa typically did not create opportunities for emerging markets buyers to take a position," Gibian said. "We are very keen to build companies that deserve to be liquid."

Low liquidity continues to be one of the major problems for investors in Africa's equity markets, with the exception of South Africa, Egypt and partially, Nigeria. The ratio of market capitalization to GDP remains low, while sector composition is also mostly biased toward the financials.

"With the exception of South Africa and Egypt (relatively diverse sector composition) and Côte d'Ivoire (dominated by a single telecommunications stock) financials account for between 40% and 90% of African equity markets," according to UBS's Orford.

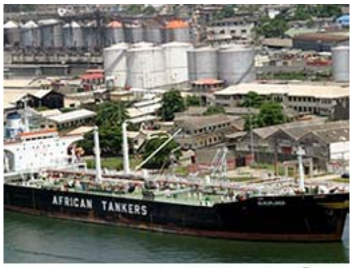
South African stocks stand out as the clearest beneficiaries of African growth, he said. UBS's favored picks from South Africa are communications company MTN; the country's largest retail bank ABSA; food retailer Shoprite; and construction firm Group 5.

One way for American investors to invest in South Africa is through the iShares MSCI South Africa Index Fund (EZA) , an exchange-traded fund that tracks the performance of the country's stock market. Read more about South Africa.

Today's prices and tomorrow's liquidity

Speidell looks beyond South Africa in his search for attractive African stocks. As of March 31 this year, the Frontier Market Select Fund owned 18 stocks in 12 countries around the world. Country-weightings include Botswana (10%), Ghana (21%), Nigeria (9%), Malawi (2%), Senegal (8%), Tanzania (5%) and Zambia (5%).

Speidell points out four reasons why he invests in frontier markets.



Reuters

Oil tanker discharges petroleum products at fuel depot in commercial city of Lagos

First, the history of emerging markets is the future of frontier markets, Speidell said. Second, globalization and technology, particularly cell phones and the Internet, are making information available to millions of people in some of the poorest and most remote places in the world. Third is optimism, and the fourth reason is risk.

"The reason I say that these countries offer a different kind of risk to a portfolio is because they are different in that they do not move with the other established world markets," Speidell said. "They don't move with New York, London or Tokyo or Russia or China."

Only about 6% of the movement in frontier markets could be considered related to the movement in the S&P 500, Speidell said: "Frontier markets certainly move, but in a way that's so largely independent that they provide wonderful diversification to a global portfolio."

Among Speidell's favorites are the smaller markets in Africa like Ghana, Botswana, and Zambia.

"We're hoping to benefit from the fact that these markets are not well-understood and that there will be undervalued names in almost every market," he said.

"There are local brokers, the companies do publish annual reports," Speidell said. "There are broker services that go out to companies and get the reports; when you have the report, you have market opportunities because the data are not so closely followed that the stocks will only move within a narrow band."

Speidell's fund invests in a variety of sectors, including consumer staples, finance, telecommunications, transportation and construction.

"Liquidity is a problem," Speidell said. "It's not to say that trading is impossible. One needs to be patient to figure that the opportunity here is to get today's prices and tomorrow's liquidity."

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