As Time Goes By: Update on Africa

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In Casablanca, the 1942 film that defined a cause and a generation for the West, the glittering title city on the Northwest African coast teems with intrigue and a wartime population of disparate cultures and motives. The cast itself was remarkably diverse for a midcentury production that ventured no further from its Hollywood soundstage than the Van Nuys airport. The film's 23 actors hailed from 10 different countries. Six were refugees, including two who fled Russia, three who left Germany and one who slipped out of occupied France.

Casablanca: Africa's melting pot

Modern Africa has a lot in common with that production. It is many things and never just one thing. It throbs with nuance, subtext and history, propelled by rhythms undecipherable to the untrained ear. On a recent trip to the continent I visited three countries where the economics, politics and outlook held little in common. Yet all three presented as distinctly African.

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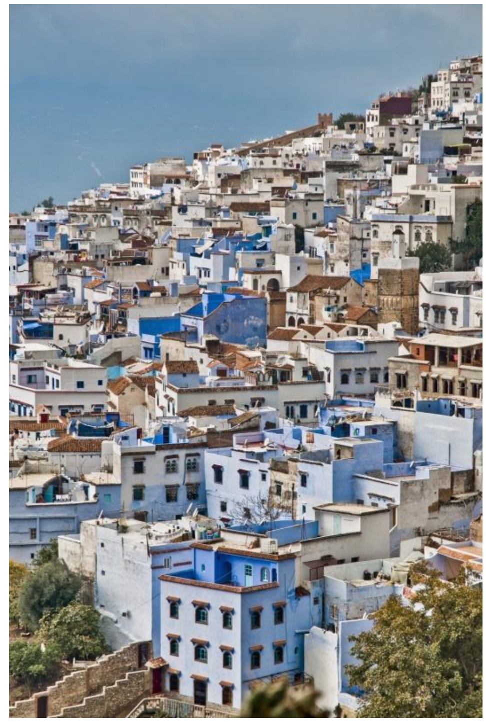
Morocco

Casablanca may not live up to the romance and mystery of the famous movie that bears its name (how could it, really?), but the city and its country have rewarded investors over the past several years with solid performance on the strength of infrastructure investment, subsidy reform and a defensive position relative to other African markets. It was the top performing African market in 2016, serving as a key destination for investors leery of Nigeria, fully invested in East Africa, and unenthused with South Africa.



Chefchaouen, Morocco's famous blue town

Morocco's relative defensive qualities: price stability, low interest rates and concentrated stock ownership – the government and monarchy are major shareholders – translate into rich valuation multiples. The market trades at approximately 20x earnings on average. This can pose a challenge when looking for compelling opportunities.

On a macro level, agriculture accounts for 14% of Morocco's GDP, but employs 40% of the country's workforce. Rainfall remains the primary source of irrigation. As a result, agricultural output is often volatile and can have a disproportionate impact on consumption. The current year looks promising, however, backed by decent rainfall, with GDP on track to expand 4.0-4.5%. In the Sub-Sahara context, ~4.0% growth might look boring, but many less developed African countries have failed to meet lofty economic growth estimates. As a result, Morocco has provided an alternative playing field for investors. Caution should prevail when considering the market long term, however. Literacy levels are low and unemployment high. This could curb productive growth over time unless the country can address this skills shortage.

I met a wide range of companies including two leading banks – Attijariwafa Bank and Banque Centrale Populare, real estate companies, consumer staples and a major port operator. Banks have struggled with net interest margin pressure and some legacy non-performing loans triggered by the European debt crisis, as that region is a major trading partner. Loan growth remains low, but fee income is improving. Not surprisingly, Moroccan banks have looked at greater Africa to boost growth. Still with mid to high single-digit earnings growth and PE multiples in the high teens, the sector appears more than fairly valued.

The Moroccan government has boosted investing via port expansions, high speed rail and new ports to lure French automakers to the country. Recent IPO SODEP Marsa Maroc operates 10 ports with 44% market share. Their Tangier-based port operates as a gateway only, but will also provide transshipment services in 2019. On the consumer side, French grocery retailer Carrefour's franchise partner LableVie is expanding its store space, and would do so faster if management could secure affordable real estate and find skilled workers (the country's education shortfall is having an impact on growth). They are the only grocery retailer selling alcohol in the country and will possibly be raising equity this year. Given what we perceive to be relatively rich valuation multiples and modest growth, immediate opportunities are few in Morocco, but we continue to monitor the market.

Nigeria

"Nigeria is not for the faint-of-heart traveler," I was frequently warned prior to my first visit. Perhaps my expectations were low considering such warnings but I found the people warm and engaging, the traffic no less maddening than most frontier markets (and who wouldn't appreciate the informal retailers that walk along the congested highways?), and businesses capably managing through the current economic malaise. Even so, for the past few years Nigeria, Africa's largest economy, has not been for the faint-of-heart investor either. The government has mismanaged the critical oil industry and has woefully underinvested in infrastructure, education, and healthcare. Power outages are common, forcing companies to rely on expensive back-up diesel generators. There have also been ongoing militant attacks on the country's oil and gas pipelines, compounding problems already facing the industry due to pricing pressure. And while Boko Haram appears to be contained, the northern part of the country remains on guard against the terrorist group.

Despite all these challenges, I came away from Nigeria more optimistic than I expected, but guarded given the lack of visibility on currency policy. The oil price collapse has stressed the economic system, particularly the currency, which has been closely managed by the central bank. But perhaps the current economic contraction will usher in reform, more effective management of the country's oil industry, and a concerted effort to increase critical investment. In addition, the political situation has remained stable in the last 2 elections. Despite President Buhari's ongoing absence due to poor health, the vice president and cabinet members have seamlessly assumed responsibility for governing.

Nigeria's maritime industry, celebrated in a 1980 postage stamp

My initial set of meetings were with the country's Tier I banks. All were sanguine regarding asset quality (despite a high profile telecom near-default that hit each bank), and quite open about their ability to capitalize on the FX market. I was told there was no price discovery in FX, that customers were price takers, and also that it could not last. Most were expecting devaluation once FX reserves increased to $30B. Rather than devalue, however, the CBN introduced a new FX rate for investors and exporters that has helped clear the repatriation backlog and improve FX liquidity. Market volume and performance have improved as a result, but activity has been volatile and we remain cautious about committing new capital to Nigeria.

On the consumer side, Nestle Nigeria has managed price increases steadily to absorb input cost inflation without causing too much of a volume hit. The company has increased local sourcing, but this has not curbed gross margin pressure, as Nigerian suppliers are using international prices, including the FX depreciation. Still, demand for the company's key products has held up well, and they plan to offer smaller, lower priced packages and new beverages later this year.

Oil company Seplat indicated that production should improve once the vandalized Trans Forcados pipeline is reopened. (It was finally operational this past quarter.) The company capped wells in the interim and has not suffered reserve losses. Going forward, management has established two new evacuation routes, in addition to Forcados, to protect production in case of future militant activity.

Nigeria's leading cement company Dangote was upbeat on potential government infrastructure projects. The company's pricing strategy is all about protecting market share, and it is working to improve margins through fuel mix (coal and gas). Dangote is also working to become pan Africa's leading cement company.

The Nigerian stock market has run up sharply following the NAFEX launch. We are watching closely to determine if currency liquidity is sustainable before taking advantage of any stock specific opportunities in the near term. Looking further out, we are optimistic that Nigeria's vibrant business sector will overcome today's challenges and hopeful that the country will address capital investment and educational shortfalls.

Ghana

Accra, the capital of Ghana is a short one hour flight from Lagos but feels worlds away. Ghana, the first Sub-Sahara colonial country to gain independence, has for the most part not fallen victim to its wealth

of natural resources. Infrastructure is good by comparison, literacy levels high, and the business sector is one of the more competitive in Africa. However, profligate fiscal spending – much of it on public sector salaries – and a rising current account deficit have weighed heavily on the currency for the past few years. Inflation has hit margins in many consumer companies, and the low oil prices have caused non-performing loans to rise in the state-backed energy sector. Inflation has also led to soaring interest rates, curbing interest in the equity market (why bother when you can earn low 20% yields on cedi government bonds?).

Fishermen on the beach near Accra, Ghana

Fiscal consolidation hasn't yet taken hold, but the new government has reiterated its commitment to reigning in spending while increasing revenue collection. A recent IMF credit agreement should help encourage more expeditious fiscal reform. Regardless, it appears that inflation and interest rates have finally reversed the upward trend, which should help consumption and help local producers compete with cheaper Asian imports.

Unilever Ghana has been battling the import trend, especially in the homecare segment. Management has been increasing prices in line with input cost inflation, pruning the product portfolio, and cutting costs across business units. The company is optimistic that 2017 will be better for Ghana's consumers.

I also met with several banks, whose managements echoed Unilever's comments on Ghana's improving prospects. They believe the cedi FX rate has stabilized and could possibly recover as inflation declines to below 12% and interest rate cuts take hold. NPLs remain an issue, mainly in the aforementioned energy sector, and banks have been more inclined to park money in high yielding government bonds than to take on more credit risk. GCB Bank Limited would eventually like to move the loan-to-deposit ratio to 70% from the current 42%, but this will be gradual, in line with macroeconomic improvement and normalization of government bond yields. In the near term, net interest margins will likely decline with interest rates.

If not for Ghana's dearth of market liquidity, its current transition would be tempting. As economic conditions improve, business operations should pick up. And the country's lower valuation multiples could expand. However, until trading volume improves, it's wise to be selective in allocating capital to the market.

Moving forward

Beyond Morocco, Nigeria and Ghana, the story of African markets is full of economic potential, company-level opportunities and, unfortunately, the usual suspects of frontier market risks, which are political, economic and currency related. In these markets and in other countries as diverse as Egypt, Kenya and Zimbabwe, we find companies shrugging off the effects of politically-biased government policy, commodity market doldrums and the recent period of uncertainties in world currency valuations.

The beginning of a beautiful friendship

Overall, Africa's recent rebound within the wider frontier universe is a welcome development. The continent should benefit from its young population and enterprising corporate sector. Government inefficiency is an ongoing problem, but recent peaceful transfers of power and anti-corruption initiatives are reassuring and will hopefully support longer-term reform.

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