Kenya and Tanzania, Diamonds in the Rough

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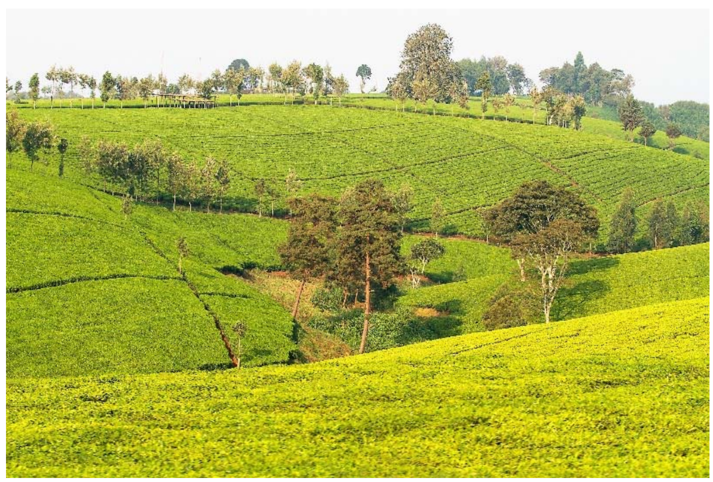
Stretching some 3,000 miles along the Indian Ocean coast, Kenya and Tanzania are home to some of Africa's most iconic images – lakes, peaks and wildlife that are synonomous with the continent. The region supports tranquil and lush tea plantations and bustling urban centers. The countries present attractive economic growth rates, healthy demographics, a record of relative stability and well-run public companies that hold significant potential for equity investors. Unfortunately, political events – ranging from the rerunning of the presidential election in Kenya to the authoritarian rule of Tanzanian President John Mugufuli have clouded the operating environment in East Africa's largest and most dynamic economies.



Just this year, Kenya endured two disputed elections that retained President Uhuru Kenyata in power and in the aftermath brought demonstrations and violent clashes between protestors and police. To the south, Tanzanian President Magufuli, two years into his term, increasingly rules with an iron hand. This year his government imposed a fine of $190 billion, an amount roughly four times the size of Tanzania's GDP, on the country's largest foreign investor. Acts of dissent have been put down forcibly and a leader of the main oppostion party narrowly survived a suspicious assasination attempt.

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At recent investor conferences in Nairobi, we met with representatives of company managements in the financials, materials, consumer staples, real estate and telecoms industries in Kenya and Tanzania. Generally, these officials expressed confidence in the long-term prospects of their enterprises while conceding to the day-to-day challenges they face operating in Kenya and Tanzania.

Kenya

The trip was purposely scheduled after the election date, August 8th, 2017, with the hope to have a better idea of the macro environment. Unexpectedly, the opposition leader refused to accept the results and contested in the Supreme Court. More surprisingly, the Supreme Court annulled the result and ordered another election. One could praise for the judicial independence which is not very common in the Frontier universe. However, the prolonged election process did further slow economic development. By the time I was in Kenya, everyone, including the management, was in a wait-and-see mood.

The political risk is not the only factor that impacted the Kenyan economy. It faces uncertainties brought on by severe drought, an interest rate cap imposed by the country's central bank, and slowing economic growth in the East African region. Some of above-mentioned factors will improve, like the drought. Some of them are unfortunately expected to remain in place for longer periods, like the interest cap. GDP growth for 2018 is expected to be 5.0% according to IMF estimates. This is a slowdown from 5.8% in 2016, but still attractive relative to many developed and emerging markets. While the interest rate cap is not expected to be lifted until late 2018 or 2019, stock prices have advanced in anticipation of the move. From a long-term perspective, the country remains the commercial hub of East Africa and is known for its strong service sector, young and relatively well-educated population and business-friendly operating environment.

Kenya's banking sector continues to confront headwinds. There has been a slowdown in credit growth, coincident with the central bank's cap on interest rates, and the level of non-performing loans has been on the rise. These conditions have led to a flight to safety in the industry as the top 10 banks in Kenya control 90% of total assets and are perceived to have the greatest ability to weather the adverse conditions.

We met with Kenya Commercial Bank (KCB), East Africa's oldest bank which traces its roots back to 1896; Equity Bank Group; and Housing Finance Group. KCB and Equity Bank are both considered high quality banks, but they adopted very different strategies in this challenging environment. KCB, thanks to its access to cheap deposits, was able to grow its loan book quite nicely, especially in retail and SME (small & medium size enterprise) segments. On the other hand, Equity Bank has become much more conservative and shifted its assets into government securities. Housing Finance Group is more affected by the current environment. While the institution has lost deposits to tier 1 banks, management advises that it has secured enough cash for bond repayment and is focused on fund raising.

We met with representatives of Safaricom, the successor to the once state-run Kenya Post and Telecommunications Company, and now one of East Africa's most profitable companies. The company is also weathering the political uncertainty but is nonetheless expanding its subscriber base as adoption of mobile wireless telephony continues apace in East Africa, where wireline communications are less developed and reliable. The company is also the beneficiary of rapid consumer adoption of such services as mobile banking and electronic cash services that operate off its platforms.

Brewer EABL, maker of Tusker Lager, reported that the business environment in Tanzania was proving challenging but that the Kenyan market has improved. The company is establishing a new brewery for its lower-priced Senator brand lager, which achieves lower margins but holds potential for significant top line growth.

Management of Centum expressed optimism in its diversified portfolio of Kenyan infrastructure, real estate, healthcare, education and agricultural investments. The company, which has a history of solid returns on investor capital, reports that current shares represent an attractive discount to their net asset value.

Tanzania

The operating environment in Tanzania has become very challenging since the election of President Magufuli. Elected as an anti-corruption reformer, the president rode to victory with strong populist appeal. Since assuming the powers of the presidency, he and his administration have opened few lines of communication with the private sector, essentially marginalizing the private sector and creating significant uncertainty in the investment environment. This change in regimen has imposed a chilling effect throughout the bureaucracy which has filtered through in the government's day-to-day interactions with the private sector. GDP growth is expected to reach 7.1% for 2017 but the advance is not broad based. Private sector credit growth has fallen to 2.5% this year down from a 22% increase in 2016.

We visited with managements from aviation services company Swissport, commercial banks CRDB and NMB, and telecommunication companies Vodacom and Tigo. All of them shared frustrations over the uncertainties of the regulatory environment. The management of Stanbic Tanzania made a comment: "The country has become a more centralized government system. Initiation is dead. Initiation gets you fired." All of the managements agree that Magufuli will be certainly a two-term president. In this difficult environment, companies are re-evaluating their business strategies, setting up new goals and trying to adapt to the new environment. After almost two years of holding-back on business activities, we now start to see more actions from the private sector. Another piece of positive news we learned is the government has finally realized the importance of the private sector and is attempting to seek advice from them, after several proven wrong policies. Might this be the light at the end of the tunnel? I am not sure. We will just have to watch.

Moving Forward

The challenges and uncertainties in East Africa today are consistent with the ebb and flow experienced in all developing markets. While we are disappointed to see opportunities squandered for near-term growth and development, we are heartened to see that the long-term potential remains intact and that economic growth persists along with the desires of East Africans to improve their lives and countries.

We remain confident in the ability of our Kenyan and Tanzanian holdings to deliver attractive returns to clients over the long term, just as we expect the political regimes of Kenya and Tanzania to change or be changed and the rains to finally fall.

About Frontier Market Asset Management

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