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Debunking the biggest myths of investing in listed African equities

"The great enemy of the truth is very often not the lie, deliberate, contrived and dishonest, but the myth, persistent, persuasive and unrealistic." John F. Kennedy

by **Gaetan Herinckx** | August 27th, 2013

Myths tend to thrive in environments of imperfect information. Africa and its financial markets certainly fall into this category, with myths often perpetuated by outsiders (including investment professionals) whose Africa first-hand experience is limited and whose perceptions of Africa are informed by mainstream media such as television news networks. Good news is difficult to sell, which explains why perceptions of Africa are often completely out of touch with the reality on the ground. The emergence of investment markets in Africa (outside of South Africa) over the past 10-15 years has been accompanied by its own category of myths, some of which have managed to survive despite clear factual and empirical evidence to the contrary. The most persistent of these 'African investment' myths have an element of truth that makes them intuitively appealing, yet they fail to pass muster under the close scrutiny of empirical evidence.

Myth #1: "Investments in African listed equities are 'off the page' risky": A key underlying assumption of this myth is that socio-political risk is equivalent to investment risk. This is clearly an incorrect premise, since investment risk is a function of both fundamentals (such as country or company risk, or growth prospects) as well as the crucial element of price. From a fund manager's perspective, we believe that investment risk in Africa comes from: a) Not knowing what you are doing (not knowing enough about the company that you are investing in); b) The price paid for an asset (a share of a company, in our case). The former risk source can be mitigated through detailed company research and due diligence. The latter can only be overcome through a disciplined investment process. Also, Africa (ex-South Africa) listed equities, in the context of a global portfolio diversification/risk management, offer a compelling investment case considering its correlation with developed and emerging markets, respectively 0.25 and 0.3. It is probably one of the few market sectors in which one can enjoy such diversification benefit while being exposed to a long-only equity strategy.

Myth #2: "African currencies are highly volatile": The historical performance and volatility of the key African currencies over the past 10 years provides evidence that this idea is simply not supported by fact. African ex-SA currencies have been less volatile than most of their developed and emerging market counterparts and less than half the volatility of the South African Rand. In keeping with the relative strength of African economies, most of the key African currencies for listed equities (including Nigerian Naira, Egyptian Pound, Kenyan Shilling, and Tunisian Dinar) have outperformed the US dollar over the past 10 years.

Myth #3: "There are not enough high quality African companies to invest in. Management quality is generally poor": There are about 900 Africa-dominant listed equities amongst which 300 are meeting our minimum liquidity criteria. Based on our first-hand experience, we can confirm that the proportion of poor- or high-quality management in Africa ex-SA is probably similar to developed markets. The low success rate of international companies who have entered Africa over the past decade on the assumption of inferior domestic competitors provides credence to our case. Since we typically aim for

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high-conviction, concentrated portfolios of less than 25 stocks (with most of our portfolios concentrated in the top 10), we only need to be invested in less than 5-10% of the investment universe at any point in time. Our job is to find the top 5% of Africa's high-quality companies that are trading at material discounts to their fair values and thereby warrant material overweight positions in our portfolios.

Myth #4: "Listed subsidiaries of multinational companies (LSMC) in Africa present higher corporate governance practices than the average listed 'domestic' company": Our research indicates that investing in listed subsidiaries of multinational companies' (representing close to 30% of the top 100 companies by market cap) does not correspond de facto to better protection of minority shareholders. Major conflicts of interests may arise when 'slicing the pie' (distributing value between majority and minority shareholders). This risk is exacerbated by perverse management incentives whereby LSMC's management teams are employed by the parent company and benefit from share-based incentives at the holding company level (80% of share-based incentives take place at the parent company level), providing no meaningful incentive for value creation at the local subsidiary level. This disconnect between management incentives and LSMC's minority shareholders interests would for instance materialise in management/service/brand fees that are generally charged as a percentage of the subsidiary's revenue, which seldom bears any resemblance to the fair value of the service provided and in some case represents up to 40% of the profit before tax. We therefore believe different controlling shareholding structures demand a case-by-case, company-specific research approach that includes an analysis of sector dynamics, the historical and cultural context of corporate governance practices in specific companies and countries, and the economic value derived from the controlling shareholder's input.

Myth #5: "It's best to access African companies through private equity (listed equity is too constrained by liquidity)": We agree that both private and listed equity asset classes in Africa deserve close attention from investors at different points in the valuation cycle. It is certainly true that listed equity markets in Africa are less liquid than their developed market counterparts, with significantly lower tradable free floats. Even so, our experience indicates that it is quite feasible to manage a diversified portfolio of listed equities in Africa ex-SA on a monthly subscription-redemption cycle at relatively low liquidity risk, under the following conditions: a) The fund manager cannot afford to be greedy in terms of fund size, which needs to be capped at levels where good historical performance can be replicated; b) Liquidity risk needs to be managed in a disciplined manner at a portfolio level. When comparing liquidity, we need to ask ourselves which asset class has a greater liquidity challenge: Monthly liquidity (as is typical with Africa listed equity funds) or the 5-10 year lock-up of a private equity fund? The next obvious question is what return premium (or valuation discount) private equity investors should demand for incurring the opportunity cost of an extended lock-up? In our opinion, buying listed equities at similar valuation levels to private equities falls into the 'no-brainer' category on a liquidity risk-adjusted basis.

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London, 11th October 2013

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Myth #6: "It is safest to get Africa exposure through foreign listings (including the JSE for Africa ex-SA stocks)": We measured the underlying economic footprint of Africa ex-SA 'plays' listed in South Africa and Europe. Our analysis demonstrates that the investment universe of Africa ex-SA dominant stocks listed on international exchanges is extremely constrained (with the notable exception of the resources sector). Equally-weighted portfolios of 'Africa plays' listed in SA and Europe offer underlying Africa exposure of only 26% and 11% respectively. As a consequence, we seriously question the viability of getting meaningful Africa exposure through stock exchanges outside of Africa ex-SA.

Myth #7: "You can't do sustainable investment in African listed equities": There is a wide gap between disclosure (if any on ESG dimension) and reality in African companies. Equally, there is a major divergence in company sustainability quality. Some companies masquerade in their reports as exemplary corporate citizens, yet a due diligence of their operations often reveals a very different picture. At the other extreme, there are companies that fly completely 'below the radar screen' with limited reporting, yet on closer inspection it becomes clear that they are world-class, cutting-edge organisations ahead of best international practice in everything ranging from labour practices to corporate governance. At this stage, there is only one reliable way to differentiate between 'spin doctor' pretenders and companies of authentic quality, and that involves 'kicking the tyres' on the ground in African countries.

The reality is that sustainability disclosure and third-party research is probably 10-20 years away from the point where high-conviction investment decisions can be supported purely by desktop research conducted from a stuffed chair in an air-conditioned office. We see clear evidence that long-term sustainability factors are materially mispriced in African equity markets, which is not particularly surprising in an environment of imperfect information. We would argue that the potential to generate 'sustainability alpha' (outperformance generated by taking advantage of mispriced sustainability risks and opportunities) is far greater in Africa, where few listed equity investors are conducting true sustainability research, than it is in more mature markets where disclosure is freely available and markets are more efficient. We have tested some of the 'urban legends' of African equity investment against the hurdle of empirical research and objective analysis. We believe Africa deserves more attention from international investors than just relying on myths. Proper research on potential asset allocation to Africa Ex-SA is part of our fiduciary duty ('optimise the asset allocation of our clients') and our 'societal' duty ('Assess the relevance to allocate capital to Africans eager to take part to sustainable economic development').

Gaëtan Herinckx is Partner – Senior Investment Analyst at Sustainable Capital, whose research team is based in Cape Town

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