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Sustainable shops for top consumer names

Africa-focused boutique sees compelling valuations and long-term growth prospects with nimble portfolio

Africa-focused, owner-managed boutique Sustainable Capital sees significant potential in the consumer space, despite a particularly tough patch for markets across the continent and ongoing macroeconomic speculation about the strength of consumer spending in the current cycle, given a lower-growth scenario in several African countries.

The company launched its Africa Consumer Fund in March 2013, investing in a concentrated portfolio of 15 high-quality listed consumer-driven companies in Africa (ex-South Africa). The fund aims to provide investors with active equity exposure to the growing African consumer markets within a sustainable investment framework at relatively low cost.

Sustainable Capital uses a similar investment process across its portfolios, focusing on high-quality companies with adequate underlying liquidity and strong financial track records. Stock selection is informed by detailed in-situ company due diligence with an emphasis on asset quality, robust corporate governance standards and industry-leading environmental and social performance.

Since its inception, the Consumer Fund has returned -0.9%, outperforming the African markets by 25.8% in US dollar terms (the S&P Africa ex-SA capped index returned -26.7% over the same period). The fund is 14.1% lower so far this year (6.4% ahead of the market), after a 5.4% gain in 2014 and 9.5% in 2013.

Sustainable's Greg Barker notes that the fund has significantly outperformed other consumer-based portfolios and the broader market indices. "It is difficult to manage an Africa-dominant consumer fund at prohibitively large fund sizes. Liquidity constraints make it a mathematical certainty that excessive fund size curtails the investable universe and thereby handicaps the manager's ability to generate outperformance through stock-picking," he says.

Now at US$11.9 million in size, the fund will be closed to new investments at $200 million to preserve its ability to invest in the small and medium-sized companies that tend to exhibit severe mispricings. Its anchor investor is a UK-based frontier specialist, with other investors recently having joined the fund.

"We have a holistic definition of consumer companies that extends beyond the traditional food and beverage category to include consumer microfinance, residential real estate, generic pharmaceuticals and retailers. If you limit your portfolio to the well-trodden, fashionable multinational food and beverage companies, you can be trapped in expensive investments due to style bias. Before the recent pullback, several of these companies had been trading at demanding earnings multiples of 30-40 times and were priced for perfection in some cases. Investors have been overpaying."

In terms of stock selection, the fund focuses on high-quality, well-managed assets with excellent long-term growth prospects. For 2015, the portfolio has an average price-earnings (PE) ratio of 16.7, which is expected to fall to 14.4 times next year. The cash dividend yield is 4.6% this year, and expected to reach 6.1% next year, giving the portfolio a strong cash underpin.

By country, the fund has the most exposure to Nigeria (28.4%), Kenya (21.9%), Morocco (12.3%) and Egypt (10.8%). By sector, it has the most capital allocated to beverages (38.4%), consumer microfinance (23.1%), food products (14.7%) and residential real estate (12.3%), with lesser allocations to food retail and pharmaceuticals.

Barker says current market prices in African listed equities have dislocated from economic reality and appear "absurdly cheap" relative to their own long-term histories and underlying fundamentals, with several companies displaying PE ratios below 5 and cash dividend yields of over 10%. He notes that attempting to time these markets is futile, given finite liquidity. This is exacerbated by stock-market rules such as daily limits, which make it practically impossible to establish a position once the market is 'limit-up'.

The company's first fund, the Sustainable Capital Africa Sustainability Fund, is a smart-beta portfolio that invests in the top-40 sustainable listed companies in Africa (ex-South Africa). The portfolio is balanced quarterly. The fund is 17% lower so far this year against a 20.6% decline from the S&P Pan Africa ex-SA Index, and is a net annualised 1.6% lower since inception, against a -2.4% index decline.

The Sustainable Capital Africa Alpha Fund launched in February 2012 after three years of intensive valuation-based research. Since inception it has returned a net annualised -0.4% versus -4.7% from the index, and is 31% lower this year. Stocks in the fund have an average PE ratio of 5 currently, which is forecast to decline to 4.1 next year, with a dividend yield of 9.7%.

"African companies are growing their earnings bases off exceptionally strong balance sheets, yet we are able to buy them today at significant discounts to the replacement cost of their tangible assets. Current price multiples suggest the most favourable entry point for African equities since we started Sustainable Capital eight years ago," says Barker. "Externalities such as short-term socio-political risk perceptions and fund flows have driven prices over the past year. Price-indiscriminate selling has led to distressed valuations, yet companies continue to prosper, despite the challenging macroeconomic environment."

The Sustainable Capital Nigeria Fund, a long-only country-focused portfolio, is a net 15% lower on the year, investing in the top-15 sustainable listed Nigerian companies. Here again, the team believes that Nigerian equity prices reflect immense short-term negative risk perception, rather than the strength of long-term growth prospects at a company level.

"We don't spend a lot of time trying to explain why share prices are down," says Sustainable's Kevin Macdonald. "We believe that our research-driven sustainable philosophy will reward our investors over longer-term time periods as reported future earnings are likely to make current prices look exceptionally compelling."

The team does not use an exclusionary 'negative screening' approach to its sustainability assessments, preferring to examine companies on a case-by-case basis. "We search for companies that overcome the hurdle of being in traditionally difficult industries by making a positive contribution, reinforcing their licence to operate," says Macdonald. "For example, we invest in several well-managed resource stocks in Africa where our research indicates that their positive socio-economic impact more than outweighs the negative footprint associated with the industry."

Sustainable Capital has a seven-strong investment committee, with no turnover of full-time staff since its inception. With over $100 million under management across its funds, it has a diversified client base, with more than 100 underlying investors.

FUND FACTS
Sustainable Capital Africa Consumer Fund
Strategy: long-only, pan Africa ex-SA
Fund manager: Sustainable Capital
Inception date: March 2013
Administrator: Apex Fund Services
Domicile: Mauritius
Custodian: HSBC Bank
Auditor: Ernst & Young
Open for investment: Yes
Minimum investment: US$100,000