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Sustainable Capital uncovers value

Agnostic approach to stock-picking unearths opportunity, as team finds African listed equities "exceptionally cheap" in absolute and relative terms

Mauritius-based African investment specialist Sustainable Capital has made steady progress with its Africa ex-South Africa funds. The manager's flagship Sustainable Capital Africa Alpha Fund, managed by director of research and co-founder Greg Barker, is up a net 41.9% in US dollars this year to the end of September (38.7% ahead of the market return) with a track record of just over four-and-a-half years.

The fund typically holds a concentrated portfolio of 15 to 25 stocks (currently 20 stocks), with 80% of the portfolio invested in the top 10 holdings. Of a liquidity-screened investable universe of close to 300 listed equities across Africa (excluding South Africa), the fund takes a country, sector and benchmark agnostic approach in order to identify the top 20 stocks at any point in time based on a bottom-up company valuation process. The fund's returns have low correlation to developed and emerging-market equity indices, sitting at less than 20% since inception.

According to Barker, African listed equities are currently exceptionally cheap in absolute and relative terms, with the Africa Alpha Fund currently trading on a portfolio-weighted price-earnings ratio of 5.1 (based on expected earnings over the next year). Furthermore, Africa's environment of imperfect information creates market inefficiencies and makes it possible for diligent stock-selectors to take advantage of material mispricing opportunities.

"The entry point for investors in Africa today is so much less demanding than 2007," he says. "The Africa Alpha Fund is currently trading at a 20% discount to its book value, despite an average return on equity of over 23%. The cash underpin of a 7% dividend yield at a portfolio level provides a measure of downside risk protection. The average discount to fair value in the fund today is 49%, implying an expected return of 97% if our holdings revert to their fair value."

Barker's view is that the drawdown in African equities since mid-2014 has been largely driven by negative investor sentiment focused on short-term socio-political risk perceptions, which has resulted in market prices disconnecting from the economic reality of company fundamentals.

"Unlike the precursor to the global financial crisis in 2007 (when all asset classes were expensive), African equity valuations are not far from their all-time lows, in contrast to developed markets, which are currently approaching all-time highs," he says.

For global investors looking to allocate capital rationally, Barker says the probability of a significant de-correlation event for African equities under a scenario of falling global equity markets has grown due to the wide disparity in valuation levels.

The fund's highest monthly performance this year was in April when it was up 16% in US dollars. This was due to prices reverting from distressed valuation levels, where some companies were priced for bankruptcy despite underlying fundamentals that have remained largely intact. As prices adjusted downwards, Barker had progressively rebalanced the portfolio into existing positions, which accentuated the fund's losses during 2015, but is now conversely beginning to reward the fund's investors.

"In the short-term (over one to two years) it can be an extremely painful approach because you are putting more capital to work in a stock that continues to be driven down by momentum," he says. "Eventually you reach a capitulation point where the reported assets, free cash flows, company earnings and revenues make the stock absurdly cheap, forcing a re-rating."

By the end of 2015, most companies in the portfolio were trading at extremely wide discounts to the replacement value of their tangible assets, with valuations approaching two standard deviations below their long-term averages. Barker describes it as the kind of opportunity to buy into listed African equities that will only present itself every 20 or 30 years.

The fund's biggest monthly drop this year was in January when it was down 8.6% in US dollars due to losses in the Nigerian market, while also weathering negative short-term market performance to take advantage of longer-term opportunities.

The fund currently has US$89 million in assets and, under current market conditions, will close to new inflows at US$300 million. Over the past two years, the fund has benefitted from net inflows with further commitments in the pipeline from existing investors, leaving it with less than US$150 million in remaining capacity.

The Sustainable Capital Africa Consumer Fund has a track record of over three years, and focuses specifically on consumer-led and consumer-driven companies tied to Africa's changing demographics and growing middle class (including consumer microfinance, food products, beverages, consumer goods, retailers, residential real estate and pharmaceuticals). The fund's investment universe, therefore, excludes insurance companies, banks, industrial manufacturers, cement producers, and commodity and resource companies.

The fund was launched for investors looking for pure exposure to Africa's domestic-led consumer growth story. With 15 stocks it is slightly more concentrated than the Africa Alpha fund, and follows a similar philosophy of investing in high-quality companies trading at significant discounts to intrinsic value.

The fund's concentrated focus results in higher short-term volatility but with the opportunity for longer-term gains as the consumer growth story unfolds.

So far this year to the end of September, the fund is down a net 10% in US dollars. In June it dropped 8.7%, while its biggest gain this year was a net 5.6% return in March. Since inception, the fund has outperformed the African market by 12%, delivering its returns at half the risk of the market, with a portfolio beta of 0.5.

The fund has US$8.4 million in assets under management, with capacity to grow to US$250 million before closing.

Key to Sustainable Capital's success has been its long-standing and sophisticated investor base, which Barker says has been fundamental to maintaining its investment philosophy and not destroying value through short-term redemptions.

"We have the benefit of patient capital in our investor base where the average holding period approaches 10 years," he says. "Our investors have been in Africa for many years and understand the nature of market cycles, and that drawdowns represent opportunities to increase exposure."

"With any liquidity-constrained market, like Africa, if you don't have the support of your client base then you can destroy a huge amount of value as short-term redemptions force you to sell stocks at the worst possible time. By doing that, you drive market prices down further, which then becomes a self-fulfilling prophecy."

Investors include predominantly US- and European-based high-net-worth investors, endowments, family offices and long-term institutional investors.

Looking ahead, Barker is focused on advancing the team's pipeline of new investment ideas and progressively rebalancing the portfolio as current holdings continue to rerate towards fair value.

He describes a growing divergence between the recent performance of resource companies (mining, mining services, and energy companies) where the fund has invested, and domestically led African companies that have been underperforming.

"Certainly on a relative basis there has been a massive delta between the performance of these asset classes," he says. "This creates an excellent opportunity for us to rotate the portfolio and rebalance profitably on behalf of our clients into good new ideas that we've been working on."

Sustainable Capital Africa Alpha Fund
Strategy: Long-only, pan Africa ex South Africa
Fund manager: Sustainable Capital
Inception date: February 2012
Administrator: Apex Fund Services (MU)
Custodian: HSBC Bank Ltd (MU)
Auditor: Ernst & Young
Assets under management: US$88.7 million
Open for investment: Yes
Minimum investment: US$100,000

Sustainable Capital Africa Consumer Fund
Strategy: Long-only, pan Africa ex South Africa, consumer focused
Fund manager: Sustainable Capital
Inception date: March 2013
Administrator: Apex Fund Services (MU)
Custodian: HSBC Bank Ltd (MU)
Auditor: Ernst & Young
Assets under management: US$8.4 million
Open for investment: Yes
Minimum investment: US$100,000