HedgeNews Africa

THE QUARTERLY JOURNAL OF THE AFRICAN ALTERNATIVES AND HEDGE FUND COMMUNITY
AUGUST 2011 ◆ WWW.HEDGENEWSAFRICA.COM

Shareholding structures key for Africa investors

Sustainable Capital focuses on corporate governance risks across continent

Shareholding structures pose material corporate governance risks for investors in listed African companies, according to independent asset manager Sustainable Capital, which specialises in the management of listed equities in Africa excluding South Africa.

According to Sustainable Capital, of the top 100 firms by market capitalisation in Africa ex-SA, 71% have majority or controlling shareholders and, more specifically, 28% are listed subsidiaries of multinational companies.

"Contrary to the traditional corporate governance wisdom, investing in the listed subsidiaries of multinational companies (LSMCs) does not automatically correspond to better protection of minority shareholders," said Gaëtan Herinckx, Sustainable Capital's senior investment analyst. "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."

Sustainable Capital's research shows that corporate governance practices at these companies can impact the entire chain of shareholder value creation or destruction, ranging from capital allocation (including dividend policies, financial leverage and corporate actions) to operating profit margins and earnings growth (influenced by transfer pricing, management incentive systems and profit-sharing arrangements).

"As minority shareholders invested in listed subsidiaries of multinational companies in Africa, investors should ensure good corporate governance practices in order to overcome the inherent conflict of interest between minority shareholders and management and majority shareholders such as multinational parent companies that control their local subsidiaries," said Herinckx.

Greg Barker, Sustainable Capital's portfolio manager and head of research, added that many investors were of the opinion that multinational subsidiaries offered an easy entry point to the African markets.

"When we concluded this research, it was quite startling to see how many listed equities in Africa are controlled by multinational holding companies, which have their own specific risks," he said. "There is a very different governance risk to investing, for example, in the foreign-listed Unilever group as opposed to a locally listed subsidiary of Unilever in Africa. Minority shareholders have very little leverage over the actions of the group holding company."

Barker said key risks include conflicts of interest related to how managers are incentivised and how balance sheets are managed.

"Management fees and royalties can be levied at revenue level. Fees of 2-3% at revenue level paid to a parent company can represent up to 24% of profit before tax, particularly with a low-margin business such as a cement company," said Barker. "We have found cases where it is difficult to justify the level of fees charged by the parent for services provided. This can impact dividends to shareholders and taxes paid to the government of the country in which the subsidiary operates. These factors can be highly material to shareholder value."

Family-owned businesses often presented better prospects as management tends to be better aligned with minority investors through share ownership and longer-term time horizons.

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"Often with a family-owned business you are in a much better position than you would be investing in an MNC," he said. "Management at LSMCs tends to be expatriates on a three- to four-year contract, often hired by the parent company and incentivised at the group level. The manager often has little vested interest in growing the value of the local subsidiary; they often have no 'skin in the game'."

Research is critical

Sustainable Capital believes such factors underscore the importance of intensive on-the-ground research.

"[Our research findings] do not mean we would avoid majority-controlled companies altogether," said Barker. "But these [corporate governance] factors do need to be considered as part of the research process. Corporate governance issues are a big factor in our investment decisions."

The team's Africa Sustainability Fund, a long-only, 50-stock equity portfolio, is diversified across African geographies, currencies, sectors and companies, focusing on those companies with over 50% of their economic footprint in Africa ex-South Africa. The fund aims to provide long-term investors with equity exposure to African companies within a sustainable investment framework at relatively low cost.

It employs a market-value independent strategy based on fundamental financial factors (such as revenue, operating cash flow, shareholder equity and cash dividends) and sustainability factors (including company and country sustainability ratings). These assessments have the net effect of aggressively up-weighting stocks and currencies in the most sustainably managed companies and countries, and vice versa.

The fund now has around $25 million under management, with exposure limits set for a fund size of $500 million in anticipation of future growth.

"If the fund were bigger, there would be no difference in the way we run the portfolio with regard to liquidity and other factors," said Barker.

By geography, the fund has 28% in Egypt, a big market in the African context where it is underweight relative to the market-cap benchmark. Morocco is its biggest overweight position at 25% of the fund, with Nigeria at 9% (compared with exposure of 20-30% with many other managers). Mauritius accounts for 6% of the fund, with Kenya at 5.5%, Zambia at 3.2% and Ghana and Tunisia at 2.5% each. Countries such as Mali and Senegal make up the balance.

By sector, financials account for 34% of the fund, mostly via commercial banks, with telecommunications at 28%, industrials at 11.3%, and mining & metals at 11% (including copper miners, gold and steel). Energy and real estate are at more than 5% each with consumer and food & beverage at 7%.

The team conducts a disciplined rebalancing process, trading once a quarter with the next rebalancing at the end of September. The fund is 10.01% lower this year to the end of July, and has gained a net 5.23% since inception in November 2009.

Taking the long-term view

"We are not unhappy with the fund's performance so far," said Barker. "Our biggest exposure is to Egypt, where the market is down 35% year to date. So it's been tough to generate a positive return in absolute terms. But market volatility tends to work in our favour due to our disciplined rebalancing process. If stocks run ahead of their model portfolio weights we take profits and if they go down we can materially increase our position providing the fundamental reason for the investment has not changed. But we don't get involved in short-term trading."

"We do emphasise downside risk and our fund tends to be more defensive than many. If you look at the 25 biggest drawdown days in our markets since inception, we go down a lot less than the market. The fund also offers a 4.6% portfolio weighted dividend yield, which is exceptional. You can't get that on a bond in the US."

Bottom-up, on-the-ground research is key to the team's process. It did a lot of work in Egypt late last year and again at the start of the year, giving it comfort in its positions despite this year's market turmoil.

"Egypt was a 'black swan' for the markets. We were there late last year and none of the locals had a clue what was coming. The general consensus was that [ousted president Hosni] Mubarak would be there forever. We did a lot of work again in Egypt at the start of the year. Some good-quality companies were down 30-40% and we increased positions quite materially. It is a very retail-driven market, which can drive share prices to diverge materially from their fair values. At the moment, Egyptian shares are pricing in a low-road scenario and we believe that there is less than a 10% chance that will happen so we are happy to take a long-term view."

Blue-chip Egyptian bank Commercial International Bank is one example of a promising company the fund has exposure to. "It is still growing its loan book. It has no meaningful bad debt. And that's in a bad year.," says Barker.

Sustainable Capital says it sees increased interest in Africa, most notably from European institutions and South African pension funds. The fund is dollar-denominated and listed in Mauritius, although it also sits on Sanlam's Glacier platform, giving South African investors rand-based access.

"We believe it is a very good time to allocate to Africa. History shows that the best time to buy in emerging and frontier markets is usually when it feels least comfortable," said Barker.