

## Monthly Investment Commentary – October 2013

I have just returned from about 10 days in Africa, visiting Mauritius, South Africa, Namibia and Ghana. There is no question of the importance of this region in the next decade. The population of sub-Saharan Africa is now around 1 billion, and is likely to increase rapidly to around 2 billion by the year 2040, contributing most of the growth in the world population in the next generation as over 70% of the African population will be under 25. Africa has already experienced an unprecedented decade of post-colonial growth of around 6% per annum GDP since 2000 and during the same time, the number of democracies on the continent has grown from 2 to 42, and the number of on-going conflicts fallen from 12 to about 4.

The penetration of the mobile telephone has jumped from 12 to 600 per 1,000 people over the last 20 years, and has had a dramatic effect on political and economic activity. Education is beginning finally to improve in numbers and in quality, but it still has a long way to go with 1/3rd of African schoolchildren not completing primary school. The role of women is of great importance as they improve their education and economic status and they already own around 10% of the African economy.

Notably, Africa contains about 60% of the world's arable land, and nearly all of the untilled land which needs to be used to feed the potential 10 billion human population by mid-century. Only 20% of Africa's land is cultivated (and as we have seen in Brazil's Rondonia area in the last 20 years, it is possible to clear and plant such bush country and achieve yields rising from 1 ton per hectare to 12 tons per hectare, as is the case in North Africa). At present nearly all sub-Saharan African countries are food importers, but there have been some notable improvements in Zambia, for example, and Mozambique.

The estimated size of the African economy is about \$1 trillion, of which the largest countries are: South Africa, with a GDP of \$365bn and Nigeria, with a GDP of over \$200bn. Nigeria's population is now 160m and will most likely reach 400m by 2050 and 1 billion by the end of the century. Despite the western impression of chaos and corruption, there are a lot of positive changes occurring.

We have visited one of our largest investment holdings, Guaranty Trust Bank of Nigeria, which has operations in Ghana and several other countries. They have 5.2% return on assets and a 34% return on equity, pay a 6% dividend yield and are growing earnings at over 36% per annum. There is a strong impression of dynamic, disciplined and efficient capital management which has delivered good returns to shareholders over more than 10 years. Nigeria is certainly the dynamo in West Africa and Mr. Aliko Dangote who runs cement and other industries is most likely to become the world's richest man in the next few years, overtaking Carlos Slim.

The capital markets in Africa are certainly illiquid and undeveloped and account for less than 20% of GDP. Over the next few years there will be a number of important privatisations and IPOs which will most likely lift this figure to 50% of GDP and daily share turnover up to levels similar to those of India and Brazil. We cannot, of course, speak of Africa as a single entity, as it is more than 50 countries and we expect that there will be some 'break out nations' or successful economic and political models which will inspire and lead the rest.

Among these will most likely be Mauritius, Namibia, Botswana, and possibly Mozambique, Kenya and Ghana. Some observers even see Rwanda as a recovery opportunity. In all these cases there has been a strong emphasis on education, land reform and political stability as well as good corporate governance. Although corruption is still an endemic problem all over the continent there is gradually improving transparency.

The advent of China as a major trading partner, and investor, has already had a dramatic effect on nearly every African country over the last decade. Everywhere we travelled we heard about the Chinese building airports, roads, dams and even presidential palaces. They normally bring in their own labour force, complete the job and go home. They also extend soft loans to many of the countries, in exchange for advantageous terms, to develop natural resources.

They depend on several African nations, such as Angola and Nigeria for an increasing percentage of their oil imports. They also source many minerals such as Platinum, Gold, Tungsten and Cobalt from southern and central Africa.

In many cases there are small 'mom and pop' stores run by Chinese in remote areas of the continent, but it is also true to say that the commodity boom of the last 10 years, which has been driven so much by Chinese demand, has had a deep and lasting effect on Africa's economic development and average African incomes. If the commodity boom falters, there is no doubt that Africa will feel it.

On the other hand, we have identified many good consumer brand companies, which have, in many cases, a self-sustaining growth, which is dependent on basic daily needs and consumer tastes, rather than income for mining or oil. We like to say that we can find 'good companies in bad countries'.

Examples include the tobacco business in Egypt, a brewery in Zimbabwe, micro lending in Botswana, ice cream and milk distribution in Ghana and banking, tobacco and breweries in Nigeria, as well as a supermarket in Kenya, trade finance in Mauritius and a telecom in Senegal.

In every case we have diligently visited and revisited management, checked with competitors and subsidiaries and established for ourselves that we have the true picture of cash flow, debt and return on invested capital.

Most of the companies we own in Africa are paying us good and growing dividends with a 5% yield. In most cases we see the transition from average annual incomes of US\$500-\$1,000, up to US\$2,000-\$5,000 over the next decade as being a time of tremendous investment opportunity, especially in these key areas of retail, food and beverage, tobacco, banking, insurance, tourism and travel.

In fact, we are looking at a similar phase of development to what we saw 30 years ago in Asia, when incomes were similarly low and the consumer was not yet a major factor. Today the Asian consumer accounts for over 60% of GDP and we expect the same pattern of development to occur in Africa over the next 20 or 30 years.

It is also worth emphasising (in the context of a risk repricing by investors following a potential US Dollar crisis) that we do not invest in companies which use heavy debt financing (most pay for capital expenditure from cash flow) nor do we have any exposure to developing economies which have high current account deficits.

China's economy has shown signs of recovery in terms of exports, industrial production, and the official growth rate continues to be around 7.5%. Although we continue to treat the official numbers with some caution because we see a slowdown in employment and foreign direct investment, we recognise that the momentum of China's economy continues to be impressive. It does not logically follow that Chinese A share prices will outperform, as there are still some structural problems with the overhang of state owned shares and the opacity of published accounts.

It is possible that we could see the Renminbi weaken against the Dollar over the next 12 months as China's terms of trade have significantly changed with the stronger currency, rapid rise in factory wages and other costs, electricity, water and transport, which have made Chinese exports less competitive. Also, the pressure from a weaker Yen will continue to put pressure on China and other Asian exporters such as South Korea.

The Indian situation has improved, with the Rupee recovering from its all-time low of around 70 to the US Dollar. The new Governor of the Reserve Bank of India, Mr. Raghuram Rajan, has started strongly with an increase of interest rates (and forex swaps for oil imports, and bringing in US\$7 billion from NRI deposits) and there is still every expectation that in 2014 we will see a change of government in New Delhi, leading to a BJP led coalition and Mr. Narendra Modi as Prime Minister. This would be a powerfully positive signal to foreign investors in India and we believe it is worth investors taking the long view now on Indian equities.

The whole financial world is somewhat overshadowed at the time of writing by the seemingly unthinkable prospect of a US default on its debt obligations and the government shutdown, which has now lasted nearly two weeks. So far, the reaction from the markets has been quite muted, as nobody believes that the American lawmakers can be quite so irrational as to push their economy over a cliff. Sometimes the unthinkable does however happen, and we are trying to analyse the secondary consequences for the major creditors of the United States, led by China, Japan, the OPEC countries and Europe.



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