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Centre Asset Management, LLC
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2020 Equity Market Outlook: Frontier Africa Markets
January 2020

2010 - 2019 Review

At the end of every year, we usually get the opportunity to look back and reflect on the year's events. As we enter into a new decade, we also have the added benefit of looking back at the dramatic changes that have occurred in Africa over the last ten years, as we contemplate the opportunities and challenges that might lay ahead for the continent.

Over the last decade, we have learnt a lot about African markets. Falling oil and commodity prices have caused setbacks in some of the large resource dependent economies, and the relative illiquidity in the continent, coupled with risk aversion towards frontier markets has negatively impacted investor sentiment. Despite these unique challenges, the structural growth across Africa remains strong. With accelerating economic growth and stocks trading at historically low valuations, we expect strong returns in the medium to long term.

Post Financial Crisis

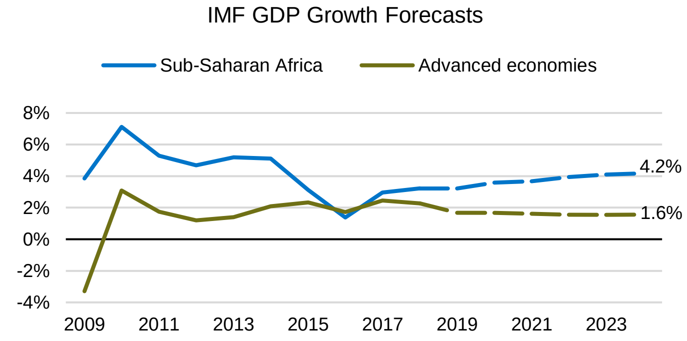
As developed and emerging economies recovered from the global financial crisis, African economies emerged relatively unscathed. In the period between 2009 and 2014, they continued to post high levels of economic growth of 5-7% and attracted both private and public investment capital.

African equity markets posted strong returns during the early part of the decade with the MSCI EFM Africa ex SA index posting a total return of 36.6% from 2010-2013. These returns were supported by strong investor optimism, positive investment flows and monetary easing in the U.S. and Europe. Africa was clearly decoupled from what was happening in the global markets, as African economies were experiencing strong growth and stable macroeconomic environments.

Recovering Economic Growth

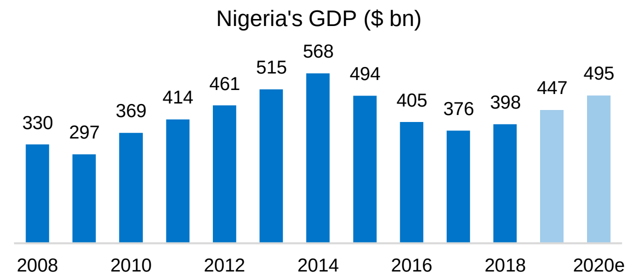
Investment returns however, were disappointing between 2014 and 2019. Some of Africa's largest economies such as Nigeria and Egypt suffered major setbacks due to the fall in oil and commodity prices. Consequently, economic growth slowed rapidly from 2014 and has only recently started to recover.

During this period, oil prices fell by 40.4%, iron by 24.5% and copper by 17.7%, triggering a currency crisis in countries such as Egypt, Nigeria and Zambia



Source: IMF World Economic Outlook - October 2019

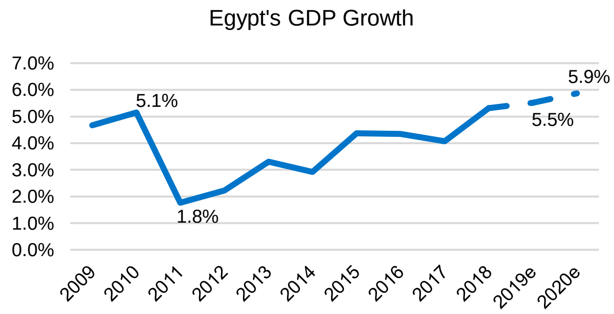
Nigeria's GDP chart highlights some of the difficulties that the continent's largest economy has faced. Over the decade, Nigeria struggled to generate growth and has suffered a major currency devaluation. In recent years, the economy has subsequently rebounded and GDP is projected to grow to $495 billion in 2020.



Source: IMF World Economic Outlook - October 2019

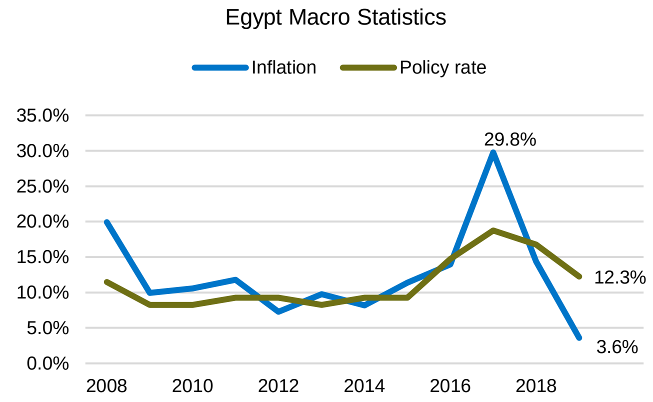
Over the last three years, Egypt has carried out difficult economic reforms after receiving IMF support of $12 billion.

The devaluation of the Egyptian pound in 2016 and the subsequent reform program was painful for the country. Three years on, the economy is now stronger with GDP growth projected to rise to 5.5% in 2019 and inflation at multi-year lows.



Source: IMF World Economic Outlook - October 2019

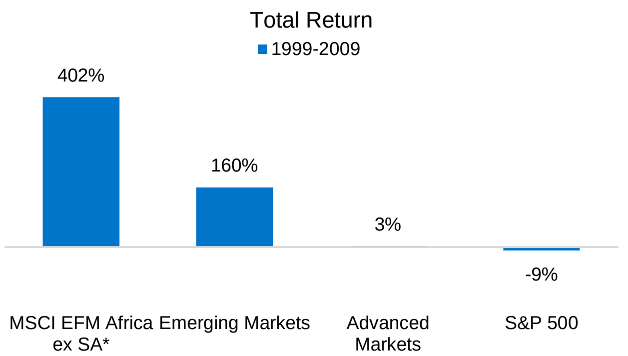
This has enabled the Central Bank of Egypt to systematically reduce interest rates. We expect further cuts in 2020.



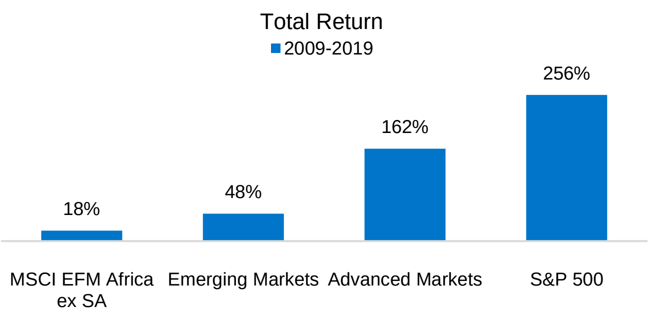
Source: Central Bank of Egypt

Reversal in Investor Sentiment

African stocks performed exceptionally well between 1999-2009 but have lagged in comparison to global peers in 2009-2019.



*Index inception: May 2002

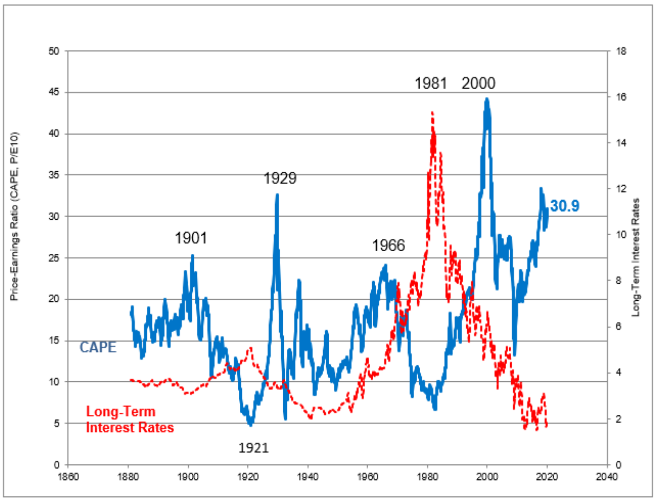


Source: Bloomberg. Total returns including reinvested dividends.

Over the last 10 years, developed markets, especially the U.S., have registered strong performance. Africa, like many emerging and frontier markets have underperformed in comparison. The lack of liquidity in Africa has had a major impact on investor sentiment.

In addition, interest rate normalization in the U.S. has supported investor flows back to the States. President Trump's protectionist trade policies have rattled the EMs and contributed to higher risk aversion towards frontier markets.

We believe that investor sentiment can turn. It was not too long ago when EMs and FMs were performing much better than developed markets. Looking at a chart of valuations, we do however, wonder about the current level of U.S. market valuations.



Source: US Stock Markets 1871 - Present and CAPE Ratio by Robert Shiller https://www.econ.yale.edu/~shiller/data.htm; Sanlam analysis

Clearly, the valuation gap between African markets, EMs and DMs is substantial and hard to ignore. We believe that recent reforms undertaken will place African economies on a sustainable growth path, reduce future FX volatility and make African economies less reliant on the export of commodities. Across the continent, countries are focusing on stimulating internal demand and attracting capital investment.

	MSCI EFM Africa ex SA	Emerging Markets	Advanced Markets	S&P 500
P/E	6.6	15.4	20.6	21.6
P/B	2.6	1.7	2.6	3.6
Dividend yield	4.4%	2.6%	2.4%	1.8%

Source: Bloomberg as at December 2019

We believe Developed Market returns will be subdued over the next 10 years. There are many factors behind the last 10 years of developed market returns. Ultra-loose monetary and fiscal policy, quantitative easing and tax rate reduction have supported global equities.

We doubt many of these factors will be sustainable and there is a risk developed market growth will slow down.

Brexit and global trade wars are some of the risks that can affect investment and growth.

We question whether policies that have been supportive for investors can continue as overall debt levels are significant. Policy makers may also struggle to keep monetary and fiscal policy loose to support markets.

Portfolio Fundamentals

Markets have struggled in the slower growth environment and investor sentiment has been weak due to the factors mentioned earlier in this note. This has created a unique valuation opportunity. The fund now trades on multi-year low valuations and has a dividend yield of 5.5%.

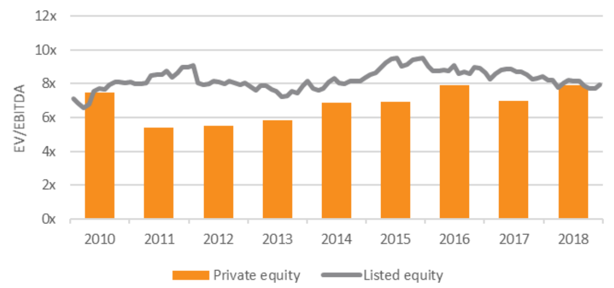
We calculate intrinsic values of individual holdings. The overall portfolio trades at a significant discount to intrinsic value. Based on our expectations and forecasts, we anticipate a weighted upside to intrinsic value of 58.7%.

SIEAL Africa Fund	2019 Valuations
Trailing 12-month portfolio earnings growth	16.6%
Trailing 12-month P/E	11.7
Trailing 12-month dividend yield	5.5%
Net Debt/EBITDA	0.2
ROE	32.1%
Weighted upside to intrinsic value	54.4%

The overall quality of the portfolio is high. Returns on equity are significantly above the costs of capital for our portfolio companies.

The portfolio trades at an EV/EBITDA of 6.5x, a significant discount to both private and listed equities in Africa. Listed equities are currently trading in line with PE multiples despite having significant advantages such as superior liquidity and better corporate governance.

Private equity prices on the rise
Median EV/EBITDA of listed and private equity transactions in Africa



Source: RisCura: AVCA Valuation trends

Since cost of capital is expensive in Africa, we are pleased that the net debt level for our average portfolio company is only 0.2x EBITDA. Our companies have strong balance sheets and are well positioned to grow over the next several years.

Sustainable Investing

Since 2012, the Sanlam Group has been a signatory, committed to the UNPRI principles of responsible investing. This process helps us better understand how our portfolio companies impact all stakeholders.

We have integrated Environmental, Social and Governance (ESG) issues to the core of our investment thesis in our internal research framework. This enables us to have a consistent approach in incorporating ESG factors in our research process.

Ignoring ESG factors can be very costly and can lead to value destruction. We strongly believe that companies which do not care about their impact on the environment and society will struggle to sustain business performance, therefore we invest in companies that align their business practices with positive social outcomes.

Our framework looks at risk by reviewing specific company risk factors. We adjust discount rates for companies depending on how they score on various ESG issues. From our analysis, we conclude that leaders in ESG implementation benefit from stronger revenue growth, innovation and product relevance, reduced cost and productivity gains. By focusing on waste reduction, a move to clean products, staff wellbeing and regulatory support to deliver on innovation, ESG leaders are less likely to suffer regulatory sanctions or fines. We also strive to work closely with regulators and listed companies to ensure they provide better transparency and detailed disclosures about their activities.

With its vast natural resources, Africa has strong links to commodities and oil markets. As a result, we consider the impact of extractive industries on climate change. There is a need to decarbonize economies if we are to avert major climate catastrophes in the future.

Outlook

The key factors we expect to drive growth for the next 10 years include:

1. The **growing human resource pool** in Africa. Literacy levels and life expectancy continue improve. The demographic story is building a strong base for structural growth for many decades to come.
2. **Rapid urbanization** is spreading across Africa in line with demographic trends. The rise in urbanization increases per capita GDP and wealth. As a result, we expect the strong consumer demand to continue.
3. **Improvement in infrastructure** to help Africa fulfil its growth potential. Pan African infrastructure projects e.g. LAPPSET that connects Kenya to Ethiopia and South Sudan are expected to promote cross-border trade within the continent.

With growth accelerating and valuations trading at historic lows, we are confident medium-term returns will be strong. Our focus on investing in ESG leaders should enable investors to benefit from Africa's long-term potential.

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