FRONTIER MARKETS

Opportunities in the Next “Emerging” Emerging Market

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Emerging markets offer a broad opportunity set for investors. However, many investors focus on the high-profile stories in Asia and Latin America, overlooking potential opportunities in other regions, as Franklin Templeton Emerging Markets Equity’s David Haglund explains. He notes how Africa is often an overlooked part of the emerging-market story, and why recent investments from China reflect the growth potential for countries such as Kenya and Nigeria in particular.

As emerging-market investors, we’re open to potential opportunities across the frontier market universe. So while there’s a lot of attention on the high-profile emerging markets in Asia and Latin America, we also cast our eyes over other regions, including Africa.

Notably, we see three themes in emerging-market economies that could become long-term growth drivers in Africa: Demographics, technological innovation and international investment.

Many investors identify South Africa as the only important market on the continent, but we believe other countries such as Kenya and Nigeria could offer even more exciting long-term investment stories.

Demographics: An Underlying Driver for Growth

With a large, young and fast-growing population, demographics will be a key underlying driver for growth in Africa. Of the 2.45 billion people expected to be added to the global population between 2017 and 2055, more than 1.4 billion (57%) will be added in Africa.[1]

Nigeria, for example, has one of the fast-growing populations in the world with a projected increase to 410.6 million from 196 million by 2050[2] which would make it the world’s third-most-populous country by 2050,[3] while Kenya’s population—a hub of the East African community that includes Kenya, Tanzania, Uganda, Rwanda, Burundi and South Sudan—is projected to double from 50.9 million to 95.5 million.[4] Some experts suggest that Nigeria and Kenya’s size, population growth and growing workforce will likely drive the continued expansion of Africa’s middle class. Nigeria’s median average age is 18.3 years, while Kenya’s median age is 20.[5]

The continent also has one of the largest urbanization rates in the world.[6] As a result of mass population growth, consumer-focused subsidiaries of multinational and local companies are now tailoring products to a growing African middle-class demographic. Products such as foods, personal, home care and even brewing companies are seeing opportunities to increase penetration in underserved markets.

Many of these companies are moving the African consumer into the organized retail space with a low-cost and tailored domestic product to substitute for imported goods. These companies are also actively working on localizing their inputs to better currency match their revenues earned against their cost of goods sold. A number of African countries which were highly dependent on exports of raw commodities have been transforming and producing more finished goods. However, it’s been a slow process at times, and not without challenges.

At the same time, we see signs of premiumization with the increased wealth seen in African markets, increasing scale of consumption further. For example, spirits are a premium product in Africa and middle/upper-income East Africans have been driving double digit growth in this segment. Even during macro and consumer slowdowns, we have seen spirits growth remain relatively resilient and less price sensitive as premium products tend to be. African consumers are generally quite aspirational and hence we are seeing faster growth in consumption by the middle/upper-income segments of the population.

Technology: A Hotbed of Innovation

The speed and availability of technology suggest there are huge opportunities for some countries in Africa to capitalize on technology faster than advanced economies.

"Leapfrogging" allows the adoption of new technologies that bypass legacy models or systems. African companies are now leapfrogging over obsolete technologies and going straight to modern solutions, which are often cheaper and more sustainable than older technology.

Potential Industry Leaders

The rapid pace of technological development indicates some countries in Africa could become future leaders in their industries. For example, the world's first national drone delivery system launched in Rwanda. But it doesn't bring food or online orders, it delivers blood to patients in remote areas.

In other sectors like banking, penetration remains very low in Africa and as a result is a natural beneficiary of growth in many African markets. Local established banks have access to a growing pool of low-cost deposits and are able to lend to established quality local and multi-national corporates.

In certain markets like Kenya, small-to-medium enterprise banking is prominent and has been a driver of growth at a more granular level, allowing small businesses access to capital they might never have been able to otherwise.

We initially saw a major company in Kenya pioneer mobile payments and related services and we are now seeing that replicated in other parts of Africa by other companies.

We are seeing telecommunications companies race to deliver the next big thing—applying for banking licenses to offer mobile payments to a population where cash still reigns supreme, particularly in countries such as Nigeria. This allows for mass financial inclusion, even to the rural populations.

Mobile money growth exploded in several African markets. Around half of global money users are now African, according to mobile industry reports. This forms a digital backbone for a host of other services.

The telecommunication companies are entering into partnerships with banks that allow mobile customers to have a bank account and do digital transactions. In doing so, telecom companies have added a new income stream, and banks have increased their customer base as well as reduced their brick-and-mortar cost bases. Meanwhile, consumers benefit from a cheaper and more convenient experience.

Solar power solution is helping to electrify the countryside. Independent solar providers and telecommunication companies are offering off-grid pre-paid electricity allowing customers leapfrogging from no electricity straight to green power.

International Investment from China

Chinese investment in Africa has ballooned in the last few years, funding investments in much-needed infrastructure development in railways, highways, airports and ports as part of China's Belt and Road initiative. During the 2003-2014 period, China's foreign direct investment (FDI) into Africa rose significantly from US$491 million to US$32.4 billion.[7] Interestingly, the number of African country recipients of FDI increased over the same time period too.[8]

Chinese investment has helped Nigeria establish industrial areas by creating infrastructure that was previously lacking, using natural gas-powered generators and all-weather roads to pave the way for development. As a result, these areas that once were difficult to navigate due to lack of infrastructure have transformed into a manufacturing hub that includes factories for construction materials, printing and furniture.

In Kenya, a Chinese-funded railway project linking the coastal city of Mombasa to capital city Nairobi is the country's largest infrastructure project to date. It opened 18 months early in mid-2017 and slashed the journey time by 7.5 hours compared to the previous railway line. A similar rail project is being constructed in Tanzania by a Turkish and Portuguese consortium which aims to connect Dar Es Salaam with the capital Dodoma in its initial phases.

Chinese are not only active in infrastructure investments. A large part of investments is driven by private companies in the manufacturing space. There are tens of thousands of privately-owned Chinese companies in Africa, bringing in an influx of Chinese to Africa. A large part of them are small entrepreneurs who are involved in segments spanning from retail to agriculture.

The Case for Local Influence

In our experience, with so many companies emerging in thriving countries like Kenya and Nigeria, we believe this growing investment universe could provide us with opportunities to uncover mispriced companies.

Smaller, growing companies tend to be disproportionately owned by domestic retail investors with shorter investment timeframes. On the other hand, foreign institutional investors would likely trade more frequently. As a result, this tends to boost liquidity.

Of course, investing in Africa is not without risks and challenges—some of them difficult to overcome. But we believe the African continent could provide fertile ground for active managers like us who are patient. Our role is to seek out companies with long-term potential using our on-the-ground team—something that's particularly useful in what we'd consider to be a relatively untapped segment of the market.

What Are the Risks?

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

1. Sources: UK Research for Evidence Division, UK Department for International Development, May 2018.

2. Source: Population Reference Bureau, 2018. There is no assurance that any estimate, forecast or projection will be realized.

3. Source: United Nations, World Population Prospects 2017. There is no assurance that any estimate, forecast or projection will be realized.

4. Source: Population Reference Bureau, 2018. There is no assurance that any estimate, forecast or projection will be realized.

5. Source: CIA World Factbook, 2018 estimate. There is no assurance that any estimate, forecast or projection will be realized.

6. Source: World Bank, Opening Doors to the World, 2017.

7. Source: U.N. Habitat, State of African Cities, 2018.

8. Ibid.