PERSPECTIVE

Opportunities on the African Continent – A Balancing Act

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It would be remiss to paint the African continent with one brush as many countries are at varying stages of their macroeconomic and political cycles, according to Franklin Templeton Emerging Markets Equity's Danesh Ranchhod. He highlights some developments happening right at the heart of these economies, and explains why investors should consider opportunities in this region on a case-by-case basis.

As emerging market investors, understanding cycles and developments in the region of Africa in relation to other earlier stage frontier and emerging markets provides context to the investment opportunities we're presented with.

We're cognizant that a combination of the pace of government reforms, regulatory framework and political landscape affects countries such as Nigeria, Kenya and South Africa in very different ways, as they are at different stages of the economic cycle.

Underpenetrated Industries in Nigeria Could Shine Despite Muted Economic Environment

Nigeria is the largest economy in Africa based on nominal gross domestic product (GDP) and also boasts the largest population on the continent, with 206 million inhabitants.[1] Typically, a large and young demographic with growing incomes tends to drive domestic consumption, and provides a long runway for sustained economic growth potential.

From an investment standpoint, we see many industries in Nigeria that are underpenetrated—notably banking, consumer packaged foods and telecommunications. In our view, businesses that operate within these industries could likely see multi-decade growth.

However, the path hasn't been smooth in Nigeria, so we are also conscious of bumps to this potential economic trajectory. Nigeria's reliance on oil represents a double-edged sword, as it makes up the bulk of its fiscal revenues. When oil prices have crashed in the past, Nigeria faced severe impacts on its economy and currency.

Some key policy reforms in the West African country have also stalled. The current government is in its second term, and has not really committed on infrastructure, subsidy removals and growth initiatives. These have led to a more muted growth environment in the past three years. GDP contracted in 2016 at -1.6%, but we've seen signs of a muted pickup in GDP growth over 2017 and 2018, at 0.8% and 1.9% respectively. [2]

Amid the slow execution of some government policies, the economy and currency have managed to stabilize, while weak economic growth is starting to show some mild improvement. Notably, schemes such as farm and small business loans backed by the Central Bank of Nigeria, to reduce Nigeria's dependence on oil have made an impact—Nigeria's agriculture industry employs two-thirds of the entire labor force.

There are also recent signs that business activity in Nigeria is picking up, with some sectors continuing to remain highly profitable and growing. A recent finance bill signed by Nigerian President Muhammadu Buhari in January exempts small businesses with a turnover of less than N25 million, and lowers the tax rate for companies that make up to N100 million. We'd expect this move to encourage foreign investment if implemented in an appropriate timeframe.

Within these sectors, we have identified banking as one we believe offers meaningful upside potential from an investment standpoint, despite increasing regulation.

The large Nigerian banks are exposed to better quality companies with potential for consolidation opportunities, and have well-managed cost bases. The increasing focus on alternative banking channels is helping to drive fee income and lower branch costs, while offering cash dividend yields in excess of bond yields to investors. This presents an investment opportunity that appears favorable to us, despite the weak macroeconomic environment.

Potential Growth Prospects for Kenyan Businesses That Can Adapt

In our view, Kenya has been a jewel among the larger sub-Saharan Africa nations, growing on average 5.7% over the past three years.[3] The country also has had a stable currency and has offered a respectable stock market return against the MSCI Frontier Markets Index over the same time period.[4] Some of this growth is tied to a more diversified economy, improved funding for infrastructure, especially roads, and an increased literacy rate of 82% among the population.[5]

This vast improvement in the ability to read and write is the result of a scheme that offered a low-cost early literacy intervention program, that started after a 2011 Kenyan Uwezo survey found that nearly seven out of 10 students in third grade could not read at a second-grade level. Though some investors are concerned about rising debt-to-GDP levels and a currency that may look too strong, we think the overall macroeconomic backdrop remains positive.

Kenya has a relatively benign regulatory framework, but in the past few years we have seen increasing regulation across sectors from banking to the alcohol industry. In our view, businesses that have adapted to regulations have created some appealing investment opportunities, including some select companies in the aforementioned industries.

Due to rate-cap regulations set at 4% since 2016, some banks have experienced slow credit growth for the past four years. They have used this period to strengthen their deposit franchises, as well as focus on alternative funding channels by partnering with mobile telecommunication companies to drive a larger customer base.

That said, an unintended consequence also reduced credit to the private sector. A recent lift of the lending cap should encourage some banks to use their low-cost deposits to grow their asset books at increased margins, while the lower operating cost base will likely see good operating leverage.

In the case of a dominant Kenyan brewer, its work with the government on reducing the impact of excise taxes, a legislated tax at the manufacturing point on goods, was mutually beneficial. A more manageable excise regime increased company profitability, while the government received an increase in its tax revenue.

Lack of Reforms in South Africa Leaves Little Room for Investment Opportunities

South Africa has generally disappointed investors for several years on the back of weak economic growth, rampant corruption, state-owned entity mismanagement and a policy stall. Much of this malaise accelerated under the leadership of former President Jacob Zuma and his affiliates.

Over the past two years, we've seen a change in direction. These include a new president with what appears to be better intentions, an election with a subsequent change in cabinet ministers, as well as an attempt to change the boards of weak state-owned institutions. While these remain positive developments, the deterioration in the economy and state institutions still require serious attention going forward—and won't change overnight.

Earlier this year, we had highlighted several reforms we thought were needed to indicate progress, but we have not seen much movement due to the ongoing infighting within the ruling party and the resistance from public-sector unions to allow some hard decisions to be made at state-owned entities. It appears that government execution will likely remain poor, thereby leading to a potentially weaker economic environment.

Considering these broader political risks and weak business and consumer confidence, we think opportunities in South Africa remain slim. This does not mean we would dismiss South Africa as an investment destination—there are still many quality companies operating with sound management teams there. However, for now, we continue to monitor the political progress and look for indications of a meaningful turnaround before turning more bullish on the market generally.

To conclude, understanding company fundamentals together with the broader economic, regulatory and political landscape allows us to better our analysis when pursuing investment opportunities in emerging markets, particularly in the African region.

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1. Source: International Monetary Fund, World Economic Outlook, October 2019.

2. Source: International Monetary Fund, October 2019.

3. Source: International Monetary Fund, World Economic Outlook, October 2019.

4. The MSCI Frontier Markets Index captures large and mid-cap representation across 28 frontier markets countries. Indexes are unmanaged and one cannot invest in an index. They do not include fees, expenses or sales charges.

5. Source: World Bank, 2018.