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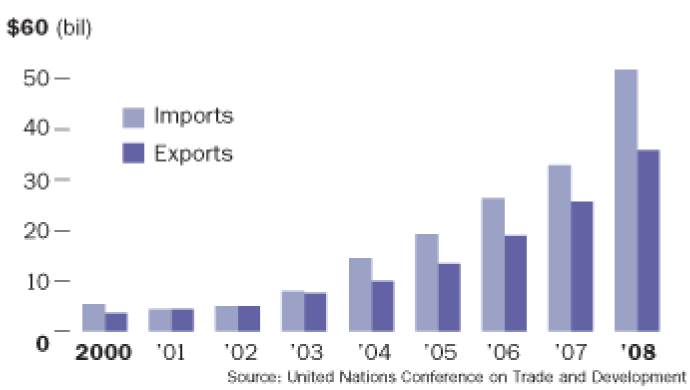
The Final Frontier

By VITO J. RACANELLI

Investors will lose a huge opportunity if they avoid vibrant and changing Africa. Fast growth in a continent of misconceptions.

Sizing Up the Real Risks of Investing in Africa

WHAT IMAGES DOES AFRICA conjure in the mind of the average Westerner? Probably skinny children in dire poverty, corrupt dictators and, thanks to Hollywood, blood diamonds. Africa doesn't get much attention in the West beyond that. During South Africa's successful World Cup this summer, for example, many news reports focused on vuvuzelas and few on the capable management of the event itself.



China Raising the Stakes in Africa: China's trade with sub-Saharan Africa has expanded by a factor of about 10 in the past decade. China is importing mostly commodities and exporting infrastructure and machinery, among other things

Likewise, the noisy financial crises in the developed financial markets appear to have drowned out a decade of impressive and sustained economic and institutional progress in sub-Saharan Africa. (See table: A Decade of Improvement.) To many Western investors who don't look past the stereotypes, Africa is terra incognita. Their ignorance could cost them plenty in lost opportunity.

Take the U.S. Chamber of Commerce, which in a survey last summer revealed that "over all, U.S. businesses do not view Africa as an attractive place to invest. The image of lawlessness, corruption, unstable governments, an inadequate infrastructure, uneducated or untrained people and an unwelcoming government attitude toward business serve as major deterrents."

That depiction is increasingly mistaken.

"Africa suffers from misconceptions more than any other area in the world," argues Miles Morland, whom many consider the father of fund investment in Africa. He founded Blakeney Management in the early 1990s, and now is chairman of Development Partners International, a London-based private-equity firm that invests in Africa.

Perceptions based on the way Africa once was linger in the minds of many investors, he says. The U.S. and U.K. effectively have nationalized more companies during the financial crisis (think GM, Chrysler, AIG, Citigroup, Royal Bank of Scotland, Northern Rock) than African nations have in the past nine years, he quips, and national debts are far less worrisome there than in America or Europe.

"Funnily enough," Morland continues, "people wearied by bankruptcies, meltdowns, restructuring and bank bailouts are amazed to learn about a continent that has transformed itself into one of the fastest- growing regions in the world, where banks haven't needed bailing out, no large companies have folded, with no accounting scandals and where the biggest problem businessmen have is getting capital to finance growth."

He is seconded by another investor with decades of experience, Donald Elefson, portfolio manager of the **Harding Loevner Frontier Emerging Markets Fund** (ticker: HLFMX). Among frontier regions, Africa is the most interesting, he asserts, because it offers strong markets with huge potential, liberalizing policies, good capital flows and undiscovered high-quality companies. And Nigeria is one of his favorite frontier countries. He contends that the giant nation of about 150 million people eventually can fill the same leading role for Africa that Brazil has played for emerging markets.

Like Brazil, Nigeria hasn't liberalized its petroleum and telecom industries yet, and its stocks in those sectors will benefit whenever that happens. Again like Brazil, Nigeria has grown strongly, even though its banks curbed lending last year. Whenever the banks ratchet up lending, that will further fuel growth. (Nigerian regulators recently forced some banks to take bigger-than-expected write-downs on loan losses. That hurt reported earnings, but has removed a nagging issue and will help future profits.)

Indeed, after a big drop from boom highs in early 2008, African stock markets—despite their problems—now offer the long-term investor a number of fast-growing companies with stocks that sell for about 11 to 12 times trailing 12-month earnings per share as of June 30, according to S&P Indices. They look inexpensive compared with price/earnings ratios in most developed markets or even in the broad world of emerging markets, where the average stock fetches 15 times trailing profits.

With many economies on the continent growing 5% to 8% annually, according to the International Monetary Fund, investors can find banks, brewers, supermarket outfits and mobile-phone companies with good prospects, decent balance sheets and relatively low P/Es (especially compared with their growth potential). Some have few rivals, provide important consumer services and boast profits that are growing faster than their homelands' economy.

IF THE WEST HASN'T NOTICED this big change, China has. With relatively little fanfare, it has made a huge foray into Africa. China's rapidly rising middle class isn't just pulling itself up by the bootstraps, but also is creating demand for resources from Africa. That's helping to raise income levels on the vast continent, as well.

Africa's bounty of natural resources, such as oil, iron ore, gold, copper and numerous others, have brought in strong trade flows from the Asian giant, with $88 billion in 2008 in exports and imports between the two, up 10 times from 2000 (see table, China Raising the Stakes in Africa). In return for those commodities, China is building seaports, power plants, roads and other infrastructure projects, which should help sustain the growth in gross domestic product expected in many parts of the sub-Sahara. Africa's economy is growing at a tiger-like 5% to 8% pace, versus 4% for countries like Russia and Brazil. And the IMF has been nudging up its forecasts for Africa.

There are compelling long-term trends on the continent, says Razia Khan, the London-based head of research on Africa at Standard Chartered, a U.K. bank with businesses in many emerging and frontier markets. Political stability and economic policy has improved. Consumption is rising, with the working-age population expected to hit 65% of the total population in 2050, versus about 50% now. And new capital, some from investment funds, is coming in. Africa's debt and foreign-exchange markets are opening up, too, Khan adds, another encouraging sign. Over all, "Africa is becoming more accessible" to Western investment.

Some Ways to Play Africa

There are few African pure plays available to individual investors in the U.S., but there are a few stocks, as well as frontier funds and an ETF, that are significantly exposed to sub-Saharan Africa. There are also locally traded stocks that are investable by institutions, though liquidity is a problem.

Company / Ticker	Where Traded	Industry	Market Value (bil)	P/E * 2010E	P/E * 2011E
MTN Group / MTNOY	Pink Sheets	Mobile Phones	$29.7	12.1	10.2
Shoprite Holdings / SRHGY	Pink Sheets	Supermarkets	6.9	21.1	18.3
Tullow Oil / TUWOY	Pink Sheets	Energy Exploration	17.5	131.1	33.7
African Bank Inv / AFRVY	Pink Sheets	Banking	3.6	12.6	9.9

Mutual Fund or ETF / Ticker	Assets (mil)	Return Since Inception	Comment
Morgan Stanley Frontier Emerg / FFD	$85.9	-15.9%	Overweight Africa
T. Rowe Price Africa & Middle East / TRAMX	200.8	-8.6	Doubled Africa weight recently
Harding Loevner Frontier Emerg Mkt / HLFMX	21.5	-15.1	Invests in Nigeria and Kenya
Templeton Frontier Mkts / TFMAX	44.3	25.0	28% of fund in sub-Sahara

iShares MSCI South Africa ETF / EZA	441.0	19.4	Mimics MSCI S. Africa Index

Locally Traded Company/Ticker	**Industry (bil)**	**Market Val (bil)**	**P/E 2010 E**	**2011E**
Cal Bank / CAL.Ghana	Banking	$0.43	10.0	8.0
CRDB Bank / CRDB.Tanzania	Banking	0.17	5.0	NA
East African Breweries / EABL.Kenya	Brewer	1.70	16.2	14.8
Equity Bank / EQBNK.Kenya	Banking	1.10	12.2	10.0
Ghana Commercial Bank / GCB.Ghana	Banking	0.28	5.8	5.1
Guaranty Trust Bank / GUARANTY.Nigeri a	Banking	2.70	7.9	6.0
Safaricom / SAFCOM.Kenya	Cellphone & Internet Provider	2.80	14.1	12.2
Sonatel / SNTS.Senegal	Telecom Provider	2.70	7.1	6.7
Standard Bank Group / SBK.South Africa	Banking/Insurance	24.30	12.1	9.2
Standard Chartered Bank / SCB.Ghana	Banking	0.57	10.5	7.2

E=Estimate *Based on estimates of home traded stock.Sources: Securities Africa, Bloomberg; Lipper

A key sector is banking, a necessary engine for consumer and corporate growth. Credit to the private sector in East African nations, for example, is growing at a healthy yearly clip of 15% to 20%, notes Simon Migangala, the Dar es Salaam-based treasury director for CRDB Bank in Tanzania, which operates in East Africa. The global recession has hurt, but regional economies are recovering, with banking, construction, energy and telecommunications showing gains. "It will be much higher than expectation," he predicts of banking growth.

With net-interest margins significantly higher than in the rest of the world, Morland views bank stocks as one of the best investments in the early stages of a frontier market's growth. If an economy is expanding by 7% a year, for example, banking assets can grow 30% to even 100%. "Businesses we like to invest in are the same ones others are buying in China: banks, brewers and telcos," he says.

The consumer-growth potential is huge. Africa, the second most populous continent, has close to 900 million people. While many are very poor, incomes generally are rising, thanks to globalization and China's hefty appetite for commodities.

Alan Dowokpor, 44 years old, who grew up in Ghana, departed and then returned to Accra to head Tullow Oil's drilling program, says that when he was a child, visitors from the U.K. used to bring a suitcase full of necessities like soap. Now people are earning enough to afford consumer items like that. Making a phone call used to be a "real big deal," but mobile phones have changed that. Perhaps most important, former economic emigrants, "qualified, educated Ghanaians, are coming back and that in itself says something about improving opportunity."

These days, investors artificially distinguish between emerging and frontier markets, contends Lawrence Speidell, chief investment officer for Frontier Market Asset Management. Africa is the most neglected frontier market, he avers, because its countries are "a little bit poorer and their stage of development a little behind" that of emerging markets in general. But, he adds, "from the standpoint of the people living in those nations and their everyday lives, the differences between them are slighter than many believe."

Speidell's firm has investments in Ghana, where the banking industry has a net-interest margin of 8% and banking shares have relatively low price/earnings ratios. **Ghana Commercial Bank** (GCB.Ghana), for example, is the largest in that country, with the longest reach, 157 branches and a stock price around six times expected 2010 earnings.

HIS OTHER AFRICAN INVESTMENTS include **Standard Chartered Bank Ghana** (SCB.Ghana), which is focused on high-end clientele, has a 48% return on equity and trades at a multiple around 10. **Cal Bank** (CAL. Ghana) is another of Speidell's favorites. Small and nimble, it's the only independent bank in his top 10. It focuses on the high-end market, targeting recent university graduates. And it has a P/E of 6.6. (It must be noted that frontier-market P/Es often are based on only a handful of profit estimates. The 10 multiple listed for Cal Bank in the table at left, for example, is based on an analysis from only one broker, Securities Africa in Johannesburg.)

After the frontier stock-market boom ended in early 2008, African shares fell hard along with the major global markets. They remain far below their highs, despite a nascent recovery that began late last year. Nigerian stocks, for example, are more than two-thirds below the highs of 2007-08, when hedge-fund money was pouring in, creating a bubble in which too much cash was chasing too few companies.

A lot of that hot money was among the first to leave during the global crisis, observes Jenni Chamberlain, a portfolio manager at Finch Asset Management. Still, she's seeing "more interest from long-term investors" in Africa lately. One of her favorite stocks is **Sonatel** (SNTS.Senegal), a fixed- and mobile-phone outfit that trades in Senegal and is 42% owned by **France Telecom** (FTE) and 27% by the government. It's the most attractively valued sub-Saharan telecom operator, as well as the dominant player in both Senegal and Mali, with a growing share in Guinea Bissau and Guinea. The company has a strong balance sheet and a 10% dividend yield, Chamberlain notes.

The share-price drop across markets in Africa should entice new investors willing to look five years down the road as an opportunity to pick up stocks at some of the lowest prices since 2006, when *Barron's* last wrote at length about frontier markets ("**Finding Riches on the New Frontier**," Nov. 6, 2006)

Profit growth has been much higher in Africa than in the rest of the world, mitigating some of the higher risk there. For example, from 1995 through 2009, earnings per share advanced at a compound annual rate of 17% for the companies in the Blakeney Africa portfolio, which also includes Middle Eastern stocks. That return far outpaced the 4% to 5% average for companies in the Standard & Poor's 500 index and the MSCI Emerging Markets index in the same span.

What would you pay for 4% to 5% annual growth? Morland says maybe nine or 10 times earnings, but adds that he would "pay 25 times for 17% growth." Yet the P/E for Blakeney's African portfolio is about 10 times 2010 earnings.

A Decade of Improvement

Many investors in developed markets don't know the extent of the dramatic economic improvements that have occurred in sub-Saharan Africa over the past decade. While the region remains among the world's poorest, it is growing swiftly. That should boost profits at many of the companies that operate there.

Sub-Saharan Africa	**2000**	**2008**
Population (mil)	672	819
Gross national income per capita*	1,272	1,950
GDP ($US bil)	342.4	978.1
GDP growth (annual%)	3.6	5.1
Days required to start a business	61**	46
Mobile-Phone subscriptions (per 100)	2	33
Internet users (per 100)	0.5	6.5

*Measured by purchasing-power parity in U.S. dollars. **2005Source: World Bank

For the 10 years ended June 30, the S&P BMI frontier stock index's average annual total return in dollars—which includes dividends, as well as changes in share price—was 14%, while the S&P BMI emerging index's was 10%. Both were far ahead of the S&P 500's yearly loss of 1.5% in the period.

African equities—not including stocks issued by companies in South Africa, which is classified an emerging market—represent roughly 15% of the frontier indexes.

In recent months, the flow of money into frontier markets has accelerated. About a $1 billion has been added this year, 14.5% of total frontier-fund total assets, according to EPFR Global, which tracks institutional flows. With frontier- and emerging-market money managers growing more enthusiastic about the continent, more of their cash is going into African stocks.

Many institutional investors argue that Africa is now where emerging markets were 20 years ago—a place investors are deathly afraid of, but one that is rapidly changing and in which returns can be high.

Says John Niepold, managing partner at SQM Frontier Management and a 20-year veteran of emerging and frontier markets: "If you go around on the ground in Africa, as I do, you'll find companies are doing well. Information isn't readily available, but that also means there are market inefficiencies and the possibility for a good return. It's probably the place that investors should consider."

Joseph Rohm, who runs the **T. Rowe Price Africa & Middle East** Fund (TRAMX), says South African stocks are among his most preferred and that he's doubled his weighting in African stocks to 35% of the fund since April 2009. Frontier stocks were laggards last year, so they might contain more bargains than emerging-market stocks, which were on fire in 2009.

Nigerian banks, for example, were trading at four to even six times book at the top, Rohm adds, but now have forward price-to-book-value ratios of about one times. Although Nigeria has 150 million people, only eight million have bank accounts, he says, so there's huge growth potential.

AMONG BIG STOCKS, Rohm likes Africa-related play **Tullow Oil** (TUWLY), a growing U.K.-based energy-exploration company with significant assets in Uganda, Ghana and other parts of the continent. Among local stocks, Rohm's fund holds **Safaricom** (SAFCOM.Kenya), an innovative Kenyan mobile-phone outfit with one of the most successful mobile- banking applications; **Guaranty Trust Bank** (GUARANTY.Nigeria) and **Standard Bank Group** (SBK.South Africa).

Another fan is Timothy Drinkall, whose **Morgan Stanley Frontier Emerging Markets** Fund (FFD) is overweight Africa. He notes that frontier-market valuations are trading at a big discount to emerging markets', instead of the premium seen during the boom. And he adds that frontier markets show lower correlations with developed-market moves.

Emerging markets rallied 75% in 2009, but the stock market in Nigeria, one of his favorite investment areas, fell 33% in dollar terms, and Kenya rose only 5%. In Kenya, he says, the underlying profit growth potential is more than 15%. There he holds **East African Breweries** (EABL.Kenya) and **Equity Bank** (EQBNK.Kenya). The latter has the most accounts in Kenya and is expanding in Uganda.

Another stock worth a look is **Letshego** (LETSHEGO.Botswana). It's a growing payday lender, with relatively low credit risk, a P/E multiple around 10 and a return on equity of 27%, says Nick Padgett, whose Frontaura Global Frontier fund has been increasing its weighting in African stocks. Another of his holdings, **CRDB Bank** (CRDB.Tanzania) is one of the largest banking institutions in its home country. It sports a P/E of five, a price-to-book ratio of 1.1 and a potential for a double-digit net interest margin.

Sub-Saharan Africa is far more attractive than its media stereotype would lead one to believe. Yes, poverty and violence are still huge problems in some parts of the continent. But, increasingly, the miseries of lands like Zimbabwe are more the exception than the rule. Africa isn't an easy place to invest in. But the patient are likely to be rewarded for venturing into what for many is the last overlooked investment frontier.

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