Africa's Economic Outlook: Beyond the Hype, Hope, and Despair

Promising Long-term Opportunities for Selective Investing

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Africa has faced more than its share of headwinds over the centuries. While rich in industrial metals, energy, and agricultural commodities, and exhibiting strong demographic tailwinds with an improving political climate, the deleterious aftereffects of European colonialism remain. Consequently, the continent has been wracked by poverty, revolution, corruption, poor education and health care, and war for many years. However, we believe Africa cannot be viewed as a monolith, as it remains a dizzying collection of frontier markets, each with its own unique risk profile, business environment, and investment potential. While the continent has witnessed numerous false dawns over the past 40 years, we believe it is fundamentally changing for the better. We are beginning to see investment opportunities and believe Africa will become an important consideration for global investors over the long term.

We recently visited the region and met with representatives of several central banks, dozens of private and public companies, and numerous private citizens and business people to assess the landscape for potential investment opportunities. We believe three countries in particular have significant potential from a longer-term investment perspective: Kenya in East Africa, and Nigeria and Ghana in West Africa, with potentially compelling growth opportunities in the technology, banking, and consumer industries.

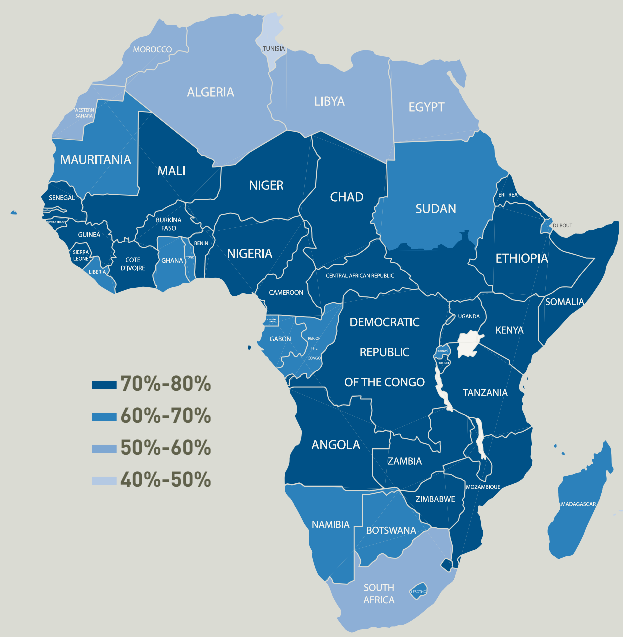
AFRICA: THE LAST FRONTIER? OPPORTUNITIES AND RISKS IN THE REGION

There is a diminishing opportunity set of frontier markets to invest in throughout the world. Africa remains one of them for now. We have been investing in Africa for years, both indirectly through multinational corporations for more than two decades and directly for the past five years in places like Kenya and Nigeria. Due to the region's various challenges, it can be a highly volatile place to invest. Accordingly, one has to play the long game.

Africa is the second largest continent by land mass, with more than 54 countries and numerous diverse cultures and languages. With a labor force of over 400 million and more than one billion consumers, it is also rapidly urbanizing. By 2030, over half of the population is expected to live in cities, up from a third now and its emerging middle class is expected to amount to over 30% of the population. Finally, the continent has significant natural resources to drive sustained growth.

Although Africa has all the key ingredients to support substantial growth, it is still behind its time in many ways, with history playing a primary role. European colonization, which consumed nearly the entire continent by the early 20th century, caused lasting deleterious effects in the region, as boundaries were arbitrarily drawn across ethno-linguistic lines, ignoring tribal territories, which set the stage for ongoing and future friction. Many countries achieved independence only in the recent decades following World War II, leaving newborn nations often wracked with violence and turmoil.

Percentage of Population Under 30 Years Old



Source: United Nations, Department of Economic and Social Affairs, Population Division (2017). World Population Prospects: The 2017 Revision, DV

While Africa actually entered the postcolonial era with a running start over most other emerging regions, including Asia and Latin America, the continent slowly lost its way due to weak governance, corruption, ethnic conflict, and heavy-handed government interference. In fact, a new dawn began at the turn of the millennium when GDP growth accelerated after two decades of stagnation, but growth (and optimism) again faded after the global financial crisis. Since then, investor sentiment additionally soured as commodity prices fell, Islamic militancy increased, an Ebola epidemic wreaked havoc, and drought slowed economic expansion.

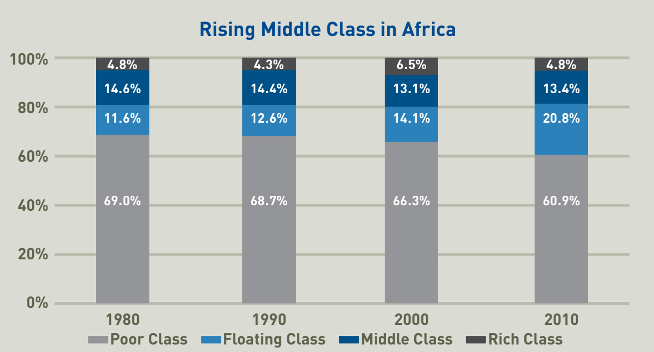
According to the International Monetary Fund (IMF) in its World Economic Outlook (October 2018), GDP growth in Sub-Saharan Africa rebounded to 2.7% in 2017 after slowing sharply to 1.4% in 2016, due to a recovery in commodity prices, favorable global financing conditions, and an expanding world economy. Headline inflation declined across the region, reflecting the confluence of stable exchange rates and slowing food price inflation. Better terms of trade contributed to narrowing of the current account deficits in most resource-intensive countries. However, while external imbalances have improved, fiscal vulnerabilities are mounting: About 40% of low-income countries in the region are now assessed as being in debt distress or at high risk of debt distress, according to World Bank estimates.

Overall, the recovery in Sub-Saharan Africa is expected to continue, with GDP growth estimated to increase to 3.1% this year and improving further to 3.8% in 2019. However, recent growth has been far from uniform. A mix of resource-intensive and non-resource-intensive economies, including Burkina Faso, Côte d'Ivoire, Ethiopia, Ghana, Guinea, Rwanda, Senegal, and Tanzania grew 6% or faster in 2017. In contrast, 12 countries, which combined account for about a third of the Sub-Saharan population, saw per capita incomes decline in 2017, and most of these nations are expected to see further declines in 2018.

Corruption remains a continent-wide problem, although democracy is slowly taking root in fits and starts. Many countries that have been governed by strongmen or single-party rulers are now under pressure to reform. Even Zimbabwe conducted an election recently after decades of one-man rule by President Mugabe. While many African countries, such as Nigeria and Kenya, now have governing opposition parties that overcame long entrenched powers, guiding those nations beyond powerful leaders and single-party rulers is difficult. Religious-based clashes are frequent in some areas, and terrorism and insurgencies remain ever-present threats. The region also still relies on foreign money. The West provides mostly direct aid, while China focuses more on infrastructure investments, and the IMF remains. remains an integral part of the economic wellbeing for a number of countries.

Additionally, with the recent commodity super cycle now over, the IMF has warned that Africa needs to rely less on commodities and must increase industrialization and local production. In addition, foreign direct investment has dropped considerably over the last few years and unemployment remains stubbornly high. African lives have already greatly improved over the past decade, but healthcare crises like the Ebola epidemic are an ongoing concern. Sub-Saharan Africa still has a long way to go to improve healthcare and education, create jobs and reduce poverty, and develop functioning transportation infrastructure—the collective lack of which clearly and negatively affects productivity and health. During our recent trip, we personally experienced some of the worst traffic jams in Nairobi, Accra, and Lagos that we've ever encountered in over 30 years of international travel.

Despite these challenges, we believe investors would be foolish to ignore Africa over the long term. It is the world's second most populous region, with close to about 17% of the total population, and it's still growing. While approximately 45% of Africans live in cities, the continent continues to urbanize at a fast clip, and the median age is less than 20 years old. East Africa in particular is expected to remain the most vibrant region on the African continent, with markets, such as Kenya, Rwanda, Tanzania, and Uganda among the fastest-growing economies over the next few years, not just in Sub-Saharan Africa, but globally.



Source: AfDB Market Brief, April 20, 2011

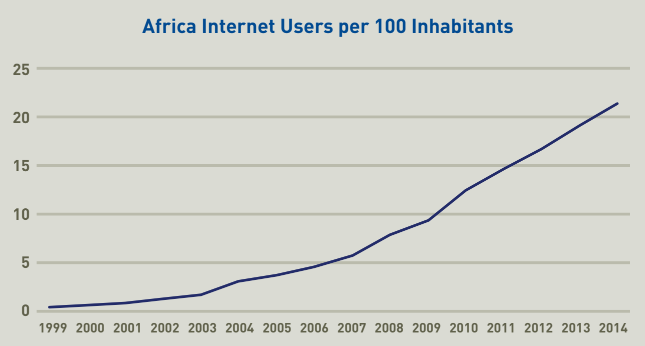
Many emerging markets have either strong expected demand growth (fueled by shifting demographics, urbanization, etc.) or significant infrastructure needs, Africa has both. Over the years, there have been conflicting and polarizing claims about Africa's potential and its future. Some have suggested that the next century will be the African century, while others have claimed that the continent is doomed to fall into a social and economic malaise. We prefer to look beyond the hyperbole, and focus on what we expect to be a more measured, but decidedly positive, long-term future.

EMBRACING THE TAILWINDS OF CHANGE

Several positive secular tailwinds are decidedly working in Africa's favor relative to many other regions of the world, including its demographic profile. The continent has a young population and a growing labor force, which we expect to fuel demand for goods and services as individuals move up the consumption curve. By 2035, Africa is expected to have a working population of 1.1 billion people, with a total population of close to 2 billion by 2040. Additionally, Africa is still urbanizing, providing a runway for continued economic growth, as productivity in cities is estimated to be three times as high as in rural areas. Over the next decade, an additional 187 million Africans will move to the cities, according to the United Nations. This urban expansion will generate rapid growth in consumption by households and businesses. The continent already hosts some of the world's largest urban mega-cities, including Lagos, Nigeria (21 million); Cairo, Egypt (20.4 million); and Kinshasa, DR Congo (13.3 million).

As an example of Africa's vast consumer potential, beer consumption in Sub-Saharan Africa is rising fast and is expected to continue at 5% year-over-year growth from 2015 to 2020. At this rate, the region should outpace Asia, the Middle East, and North Africa (each growing at 3%), not to mention Western Europe and North America (projected at 1% annual growth), according to market research firm Canadean. Sub-Saharan Africa is expected to make up 40% of global profit growth for breweries over the next decade, overtaking China as the industry's main growth engine. For many people, beer represents one of their first affordable luxuries, with opportunities to trade up to higher value-added products over time.

For decades, many large multinationals have invested in Africa in order to take advantage of the growing consumer opportunity, but many have been losing ground to more competent local competitors, especially in the areas of food and beverage and cement. These local upstarts are better able to navigate consumer tastes, infrastructure and logistical demands, and regulatory hurdles. A one-size-fits-all strategy has generally failed, as foreign companies will need to adapt to local markets. For example, in the race to become Africa's dominant ride-hailing app, upstarts are gaining ground against global brands like Uber Technologies. Uber is trailing much smaller rivals like Taxify, which sports close to 2.5 million active users in six countries.



Source: African Development Bank Group

In addition to demographics, we expect African economies to benefit from technological advancements that should help unlock growth and leapfrog the limitations of its current underdeveloped and underfunded physical infrastructure. For example, the World Economic Forum estimates smartphone penetration in Africa will hit at least 50% by 2020, up from only 2% in 2010. Increasing use of smartphones will provide ready access to goods and services delivered via the internet, without the investment of time and capital that more advanced economies have made over the years as they evolved from hardwired, landline-based communications to wireless.

Further reinforcing Africa's positive outlook for growth is a continuing rise in infrastructure investment, which should pay dividends into the future. Additionally, the continent is a rich resource in minerals, energy, and other commodities. Palm oil, cocoa, tea, and cotton are widely farmed in many countries for export throughout the world. More significantly, Africa is a major exporter of oil as well as various industrial metals, including copper, platinum (70% of global production), cobalt (60% of global production), manganese (38% of global production), and gold (20% of global production), which are vital to the global economy.

Areas where we have historically focused our past investment efforts include banking, technology and communications. Across Africa, smartphones have begun to transform the way Africans live and work—essentially skipping complete stages of economic development. By 2025, the continent is projected to have over 360 million smartphones with internet penetration reaching over 50% of the 1.6 billion people. Nowhere is demography more favorable to mobile money than in Sub-Saharan Africa. Kenya has been at the forefront of technological innovation the past five years, leading not just Africa, but the world in game-changing areas such as mobile money and crowdsourcing.

As mentioned at the outset, opportunities in Africa come with risks, calling for careful and selective investing. Coupled with decades of investment experience and an expanding team of investment professionals, our unique top-down country allocation framework and disciplined security selection process helps us navigate the many opportunities and risks in Africa and throughout the world. In that regard, we believe markets such as Kenya, Nigeria, and Ghana offer significant potential.

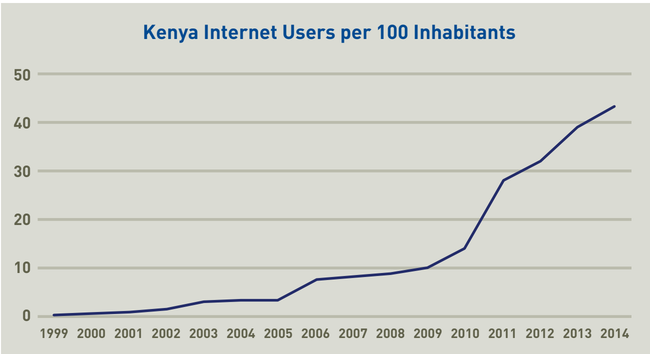
KENYA – AT THE FOREFRONT OF GLOBAL MOBILE TECHNOLOGY

Situated on the east coast of Africa, Kenya is the second largest economy in east Africa and is known as a major pioneer in the use of mobile technology. As a major trading hub for the Middle East and the interior of the continent, especially Uganda, Rwanda, and Tanzania, the country is also a major coffee and tea exporter and relies heavily on tourism. It has made significant political, structural, and economic reforms in the past few years that have driven sustained economic growth, social development, and political gains.

Political reforms stem from the passage of a new constitution in 2010, which embraced decentralization that strengthened accountability and public sector delivery at local levels. This has ushered in a new political and economic governance system that has eroded opportunities for corruption at the central government level. It also led to the dominant party giving up power after 40 years in a generally peaceful political transition. Notably, as Kenya is a pioneer in the use of mobile technology, the country's elections agency recently adopted blockchain for voter transparency to offer real-time results.

Kenya's economy recovered nicely following the Great Recession to become one of the fastest-growing economies in the region. GDP grew 4.9% in 2017, and the IMF projects that it will expand by 6.0% in 2018 and 6.1% in 2019. After recovering from the 2016 drought, the worst since the early 1990's, Kenya's economic expansion has been boosted by a stable macroeconomic environment, lower oil prices, a rebound in tourism, strong remittance inflows, and a government-led infrastructure development initiative.

Kenya is at the forefront of technology on the continent, and with M-Pesa—Swahili for "mobile money"—it is among the world leaders in mobile transactions. Originally designed as a system to allow microfinance loan repayments to be made by phone, M-Pesa launched in 2007 and was quickly broadened to become a general money-transfer scheme and a branchless banking service. There are now more than 25 million users in a country where 80% of the population lives beyond reach of the electric grid. It is estimated that one third of the entire country's economy is flowing through the M-Pesa mobile payments system and that it's helped lift over 200,000 people out of extreme poverty.



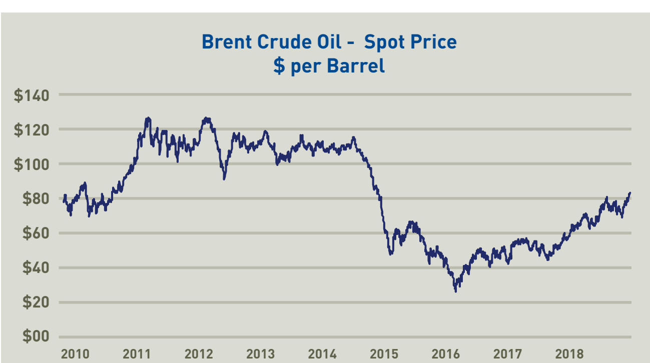
Source: AFDB Socio Economic Database, 1960-2019

Indeed, hundreds of thousands of people are rising out of poverty as mobile money services turn subsistence farmers into business people. Mobile phones are allowing the average person to become their own cash machine, increasing economic activity by enabling direct payments for consumer goods, food, travel, and business. With M-Pesa, Kenya bypassed the brick-and-mortar branch stage of banking with its rapid acceptance of mobile financial services. In addition to Kenya, M-Pesa now also operates in Tanzania, South Africa, Afghanistan, India, Romania, and Albania.

Kenya's central bank is committed to a flexible exchange rate regime, as opposed to a pegged currency, which has been a source of strength and has contributed to economic stability. Kenya's foreign exchange reserves are strong, reaching an all-time high earlier this year, and a tax amnesty for expatriates has generated a flow of money coming back to the country. However, Kenya's public debt has grown significantly in the past five years, and its public debt burden as a share of GDP is the fifth largest on the continent. China in particular now holds over 21% of Kenya's external debt.

Kenya's president has pledged to make economic growth and development a centerpiece of his second administration, focusing on his big four initiatives of universal healthcare, food security, affordable housing, and expansion of manufacturing. In spite of recent missteps, including introducing interest rate caps, we believe Kenya has the potential to be one of Africa's success stories as a result of its growing youthful population (the median age of its 48.5 million citizens is 19.7 years old), vibrant private sector, decreasing fiscal budget and current account deficits, highly skilled workforce, improved infrastructure, new constitution, and its pivotal role in East Africa.

NIGERIA –IT MAY NOT BE ALL ABOUT OIL MUCH LONGER



Source: Factset®

Nigeria is all about size. It is Africa's most populous state, with an economy that's largely reliant on oil. A multi-ethnic and culturally diverse society with 250 different ethno-linguistic groups, the country is a fragmented state. It also recently surpassed South Africa as the continent's largest economy. Nigeria's capital, Lagos, is a sprawling lagoon city of some 21 million. Nigeria is also the biggest oil exporter, with the largest natural gas reserves on the continent. According to a United Nations report, Nigeria is projected

THE NEW BIG BROTHER: SINO-AFRICA ECONOMIC TIES

Africa has become a firsthand witness to the worldwide influence of an insatiable China. In its quest to secure resources to sustain its expansion, China has offered vast trade, assistance, and investment deals to resource-rich African countries linked with low-cost financing. In addition, Chinese companies are diversifying their business pursuits by expanding into Africa, primarily in the infrastructure, manufacturing, telecommunications, and agricultural sectors. McKinsey highlights that there are more than 10,000 Chinese companies operating in Africa, up from just 2,500 a decade ago.

Investment in Africa also fits into Chinese President Xi Jinping's Belt and Road Initiative, an infrastructure and investment project intended to join a continental economic "belt" and a maritime "road" to enhance China's trade and economic expansion from Eurasia to Africa. The initiative involves major investments to build ports, highways, and other trade-related infrastructure. In fact, at the Forum on China-Africa Cooperation earlier this year, President Xi pledged US$60 billion toward Africa's development.

As a result, economic ties between China and the African continent have deepened. In 1995, advanced economies accounted for close to 90% of Sub-Saharan Africa's exports. But 20 years later, new partners, including Brazil, China, and India, accounted for more than 50% of exports, with China representing about half of that amount. The story is similar on the import side: By 2014, China was the single-largest source of Sub-Saharan Africa's imports. China also surpassed the United States as Africa's largest trade partner in 2009.

China's presence in Africa is not without controversy, however. Many African leaders claim that China, like the European powers before it, has exploited resources and is exacerbating a looming debt crisis without adequately building up local economies. China has become the region's largest creditor, accounting for 14% of Sub-Saharan Africa's total debt stock. Johns Hopkins University's China-Africa Research Initiative estimates that China provided some US$136 billion

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to grow from 186 million people today to 392 million in 2050, overtaking the United States to become the third-most populous country in the world. With a median age of only 18.4 years old, Nigeria has an especially young population.

The oil price shock in mid-2014 confronted the government with the challenge of building an institutional and policy framework capable of managing the volatility of the oil sector and supporting the sustained growth of the non-oil economy. Nigeria further experienced a currency crisis and entered a recession in 2016 as a result of lower oil prices and production, problems that were exacerbated by militant attacks on oil and gas infrastructure in the Niger Delta region. GDP growth turned positive in 2017, as oil prices recovered and output stabilized. Nigeria's economy is now slowly getting more of a boost from agriculture, telecommunications, and services, even as its high fiscal deficit is crowding out the private sector.

The current administration, led by President Muhammadu Buhari, identifies fighting corruption, increasing security, tackling unemployment, diversifying the economy, enhancing climate resilience, and boosting the living standards of Nigerians as main policy priorities. The president wants to increase transparency, diversify the economy away from oil, and improve fiscal management. He's also made some headway in alleviating corruption. For example, the implementation of a Treasury Single Account allows the government to better manage its resources and have a more transparent government payroll and personnel system. The government is also focused on developing stronger public-private partnerships for roads, agriculture, and power.

Nigeria is undergoing a fragile recovery, with the economy contracting for first time in two decades in 2016 due to falling oil production. With a renewed focus on economic diversification away from oil, promoting growth in the private sector, and driving job growth, GDP still only grew by a lackluster 0.8% in 2017. The IMF projects that Nigeria's GDP will accelerate to 1.9% in 2018 and stabilize around 2.3% in 2019. With recovering oil receipts, the country is expected to maintain a positive current account surplus in spite of persistently high food inflation and unemployment.

THE NEW BIG BROTHER: SINO-AFRICA ECONOMIC TIES

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in loans to African governments and government-owned enterprises from 2000 to 2017. Many of these large loans are beginning to raise questions about heightened debt loads in African countries.

In fact, the IMF recently warned that 15 of the 35 low-income Sub-Saharan countries face serious financial risks from over-indebtedness. In particular, critics of Beijing's Belt and Road initiatives say that these numerous infrastructure projects leave host countries with too much debt. In Kenya, for example, the public is openly questioning whether the US$3.2 billion Chinese-built railway is even close to generating the required levels of revenues to justify its costs. In addition, Chinese companies generally bring their own workers rather than employing native labor. Local grievances range from poor compliance with safety and environmental standards to violations of local laws and unfair business practices.

After throwing off the yokes of European colonialism, the rise of China has complicated the longer-term prospects of the continent, both in term of human rights and over indebtedness. The global economy continues to look to Africa for access its industrial and agricultural commodity wealth and its growing consumer class, but becoming overly reliant on Chinese financing for infrastructure investment may not be in its long-term interest. The world would benefit greatly from African economic growth without it remaining an over-indebted region.

The country continues to face challenges, including national security, crime, economic diversification, pervasive corruption, a large infrastructure gap, and needing to improve the living conditions of the population (over 62% of Nigeria's population still live in extreme poverty). Islamic terrorism remains a constant threat, as Boko Haram and ISIS continue to be active in parts of the country. But with its swelling population, enormous oil and gas reserves, big and vibrant economy, teeming cities, can-do spirit, and unshakable optimism, Nigeria is a country to be reckoned with.

GHANA—MAKING STRIDES TOWARDS A PROSPEROUS FUTURE

Unlike Nigeria, Ghana is much smaller and generally more open, stable, and entrepreneurial. In 1957, it became the first Sub-Saharan Africa country in colonial Africa to gain independence. Bordering Togo, Cote d'Ivoire, and Burkina Faso, Ghana sits on the West Africa's Gold Coast and is a large transshipment hub for Niger. With a population of about 30 million people and a median age of 21.1 years old, Ghanaians are also a young people.

Ghana has a market-based economy and a competitive business environment well-endowed with natural resources. Gold, oil, cocoa exports, and individual remittances are major sources of foreign exchange. Agriculture accounts for about 20% of GDP and employs more than half of the workforce. Ghana also has a nascent oil industry, which will provide an added boost to growth. Its location on the Atlantic coast makes it a transit point for trade in the interior to Burkina Faso and Niger.

In the past two decades, Ghana has taken major strides toward democracy under a multi-party system, and its independent judiciary has gained the public's trust. Peaceful elections in 2016 led to a smooth transfer of political power. The nation consistently ranks in the top three countries in Africa for freedom of speech and press freedom, with strong broadcast media in particular. Finally, it is one of the least corrupt countries in Africa according to the Corruption Perception Index.

But the country's economy has been sluggish, its banks undercapitalized, and it has had to rely on external funding for support. Ghana signed a US$920 million extended credit facility with the IMF in April 2015 that requires the country to reduce its deficit by cutting subsidies, decreasing the public sector wage bill, strengthening revenue administration, boosting tax revenues, and improving the health of Ghana's banking sector. The fiscal deficit dropped to 6% of GDP in 2017 from 9.3% in 2016, underpinned by serious fiscal consolidation efforts.

The external sector improved in 2017, reflecting stronger performance in earnings from oil, gold, and cocoa, while imports were subdued. The current account deficit narrowed to 4.5% of GDP (US$2.1 billion) from 6.7% of GDP a year ago. Gross international reserves were estimated at US$7.6 billion, equivalent to 4.5 months of imports, up from US$6.2 billion equivalent to 3.1 months in 2016. Strong oil production and moderate success at structural and monetary policy reforms are helping the country's government to stabilize its economy and boost growth prospects. Furthermore, declining lending rates contributed to a strong rise in business sentiment. Still, Ghana remains an economy at risk due to the rising value of the U.S. dollar. It will be essential to restore macroeconomic stability and reduce its current account and budget deficits.

OPPORTUNITIES ON THE HORIZON FOR SELECTIVE, LONG-TERM INVESTORS

We have often referred to Europe's lurching recovery as two steps forward, one step back. In Africa, it's been more like two steps forward and one-and-a-half steps back. On the one hand, Africa exhibits heightened country-specific risk, with elevated levels of poverty, sub-par education, and limited infrastructure. Additionally, the fate of the continent's growth in the near term remains somewhat anchored to the rise and fall of commodity prices. However, the region has plenty of tailwinds, ranging from its mineral wealth to its growing population and consumer class.

As mentioned at the outset, opportunities in Africa come with risks, calling for careful and selective investing. Coupled with decades of investment experience and an expanding team of investment professionals, we believe our unique top-down country allocation framework and disciplined security selection process helps us navigate the many opportunities and risks in Africa, as well as throughout the world. In that regard, markets such as Kenya, Nigeria, and Ghana offer significant potential. However, investors must commit themselves to the long-term.

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