

# Risk in Africa – not simply a number

INVESTING in Africa clearly carries risks over and above those which investors are familiar with in more developed markets. The primary risks include: markets are small and illiquid; government is often inefficient and immature; while reporting and governance levels can be inadequate.

Peter Townshend, a portfolio manager within Coronation Fund Manager's Africa unit, explains the concern investors feel regarding these risks: "In calls with investors, we are usually thrown a question on risk, generally along the lines of 'how do you measure risk in your African portfolios and how do you account for it in your valuations?'" It is a difficult question to answer simply, he says.

Kenya and Nigeria are two key markets and Townshend says it is worth remembering just how small they are. Nigeria has a total market capitalisation of \$56 billion and trades around \$450 million a month, while Kenya has only a \$15 billion capitalisation and trades \$100 million a month.

"By developed world standards these are tiny markets and illiquidity can be a real killer – we know of one fund that went under during the 2008 financial crisis, while both Egypt and the Ivory Coast have been closed for periods this year as revolution rages.

"We naturally measure and track liquidity and have liquid-

ity limits in our portfolios, but the reality is that when you need it most liquidity in these shallow markets will likely dry up considerably. And, as recent events have shown, markets in which we invest can close for long periods."

The countries Coronation can invest in cover the spectrum from ill-tempered and fragile unity governments (Kenya and Zimbabwe), monstrosities inefficient and corrupt 'democracies' (Nigeria and the DRC) to recently-fallen dictatorships such as Egypt and Tunisia.

Even where it invests in supposedly stable and democratic countries such as Zambia and Ghana, it is only a few decades since they too were military/socialist dictatorships.

Further, while state control of the economy is being lifted in many countries (Zambia and Ghana) others such as Zimbabwe are moving the other way.

"Of course we have country limits in our portfolios and closely monitor developments. But, the reality is that we invest in a lively neighbourhood and

while Africa as a whole is developing, this advancement is unlikely to be linear. Surprises are almost guaranteed," says Townshend.

"Furthermore, many of the businesses we come across do not meet what would elsewhere be considered minimum standards of financial reporting. Disclosure can be poor and reports many months late.

"The idea of good corporate governance is an new concept in many countries, as is interacting with investors.

"This is not to say that businesses are poor quality or their accounts dodgy but getting comfort on the quality of a business, its management and its numbers can take a lot of effort.

"So, to return to the question of 'how do we measure risk in our Africa portfolios and how do we account for it in our valuations?'

"We measure those risks that we can and apply what we consider prudent limits where we invest. And, implicit in the ratings we apply to companies and in our valuations, is a country and company discount factor," says Townshend.

By some commonly used measures, investing in Africa is less risky than might be expected. For example, the standard deviation on Coronation's Africa Fund is 26 percent, substantially lower than the 34 percent of the MSCI Emerging Markets Index.

"The best way that we know of mitigating the risk of permanent loss of capital is by investing in high quality businesses, occupying dominant, defensible, market positions and with good management and governance standards.

"These characteristics give us higher conviction in our valuations. Most importantly, we then look for a wide margin between this valuation and the market price."

Exaggeration of the risks in Africa often results in potential investors overlooking the opportunities available.

"Comments such as 'I don't need to own Zimbabwe' by competing investors are music to our ears. In a world flush with liquidity competing for very limited investment opportunities, finding a neglected neighbourhood with extremely attractive valuations cannot be ignored, in our view.

"We make no pretenses as to the potential volatility investors might experience, but we do think we offer up interesting opportunities for investors who can stay true to the mantra of 'long term'," says Townshend.