

Africa: the next big thing

AT A GLANCE

- The negative perception of Africa is not matched by reality, creating potential opportunities for investors
- The vast consumption potential of Africa is underappreciated
- The mounting resource requirements of China's continued economic expansion will be a key driver of African trade, investment and economic growth
- High commodity prices have benefited African resource-producing countries
- Africa was relatively resilient during the recent global financial and economic crisis; improved macro-fundamentals were a major reason for this
- Political risk varies, but is generally high for the region
- The low correlation argument is more relevant for Africa than for more developed emerging markets
- The high risk environment and significant barriers to entry mean that good research and in-depth knowledge of local African investment markets can offer a competitive advantage

The recent football World Cup in South Africa shone a spotlight on Africa, sparking renewed interest in this often underappreciated region. Africa is vast, with varying levels of development across different countries, but the success of South Africa in staging such as an important global sporting event was nevertheless seen by many as a sign of Africa's emergence onto the global stage. There are many factors likely to support Africa's continued economic development and investors should be open to how they might best profit from them.

RESOURCE ENDOWMENTS AND THE CHINA FACTOR

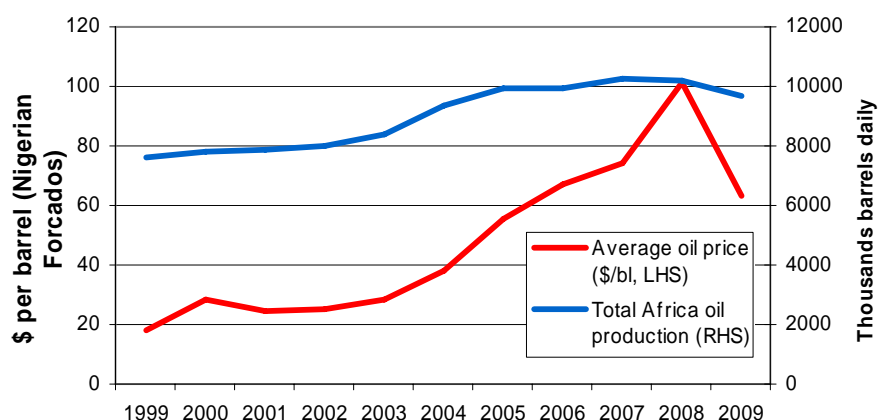
"Africa is rich and its stock is rising. The value of its land and minerals is going up."

Kofi Annan, former UN Secretary General

With a large and topographically varied land mass, Africa benefits from having a wide range of valuable natural resources. A key support for the region's strong growth in the last decade has been the structural rise in oil prices. Not much more than a decade ago in 1999, the oil price was as low \$20 per barrel; although it is now down from the peak level reached in mid 2008, at around \$80 per barrel, the current price is still around four times higher.

The strong oil price boosts the economic output of the region's leading producers and exporters, such as Nigeria and Angola, through a number of channels. At the industrial level, high oil prices have spurred higher investment, especially on the part of foreign oil majors seeking to increase output. In addition, higher oil prices and increased oil output boost government tax revenues which are then effectively recycled in the form of increased government spending on infrastructure and basic services. Most importantly, these actions create additional jobs, which boost domestic consumption. Aside from growth benefits, higher oil prices have allowed many countries to improve their other macroeconomic fundamentals by, for example, reducing their public and external debts and by building up larger foreign exchange balances.

AFRICA'S OIL SECTOR



Source: BP Statistical Review of World Energy 2010

Of course, not all African countries are rich in oil, but the region also benefits from a wealth of other resources, including industrial commodities such as aluminium, bauxite, coltan, copper, iron ore, lead, nickel and zinc, and industrial minerals such as phosphate rock, coal and uranium. South Africa, which is among the region's biggest outliers in terms of economic development, remains one of the world's biggest producers of gold. There are also ten major diamond-producing nations in Africa, with the regional industry estimated to be worth around USD8bn per year;

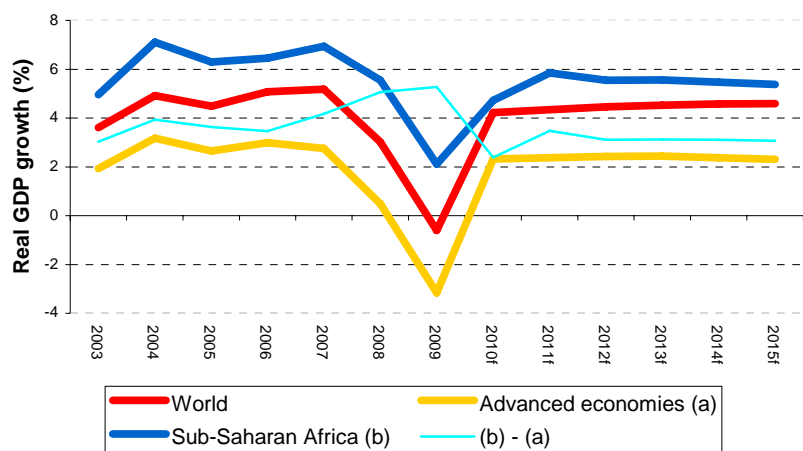
Botswana is a notable example, not only because it is the world's largest diamond producer but also because it is seen by other regional countries as a model of how to exploit natural resource endowments to boost wider economic development and living standards.

One distinctive feature of Africa's development in recent years, particularly its natural resources sector, has been the increasing involvement of China. In a bid to improve its long term energy security, China has been investing heavily in oil-producing nations such as Nigeria, Angola and Sudan, but also much further afield - in Niger for its uranium, for example, and Tanzania for its copper. In return for this, China has provided a diverse programme of assistance that has included debt forgiveness, aid assistance, long term off-take agreements (whereby a buyer agrees to buy a certain portion of a resource producer's future production) and, perhaps most importantly, large-scale infrastructure projects. Of the \$33bn of aid and investment which China provided to Africa between 2002 and 2007, over half was to support infrastructure projects. Collectively, these actions have been supportive of regional economic growth and stability in recent years. Looking ahead, it seems very likely that the mounting resource requirements of China's economic expansion will continue to be a key driver of African trade, investment and economic growth.

IMPROVED RESILIENCE AND ENHANCED MACRO-FUNDAMENTALS

According to the International Monetary Fund's April 2010 regional outlook, one of the least-noticed aspects of the recent global economic downturn has been the resilience of sub-Saharan Africa (SSA), a region which includes the majority of all African countries¹. As the chart below shows, economic growth in SSA has been consistently above that of advanced economies in recent years. When the global downturn occurred, economic growth also dropped sharply in the SSA region but outright recession was comfortably avoided and the growth differential with advanced countries widened.

REGIONAL v GLOBAL GROWTH COMPARISON



Source: IMF Africa Regional Economic Outlook (April 2010)

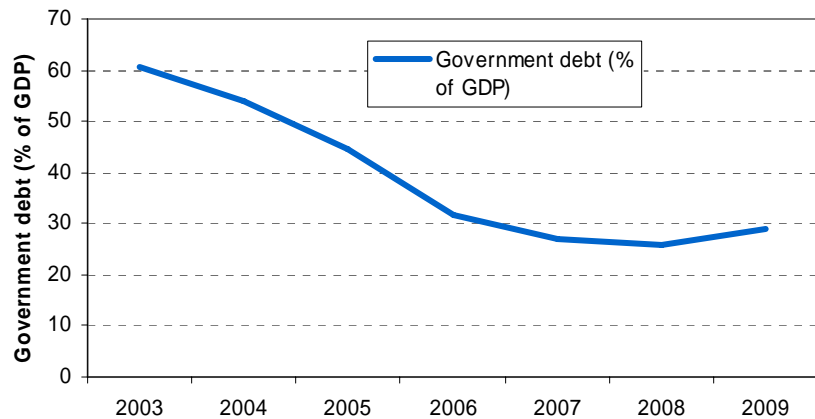
According to the IMF, the limited integration of many SSA countries into the global economy may have contributed to the region's resilience during the global downturn, but a much more important factor was the improved macroeconomic position of most of the countries. Indeed, in past decades, when economic fundamentals were considerably weaker than today, even much milder global economic slowdowns could have a larger negative impact on the region.

A key area in which SSA countries were in a much healthier position going into the global crisis was public debt. The graph below shows how the public debt of the SSA region at the end of 2009 was around half that of 2003, settling at a far more manageable level than in most developed countries. This was important because it enabled most countries to undertake significant counter-cyclical stimulus measures, which helped to counteract the effect of the global demand shock. Similarly, on the monetary side, significantly lower inflation rates than in the past provided

¹ The sub-Saharan Africa group of countries includes the majority of all African countries (47 out of 53). Organisations such as the IMF and the World Bank tend to group the Arabic-speaking countries of North Africa into the Middle East segment.

many central banks with the flexibility to lower policy rates. Other positive factors during this period included the region's low reliance on potentially volatile short term capital inflows and relatively low reliance on exports, in contrast to the Asian region, for example.

PUBLIC DEBT IN SUB-SAHARAN AFRICA



Source: IMF Africa Regional Economic Outlook (April 2010)

STRONG DOMESTIC CONSUMPTION POTENTIAL

"An eminent businessman once commented that profit lies where the gap between perception and reality is the greatest. That surely applies to sub-Saharan Africa."

Nguzi Okonjo-Iweala, Managing Director, World Bank

One of the reasons why Africa has been largely absent from the radar of many western investors has been the perception that domestic demand will be constrained, with limited potential for foreign and domestic firms to sell goods and services. It is likely that this perception has been perpetuated by frequent images of poverty, famine and conflict. However, as in many other areas, perceptions can be inaccurate and unfair, creating potentially profitable opportunities for savvy investors. In Africa's case, it seems likely that the potential for consumption is underappreciated.

In aggregate, the consumption potential of a region or country is affected by demographics, the level of disposable incomes and the rate of economic growth. Africa has a vast population of over a billion people today that the UN forecast's will grow to 1.9bn by 2050. Because the population is relatively concentrated in younger age groups, the continent already has a large working age population estimated at more than 500m people; this is forecast to more than double by 2040. The expected growth in Africa's labour force will be supportive of economic growth in the future.

Other favourable demographic features include a clear shift towards urbanisation (urban people generally earn more and spend more) and a relatively low dependency ratio (the ratio of dependants to the working age population) which will ensure that African nations will not have to worry any time soon about the various ageing-related resource issues of countries in the developed West.

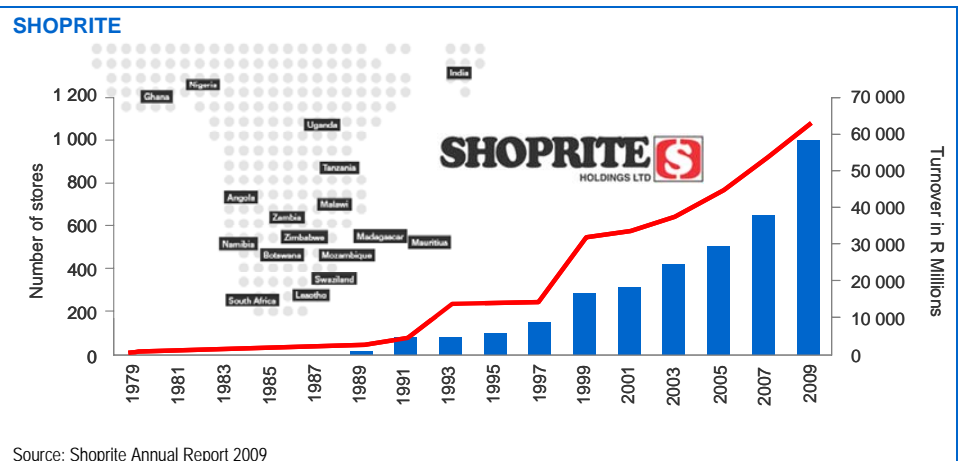
Consumption potential also depends on income levels, specifically after-tax disposable real incomes. In aggregate, these have been rising because of strong economic growth and increasing employment opportunities. According to the UN, GDP per capita for the African region as a whole more than doubled from less than \$681 in 2002 to over \$1,545 in 2008. If a similar compound annual growth rate is sustained in the future, regional per capita GDP would double again by 2013.

An important contributory factor behind this trend is falling rates of poverty, but probably of greater importance than this from an investor's perspective is the increase in the absolute size of higher-income groups that have the means to spend on a wider range of items. According to McKinsey, Africa already has more middle class households (defined as those with incomes above \$20,000) than India. Moreover, the number of people with annual earnings of \$5,000 or more in purchasing power terms (a level above which consumers are seen as being able to start spending roughly half their incomes on non-food items) could nearly double to 106m by 2014, from 59m in 2000.

As Africa's middle class population continues to grow, this is likely to create opportunities for domestic and foreign providers of goods and services. According to the McKinsey Global Institute, the resources sector accounted for nearly a quarter of Africa's real GDP growth between 2002 and 2007. However, by far the largest of all business opportunities in the next decade will be in consumer goods and services, an area which is projected to provide cumulative revenue for the region of \$1,380bn, in comparison to \$540bn from the resources sector in the same period.

So how can investors seek to benefit from Africa's future consumption growth? Although the region is known for its very challenging business environment, particularly for foreign firms, this disadvantage is offset to some extent by a relative lack of competition, high growth and low labour costs, all of which are supportive of higher profit margins. The way to take advantage of this is to seek out well-managed domestic or regional firms that have a leadership position in their respective consumer fields.

A good example is Shoprite, a South Africa-based food retailer which has been quickly expanding its tried and tested high volume/ low cost business model to other countries in the region. Since organised, large-scale retailing of this kind is a relatively unheard of concept in most African countries, the prospects for Shoprite's successful regional expansion seem bright. Nick Price, an emerging market equities portfolio manager at Fidelity, points out that in Lagos, a city of around 18m people, Shoprite is currently the only major supermarket; the lack of competition helps to explain why this particular store is currently among the most profitable in the world and the reason why Shoprite has ambitious plans to expand its presence in Nigeria to 50 stores by 2013.



Source: Shoprite Annual Report 2009

Other stock specific examples of how investors might gain exposure to Africa's emerging consumption growth story include beverage company Guinness Nigeria and South Africa-based media conglomerate Naspers. Guinness Nigeria benefits from operating in a high growth environment and having industry-leading profit margins for its core beer product. On the other hand, Naspers is a more diversified global operator that, among other areas, has significant exposure to the fast-growing satellite and cable television markets of a number of sub-Saharan African countries, including its more mature home market of South Africa. In June 2010, Naspers released strong annual results, showing it had gained 634,000 additional subscribers in SSA over a one year period.

LOW CORRELATIONS

Rational investors who seek to maximise their returns for any given level of risk should diversify their portfolios by the addition of lowly-correlated assets. This argument is often used for investing in emerging market equity and bond markets. The theory is that emerging markets should be responsive to unique, or at least more differentiated, risk factors than more developed markets. The problem, however, is that correlations change over time and the evidence clearly suggests that correlation levels across many regions are rising because of the increasing connectivity of the global economy. For example, a recession in western markets today will have a much more detrimental impact on the economies of south east Asia than was the case 20 or even ten years ago because countries in this region have greater export ties to the West.

References to specific names are for illustrative purposes only and are subject to change without notice. They should not be construed as a recommendation or advice to transact in the securities.

Ahead of the recent global and financial crisis, the so-called 'decoupling thesis' which claimed that emerging markets were becoming less linked to economic conditions in developed countries was gaining ground. However, the strongly-synchronised manner in which most emerging market stockmarkets fell in line with their more developed counterparts during the crisis period reduced the appeal of this idea. In fact, recent experience has provided yet more evidence that correlations tend to rise during periods of heightened market stress so that, unhelpfully, the value of diversification can seem to lessen when it is most needed.

The key lesson from this is that correlations are dynamic and rising over time in many cases. Investing in emerging equity and bond markets clearly still makes sense but investors should understand that the value of diversification in many areas has been declining because of rising correlations. One way in which smart investors have been responding to this is to look further afield for lower correlation assets. This has helped to generate increasing interest in so-called frontier markets such as those in Africa.

Although there will be significant variations across countries, there are some good reasons why correlations between developed/ western markets and Africa are relatively low. Unlike Asian countries, most African countries are not heavily geared to external demand, which helps to limit the fall-out from global recessions. African banking systems were also relatively protected from the recent financial crisis because of the limited interdependence of domestic banks on foreign banks and minimal reliance on external financing. In addition, most investment in Africa has so far tended to be of the direct variety, rather than potentially more volatile portfolio investment, which is much more responsive to shifts in global investor risk appetite.

Looking ahead, Africa's development will naturally increase its integration with the global economy, which will push up correlations with global markets. However, this will be a slow process and, in the meantime, the correlation argument will be a stronger one in the case of African markets than for most more advanced emerging markets.

RISK FACTORS

Wherever potentially high rewards are available, it is also natural to expect significantly greater risk. As such, investors looking towards Africa need to be aware that the region as a whole represents a fundamentally high risk environment by global standards. Political risk is often high, with many countries recovering from long periods of instability with a high susceptibility to renewed conflict or unexpected changes of government. In many cases neither democracy nor the rule of law is well established. Foreign companies that seek to enter African markets directly tend to face highly-challenging business environments that are often characterised by factors such as corruption, powerful vested interest groups, weak regulation and poor corporate governance.

However, in all these areas, it is important to note that there is a high degree of variation among African countries. At the positive end of the scale, South Africa in many ways resembles advanced western markets. At the other extreme, there are more chaotic examples such as Zimbabwe. The task for investors, therefore, is to separate those countries which offer a sufficiently high return potential for an acceptable level of risk. This can be a research-intensive and time consuming process that, in most cases, is probably best outsourced to experienced managers with in-depth regional expertise.

Even when the most viable markets can be identified, a further problem for investors is often the absence of investable instruments through which to express a particular view. Indeed, financial markets in Africa tend to be generally underdeveloped, with poorly functioning equity and bond markets that suffer from significant liquidity constraints and sometimes regulations that discriminate against foreign investors. However, in this regard too, significant intra-regional variations exist, further underscoring the need for good research and local expertise.

CONCLUSION

The negative perceptions of Africa are not matched by the reality. Indeed, Africa could represent the classic instance of where the gap between perception and reality is unjustifiably wide, creating opportunities for investment.

The region benefits from a vast array of natural resources, which are helping to boost investment, trade flows and economic growth. Revealingly, a country with a reputation for taking a long term view, China, is playing a central role in the region's development in return for enhancing its own long term resource security. However, while Africa's resource potential has been known for some time, a much greater opportunity lies in the region's own consumption prospects. With an already huge population that is growing and steadily becoming wealthier, the region's scope for consuming goods and services is vast.

The case for investing in Africa is further bolstered by low correlations with developed markets owing to the region's relative lack of integration into the global economy; if the correlation argument still works for more developed emerging markets, then the case for diversification into the frontier markets of Africa is even stronger. However, it is important to remember that Africa is a fundamentally high risk region where the numerous barriers to finding the right investment can be prohibitively high. This means that there will always be a premium for good research and deep knowledge of local investment markets.

"While more fashionable and established emerging markets have been getting a lot of attention, the real long term growth story that investors should be getting excited about is Africa, specifically the region's consumption story. Strong and consistent GDP growth in recent years is seeing rising incomes and a developing middle class in many countries here. From the portfolio perspective too, frontier markets such as those in Africa are considerably less correlated with developed markets than is the case for more established emerging markets."

Nick Price, Portfolio Manager, emerging markets equities



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