QUARTERLY SHAREHOLDER LETTER

Investing in Africa

30 June 2020

Dear Shareholder,

Africa has been a source of profitable investment ideas since we first bought grocery retailer Sefalana, in Botswana, thirty years ago. Despite often challenging operating environments many of our holdings delivered decent growth and one or two have been stunning. Excluding any commodity investments, which dance to a different tune, the main African investment story has been domestically focused franchises. Over the past 15 years, these investments have cumulatively contributed over 400bps of alpha. The largest contributor by country was South Africa, but Egypt, Kenya and Francophone West Africa have also added significantly.

We have learned many lessons over the 30 years, perhaps most importantly at the macro level. It is easy to be seduced by the enormous growth potential, and we have developed specialised antennae to identify the various ways in which governments and policymakers can waste opportunities. Bad policy generally manifests in rising debt and currency devaluation; in the past ten years South Africa, Nigeria and Egypt have seen their currencies depreciate on average by 6-7% a year. The less obvious effect of mismanagement is that a country grows below its potential, delaying the potential for large scale poverty reduction. But at the bottom-up level, companies, like people, can be remarkably resilient and we have been impressed by the way our investments have been able to grow. What has become clear is that successful investing in Africa requires significant fundamental on-the-ground research; a long-term horizon; business models that generate value for all stakeholders, not just a select few; a broad understanding of the license to trade (crucial in the absence of strong institutions); and a focus on the strategic value of rare, high quality, assets with strong economic moats. Many of these factors have universal application in investing, but the volatile conditions in Africa make them especially relevant and they are burned into our institutional memory.

Our largest and most successful investment in Africa was in the South African Breweries, which we held at various times between 1999 and 2016. SAB started expanding north from South Africa in the early 1990s and for over twenty years we visited their breweries throughout Africa, learning from their excellent local management teams. This on-the-ground research was critical to understanding the company's culture and values. SAB became our largest position, at 5%, and was ultimately bought by Anheuser Busch-Inbev in 2016 for over US$100 billion. ABI said the attractive growth opportunities in Africa was a key reason for the acquisition. The SAB deal also showed how an African business can have a strategic value beyond the perceived local franchise, as multinationals increasingly see Africa as one of the last great growth opportunities that can complement a global network. More recently we saw an extension of this theme in Heineken, which, like SAB, has a long history in Africa. Although not founded on the continent, Heineken opened its first brewery there in 1923 in Belgian Congo (now the DRC) and has expanded to 22 countries with operations covering 75% of the African population. Over half of Heineken's African volume is in Nigeria, Ethiopia and the DRC – the three most populous Sub-Sahara African countries. Indeed, Africa contributes 14% of total volume and, despite a challenging consumer environment, it has grown 6% CAGR over the past 10 years. The growth runway for beer in Africa is long: consumption in most Sub-Saharan African countries is between 6-12 litres per capita per year, compared with 60 in South Africa or Brazil, and mid-70's in the UK and US.

Africa's rise has been anticipated for a long time. In the 1960s hopes were high. The remarkable leaders of the independence generation – such as Ghana's Kwame Nkrumah and Kenya's Jomo Kenyatta - brought a fresh sense of optimism. Yet for decades Africa remained stagnant, mired in poverty, with low life expectancy and high fertility rates. Ironically it was the continent's resource wealth that in many ways hampered economic progress, both for reasons of Dutch disease (no need to be competitive in anything other than resource extraction) and because it fuelled conflict between officials and all the various bandits who wanted to control it. Low levels of literacy implied limited understanding of the proper role of government and therefore limited accountability. But as the twenty-first century dawned things began to change. Between 2000 and 2014, Africa achieved one of its longest episodes of sustained economic growth since the 1960s. And despite a sluggish global economy after 2014, the growth has remained resilient.

The Investment Opportunity

Structurally Africa offers significant growth potential and the conditions may finally be in place to enable rapid industrialisation. By 2025, Africa will be home to almost a fifth of the world's population, and by 2035 Africa's working-age population should surpass both India's and China's. A few important things are happening at the same time. The dependency ratio is falling, mainly because fertility has dropped across the board. This allows women to enter the workforce and households to save more, providing domestic funding for industrial growth. At the same time literacy is rising. Research by Renaissance Capital suggests that countries have a hard time industrialising until literacy is above 70%. Of the 15 largest African countries (accounting for 75% of the continent's population) in 2000 only South Africa met this criterion. Today 11 of the 15 do.

With industrialisation comes urbanisation. By 2025, an additional 110m people in Africa are expected to be living in urban areas, where per capita consumption of consumer products is some 80% higher than the national average. Technology can leapfrog traditional business models with affordable smartphones and lower data costs. Mobile internet penetration is expected to double, to 67%, by 2025. McKinsey expects consumer spending in Africa to reach US$2.1 trillion by 2025, a US$700bn increase over 10 years.

This abundant workforce and growing consumer class is meeting positive change in governance, democracy, and ease of doing business – half of the top 10 countries with a population above 10m people with most improved ease of doing business over the past five years are African. Kenya has increased its score the most globally, with improvements across all 10 sub-indicators. This has been enabled by rapid digitisation, a significant increase in access to power and improvements in logistics infrastructure. In addition, businesses are benefitting from falling trade barriers, notably with the African Continental Free Trade Area coming into force in 2019. Inter-African trade lags other developing regions but ACFTA reduces barriers. The ASEAN FTA, enacted in the 1990s, drove inter-ASEAN trade from mid-high teens – which we see in Africa today – to over 25% of total trade, and we see the same potential here.

The positive changes have not gone unnoticed by direct investors looking for growth overseas. FDI wakes up when it sees a stable political and economic environment and business-friendly policies. Ethiopia and Morocco stand out, with FDI taking fixed capital formation to over 30% of GDP in recent years. The investment has gone into infrastructure, education and manufacturing, and is delivering a more diversified economy and export growth. Remember Live Aid? That was in 1985 when Bob Geldof raised awareness of the famine in Ethiopia. After 17 years of communist military rule, Ethiopia transitioned to civilian rule in 1991. Following Chinese-style industrialisation, its GDP has increased 11x since the early 2000s and it has been in the top 10 fastest growing economies globally in each of the past 10 years.

Sometimes controversially, the opportunity is increasingly recognised by Chinese companies. Over the past 20 years Africa-China trade has grown by 20% per year and FDI has grown even faster. Investment was initially by quasi-government firms into commodities and large infrastructure, but more recently private companies are coming to serve domestic demand. McKinsey estimates that Chinese firms generate over US$200bn of revenue in Africa and are market leaders in many industries including technology, manufacturing and, increasingly, agriculture. This investment is likely to continue as Chinese firms look for new growth amidst overcapacity and a declining working age population at home. This presents interesting possibilities for Genesis given our collaborative structure which gives us insight into these companies in Africa and China.

The African Development Bank released a report in January this year projecting real GDP growth in Africa to accelerate to 3.9% in 2020 (up from c 3.4% in 2019) and to 4.1% in 2021. Unfortunately, the economic fallout of the COVID-19 pandemic has temporarily paused this upward curve. Although most African countries have had low infection and death rates, the second order economic consequences of lockdowns are likely to be severe. The possibilities are limited for fiscal and monetary stimulus, and the weak social safety nets pose a stark dilemma for many African countries: continue to repay debt or use the resources to support incomes. The median government debt-to-GDP ratio in Africa was 56% in 2018, up from 38% 10 years earlier. This upward trend was partly driven by the end of the commodity super-cycle and may yet result in restructuring or partial default – which may make global headlines as Eurobonds constitute around a fifth of the continent's total external debt burden of nearly US$500 billion.

Our investments in Africa

In the early 1990s the opportunity set was largely banks and beer companies. By 1997, 14% of the Fund was in Africa, mostly in – you guessed it – banks and brewers in Botswana, Ghana, Kenya, Morocco, Egypt, Tanzania, Uganda, Zimbabwe and South Africa. Beer is the dominant alcoholic beverage in most of Africa, and local beer companies did well. Our investments in local brewers were successful partly because multinationals acquired majority stakes, driving earnings growth through operational and marketing best practice.

By the late 1990s the opportunity set expanded, led by mobile communications companies as governments opened the sector to private investment. Mobile penetration rose from 2% in 2000 to over 75% today and changed lives. South African based MTN saw the opportunity, starting its international expansion to Uganda and Rwanda in 1998, Nigeria in 2000 and today operates in 21 countries. We invested in MTN in 2002 and the share price returned over 9x by the time of our exit in 2006. We also invested in Francophone West African leader Sonatel and Kenyan leader Safaricom.

Improvements in technology, initially led by mobile phone penetration, and more recently mobile internet, have provided a low-cost distribution platform for other sectors, with a positive impact on society as well as shareholders. Digital financial inclusion is one of Africa's great success stories over the past decade. Forward-thinking regulators have developed frameworks for affordable financial solutions, providing the opportunity for innovative companies to profitably address the bottom of the pyramid. In our recently published inaugural ESG report, we discussed how the low-cost banking solutions at Guaranty Trust Bank in Nigeria have tripled retail customers in 8 years to 17.5 million. GTB has been a Fund holding since 2007 and has been able to successfully navigate challenging macro and regulatory environments, generating value for its customers and shareholders alike. It is one of the most interesting banks we know in that is has successfully taken on customers that in most parts of the world would have been regarded as unbankable.

Around the time that we invested in GTB, Safaricom was busy launching m-pesa in Kenya. M-pesa became a global phenomenon when it enabled "mobile money" using telecom infrastructure to give low cost access to financial products. In 2007 only 28% of Kenyans used formal financial services, but largely due to m-pesa, 10 years later financial inclusion had reached 83%. Today over 25 million active users make over 13 transactions each per month, including in savings, borrowing and international remittances. We first invested in Safaricom in 2008 and it was fascinating watching its success, which has now been well documented and replicated elsewhere. Another successful investment in financial services was Capitec in South Africa. Through simple, affordable products based on state-of-the-art technology, Capitec disrupted a stable oligopoly of four established banks to become market leader by number of clients. From when we invested in 2013, it has tripled its active customers and quadrupled profits. Capitec's low-cost, technology driven model charged lower fees than the incumbents and brought formal banking to many more South

Africans. We exited the investment in 2016 when we figured the share price was reflecting a lot of the good news.

As consumers become wealthier their requirements evolve and they need more complex financial products like savings and insurance. Sanlam, the leading African insurer with operations in 35 countries, is taking advantage. It has partnered with Capitec and MTN throughout Africa to distribute insurance products on low-cost digital platforms. Insurance penetration is in its infancy in most of Africa, but it is growing fast, and Sanlam has grown the value of new business in Africa[1] at double digits in USD over the past 5 years. We have been following Sanlam's success and used the valuation opportunity earlier this year to initiate a position.

Although our weight in Africa is currently the lowest for over 20 years at just over 2%, our investments there are well positioned in the most interesting growth areas including in food, beverages, consumer, internet and insurance. What's more, valuations are at 11-year lows: the African portion of the Fund has a 35% ROE, grew cash flows 30% in 2019 and is trading on 11x FY20 PE.

Around half of our current African exposure is in Nigeria, in three targeted positions: Nestlé Nigeria, GT Bank and Nigerian Breweries. Nigeria accounts for around a fifth of the continent's total consumer spend, yet remains very underpenetrated. To an investor, Nigeria is perhaps the most frustrating high potential country in the EM universe. By 2050, it is expected to be the world's third most populous country, at over 400 million. But it has been badly served politically, so that ineffective policy and systemic corruption have kept a lid on growth, and the currency is currently only partially convertible. Nigeria is the only major African country where we have suffered significant investment losses. When we got local custody to invest in 2007, we made four investments in quick succession, eager to benefit from the enormous opportunity. As it turned out this was just before the Global Financial Crisis, when oil was reaching a peak. The subsequent oil price collapse triggered a banking crisis in Nigeria and many share prices have still not recouped the losses from 2009. The country achieved its first democratic change of power only in 2015, and we are still waiting for real institution building and fiscal reform.

But the long-term growth could be impressive. Financial services reform – plus the technology discussed above – has driven an explosion in banking penetration, with the banked population doubling in the past four years to 42 million. Online media is stimulating growth in Nollywood, Nigeria's film industry, which is now the world's second largest by film output. A new wave of "super-apps" is emerging, offering solutions to transport, e-commerce, financial services and education. We believe our Nigerian investments are well placed to take advantage of the opportunities and they are trading at significant discounts to intrinsic value. Nestlé Nigeria, for example, has compounded USD revenue at 13% CAGR over the past 20 years, achieving an average return on capital of 70%, allowing it to pay 80% of profits in dividends. Growth in USD has in fact exceeded that in its sister subsidiary Nestlé India over the past 20 years. Although both companies had the same market cap in 2007, today Nestlé India's market cap is 11x higher and it trades on 85x earnings compared with 15x for Nestlé Nigeria. Nigerian Breweries, the leading brewer with 55% market share, currently trades at less than half replacement value. Despite the weak institutions and deeply flawed policymaking, as long-term investors we feel Nigeria is too interesting to ignore.

[1] Excluding South Africa Retail Affluent segment.

Conclusion

Africa offers enormous long-term potential but achieving it will not be a smooth process. The next few years will be challenging, exacerbated by the impact of COVID-19. We expect the unfolding crisis will create some impetus for change, ultimately increasing the investable opportunity set. 30 years of experience should help us spot the promising ideas, and our framework of deep fundamental research and long-term time horizon put us in a good position for investing success in the years to come.

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