Africa: The land of opportunity for smart investors

Africa has long been considered by many to be an interesting investment proposition, but with six of the world's top 10 fastest growing economies on the continent over the last decade, it is a region that smart investors must now take seriously. Successful investment in Africa does present significant challenges, but those with vision, endeavour and the guidance of a trusted partner have an opportunity to reap huge rewards.

There has been much hype and discussion about the untapped potential of Africa for some time now, but it is worth considering a few hard facts to put this investment opportunity into perspective.

The continent has 7.8 per cent of the world's oil reserves and 7.7 per cent of its gas[1], much of it still untapped due to lack of infrastructure. According to the World Bank, Africa also requires investment of USD93 billion per year for the foreseeable future in order to improve ports, power plants and roads at an acceptable rate.

Despite its huge volumes of natural resources, African economies are not heavily dependent upon them. While resources still dominate export sectors, the reality is that domestic demand is now providing the principal growth impetus in Africa. Despite softer commodity prices, African exports continue to grow as greater exploration spending and investment drive output gains. But almost everywhere, growth is driven primarily by growing domestic consumption.

Sustained economic reform across many African markets has seen many countries make rapid strides in GDP growth in the last decade. Economists at Standard Chartered believe we are experiencing the start of an African "supercycle" which will see markets double in size over the next 10 years[2].

Based upon a weighted average of key markets, Standard Chartered is currently anticipating 5.4 per cent GDP growth for Sub-Saharan Africa (SSA) in 2014. This growth is well above the global average and is being driven by a combination of political and economic reform, demographics and increased foreign direct investment (FDI). More than half of global population growth between now and 2050 is expected to occur in Africa[3], while FDI increased by 7 per cent last year to USD56 billion[4] as investors became more confident.

South Africa is the most developed of African nations and it has reaped the rewards of a relatively stable economy and a developed corporate infrastructure. In 2013, FDI in the country

[1] BP, "BP Statistical Review of World Energy", June 2013.

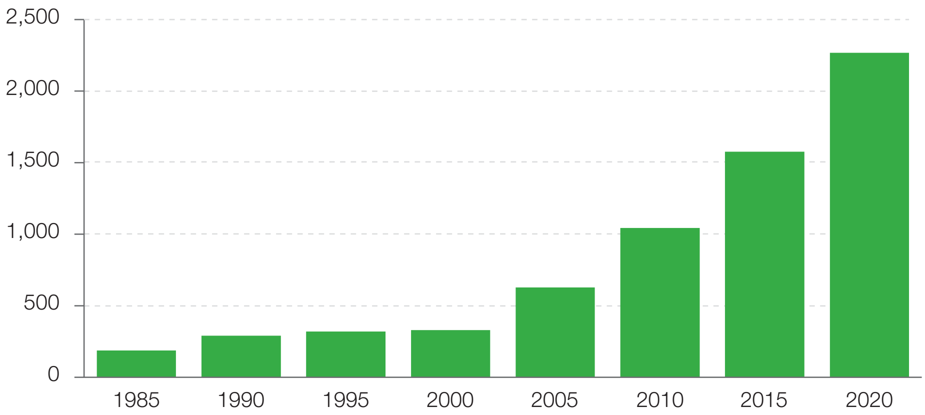
[2] Economies such as Nigeria, Ethiopia, Uganda, Tanzania, Mozambique and Angola have all seen sustained growth of around 7 per cent , allowing them to double in size every 10 years.

[3] United Nations, "World Population Prospects: The 2012 Revision", June 2013.

[4] Standard Chartered, "Global Focus", March 2014.

An African supercycle

Sub-Saharan Africa's GDP to reach USD2.3 trillion by 2020



- Supercycle characteristics
- Sustained, diversified growth
- The 7 per cent club (e.g. Uganda, Tanzania, Nigeria, Angola) is expected to double in size every 10 years

Source: IMF Regional Economic Outlook 2012

almost doubled to USD10.3 billion. Despite this, sentiment towards South Africa is fairly downbeat as growth remains weak, and a series of problems, including protracted industrial unrest, cloud its future.

The country's well established status as a gateway to the rest of the continent means it will retain its status as Africa's 'superpower' for some time, but we believe there is also growth potential elsewhere.

Africa's golden trio

Nigeria

With the rebased GDP released in April 2014, Nigeria surpassed South Africa to become Africa's largest economy. The country has a solid growth outlook, with agriculture and power sector reforms set to drive medium-term improvements. Already the world's seventh most populous economy, United Nations population projections suggest that Nigeria will be the fourth most populous by 2035, after India, China and the United States, with many of those people of working age, between 15 to 64 years.

Calculating the size of Nigeria's economy is difficult due to rapid growth. The rebasing of Nigeria's GDP calculations now takes into account new sectors such as finance, telecoms and entertainment, resulting in about 60 per cent uplift to estimates of 2010 GDP figures, and a 2013 estimate that is 89 per cent greater than previous projections. At USD512.3 billion[5], Nigeria has the second largest stock exchange by market capitalisation after South Africa. Increased listing of large companies over the years has accelerated market capitalisation growth.

With potentially contentious elections due in 2015, near-term political risks are building. In the months ahead, a surge in pre-election liquidity may lift economic performance broadly, although it is expected to hurt the Nigerian naira.

Kenya

Similar optimism applies to Kenya where a well-established private sector and diversified economy are benefitting from orderly elections in 2013.

Technology, especially mobile technology, is also helping to drive rapid growth in financial inclusion with a third of the population having access to finance through mobile money[6], in addition to the third that are formally banked. A combination of oil discoveries and an infrastructure boom are further factors supporting Kenya's rapid growth story. Growth of listed companies due to increased investor confidence has boosted market capitalisation to USD23 billion[5]. This is evident through the stellar performance of share prices.

In anticipation of increased spending requirements with the adoption of a more devolved system of government, Kenya has also been working hard to improve its tax take. The VAT Act 2013 should raise approximately 0.25 per cent of the GDP in 2014. Plans to issue a maiden eurobond will also limit the country's domestic borrowing requirement in the near-term, creating a lower interest rate environment domestically. This should help to spur growth.

Ghana

As a relatively new oil producer, Ghana has attracted considerable external interest and was one of the top five African foreign direct investment recipients in 2012. Standard Chartered believes that increased hydrocarbons production in the medium-term will see a restoration of Ghana's 6 per cent trend growth.

Ghana has many established strengths. It has a relatively diversified economy. It has seen two peaceful transitions from one political regime to another in less than a decade. It does better than most African countries on the achievement of the

[5] Bloomberg, 8 June 2014.

[6] Mobile money refers to the safekeeping and usage of electronic cash by individuals where the main mode of transaction is via the mobile phone. This is a service offered by mobile wallet providers to large masses of individuals who may be unbanked or not bankable by formal banking institutions.

Millennium Development goals. Nonetheless, near-term growth is threatened by a high and growing domestic debt burden. However, Ghana is expected to issue a third eurobond in the near-future. Positive investor reaction would allow it to retire much of its expensive, short-term domestic debt, helping to create more stability for the future – while still offering investors significant returns.

Ghana has also made great steps in improving government revenues via avenues such as taxation, though this is being outstripped by increases in government spending. The country's current account deficit is increasing and it will need to find ways to shift some of that spending from wages and subsidies to investment. The Ghana stock exchange has registered good performance in the first half of this year in local currency terms. However, the market capitalisation in USD terms has reduced to USD3 billion[5] from USD5 billion this year due to a depreciating cedi.

Accessible Africa – a sleeping giant awakens

Market accessibility in Africa is generally improving as countries continue to liberalise. This attitude is commonplace now as governments see the benefit of improving the economic environment to the benefit of foreign investors.

China-Africa trade reached approximately USD210 billion in 2013, up 6 per cent year-on-year. Trade has grown strongly, from only USD7 billion at the end of the 1990s. Standard Chartered expects total trade to grow eight-fold by 2030. This stratospheric increase is partly driven by Africa's attitude to accessibility and the various governments' understanding of the huge benefits that FDI can bring.

Outside investment has encouraged the rapid emergence of a middle class, already equal in size to India, making domestic consumption a major driver of economic growth across the region. This growing wealth within the continent has fuelled the development of industries such as financial services, entertainment and telecommunications, as mentioned earlier; creating more diverse and vibrant economies.

The financial services industry in particular is growing in depth and complexity, and as the population demographics in the key African markets change and incomes rise, the domestic institutional investor base and pensions industry will become more important.

This is most apparent in leading economies such as Nigeria where domestic pension funds (known locally as pension fund administrators) have played an important role in stabilising the bond market. Kenya is also seeing the evolution of a very substantial and active domestic institutional investor base consisting of banks, insurance companies and pension funds.

There is increasing equity and bond market activity across Africa's major markets, and some larger private equity players are setting up Africa-focused private equity funds.

Africa and the Middle East make up 81 per cent of the MSCI Frontier Index by benchmark, with 75 per cent in the five leading markets of Qatar, Kuwait, United Arab Emirates, Nigeria and Kenya. Investor interest in these pre-emerging markets was on the rise in 2013, as highlighted by a number of large fund managers which have started frontier funds, including Schroders, BlackRock and Franklin Templeton.

It is important to note that South Africa has the only functioning derivatives market at present, but there are signs that Kenya and Nigeria will also be launching derivative markets in due course. Ghana has shown capital markets innovation recently; shifting foreign investors to buy select 2 year bonds.

The increasing accessibility of Africa is progressing in a manner consistent with its financial market deepening, making it more attractive and flexible for foreign investment.

> "For a long time, people assumed that African growth was just about commodities. It's much more than that. Africa has the strongest demographic profile of any region. The share of its working age population continues to grow. Combined with other reforms, this will drive strong consumption growth for decades. Africa is the region to watch."
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> Razia Khan
>
> Regional Head of Research, Africa

Winning in Africa – navigating the ecosystem with Standard Chartered

While Africa presents many opportunities for institutional investors, there remain challenges that do not typically exist in developed markets. The key to success in this investment situation is knowledge, planning, preparation and execution. These elements are best delivered by a trusted partner such as Standard Chartered, using its on-the-ground knowledge of the region to help global and regional investors identify and navigate investment opportunities.

As a leading full service international bank in Africa, Standard Chartered is committed to the potential of Africa, backed by more than 150 years of experience and coverage of 37 markets on the continent and Africa being the leading region in the Bank's international private equity portfolio. With deep-rooted local insights, extensive international expertise and a well-established brand, we lead the way in the region through product innovation and strong financial performance.

One opportunity is the rise of mutual funds in Africa, encouraged by the huge strides made by a number of governments in creating a stable political and economic environment amenable to long-term investment.

Alexis Calla, Global Head, Investment and Advisory at Standard Chartered, believes the potential for the industry is substantial. "Mutual funds are set to take off in Africa as an environment of declining inflation and lower interest rates creates an ideal platform for long-term investing. Similar to Asia in the 1990s, this is the perfect environment for a developing mutual funds industry to enjoy rapid expansion."

Elsewhere, a growing demand for more innovative and complex financing structures in Africa is also drawing attention, creating strong appetite for both local and hard currency financing. We are able to help investors gain access to the increasing number of debt issues from central banks and corporates seeking to broaden their investor base, and also help explain any market volatility.

A good example is the recent outflow from local currency bond markets across the second half of last year. When investors saw those outflows, US Federal Reserve tapering was blamed in some quarters, despite the fact that SSA frontier markets were not expected to be impacted.

With its intimate knowledge of African markets, Standard Chartered understood the key local factors at play and the expected impact on the investment landscape. Concern about the Central Bank of Nigeria's monetary policy leadership transition in Nigeria, Ghana's deteriorating debt profile, and the regulatory response to currency weakness in Zambia drove much of the initial selling across these markets. East African markets generally performed better, and, in the next quarter, we expect to see a pronounced rally in Kenyan local currency debt, subject to the usage of the proceeds from the maiden USD1.5-2 billion eurobond issuance.

The largest local currency bond markets in Africa (ex-South Africa) are in Nigeria and Kenya, which are dominated by governments, states and government agencies, but offer access to banks and a number of large companies, such as the Nigerian Aviation Handling Company and Kenyan telecommunications firm Safaricom.

While not particularly large, there has also been increasing investment activity from domestic institutions, with some South African investors investing in Nigeria. Nigerian pension funds, for example, have dominated investment in domestic government bonds for much of early 2014. The bonds have proved popular because of the yields on offer, with buying of domestic debt by pension funds helping to cap the rise in yields whenever foreign investors have exited.

The custody question

There has been significant positive developments within SSA's markets over the last decade and there is a genuine commitment to address the infrastructure challenges in the region. Almost all SSA markets now have a functioning infrastructure, as far as their capital markets are concerned. However, financial market regulation is still evolving in Africa, and there are many subtle variations across countries that can often catch institutional investors out unless they are vigilant.

Increased interest from foreign and regional investors is now driving demand for custody services. Margaret Harwood-Jones, Global Segment Sponsor for Investors and Intermediaries, says getting your custody arrangements correct, is crucial to investing in Africa.

"A reliable custody partner with intimate knowledge of the intricacies of each country's legislation is essential to avoiding mistakes that cost money. When doing business in markets that are operationally complex, it is even more important to get things right the first time."

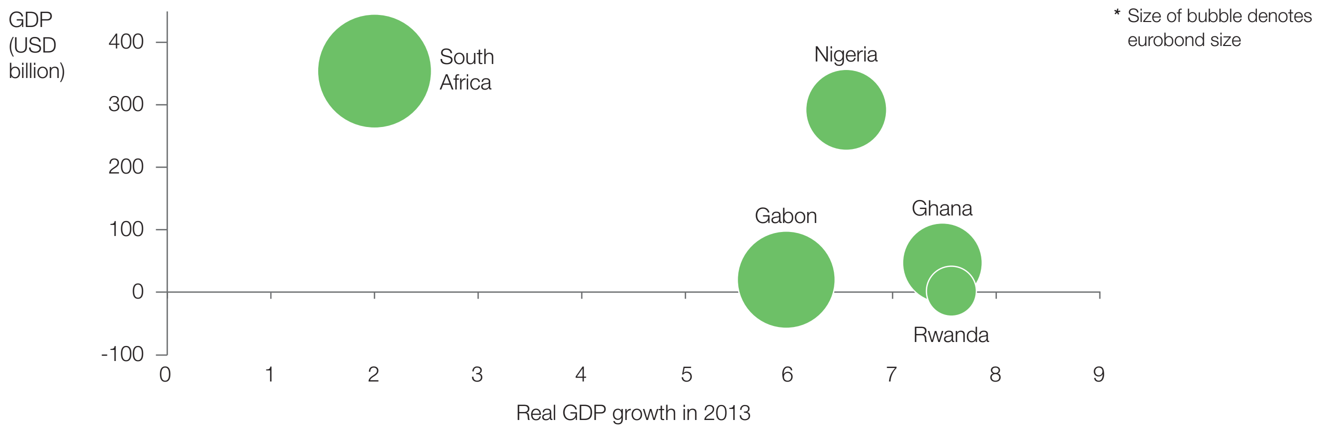
Standard Chartered provides custody services in 17 African markets, available per market or collectively via our Mauritius hub. This is backed by access to domestic custody expertise, and an advanced custody platform providing live transaction updates and intra-day position information. Standard Chartered provides integrated services combining cash, custody and FX offerings across SSA.

We also provide trustee and fund services that includes performance measurement, compliance monitoring and reporting.

The rise of hard currency debt issuance in Africa

Aside from local currency debt, we saw more than USD10 billion of US dollar-denominated sovereign bonds issued in Africa in 2013, of which SSA countries accounted for around USD6 billion, excluding small private placements from Mozambique and Tanzania.

Eurobond issuance by Sub-Saharan Africa sovereigns in 2013



Source: IMF, Standard Chartered Research

Issuance of hard currency debt can benefit African countries because of the volatility of their currencies, and is becoming more attractive to investors as the effects of a reduction in quantitative easing by the US Federal Reserve are better understood and priced into the market.

Standard Chartered is seeing a structural change in Africa towards hard currency issuance, as countries look for more innovative ways to fund large financing requirements, especially to overcome significant infrastructure deficits built up over many decades.

Notwithstanding Fed tapering, many African sovereigns are lining up to issue eurobonds in 2014. But investors should still be wary of jumping in with two feet, as many African capital markets are still in their infancy. Both Ghana and Zambia saw significant deterioration in fiscal policy soon after their respective maiden eurobond issuance, while policy making and governance are perceived to have slipped in Senegal following its borrowing from international capital markets in 2010.

This is likely to be temporary though, and we believe the need to tap markets frequently for refinancing will finally bring about a greater level of market discipline, and with that, more opportunities for international debt investors.

Enhancing returns via non-cash instruments

Away from the bond markets, Africa is seeing increasing activity in non-cash instruments. Investors are trading in total return swaps and credit linked notes, where the underlying instrument is a treasury bill or government bond. South African fund managers, for example, are currently looking to buy credit assets and then swap them into a South African rand return.

Standard Chartered is particularly active in the cross-currency swap market and can help institutional investors find the most liquid markets. There has been huge growth in Nigeria's non-deliverable forward market, which is very liquid out to one year. In addition, a small cross-currency swap market is starting to develop in some markets and there is the possibility that

"With deep-rooted local knowledge, extensive international expertise and a well-established brand in Africa, we have an important advantage in capturing Africa's growth potential. As institutional investors navigate their way into this fascinating continent and its markets, our leading research expertise, trading capabilities and custody solutions, make Standard Chartered the natural partner for their investment needs."

Jeremy Amias

Global Head of Investors and Public Sector this will evolve in a similar fashion to markets such as Turkey where cross-currency swaps trade more actively than interest rate swaps.

Standard Chartered has championed the establishment of cross-currency swap markets in several key economies, where they have become increasingly popular for hedging. The scale of this popularity is apparent from the growth in individual transaction sizes, which were typically USD1-2 million in 2009, but are now often in the USD50-100 million range.

A similar picture applies to vanilla foreign exchange, where volumes have risen dramatically partly due to the rapid adoption of technology in Africa, as witnessed by significant growth in foreign exchange e-commerce platforms. For instance, the Standard Chartered Straight2Bank Exchange platform now has over 290 clients.

The size of Standard Chartered's African operations and its local market involvement means that, when it comes to trade execution, international investors can enjoy a globally consistent service proposition together with local expertise and information. Equally, our international network makes us uniquely placed to offer African investors unrivalled access to global markets and international expertise.

Africa is a land of opportunity and contrasts, offering great possibilities to those investors well prepared and determined enough to succeed, but presenting significant challenges to those without the correct guidance. While good return opportunities exist, they may be difficult to come by in developed markets picked over by thousands of intelligent investors. Those opportunities still remain in Africa, a frontier land that relatively few have yet to spend significant time analysing. Standard Chartered has the expertise, experience and international scope to guide its partners around the obstacles on the road to African investment; helping them to participate in the success story that we expect Africa to be throughout the next decade and beyond.

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