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Africa's public markets: Issues for investors

By Gustavo Medeiros and Jan Dehn

African public markets are relatively young. Alongside Chinese finance, they are encroaching on space previously monopolised by donors. Despite the rapid growth of Africa's public markets in recent years, the continent remains by far the most finance-constrained region in the world.

This report presents an overview of Africa's public markets, highlighting seven features which make these markets special.

The unique characteristics of African markets act as a barrier to entry, but this should not deter investors. With specialist management skills, the value in Africa's public markets can be unlocked readily.

Section 1:

Introduction

The birth of modern African public financial markets can be traced to the end of the Cold War in 1989. As the superpowers relinquished their icy grip on the region, African governments became more accountable to local populations with strong preferences for stability and growth. As policies improved, economic performance picked up and permanent public markets became possible for the first time.

Today, African countries have gained a firm foothold in global financial markets. More than a fifth of the seventy three countries in JP Morgan's index of Emerging Markets (EM) sovereign bonds are African. The same is true for the MSCI Frontier Markets equity index, while over 10% of countries in the main EM corporate bond index are African.

African countries have already secured a foothold in global financial markets, but investing in the region still poses special challenges

Still, African markets remain the shallowest and least diversified in EM. Africa is also the poorest of all EM regions. Local bond markets are rudimentary. The combination of relatively small illiquid markets, low per capita GDP and associated institutional weakness poses special challenges for investors in Africa.

The main purpose of this paper is to present an overview of the main issues facing investors in Africa.

- Section 2 – traces the origins of Africa's modern public markets and highlights three dominant trends within these markets.
- Section 3 – focuses on Africa's unique and severe finance constraint, which expresses itself as a difference in the composition of African public markets relative to other EM regions.
- Section 4 – presents an overview of the size, composition and valuation metrics for Africa's local bond markets, the Eurobond market and African stock markets.
- Section 5 – the main body of the report – explains seven key features of African public markets that are particularly pertinent to anyone wishing to invest in the continent today.

The unique features of African public markets pose challenges and create opportunities. They tend to compound as investors go from external to local markets, from government securities to private sector investments. The resulting complexity should not deter investors; rather, as a barrier to entry, they ensure that African markets can deliver excess returns provided that specialist management skills are brought to bear.

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Section 2:

Post-Cold War African markets

Prior to 1989, African countries obtained the bulk of financing from aid donors. Today, markets and China play a much larger role

Before the end of the Cold War in 1989, the bulk of African countries obtained nearly all their financing from official development assistance (ODA). China played a very small role and markets were almost non-existent. While African countries occasionally attracted foreign investors, this was mainly due to temporary spikes in commodity prices, but as soon as external conditions soured these hit-and-run investors would quickly turn tail, often leaving a legacy of volatility and worse in their wake. South Africa with its deep and broad markets was the sole exception, but even South African markets were off-limits for most global institutional investors due to the country's pernicious Apartheid regime. In general, the Cold War period was a period of decline for African countries (Figure 1).

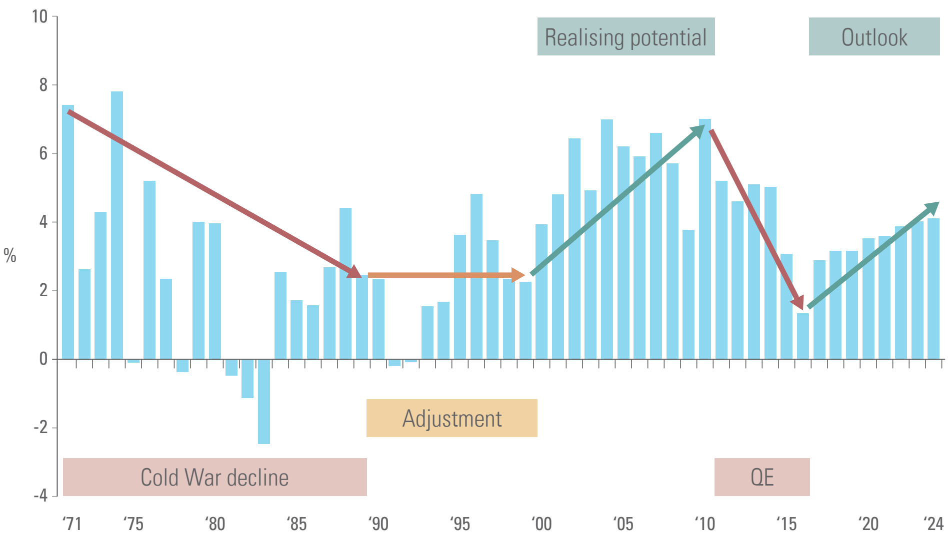
Things began to look up after the Cold War ended. With greater local political accountability, politicians faced greater incentives to deliver better policies. It took most of the 1990s to overcome the hangover from the Cold War period, but African economies were beginning to show genuine improvement by the early 2000s, including widespread democratisation, greater political stability, faster economic growth, improvements in the quality of macroeconomic management and better institutions. It is also during this period that Africa's public markets really started to flourish.

Equity investors were the first to spot the opportunity in Africa's budding public markets. Early movers had already begun to take an interest in the region in the late 1980s. By the early 2000s, bond investors followed suit as many African economies put in place the basic institutional building blocks, such as bond auctions and primary dealers, frameworks for custody and settlement and market making.

African economies were knocked back by the Global Financial Crisis in 2008/2009, but markets are now set for a rebound

The Global Financial Crisis in 2008/2009, declining commodity prices and the aftermath of Quantitative Easing (QE) policies triggered a sharp reversal of capital flows to Africa as developed markets economies delivered outsized returns. However, African markets for the most part survived and economic performance in Africa's public markets is now set for a renaissance.

Fig 1: **Real GDP growth (in constant 2010 USD terms)**



Source: Ashmore, World Bank, IMF.

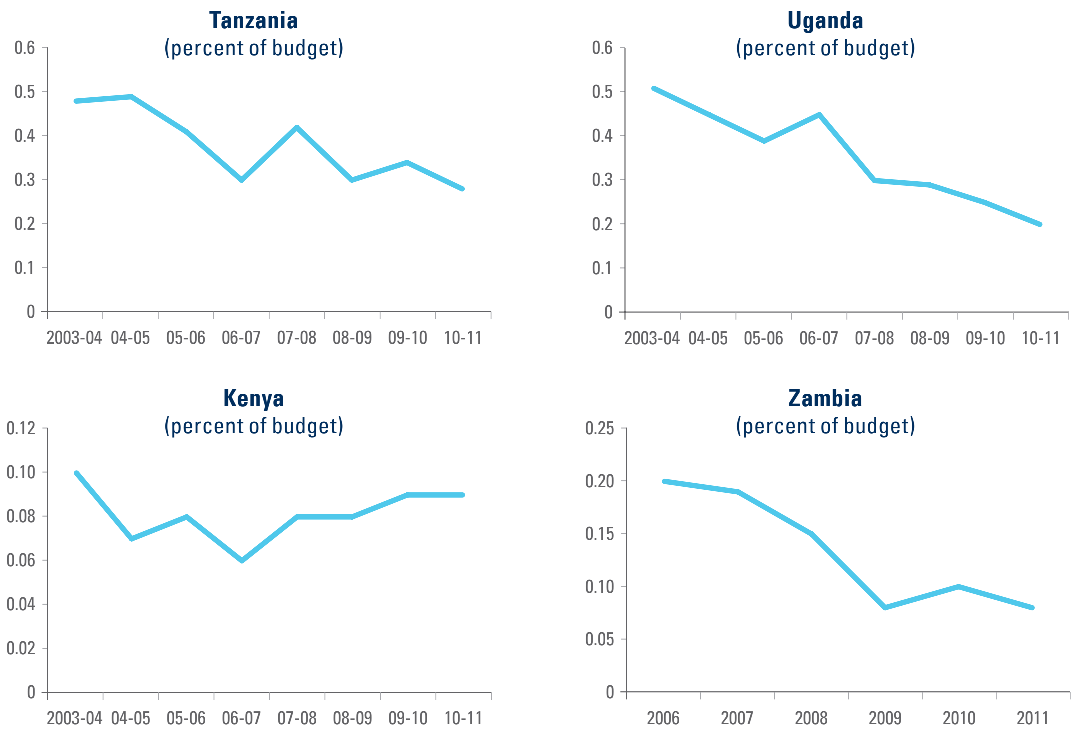
Section 2:

Three structural trends have dominated the emergence of public markets in Africa.

- **First** – ODA has become less important due to disillusionment with aid effectiveness, declining willingness of donors to extend ODA and the emergence of alternative financing options for African governments (Figure 2).

The role of donor money is steadily declining in Africa

Fig 2: **Declining role of donor financing (selected countries)**

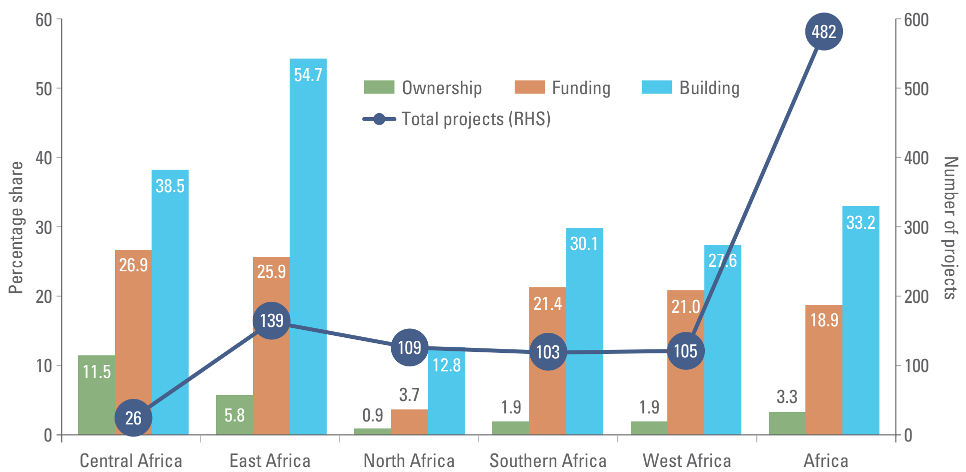


Source: Ashmore, IMF Staff Working Paper WP/17/203 September 2017.

- **Second** – China has emerged as a hugely important source of financing across almost all sectors in many African countries. Chinese finance offers several clear advantages over conventional ODA. China generally does not involve itself in local politics, which has been welcomed by Africans. China has also been able to put massive resources to work. China's focus has been on infrastructure, which is sorely needed in the region. Finally, China has been keen to get involved in order to deploy capacity freed up within China as the country rotates from investment-led to consumption-led growth. Though controversial in some quarters, China's entry in Africa has generally been hugely positive – and effective. As of 2018, Chinese companies were involved in more than 300 individual projects across the continent, where they construct one third of all building works, provide a fifth of all financing and own more than 3% of all property (Figure 3).

China has become a very important source of investment across the entire African continent

Fig 3: **China has become the most important source of foreign financing in Africa**



Source: Ashmore, Johns Hopkins University, CNN, Deloite. Data as at 2018.

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Section 2:

- **Third** – African public markets have expanded in breadth and depth and become more integrated into global financing markets. Today, one fifth of the countries represented in the JP Morgan benchmark of sovereign bond issuers in EM (EMBI GD) and a similar proportion of the member countries in MSCI Frontier Markets equity index are African. Seven African countries have corporates in the JP Morgan index of corporate Dollar bonds (CEMBI BD), two African countries are represented in the MSCI Emerging Markets index and one country is represented in the main local currency bond index, the JP Morgan's GBI EM GD (Figure 4).

One fifth of the countries represented in the EMBI GD today are Africa. African countries are also represented in stock and corporate bond indices

Fig 4: **African country representation in benchmark indices**

Index	African countries in index	Share of index (number of countries)
EMBI GD (external debt)	16	22%
CEMBI BD (corporate debt)	7	13%
GBI EM GD (lcoal currency debt)	1	5%
MSCI Frontier Markets (equities)	6	21%
MSCI Emerging Markets (equities)	2	8%

Source: Ashmore, MSIC, JP Morgan. Data as at October 2019.

Going forward, it is clear that Africa is only going to become a bigger part of everyone's future. One simple statistic illustrates this point: Africa's population will account for 38.5% of the world's population by 2100 and Africa's working age population will account for an even higher 41.2% of the world's working age population by the end of the century, according to estimates from the IMF (Figure 5). As other regions start to struggle with age-related challenges, Africa will become the world's reservoir for saving, consumption, investment and growth.

Fig 5: **Africa's demographic potential is awesome**

Africa vs World	Population (bn)		Working age (bn)	
	2010	2100	2010	2100
World	6.9	10.9	4.5	6.5
Africa	1	4.2	0.6	2.7
Africa's share	14.90%	38.50%	12.60%	41.20%

Source: Ashmore, IMF.

Overall, the direction of change in African finance is hugely positive, even revolutionary. Erstwhile ODA dependent economies can now tap into three sources of finance instead of just one. Africa's glaring infrastructure deficit is being addressed. The development of bond markets has improved the transmission of monetary policy and reduced fiscal dominance, while private sector companies can now issue bonds on the back of sovereign curves.

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Section 3:

Finance constraints

Positive trends in African finance notwithstanding, Africa remains woefully under-financed. Compared to Africa's share of global GDP (5%), Africa only accesses 1% of global finance. The ratio of Africa's share of global finance to its share of global GDP is the lowest of all regions in the world (0.3). By contrast, the average for EM as a whole is 0.9 and 3.6 for developed markets (Figure 6).

Africa as a region remains woefully under-financed with only a 1% share of global capital compared to a 5% share of global GDP

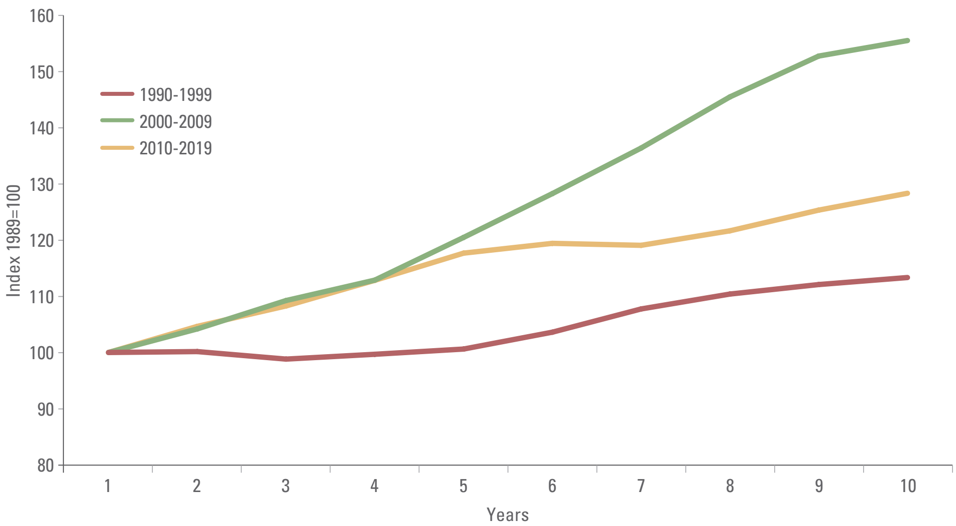
Fig 6: **Africa's share of global markets and global GDP (PPP-adjusted)**

Region	Market share		GDP share	Ratio: financial markets share to GDP share
	Stocks	Bonds		
Africa	**1%**	**1%**	**5%**	**0.3**
Emerging Markets	*31%*	*23%*	*60%*	*0.9*
Developed Markets	*69%*	*77%*	*40%*	*3.6*

Source: Ashmore, Bloomberg, MSCI, BIS, IMF. Data as at end 2018.

The extreme financing constraints facing African economies naturally amplify the fallout from any changes in financial conditions and economic conditions. This can be seen clearly from Figure 7. In per capita GDP terms, Africa's growth was slowest in the 1990s, when the region was still largely cut off from public markets. Per capital GDP growth was strongest in the 2000s due to benign external conditions, Africa's growing ties with China and, importantly, African issuers' entry into financial markets for the first time. The most recent decade saw per capita GDP growth slow again due to the fall in commodity prices as well as the negative fallout from capital being pulled back from EM. In short, severe finance constraints mean that any shift in global conditions tends to be felt far more violently in Africa than in any other region of the world.

Fig 7: **Per capita GDP in Sub-Saharan economies**



Source: Ashmore, IMF.

Sadly, it is unrealistic to expect that Africa's finance constraints will ease rapidly, so supply of global capital will continue to be the binding constraint on investment and growth. This may be tough for Africans, but it is good for investors. African issuers – corporate as well as sovereign – will not stand idly by, however. They will do what they can to overcome the reluctance to finance Africa by developing the legal and regulatory infrastructure, building institutions and seeking inclusion in indices. The African opportunity will continue to grow, not as fast as Africans would like, but fast enough that investors in the rest of the world need to pay attention.

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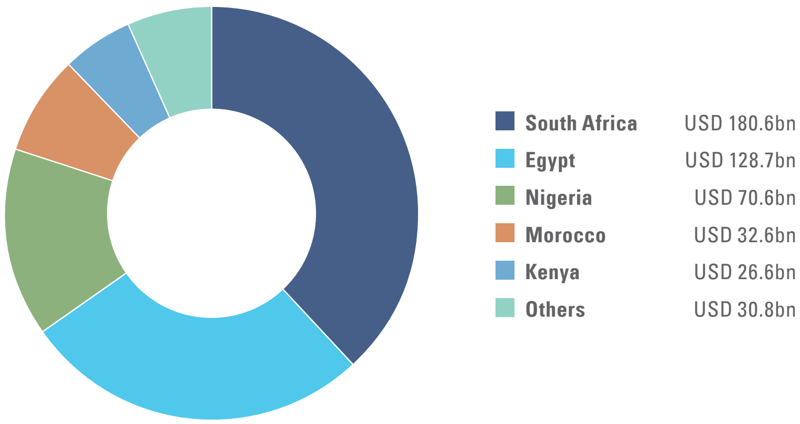
Section 4:

African public markets – a quick overview

African public markets comprise three broad categories: local currency bonds, Eurobond and stocks

Africa's public markets fall into three major segments – local currency denominated government bonds, Eurobonds (hard currency-denominated sovereign and corporate bonds) and stocks. The biggest segment within fixed income is local currency bonds with USD 474bn in total outstanding comprised of USD 301bn of bonds and USD 173bn of treasury bills (Figure 8). Almost all African countries issue some kind of local currency fixed income instrument, but only about ten markets are regularly traded internationally. South Africa is the only local bond market to be part of the GBI EM GD, but Nigeria was a member and could re-join again one day, while Egypt is clearly a contender for future index inclusion. The weighted average yield on African treasury bills is around 13.8%, while 10-year bonds yield about 10.2% on average. This compares to a yield of approximately 5.2% for the GBI EM GD.

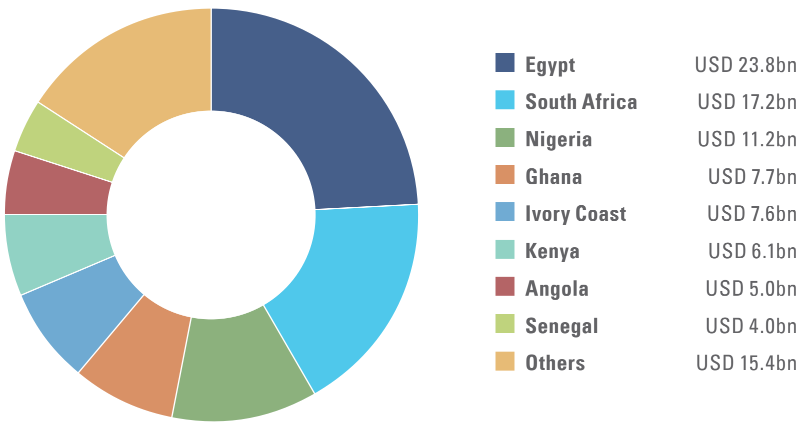
Fig 8: **African local bonds**



Source: Ashmore, BAML. Data as at October 2019.

The African Eurobond market consists of USD 140bn of corporate and sovereign bonds of which sovereigns account for the bulk (USD 98bn, Figure 9). African sovereign Eurobonds currently make up a respectable 8.1% of the EMBI GD, pay a yield of 6.8% versus a benchmark yield of 5.2% and have a duration of 6.9 years versus 7.3 years for the broad index. Egypt and South Africa account for just over one third of total outstanding followed by Nigeria, Ghana, Ivory Coast, Kenya and then a tail of very small issuers.

Fig 9: **African Eurobonds**



Source: Ashmore, BAML. Data as at October 2019.

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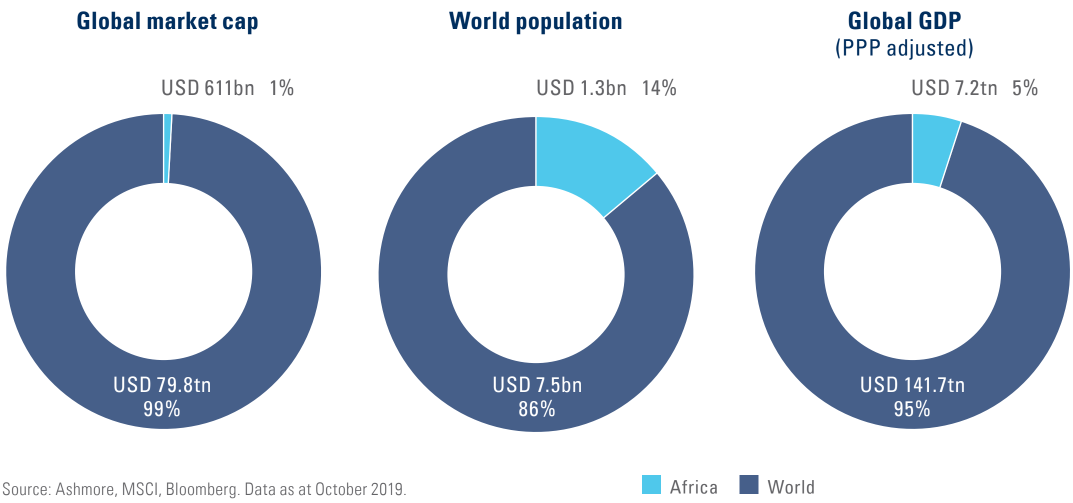
Section 4:

African stock markets measure about USD 611bn, or 0.8% of global equity market cap (Figure 10). Market capitalisation in Africa is therefore far behind Africa's share of global population (14%) and GDP (5% on PPP-adjusted basis). Return on equity is about 22%, dividend yield about 5% and price/earnings ratio is about 9.1x.

Fig 10: **African equity markets**



Source: Ashmore, MSCI, Bloomberg. Data as at October 2019.

The composition of Africa's public markets reveals a lot about the relative youthfulness of these markets compared to the rest of EM and markets in developed economies.

In particular, three stylized facts set them apart:

Going forward, fixed income markets will outpace stocks market and local markets will outpace Eurobond markets in Africa

1. African stock and bond markets are almost identical in size (roughly USD 610bn). This is in sharp contrast to markets in higher income countries, where bond markets tend to dominate.
2. Eurobonds make up a larger share of the total outstanding (23%) in Africa than in the average EM country (18%).
3. Corporate bonds only make up 30% of the total Eurobonds in Africa compared to the EM average of 72%.

These differences from more developed markets imply that investors can expect the coming years and decades to deliver faster relative growth in fixed income compared to stock markets, faster relative growth in local fixed income markets relative to Eurobonds and more rapid growth in corporate debt markets than sovereign debt, all else even.

Section 5:
Selected issues in African public markets

With more than 54 countries, Africa offers plenty of variety. Each country has entirely unique political and economic dynamics. Still, a few characteristics are common across many countries, such as:

1 **Sovereign governance and transparency**
2 **Politics upheavals**
3 **Pension systems**
4 **Macroeconomic management**
5 **Information asymmetries and the illiquidity premium**
6 **Leapfrogging**
7 **Institutional quality and market depth**

The purpose of this section is to draw attention to these 'Africa-specific' characteristics. The challenges of investing in African markets tend to multiply as one moves from offshore markets to local markets, from government to corporates, from bonds to equities.

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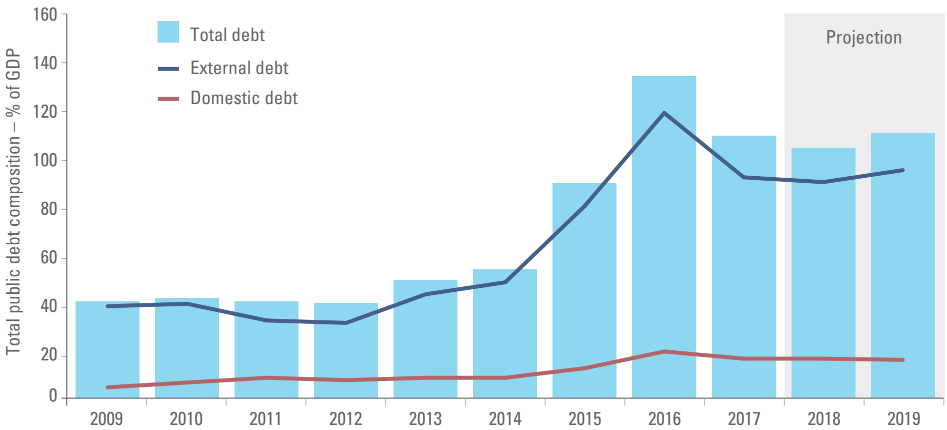
Section 5:

1 **Sovereign governance and transparency:** There may be no better illustration of the importance of good governance and transparency than Mozambique in the context of the 2013 USD 850m infamous 'Tuna bond'. The bond never paid a single coupon. It was ruled to be illegal by local courts. It was restructured into a sovereign Eurobond in 2016, which then also defaulted without ever paying a single coupon. As this disaster unfolded, it became apparent that the government had illegally borrowed another USD 1.2bn from bilateral donors without formal parliamentary approval. Moreover, the proceeds of the Tuna bond were not spent as stated in the bond documentation. Figure 11 illustrates the scale of the problem. The public debt stock as a share of GDP increased from less than 50% in 2013 to 140% by 2016 as the true scale of the government's borrowing was disclosed.

Fig 11: **The Mozambique 'Tuna bond' scandal**

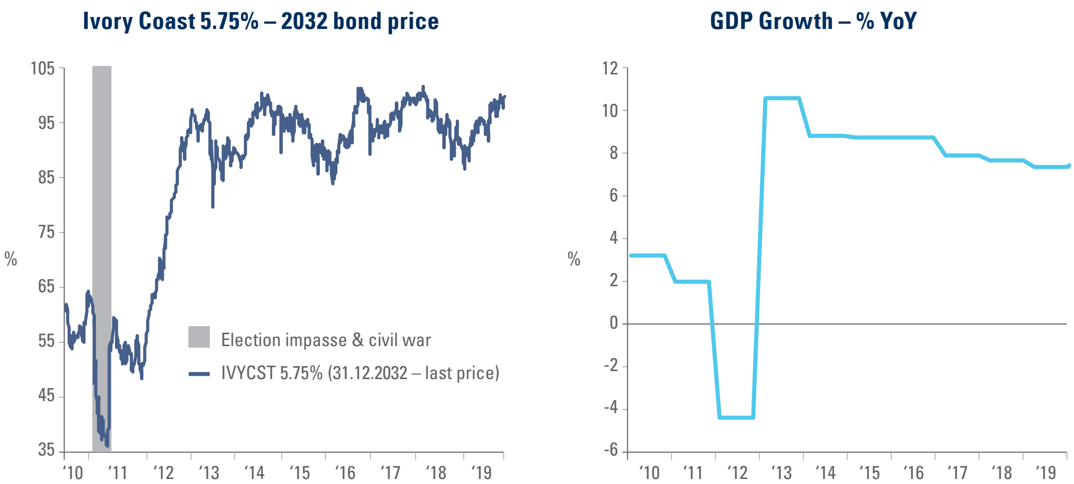


Source: The Economist, World Bank, IMF, Ashmore.

2 **Politics upheavals:** African governments are, like their populations, poor. They can find it difficult to mobilise sufficient resources to uphold the rule of law, protect property rights and monitor borders. Armies can be hired for little money due to desperate poverty. In the Ivory Coast Laurent Gbagbo lost the 2010 election but refused to give up power. A civil war ensued. Ivory Coast missed two coupon payments and bond prices crashed. Alassane Ouattara assumed the presidency in late 2010. He cured the default and went on to implement some of the best economic policies in Africa. The Ivorian economy and government bonds both staged spectacular recoveries (Figure 12). Some African states end up as failed states, but the majority of political crises are brief. Voters generally favour stability due to a lack of social security, unemployment benefits and ways to hedge against inflation.

Political upheavals rarely produce failed states in Africa; more often they are buying opportunities

Fig 12: **The brief civil war in Ivory Coast and the subsequent recovery**



Source: Ashmore, IMF, Bloomberg.

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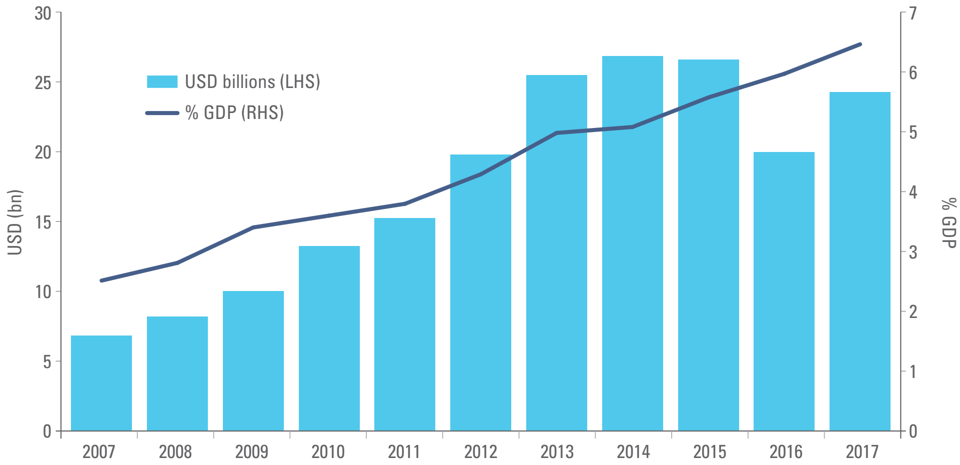
3 **Pension systems:** The single most important piece of financial infrastructure in EM countries is pension systems. By establishing a local institutional investor base, governments can break the link between volatile foreign investor flows and economic performance. Local yield curves also enable corporates to issue on the back of government curves, aiding private sector development. South Africa and Morocco have large domestic capital pools. Some African governments, such as Nigeria, are late-comers, but have made great strides in recent years. Nigeria's pension system is a 'state-of-the-art' defined-contribution systems. The assets in the system have grown from less than 2% of GDP to 6% of GDP in just ten years (Figure 13). Due to the extremely benign demographics in Africa, pension funds are a hugely effective as means of generating savings. These savings in turn can be used to address many of Africa's most pressing problems, including the external financing constraint, infrastructure deficits, inadequate private sector investment, macroeconomic instability, etc.

Fig 13: **Nigerian pension system assets**

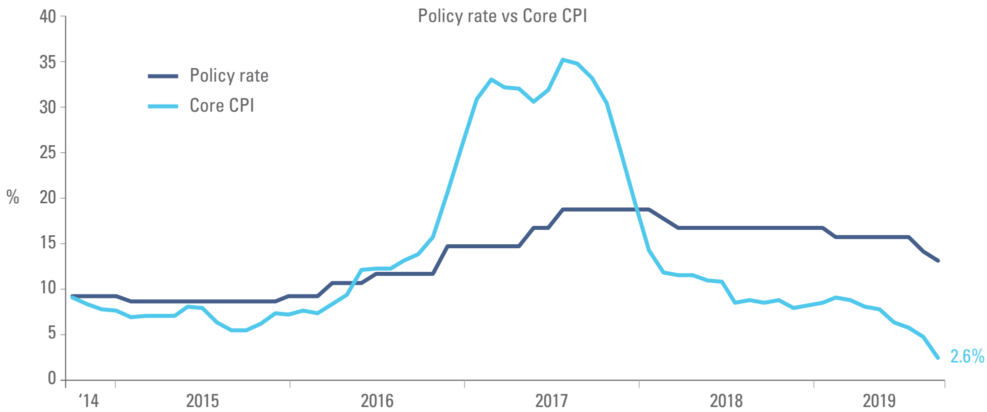


Source: Ashmore, OECD.

4 **Macroeconomic management:** It is far tougher to manage business cycles in Africa than in other countries due to the rudimentary state of domestic financial markets, fiscal dominance, dependence on external capital and lack of economic diversification, including extensive reliance on commodity exports in a few countries. African finance ministries and central banks tend to be staffed with competent officials, but they are naturally extremely risk averse. Skilful macroeconomic management is critical to investment performance. Egypt illustrates this point. Faced with rising inflation rates in late 2015, the Egyptian central bank decisively raised rates and adjusted its fiscal accounts until inflation began to fall. Investors were richly rewarded; the on-the-run 10-year local bond is up 10% year to date and still pays a yield of 14% against an inflation rate of just 2.6%. Similar experiences have been had in the past in other local markets (Figure 14).

Macroeconomic management can be more challenging in Africa than in other regions due to lower per capita GDP, less economic diversification and more shallow financial markets

Fig 14: **Textbook macroeconomic management in Egypt**



Source: Ashmore, Bloomberg.

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5 **Information asymmetries and the illiquidity premium:** There is a perception that African companies have poor corporate governance and abuse minority shareholders. This is a misconception. The level of corporate disclosure and governance in South Africa is one of the best in the context of emerging markets. In Africa ex-South Africa, the largest companies in each sector are owned by multinational companies or have adopted best-in-class practices in order to attract capital. Examples include:

a. **Financials** – Commercial International Bank, Egypt

b. **Communications** – Safaricom (Vodafone Group), Kenya

c. **Consumer Staples** – Nestle Nigeria (Nestle SA), Nigeria

d. **Materials** – LafargeHolcim Maroc (LafargeHolcim SA), Morocco

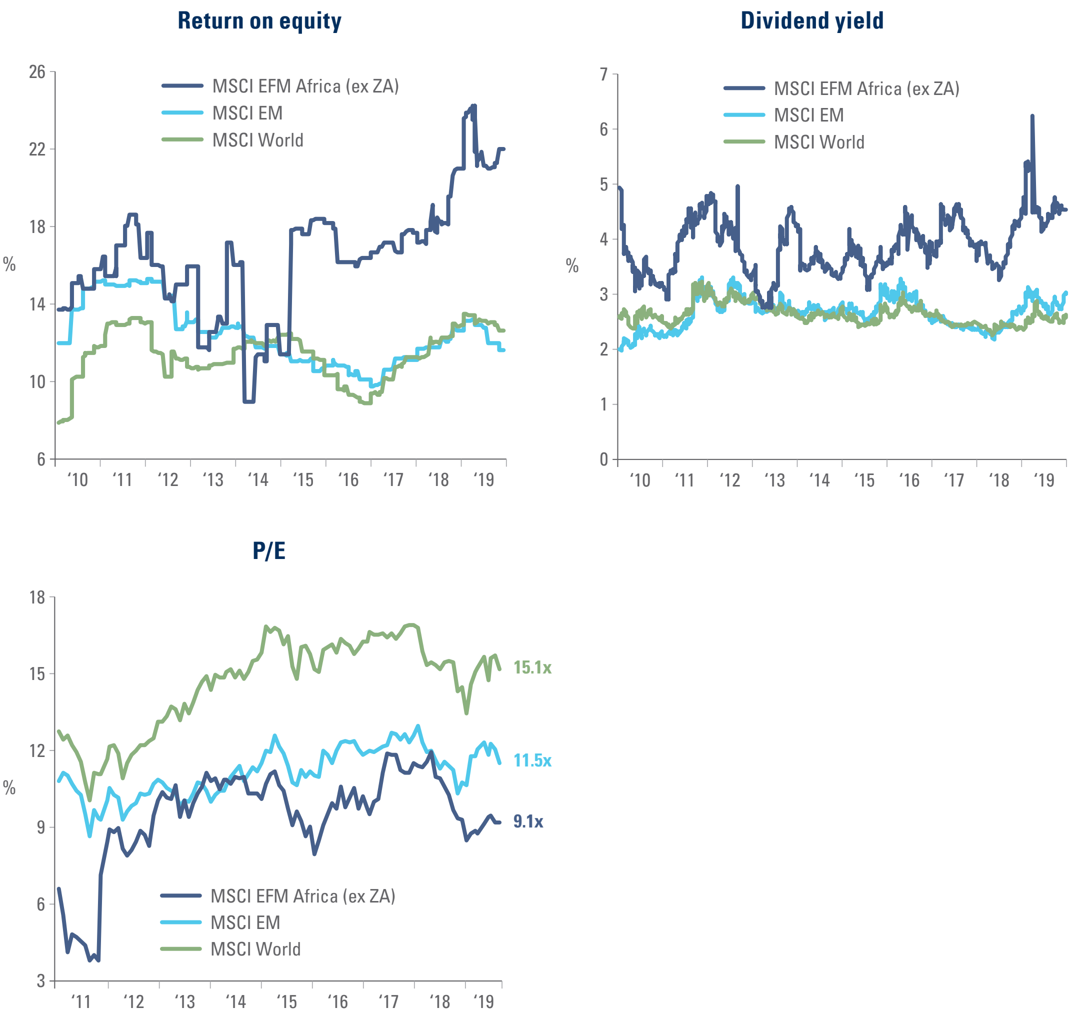
e. **Utilities** – TAQA Morocco (TAQA Group, Abu Dhabi Government), Morocco

f. **Consumer Discretionary** – Total Maroc (Total SA, France), Morocco

Large multinational companies, by virtue of their listings in developed countries, are as much at risk if they pursue bad governance practices in Africa as elsewhere. African stock markets therefore do not trade with permanently lower price earnings ratios than EM stock markets and US stock markets due to governance issues. Rather, the reasons are mainly that (a) liquidity tends to be lower in African stocks; and (b) African companies are generally not as good at keeping investors informed as companies in other regions. Importantly, the lower valuation of EM stocks is not reflected in a higher number corporate failures. This means that return on equity and dividend yields are generally better in Africa than elsewhere (Figure 15).

Corporate governance is generally strong in Africa, but markets can be less well informed and more illiquid

Fig 15: **Corporate governance problem or information asymmetry and illiquidity?**



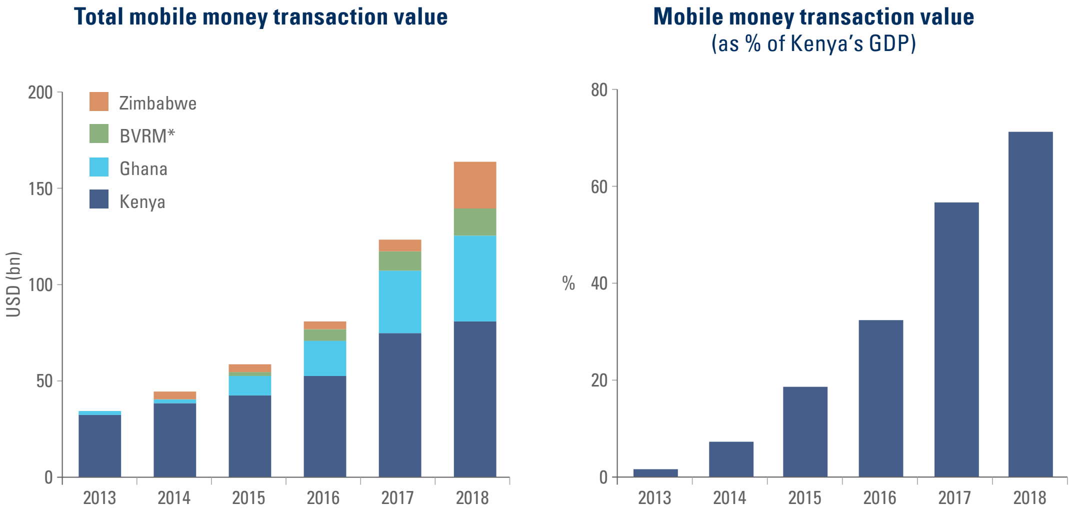
Source: Ashmore, Bloomberg, MSCI, Citi Research. Data as at 19 August 2019.

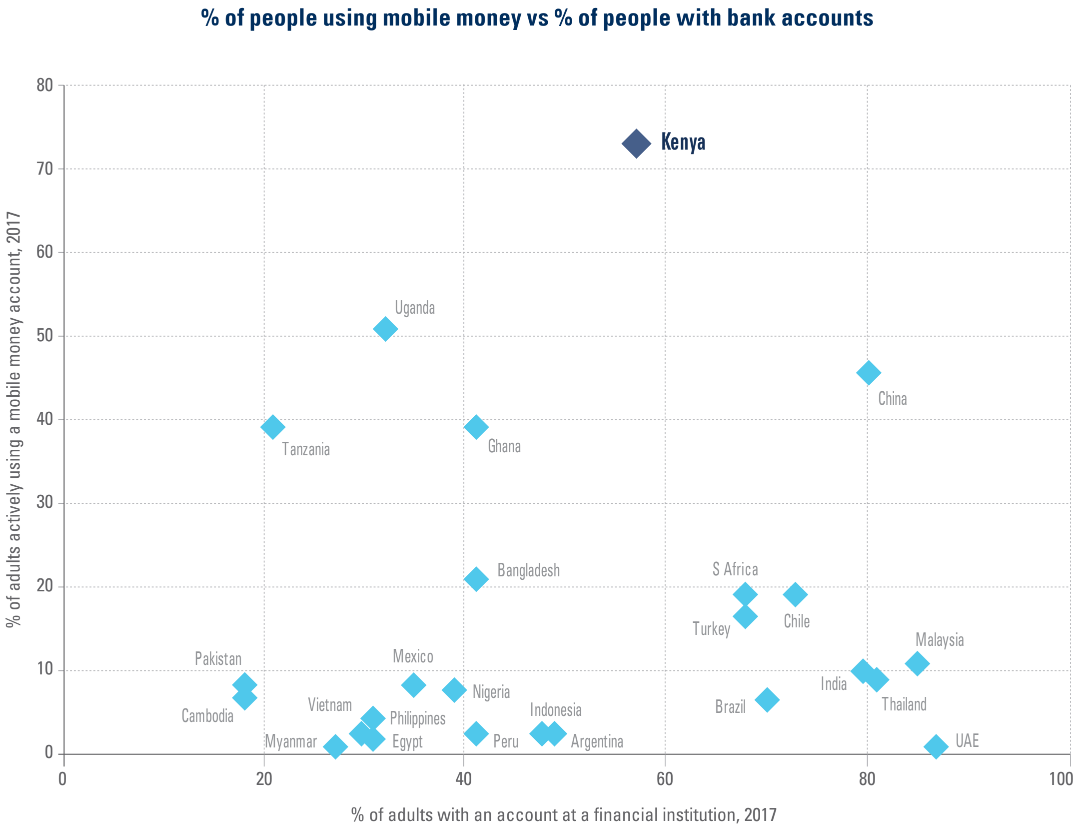
Section 5:

6 **Leapfrogging:** Developed economies have to eke out marginal productivity gains by inventing brand new stuff. African companies can skip entire technological stages by leapfrogging directly to the knowledge frontier, or just within it. The famous example is Africa's leap directly to mobile, skipping hugely inefficient and costly investments in fixed line telephony (Figure 16). Similar leaps are being made in finance, transport, access to markets, healthcare, education, etc. A big part of investing in Africa is to identify the next big technological convergence.

Leap-frogging is common in Africa; countries often skip entire development stages by moving straight to the knowledge frontier

Fig 16: **Leapfrogging – mobile technology**





Source: Ashmore, Citi Research – *'The Future of Money is Mobile'*, World Bank Survey. China and India data based on Citi Research Estimates; Mobile money adoption data for Russia and KSA not available; UAE data adjusted based on our estimates.

*The Bourse Régionale des Valeurs Mobilières SA or BRVM, is a regional stock exchange serving the following west African countries: Benin, Burkina Faso, Guinea-Bissau, Côte d'Ivoire, Mali, Niger, Senegal, Togo.

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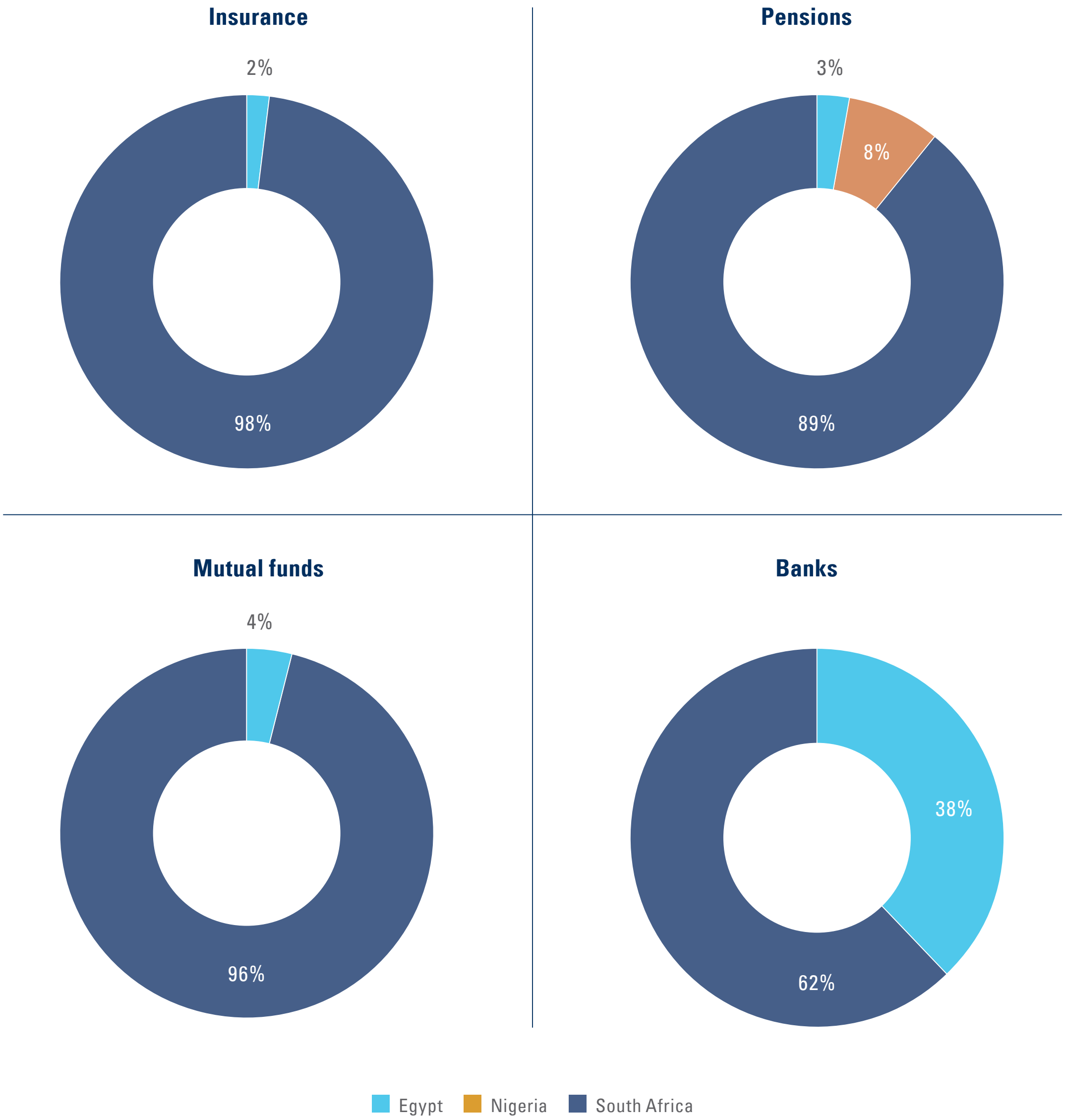
Section 5:

7 **Institutional quality and market depth:** From the narrow perspective of market size, one can describe Africa as South Africa with a few countries attached. That is how much South Africa dominates the region's market capitalisation. South Africa has a strong regulatory framework and sophisticated securities legislation. Its institutional investor base is also enormous, accounting for around 90% of African insurance capital, 80% of African pension money, 95% of Africa's mutual funds and half of African bank capital. In total, South African capital accounts for approximately two thirds of all institutional assets in Africa (Figure 17). However, in recent years the volume of IPOs has increased in other countries due to changes in regulations pertaining to minimum free floats on local stock exchanges, tax incentives and better licence conditions, especially in telecommunications. A number of Africa-focussed companies have also listed in markets with deeper capital markets, such as London, including VIVO, Helios Towers, Airtel Africa, Tullow Oil and New York (Jumia). This has expanded the investable universe for Africa-focussed investors.

Fig 17: **The dominance of South Africa**



Source: Ashmore, Standard Chartered Bank. Data as at 2017.

Section 6:

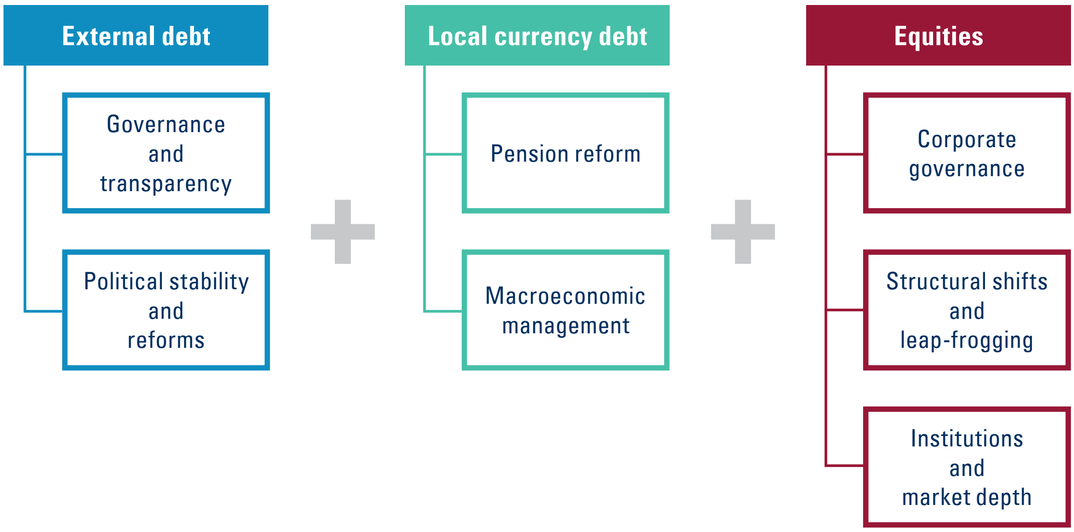
Conclusion

Many of Africa's markets are 'broken' in the sense that there is insufficient breadth and depth to support a permanent presence over the full investment cycle. Opportunities often revolve around discrete reforms or market innovations, so that, once priced in, the rationale for remaining invested disappears until the next structural leap forward. Still, it makes sense to get in involved with Africa's nascent markets. The number of markets – and therefore diversification – is increasing all the time. Africa is destined to be the world's reservoir for saving, investment and consumption.

Still, significant challenges face anyone investing in African markets. Governance, transparency and political instability affect external debt markets. The quality of day to day macroeconomic management practices and the emergence of pension systems are hugely important for local bond markets. Liquidity issues, information access, leapfrogging, regulatory quality and market depth affect stocks.

The special challenges facing investors in Africa can readily be overcome with specialist knowledge to unlock good value

Fig 18: **Both challenges and opportunities are compounded**



Source: Ashmore.

As Figure 18 illustrates, each of these issues get compounded as investors move from Eurobonds to local bonds and from local bond markets to local stock markets. This is no reason not to get involved, however. Rather, the opposite is true. The complexity of African markets act as a barrier to entry for many, which means that African assets are generally under-owned and hence cheaper than they should be. This implicit value in Africa's public markets can be unlocked, but only with specialist asset management skills.

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