Fifteen years
Fifteen lessons from Africa

INVESTISSEURS & PARTENAIRES

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Lesson of Strategy

1. **Lesson n°1: Africa is one continent, but a diverse one**
2. Lesson n°2: The business environment is improving, but in a gradual and disparate way, which engenders integrity risks for firms
3. Lesson n°3: The African middle class is shaking up market dynamics but has not closed the debate on growth patterns

1 Lesson n°1: Africa is one continent but a diverse one

The African continent is commonly considered as a region of poverty and misery, of war and crises, of corruption and inefficient bureaucracy. Its economic development can be seen as a two-lane road, dividing oil-producing and mining economies from the others, English-speaking countries from French-speaking countries, or countries which have already experienced their demographic transition from the others... At the same time, over the past 10 years, Africa has been increasingly described in the media as a new Eldorado with endless opportunities and where one's success is possible as long as one mimics the methods that are being applied in developed nations.

Africa is all of this: it is diverse. Composed of 54 countries approximately one billion people live on the continent today and this number will double by 2050. Africa's diversity is, in fact, multi-faceted and vast and encompassing geographic, social, political, institutional, not to mention cultural and linguistic diversity (English, French, Portuguese, Swahili, Bambara, Wolof...). This staggering diversity is part of the continent's collectively rich history and **obliges us to be both pragmatic and cautious, while it also offers enormous potential for risk diversification** for investors developing a Pan-African strategy (whether political, macroeconomic or foreign exchange risk exposure).

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Africa is growing, but remains volatile

The first fifteen years of the 21st century have been a period of tremendous growth for Africa. However, during this period, I&P has experienced a macroeconomic crisis in Ghana, a several political crisis in Côte d'Ivoire, an earthquake in Kenya, fifteen coups d'Etat, and the beginning of the Sahelian instability crisis.

There is no reason to believe that the next fifteen years will be any more stable. Oil producing and mining economies remain highly dependent on changing commodity prices. A growing public debt makes macroeconomic equilibriums more unstable. In many countries, social and institutional fragilities frequently lead to political crises. The Sahelian crisis and the multiple security challenges it induces have now become a long-term situation. Internal migratory flows fragilize the balance of local regions. Yet these facts do not render Africa's fantastic foundations invalid. These foundations include disparate and slower than desirable entry into a demographic transition, generating a demographic dividend that will benefit the region in the twenty years to come[1]. They also include the fast-moving urbanization process that is leading to continuous productivity gains, and technological revolutions that are altering the very nature of development (to which we will come back later). Finally they include the role played by China in African growth, not only through imports and investments but also through the very first flows of industrial relocations.

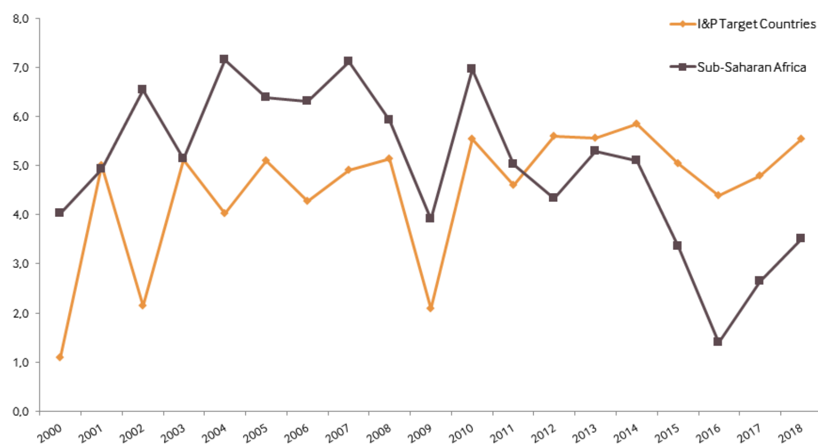
Our direct experience leads us to conclude that Africa's situation will continue to diversify among its countries. We consider four different categories of countries. First, those depending on oil and mining resources and whose middle-class development has been mitigated by the 2008 global financial crisis. Second, the most stable countries, those who rely first and foremost on their domestic growth. Third, those that are entering into the sphere of outsourcing of Chinese manufacturing and that could become part of the new "African miracle." And lastly, the countries experiencing political and military crises. The Sahelian region will play a critical role in this landscape, offering both growth opportunities and security challenges. In fact, each of these categories of countries will experience particular evolutions that will make the term "average" less and less meaningful for Africa.

1. For more information on how Sub-Saharan Africa can harness the demographic dividend: "Regional Economic Outlook: Sub-Saharan Africa", International Monetary Fund, Avril 2015.

Concerning I&P, risk diversification in our fifteen countries has been an important stabilizing factor for our operational performance. We have never renounced investing as long as opportunities were real, even in so-called very fragile countries. Only security threats to our employees and partners have been cause for temporarily closing certain destinations. These constraints will continue to be the biggest challenge to be overcome.

We have also deliberately chosen to invest only marginally, and very selectively, in oil or mining economies. Because of the high volatility of these economies, we do not trust the capacity of an investment fund to "exit" at the optimal time. In addition, we have always been very selective when investing in companies strongly linked to the public sector. Few companies located in oil and mining countries and oriented towards exports or private consumption are competitive enough to present real entrepreneurial potential. The countries in which we have invested are almost exclusively oil-importing countries in the dynamic regions of sub-Saharan Africa. This section of the continent continues to record strong economic performance.

Growth rates of fifteen Sub-Saharan Africa countries in which I&P operates [1], in comparison with the rest of the region



Source: IMF (2017)

1. Benin, Burkina Faso, Cameroon, Comoros, Côte d'Ivoire, Gabon, Ghana, Madagascar, Mali, Mauritania, Namibia, Niger, Uganda, DRC, Senegal.

Foreign exchange risk is not going to decrease anytime soon

In the case of equity investments in our region of operations, it is not possible to be protected from this foreign exchange risk

The foreign exchange risk is particularly harrowing for an international investor over the long term. Volatility remains high in Africa. Though contraction periods have become less frequent, their magnitude in Africa is unique – reaching 10 points of growth on average – and may explain the convergence of both weak economic diversification and macro management that remains pro-cyclical and susceptible to external shocks. In the case of equity investments in our region of operations, it is not possible to be protected from this foreign exchange risk. Currency hedging is either nonexistent or very costly, and the ascent of currency flows is hardly predictable and for amounts that remain hazardous. There is no alternative than to fully accept this foreign exchange risk.

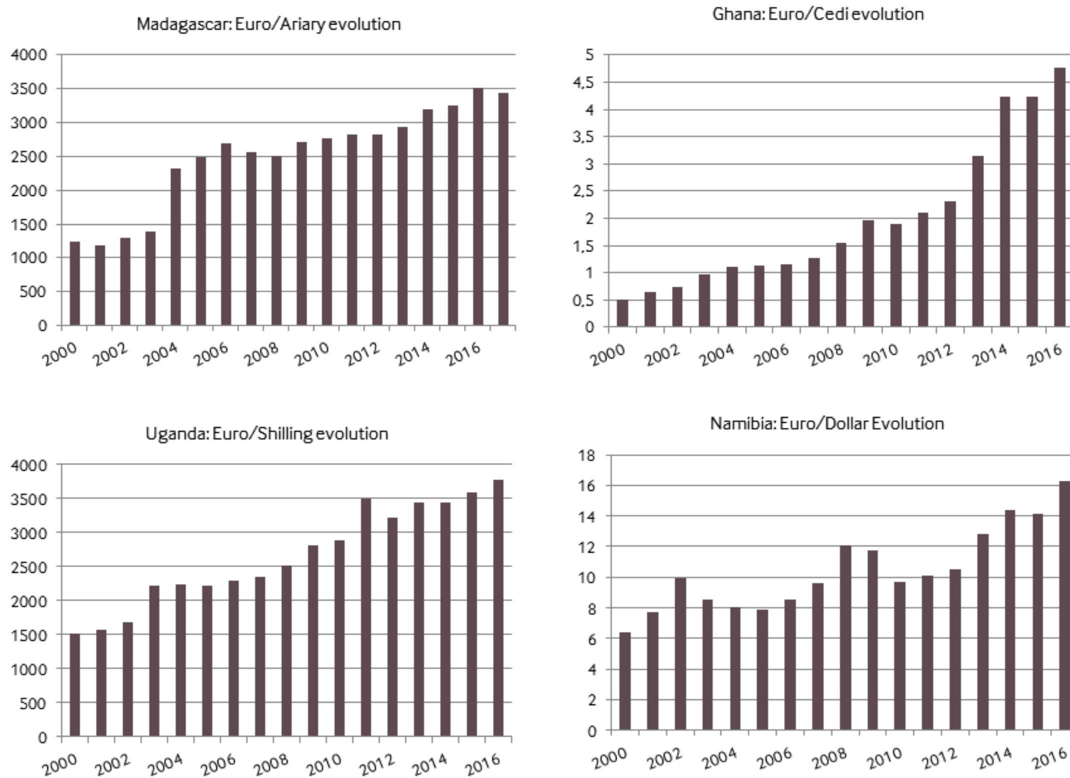
Nevertheless, several factors should help mitigate the perception of foreign exchange risk.

The first one concerns the CFA franc zone. For European investors, this zone represents an important option for foreign exchange risk reduction. Since the 1994 devaluation, such risk has been almost entirely eliminated. An adjustment could occur in the future, or even a modification of the regime, either in one of the sub-regions or throughout the entire zone, but the extent of the changes is unlikely to be comparable to 1994.

The second factor concerns the nature and magnitude of parity changes over the middle term in the countries we operate. The negative tensions affecting the foreign exchange market of the various countries where I&P has operated in recent years began to diminish in 2017.
This was due to various factors. The first was the tightening of domestic policies that occurred in Uganda and Namibia. As their currencies are linked to the South African rand, the Ugandan and Namibian Central Banks followed the South African Central Bank's decision to lower bank rates from 7% to 6.75% in August 2017. In Ghana, inflationist tensions have been progressively mitigated with the tightening of monetary policy and exchange rate stabilization. In addition, the inflows of portfolio investments attracted by the issue in bonds of two billion dollars in Ghanaian currency for has led to a decrease of official foreign reserves of imports from 2.6 months to 3.3 months between end of 2016 and June 2017. Finally, the relative political stability in Madagascar in recent years has put an end to major parity shifts in the Ariary seen in recent years.

The average lifetime of a fund like those managed by I&P is ten years maximum or from five to eight years for a specific investment. **At these scales, there is no macroeconomic approach that helps investors foresee the evolution of the exchange rate in a country or a group of countries after the divestment phase**.

Magnitude of parity changes in I&P's countries of operation (outside the the CFA franc zone



Source: IMF , Central Banks (2017)

Only two methods are available to manage the risk.

For both macroeconomic and political risks, the first method consists in allocating investments in a significant number of countries. This simple rule is often little known. It is the same rule, for instance, that explains the severe delusions met during the 2000s and 2010s by those who concentrated their investment flows towards oil-producing and mining economies.

The second method involves looking for "natural" hedging strategies when countries experience substantial fluctuations in exchange rates. In a number of countries, we have focused our investments on exporting firms. Without being excessive, it is possible to select investments in sectors that would benefit from a devaluation (a small part of costs expressed in the strong currency, for example). In these countries, we would avoid sectors with substantive imports or high operational and depreciation costs in foreign currencies, especially where fare modifications are limited (regulated sectors, for instance). In many cases, "natural" hedging can balance financial losses due to the devaluation because of the growth of the extra value created by this devaluation. However, this strategy can work only if the exchange rate fluctuations are not accompanied by capital controls preventing capital flight or by the fixation of artificial exchange rates.

This is our first lesson for investing in Africa. Develop a diversified approach based on sectoral and geographic bases, and allocate political, macroeconomic and exchange rate risks in order to benefit from Africa's diversity of situations and to manage "African risk". Remain aware of security issues and watchful of exchange risks, which are major challenges for international investors that have to integrate these parameters into their investment strategy and constantly adapt them to the continent's volatility and instability.