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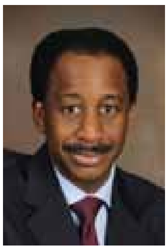
FRANCIS DANIELS, DIRECTOR OF AFRICA OPPORTUNITY PARTNERS, OUTLINES THE MANY COMPLEX FACTORS THAT INFLUENCE HIS INVESTMENT FUND'S DECISIONS IN AFRICA



Francis Daniels is a director of Africa Opportunity Partners (AOP), the investment manager of Africa Opportunity Fund Ltd, an investment fund listed on the AIM market of the London Stock Exchange. He has more than a decade's worth of investing experience in Africa. Born in Ghana, he moved to North America, where he trained as a lawyer before working at New York City firm Milbank, Tweed, Hadley & McCloy. He moved into fund management and, in addition to AOP, he is now a director of investment companies TA Holdings Ltd and Masawara PLC.

The signs and signals of investment opportunity vary from country to country across the continent – one cannot speak of "the African market" in that sense.

As a general proposition, in the case of companies other than natural resource companies, we do not like to pay a price-to-earnings multiple exceeding 11x for any African business. We also like our investments to have a high real return on assets, preferably matching, if not exceeding, the yield on local government debt.

These criteria substantially reduce the universe of investable companies at any given point. They force us off the beaten track. Thus, we look at companies in small, ignored sectors, such as agriculture in Nigeria, or look at a market after it has declined sharply in value in US dollar terms.

That decline often emanates from the collapse of that country's currency. For example, the collapse of the Egyptian and Kenyan markets last year created lots of interesting investment opportunities today. The disappearance of a currency, such as the Zimbabwe dollar, implies several years of investment opportunity in that country, because the cost of capital will be higher than it would be if the dollar had been retained.

CURRENCY DEPRECIATION

We worry about the probability of currency depreciation against major currencies such as the euro, the US dollar or the pound sterling. Another important signal is whether a country has foreign exchange controls. We prefer countries without those controls, such as Botswana, Zambia and Mauritius.

We also pay particular attention to drought, historical patterns of political

"In the case of development companies, forward-looking data is more important than historical financial statements"

The Johannesburg Stock Exchange

succession and literacy levels. Drought can be a major source of macroeconomic turbulence in Africa. For example, one factor behind the weakening of the Kenyan shilling in 2011 was a drought that reduced its hydroelectric power, forcing Kenya to increase its diesel imports. Since there is little irrigated land in Africa, we pay attention to rainfall patterns and water levels.

Military coups, as a form of political succession, have been prevalent in West Africa but almost absent from southern Africa. One has to ask whether this is a danger in a West African country in which one is investing. On the other hand, in southern Africa, one has to assess whether a company in the agricultural sector may be subject to a risk of land claims. Namibia, South Africa and Zimbabwe all face these issues as a result of their histories.

Literacy levels are another challenge. For example, the speed at which data revenue becomes an important part of a telephone company's income depends on this. Senegal has significantly lower literacy than Kenya, so one cannot simply extrapolate from the rate at which data revenue is growing for a telecoms company in Kenya to a similar growth rate for one in Senegal.

FACTORS TO CONSIDER

When it comes to looking at individual countries, we like democracies that abide by the spirit of the rule of law and are genuine free societies, especially those with long traditions of peaceful elections, such as Mauritius and Botswana.

We also tend to look at the degree of control a government has over its economy. Countries that don't possess their own central bank strike us as much safer than countries that do, because the lack of control of a central bank implies an incapacity to create high levels of inflation. Zimbabwe, for instance, does not have a central bank. Consequently, the power of the Zimbabwean Government, regardless of the powers of its president, is much more constrained than it was during the Zimbabwe dollar era.

We also like countries with low inflation growth records; most of the French-speaking African countries come into this category.

As for industries, we prefer those that produce goods that are in short supply in Africa. That scarcity should be manifest in a high return on assets for the best companies in those industries, many of which are vital to the emergence of a modern, urban Africa.

Consumer finance is one such area. To reach the level of financial sector maturity of countries in the developed world, the African financial sector has to grow at a rate even faster than the respective national GDP growth rates. That is the only way, over time, for the services sector to become the largest sector in a typical African country. In turn, this implies that the best financial services companies will sport a high real return on assets.

ASSESSING GROWTH POTENTIAL

In the case of established companies, we pay great attention to their cash flow statements. We tend to look at those first, then their balance sheets, and finally their income statements. We like to see financial statements that cover a period of at least five years, if possible, in order to get a sense of a company's performance over cycles. We hope to see a pattern of free cash flow generation supported by high returns on assets.

Yet that historical cash flow data does not constitute a linear guide to future possibilities. For example, rubber and palm oil trees both increase their yield in specific patterns based on their age. An investor should be aware of those patterns; otherwise, historical data from one stage of a plantation's life can serve as an inaccurate guide to future production and revenue levels.

In the case of development companies, which are often found in the mining and oil and gas sectors in particular, forward-looking data is more important than historical financial statements. We tend to study technical reports and build financial models, based on anticipated production levels, for those kind of investments. ■

To read *Building bridges: Ernst & Young's 2012 attractiveness survey – Africa*, go to www.ey.com/ZA/en/Issues/Business-environment/2012-Africa-attractiveness-survey