Sustainable Capital delivers 10-year track record in Africa

Since launching the flagship in 2012, the firm has endured several bear markets in Africa that have been a stern test of its fortitude and investment process

African equity specialist Sustainable Capital's flagship fund, the Africa Alpha Fund, has reached its 10-year track record, delivering 54.9% to investors at a time when the S&P Africa ex-SA equity index has declined by -5.2% over the same period.

By comparison with the beleaguered African markets over the past decade, global equity markets have rallied until recently, buoyed by prolonged quantitative easing post the global financial crisis and into the Covid era.

The Africa Alpha Fund, which invests solely in Africa-dominant listed equities (excluding South Africa), has added 5.93% so far this year to the end of May, with its 4.8% annualised gain since inception compared with -0.7% return from the S&P Africa over the same time frame.

"The beta story for Africa has been extremely disappointing," says Barker. "In the aggregate listed equity market, nobody has made money in real terms over the past decade. We have only created value for our clients by generating stock-selection alpha."

The fund is a concentrated 15-25 stock equity portfolio that takes material positions in small and medium sized companies. It aims to identify selected opportunities where the market price of a company has deviated materially from its fair value. Portfolio construction is driven by a disciplined, bottom-up research process with an emphasis on detailed, company-specific due diligence.

With over 1,000 listed domestic African companies, Sustainable screens for liquidity to start with a universe of around 400 companies. The portfolio is highly concentrated, with an average of 20 stocks since inception and typically over half of the portfolio in the top five holdings and over 80% in the top 10.

Sustainable Capital's buy-sell discipline is led strictly by valuation using a long-term investment time horizon. Investment decision-making is informed by first-hand, proprietary data and stock selection is led by fundamental research conducted in-situ in African countries.

"For us it is about the valuation opportunity," says Barker. "We don't pretend to forecast any macroeconomic variables. Our job is to buy companies that are worth a dollar for 30, 40 or 50 cents."

Founded by Greg Barker and Kevin Macdonald following the global financial crisis in 2008,



Greg Barker

Sustainable Capital has endured several bear markets in Africa since the flagship fund's launch in February 2012, which has been a stern test of its fortitude and has sharpened the discipline of the investment process.

"We are a resilient, lean organisation that has been operating in a difficult market with disciplined investors and patient capital. If we had started in a bull market, it would have been much easier to raise capital but paradoxically more difficult to develop a robust investment manager."

Over the 10 years to the end of May, Sustainable notes that the S&P500 returned 319%, the S&P Emerging Markets index has gained 56% while the S&P Africa ex-SA index has lost 5%. This extreme divergence is not explained by company fundamentals, meaning that investors in foreign markets have progressively paid more for each dollar of revenue, earnings or book value while the opposite has occurred in African frontier listed equities, which have become cheaper.

In its mid-year review, Sustainable notes that investors have not been adequately rewarded for the sovereign, currency and liquidity risk that they have borne in Africa in the past decade. This has ultimately led to the distressed valuations that are evident in African equities today.

"Not only have absolute market returns in Africa been extremely disappointing – relative returns have been far worse," they state, noting that African ex-SA listed equities are trading at all-time lows at a price to sales ratio of 1.6 times, while Sustainable Capital's own portfolio is trading at a steep discount to the market at 0.6x, implying above-normal returns over the next five years if this historical relationship holds.

The fund has added 68.5% alpha since its inception, which Barker says would not be possible in a more mature market like South Africa, where equity funds outnumber stocks. "There is simply not enough imperfect information in well-penetrated markets. In the land of the blind, the one-eyed man is king."

This edge has become more pronounced with the contraction in assets invested in African equities as many specialist funds have shut and investors have capitulated.

"We track all Africa-specific fund assets, and we've seen these shrink from $10 billion in 2014 to around $4 billion now," he said. "There has been an absolute haemorrhaging in assets from specialist Africa funds, in contrast to a raging bull market in the rest of the world (using the S&P500 as a proxy)."

"There are only a handful of credible specialist African equity managers now that have sufficient assets, credible track records and experienced teams of investment professionals."

Barker believes that one of the biggest lessons has been that funds of over $1 billion are not sustainable in the African markets. The well-established size handicap of asset management is accentuated by the liquidity constraints of African frontier listed equity markets.

"Our post-mortem of the contraction in assets shows that size is the single biggest factor that led to the decline and closure of several of the largest Africa equity funds over the past decade. It is a mathematical certainty that if you are over $1 billion in size, you can't do active management in Africa listed equity. Maybe 5-10 years from now, but not today."

"It accentuates risk if you're too big. It's a recipe for disaster once markets turn."

For Barker, the "other big elephant" in the room is who the clients are. Sustainable Capital has turned away more than its current assets under management in order to ensure that its client base matches the time horizon of the fund.

"What is their time horizon? A big difference for us has been that our client base is predominantly university endowment funds

and foundations in the US and similarly sophisticated investors. They have inter-generational time horizons with an average holding period of 10 years or more."

"Even some institutional pension funds that claim to be long term can be extremely fickle. Clients panic. If there is a mismatch between the client's time horizon and an Africa listed equity frontier fund, it exacerbates the liquidity constraints, with redemption requests in falling markets becoming a self-fulfilling prophecy for the fund investors. Clients that ask short-term oriented questions are a red flag for us."

Sustainable Capital manages assets of $340 million in its main fund and a further $150 million in client-specific, concentrated co-investment mandates. The co-investment mandates only include companies that are already in the flagship fund, which means that they do not create any additional research burden for the investment team.

"We have learned that if we are sitting in a room explaining 'why Africa', then we're in the wrong place," says Barker. "Our best discussions are with clients that are interested in the companies that we invest into. Our highest-quality investors have travelled with us into Africa and accompanied us in company research meetings and site visits, as a 'fly on the wall'. They then have far greater conviction in the fund's underlying holdings, which gives them the confidence to add to their holdings during market downturns."

Barker adds that after a "long brutal series of outflows" from African equity markets, shareholder registers today show very little foreign capital left in the markets, saying that "all the money that could have left, has largely gone. At some stage, foreign capital will have to return to African equities". Even so, domestic pension funds are likely to be the "most significant and predictable marginal buyer" over the medium-term, with equity allocations of just 10% (the remaining 90% is invested in government Treasury bills).

"Domestic pension fund assets in Africa are approximately doubling every three years and that will bring a more stable local investor base. If we look forward 10-20 years, the current equity allocations of 5-20% have to move closer to 30-50%," says Barker. The combination of the growth in domestic pension assets and the normalisation of equity allocations implies a significant shift in capital flows."

For Barker, the silver lining of the current downcycle is that market prices and valuations are now at a point where they are "met with incredulity".

"It sounds counter-intuitive to say that Africa could be defensive in market drawdowns, but it has safe-haven potential. The valuation disparity with the US and Europe is at such extreme levels that they are more at the bleeding edge of risk."

Using its well-established integration approach to sustainable investment, sustainability has always been part of the company's core values and DNA, long before it became a boardroom buzzword.

"There is no published database of sustainable investment intelligence in Africa - we had to do that work on our own," says Barker. "It takes a long time to build up intellectual capacity. In more established markets, you can buy information on companies and you can squash box a fund to be 'sustainable'. In Africa, the only way is through detailed forensic sustainability research. You need to ask each management team about their environmental liabilities, social externalities and corporate governance practices."

"If I look back on our decade in business, when we'd ask tough questions on sustainability in meetings with CEOs, boards of directors and operational managers, they'd look at us stunned. They'd been asked these questions before by DFIs, but not by investors. Our team has accumulated company-specific information over many years that now we use to make investment decisions."

Sustainable Capital remains an independent owner-managed business, with Sanlam retaining a 40% shareholding in the company, as a silent partner. All core team members are also shareholders.

"Kevin and I learned early in our careers that the single biggest destruction of value for fund investors is losing key investment people," says Barker. "We co-invest materially alongside our clients and that means we behave differently. The owner-manager model encourages a long-term view and has resulted in minimal staff turnover over the firm's history. As the fund manager, more than half of my net worth is in the fund with our clients and we have the same expectation from the rest of the team."

Gareth Visser and Diane Laas are senior investment analysts and the team has recently added a further investment analyst, Jedrick Theron. Visser joined in 2017, and was previously an equity analyst at Avior Capital Markets, where he spent five years in African frontier markets, having completed his accounting articles at Ernst & Young.

Laas joined the team in September 2020 as senior investment analyst, having spent many years with the African equity team at Investec Asset Management before working at Uqalo Private Equity, which focused private companies in African markets.

Based in Mauritius, Maharishi Ramkorun oversees operations together with Macdonald and has been with the firm from the outset.

Since inception, the company has taken care to separate business and investment functions. "You can't distract the investment team. Our analysts spend 90% of their time looking at companies, doing investment research," says Barker. "We are comfortable with our research bandwidth but we are planning for the future. For us it is important to find the right culture fit when we take on new people."

Sustainable Capital has $100 million of remaining capacity in the Africa Alpha Fund and will close its main fund at $500 million as part of its ongoing capacity calculations, a commitment that is enshrined in the side letters with its main clients.

"Ten years ago we calculated our fund capacity at $300 million and we've seen liquidity steadily increasing by 60% over 10 years, even though prices have declined to distressed levels," says Barker. He notes that Sustainable Capital's investable universe includes foreign-listed companies that are Africa-dominant (mostly natural resources companies), which represents about double the liquidity of funds that focus exclusively on domestic African frontier listings.

Today, the markets have returned to valuations close to the market trough of early 2016 and approximating post-GFC lows, presenting an unusual opportunity for its patient clients that closely resembles what the team was seeing during these historical low points.

"Back then our equity analysts were doing plenty of credit analysis due to the debt burden that companies were bearing, which introduced substantial financial risk into the investment case despite compelling valuations. Now, we have the opposite situation: There is so much net cash on balance sheets, the main challenge is forcing management to return surplus capital to shareholders, which is a good 'first world problem' to have in a period of rising interest rates and falling equity markets."

The team's investment process has remained essentially the same over time, relying on ultra-detailed, granular, deep-dive research. Through different business cycles, they have adopted a healthy degree of scepticism and cynicism. This has led the team to refine and evolve the sources of their research information to allow for greater stress-testing of investment assumptions.

"Having done the groundwork beforehand allows you to take full advantage of distortions in the market. It is hard to get sufficient conviction to pull the trigger unless you have already done that work."

The fund takes long-term positions, with portfolio turnover ranging between less than 10% (implying average holding periods of over 10 years) and 60%, depending on the extent of differential price moves.

In 2021, the Africa Alpha Fund grew its portfolio-weighted earnings per share by 36.2%, and the team expects further earnings growth of 26.9%, 24.5% and 31.6% in 2022, 2023 and 2024 respectively. By 2024, they expect the fund's dollar earnings to have more than doubled from their current levels, with cumulative growth of 108% based on its stock-specific estimates.

"In the case of the Africa Alpha Fund, not only is the historical 2021 price-earnings multiple of 6.7 undemanding given the quality of the underlying holdings, but if our estimates are even vaguely accurate then we can conclude that we are well below mid-cycle in terms of earnings. This bodes well for the possibility of a virtuous combination of earnings growth and market rerating ('rating' being the price that

investors are willing to pay for each dollar of earnings in the fund)."

"This is in stark contrast to what we observe in developed market equities, where earnings appear to be well-above mid-cycle and valuation multiples are measurably elevated, raising the possibility of a 'double whammy' of declining earnings and multiple compression."

Dividends and earnings growth have been the significant contributors to gains in the past decade – Sustainable notes that of the fund's total return of 54.9% generated since inception, 62% (or 113% of the total return) has come from cash dividends, with a further 42.2% (77% of the total return) ascribed to cumulative earnings per share growth.

The fund currently has a portfolio-weighted dividend yield of 11.3%, which now far exceeds many sovereign bond yields in Africa, offering a cash underpin the team believes is likely to become a significant differentiator in terms of downside risk protection should global equity prices substantially retrace.

"Our core holdings have no debt on the balance sheet and their share prices can't go down much more, since investors are already being 'paid to wait' with cash dividend yields of over 10%. These are high-quality companies that are going to be around 10, 20, 30 years from now and are going to continue to grow their revenues and earnings with no meaningful financial risk."

"The average African market has made no money for the past 10 years. Because equity valuations are so chronically distressed, to get an above-normal outcome on equities - nothing spectacular has to happen. The investment case does not rely on any onerous growth assumptions."

Barker notes that, in aggregate, African frontier listed equity markets have continued to lag the post-Covid recovery in developed equity markets, despite the fact that, from an economic perspective, they (ex-South Africa) have weathered the impact of Covid far better than their developed and emerging market counterparts, continuing to grow their economies in real terms during 2021 and 2022, which is reflected in continued revenue and earnings growth amongst African equities.

He adds that when African markets re-rate, it won't be in an orderly, linear fashion. "When it happens, it is not going to be an orderly re-rating. You can expect some market anarchy as we have observed in previous cycles. Even if you are buying every day, you are not going to accumulate a meaningful position. The markets can go limit up 5-10% and then trading is locked for the day. The next day, the same. After a few weeks, the market can be up 40-50% but you still have no real position. It is an exercise in futility trying to time these markets and it's simply 'too late for tears' if you don't have your positions in place."

The team is increasing its research efforts in Kenya, Nigeria and Egypt, where there is the potential for severe stock-specific mispricing, ensuring that all the necessary due diligence is concluded in order to take advantage of new opportunities that emerge.

"We are nimble, we don't have a lot of portfolio rules and constraints. Our initial positions can comprise up to 15% of the portfolio in a single company."

Of late, the team has been rotating quite aggressively from natural resources into consumer goods holdings, driven by outsized differential price moves, and also has positions in financial services and industrial manufacturers.

The fund's portfolio-weighted discount to fair value today is 55%, reflecting an expected dollar return of 120% for companies to get to fair value.

Sustainable Capital's investment process means it has made money out of some portfolio holdings multiple times over the past decade, buying and selling based on its estimates of fair value. The fund does not use gearing or derivatives and aims to be fully invested in equities at any given time, having averaged 99% in equities since inception.

"Basically our job is to find companies that are hated in countries that are out of favour and in sectors that are neglected, which leads to 'one in 20-year' opportunities to buy high-quality assets for our clients," concludes Barker.

"We stick to our capital discipline and portfolio construction, focusing on fine-tuning sensible estimates of fair value. It is not just what you hold. Position sizing is a critical part of the portfolio construction process and leads to extremely different return outcomes to an equally-weighted portfolio of the same holdings."

Spotlight on Nigeria – a game changer

Nigeria's privately owned Dangote Refinery, just outside Lagos, is probably the most important capital project that Africa has seen in the past 50 years, according to Greg Barker at Sustainable Capital, heralding a structural shift over the medium term as the 650,000 barrels per day refinery comes online.

The fertilizer component was commissioned in May and fuel production is set to ramp up in early 2023, with overall progress currently over 90% complete, project head Devakumar Edwin, an executive director at Dangote Industries, announced recently.

Edwin said that despite delays caused by the coronavirus pandemic in 2020, work has been picking up. "We are targeting mechanical completion by the end of this year and the commissioning to start in January next year," he said. Edwin has said previously that the refinery would reach full capacity within six months of the start of commissioning. The start-up date for the refinery has been repeatedly delayed, after the company first announced the project in 2013.

"It is not an exaggeration to claim that this is amongst the most ambitious and largest-scale private-sector capital projects ever attempted on the African continent," says Barker. "The refinery will result in an approximate 40% reduction in the country's forex import bill, with significant implications for the value of the Naira. The fertilizer component has already been ramped up with sales progressing, and offtake agreements for the fuel are under negotiation in Nigeria with a view to meaningful production from early 2023 onwards."



Nigeria's Dangote Refinery

Ramping up the Dangote Refinery will structurally alter Nigeria's balance of payments as soon as full production volume is attained – refined oil is currently the single biggest import in Nigeria and now stands to become a significant export. Nigeria's current fuel subsidy regime has meant that the country has failed to reap the windfall benefit of high oil prices.

Total capital expenditure estimate for the project is now more than US$20 billion and the refinery will displace over US$15 billion a year of fuel imports at current oil prices. About one-third of production will be exported, generating foreign exchange of about $10 billion per year – so combining the import substitution and the exports is a swing factor of US$25 billion per year, excluding the petrochemicals import substitution.

Late last year Nigeria's National Petroleum Corporation (NNPC) acquired 20% equity in the refinery.

"It has taken a long time and there is a lot of fatigue around this project – people are sleep walking into this, but the asset's construction is approaching completion. Once production ramps up, it will completely change the structure of the economy. It will free up cash on the sidelines that is waiting to go to Nigeria, and allow an unlock of the repatriation friction that is currently holding the country back from achieving its potential."