First State Investments

SUB-SAHARAN AFRICA

Emerging Market Debt
Research trip report
February 2020

Africa trip notes:

We recently travelled to Sub-Saharan Africa to undertake bottom-up research on a number of high yield sovereign credits, namely: Kenya, Zambia and Angola. Research trips, such as these, form a vital part of our investment process; particularly for countries where idiosyncrasies are the dominant driver of return and where information dissemination and/or transparency is poor. Travelling to the countries that our clients are invested in also provides us with valuable opportunities to engage with local policymakers and stakeholders on the environmental, social and governance issues that are determinants of our clients' ultimate performance. The note below highlights some of our major takeaways:

Overall impressions

What is immediately and abundantly clear on travelling to the region, is that rising global temperatures and varying rainfall patterns, as a result of climate change, are already having a major impact on economic outcomes and prosperity for many African countries. Southern Africa is experiencing its worst drought in decades and the degree to which individual countries have political and economic capacity to respond to this exogenous shock is creating the conditions for divergent bond performance.

Climate and governance challenges notwithstanding, one underappreciated regional dynamic we observe is the relative resilience of many African populations to arduous economic conditions. 2019 brought with it a stark rise in global populism, which undermined the ability of governments all over the world, particularly those in Latin America, to undertake painful but necessary fiscal reform. We see fiscal risks from popular protest as less of a challenge for African policymakers and remain optimistic that this societal dynamic should serve those governments willing to take steps to improve fiscal accounts.

Stop 1: Nairobi, Kenya
We arrived in Nairobi especially keen to understand the trajectory of fiscal accounts, which remain, in our view, an impediment to the negotiation of an IMF program for the country. Kenya is a relatively young democracy and a history of tribalism, as well as still developing institutions, have both contributed to weak fiscal outcomes. In recent years, the country has devolved some power to individual counties as a means to promote ethnic harmony following violent elections in 2007. On the one hand these reforms serve to improve social inclusion, reduce the risk of future ethnic tensions and promote a smoother democratic process; on the other hand, with more centres of power, it becomes harder for policymakers to take the measures needed to tighten fiscal.

Following discussions in Nairobi we do not see the Kenyan government taking the necessary steps to meaningfully reform fiscal policy in 2020 and our base case remains that the country will not be able to agree an IMF program. Whilst the market continues to focus on an IMF program as a potential panacea for Kenya, we came away from the trip more conscious of downside catalysts. Most notably, we were concerned at the extent to which government borrowing has fed through to local market liquidity conditions, a dynamic akin to that which we observed in Costa Rica in 2018, prior to a blow out in sovereign spreads of over 200bps. While we do not think such violent price action is imminent in Kenya, at a minimum, we expect considerable supply in USD bonds, which should weigh on relative performance. We remain underweight.

Stop 2: Lusaka, Zambia
At the time of our trip, Zambia sovereign Eurobonds traded at around 65 cents on the dollar, reflecting a material degree of credit stress relative to the EM debt high yield universe. As such, our meetings focused heavily on the Zambian foreign exchange (FX) reserve position and the likely sustainability of that position through to the next Eurobond maturity in 2022. Holders of the 2022 Eurobond stand to make an annual return of over 20% through to maturity if the Zambian government ultimately pays the $750 million face value as it falls due.

In our assessment, political dynamics and poor governance are at the root of Zambia's economic distress and the situation has been dramatically exacerbated by the multi-year drought that is affecting Southern Africa. In general we observe a stronger relationship between ESG factors and bond price performance at the lower end of the credit spectrum, and no truer is this so than in Zambia. In Zambia's case, the drought has had the impact of pushing a country that was already 'stressed' into 'distress' and this has happened via two main channels. The first is the very intuitive impact of lack of rainfall on the agricultural sector, which employs almost half of all working Zambians. Typically, when we assess a country's vulnerability to climate risk, the extent of importance of the agricultural sector to the country's economy is the material determinant. However, in Zambia's case, weather vulnerability is further magnified due to the reliance of households and non-agricultural industries on hydroelectricity. Regrettably, in 2019, there wasn't enough rainfall to ensure major hydroelectricity facilities were fully functional, resulting in power cuts of up to 18 hours a day and additional pressure on the already precarious balance of payments.

Pictured above is Kariba dam, the world's largest man made hydroelectricity reservoir which Zambia shares with Zimbabwe. While we were in Lusaka, water levels at Kariba fell to under 8% of capacity, extremely close to the point at which the facility becomes completely non-operational.

Our meetings in Zambia were particularly fruitful from an ESG engagement perspective, and we were able to discuss the impact of the drought as well as ways to reduce climate vulnerabilities with both government policymakers and private sector participants. By engaging on the ground with representatives from the World Bank, we learnt of some initial progress the country has made to explore alternative power generation sources, with the help of the International Finance Corporation (IFC) initiative 'Scaling Solar'. With a rubberstamp from the IFC, Zambia has been able to procure private investment into two large-scale solar projects that commenced operation in early 2019. The projects have been a resounding success and have generated solar power at tariffs which are the lowest in Africa, to date. Although the total generation has been minimal relative to the overall energy need of the country, we believe the success of the programme is the first step towards finding a viable long-term solution to Zambia's energy crisis. Such a resolution would unlock multiple percentage points of potential growth and would be materially positive for both Zambian citizens and bondholders.

Taking current ESG vulnerabilities into account, we ultimately came away from the trip more bullish on Zambia, given valuations. In our assessment, the country is facing a liquidity crisis rather than a crisis of solvency as many in the market perceive. We also believe that political incentives are increasing for President Lungu and his cabinet to take the necessary steps to alleviate external funding pressures and that the fiscal adjustment required will be palatable to the voting population in Zambia. This is an important consideration given the rise of global populism and the corresponding roadblock that this dynamic has created for several indebted sovereigns requiring reform. We expect populism will continue to be a catalyst for performance differentiation in 2020 and in this context, we view societal dynamics in Zambia as more favourable than in other high yield credits, such as Ecuador.

Precluding major exogenous shocks, our base case is that the sovereign will continue to service Eurobond coupons through 2020, supported by a very capable central bank. We continue to monitor idiosyncratic developments, including the weather, very closely.

Stop 3: Luanda, Angola

We were excited to visit Angola for our final stop, particularly to take stock of the political change that has occurred in the country in the last two years, much to the market's surprise. Within our investment universe Angola ranks extremely poorly on measures of governance and historically has had one of the highest rates of corruption in the world. Under the 38 year rule of President Jose Eduardo dos Santos, which ended in 2017, material revenue generated by the country's oil production was misappropriated. Despite being one of the richest countries in Sub-Saharan Africa, in overall terms, Angola's debt burden grew and the government failed to deliver basic infrastructure, health and education to the population. Human capital suffered as a result and the economy failed to build productive capacity outside of the oil sector.

Today Angola's trajectory looks markedly different thanks to the leadership of a new President, João Lourenço. Lourenço assumed the Presidency in 2017 and took quick measures to fight corruption as well as committing to restore macroeconomic stability under the guidance of an IMF reform programme. The extent of deep and genuine political will to reform, both on the part of the Angolans but also from the multilaterals was abundantly clear in our meetings in Luanda. In our assessment, the government's performance on fiscal and monetary targets under the programme will be sufficient to retain multilateral financing in the short-term, buying the government some (but not much) time to address longer-term structural bottlenecks.

During our visit, we engaged with representatives from the World Bank to discuss potential areas of diversification for the Angolan economy, as well as the need for an easier business climate and a more productive and competitive workforce. While there remains much to work on, we are encouraged to learn of a co-ordinated government effort to focus on three specific priorities to boost Angola's human capital: empowering adolescent girls, reducing the very high child stunting rate and boosting educational outcomes. In the context of overall fiscal prudence, we view investment in human capital as a productive use of government resources in order to boost longer-term growth and improve inclusion.

As bondholders we are encouraged by the reform momentum and prefer to hold long-dated Angolan bonds relative to peers like Ghana, where we see little reform impetus. That said, we note the lack of room for policy error in Angola as the country grapples with an extreme debt burden, an oil industry with declining capacity and an inability to attract investment and capital inflows in the short-term. The country has extremely limited capacity to weather exogenous shocks and as such, our risk position in Angola will be continually reassessed in the context of any changes in the macroeconomic environment.

For further institutional enquiries contact institutionalenquiries@firststate.co.uk
For wholesale enquiries contact enquiries@firststate.co.uk

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