

Macro forum  
insights and  
perspectives

April 2016

# Welcome

In this first issue of our Macro Newsletter, we hope to share some insights from the Actis Macro Forum, a group composed of professionals from across our regions and from each of our three key business units, Energy and Infrastructure, Private Equity and Real Estate.

The Forum meets regularly to share experience and perspectives on key macro and political developments across our markets and is also represented in all Investment Committee discussions.

In this issue, we have two focus articles, one of which covers the current situation in North Africa and one which looks at developments we are seeing in China. We conclude with an introduction to our longer term view on the local currencies in which we invest and how we seek to manage our FX exposure through the use of this analysis.

## Macro forum team



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# North Africa

## Reality versus perception in North Africa: Perspectives from the front line

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**As Aldous Huxley said “There are things known and there are things unknown, and in between are the doors of perception.”**

**Five years after the Arab Spring, North Africa continues to face its own macroeconomic and geopolitical challenges. The changes that swept across the region saw regimes toppled (sometimes twice) and brought a wave of hope that new governments would deliver overdue reform and improvements in social inequality and economic growth. Difficulties in meeting these high expectations have led to continued geopolitical unrest, making North Africa seem an unlikely investment destination for foreign capital.**

However, the region has continued to generate strong returns for those investors with an on-the-ground presence and local insight. Why did that happen?

Largely because of the fact that buried in the rubble of the Arab Spring, there is a very interesting ‘emerging middle class’ consumer investment thesis.

Question: Which region has the largest concentration of Africa’s Middle Class consumers?

Answer: North Africa with over 40% of Africa’s total middle class population.

So what have been some of the key recent macro economic considerations:

### Commodity prices

The decline in commodity prices has affected North African countries in different ways. As the largest producer of oil in North Africa, Algeria has suffered from the drop in oil prices, however the same drop has helped to improve public finances in Egypt, Tunisia, and Morocco which are all net oil importers.

### Monetary policy

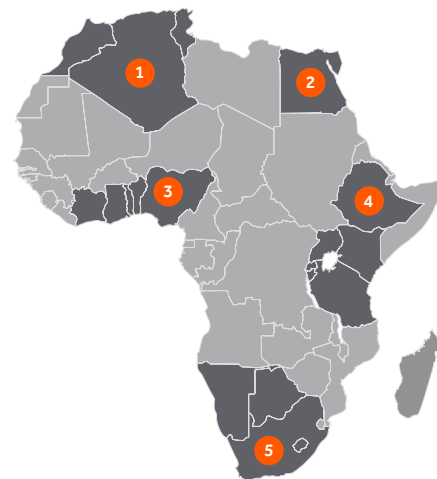
In the last 12 months, North African economies have all faced what the IMF’s Chief Economist, Maurice Obstfeld described as the “developing countries trilemma”. This implies that a country cannot simultaneously maintain fixed exchange rates and an open capital market while pursuing a monetary policy oriented towards domestic goals.

A country can consequently choose either to block the mobility of capital by prohibiting international financial transactions from being conducted through its system (thus cutting itself off from global financial markets), or it can abandon its FX controls, leaving exchange rates to be determined by the forces of market supply and demand.

Over the past decade, North African economies have all chosen to open up to the global economy to varying degrees, and in the last 12 months, all have come under pressure to devalue their currencies as a result of macroeconomic headwinds.

### African Population

<b>Rich</b>	43m
<b>Middle</b>	112m
<b>1 Maghreb</b> (Morocco, Tunisia, Algeria)	20% 22.4m
<b>2 Egypt</b>	23% 25.7m
<b>3 West</b> Nigeria, Benin, Togo, Ghana, Cote d’Ivoire	22% 25m
<b>4 East</b> Ethiopia, Kenya, Uganda, Tanzania, Rwanda, Burundi	10% 11.2m
<b>5 Southern</b> South Africa, Botswana, Namibia	9% 10.6m
<b>Other</b>	16%
<b>Floating</b>	192m
<b>Poor</b>	555m
<b>Total</b>	902m



Source: African Development Bank

## A closer look

### Egypt

As the largest and most populous market in MENA, Egypt is the economic heart of the region.

The last 12 months have seen US\$ liquidity challenges, with the Central Bank of Egypt acting slowly to devalue the currency in line with other growth market currencies, spurring a parallel market for US\$ where dollars were exchanged at a premium, peaking at LE/USD at 25% above the official rate.

Authorities have taken steps to resolve foreign exchange shortages by :

- partially removing capital controls on individuals and a wide range of corporates to channel dollar liquidity away from the parallel market back to the banking system;
- devaluing the LE by c. 13% against the USD in March 2016, signaling a move towards a more flexible exchange rate regime; and
- increasing policy rates by 150 bps in an attempt to control inflation and stimulate de-dollarization.

The recent Cabinet reshuffle and the Government's 2016-18 program presented to Parliament in March both point to a continuing positive direction of reform. Recent measures to ease FX shortages are expected to add pressure on an already high fiscal deficit (budget deficit expected to be 11.5% of GDP in FY2015/16), pointing to a likely IMF agreement which would boost investors' confidence.

In the short-term, we expect GDP growth to settle at around 3.5% p.a. as FX shortages, import rationalisation measures and challenges facing the tourism sector put pressure on economic growth. Signing an IMF deal and implementing the reform program would potentially help improve FX shortages, gradually unlocking the economy's potential and leading to growth moving to above 4% in the next couple of years. In the short-term, one can expect continued stop-gap funding for Egypt from Saudi Arabia and UAE while the Government continues with its structural reform measures.

### Morocco

Morocco has continued to show resilience and is expected to continue to perform better than its neighbors, Tunisia and Algeria in the coming year. However, 2016 GDP growth is set to fall below 1% versus 4.2% in 2015 due to a sharp decline in agricultural production, with the poor rainy season this year leading to a decline in agricultural production of c. 15%. This in turn is likely to lead to decelerating private consumption growth with c. 40% of the country's labor force working in the sector.

Non-agricultural growth is likely to remain stable around 3% with accelerated investment growth counterbalancing weaker private consumption.

To stimulate the economy, the Government is stepping up investment in infrastructure, including renewable energy, and foreign investment is also picking up. Private sector and corporate credit growth remain weak due to a lack of confidence and poor external demand. Tourism revenues continue to contract while exports are likely to normalize in 2016 on weaker growth in the Eurozone and lower commodity prices. The Moroccan Dirham is expected to devalue by between 3% to 5% over the course of 2016.

Parliamentary elections will be held later in the year, at which the Islamist Justice and Development Party (PJD) is expected to maintain its majority.

### Tunisia

Tunisia is in a more difficult position than Morocco. Public discontent regarding unemployment has triggered sporadic demonstrations across the country in Q1 2016. The Tunisian Dinar has devalued by c. 8% over the course of 2015 and is expected to devalue by c. 6% in 2016, as its fortunes are closely tied to those of the Euro.

Consumption continues to be a key driver of the economy and is set to grow at c. 1.7% this year; inflation is set to ease from 4.9% in 2015 to 3.9% in 2016. Ideological differences between members of the coalition government are causing inefficiencies and slowing down reform. Due to the current political and economic challenges, private investment growth is likely to remain negative in 2016 due to low investor confidence, but is likely to improve in the medium term.

GDP growth is expected to be c. 1.5% in 2016, and is expected to further rise to c. 3.5% by 2020. Controlling the growing fiscal deficit will remain elusive in the short term given anaemic growth and social pressures; continuing aid flows from the EU will continue to be essential as Tunisia navigates a challenging geopolitical and socioeconomic landscape.

France has promised €1bn in aid over five years to help Tunisia address unemployment. The EU has promised €500m of soft loans to help Tunisia cover its external financing needs in 2016-17. The World Bank is providing US\$4bn over five years and negotiations are underway with the IMF on a US\$2bn stand-by loan.



## The investment opportunity

Despite the macro headlines, we believe the North African investment opportunity remains solid. The population is young, with Egypt having a median age of 24, and with over 40% of the entire African middle class being North African, we expect the demand for consumer goods and services to grow faster than the economy at large. These consumption-driven economies are strategically located to act as a gateway to Europe and Asia and the region has stable financial systems that are increasingly well regulated.

Being on the ground, we see the challenges, but also the opportunities every day through the prism of our portfolio. Our consumer facing businesses in North Africa have gone from strength to strength: Edita, a snack food business, grew volumes by c. 10% in 2015. Integrated Diagnostic Holdings, Egypt's largest private sector diagnostics service provider, grew its number of tests by c. 10% in 2015 and our North African education business accepted c. 15% more students in Universite Centrale in the academic year 2015/16. So the North

African middle class story is real, and it spills over not just into the consumer sector, but the healthcare sector, the financial services sector and even the energy sector, where our Lekela platform is rapidly emerging as one of Egypt's leading solar and wind developers.

Cairo, Egypt



# China

## 2016, the year of the 'Fire Monkey' and structural reform

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**2016 is the year of the "Fire Monkey" in China, which signifies volatility and change, an appropriate starting point in the process of rebalancing the Chinese economy from investment-led to consumption-led. At the closing of the National People's Congress in March, 2016, the '13th Five Year Plan' was approved, identifying supply-side reform as a key policy pillar in the short to medium term to rebalance the economy, revive growth and reduce excess capacity in traditional industrial sectors.**

Some of the key policy initiatives from the plan included GDP growth targeted at 6.5% to 7%, driven by measures to encourage innovation in the form of mass entrepreneurship; Fiscal and tax reform: to reduce the overall tax burden on corporations; Modernisation, particularly through the "Made in China 2025" plan to support domestic champions in strategic emerging industries; investment in the Information economy; investment in Infrastructure; and continued support for Urbanisation.

So starting with the growth outlook, while the days of double digit GDP growth may be over and 7% may be the "new normal", it is important to remember that 7% would equate to RMB5 trillion in incremental GDP in 2016, which is the same as the entire Chinese economy 20 years ago, or the size of the entire Indonesian economy in 2014. So the Chinese "slowdown" needs to be kept in perspective. That said, corporate performance in this environment has been, and will continue to be impacted by over-capacity and the resultant intense competition, and in traditional industry it will be some time before demand catches up with supply. Good news then that the Government has confirmed its support for reducing excess capacity in traditional heavy industries (where state owned enterprises tend to dominate) such as steel and coal mining, and to close down "zombie" firms.

There was also bad news for investors in the form of revisions to proposed capital markets regulation, and the removal of the planned launch of a "strategic emerging industries" board on the Shanghai Stock Exchange. The board's creation was once widely regarded as an important new listing venue for China's SMEs, and for more than 30 overseas-listed Chinese TMT companies seeking to delist from abroad and re-list at home. It was also expected to

become a testing ground for the planned new registration-based IPO approval process. Domestic capital markets have reacted positively to the news, fearing an inflow of new entrants would divert investment capital from existing trading venues, but by some estimates, as many as 380 companies had already met the listing requirements and were planning to publicly list and raise capital. Such companies will now have to seek alternative routes to access capital.

On FX, China adopts a "Managed Float" policy that is market demand-based with reference to a basket of currencies, dominated by the USD. However maintaining a stable exchange rate alongside monetary easing could be challenging; policymakers are likely to prioritise the goal of a stable exchange rate using FX reserves and de facto capital controls over aggressive monetary easing. In February 2016, China's FX reserves showed a much narrower decline (US\$29bn vs. c.US\$100bn in the previous month), consistent with a visible drop in onshore USD/CNY spot trading volume and a more stable RMB exchange rate, indicating relief for China's capital outflows pressure. Market consensus points to a modest RMB depreciation of c. 5% vs. USD with an exchange rate target of 6.80 by the end of 2016.

This is in line with what we see on the ground in China. While we saw tightening de facto capital control measures in late 2015 and extending to the start of 2016, we are now seeing these measures relaxed as pressure on net capital outflow eases. This is especially true when it comes to transactions that support industry consolidation, for example, the acquisition of technology and brands, and is evident in Actis' recent exit from Plateno Group, a transaction that required the Chinese buyer to pay USD1.35 billion in total.



In common with many of our markets globally, while industrial growth may be constrained and corporate profitability under pressure due to excess capacity and rising labour costs, consumption growth should exceed China's headline GDP growth by a significant margin. That's why the recent news that industrial profits for the first two months of 2016 grew at 5% year on year, the fastest growth rate in 18 months, should give the policy makers some breathing space in implementing structural reforms.

While the year-long anti-corruption drive has arguably resulted in a leaner and more efficient bureaucracy, historically the Chinese government is at its effective best when it is under pressure and sees no better alternative. All the signs are pointing to a rapid implementation of overdue structural reforms, benefiting sectors that Actis is focusing on in China: consumption related industries, demographically driven health care, deregulation and technology influenced financial services and an upgraded industrial sector.

And in our existing China portfolio companies, we continue to see signs of consumption growth exceeding GDP. At Bellagio, our casual dining restaurant chain, customer numbers grew by 15% in 2015. Our branded biscuit business Jiashili sold 10% more biscuits in 2015; China Micro-Tech, the largest manufacturer of endoscopic consumables in China sold 15% more sets of medical consumables, and our leading Chinese In Vitro Diagnostics company Chemclin sold over 40 million CLIA tests in 2015, an increase of about 20% over the previous year.

Beijing, China



# Foreign Exchange

## A 'Long Run', not a 'Random Walk'

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**Of all markets, EM foreign exchange is one that can reward an investor with more arbitrage opportunities than most. At Actis, we do not speculate on FX rates, but our returns are heavily influenced by the relative performance of our local currencies to the US dollar, and in consequence, over time we have developed a long term view on FX which we use to inform our decisions around investment, exit timing and hedging alternatives.**

In its simplest form, the exchange rate of a currency is determined by the supply and demand for that currency. Demand is from foreigners wanting to buy domestic goods/ services or assets, while supply is from residents wanting to buy foreign goods/ services or assets. The supply and demand for goods and services is accounted for in the 'current account' of the balance of payments and the supply and demand for assets in the 'capital account'.

In the short run, the theory of Uncovered Interest Rate Parity (UIRP) holds that the difference in interest rates between countries should be reflective of the expected appreciation/depreciation of the currency. An investor should be indifferent to holding deposits in different currencies because the movement in the exchange rate would be fully compensated for by the interest rate differential. In the very short run there is some evidence that this holds but practically this is not the case. If this held, there would be no basis for investors to borrow in a low interest country to purchase instruments in a higher interest country, also known as the 'carry trade' (the emerging market carry trade is estimated to be worth at least US\$2 trillion).

The theory of Covered Interest Rate Parity (CIRP) extends using the Forward Rate. This theory states that the difference in interest rates between two countries is equal to the expected depreciation/appreciation as measured by the forward curve. Under the assumptions of capital mobility and perfect substitutability of domestic and foreign assets, this is a no-arbitrage condition, representing an 'equilibrium' state. Economists have found evidence that this holds in most instances. So then is the forward curve a good predictor of exchange rate movements?

The existence of 'covered interest arbitrage' as a trading strategy shows CIRP does not hold all the time either. The global financial crisis laid bare how it can also breakdown completely. Counterparty risks, political risks, transaction costs and tax implications can all lead to divergence. These can be more acute in the emerging market context.

In the long run, economic theories of exchange rate determination move from

the capital account to emphasize the 'real economy' and the current account mechanism instead. Economic theory suggests that with perfect markets and where there are no transportation costs or differential taxes, identical goods should sell for the same price in two separate markets. If they didn't there would be an arbitrage opportunity by buying in the cheaper market and selling in the more expensive market, hence equalizing prices. This is known as the 'Law of one Price'.

From this principal derives the 'Theory of Absolute Purchasing Power Parity' (APPP) which holds that the exchange rate should equal the difference in the price levels between the respective countries. The implication is that if a good costs less in one country than in another, when taking into account the exchange rate, then one would expect the currency where the good is cheaper to appreciate relative to the other currency. In the aggregate, this principal holds relatively well between developed markets but doesn't work well for growth markets, most of which have persistently lower prices.

The reason for this is partly because markets are not perfect, there are information costs, trade barriers, tax distortions and transportation costs. What is more significant is that many goods and services are not sensibly tradable, and so not subject to arbitrage. The proportion of tradable versus non-tradable goods evolves slowly and in an evolutionary fashion. The implication is that the real exchange rate (RER) can be different from parity, but should be fairly constant over time.

The RER is not constant. A reason for this is because of differences in productivity impacted through non-tradable goods. The effect of productivity on the RER is known as the 'Balassa-Samuelson effect'. Basically, if wages are determined by productivity and productivity in an economy increases allowing workers to move between working in tradable and non-tradable sectors, then an increase in productivity should result in an increase in the overall price level or an appreciation of the RER (or both). Therefore, all other things being equal, if a country is 'catching up' with increasing productivity relative to another, its RER would likely increase over time relative to the other.



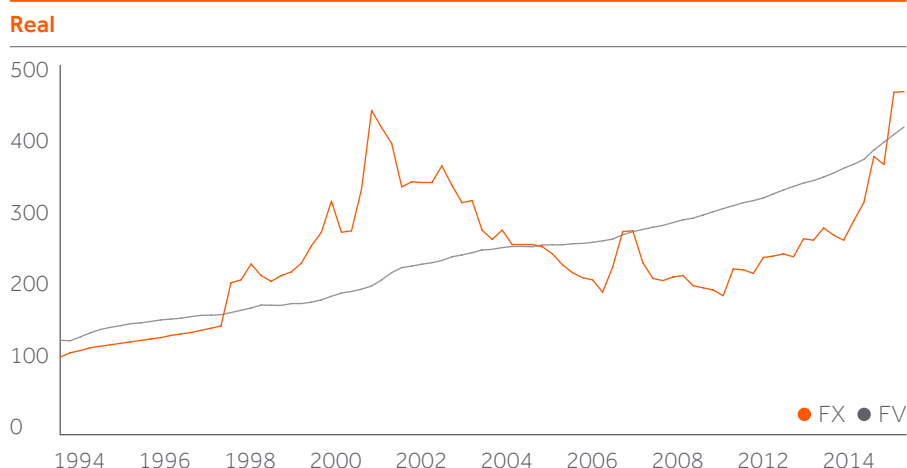
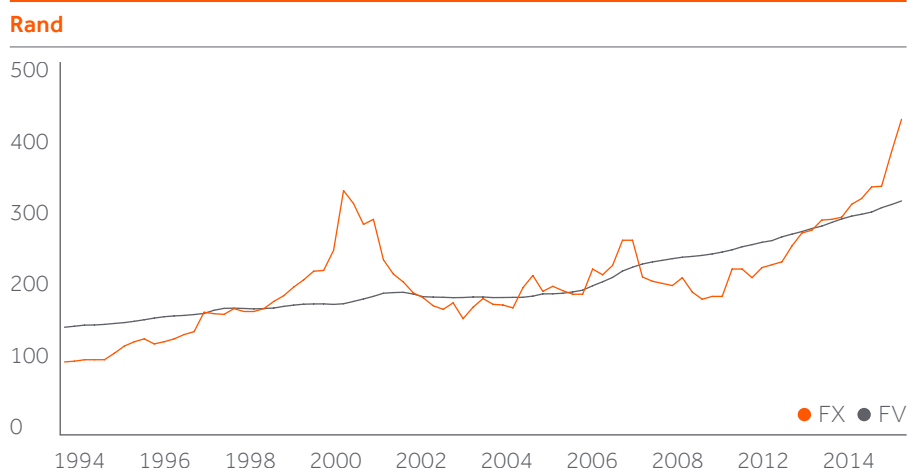
So what does this all mean? Well, it means developing a view on 'fundamental value' for exchange rates, independent of the forward curve or other oscillations opens up a 'pricing' opportunity for medium and long term capital. If in the long run, exchange rates revert to the inflation rate differentials between countries adjusted for productivity differentials, while the market is primarily driven by short term interest rates and other factors (from commodity prices to the weather) there is a mispricing of exchange rates.

In the midst of the storm that hit emerging market currencies over the last couple of years, it was easy to believe emerging market currencies were following some inexorable depreciating path, or at best a 'random walk'. Those who held fast to a conviction in fundamental value and reflected on the long run, would be reminded of Keynes' observation that 'in the long run, we are all dead'.

With our sense of history and with the perspective that comes from being a long term investor, we took a step back to look forward. We looked to compute fundamental value across our currencies in order to determine how "long" the long run is. A good place to start with such an analysis is the Rand and the Real, the two most volatile currencies. We invest in both.

An important observation is that the FV line is not a 'mean reversion line'. Whilst such a tool cannot be used to accurately predict where the currency will move in the short run, it can help infer it in the long run... and the long run is within a private equity time horizon. Both currencies cross the FV line several times over a 20 year period.

The analysis shows clearly that from 2009-2013 both currencies were overvalued relative to the dollar, however, the sharp depreciation over 2014 means that both became undervalued (with the recent appreciation in the Real bringing it back to fair value).



Source: Bloomberg and Economist Intelligence Unit

In practical terms, looking at exchange rates through the lens of fundamental value means we are able to make more informed investment decisions both on entry and exit. In early 2016, we formally rolled out the FV Model and as such, investment decisions at Actis are made with reference to where currencies are against their fundamental value. This provides a valuable anchor in short term storms, and a clearer horizon with which to navigate the portfolio in the interest of our investors and to deliver the best absolute US\$ returns we can.

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