Bull's Eye.

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Portfolio insights | Strategy | Equities | Ghana

Painting a silver lining on sombre clouds

IN BRIEF

Portfolio Manager, Equities:
Derrick Mensah +233 24 415 5765
derrick.mensah@ic.africa

Analyst, Equities:
Bernard Tetteh +233 24 864 7114
bernard.tetteh@ic.africa

- The Ghanaian equity market has rallied significantly since the start of the year and as a result, our equity portfolio has returned more than 46.0%

- In our opinion, a relatively stable currency, a refocus on fundamentals and poor risk-adjusted returns in money market securities have supported bullish sentiments despite the fragile macro backdrop

- After such a rally, we admit that we are tempted to cash in our chips while we are ahead. However, being value investors, we still see some upside from current levels despite our view of a weaker macroeconomic outlook

- We see four key themes emerge as we look beyond 4Q2021:
    - How sustainable is the rally and is there more upside in MTNGH?
    - Can the new pensions regulations provide some support amid a decline in global liquidity?
    - Consumption has improved due to successful vaccination rates but our consumer stocks overpriced?
    - Banks will drive the next rally as asset quality improves and credit expands

- Market appears fully priced but we see plenty of interesting long-term themes and attractive opportunities where research-focused value investors can differentiate among winners and losers

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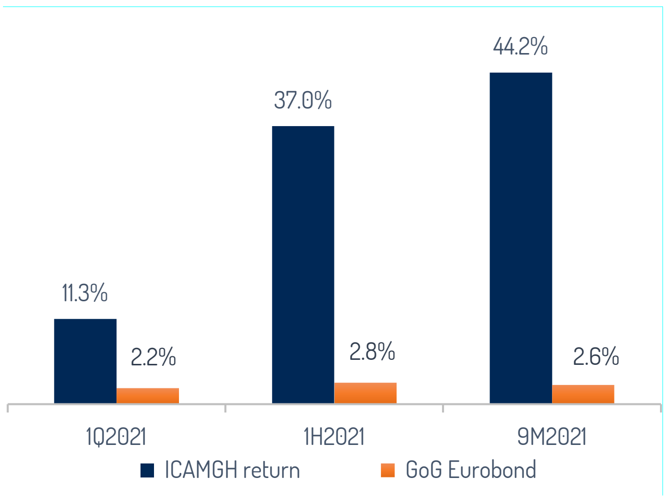
Taking stock

What a difference a year can make. By this time in 2020, we were struggling to convince our clients to hold on to their equity positions and finding it even harder to persuade them to accumulate some counters which offered attractive entry points. A little over twelve months later, and the Ghana Stock Exchange Composite Index (GSE-CI) is up by 47.1%, making Ghana the best performing stock market in Africa.

Our equity portfolio returned 46.0% at the close of 9M2021 and even when adjusted for the 1.8% currency weakness within the period, we still outperformed the average yield on Ghanaian Eurobonds by 41.6pp.

Equity portfolio performance vs. GoG 2022 Eurobond performance



Source: IC Insights
Note:
1. Returns have been adjusted to reflect currency weakness
2. Shortest dated Eurobonds selected to reflect near-term sentiments

In our last publication, *Dare to catch a falling knife*, we touted the significant upside Ghanaian equities offered and the disconnect between fundamentals and market pricing. Since then, the market has responded strongly despite the fragile macroeconomic backdrop.

In our opinion, we believe that three major factors have supported the rally.

Stable Cedi act as bull bait

As at 9M2021, the USDGHS exchange rate had weakened by 1.8% which compared favourably to its three-year average depreciation of 3.3% and seven-year average of 6.8%. Furthermore, foreign exchange liquidity had improved over the years through a series of policy interventions (i.e. Introduction of forward sales and new guidelines to regulate bid and ask spreads).

The improved stability of the Cedi was a major attraction for foreign portfolio inflows. Given the challenges with foreign exchange liquidity in the subregion, the GSE became a preferred destination for frontier market equity investors.

MTNGH rally refocuses investors on fundamentals

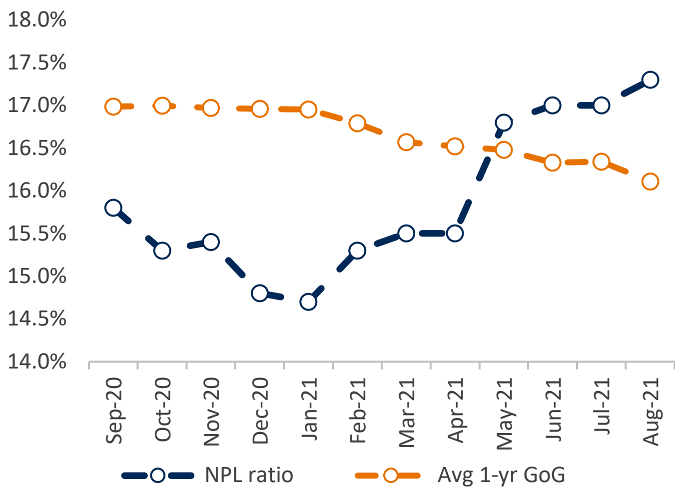
Due to panic selling following some regulatory directives, MTNGH which has outperformed analysts' consensus estimates since listing in September 2018, was down by 14.7% on the GSE at the start of the year. After clarity on the directives and a surge in data consumption as well as peer-to-peer transactions on mobile money, investors refocused on the long-term potential of MTNGH. This sparked the market rally, pushing the GSE from 0.7% to 40.1% in May 2021 when demand in MTNGH began to taper.

The surge in the broader market attracted additional value investors, causing further gains in fundamentally undervalued counters in the consumer space.

Poor risk-adjusted returns in money market stokes local demand for equities

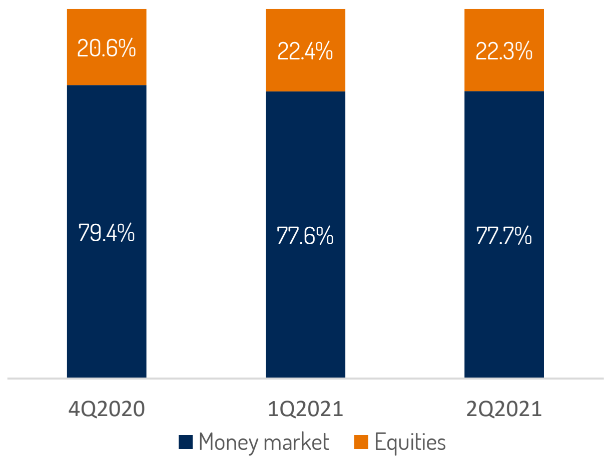
Local participation in equities has grown by 129.5% y/y. In our opinion, this has been driven predominantly by the divergence between risk and return following accommodative monetary policy amid weakening asset quality since the pandemic. In effect, local institutional investors have realigned their portfolios in favour of equities.

Evolution of risk-return dynamic over the last twelve months



Source: Bank of Ghana

Portfolio split between money market & equities of top four institutional pension assets



Source: IC Insights

With stocks appearing to be fully priced, global liquidity expected to recede and potentially exposing the fragility of the economic recovery, we dig deep to analyse the impact of these factors on Ghanaian equities.

How far can the bull run?

After a year-to-date return of 47.1%, several investors are cautious about the outlook for Ghanaian equities. Taking a cue from Nigeria (which was up by 50.0% in 2020 but hit a low of -6.7% in 2021), we admit that we are tempted to cash in our chips while we are ahead. However, being value investors, we still see some upside from current levels despite our view of a weaker macroeconomic outlook

Liquidity to subside but there will be enough to fan the flame

The major central banks around the globe are expected to start winding down their asset purchase programmes as borders open and economies rebound, following improved vaccine rollouts. Consequently, liquidity is anticipated to decline considerably with significant implications for frontier markets like Ghana.

Potentially, secondary market yields could increase as global liquidity recedes and pricing of treasury securities begin to reflect macroeconomic fundamentals.

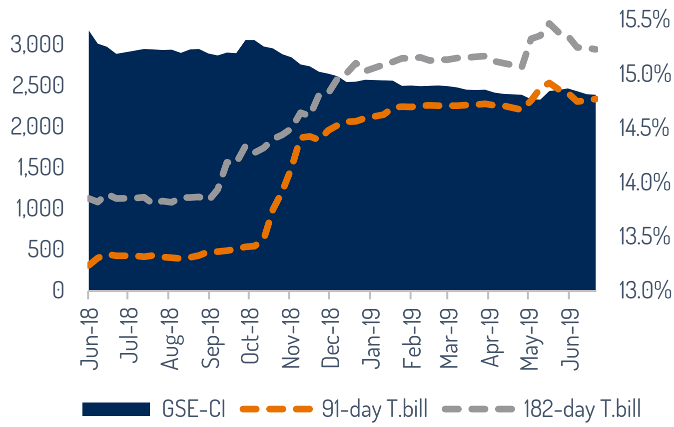
The above notwithstanding, we believe markets have already priced in the decline in quantitative easing, given that it has been on the table for close to six months. Furthermore, it will be surprising to see a rate hike before 3Q2022. Our assumption is based on the fact that, there is a lot of uncertainty regarding medium-term inflation trajectory and how far rates need to rise in response. As a result, we foresee a bit more liquidity driven bulls galivanting across markets but slightly more selective of risky assets.

Money market to pick up but new regulatory minimum allocation to equities to provide support

Although rate hikes may delay in developed markets, locally, we envisage hawkish monetary policies and fiscal consolidation to be implemented a lot faster. In our opinion, this will be driven by the relatively faster recovery and the fiscal slippage during covid-19.

Consequently, interest rates particularly on money market securities are likely to adjust upwards and potentially siphon local demand for equities.

Historic performance of rising interest rates & impact on equity performance



Source: Ghana Stock Exchange, Bank of Ghana

Despite being cautious of the re-rating of money market securities, the recent introduction of constituent funds by the pension fund regulator, has set a floor on the exposure to variable income securities of which public equities are the most easily accessible.

From our analysis, we estimate that about 40% of pension fund assets will have to be redistributed across the aggressive and moderately aggressive constituent funds. This implies that, private pension assets' exposure to equities could go up from the 3.9% recorded in FY2020 (most recently available public data) to 8.0%. This will provide additional liquidity to support the equity market.

Despite potential currency blowout, Return on equity is still expected to exceed Cost of equity

By now, it is clear that we are extremely cautious of the macroeconomic outlook. In our opinion, policy makers can either pull the brakes on the dovish stance and implement austere measures or proceed with accommodative monetary policy and risk a currency blowout. The former will sacrifice growth for fiscal alignment, while the latter may spur growth but lead to significant currency weakness.

Our earlier arguments have factored in the former but how about the latter?

From our analysis, the cost of equity (CoE) will increase by 100bp with every 1% depreciation of the local currency

Sensitivity analysis on impact of risk-free rate and cedi depreciation

SENSITIVITY ANALYSIS

		Risk-free rate				
	24.0%	**17.0%**	**18.0%**	**19.0%**	**20.0%**	**21.0%**
Cedi depreciation	**8.0%**	22.0%	21.0%	22.0%	23.0%	24.0%
	9.0%	20.0%	20.0%	21.0%	22.0%	23.0%
	10.0%	19.0%	20.0%	21.0%	22.0%	23.0%
	11.0%	19.0%	21.0%	22.0%	23.0%	24.0%
	12.0%	20.0%	23.0%	24.0%	25.0%	26.0%

Source: IC Insights

Given this perspective, the Ghanaian Cedi will have to weaken by as much as 5.9% for CoE to exceed our average return on equity (RoE) estimates for our coverage universe. While this is plausible, we will be surprised if the Cedi depreciated by that much given its recent historic performance and the current level of gross international reserves.

MTNGH, is there more upside from here?

In our last publication, we indicated that we had cut our earnings estimate for MTNGH by 11.6% following a downward revision of off-net voice revenue while reducing the average revenue per user for data and mobile money by 5.3% and 27% respectively. These adjustments were made following the regulatory directives that accompanied MTNGH being declared as a significant market player (SMP).

Since then, the company's earnings have exceeded our expectations by nearly 20%, with short-term earnings momentum being carried through to 1H2021.

Consequently, the share price has responded by gaining as much as 87.5% since year-open, causing several investors to wonder if there is any further upside from current levels.

In our opinion, the answer lies in whether you see the company as a telecommunication business or a fintech. In valuing the former, you will be saddled with concerns about how voice traffic, a high margin play, is giving way to lower margin data traffic with potentially negative implications on profitability. However, in valuing the latter, you will recognise the enormous growth potential for mobile money to act as a digital distribution platform for financial and non-financial services, and content more broadly. Eventually, Ghana could end up with a digital ecosystem closer to what has been developed in China than what currently exists across most of Africa with MTNGH in the driving seat.

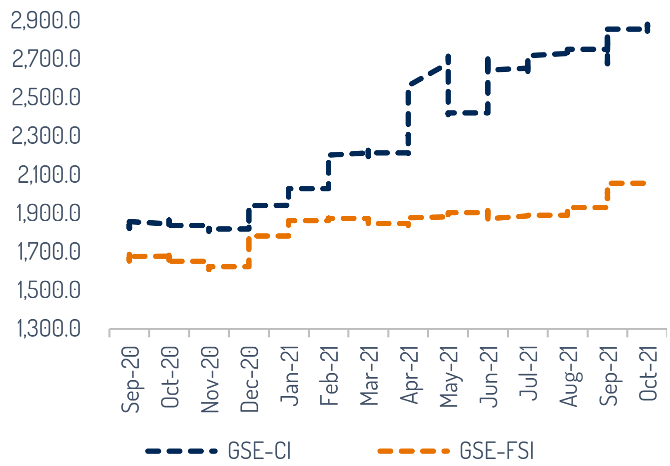
For us, we choose to value MTNGH as a fintech which is leveraging the resources of a once thriving but still relevant GSM business. In effect, although we are cautious of regulatory disruptions, we continue to see value even after adjusting for all (to the extent that we can) potential regulatory drawbacks.

As a result, and based on better clarity regarding regulatory directives, we have revised upwards our earnings estimate by 10.8% on higher average revenue per user (ARPU) numbers for mobile money and data. Consequently, we see a further 50.7% upside from current levels.

Banks will drive the next rally; buy now

Historically, banks have been the key drivers of sentiment on the Ghana Stock Exchange. However, in the 2021 bullish market, the GSE-FSI has lagged the benchmark index by 30.6pp.

Historic evolution of GSE-CI vs. GSE-FSI



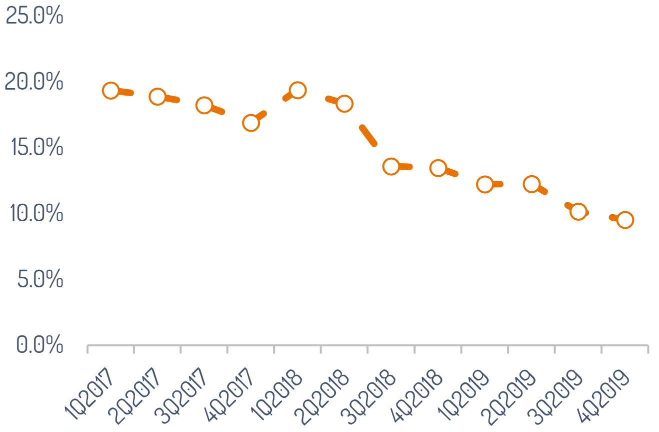
Source: Ghana Stock Exchange

The financial sector clean-up and the uncertainty which followed it, coupled with the risk of equity dilution after the mandatory capital raise as well as asset quality concerns due to the pandemic have been the key reasons underpinning the recent performance of banks on the GSE.

While asset quality concerns continue to plague the industry due to the lingering effect of the pandemic on sectors such as real estate and tourism, we believe the worst is over.

We are beginning to see NPL ratios decline.

Historic evolution of non-performing loan ratio



Source: Ghana Stock Exchange

To add to the improving asset quality, loan-to-deposit ratios have significantly reduced since the financial sector clean-up, necessitated by risk-off sentiments and a conservative view on credit.

Although the macro backdrop may not be entirely supportive of an expansive loan book agenda, we believe the opportunities in non-funded income have plateaued as liquidity recedes on the fixed income market. This, in our opinion, will force credit growth as the economy opens up.

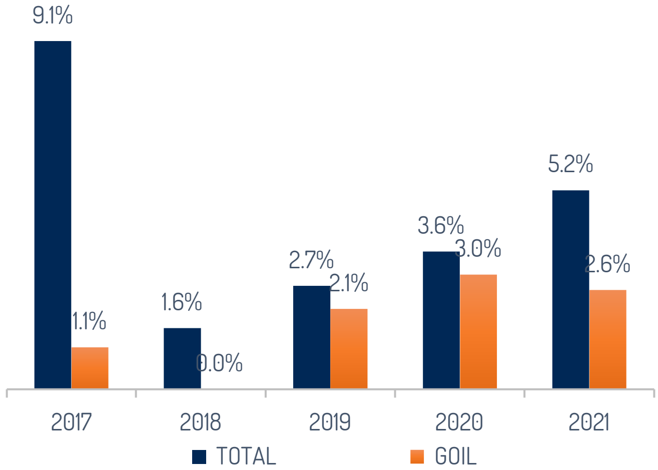
As a result, we have adjusted upwards our medium-term outlook on loan book growth which has impacted profitability significantly particularly post 2022. We, therefore see significant upside but given the outlook for cost of equity, we will be selective in our picks.

We like OMCs but only as a dividend play

Despite the positive outlook for petroleum consumption, we do not see any significant upside in listed oil marketing companies. This is because, GOIL which has higher margins, better market share and well-diversified revenue lines has its profitability being choked by huge expenses. Total Petroleum, the only other listed OMC has a more efficient business but has lost significant market share to GOIL owing to a less aggressive growth strategy.

The above notwithstanding, the sector has a proven track record of high dividend payouts and dividend yields.

Historic evolution of dividend yield for listed OMCs in Ghana



Source: Ghana Stock Exchange

We, therefore, will utilise OMCs under our tactical asset allocation strategy as we seek some level of income to stabilise portfolio volatility.

Are consumers overdone?

We have been bullish on consumer cyclicals since mid-2020 with a particular interest in Fan Milk. The ice cream maker's improved route-to-market, diversified product portfolio and expansion into formal retail have supported revenue growth. Although earnings momentum is yet to reach pre-Danone acquisition levels, we remain confident that this will be surpassed as the effect of the pandemic on the sector wanes.

However, the stock has gained 363.0% over the past seven (7) months, exceeding our fair value by 26.3%. Similarly, other consumer stocks with favourable growth stories such as Guinness Ghana Breweries also appear fully priced.

In our opinion, the sector appears to have benefitted from the liquidity induced rally in 3Q2021, pushing the stocks to trade above their fair valuation.

EGL appears cheap but we need more colour on Life Fund Liability

Enterprise Group is currently trading at a PB ratio of 0.6x, RoE of 20.8% and a CoE of 19.5%, implying a significant discount to its intrinsic value. We like EGL's diversified business lines and its market dominance in the various businesses in which it operates. Although the non-life business may have matured and unlikely to see significant growth without improvement to insurance penetration across the sector, the life, pension and funeral businesses have significant growth momentum.

The entry into health insurance via the acquisition of Acacia is also a great strategy in our opinion given the growth opportunities in

Ghana's private health insurance sector. Furthermore, the acquisition offers EGL a decent market share from the start.

We are however concerned about the property portfolio due to the impact the pandemic has had on occupancy and rental yields as well as the potential implosion in commercial real estate as "working from home" gains further momentum. We are also cautious about the group's African expansion, particularly into the Nigerian market given the level of regulatory disruption in that market. Furthermore, the significant swings in the insurer's Life Fund liability clouds earnings visibility.

Conclusion: Buy undervalued banks with high RoEs & support with OMCs for income

From an economic perspective, the path toward a full recovery will be a bit bumpier but will remain largely above trend, supported by increased vaccination rate.

The tapering of the asset purchasing programme is expected to dominate market sentiment in the near term but that notwithstanding, there will be some liquidity slushing around to support risky assets until rate hikes kick in.

Corporate earnings is expected to continue to recover despite concerns about the macroeconomic outlook. However, its sustainability beyond 2022 will be determined by the extent of austerity implemented next year.

We are concerned about high valuations following the bullish run and that restrains our enthusiasm to some extent. However, we still see upside from current levels in selected sectors and that together with increased liquidity from new pension regulations should sustain the rally albeit at a moderate pace.

For strategic asset allocation, we see good opportunities in banks and telcos driven by plenty of interesting medium to long-term themes which require research to differentiate the winners from the losers.

In addition, we recommend introducing some OMCs into your portfolio purely as a tactical play to smoothen the potential volatilities given that uncertainty continues to linger.

In short, buy undervalued banks with high RoEs, reduce beta using OMCs and monitor consumer cyclicals for buying opportunities when profit-taking emerges.

For more information contact your IC representative

Business development & client relations

Derrick Mensah
Head, Business Development
+233 24 415 5765
derrick.mensah@ic.africa

Dora Youri
Head, Wealth Management
+233 23 355 5366
dora.youri@ic.africa

Kelvin Quartey
Analyst, Business Development
+233 57 604 2802
kelvin.quartey@ic.africa

Corporate Access

Joanita Hotor
Corporate access
+233 50 137 6100
Joanita.hotor@ic.africa

Investing

Isaac Adomako Boamah
Chief Investment Officer
+233 24 337 3118
isaac.boamah@ic.africa

Derrick Mensah
Portfolio Manager, Equities
+233 24 415 5765
derrick.mensah@ic.africa

Obed Odenteh
Portfolio Manager, Fixed Income
+233 54 707 3464
obed.odenteh@ic.africa

Timothy Schandorf
Portfolio Manager, Credit & Alternative assets
+233 24 292 2154
Timothy.schandorf@ic.africa

Bernard Tetteh
Analyst, Equities
+233 24 864 7114
bernard.tetteh@ic.africa

Herbert Dankyi
Analyst, Rates
+233 55 710 6971
herbert.dankyi@ic.africa

Operations

Nana Amoa Ofori
Chief Operating Officer
+233 24 220 6265
nanaamoa.ofori@ic.africa

Emmanuel Amoah
Fund Administrator
+233 20 847 2245
emmanuel.amoah@ic.africa

Kelly Addai
Fund Accountant
+233 20 812 0994
kelly.addai@ic.africa

Trading

Randy Ackah-Mensah
Head, Global Markets
+233 24 332 6661
randy.amensah@ic.africa

Allen Anang
Trader, Equities
+233 54 084 8441
allen.anang@ic.africa

Isaac Avedzidah
Trader, Fixed income
+233 24 507 782
isaac.avedzidah@ic.africa

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