M&G Insights

M&G Investments

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The Egypt opportunity

The M&G Investments Africa team recently spent some time on the ground in Egypt, meeting with management teams and visiting the facilities of various companies listed on The Egyptian Exchange to gain a deeper understanding of the investment opportunities available for clients of the M&G Africa Equity Fund. This Africa Day 2022, we aim to share with you why Egypt could offer investors with a relatively high risk appetite the chance to add some high-quality companies to their portfolios at attractive valuations.

Our rigorous process of in-depth fundamental analysis involves engaging directly with senior company management, relevant industry participants, and in the case of our investments in Africa, country visits that allow us to get a first-hand sense of what is happening on the ground. On this week-long trip, we spoke to management teams across a broad range of industries and visited several operating facilities. This supports our investment philosophy of making decisions based on known facts.

Our visit happened to coincide with the announcement of a devaluation of the local currency and an interest rate hike, and we were able to engage management teams and local analysts on the impacts of these events and the inflationary pressures we were seeing both globally and in the local market.

A decoupling of the market's views from the fundamentals

Before the trip and in months subsequent to the onset of the Coronavirus pandemic it had become clear that the Egyptian stock market had dislocated from the fundamentals - stock prices, representing the market's view of the value of companies; and earnings, representing the underlying fundamental driver of a company's value, were diverging.

Equity outflows were significant during the initial stages of the pandemic. High yields offered on local bonds, to attract foreign investment, were providing very attractive returns relative to equity. During this period of outflows, the earnings base of stocks listed on The Egyptian Exchange was not significantly impacted; in fact, earnings proved to be relatively stable. Yet market prices fell substantially. The traded value of the market had decoupled from the earnings of the market. Since those initial pandemic months, that valuation gap has continued to widen such that the market is currently trading on a 6.0X price/ earnings (P/E) multiple, versus the 10-year average of around 9.0X. In our view this represents a very attractive valuation.

The risk of inflation

Global supply chain issues and a spike in global commodity prices driven by the Russia-Ukraine conflict are currently driving inflationary pressures in the Egyptian economy and globally. This inflationary pressure creates uncertainty around economic growth and the near-term earnings potential of the companies we invest in. If we look at the earnings performance of the EGX30 in previous high-inflation periods, it is evident that the earnings base of companies listed on the exchange is quite resilient. In September 2016, the Egyptian pound (EGP) depreciated from EGP9 per US dollar to EGP18, which resulted in inflation peaking at around 30% in July 2017, and then subsequently moderating to the high-teens in 2018. Despite this massive shock, the earnings base of the EGX30 recovered steadily in USD terms. Consumption has helped to underpin corporate earnings, proving to be relatively inelastic in previous instances of high inflation. At the time of our visit in March 2022, the Egyptian pound was devalued by 15%, and we are presently seeing inflation at around 13%. Many management teams we engaged with reassured us of their ability to navigate this environment.

Our preference for quality

Within the investible universe open to the M&G African Equity Fund, we have a preference for the higher-quality names: companies with the ability to price up their goods and services in periods of high inflation; companies with a US dollar earnings base; and companies with good cash-flow generating ability and strong balance sheets -- i.e. companies that can withstand the challenging environment better. Return on equity is one measure of quality we pay attention to, and on balance the stocks we invest in generate a return on equity higher than the market average. We believe that our portfolio is therefore able to show better resilience than the broader market.

Market reforms

We are positive about the level of structural reform that is taking place in Egypt. The Egyptian government is taking bold steps to help the economy withstand the current pressures. The government is working on incentivizing local production in the industrial sector. They are also working to increase the private sector shareholding in state- and military-owned assets, as the army's control of significant assets has historically created a negative perception of the business environment. Going forward, increased private sector involvement in the economy should drive improved investor sentiment, as will the engagement with the IMF on a reform program.

Risk versus return

It seems that market participants underestimate the ability of African companies to weather tough economic periods. A focus on both the short-term impacts of economic events and short-term trading leads to a mispricing of assets, and in that mispricing lies an opportunity for funds like ours. We construct our portfolios on a risk-conscious basis and are aware of the risks present in African markets. The level of risk is elevated versus developed markets, and concerns around political instability, currency, inflation, liquidity and market volatility are front-of-mind for us. We recognize and acknowledge the higher risk, but at the same time we are optimistic about the potential return associated with taking on such risk.

For more information on investing with M&G Investments, please feel free to contact our Client Services Team on 0860 105 775 or email us at info@mandg.co.za.