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CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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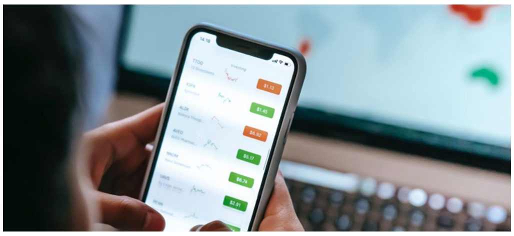
Invest For The Future

MAY 2021

Economic recovery and the contribution of policy intervention



Economic policy responses in 2020 combined efforts of both fiscal and monetary policy.

Monetary policy intervention is often mistaken for a short-term fix to the challenges facing an economy and this may be driven by the immediate response by financial markets. Monetary policy can take a long time before the effects show, the lags can vary from three months to two years. The effect on inflation could take even longer.

It has been more than a year since global economies started implementing response measures to minimize the spread of COVID-19, this is therefore a good point to start looking at the effects of monetary policy easing.

Global economic recovery underway

The IMF has increased its forecasts for global growth to 6% and 4.4% in 2021 and 2022 respectively. These represent much stronger numbers compared to the projections in the world economic outlook in the fourth quarter of 2020.

The upward revision reflects additional fiscal support in a few large economies, the anticipated vaccine-powered recovery in the second half of 2021 and the recovery of economic activity.

Locally, South Africa's GDP contracted by 7% in 2020, which was one of the bigger contractions globally. This outcome was still better than anticipated last year, however, at the height of the pandemic. This also contrasts with Thomson Reuters' consensus predicting a contraction of 8.5%. This means that the country's economic recovery has been faster than anticipated.

Strong fiscal and monetary stimuli behind the robust recovery in advanced economies

Sentiment is now less negative compared to six months ago. However, the new virus mutations, high debt levels and the slow growth of vaccine coverage continue to be serious risk factors.

There is divergence in economic recoveries across countries and sectors, and this reflects the differences in the nature and intensity of pandemic-induced disruptions and the policy responses thereto.

Growth outcomes in 2020 were mostly better than anticipated due to additional fiscal support measures implemented late in 2020, monetary policies of major central banks remaining accommodative and positive news around vaccines. These were helpful in normalizing economic activity faster than initially anticipated.

The recovery in advanced economies has been strong and this was fueled by the significantly large fiscal relief measures. According to the IMF, the change in global government gross debt was 18.7% in 2020 due to the pandemic versus 10.5% in 2009 during the global financial crisis.

Emerging market recovery muted as the scope of policy intervention was limited.

The hit on emerging markets was more severe than initially anticipated as the fiscal responses in most emerging markets were limited given the pre-existing fiscal vulnerabilities. According to the SARB, the fiscal stimulus of advanced economies averaged 16% of GDP, while emerging markets could only inject an average of 4% of GDP (Figure 1).

South Africa was already operating within a crisis level budget deficit and debt-to-GDP was already high before the pandemic. This limited the scope for fiscal policy to provide enough cushion to the economy during the crisis. Revenue losses caused by lockdown restrictions have left most emerging markets, including South Africa, with high debt burdens and fiscal deficits which will take long, painful years to recover fully.

Global inflation on the rise but contained.

Global inflation has been increasing modestly after a sharp decline in 2020 at the height of the pandemic. The increasing inflation follows the economic recovery as economic activity heads towards normalisation. In 2020, inflation in the US, Japan, and Eurozone (the G3) averaged 0.7%, while the target range is around 2%. The IMF forecasts for 2021 see inflation for the US increasing sharply to 2.3% and the Eurozone and Japan increasing to 1.4% and 0.1% respectively.

Emerging markets' inflation has already started to increase. The IMF forecasts 3.5% for 2021, which is well below the historical average for emerging markets. Similarly, in South Africa, inflation is on a rising trajectory largely on the back of fuel price base effects. However, it will remain contained within the reserve bank's target band in the near term and remain below 4.5% (the mid-point of the target range) (Figure 2).

Some emerging markets have started tightening, but major central banks remain largely accommodative.

With inflation expectations well anchored in advanced economies, monetary policy should remain accommodative to support economic recovery. In emerging markets, the picture is slightly different as some economies may have limited scope to remain accommodative for prolonged periods given rising inflation (Figure 3). Most central banks are trying to maintain monetary support, however, some major emerging markets such as Russia, Turkey and Brazil have started tightening.

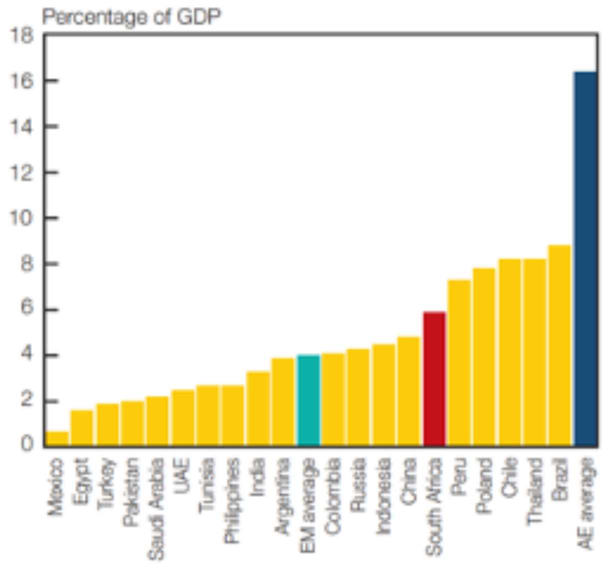
The SARB expected to remain accommodative for as long as inflation is contained.

In the last three meetings the MPC left rates unchanged, which came as no surprise as their communication was clear that they have "frontloaded" repo rate cuts earlier into the crisis. With the large output gap (the shortfall between actual GDP and potential GDP) and contained inflation, the SARB is most likely to remain accommodative and keep interest rates on hold until a point where inflation starts posing a serious threat.

Conclusion

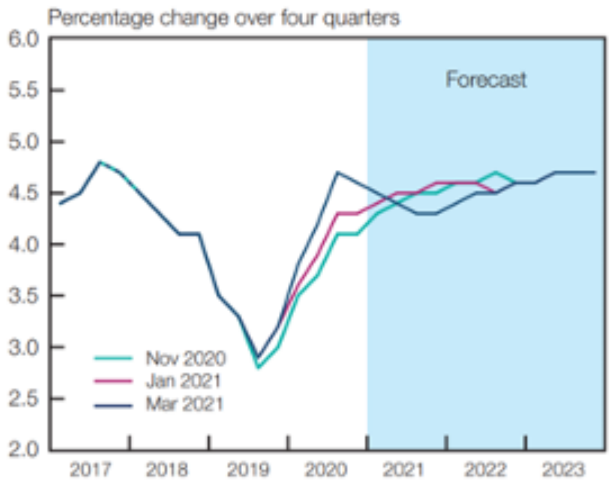
The global economy is recovering gradually, yet the pace of recovery is divergent across different countries. Continued monetary policy accommodation by major central banks and the improved pace of vaccine rollouts, especially in poorer countries, support the recovery. Notably, however, the mutated and resistant variants of the virus, the slow pace of vaccination, a high debt burden and power interruptions are just some of the potential risks to the local recovery.

Figure 1: Emerging market fiscal response



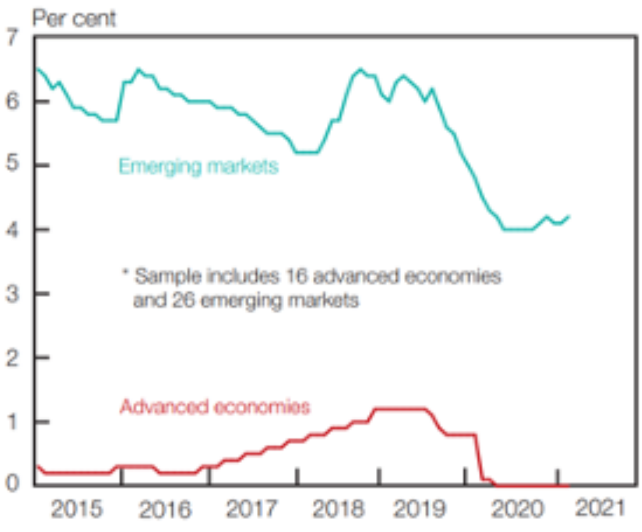
Source: IMF

Figure 2: Average Inflation (3-5 quarters ahead) - South Africa



Source: SARB

Figure 3: Policy rates – Advanced economies and emerging markets

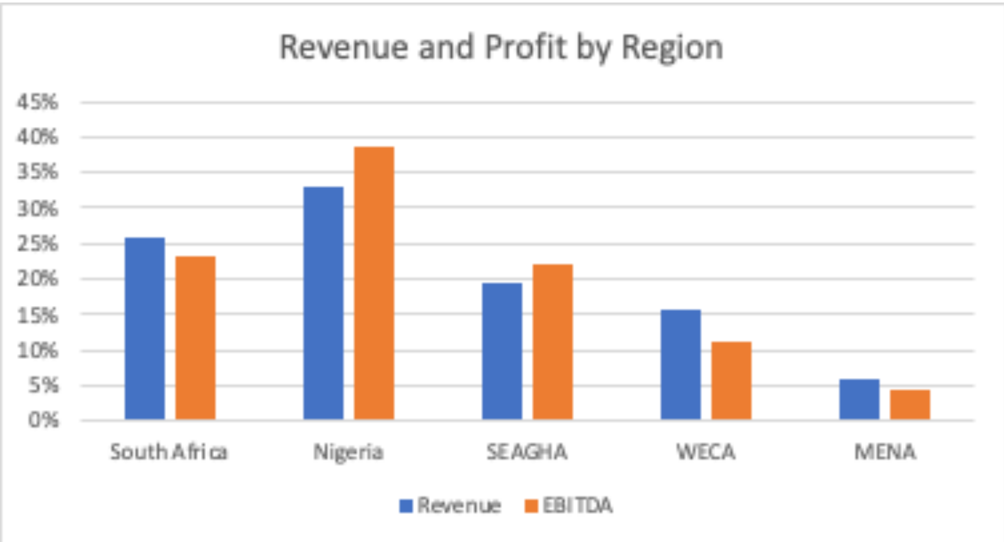


Source: SARB

MTN – Africa's Largest Telco

MTN is an emerging market focused mobile telecommunications company operating across 21 countries in Africa and the Middle East. In just over two decades, MTN has grown rapidly to offer voice, data, digital, fintech, enterprise and wholesale services to 278 million subscribers. MTN has been voted as one of the most admired and valuable brands in Africa, and in 2020 they had the leading Net Promoter Score (NPS) in 15 of their 21 markets. MTN enjoys the largest market share in most of the markets in which they operate, and their blended market share has increased to 46.1% in 2020 from 40.7% in 2017. In the markets where MTN do not hold the number one position, they are the number two operator.

MTN generates most of its revenue and profits from just two markets – Nigeria and South Africa. MTN is the number one operator in Nigeria, and it is the group's biggest market in which they generate about a third of their revenue and 40% of their operating profits. MTN is the number two operator in South Africa, which is MTN's second biggest market. The group generates approximately 26% of their revenue and 23% of their operating profit from South Africa. Other important individual markets for MTN include: Ghana, Uganda and Côte d'Ivoire.



Source: Company Reports; Cadiz Asset Management

MTN still generates most of its revenue from voice (c.52%), although data revenue has been growing quickly over the last few years and now makes up c.27% of group revenue. Fintech currently makes up c.8% of group revenue, and management have set a target of lifting this to around 20% over the next three-to-five years.

MTN Benefits from High Barriers to Entry and Scale

MTN operates in an industry where barriers to entry make it difficult for new competitors to enter the market and compete for a share of MTN's customers and profits. These barriers to entry come about due to government regulations and the high fixed cost nature of the industry, as well as the upfront capital investment required to roll out a network.

Regulations require mobile operators to obtain a license to operate and limited spectrum usually leads to a maximum of four or five operators in a market, with the number one and two operators earning good returns, while the remaining operators struggle. The cost of compliance can also be high, as MTN has experienced in the recent past, and can further prevent new competitors from entering the market.

The high fixed costs and upfront capital investment needed to bid for spectrum, roll out a network, and invest in marketing and distribution requires access to a large pool of upfront capital. It can take years to generate a return on this investment as the new network will require scale in order for the economics to work. Over the last couple of decades, MTN have invested heavily in their network to establish their leadership position and provide excellent coverage for their subscribers. This reduces the likelihood of customers switching to another network that offers inferior network coverage. MTN also has approximately 278m subscribers and this scale allows the group to spread their fixed cost base over more subscribers, essentially lowering the cost per subscriber. This, in turn, enables the group to generate strong cash flows and reinvest into their network to further strengthen their position. This again makes it more difficult for smaller operators that do not have sufficient scale to compete.

MTN still has good growth prospects, as it operates in fast growing markets with large and growing populations that will drive subscriber growth, and where smartphone penetration is still relatively low. This, combined with the increasing adoption of data, digital and fintech services, is likely to drive revenue growth for years to come. Management's strategy of moving more into the digital service offering should also see lower capex intensity which will improve free cash flow and boost return on capital metrics. Management also intends to spin off or list certain business units which could unlock value for shareholders.

Risks to Watch Out For

No investment comes without risks, and some of the risks to the MTN investment case include political and regulatory risk in certain markets where MTN operates (most notably Nigeria and some of their Middle Eastern markets).

Operating in emerging markets can also result in complex environments, presenting unique challenges and execution risk. The group is also vulnerable to depreciating currencies and restrictions on repatriating funds, both of which can impact the cash flow it is able to generate from some of these markets.

With regard to financial risk, although we do not believe the group is currently at risk of breaching debt covenants, the holding company (Holdco) leverage ratio is above management's target range. The Holdco also has c.48% of its debt is USD, which can make the group vulnerable to a weakening ZAR (versus USD). This is something management is addressing, and we expect the USD denominated debt to be reduced.

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How Are We Positioned?

Although MTN has enjoyed a strong run recently (+60% YTD), we are still comfortable holding the share at current levels. As the number one or two operator in each of their markets, we believe this dominant position will allow the group to take advantage of the explosive growth in data traffic, and the acceleration of the digital economy along with financial inclusion across Africa in the years ahead.

Physical Address: Alphen Estate, Alphen Drive, Constantia 7848, Cape Town / **www.cadiz.co.za**