Further development of Africa's Securities Markets will drive increased FDI

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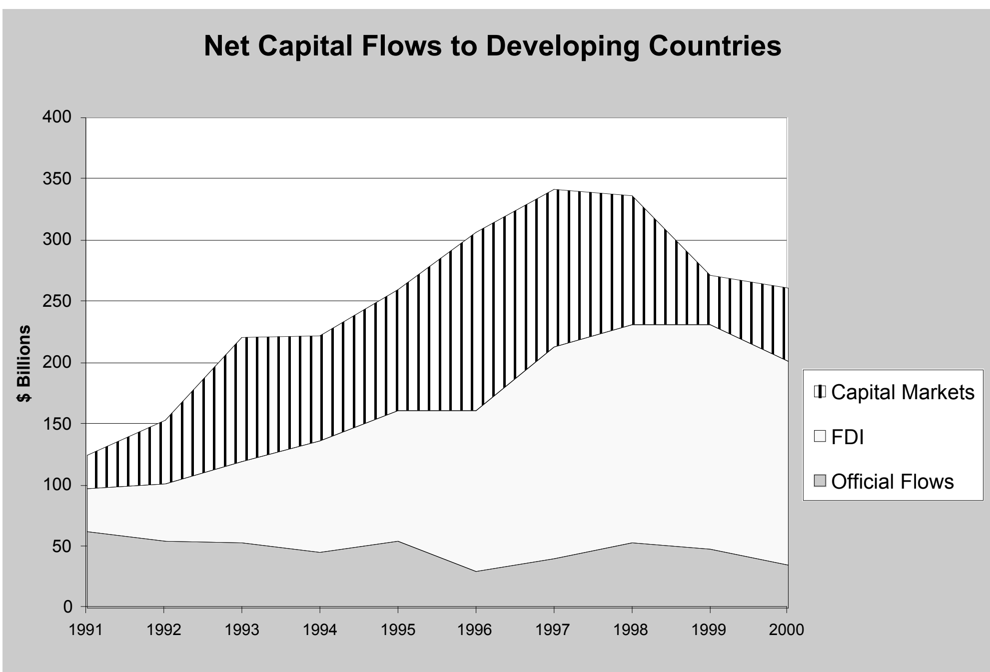
"This short paper is a handy introduction to Africa's nascent private portfolio sector. Within a few pages, Emerging Africa has sketched out this sector for us in quantitative perspective and packaged this description with a few solid recommendations signaling steps which need to be taken by Africa and its friends if private capital inflows are to be substantially enhanced."

Robert S. Browne, Economist and Africanist. Formerly; Executive Director of the African Development Bank/Fund and Staff Director of the House Banking Subcommittee on International Development, Finance, Trade and Monetary Policy.

The graphic below shows the net capital flows to developing countries. It illustrates how capital market flows, along with Foreign Direct Investment (FDI), have driven the increases in capital flows to developing countries. Capital markets (in the form of stock markets, bond markets, and loan facilities) and FDI will continue to increasingly drive the development of Africa in the 21st Century.



Notes:

Capital Markets: loans from private banks and other financial institutions and privately placed bonds, portfolio equity (the sum of country funds, depositary receipts (US or global), and direct purchases of shares by foreign investors.)

Foreign Direct Investment: investment made to acquire a lasting management interest, usually at least 10% of voting stock, in an enterprise operating in a country other than that of the investor.

Official Flows: including official grants and loans from bilateral and multilateral organizations.

Sources: World Bank, World Debt Tables 1991-2001, Global Development Finance 2001.

Further development of Africa's capital and stock markets will stimulate foreign investment. Stronger capital markets drive the development of private investment – because public stock markets provide an exit strategy for private investors that otherwise does not exist. Moreover, stronger capital markets provide investors with (1) lower transaction costs, (2) greater transparency, (3) greater liquidity, and (4) publicly-available quantitative measures (stock indexes, price-to-earnings ratios, price-to-sales ratios, etc.)

We recommend that several specific steps be taken immediately to benefit Africa's capital markets. These steps are neither expensive nor difficult to achieve. These specific recommendations are:

(1) Advocate the development of Dow Jones Indexes for the African continent as a whole as well as for Africa's smaller stock exchanges.

(2) Encourage development of Depositary Receipts for the largest publicly-traded companies in Africa.

(3) Stimulate development of regional exchanges, and even an "African Continental Exchange," to attract investment.

(4) Demand that governments and securities commissions in Africa promote corporate governance through both education and enforcement.

Before addressing these specific recommendations, we will first provide a broad overview of the African Securities Markets.

THE STATE OF AFRICAN SECURITIES MARKETS

The South African (Johannesburg) and Egyptian Stock Exchanges are the two largest and constitute about 85% of the value of total publicly traded securities on the continent. For this reason, investors often group the South African and Egyptian Stock Exchanges together and view them separately from the 10 smaller markets in Africa. (See chart below)

The Top 12 African Stock Exchanges

Market Capitalization (US$ million)

COUNTRY	2001	%
South Africa	139,750	72.0%
Egypt	24,335	12.5%
Morocco	9,087	4.7%
Zimbabwe	7,972	4.1%
Nigeria	5,404	2.8%
Tunisia	2,303	1.2%
Botswana	1,269	0.7%
Cote d' Ivoire	1,165	0.6%
Mauritius	1,063	0.5%
Kenya	1,050	0.5%
Ghana	528	0.3%
Namibia	151	0.1%
Total	***194,077***	***100%***

Top African Stock Exchanges (excluding SA & Egypt)

COUNTRY	2001	%
Morocco	9,087	30.3%
Zimbabwe	7,972	26.6%
Nigeria	5,404	18.0%
Tunisia	2,303	7.7%
Botswana	1,269	4.2%
Cote d' Ivoire	1,165	3.9%
Mauritius	1,063	3.5%
Kenya	1,050	3.5%
Ghana	528	1.8%
Namibia	151	0.5%
Total	**29,992**	***100%***

Sources: Standard & Poor's, IFC, Emerging Africa, Ltd.

The African capital markets are small in world terms, as the total capitalization of the 12 largest stock exchanges in Africa was approximately $194 billion at the end of 2001. This is about 1.2% of the 2001 market capitalization of the NYSE of $16 trillion.

Egyptian and South African returns diverge from those of the rest of Africa

Overall, the total return of African Stock Exchanges (ex-SA, Egypt) increased 15.2% in 2001, while the return of the Egyptian Exchange negative 40% and the return of the South African Stock Exchange was negative 19%. This compares with a decline of the Dow Jones Industrial Average declined 7.1% in 2001. This divergence can be seen in 1997 through 2000 as well.

S&P/IFC Total Return Index % Change

	1997	**1998**	**1999**	**2000**	**2001**
Africa (Ex-SA, Egypt)	2.1	2.8	17.1	-7.1	15.2
South Africa	-11.5	-28.4	61.0	-14.0	-18.5
Egypt	23.6	-25.3	23.8	-41.8	-39.5

Sources: S&P, IFC

The divergence of returns experienced in Egypt and South Africa from the rest of the continent illustrates that one must analyze and view Africa (ex-SA, Egypt) differently. Additional evidence of this divergence can be seen by looking at the changes in market capitalizations in for the Egyptian, South African, and the remaining 10 largest African exchanges.

Market Capitalization % Change

	1997	**1998**	**1999**	**2000**	**2001**
Africa (Ex-SA, Egypt)	2%	11%	-4%	-11%	15%
South Africa	-4%	-27%	54%	-22%	-32%
Egypt	47%	17%	35%	-12%	-15%

Sources: S&P, IFC

Often when investors speak of "investing in Africa," they refer to only South Africa and Egypt, which together comprise 85% of the market capitalization on the continent. However, investors need to look beyond only South African and Egypt. Investors need to expand their horizons to the rest of the African continent in order to achieve diversification and attractive returns not available in other markets.

Sources of Investment in Africa

Historically, increased foreign cash flows and foreign direct investment (FDI) have resulted in more jobs, growing prosperity, and increased standards of living in the recipient country. Although FDI has traditionally been the major channel for such cash flows, stock markets have developed to provide a less expensive, more transparent, and more liquid mechanism for facilitating foreign participation in a country's growth. Conversely, private (non-public) investment provides a more expensive (due to greater transaction costs), less transparent, and less liquid mechanism for foreign investment.

Much of the expansion in the African stock markets is derived from local capital flowing in from retirement funds. Privatized firms listing their shares on local stock exchanges are also a source of the stock market expansion. There is evidence that some investment funds targeting Africa have retreated from investing due to recent market volatility. However, regional investment funds continue to provide an important source of capital to the African stock exchanges.

African Stock Markets have room to grow

A useful measure of the growth potential for a stock market is the "market capitalization to GNP ratio" for a country's stock exchange. For example, in 2000 the USA market capitalization to GNP ratio equaled 123%.

Africa's market capitalization to GNP ratio for the largest 12 markets equaled 72% in 2000. Excluding South Africa and Egypt, the market capitalization to GNP ratio is only 19%. This low capitalization to GNP ratio represents the tremendous growth potential for Africa's markets.

Market Capitalization-to-GNP Ratios in Africa

Country	2000 Market Capitalization (US $Millions)	2000 GNP (US $Millions)	2000 Market Cap/GNP Ratio
South Africa	204,952	131,127	156%
Egypt	28,741	89,148	32%
Morocco	10,899	34,998	31%
Nigeria	4,237	35,045	12%
Tunisia	2,828	20,944	14%
Zimbabwe	2,432	5,608	43%
Mauritius	1,311	4,244	31%
Kenya	1,283	10,368	12%
Cote d'Ivoire	1,185	11,206	11%
Botswana	978	5,996	16%
Ghana	502	7,774	6%
Namibia	311	3,075	10%
Total	**259,659**	**359,533**	72%

Sources: S&P, World Bank

Total African Market Capitalization represents 0.76% of World Total Market Capitalization

Specific Recommendations:

Recommendation #1: Advocate the development of Dow Jones Indexes for the African continent as a whole as well as for Africa's smaller stock exchanges.

The World Bank's International Finance Corporation (IFC) created the Emerging Market Data Base (EMDB) in 1981 to collect data for in-house use. In 1987, IFC began offering several country-specific indexes commercially to the investment community. Nigeria and Zimbabwe were the first African country's to have IFC indexes. In January 2000, the IFC sold the EMDB to Standard & Poor's. In 1995, indexes were added for 7 additional African country stock exchanges. Finally, in 1998 an index for the Namibia stock exchange was added. Although this information is useful and beneficial for the development of Africa's stock exchanges, the information is not widely disseminated and only available by subscription.

Conversely, Dow Jones indexes are widely disseminated in both the financial press (Wall Street Journal, Barron's, Smart Money magazine, etc.) and online. A Dow Jones "African" Index and individual African country indexes will provide numerous benefits: (1) increased visibility for African stocks and markets, (2) useful benchmarks for portfolio managers investing in Africa, (2) independent valuation and price levels for all investors.

Recommendation #2: Encourage development of Depositary Receipts for the largest publicly-traded companies in Africa.

Depositary Receipts (DRs) were created in 1927 to assist US investors that wanted to purchase shares of non-US corporations. Since that time, DRs have grown and enable issuers worldwide to access investors outside their home markets. DRs allow the non-US companies to (1) raise equity capital, (2) diversify and expand their shareowner base, (3) globalize their non-U.S. shares, (4) increase demand for their securities, and (4) improve their share valuation.

A DR is a negotiable certificate evidencing ownership of shares in a foreign corporation. Each DR denotes depositary shares representing a specific number of the underlying shares remaining on deposit in the issuer's home market. (For example, one ADR share of the South African mining company Avgold Limited represents 10 shares traded in South Africa.) The term "DR" is commonly used to mean both the certificates and the underlying deposited securities themselves.

DRs are quoted and traded in the currency of the country in which they trade, and are governed by the trading and settlement procedures of that market. (Thus, a fund purchasing an Avgold Ltd. ADR in the US would pay in US dollars and follow normal OTC settlement procedures.) The ease of trading and settling DRs makes them an attractive investment option for investors wishing to purchase shares in foreign companies.

Only a small number of African companies have established DR programs. A company needs to have an adequate amount of liquidity of their underlying shares as well as a certain minimum size market capitalization for a DR program to be viable. For example, some DR professionals believe that a minimum capitalization of US$50 million is the minimum size needed to launch a DR program. However, the annual trading volume of security (in both home market and the overseas DR market) is the most important determining factor.

Sprinkled throughout Africa is a stable core of consistently successful enterprises trading on the exchanges. We have classified those companies that have a market capitalization of greater than US$50 million as being African Blue Chips (ABC) companies that are candidates for DR programs. Although 42% of these are in South Africa, the remaining 58% are distributed throughout the continent. The table below shows the location of these ABC companies.

Encouraging DR programs for African companies will increase the visibility and viability of African investment opportunities. DR programs will provide an inexpensive and straightforward way to facilitate foreign investment in Africa.

Number of African Companies with Market Capitalization Greater than US$50 Million

as of 31 Dec 2002

South Africa	67
Zimbabwe	25
Morocco	16
Nigeria	15
Egypt	14
Tunisia	6
Botswana	5
Kenya	4
Mauritius	4
Cote D'Ivoire	1
Ghana	1
Total	158

Recommendation #3: Stimulate development of regional exchanges and even an "African Continental Exchange" to attract investment.

Many African countries are working to consolidate stock exchanges into regional markets. This consolidation is being done to better achieve economies of scale as the sustainability of smaller stock exchanges is still in question. For example, a regional exchange is functioning in Abidjan, Ivory Coast, offering securities of seven francophone countries. Also, a new regional stock exchange for Central Africa is being planned, serving Cameroon, Chad, Equatorial Guinea, Gabon and the republics of Central Africa and Congo. Finally, another regional stock exchange in East Africa serving Kenya, Tanzania and Uganda could be in place in the next year or so.

These regional stock exchanges will decrease trade transaction costs, increase availability and access to shares, increase liquidity, and attract investment. Stimulating development of these regional exchanges will benefit both investors and companies in need of equity capital.

It is also possible that a stock exchange can be created to link all of Africa. Such an exchange could operate in a manner similar to NASDAQ. Whether such an exchange links regional exchanges, individual country exchanges, or a combination of both isn't important. What is important is that new exchanges decrease the cost of transactions, increase availability and access to shares, increase liquidity, and attract investment.

Recommendation #4: Demand that governments and securities commissions in Africa promote corporate governance through both education and enforcement.

Effective corporate governance is a crucial factor for the successful operation of a company in a market economy. This market requirement has acquired increased attention from investors, financial institutions, stock exchanges and governments. Without an effective structure defining relationships between the Board of Directors, executive management and shareholders, growth of African companies and the African economy at large will continually be hampered by lack of capital.

At present, many African capital markets are in the early stages of development. The bulk of capital to fuel these markets needs to be obtained from foreign investors. In the past, foreign investors used to shut their eyes to the weakness of corporate governance in emerging markets. Today in Africa, due to the perceived high risk, investors have placed increased importance on corporate governance. For example, many investors demand board representation in proportion to their ownership. Periodic financial reports audited by independent accountants are not only a desire, but a requirement. In summary, in order for African companies to gain access to foreign investment, African companies need to adopt effective procedures of corporate governance.

Foreign investors will be highly unwilling to invest in African companies unless they feel convinced that their rights are safely protected. The risk experienced by investors today will remain very high as long as there is doubt that shareholders' rights are equitably protected.

Christian C. Johnson has worked in more than a dozen countries helping businesses in a broad range of industries. His work in Bosnia-Herzegovina and the former Soviet Union resulted in the launch and growth of several emerging-market stock exchanges. Mr. Johnson is an MBA graduate of Harvard Business School and a former US Naval Officer.

Thomas Mims has worked in Africa for twenty-five years as a consultant to the African financial community. He is the founder of Emerging Africa, which has for the past seven years been a third party contributor on Bloomberg (EAR <GO>) as a publisher of data and information from the African stock exchanges.