REFLECTIONS OF A VALUE INVESTOR IN AFRICA

By Francis Daniels

INTRODUCTION

My remarks cover the lessons from a personal investing odyssey spanning more than 15 years.[1] Today, Africa has a population estimated at 1 billion people. Its continental gross domestic product stood at \$1.6 trillion at the end of 2008, roughly equal to that of Russia, and its real average gross domestic product growth from 2000 to 2008 had been 4.9%. 18 of Africa's 57 states are democracies which conduct elections, whether fair or flawed. It is the home of 19 stock exchanges with an aggregate market capitalization exceeding \$ 700 billion. Its population is large, its economies small, and its capital markets are Lilliputian in size. Yet, despite the headlines of gloom, corruption, depravity, and disease supplied by a seemingly endless parade of African heads of government and non-governmental organizations, those African heads of state manufacturing misery and the non-governmental organizations marketing misery, the average African is no different from the stereotypical emerging market consumer garnering positive accolades from global investors. Quietly, Africa's economy and politics have changed sharply from the vista confronting me on August 16, 1982 when I left Ghana to study in Canada. Then, Ghana was enduring its 6th coup since 1966, had no stock exchange, and the Ghana government controlled the so-called "commanding heights of the economy" (gold mining companies like Ashanti Goldfields for example). South Africa was cordoned off from the rest of Africa by its policy of apartheid. I must confess that my attitude to the 6th coup was radically different from my view about Ghana's first coup on February 24, 1966. That first coup had the tremendous benefit of giving me an unexpected school holiday. It seemed a good type of political development to a child. By 1982, I was tired of coups and felt exhausted by Africa's seemingly perennial coups, corruption, and mediocre leaders. My father assured me that things which heat cool eventually, therefore Ghana would return to democracy. I did not believe him and left to get some education and experience outside Africa. Nine years later, I left the law firm-Milbank, Tweed, Hadley & McCloy-for which I worked in the early recession of the 1990s. In reflecting on my sentiments about this somewhat unsolicited turn of events, I realized that I had no appetite for risk or uncertainty. Yet, it intended to seek me out regardless of my wishes. I decided to learn to be comfortable with uncertainty by learning the craft of an investor in stock markets, while continuing to work as a corporate lawyer. My goal was amply

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satisfied as I experienced losses along with gains. I also discovered that the craft of investing was analytical, which was a pleasure for me.

I got hooked and decided to look for a place where, as a small retail investor, I would not be at a disadvantage to institutional investors. I decided to learn how to be a successful investor in Africa's capital markets. In the mid-1990s, I discovered Ben Graham and Warren Buffett. Their precepts of investing, with a margin of safety, seeking companies blessed with a predictable future, and the concept of the "float" seemed tailor made for the African investing landscape. The Chairman's Letters of Warren Buffett had the additional merit, like much of Jim Grant's writing, of evincing a distinct literary style in the course of providing financial instruction. I wanted to apply those precepts to African investing. My belief was that, as the home to the least developed economies, Africa, as a continent, was a predictable investing terrain. A continental portfolio would be more stable and less volatile than its parts. As the most capital starved continent, because of the depredations of numerous notorious African despots, it had to be a venue for investors to earn high returns on capital. There was latent demand for several goods and services, freely available on other continents, but either non-existent or in minuscule supply in Africa: for example, commercial banking, consumer finance, property and casualty insurance, life insurance, telephony, modern office buildings, and comfortable retail shopping experiences. Africa's natural resources, which had been explored and exploited in modest quantities in the 1980s and the 1990s when they tended to be in the custody of African states, promised great profit for investors willing to finance their entry into the streams of global commerce.

By 1998, when I moved to Johannesburg with my collection of Buffett Letters and Ben Graham books, I had graduated into a value investor with some African investing experience under my belt. By 2000, I had started to work with the collaborators with whom I would test and refine my beliefs about investing in Africa-Shingai Mutasa, then Executive Chairman of TA Holdings Ltd, in Harare, Zimbabwe, and Robert Knapp, then, a hedge fund manager at Millennium Partners, L.P. in New York and now the manager of Ironsides Opportunity Fund in Boston, USA. Robert and I have invested in every region of Africa. Shingai and I worked together in South, East, and West Africa. Since August 2007, the primary vehicle through which Robert and I have continued our investing work in Africa has been an investment company, the Africa Opportunity Fund (AOF LN), traded on the London Stock Exchange. My work with Shingai was more akin to private equity as we strove to reduce large debts at TA Holdings, slim its presence in 14 separate industries, and expand across Africa in the midst of a hyperinflationary tornado in Zimbabwe, its domicile. Most of my work with Robert took place in the secondary markets.

Over the ensuing decade, we have invested in distressed debt, local currency denominated African sovereign debt, listed equity, private placements of equity by mining development companies in advance of initial public offerings, subscriptions for negotiated corporate debt issues, and some arbitrage. My reflections will be in four parts: (a) my personal and hedge fund experiences; (b) Zimbabwe; (c) some investment ideas; and (d) lessons.

EARLY PERSONAL PORTFOLIO EXPERIENCE

My first application of Buffettian investing precepts was in a tiny property and casualty insurance company listed on the Ghana Stock Exchange, called Enterprise Insurance Ltd. ("Enterprise"). The oldest insurance company in Ghana, founded in 1924, its life reflected the turbulence of Ghana's independence history. Ghana's first government prohibited foreign insurance companies from insuring Ghanaian lives in 1965. So, Enterprise had to sell its life insurance business to a local competitor. In 1976, one of Ghana's military regimes had acquired a 20% stake. Its principal competitor, the State Insurance Company, was granted a monopoly over the provision of insurance services to state-owned or controlled companies in the 1970s. Throughout this period of expanding state control over the insurance sector and high inflation in Ghana, Enterprise earned underwriting profits. A powerful sign that the Ghanaian state was beginning a retreat from the "commanding heights" of Ghana's economy was the establishment of the Ghana Stock Exchange in 1990. Enterprise was one of the first companies to list on the Ghana Stock Exchange in 1990. The Ghana government sold its stake in 1994 and announced its intention to repeal the statutory monopolies granted to the State Insurance Corporation.

At the time of my initial interest, in December 1996, Enterprise had a market capitalization of 2.15 billion Cedis ($1.25 million). It was the second smallest company on the Ghana Stock Exchange and its largest shareholder, with 40% of its share capital, was the Guardian Royal Exchange Assurance Limited of England. No one published research about Enterprise in those days. Both Ghanaian inflation and interest rates were approximately 45% and had been rising rapidly for a few years, with the inevitable consequence that the Ghana Stock Exchange had declined in value. Ghana's Cedi had depreciated by 80% against the US Dollar from 1990, its current account deficit had hovered around 7% of Ghana's gross domestic product for the last few years, and gold, its largest export, was continuing its fitful decline to its post-1980 low of $252 per ounce in 1999. Ghana's macro-economy was in poor shape. Still, Enterprise caught my attention because it was in the insurance industry and had a history of reasonably stable net profits in US Dollars, despite the steep depreciation of the Cedi against the US Dollar.

In an era when African currencies seemed to be sinking currencies- against the US Dollar-rather than floating currencies, it was not easy to find financial service companies that could maintain their profits in US Dollars. I felt that members of the elite group of African companies able to maintain their profits in US Dollars deserved to be valued according to the Fed model, as if they were US Dollar denominated bonds, despite the turbulence of their surrounding political economies. Yet, Enterprise was trading on a P/B ratio of 1.07X and a P/E ratio of 2.24X (the reciprocal of an earnings yield of 44.66%).[2] It had a combined ratio of 80[3], a solvency margin of 55%, a nominal return on average equity of 56% (a real return on equity of 12%), and a nominal return on average assets of 18%. I used Geico as my global benchmark of financial excellence for a property and casualty insurance company. Geico's 1995 vital statistics were a combined ratio of 97, a solvency margin of 67%, and a return on average equity of 14%. By comparison, Enterprise's financial ratios were respectable. Enterprise Insurance had generated

[2] These ratios were based on the 1996 end of year results. The comparable ratios based on the 1995 results had been a P/B ratio of 1.54X and a P/E ratio of 3.96 (an earnings yield of 25.26%)
[3] The comparable 1995 combined ratio had been 87.

underwriting profits for decades, maintained about 10% of its policies in US Dollars, had a renewal persistency ratio exceeding 90%, and had its investment portfolio invested in high yielding Ghana government treasury bills and excellent companies listed on the Ghana Stock Exchange. As I wrote to some of my friends at that time: "As students of Warren Buffett's Berkshire Hathaway reports know, an insurance company that covers its underwriting expenses purely from its underwriting premiums is one whose shareholders borrow funds from the insurance policyholders at 0%. Even the Ghanaian banks have to pay depositors for their deposits." Enterprise was trading on a P/E ratio of 3X when insurance companies in Malawi and Kenya were trading on P/E ratios of 6X and 10X respectively.

A price/book valuation is only as good as the sobriety of values in a company's book. Some of the values underlying Enterprise's book in 1996 were sober in the extreme. For example, after purchasing its head office building in its entirety in 1994, it recorded the value of that building as 87.9 million Cedis (or $83,500) on December 31, 1994. But, Enterprise had acquired 26% of that building in the early 1970s before Ghana endured its bouts of triple digit inflation in the late 1970s and early 1980s. That 26% interest was kept in its books at the original Cedi cost, despite the Cedi having lost 99% of its exchange value against the US Dollar in the intervening 15 year period. Residential houses in the best part of Accra were more expensive than the cost of the head office of Enterprise maintained on its books.

A year after I made my initial investment in Enterprise, it revalued its head office building. The revaluation surplus[4] of that building alone equaled one third of the market value of Enterprise at the time of my initial investment.[5] But, there were more hidden treasures in Enterprise's book value. In those days, Enterprise recorded its investments at historical cost; not mark-to-market. Its long term investment portfolio was recorded in its book at a historical cost of 716 million Cedis ($408,000), with a footnote disclosing that the market value of the listed equities alone had a market value of 1 billion Cedis ($600,000). But, neither the original cost of those listed equities nor their identities were disclosed to enable a shareholder to identify the exact quantum of unrealized profit providing subterranean support for Enterprise's book value.   I picked up the telephone in New York to call its financial accountant in Accra. I found out the cost and exact composition of the listed equity portfolio. Imagine my delight to discover that 80.9 million Cedis ($46,000) was the historical cost of the listed equity portfolio, so that the unrealized gains were $552,828. Enterprise's investment portfolio represented 75% of its entire $1.25 million market capitalization. Consequently, its insurance operation was available in the market at a price of $306,342 when its underwriting profits alone were $186,995 and it had received dividend and interest payments of $472,507 in 1996.

It was obvious that Enterprise was a bargain. Its managers had done an excellent job of protecting its shareholders equity against the inflationary wolf by investing in listed equities and commercial property. Some protection against currency depreciation was provided by the denomination of some of its policies and premia in US Dollars. What was uncertain was whether it would retain its value under different inflation and monetary policy scenarios. Two scenarios were of particular concern. The first was one in

[4] 888,251,000 Cedis ($390,830[4]). I use the end of period 1996 exchange rate of 1754.39 Cedis/US Dollar set forth in the International Monetary Fund's 1999 International Financial Statistics Yearbook, page 461.
[55] The entire building was revalued as 1,005,560,000 Cedis ($442,446).

which Ghana endured negative real interest rates and the second was one in which Ghana experienced low single digit inflation, a là developed countries. I concluded that the first scenario was unlikely to happen for a long period of time because it would lead to a surge in Ghanaian inflation from its then high levels, jeopardizing the ruling party's electoral fortunes. To answer my second question, I recast Enterprise's income statements and balance sheets under the assumption that Ghana had maintained a currency board system akin to that of Hong Kong. Enterprise's net profits declined under those assumptions, but its shareholders equity and balance sheet increased in size because that shareholders equity did not suffer from currency depreciation. I concluded that Enterprise would thrive under the most likely alternative macro-economic scenarios, and therefore, its future was predictable to me. As Ghana's use of modern buildings, property, plant, and equipment grew, the premia received by the property and casualty industry were bound to rise, as a percentage of Ghana's gross domestic product. Furthermore, the Ghana government had repealed a monopoly granted to the industry leader-the State Insurance Corporation-so I could imagine that Enterprise, along with other privately owned insurance companies, would benefit from the new ability to seek business from state-owned companies. There was also the possibility of Enterprise re-entering the life insurance field. In fact, it did so in 2000, in partnership with Sanlam of South Africa and the International Finance Corporation to become the second largest life insurance company in Ghana. I was confident that Enterprise had a profitable future and it was deeply undervalued. What has happened since my initial purchase of Enterprise shares in December 1996? The shareholders equity of Enterprise Insurance, without the issuance of new capital, has grown, from $1.246 million in December 1996 to $24.3 million by June 2010, despite the Cedi depreciating by 88% against the US Dollar over the intervening period. My overall investment grew by 1,750% in US Dollars over my 13+ year experience as a shareholder of Enterprise.

EARLY HEDGE FUND EXPERIENCE

Robert first's foray into Africa was to purchase shares of Enterprise Insurance, for his private account, on my recommendation in early 1998. His first investment in Africa for his hedge fund was in September 1999 when he started acquiring the ordinary shares of Ashanti Goldfields Ltd. ("Ashanti") in the midst of its infamous hedging crisis. Ashanti was Ghana's oldest and biggest company. Its two biggest shareholders were the Ghana Government and Lonmin. I had recommended Ashanti to him at the end of 1998 because its shares in Zimbabwe traded at a steep discount to the New York and London prices of those shares. Ashanti's shares were priced at $1.71 at the end of 1997 in Harare when they traded in New York for $8.13 per share. The reason for Harare's 78% discount was that Ashanti's Harare shares were maintained on a separate register from the shares listed on other exchanges to satisfy Zimbabwe's exchange control regulations. In any event, Robert started buying Ashanti shares for his hedge fund when its New York share price dropped below $4 or thereabouts. At the time, it was a dividend paying stock. It was obvious that its days as a dividend paying stock ended with its hedging crisis, a prospect which he disliked. In our e-mail exchanges he expressed his dislike, which led us to Ashanti's 5 ½ % exchangeable notes due March 2003. Their right to convert into Ashanti shares at a price of $27 were worthless, but they were trading in the 60s, to yield approximately 30%. It appeared clear that Ashanti would have to restructure those notes because it did not have the cash to redeem them at par. But, in the meantime, Ashanti would service the notes. Robert took a position in them and, in due course, an ad hoc committee was formed. Robert became a member of the committee and asked me to serve as his legal adviser. The notes got redeemed at par in 2002, several months ahead of schedule. Then, Robert increased his investment in Ashanti's ordinary shares because its share price in 2002 did not react much to the note redemption.

Ashanti was noteworthy for us because its fate was a matter of intense political significance in Ghana as we sought to publicize our views about Ashanti's prospects. Grant's Investor, for example, featured the Ashanti notes in issue entitled "Golden Yields, Part II", with Robert appropriately extolling their virtues and creditworthiness, in its March 30, 2001 issue. At my end, I adopted the pseudonym "Uncle Kwesi Mensah"-a deceased grand uncle who had the distinction of being the Gold Coast's first indigenous mining engineer-to write articles which were published in the Ghanaian newspapers challenging publicized government views about Ashanti's future strategy. I also wrote articles under my own name for an African financial publication, based in London, about Ashanti. My favorite was entitled "The Rumble of the Morila Gorillas" comparing the competing bids of Anglogold and Randgold to acquire control of Ashanti in 2003. I treated Randgold as Mohammed Ali, the underdog, and Anglogold as George Foreman. Unsurprisingly, I predicted that Randgold would knock out Anglogold's bid. My journalistic efforts resulted in an October 2003 invitation from Anglogold for me to visit their deep underground mines and from Ashanti to visit their flagship mine-Obuasi-to determine whether my views were justified. The upshot of those visits was the last series of articles from Uncle Kwesi Mensah outlining a framework to assist Ghanaians assess the Anglogold and Randgold bids. Ashanti got acquired and Robert earned approximately 100% return on his Ashanti equity investment.

Dyed in the wool classic value investors may be wondering, at this juncture, how I can be discussing value investing in the mining area. After all, Ben Graham's original 1934 treatise on value investing devotes a grand total of 11 out of 616 pages to mining companies.[6] On a continent famous for large natural resources, a value investor has to figure out how to apply the essence of value investing-buying assets at a material discount to intrinsic value-in the natural resources dominated continental economy. Consequently, the best South African value investing funds have developed an ability to work in natural resource industries. In many ways, similar to funds in countries like Canada and Australia. The rediscovery of Africa as an exploration destination in natural resources created a challenge of extending value investing precepts to the world of exploration companies. Advising Robert compelled me to expand my mining investing experience from the assessment of mining producers to mining development companies.

One fine day, in late June 2005, Robert asked me whether I had the time to visit the virtual data room of a 6 month old uranium development company. Thus started a two year experience culminating in our respective best investment—Robert's fund's investment in Uramin. Robert's original thesis was that listed uranium development companies and producers were exploding in valuations because of the rising uranium price. Yet, unlisted uranium development companies were still valued at deep discounts to their listed peers. Therefore, it was possible to invest in a private uranium development company

[6] Benjamin Graham and David Dodd, Security Analysis, 1934 editions, pps 51, 369, 396, 420-422, 442-447

ahead of its listing and benefit from the value created by its listing. The intellectual puzzle for me was how to obtain a high measure of confidence in the underlying value of that private company.

Uramin was presented as an attractive investment opportunity based on its exploration concessions in Namibia and South Africa. After reading the actual original exploration reports by reputable companies such as Esso from the late 1970s and 1980s, I was left in little doubt that the Namibian property had uranium. In the case of South Africa, I feared that the grant of prospecting rights over the South African deposits would be delayed by the need to comply with South Africa's black economic empowerment regulations. Thus, my value approach was to assess Uramin solely on its Namibian assets, with the South African prospects providing a margin of safety. Even though the reports had been prepared before the current regulatory rules for reporting mining resources and reserves, I took comfort from the reputation of the old explorers, coupled with the considerable amount of detailed drilling data contained in those reports-the spacing of drill holes and the adoption of plans to commence trial mining. These deposits had been orphaned by the collapse in the uranium prices in the early 1990s. In addition, metallurgical techniques, such as variants of leaching, had been developed in industries like the gold industry for processing marginal orebodies that could be applied to uranium mining. By comparing the proposed investment price against the valuations accorded to listed peers, I concluded that the price of the specific financing round in Uramin was cheap. Then, I joined the board of directors of Uramin. It has to be disclosed that I had no forewarning about the spike in uranium prices following the flooding of Cigar Lake in Canada. The investment in Uramin exceeded our highest expectations. $13.9 million mushroomed into $131 million. We got a 10X return in 2 years. But, I came to realize that value investing could be extended by analogy to development companies. Of course, mining and oil and gas exploration are fields for probabilistic assessment; not investing certitudes.

I would like to end this part of my reflections by sharing our experience in investing in a large cap South African company-African Bank Investment Limited ("ABIL") in 2002. ABIL's share price had declined from a high of 26.63 Rands in August 1998 to the 7-5 Rand range when we started our investing. ABIL was the largest "micro-lender" or consumer finance company in South Africa, granting loans of an average size of 3600 Rands (or $400) for terms ranging from 2 months to 44 months at interest rates hovering around 38%. It was an extremely liquid security with 71% of the shares in issue trading in 2001 and it was available at a steep discount to its intrinsic value. Africa Opportunity Fund, owns shares of ABIL. The US Dollar total return on an investment in ABIL from March 2002, when Robert started acquiring ABIL equity, followed subsequently by its bonds, to September 2010, has been approximately 2,005%. Micro-lending was, and remains, a controversial industry in South Africa because its operators extend credit at high interest rates. The closest analogy to them in the United States might be payday lenders. It was fashionable then for commentators to describe it as morally scandalous because it had an exemption from the usury limits permitting its operators to provide high interest rate loans to people of modest incomes. I had a different take. As I described it in 2002 to Robert: "To me, the question is what is the implied interest rate for a person who is denied 100% access to credit? An infinite interest rate, as far as I can tell. For purposes of calculation, I would say at least several thousand percent. Is a usury limit of 25% per annum not equivalent to an infinite interest rate if the big established banks of South Africa are unable or unwilling to lend money to a poor black person at rates equal to or less than the usury limit? So, to lend to that person at 40% for six months, when no one else is willing to lend that person money is offering that person a cheaper choice of credit."[7] Black and other previously disadvantaged South Africans had been extremely limited in their access to credit under apartheid. The largest single category of credit in South Africa is mortgage finance. Black South Africans were excluded from that category for decades under apartheid rules that prohibited black South Africans from owning property in urban areas. So, unlike payday lending, which, arguably, is for subprime borrowers, micro-lending made credit available to entire groups of people, without regard to their personal credit histories. They tended to have little to no history and a period of high pricing for all and sundry was the price those groups had to pay to entice lenders to develop the credit-scoring data which would, in time, enable discrimination among the micro-lending customers.

ABIL's share price had collapsed because the micro-lending industry had focused on extending credit to government employees since their wages could be debited electronically, thus eliminating default risks. The South African government eventually and unexpectedly prohibited that industry from granting credit to government employees unless they had signed various agreements with the South African government putting limits on bad collection practices. Micro-lending's high valuations collapsed. Just as they were beginning to recover at the beginning of 2002, two of the three largest micro-lenders collapsed because they had borrowed call deposits and short-term deposits to fund their micro-loans. Valuations collapsed again. ABIL, I noticed, was different because it borrowed long to extend short-term credit. Yet, it was valued in the same manner as its peers with the opposite funding strategy. Furthermore, the Rand had collapsed in value against the US Dollar. ABIL's strategy has been to reduce its operating costs per loan, enabling it also to gradually increase its use of leverage, and to share most of its constantly declining costs with its customers, thus leading to a growing book of borrowers. ABIL earned the trust of the market over a few years and Robert and I were able to enjoy the revaluation arising from ABIL's growing trustworthiness. Despite the nice return garnered by ABIL shareholders, it remains undervalued today because it entered the furniture retailing market a few years ago. It paid too handsomely for South Africa's largest furniture retailer-Ellerines Holdings-just as the South African consumer was about to experience a decline of income and borrowing capacity. Its intention was to use Ellerines to grow its loan book by offering cheaper loans to a larger group of borrowers. But, we believe that its intrinsic value per share is about 20% higher than its current share price.

INVESTING CRITERIA FROM EARLY EXPERIENCES

Value investing accords primary weight to specific audited information of companies. Macro data tends to be of lesser importance. My approach is to invest in companies that both have a record of maintaining their earnings in US Dollars and an earnings yield (the reciprocal of the P/E ratio) equal to or higher than the longest-dated government bond yields in the domiciles of those companies. It is a simple Fed model, with two qualifications. My strong preference is to invest in sectors that will expand in Africa at growth rates higher than African gross domestic growth rates. Financial services is one such sector. Second, I am uncomfortable accepting earnings yields lower than 10% in Africa. Money supply data, electoral cycles, weather patterns, macro data in a country enable me to form a sense of the

[7] African Bank: To Micro-lend or not to Microlend., paper of May 2002 by Francis Daniels

appropriate cost of capital for that country at specific point in time and the industries to avoid. My approach for natural resource companies with wasting assets is different. I attempt to ascertain the net asset value of the deposits exploited or explored by a company, based on current spot prices for the particular commodity, and invest if the enterprise value of that company is significantly lower than that net asset value. My strong preference is for large low cost deposits. Whatever the type of investment, a margin of safety is necessary.

SURVIVING THE ZIMBABWE HYPERINFLATIONARY TORNADO

The acid test of predictability came from my experience of investing through hyperinflationary Zimbabwe. If an investor could anticipate Zimbabwean hyperinflation and make profitable investing decisions based on that anticipation, then that experience should constitute powerful evidence in support of the proposition that Africa is a predictable investment destination. To anticipate the eventual emergence of Zimbabwean hyperinflation and to make profitable investment decisions, I had to compare its political and monetary environment with similar environments on other continents in ancient and modern times.

It is a notorious fact that Zimbabwe suffered the first case of hyperinflation during the 21st century. Its inflation rate peaked in September 2008 at 556 billion (10^9) percent. By the end of its life as a currency, 35 quadrillion[8] Zimbabwe Dollar equaled $1.[9] Zimbabwe's gross domestic product declined by 40% from 1999 until 2008.[10] Its gross domestic product declined by 14% in 2008 alone and its current account deficit, as a percentage of gross domestic product, was 28%, a rate which might have invited looks of envy from the likes of Iceland—Iceland's 2006 and 2007 current account deficits were mild by comparison. Could such an environment possibly be hospitable for a member of the value investing community? In fact, it turned out to be so for a few members. My tale is one such account. It is also a tale of ordinary African businesspeople surviving by both anticipating the likely actions of African politicians and trying to run their businesses with a modicum of competence.

Zimbabwe endured high inflation for several years before the onset of hyperinflation. By January 2004, the Zimbabwean annual inflation rate was 622.8%, declining to 251.5% by September 2004. The December 18th, 2003 inaugural monetary policy statement of Dr. Gideon Gono, the current Governor of the Reserve Bank of Zimbabwe, set forth an inflation target of 200% for December 2004, with 7-9% annual inflation by December 2006 and 5-7% annual inflation by June 2007.[11]

In October 2000, I became a director of TA Holdings ("TA"), listed on the Zimbabwe Stock Exchange as a conglomerate.[12] Its current chairman, Mr. Shingai Mutasa, had acquired control of TA in November 1997 through Zimbabwe's first proxy fight. His mission was familiar to members of this audience: reduce TA to a few industries to increase its value to long-suffering shareholders. His program was the

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[8] In US terminology, 1 quadrillion is a trillion trillion.
[9] Zimbabwe : Challenges and Policy Options After Hyperinflation, by Vitaly Kramarenko, et. Al, p.3 (2010)
[10] International Monetary Fund, 2009 Zimbabwe Article IV Staff Report, page 5.
[11] Dr. Gideon Gono, Governor of the Reserve Bank of Zimbabwe, Monetary Policy Statement, October 2004.
[12] TA was founded in 1935 as a tobacco auction house. During the era of sanctions against Rhodesia, it had expanded into several different industries, at one point holding investments in 14 different industries.

familiar one of asset disposals to retire debt. Its enterprise value on May 31, 1997, before the proxy fight, had been $46.5 million, of which $27.4 million constituted its market capitalization and $12.5 million was in the form of floating rate short term bank debt. The Zimbabwe Dollar fell from Z$11.4/$1 just before the TA proxy fight to Z$18/$1 by the end of November 1997. Nominal interest rates started to soar to control the inflationary effects of a 58% decline in the external value of the Zimbabwe Dollar. His program ran aground in the shoals of Zimbabwean macro-economic turmoil because asset prices collapsed in a rising nominal interest rate environment while the stock of TA's debt rose several fold. By December 31, 1998, TA's enterprise value had risen in Zimbabwe Dollars, but collapsed in US Dollars to $24.1 million. Its market capitalization was $2.7 million and floating interest rate short-term debt was $20 million.

Zimbabwean inflation, then, was 55% per annum and the Zimbabwe Dollar had declined by 71% against the US Dollar from Z$38 to Z$65 to the US Dollar.[13] TA's share price in US Dollars had risen from 5 US cents (Z$3.5 or $0.05) on December 31, 2000 to $0.58 by December 31, 2009. Today, its share price has dropped to $0.24. TA's market capitalization rose from $ 8.5 million to $95.6 million over the same period. In 2000, it traded on a Price to book ratio of .52X and a Price-Earnings ratio of 13.6X, had a nominal return on equity of 4.4% and an inflation-adjusted return on equity of -51.5%. By 2009, it was trading on a Price to book ratio of 1.6X and a negative Price-Earnings ratio because of losses. It had been rerated by investors on the Zimbabwe Stock Exchange.

Zimbabwe was in deep economic and political crisis in 2000. It had experienced two violent elections and was defending the government of the Democratic Republic of the Congo against invasions from other African countries. Its so-called land reform program had commenced. Zimbabweans had tired of high inflation and desired to experience low inflation. How to attain that desire was the challenge. Since TA was extremely vulnerable to the monetary consequences of the Zimbabwe government and central bank arresting high inflation-to wit, high nominal interest rates—it was vital to understand whether and how politicians would arrest inflation. It seemed to me that the high inflation had its roots in political decisions. Thus, I set myself the assignment of imagining that I were an advisor to President Mugabe to anticipate possible policies. As an imaginary advisor, I tried to discern the rationality of Zimbabwean governmental actions from the perspective of a ruler determined to retain power. What would the government need, no matter what? What were the practical limits of its power?

I started my assignment by recalling a comment by Alexis De Tocqueville about the 1848 revolution in France. A propos of those revolutionaries, he had written: "they gullibly imagined that to summon the people to political life was enough to attach them to their cause; and that, if they gave the people rights but no advantages, it was enough to make the Republic popular. **They forgot that their predecessors at the same time that they gave every peasant a vote did away with tithes, abolished the *corvee* and other seigniorial privileges, and divided the nobles' land among their former serfs**....to commit acts of violent injustice, it is not enough for a government to desire them, or even to have the ability to do

[13] The consumer price index released by the Central Statistical Office of Zimbabwe for 1999 was 1188.2 and was 1844.2 for 2000. The exchange rates were Z$65/$ and Z$37.95/$ in 2000 and 1999 respectively. See TA 2000 Annual Report of TA, pages 40 and 44.

them; **it is essential that the mores, ideas, and passions of the time lend themselves to the enterprise.**"[14] Like the 1789 French revolutionaries, President Mugabe had to provide Zimbabweans with "advantages". White-owned commercial land, latter-day "nobles' land", constituted the "advantage" which would give meaning to the "right" of Zimbabwean independence.

To this day, I am yet to encounter an indigenous Zimbabwean who disagrees with the goal of land redistribution out of which small scale black farmers are supposed to emerge. An aspect of Zimbabwean business executives which had struck me as unusual was that a high percentage of those I met owned farms. Only 37% of Zimbabwe's population is urban; therefore, the fate of electoral democracy is determined in the rural areas. Buying the vote of the indigenous rural farmer by land dispossessions made eminent electoral sense. The role of intimidation by President Mugabe's supporters was captured for me in the words of the late Nobel-laureate of economics, W. Arthur Lewis: "**Politics is rough** in West Africa. Every party attracts its fringe of hooligans, unimportant numerically, but highly important tactically. They become bodyguards; they rough up party opponents and intimidate waverers. In areas where chiefs are still powerful, their police do the same. To launch a new party in somebody else's area is a formidable exercise."[15] I concluded that land reform was irreversible and that the violent disruptions of commercial farming were a lot more popular than it appeared in the press. In essence, President Mugabe would be as successful as the 1789 French revolutionaries in using land gifts to increase his rural electoral base.[16]

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[14] Alexis de Tocqueville, Recollections, p.122,123 (Anchor Books, 1971).

[15] W. Arthur Lewis, Politics in West Africa, p.17 (George Allen & Unwin, 1965)

[16] For contrasting behavior of a statesman, not subject to electoral pressures and blessed with wealthy friends, see Cicero, On the Good Life, Penguin Classics, (1987), translation of Michael Grant, pps. 166-167, about Aratus of Sicyon who represented individuals who had been dispossessed of their land several years before his seizure of power in 251 BC. Aratus obtained a large financial subsidy from Ptolemy of Egypt to offer cash settlements to some of those individuals as compensation for the loss of their land and to acquire land from some of the then current landowners. In the words of Cicero: "the question of property ownership involved him in great difficulties. For, on the one hand, he regarded it as entirely unfair that men he himself had brought back from banishment, men whose lands had previously been occupied by other people, should be left in want. On the other hand it also seemed by no means just to disturb tenures that were already fifty years old. Besides, during the course of that long period, many estates had been transferred quite innocently into other hands, through inheritance in purchase or dowry. Aratus therefore decided that, whereas it would be wrong for the present occupants to be deprived of their estates, the former owners must receive something in exchange. However, to deal with this situation, money was obviously required…..Ptolemy, whose resources were enormous, readily agreed to give him the substantial subsidy he wanted. With this in hand, Aratus returned home, and set up a commission consisting of fifteen leading men of the city. With their assistance he examined the cases of both types of person, those who were occupying property that rightly belonged to someone else, and those who had been deprived of their possessions. Aratus ordered that valuations should be made of all the estates concerned, and finally managed to persuade some of the occupants to leave their lands, and accept compensation instead. At the same time he convinced a number of his own followers that it was in their own interest to accept a good cash sum rather than receive their original holdings back. And so everyone concerned was satisfied, and harmony had been successfully re-established. Aratus was a great statesman; he deserved to have been a Roman!...Aratus the Greek, on the other hand, like the wise and admirable man he was, considered it his duty to work for the interests of *every* class in his community. And, indeed, that is the real sign of a right-minded citizen's statesmanship and wisdom—not to allow the special interests of different groups to be at variance with one another, but to unite the entire community without partisanship."

White farmers in colonial times had acquired the best rain- fed land for growing maize and tobacco[17]. The indigenes were relegated to the poor and scrappy land. Since many of them were reluctant to become farm workers, Rhodesia imported farm workers from other African countries like Malawi, Zambia, and Mozambique.[18] Although in time, those workers were accepted as Zimbabweans and learnt to speak Shona, in Marxist terminology, they were a rural proletariat, surrounded by indigenous Zimbabwean peasants. From the perspective of mobilizing a rural electorate, they fell beyond the control of Shona chiefs. Like ward heads in Chicago or the South, chiefs in Africa deliver the votes of their rural subjects. As land seizures spread and white farmers resisted the loss of their principal capital assets by joining and funding the Movement for Democratic Change ("MDC") led by Prime Minister Morgan Tsvangirai, I believed that the farm workers were likely to support the political preferences of their employers, if for no other reason than to keep their jobs. Consequently, accelerating land seizures, combined with acts of intimidating, brutal, and harrowing violence, had the benefits of disrupting funding for the MDC and reducing its rural electoral base. But, it came at a remarkably high cost.

I doubted that President Mugabe would be as successful as those revolutionaries in maintaining national farm production. In the case of France, existing experienced peasant owners of land received more land. Zimbabwe was different. It is a semi-arid country. White farmers had improved the productivity of that land, introducing irrigation and several other agronomic improvements. It has to be said that white Zimbabwean farmers were excellent large scale commercial farmers. Indigenous Zimbabwean farmers who had been restricted to practicing subsistence farming on inferior lands anticipated a jump in their income from working their new large scale farms. Personal improvement for the indigenous Zimbabwean peasant was bound to lead to a collapse in national output, agricultural foreign exchange earners like tobacco, and tax revenues. It would win votes and destroy US Dollars in the ground.

Electoral victory, through land dispossessions, was akin to dropping bombs on Zimbabwe's agricultural export sector. Thus, a foreign war in the Democratic Republic of the Congo was succeeded by an economic civil war. I noticed also that Zimbabwe had run a current account deficit since its 1980 independence, funded in great part by multilateral loans and foreign aid. Aid and multilateral loans were curtailed. So, I foresaw that Zimbabwe's foreign exchange earnings were likely to decline. Its manufacturing sector, which relied on Zimbabwean produced agricultural inputs, would weaken because of declining agricultural production. Taxes, in turn, would decline.

Niall Ferguson's book, The Cash Nexus, published in 2001, had statistics about central government budget deficits as a percentage of gross national product during war and the funding of those deficits. Although Zimbabwe's national budget deficit as a percentage of its gross domestic product in the wake

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[17] Maize, tobacco, horticulture, wheat, barley, potatoes, sunflower, and livestock were cultivated and reared on large farms. Cotton and maize were cultivated by communal farmers or peasants.

[18] "Labour for Southern Rhodesia was once secured through the Rhodesian Native Labour Bureau…The territory is largely dependent on outside labour; at the time of the 1936 census, of the number of nativs in employment 42.5 per cent were of Southern Rhodesian origin; 28 per cent were from Nyasaland; 18.5 per cent from Northern Rhodesia, and 10 per cent from Portuguese territory." An African Survey, p.653, by Lord Hailey (Oxford University Press, 1938)

of the land invasions did not approach the British First and Second World War ratios of 35.9% and 30.9% until the last year or so of its hyperinflationary episode, its methods of financing hinted at its vulnerability to that disease. Zimbabwe relied on treasury bill financing and medium term bond financing. Issuing bonds for a term of more than 5 years was quite rare, so it had to rely from time to time on its central bank buying those bonds. The inflationary vulnerabilities of short-term financing of war debts was captured by Mr. Ferguson in the following words: "This was the real difference between British and continental war finance. On average, only 18 percent of the British wartime debt was short-term. The United States, which spent in relative terms less on the war, was unique in being able to rely almost entirely on long-term bonds…In particular, central banks which were statutorily obliged to discount short-term treasury bills simply monetized short-term debt, leading to considerable inflationary pressures during and after the First World War."[19] Reducing a country's production capacity, along with reducing its physical production of goods and supply without reducing money supply, it seemed to me, would lead to rising inflation, whatever the governor of the Central Bank said. Central bank purchasing of escalating amounts of government debt, whatever the name of that policy, was bound to lead to rising inflationary rates of either consumer prices or assets or both. I saw none of the stigmata of tightening monetary conditions: positive real interest rates or high deposit requirements for mortgages, to mention two examples.

Rising inflation had to end in hyperinflation[20], a lá Latin America, if President Mugabe and the ZANU ruling party remained in power. This conclusion about hyperinflation was not self-evident as late as 2004. After all, the Governor of the Reserve Bank of Zimbabwe boasted in October 2004 about how the annual inflation rate had declined from 622.8% in January 2004 to 251.5% by September 2004.[21] He had announced a target in December 2003 for inflation to glide gently to single-digit inflation by mid-2006. He seemed to be ahead of his targets by September 2004 when monthly inflation had declined from 33.6% in November 2003 to 5.9% in September 2004.[22] Yet, risk-free lending rates were very negative in real terms and the government and the state-controlled sector of the Zimbabwean economy had access to foreign exchange at privileged overvalued official rates, which had the consequence of creating very loose financial conditions for the government sector, financed in part by harsh financial conditions suffered by the private sector. I had only one difficulty with Dr. Gono's promises to destroy inflation. A gentle gliding death was not how hyperinflation had ended in Latin America and other countries. The disease seemed to end with a short sharp collapse because the old currency was abandoned in droves.

Were there practical limits to the power of the Zimbabwean government respected by the Zimbabwean government and its ruling party? I concluded that there were limits insofar as that government could

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[19] Niall Ferguson, Money and Power in the Modern World, 1700-2000, The Cash Nexus (Basic Books, 2001), pps 118-119.

[20] Hyperinflation was defined by Phillip Cagan as beginning in the month the rises in prices exceed 50 perent and ending in the month before the monthly rise in prices drops below that amount and stays below for at least a year. Cagan P. 1956. The monetary dynamics of hyperinflation. In *Studies in the Quantity Theory of Money,* ed. M. Friedman, Chicago: University of Chicago Press. Cited in McIndoe, T. Hyperinflation in Zimbabwe, Money Demand, Seigniorage and Aid shocks, March 13, 2009.

[2121] Monetary Policy Review, October 2004, by Dr. Gideon Gono, Governor of the Reserve Bank of Zimbabwe.

[22] Monetary Policy Statement of October 2004, paragraph 5.2, p.41.

not seize foreign exchange earned outside its borders. An example, which would provide an investment opportunity discussed later in these reflections, was the difference in the fates of the gold and platinum industries of Zimbabwe. Zimbabwe produced 24.9 tonnes of gold, [23] 60,000 ounces of platinum and 9,000 ounces of palladium in 2000.[24] By 2009, gold production was down to 9.1 tonnes while platinum and palladium output were 229,000 ounces and 177,000 ounces respectively.[25] How could gold production decline by 63% at the same time as platinum and palladium production soared by 282% and 1,867% respectively? The answer was that Zimbabwe's platinum mines produced a matte which was of no commercial use in Zimbabwe while the gold mining industry's output had commercial value before it was exported outside Zimbabwe. Zimbabwe had no choice but to allow its platinum and palladium matte to be sold to Impala Platinum in South Africa for foreign exchange that would be released by Impala Platinum to the Zimbabwean government on terms that complied with existing agreements between the Zimbabwe government and the subsidiary of Impala Platinum, Zimplats. Only after refining by Impala Platinum would Zimbabwe's raw material command a commercial value. If the Zimbabwe government failed to abide by its agreements with Zimplats, it would not get any foreign exchange, a precious commodity in its eyes.

A great amount of time in the TA group of companies was spent debating the possible end of a condition which was new to all the directors and senior management of TA. In the meantime, TA's consolidated balance sheet was enduring considerable pressure. What to do? In principle, it seemed that there were a few ways to survive: (a) find ways of borrowing money at negative real interest rates; (b) invest in non-Zimbabwean dollars; or (c) invest in tangible assets impervious to hyperinflation. TA tried all three methods. By 2003, TA shifted its focus more and more to the second and third method of hyperinflationary survival. It started to invest in non-Zimbabwean Dollars in earnest.

One of its major steps to invest in non-Zimbabwean assets arose from the September 11, 2001 attack on the World Trade Center. St Paul Fire and Marine Insurance Company, of Minnesota, had suffered losses from the damage caused by the World Trade Center bombings. It owned the largest property and casualty insurance company in Botswana-Botswana Insurance Company ("BIC"). In response to its September 11 losses, St Paul decided to sell many of its foreign subsidiaries, including BIC. BIC had approximately 40% of the property and casualty insurance market of Botswana and a history of profitable underwriting. Botswana was the opposite of Zimbabwe in several respects: it had low inflation and was a peaceful democracy. Not only did it have a credit rating from the credit rating agencies, it had the highest credit rating in Africa. So, TA, through foreign associates, joined forces with local businessmen to buy BIC at book value. Then, it set about the task of growing BIC.

St Paul's investment policy for BIC had been one of combining BIC's assets with those of other St Paul companies and investing them in safe American bonds. That investment policy had led to material foreign exchange losses in 2003 because the Rand and the Pula (Botswana's currency) were both appreciating against the US Dollar. Furthermore, it seemed illogical for the policyholders of a relatively

[23] GFMS, Gold Survey 2004, table 3, page 37.
[24] GFMS, Platinum and Palladium Survey 2004, Appendices 1 and 2
[25] GFMS Gold Survey 2010, table 5, page 41. And GFMS Platinum and Palladium Survey 2010, Appendices 1 and 2.

poor country like Botswana to be lending scarce capital at negligible rates to the wealthiest government and people on earth. TA decided immediately that BIC should shift its investing terrain to Africa. I was asked to supply the initial ideas because it was known that I had some experience of investing in African stock markets. We studied the annual reports of Berkshire Hathaway, Markel Corporation, and a few other American insurance companies to figure out how to avoid asset-liability mismatches and satisfy the liquidity needs of BIC. Then, we dived into investing in African equities in Botswana, South Africa, Senegal, the Democratic Republic of the Congo, Egypt Uganda, Tanzania, and Zimbabwe. The results were satisfactory in US Dollars: 96%, 33%, 17%, and 39% between 2004 and 2007. TA's investment in Botswana Insurance Company proved very rewarding. BIC's shareholder equity immediately after TA's acquisition of control in September 2003 was $7.9 million. By December 2009, it had risen to $21.7 million after paying the following dividends: $2.3 million (2009 dividends); $2.4 million (2008 dividends); $2.4 million (2007 dividends); $ 4.2 million (2006 dividends); $ 3.9 million (2005 dividends); $1.3 million (2004 dividends). The total return on that September 2003 shareholders equity was $30.3 million. Its 2009 solvency margin of 103% bespeaks a focus on substantial capital strength.

In Zimbabwe, TA's insurance subsidiaries tried to invest as much as possible in equities and went the extra step of keeping their liquid assets in equities rather than cash or government debt instruments. There was one equity listed on the Zimbabwe Stock Exchange which served as foreign currency and a profit-generating investment: the ordinary share of Old Mutual which was also listed in the United Kingdom, South Africa, Namibia, and Malawi on the same share register. The Old Mutual shares traded on a persistent discount in Zimbabwe from the share prices on other exchanges, despite their sharing a common shareholders register. Thus, the degree of discount, varying daily, became a de facto measure of the actual external value of the Zimbabwe Dollar. Better still, an investment in Old Mutual was an investment in non-Zimbabwean assets. TA's insurance subsidiaries began to focus their investing in Old Mutual shares and Zimbabwean exporters-Bindura Nickel or Rio Zim, for example, which earned hard currency. We felt that the short term lack of visibility of earnings growth in a hyperinflationary storm was compensated by the certitude that foreign currencies would remain in great demand in Zimbabwe and that buildings would survive that storm. Whenever possible, TA and its insurance subsidiaries tried to acquire more of those assets. It bought Swiss Re's reinsurance book as it left Zimbabwe and it purchased AIG's property portfolio by merging AIG's Zimbabwean subsidiary with Zimnat Lion. Zimbabwean Dollar denominated debt was avoided like the plague.

TA was a member of the class of Zimbabwean domiciled companies with substantial non-Zimbabwean foreign exchange earning assets. The significance of the non-Zimbabwean location of those assets is that TA did not have to sell their foreign exchange earnings to Zimbabwe's Reserve Bank at confiscatory overvalued exchange rates. Ironically, the companies with the greatest ability to earn foreign exchange free of the clutches of the Reserve Bank of Zimbabwe operated exclusively in Zimbabwe. They were platinum mining companies-Zimplats, listed on the Australian Stock Exchange, and Mimosa, owned by Aquarius Platinum and Impala Platinum.

I made a firm recommendation to Robert in early 2003 to buy the shares of Zimplats. My investigations had revealed that Zimplats did not produce refined platinum and palladium. Rather, it produced an intermediate product, called a matte, which had to be sold to a member of a refining oligopoly in South

Africa before it could receive US Dollars or Rands. Zimbabwe had no refinery. Impala Platinum of South Africa, the 2nd largest producer of platinum in the world, and the purchaser of Zimplats' output under off-take agreements was also the 87% shareholder of Zimplats. I thought it unlikely in the extreme that Zimplats would suffer from the misfortunes of most other Zimbabwean companies because Mugabe could not lay his hands on its foreign exchange earnings without the support of its largest shareholder. We discussed it on and off throughout that year, but he rejected my recommendation because Zimplats was not paying a dividend to compensate him for bearing "Mugabe" risk. I followed my own recommendation and bought Zimplats shares. Its average price per share in 2003 was $2.25. Today, its share price is $10.3[26], market capitalization is $1.1 billion, and its shares are listed on the Australian Stock Exchange . Its net profits for the year ended June 30, 2010 was $122 million, so it trades on a P/E ratio of 10.34X. Despite the 358% appreciation in its share price since 2003, Zimplats continues to suffer from a steep Mugabe discount. Its enterprise value per produced PGM ounce was $3,636, compared to $8,263 for Impala Platinum, and an industry average of $6,485. Yet, it was the lowest cost producer in the world, with costs of $ 325 per PGM ounce, after by-product credits[27].

Zimplats was, and remains, the largest platinum and palladium ("PGMs") miner in Zimbabwe, the 3rd largest PGM metal producing country in the world. South Africa and Russia rank ahead of it. Unlike most South African PGM producers, Zimplats mines its PGM ounces from a shallow underground deposit. At depth, it mines at 50 meters below surface, versus the shallowest South African mines which mines at 100 meters below surface. Zimplats mines 350,000 of PGM ounces per year and plans to raise its output eventually to a million ounces. Its proved and probable reserves alone will last another 67 years at current production. It has approximately six centuries of resources. It is prudent to assume that President Mugabe will not be in power at the end of the 67 year life of the current reserves of Zimplats, yet they are valued as if he were guaranteed to accomplish this feat. A value investor embraces the Mugabe discount foisted on Zimplats.

It is unsurprising that AOF owns shares of Zimplats. However, our exposure to Zimbabwe is not limited to platinum. We have been investing indirectly in depressed commercial property at enterprise valuations per lettable area of $200/square meter (or $18.6 per square foot) and undeveloped but serviced land in prime commercial spots of Harare at $2 per square meter (or $0.19 per square foot). Recent private purchases of commercial land near some of our best spots have taken place at a price of $55 per square meter. Monthly rental income per square meter is $3.94 compared with $9.26 per square meter in Malawi, $9 in Botswana, and $17 in Zambia. Someday, Zimbabwe's rents will rise closer to its regional peers. In the wake of Zimbabwe's conversion to the use of US Dollars as legal tender, its mortgage market has collapsed because banks do not have long term funding in US Dollars and are still building their deposits. Consequently, mortgage rates hover around 15% for 5-10 years. A few months ago, mortgages were available for only 6 months.

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[26] September 21, 2010.

[27] The industry average costs per PGM ounce, after by-product credits, was $948 per PGM ounce.

By 2007, it was obvious that Dr. Gono would not meet his goal of single-digit inflation. But, it was almost too late for his believers, even though the tornado had another two years to lose its force. Those who had believed him were wiped out. TA had survived!

CURRENT INVESTMENT IDEAS

Let me turn my attention from history to the present and future of our Africa investing work. I would like to share two of our current investment ideas. They embody our belief that betting on the expansion of a modernizing Africa, especially if one invests in goods or services in short supply, is a predictably profitable arena. Sure, those investments may suffer from global economic turbulence and disappointments from time to time, but the weight of recent history suggests that those disappointments tend to be temporary.

Shoprite Holdings Ltd. ("Shoprite") is the largest food retailer in Africa. It has outlets in 16 African countries ranging from South Africa to Nigeria in the west and Tanzania in the east and the Indian Ocean islands of Madagascar and Mauritius. It has a market capitalization in South Africa of $7.5 billion, trades on a P/E of 21.3X and a dividend yield of 2.36%. Shoprite is priced on the JSE as a growth stock, par excellence. AOF owns shares of Shoprite listed on the Lusaka Stock Exchange because the same shares that trade on a P/E of 21.3X are available in Lusaka on a P/E of 9X and a dividend yield of 5%. Shoprite's Lusaka share price offers an entry at a steep discount which brings them squarely into value territory, albeit at the price of poor liquidity. Working capital management and frequency of asset turnover separate the good retailers from the greats. Consequently, we measure retailers by comparing their cash flow from operations against their shareholders equity, return on equity and return on assets.

How does Shoprite compare against a few global icons and some emerging market peers? Shoprite's return on equity in its most recent year was 38%, return on assets was 13%, and return on cash flow from operations was 17%. Whole Foods Market, Inc, purveyor of the organic food retailing experience for which its affluent customers pay a premium has a return on equity of 13%, a return on assets of 6%, and a return on cashflow from operations of 16%. Walmart's respective returns on equity, assets, and cash flow from operations were 21%, 9%, and 15%. Walmart Mexico's comparable ratios were 22%, 14%, and 20%. Tesco and Carrefour are European icons. Tesco's respective returns on equity, assets, and cash flow from operations were 16%, 5%, and 11%. Carrefour's comparable ratios were 5%, 1%, and 7%. How about Asian benchmarks? Dairy Farm International Holdings of Singapore and Guangzhou Friendship Co of China have some of the finest ratios in Asia. Dairy Farm's return on equity, return on assets, and cash flow from operations are 72%, 14%, and 17%. Guangzhou's were 24%, 14%, and 20%. Clearly, Shoprite is a member of the top class of retailers. Does it have one of the top valuations in Zambia? Shoprite's P/cash flow from operations is 6.8X in Zambia. Whole Foods' is 10.7X, Walmart's is 7.4X, Walmart de Mexico is 21.9X, Tesco's is 6.9X, Carrefour's is 7.2X, Dairy Farm's is 22.3X, and Guangzhou's is 25.9X. Shoprite in Zambia is valued as if it were a first world retailer; not an agile emerging markets retailer. Therein lies an opportunity for the value investor. Some day, the huge gap between Shoprite in Lusaka and Shoprite in Johannesburg will close.

Our next investment idea is the equity of Sonatel (SNTS BC). It is trite today to express an interest in emerging market mobile telephone operators. Grant's has written about them a couple of times. The largest single holding of the Africa Opportunity Fund is in Sonatel. It accounts for 13% of AOF's net asset value. A former Senegalese state monopoly, Sonatel is listed on the Bourse Regionale de Valeur Mobilier in Abidjan, Cote d'Ivoire. It is a mobile and fixed line operator in Senegal, Mali, Guinea, and Guinea-Bissau. It has a market capitalization of $2.74 billion and an enterprise value of $2.77 billion. Now, Sonatel trades on a trailing 12 month P/E ratio of 7.7X and a dividend yield of 9%. The currency in which it conducts its operations, the CFA Franc, is best thought of as the Euro in Africa because it bears a fixed exchange rate to the US Dollar. Contrast Sonatel's valuation with that of Africa's largest mobile phone operator, MTN Group, which trades on a trailing 12 month P/E ratio of 16.8X or America Movil with a P/E ratio of 16X or China Mobile, sporting a P/E of 12.5X or Bharti Airtel of India which has a P/E ratio of 15X and you will be forgiven for thinking that Sonatel must be a somnolent phone operator in a mature market. Nothing could be further from the truth.

Sonatael's EBITDA margin of 56% compares favorably with China Mobile's 50% EBITDA margin, America Movil's 40%, Bharti Airtel's 42%, and MTN Group's 41%. These EBITDA margins are higher than the 38-40% EBITDA margins of developed market companies such Verizon Wireless, despite having ARPUs (average revenue per subscriber) that are 1/5th of their ARPUs. Net margin ratios are 31% for Sonatel, 25% for China Mobile, 18% for American Movil, 26% for Bharti Airtel, and 16% for MTN Group. Its superior financial quality does not change in the return on equity or return on asset categories: 38% for Sonatel, 22% for China Mobil, 16% for America Movil, 24% for Bharti Airtel, and 23% for MTN Group. These numbers are understandable when one looks at the annual operating cash flow per subscriber. Sonatel's $64 ranks ahead of China Mobile's $59, MTN's $46, American Movil's $35, and Bharti Airtel's $20.3. Yet, these kind of numbers do not imply that Sonatel's monthly ARPUS are higher than those of its larger peers. Sonatel's ARPU of $9.5 is lower than America Movil's $12.3 and China Mobile's $10.4, but much higher than Bharti Airtel's ARPU of $4.7. In fact, 2009 penetration rates for Senegal of 55%, for example, are closer to China's penetration rate of 55.51% and India's penetration rate of 43.83%.[28] Compound annual growth rate of mobile telephony between 2005 and 2009 lies between the growth rates of China and India. Senegal's 37.7% growth rate far exceeds China's 16.6%, but lags India's 53.1%. Sonatel's undervaluation is best captured by comparison with France Telecom, its largest private shareholder. France Telecom trades on a P/E ratio of 13, despite having a lower ROE, lower EBITDA margin than Sonatel. Sonatel is priced as if the prospects of Africa are worse than other parts of the world. Well, I disagree. With penetration rates still under 70%, undersea cable capacity increasing, with a concomitant lowering of prices, the era of dramatic surges in broadband usage and data consumption is about to unfold in Africa. Sonatel's high dividend yield implies that we own a sort of convertible bond which we expect to deliver handsome returns over the years.

DISAPPOINTMENTS

My investing odyssey has had its share of losses and disappointments. Two areas which jump out for me are investing in African sovereign debt issues and venture capital investing. African sovereign issuers

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[28] International Telecommunications Union 2009 data.

are simply much riskier than their corporate subjects. Côte d'Ivoire, for example, defaults on its obligations at the same time that listed rubber plantations such as SAPH declare and pay dividends. Many listed Ivorian companies paid dividends to their shareholders throughout the civil war of the Cote d'Ivoire. Years ago, I invested in Malawian Kwacha denominated 6 month treasury bills yielding about 30%. The Malawi government imposed a withholding tax before the maturity of those bills. Even the highest rated country in Africa, Botswana, has disappointed Robert and I. Botswana government issued its first Pula denominated bond instrument in the mid-2000s. It devalued the Pula against major currencies three days before the maturity of those bonds.

I believe that the heart of value investing is buying an asset at less than its intrinsic value. Warren Buffett and Ben Graham require a large dose of predictability in identifying an asset's intrinsic value. Consequently, they have been leery of commodity producers and avoided mining exploration and development companies. Africa is awash in minerals and oil and gas. Since a mining and oil and gas renaissance is underway, I have tried to extend my application of value investing into those areas. Robert's use of probabilistic assessment (measuring potential gains against the probability and quantum of potential losses) has been vital to the effort to push the boundaries of value investing. Nevertheless, the theatre of exploration and development companies has delivered 90% of the losses I have experienced in Africa.

It would be remiss of me to leave you with the impression that all investments in Africa come with macro-economic turbulence or political clouds. Not true! Our investment in Letshego combined classic value principles with spectacular growth prospects. This was a straight beauty. I invested in Letshego at 0.65 Pula ($0.12) per share in 2003, Robert joined at 1.35 Pula per share in 2004. He exited at 6.5 Pula per share in 2006 and I exited at 15 Pula ($2.2) in 2010. AOF has more than 5% of its net asset value in Letshego. I paid no attention whatsoever to Botswana's politics and economy. I simply compared Letshego against another investment we had in consumer finance-ABIL in South Africa. Ironically, my broker tried to dissuade me from investing at 0.65 Pula and was a fiery advocate of it at 15 Pula.

LESSONS

There are a few lessons both Robert and I have picked up over the years of our African investing: (a) Macro-time is much slower than micro-time. It took a few years for the inherent hyperinflationary logic of Zimbabwe's fiscal and monetary policies to end in actual hyperinflation. My timing was off by a few years, but the market rewarded TA for having the foresight. That foresight definitely did not apply to my expectations about the longevity of President Mugabe's political life. My predictions of his imminent departure have had a perfect failure rate. Not one of them has been accurate. (b) The second lesson is that, contrary to standard corporate finance theory, governmental paper is riskier than private paper. African equities have proved far more reliable than the promises of governments. Fantastic promises prove to be just that in the long run. (c) The third lesson was that the best way of preserving real wealth in Zimbabwe was to own the equity securities of companies that earned non-Zimbabwean Dollars that were exempt from the duty to exchange those foreign earnings for Zimbabwean Dollars at overvalued exchange rates. By extension, it appears that bonds preserve wealth better than equities in a deflation. (d) The fourth lesson is that the withdrawal of African states as commercial actors from African industries generates powerful and profitable companies when state-dominated companies fall into the hands of capable private operators—e.g. Sonatel, Enterprise, Ashanti, Tanzania Breweries. (e) there are rapidly growing companies in the modernizing parts of Africa available at classic value criteria. (f) The final lesson is that Africa is a legitimate theater of predictable and profitable investing.

Thank you.