Emirates MENA Top Companies Fund – Notes on Egypt

Emirates MENA Top Companies Fund currently maintains a high conviction weighting of 18% in the Egyptian equity market. Performance has been strong with the Fund outperforming its benchmark by 6% YTD.

	YTD	12 Months	P/E 2020	Active Share	Volatility
Emirates MENA Top Companies Fund	11.21%	5.64%	11.6	86.9	13.22%
Benchmark	5.22%	3.12%	12.2	n/a	13.71%

Source: ENBDAM as at 31st August 2019. *Benchmark: 45% MSCI Saudi Arabia Domestic Index, 55% MSCI Arabian Markets Index ex Saudi Arabia.

Sector Update

- **Real Estate (Challenging despite strong tailwind from rate cut):** The sector would seem to be one of the biggest beneficiaries of rate cuts and companies are confident of strong pre-sales. That said, on a negative note, the space seems to be crowded with many new participants who are extending payment plans to 8-10 years (every 2 out of 3 hoardings in Cairo are of real estate developers). We expect consolidation to happen in the longer term as smaller players exit the market due to competitive intensity, in the near to medium term, this could lead to margin pressure and worsening cash flows for developers.

- **Financials (Positive):** The sector is a strong beneficiary of rate cuts. Although NIMs could temporarily compress due to loans repricing faster than deposits, the key driver would be strong loan growth and its corresponding multiplier effect on earnings. Egypt as a country has remained underinvested for almost a decade and now the tide is turning in its favour (lower inflation, lower rates, tourism revival, strong remittances, a more stable currency etc.). In all investors are expecting c.25-30% loan growth for 2020. At the same time, lower rates should lead to contained cost of risk while banks continue to increase efficiencies leading to lower cost to income ratios.

- **Consumer Staples and Discretionary (Negative):** Inflation has reduced from a high of 14-15% at the beginning of the year to 7.5% in August. That said, Egyptian consumers do not seem to have fully recovered from the impact of successive currency devaluations and consequent inflation. It seems there is a c.20% difference between salary hikes and increase in prices of goods over the previous two years. Consequently, consumers have become more value oriented and companies in a bid to increase revenue are venturing out in other companies' territories (especially true for staples names), leading to overall increase in competitive intensity.

- **Industrials (Mixed):** The contracting segment seems to be under a lot of competition both in the local market (aggressively competing for key large ticket projects) and African market (mostly Chinese competitors). The key to securing a contract includes offering a complete solution including finance. That said, margin compression seem inevitable which is generally not a healthy sign for contractors. On the other hand, companies operating in strategic sectors of the economy (such as the value chain of energy reforms) seem to be quite bullish on future prospects.

- **Healthcare (Mixed)**
  - **Hospitals (Positive):** The market seems to be undersupplied with only 1 bed/1000 people. That said, while footfall seems strong even for facilities which would not be considered high quality by GCC standards, consolidation seems to be the trend. While standalone operators are finding it difficult due to cost escalations, chain operators are able to extract economies of scale by negotiating with insurance companies, suppliers, integrating back offices etc. and also successfully able to find acquisition candidates. In all, quality companies with strong management teams should be able to show strong topline growth and efficiency enhancements leading to margin uplift.

  - **Pharma Manufacturer (Negative):** The market seems to be very fragmented without many entry barriers. Furthermore, the market is highly regulated leading to difficulty in raising prices. Furthermore, some of the export markets such as Iraq, Libya, Syria are facing challenges. While companies are looking to cut costs and increase efficiencies, the impact is likely limited due to sectoral headwinds.

  - **Pharma Distributors (Positive):** While producers and retailers are fragmented in the pharmaceutical value chain, distributors are concentrated with three main players accounting for c.80% market share. The modus operandi is simple: sector volume growth of 5-7%, increase in realized prices by c.7-8%/year through product substitution and mix change and capture market share from smaller players. Since this is a high operating leverage business model, higher topline leads to disproportionate increase in net profit.

- **Telecom (Negative):** At the sector level, given the lower penetration level of fixed broadband and converged offerings, we believe there is scope of materially increasing revenues. That said, the key issue seems to be that of cash flows as the incumbent operator Telecom Egypt goes through a heavy capex phase to fund infrastructure. While the company remains free cash flow negative this year, it is expected to become FCF positive only in 2021.

- **Fertilizer (Neutral):** At this stage where urea prices are expected to remain flattish and low cost producers are operating at near full capacity, the only catalyst for the sector seems to be urea price liberalization (all producers are mandated to sell 55% of their produce at the local market at a significant discount). That said, street consensus seems to be any liberalization in urea price should also be accompanied by liberalization in gas price, magnitude of which remains unclear.

High Conviction Names

EK Holding

- Primarily a play on Egyptian energy reforms (ONS concession, conversion from cylinders to piped gas, electricity production) and import substitution (MDF board manufacturing)
- NatEnergy
- For EK's concession area, only 1.3m out 3m are connected leaving significant opportunity for growth
- Monthly household gas bill could be reduced to EGP40-50 from EGP180
- ONS Concession
- Maintains USD25m profit guidance for 2019 implying significant ramp up in 2H19 after earnings miss in 1H19
- Set to drill 2 new wells in the next three months
- Company looking to monetize the deeper layers of the ONS concession
- In all, 20-30% earnings CAGR for the next three years.

Cleopatra Hospital

- Market undersupplied with only 1bed/1000people
- Chain operator with a premium product targeting A and B class patients
- Bed capacity set to increase from 640 beds in 2018 to 800 beds (+25%) by 2019 end and to 1200 beds (+85%) in 2021
- Efficiency enhancement programme ongoing (back office integration, supplier negotiation, lower SKUs) leading to further margin uplift potential
- Potential expansion into IVF
- 2018-2021 Earnings CAGR c.30%

Ibn Sina Pharma

- Market consolidation ongoing with larger players acquiring market share from small ones; industry is concentrated with top 3 players accounting for c.75-80% market share
- Business model is straightforward: c.7-8% pricing growth from product substitution and mix change, 5-7% market volume growth and market share increase. In all, operating leverage leads to margin uplift
- Manufacturers more open to work with independent distributors leading to further opportunities
- Recent Roche contract can add c.5-6% to 2020 earnings on a conservative basis
- Working capital spike is expected to normalize by 70-80% in 3Q19 and fully by 4Q19 (working capital negative company)
- 2018-2021 Rev CAGR c.20% and Earnings CAGR c.30%