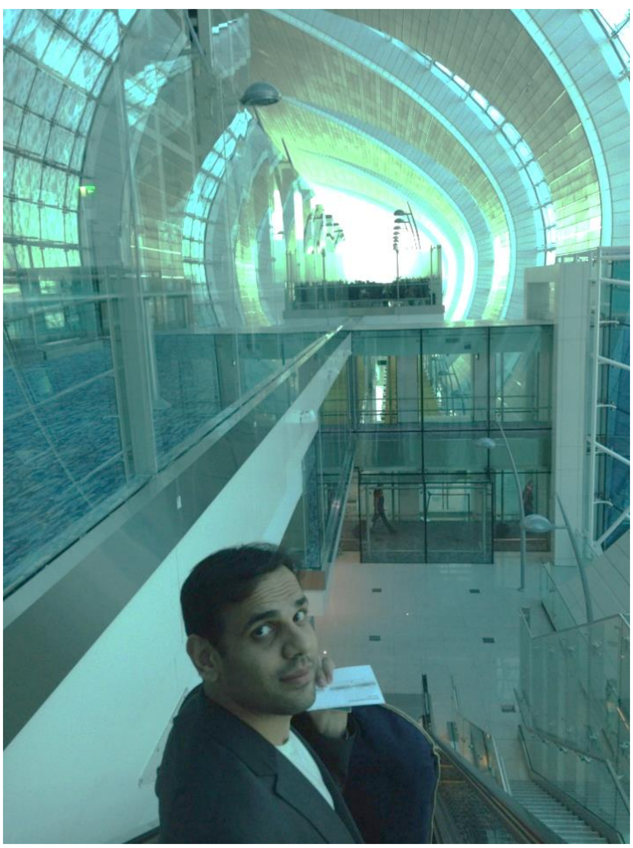
Travel Journal
Morocco
July 2015

TUNDRA FONDER

Travelling between Kenya and Morocco is time consuming since one has to take a 7.5 hour-long flight to Dubai, which is followed by an equally long flight to Casablanca. All this while, the stark contrast between the airports of Nairobi and Dubai could not be more obvious. Dubai is an infrastructure transformation story – developing from desert backwaters to the Manhattan of the Middle East in 20 years. To simply Google "Dubai 1990", one can find pictures of how the UAE looked before it had all the gleaming spires. Similarly, one ponders the potential of Nairobi Airport 10-15 years from now.

Shamoon at Jomo Kenyatta International Airport (Nairobi, Kenya)



..vs Dubai International Airport (Dubai, U.A.E.)

..vs Mohammed V International Airport (Casablanca, Morocco)

We reached Casablanca on a Wednesday at noon, somewhat tired after spending 15 hours on the plane. Quickly catching up on our rest, we decided on dinner at one of Casablanca's excellent restaurants before going back to the room to prepare for the next day's meetings.

Our first meeting was at a 1.5-hour drive towards Rabat with 'Maroc Telecom' – Morocco's largest mobile operator; and was scheduled with the individual responsible for strategic development. We were provided with an overview of current market conditions and the company's continued development. Morocco, with 35 million inhabitants, has a cellular penetration of 120% (many users have more than one subscription). Out of this, 'Maroc Telecom' leads the pack with a 41% market share followed by 'Meditel' at 31%. While 'Inwi' features third at 28%. Measured in terms of the value of mobile services though, 'Maroc Telecom' is by far the largest operator with 60% market share. The high-penetration rate and strong price competition has led to a decline in average cost for traditional voice calls (from USD 0.1 / minute to currently just under USD 0.03 / minute). In combination with the fact that 'Maroc Telecom' is gradually losing more price-sensitive customers to competitors, it's Moroccan mobile revenues are showing negative growth despite the fact that talk time has increased. Fixed-line telecom services are still ~1/3 of revenue. This part of the business has shown ~10% growth in 2014 due to an increase in Internet subscriptions and means that the Moroccan business overall showed only marginal negative sales growth of 1% during 2014. Pressure on the company's fairly high margins (EBITDA margin decreased from 58% to 55% in 2014) however means that the operating income of the Moroccan business saw an overall decline of almost 10% during the year. Given the price trend of traditional voice telephony and presence of fairly aggressive competition, we believe margins will continue to come down, which is quite natural for a maturing market subject to competition.

Mattias and Shamoon meet with 'Maroc Telecom'

More interesting is the company's expansion in the rest of Africa. Previously, the company had operations in four African countries: Mauritania, Burkina Faso, Gabon and Mali. Collectively, their population is about as big as Morocco, and the countries each have high mobile penetration rates. The lowest penetration numbers are for Burkina Faso with 72%, with markets such as Mali and Gabon showing similar penetration levels as Morocco today.

Through purchase of Etisalat's operations (UAE's mobile telephone company) in 6 additional countries, 'Maroc Telecom' has established itself in markets with a total population base of 90 million inhabitants, i.e. doubling its current base. Three of these countries have penetration rates below 60%, which seems to offer some growth opportunity. In the markets with the greatest opportunities for growth, the company is however currently not among the top-two largest players; this will likely require accepting slightly lower margins than in existing markets. Overall, we believe 'Maroc Telecom' should be able to show revenue growth over the next three years (taking into account the 6 new African markets on a pro-forma basis). However, we are less certain about their ability to show significant profit growth due to the profitability pressure in the Moroccan business. It is a well-managed company, but at P/E of 19, marginal revenue growth and the risk of falling margins it appears less attractive to us as we have the opportunity to select companies in other markets.

After the meeting with 'Maroc Telecom', we took a 5-minute walk to the retailer Label Vie, the second largest grocery retailer in Morocco. As in so many other emerging and frontier markets, modern retail represents a small part of total retail format, at only 15% in Morocco. Label Vie has the franchise for Carrefour in Morocco that is partly a supermarket concept ("Carrefour Market"), but also runs a hypermarket concept branded only "Carrefour".

Driving past a "Carrefour market"

In addition, the company runs a low-cost grocery chain called "Atacadão". The company's market share of modern retail grocery retailing is about 30%. Largest player Marjane has about 58% market share. 28 million receipts are printed annually and the average receipt is about USD 17-18. According to the management, demand in the big cities is sufficient for a much larger number of stores. Availability of store location remains a problem though. Currently, the company is able to open only 10-15 new supermarkets per year. It points out that real estate developers thus far have not embraced the Western concept of the ground floor or basement being adapted for modern retail business. We conclude that modern grocery retailing in the last ten years has taken about 1% market share each year. It is slower than what one would expect and provides food for thought when looking at less developed countries (Morocco has GDP/capita of approximately USD 3,500, compared with Pakistan, Kenya, Bangladesh, Vietnam ranging between USD 1,000 – 2,000). According to the company, it is government's target to have modern grocery retail reach 30% of total by 2020. This would mean a 3% growth annually and provided 'Label Vie' can maintain its market share, it can potentially double its turnover.

Tundra team meets with Label Vie

From 'Label Vie' the journey carried us back to Casablanca to a meeting with real estate developer 'Addoha'. The company specializes in so-called low-cost housing. There is a state-supported project in Morocco, which provides apartments with tax benefits at a cost up to USD 25,000 (2 bedroom, maximum of 50 square meters). Provided the property developer sells the defined production of square meters, it is exempted from profit tax. For the buyers of such apartments, a state fund guarantees loans of up to 70% of the purchase price. It is an opportunity for the less affluent families to acquire their first housing. 'Addoha' annually constructs 25,000 of these apartments and claims to have over 50% of all new construction in this segment. In addition to low cost housing , the company annually constructs 1,500-2,000 houses and apartments in the premium segment range i.e. houses in the price range of > USD 200,000.

Mattias outside Addoha showrooms

Tundra meeting Addoha

Premium segment has been hit hard by Europe's economic problems in recent years. The most popular foreign destination, Marrakech, has seen prices decline for several years in a row, and some real estate developers in the segment are in financial trouble. The demand for low-cost housing, however, remains strong. 'Addoha' currently has an order book equivalent to about 4 years of production, but an increase in growth from current levels of production is difficult given constraints on obtaining bank loans. Normally, the customer pays 20% to book an apartment/house, with the remaining balance paid upon occupancy. That makes it a fairly capital-intensive business. The company's valuation at P/E 10 is reasonable based on this.

Unfinished construction site on the road between Rabat and Casablanca

Our next stop was 'Lesieur Cristal' – a producer of consumer products with well-known brands in cooking oils, soaps and cleaning products.

Meeting with Lesieur Cristal

Cooking oils constitute 75-80% of company's sales, while soap products constitute about 20%. According to the company, they have a market share of 60% in cooking oils and 75% in soap for personal use. Cooking oil market is mature and growing slowly (about 1% per year). A lot of product development work has been lately focused on soaps and detergents with new products exhibiting double-digit growth. Overall, the company has modest consolidated revenue growth of 3-4% per annum. Backed by the French majority owner, the company is trying to extend the brand into new product categories. Examples of new trial products are ketchup and mayonnaise. Currently 'French Lesieur' makes these in France. But if the experiment proves successful, local production can be considered. The company has very strong local brands and it is a popular stock among local investors, which despite marginal growth, is trading at 20 times the net profit; a bit on the higher side for us.

Friday started with our meeting with 'Ciment du Maroc' (Cimar). As the name suggests, the company is engaged in the manufacturing of cement. Morocco has a fairly large cement market. Production capacity amounts to ~ 23m tonnes, while production is only ~16 million tonnes, which means about 500 kg / inhabitant per year. In comparison, Kenya's consumption is ~ 100 kg / inhabitant per year. Those who visit Morocco will observe that concrete structures are dominant in home construction. This plays into the relatively higher consumption. Given that housing construction accounts for 80% of cement consumption, high activity in construction is needed to maintain demand at these levels. Three players currently dominate the market. The largest is Lafarge/Holcim (merger expected to be finished late July) at 55-60% market share. Cimar is second with 23-25%. Margins are generally quite high in the sector (EBITDA margins for Lafarge are over 50% and about 40% for Cimar). Fully integrated and cost-effective production, good infrastructure and relatively short distances are the main drivers. Price levels are currently about USD 90/ton. By international standards these are between normal to slightly-low; and by African standards standards very low. The most expensive part of the production is clinker production that requires large amounts of fuel. Cimar currently uses coal, but is in the middle of a project in which 20% of the fuel shall be replaced by alternative fuels (i.e. used tires). This will, according to the company reduce fuel costs by nearly

50% on the parts being replaced. The price of electricity is an important component in the cement grinding process and is currently at USD 0.08 to 0.09 / kWh, a relatively competitive level. New wind power projects in Morocco means that the company believes it can reduce this cost further down by 10%. The company is very well run, though unfortunately it is well reflected in the valuation. Flat revenue in the last three years, profitability at the high-end from a frontier perspective and a P/E ratio of above 20x means it is currently not eligible to be featured in our portfolio.

Mattias and Shamoon with CFO of Ciment du Maroc

After 'Cimar' we went on to meet 'Attijariwafa Bank', Morocco's largest bank. As usual when meeting the leading banks the discussion becomes very macro-focused. With both the President and Head of Research present it became an interesting discussion. Morocco is an agriculture-based economy that has been reoriented to largely rely on the services sector (including financial services and tourism). Agricultural production however is still the primary swing factor for the economy. Despite a relatively low share of GDP (at 15%) the large output fluctuations (of 15-20% annually) result in a strong year-to-year effect on the economy.

There is also a psychological effect at play given Moroccans are historically accustomed to being significantly effected by swings in agricultural output. In the early 2000s, Morocco adopted an economic plan aiming to attract large foreign direct investment. These investments were later supposed to trickle down to smaller companies through subcontracting – a model that we conclude sounds much like one that Kenya is currently undergoing. Few years ago, Morocco managed to attract Renault, which now produces 400,000 cars / year in the country. This in itself has led the suppliers base to establish locally as well. There have also been investments in the textile sector where the focus has been on more value-added goods. Today, a fashion company in Europe can send drawings (Week 1) and get back ready-made goods (Week 2). The automotive industry currently accounts for 20% of exports, while the textile industry represents 17%. Morocco's history of phosphate completely dominating exports is no longer applicable. Phosphate is still an important export commodity, but today represent around 19% of exports.

Mattias outside Attijariwafa headquarters

The discussion then moves over to the bank's operations. Credit growth is relatively low, 2% overall. Consumer credit is growing rapidly in the lower rate environment (>10%). Corporate loans today comprise 50% of the loan book, 20% is made up of small and medium sized enterprises (SME) and 30% of private loans. Of the private loans 1/3 is consumer credit and 2/3 is home loans. Net interest margins are low at 3.5% but in the corporate segment margins are even lower. Private sector loans, as a share of GDP are 87%, which is very high, if compared to other frontier markets. Just as an example, the corresponding proportion in Pakistan, Sri Lanka and Nigeria is in the range of 20-30%. For 'Attijariwafa', expansion in the French-speaking parts of Africa therefore is important going forward. Of the Bank's total assets outside Morocco, Africa constitutes 20% and this portion is growing. The bank takes a cautious approach to expansion and emphasizes the higher risks. We get the impression of a well-run bank working in an environment with discerning customers and fierce competition. It will be interesting to see what they can achieve outside of Morocco. A successful expansion and thus a higher growth rate going forward is necessary to motivate current valuation of 15 times net earnings and 1.8 times book value. At the same time we are aware of the challenges often faced by foreign banks in the smaller African countries where brand awareness and trust is often hard to achieve, which makes it hard to attain cheap funding (deposits).

Tundra meeting Attijariwafa Bank's management

We then went on to 'Managem', which is Morocco's largest mining company. It is relatively rare to see these companies listed on the actual underlying market as usually one finds these companies, with foreign management listed on either the London Stock Exchange or the Toronto Stock Exchange. 'Managem' thus constitutes an interesting exception. With a strong base in Morocco since almost 90 years and a well-functioning organization it has an interesting platform for expansion into other African countries in the coming years. All mining companies are ultimately dependent on the prices of the metals that are extracted but it is interesting that for once to have the opportunity to invest in this type of company with in our view less of the usual corporate governance risks that normally are associated with the smaller, foreign-listed companies in the sector. Going out from our meeting we bumped into a paramilitary force, a rare reminder of Morocco's investment category.

Mattias outside Managem's office

Our next stop was 'Cosumar', that is one of Africa's major sugar producers. Sugar may sound like a fairly generic product to manufacture, but the meeting developed into an interesting encounter thanks to an unusually active management. The company currently has a production capacity of 1.6m tonnes of sugar per year. Out of this 1.2-1.3m tonne is sold to the Moroccan market and for the remaining part the company seeks export opportunities. Some exports have even gone to Europe. The company is now preparing for 2017 when it is believed that Europe will eliminate the tariffs that today are levied on Moroccan sugar.

In the manufacturing process of sugar, 90% of the manufacturing cost is raw material e.g. beet or cane. Out of the remaining costs, about 60% are energy related. It turns out ‘Cosumar had the foresight to hedge its diesel costs 2 years into the future on an oil price of USD 48 / barrel. Meanwhile, the company is building new coal-fired turbines that will be ready in time to fuel its facilities when the hedge expires. According to the company, this will reduce the company's energy costs by about 50% compared to a normal pricing scenario of diesel. The company is debt-free and the management has been mandated by the Board to look at acquisitions in other African countries, primarily the French-speaking parts. It is an interesting time to look at acquisitions, when many of the local producers are going through some tough times. Again we are reminded of Morocco's unique advantage, with one foot in Europe and the other in its home continent, Africa.

Shamoon outside Cosumar’s headquarters

Tundra with Cosumar’s CFO

Generally easy traffic conditions meant we had some spare time in between meetings. This was utilized to do our usual “shopping tour”. This time we visited the largest grocery retailer ‘Marjane’.

Shamoon checking UHT milk range

Mattias with Lesieur Cristal products

Our last meeting was with Group Des Brasseries Du Maroc (SBM), Morocco's only listed alcohol producer, where we got an opportunity to meet the company's easily likeable CEO Mr. Filali.

Mattias with CEO of SBM

A bottle of SBM's flagship product "Casablanca"

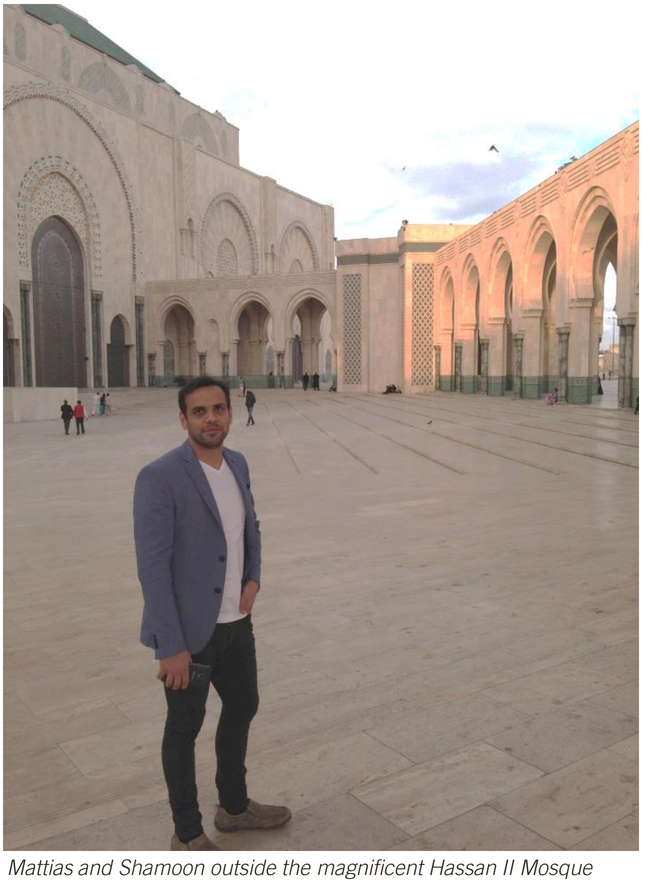
He explained the company's somewhat tangled ownership structure. A company called MDI owns 68% of SBM. MDI itself is 75% owned by the French alcohol giant Castel and 25% by SAB Miller. Heineken also has a smaller ownership (<3%) in SBM.

Heineken has licensed manufacturing of Heineken to SBM until 2023. Today 90-95% of SBM's revenue comes from beer sales. By far the largest brand is Casablanca, a product we would call premium, both in taste and brand. In addition to beer, the company has two smaller wine bottling facilities and has recently also introduced its own bottled water. Being a Muslim country, only part of population drinks beer. Heineken conducted a survey that indicates that this percentage amounts to 12%. Unlike a country such as Pakistan, beer, wine and liquor are served at most restaurants and you can buy alcohol from many of the grocery stores (although a license is required). SBM claims to have 95% market share (5% are imports). There are high taxes on beer with approximately 60-70% of the final price consists of taxes which implicitly means an ex-factory price tax of over 100%. That compares with the average in Africa of slightly above 30%, Kenya 50% and Nigeria at 6%. This means that large quantities of beer are smuggled across the border, something that the government is aware of. Given current high taxation, we believe it is unlikely the tax will be raised further but rather should be cut. SBM has had some tough years behind it. A few years ago, Morocco's largest grocery chain, 'Marjane' (58% market share of the organized grocery retail) was about to be sold to Saudi investors. A part of the arrangement was that 'Marjane' would cease to sell alcohol in their stores. This meant that 15% of SBMs sales disappeared overnight. The deal eventually did not go through but 'Marjane's' license had already been revoked. It is uncertain whether 'Marjane' in the future will reinstate alcohol sales (if they can get a new license, which is not a given). To counteract this event SBM along with some other smaller manufacturers have launched their own store concept, Nikola, where alcohol products are sold. The company now has fifteen stores, mini-versions of the Swedish "Systembolaget". Another challenge for SBM has been Ramadan, the holy month in which the Quran (holy book) was revealed. Muslims observe a month-long fast during Ramadan; neither eating or drinking till sunset. As summer is the period when most beer is usually consumed, the occurrence of the holy month during this period has adversely affected company's sales. This year Ramadan started around June 17-18th, but it will occur 10 days earlier each successive year.

Over next few years, as Ramadan will progressively move earlier into the year, it should positively effect sales. SBM has a capacity of 1.5 million hectoliters but produce only 0.8 million. Given that beer consumption in Morocco at present is around 2 liters per inhabitant per year (15 litres in Kenya, 60 litres in developed countries), and given the problems the company has had for a number of years, it is difficult to see how the conditions for business can become much worse. Behind the problems we sense a good business with a number of premium products, and with Europe's current problems, strong long-term prospects in the country of tourism as well. From this perspective, we note that this was perhaps the most interesting meeting we had during our time in Morocco. Current valuation of around 20 times earnings is high but as opposed to many other companies the valuation is based on very tough current conditions that are very likely to improve going forward.

Summarizing our impressions, we conclude that Morocco is very different from many of our more traditional frontier markets. We see Morocco more as "poor Portugal or Italy" than as a comparable to markets like Kenya or Pakistan. Morocco has a great advantage in terms of being adjacent to Europe and in terms of financial and legal infrastructure, its far ahead of many of our more traditional markets. The economy is linked closely to that of Europe's, which currently is a disadvantage but at some later stage can turn into an advantage. A city like Casablanca is especially worth a visit from a tourism perspective – great location, excellent weather, good restaurants, safe, and with many historic landmarks.

The presence of local institutional investors with few options to invest in means valuations are kept up at very high levels, too high for most of the companies we met, but as everyone knows valuations vary over time. With these words, we conclude that the only Moroccan company currently eligible to be included in our portfolio is 'Groupe Des Brasseries du Maroc'; but we hope more Moroccan companies will be eligible for our portfolio in the future.



Mattias and Shamoon outside the magnificent Hassan II Mosque