

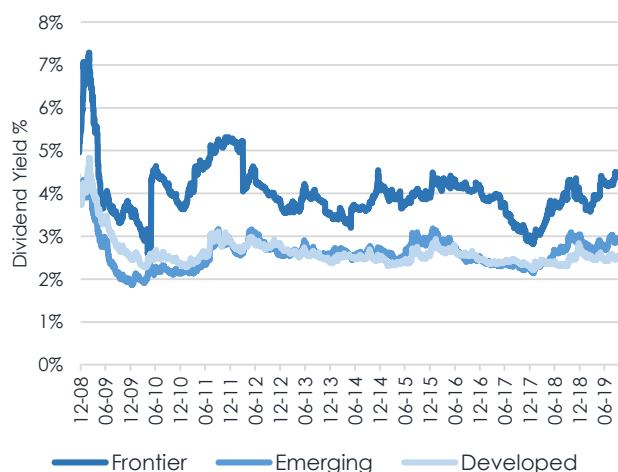
Frontier Markets – A Compelling Source of Income

January 2019

In our previous paper, we have demonstrated why Frontier Markets are extremely appealing from an investment strategy standpoint. They offer a significant diversification opportunity along with huge growth expectations and high returns in the mid-long term.

This piece aims to highlight a further reason as to why investing in Frontier Markets is an attractive. This is because they represent a compelling source of income, having always offered dividend yield at least twice those offered by more developed countries. As shown in Exhibit 1, as of October 2019, the dividend yield in Frontier Markets stands at 4.2%, while in Emerging and Developed Markets it is at 2.6% and 2.4%, respectively.

Exhibit 1: Dividend Yield Historical, Frontier, Emerging, and Developed MSCI



Source: Bloomberg

This significant difference could be explained as a Frontier corporate's means of attracting investors hungry for income. However, growth investors could be discouraged from investing due to the potential impact on growth. They might argue that those corporates, in offering their shareholders higher dividends than both Emerging and Developed Markets, retain less capital to reinvest, and so in some way potentially compromise their growth.

In our last paper we showed that Frontier Markets rely on dividend policy to affirm their good health and strong governance to investors¹. We want now to demonstrate why they are capable using dividends as an instrument to attract investors without risking their growth.

The Dividend Discount Model - (DDM)

When evaluating a firm, one of the first things to consider is the level of profitability. Profitability defines the amount of money a firm can make after accounting for the various expenses and inputs required to generate those earnings. Ideally, little money is spent, few resources are used, and significant profits are made. The return on equity (ROE) is one of the most important profitability metrics that relates profits to equity. Equity is the money the shareholders have invested into the business, and a higher ROE means that more profits are being made relative to their cumulative investment in the firm.

In literature², return on equity is critically linked to dividend growth through the dividend discount model (DDM). The DDM for stock valuation states that the value of a stock, P , is given by

$$P = \frac{DPS_1}{r - g}$$

Where DPS_1 is the dividend per share expected to be received in one year, r is the required rate of return for the investment (the so-called cost of equity capital), and g is the dividend growth rate.

The dividend growth rate is determined by what fraction of earnings is reinvested into the firm and how profitable those earnings are in their subsequent use. When earnings are reinvested into the firm in this way, they accumulate as part of the equity capital held by the shareholders. A high ROE over time indicates that this money is being used efficiently, generating more profits relative to the investment received and so giving the opportunity to pay higher dividend.

In Exhibit 2 we plot the average ROE and dividend yield of all equities, within iShares MSCI World ETF, iShares MSCI Emerging ETF and iShares MSCI Frontier 100 ETF, respectively³. On average Emerging and Developed Markets' firms show a similar level of dividend yield (3% for EMs and 2.7% for DMs) and ROE (18% for EMs and 19% for DMs). By contrast, Frontier Markets' average is in the upper right corner, which indicates that they are associated not just to higher dividend yield (5%), but also to higher ROE (34%) than both Emerging and Developed countries⁴. In other words, Frontier Markets are able to

² Gordon, M.J and Eli Shapiro (1956) "Capital Equipment Analysis: The Required Rate of Profit," Management Science, 3 (1) (1956) 102-110.

³ Data were not available for all stocks; 61 out of 100 for Frontier (76% total AUM), 801 out of 1044 for Emerging (76% total AUM) and 806 out of 1194 for World (69% total AUM); as of October 31st, 2019.

⁴ Most analysts in the past have used ROE as an indicator of higher dividend.

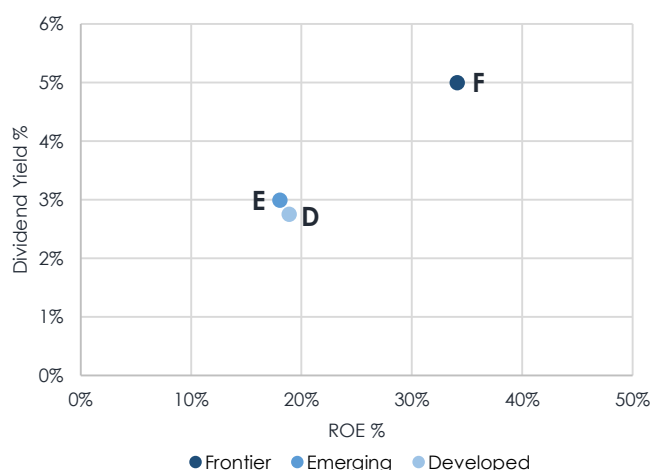
¹ Kallisto Partners - The Importance of Dividend Policy in Frontier Markets, Sep 2019.

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generate more profits relative to the amount of investment received, which is why they can afford to pay a higher share (dividend) of these profits to their shareholders⁵.

Exhibit 2: Dividend Yield and ROE

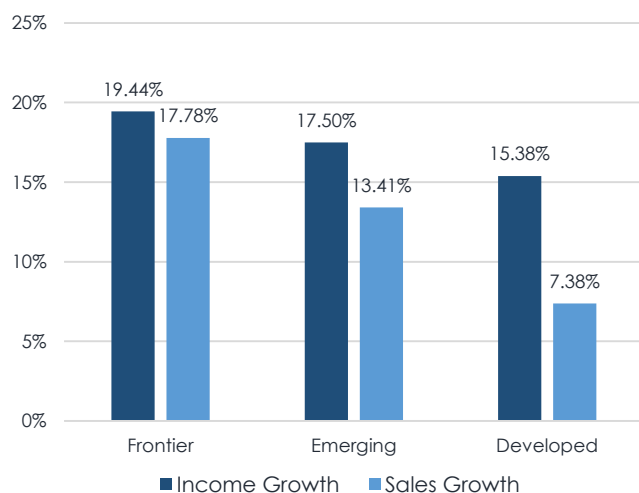


Source: Kallisto Partners, Bloomberg

Sustainable Growth

As we said above, it might be that Frontier Markets' corporates are giving away a large part of earnings to their shareholders in order to pay a higher dividend, and retaining a small proportion to reinvest in their company, which could undermine their own growth.

Exhibit 3: Growth



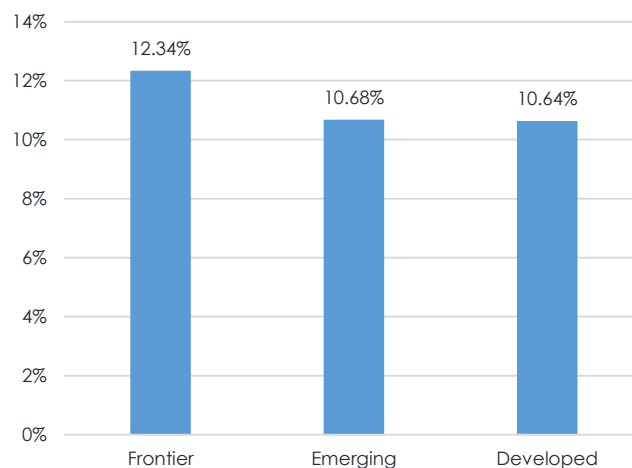
Source: Kallisto Partners, Bloomberg

Analysing the income and revenue growth rates (Exhibit 3), we can see how Frontier Markets are actually far from slowing down. In fact, both income and revenues are growing at a higher rate than Emerging and Developed Markets, which is another way to say that Frontier businesses are more rapidly expanding.

In summary, Frontier Markets companies manage to pay higher dividends because, at the same investment level, they produce higher profits than both Emerging and Developed Markets (have a higher ROE). The question now is: how is it that Frontier Markets managements are able to perform better?

The answer is given by the Sustainable Growth Rate. The Sustainable Growth Rate (SGR) is the maximum rate of growth that a company can sustain without having to finance growth with additional equity or debt. It is an indicator of what stage a company is in, in its life cycle, and in this case, understanding where a company is in its life cycle is important. A very high SGR signifies that a company has higher growth margin, and that is the case for Frontier Markets (Exhibit 4).

Exhibit 4: Sustainable Growth Rate (SGR)



Source: Kallisto Partners, Bloomberg

Being at an early stage of development Frontier Markets companies have higher profit margin than both Emerging and Developed companies, which have already reached their growth peak and even if they are still growing, they are doing it at a lower rate (their margins have narrowed down).

⁵ Average results are in line with MSCI Frontier Index, MSCI Emerging Index and MSCI World Index.

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Conclusion

Frontier Markets can afford to pay higher dividends to attract investors whilst not compromising their growth. Being at an early stage of development, they have higher growth margins (higher SGR), which means that considering an equal amount of investment, they manage to produce more profits (higher ROE) than both Emerging and Developed Markets.

Frontier Markets represent an interesting asset class not only because of their diversification and high long-term returns benefits, but also because they are a compelling source of income, providing investors with higher dividend yield alongside sustainable growth levels.