CITY OF LONDON
Investment Management Company Limited

Morocco, Beyond the Bazaar

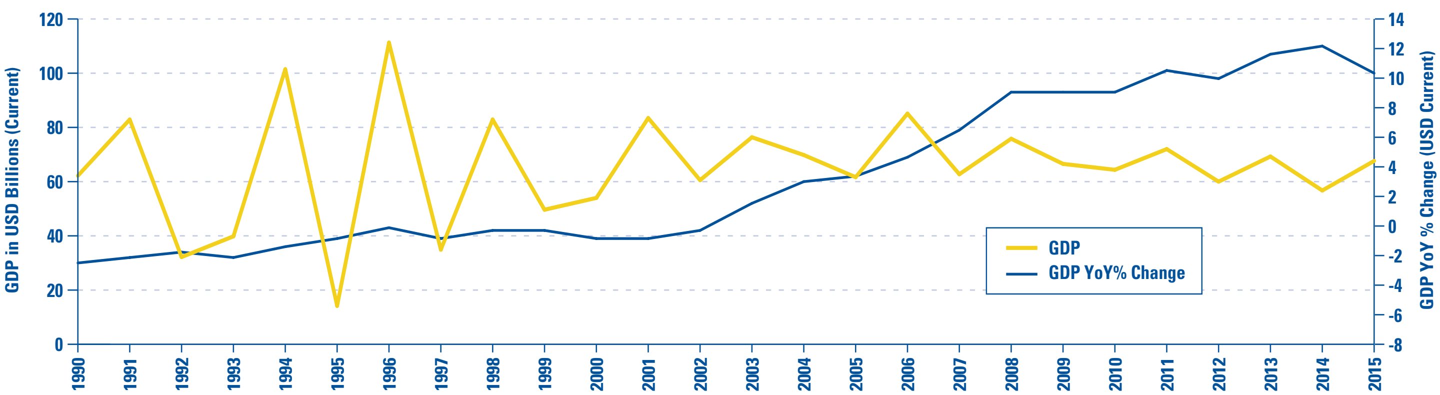
November 2016

Morocco, a French speaking Arabic nation that is reliant heavily on trade with France due to its colonial history and Spain due to its geographic proximity, has been forced to endure the effects of the European debt crisis. Combined with the aftermath of the events of the Arab Spring, it has come through a challenging period with an economy that is beginning to see the benefits of investment into infrastructure, regional diversification and economic liberalisation. In October, we spent five days in Morocco, meeting mutual fund managers in Casablanca, attending various industrial site visits and meeting companies and officials at the CFG Conference in Marrakech.

Hassan II Mosque, Casablanca – Source: Own Archive

Morocco has a population of thirty three million and is governed by a constitutional monarchy with an elected parliament. King Mohammed VI holds executive and legislative powers, with significant input into the strategic direction of the country. The monarch is relatively young, aged 55, and whilst being the religious head of the country has protected the country from extremist religious fervour and promoted women's rights. In 2011, responding to Arab Spring protests, he was quick to appease the population by reducing his powers and defusing ethnic issues such as making the Berber[1] language an official state language alongside Arabic. The judiciary system was also made independent from the legislative and executive branch; the king guarantees its independence. In October, the second general election since the reforms were enacted passed peacefully with the incumbent Justice and Development Party taking the most seats again. In practice, this means another coalition is required, but parliament is now less fragmented than it once was. The top three parties account for 69% of the seats, compared to 46% in 2011, potentially resulting in a more effective legislature.

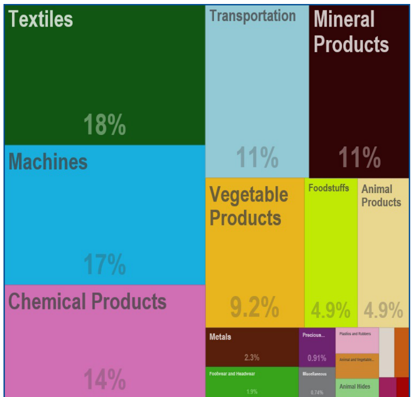
Gross Domestic Production



Source: World Bank, 2015

The economy is diversified, with the service sector accounting for over 56% of the economy, with another 29% accounted for by industry. Only 15% of GDP is accounted for by agriculture; however, it employs 39% of the population and is commonly subjected to drought due to the semi-arid climate, making earnings for a large part of the economy volatile.[2] This year's crop for example has been affected by a drought, following a relatively bountiful 2015, resulting in a large swing in production, with 2016 forecast to show a 9% decline from the previous year. This has a significant impact on national growth, with overall growth in 2016 forecasted to be 1.4%, compared to 4.5% in 2015. Market participants therefore find a more accurate measure of the economy's progress to be the non-agricultural GDP which grew by 3.5% in 2015 and is forecast to grow by 2.9% in 2016 and 3.2% in 2017.[3]

[1] Berbers are an ethnic group indigenous to North Africa. The number of Berbers as a portion of the population in Morocco is unknown but is estimated to be between 9 and 14 million. Source: Wikipedia
[2] Source: CIA World Factbook, 2015 estimates.
[3] Source: Bank Al-Maghrib (Central Bank), CFG Conference Presentation, 2016



Exports by Sector – Source: The Observatory of Economic Complexity, 2014.

The European Union is Morocco's largest trading partner and accounts for 58% of its export market. Exports have been growing by a compound annual growth rate (CAGR) of 8.8% during the past five years.[4] Spain and France have traditionally been the country's largest export markets but emerging Europe, sub-Saharan Africa and the US have grown in share. Exports are fairly well diversified in terms of sectors led by textiles, which represent 18% of the total, machinery (mostly electrical components) 17%, chemicals 14% (mostly fertilizer) and transportation (mostly cars) 9%[5]. The country remains a net importer, with a current account deficit of 1.9% due to its imports of oil, materials and other consumption goods.

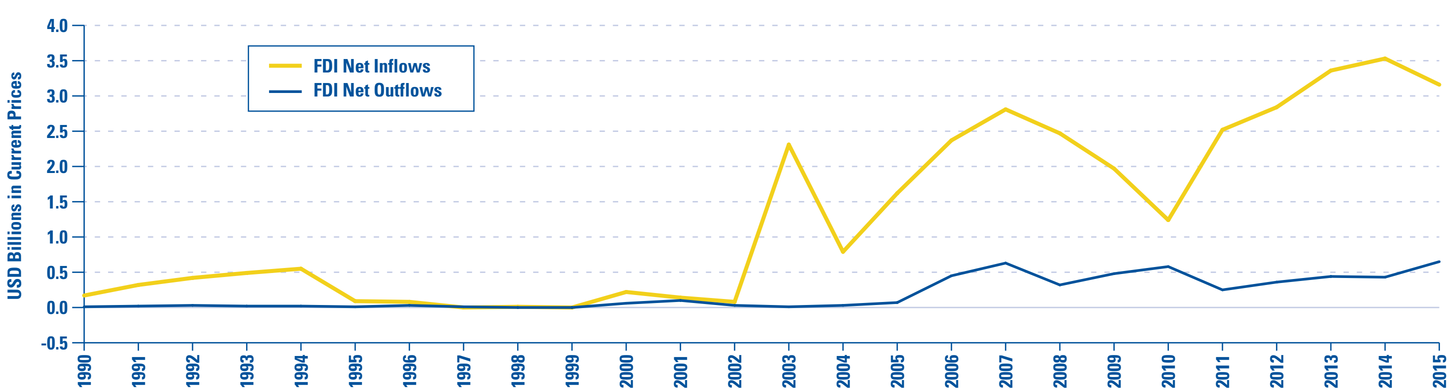
Fiscal reforms have been aided by the removal of fuel subsidies, which were a significant burden on the budget, accounting for 5% of GDP. This was made possible by the fall in energy prices, however it does leave open the possibility that any future sharp rise in oil prices could risk the re-introduction of subsidies. Total government subsidies now account for 1% of GDP, with that due to a remaining subsidy on sugar, which is intended to help the poorest of households. The fiscal deficit is expected to fall below 3% in 2017, with greater flexibility targeting infrastructure investment according to the central bank.[6]

Morocco's infrastructure development is a multi-pronged strategy focused on power generation and transportation. The country imports 97% of its energy needs, which are growing by 7% a year and therefore is targeting renewables as a practical long-term solution. The first major undertaking is a solar farm on the edge of the Sahara desert taking up an equivalent acreage as the nation's capital, Rabat, with the capacity to supply electricity to 1.1m people, expected to be completed in 2018. The country has targeted 2030 for the vast majority of its power needs to be generated through renewables, either through solar, wind or hydropower generation.[7] The rail network is being developed in partnership with Alstom and Bombardier, who are also both using the country as a hub to export to regional markets. Several new ports are planned including a fully automated terminal in Tangier, with an annual capacity of five million containers, to be completed by 2019[8].

Tramway, Casablanca - Fleet of 74 Trams supplied by Alstom serving 5m people, will expand to 124 trams by 2018. Source: Own Archive.

Morocco has been attracting investors through free trade zones offering tax incentives, with most of these zones spread across its territory and located in areas where the populations are underemployed. This strategy not only provides a source of cheap labour but also adds to the overall social cohesion of the country through job creation and infrastructure investment. Renault has been building cars in Morocco since 2012 and produced 229 thousand cars last year. Morocco is expected to overtake South Africa as the continent's largest car producer helped by the introduction of PSA Peugeot Citroën. PSA expects to begin production in 2019, with production expanding to 200 thousand vehicles by 2022.[9] Alongside the assembly plants, parts manufacturers are also following the big brands to provide local production.

Foreign Direct Investment

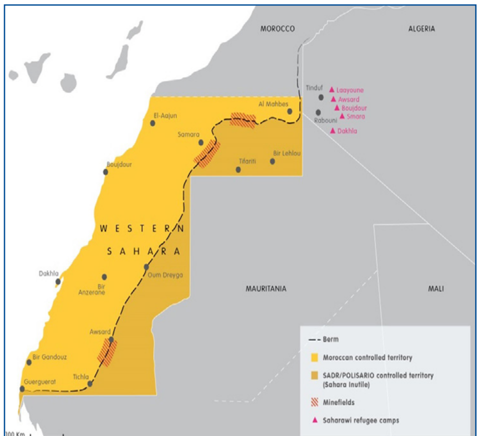


Source: World Bank, 2015

[4] *Source: Bloomberg/International Monetary Fund, 2015*
[5] *Source: The Observatory of Economic Complexity, 2014*
[6] *Source: Bank Al-Maghrib (Central Bank), CFG Conference Presentation, 2016*
[7] *Source: The Guardian, 'Morocco to switch on first phase of world's largest solar plant', February 4 2016*
[8] *Source: APM Terminals, 'APM Terminals announces new port investment in the Kingdom of Morocco', March 31 2016*
[9] *Source: Reuters, 'Peugeot to build Morocco plant to cut costs, lift emerging-market sales', June 19 2015*

Outside of auto manufacturing, Morocco is now home to over 110 aerospace related corporations that specialize in metalworking, electronics and avionics, composite manufacturing, and many other related production services.[10] This has led to Bombardier's decision to relocate its Belfast plant to Morocco, on the heels of which Boeing also announced plans to build a facility that could generate $1bn in export revenues. The policies the country has used to attract these companies have been formulated into an investment charter, which helps to promote the legal foundations of existing and future agreements, providing greater comfort for investors.

Well established Moroccan companies are also expanding aggressively in Africa and in many cases are better placed to do so than developed market rivals. Taking advantage of their common tongue with the Francophone states, financial services have gained a significant foothold in Africa. BCME Bank, which is Morocco's third largest bank by assets, now generates 40% of its revenues from sub-Saharan Africa. Attijariwafa Bank, Morocco's largest bank, also recently announced its planned acquisition of Barclays Egypt. The pickings are rich for those that can successfully manage the expansion: Attijariwafa Bank's domestic loan growth is 2%, whilst its African portfolio generates 12-15% growth. The telecoms sector is an area where Morocco is sharing its technical expertise. Maroc Telecom grew its revenues by 17% in 2015 and is present in most francophone African countries, which account for 41% of its revenues.

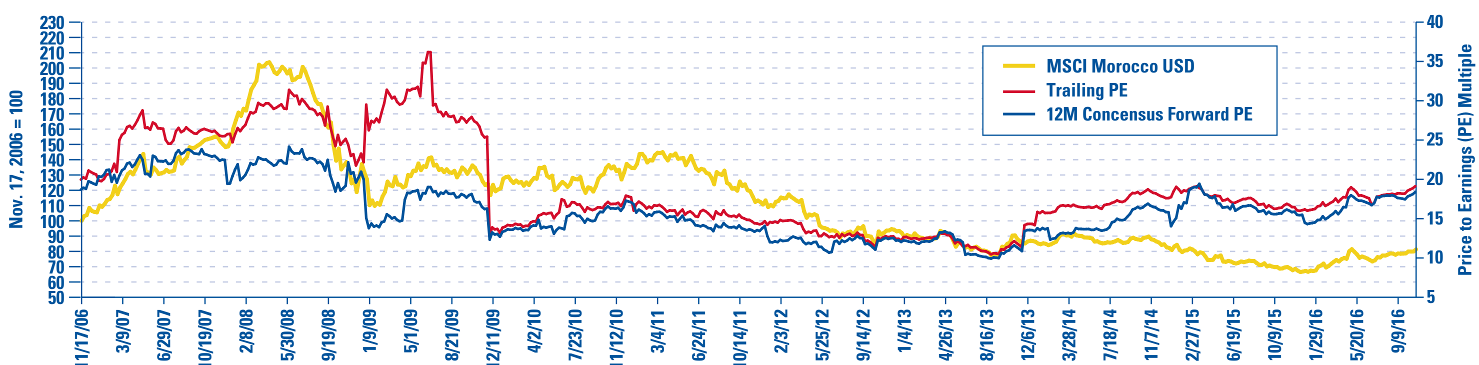


Map of the Western Sahara – Source: European Council on Foreign Relations

Morocco's foreign policy has embraced the international community and in November, locals took great pride in hosting the United Nations Climate Change Conference in Marrakech. However, tensions exist with its neighbours due to its annexation of the vast majority of the Western Sahara in 1975 when the Spanish withdrew[11]. Algeria and to a lesser extent Mauritania are the most critical of Morocco and relations with the former are effectively frozen. Whilst many are sympathetic to the native Sahrawi people's right to self-rule, they are also cognisant of the fact that the Western Sahara is largely uninhabited, which if left unsecured could foster extremist groups that promote terrorism as has been the case in Algeria, Mali, Niger, Libya, Mauritania and Tunisia.[12] Admittedly, there are numerous cases of human rights abuses as well as a large number of political refugees in the surrounding countries, none of which is conducive to social cohesion. However, as things stand both the Western Sahara and Morocco are largely secure, with the risk of terrorism in Morocco being low by even western standards. The country ranked 92 in the Global Terrorism Index[13], which is close to Switzerland, which ranks 95.

Investing in Morocco has been a good investment in the past year with the Casablanca CFG 25 Index rising by 14.5% in US Dollars, whilst the MSCI Frontier Markets Index lost 3% during the same period.[14] It has been a haven in Africa where many countries have been blighted by lower commodity prices and the subsequent impact on their respective currencies. Relative to most emerging and frontier markets, Morocco has generally tended to be an expensive market, largely due to a captive pension fund and insurance industry. There are 73 companies listed on the Casablanca Stock Exchange, but only 30 of these are sufficiently liquid for institutions to trade. These firms are restricted in investing at least 90% of their assets in local securities and hence end up chasing the same assets.

Stock Market Performance and Valuations



Source: MSCI, Bloomberg

As a result, valuations are expensive with a price to earnings (PE) multiple of 17x for the MSCI Morocco index on a twelve-month (12M) forward basis, with 7% earnings growth. Though pension funds have the option of investing 10% of their assets abroad, little use of this

10 Source: Morocco World News, 'Morocco Becomes International Hub of the Aerospace Industry' September 29, 2016

11 The Western Sahara remains a thorny issue with Morocco controlling two thirds of this underpopulated territory including most of the coastline. Whilst we won't go into the details of this issue here, which are complex, it resulted in Morocco withdrawing from the African Union after the latter recognized the Sahrawi Arab Democratic Republic (SADR), which wants full autonomy over the Western Sahara for the native Sahrawi population. Relations with Algeria remain frozen as they have long supported and funded the SADR.

12 European Council on Foreign Relations – 'The EU, Morocco and the Western Sahara – a chance for justice', June 2016

13 The Global Terrorism Index (GTI) is a product of Institute for Economics and Peace (IEP) and is based on data from the Global Terrorism Database (GTD) which is collected and collated by the National Consortium for the Study of Terrorism and Responses to Terrorism (START) at the University of Maryland. The GTD has codified over 125,000 cases of terrorism. Iraq tops the list at number one, whilst Zambia is at lowest risk at number 124. Source: Wikipedia.

14 October 31st 2015-October 31st 2016 facility has been made.[15] However, with the country on the slow march to liberalisation with an expected gradual currency float starting next year, we would expect greater leakage as official routes open for Moroccan's to invest/spend abroad.[16] The currency is also expected to be floated next year, and whilst it is considered to be fairly valued currently, any significant rise in energy prices could result in devaluation. The central bank also indicated that in such a scenario, fuel subsidies would also need to be re-introduced, leading to less of the fiscal budget being available for investment, possibly resulting in lower growth.

In conclusion, we are positive about the general direction of the economy and feel there is great potential. GDP growth for 2017 is forecast to be 4.0%[17], whilst attractive, does not justify the valuations being paid in Morocco. It is also worth noting that for the large scale projects mentioned earlier, there are very few direct beneficiaries listed on the stock market. Comparing valuations across frontier markets, Romania has a comparable consensus GDP growth figure of 3.4% for 2017, whilst valuations for the MSCI Romania are 10x 12M forward PE with earnings growth of 14%; Vietnam has a consensus GDP growth figure of 6.4% for 2017, whilst valuations for the MSCI Vietnam are 16x 12M forward PE with earnings growth of 27%. In light of this and taking a global view we remain underweight Morocco, but continue to monitor the market closely.

Tarang Patel, CFA, November 2016.

[15] We found there to be contradictory messages as to why these investments were not being undertaken, with examples being made of heavy questioning by authorities before permitting such transfers, whilst the central bank official indicated that obtaining permission was a simple matter.
[16] Moroccan's are currently limited to buying $2k of foreign currency, which makes investment and travelling difficult.
[17] Source: Bank Al-Maghrib

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