IMARA
Asset Management

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Author: Rainer Orth, Tony Schroenn, April Mthupha

Imara Asset Management 1Q 20 Investor Call - Transcript

Good afternoon everyone, thank you for taking the time to dial into the call.

With any crisis, while you are in it, it is unprecedented, with both the extent of the damage and the timing of a possible exit, uncertain. Covid-19 is no different. What we would like you to take away from this call is how individual companies in the portfolio, have managed to date and how they are likely to perform going forward. As a quick teaser, Safaricom, the leading telco in Kenya, has seen data consumption by its customers surge by 70% since lockdown, yet the share is trading at the bottom of its historical valuation range. For companies like these, a crisis creates and attractive entry for investors and Covid-19 is no different.

We are bottoms up, fundamental managers and believe that sustainable returns drive long term share price appreciation and that these returns are best delivered by high quality companies that are both robust and on long and wide growth runways. At this juncture I would like to emphasize to listeners that we are a Fund invested in companies that deliver essential goods and services to the fast growing African consumer market. This market will require these goods and services, regardless of current restrictions and future trends such as increased social distancing. In many cases demand is and will continue to be boosted. Africa has large populations, but low disposable income, so in order to be successful in Africa, there is an additional requirement overlay, in that these goods and services also need to exhibit the following characteristics:

- Firstly, small per unit, repeatable purchases.
- Secondly, they need to service the whole pyramid – Africa has wide base population pyramids, an excellent pioneering example of penetrating the bottom and largest part of the pyramid, is innovative rural banking by Equity Bank.
- Thirdly, they need to be cheaper and more efficient – eg formalized retail in Morocco, mobile money.
- Lastly, for a Covid 19 world, they need to be accessed safely and if necessary, remotely.

These characteristics are found in the following sectors:

- Telco
- Payments and fintech
- Banks
- Food retail
- Food production
- Healthcare

At Imara we have specialists in these sectors, each with over 15 years African experience.

In preparing the feedback for this call, we had to stand back and ask what do we think investors want to know right now.

- Firstly, are companies able to grow revenue through the crisis. If not, are they strongly positioned to grow afterwards from customer demand and/or market share gains.
- Secondly, Can they grow profitably.
- Thirdly, are they sufficiently robust to survive and achieve this.

Thanks to our QVG system, developed in-house and consistently applied over 11 years, it was encouraging that the answers to these questions came back easily and clearly. In QVG, Q stands for quality, which uses a Likert scale to consistently quantify points 1-3 above in a snapshot and over time, providing powerful assessment and predictive data.

Just a quick emphasis on the third point above, Robustness. It is a term easily bandied about in our industry, however, particularly in times like these, it is a term that we believe is multi faceted and holistic. Importantly our system measures robustness as:

- Firstly, Balance sheet strength – our companies have net cash or extremely low leverage and are typically working capital negative and highly cash generative.
- Secondly, sustainable competitive advantage – our companies have superior network, economies of scale, highest market share and better pricing power, which all positively reinforce sustainable competitive advantage.
- Thirdly, ESG – last but not least, Covid 19 has thrust companies into the ESG limelight. How you behave in your ecosystem, the fair treatment of customers, employees and environment is no longer optional, but critical for sustainable competitive advantage. We have incorporated ESG into our QVG system and as we do for financial metrics, we now have a systematic, consistent and methodical scoring system. I refer you to slide 5 for an overview and our detailed report is available on request.

Without further ado, we are going to jump into the bottoms up of our key portfolio holdings.

Safaricom

One of our largest holdings and it addresses two of our key themes, data and fintech, specifically mobile money.
Safaricom is a Global leader in Mobile Money, with Safaricom the number1 consumer brand name in Kenya and its MPESA mobile money service, the number1 brand in East Africa, higher than names you typically expect to see like CocaCola.

Turning to their first growth driver, **Data** – Africa has no legacy copper network, this has left a huge broadband opportunity for the mobile phone companies to capture, through mobile data and fixed fiber. Data demand was roughly doubling and then received an additional surge from Covid. Safaricom captures the lion’s share of this, with a wider, deeper network, that is both overhead and underground and economies of scale, reinforce market leadership and widen the moat, sustaining competitive advantage.
Now for Mobile Money (**MPESA**) – here the competition is cash and the fight even more urgent and critical now that Covid can be transmitted from person to person on cash and coins. To give you an indication of the scale of the mountain to climb, 97% of transactions in Africa are still in cash, thanks to MPESA, Kenya has made huge strides and is now at 90%, but there is a long way to go. In describing African growth potential, we use terms like use cases and a long and wide runway for growth. What this means for MPESA, is that their existing suite of services, say money transfer can still grow by adding more customers, more transactions per customer and larger amounts per transaction. That is what is meant by

a long runway. A wide runway is the scope to develop completely new services or use cases, that have their own long runway ahead of them. An example is pre-paid smart electricity meters in Kenya. An MPESA customer pays Kenya Power from their MPESA wallet on their mobile, as MPESA is real-time and fully integrated into Kenya Power's IT system, the meter is recharged real time via a Safaricom sim card in the meter. Job done. Now compare this to queuing up once a month at a crowded City Hall to pay your bill with cash, especially in a Covid 19 world! To put some numbers on this widening of the runway, the number of transactions per customer per month on MPESA has risen from 5 to 13 over the last 4 years, in the last financial year alone, the number of tills that can accept MPESA has risen by 40%. From a financial perspective, the marginal cost of these new services is low, as they leverage off existing infrastructure, so revenues flow to the bottom line.

Getting back to numbers, the success of data and MPESA have taken Safaricom from a 30% ROE business to a 60% ROE business, despite pressure on traditional Voice and SMS revenues. It has a very strong, net cash, balance sheet and we expect revenues to comfortably grow above nominal GDP for the foreseeable future.

In terms of ESG, and specifically related to Covid, Safaricom has:

- Made available its network of 175,000 agents nationwide to distribute masks for the government and Aid organizations.
- Zero rated all person to person transfers less than 1,000 Shillings as well as zero rating all transfers made by hospitals and dispensaries.
- Doubled the speed of its home fiber, for NO extra cost, for the next 90 days.

To conclude, Safaricom is robust and can grow shareholder returns through and on the other side of Covid. Full year results to 31 March have just come off the tapes and for the second half of the year EPS is +24% and Free Cash Flow +34%.

Hightech Payments Systems (HPS)

Sticking with the Fintech space, we move on to Hightech Payment Systems, listed in Morocco. They are the market leader in Africa for bank card software and are helping drive financial inclusion and the cash to non-cash revolution. Covid 19 is a TAILWIND for them, as cash transmits the virus and drives quicker uptake of cards and mobile money.

Over and above this, they own the Moroccan interbank switch, which is seeing an exponential growth in traffic, as card transactions and lately mobile money become increasingly popular. Government and large retailers are further driving take up of non-cash payment through various incentives for cards and mobile money and disincentives for using cash.

HPS is an asset light business, with an ROE 3x its local cost of capital. We expect the business to comfortably deliver 20%+ revenue growth over the next few years, with rising profitability.

Their valuation is exceptionally cheap in their sector at 2x EV/revenue and it is a likely acquisition target by one of the large global payments companies.

Label Vie

Moving onto our next bottoms up opportunity, we have Label Vie, a Wholesale and retail supermarket chain driving formalized food retail in Morocco. Formalized retail penetration in Morocco is surprisingly low at 17%, with most shopping done at traditional markets and mom and pop stores. This represents a huge opportunity for the operator that gets it right and we believe that operator is Label Vie, with its multi store format to address the different tiers of customers. Covid has increased traffic through their stores by 250%, as traditional markets have been closed and 25% of mom n pop stores shut. A number of first time customers, quickly became repeats due to better sanitization, more choice and lower prices. There are massive gains from economies of scale and margin expansion from the positive reinforcement cycle of increased volumes driving increased supplier rebates. Sale of their de-merged real estate division in 2021, via a listed REIT, should result in a substantial tax free gain versus current carrying value. Revenues should continue to grow substantially above nominal GDP, generating ROE's significantly higher than cost of capital and an attractive valuation of 8x EBITDA for a high growth retailer.

Banks impact

Banks are seen as an "essential service" and so retail branches remain open with social distance practices. But then strategy focus is on electronic channels of distribution. At its core banks do not have to interact face to face to make money. I will briefly outline the impact on our top 2 banks positions – Commercial International Bank of Egypt and Equity Bank in Kenya.

Commercial International Bank (CIB)

CIB will keep on making money despite curfews and lockdowns. The majority or 60% of its revenue is from government bonds, 20% from loans and 20% from transaction fees. If you look at its main source, the bond portfolio, despite several rate cuts, management says bond market remains stable and in many cases, they have been able to lock in higher rates on bonds. Its also some where it can flex a bit and build some leverage. The advantage of being the largest Tier1 private bank is you are the go to bank for deposits and this has been the key success for CIB over the years – the way they are able to mobilise low cost current accounts.

20% of income comes from loans which is mostly to multinational firms that require working capital, so a very safe source of income. Management has noted that they have a 4% exposure to the tourism and hospitality area which will be provided for.

20% of income is fee income on FX, remittances, credit facility fees, transaction fees. Now the fee portion has already seen a slowdown as shopping hours are less and the economy slows to what is now predicted to be about +1% GDP growth from 5-6% before. However, they did have a good 1q20 after booking several new capex loans.

As you can see the picture still looks robust and we expect to see 10% of operational growth instead of that 25% initially anticipated.

Equity Bank

In Kenya, our banks position is Equity Bank.

The focus for the last 8 years has been on building a mobile and digital bank infrastructure. So, what COVID-19 really does is to accelerate that strategy. Customers want to transact remotely and not handle cash. This theme still has a long runway for growth. Currently, Kenya is still 90% cash based transactions (other countries in Africa are still well above 95% cash based).

40% of Equity Bank's income comes from transaction fees. March transaction numbers show that transactions below KES1,000 doubled y/y and transactions of KES 1,000-5,000 (USD10-50) is up 25%. So as the economy slows you are likely to see overall transactions to slow but overall digital transactions to still see growth. Effectively digital transactions is taking more market share of the transactions space.

25% of Equity’s income is from its sizable bond book which they will likely grow / flex this year but adding more cheap deposits.
35% come from their loan book which is much smaller than before as the interest rate cap made them de-emphasise this area. It is largely focused on trade and working capital for corporates and SMEs and also a consumer loans to civil servants. It is clearly an area which they will continue to de-emphasise.
So again, where we may not see the growth of 20-30% we were expecting in 2020 earnings will remain robust. Equity has kept their ROE guidance at 22% which is close to their trend for the last 3 years.

Thank you for dialing in. I will now open the line for questions.