Imara Asset Management

Imara Funds Quarterly Report

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Performance Review:

The year started very poorly for most asset classes, with significant declines in developed and emerging markets, commodities - especially oil - as well as currencies such as the Rand, Rouble and Real. Africa was not spared. Commodity, energy and financial stocks globally took a pounding. By the end of the quarter we saw many of these losses reverse. For investors it was a very difficult quarter both for long only funds but also hedge funds who had one of their worst quarters in a while. In terms of African markets, there were very few that were up. South Africa being the most notable but only in March as the currency recovered and the market with it. Over the quarter South Africa (FTSE/JSE) was up by 8.6% . Nigeria was down 17.1% and Egypt down 7.2% that included a devaluation against the dollar of 12% in March. Kenya ended 6.0% up. Of the smaller markets, Zimbabwe fell by 13.7% but on low volumes. (All indices quoted except SA are MSCI in US dollars).

Our flagship Africa fund, the Imara African Opportunities Fund ('IAOF') fell by 8.1% over the first quarter. This compares with a decline of 3.8% in the MSCI Africa ex SA index and a rise in the MSCI Emerging Markets index of 5.7%. Unfortunately our exposure to the smaller markets and in particular Zimbabwe accounts for the relative underperformance in what has been a tough quarter. Over the past twelve months, IAOF is down by 21.2%, as compared with the MSCI Africa ex SA Index decline of 19.4% and an MSCI EM fall of 12.0% (All indices net).

Valuations are now back to where they were in 2009…low PEs but with attractive dividend yields. This makes us optimistic for the future but are aware that as in 2009, we may need to be patient.

Portfolio Review:

As we have stated previously, the portfolios of our various Africa funds are largely driven by our investment approach. We aim to buy good companies with high returns on invested capital and with sustainable business models at the right price wherever they might be listed in Africa. In this way we are index agnostic. The liquidity terms of the Funds allow us to invest in such businesses that may trade less often than the blue chips in the more liquid markets that make up much of the various African indices. As a result, the Funds have exposure to a number of the smaller markets and companies in Africa that more benchmark orientated portfolios might miss or ignore altogether. We choose to hold a focused portfolio of businesses that currently number less than thirty. Our aim is not just to pick the winners, but as best as possible to avoid the losers. This approach has allowed the portfolio to sustain less volatility than the indices and outperform them over the medium to longer term.

Since our focus is primarily on investing in strong business models rather than speculating on market sentiment or economic outcomes, neither of which we have any expertise in, our portfolio turnover is low....often less than ten percent. It allows our investors and ourselves to sleep better at night. Our weightings have not changed much this quarter and we have added no new names to our portfolios. Indeed in many instances weighting changes reflect the movement of the underlying asset values within the portfolio.

That is not to say that we have been sitting back on our laurels. Far from it. We have maintained our schedule of country and company visits that has included meetings with companies in Nairobi, Lagos, Harare, Lusaka and one-on-one meetings with various African companies in Cape Town and Dubai.

Commentary:

Markets globally have experienced huge volatility over the first quarter and Africa has been no exception. After serious market falls in January in both developed, emerging, frontier, currency and commodity markets, by the end of the first quarter many of these markets had recovered their losses. Africa ex SA did not however, falling as it did by 5.2% in dollar terms over the three months. Such volatility across the board may suggest that we might be at a turning point in capital markets. The trade-weighted US dollar had by the end of 2015 risen by nearly 40% from its previous low (2011), and its rise has proved detrimental to commodity prices and emerging markets in general. This is not unusual and indeed such a negative correlation can be traced back to the 1980s. One might have expected emerging markets to have fallen earlier than they did (e.g. 2012), in line with the rise in the dollar and the fall in various commodity prices, but they held up for longer we believe as a result of the substantial quantitative easing that global central banks have embarked upon since 2009. That has led to extremely low rates of interest, now negative in some instances that have seen capital flows chasing yields wherever they might be: in this case, in emerging markets. The fall in markets over the last two years in particular have been substantial in US dollar terms, thanks in part to currency devaluation but also in terms of local stock market performance. Developed markets have been the place to be invested over this period. The last time that the US trade-weighted dollar rose by 40% or so was over the 1994-2000 period which included the Mexican, the Asian and then the Russian crises. Arguably then, we could be at or close to the current peak in the dollar. Hence the bounce in oil, commodities, commodity stocks and emerging markets. The MSCI Emerging Markets index rose by 13.0% in March alone. No wonder certain strategists are calling the bottom of emerging markets. For Frontier markets such as Africa, we may well see a lag in their recovery relative to their larger and more liquid peers as we saw in 2009. From an index perspective and from fundamental criteria, valuations in Africa are certainly back to where they were in 2009. Low price earnings ratios and attractive dividend yields in many African markets illustrate this point. We believe we are therefore close to a bottom in Africa and indeed we may have seen the worst already.

As part and parcel of the current environment in Africa's frontier markets, volumes traded in the various markets have also fallen dramatically. Whilst foreign investors may have remained important for daily volumes the quantum has fallen. In Nigeria for example, where the official rate of the currency is set at an artificial and unrealistic level, foreign investors are naturally staying away not wishing to invest at the official exchange rate. Further it is now hard to repatriate any proceeds from sales into US dollars. So for the foreign portfolio investor, Africa's largest market outside of South Africa is now all but closed for trading. No point in buying and no point in selling either. Interestingly too, local investors – in large part the domestic pension funds – are also scared, despite the fact that interest rates are lower or close to inflation. Yet valuations suggest equities are a buy. With less than 10% of their portfolios – which are increasing at over 15% annually with new inflows – in equities, we estimate that it would take at least 40 days of daily volumes at current levels just to stay still. Trapped dividends owed to foreign investors could be large too. When a turn comes, the upside could be dramatic.

The Nigerian economy has slowed dramatically as can be expected with the collapse in the oil price, their primary export and foreign exchange earner. However Government - or maybe the President himself - has been reluctant to allow the currency to devalue fearing it will be harmful for the general populace. This has forced the Central Bank to control what available currency there is. For businesses this has forced them into the parallel markets to access currency that can then be used to import raw materials. This has driven the 12 month forward rate down to N280 per US dollar vs. the official rate of N199 (the black market rate is much lower but hard to gather reliable data on) but it has forced businesses to adjust their prices to match the cost of raw materials, in effect driving local inflation which has now moved to 11.4% thereby harming the local populace! Another consequence of the shortage has been to encourage import substitution of raw materials but it takes time for local producers to gear up and if they can, their prices are often higher than imported prices. The vast majority of our holdings in Nigeria already access much of their product from local sources so are better positioned than many, and of course many of these are subsidiaries of multinational companies who can provide outside assistance. Despite the adverse economic and financial fundamentals, the results season that has just ended has been surprisingly positive. In the consumer manufacturing sector, cash generation for Unilever and Nestle has been strong enabling debt levels to be cut sharply. In the banking sector, the results for 2015 have also been better than expected, although there is always the concern that Tier II banks have skeletons in their closets. Having met with the management of GT Bank and Zenith, we remain comfortable that they can handle the difficulties better than most and guidance for 2016 remains positive despite the environment. The situation today is far better than it was after the 2008/9 Nigerian banking crisis, yet the valuation of the top tier banks are back to 2009 levels with dividend yields in double digits but with PEs at 5x or less. ROEs are down but still very respectable on average around 20% for the Funds' banks.

The Egyptians have also tried to peg their own currency which has also led to shortages of currency for imported raw materials or for foreign portfolio investors looking to repatriate money. GCC countries have helped bolster Egypt's foreign currency reserves, but with the fall in the price of oil, this is no longer as easy as it was. In mid-March the Egyptian central bank chose to devalue the Egyptian pound by 12% which saw an immediate upward move in the blue chips, with smaller stocks reacting less speedily thereby ending down in dollar terms post the devaluation. Stocks remain cheap however but this reflects the tough economic environment. It also reflects the difficulty foreigners have had in repatriating their funds. Excluding South Africa, Egypt and Nigeria account for 54.3% of the indices implying that any new money would likely go toward Morocco and Kenya, the next two largest markets and which are now both about the same size as Egypt. This may explain why both these markets have held up well so far in 2016. We wrote in our last quarterly that we were concerned about the Kenyan banking sector and it was an issue we raised with the IMF in Nairobi when we visited them in October. It has been of interest to us to see the recent results from the banking sector which in the majority of cases admitted to a sharp rise in non-performing loans, an area we have felt that the banks have been too relaxed about in the past, with the exception of Barclays Bank where they appear more conservative. Post quarter-end, a mid-tier bank has been put under curatorship by the Central Bank, highlighting to us that the banking sector remains an issue and needs to be watched. It has had no effect to date on the rest of the market and our industrial companies continue to perform as expected.

Volumes in the smaller African markets have been minimal as one would expect in this environment whether in Botswana, Mauritius, Zambia or Zimbabwe. In Zimbabwe, whilst the market was weak over the first quarter much of this was in January. In March we have noticed a recovery in certain blue chips whilst the recent results season has proved better than expected and encouragingly, with more companies paying out dividends. In some cases the dividend yield is now well over 6% in dollar terms. This has been as a result of a determination to cut costs thereby allowing product sales prices to be cut that in itself has brought about a recovery in volumes. With the rand now stronger against the dollar at a time that rand costs are rising, the deflationary impact of a strong dollar/weak rand are easing for Zimbabwean companies. On a negative note, the Reserve Bank reintroduced exchange control effectively as a measure to control dollar outflows. Unfortunately it has had the reverse effect that has resulted in a physical cash shortage. We hope the Bank will reverse this policy soonest. Positively though, Zimbabwe received a good report from the IMF delegation that visited the country in March to assess the just ended Staff Monitored Programme. The Executive Board of the IMF meets in early May to discuss Zimbabwe whilst the Government is now putting together a three year economic reform package to present to the IMF as part of a move to a Structural Adjustment Programme. The ultimate intention is for Zimbabwe to clear its arrears with the World Bank and IMF so as to free up concessionary loans from the multilateral lenders toward the end of 2016 and into 2017. This would be very positive for the economy and country and hopefully the stock and property markets.

John Legat, April 2016
