IMARA
Asset Management

Imara Funds Quarterly Report

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Performance Review:

The year started poorly for most asset classes with significant declines in developed and emerging markets during Q1. For Q2, the developed and emerging markets were effectively unchanged. The African markets were mixed, with Q2 gains in South Africa, Egypt and Zimbabwe and losses in the bigger markets of Nigeria and Kenya. A devaluation of the Nigerian naira by 40% in mid-June dominated the news – before being displaced as the lead story by Brexit.

Nigeria was down 12.7% over the quarter whilst Kenya and Mauritius both fell just under 4%. Of the smaller markets, Botswana fell by 6% while Zimbabwe rose 3.5%. (All indices quoted except SA are MSCI in US dollars).

Our flagship Africa fund, the Imara African Opportunities Fund ('IAOF') fell by 2.8% over the second quarter. This compares with a decline of 3.5% in the MSCI Africa ex-SA index.

We wrote last quarter that "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." This is still the case and especially now that Nigeria is allowing the naira to float more freely thereby enabling commerce to re-start following the dollar drought.

Portfolio Review:

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 to avoid the losers as best as possible. 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.

Commentary:

Global markets settled down after the turbulent first quarter although volatility rose sharply again at the very end of the period as the markets had seriously misjudged the result of the Brexit vote. The main impact was felt in the currency and fixed income markets. Overall for the quarter the developed and emerging markets were effectively unchanged. Although Africa barely reacted to the Brexit vote, the Africa ex-SA index was down by 3.5% thanks to the sharp 40% devaluation of the Nigerian naira just days earlier. The devaluation was forced on the government as the forex shortage started to bite; airlines were invoicing in US dollars or from Ghana, and some airlines suspended their flights to Nigeria completely. Whilst this hasn't deterred FDI; Pick n Pay announced plans to partner with AG Leventis to roll out large and small shopping formats, for example, domestic companies are now sharply accelerating local content programmes where possible. The central bank has also introduced an OTC FX futures market and FX Liquidity in the interbank market is now starting to rise. Inflation has also been rising, to 15.6% in May, as most trade has been conducted at the weak parallel exchange rate. The central bank cleared a UD$4.6bn FX backlog in spot and forward trading as the naira floated. The government is also talking to militants who have been attacking oil infrastructure in the Delta region. MTN may list its Nigerian subsidiary as part of a deal to settle its fine. The impact on earnings of our Nigeria holdings' varies. The banks have fairly large FX balance sheets so should weather this storm. The consumer stocks have expressed the view that profits will be down around 25% based on import content although this looks to have been discounted by the market over the past few months. The naira still looks slightly overvalued to the extent the rate still seems to be being managed by the central bank. No doubt when the foreign exchange market does finally clear foreigners will start to buy the market and this could then tempt the sizeable local pension funds back into the market.

In Kenya the main focus has been on the secondary banking sector and the desire of the new central bank governor to police bad banking practices before they become a problem. The main issue seems to be (the age-old problem of) insider loans to directors against a background of a booming property market. The Central Bank continues to weigh against poor governance and the suggestion is that tax relief for NPL's arising from insider loans will be withdrawn. The Central Bank has mandated higher general provisions. An expansionary budget was also announced with the deficit rising to 9.8% of GDP although this includes the Single Gauge Railway project. Excluding this, the deficit falls to 8.5% of GDP with economic growth of 6% forecast. The Kenyan shilling has remained steady despite Brexit fears on the horticultural sector, a surprise rate cut of 1% to 10.5% as inflation has fallen to 5.3% and is expected to fall further, and higher oil prices. The price of tea has fallen around 25% yoy due to much higher production because of El-Nino rains. South Sudan has become the sixth member of the East African Community following a more stable political background. The country has about 10m people.

There was little news from Egypt during the quarter. The economy slowed slightly in 2015/16 to 3.8% with similar expectations for 2016/17. The Central Bank also raised interest rates but private sector commercial banks ignored this and left rates unchanged. Brexit is not expected to have a great economic impact on North Africa.

In the smaller markets Zambia is planning/looking for an IMF programme - although after elections scheduled for next quarter. In Mauritius, the double taxation treaty between Mauritius and India was modified suggesting a potential fall in financial income although this change was well known. For most of southern Africa El-Nino has been a major disaster for farmers with several countries requesting significant food aid. The worst El-Nino in the 20th century was 1997/8 although 1992-95 was also very serious and this year is bad by comparison too. For countries reliant on agriculture, it is tempting to suggest that very poor harvests and political unrest tend to go hand-in-hand, hence 1997 produced the Asian Crisis which resulted in political unrest and even a long-term president like Suharto being unseated. Also, in 1997, Zimbabwe began it's downwards slide when the War Veterans who were demanding unpaid pensions were paid off by an embattled government. This drought is clearly causing turbulence in Zambia, conflict is starting to flare up again in Mozambique, SA has seen a rise in political unrest surrounding municipal elections, and Zimbabwe may once again be on the edge of change. The government is close to running out of money leaving few options except change and reform. Fingers crossed.

Jon Chew, July 2016