Investment note - December

IMARA
Asset Management

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On the road with Imara Asset Management – Kenya, Zambia and Zimbabwe

Last month we travelled to Kenya, Zambia and Zimbabwe. We arranged meetings with blue chip companies, entrepreneurs as well as multilateral institutions such as the IMF. We used strictly local airlines and stayed in or near the CBD in all three countries. Two foreign investors joined us to witness first-hand the opportunities on the ground. We started the trip in Nairobi and ended it in Harare, with a day-trip to Lusaka in between. The service and scheduling on Air Rwanda and Kenya Airways was excellent and bodes well for intra African connectivity.

Whilst there are similarities between all three countries, there are huge differences, in policies, opportunities and appreciation potential. We are invested in all three countries with Kenya having the highest allocation and the main body of this note will be focused on Kenya with short sections on Zimbabwe and Zambia. We have also included some of our key company notes in our monthly commentary, click here to access it on our group website.

First stop was Nairobi, the people, the energy and the growth potential is immense. Mobile penetration has been catalytic to internet access and financial inclusion. The dominant platform, Safaricom, one of our top investment opportunities was our main meeting. The business has been a key enabler to internet penetration, with their latest numbers showing 91% 3G coverage and 17m data subscribers. On the fixed data side, they have laid 5,500kms of fibre, passing 200,000 households with FTTH and 2000 buildings with FTTB. The company is one of the most innovative companies on the continent, continually evolving and incubating new ideas to stay ahead of competition.

One of Safaricom's key advantages is that they don't operate in a country where access to capital is cheap. When access to capital is cheap, investors can place their bets on management or an idea. In Africa, access to capital is scarce and therefore the big companies have a significant advantage in funding and innovation, they hire the best teams, pay the biggest salaries and access the cheapest credit. They also have the benefit of a multi-year investment in brand equity and infrastructure, which gives them a strong barrier to entry against competition and a lower obsolescence risk than other tech companies. Although 4G coverage is much lower at 53%, this will increase in time and so will fintech, e-commerce and data revenues.

After on-site discussions with management we were further encouraged by the growth prospects. Kenyans have used the telco led payment platform MPESA with great success and there is an entire industry that is forming off its backbone. Currently there are 21m active day users of MPESA, consumer network effects are strong and Safaricom's competitive advantage is further entrenched by 1) low acquisition costs and 2) sticky customers/enduring relationships.

Use cases are being created to leverage and in some cases compete with MPESA although ultimately the real competition is cash. Currently 80% of all transactions are still in cash, giving a long runway for growth for cash displacement technologies. We want to see more competition in the space as this will encourage adoption of electronic forms of payment. The consumer behavioural data that comes from this backbone is extremely powerful, providing scope for more products including loans, insurance, healthcare, education, enterprise solutions and market place solutions. Because we like the financial services industry and we believe that financial inclusion will be an important driver of aggregate demand and therefore GDP at a consumer level, we are watching the developments in mobile loans closely. Both the banks we met, KCB and

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Equity Bank are growing mobile loans in absolute size and volume, whilst reporting low NPLs. By nature, the loans are very small in size and short duration, therefore highly responsive to the microconsumer environment.

Our last meeting in Nairobi was with the IMF, we discussed the debt sustainability analysis of the country as well as their view that the KES is 17.5% overvalued. Whilst we agree that the KES is overvalued, we are of the opinion that the country will successfully refinance its 2019 Eurobond. Although credit growth remains weak, GDP growth remains high, with a growth projection of 5.5%-6% this year (In 6.2% in 2Q18). Inflation remains low relative to African peers and whilst we remain concerned about the growing composition of USD commercial loans in the country debt mix, we are confident in the ability of the central bank and policy makers to manage themselves out of the rising debt levels. Politically the relationship between the IMF and the Government remains strong, which is encouraging because we were concerned by the delay in issuing the IMF article IV consultation. A key concern for the IMF was the lack of implementation of reforms needed to reduce the budget deficit as well as a lack of progress on rate cap modification. From our meetings with the Kenyan banks, they still believe that there will be a form of rate cap modification and it is a question of when and not if. The IMF supports rate cap modification, their recommendation is that they remove the floor, delink from CBR and move the ceiling/cap upwards (in a manner that doesn't constrain ability to price risk), this would enable the banks to start lending again and price risk appropriately.

In Zambia we arrived and went straight to visit one of our Private Equity investments, Zambezi Berry Company. This is an exciting project, a pioneer, large scale investment in a blue berry farm currently doing 50ha with scope to expand to 500ha. If the project proves successful, the upside is significant. Ultimately it will come down to choosing the right varieties that give the best yield and pricing. So far indicative yields are looking good and although it will be an export focused business there is scope to develop domestic taste. The other highlight was a meeting with AB Inbev's local subsidiary Zambrew. It is an extremely well-run business and management is very thoughtful about how they segment the customer, using pack size and price moderation effectively. They are doing some fantastic ESG work and improving local sourcing of grains. They estimate that 75% of the alcohol segment is informal (mainly illicits), the runway for growth will come from taking market share from the informal sector as well as growing in line with the drinking age population.

The trip ended in Zimbabwe. We had meetings with several of the large listed companies and we went to the informal market too, to get a feel of activity on the ground. The informal market was a hive of activity, with fruit and vegetables, cooked food, clothes, shoes and construction material on show. Anecdotally, I believe that the informal sector seems to be growing, a worrying situation, but an unsurprising one given the economic mismanagement of the economy over the years. In our conversation with the vendors they all seem to source USD locally somehow, despite the shortages, they then use that hard currency to buy various items in the border towns.

Whilst it is always good to see trading activity, some of the personal stories shared by the vendors and the difficulty with which they operate is heartbreaking. In the formal sector, despite the challenging trading conditions, our key investments, particularly Delta Breweries, talked to robust volume growth, with lager volumes up 54% in the first half of the year (financial 1H not calendar), these are peak levels post-dollarisation (since Feb 2009). On the downside, the management teams highlighted the negative impact on activity of the 2% money transfer tax, national payment statistics reflect this too (we commented and provided tables on this in our October monthly report, click here if interested). Since the tax, shortages have worsened, and speculative pricing has kicked in with some outrageous pricing for imported luxury items.

On a positive note we were told that the government has stopped issuance of treasuries and most management teams believed that the Finance Minister and the President were committed to reducing the budget deficit and turning the economy around. Given that government is past the election hump and the ruling party controls 2/3rds majority, we hope that they can implement some of the policy reforms necessary to enable this. Cabinet was put in place from September, so it is still too early to tell whether this team has been effective or not.

We all learnt a great deal and came away even more convinced that the perception of the risks in Africa are different from the reality when you meet the companies and management teams. You need to get on the ground, meet the people and see for yourself.

We will be planning more trips to come in 2019!

Craig Bandason, Portfolio Manager
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