IMARA
Asset Management

Zimbabwe update

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Circumstances do not make the man, they reveal him.

Man is buffeted by circumstances so long as he believes himself to be the creature of outside conditions, but when he realizes that he is a creative power, and that he may command the hidden soil and seeds of his being out of which circumstances grow, he then becomes the rightful master of himself. ~ James Allen

Much has been written about Emmerson Mnangagwa and the so called second republic. In truth, very little is clear about what kind of leader he will turn out to be. After he narrowly emerged as the winner in the July elections there was a challenge of the results by the opposition party, the MDC. The outcome was closely followed both at home (in Zimbabwe) and abroad, in the end, the constitutional court dismissed the application due to a lack of evidence. The regional observers were non-committal and the EU observer mission concluded that the election failed to meet international standards and made 23 recommendations in their final report (if you are interested in the full EU Observer mission report click here). In our view, whilst the pre-election phase was peaceful, the post-election violence was deplorable and there has been a lot of finger pointing since. It is tempting at any election phase to dare to predict the political outcome, but that is not our game, so I will steer away from that. What we believe is that legitimacy comes from stringing together credible actions. In all our markets we try to focus not on what the leaders say, but what they do. There is usually a gap between what politicians say and do, the really good ones can narrow this gap, but most of the time we find that type quite rare. Every time long standing leadership in the Africa region changes, our hearts skip a beat and we hope, we genuinely hope, that we have a good leader. One who says what he does and does what he says and the whole world buys into it.

One of President Mnangagwa’s new appointments was Dr Mthuli Ncube as the Finance Minister. Two weeks ago, we finally got a taste of some of his policy and it is proving a bitter pill to swallow for both the business community and the rest of the Zimbabwean population. We have spoken at length to our investors about the age-gap disconnect, leaders who have been in power so long that they often seem too old to care and a youthful population on the other side that is too young to know the evils of the past. This tension between the “too old to care” group and the “too young to know” group is what we think will push out the old and usher in the new over the long term. Initially we viewed the announcement of Dr Mthuli Ncube as positive, at age of 55, he is certainly not in the “too old to care” category and definitely not in the “too young to know” category, he is perfectly wedged in between the two. Layer onto that his impressive qualifications, international business experience and you have a recipe for a policy maker who can shake things up and steer Zimbabwe in the right direction. We still believe if given the chance, some of his policies will put Zimbabwe in a better place, truth be told he was handed a poisoned chalice and it was never going to be easy to turn things around in a short time frame. In his fiscal statement we would have liked to see a more aggressive fiscal consolidation commitment and a less onerous transfer tax. Having initially failed to consult the business community on the transfer tax, it seems Dr Ncube has been engaging and open to feedback both positive and negative, usually a good sign.

There were actually two key policy statements this month and although Dr Ncube’s fiscal statement stole the attention, we viewed the announcement in the Monetary Policy Statement of the separation of Nostro FCAs and RTGS FCAs as the first step in official devaluation. For our short commentary on both statements, you can click here and scroll down to the

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Zimbabwe section in our monthly commentary, there is also additional commentary on the outlook at the end of the document.

This note is meant to supplement our monthly commentary and highlight where the market is, how we are valuing our portfolio and how we are positioning our portfolio. In our investor update call on the 24th of October, we will also be available to take any questions. We think circumstance and time will reveal what kind of leader President Mnangagwa is and how good a finance minister Dr Ncube is. What is particularly difficult for both is the behavioral economics of a populace that has lost faith in policy makers, that doesn't trust any form of local currency and that is scarred by the recent experience of hyperinflation. Given what has happened over the past 2 weeks – the fuel queues, shortages of goods and store shut downs, we are sure the minister will engage the business community more and further refine his policies. The Imara Zimbabwe team has been particularly vocal in this regard, at a group meeting 2 weeks ago, they mentioned they were pushing for official devaluation and possibly joining the Rand monetary area instead of the dollar.

Where is the market and how are we valuing our Zimbabwe positions?

- In local currency terms the market is up 85,0% as locals look to hedge against inflation.
- In USD terms, using the Old Mutual Implied Rate (OMIR) the market is down 37,3%. The actual OMIR has moved from 1,77 (implying 1,77 units of local currency to 1 USD) at the beginning of the year to 5,19 yesterday (see table below). We use the OMIR to value our Zimbabwe positions, this means, at current rates every position is valued at 5,19 units of local currency (some call it the zollar) to 1USD, or 19,3 cents to the dollar, or an 80,7% haircut to all Zimbabwe positions. We often get the question, why OMIR? Our thinking is that the Old Mutual mechanism is the only way we could legally source USD given the foreign currency shortages prevailing in the country. It was also the fairest way to treat any investors subscribing or redeeming funds instead of imposing asymmetric levies. The Old Mutual Implied Rate was the best compromise between liquidity and valuation. In addition to this, we were of the view that our investors are focused on the long term and therefore would be willing to ignore the short-term volatility in the OMIR with a view that it would mean-revert eventually, which it has in the past. The fund managers have used the OMIR in such extra ordinary periods such as the hyperinflation period 2007-2008. Once the economic situation improves and we have a viable local currency, we will revert to using the prevailing FX rate. What is fascinating to us, is that exactly a year ago the rate moved sharply to 5,83 on the 20th of October 2017, implying an 83% discount to the USD, valuing positions at 17cents to the dollar, this turned out to be the peak last year and the rate dropped to 1,77. We are not saying the same will happen this year, but the market has been prone to extreme volatility. Currently the parallel market rate, the street rate, is 3,50 to the USD, significantly lower than OMIR. We are in the exact same position this year except we have the elections behind us instead of ahead us. This leaves us extremely optimistic that with the right political will things can be turned around, the leadership just needs to deliver. There will be pain in the fiscal consolidation required and the burden of responsibility is a big one if they are to regain trust and hold themselves accountable to the business community and the Zimbabwean citizens. You can see from the table below the OMIR has been extremely volatile, but the average OMIR since dollarization is just above 1 and although it moved sharply last year it just as quickly appreciated, we think the same can happen if this government starts putting together credible actions.

How are we positioned in Zimbabwe?

Date	OMIR	% Discount to the USD
Average since dollarisation 2009	1.06	-5.6%
1 year ago today (18 Oct 17)	5.41	-81.5%
29-Dec-17	1.77	-43.4%
28-Sep-18	2.50	-59.9%
18-Oct-18	5.19	-80.7%
Average ytd	2.20	-54.6%

- In our note in November last year we wrote

  "One of Zimbabwe's top economists John Robertson, estimates that domestic industry has shrunk 65% since 2000. If that is true, domestic industry would have to grow by 185% to get back to where it used to be. Whilst there is some permanent capital loss and this measure may not be appropriate because some industries have completely shut down and are unlikely to recover (e.g textiles) we believe that the scope for recovery growth for most companies within our portfolio is high. Most of the companies are trading at 40-55% discounts to regional peers and operating at 55-60% capacity utilization. Some of them like Delta Breweries, the monopoly brewer in Zimbabwe, managed to emerge from hyperinflation in the 2007-2008 period (hyperinflation peaked at 500 billion percent) with their asset base intact and with minimal debt. Post dollarization, they then used internally generated cashflows to fund CAPEX programs when FX was readily available, purchasing machinery and equipment at 1:1 with the USD, building a new Chibuku Super plant in the process, replacing obsolete lines, and adding new ones. In addition to this, they managed to reduce overheads and maintain competitiveness."

  For the full note click here

- Largely, we are still positioned the same way, in our Zimbabwe country fund we have tilted the portfolio aggressively in Econet because Ecocash is treated as a quasi-currency and therefore buying Econet is buying Ecocash, which makes it a good hedge if the currency devalues or you get a bout of hyperinflation. We have also shaped the portfolio to remove smaller illiquid positions in the flurry of activity and panic buying to take advantage of pricing and further concentrate the portfolio in a few corporate champions.

  In conclusion, despite the volatility and the politics, we are still very confident on our allocation. The corporate results so far have been impressive, with our companies showing double digit volume growth driven by both pricing and volumes. However, the FX shortages are the biggest risk in the near term and the money transfer tax has been viewed negatively by the business community so short-term management strategy may shift to a defensive stance. We have always communicated to investors that we are valuing these companies on an asset basis and not necessarily just an earnings basis, after an 80% haircut a lot of them are looking attractive. We are traveling to Harare in mid-November and we will include some of our highlights in our November monthly commentary.