IMARA
Asset Management

Investment Note - Zimbabwe

Date: October 2015

Issued by: Imara Asset Management Limited

Zimbabwe: Ever Closer to an IMF deal

It's easy to get depressed when the lights go out for most of the day, companies are closing down and jobs are being lost. In the financial markets, interest rates have fallen to very low levels making it tough to place funds in the money markets to earn a return, whilst the stock market is down 19% so far this year (to end September). The economy is barely growing with the latest Government/IMF forecast suggesting GDP growth of 1.5%.

Then again, Russia and Brazil are in recession and China is suffering a severe economic slowdown. Currency markets have also been in turmoil with the Brazilian real, the Russian rouble, the South African rand, the Australian dollar and the Euro all under pressure this year against the US dollar. Zimbabweans on the other hand have at least seen their purchasing power rise thanks to the dollar which has shown itself as an important store of value. So relatively speaking things are not that bad as compared with other emerging and frontier countries and that of our neighbours.

Of course a rising dollar makes Zimbabwe less competitive with its neighbours in the short term, until such time as local costs for our neighbours rise in line with their devaluations at which point that current competitiveness with Zimbabwe disappears. In order for Zimbabwe to stay competitive, prices need to fall and costs need to be cut. That requires flexibility especially within the labour markets. Salary cuts and /or a reduced working week are now common place in Zimbabwe. As costs fall, prices can be cut to stimulate volume growth. By comparison, when Ireland suffered its own financial and economic crisis in 2008/09, they could not bail themselves out by devaluing their currency as they use the Euro. That forced them to cut costs across the board as well as to cut prices in order to stimulate demand. Today Ireland is recovering rapidly whilst other European countries continue to stagnate. Indeed in France for example, it is legally difficult to cut wages let alone cut jobs to reduce costs. Importantly in Zimbabwe it is government policy to encourage disinflation or 'internal devaluation' as regularly stated by the Governor of the Reserve Bank. This makes much sense!

The cost of living in Zimbabwe is falling according to the consumer price index, the latest number being a negative 3.1%. This is a consequence of increased competition from both local and foreign suppliers of goods but in addition, companies who have been able to cut their costs and improve their efficiencies have been able to cut their prices which itself has boosted demand for their products. Innscor's Bakers Inn would be an example. They cut their bread prices from $1 to 90cents with the introduction of bond coins, rebranded, changed the recipe, changed the management and volumes rose from 250,000 loaves per day to 450,000 in a matter of months. Breakeven is 310,000 and they will shoot the lights out if they reach 475,000 a day.

Introducing more efficient plant and machinery into industry is all part of the process to reduce costs and in turn cut prices to stimulate volumes. Taking on debt to fund such investments may not make sense for many companies but taking on a technical partner into the share capital of the business might prove a sensible way forward as Seed Co did with Limagrain in 2013. We have seen this take place in the private equity space where companies such as Dendairy have brought in the necessary capital to expand their businesses by selling a part of the company to a private equity partner. OK Zimbabwe did the same in 2010. For Zimbabwean companies with strong brand names both at home and within the region, a technical partner could find such investment opportunities attractive as a good way to gain access into these markets. We hope to see more of such deals in the years ahead.

We see foreign investment as a critical element in Zimbabwe's long term economic recovery not least following the destruction of Zimbabwe's own domestic capital base during the hyperinflationary years. Zimbabwe simply has no choice but to look outside its borders for the necessary investment capital. Key to unlocking these funds will be to win the seal of approval from the likes of the multilateral lending institutions led by the IMF and the World Bank. These institutions stopped lending to Zimbabwe at the end of the 1990s when Zimbabwe failed to service its debt. Re-engagement started under the Unity Government when the IMF embarked on a Staff Monitored

DISCLAIMER This document provides general commentary on market activity and industry trends and does not constitute investment advice, nor does it constitute a recommendation for any particular investment. The economic and market information presented, and views expressed herein, are as at the date hereof and are subject to change at any time. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed, and any opinions stated should not be relied upon. This document is issued by Imara Asset Management Limited, which is licensed by the British Virgin Islands Financial Services Commission. This document may not be reproduced, transferred, or distributed without prior written permission from Imara Asset Management Limited.

Programme (SMP) in 2013 to assist in terms of technical and economic support. This support has continued in earnest under the current Government with the IMF reopening its representative office in 2014 which it closed back in 2004. For Zimbabwe to move from an SMP to a Structural Adjustment Programme called an Extended Credit Facility (ECF) that would imply a resumption of lending by the IMF, requires Zimbabwe first to repay its obligations to both the IMF and The World bank, together with that of the African Development Bank. This amounts to some $1.8 billion. At the conclusion of the most recent review by the IMF in September, the IMF mission chief stated that it was their intention/hope that at the conclusion of the current SMP at the end of December 2015, that Zimbabwe could move to an ECF in 2016 that would last three years. The attraction of this for the IMF and especially for Zimbabwe, is that Government could move away from the current constraints of running a cash budget and be in a position to borrow for the likes of long term infrastructural projects.

For Zimbabwe to move onto an ECF and access international concessionary and other capital, it first has to convince lenders that it has a credible action plan to repay the $1.8billion in arrears and then be able to service any future debt going forwards. Zimbabwe presented its debt arrears clearance strategy at a meeting held on the sidelines of the most recent IMF/World Bank annual meetings that took place in Lima, Peru two weeks ago. The Zimbabwe delegation was led by the Minister of Finance and the Governor of the Reserve Bank. Of great significance, the strategy was accepted! We met with the IMF representative here in Harare to better understand the implications of this meeting. The timetable agreed in Lima is tight with a promise to repay those arrears by the end of April 2016. The IMF itself then wishes to have embarked on the start of the ECF by June of next year at the latest. Between then and now, the Government will need to put ‘meat’ on its own reform programme which the IMF has stated should be home grown and credible.

The importance of an ECF to Zimbabwe should not be under estimated in our view. It will lead to new credit lines being opened on concessionary terms from a multitude of investors rather than just a few. It will also bring back the trade and investment banks, such as the US AfriExim Bank which assists with trade finance. The World Bank will once again be able to consider providing concessionary finance or certain guarantees for vital infrastructure projects. After all it was the World Bank which assisted with the Hwange Power Station and the Kariba Dam all those years ago. No longer will Zimbabwe have to rely solely on Chinese backed projects that may not be the best deals for the country. The International Finance Corporation (IFC), which is the investment arm of the World Bank and which provides equity capital to businesses, returned on a fact finding visit a few months ago. The European Investment Bank (EIB) are here this week to do the same. Meanwhile, an increasing number of trade delegations from various countries around the World are visiting the country. Africa’s richest man, Aliko Dangote from Nigeria, brought a delegation to Zimbabwe in early September looking at investments in cement, power and infrastructure. He was looking for assistance to ‘ease doing business’ in the country. One hopes that what concessions he might get, will be open to all investors!

An increase in liquidity, a consequence of renewed lending, will imply that interest rates will stay low or likely move lower from the current levels. So returns in the money market will continue to be unattractive to investors. An increase in dollar liquidity and investment spending on the other hand will help the economy to expand and as it grows so will the earnings of many listed companies who are already paying dividends and whose dividend yields today far exceed current money market rates. This should ultimately lead to rising share prices and an improved stock market. Zimbabwean company valuations, and indeed property values, continue to be priced well below regional and African peers. This reflects the perceived risks of investment in Zimbabwe and the implied higher discount rate that investors use to determine valuations. One would hope that a US dollar economy with the renewed backing of the multilateral lending agencies will help to reduce that discount rate and hence boost asset values. After all, dividend yields on many listed counters are now more attractive than the money market: BAT Zim yields over 8%, Delta 4.5%, OK Zim 5.5%, Econet at 3.5%, Old Mutual at 5.5% and Fidelity at 5%. These are of course all in

US dollars. (Source: Imara Asset Management (Zimbabwe) Pvt Ltd)

Government for its part, needs to be improving the supply side of the economy by making business easier for foreign and domestic investors. Sadly the 'succession debate' in the country that arguably is causing the factionalism within all political parties, remains a major deterrent for investors. Put simply, it makes it hard for Government to speak with one voice as various politicians seek to gain populist support. Encouragingly though, it is good to see the donor and investment community increasingly ignoring the news headlines and focusing instead on the future.

In the very short term, we don't expect to see any changes on the ground. Indeed the rumoured El Nino could result in a drought which itself will be bad news for hydro power generation, not least agricultural output. We expect to continue to see company closures as part of Zimbabwe's medium term restructuring which we wrote about in these Notes last year. Ultimately a number of businesses will never be viable in a dollarized environment, or for that matter in a rand based environment. To succeed they would require the economies of scale that Zimbabwe simply cannot provide. That said there are new businesses being established each week and the informal sector continues to thrive.

Focus should be on the future drivers of the economy and these must reflect Zimbabwe's comparative advantages. In our view these are in agriculture, mining, tourism, services and, thanks to the US dollar, finance. In addition selective manufacturing and construction businesses that support these sectors will do well. Import substitution businesses will close as many have already done. Critically in our view and to speed the process up, Government needs to urgently encourage investment, both foreign and domestic, into agriculture and mining. At the moment, uncertainty with regard property rights in both agriculture and mining is having the opposite effect. So little investment is happening in these two crucial sectors of the economy which also happen to be political playing fields. That has to change if the economy is to take off. That said, apparently the cabinet has agreed on the principles of the fiscal regime for mining which aim at generating additional revenue without undermining investors' incentives. IMF is assisting on this front and is working on specific proposals for mining taxation. This is an important step in the right direction given that the mining industry has been spending many management man hours arguing with Government following the implementation of ad hoc taxation policies, such as export taxes.

Following the Lima meeting, the Minister of Finance and the Reserve Bank Governor, together with other arms of Government, will have a very busy six months as they implement the debt arrears strategy which encouragingly the ZANU-PF Politburu apparently endorsed soon after that crucial meeting in Peru. For Zimbabweans and for foreign financiers, to take the words of the IMF resident representative, the "Go button" on re-engagement has been pressed and the ball is in the authorities' court to "walk the talk". For us this is extremely encouraging if not exciting at a time when the general mood in the country is depressed.

John Legat, Chief Executive,
Imara Asset Management Limited