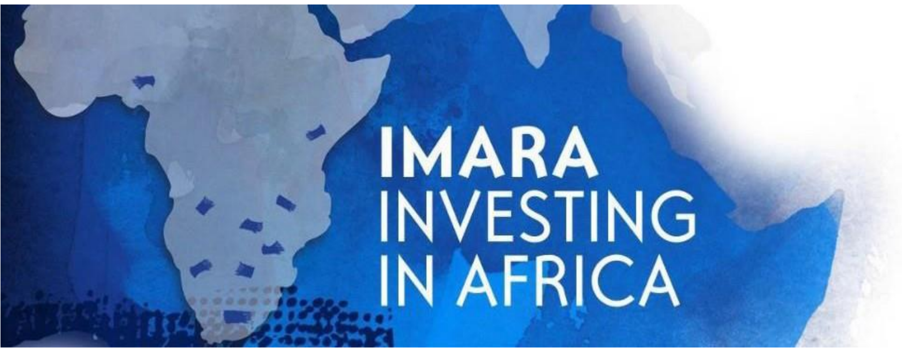

Zimbabwe Investment Notes

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"Toward a 'new' Zimbabwe":

Up until the end of October, the Zimbabwe Stock Exchange ('ZSE') had risen by 261%, making it the strongest gain in the market since dollarization, and the best performer in the World. Driving these powerful gains were investors' fears about the real value of their savings as it became apparent that the dollars in their bank accounts were not US dollars as they had assumed. We wrote about this in previous Investment Notes and specifically the July Notes "*The Great Illusion*". By contrast during the final two months of the year the ZSE declined by 37% ironically peaking the day before the army's intervention. At that time, 14th November, the Old Mutual Implied Rate (OMIR) had risen to 5.75 to the US dollar whilst the black market rate was still trading around 1.85 to the US dollar for small currency amounts, and less for corporates. The OMIR was being driven by foreign investors trying to legally externalize their ZSE sale proceeds by buying Old Mutual PLC shares in Zimbabwe and selling them in South Africa. At the time there was little supply of shares for them to buy. OMIR was also a reflection of local investors' fears that Zimbabwe was on a course to hyperinflation; we wrote about people behaving as though we had hyperinflation even when we were far from it. It may seem strange that the euphoria on the streets of Zimbabwe with the resignation of former President Mugabe should be met by a dramatic fall in the ZSE. But in reality and as we wrote in our mid-November Investment Notes, the market was behaving entirely rationally as investors, both foreign and domestic, believed that the likelihood of a new Government reforming the economy, re-engaging with the multi-lateral lenders and by so doing, averting an impending inflationary spiral as they had previously feared, was a strong possibility. As such foreign investors stopped buying Old Mutual PLC whilst local investors sold them causing the share price to tumble from $14.3 to as low as $4.5 in December. At that lower level OMIR traded at 1.50 to the US dollar in line with the black market rate that had also declined. As the OMIR fell, other shares on the ZSE also looked expensive in US dollar terms hence their fall.

By contrast, looking at the ZSE from a foreign investor standpoint, many of whom had been valuing their Zimbabwe shares using the OMIR for several months, the market rose in US dollar terms by 106% during the final two months of the year reflecting the perceived dramatic improvement post Mugabe's resignation! For domestic investors the ZSE ended the year 130% higher providing them with a significant gain over and above inflation and likely far above money supply growth which we estimate to be at less than 50%. In summary, 2017 returns initially reflected investors' fears for inflation as described above but by year end were signaling the optimism for the country under a reformist Government, an extraordinary contrast that could only occur after an extraordinary and unpredictable event as we all witnessed in November.

For these Investment Notes we are fortunately able to draw upon the Minister of Finance's 2018 Budget presented in December as well as the latest economic bulletin from the Reserve Bank ('RBZ') providing October data. Zimbabwe's principal economic problem is the Government's budget deficit which for 2016 and 2017 was around 9% of GDP a number that is very large by anyone's standards and unsustainable for a country that has supposedly adopted the US dollar and which runs a current account deficit. Further those budget deficits have not been funded entirely by Treasury Bills ('TBs') sold to the private sector (ie mainly the banks) as in the past but increasingly by creating electronic money in the form of an overdraft/short term loans from the RBZ. At the end of October this number stood at $3.6 billion (up 81% year on year) against TBs held by the banks of $2.4billion. This overdraft is swelling the money supply (M3) which rose by 45% over the previous year's number. This is ultimately inflationary. Meanwhile the banking sector's balance sheet is precarious to say the least. Deposits rose by $2 billion over the year to October, of which $855m was accounted for by increased TBs holdings, $984m into RTGS money with the RBZ and a mere $200m into a rise in private sector lending. Actual hard currency assets totaled just $241m of which under $50m was in cash notes. This is the reason that the majority of depositors cannot access actual US dollar cash or US dollar transfers; depositors' wealth is as a result held in RTGS (electronic) and mobile money. As the illusion became apparent to the public at large during the second half of 2017, there was a rush to spend RTGS deposits as fast as possible on goods and services and shares on the ZSE that would preserve money as Government created electronic money to fund itself.

We believe that the Ministry of Finance and the RBZ are well aware of the problems, and we now hope that the new Cabinet and President are fully aware of these issues as well, now that economic policy has taken precedence over political jostling …… we hope. Like it or not, the previous Government created a new local currency called the Bond Note which incorporates both cash and RTGS money and there is a black market exchange rate which we are told is currently similar to that of the OMIR ie 1.5 to a US dollar. The official rate remains one to one and a new foreign investor would receive the parity rate unless they entered through the laborious process of the Old Mutual mechanism. That is messy. Rather have an official exchange rate that is managed through the banking system with transparency. The dilemma for Government of adopting an official exchange rate is they would be required to inform the public at large – including the army - that their deposits in the bank are currently worth 67% of what they thought they were assuming a rate of 1.5 to the US dollar. This we believe unlikely before an election. Of course, the parity problem could be resolved if the Government issued TBs to cover their $4 billion overdraft/short term loans from the RBZ to a foreign agent or agents for US dollars and maybe that agent could buy a further $1 billion of TBs from the banks for US dollars to give the banking system US dollar liquidity. That would of course increase Zimbabwe's foreign debt by $5billion but it would avert a default for domestic savers. Whilst this option is possible we believe it to be highly unlikely. Either way to maintain the status quo and avoid further devaluations either option would require the RBZ to cease creating new local monies, which would require a balanced budget, or the deficit to be funded by external parties.

We suspect that the Government is hoping to muddle through at least until after the election which they would hope to win. However until this exchange rate issue is resolved foreign investors will be reluctant to invest in the country, either through the ZSE or direct investment, domestic corporates will struggle to access foreign exchange and domestic depositors will continue to face long queues at the banks. Foreign portfolio investors still cannot expatriate their capital unless they use the Old Mutual mechanism. Multi-nationals cannot receive their dividends. In Nigeria the Central Bank eventually introduced a new currency mechanism (NAFEX) for foreign investors and importers exporters whilst maintaining an official exchange rate but Nigeria has a current account surplus and rising foreign reserves which Zimbabwe does not have. We therefore doubt that such a scheme would work here as part of a muddle through policy.

The root of the problem of course has been Government overspending since 2013. Up until that time and since 2009, Government ran a cash budget. This is at least one area that Government can do something about and we were delighted that the reinstated Minister of Finance announced in his December budget for 2018 a crackdown on spending. The aim is to reduce the budget deficit to 4% of GDP (The GDP number was inflated from past estimates) and he hopes to keep it below 3% going forwards. These are still big numbers when you are hoping to peg yourself to the US dollar or run a functioning US dollar economy. But it is a good start. He announced many measures to cut spending including a reduction in the civil service and various ministries and importantly a focus on selling off many loss making parastatals. Foreign travel will be slashed and a number of foreign embassies closed. This process has begun. Also in his budget, he cleverly included changes to the Indigenisation regulations in his budget that will now be passed through Parliament in January as part of the Finance Bill rather than under a separate Bill. This will fast track the legal process. Essentially he has all but scrapped indigenisation in all industries bar diamond and platinum mining. He was not clear whether meeting the indigenisation requirements for these two sectors could be achieved through a combination of an equity stake plus ‘other’ credits such as supporting the community with housing and hospitals, schools and clinics etc.

Significantly he eliminated the Ministry of Indigenisation which is a very important statement and will inevitably improve the ‘Ease of doing Business’. A further important element in his Budget speech and which was a part of the President’s inaugural speech was Zimbabwe’s wish to re-engage with the international community and especially with the international financial institutions, a process that was begun in 2013 but derailed through political infighting.

We suspect Zimbabwe will wish to re-enter the Commonwealth as well. A full re-engagement with the global community will be possible if Zimbabwe is seen to hold democratic elections which need to take place by August of this year. Whilst the opposition remains fragmented and broken, with their raison d’etre now gone with Mugabe’s resignation, we suspect President Mnangagwa will call early elections to take advantage. If those elections are open to international monitoring and are seen to be democratic, we believe that aid and investor flows into Zimbabwe could be significant and far more so than we saw back in 2009. This could allow Government to muddle through with the US dollar illusion for longer until they can find a permanent solution to resolve this dilemma. It may also allow Government to balance its budget if foreign aid/grants fund a greater part of spending such as health and education.

The President has also made it clear that he wants to move quickly to revitalize the agricultural sector as this is such an important element to Zimbabwe’s economy. In this regard he welcomes white farmers and will stop any land and farm invasions. He further stressed the importance of compensating former farmers for the improvements to the land that they made whilst they were farming. A full engagement with the international community would assist in financing this process. These issues were reiterated in the Budget speech.

In summary, the new Government is barely one month old, but statements to date are all positive. Cutting Government spending and reducing the civil service, mass privatization of parastatals, abolishing indigenisation, encouraging foreign direct investment, re-engaging with the international financial institutions, ending farm invasions and encouraging all skin colours to invest in the land plus holding democratic elections are highly encouraging. The key of course will be in the implementation. The President himself we understand is a hard worker, including weekends, whilst Parliament has been recalled earlier than usual to pass the Finance Bill. Further he has given his Ministers just 100 days to put various initiatives into play to produce tangible results. So far so good.

The Budget forecast economic growth of 4.5% for 2018 and after, following a 3.7% gain in 2017. As we saw from 2009 to 2013 when growth rates of 10% were achieved we hope that the Minister’s forecasts are conservative but reasonable until such time as we have a stable and effective monetary system. A strong economy will be good for corporate revenues and ultimately for profits, all of which have been under pressure for most businesses since 2013 when Mugabe’s government was elected to power.

The events of the past two months have been extraordinary for Zimbabwe and unpredictable. But they have proved positive as the new Government has engaged on the critical road to economic reform which we hope will be sustainable. This can only be achieved with a strong Government with tough leadership that is able to take the necessary tough decisions. The current Government being one month old as we write and is by no means strong, coming so soon after internal factional fighting within the ruling party and the security services. Stability under a stronger Government may only occur after new elections have been held sometime during the first half of the year. It is encouraging though that Government has started the reform process well before elections have been called. The Budget was a welcome relief in this regard.

We hope that elections will be free and fair and critically backed by the international community. This will help to open the door to foreign assistance, whether technical or financial, and encourage foreign direct investment, something that has been lacking in Zimbabwe for decades. The potential upside for Zimbabwe as a country is enormous IF the correct policies can be pursued and importantly, implemented. This will be hugely positive for asset values in Zimbabwe over the medium to longer terms. In the very short term, and after such a strong real rise in the ZSE in 2017, and whilst uncertainty exists, the market looks fairly valued for domestic investors and may well move sideways on lower volumes than we have seen for a while. That is often an environment to pick up stakes in good business models. Foreign investors entering via the Old Mutual mechanism will find the market cheap in US dollar terms even at these levels. We will be spending time meeting with corporate management as we always do to understand better what is happening on the ground and for signs that business is improving or stagnating. Change takes time and we will need to be patient but so far the signs are extremely encouraging.

We wish all of our clients and readers a prosperous 2018 in a “New Zimbabwe”.

John Legat – Chief Executive