Zimbabwe Investment Notes

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The Financial Sector is shrinking by the day

The introduction of Zimbabwe's own currency, the ZWL, in February 2019 has been a disaster as many economists, as well as ourselves, had predicted. Since it was launched the ZWL has fallen from its initial level of ZWL2.5 to the US dollar (USD) to almost ZWL16.77 to USD 1 by the end of 2019 using the official interbank rate. The black market rate ended the year at ZWL23 to USD 1, a difference between the two rates of 37%. Prior to February 2019 the Government's official position was that the currency was 1 to 1 with the USD.

The effects of the decline in the value of the ZWL upon Zimbabwe's banking, insurance and pensions sectors have been devastating in real USD terms. In short, the local capital markets will find it hard to fund any meaningful investments as we start the next decade, implying that only foreign capital has that ability. Sadly foreign investors are no longer much interested in Zimbabwe although they continue to keep a close eye on events should the investment climate change. The danger therefore is that Government will step in but financed through the printing press, which as we all know will undermine the ZWL further. As we will explain below, the domestic capital markets are no longer able to fund Government; recent under subscriptions in Treasury Bill auctions is further evidence of this. In our view, this is a real risk for 2020.

To put our domestic capital markets into perspective in real terms, we shall draw our data from the RBZ Monthly Economic Bulletins and from the IPEC Quarterly reports both based on September 30th 2019 data. At that time the official interbank rate was ZWL15.2 to USD 1 and the black market rate was ZWL19 to USD1. The IPEC report was excellent and contains much data. The pensions industry consists of Insured Funds (eg Old Mutual/First Mutual etc), Self-Administered funds (most of our clients) and Stand-alone Self-Administered funds (eg MIPF, ZAPF, NRZCPF). At the end of September, the value of these pension funds combined was just under ZWL10 billion but in USD terms at the interbank rate, this amounts to just USD622 million. The contributions from employees into these funds for the nine months was ZWL413million or USD27 million. If we dig deeper into the data, we find that of the USD 622million, USD244million was invested in equities with USD225million invested in property. A total of USD47million was invested in prescribed assets in some form, with around USD28million invested in cash or money market instruments. The remaining assets could be classified as 'other' such as mortgages, staff loans, external assets (NRZCPF only), guaranteed funds and pension fund arrears (USD40million on their own!). Analysing the consolidated income statement and stripping out fair value gains on investments held (not cash items), total income amounted to around ZWL975million over the first nine months against total expenses of ZWL349million giving a surplus of ZWL626million which is the equivalent of USD40million. Annualised this would amount to USD53million.

In order to meet the 10% prescribed asset level target, these combined pension funds would need to invest USD15million of their cash into prescribed assets. They have no other liquid asset to call upon except for equities but these too are illiquid; on a good day the market trades just USD500,000. Property is likely totally illiquid in this environment without significant write downs being incurred to force sales through. Putting the pension fund industry in perspective then, available liquidity for new investments amounts to well below USD30 million and at today's black market rate less than USD20 million at best.

Moving to the insurance sector and again using IPEC data as at September 2019, the total assets of the sector were valued at ZWL10.8 billion or USD700 million. Interestingly this asset base jumped from ZWL6 billion at the end of June 2019 to ZWL10.8 billion largely due to a revaluation of property assets by 313% over that three month period. As a result property accounted for 47% of total assets of the insurance sector. This surprises us for two reasons. Firstly we question the value of the properties being used as it would appear that the ZWL value is calculated simply by multiplying the 'assumed or preferred' US dollar value of the property by the interbank rate, which would be wholly unrealistic and in our view lead to a gross overvaluation of property values (the same practice occurs in the pension industry). Second, by increasing the total asset values by undertaking such a revaluation pushes the required amount that must be invested into prescribed assets that much higher; the compliance level being 15% of total assets. As such the insurance sector now needs to invest more funds into prescribed assets; had they not adjusted property values, this would not have been required.

The amount invested in equities by the insurance sector at the end of September amounted to ZWL3.7 billion or USD240 million. Prescribed assets stood at ZWL1.4 billion. Cash and money market funds stood at a mere ZWL241 million or USD16 million, which to us looks a scary number given the need to pay out for insurance claims as they fall due. If they are to meet the prescribed asset requirements, most of their liquid assets will need to go into prescribed assets. Bottom line is that there is little to no money available for new investments at a time when policy holders must be questioning whether they can afford insurance at all and may choose to stop paying their premiums altogether.

Turning to the banking sector and using RBZ data for September, total deposits for the banking sector amounted to ZWL21 billion or USD1.4 billion at the then interbank rate. Of that ZWL21 billion, ZWL5.9 billion were invested in loans to the private sector implying a loan to deposit ratio of just 28%. ZWL3.4 billion were allocated to Government bonds. Funds held in the banking system at the RBZ, the interbank market or in cash notes totalled ZWL 14.8 billion. ZWL7.4 billion was held in FCA accounts. The remainder of the assets of the banking sector were held in contingent assets, non-financial assets and other assets. In theory then, the banks could reduce their liquidity to lend more to the private sector or buy more Government securities.

The reality is different however. First, the bulk of bank deposits are demand deposits. This explains the large amount held in the banking system to cover customers' use of swipe cards and mobile money. Second and more concerning is the level of bank capital and reserves which stood at ZWL 3.9 billion or just USD257 million. This compares with "other liabilities" that have grown rapidly to ZWL4.6 billion (USD 300million) which we have to assume are foreign exchange linked liabilities given their rapid rise since February 2019 when they represented 31% of bank capital. This is another scary number that we would like to look into in greater detail as it might be highlighting the possibility of a bank or banks failing. Put another way, banks need to maintain very high liquidity levels and restrain from lending medium and long term either to Government or the private sector. We noticed this at the end of last year when a number of the listed companies we speak to highlighted the difficulty of obtaining loans of any meaningful amount from their banks. Further in our last Notes we made mention of the fact that bank balance sheets were falling rapidly in real terms as compared with their client base as a result of bank assets largely being held in ZWL denominated assets, whilst their clients' revenues and profits could move more in line with inflation. Put simply, banking sector borrowers have become far greater in balance sheet terms than the banks themselves.

This in turn has forced the private sector and Government to turn to the pension funds and the insurance sector for liquidity. As we have highlighted above, these two sectors have very little liquidity and it is entirely held in ZWL denominated assets. The private sector's needs though are based on the USD rather than the ZWL. For example, to plant and grow a hectare of maize is estimated to cost around USD800 for dry land or rain reliant maize which covers mainly diesel, fertilizer, spare parts etc. all of which are USD denominated. So a crop of 1 million tonnes, assuming an average yield of say 4.5 tonnes per hectare, would require say USD180 million which, at the interbank rate at the end September, would have equated to ZWL2.7 billion. At the parallel rate of ZWL19 at that time, this number would rise to ZWL3.4 billion and at today's rate of ZWL24 would imply a need for ZWL4.3 billion. For large commercial farmers with access to irrigation on the other hand, the cost per hectare would rise to USD1650 per tonne but the yield will rise to maybe 8 tonnes or more per hectare. In reality Zimbabwe relies on both dry and irrigated land but the amounts involved provide a good illustration that can be compared to the current size of the domestic capital markets.

Anecdotally we saw this at the end of 2019 as we were approached by a number of agricultural commodity consumers seeking capital to provide farmers for the 2019/2020 planting season, capital that they would normally obtain from the banks. Sadly the pension and insurance industry could not fill those shoes and as such we assume that the number of hectares planted was substantially down on the previous year.

We were very interested to see CBZ Bank last week offering a ZWL500 million bond together with a USD50 million bond in order to raise a total amount of USD80 million at current interbank rates. These funds would be used for the current agricultural season, 2019/2020, specifically to grow maize (170,000 hectares) and soya (30,000 hectares). The offer closed last Friday on 10th January. This strikes us as being rather late as we understood planting needed to take place by the end November in time for the rains, which have yet to materialise in any consistent way. We note however in the risk clause within the term-sheet that should farmers not be able to supply the products to the GMB for whatever reason, Government will step in and supply the necessary amount of ZWL to allow for the conversion by the RBZ to cover the USD50 million repayments together with interest at 9.5% in USD terms. That equates to an unlimited liability in ZWL. The same is true for the local ZWL bond, where the Government would guarantee the repayment plus an 18% coupon all in ZWL. There appears to be no risk to CBZ. Given the lateness in the placement of these two bonds from an agricultural perspective and the likelihood of drought, the default risk must surely be high and could therefore prove expensive for Government in 270 days' time which is the maturity date of the two bonds. That of course assumes that both bonds are subscribed for which given the liquidity numbers we have outlined in these Notes, suggests that this will be a tall order. The Ministry of Finance must be hoping as much!

This brings us back to a point that we made in our last Notes published in October where we surmised that "*the RBZ has become the lender of 'first resort'*" given the constraints of the domestic capital markets. We explained that if Government was unable to fund itself through taxation and the issuance of Treasury Bills, then one of the few options would be to print money thereby undermining the currency by boosting reserve money. This of course happened in August 2019 as we highlighted in our October Notes and resulted in the currency halving on the black market in a matter of weeks. That action by the RBZ has also put at risk the IMF's Staff Monitored Programme (SMP).

Returning to the domestic capital markets and specifically prescribed assets ('PAs'), IPEC is encouraging the insurance industry as a whole to move to 15% of assets in PAs. That would require investing an extra 2% or ZWL216m as at Sept 2019, the equivalent of USD14m at the time. For the pension fund industry, the IPEC level stated in their quarterly report is 10% (until December 2019) implying a further ZWL230m or USD15m. Although these could be funded out of money market assets, in reality this could not be the case as liquidity is required to pay pensions, insurance claims and run the various businesses. In the overall scheme of the economy USD29m (at September 2019 rates) does not fund very much even if these sectors coughed up those funds. IPEC or Government could force the insurance/pension sectors to sell down their property and equity assets but in reality that would be very difficult indeed; outside of strategic shareholders local pension and insurance funds are the largest owners of domestic property and equity which implies that foreign investors would be required to purchase these assets from the local institutions. This seems highly unlikely as foreign investors remain net sellers of the ZSE.

Further, as IPEC states in its report, equity and property have proved to be the best performers of local assets even if they haven't kept pace with the decline in the local currency. Local debt assets have lost significant value in real terms by contrast. Herein lies the dilemma for pension fund trustees. On the one hand their fiduciary duty to their stakeholders (employees and pensioners) is to protect the real value of the pension funds under their supervision as best they can. If they then knowingly buy an asset that will likely lose real value -if not all of it- as compared with other assets such as property and equity which both have proven to be excellent assets to hold in the event of the demise of the ZWL (eg 2009), then they risk being sued for negligence by those stakeholders and maybe their unions. Under the new Company's Act passed in the latter half of 2019, that would mean being sued in their personal capacity. On the other hand IPEC may fine the pension fund for not meeting the targets. For now IPEC is giving trustees the time to attempt to comply with their targets all of which would delay implementation. In a hyperinflationary environment, the longer this implementation takes the better for the stakeholders as value would be preserved to some extent.

Most of the prescribed assets on the market are debt orientated and denominated in ZWL. In the event of the demise in the ZWL at any point, these assets would cease to exist –and become valueless - as occurred in 2009. We have found few such debt instruments that have a clause that protects investors should such an event occur, by for example an immediate conversion to USD or into a related equity instrument. We have seen one such instrument in the making but it is not a prescribed asset. It is even harder to find an equity-related prescribed asset and those that exist may not make economic sense to the investor.

As stated in our previous Notes during 2019, we have looked at a number of private equity investments as alternatives to equities and property. Similar to agriculture though, the difficulty is that all of these projects usually have some need for USD or the ZWL capital requirements are linked to the USD. That implies an unlimited liability for ZWL investors should the ZWL continue to decline. Take for example a solar project of which there have been a number approved in recent months. An USD10million investment either in debt or equity (usually a mix) equates to ZWL170 million at today's interbank rate or more appropriately ZWL240million at the black market rate. That might provide 10MW of power. Since the equipment has to be imported, the solar company may well have USD debt on its balance sheet which would need to be funded and eventually repaid. But ZESA can only pay in ZWL even if the tariff paid to the solar company is in some way linked to the USD. The risks therefore remain extremely high. As illustrated above, the pension and insurance industry do not have the free funds to invest in such a project. The project may be scaled back into smaller bundles at which point the economics of power generation start to fall away.

Meanwhile, as highlighted in our October Notes, the valuations of listed equities in USD terms remain extremely low and cheaper arguably as compared with the latter days of the Zimbabwe Dollar in 2008. That of course is not surprising; foreign investors have been net sellers of equities over the past twelve months and domestic investors have had little surplus money to buy more. Valuations of any asset around the World tend to fall when few want to buy whilst they rise to very high levels when investors refuse to sell as prices rise, sometimes to astronomical levels as we have seen on Wall Street in the recent past. The best time to buy an asset is therefore when nobody else wants it, or indeed is able to buy it and that is usually when assets can be bought at a huge discount to their intrinsic or real value.

Equally the best time to sell is when there are no sellers despite rising valuations.

In this regard we have been asked by a number of our pension fund clients whether now is not a good time to wind up their pension funds as they have lost so much real value since 2016 (US dollar terms). There seems little point they argue in making contributions if they will lose real value, better to spend that money now. The answer of course is that now is very much NOT the time to be selling undervalued assets and indeed it is the best time to be buying into such low valuations by continuing to make contributions to their pensions. Recent history has shown that to be the case when valuations in USD terms rose exponentially between 2008 and 2013 as the economy recovered. We have no idea when this may occur again but as with 2008, the current economic situation is unsustainable ultimately. Something will have to give.

If what 'gives' leads to stability in Zimbabwe's monetary foundations as occurred in 2009, then the prospects for the domestic pension and insurance industries will be excellent so long as they enter that period with solid or real assets such as the ones they hold today. In other words, valuable stakes in Zimbabwe's finest companies and secure property assets.

The IMF team was in Harare in early December to continue negotiations with regard the SMP and the Article IV Report, the latter is expected to be published in February 2020. This will give us an idea of how the IMF is thinking and whether indeed the SMP will be extended or cancelled.

With inflation running at 521% per annum (December 2019), the economic numbers that Government, the IMF and economists are dealing with are fairly meaningless. This was apparent in the Budget where the numbers both in real and nominal terms bore little resemblance to any prior budgeted figures. As we write, the rains have been worryingly erratic. Early warnings back in September suggested above or normal rains prior to January with below average for the rest of the season. Rains prior to January have been below normal with long periods of no rain and if there is little change to that between now and the end of the rains in April, agriculture will suffer dramatically. Dams are already below 50% whilst the water table has not recovered implying that boreholes will likely struggle through 2020. This would cause a contraction in the agricultural sector with knock-on effects across the economy. The World Food Programme has already issued an alert to the international community to raise funds for Zimbabwe in the likely event of a severe drought. Even if we receive food aid, the logistics of bringing that food in will be enormous not least in terms of the number of trucks required to ship it in and of course the fuel to drive those trucks.

Low dam levels suggest that electricity from hydro-power plants will remain constrained. Without external assistance, 18 hour power cuts are likely to persist well into 2020 with the consequent strain that this will put on the industrial and farming sectors. With more foreign exchange directed to food imports, the ability to source petrol and diesel will also be tough and hence we expect shortages to continue during 2020. A weaker economy is therefore more likely than a stronger one.

The prospects for Zimbabwe in December 2008 looked bleak and uncertain. Industry was devastated after years of neglect and under investment. The domestic savings industry was in a far worse state than it is now but thanks to the Stock Exchange it was at least invested in non-monetary assets. The banking sector could not lend back then due to the second highest hyperinflation the World had ever seen. Real disposable incomes had been destroyed with a large part of the population on the poverty line. But then in 2009, something "gave", and the country dollarized in its entirety providing the economy with a stable monetary foundation from which to grow. It grew rapidly from then on. We knew back then that the status quo was unstainable and that something would have to 'give' but it was hard to predict how it would end. When it did end, asset values grew rapidly in USD terms enabling the domestic capital markets to once again provide capital to those that needed it.

We would like to wish all of our Readers best wishes for 2020 and for the new decade ahead.

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