Zimbabwe Investment Notes

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Pension Funds: More Smoke and Mirrors?

On April 15th 1912, the state of the art luxury cruise liner Titanic struck an iceberg off the coast of North America on its maiden voyage and sank to the bottom of the sea. Despite receiving warnings from other ships in the area that icebergs had been spotted, the Captain and the ship's owner chose not to reduce speed preferring instead to make a fast and glorious entrance into New York's harbour later that day. They believed that the Titanic was unsinkable which may have clouded their vision. Whatever, their decision was both reckless and catastrophic for the Titanic and the 1,500 or so passengers that lost their lives early that morning. After rapidly plunging to the sea bed, the Titanic finally found stability and it has remained there ever since. Lessons were quickly learned and new regulations were immediately implemented to ensure water tight compartments rose to the top of ships' hulls and sufficient lifeboats were provided for all passengers. As time passed, the Titanic was largely forgotten becoming less relevant as time progressed and it is now confined to the history books.

In our last Notes, we wrote about Zimbabwe's monetary statistics (based upon July 2020 numbers) and outlined our views on the economy at length. We have not changed our thinking since that time and hence these Notes will not focus on the economy to the same extent as before should we risk boring our readers. We refer them to our website (www.imaracapital.com) where previous Notes can be found, the most recent dated October 2020.

Instead we will focus on the health of the pension fund industry, a topic we first covered one year ago in our January 2020 Notes. To do this we will draw upon the excellent and data-packed quarterly report produced by IPEC (Insurance and Pensions Commission) based on data as at September 2020. At that date, the total value of the pension industry was ZWL108 billion or USD1billion at the parallel rate and USD1.3billion at the auction rate. This compares with a value of USD622 million (based on the official rate) in September 2019, effectively doubling in size in real terms over the year. Drilling down into the numbers we note that equities, which accounted for 39% of pension assets in 2019 have fallen to just 28%. Investment Property on the other hand rose to a whopping 50% of assets as compared with 36% a year earlier. Putting it in USD terms, investment property rose from USD225million to USD671million over one year, a gain of USD446million, accounting for 66% of the entire gain of the pension funds. Equities rose from USD244m to USD 366m or by USD122m a 50% gain in value. By contrast the ZSE Industrial Index rose by 30% implying that pension funds may have allocated $50m of new funds toward equities or the equities held by pension funds outperformed the ZSE, or a combination the two. Liquid assets back in Sept 2019 were just 5% at USD30m and had fallen to 3% last September. Although the percentage in prescribed assets rose slightly from 7.6% to 8%, in real USD terms fund managers must have added substantially given that the real value of the prescribed assets held in 2019 would have been reduced substantially by inflation.

This then suggests that there would have been very little of liquid assets available to invest in property. Indeed over the past year property investments were illiquid unless paying in USD which pension funds don't have OR the investments were in new developments where ZWL could be used for parts of them. These developments would likely be half finished today or put on hold due to the lack of USD liquidity to complete the project. This then begs the question as to how on earth investment property could have risen by so much in ZWL AND USD terms over the year to Sept 2020. We very much doubt it is possible for investment property to nearly triple in USD over that period. Let's look at Imara's largest property development completed in September 2018 on Second Street Extension. This project was completed before the ZWL era and to budget at a final cost of USD8million. In September 2019, we valued the development at USD5.5m, a 30% discount to replacement value, reflecting the fact that the property was empty with no tenants on the one hand, and on the other, a realization that in reality, it would have been highly unlikely that a buyer would pay USD8million back in 2019 given the deterioration that had taken place in the economy since 2017/18, a deterioration that had already been reflected by the decline in USD valuations on the ZSE. Complying with SECZ rulings, we had the development valued by professional evaluators based upon December 2020 market values; market value being the price the property could be sold for. At the time, the development was fully rented. The valuation we were given and have used in our December valuations is USD5.2million which we converted to ZWL using the auction rate. In short no upward revaluation but a marginal decline from the June 2020 valuation. At current levels, rentals provide a gross yield of just over 6% per annum.

This analysis therefore makes us question even more the upward adjustment to investment property valuations over the past year. It may also explain why SECZ and IPEC are insisting upon professional evaluators to investigate property values. There must be a concern that pension fund managers or trustees are taking USD valuations say back in 2017/2018 and multiplying by the auction rate. Of more concern would be if those USD valuations were based upon book costs rather than market values. For example, had we valued our development at USD8m and adjusted for the official exchange rate on valuation dates, we would be massively overvaluing the development, the consequences of which we outline further in this paper.

IPEC is also insisting on fair valuations for 'alternative investments' many of which have been given prescribed asset status. Alternative or private equity investments are notoriously difficult to value given different assumptions that can be used. The easiest option under such circumstances would be to take the book value and adjust for the change in the exchange rate. This however could lead to a serious overvaluation of a project given the circumstances of a weak economy with an unstable monetary environment as we have in Zimbabwe.

Take for example a solar power project. Before it can generate cash flows, which will likely be in ZWL if the buyer of that power is the ZEDTC, the project or phase one of that project needs to be 100% complete otherwise it won't be able to generate any revenues to cover its operating costs and to reward its investors. A large part of a solar project is based upon USD imports for items such as solar panels, inverters, sub-stations and cables whilst a smaller part can be paid in ZWL for the likes of civils. As we have argued before, for a ZWL investor operating within a depreciating exchange rate environment, such an investment can lead to an unlimited liability in ZWL terms. If the project requires USD10million but only raises say USD6million there is a large shortfall. That USD6 million can be used to build out a part of the first phase of the project so that investors can see panels, cabling and civils in place, but without the sub-station and other imported materials, the project will not generate revenues. In short the project is on hold until the remaining USD4million can be raised. Meanwhile, the fixed assets that have been installed are depreciating every day. Unless the existing shareholders can raise the remaining USD4million, the project is only really worth the second hand value of the equipment in place. If a new shareholder is found to put in the remaining cash, then existing investors will be heavily diluted and their claim on future revenues will fall. Under such circumstances, an incomplete solar project should be heavily discounted relative to its book value when assessing a market value. The same should be the case for incomplete property developments that have been put on hold pending further investment.

Overvalued investments, whether property or alternative investments, can have serious consequences for a pension fund. Whilst the performance of that fund might look good on paper, in reality the real or market value (the value another investor may be prepared to pay for those assets) may be much less. Overvalued pension fund assets will serve to boost any fees that are determined by the value of the pension fund thereby increasing the expenses of the fund. More seriously, any pension payouts will also be overinflated leading to far greater cash calls than should be the case. This would benefit those receiving those cash calls now and be disadvantageous to those individuals remaining in the fund who may have to experience a write-down in such asset valuations at a later date. In addition an overvaluation of assets would imply that trustees could allocate too much of the fund toward prescribed assets which are based on a fixed percentage of net assets. If we are right about such overvaluations, a sizeable part of pension fund assets may in fact be an illusion. IPEC should take note.

There is a further negative consequence to consider. If pension payouts are in reality too great for the real underlying value of the pension funds' assets on the one hand, and on the other, there is minimal cash to make those payouts, then the only liquid asset left to sell are equities which trade on the ZSE on a daily basis. The property investments and alternatives cannot be sold without taking a significant write down given a lack of demand for such investments. Overtime equities will become a smaller portion of pension funds as a result. The irony is that equities over the past year have been the best performing assets in USD and ZWL terms based on true, realisable market values. It should also be noted that in the September 2020 IPEC statistics, unquoted equities have gone from 1% of pension fund assets to 4% which we suspect are largely pension fund holdings in Old Mutual and PPC which Government will not allow to be sold offshore and hence are now as illiquid as a private equity investment. (At least there is a daily ZWL market value for OM and PPC derived from their respective share prices in South Africa).In short, there are less liquid options for fund managers to consider when trying to raise funds for payouts.

Anecdotally a number of our clients have asked us to raise sizeable amounts by selling equities in order to fund large pension payouts as a result of early retirements and redundancies. Should this continue into 2021, then we should expect equities as a proportion of pension funds to fall even further. At some point there could be a severe liquidity crunch for those pension funds who hold too great a proportion of their assets in illiquid assets and can no longer fund payouts. This situation could be even worse if the company behind the pension fund is not paying pension contributions on time or the contributions are less than the payouts.

Prescribed assets (PAs) at the end of September stood at 8%, which, as IPEC reminds us all, is below the prescribed 20% level. For pension funds to reach 20%, all new contributions would be forced into PAs and equities would have to be sold down to achieve those levels. Prescribed assets that are loans or bonds will lose real value over time given high inflation rates and negative interest rates, whilst alternative prescribed assets like a solar project, are illiquid. To force pension funds to move to 20% would therefore make the liquidity situation even worse than it is now and destroy real value. Trustees have a fiduciary duty to ensure that this does not happen.

It will be interesting to read IPEC's December 2020 quarterly. The auction rate has stood stable during the last quarter and hence ZWL valuations linked to investment properties and alternatives should also be stable or possibly even downgraded. Equities meanwhile rose by 63% in ZWL terms so in theory equities should be a greater proportion of portfolios than in September. Time will tell. The statistics that we have referred to above are for the consolidated private pension fund industry. Drilling down, the self-administered schemes which form the bulk of our clients are not in such a precarious position. The asset exposure for this group of funds has equities at 41% (down from 49% in 2019), investment property at 30%, prescribed assets at 10%, money market at 4% and 'others' at 14%. This latter group may hold some alternative investments, as well as contribution arrears; it is not stated in the report.

The IPEC report clearly illustrates the lack of capacity that the domestic pension fund industry has to fund public or private sector investments going forwards. We don't see this changing anytime soon and it is a point we have been making in our previous Notes concerning the small size (i.e. in US dollar terms) of the pension fund and the banking industries, both of which operate in the ZWL economy.

Looking forwards into 2021, we remain skeptical of the foreign exchange auction system as we wrote in our last Notes. The fact that the exchange rate has remained stable at around ZWL82 to USD1 for the past four months is enough to generate mistrust in any such system in the developing world. Speaking with numerous corporates from different sectors who had been successful in being allocated US dollars at the auction, they found that receiving actual US dollars for imports was a different matter. By December we were hearing of delays of five weeks in settlement of allocated US dollars. That implies that the RBZ did not have the dollars available to settle. Yet allocations at the auction system remained at USD30million per week on average which made no sense when the supply was limited. As a result of these delays we would now expect corporates to use the parallel foreign exchange market should the settlement delays persist. In early January 2021, the RBZ announced that all exporters would have to hand over 40% of their export earnings to the RBZ rather than 30%, in addition to the 20% taken from local earners of USD, which we assume is to provide the RBZ with more foreign exchange to allow for improved settlement on the auction. As we have written many times before over the years, it would be so much better to allow the private sector and the commercial banks to run the foreign exchange markets as happens elsewhere in the World.

One wonders what exporters will do now. With say 100% of their revenues earned in US dollars, the tax man, employees and suppliers all want to be paid in those same US dollars. Now that the RBZ is taking 40% of them and exchanging ZWL at ZWL82 to USD1 puts them in a very tough position as they won't be able to meet their USD obligations and will end up with ZWL which nobody in their business dealings want! Who would be an exporter in this environment?

We spoke with many banks in November and most stated that they had seen a large increase in ZWL liquidity which they were on-lending where they could. This is likely to have been the result of the Government printing ZWL for domestic needs, such as for wages and for agriculture (eg GMB). We do not have the broad money supply numbers as yet to prove that but there was a sharp jump in reserve money at year end according to the RBZ publications. Reserve Money jumped by 28% from the end of October to the end of December.

This likely helps to explain why the ZSE jumped by 66% in December and the parallel or black market rate for cash jumped from ZWL100 to USD1 to ZWL110. Returning to the shops after the festive season, we have noticed a rise in prices. This can perhaps be explained by corporates being forced to access imported product using the parallel foreign exchange market; this then increases their input costs. Local fuel prices, diesel specifically, has also risen by more than 20% in USD terms. There has also been a noticeable increase in global commodity prices in recent months, in part due to a weak US dollar against the major world currencies, as well as an expectation that the World economy will recover in 2021 post the pandemic thereby increasing demand. For example, we understand from the commodity traders that the landed price of maize in Zimbabwe has risen from USD280/MT to USD340/MT despite there being an abundance of maize in South Africa. This is therefore a global phenomenon and one which we would expect to continue into 2021. It explains why the price of basic commodities such as Pearlenta have risen in price by upwards of 20% and may well rise higher as 2021 progresses.

The recent resurgence, or second wave of the COVID pandemic in Europe and Southern Africa, has once again led to severe lockdowns being introduced. Zimbabwe has moved back to level 4. This will inevitably cause the economy to slow once again and so we hope that this second wave is quicker than the first which statistics in South Africa might suggest. The longer the lockdown lasts the weaker the economy. The fact that we have returned to a dual currency system should help the economy to recover more quickly than under the ZWL alone as we witnessed in 2020. So far it looks like Zimbabwe is receiving good rains although some parts of the country look better than others. What is needed is for sufficient rain to refill the dams and lift the water table. Hopefully there will be a recovery in agriculture this year as a result.

Turning to our investment strategy and at the risk of sounding unenterprising, we will stick to our proven methods. Our underlying assumptions are that Zimbabwe will remain short of foreign exchange and that the RBZ will attempt to manage the auction at around ZWL82 for as long as possible by controlling the weekly fix. This will be driven by the parallel rate premium. Exchange rate stability will only be possible when there is stability in the monetary aggregates. As we have seen all too many times over the past thirty years in Zimbabwe, rapid growth in the money supply will lead to devaluation and ultimately inflation. The last monthly review of Zimbabwe's monetary data was for September 2020 which makes it difficult to comment on the current situation. The fact that the ZSE rose by 63% during the fourth quarter in the face of continued foreign selling, would suggest that domestic liquidity was relatively plentiful as the December reserve money numbers suggest. Without a stable monetary foundation, the ZWL will more than likely lose its relevance and over time, and like the Titanic, be confined to the history books.

A high fixed exchange rate will work against the country's exporters; an unattractive export sector can only lead to leakages as we have seen in the gold sector these past years. Government will also be short of ZWL for paying wages and funding infrastructure and agricultural projects as was the case in 2020. That implies that monetary policy will remain loose and that broad money will continue to grow at high levels. This will result in high inflation and a depreciating currency. That makes monetary assets such as credit, bonds and bank deposits in ZWL unattractive as has been the case for many years now. We remain very cautious of alternative assets in such an environment due to the unlimited liability of many such projects in ZWL terms. Which once again leaves the ZSE as one of the very few avenues where ZWL can buy hard assets. We would also expect to find corporates, especially exporters with surplus ZWL, buying shares as a hedge against devaluation.

2020 saw a number of counters leave the ZSE. It was sad to see Old Mutual, Seed Co International and PPC effectively delist through their forced suspensions. We were very sorry that Seed Co International will be taking over and delisting Seed Co Zimbabwe in 2021 for such a low valuation. (USD50m). We voted against that proposal. We are expecting more companies to delist in 2021 as major shareholders take advantage of low USD valuations and surplus ZWL with which to buy more shares; this will make the pool of available counters to buy that much smaller. We assume that foreign investors who have been sellers of the ZSE, are now largely finished which is also very sad as such investors provide an important and liquid two-way market. This leaves domestic investors. Illiquid pension funds will remain sellers making their funds ever more illiquid for future cash calls as described above. Surplus ZWL looking for a home will more than likely outweigh that selling pressure. A smaller pool of counters with excess ZWL in the system will see the ZSE continue to rise despite what remains an uncertain environment, very similar to the one that we experienced in 2020. The industrial index rose by over 1000% in ZWL terms despite that uncertainty and an economic meltdown.

We would like to take this opportunity to wish all of our readers our very best wishes for a healthy, as well as a prosperous 2021.

John Legat,
Chief Executive
Imara Asset Management (Zimbabwe) Ltd