IMARA INVESTING IN AFRICA

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The Auction System: Devalue or Lose Relevance

In our July Notes, we outlined our basic assumptions. These consisted of a number of economic indicators; strong rebound in the economy as Zimbabwe emerged from lockdown and supported by a good harvest and rising commodity prices; increasing dollarization as corporates 'gave up' with the formal auction system due to unacceptable delays in settlement; rising US dollar inflation feeding through into ZWL inflation; increased ZWL liquidity as Government spending on maize and civil service wages feeds through and finally further strength in the ZSE as surplus ZWL looks for a liquid home in undervalued assets.

Our assumptions held true. Recent corporate announcements mostly point to a strong rebound in volume growth not just year on year but also year to date in many sectors across the economy, and this despite two lockdowns in 2021. There has been a good maize harvest (although maybe not the 2.8 million tonnes that Government is expecting), a better tobacco crop and shortly a decent wheat harvest. Commodity prices have been rising year to date, including gold that has encouraged increased production in both the formal and informal sectors. That implies increased disposable incomes for farmers and miners that then supports strong demand for goods and services. A strong rebound in the economy requires growing imports and hence the demand for foreign exchange is rising. As we speculated, the foreign exchange auction system cannot cope with the demand and hence delays of anything between 11 and 14 weeks for settlement proceeds in USD are more common place. As we wrote in July, you cannot run a business on that basis from a working capital perspective. That in turn encourages businesses to shun the auction and look elsewhere either in the parallel market, or simply to charge for goods and services in US dollars to boost USD revenues. This boosts dollarization.

Inflation is also on the increase. As we warned in our April and July Notes, US dollar inflation is gaining momentum globally. Oil prices recently topped $80 per barrel with Goldman Sachs forecasting $90 by the end of this year. Freight rates are up over 400% this year and by 600% on the Asia/Europe routes as supply chains are re-activated. Gas prices in Europe are up well over 100%. Inflation in the US is up over 5% but in reality the cost of living is up by more, ditto in Europe. Wages are also rising in the developed world as employers attempt to entice people back to work after a year's lockdown. This will further drive inflation. Zimbabwe will therefore also be experiencing imported inflation and rising fuel prices so far in 2021 illustrate this. It is also hitting food prices both globally and in the region with rising wheat and soya prices hitting the bread and stock feed industries respectively. The bottom line is that farmers will require more funds to grow the same amount of crops for the forthcoming planting season. This will impact private sector and Government funded programmes and indeed it will put additional pressures on US dollar import requirements.

Recent inflation data for Zimbabwe show the CPI rising by 4.7% month on month in September suggesting a re-acceleration in month on month inflation; recent numbers reached a low of 2.3% per month in March and have been rising since. With the parallel exchange rate having moved significantly during September our assumption must be that monthly inflation will rise by more in October. Now that the favourable base effects for year on year inflation are starting to fall away, we should expect to see higher annual rates going forwards. If we inflate the CPI index by 5% between now and the end December, year on year inflation for 2021 would be around 57%, being above the upper level of the RBZ's revised numbers for 2021. We further estimate that around 25% of the components of the CPI index are priced off the auction rate. Should the auction rate devalue at a faster rate, then monthly increases in the CPI will accelerate. Higher annual inflation will of course have a bearing on year end wage negotiations for both the private and the public sectors.

The export sector will be in dire straits having suffered from the RBZ policy to 'fix' the auction rate at around ZWL87 to the USD when they are having to source their input requirements from their suppliers who are pricing at the parallel rate or indeed in USD. With the parallel rate now around twice the auction rate, one wonders how on earth export companies can survive without having to move to care and maintenance. Their suppliers don't want the ZWL that the RBZ have given the exporters (which is now half their real value), they want the USD that the RBZ has held back. As the supply of USD going into the auction from our exporters falls short, then the gap will need to be filled from elsewhere. More loans from Afreximbank may be the solution albeit an unsustainable one.

We believe that low margin export businesses may well be the canary in the coalmine; such companies will be an early casualty of the widening gap between the parallel exchange rate and the auction rate as lower returns will eat into their margins forcing them to move to care and maintenance. It would not surprise us if the RBZ reduces surrender requirements on a sector basis so as to ease the pressure on such businesses. In the meantime, such exporters will be using every tool in their book to avoid surrendering any of their USD revenues.

It's hard not to see the auction rate devaluing at an accelerating rate over the coming months; there is little to prop it up that we can see. As we have written before, the best solution would be to float the currency and allow the market, not the RBZ, to determine the exchange rate and for the RBZ to abolish the surrender requirements on export proceeds. What better time to do that when you have just been given USD1 billion in additional foreign exchange reserves from the IMF. A freely determined exchange rate at a time of rising commodity prices would encourage higher exports and provide greater amounts of foreign exchange. Instead and at the moment, exporters have little incentive to invest in new, let alone existing production, when surrender requirements on export proceeds remain so high in order to 'assist' the funding of the auction system. That policy clearly isn't working! Maybe too, and as a means to support the ZWL, Government should revise its tax payment policy and insist that all taxes, and especially for USD earners, are paid in ZWL, thereby forcing businesses to sell their USD for ZWL at the free market determined exchange rate. That should provide underlying support for the ZWL and give the Government ZWL for its domestic spending.

The RBZ is clearly worried about the rising parallel rate and the backlog. They recently announced that they would 'ring-fence' USD owed from the auction to importers up to and including 14th September. Any allotments after that date would be honoured within two weeks from the auction date. There was no mention of how the backlog would be cleared or indeed how future allotments would now be met timeously. The IMF SDRs perhaps? Maybe Afreximbank is assisting with more USD loans? The latter could be a double edged sword as these loans, as we understand, are collateralised against future exports proceeds. All in all we would expect the auction rate to devalue over time from current levels since the RBZ has few other options left to hand.

Meanwhile Government is pushing hard on its infrastructure programme with a focus on road rehabilitation and dam building being the major projects. Contractors are being paid in ZWL although they should be given priority at the auction to fund their USD inputs. If on the other hand, the required USD numbers are simply too great for plant and equipment, then these contractors, whether local or foreign, may have no choice but to look elsewhere for foreign exchange and index their ZWL quotes to USD. The same could also be said about the forthcoming agricultural season where the RBZ will be printing ZWL to provide to the suppliers of fertilizers and chemicals for the farmers. These same suppliers will then be looking to convert that ZWL so that they can import the products. Ironically therefore, it might be that it is Government's infrastructure drive together with the financial support that it is giving the farming sector that is adding to the current pressure on the parallel rate.

The RBZ tried de-dollarisation back in June 2019 when the use of the USD in transactions was made illegal. Should they try that again, there will be immense upward pressure on the parallel rate as companies scramble to convert their ZWL into USD. The economy would crash as it did in the second half of 2019. We doubt therefore that such a policy change would occur especially in the run-up to an election. Allowing companies to sell their goods and services in USD allows them to generate their own foreign exchange necessary to import their inputs. Such a policy therefore takes the pressure off the auction and the parallel markets for foreign currency.

We have been intrigued to read reports from corporate management during the year praising the success of the foreign exchange auction system for bringing about stability and the revival in the economy. For those businesses lucky enough to have been consistently successful on the auction and to receive the allocated USD within a short period of time, that might be the case. But for the vast majority of businesses and especially the larger ones, this has not been so. It is our belief that the 'stability' that we have seen and the growth momentum witnessed in volumes sold (for those businesses that have been allowed to operate during lockdown), has come from the use of the US dollar, that was permitted at around the same time as the auction system was launched in June 2020. Indeed 'stability' is probably the wrong word to use; the auction rate – which is set by diktat - might have been stable but much of the economy has been growing rapidly thanks to a good agricultural season, growing mining production, increased private demand for construction material and high government expenditure on infrastructure projects! Prices are also not stable with official year on year inflation of 55% which of course is being reflected in the free-market exchange rate.

With regard corporate announcements and our on-going management interviews, we have tended to focus more on operational performance rather than the financial performance of businesses. All financial accounts are qualified and have been for two years following the re-introduction of inflation accounting. They will remain so when accounts are once again prepared on an historical cost basis. As a result, a Board of Directors can choose the basis on which they prepare their accounts with little concern should their auditors choose to qualify them since they will already be qualified! In this regard we were delighted to read the recently published abridged annual report for Simbisa for its June year end. Their auditors gave an adverse opinion on their financial statements since the company chose NOT to use the official foreign exchange auction rate to determine their earnings and balance sheet. They chose not to for the simple reason that Simbisa does not access any of its foreign exchange from the auction system. The Directors point out that even if they did, they would not receive the foreign exchange in sufficient amounts to satisfy their needs and in a timely manner. Instead under a proposed amendment to IAS21, which focuses on a lack of 'exchangeability' between two currencies, they have chosen to estimate the spot rate at the time.

In our January 2019 Notes, we coined the term Simbisa Implied Rate ('SIR') which compared the USD and the ZWL prices of a '*two piecer and chips*'. Prior to Xmas 2016, Simbisa was offering a discount to its customers if they paid in USD which was a way for the company to access sufficient foreign exchange to import their raw materials. Delta tried to do the same thing at the start of the 2017 but finally agreed with Government to continue pricing in RTGS$ if the RBZ provided them with sufficient USD (which they didn't in the end). The SIR rate gave us a better reflection of what the 'street' was prepared to offer USD for rather than the OMIR which could be distorted by financial flows and financial events outside of Zimbabwe. The Simbisa directors didn't define in their press release what rates they used for their June 2021 accounts and it may well not be the SIR. Time will tell. At the moment the SIR is at ZWL150 to USD1 based on their two piecer and chips.

The net effect of using their own spot or 'transactions-based' exchange rate rather than the official rate was to inflate their profits and balance sheet by around 17% on average. This allowed them to pay a higher dividend to their shareholders but we assume a higher amount of taxation to Zimra as well. We commend the Simbisa board for thinking outside of the box in order to make their accounts more meaningful to their shareholders. It will be interesting to see whether other companies do something similar going forwards.

The Simbisa results were also interesting from the perspective that their operations both in Zimbabwe and in Africa were heavily disrupted by the various lockdowns that were introduced to stop the spread of COVID. These impacted upon their operating hours, their seating capacity and the disposable incomes of their customers. Despite that, in Zimbabwe customer counts rose 6% allowing them to record organic growth in both their revenues and profitability. A focus on Dial-a-Delivery as well as other promotions proved successful and of course they were helped by the fact that their competition, in the form of seated restaurants, was closed for long periods. Further they expanded their counters by 13 over the course of the year. Simbisa will therefore be well positioned to take advantage of a reopening of the economy – we hope on a sustained basis – for the year ahead.

A few days after Simbisa, Innscor released their June year end numbers. Innscor confirmed our hunch that operationally businesses that were allowed to trade under lockdown have performed better than might have been expected, reflecting not the stability in the foreign exchange auction, but the strength in the underlying US dollar economy. Indeed when reading the Innscor results, a financial analyst returning from an eighteen month visit to Mars, could be forgiven for not noticing there had been a global pandemic that had shut down the economy three times since March 2020! The volume numbers simply point to growth in almost all Innscor's areas of operations, with on average at least a 30% increase year on year in volumes sold as compared with the year to June 2020. We will be looking at how other companies report over the coming weeks to confirm our thinking but the trend suggests strong growth.

Strong volume growth necessarily requires greater inputs of which a proportion will be imported. In short, the demand for foreign currency will rise with economic growth. This will put pressure on the parallel rate for those companies that cannot sell their goods or services in US dollars. As the parallel rate devalues, inflationary pressures will rise and the call for higher wages will become that much louder.

We have been analysing the RBZ monthly monetary statistics in more detail to give us a better idea of underlying real money growth. This helps us to better understand the growth in the underlying economy. Back in October 2018, the RBZ directed banks to separate real nostro accounts from the local RTGS accounts. This was necessary as the commingling that was happening made it difficult to understand the real value of dollars in the system. Post the directive, a separate line to capture FCA deposits, in ZWL converted at the auction rate, has been included in the monthly economic bulletins. These have grown significantly from USD149 million in October 2018 to just over USD1.6 billion in July 2021 which is the latest available bulletin. Compounded annually, they have been growing by an average of 25% per year. A closer look at the numbers reveal that they remained relatively flat oscillating around USD500 million in the first 18 months after the split to March 2020; dragged down by the ill-fated de-dollarisation experiment. Since April 2020, about the time we had the initial tight lockdown, these deposits have grown by close to USD1 billion dollars. In fact from June 2020 to June 2021, FCA deposits grew by close to 73%. It is no coincidence that this phenomenal increase coincided with the return of the multi-currency regime with businesses able to independently generate their own USD reducing dependency on auction allocated funds or indeed on the parallel market.

Put another way, it is the rapid growth in the USD money supply that is fuelling the strong economy which is further being assisted by a good agricultural season and higher commodity prices.

The fact that the ZSE has risen a further 40% odd over the third quarter after a similar gain during the second quarter implies that there is plenty of ZWL liquidity around looking for a home. Local pension and insurance companies are unable to convert their ZWL inflows into USDs for investments offshore or indeed on the VFEX. With interest rates set at around 20% in ZWL, money market assets are not an option with inflation now rising again from the August low of 50%. Trustees rightly have a fiduciary duty to protect the real value of the assets under their control and the ZSE becomes the only liquid and viable option.

With regard to prescribed assets (PAs), whilst we applaud IPEC for opening up the space to privately developed PA instruments, we are concerned about the quality of some of the instruments being offered, sometimes directly to trustees. Getting PA status is just one side of the equation, but an investment still has to be scrutinized to ensure that it meets all the risk/return attributes before pensioners' money can be deployed. In the same vein, there is also an inherent conflict in most instruments being driven by fund managers and/or fund consultants. Trustees must make independent and informed decisions before investing in unproven, opportunistic, mostly green-field investments just for the sake of PA compliance. Whilst some might offer more attractive returns than treasury bills, we have seen few with returns above 40% which implies negative real returns. That means that such investments will lose investors real money.

As we wrote back in July, despite the ZSE's rise over the past eighteen months, it remains inexpensive in USD terms. This is especially the case when underlying volume growth for businesses is rising dramatically as the economy rebounds. An easing in lockdowns would suggest this momentum will be sustainable for the time being. That provides a favourable background for local stock market investors looking ahead. Overseas markets on the other hand might be in for a more turbulent time due to rising inflationary pressures in the developed world. This will likely result in rising bond yields in the US and Europe ending a long period of easy money. Interest rates are already rising in many developing countries and it is likely just a matter of time before we see rates rising in the US and Europe as well.

John Legat
Chief Executive
Imara Asset Management (Zimbabwe) Ltd