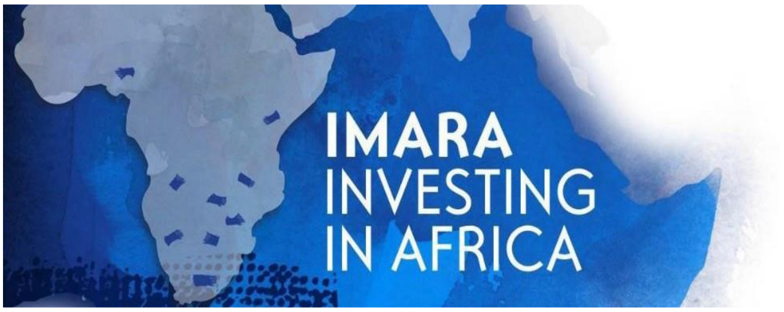

Zimbabwe Investment Notes

Edition: **Quarterly**

Date: **January 2022**

Issued by: Imara Asset Management

The Cyclical Rebound and Re-Dollarisation Dominate the Economy

2021 proved to be a strong year for the Zimbabwe economy despite the various COVID induced lockdowns. 2020 was not a great year so in part 2021 was a recovery year greatly assisted by the RBZ's decision to allow the USD to be used for transactions alongside the ZWL back in July 2020. Good rains in early 2021 led to a bumper maize harvest which fuelled incomes in the farming sector and reduced the need for maize imports. Rising commodity prices coupled with growing mineral output assisted the mining sector, especially in the informal gold sector. Government's infrastructure programme which was largely focussed on road rehabilitation and the building of new dams greatly helped the construction sector. So too has the lack of trust in the banking sector as individuals have chosen to 'save' their earnings by buying bricks and mortar rather than investing into low yielding bank deposits as a means to protect their savings against rising inflation. Finally rising wages in real terms has helped sustain consumer spending and we expect that Government's policy to pay year-end bonuses in USD will have provided an extra fillip for spending in December.

Attempting to put a number on the growth in the economy is a tough exercise given the large size of the informal economy. We know at the micro level how hard it is to understand ZWL hyperinflationary accounts for listed companies and in this regard they remain fairly meaningless for financial analysis. Trying to make head or tail of numbers at the macro level is equally hard, if not more so. The recently announced budget for 2022 gave an estimate of 7.8% growth for 2021 and the Ministry of Finance is predicting 5.5% for 2022. We have no idea whether those numbers are realistic or not; indeed looking at the underlying growth in volume demand across many sectors in 2021 might suggest that 7.8% is on the low side. There are few assumptions provided in the Budget as to Government's estimates for the auction rate or the parallel rate. The Ministry would need these rates in order to formulate the Budget.

Estimating the actual size of the economy in USD is equally hard. Government's own numbers put GDP at ZWL3000 billion which at the auction rate is roughly USD30 billion but at the parallel rate would be USD15 billion. This latter number is more in tune with the Annual Debt Bulletin 2020, where the USD estimate was put at USD14.7 billion in that year. By comparison Zambia's economy using IMF data suggests their economy is USD23 billion. USD15 billion for Zimbabwe looks low but USD30 billion looks way too high. Including the informal economy a number somewhere between USD15 billion and USD20 billion is probably closer to the mark. This is especially the case with increasing dollarization within the economy driven by both the private and public sectors. With Government now paying civil service bonuses and pensions in USD and their intention to pay a part of the salaries in USD in 2022 implies Government has greater access to USD through USD taxation and potentially the use of the IMF monies. Speaking to the road builders we understand that Government has been paying up to 45% of contracts in USD as well. Meanwhile the private sector has been using the USD since July 2020. The recent proclamation by Government that wages paid in both USD and ZWL are now taxable entirely in USD is a further sign of dollarization. If civil servants are now about to start earning a part of their salary in USD and the rest in ZWL but are now required to pay income tax as though the full amount was paid in USD, then this implies a higher effective tax rate given the difference between the parallel rate and the auction rate and the applicable tax bands in USD and ZWL. This makes little sense to us.

As we enter 2022, the last auction rate of 2021 which was held in mid-December was ZWL108.7 to the USD. The parallel rate is somewhere around ZWL 200 or higher. The auction system was supposed to have started on 11th January but has since been delayed a week till 18th January. One wonders what businesses must do in the meantime but such delays only help in promoting the parallel market as a source of USD for those businesses that cannot charge for their goods and services in USD. When the RBZ made the decision in November to allow the auction rate to devalue from the fixed level of ZWL86 to USD, we had thought that the rate would be allowed to move toward ZWL125/130 by year end so we will be interested to see at what rate the first auction of the year takes place at. With the tobacco sales about to start we may find that the gap between the two rates remains high. As we wrote in our October Notes, such a gap plays havoc for exporting companies, especially those operating on low margins.

It is early days to assess whether Government's target for real growth of 5.5% growth is attainable. The summer rainy season has been patchy and in the main growing areas was late so dry-land crops may have been badly affected. January has seen increased rains so we hope that they will continue well into March to ensure another good maize and tobacco crop. The 2022 Budget assumes that the agricultural sector will grow by a further 5% after a 36% rebound in 2021. With decent rains such a growth rate should be attainable.

The mining sector is expected to grow by a further 8% in 2022 after an estimated 3.4% in 2021 (Budget '22). The latter number seems low given the rise in commodity prices in 2021 and increased output in many minerals. The elephant in the room remains the informal mining of gold which due to smuggling makes estimates hard to formulate. Government would have been encouraged by the news released by Zimplats on 7th December that they intend to invest USD1.8 billion into Zimbabwe over the next ten years with nearly USD1billion allocated to increased production which they hope to grow by 30%. USD200 million is being earmarked for a solar power plant. Also announced in December was the acquisition of the Arcadia lithium mine outside of Harare from Prospect Resources and the remaining minority shareholders in the mine by a Chinese group, Zhejiang Huayou Cobalt Co. Ltd for around USD400million in cash. One hopes that this will kick start the development of the mine which Prospect has been struggling to fund in recent years. Government will need to keep a close eye that the Chinese go ahead and develop the sight rather than just sit on it for China's future needs.

Consumption should be buoyant in 2022 assuming of course no more lockdowns. Real wages have been rising since the lows of 2017/18 which has helped. So too has the growing informal economy. Now that the Government is looking to pay a part of civil servants' salaries in USD this will also be favourable toward consumption. If the agricultural sector is indeed another good one, then farmers' incomes will benefit as they did in 2021. Even more so if they are not compelled to pay back their agricultural loans! We were shocked, although perhaps not surprised to learn from the Budget speech, that few of the CBZ Agro-loans issued to farmers were actually repaid. These loans were underwritten by Government, so no loss to CBZ and were valued at around ZWL19 billion or USD100 million at the parallel rate. So for those lucky farmers who benefitted from the loans and the inputs could grow their crops, and then sell them, but with little input costs as Government in effect paid those for them. A case of profit equalling revenue. Having underwritten those loans, we would have expected to see a blacklist of those who defaulted on their loans so that the banks wont make the same mistake again. Indeed Parliament should have demanded such a list. USD100 million injection into the hands of relatively few could explain why there are many brand new cars on the roads and new houses being built!

The budget also spoke about total external debt which at the end of September 2021 stood at a whopping USD13.2 billion. At the time of the 2016 Lima Agreement on external debt, Zimbabwe had USD6.8 billion on its books (2015 numbers). That number has now expanded by nearly USD7 billion in just five years which for a country that suggests that it is under international sanctions should be seen as a serious increase. Of that USD13.2 billion, USD4.9 billion can be accounted for by the RBZ's own actions, its liabilities have been taken over by Government. USD3.3 billion of the USD4.9 billion are blocked funds or the so called legacy debt going back to the introduction of the ZWL in 2019. USD1.45 billion are loans that the RBZ guaranteed of which a part are we assume related to agricultural loans. These are very large numbers and should have received in depth scrutiny by Parliament in our view as to where all that money ended up. What is to stop something similar happening in 2022 on the eve of an election?

There is much discussion across Africa as to the extent of Chinese loans to various African Governments which in a number of cases put such countries in precarious debt positions. In Uganda, their Parliament is only now learning about Chinese loans of USD200 million to expand Entebbe International Airport to the extent that revenue generated by the airport is going into escrow accounts to fund the Chinese loans. The loan is governed by Chinese law. There is a risk that the Chinese will take control of their airport. The new Zambian President "HH" is still trying to get to the bottom of the various loans that China has given to Zambia over the past decade so that it can be accurately accounted for. Other bilateral lenders to various African countries are unhappy that the Chinese are receiving preference when it comes to servicing such loans. In Zimbabwe, according to the Public Debt Bulletin 2020, Chinese debts appear under Non-Paris Club Bilateral debt which total USD1.66 billion. In 2020 we note that China received 84% of the total token debt service payments that Zimbabwe made. Such is the Chinese loan problem in Africa that President Xi stated back in November that over the next three years China would cut the headline amount of money it supplies to Africa by one third to USD40 billion and that it would redirect money away from large infrastructure projects.

As we wrote in our various Notes in 2021, inflation is rising across the World and we expect the same to be the case in 2022. In Zimbabwe, local inflation ended the year at over 60% and we would certainly expect it to rise further in 2022 as base effects fall away and as the auction and parallel rates devalue. In recent weeks, we have seen increases in electricity, fuel, transport and toll fees. Food prices continue to climb globally. Rising prices are resulting in higher wage demands not just from the public sector unions but also within the private sector. It will be critically important though that real wages are contained. Demands that USD wages should return to October 2018 levels make little sense since wages at that time were not actually being paid in USD but in RTGS$. RTGS$ were worth 50% of a USD at that time;

RTGS$500 was really only USD250 in September 2018. After the announcement of the introduction of USD nostro accounts in the MPS of October 2018 when Government first broke the illusion that an RTGS$ was a USD, the rate collapsed from 2 to 1 to 8 to 1. Government should therefore not cave in to demands to restore USD wages back to September 2018 RTGS$ levels.

The big mistake the public and private sectors made post dollarization in 2009, was to increase USD wages steadily and at high annual percentages to the extent that Zimbabwe had become uncompetitive by 2013 and was burdened by an expensive workforce. Indeed almost all Government revenues were consumed by public sector wages. This has to be avoided this time around. Our fear however is that with elections looming in 2023 and with some IMF loose change in the kitty, that public sector wages will steadily rise in 2022 with the danger that Zimbabwe will find itself right back where it started in 2017, with a bloated and expensive civil service.

Despite the various lockdowns in 2021, most businesses save for those in the formal retail and hospitality sectors, did remarkably well thanks to growing demand. We see no reason why that should not also be the case in 2022 especially with further economic growth forecast. 2020 was a very difficult year, especially the first half, so 2021 witnessed strong year on year growth. It will be interesting to see how the momentum in volume growth continues into 2022. Certainly numbers up to the third quarter of 2021 largely highlighted growing momentum. We therefore expect a relatively buoyant fourth quarter and annual reporting season that should start in February this year although we may see some earlier quarterly updates sooner than that.

Accounts will continue to be qualified for most if not all listed companies as hyperinflationary accounting continues. Further we note a growing number of company Boards are defying their auditors' recommendations by using different exchange rates to the official one. We discussed Simbisa in our October Notes and it was interesting to see that Delta did the same when they reported their six month numbers. Like Simbisa, Delta also has external operations on the one hand and receives no foreign exchange at the official rate, so it makes little sense to produce meaningless accounts based upon the auction rate, despite what their auditors might have thought. We commend Boards for thinking outside of the box and in the interests of their shareholders.

The ZSE proved to be an outstanding performer in 2021 in both USD and ZWL terms, albeit coming off a very low base from early 2020. There was little competition from other ZWL asset classes; property is largely a USD asset nowadays leaving money market assets yielding 20% or, for some prescribed assets, 40% at best. Equity assets more than doubled in USD or in real terms which does not happen that often. Looking forwards, we don't expect money market assets to offer higher yields in 2022 not least because the largest borrower is the Government. Equities will therefore remain the preferred asset class. We expect listed companies to continue to report positive volume and earnings growth which will provide upward momentum for the ZSE. We are not expecting to see any significant re-ratings in USD terms in 2022. After such strong gains in 2021, market valuations in USD terms for listed companies offer fair value at current levels, although there could be selective revaluations for certain counters. In ZWL terms though, equities will continue to rise reflecting the depreciation in the ZWL and continued growth in the underlying businesses. That provides a favourable background for local stock market investors looking ahead into 2022.

In our October Notes, we wrote about our concerns for potential turbulence in overseas markets. As it turned out markets ended stronger. This makes us more concerned for overseas markets in 2022. With inflation rising globally – in the US the rate hit 7% in December, the highest in forty years – and with Central Banks now recognising that they need to raise rates sooner rather than later, we expect US and European bond yields to start rising. Real wages in the developed world have been falling behind as prices rise so we expect wage demands to increase. As Central Banks cut back on their quantitative easing of money by halting their bond buying programmes, bond yields and credit spreads should rise. This is potentially bad news for overvalued equities and overleveraged businesses which could experience a sharp correction. Over in China, the default by China's largest real estate developer, Evergrande, is just one symptom of the Chinese Government's attempts to cut speculation within the economy. Further, there is strong evidence that the Government is attempting to slow down the speculative accumulation of raw materials. We believe that there is a good chance that commodity prices in certain areas may start to fall during 2022 as current global supply constraints are eased. Gold may actually perform reasonably well if there are growing fears that inflation may be around for longer than many had realised. It will be important therefore for us to keep a close watch on events in financial markets outside of Zimbabwe as 2022 progresses. For the time being and to a certain extent we remain insulated from them, but this could be short-lived depending upon any global financial shocks.

We would like to wish our clients, our investors and our readers a prosperous and hopefully, a pandemic free 2022.

John Legat
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