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ZAMBIA

Political and Economic Challenges Can't Obscure a Fundamentally Strong African Story

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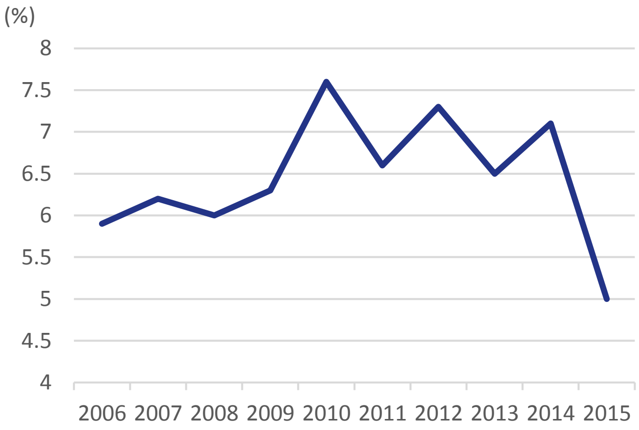
Drive around the streets of Lusaka, Zambia's capital, and you'll be struck by the large, modern shopping malls, both built and in progress, that sit lushly off well-tarred roads. Filled with brands you would find in Johannesburg or London, they are the product of a decade of rapid economic growth which has driven a boom in consumption spending. The neat sidewalks and roads are the fruits of an infrastructure splurge over the past three years.

It is certainly not the country that Zambia's post-colonial leaders would have envisaged. They positioned the state as the only economic actor. When that led to economic disaster in the early 1990s, Zambia embraced market-led liberal economic policies, a commitment that remains strong despite occasionally wavering.

FIGURE 1: GDP ANNUAL GROWTH RATE



Source: Bank of Zambia

Another surprise for those early leaders of the one-party state would be Zambia's vibrant democracy. The country goes to the polls on **11 August for a national election that is too close to call.** Street corners and boardrooms are filled with chatter over who the likely winner will be.

Violence has occasionally flared during the campaign and the government's tax authority has seized the assets of The Post, an independent newspaper, alleging unpaid taxes. That has threatened Zambia's reputation as an African country where elections are regular and losers give up power gracefully. But whoever eventually wins control of State House, the task will be the same: to tackle the economic headwinds that have grown in the past three years.

Weaker prices for copper, the mainstay of the economy, an energy crisis and the large infrastructure spending programme have contributed to a rapid expansion in the budget deficit. Whether the incumbent Patriotic Front (PF) or the leading challengers, the United Party for National Development (UPND), get the job, they will have to face up to Zambia's economic troubles quickly. That is almost certainly going to involve a package from the International Monetary Fund that will see fiscal discipline reintroduced. There will be short-term pain in its wake, but the path to

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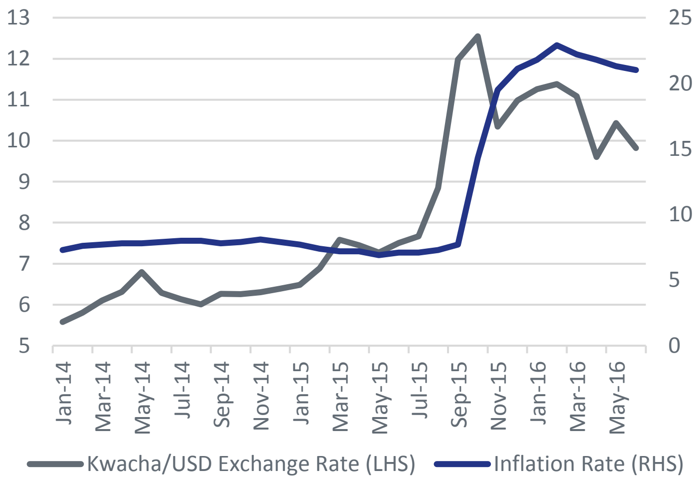
returning to a plus 5% growth rates looks clear. Even this year, with the economy beset by problems, real GDP growth is forecast at 2.7%.

For international investors, Zambia continues to present real opportunities. The country needs new power projects, new mines, new agri-industries and manufacturing to service not only its own growth but the region's. A positive election outcome could set the scene for rapid development. In what follows, I consider in detail what it will take for Zambia to get it right, and the opportunities for foreign investors.

GOVERNMENT FINANCES

The PF government, which first took power in 2011 after a populist campaign, has spent extensively on infrastructure, subsidised fuel and electricity, and underwritten prices paid to maize farmers. Those policies are hugely popular, but clearly unsustainable. To finance them, government has burnt through the proceeds of a $1.25bn Eurobond issued only a year ago, while tapping the domestic financial sector for almost all funding available. The result, as at the end of the last financial year, was a budget deficit standing at 9.4% of GDP and a banking industry that has been choked of liquidity.

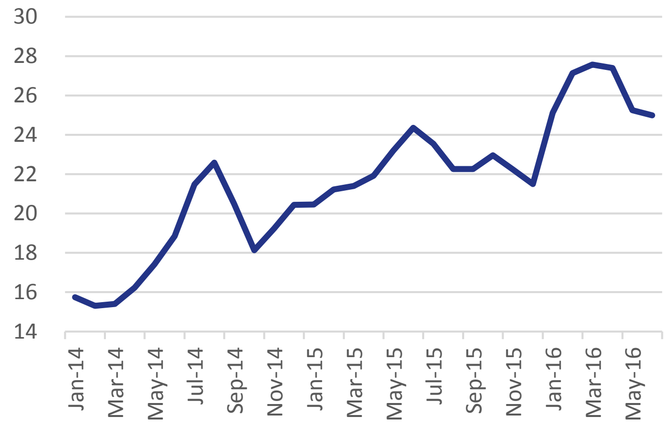
FIGURE 2: KWACHA/USD EXCHANGE RATE AND INFLATION RATE (%)



Source: Bank of Zambia

Weak copper prices also induced a balance of payments deficit, leaving Zambia with a dreaded twin deficit, substantially complicating the outlook for its large hard currency liabilities, including $3bn from three Eurobond issues in the last four years. That induced a 42% fall in the value of the kwacha against the dollar in the third quarter of 2015, triggering inflation and higher interest rates. In Zambia's semi-dollarised economy, the transmission from exchange rate weakness to inflation is rapid, with many inputs and rents priced in dollars while consumers pay in kwacha. Inflation rocketed from 7.9% at the end of 2014 to 21.1% a year later.

FIGURE 3: 364 DAY TREASURY BILL RATES (%)



Source: Bank of Zambia

The central bank took steps to try and stem inflation, given its 2015 target was 7%. That included increasing bank interest rates and statutory reserves and limiting bank access to overnight lending. Those moves succeeded in partly reversing the collapse in the currency and began bringing inflation down, but it remains high, particularly for foods.

Food prices have become a major campaign issue in the elections, the one area where fiscal discipline finds traction in the popular imagination. Government has looked increasingly cash strapped, pursuing multinationals for taxes and royalties while drawing a dividend from the central bank. The yield spread on its Eurobond has at times crossed 10 percentage points over US bonds of similar maturity, and was yielding 7.3% in June. Back in 2012 when the Eurobond programme began, Zambia could borrow at lower rates than Spain.

Four years of extensive investment in infrastructure has put down new roads across the country, but there are critics. They question the quality of much of the spending – both build quality and economic impact. There is limited project assessment and selection in public procurement processes. Several projects are accused of pandering more to political than economic objectives.

POLITICAL MANOEUVRES

The PF government has seen a significant turnover of leadership. In 2014, Michael Sata, who had led the party to power in 2011, died. His deputy, Guy Scott, took the presidency until an election in January 2015 saw Edgar Lungu, who had been defence minister, elected. He won by just 27 757 votes (1.66%) ahead of Hakeinde Hichilema of the UPND, but with only a 32% voter turnout. The August elections are timed in with the normal five-year election cycle, with the elections last year triggered by the death of Sata.

UPND's "HH", as he known in Zambia, is a successful businessman having headed the local practice of Grant Thornton. Although he has no record in government, despite having run for office many times, he is widely seen as a fiscal hawk, campaigning under the slogan "HH Will Fix It". He has loaded his slate with well-known ministers from the Movement for Multiparty Democracy (MMD) government that preceded the PF, as well as Guy Scott who defected from the PF following a bruising battle with Lungu. While acting president, Scott had refused to allow government resources to be used in Lungu's 2015 campaign. The MMD is also campaigning, but its support has plummeted and many key figures have switched to the two major parties.

FIGURE 4: MAP OF ZAMBIA'S PROVINCES

Lungu has used his incumbent position to rapidly try and build a reputation for delivery. His campaign emphasises "continuity, unity and prosperity" and the major infrastructure push under the PF government is cited as evidence of its delivery record. Holding down energy prices has been popular. The floor for maize prices, underwritten by government, has endeared PF to rural farmers. Lungu has also used the advantage of incumbency to ensure positive coverage through the state-controlled media and has been able to put together a well-financed campaign.

One of the most bizarre episodes of the election has been government efforts to shut down The Post, a feisty independent newspaper, seizing its assets on allegations of unpaid taxes. Its journalists have continued producing the newspaper using laptops and mobile phones on an empty piece of ground in front of their police-guarded offices.

The press is full of conspiracy theories about manipulation of the voters roll and plans to rig the elections including mysteries around the printing of ballot papers. This is difficult to take seriously. Zambian politics is a fairly close affair with individuals swapping sides regularly. There seems little scope for any serious conspiracy to manipulate the results.

Polling data in Zambia is poor. The low turnout in the previous election makes it an unreliable trend indicator. Since then, there has been a remarkable surge in new voter registrations of 1.69-million, more than the total number of votes cast in 2015. So this election faces a radically different electorate. The parties tend to split along class and geographic lines, with the PF dominant in the east and north, particularly among the working class, and UPND in the south and west and the middle class. The election could turn on Zambia's two most populous provinces, Lusaka and Copperbelt, where campaigning has been vigorous.

Whatever the outcome on August 11, the new government will swiftly have to get to work on turning the economy around. That is going to involve the IMF, and Lungu has already conceded that a deal is likely to be struck by the end of 2016.

COPPER IS CRITICAL

Copper has always been the mainstay of the economy. Zambia is the largest in Africa and eighth-largest producer in the world. The metal makes up 77% of export earnings. The copper price has steadily depreciated since its 2011 highs as Chinese consumption of the metal has slowed. Mines have additionally had to contend with massive uncertainty over taxes, including a dispute over VAT refunds, and power shortages. Some mines have been put on care and maintenance and new production capacity has been delayed.

FIGURE 5: COPPER SPOT PRICE

LME MONTHLY CLOSE $/METRIC TONNE

Source: Inet BFA

Figures for the volume of copper production are somewhat unreliable. Government levies royalties on the amounts produced and it regularly alleges that mines underreport output. But there's no doubt that copper production has fallen sharply since a 2013 production record of over 1-million metric tonnes. In 2015 the production of 711 000 tonnes was recorded, though this earned 31% less than roughly the same amount of production the year before.

There are signs that this trend is now turning. New power supply and increased efficiencies are enabling higher output. Canadian miner First Quantum Minerals is expected to double output at its Kalumbila mine (also known as Sentinel). Glencore is due to bring online a shaft at its Mopani mine. Even at prices around $5 000/tonne these new mines are expected to be profitable, relying on cheaper open cast mining. That can't be said for Zambia's oldest mine, Konkola Copper Mines, owned by India's Vedanta Resources, which produced 123 000 tonnes in Zambia in the year to end-March, down from 160 000 in 2013. Its cash cost is still higher than the copper price, but it managed to cut costs from $7 255 to $5 754 in 2016 over a year earlier. Aggressive cost reduction strategies are ongoing.

Wildly optimistic forecasts have copper production surging to over 1.5-million tonnes in 2017, though this will take a strong copper price and no delays in new projects or the power that is needed to support them. The First Quantum expansion has been held up due to delays in commissioning the 300MW Maamba Collieries plant and faith in on-time project delivery is low.

POWER CRISIS

Zambia has been suffering a power deficit since 2008 and in 2015 demand exceeded supply by 34%, according to World Bank estimates. The country experienced rolling blackouts last year, leaving households and businesses without power for eight hours a day, although mines were spared. Most power is produced from hydroelectric generation at Kariba and Kafue. The lack of power was blamed on low rainfall, though an underlying capacity constraint is clear thanks to years of delays in new capital expenditure.

To deal with the problem, particularly as the election has approached, government sourced emergency power from the Southern African Power Pool, Aggreko PLC, and a 200MW Karpower generating ship moored on the coast of Mozambique. The IMF estimated in March that this emergency buying could cost the government $660m this year. It is also widely thought that government is running down reservoirs to keep the lights on in the run-up to the elections. It has been only partly successful – rolling blackouts are now four hours per day.

Despite the major cost increase, with emergency supply costing up to 18.8 USc/KWh, electricity tariffs have been held at 7 USc/KWh. Some miners pay less due to old supply agreements. An attempt was made early this year to increase tariffs by about 73%, after initial proposals of up to 248%, but they were aborted after an outcry. Mines have also stubbornly resisted attempts to increase their energy prices.

Post the election, when political sensitivities are likely to abate, a dramatic increase in tariffs seems inevitable. If done sensibly they will be staged so the impact on consumers is not immediate. Tariffs need to increase to above the cost of production, especially for the government to attract new independent power producers. The good news is that government is committed to relying more on the private sector.

There are six new power plants at various stages of development that will collectively add 1 730MW to the grid, mostly by private producers. The first output from Maamba began in mid-July. Total generation in the country will almost triple, though most are several years from completion. In addition, the country's first two photovoltaic plants have been approved for construction near Lusaka, each with 50MW. The prospects look good for independent power producers. As power constraints ease, investment in mining and other industries is likely to pick up.

Fuel subsidies are another problem for government finances. These were removed in 2013 in much better economic conditions, but government has not passed the impact of last year's collapse of the Kwacha to consumers, effectively reintroducing subsidies. Those are thought to be costing government $50m/month.

ECONOMIC DIVERSIFICATION

While copper is at the centre of the Zambian economy, it is not the only game in town. Those shopping malls in Lusaka reflect the growth of a consumer sector, with some 1.5-million people now forming an urban retail market, out of a population of 15-million. It has been driven by a growing civil service, growth in public spending and the multiplier effects of a decade of strong mining growth. One negative result has been increasing inequality and a growing rural/urban divide with poverty in Zambia's rural areas almost unaffected by the growth, though total poverty levels have been shrinking.

In urban areas commercial and housing development has been strong but the lack of bank credit availability is a major constraint. Construction activity has been the fastest-growing GDP sector over the past two years with government's infrastructure spending the biggest driver. This demand has been serviced by a variety of companies with Chinese constructors taking on some of the biggest infrastructure projects.

GROWTH IN REAL GDP PER SECTOR	2013	2014	2015*
Agriculture, forestry and fishing	-4.1	8.0	-7.7
Mining and quarrying	3.6	-2.2	0.3
Manufacturing	6.2	4.0	4.4
Electricity, gas, steam and air conditioning	8.0	8.4	-1.5
Water supply; sewerage & waste management	28.6	-7.9	6.9
Construction	-2.7	8.9	18.9
Wholesale & retail trade; repair of motor vehicles	19.7	3.5	3.6
Transportation and storage	-19.7	6.7	1.4
Accommodation and food service activities	3.5	3.5	0.0
Information and communication	-3.5	7.4	2.5
Financial and insurance activities	-5.0	-3.6	8.3
Taxes less subsidies on products	5.1	5.0	3.2

*Preliminary estimates. Source: Bank of Zambia

The banking sector has been massively constrained by the draining of liquidity from the market. The consumer sector is used for little more than deposit gathering, at a cost of a few percent, which can be lent to the government at 24% for a healthy, risk-free margin. Consumer and business funding has been curtailed as a result with private sector credit extension on a declining trend. Consumer loans are advertised by banks at interest rates of 30% to 50%. The lack of domestic financing is a major constraint to growth. An IMF package may include strategies to address it, potentially through wholesale lending to the banking sector by supporting multilaterals.

Communications has been a good area of growth with Zambia's mobile phone penetration still increasing. Broadband is fairly good with LTE, which enables high-speed wireless communication, available in Lusaka.

Agriculture has traditionally been the second major economic sector but its contribution declined sharply last year because of poor rainfall. That appears to have changed this year following good rains, and maize production is now expected to rise 10%.

Policy is also not helpful, with export restrictions on grain designed to keep domestic prices low discouraging planting, despite a good crop this year. There is extensive smuggling of maize, to neighbouring countries, and the policy needlessly worsens Zambia's foreign exchange position. Production of other staple crops faces similar policy obstacles, though niches like tobacco, cotton and fisheries are big contributors. Zambia imports many foods which could be grown domestically, like potatoes.

Mining also has some diversity with gem stones (Zambia is the world's second-largest supplier of emeralds), cobalt, manganese, quarrying, gold and uranium. There are extensive government incentives on offer to attract new investors to the sector. Chinese mining companies have been quick to move into the country along with several Chinese yellow metal suppliers.

Manufacturing, despite being squarely hit by the power crisis, has also grown strongly over the past three years. Much manufacturing relies on the Africa Growth and Opportunity Act's (Agoa) provision of duty free access to the US market. There is a strong incentive campaign to promote new investment including zero corporate tax and import duties for the first five years of profitable operation if located in certain zones. With reliable power supply likely to be available from 2018 onwards, the opportunity beckons to fill current gaps in the local supply chain such as steel making and agri-processing.

The relative stability of Zambia compared with the Democratic Republic of Congo has led to a vibrant industrial zone on the border with the mineral rich Katanga province, particularly in basic commodities like cement, while much of Katanga's copper ore is smelted in Zambia. Imported capital equipment also finds a good market near the border. However, the DRC has occasionally tried to disrupt this flow in an effort to promote more economic activity inside its borders.

Tourism is another significant opportunity for the country, abundant in natural parks and wildlife. However, tourist arrivals have been stagnant at just under 1-million per year, less than half the number of neighbouring Botswana. A new airport is being constructed in Lusaka that will dramatically improve air capacity, which, combined with good new roads in many rural areas, sets up the tourism sector for strong growth.

INVESTMENT OUTLOOK

Zambia offers a strong policy environment for investors with no exchange control, no capital gains tax and a fairly good legal system protecting property rights. There is an investment guarantee regime backed by the World Bank and Zambia is a member of the International Convention on the Settlement of Investment Disputes. Despite occasional political rhetoric against foreign investors, Zambia stands among the most foreign investment friendly countries on the continent.

The problem is identifying the right opportunities. For portfolio investors, Zambia's Eurobonds have captured the attention of some large international investors recently, though kwacha-denominated government instruments have been avoided since last year's currency collapse. The Lusaka Stock Exchange is quite sophisticated and well-regulated but has almost no liquidity. Much of it is accounted for by subsidiaries of foreign parents like Shoprite and Standard Chartered. Major local companies like agricultural giant Zambeef and government-controlled ZCCM Holdings can be traded via secondary listings in London.

Most interesting to investors are direct investment opportunities, from the mines to tertiary sectors. New mining investments have various government incentives on offer. The power sector is likely to offer many new opportunities for independent power producers. Agriculture and agri-processing has the potential to thrive if the right policy moves are made. Tourism and manufacturing all have great potential.

South African retailers have moved into the market in a big way, with Woolworths, Pick n Pay, Truworths, Foschini, Massmart, Famous Brands, Edcon, Mr Price and Shoprite all heavily invested. The financial sector is dominated by foreign banks while South African insurers like Hollard and Liberty, and the UK's Prudential PLC have been moving into the market through acquisition and organic growth. Business services from accounting to IT have also seen extensive South African investment.

With Zambia set to regain growth rates of over 5%, opportunities are likely to abound. The outlook will be clearer after August 11, but any scenario is positive. Zambia will continue to be a standout opportunity in Africa. ■