IMARA
Asset Management

Investment Notes - Zimbabwe

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Summary

- **Regime change** - now a certainty, with a pro-business, new leadership in the medium term a real possibility.
- **Best access point** – Imara manages an open-ended Zimbabwe listed equity fund, launched in 2007.
- **Excellent entry point** – We invest in the top corporates, which trade at 40-55% discounts to regional peers, operate at 55-60% capacity utilization and are perfectly poised to benefit from economic recovery.

All the world's a stage, finding alpha in Zimbabwe's political climate

To the world, the events in Zimbabwe over the past week have been met with amazement and some confusion. On Sunday 19th November, Mugabe was expelled as head of the ruling party (ZANU-PF) following the military intervention on the 15 November. At the time of writing, he remains president of the nation and the de jure leader of Zimbabwe. Removing him from power, via constitutional channels, was always going to take longer than a conventional military coup. Mugabe and his wife have been expelled from the party, but removal from presidency requires resignation or impeachment, the latter requiring a two thirds bipartisan majority. Resignation is clearly the most expedient and palatable option for the new ZANU-PF leadership, as it does not require negotiations with, nor concessions given to, the opposition MDC party. Mugabe has other ideas however and in a self-contradicting broadcast on Sunday, that resembled something out of Orwell's 1984, he insisted that the coup is not a coup and that he would preside over the ZANU-PF Congress in December, despite his expulsion only hours earlier from ZANU-PF.

We have always taken a long-term view to investing in Zimbabwe. We prefer to look through the political noise, factionalism and posturing and instead focus on identifying corporate champions that can generate excess returns above the domestic cost of capital despite the political regime and macroeconomic challenges. On average, the companies in our Zimbabwe portfolio are trading at 40-55% discounts to regional peers and operating at 55-60% capacity utilization, with scope to rerate if there is an improvement in the economic environment. Delta Breweries (AB Inbev) trades at an EV/EBITDA multiple of 3,9x (using the Old Mutual Implied Rate) compared to an average of 10,2x for African brewers on our watchlist. We use Delta Breweries as an example of an undervalued corporate champion in the last section of our letter.

Politically, while the situation is dynamic and changing by the hour, the struggle for power within ZANU-PF ahead of the 2018 elections, is out in full force. While many were hoping for a popular, velvet revolution, social media revolution (#Tajamuka or #Thisflag), the reality of politics, struggle for power, and the intricacies of the key actors: Mugabe, the army, SADC, AU, ZANU-PF (now with Mnangagwa as the de facto leader) and the main opposition party MDC, means the situation may continue to drag. What is different for Zimbabwe is that change is now a certainty with these different 'actors' now out in public and jostling for power. A pro-business outcome is a real possibility, ideally being an ***all-inclusive*** transitional government formed for a specified period as the platform for free and fair elections is prepared. Another possibility is that ZANU-PF may come out of this stronger, having solved its internal succession battle, replacing one authoritarian leader with another, the difference being the new leader is more pro-business and doesn't have to worry about a succession battle.

Whilst this has been happening, the equity market in Zimbabwe has been selling off as expected, down 20% last week and down another 10,5% yesterday (20th November). YTD the Zimbabwe Industrial Index is still up 168% (it peaked at over +250% YTD a few weeks ago), mainly driven up by local investor fear over holding local electronic cash and as a hedge against the risk of a return to hyper-inflation. The issuance of quasi-currency Bond notes over the year, monetary financing of the fiscal deficit and excessive government borrowing triggered panic buying of equities and left local institutions fearing a return to hyperinflation. Using the August numbers, domestic debt stood at USD5,4bn, 31% of GDP from 25% of GDP end of 2016 and 14% of GDP in 2014. Money supply was up 37% y-o-y for August 2017. If Zimbabwe can navigate the current political environment successfully and re-engage the international financial institutions (IFIs), a strong fiscal reform strategy is still needed. As recently as July, the IMF concluded its Article IV consultation with Zimbabwe, the staff report is very clear on the structural reforms that the country needs to undertake to facilitate resolution of arrears with bilateral creditors. The political environment undermined implementation of the reforms. Zimbabwe needs the support of the international community to pave the way for sustainable economic growth.

We are currently valuing all Zimbabwean assets using the Old Mutual implied rate (OMIR). The OMIR has strengthened from 5,67 at the end of October to 3,67 yesterday (20th November). This implies that 1 unit of local currency was worth 18 US cents at the beginning of the month and now that same unit of local currency is worth 27 US cents, up 51,7% MTD. We expect equities to continue to fall as well as the OMIR to appreciate cancelling each other out and perhaps recording a gain depending on how fast the OMIR unwinds. We doubt that OMIR will go back to parity, because of the creation of electronic dollars and scarcity of USD. YTD the average OMIR is 2,2, implying a discount of 55% to the USD for the local currency. The OMIR movements are summarised in the table below:

Date	OMIR	Discount (%)
Average since dollarisation 2009	0.93	7.1
Average YTD	2.21	-54.8
30 Oct 17	5.76	-82.6
15 Nov 17	5.75	-82.6
20 Nov 17	3.63	-72.5

The Imara Funds

Imara has been managing a dedicated Zimbabwe equity fund since 2007 as well as including Zimbabwe as part of our pan-African listed equity funds. Within both the country and the pan-African funds we allocate the same way.

At the beginning of the year we could not have predicted these political events to happen, our allocation to Zimbabwe has always been premised on the bottom up opportunities in the country. Our process is focused on identifying companies that satisfy our quality criteria (high Return on Invested Capital, durable competitive advantage, strong cashflow, clean balance sheets) and trade at a discount to intrinsic value. These quality corporates (corporate champions) can generate alpha over the medium to long term through utilizing their durable competitive advantages to generate excess returns above the cost of capital as well as strong free cashflow despite the politics. Our view was that the political environment was as bad as it gets but nonetheless our bottom up investment process has been able to identify assets that have consistently met our quality criteria. A change in the political climate would be an additional catalyst to unlocking value but not core to our investment decision making.

We believe that Zimbabwean equities are undervalued because of the political risk as well as a focus by some other allocators on the short to medium term, our advantage, in having our Zimbabwe fund since 2007, is that we have been able to identify and invest with quality companies that have consistently delivered stable growth locally and that are attractive now and have scope to rerate if there is an economic recovery.

Some of them like Delta Breweries, the monopoly brewer in Zimbabwe, managed to emerge from hyperinflation in the 2007-2008 period (hyperinflation peaked at 500 billion percent) with their asset base intact and with minimal debt. Post dollarization, Delta used internally generated cashflows to fund CAPEX programs when foreign currency was readily available, purchasing machinery and equipment at 1:1 with the USD, building a new Chibuku Super plant in the process, replacing obsolete lines, and adding new ones. In addition to this, they managed to reduce overheads and maintain competitiveness, retaining key management whilst other corporates were suffering from brain drain. See table below for a comparison of

Delta volumes and costs in its peak year following dollarization to the most recent full year financial numbers (March 2017). It is clear from the table, Delta reduced total costs from a peak of USD 470m in 2012 to USD 370m in 2017, a 21% drop, reducing costs/hl and growing free cash flow.

Delta Zimbabwe	2012/13	2016/17
Volumes (M hl)	6.9	6.1
Total costs (US$m)	470	370
Costs/hl (US$)	68	61
FCF	50.8	72.3
Average Enterprise Value (US$m)	1,606	968
EBITDA (US$m)	162	113
EV/EBITDA (using 20 Nov OMIR)	9.9	2.3
EV/EBITDA**		
(using average OMIR for 2017)		3.9
Average ROIC since dollarization		18.4%

Using yesterday's OMIR to value Delta, it is trading at an EV/EBITDA multiple of 2,3x relative to its historic average of 9,0x since dollarisation. If we use the average OMIR for 2017 instead of yesterday's rate to calculate EV, we get an EV/EBITDA multiple of 3,9x still significantly below its historical average and well below peers on the continent which trade at an average of 10,2x.

In conclusion, using the average OMIR for 2017, the Zimbabwe portfolio trades at an EV/EBITDA of 6,7x and an average ROIC of 17,4% since dollarisation. This compares favorably to our average EV/EBITDA of 7,8x and ROIC of 16,5% for our Africa watchlist.

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