IMARA Asset Management

Monthly Market Report

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Market snapshot

The month started off negatively due to an emerging market and global market sell-off sparked by fears of more than expected FED interest rate hikes. After a 2-week period of heightened intra-month volatility (9 February to 23 February), markets recovered. Against this backdrop, African markets held up well, Egypt was up (+3.3%), BRVM (+2.6%), followed by Kenya (+0.8%). Zimbabwe was the largest decliner down (-3.7%), followed by Nigeria down (-2%) and Morocco (-0.53%).

Economic and political overview

Nigeria – We visited Nigeria during the month attending a regional conference for one-on-one meetings with corporates and policy makers. We also drove out to see the multi-purpose, deep sea Lekki port project which is being promoted by the Tolaram Group of Singapore. The port will be Nigeria's deepest port and upon completion, the container terminal will support a throughput of 2.7 million TEUs annually. Port congestion at Apapa port is a major problem and the view on the ground is that a lot of capacity there will move to Lekki. This will have a positive impact on local industry and free up working capital as well as reduce the demurrage costs being suffered due to Apapa.

We met with 15 Nigerian corporates, business sentiment is very positive at the moment and foreign currency availability has significantly improved. In the consumer space, affordability remains the main driver of growth, value packs and promotions are a key differentiator in the space. In our meetings we focused on understanding how unit contribution margins have been managed following the sharp devaluation of the Naira. Lower unit contribution margin + sticky downwards fixed costs, leads to a decline in operating margins. The good corporates managed to drive out fixed costs, whilst limiting the damage to contribution margin and as a result reduced the squeeze on EBITDA margins. Encouragingly, the companies we are invested in managed to keep fixed cost growth below inflation and pass on a large portion of the cost increases to the customer. In general though, we do expect EBITDA margins to be under pressure, which will dampen the trickle down from revenue growth to earnings growth. In a declining yield environment, which should enable credit extension, the Banks are guiding for 10-15% loan growth this year. NIM's will be under pressure and the impact will be higher for banks with low demand deposits and large treasury holdings relative to total assets. The combination of IFRS 9 and Basel 3 requirements may be onerous for some of the smaller Tier 2 banks and it is likely they will have to apply for a release of cash reserve ratio funds (CRR) or do a rights issue. We have chosen to invest in the Tier 1 space and none of our bank exposures have indicated that they will be raising capital.

In terms of the macroeconomic picture, 4Q17 GDP growth came in at 1.9% y-o-y, compared to -1.7% y-o-y in 4Q16. This pushed up overall 2017 GDP growth to 0.8% for the year compared to -1.6% in 2016. The February Stanbic IBTC Nigeria PMI data was released, with a reading of 56, which, although lower, shows that the Nigerian economy is still expanding.

Egypt – Equities rallied strongly this month as the Egyptian central bank cut interest rates by 100 bps. The magnitude of the cut was higher than we expected and it points to a pleasing moderation in inflation and further cuts this year are likely. The consensus view is that we may see an additional 200-300 bps worth of cuts this year. The backdrop still remains a tight monetary policy. Prior to the latest cut, the CBE had hiked rates cumulatively by 700 bps, since the devaluation in November 2016. 400 bps worth of cuts this year, would bring rates back to what they were at the beginning of 2017. Reserves since then have grown to USD 42.5bn as at the end of February. The next MPC meeting is on the 29th of March.

We feel that Egypt is well positioned for growth and that an easing policy will stimulate corporate earnings in 2018 and 2019. To put in perspective where we are, the Emirates NBD Egypt PMI still hasn't gone above 50, falling to 49.7 in Feb from 49.9 in Jan. Corporates have been focused on volume recovery and margin repair following the devaluation. Elections are scheduled for the 26th of March and it should be a formality for the incumbent Sisi.

Kenya – The Stanbic Bank Kenya PMI rose further to 54.7 in Feb from 52.9 in Jan. The outlook remains positive, with GDP growth forecasts ranging from 4.5-5.5% (Government forecast 5.3% in the 2017/18 budget), despite the political noise. As long as inflation remains low and more effort is put in place for fiscal consolidation, we do not expect a change to our view. Of concern are the growing twin deficits and the external debt balance, which leaves the KES more vulnerable than we would like. According to the National Treasury’s latest data, public debt stood at KES 4.57tn (USD 45bn) which is c53% of GDP as at Dec 2017, up from KES 3.82tn in Dec 2016. 52% of the Debt is foreign and 48% is local. Even though it is not excessively high, the IMF last week raised concern over Kenya’s growing debt level. We are of the opinion that it is manageable and post the election hump, we expect strong policy reform.

Morocco – The central bank (Bank Al Maghrib) released sector data for Jan 2018, showing 3.2% loan growth with consumer loans up 4.7% which is positive for aggregate demand. Our large bank exposure there released strong results for 2017, which we comment on later in the report. We also received confirmation of the recovery in tourism, with tourist arrivals up 10% y-o-y and occupancy rates of 43% compared to 40% in 2016.

South Africa – Following the appointment of Cyril Ramaphosa as president of the ANC and the country, markets as well as the rand strengthened substantially. Growth forecasts have on average doubled to 1.7% for 2018 compared to 0.9% previously. He needed to seize the moment and purge the cabinet, which to some extent he has done following a Cabinet reshuffle. Investigations around corruption have also gathered pace. This could also lead to the binning of the mining charter and the expensive nuclear power plant that SA cannot afford as well as reform of the rigid SA labour market.

Zimbabwe – In addition to Nigeria, we also visited Zimbabwe during the month. We met with the IMF, RBZ Governor, the Deputy Finance Minister and a few of the large corporates and they are all in agreement in that if elections are conducted properly (credible, free and fair) a bailout package from multilateral institutions is likely which will be an enormous kicker to the economy. On the corporate side, companies continue to have stretched credit lines and are competing on promotions and affordability. Outside of 15 items that are de facto regulated, pricing for most goods and services is up over 40%. The official inflation number is 3.5% y-o-y (Jan 18), but this does not reflect the reality on the ground and the pricing of local goods and services. The bigger companies are able to organise better supplier terms and get more leeway for repayment of foreign payables, but they are struggling for currency allocations from the central bank. In electronic dollar terms, a lot of the companies are extremely profitable, but because of foreign currency constraints, you are likely to see a narrowing of product portfolios, as companies focus on key revenue generators and allocate scarcely available foreign currency for key inputs. Bargaining power with foreign suppliers is an important factor right now and most of our meetings left us satisfied that although some of our investments have stretched credit lines, they are sufficiently stocked to ride out the current foreign currency constraints before the tobacco season kicks in to provide a welcome source of dollars. Zimbabwe remains to us extremely attractive on a real asset basis or on recovery earnings, but on current earnings stream the market appears fairly priced after a strong rally.

Market outlook

Nigeria – As we mentioned in last month's commentary we were looking to see the level of interest in the latest USD2.5bn Eurobond issuance. The issuance was a success with a peak order book of USD11.5bn, 2 notes were issued, a 12 year and a 20 year note, with interest rates just over 7%. The issuance was important for us, for two reasons 1) indicative sovereign risk pricing for Nigeria and 2) replacing domestic debt with foreign debt, which frees up domestic capacity for local lending, right now the skew is still 77% domestic debt and 23% external debt. On a corporate level, we were encouraged by our country visit and we believe that stock selection is key in the banking sector considering Basel 3 and IFRS 9 requirements. In the consumer space, we continue to favour companies that have cost leadership and can shape their portfolio to win the affordability race through value products.

Egypt – Elections are scheduled for the 26th of March and it is shaping up to be a non-event and we expect low voter turnout. Whilst elections can be volatile, this one is shaping up to be relatively straightforward compared to elections of the recent past. We expect further rate cuts, with the consensus view being another 200-300 bps of cuts, which will be positive equities.

Kenya – As we get further away from elections, attention now turns to macroeconomic policy, whilst, we do not expect much to change in the current account, we expect the Government to make fiscal improvements. We highlighted earlier the growing debt burden which is compounded by the twin deficits. Although the twin deficits and low reserves, leave the KES vulnerable, Kenya has an IMF Stand-By Arrangement (SBA) and Standby Credit Facility (SCF) which gives it access to funds totaling USD1.5bn. After some initial confusion in the market, due to policy reviews for the program not being completed last year, the IMF issued a statement reiterating that the arrangement remains in place until end of March 2018. Thereafter the expectation is that the IMF will likely negotiate a new program or extend the existing program with more stringent fiscal requirements. We remain cautiously optimistic of a modification of the interest rate cap as a pre-condition of this funding.

Zimbabwe – We believe that stock selection is of paramount importance and some businesses will struggle with the cash shortage, particularly corporates that do not have bargaining power with foreign suppliers and therefore are unable to extend credit payment terms. Zimbabwe has the highest chance of a positive outcome in its recent past and a lot depends on credible, free and fair elections. In terms of a bailout package, there will be some pain in the form of fiscal reforms and structural adjustments but in the long term this will be positive for the economy as it will reduce the role of government in the economy and free up pools of capital to lend and invest in the private sector. In the near term, the risk of mixed signals and policy risk is high heading into elections in July and August. Most political analysts are expecting an easy win for the incumbent, we believe it may be closer than anticipated, nonetheless, we believe by opening the elections to the international community, the elections are likely to be free and fair which will add legitimacy to the outcome and create the platform for multi-year economic growth.