NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS GROWTH FUND

Quarter Two, 2019

For the period ended 30 June 2019

NEDGROUP INVESTMENTS GROWTH FUND

Performance to 30 June 2019	Nedgroup Investments Growth Fund[1]	ASISA category average	FTSE/JSE ALSI
3 months	%	%	%
12 months	-1.19%	1.47%	%

MARKET COMMENTARY

GLOBAL FINANCIAL MARKETS

As mentioned in prior commentary, the quantitative easing in developed markets post the GFC in 2008 created a great deal of "investor complacency", with borrowers of "free capital" becoming too aggressive in their investment strategies, highlighted by an ever-increasing misallocation of investors' capital. Household balance sheets are in good health, but corporate and government balance sheets are over-indebted and the quality of the much-increased US and European corporate debt is very poor.

In Q2 2019, we saw a continuation of the US and China trade war, as well as further evidence of the global economic slowdown and a decline in global bond yields. We now have a situation where the bond yield curves in developed markets are very flat and there are negative yields on 10-year government bonds in key countries such as Japan, Switzerland and Germany, while Italy is in serious structural trouble as the third largest economy in Europe. As seen in early January 2019, once again the US Federal Reserve has become even more "market friendly" and is now indicating the likelihood of interest rate cuts. It has become clear that a global recession is a very strong possibility in late 2019 or 2020.

As predicted last quarter, as there can be no "winner" in the US and China trade war, we saw a "temporary cease fire" at the end-June 2019 G20 meeting. We believe that based on the above issues, and with the slowing global economic growth and downward earnings revisions, global corporates will become more cautious during all of the uncertainty. Global equity markets have performed extremely well in 2019, but with weak earnings growth, they have become increasingly dependent on US interest rate cuts and further stimulation by the ECB in Europe. The result is that the key global equity markets are now slightly overpriced.

SOUTH AFRICAN MARKETS

In terms of SA's economy, it is very positive that corruption is being tackled and that the five-yearly general election went smoothly in May 2019. However, while President Cyril Ramaphosa has received a stronger mandate, we still believe that SA requires positive structural changes around state-owned enterprises (SOEs), education, skills, productivity and labour flexibility. Only if these positive structural changes occur, together with a more muted public sector wage growth rate, will it enable SA to have an economic platform where the country can have a sustainable annualised GDP growth rate greater than 2%.

In Q2 2019, the JSE's key indices rose strongly by between 3-4%, which was probably due to the rising global equity markets and an uneventful general election, combined with a stronger mandate for President Cyril Ramaphosa. However, it is concerning that there is much greater monthly volatility and nervousness on the JSE, and the resource and bank sectors remain fully valued. As mentioned last quarter, we are still finding excellent value in most mid-sized, non-retail, industrial companies, selected insurance and property companies, as well as selected rand-hedge consumer shares.

INDUSTRY FOCUS – MOTOR RETAIL

Last quarter we updated you on our research and views on the SA telecommunications (Telco) industry and its SA listed companies, being MTN, Vodacom and Telkom, while this quarter we are sharing our research on the SA motor retail industry and why the Nedgroup Investments Growth Fund has been invested in Combined Motor Holdings (CMH) for >15 years. To understand our views and position in CMH, we first need to explain how the SA motor retail industry operates and CMH's role within this industry.

[1] Net return for the Nedgroup Investments Growth Fund, A class. Source: Morningstar (monthly data series).

NEDGROUP INVESTMENTS

After a house, a vehicle is generally the next largest and most expensive purchase most of us will make. A key part of purchasing a vehicle involves visiting a dealership in the search to find the new or used vehicle that best suits our needs and satisfies our desires. Whilst we have all visited a vehicle dealership, very few buyers have given thought to how a dealership runs as a business and whether it is a good investment. This research aims to provide insight into how dealerships operate, the profit drivers of automotive retail businesses and why we believe CMH is a good investment for the Growth Fund.

The linchpin of a dealership's integrated business model is the volume of new vehicles it can sell, either to new customers or to existing customers, as these sales increase the customer pool (car parc) off which the rest of the divisions generate their profit streams. New vehicle sales are very cyclical, with very low operating margins of ±1%, but given the price of new vehicles they deliver substantial rand profits for a dealership. Importantly the sale of a new vehicle creates an opportunity for the dealership to establish a relationship with the buyer which they can monetise through a variety of ways, over the period the vehicle is owned by that buyer. In tough times, dealers are willing to sell vehicles "at cost" to grow the car parc and grow their annuity income streams.

Given the magnitude of the purchase few people can pay for a new vehicle in cash, hence over 80% of vehicles are financed. Dealers will facilitate these financing arrangements, for which they earn a referral commission and a share in the profit of the finance product. In addition, dealerships sell insurance products that cover the outstanding amount on the vehicle for the duration of the financing agreement and value-added-services such as extended warranties, road-side assistance and scratch and dent protection. The sale of these products provides high margin and cash generative annuity-type income streams.

Parts and services provide the dealership with income from the vehicle for the duration of the maintenance/service plan. All new vehicles are sold with a manufacturer's warranty that protects the buyer from failure of certain components for between two – five years. In addition, most new vehicles are sold with a maintenance/service plan of between two – seven years. These divisions deliver annuity-type income streams, as buyers typically repair/service their vehicle at the dealership where they purchased it, at higher operating margins, being ±10% for parts and ±25% for services.

Due to the rapid depreciation of a vehicle's value, used vehicles offer a buyer a much better entry point, allowing the buyer to purchase a vehicle that they could not afford to buy as a new vehicle. Most new vehicle purchases involve trading in the buyer's old vehicle, a mechanism which lowers the price of the new vehicle. "Trade-ins" account for approximately 30% of the used car stock, with the balance sourced from fleet/rental car retirements, wholesalers, or in the open market. The used vehicle division earns an operating profit margin of ±2%, which is double the new vehicle division, due to its higher volumes, greater ability to negotiate both the cost and selling price of the vehicle, less floor space and smaller sales incentives per vehicle.

With the high level of cyclicality of new vehicle sales, dealerships are forced to manage their absorption ratio. The absorption ratio is the percentage of fixed costs and interest expense that is "covered" by the combined profits of the more stable financial services, parts and services, and used vehicles divisions. The higher the absorption ratio, the less exposed a dealership is to the cyclicality of new vehicle sales. In SA most dealerships achieve an absorption ratio of between 75-85%, meaning that they don't require significant new vehicles sales volumes in order to break-even, resulting in a dealership business model that is far less cyclical than new vehicle sales. While vehicle rental and fleet management divisions are not positioned within a dealership structure, they also contribute towards making SA's automotive companies more integrated and less volatile.

If we analyse the current SA automotive retail industry, despite the relatively low-price increases and increased incentive/promotional spend by the vehicle manufacturers, new vehicle sales have continued to be very weak in 2019, with NAAMSA reporting unit sales down -6% year-to-date. A low base should result in a small improvement in the balance of 2019, yet the weak macro environment is likely to limit new vehicle sales growth to being flat in 2019 and low single digits positive in 2020. We expect annual new vehicle sales to return to the 600 000-plus level in 2-3 years and then grow slightly ahead of GDP growth as it is supported by urbanisation and middle-class wealth accumulation.

Within SA, we believe that CMH is the automotive retail market leader and superior to both Motus and the automotive divisions within Barloworld and Super Group. Based on the following factors, we maintain that CMH is best positioned for both the short-term cyclical, and long-term structural, changes in SA's automotive industry:

- A small and well diversified manufacturer base that is focused on value brands, means CMH is not over exposed to any one manufacturer (like Motus is over-exposed to Hyundai & Kia) and will have more consistent demand.

- Dealerships are concentrated in SA's main economic hubs, which are likely to benefit from increased car ownership in SA as incomes rise and urbanisation continues.
- CMH is owner managed, with the executive directors owning ±43%, meaning that they are far more aligned with shareholders than the other SA automotive businesses. CMH's management team is much more focused on cost management and cash generation than its competitors, which is evident in CMH's higher margins and industry leading Returns on Invested Capital (ROIC).
- The Carshop.co.za online portal and Rokkit, the proprietary lead generation and CRM system, put CMH structurally ahead of its SA competitors in the shift to omni-channel automotive retail and positions CMH well to benefit for the time when manufacturers consolidate their dealer franchisee base.

Based on the above SA automotive retail industry and CMH's position within it, we believe that with CMH's integrated business model, its strong management, and its 20-year through-the-cycle return on equity (ROE) in excess of 25%, CMH is worth a share price above R40 per share. Therefore, at its current market price of approximately R23 per share, CMH offers excellent upside with a high margin of safety. The above factors should help explain why we have owned the company for more than 15 years and CMH is currently a 5% weighting in the Growth Fund.

PORTFOLIO COMMENTARY

In the general equity unit trust sector, the Growth Fund continues to produce strong performance over any meaningful time period during the 18 years that we have managed the fund. The historic absolute and relative performance of the Growth Fund has been helped by quality companies such as Italtile and the above-mentioned Combined Motor Holdings (CMH), which have both been held in the Growth Fund for over 15 years. The fund's top five performing positions added 2.79% to returns in Q2 2019, while the bottom five detracted -3.18%.

Winners	Average weight	Performance contribution	Losers	Average weight	Performance Contribution
Libstar	4.66%	1.00%	Novus	5.03%	-0.73%
ABSA	2.87%	0.55%	Sasol	3.14%	-0.71%
Combined Motor Hold.	4.92%	0.44%	British American Tob	4.46%	-0.69%
MTN	2.06%	0.42%	Grindrod	3.46%	-0.68%
Ethos Capital	5.31%	0.37%	Glencore	2.05%	-0.37%

CURRENT POSITIONING AND OUTLOOK

Based on our bottom-up aggregation of the 120 companies that we analyse and value, the main JSE indices, which have performed very strongly in the past quarter and year-to-date, are now trading only 11% below their appropriate price levels. However, because we believe that the most attractive companies in SA are the domestically-biased mid-sized industrial shares, as well as selected insurance and property companies, on an equally weighted market-capitalisation basis, the average share in SA is still 22% undervalued. We have been using this normalised methodology for determining the fair level of the SA equity market and the Growth Fund since the beginning of 2009 and it has proven to be very accurate. The well-diversified Growth Fund currently has upside of 42%, which suggests above average absolute and relative prospective returns.

As we wish to maintain a high level of active share and tracking error risk in the fund, we currently only hold 25 companies, with all shares having a targeted weight of more than 1.5%. This clear focus and positioning, with suitable diversification and strong risk management, enables us to target excess returns for clients from specific share selection and not from sector selection. The Growth Fund is currently 97% invested in SA listed equities and we always target being more than 98% invested.

In the financial sector, we are still finding good value in Investec, as well as in RMI Holdings, Clientele and Texton. With the underperformance of the domestically-biased Industrial shares, we have key holdings in HCI, Ethos Capital, Libstar, Italtile, Combined Motor Holdings, Hudaco and Novus. In the high-quality industrial rand-hedge sectors, we have key holdings in Naspers, British American Tobacco and AB InBev. In the fully valued Resource sector, we prefer the diversified mining shares such as Anglo American, BHP Billiton and Glencore.

RESPONSIBLE INVESTING & CORPORATE GOVERNANCE

Following the Steinhoff collapse in December 2017 and the ongoing Resilient related issues since Q1 2018, in June 2019 we saw the suspension of Tongaat due to its historic financial accounting and auditing issues. The Growth Fund will not even consider investing into Steinhoff, Resilient or Tongaat.

DISCLAIMER

WHO WE ARE

Nedgroup Collective Investments (RF) Proprietary Limited, is the company that is authorised in terms of the Collective Investment Schemes Control Act to administer the Nedgroup Investments unit trust funds. It is a member of the Association of Savings & Investment South Africa (ASISA).

OUR TRUSTEE

The Standard Bank of South Africa Limited is the registered trustee.
Contact details: Standard Bank, Po Box 54, Cape Town 8000,
Trustee-compliance@standardbank.co.za, Tel 021 401 2002.

PERFORMANCE

Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. Certain unit trust funds may be subject to currency fluctuations due to its international exposure. Past performance is not necessarily a guide to future performance. Nedgroup Investments does not guarantee the performance of your investment and even if forecasts about the expected future performance are included you will carry the investment and market risk, which includes the possibility of losing capital.

PRICING

Funds are valued daily at 15:00. Instructions must reach us before 14:00 (12:00 for Nedgroup Money Market Fund) to ensure same day value. Prices are published daily on our website and in selected major newspapers.

FEES

Certain Nedgroup Investments unit trust funds apply a performance fee. For the Nedgroup Investments Flexible Income Fund and Nedgroup Investments Stable Fund, it is calculated daily as a percentage (the sharing rate) of total positive performance, with the high watermark principle applying.

A schedule of fees and charges and maximum commissions is available on request from Nedgroup Investments.

DISCLAIMER

Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. Nedgroup Investments has the right to close unit trust funds to new investors in order to manage it more efficiently. For further additional information on the fund, including but not limited to, brochures, application forms and the annual report please contact Nedgroup Investments.

NEDGROUP INVESTMENTS CONTACT DETAILS
Tel: 0860 123 263 (RSA only)
Tel: +27 21 416 6011 (Outside RSA)
Email: info@nedgroupinvestments.co.za
For further information on the fund please visit: www.nedgroupinvestments.co.za

OUR OFFICES ARE LOCATED AT
Nedbank Clocktower, Clocktower Precinct, V&A Waterfront, Cape Town, 8001

WRITE TO US
PO Box 1510, Cape Town, 8000

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