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NEDGROUP INVESTMENTS ENTREPRENEUR FUND

Quarter Three, 2019

For the period ended 30 September 2019

Performance to 30 September 2019	Nedgroup Investments Entrepreneur Fund[1]	ASISA category average	Small Cap Index	Mid Cap Index
3 months	-4.1%	-2.1%	-3.2%	-1.8%
12 months	-10.9%	-4.4%	-11.8%	5.1%

Market Commentary

In the third quarter of 2019, the JSE All Share Index (ALSI) recorded a loss of -4.6%. This compares poorly to quarters one (+8.0%) and two (+3.9%) of 2019.

The fund disappointingly under-performed both the Small and Mid-Cap Indices which declined by 3.2% and 1.8% respectively.

Of the equity sectors, Platinum (+25.8%), Tobacco (+13.7%) and Gold Mining (+12.3%) recorded the strongest returns in Q3 2019. The worst performance came from Chemicals (-25.6%), Household Goods (-24.6%) and Coal (-24.1%).

Over Q3 2019 the rand weakened by 7.5% from R14.08 to R15.14 to the US dollar.

Overall investors remain very bearish on the prospects for the South African economy given the lack of any meaningful policy direction. Policy uncertainty is weighing heavily on business confidence and manufacturing activity in South Africa, as indicated by the PMI manufacturing numbers, remaining trapped below 50 or in contraction! In fact, the ABSA PMI declined to 41.6 points in September 2019 – its worst level in 10 years. Both Consumer and Business Confidence Indices plummeted to multi-decade lows in August. In addition, according to the Reserve Bank's Quarterly Bulletin, the economy entered the 70th month of a weakening cycle in September – and remains trapped in its longest downward cycle since 1945. These factors have an especially negative impact on smaller businesses, and even more so on those exposed to domestic consumer or industrial demand which is currently practically absent.

In response to the economic challenges, and spurred by an internally controversial document produced by National Treasury, the ANC recently announced its plans on how to revive the economy, most of which was included in the National Development Plan of 2011 – something the party has rhetorically committed to year after year without ever actually implementing much of. Significantly more urgency is required with the implementation of reforms to stem the economic and fiscal deterioration currently being experienced in the South African economy, however it is clear that local business is not expecting this to occur.

Globally, manufacturing survey numbers show that the trade war is starting to affect confidence. While European and Chinese manufacturing survey numbers have been weak for some time, the US joined this weakness in September. The US Institute for Supply Management (ISM) said its index of national factory activity fell to 47.8, the lowest reading since June 2009. A reading below 50 signals the domestic factory sector is contracting.

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

Portfolio Commentary

The fund's top five performing positions added 2.75% to returns over the second quarter while the bottom five detracted -2.61%.

Winners	Ave. weight	Performance contribution	Losers	Ave. weight	Performance Contribution
WBHO	3.26%	0.94%	Truworths	2.95%	-0.76%
Reinet	3.41%	0.67%	Merafe	2.21%	-0.51%
Impala Conv Debs	2.28%	0.67%	KAP Industrial	4.58%	-0.51%
BAT	2.18%	0.26%	PSG Konsult	1.88%	-0.44%
Transaction Capital	0.99%	0.21%	Barloworld	3.95%	-0.39%

WBO had an outstanding Q3 2019 climbing more than 30% (off a low base) as it reported a reasonable set of financial results for the year ended June 2019. The company appeared to be recovering from the losses suffered on a poorly executed road widening contract in Australia and reporting a healthy order book and reasonably confident outlook statement for the year ahead. Entrepreneur holds very selective exposure to the building and construction sector which has been decimated by the collapse and / or complete failure of many of the players in this industry (which we have thankfully managed to avoid completely) that used to be household names and highly respected businesses – think only of PPC, Grinaker, Basil Read, LTA, Group Five, Murray & Roberts, Concor – all gone or trading at a small fraction of their peak valuations.

Due to a collapse in public sector infrastructure spend over the last few years and an absence of any business confidence, there have been few opportunities for work and the sector has contracted substantially with the inevitable unpleasant and unaffordable consequence of job losses. Very recently, despite the disappointingly slow progress the state under Cyril Ramaphosa has made regarding capital spending, we have noticed two glimmers of hope for the industry from a commitment by ACSA to spend about R5bn expanding and extending runways at Cape Town International and O.R Tambo airports, as well as the provision of R8bn in funding to SANRAL from the African Development Bank. These projects which will commence in 2020 are likely to absorb a lot of operating capacity in the industry and in the event of at least low economic growth in SA (<2%, but still better than what we have had for the last three years) will create profitable opportunities for the limited number of survivors in the space. This is the rationale behind two key positions in the portfolio - WBHO and Raubex.

KAP Industrial has been an enormous disappointment and a significant detractor from the fund's performance and has caused us much concern. We have recently spent some time with the management team. At the current price of R4.50 the share is down 48% from its February 2019 high and has de-rated from a PE of 15X to 8.4X. The dividend yield is 5.3%. We consider this to offer tremendous value and gives exposure to a diversified mid-cap business that operates across a spread of domestic economic activity, ranging from consumer goods to specialized transport, integrated bed manufacture and timber products. The financial results to June 2019 contained many positive aspects most notably the impressive generation of cash and consequent reduction in Net Debt from 1.5X EBITDA to only 1.2X and down from 47% of shareholders equity to 35%. Our concern is that for the last two years, while some of the businesses have performed exceptionally well, others in the portfolio have disappointed unexpectedly and materially. And in at least one case due to poor project management. We attribute the consequent de-rating of the share to a decline in the market's confidence in the management team, as well as a capitulation from certain shareholders who acquired shares in the two placements done by Steinhoff as it sold its interest in the firm at higher levels. We are uncertain as to how long this effect may last, but for the time being and at these valuation levels we are prepared to be patient and back management to repair their damaged credibility.

Some major changes implemented during the quarter include:

- Selling out of long-term winner Transaction Capital which has simply become too expensive and investing the proceeds into Alexander Forbes, which under new management is reasonably priced with a variety of self-help options to drive a recovery in the level of profitability, and which we have reasonable confidence can be achieved.

During the quarter we have had meaningful engagement with the following companies regarding specific ESG related challenges – Naspers (regarding the Prosus IPO), Distell (remuneration and executive reward versus shareholder experience), Reinet (multiple matters) and Barloworld (BEE deal and management interests).

Current positioning and outlook

The emphasis of our work and fund positioning has for some time (about three or four years now) been focused on capital preservation by investing in reasonably priced, defensive businesses that we felt had the ability to hold and even grow profits despite the headwinds they were all facing from the local macro-economic environment. We concede we have had mixed success in achieving that with KAP, Netcare, MediClinic and Coronation being the most notable disappointments. In addition, our limited exposure to the precious metal miners has also detracted substantially from the fund's relative performance – especially against the Mid and Small Cap Indices. I refer readers to the Q2 2019 commentary where we discussed the precious metal miners in some detail and hope you have all had a chance to read that. Our explanation is not intended in any way to sound as an excuse, but it is very important that investors in the fund appreciate this in the context of the investment approach followed at Abax Investments.

South Africa is wrestling with many difficult issues at present; violence, xenophobia, corruption and economic stagnation are just some of the topics that are generating a plethora of negativity.

Much of the focus in the months ahead will fall on President Ramaphosa's capacity to deliver a bolder and more cohesive economic plan for the country – it's nearly two years since he was elected head of the ANC, and to the general public progress on matters driving the economy have been largely absent. It is time for decisive action, with Finance Minister Mboweni's economic reform plan a step toward the growth-oriented reforms needed. Internal ANC communist-minded resistance to this is disappointing. I wonder if the irony of being publicly criticised by China (a country ruled by their Communist Party) for your failure as a state to be doing enough to grow your economy and warrant investment by that country in South Africa through their well-funded One Belt One Road initiative occurs to anyone in the ANC's NEC. Probably not.

For South Africa, the Medium-Term Budget Policy Statement in October is a key event, together with Moody's sovereign credit rating review (scheduled for 1 November).

Conclusions

Against this backdrop, domestic equity valuations are reasonably attractive - the JSE Top 100 (ex-Naspers) is now trading on a forward P/E of approximately 10x versus the long-term South African average of 14X. The Mid and Small Cap Indices are trading at a discount to this. There are a significant number of positions in the portfolio with PEs of less than 7X and dividend yields greater than 5.5%. While the prospects for growth driven by a robust economy are not expected in the next two years, our research is focused on businesses we believe can grow their profits notwithstanding the unsupportive trading environment. Off this base we feel the upside outweighs the downside, although, as we have been cautioning investors for some time, we are not recommending that investors add significantly to South African equity exposure at this time.

We are mindful that the fund has delivered a period of average and at times poor performance over the last two years and expect that this will have raised concerns in the minds of our patient investors. This has naturally caused some introspection and we are of course acutely aware of the specific positions and contributors to the performance that has been generated. We remain, however, committed as a stable team to our investment philosophy and process which we believe serves our clients' best interests in the long term and continue to apply it, confident of better times ahead and a return to the attractive long-term returns we have produced in the past. We hope our investors will share this confidence, but welcome questions from clients with any specific concerns you may have.

The portfolio currently trades on a forward rolling Price/Earnings (P/E) ratio of 11.0x and offers a dividend yield of 4.7%.

DISCLAIMER

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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).

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