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NEDGROUP INVESTMENTS GROWTH FUND

Quarter 3, 2019

For the period ended 30 September 2019

NEDGROUP INVESTMENTS GROWTH FUND

Performance to 30 Sept 2019	Nedgroup Investments Growth Fund[1]	ASISA category average	FTSE/JSE ALSI
3 months	-6.7%	-3.7%	-4.6%
12 months	-7.1%	-1.6%	1.9%

MARKET COMMENTARY

GLOBAL FINANCIAL MARKETS

As mentioned previously, 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 Q3 2019, we saw a continuation of the US & China Trade War, as well as further evidence of the global economic slowdown. 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 per in early-January 2019, once again, the USA 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.

While there can be no “winner” in the USA & China Trade War, we have seen various announcements from both countries, but the uncertainty and its global impact remains in place. 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 they were flat in Q3 2019 and, with weak earnings growth, they have become increasingly dependent on USA interest rate cuts and further stimulation by the ECB in Europe. The result is that the key global equity markets are now slightly over-priced.

SOUTH AFRICAN MARKETS

In terms of South Africa’s economy, it is very positive that corruption is being tackled in SA and that the five-yearly general election is behind us. However, while President Cyril Ramaphosa has received a stronger mandate, we still believe that SA requires positive structural changes around State Owned Enterprises (SOEs), especially Eskom, as well as 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 Q3 2019, the broad JSE indices declined by about -5%, giving back their positive gains of Q2 2019. However, while the SA economy remains weak, we believe that there are very attractive domestically focused shares in SA, especially the mid-sized industrial companies, as well as selected insurance and property companies.

INDUSTRY FOCUS – SA INC INDUSTRIAL

This quarter we provide commentary on our research into what we refer to as SA Inc, being the 60 SA listed, based and locally focused industrial companies that we analyse. The key question for these 60 SA Inc industrial companies, is “are they broken”, or “are they a strong buy on the JSE”, and below we attempt to briefly answer this.

With the massive relative underperformance over the past decade by these companies relative to the broader JSE and its Top 40 shares, before trying to decide which shares are worth buying, we need to understand what has gone wrong with many of these companies over the past 10 years. There have been numerous disappointments and in aggregate they have caused SA to become increasingly less attractive as an investment location in the eyes of the foreigner.

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

NEDGROUP INVESTMENTS

While SA has suffered from a “lost decade” of pedestrian economic growth, and shows no indication of a quick improvement, it is too easy to solely blame the tough SA economy as the reason for the underperformance of these companies. Our analysis suggests that a combination of the following 5 factors, which are all under the control of SA Inc companies, has led to the downfall of their businesses over the past 10 years:

- **Weak boards and bad governance**
- **Bad management**
- **Lack of business focus**
- **Bad capital allocation**
- **Excessive debt**

We need to discuss these above-mentioned five factors individually, giving some specific examples.

WEAK BOARD AND BAD GOVERNANCE

The aspect of governance is led by the company's board, so board mix, skills, independence and functioning must be examined. It seems that too many SA Inc companies have weak boards, where many independent non-executive directors merely "tick the box" in terms of board and committee meeting attendance. Ultimately this seems to have led to a proliferation of companies where executive directors are “un-managed” and there is both poor strategic decision-making and poor capital allocation. A big danger is an all-powerful CEO, such as Markus Jooste at Steinhoff or Peter Staude at Tongaat-Hulett. These CEOs effectively "controlled" the company and the Board, to the detriment of all shareholders.

BAD MANAGEMENT

Once the executive directors have been appointed and the corporate strategy has been determined and agreed by the board members, it is the role of the company's executives, such as Chief Executive Officer (CEO), Chief Financial Officer (CFO), Chief Operating Officer (COO) and the broader senior management, to lead, manage and implement the strategy. It should be a "given" that executive management have the skills to deliver the company's strategy, but a key frustration of ours is that management are seldom aligned with external shareholders. This misalignment stems from the fact that executive management is incentivised through salaries, annual bonuses and share options, with share options offering no loss, but huge upside potential, often leading to management and the board taking excessive risk with regard to a company’s capital allocation. This is why we are strongly in favour of executive management teams and all staff actually owning shares in their company.

LACK OF BUSINESS FOCUS

A key aspect of a company's success is their ability to be extremely focused on delivering successful outcomes in areas where their company has an "edge". Many SA based and focused companies have an “edge” in their industry in SA but have ventured offshore and/or into the Rest of Africa. Our view is that this geographic expansion seems to normally be undertaken because Boards and executive management would prefer to manage a larger company, enabling larger salaries to be paid. Hence, with the above-mentioned misaligned incentive structure, it is easy to fund the growth and/or acquisitions through the issue of new shares or by taking on excessive debt.

While SA was isolated from global competition during the apartheid years, many SA-based and focused companies became lazier and their ability to be globally competitive businesses slowly declined. Many of the old SA Inc companies ventured offshore with disastrous consequences for their business, their returns on investment and their shareholders. In terms of imports into SA, due to the lack of global competition in SA in the apartheid years, many SA companies misunderstood their ability to be globally competitive. This was especially true of SA based manufacturing companies, such as ArcelorMittal SA (previously called Iscor). When imports returned into SA post 1994, the local businesses, which had been starved of capex for new plant, equipment and machinery, had become globally uncompetitive.

BAD CAPITAL ALLOCATION

The above comments on business focus and a company’s “edge” are critically important to our understanding and analysis of a company’s capital allocation. Simply put, it is absolutely essential for all companies to have a strong and disciplined capital allocation framework, a process which is led by the board. The reason we say this is because, if companies can get their capital allocation right, they can set themselves up for many good years into the future, but if they get their capital allocation “wrong”, the future is almost certainly a disaster, which can take many years to correct.

Sadly, the past 10 years in SA has generally seen very poor ability by boards and executive management teams to understand and focus on where their company has an "edge", which has subsequently led to very poor capital allocation decision-making. As examples, over the past decade, we have seen once-great companies such as MediClinic, Woolworths and Famous Brands expand and over-pay for their international acquisitions, while PPC has made the same mistakes across the Rest of Africa. Other mid-sized companies such as Altron, Omnia, Invicta, Nampak and KAP also lost focus with bad SA based acquisitions and/or capital allocation.

Once these above mistakes have been made, it is seldom that these companies are able to totally fix their mistakes, with Altron being the only example of a company where they have successfully managed to correct their mistakes.

EXCESSIVE DEBT

Over the past 10 years we have seen several SA Inc companies suffer from having too much debt, which negatively impacted their previously strong gearing ratios. Normally this high level of net debt was taken to fund offshore, Rest of Africa or SA based acquisitions, and the companies hoped for, and relied on, positive business cycles and economic expansion to enable them to pay-down and reduce their net debt.

However, over the past 10 years most of the offshore, Rest of Africa and SA growth has been poor, and these highly-geared companies have been unable to grow at an adequate rate to reduce their net debt to suitable levels. The other problem with weak economic growth is that these companies become operationally "geared" or "leveraged" as their revenues are flat or negative, but they are unable to adequately reduce their cost structures to sustain their operating margins. Companies such as PPC, Sun International, Altron, Omnia, Invicta, Nampak and KAP all suffered post their aggressively funded acquisitions due to the combination of their financial leverage together with their operating leverage.

It is easy to criticise several companies, as we have done above, but it is equally important to show what is possible if strong boards and good executive management are in place, businesses are very focused and understand their “edge” and disciplined and sensible capital allocation is undertaken. Following 10 years of a weak global economy and a flat SA economy, it is worth noting that there are SA Inc companies that have not made the same mistakes as we have highlighted above, and it is worth discussing these companies.

We have previously discussed our research on Combined Motor Holdings (CMH), which we believe is the best motor vehicle retailer in SA and has been a key part of our funds for more than 15 years. Another mid-sized SA focused company that has been held in our funds for more than 15 years is Hudaco, which is a distributor of a vast range of imported industrial components and products that are used in the mining, manufacturing, automotive, security, communication and broad consumer industries. Hudaco has a track record of having competent executive management, with disciplined & sensible capital allocation, enabling small bolt-on acquisitions, that have been financed through a very manageable level of debt.

A further company that we have owned for more than 15 years is Italtile, which was started 50 years ago by Mr Ravazotti, who also owns more than 50% of Italtile's shares. Italtile has a superb business model, being vertically integrated through its tile manufacture (Ceramic) to tile retailing (Italtile, CTM & Top T). Ceramic can manufacture ceramic tiles about 15% cheaper than imported standard ceramic tiles from China, while about 50% of its manufactured tiles are sold via its own group stores. The above enables Italtile to manage a business with high gross margins of about 50%, high operating margins of about 20% and a high ROE above 20%, all of which enables Italtile to maintain its self-funded growth.

AVI, the food manufacturer, is an example of an excellently managed larger company that is solely focused on SA. With a clear understanding of its “edge”, AVI is a globally competitive manufacturer, astute with its capex, and a superb manager of its branded food and consumables. Rather than wasting capital on value-destroying global or Rest of Africa acquisitions, AVI spends sensibly on capex and is also a regular payer of special dividends to shareholders.

The points we are trying to make above with CMH, Hudaco, Italtile and AVI are to prove that it is possible to be a strong SA Inc type of company that is not dependent on doing expensive acquisitions. However, like us as fund managers, we do accept that companies make mistakes, like the above-mentioned Mediclinic, Woolies, PPC, Sun International, Altron, Omnia, Invicta, Nampak and KAP. The key is acknowledging these mistakes and fixing the business in a reasonable timeframe. Of the above companies, the only company that has completed this fixing in the past few years has been Altron, so it is worth noting what Altron did to fix its business.

During 2007-2015 Altron made many bad capital allocation decisions, made bad acquisitions, had poor management and was an unfocused business that slowly destroyed shareholder value. Altron's share price declined from 5200cps in mid-2007 down to 600cps in 2016 and then in late-2016 the positive catalyst happened. The Venter Family collapsed the dual share structure and gave up their voting control of Altron, while they also stood down as the management and the board was restructured with improved governance, a clear strategy and new professional management. The new board decided to sell two non-core, value-destroying, manufacturing businesses, being Powertech (transformers, where Eskom was their key customer) and UEC (TV set-top boxes, where Multichoice was their key customer). The proceeds were largely used to reduce the high level of net debt and make a few mid-sized selected bolt-on acquisitions. The number of offices, distribution warehouses and brands were consolidated, and this enabled the cost structure to be simplified and staff to be retrenched. The Nedgroup Investments Growth Fund benefitted from this improvement, having bought Altron shares at 680cps in mid-2016 and sold them at about 1700cps.

The above example of Altron's successful turnaround is merely to highlight what is currently being faced by many SA Inc businesses. Altron was faced with similar issues and successfully managed these over the past three years. We acknowledge that it took a new board, improved governance, a new strategy, renewed business focus, new executive management, tough cost cutting and debt reduction to deliver this success, but this is what is required to once again become a great or good company. SA Inc type businesses cannot just wait for the next economic up-cycle to help fix their issues. They must rather aggressively manage their businesses with greater discipline and a culture of self-help.

Our job at Electus is to selectively try and invest into the next Altron-type of turnaround situation for the Nedgroup Investments Growth Fund. While we would ideally like to only buy high quality companies such as Italtile, there is a scarcity of these high quality companies in SA and they are normally over-priced, examples being the excellent Capitec or Clicks, which we believe are both extremely over-priced. In the current SA equity market and in the Nedgroup Investments Growth Fund, we believe that the best medium-term investment returns will be made by very selectively investing in average quality, mid-sized, industrial companies that undertake a positive turnaround based on our above-mentioned factors, meaningfully improving their financial metrics.

PORTFOLIO COMMENTARY

In the General Equity unit trust sector, the fund continues to be a strong performing fund over the 18 years that Electus has managed the fund. With our team being solely focused on researching and managing SA equities, we have an excellent understanding of 120 SA listed companies, many of which are quality mid-sized, but market leading, South African financial and industrial businesses. Through our small asset size and research focus, we believe that our ability to selectively invest across quality mid-sized South African financial and industrial businesses will be a key differentiator for Electus and the Nedgroup Investments Growth Fund in the coming years.

The fund’s top five performing positions added 1.96% to returns in Q3 2019, while the bottom five detracted -4.33%.

Winners	Average Weight	Performance Contribution	Losers	Average Weight	Performance Contribution
NORTHAM	2.43%	0.86%	TEXTON PROPERTY	5.12%	-1.21%
CLIENTELE	6.80%	0.45%	GRINDROD	3.22%	-1.00%
BRITISH AMERICAN TOBACCO	3.76%	0.26%	LIBSTAR	5.00%	-0.76%
MUSTEK	2.76%	0.20%	SASOL	2.40%	-0.71%
LIBERTY HOLDINGS	2.33%	0.19%	NOVUS	4.97%	-0.65%

CURRENT POSITIONING AND OUTLOOK

Following their strong price performance during 2019, although they were flat in Q2 2019, there is now little value to be found in US and global equity markets, especially as developed markets seem very reliant on interest rate cuts and ongoing stimulation. However, we believe that there are very attractive domestically focused shares in SA, especially the mid-sized industrial companies, as well as selected insurance and property companies. Based on our bottom-up aggregation of 120 company valuations, the main JSE indices are now trading 20% below their appropriate price levels, although on an equally weighted market-cap basis, the average company in SA is 30% undervalued. The well-diversified fund currently has upside of 52%, 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 Nedgroup Investments Growth Fund is currently 97% invested in SA listed equities and we always target being more than 98% invested.

The main change in the Nedgroup Investments Growth Fund in Q3 2019 was related to the September unbundling by Naspers of its new 74% owned subsidiary, Prosus, which is listed on the JSE and also in Amsterdam. Prosus holds Naspers' key 31% stake in Tencent and also Naspers' other smaller internet and e-commerce related businesses. The fund now has positions in both Naspers and Prosus. We also switched the holding in British American Tobacco (BAT) into Reinet, which has BAT as its largest investment. We particularly like Reinet's 2nd largest investment, in Pension Corporation, which we believe is very undervalued by Reinet.

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 Nedgroup Investments 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
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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.

For the Nedgroup Investments Bravata World Wide Flexible Fund it is calculated monthly as a percentage (the sharing rate) of outperformance relative to the fund's benchmark, with the high watermark principle applying. All performance fees are capped per fund over a rolling 12-month period. 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.

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