see money differently

# NEDGROUP INVESTMENTS GROWTH FUND

## Quarter 4, 2019

For the period ended 31 December 2019

## NEDGROUP INVESTMENTS GROWTH FUND

| Performance to 31 Dec 2019 | Nedgroup Investments Growth Fund[1] | ASISA category average | FTSE/JSE ALSI |
|---|---|---|---|
| 3 months | 2.5% | 4.4% | 4.6% |
| 12 months | 1.1% | 8.0% | 12.1% |

## 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 USA and European corporate debt is very poor.

In Q4 2019, we saw a maturation process of the USA and China Trade War, with the completion of the so-called Phase 1 deal and the unlikelihood of further “phased” deals before the USA Presidential Election in November 2020. This has brought some stability and certainty to global financial markets, even though the global economic slowdown remains evident and a global recession is a strong possibility during mid/late 2020. The flat bond yield curves in Developed Markets remain, as do zero or negative yields on 10-year Government Bonds in key countries such as Japan, Switzerland, Germany and France, while Italy remains in structural trouble as the third largest economy in Europe.

Since January 2019 the USA Federal Reserve has become very “market friendly”, with interest rate cuts and liquidity stimulation, providing strong support to financial markets and offsetting the disappointingly flat aggregate earnings growth. Equity markets were strong in 2019 and also rose strongly in Q4 2019, but most developed markets and Chinese equity markets have become increasingly dependent on rate cuts and stimulation to support their now moderately over-priced levels.

### 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 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 Q4 2019, the broad JSE indices followed global markets and rose by about +5%. While the SA economy is weak and suffers from Eskom related power and debt issues, we believe that there are many attractively priced, and well-managed, SA mid-sized industrial companies. Based on our bottom-up aggregation of company valuations, the main JSE indices are now trading 16% below their appropriate price levels, although on an equally weighted basis, the average company on the JSE is 27% undervalued.

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

## SASOL – THE RECENT VALUE DESTRUCTION AND INVESTMENT CASE

Last quarter we updated you on our research and analysis on SA Inc, being those 60 SA-listed, based and SA-focused industrial companies that we analyse at Electus. This quarter we provide you with our proprietary research and analysis into Sasol and its recent greenfields expansion and investment into the USA, which to date has proven to be very poor, being 50% over budget and two years behind schedule.

Historically Sasol's operations were focused in SA and developing markets, and it was able to obtain favourable terms for using its technology, intellectual property and expertise to unlock the economic potential of the countries in which in operated (across Africa, Middle East & Asia). For over 50 years it operated with these advantages, in relatively closed economies, protected from external competition, with high barriers to entry (high capex costs and regulation) and sustainable competitive advantages (low feedstock costs). Coupled with rising oil prices, this led to high returns on capital and a steady increase in shareholder value, with its share price rising from R6 in 1985 to its peaks of R630 in 2014 and R600 in 2018.

However, as Sasol's business matured, global economies opened-up and at same time global energy and chemical markets were evolving, the search for growth and diversification inevitably led Sasol into new geographies with more competitive markets, higher operational risks, and where sustainable advantages where not as clear-cut. As a key negative for Sasol, there are also several reasons why peak oil demand is likely in the next decade, including an emerging market switch from "industrialisation" to "services", greater energy efficiency, greater electrification through "renewables" and less use of fossil fuels and a "de-carbonisation" focus with the goal of lowering greenhouse gas emissions.

Due to the above reasons, Sasol has diversified and grown into the chemical and plastics markets, where growth has been very strong for the past few decades. The shale fracking revolution in the USA has led to an abundance of ethane gas, which is produced as a by-product in shale fracking. This excess ethane supply has driven the price down, making it relatively cheap as an input product. An ethane cracker processes ethane gas (or "cracks" it) into ethylene and other derivative products. Therefore, USA petrochemical producers have benefitted from using low-cost gas feedstocks (ethane) instead of oil-based feedstocks (naptha) in the production process, placing them in a highly cost-advantaged position and on the low-end of the global ethylene cost curve. This advantage was most pronounced during the period of high crude oil prices that ended in 2014.

In theory, Sasol's 2014 expansion of the Lake Charles Chemicals Project (LCCP) in Louisiana, USA, made sense; low-cost differentiation, better relative demand growth for chemicals versus oil, diversification, reducing overall exposure to highly pollutive Coal-to-Liquids technology and Environmental risks. But the LCCP execution and cost delivery proved to be very poor, and most importantly, the limited sustainable competitive advantages have had material implications for the Sasol investment case. The USA cost advantage is due to cheap natural gas liquids used as a feedstock in the manufacturing of petrochemicals. The primary feedstock is ethane, which is used in the production of ethylene, while 60% of global ethylene is used to manufacture polyethylene, which is used for plastic packaging. While a huge project for Sasol, the LCCP has only added 1.1mtpa[2] of polyethylene capacity in a 400mtpa global market.

Sasol's LCCP cracker project in the USA's Gulf is expected to treble group polyethylene capacity to 1.6mtpa and generate $1 billion in earnings before interest, tax, depreciation and amortisation (EBITDA) by their financial year ending in June 2022. There have been several new cracker projects in the USA as the global majors all try to secure their position on the low-end of the cost curve. Sasol is materially smaller than the largest producers of polyethylene such as ExxonMobil, DowDuPont and SABIC, but its cracker came at a significantly higher capital cost. Initial cost projections started at $8.9 billion when the project was first approved in October 2014, but escalated to $11.0 billion in June 2016, $11.8 billion in February 2019, and $12.9 billion in May 2019. The initial total expected cost was 27% of Sasol's market cap at the time, vs the current 105% of market cap, and was over $3 billion more expensive than comparable ethane crackers in the region. Beneficial operation of the cracker was first expected in 2018, but due to several construction and weather-related delays, it was pushed out to 2020.

Sasol's timing of the LCCP was also poor, as in late-2014 the oil price was trading above $100 per barrel and the Henry Hub gas price was around $4 per metric million British thermal unit. The LCCP economics assumed inflated (in hindsight) long-term pricing assumptions which generated a return exceeding Sasol's hurdle rate of 10.4% (in US dollar terms). Spot oil is now much lower at $65 per barrel and chemical margins are structurally lower due to overcapacity. Sasol's forecasted internal rate of return on the LCCP is now 6-6.5%, well below the company's weighted average cost of capital (WACC), meaning that there has clearly been a destruction in shareholder value.

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[2] mtpa: million tons per annum

Another key issue for Sasol is that environmental factors are becoming increasingly important to governments, regulators and investors. Sasol's Coal-to-Liquids process emits far more carbon dioxide per barrel (c.1,000kg) than conventional oil extraction and refining (c.20-60kg per barrel) and their Secunda plant in SA is reputably the largest global single-site carbon dioxide emitter, at around 57 million tons per annum. This is equivalent to the total emissions of most medium-sized European countries like Portugal, Hungary and Norway. The SA carbon tax rate is well below global levels, and it is likely that higher carbon taxes will place additional real costs on the business. Sasol has been very poor in having a clear and acceptable framework regarding their plan to reduce their emissions, but they have promised to publish this framework in 2020.

In conclusion, over the past decade Sasol has created the perfect storm for value destruction, although weaker oil markets have had an impact, and Sasol's problems were mostly self-inflicted due to poor capital allocation and poor project execution. Sasol is probably now in its weakest position in its history and cannot afford any more mistakes. It has a stretched Balance Sheet with too much debt, meaning there are big risks to the dividend for the next two years, a lower sustainable return on capital, rising Environmental concerns and a lack of company management and Board credibility.

Significantly, in our view, is the change that the LCCP capital allocation and execution has had on the quality of Sasol's investment case. Historically Sasol had a strong moat, driven by a sustainable competitive cost advantage from access to low-cost feedstock. This resulted in high returns on capital, profitability and capital efficiency and, even though Sasol operated in a volatile commodity market, it performed better relative to most of its peers. The chemicals expansion led to a significantly weaker overall moat for the business, as Sasol expanded into highly competitive markets with lower sustainable margins and dwindling competitive advantages, which implies a lower expected average return on capital relative to its past and therefore a lower quality investment case.

A supportive macro environment is required to restore Sasol back to its prime. The only positive near-term driver for value creation, which is under Sasol's control, is from the LCCP ramp-up in 2020 and thereafter from an improving balance sheet and de-gearing. However, the outlook for the global economy and oil or chemical prices are very muted and uncertain. Meaning that there is a lack of clear "forecastability" for Sasol. While Sasol has good potential upside from its current price of R280 to our Electus valuation of just over R400, in order to manage this big forecast risk, we only hold a relatively small 2% weighting in our client funds.

## 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, SA financial and industrial businesses. Through our small asset size and research focus, we believe that our ability to selectively invest across quality mid-sized SA 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 +3.94% to returns in Q4 2019, while the bottom five detracted -1.34%.

| Winners | Average Weight | Performance Contribution | Losers | Average Weight | Performance Contribution |
|---|---|---|---|---|---|
| NORTHAM | 3.00% | 1.38% | NOVUS | 3.87% | -0.42% |
| COMBINED MOTOR HOLDINGS | 5.47% | 1.16% | HOSKEN (HCI) | 6.89% | -0.41% |
| ANGLO AMERICAN PLC | 4.89% | 0.66% | LIBSTAR | 4.47% | -0.21% |
| SASOL | 2.64% | 0.45% | TEXTON | 4.72% | -0.15% |
| GRINDROD | 2.35% | 0.29% | PROSUS | 3.50% | -0.15% |

## CURRENT POSITIONING AND OUTLOOK

Following its strong price performance during Q4 and also for 2019, there is very little value to be found in the USA equity market, especially as Developed Markets and China still seem very reliant on interest rate cuts and ongoing stimulation. However, while the SA economy is weak and suffers from Eskom related power and debt issues, we believe that there are many attractively-priced, and well-managed, SA mid-sized industrial companies. Based on our bottom-up aggregation of company valuations, the main JSE indices are now trading 16% below their appropriate price levels, although on an equally weighted market-cap basis, the average company on the JSE is 27% undervalued. The well-diversified fund currently has upside of 53%, 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 2.0%. 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. Having briefly held excess cash into year-end for the annual fund distribution, the Nedgroup Investments Growth Fund is more than 97% invested in SA-listed equities.

The key changes to the fund in Q4 2019 were the sales of Standard Bank, Liberty Holdings and the NewGold ETF. With the proceeds we bought new positions in the underperforming and undervalued Old Mutual, Hammerson and City Lodge. Purely for global risk management purposes we also bought a small new position in AngloGold Ashanti.

## RESPONSIBLE INVESTING & CORPORATE GOVERNANCE

Following the Steinhoff collapse in December 2017, the ongoing Resilient related issues and the suspension of Tongaat due to its historic financial accounting and auditing issues, the Nedgroup Investments Growth Fund will not even consider investing into these shares.

Pleasingly, in Q4 2019, our ongoing collaborative approach to the JSE regarding fuller disclosure of share trading by company directors, in terms of personal shares being used as “security”, was successful.

Also during Q4 2019 we interacted collaboratively with the JSE in attempting to get Naspers and Prosus “capped” as one combined entity in the JSE’s Capped benchmarks. Sadly, we were unsuccessful in this endeavour.

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.

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.

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