NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS Private Wealth Equity Fund

Quarter Three, 2022

Nedgroup Investments Private Wealth Equity Fund

Performance to 30 September 2022	Fund[1]	Benchmark[2]
3 months	-3.3%	-3.4%
12 months	-5.8%	2.0%

Market Overview

The third quarter saw continued market volatility across the globe. Fears around further hawkish action from global central banks remain front and centre for market participants. At the end of the quarter, eleven of the global equity indices which we track are all in so-called bear market territory, with YTD returns of negative 20%. The worst performer YTD being the tech-heavy Nasdaq 100 at -32.4%.

Economic data releases across the globe remain mixed, but broadly reaffirmed weaker activity data, robust employment figures and cost of living challenges, with the latter pronounced in the UK and Eurozone due to escalating energy costs. US nonfarm payrolls confirmed employment in the United States is above pre-pandemic levels, with unemployment at 3,5%.

While still high, global PMI data showed a moderation in pricing pressure while freight costs and supply chain indicators all confirm some easing in the factors that have added to inflation since the onset of the pandemic. Similarly, soft commodity prices have subsided from their highs. Combined with a lower oil price, factors appear to be lining up for a peak in inflation for several countries around the world.

China announced further stimulus measures amidst lacklustre economic data releases. Thus far, policy support has done little to reinvigorate economic activity, which is still subdued in the face of periodic lockdowns and an embattled property sector. Nancy Pelosi, Speaker of the US House of Representatives, visited Taiwan, stirring geopolitical tensions. China responded by enforcing trade restrictions with Taiwan and military drills around the Strait. While matters did not escalate further, it emphasises the importance of the region for global trade access and the underlying instability of global diplomatic relations at present.

Headline inflation for August came in at 7,6% y/y, marginally lower than the July peak of 7,8%. While the inflation print was largely in line with expectations, producer price inflation surprised to the downside at 16,6%. In line with expectation and hawkish commentary ahead of the meeting, the South African Reserve Bank (SARB) increased interest rates by 75bps. Three members voted in favour of a 75bps hike and two were in favour of a 100bps hike, underscoring concerns of a weaker Rand and persistent risks to the inflation outlook.

The Brent crude oil price reflected weaker global growth expectations with a decline of circa 8,8% in September and 23,4% over the quarter, with prices near levels last seen before the Russia/Ukraine conflict. OPEC+ leaders are due to meet in early October, with the expectation that production cuts will be discussed, with Russia the main advocate for more meaningful cuts.

For the quarter, the Capped SWIX 40 delivered -3.4%, while the ALSI returned -1.9%. At the September index review, the new group capping methodology was implemented, which reduced the weighting of Naspers and Prosus in the capped index to ~8% and ~4% respectively.

Most sectors were down for the quarter. Energy (+38%), Consumer Staples (+1%) and Consumer Discretionary (+1%) were the best performers for the quarter, while Telecommunications (-6%), Technology (-6%) and Financials (-4%) underperformed. Overall, the Top 40 returned -2.7%. Small Caps returned 4.7%, while the Mid Cap index was broadly flat at 0.7% for the quarter.

[1] Net return for the Nedgroup Investments Private Wealth Equity Fund, A class. Source: Morningstar (monthly data series).
[2] Benchmark is the Capped SWIX40

The standout performers on the JSE during the quarter were Montauk (+89%), Thungela (+70%) and Telkom (+27%), while the laggards included Capitec (-22%), Kumba (-21%) and Sasol (-19%).

The USD/ZAR ended the quarter 11% weaker, with the stronger dollar continuing to gain momentum against most global currencies, as investors take flight to safety given all the macro-economic uncertainty.

Portfolio Commentary and Activity

During the quarter the fund exited two holdings, PSG and MEI, which were both subject to delisting transactions. This trend of delisting's on the JSE has continued over the last several years and presents a challenge for most SA fund managers due to the declining universe and lower levels of overall liquidity.

However, given the sell off we have seen over the year, we continue to find both good quality SA inc shares which are attractively valued, as well as global businesses which are listed on the JSE which also present as good investment opportunities. From a see-through currency exposure perspective, the fund currently has a split of ~60% offshore, and 40% local, which is informed by our bottom-up stock selection, as well as a top-down lens for risk management.

The fund initiated positions in Absa and Discovery during the period, both of which we believe present attractive asymmetric payoff profiles. Discovery has a unique business model, which embodies the concept of shared value. At the current valuation, we believe investors are getting a material amount of free optionality, assuming the management execute on the stated strategy over time. Absa has put the Barclays separation behind them and have focused on gaining previously lost market share. The management team reshape has provided stability and the balance sheet remains in a strong position. Detailed commentary on the latest results from these two businesses is included in the next section below.

For the quarter under review, the fund outperformed its benchmark by 0,1%. The benchmark returns were driven by underperformance from Financials, which returned -4% for the quarter, while Industrials and Resources outperformed, both returning -1%. Naspers (-4%) continued its outperformance of Prosus (-10%) during the quarter. For further detail on the relative performance, refer to the attribution table on page 8 and 9.

We turn now to discuss portfolio holdings and related events of the quarter.

Absa *– Good momentum*

Absa released its interim results during the quarter, which showed revenue growth ahead of cost growth (positive jaws), as well as an improving ROE which is higher than the group's cost of equity.

Th group reported a 27% y/y increase in its normalised HEPS as pre-provision profit increased 23% y/y due to solid top line growth. Total revenue grew by 14% to R85.9bn, with NII growth of 12% supported by growth in average interest-bearing assets and a higher net interest margin. The latter benefitted from higher interest rates. Net fee and commission income, representing 63% of total non-interest income, grew 7%. Net trading income, excluding the impact of hedge accounting, remained strong and grew 12% y/y. Insurance revenue reported a strong recovery given; (i) lower Covid-19 reserving, (ii) lower claims, and (iii) growth in net premium income.

Costs were up 7%, with the cost-to-income ratio improving to 51.4%. Staff costs, which is 55% of total costs, grew by 4% y/y, while total IT-related spend (25% of total costs) grew 11% y/y to R5.9bn given continued investment in digital platforms. The credit loss ratio increased to 0.91% but remains within the Group's through-the-cycle range of 75 to 100 bps.

The Retail and Business Banking (RBB) SA franchise (52% of headline earnings) reported earnings growth of 23% and a 21.7% return on regulatory capital. These results reflect the normalisation of mortality claims, improved economic activity and balance sheet growth.

Encouragingly, deposits grew faster than advances. Production momentum was maintained across asset portfolios which led to improving retail advances market share, 1% growth in customer numbers and higher cross-sell ratios. These indicators point to continued successful execution of RBB SA's 2018 strategic transformation plan, which focused on re-engaging with customers and improving customer experiences.

Despite higher capital levels, the group's RoE improved to 17.7%. At 13.1%, the group's CET1 ratio is 0.6% above the board's target range. An interim dividend of 650cps was declared, which equates to a pay-out ratio of 50%.

In our view, Absa's investment thesis remains intact and continues to be supported by positive key performance indicators. We expect net interest margins to be supported by the positive endowment effect from higher interest rates over the medium term.

We expect Absa to reach its medium-term target cost to income ratio of low 50s, although this remains dependent on the global and local macro. We maintain our view that the successful completion of the separation process has set Absa up for continued success and strong momentum. We expect the Group to remain focused on delivering a RoE improvement, increased cross sell and appropriately priced monetisation of its client base. Absa's focus on client service and advances growth, especially in South Africa, should go a long way to restoring the Group to its previous glory.

Based on our earnings forecasts, Absa trades on a 12-month rolled forward price to book of 1.0x and a forward dividend yield of 8.0% which we believe is attractive. The fund currently has a position size of ~2.5% in Absa.

***Bidcorp** – Record results*

Bidcorp reported its full year results during the quarter. Pandemic-related movement restrictions continued to loosen, which opened the door for profits to surpass pre-pandemic levels. Cash generation remains subdued as working capital is gradually being rebuilt to normal levels. Capex is also returning to normal levels as the group moves back into growth mode following a pandemic-consolidation mode.

In Australasia (30% of EBIT), trading profit fell 3% y/y in constant currency (CC). The first half of the year saw both Australia and New Zealand face extended lockdowns. Both countries had managed to suppress the pandemic relatively well during 2020, which is why this segment performed strongly in the prior financial year. Inflationary pressures continued, particularly from labour, but the trading margin remained healthy at 7.0% which is in line with history and is the highest across the group segments.

In the UK (20% of EBIT), trading profit quadrupled y/y in CC, as the prior period suffered from extended lockdowns. Management's commentary on the Fresh business was far more positive and it beat expectations in the final quarter. The trading margin was at historical average levels of 5.0% during the second half of the year, suggesting good cost management to date. Inflation has become a pressing concern, particularly from energy costs, and may begin to weigh on consumer discretionary spend in the near term.

In Europe (31% of EBIT), trading profit increased by 131% y/y in CC. Like the UK segment, the prior period was heavily impacted by movement restrictions. Following several remedial measures, one of the group's problem children, Spain, delivered a solid 5.0% trading margin in the fourth quarter. Germany remains a work-in-progress, but management is confident of its positive trajectory. The 4.9% trading margin delivered in the second half of the year was a record, but high inflation is increasingly rearing its head in this segment too.

Across Emerging Markets (19% of EBIT), trading profit increased by 57% in CC. Most countries had fewer lockdown restrictions on average, apart from China, where the recent zero-Covid policies significantly hampered trading activity. Record earnings were produced in several regions including South Africa, Chile, Turkey, Singapore and the Middle East – some of which could be considered as difficult geographies in which to grow businesses successfully.

With most pandemic-related lockdowns having eased, most of Bidcorp's regions are now operating close to normal levels. From a sectoral end-use perspective, management commented that all customer sectors had recovered to pre-pandemic levels towards the back end of the financial year, apart from the office catering sector, which remains impacted by work-from-home behaviour.

Management's outlook remains positive, stating that "*Our expectation is that 2023 will be another year of profitable progress, as things currently stand, we are budgeting for real growth.*"

Although margins have recovered to pre-pandemic levels, cost pressures continue to rise, particularly in the form of tight labour markets and rising energy prices. Management have been largely successful in passing through price increases to customers to date. Management stressed that maintaining strong customer relationships is key to the group's success in this regard. Bidcorp's favourable customer mix (high proportion of independent customers) also helps to maintain healthy margins, in our view.

Consumers, particularly those in the UK and Europe, are facing high inflation, which may begin to weigh on consumer discretionary spend. In our view, approximately 50% of Bidcorp's revenues are discretionary in nature (restaurants, hotels, cafés, travel) and the balance being non-discretionary (retailers, healthcare, aged-care, education, canteens, caterers, other distributors).

On the strategic front, the progress on the former problem children businesses (Spain, Germany, UK fresh) is encouraging. Other improvements, such as the Poland trading margin increasing from 2.9% in FY19 to 4.9% in FY22, demonstrates continued management success. Noting the balance sheet's strength, management reiterated their disciplined approach to capital allocation and feel no pressing need for large-scale acquisitions. We remain convinced of management's ability and willingness to continue growing the business in a value-accretive manner.

The fund currently has a ~3% position in Bidcorp.

Discovery *– Sell off post results…opportunity?*

Discovery released another complex set of full year results during the quarter. The group continues to monetise its IP in global markets, while growth has slowed in certain areas of the business. The group navigated the back end of the Covid pandemic reasonably well. A total of R3.7bn in gross Covid-19 claims were paid during the period. At year end, management strengthened the assumptions with regard to "long- Covid", to account for future mortality, morbidity and lapses. Discovery Health's data suggests that there is an increased risk (1.4x more likely) of morbidity/hospitalisation for a 12-month period post infection.

The life business showed a pleasing performance from a lapse point of view, both in SA and the UK, including policy alterations. Discovery SA Health continued to report incremental growth in the number of lives covered in the Discovery Health Medical Scheme (DHMS), despite the headwinds and high base, taking the total to over 3.5mn for the first time.

The scheme remains exceptionally well capitalised and has deferred member contribution increases over the last two cycles to return some of the built up Covid-19 surplus to members. New products such as gap cover, flexi care etc, remain a new avenue for growth albeit small contributors to the segments R3.6bn operating profit.

The SA Life business reported a sharp bounce back in profits, due to the non-repeat of Covid-19 provisions, in line with peers. The life business is capitalised well above the required levels, and currently has a coverage ratio of 174%. The value of new business written (at point of sale), declined 5%, and came at lower margins of 5.3%. Management noted lower volumes during the period but alluded to market share gains during the period.

Discovery Bank reported good progress and remains on track to break even in 2025. At the end of the period, Discovery Bank reported a total of 1mn accounts, with 470k clients in total. Retail deposits grew 30% to R10.6bn, while advances grew 14% to R4.3bn. The bank currently only offers credit card and transactional products. Mortgages and term loans may be offered in future. The current acquisition run rate is 800 new sales per day with a medium-term target of 1000 per day. Management highlighted a target of 1m clients by 2026, which we believe is achievable on the current run rate. Credit losses remain low at 1.56%. Management also noted that 57% of bank clients are new to Discovery, while 26% have only one other Discovery product. Currently 74% of bank clients are either primary or active clients.

Discovery Insure reported an operating loss, due to exposure to the tragic KZN floods, as well as material motor repair cost inflation. The business managed to grow premiums 13% y/y to just under R5bn. Management also alluded to an increase in power-surge related claims due to the excessive load shedding experienced in the last few months. An interesting anecdote from the Vitality status data, which corroborates the power of the data, is that weather-related claims per Vitality status shows a downward trend from blue to diamond, which means that diamond status members are more responsive or disciplined with car movements (Discovery Insure notifies members of imminent adverse weather events).

In the UK, Vitality Health showed a pleasing operating performance, with the financial metrics all trending positively. Operating profit increased 43%, off a somewhat low base, while new business increased 30% driven by 15% more lives under cover. Given the improved trajectory for elective treatments post Covid-19, management highlighted significant demand for Vitality Health's primary care services (+45%). Also, the NHS waiting list has grown substantially (6.7mn people on the list) as the public sector faces challenges. The life business in the UK showed mid-single digit growth, but the value of new business declined sharply (-63% y/y). Management highlighted the decision to exit the Vitality Invest business, due to the ongoing margin compression in that market, and the view that the time and capital needed to scale the business is not currently feasible.

Ping An Health continues on its upward momentum, albeit it at a different growth rate to what the business reported in the last few years. As mentioned at the interim results, Discovery committed a further ~R1.5bn of capital to Ping An Health during the period, which was funded with bridging finance, with management re-emphasising a small capital raise as a permanent source of funding in the near future. The group's share of operating profit, after tax and central costs, decreased 18% y/y to R338m. The change in distribution from Ping An Life to Ping An Health's own network, has impacted the growth of the overall business. We note that the top line growth rate on Ping An Health's own network exceeded 30% for the period. Ping An's margins remain industry leading at 6.7%.

In our view, the group continues to further prove its relevance as a financial services player. The pandemic has highlighted the importance of health and wellness and has resulted in increased retention with products and services that are aligned to enhancing consumer outcomes across these areas. At its core, Discovery's purpose is to "*make people healthier and enhance and protect their lives*".

Discovery's business model of building businesses organically, from the ground up, has been repeated over many years and continues to be refined. During the results call, CEO Adrian Gore noted: "*we are not the type of organisation that looks backwards, we are looking forward",* we believe this speaks to the Discovery DNA and culture, and as such we expect further new businesses to emerge over the coming years.

We believe the group offer's significant optionality in terms of further monetising the IP developed over multiple decades. However, the potential future cash flows are hard to quantify in terms of both quantum and timing. Amplify Health, the group's JV partnership with AIA, as an example, is targeting a large addressable market and has multiple reasons to "win" in those markets. Patient, long-term orientated shareholders may be rewarded over time should the management team execute on the various plans that are in place. Discovery is truly a unique business, both globally and locally, but shareholders are now, more than ever, focused on cash-flows and not just potential earnings stream.

Discovery currently trades at a c.15% discount to its last reported Embedded Value. The reported Embedded Value does not account for all the various income streams across the group, and we therefore value the business at a premium to the Embedded Value.

The fund has recently initiated a position in Discovery which is currently a ~1% position.

Bidvest *– Navigating well*

During the quarter, Bidvest reported a strong set of results for the year ending June 2022. A broad recovery in economic activity allowed group earnings to comfortably surpass pre-pandemic levels and several segments to deliver record profits. Strong bulk commodity volumes, record pharmaceutical sales and a strong vehicle pricing environment were among the key drivers. The Financial Services segment was the only disappointment.

Cash generation remains low, expectedly, as working capital is rebuilt towards normal levels. The balance sheet has a manageable net debt / EBITDA ratio of 1.5x, while 63% of the debt is effectively denominated in offshore currencies. Currently, approximately 20% of the group's earnings are generated offshore.

Several small bolt-on acquisitions were concluded during the year in the Services International and Commercial Products segments. Post year-end, the group acquired BIC Australia for R1.8bn – the group's largest acquisition since acquiring PHS in 2020 and its first step into the Australian business services market.

Services International (31% of trading profit) and Services SA (9% of trading profit) delivered trading profit growth of 15% and 37%, respectively. The International segment benefitted from a strong performance from recent acquisitions and new business wins. The trading margin for the International segment fell by 120bps as much of the high-margin pandemic-related work has come to an end. The SA segment benefitted from a rebound in office and travel activity, arguably with some further room to grow. The margin for the SA segment improved by 180bps as utilisation levels increased. Both segments are expected to continue improving as office occupancies recover over time.

Freight (18% of trading profit) delivered a 37% increase in trading profit, buoyed by strong hard commodity and agricultural product trade. The record maize export season is expected to continue over the short term and coal volumes increased as miners try to circumvent poor rail availability. While the cyclical elements performed well, the more annuity-like businesses improved with the full 12-month inclusion of the R1bn LPG storage project completed during FY21.

Branded Products (19% of trading profit) and Commercial Products (12% of trading profit) delivered trading profit growth of 28% and 27%, respectively. Branded Products benefitted from a sharp rebound in pharmaceutical demand via its subsidiary Adcock Ingram, while the office-related products continue to recover. Commercial Products profited from healthy activity in the mining, agricultural and renewable energy sectors. Margins for both segments improved despite rising input cost pressures.

Automotive (8% of trading profit) showed a 26% lift in trading profit. The stronger vehicle pricing environment, in our view, was caused by the low rate of new vehicle production globally since early-2021. We expect this to normalise over the near term, posing a headwind to margins as vehicle availability improves.

Financial Services (1% of trading profit) struggled with a 74% drop in trading profit. Much of this was due to significant once-off costs and credit impairments, while capital deployment was slower than expected. Management is confident that the remedial actions taken will return the segment to a healthy state in time.

With profits in many of the group's segments having surpassed pre-pandemic levels, much of the pandemic-related recovery is complete. Office occupancies, which remain low, should continue to recover gradually which will boost the Services segments and demand for office stationery in the Branded Products segment.

The Automotive segment's profit is near a cyclical high, in our view, as improved vehicle availability over the next 12 years should dampen margins from current levels.

Similarly, we expect softer growth from the Freight segment over the near term as the agricultural product and hard commodity cycles soften from their current levels. We expect the Commercial Products segment to continue growing steadily as the mining sector continues to spend capex above historical levels and as the renewable energy sector continues to grow.

We expect the Financial Services segment to recover from here as management has implemented several measures to return the segment to a healthy level of profitability.

Costs are being managed well, a pleasing sight in the current inflationary environment. The Services segments have a large proportion of labour costs (more than 60% of their operating expenses on our estimates) but these are contractually passed through to clients, which is an attractive inflation-hedging attribute.

The international expansion strategy is focused in three areas: hygiene, facilities management and the Plumblink business model. PHS, Noonan and the other associated acquisitions are well-positioned in the UK hygiene and facilities management markets and have already demonstrated significant growth. On the Plumblink model, management continues to search for an appropriate international target to acquire.

The recent acquisition of BIC Australia provides a platform for the group to begin expanding its Services International business in the Australian market. While many South African-based corporates have burnt their fingers with ventures into Australia, we take confidence in Bidvest's stellar capital allocation track record and the group's previous success in Australia with Bidcorp. We estimate that BIC will contribute ~2% to the group's earnings.

We expect further discretionary capital to be allocated towards growing the Services International footprint – an approach which we support. We expect dividends to remain in-line with the group's historical pay-out range of 40-50%. Our forecasts suggest that this allows the balance sheet to deleverage over the medium term.

The fund retains a ~5% holding in Bidvest.

Detailed fund attribution: Q3 2022

Top 5 contributors and detractors for Q3 2022: Overweight positions

Top contributors	Average relative weight	Performance contribution	Top detractors	Average relative weight	Performance contribution
Cigna	3.8%	0.7%	**Alibaba**	2.2%	-0.5%
Altron	2.9%	0.4%	**Comcast**	2.7%	-0.4%
Stryker	1.4%	0.2%	**Prosus**	4.1%	-0.3%
RMI	1.8%	0.2%	**Alphabet**	2.6%	-0.1%
Glencore	0.3%	0.2%	**Quilter**	1.6%	-0.1%

Top 5 contributors and detractors for Q3 2022: Underweight positions

Top contributors	Average relative weight	Performance contribution	Top detractors	Average relative weight	Performance contribution
Capitec	-3.7%	0.7%	Shoprite	-2.4%	-0.3%
Sasol	-2.0%	0.4%	BHP	-2.4%	-0.3%
Discovery	-1.1%	0.2%	Sibanye	-2.1%	-0.3%
MTN	-2.7%	0.1%	Woolworths	-1.2%	-0.2%
Naspers	-8.1%	0.1%	ABSA	-1.1%	-0.2%

Current positioning and outlook

The Fund ended the quarter with ~27% direct exposure to international markets. The top 10 positions in the fund account for ~44% of the capital, with a total of 34 holdings.

The headlines continue to be filled with a variety of short and longer-term risks. Global central banks continue to fight off inflation, with some further along than others. The US 10-year bond yield has recently breached 3.9%, a level last seen in 2009. In addition, geopolitical risks continue to play out. We note in the coming quarter the 20th National Congress of the Chinese Communist Party which will be held in Beijing, where Xi Jinping is likely to seek an unprecedented third term. On the local front, the ANC elective conference in December also serves as an important key performance indicator for SA inc.

In the current environment, more than ever, we believe focusing on downside risk and balance sheet strength is crucial. We remain cognisant of the fundamentals of the businesses we own, despite the macro-environment. Our principle-based investment philosophy remains unchanged, with continuous learning and development a key element of our investment culture.

The positive relative performance against the benchmark over the past two quarters is encouraging, but we continue to strive to improve the medium and longer-term performance which remains below our expectations.

We look forward to the balance of 2022 and thank you for your ongoing support.

Disclaimer

Some funds may hold foreign securities including foreign CIS funds. As a result, the fund may face material risks, which could include foreign exchange risks, market conditions and macro-economic and political conditions.

A fund of funds may only invest in other funds, and a feeder fund may only invest in another single fund, both will have funds that levy their own charges, which could result in a higher fee structure.

The Nedgroup Investments Money Market Fund offering aims to maintain a constant price of 100 cents per unit. A money market fund is not a bank deposit. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument held. In most cases the return will merely have the effect of increasing or decreasing the daily yield, but in an extreme case it can have the effect of a capital loss. Excessive withdrawals from the fund may place the fund under liquidity pressures and that in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed. The yield is calculated using an annualised seven day rolling average as at the relevant dates provided for in the fund fact sheet. Nedgroup Investments has the right to close its funds to new investors in order to manage it more efficiently.

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