



**NEDGROUP**  
INVESTMENTS

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# NEDGROUP INVESTMENTS RAINMAKER FUND

Quarter One, 2018

For the period ended 31 March 2018

## NEDGROUP INVESTMENTS RAINMAKER FUND

### PERFORMANCE

For the first quarter of 2018, the Nedgroup Investments Rainmaker Fund declined -4.0% which compares favourably against the JSE All Share Index which declined by -6.0%.

Performance to 31 March 2018	Nedgroup Investments Rainmaker Fund <sup>1</sup>	ASISA category average	FTSE/JSE ALSI
3 months	-4.0%	-4.7%	-6.0%

### MARKET COMMENTARY

After the volatile end to 2017 which contained the knife-edge conclusion of the ANC elective conference and the implosion of Steinhoff with the commensurate impact on the JSE and investor portfolios, we had hoped for a return to more reasonable levels of market volatility in 2018. This was not to be. The first quarter of 2018 has continued to be volatile and following the Steinhoff debacle investor nervousness is at very high levels. This has been fuelled by a witch hunt to examine and expose any other companies that display any "Steinhoff-like" characteristics, the most dramatic of which has been the publicity surrounding the Resilient Group of companies (Resilient, Green Bay, NEPI Rockcastle and Fortress) and their inter-linked shareholdings. All of their share prices have collapsed and are trading at fractions of their values as of only three months ago. Several other once high-flying businesses have also seen substantial declines in their value and these include Aspen, Ascendis and EOH.

In addition, with little new financial information yet available from Steinhoff, and as we anticipated in our December commentary, to address its balance sheet problems, the company has started to dispose of its equity interests in the already public companies – at the inevitable liquidity discount. This started with PSG – a firm we do not hold. PSG was additionally troubled by the short-seller report on Capitec (PSG's largest contributor to the firms' asset value), which although in our opinion fraught with inaccurate statements and conclusions, in the environment of a very nervous South African market caused substantial volatility in both companies share prices. Next up was the part disposal of Steinhoff's stake in KAP, which we had also anticipated and used the opportunity to add to our positions across the firm at an attractive price.

As if the above were not enough, the deaths of so far about 190 South Africans caused by listeriosis from consuming contaminated food products has sent shock waves through the food producers companies and their shares. This was most acutely felt by Tiger Brands whose Enterprise meat processing facilities have been declared as the primary source by the health authorities. A thorough scientific investigation remains underway at the time of writing to establish full culpability for this tragedy.

<sup>1</sup> Net return for the Nedgroup Investments Rainmaker Fund, A class. Source: Morningstar (monthly data series).

## PORTFOLIO COMMENTARY

The fund's top five performing positions added +1.7% to our return while the bottom five detracted -4.8%.

Winners	Ave. weight	Total Return	Performance contribution	Losers	Ave. weight	Total Return	Performance Contribution
Std Bank	4.8%	11.8%	0.52%	Naspers	15.6%	-16.2%	-2.26%
Truworths	2.8%	16.8%	0.44%	BAT Plc	7.9%	-15.0%	-1.26%
Massmart	1.5%	18.0%	0.32%	Tiger Brands	2.7%	-17.9%	-0.49%
Shoprite	1.8%	15.1%	0.24%	MTN	5.1%	-9.6%	-0.49%
JSE	1.0%	24.5%	0.21%	Reinet	2.1%	-16.1%	-0.37%
			<b>+1.73%</b>				<b>-4.83%</b>

Primary contributors to the funds outperformance were firstly it's avoidance of many of the abovementioned problems, but also the funds exposure to domestic orientated businesses. These include South African banks, Truworths, Massmart and the JSE.

We have maintained a large position in South African banks despite recent strong performance as they remain cheap. We have sizeable positions in FirstRand (7.0%) and Standard Bank (5.9%) and a smaller position in Barclays Africa Group (2.7%). We do not currently hold any Nedbank.

Standard Bank was the largest contributor to the fund's performance in Q1. Standard Bank, although already a material position, is one which we have consistently added to over the past year. They are making good progress in their underlying operations and ROE has been improving. Furthermore they display:

- Better cost discipline – SBK is the only bank delivering positive jaws (increasing income, decreasing costs)
- SBK is at an inflection point with respect to legacy issues (IT spend and ICBCS)
- The capital position is healthy, which is leading to higher dividend pay-outs
- There is attractive scarcity value associated with their Rest of Africa franchise
- We expect SBK to deliver the best Headline Earnings per Share (HEPS) growth and Return on Equity (ROE) improvement over the medium term (vs Big 4 peers) and it still trades on an attractive 4.8% dividend yield and 12.5 PE

In contrast, Barclays Group Africa (BGA) remains frustratingly cheap (9 PE), but is strategically challenged. The BGA position is currently 2.7% of the fund as have been using recent strength to lighten this further. Our ongoing concerns with the BGA investment case are:

- Ongoing operational / financial disappointments.
- Retail earnings (their largest division) will remain under pressure. The retail banking profit pool will continue to be eroded by Capitec and new entrants
- The PLC disentanglement process will be costly, complex, will result in disruption to the franchise and negatively impact underlying profit growth
- Weaker leadership than that of their key competitors
- Lost skills – there have been several key management departures over the last few years

We built a position in Truworths in the latter half of 2017 at which point we felt that an attractive asymmetric profile had emerged. We also believed that the market failed to appreciate the cash generative ability of the company - the cash realisation rate, which is a measure of how profits are converted into cash, was 100% in their latest financial result (the average rate for the last five full financial years is 88%).

In our opinion, Truworths is ripe for improvement. Their domestic challenges should fade during the next 12 months, aided by improving consumer health and the recent favourable court ruling on the affordability regulations. We regard Truworths as a responsible credit provider, but their ability to extend credit had been curtailed in 2015 when new affordability assessment regulations were enforced.

In March 2018, the Cape Town High Court set aside aspects of the regulations to the benefit of the credit retailers (70% of Truworths South African sales are generated via credit). In addition to improving sales activity, earnings growth should be further enhanced by de-gearing, share buybacks, as well as a better bad debt outcome.

The bad-debt charge has more than doubled over the last several years, and the R1.2bn expense incurred in their 2017 financial period represented 31% of group profit-before-tax, signifying the significance of this expense item. Given the expectation that consumer health will slowly improve, we anticipate that the unwind of the bad-debt charge will provide a boost to profitability. This expectation is supported by the improving health of their debtors' book as seen in their December 2017 interim result as well as data from TransUnion, a credit bureau. The TransUnion SA Consumer Credit Index is considered a credible indicator of consumer credit behaviour and also supports the thesis of an improving sales and bad debt environment (the index measured 53.4% in the fourth quarter of 2017).

Pleasingly, the Truworths share price has appreciated approximately +40% since we acquired our shareholding. The fund retains its exposure to the company as the dividend yield (+4.8%) and relative price-earnings rating remains attractive (Truworths trades at a 20% discount to SA listed apparel peers). In addition, Truworths is most geared to a better South Africa, unlike several peers (Foschini, Woolworths) who have substantially increased their offshore presence. Massmart is the other retailer that made a material contribution over the quarter, with the share price up 50% since we initiated the position in Q4 of 2017. We have begun taking profits as the rating is now elevated relative to its history and we are finding more attractive alternatives.

The JSE was also a key contributor to the funds outperformance in the quarter. The company recently reported a better-than-expected 2017 financial result. We were particularly pleased with the earnings performance in the second half of the financial period as well as the strong cash generation. We anticipate these positive trends to continue in 2018 - equity value traded is up sharply year-to-date which bodes well for revenue delivery and significant work has been done to reduce their cost base. This, coupled with the businesses strong cash generative ability bodes well for earnings and dividend growth in the year ahead.

As always, we did not get everything right and the disappointing performance from our reduced rand-hedge exposure through Naspers and British American Tobacco / Reinet detracted from the fund's performance.

In our December report we commented extensively on the Naspers position in the fund. The Q1 2018 update on this position is disappointingly further damage done to the firm's valuation through mismanagement. Naspers sold a very small portion (6%) of their position in Tencent for cash. Tragically, management communicated a message of using all the proceeds (US\$10 billion) to reinvest in their existing other businesses which continue to consume cash. This is quite illogical in the context of the alternative to buy back shares considering the discount trapped in the firm's market valuation. Unsurprisingly this decision was punished by the market with the discount widening still further as the deep scepticism with which the market views management commercial judgement widened still further.

## MARKET OUTLOOK

The election of Cyril Ramaphosa as head of the ANC and his subsequent appointment as state president following the resignation of Jacob Zuma is the most positive political development in the country for more than a decade. Mr Ramaphosa's immediate changes especially to key economic positions of political power and within some state-owned enterprises are additionally very encouraging. Despite these, our analysis shows that it will require skill, continuity, conviction and many years of investment before the severe economic damage done during the Zuma years can be recovered.

As a consequence, despite the low base, we do not anticipate a very fast acceleration in economic growth in the short term. This is exacerbated while policy uncertainty remains in many sectors of the economy (Mining Charter, Land Expropriation without compensation, BEE Charter requirements) and considering the diverse opinions on these matters between stakeholders are unlikely to be resolved in the short term.

As a consequence, we are sceptical of the sustainability of the strong rally we have seen in the last quarter in select sectors and have reduced our exposure to some of the top performers there. In addition, the further strength of the rand has caused some high-quality businesses with non-South African generated profits to underperform and where to our mind valuations are beginning to look more attractive. In addition, we continue to unearth several other neglected domestic oriented businesses where the valuations are more appealing on a relative basis.

The portfolio currently trades on a forward rolling Price/Earnings (P/E) ratio of 13.9x and a dividend yield of 3.2%.

## 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.

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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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