

RISKS SKEWED TO THE UPSIDE



THE SOUTH AFRICA DIARIES

The ANC Elective Conference Election is expected to take place from 16-20th December. Seizing the moment, we embarked on an investor trip to South Africa to test our investment thesis by gaining local insight into the economic impact of the potential outcomes of the ANC election and the macroeconomic challenges the country faces.

DIRE FISCAL OUTLOOK

A week before we arrived, South Africa's Finance Minister presented the mid-term budget, which saw the ZAR weaken 3% to a 10-month low (R14.10/USD) on account of the dire fiscal outlook:

- GDP growth estimates were revised down from 1.3% to 0.7% for 2017, 1.1% in 2018 and 1.5% in 2019;
- Tax revenue shortfall of R209.5bn over three years vs. R34.8bn expected, and tax revenue growth revised down to 6.1% in the current fiscal year from 10.6%;
- Budget deficit of 4.3% of GDP in 2017/18 vs. 3.1% projected in February;
- Expenditure ceiling breached by R3.9bn; and
- Gross national debt is forecast to increase to 61% of GDP by 2022 while c.15% of budget revenue would go towards servicing debt by 2020/21, up from 8.8% in the 2008/09.

With this depressing reflection of the government's inability to incite investment in the country, it's hardly surprising business confidence fell to a 30 year low in August. This

inability is exemplified further, with unemployment figures the highest in 14 years at 28%, negative FDI for the past three years, cash on corporate balance sheets reported to be 40% of gross domestic product and notable South African names opting for offshore investments.

The fiscal outlook could worsen; downgrade of South Africa's local currency rating to sub-investment grade by S&P and/or Moody's in the coming weeks will trigger the removal of South Africa bonds from the World Government Bond Index, and consequently increase the country's cost of finance.

PREPARING FOR THE WORST

This sorry state of affairs accurately depicts the more than 8 years of mismanagement under President Jacob Zuma.

Against this backdrop, we attended 13 company meetings and 3 site visits to understand how businesses are positioning themselves for the potential election outcomes. All of the businesses we met had an appetite for change however, many

KEY TAKEAWAYS

1. The outcome of the ANC election has a key bearing on whether the country will address its economic challenges
2. A positive outcome should see the close of the Zuma chapter and boost sentiment
3. Strong institutions and resilient, highly adaptable companies are used to challenging conditions
4. There is strong potential for an election outcome that could kick-start recovery

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did not use the macro environment as an excuse.

The outcome of the ANC election has a key bearing on whether the country will address its economic challenges. To assess the impact of alternative scenarios, we have summarised below the potential outcomes from the ANC leadership election:

1. Scenario A - Worst Case Scenario: a clean slate win for the Zuma faction via his ex-wife Nkosazana Dlamini-Zuma and other heavily compromised associates.

This would maintain the status-quo and increase the possibility of further rating downgrades, dissolution of the tripartite alliance between the ANC, SACP and COSATU, and make ANC's leading position in the 2019 General Election tenuous. For said reasons, we consider this outcome highly unlikely.

2. Scenario B - Compromised slate headed by another Zuma friendly candidate, designed to keep the tripartite alliance together, and protect Zuma's influence.

This outcome is likely to see Zuma's aides in key ministerial positions and therefore limit the appetite for constructive reform. In our opinion Zuma's political knack and sizeable influence makes this scenario the second most likely outcome.

3. Scenario C - Headed by the

business friendly, current deputy president Cyril Ramaphosa alongside a compromised slate.

This will limit his ability to clean out the cabinet and initiate wholesale reform, but should however bring a close to the Zuma presidency. In our view, this is the most likely outcome for a range of reasons, including the tendency for the ANC's Deputy President to proceed to the leadership role. Ramaphosa has also secured the backing of COSATU and SACP, and he is relatively unsullied by the many allegations that have marred other leading ANC names.

4. Scenario D - Best Case Scenario with an investor friendly, clean slate win for Ramaphosa.

This scenario is unlikely due to the coalition needed to secure a majority vote in an opaque ANC delegates system.

LOCAL COMPANIES' POSITIONING

Many South African companies have become accustomed to operating under challenging conditions, and have prepared for the worst by focusing on cost efficiencies and their core propositions. Specifically, the companies we met fell into three camps:

1. Companies wedded to South Africa and/ or SA business activity:

More cyclical companies in this bracket, such as City Lodge, are implementing a disciplined approach with growth, but are seeing more opportunities in South Africa compared to the rest of Africa. In order to retain their competitive edge, consumer product companies such as AVI are investing in operational efficiency.

These conditions have afforded well-managed companies with a unique proposition, such as KAP and Capitec, the opportunity to strengthen and gain market share. Meanwhile, their less capitalised competitors continue to struggle under financial constraints, lacking efficient operations and technology.

2. The "Playing a Waiting Game" group:

Companies with a significant presence outside South Africa, particularly in more developed markets, have sought growth elsewhere and will revisit capex plans after the election.

Other names who have strong reputations, such as Bidvest, are leveraging their balance sheet, innovative capabilities and extensive network, to grow in niche, non-discretionary areas, where they are positioned to be market leaders without geographical constraints.

3. The supportive industry and/or market dynamics group:

Companies like Clicks, Dis-Chem, ADvTECH and Curro operate in fragmented or undersupplied markets with significant growth potential. While a better macroeconomic climate will be positive for these companies, it is considered secondary. As such, most of the companies in this grouping have maintained their ambitious growth plans.

HIGHLY ADAPTABLE

These findings did not surprise us in the slightest, as South African companies are noted for being flexible, well managed and able to operate under difficult trading conditions.

Over the last 8 years, many of the

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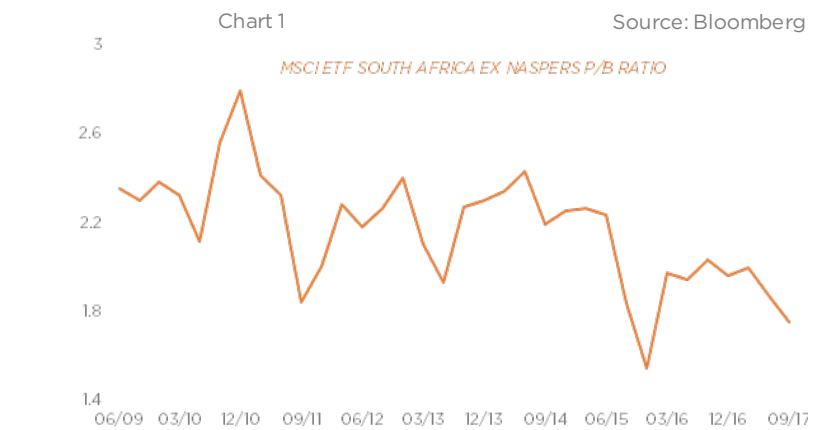
companies we have met are best-in-class in their sector. It is also of note that other South African institutions have remained strong through the years of political dysfunction. President Zuma is back in court, this time to face 783 counts of corruption and fraud charges. This highlights the strength of the judiciary, while the central bank has remained independent.

Two weeks after the mid-term budget, the ZAR has settled in the R14.10 – R14.30/USD range. SA equities have derated, the FTSE/JSE ALSI has dropped by c.15% since the beginning of 2017 and by over 20% excluding Naspers, which has a negative rump excluding Tencent (see Chart 1). YTD foreign investors have disposed of R88bn of South African Equities. The worst outcome appears to have been priced in and, as illustrated below (see Chart 2), SA equities are cheap relative to other EM equities.

ADVANTAGEOUS OUTCOMES

Given the low base, mere political change (Scenario B) and closure of the Zuma chapter will provide certainty and drive businesses to deploy their cash locally. While a Ramaphosa headed slate (Scenario C and D) will reverse the severe political drag on sentiment and drive a rally across all asset classes in the short term.

To unlock the potential of South Africa, tangible steps need to be taken to address the economy's fundamental weaknesses, which include an unsustainable debt profile, lack of growth and governance issues. Returning SA to

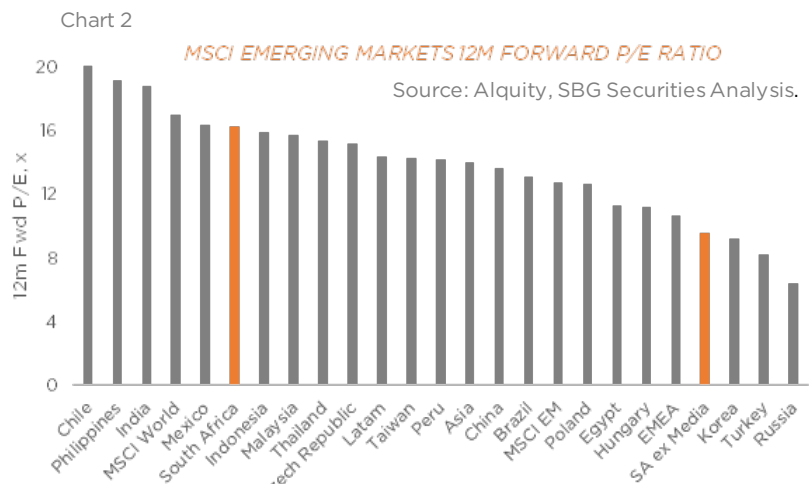


a 3% plus sustainable GDP growth would be much more likely under Ramaphosa given his business background.

The above has reinforced our view that the South African economy is at the bottom of the business cycle. There is strong potential for an election outcome that could kick-start recovery. We favour the optionality offered by South African equities, but remain aware of other possible outcomes.

COULD HISTORY REPEAT ITSELF?

To conclude, it is our view that the downside is much smaller than the upside of a more business friendly political outcome. This is a scenario we've witnessed over the past 10 years in Brazil, Argentina and Indonesia, and "History doesn't repeat itself but it often rhymes," as Mark Twain is often reputed to have said.



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