TEMI IYIOLA & GERGELY URMOSSY

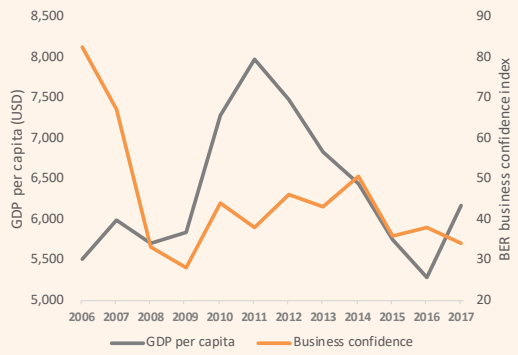
COUNTRY REPORT SOUTH AFRICA AUGUST 2018

AFRICA FUND

SOUTH AFRICA - THE LONG ROAD TO RECOVERY?

The vast potential of South Africa with its diversified economy, strong institutions and a young population, was restrained over the last decade by a combination of gross mismanagement, policy uncertainty and festering structural challenges, largely due to the administration of Jacob Zuma. Over this 10-year cycle, there was a notable decline in living standards and business confidence, and the South Africa equity market underperformed global emerging markets (see Figure 1).

Figure 1: South Africa – Decline in economic outlook and outcomes



Given the fractious and destructive period that preceded it, the election of the former trade unionist turned business tycoon, Cyril Ramaphosa as the ruling party's leader in December and President in February, came with much fanfare and hope. The upbeat view of business leaders was reflected in business confidence indices that rose to a 3-year high in 2018 Q1. Financial market participants shared the same positive opinion and celebrated the appointment of Ramaphosa by sending the South African rand to its strongest level in about three years and slashing the sovereign risk premium to a 5-year low (i.e. the 5-year CDS fell below 140).

To its credit, the new administration immediately sought to consolidate public finances, tackle corruption and strengthen governance of state-owned enterprises (SOEs), who were chronically mismanaged. While these steps are encouraging, they are of significantly lower magnitude than the bold structural reforms needed to address the country's deep-rooted challenges; deep inequality, poor public services, lack of trust

5 KEY TAKEAWAYS FROM THE TRIP:

1. Ramaphosa's ANC is committed to reversing South Africa's fortunes
2. Political posturing will, however, dominate the agenda in the next 12 months ahead of a general election
3. The business community understands the short-term political challenges and remain bullish on the medium- to long-term prospects under Ramaphosa
4. A more-than-likely political mandate is the last piece of the puzzle necessary for a job-led recovery
5. Our domestically focused holdings are positioned to capitalise on this imminent cyclical recovery

between business and the political class, and widespread corruption.

Recent data prints, including a 2.2% QoQ GDP contraction in 2018 Q1, has left many wondering where the spark is going to come from to ignite the much-anticipated recovery. On a week-long visit to South Africa in June, part of our process of building macroeconomic thesis through a combination of desk based fundamental analysis and on-the-ground research, we engaged with 24 local companies to understand the challenges of reversing a decade long decline, how companies are positioned in this context and test our thesis of an impending recovery. We also focused on governance given recent concerns around South African corporates.

BUSINESS SECTOR INSIGHTS NOW AND LOOKING FORWARD

Amongst the firms we met, there was consensus on what needs to be done to kickstart a recovery; clarity on the mining charter, investment in education and value adding skills, restructuring SOEs, supporting labour-intensive sectors, such as agriculture and tourism, reducing the complexity around the Broad-Based Black Economic Empowerment (B-BBEE) transformation programme, telecoms reform, and a well-thought out land reform programme. There is, however, an increasing realisation that there may be no short-term solution to the challenges facing the country, especially with a fractured ruling party handicapping Ramaphosa's best intentions.

Nonetheless, the prevailing view from businesses are that the President has successfully managed the competing interest of an expectant public, business community and a constrained fiscus, while being hamstrung by a divided political party and limited political capital. A Ramaphosa-led ANC is widely seen as the best-case scenario for the country. Businesses are therefore prepared to give him time to win a political mandate (general election expected between April and August 2019).

In the meantime, Ramaphosa must skilfully juggle the many competing interests. This puts the policy of *"land expropriation without compensation"* into context. Nevertheless, Ramaphosa's tact is evident in the wording that a radical land reform and redistribution programme must *"be built on the triple pillars of inclusive economic growth, increased agricultural productivity and reduced food insecurity."*

As an aside, the business community (represented by the 24 companies we met) largely support land reform. There was broad acknowledgement that land dispossession under apartheid was a historic injustice, which – if left unaddressed – could become explosive. Corporates also see land reform as a necessary stimulant for the faster-than-3% annual GDP growth that has been mooted by the new administration. Considering the structure of the economy, with more than half of the population living in poverty and 35% living in the rural area, land reform could be used to enable entrepreneurs in sectors like agriculture. However, due to the long-dated nature of the issue, there is also no quick or painless redress; expropriating the land of traditional rulers risks causing social discontent, while expropriating land from the white minority could damage business. An easier starting point would involve redistribution of state-owned land, which accounts for 18% of total land.

Looking ahead, businesses expect a challenging 12 to 18 months driven by short-term political challenges and weak consumer confidence. They, however, remain positive on the medium- to long-term outlook. The private sector is already seeing efforts by the new administration to rebuild trust, they have a close working relationship with President Ramaphosa from his time as Chairman of two of the country's leading companies; MTN and Bidvest. Furthermore, the prospect of restructuring SOEs could open up the economy to private participation and boost growth.

A POINT OF GOVERNANCE

Whilst we always place an important emphasis on governance, our sensitivity to standards of corporate oversight in South Africa were heightened by the Steinhoff accounting scandals. Of course, one should not automatically draw the conclusion, based on one example, that financial misrepresentation is a general phenomenon in South Africa. Incidents of financial irregularities and lax governance are clearly not unique to the country. Indeed, the developed markets have seen their fair share of scandals in recent years such as the Volkswagen emissions scandal, WorldCom accounting scandal and Enron financial scandal.

Notwithstanding the above, South Africa Inc. used the incident as an opportunity to self-reflect and revisit their controls. Based on our analysis, nothing is broken from a governance standpoint, and South African corporates remain on par with their developed market counterparts on reporting, transparency and governance.

The Steinhoff debacle, in our view, provides support for an investment process with ESG at its core. An investment process with consideration for material non-financial factors significantly reduces the chances of investing in companies like Steinhoff, which had well-recognised and reported red flags such as lack of transparency, a phenomenally complicated holding structure and a "ponzi style" strategy of acquisition and growth.

INVESTMENT IMPLICATIONS

For the first time in a decade, South Africa's path to economic recovery is clear and probable. The country is at the beginning of a cyclical uptick similar to Brazil in 1994 where wide-scale economic reforms kick-started the economy after a period of economic stagnation and lack of competitiveness. Unlike Brazil, South Africa has strong and independent institutions and an engine for growth in its strong companies. The combination of this and a committed political arm bode well for the country's prospects.

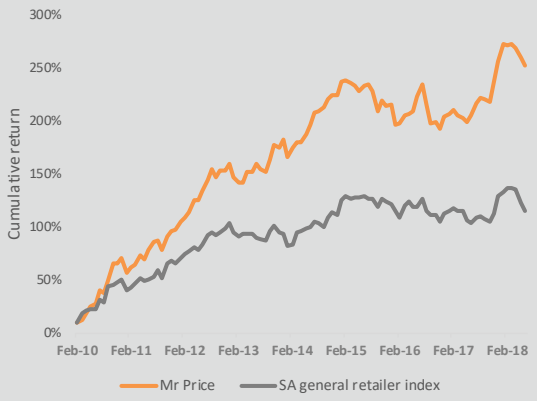
A sustainably growing economy will create jobs, boost income and the accessible markets for most companies who have battled low economic growth and constrained demand over the last decade. For example, private education providers like Curro and ADvTECH who seek to provide an alternative to the inferior quality provided by the public sector will see an increase in demand for their services, and even companies like Mr Price and Discovery who gained traction though innovation and outperformed despite economic headwinds will have a bigger market to serve.

Others also stand to benefit from the business-friendly regime and better economic outlook:

- The government has for example intimated that restructuring certain SOEs will be top of the agenda. A prime candidate is the state-owned rail operator, Transnet. Transnet has one third of the agricultural handling capacity in South Africa, but Bidvest with two-thirds of the capacity handles ca. 80% of the volume. Any party interested in Transnet's assets will be weighed down by the heavy investments needed to upgrade its stock. This will reinforce Bidvest's standing as the go to service provider
- The long period of low economic growth made it a buyer's market and restricted the ambitions of many players. This allowed strong companies to reinforce their competitive advantages. Blue chip companies like KAP invested through the downturn while others were weighed down by debt. Major infrastructure investments take three to five years to become fully operational. Companies that have invested during the downturn are thus well-positioned

Mr Price

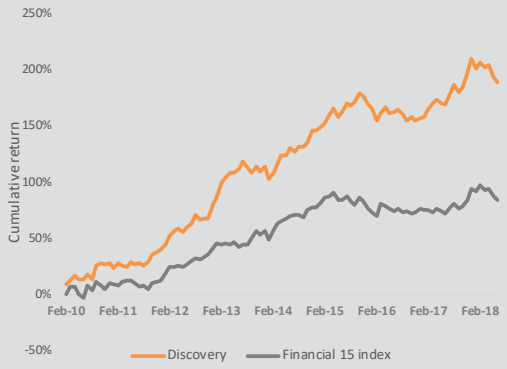
The value retailer increased sales 2.4x, operating profit 4.5x and EPS by 4.3x over 10 years' time and saw its shares outperform their competitors despite an increase in competitive intensity from multinational names like H&M, Zara and Next. Mr Price built a competitive advantage based on its scale and purchasing power and reinforced it by maintaining a lean cost structure. This has allowed the company's value proposition to remain highly competitive and accessible for lower income groups while its competitors struggle



Discovery

Discovery

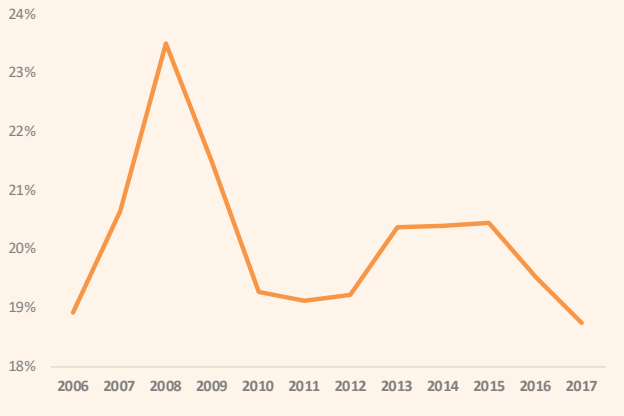
Discovery and its revolutionary business model disrupted the insurance market. Discovery gained traction by rewarding its members for improving their behaviour, reducing their risk of claims. The actuarial profit created by attracting and retaining the best risk pool, can be reinvested in more rewards. The company has since successfully deployed the model in other insurance segments in South Africa and offshore. Over 10 years, Discovery is 5x bigger at the top line and over 3.5x bigger at the EPS level



CONCLUDING THOUGHTS

The conclusions drawn from our on-the-ground research reinforces our positive view on South Africa, as the foundations for the recovery we predicted are being laid. However, we are under no illusion about the process. The reality is that after 10 years of decline, the revival is likely to be lengthy with several bumps along the way. At the first juncture, we expect political considerations to make the cyclical uptick develop slowly. The President will balance disparate and competing interests with a view to winning the electoral mandate necessary for the bold reforms which will open the economy and kickstart a job-led economic recovery.

Figure 2: Gross fixed capital formation (% of GDP)



Notably, gross fixed capital formation (a proxy for business confidence and investment) declined to a 10-year low as percentage of GDP in 2017, matching the extent of the fall observed after the global financial crisis of 2007-08. This suggests that the country is near the bottom of its economic cycle. Taking the plans of the companies we met into consideration, gross fixed capital formation will stay depressed over the next 12 months, but we are confident of its recovery over the medium-to long-term.

COUNTRY REPORT
SOUTH AFRICA

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All data correct as of 30 June of 2018. Sources: Alquity, Bloomberg

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