South African Domestically Focused Companies at an Inflection Point

Structural issues have impeded growth prospects, but headwinds may be abating.

April 2019

At first glance, it would be easy for investors to take a dim view of the prospects for South African companies. Growth has been on a downward spiral since 2009, and a range of structural issues appears to cast doubt on medium-term prospects; Among them, an eroding manufacturing base, historical corruption within state-owned enterprises (SOEs), deteriorating education standards, and high levels of economic inequality.

However, the political, structural, and macroeconomic dynamics that drive the South African economy are highly complex and evolving. A deeper look beyond some of the headlines enables pockets of opportunity to be uncovered. Indeed, with much of the negative sentiment already priced into the market, the potential for an uplift is higher than it has been for some time.

It's a view confirmed during our recent research tour that included meetings with a range of companies. The bar appears to be set low for a positive surprise.

NOTES FROM THE ROAD
Traveling the Emerging Markets

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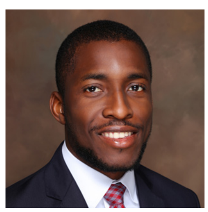

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Stunted Growth Prospects

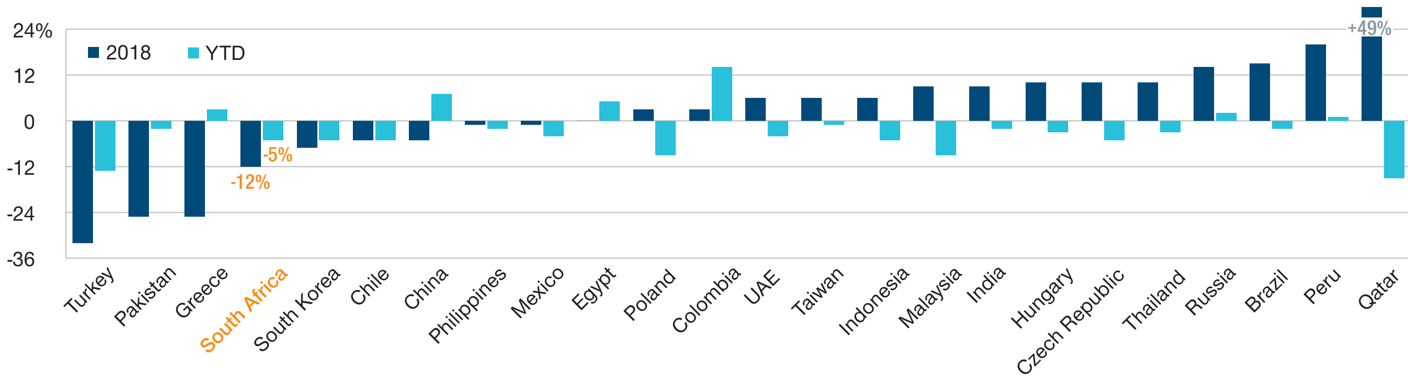
South Africa's real annual gross domestic product growth has averaged only 1.5% versus an average for the world of 3.4% in the past 10 years, while the stock market has lagged emerging market peers. This has coincided with over a decade of constant disappointment in corporate governance standards, leadership, and institutions. At its March review, Moody's kept South Africa's credit rating at investment grade and retained its stable outlook, lending some support to sentiment. The risk of a downgrade over the medium term remains, however.

Reform and the strength of institutions will be key to underpinning growth in the coming quarters. Notable progress has been made on addressing corruption, entailing leadership changes at key institutions, and tackling the misspending of government funds. Economic reforms range from delivering policy certainty for mining companies and increasing competition in the port terminal sector, to reviewing the structure of the country's electricity grids and broadening financing options for small businesses.

(Fig. 1) South African Stock Market Performance

MSCI country indices: relative performance to emerging markets

As of March 31, 2019



Past performance is not a reliable indicator of future performance.

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While sentiment on South Africa is to a high degree guided by broader global and emerging market developments, there is enough "self-help" potential in the country to cushion against the worst of these. Real progress in tackling corruption at a government and SOE level means that, for the first time in years, new leaders can potentially drive improvement, albeit from a low base.

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Focus On Domestically Oriented Companies

We are especially encouraged for the potential of some of the domestically focused companies. Our trip increased our investment conviction, especially in companies supported by strong underlying liquidity, a sophisticated and disparate local investor base, and few controlling shareholders.

One trend that has proved conducive to our holdings is the move toward the formalization of pharmaceutical retailers. Penetration remains fairly low at around 45%, but the dominant players are gaining market share in an industry that has high barriers to entry. Two of these, Clicks and Dis-Chem, are of credible scale to continue gaining share in this defensive sector, while they also could benefit further from the discretionary segment, including beauty, which represents a diverse revenue stream. We met with the new CEO of Clicks who is focused on increasing convenience for clients, differentiation, and personalization. With free cash flow, generation and returns set to improve over the next few years as capital expenditure normalizes, we retain our holding and conviction in the stock.

Another favored holding is food retailer Shoprite. Headwinds, including strike action, cumbersome SAP software implementation, devaluation in Angola, and adverse currency effects, are now abating, leaving the company well placed to claw back market share, in our view. The company is well run and stands to benefit from any improvement in the economy and an uptick in consumer confidence. From our meeting with company management, we gained conviction that the fundamentals of the business are intact, and there should be a rebound in profits, albeit slowly.

Faith In The Banking Sector

Elsewhere, our conviction in South African banks remains strong. They are embedded in a sound institutional framework given a strong and reputable central bank and Treasury. We met with Nedbank, South Africa's fourth-largest bank, which is delivering relatively strong earnings per share growth, driven by modestly expanding net interest margins and an improving asset mix. It has also implemented a medium-term cost-efficiency program, which should bear fruit in coming quarters. Nedbank appears to have a clear strategy, strong market positioning and is executing well.

We also met with management at ABSA (formerly known as Barclays Africa Group), which is the country's largest retail bank. A new CEO is expected to be in place by the time first-half results are announced, and guidance is for improved return on equity this year and growth in the 18%–20% range in 2020. These factors should lend support to share price gains.

Developments That May Lead To An Inflection Point

We have identified three key drivers of returns ahead:

- National elections in May, which the ruling African National Congress (ANC) party under Cyril Ramaphosa is expected to win and could provide an added impetus to ongoing reforms. A clear, compelling mandate for Ramaphosa would provide continuity in reforms, boost business and consumer confidence, and attract foreign direct investment.
- The government's management of ongoing issues at state electricity utility Eskom, which affects growth prospects due to the company's size and importance to the economy. The company remains riddled with debt, and overburdened grids have led to bouts of electricity outage in recent months. How the government addresses this issue will be a key driver of sentiment for the economy as a whole.
- There is room for the central bank to cut interest rates over the next 12 months as inflation has been undershooting. This could provide some impetus to growth, as we expect business and consumer confidence to improve.

Clear Mandate For Reform

While structural issues in the South African economy will be with us for some time, there are signs of more progress. A great deal hinges on President Ramaphosa winning a compelling mandate in the upcoming election and the degree to which there is policy continuity. If the country's leaders are able to deliver on proposed reforms, we believe this could be an opportune time to invest in some of the domestically focused companies that would benefit from an improved economic environment.

WHAT WE'RE WATCHING NEXT

A plethora of cyclical and structural headwinds may impede the growth prospects of South African companies. However, if these headwinds abate, pockets of opportunity are likely to emerge, which the savvy active investor can exploit. We will continue to maintain dialogue with the companies offering high growth potential and remain positioned to benefit as conditions on the ground improve.

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