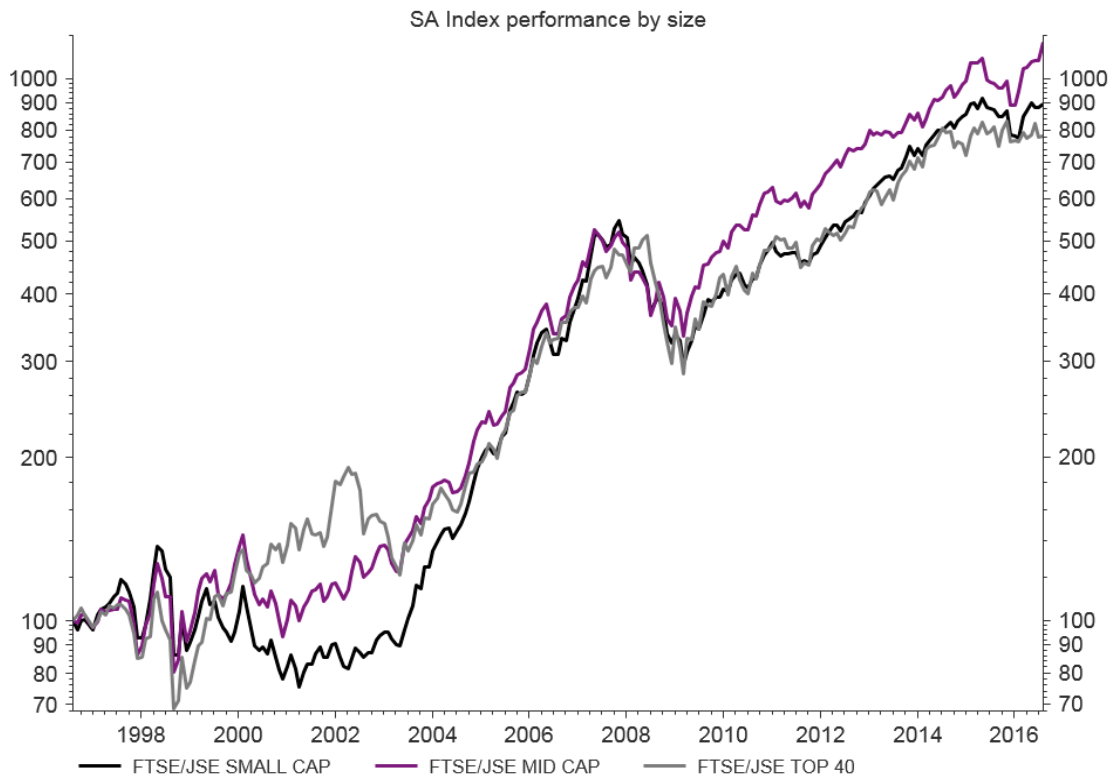


## PERSPECTIVE ON THE SIZE DEBATE IN THE SOUTH AFRICAN MARKET

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Mid & small caps have outperformed the Top 40 over the past 20 years.

Figure 1: SA Size Index Performance



Source: Thomson Reuters Datastream

Even during periods of market corrections, they have actually performed better than large caps. This is case specifically in the 2008/9 drawdown as the large mining shares had big declines. In previous downturns small caps declined by more than the

market. Due to the high growth rate, coupled with low ratings that they were trading on, small caps and mid-caps also delivered higher dividend yields, adding to the above-mentioned returns.

*Table 1: Annualised returns 1996-2016*

|                          | <b>Small</b> | <b>Mid</b>   | <b>Top<br/>40</b> |
|--------------------------|--------------|--------------|-------------------|
| Annualised price returns | 11.6%        | 13.1%        | 10.8%             |
| Dividend yield           | 3.8%         | 3.2%         | 2.7%              |
| <b>Total return</b>      | <b>15.8%</b> | <b>16.7%</b> | <b>13.8%</b>      |

## SMALL AND MID - CAP PERFORMANCE

As with all index related returns, investors have to look deeper in order to understand what drove the index returns.

With respect to the small cap index, we have identified the following shares as the exceptional performers that graduated to either the mid-cap or large cap indices.

*Table 2: Small cap stock specific performance*

|               | Date of Small Cap Index exit | PE Jan 2003 or earliest | PE July 2016 | Market Cap Jan 2003 - R'm | Market Cap July 2016 - R'm | Total price return | Annualised price return |
|---------------|------------------------------|-------------------------|--------------|---------------------------|----------------------------|--------------------|-------------------------|
| Capitec       | 19-Dec-08                    | 3.2                     | 22.5         | 161                       | 72 736                     | 26000%             | 47%                     |
| EOH           | 14-Aug-14                    | 5.7                     | 21.6         | 76                        | 20 099                     | 9187%              | 37%                     |
| Famous Brands | 03-Aug-15                    | 7.2                     | 25.0         | 96                        | 13 799                     | 8707%              | 36%                     |
| PSG           | 22-Sep-09                    | 3.6                     | 28.0         | 600                       | 45 350                     | 7476%              | 35%                     |
| Mr Price      | 17-Sep-04                    | 8.9                     | 22.4         | 1 312                     | 58 251                     | 3567%              | 28%                     |
| Coronation    | 15-Oct-10                    | 12.7                    | 15.0         | 1 400                     | 26 137                     | 2132%              | 24%                     |
| Brait         | 17-Jun-11                    | 1.0                     | 21.9         | 804                       | 63 255                     | 1872%              | 23%                     |
| Tsogo         | 28-Jun-04                    | 5.6                     | 14.8         | 590                       | 30 250                     | 1015%              | 18%                     |
| Curro         | 17-Apr-15                    | 225.0                   | 147.0        | 644                       | 16 258                     | 919%               | 17%                     |
| Omnia         | 21-Dec-12                    | 4.2                     | 16.1         | 730                       | 11 465                     | 891%               | 17%                     |
| Oceana        | 21-Dec-12                    | 8.9                     | 18.6         | 1 539                     | 15 180                     | 679%               | 15%                     |
| KAP           | 29-Jun-12                    | 3.8                     | 14.3         | 56                        | 15 670                     | 519%               | 13%                     |
| SuperGroup    | 22-Dec-14                    | 10.8                    | 13.4         | 2 103                     | 14 722                     | 501%               | 13%                     |
| Zeder         | 22-Jun-15                    | 4.7                     | 19.0         | 1 358                     | 10 630                     | 204%               | 8%                      |

What we would like to highlight is that stock selection is important as the outperformers have tended to do so by a large margin.

There are factors that affect investors' ability to realise the returns (e.g. primarily size and liquidity). As you will note from Table 2 above, the market capitalisation at entry or 2003 for many of these was very marginal. An ameliorating factor is that that many of the small caps tend to be capital hungry as they are in growth phase/acquisition phase. As a result, they tend to give shareholders opportunities to acquire more through rights issues. Further the real winners do end up becoming large companies, and therefore become more accessible, albeit with the drawback of having missed the initial returns.

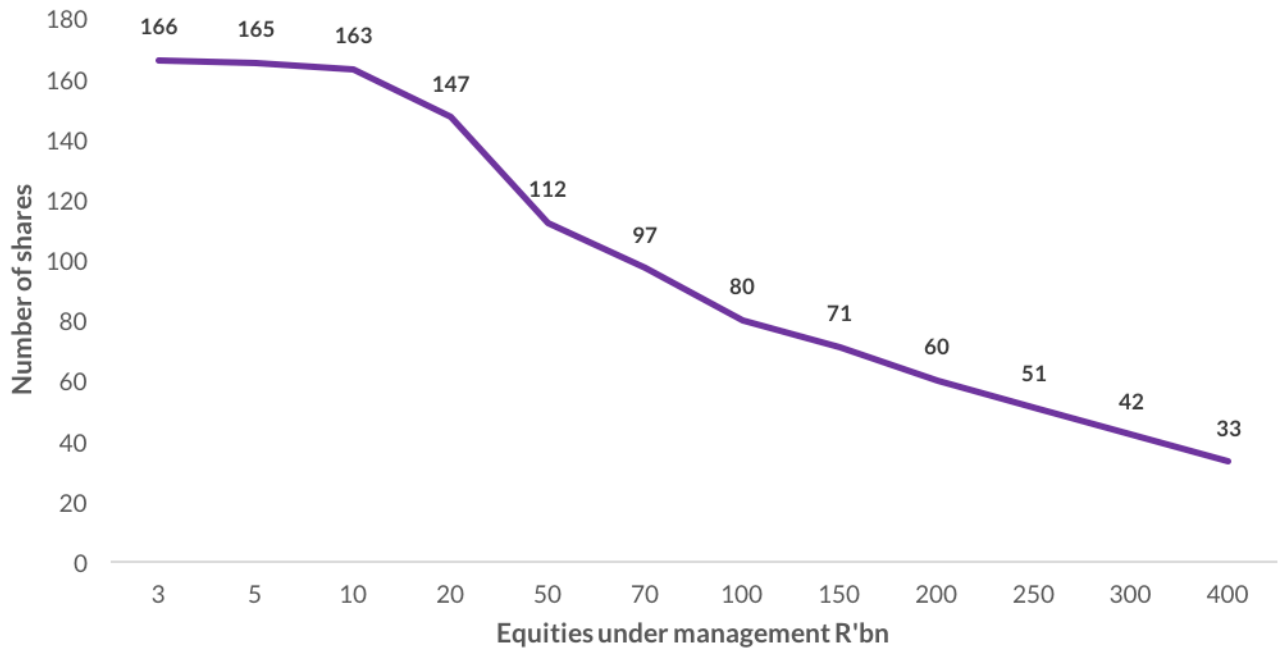
Below is the performance of some mid-cap shares over since 2003. Again the divergence in performance is notable.

*Table 3: Mid-Cap performance since 2003*

|                   | PE Jan 2003 | PE July 2016 | Market Cap Jan 2003 - Market Cap July 2016 |         | Total price return | Annualised price return |
|-------------------|-------------|--------------|--------------------------------------------|---------|--------------------|-------------------------|
|                   |             |              | R'm                                        | R'm     |                    |                         |
| Aspen             | 11.7        | 33           | 2 800                                      | 173 762 | 4967%              | 31%                     |
| Shoprite          | 9.9         | 25.8         | 3800                                       | 119 312 | 2871%              | 26%                     |
| Woolworths        | 8.4         | 25           | 4 814                                      | 83 703  | 1639%              | 22%                     |
| Hyprop            | 8.9         | 25           | 750                                        | 31 380  | 1037%              | 18%                     |
| WBHO              | 7.4         | 9.6          | 597                                        | 7 700   | 1035%              | 18%                     |
| Netcare           | 8.5         | 17.5         | 4 700                                      | 46 768  | 916%               | 17%                     |
| Santam            | 8.6         | 12.1         | 3 467                                      | 25 757  | 642%               | 15%                     |
| Imperial          | 9           | 10.3         | 11 885                                     | 35 966  | 315%               | 10%                     |
| Sun International | 10.2        | 13.9         | 2 342                                      | 9 000   | 177%               | 7%                      |
| Nampak            | 10          | 12           | 8 887                                      | 13 690  | 54%                | 3%                      |

At the core of the issue is whether smaller managers would have been able to access these opportunities. We are of the view that in order to own a meaningful position, it has to be at least 3% of fund in order to impact fund returns. Below we estimate the AUM level and how many shares a manager can own at 3% of fund. In the South African context (all else equal) the levels that manager position sizes is typically restricted is around R50bn level and again at around the R100bn mark.

Figure 2: Number of shares a manager can own to 3% based on AUM level



For this exercise we have restricted the most that a fund can own of a company at 20%, whilst still maintaining that stock position at 3% of fund.

Another way of reflecting the message is to answer the question how many companies can a manager trade to 3% of fund within 20 trading days?

| AuM Level | Market cap of smallest company can trade in 20 days | Name of entity | Number of companies can trade in 20 days |
|-----------|-----------------------------------------------------|----------------|------------------------------------------|
| R10bn     | R5.4bn                                              | Mpact          | 101                                      |
| R20bn     | R5bn                                                | PPC            | 77                                       |
| R30bn     | R28bn                                               | Northam        | 71                                       |
| R40bn     | R22.6bn                                             | ARM            | 67                                       |
| R50bn     | R50.4bn                                             | Resilient      | 65                                       |
| R100bn    | R71bn                                               | Capitec        | 40                                       |
| R150bn    | R108bn                                              | Nedbank        | 24                                       |

Note: There are many factors that affect daily traded volumes so historical trading activity is not always fully reflective.

Again the universe is reduced around R40/R50bn AuM level and at the R100bn level.

## IN CONCLUSION

Rather than the exactness of the opportunity set given a manager's size, what we would like to conclude with are the following thoughts:

- Small and Mid-Caps are eclectic combination of businesses and hence return outcomes. Stock picking is very important.
- In the current South African context, once an equity manager is greater than R50bn and again R100bn, the opportunity set declines meaningfully as evidenced by data above.
- We are not prophesying poor returns from large managers. Rather we would like to leave with the message that they will generate their returns from the large shares. Smaller managers have the opportunity to then also generate returns from small and mid-caps.
- From a long term perspective, there are times when managers should be invested in small and mid-caps. It's not obvious that this should always be the case. For example, the timing to be invested in mid-caps and small caps was good in 2003 as they were also trading on low ratings and depressed earnings.
- Investors need to have good judgement to know when it makes sense for them to use their ability to be different to the benchmark. We do think that the current market environment is conducive for small and mid-caps: large cap shares are

trading on high ratings. The rest of the market is trading on low multiples and low earnings.

**September 2016**