QUARTER 1 2018

QUARTERLY INSIGHTS

CONTENTS

INTRODUCTION

Mahesh Cooper
Chief Operating Officer

The first quarter of 2018 has certainly been a humbling one with most sectors delivering negative returns. Clearly it was a case of the local stock market getting ahead of its fundamentals post the December ANC conference. However, it is times like these that excite us as more shares that were previously off our True Value Continuum migrate back onto it.

On a separate note, there is much debate in the industry around the suitability of equity benchmarks given the size and impact of Naspers. What is interesting to note is that over the last 5 years, the ALSI has delivered 10% p.a., the SWIX 10.8%, the Capped SWIX 10.4% and the CAPI 10.1%. Over 10 years, the ALSI has delivered 9.7% p.a., the SWIX 10.9% and the CAPI 10.2% (the Capped SWIX does not have a 10-year track record). So, whilst over shorter periods of time, the return experience from the respective indices may differ considerably, over longer periods of time they tend to even out.

Similarly, we tend to be myopic in our experience of the world. In our first article, portfolio manager Patrick Ntshalintshali shows that the experience of the new dawn is not just limited to South Africa but more broadly across the continent. Despite the general euphoria we are experiencing in South Africa, there is still a great deal of work that we as South Africans need to do.

In our second article, Lonwabo Maqubela outlines why banking share, Barclays Group Africa remains a top 10 share in our portfolios despite the last decade being a lost one for the company relative to its peers.

Our third article introduces our global investment cluster and some of the opportunities they are uncovering. It is pleasing to see our True Value Continuum remains as applicable globally as it is locally, especially considering the imminent launch of our global equity strategy.Naspers remains one of the most talked about shares in the market. And with a weighting of over 20% of the SWIX, it should be! Our Chief Investment Officer, Delphine Govender outlines our investment thesis regarding Naspers and why we remain non-holders in the share in our True Value mandates. Tencent is Naspers' biggest investment, and effectively represents all of Naspers' share price. It is therefore difficult to have a view on Naspers without a view on Tencent. Using globally well-established reference points, in the next article Glen Henrich illustrates the stretch assumptions needed to justify Tencent's share price.

December 2017 will also be remembered in South African investment industry for the Steinhoff fiasco. Delphine unpacks some of the warning signs that were on the wall so that hopefully as an industry we do not make the same mistakes again. Unfortunately though, it appears that unlike engineering knowledge which is cumulative, investment knowledge isn't!

Following on from the accounting irregularities of Steinhoff, in our final article Lonwabo writes about some of the limitations of the accounting standards our industry place so much reliance on.

Staffing update

Our investment team is now 12 strong with 4 new hires since quarter 4 of last year. We welcome as analysts to the investment team Vuyo Nzube (who joins from Nedgroup Investments), Johannes Visser (who joins from RE:CM), Museja Makhaga (who joins us from SIM), and Janet Muzenda (who graduated from UCT). In addition, Christine Fourie will be joining us on 1 August as a fixed income portfolio manager. Christine joins us from Coronation where she has been in the fixed income team since 2007.

On a personal note, I have taken over the role of Chief Operating Officer from Logan Govender. I would like to thank Logan for his contribution to the business as a co-founder and COO over the last 5 years. Logan continues to remain involved in the business as a director with oversight over the finance, risk and compliance functions and importantly will be devoting more of his time to launching and managing our alternative investment offering.

I hope you enjoy reading this edition of our Quarterly Insights.

A NEW DAWN IN SOUTH AFRICA?

Patrick Ntshalintshali
Portfolio Manager

New Hope on the African continent

There has been so much activity around the globe in terms of politics, economics, geopolitics, and changing industry dynamics that we may have missed one of the biggest positive developments in the political leadership of this intriguing continent we call home: Africa.

A recent tweet by Carlos Lopes, economist and professor at the University of Cape Town, shed light on this:

> ***Carlos Lopes @LopesInsights Apr 2, 2018***
>
> *15 Changes of leadership in Africa in the last 15 months: Ethiopia, Zimbabwe, South Africa, Botswana, Ghana, Liberia, Somalia, Benin, Libya, CAR, Angola, Lesotho, Seychelles, Mauritius and soon Sierra Leone. Average 1 per month!*

How come this reality did not make the front pages of The Economist, Financial Times, Wall Street Journal and the rest of the world's most popular journals? As Africans, did we really miss this pattern and these developments? Surely such peaceful political leadership transitions happening with this kind of frequency in Africa is something we should be celebrating.

For a continent that has for decades been mired by political violence; that has become well known for the lack of (or no) political change and that is notorious for well documented human rights abuses when regimes change - these ultimately peaceful transitions are nothing short of impressive. If anything, Africa has become synonymous with a permanent haven for life presidents, dictatorship and corruption. This is a dark history that has held us back when the world appeared to be progressing on to greater things.

Perhaps Africa is finally getting its affairs in good order but the world is not witnessing it enough to talk about it. Hopefully this is a turning point for Africa - one that brings hope. A chance for renewal for a youthful population that is relatively untapped and with so much potential for growth.

South Africa: The Pressing Issues

Considerable optimism has been evoked with the election of Cyril Ramaphosa as South Africa's new president and what his leadership might mean for the country going forward. Across the spectrum, South Africans are hoping the new political guard will address some of the serious challenges we faced during the past decade. These challenges included:

- Jobless growth and youth unemployment
- Lack of meaningful direct capital investments
- Policy uncertainty and poor co-ordination
- Breakdown of trust between business, labour and social partners
- Weakening of state institutions and dwindling capacity in public service delivery
- Growing corruption
- Weak consumer and business confidence
- Highly indebted consumers

Early indications are our new President is heeding the call as is evident in his speeches, actions and promises since he took over in February. This has brought a sense of hope and renewal that the country has been desperately yearning for.

As investors, we are encouraged that the new regime has targeted some critical challenges as being the key priorities to fix. This was also endorsed and supported by the ANC National Congress in December 2017. We believe South Africa earnestly needs to focus on the execution of the National Development Plan.

Specifically, we feel that these are some of the steps that need to be taken to ensure sustainable growth and socio-economic stability in the nation for the long-term:

- Prioritise infrastructure investment and its modernisation to help to reduce the costs of doing business in the country and improve competitiveness;
- Promote small business development and funding;
- Create platforms for greater entrepreneurship, funding access and job creation;

- Enable better high-quality formative education;
- Ensure access to good effective healthcare that embraces technology as part of the delivery model;
- Increase and broaden economic freedom; accelerate development of rural/township economics and grow the middle-class;
- Improve fiscal management and implement the social and economic reforms that would help us reduce external debt in the economy;
- Strengthen corporate governance and ensure ethical leadership is in place both in government and the private sector;
- Eradicate the over-concentration of industries, reduce monopolies, increase competition and promote/encourage new entrants;
- Ensure a stable region: we believe a stable and prosperous Southern Africa, with new leadership in Zimbabwe and Angola, could be a gamechanger for the region;

South Africa has enough talent and resources in the country and continent to be able to execute all these actions identified above. All we need is the political will to put these actions first and the allocated support to enable their implementation.

New Dawn, New Hope

South Africa now has leadership in government, business, civil society and other social partners that understand and accept the urgency of action to deal with our challenges and moreover grasp the opportunity cost of not doing so.

South Africa is expected to be one of the biggest beneficiaries of the Agreement on the African Continental Free Trade Area (AfCFTA), which was signed by African leaders in March this year in Rwanda. This agreement means that no (or much lower) tariffs will be levied on exports and imports between most countries on the continent. President Ramaphosa said that the new deal will "yield great benefits for all countries on the continent as well as big business, small companies and micro-traders."

Now, this is what I call a "New Dawn, New Hope" for South Africa, Africa and its people. At last, I get the feeling that we have left our stagnation and darker past behind us. The only catch is we all have to roll up our sleeves and make positive change. With a positive attitude, good leadership and an active social compact – all our individual and collective dreams and aspirations should become a reality.

Rise Africa!

BARCLAYS AFRICA GROUP: OFFERING RELATIVE VALUE

Lonwabo Maqubela
Portfolio Manager

Barclays Africa Group ("BGA)" has struggled relative to its peers over the last five years. Going forward we expect that BGA should benefit from the rising tide and reverse some of the diseconomies it experienced over the past decade.

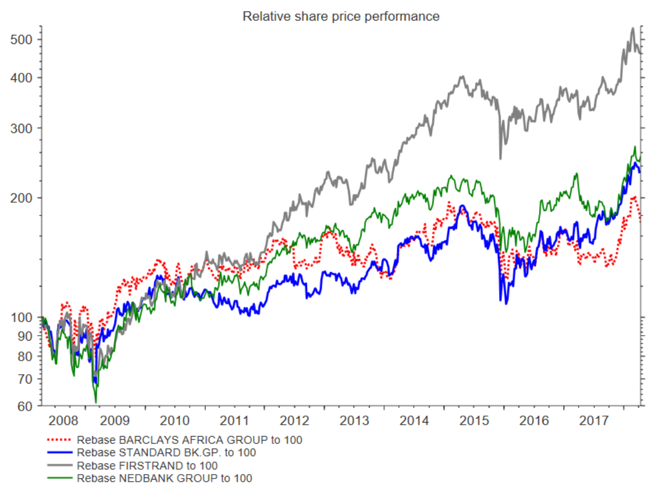
Coming full circle

BGA is a diversified financial services provider offering a full suite of banking and related products to consumers, small and medium sized businesses, corporates and governments. In 2005, UK based Barclays Bank purchased a 56% stake in then ABSA Group (Amalgamated Banks of South Africa - an amalgamation of Allied, Volkskas, United Bank and Trust Bank which occurred in 1991). The most recent incarnation of the group was formed in 2013 when Barclays combined its African operations with ABSA at which time ABSA Group was renamed Barclays Group Africa. In 2016, however, Barclays PLC changed its strategy and announced its intention to sell down its stake in BGA resulting in its stake being reduced from 62.3% to less than 15% by the end of 2017. BGA now intends to change the name back to Absa Group Limited.

The laggard

BGA has significantly under-performed its peer group over the past decade. Figure 1 shows the price performance of BGA relative to the other of the "Big Four" South African banks, namely Standard Bank, Firstrand and Nedbank.

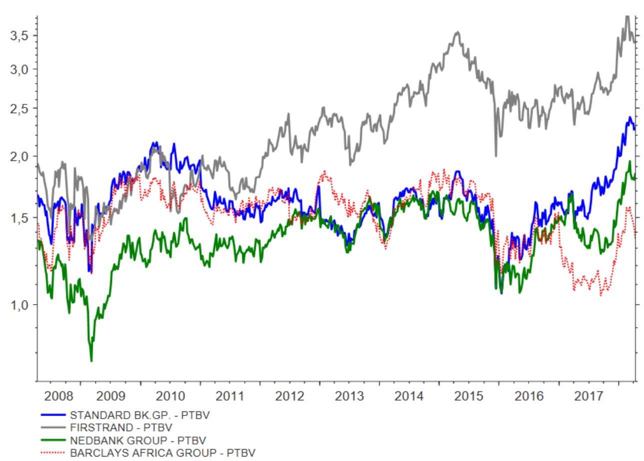
Figure 1: BGA underperforms the peer group



Source: Thomson Reuters DataStream

Relative to its peers, BGA went from being similarly rated (using price to book value as a proxy) to being the most poorly rated amongst the "Big Four" banks. See Figure 2.

Figure 2: BGA de-rates



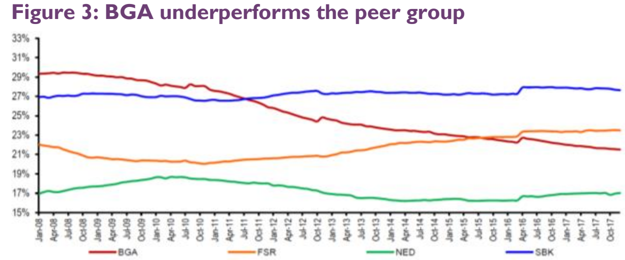
Source: Thomson Reuters DataStream

How did this happen?

The last 10 years have been a lost decade for BGA. This has been mainly as a result of:

- **Loss of number 1 position in retail banking**
  In 2009, BGA was the largest retail bank in South Africa with almost 12 million customers. Since then it has lost more than 2 million customers. This is partly due to the tightening of the bank's lending practises, which was influenced by parent company Barclays plc's overall shift to a significantly more conservative approach post the Global Financial Crisis (GFC). See Figure 3.

Figure 3: BGA underperforms the peer group

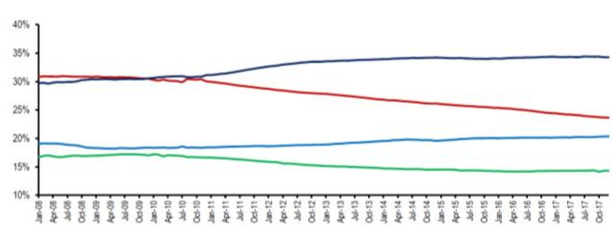


Source: UBS, SARB BA900

- **Loss of number 1 position in home loans**
  BGA's home loan book was the biggest relative to its peer group 10 years ago. Post the GFC, the mortgage loan business was orphaned by banking executives for many reasons including the requirement to hold more capital. This was done by tightening their lending practices at the expense of maintaining and growing their client base.

  Given that the mortgage loans were nearly half of BGA's loan book, the consequences of this action had a substantially negative impact on the profits of the group. The magnitude of this decision resulted in a halving of profits relative to Standard Bank's home loans business. To put this into context, on BGA's current price earnings multiple, the total value of this opportunity cost is R15bn or 10% of BGA's market capitalisation!

Figure 4: Home loans market share

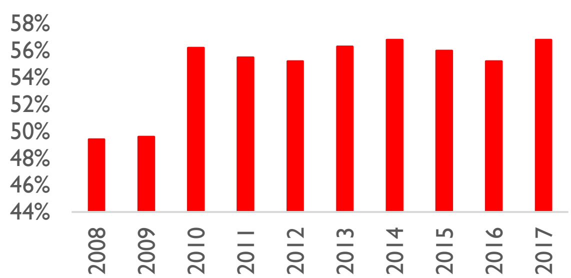


Source: UBS, SARB BA900

The impact of diseconomies of scale

In business, economies of scale are what gives companies a competitive advantage, particularly businesses with structurally low profit margins as is the case in commercial banking. It follows therefore that diseconomies arise from losing market share. As absolute levels of interest income began to stagnate, this had a substantial impact on BGA's cost to income ratio which deteriorated despite good cost control by the management team. BGA Management had a target in the low 50%'s for 2016!

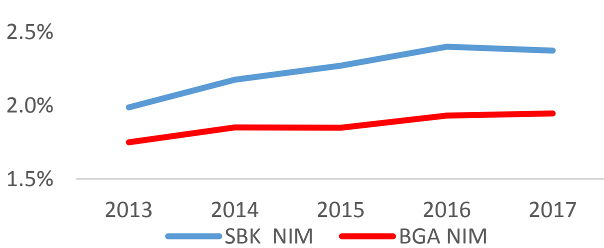
Figure 5: Cost to income deteriorates



Source: Bloomberg

A further headwind to income was that the quality of loan business written by BGA failed to improve. The market had been very competitive between 2005 - 2008 during which time loans were keenly priced. However, post the GFC, aggressive lending practices and pricing quickly abated as a whole. Notwithstanding this, BGA did not seem to optimise this better quality lending environment, as evidenced by the comparison to Standard Bank below. Standard Bank by comparison was able to write new business at noticeably better margins than its own history while BGA was not able to enjoy the same improvement to its net interest margins. This lagging performance carried through to impairments as well.

Figure 6: Home loan net interest margins fail to improve



Source: Bloomberg

A relative value investment thesis

Given the factors outlined above as well as other concerns related to inter alia the separation from Barclays; the departure of several senior experienced staff over the past 6 years and the uncertainty around management succession, BGA is poorly rated by the market compared to its peers.

We position BGA as a "relative value" thesis on the Perpetua True Value Continuum. Whilst BGA's share price offers less compelling value than it did a year ago when it was trading at around R140, at the current price of R180 we believe the market is still not factoring any improvement in its operating metrics.

In our experience with stocks that have been underperforming and poorly rated for some time, the market tends to err on the side of caution following successive periods of disappointment. Invariably however, as long as there are no permanent material structural declines in the business, when conditions turn out to be "less worse" than the market expects, this tends to be a catalyst for near term share price re-rating.

For a relative value investment thesis to hold, it is important that the investee company must not deteriorate further. On the positive side, we are of the view that the improved macro-economic conditions should be a "rising tide that lifts all boats" and is likely to benefit BGA. More recently BGA management has started to show signs that they are accelerating growth in its retail business. We believe the reversion to becoming ABSA has re-ignited the business and there is a greater hunger to regain lost ground. These positives should reverse some the above-mentioned diseconomies. On the negative side, we are mindful that in the short-term, uncertainty regarding management succession planning may undo some of these efforts. The board and management are not oblivious to shareholder concerns in this regard and therefore we trust they will be more decisive and pro-active in this regard.

Given that BGA is trading at 10 times current earnings with a 6% dividend yield, it also remains attractive in absolute terms. At the current price we therefore believe our clients are being commensurately rewarded for being patient as the relative value thesis unfolds.

Corwin Shropshire Delphine Govender Johannes Visser Mark Butler Phomolo Rabana

GLOBAL EQUITIES: TAKING ADVANTAGE OF A WIDER INVESTMENT UNIVERSE

Perpetua Global Research Cluster

In the recent budget speech, South Africa's Finance Minister increased the offshore investment allowance for institutional investors by 5%, from 25% to 30% and doubled the allowance for investments into the rest of Africa from 5% to 10%.

We believe that South African investors should make use of this increased foreign allowance to diversify their investment exposure and take advantage of the greater investment universe.

Perpetua is researching this wider investment universe for you

We have spent the last three years developing our global equity capability and managing global equities within a balanced mandate context for half that time. We now feel we are at the point where we can sustainably launch a standalone global offering.

We discuss below three global stocks we currently hold in our Perpetua Balanced Fund to illustrate the differentiated opportunities we are finding in offshore markets and in different industries that provide for diversified investment destinations for clients' funds.

1. Value in a different geography…Russia

Magnit is a Russian listed food retailer that has approximately 10% market share in a fragmented Russian food retail market where the top 5 food retailers control only 30% of the market.

Magnit reminds us of US retail giant, Walmart under Sam Walton when the company chose to first compete with weaker small-town stores, gaining scale as it went. Today Magnit has approximately 6000 trucks that regularly restocks approximately 16000 stores across Russia and because of this scale has achieved a meaningful cost advantage. Magnit has been able to pass on some of this benefit to their customers, delivering quality products often 10% cheaper than competitors.

Magnit also retained or reinvested some of this benefit to fund an enormous store roll-out with the company growing space by 25% per year over the past 10 years an averaging an operating margin of 6.5%. This margin is high by global standards where 3.5-4.5% is the norm. By 2015 Magnit had reached an operating margin of 9% and the share priced at more than Ruble 12000 per share. At this stage the share was popular among global investors for the growth it achieved.

More recently, however, Magnit fell below Ruble 4500 per share as a tough Russian economy; low price inflation and a large store refurbishment program lead to negative same store sales and a more normal operating margin. Added to this the founder and CEO recently sold his stake and stepped down, leading to investor uncertainty about the future of the business.

With the recent unfolidng of events, the investor sentinment pendulum has now swung to the other end, and the market appears to now be pricing a food retail margin in the region of 3% and a subpar return on capital in the future. This seems unreasonably pessimistic given Magnit's competitive position. By our evaluation the share trades at close to 10-12x normal earnings. This is equivalent to a yield of approximately 8% that should grow by 8% if the company at least keeps up with the economy - a return of 16% per year to investors. More probable an outcome, we believe, is that Magnit grows at a substantially higher rate for a period of time. From our perspective Magnit remains well positioned to continue to take market share as they grow new stores and acquire sub-scale regional chains. We expect the management of the business to continue to professionalise.

Taking a long term perspective we believe that at current prices an investment in Magnit is meaningfully skewed to the upside.

2. Value in a different industry…Biotechnology

Founded in 1987, Gilead Sciences is one of the largest biotech stocks in the US. It has been the cornerstone of the HIV drug treatment market and remains the market leader in the treatment of HIV and Hepatitis C virus (HCV).

A culture of continuous innovation is firmly embedded in the Group's DNA, and its track record of discovering new medications is hard to ignore. Consequently, Gilead has continued to give practical application to its objective of meeting 'unmet medical needs.'

Gilead generates most of its sales from developed markets, particularly, the US (69.5%) and Europe (22.8%) (Figure 1a). The HIV division is once again the largest portion of the Group, accounting for 61% sales (Figure 1b).

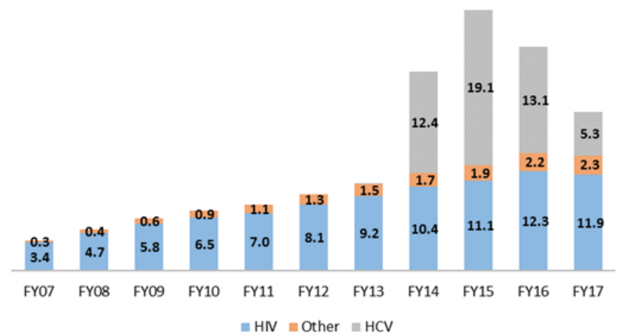
Added to this, Gilead's acquisition of Kite Pharma in 2017 positions it as an industry leader in cell therapy. Gilead's drug, Yescarta, is the first cell therapy approved for the treatment of adult patients with relapsed or refractory large B-cell lymphoma.

> **B-cell non-Hodgkin lymphoma** is the most common type of non-Hodgkin lymphoma. It is a cancer that affects the immune system, and is marked by rapidly growing tumours in the lymph nodes, spleen, liver, bone marrow, or other organs.
>
> Source: National Cancer Institute

Over the past several years, Gilead's share price has dropped c.40%, largely impacted by falling HCV sales, which have now stabilised. Currently, Gilead is trading on a forward P/E of 11.5x.

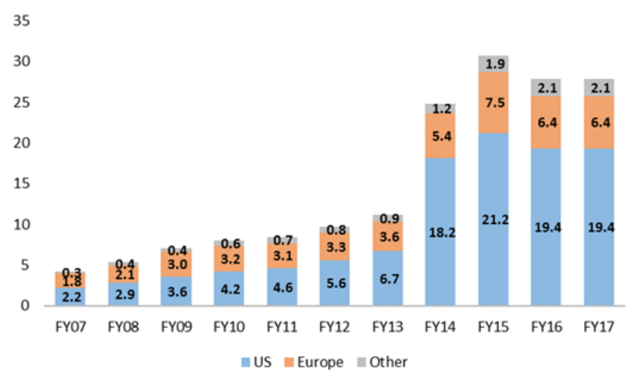
Our opinion is the current share price provides an attractive entry point to gain exposure to a highly cash generative, financially stable company, with good payer relationships and market leading positions in key therapeutic areas (HIV, HCV, and B-cell non-Hodgkin lymphoma).

Figure 1a: Gilead revenue by product ($bn)



Source: Bloomberg

Figure 1b: Gilead revenue by region ($bn)



Source: Bloomberg

3. Value in a different size company…Mid cap

The Carlisle Company is a US based industrial conglomerate operating 4 segments with distinct end markets and a market capitalization of approximately $6bn. While considered mid cap by global standards, it would actually qualify as being a large cap in a South African context!

Carlisle's two largest divisions, Construction Materials and Interconnect Technologies account for 80% of sales. The Construction Materials division supplies commercial roofing materials, insulation and waterproofing membranes. Nearly 75% of the business is related to replacements or re-roofing activity with the balance for new non-residential construction.

The Interconnect Technologies division manufactures wires and cables primarily for aerospace applications (75% of segment sales). The segment's products are used to connect and transfer power and data for many of the electrical functions of a commercial aircraft. Sales growth has recently benefited from a strong order backlog for Boeing and Airbus planes as well as Carlisle's product that enables carriers to equip planes with the ability to offer wi-fi.

Carlisle is attractive as a company for two core reasons:

1. The underlying industry fundamentals are sound in its 2 largest divisions namely a) Construction Materials which exhibits: steady sales growth; superior product to the alternative; expansion opportunities into the EU; and b) Interconnect Technologies: fast growing wi-fi opportunity; expansion into medical end markets.
2. It has a strong management team that has demonstrated an ability to identify and acquire niche industrial businesses and subsequently institute its Carlisle Operating System (a business operating initiative) to improve profit margins.

We believe Carlisle is a quality mid-size company operating in niched industries and trading at a reasonable price at a forward EV / EBITDA of 8.2x.

The more things change, the more they stay the same

For a South African investor, an allocation to global equities will complement domestic investments and should provide a better risk adjusted returns in the long term. As the stock examples above illustrate, we are pleased our investment capability at Perpetua is able to now robustly provide clients with a range of global equity investments managed on the same rigourous, steadfast and differentiated investment approach as our domestic capability has demonstrated over the past five years.

NASPERS: SHOULD ALL GOOD THINGS COME TO AN END?

Delphine Govender
Chief Investment Officer

"Every once in a while, an up-or-down-leg goes on for a long time and/or to a great extreme and people start to say "this time it's different." They cite the changes in geopolitics, institutions, technology or behaviour that have rendered the "old rules" obsolete. They make investment decisions that extrapolate the recent trend. And then it turns out that the old rules still apply and the cycle resumes. In the end, trees don't grow to the sky, and few things go to zero. Rather, most phenomena turn out to be cyclical."

Howard Marks, Oaktree Capital

A standout contributor to returns has been Naspers

South African investors have experienced solid investment returns over the past decade with the FTSE/JSE All Share Index (ALSI) returning almost 10% per annum versus inflation of 6% per annum. The Industrials sector was the driver of these returns, delivering almost 17% per annum over the same period. The Financials and Resources sectors lagged Industrials, returning 13% and -1% per annum respectively over the same period.

Many industrial shares on the ALSI contributed in notable ways to the stellar returns achieved by this sector but the standout contributor has been Naspers. Naspers' weight in the index has gone up a staggering 14 times in the ALSI and 15 times in the SWIX over the last 10 years.

Naspers index weighting	Weighting at 1 March 2008	Weighting at 28 February 2018
ALSI	1.3%	18.8%
SWIX	1.5%	22.5%

Source: Bloomberg

Naspers, which has its origins as a newspaper and magazine publisher and printer from the early 1900's, listed on the Johannesburg Stock Exchange in 1994. Since listing, the company has evolved into a multinational internet and media group - offering services in more than 130 countries and with operations now spanning video entertainment; gaming; internet communication and e-commerce. The game-changer for Naspers was its purchase of a stake in the Chinese media and internet company, Tencent. The investment in Tencent of $34 million in 2001 is now worth over $160 billion – in fact more than Naspers' entire current market valuation.

Past returns are not a predictor of future returns

Naspers has been an outstanding investment for those who have held the share from almost any point since its listing until the present time. Much of this excess return can be attributed Naspers' investment in Tencent, which itself has risen 43 times over the past 10 years. The table below contrasts this incredible performance relative to other global technology stocks:

	Cumulative returns over last 10 years
Tencent	4257%
Amazon	2246%
Apple	897%
Google	368%

Source: Bloomberg

Where to from here?

There is, however, a conundrum facing South African investors. From this point, will Naspers continue to be as good an investment as it has been; or even as good an investment as the broader South African market? This question is becoming even more valid and poignant given that most South African investors have Naspers as one of their (if not the) largest investments in their portfolios.

While many investors use Naspers' index weighting as their reference point for the quantum of their exposure to the share, we believe the position size of a share in an actively managed investment portfolio should not be guided simply by the share's weight in an index, but by the absolute return and risk expectations intrinsic in the share and company itself.

None so blind as those who will not see

When a share has re-rated to the lofty price-earnings multiple Naspers has over the past few years, the implied margin of tolerance for negative surprises; missteps; trapped value or uncertain outcomes starts to reduce considerably. The virtually unanimous positive write-up on the stock by the sell-side stockbroking community points to a situation where the consensus opinion is appearing oblivious to some quite pertinent drawbacks in the company.

We believe there appears to be mounting reasons to indicate that the return and risk dynamics for investing in Naspers from this point are not so obviously skewed in an investor's favour.

Some concerns that we believe are understated include:

- Unlocking trapped value is proving difficult: Naspers trades at discount to the value of its stake in Tencent, despite the fact that Naspers comprises several other operations albeit none in the scale of profit of Tencent. This discount has widened over the past few years, not narrowed. This is attributed in part to the fact that these "other operations" in Naspers are collectively consuming considerably more cash than they generate. Just recently Naspers reduced its 33.2% stake in Tencent by 2% to 31.2% with all the cash raised being allocated to fund these other operations, and none of the proceeds allocated for immediate value unlock to existing Naspers shareholders via a share buyback or special dividend.

- The probability of another "Tencent-type" return investment for Naspers is low – virtually nil. The investing environment is considerably more competitive especially considering there are with many very large technology companies with strong balance sheets and lots of cash to deploy.

- The required growth implied by the current share price for Tencent's average revenue per user is very, very high. We discuss this further in Glen's article. In addition, it is more probable that the overall rate of growth for Tencent will taper from current levels.

- Naspers' opaque voting control structure is archaic and highly disenfranchising to shareholders of the Naspers-N share (the most commonly held share class).

- Naspers' ownership in Tencent does not entitle it to the usual ownership rights entrenched in a standard shareholding, but instead only enshrines Naspers with a right to an earnings and revenue stream. This unusual ownership structure has some implicit risks and has not been legally tested under Chinese law.

"Trees don't grow to the sky"

One of the longest standing investment adages is "buy low and sell high". Easy to grasp in theory, however, much more difficult to implement in practice. The difficulty comes in the counter-intuitive forces which cause investors to want to hold their winners and sell their losers. In the case of Naspers, this has been a great story of investment success for investors. Both the company's idiosyncratic features coupled with a highly positive investment environment for the technology sector have contributed to this success. But indeed "tress don't grow to the sky". Naspers has become a very tall tree. And sometimes it is hard to see the wood for the trees

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TENCENT: REFERENCING EXPECTATIONS FOR ITS REACH

Glen Heinrich
Analyst

Chinese internet, social media and gaming company, Tencent has been one of the best investments in the world over the last 10 years, going up 43 times. That works out to a spectacular compound annual growth rate of 45% per year for 10 years.

This once relatively unknown company is now fully recognised by the market and is valued at over US$526 billion, making it one of the largest companies in the world by market capitalisation.

Tencent is part of an industry that has experienced significant structural tailwinds. Importantly China's regulations also enable Tencent to operate in a protected market where competitors like Google and Facebook are not allowed to operate. Tencent has a vast userbase through its WeChat platform reaching over 1 billion users and as such has the potential to monetise a plethora of services through its platform.

Figure 1: A selection of TenCent products versus comparative global competitors

As investors, we concede it is a struggle to value companies that experience prolonged periods of high growth - quite simply because it is hard to predict when the growth will slow and the rate of eventual slowdown. In addition, it is difficult to ascertain and quantify the impact of compounding high growth rates over long periods. Perhaps this is why it is rumoured that Albert Einstein called compound interest the eighth wonder of the world!

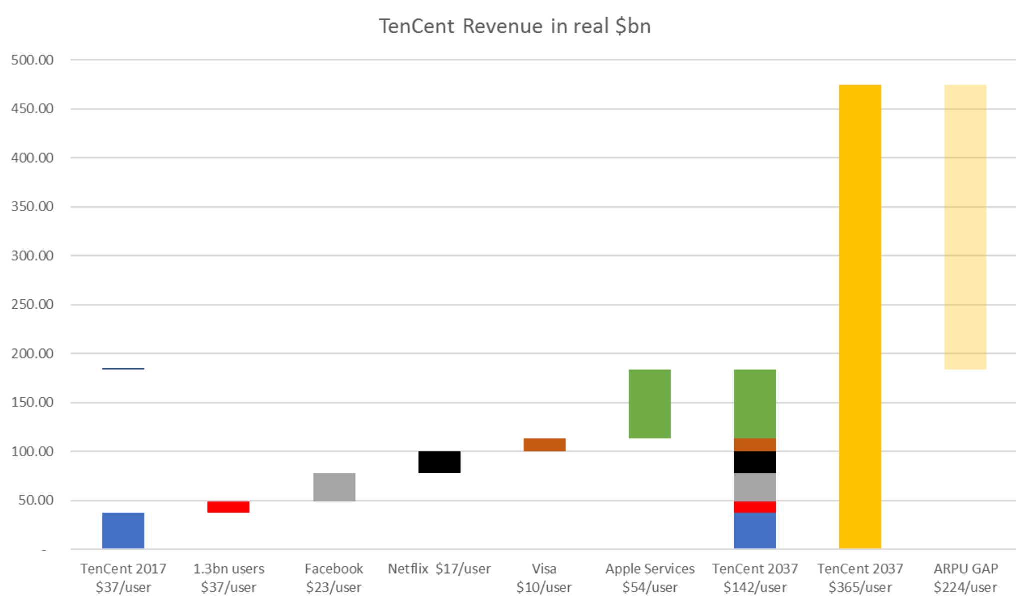
Looking forward 20 years

To make the valuation of Tencent more relatable, we have attempted to determine how much revenue Tencent needs to generate 20 years into the future to justify the current share price (assuming the company manages to maintain its current healthy operating margins of approximately 39%). According to our estimates, we believe Tencent would need to increase its revenue 14-fold in today's money in USD based on an exit PE of close to 16x (versus the 47x PE it is currently trading on).

In order to determine to the reasonability of this projected revenue growth and quantum, we decided to use a range of the world's best platforms - including advertising (Facebook), video services (Netflix), payments (Visa), music and other value-added services (Apple Services) – as the reference user base for Tencent. The build-up of this revenue is shown in figure 2 below and is based on the following assumptions.

- **The starting point**: the $37 per user Tencent generated in 2017 on its 1 billion user base - the majority of this revenue is from gaming (the blue bar).
- **Assumption 1**: Tencent increases its user base by 30% to 1.3 billion users to include the majority of the Chinese population, including children and the elderly. This additional revenue is shown in the red bar.
- **Assumption 2:** Tencent is able to achieve the same revenue per user as Facebook which generated about $23 per user in 2017 on an equivalent margin basis. Note this is a generous assumption as Facebook generates significantly higher revenue per user in the US compared to in the East. This revenue uptick is shown in the grey bar.
- **Assumption 3:** As a proxy for content streaming revenue, we assume a penetration of 20% for streaming services in China on Tencent's future user base (which is higher than the 16% penetration Netflix had in the US at the end of 2017) and apply this to Netflix revenue per user of $94 (2017) equating to an additional $17 per average Tencent user. This is shown in the black bar.
- **Assumption 4:** To account for the payments revenue stream, we use Visa as a proxy and this would add another $10/user assuming 75% of Tencent's 1.3bn users take up the payments service Tencent offers. The additional revenue is shown in the orange bar.
- **Assumption 5:** Finally, to ascertain a proxy for the premium value-added services, we used Apple Services revenue per user. This would add another $54 per user assuming 75% of the Chinese user base is willing to pay for this. This is shown in the green bar.

Figure 2. Tencent revenue waterfall in real USD (billion)



The outcome of this exercise?

Giving Tencent the benefit of each of these global leading services would increase their average revenue per user from $37 to $142 for 1.3 billion people. In absolute terms, this implied their total revenue will increase almost 5-fold from $37 billion to $184 billion in today's money.

However, despite this, we note that this still leaves a significant gap of $291bn of revenue or $224 per user versus the current level. This implies that if Tencent is to deliver the level of projected revenue that is being implied by the current share price, their existing business, which mainly comprises gaming and other related value-added services, would need to grow 6-fold over the next 20 years in today's money to make up this difference. This is a very high projected rate of growth for the existing business and we believe the probability of achieving this is unlikely.

To give context to this total required revenue per user of $365, one must also recognise that the GDP per capita in China is only a little over $8000. In other words, the projected revenue per user would mean around 5% of the Chinese GDP would need to flow through Tencent. In addition, Tencent would need to capture a margin of almost 40% on that revenue to justify the current share price.

Investing with a margin of safety

Hindsight is always 20/20 vision, and we recognise that if we did the same exercise on 30 December 2016, when the share price was more than half what it is currently, the total required revenue per user would have been $166, which is a far cry away from the $365 now required.

While we acknowledge there are elements of this exercise that may be rough or simplistic, we do believe it illustrates with the use of well-known reference points, the optimistic assumptions required to justify the current Tencent share price.

At Perpetua we place a great deal of importance on knowing the value of what we are buying with our clients' money and where we cannot establish that value with a reasonable degree of certainty, we demand a large margin of safety relative to the share price.

It is safe to say according to our estimation of Tencent's intrinsic value, we do not currently see our required margin of safety in investing in Tencent given the current share price.

FIVE LEARNINGS FROM THE DEMISE OF STEINHOFF

Delphine Govender
Chief Investment Officer

Like many of those in the South African investment industry, we at Perpetua have spent a great deal of time internalising and processing learnings from Steinhoff Holdings' massive corporate failure.

Our clients largely had a negligible to nil exposure in the stock for the past 5 years as we have for some time had concerns over the business, and its governance (hence our historically low/non-existent holding). Despite this, we acknowledge that as part of the broader investment community we need to fully grasp the extent of the ramifications of a corporate and investment failure of this scale. This is compounded by the fact that Steinhoff was a widely held and even popular stock; featuring in the top holdings of many active fund managers as well as passive managers given the stock's high index weighting.

Over the short term little good is likely to come to those investors who have permanently lost their capital. However, the investment industry need not wait to distil the grave shortcomings in Steinhoff to ensure that should we see similar signs in other investments we might own or consider owning, we must act with a knowing caution.

Five of our key learnings

The extent of the mismanagement, accounting irregularities and alleged fraud at Steinhoff are still to be fully uncovered. In the first annual meeting of shareholders on 20 April 2018 post the collapse of the company, the board itself indicated that one of the key priorities of the business is to "uncover the truth". It is almost incredulous to believe that a company which some six months ago was one of the ten largest shares in the South African stock market (and the third largest share just two years ago) could be now trading some 95% lower, struggling to survive as a business.

While hindsight is always perfect, we believe some of the warning bells were actually there for some time and if these were contextualised with the right caution and scepticism, more questions could have been asked by many more investors and sooner. Had this occurred it might have forced the company and its board to be considerably more alert to the state of affairs than they ultimately turned out to be.

Outlined below are some of our key takeaways for what we believe contributed to Steinhoff's demise and the questions we might ask going forward when facing similar circumstances:

1. The lack of true board independence and governance

Since its listing in Germany in late 2016, Steinhoff adopted a two-tier board structure which is consistent with Western European corporate governance guidelines. A two-tier board comprises a management board (made up of executives of the business) and a supervisory board (comprising non-executive directors). The rationale for this is to ensure independence between the management of a company and the non-executive board directors.

The irony of the two-tier structure in the Steinhoff case turned out to be that separating management from non-executive directors actually served to disservice the non-executive directors. We have now discovered that the non-executive directors appeared to be suffering from a vacuum or asymmetry of critical information to which the executives were privy and thereby concealing in part reckless actions.

Further, despite rated credentials, depth of experience and qualifications, it was the true independence of Steinhoff's non-executive directors on the supervisory board that was frankly questionable. This was evidenced by the fact that many of the non-executive directors were either known associates, family members or friends and admirers of majority shareholder, Christo Wiese or original founder Bruno Steinhoff. This resulted in a situation where it appeared the interests of the company and the board were more aligned to management and selected influential shareholders, than to all shareholders as a whole.

Questions to pose/ warning signs to look for:

- *Are there sufficient number of board members who have no connection to the company or its key shareholders/founders/management whatsoever?*
- *Are truly independent, unconnected, non-executive board members sufficiently represented on the various key board committees such as the critical audit and risk committees?*
- *Is the board sufficiently diverse in terms of backgrounds; demographics; hailing from a variety of disciplines and experiences, such that group think can be minimised?*
- *What is the level of cross-directorships held by board members?*

2. An overly domineering, highly persuasive CEO

Steinhoff's CEO, Markus Jooste was a persuasive, strong-willed, tactician of a CEO. His convincing, talkative and overly confident manner served to create an enigma in respect of his conduct. This in turn enabled him to escape with explaining even the most necessary of decisions in a superficial and even dismissive manner, yet eliciting scant criticism or scepticism for this behaviour from the majority of his audience.

The resultant impact that an individual of Markus Jooste's domineering character had was to effectively enable his otherwise astute audience (which predominantly included mighty bankers; prudent auditors; experienced existing and potential investors and learned board members) to suspend normal sceptical judgement and trust him almost blindly. With this trust in the palm of his hand, we have now discovered Jooste went on to engineer and conceal a web of irregular and evidently fraudulent transactions over a period of many years right under the very noses of this typically perceptive and sophisticated audience.

Questions to pose/warning signs to look for:

- *Does the CEO actually answer questions in a substantial manner or evade/avoid them?*
- *Does the CEO dominate in meetings/presentations, to the point where he is the main responder to questions that that CFO or COO or other executives should be answering? Added to this does the CFO, COO and other executives actual defer and deflect questions they should be answering to the CEO?*
- *Do market participants behave in an inexplicably "infatuated" way in respect of the CEO and his capabilities, thereby tacitly promoting his behaviour?*
- *How much obvious hubris does the CEO objectively display relative to his/her peers?*

3. A constantly changing business strategy

When examining the business strategy of Steinhoff over the past decade and especially the past five years, it would be safe to conclude it changed regularly, often in an abrupt or reactive way as opposed to a deliberately pre-emptive manner.

In 2017, major shareholder Christo Wiese defended the spate of random acquisitions stating that the pace of deals concluded over the past few years was "purely an accident of timing" and blaming it on "Steinhoff's DNA" of opportunism and nimbleness. The trouble with this narrative is it can effectively justify any investment or strategic decision, and so it did.

A track record of overpaying for acquisitions, especially very large ones, was also a feature of Steinhoff's behaviour.

Questions to pose/ warning signs to look for:

- *Does a company's strategy flip-flop over a period of time?*
- *Do the board members actually question the executives on the basis for material deviations from their publicly stated strategy? What explanation would be plausible?*
- *Do board members interrogate the inflated purchase prices paid for large acquisitions and what the basis for determining purchase prices?*
- *Are explanations such as "being opportunistic"; "it's in our DNA" used to justify strategy changes?*
- *Do shareholders truly hold the board to account for how they allowed their stated strategy to vary or do they simply go along for the ride?*

4. Opacity in financial disclosure

Steinhoff's financial disclosure was opaque. This was exacerbated by the complexity of the business itself operating in multiple geographies and across several subsidiaries; and the highly acquisitive nature of the business. The level of share issuance was extreme and the consequent financial engineering was impossible to keep up with. Divisional breakdowns changed frequently and when interrogated on the detail of financial due diligences of acquisitions, Jooste would often claim he focused on "human due diligence" in acquisitions not the usual tedious, numerate components.

Questions to pose/ warning signs to look for:

- *Does the company regularly change the basis for its disclosure?*
- *Are there inconsistencies between stated results and actual business performance through a host of adjusting entries?*
- *Are reported earnings easily reconciled to actual cash flows?*
- *Is a company's effective tax rate materially lower for an extended period of time, bringing quality of earnings into question?*
- *Does a company enter into complicated financial transactions especially at the time of its acquisitions?*
- *Does management blame the size; scale; complexity of the company's operations for not being able to conclusively respond to questions posed?*

5. Dismissal of its critics

Markus Jooste as CEO; Steinhoff as a company and Christo Wiese as a majority shareholder did not take kindly to critics. Ironically some of Steinhoff's shortcomings and vague disclosure had been identified by some (albeit the minority) of market participants over the years. These were both buy side investors and sell side stockbroking analysts.

For the traditional buy side investors, concerns were typically fully expressed in the act of not investing in any material way in Steinhoff, therefore the market did not tend to benefit from the cause of this stance. For those buy-siders who were hedge funds that wanted to take short positions in the stock, we have come to understand the company actually interfered in having its scrip out on loan, making it difficult to execute a short position in the stock.

For the sell side, however, whose opinions and views tend to be more publicly available, the actions by the company to counter, mitigate or silence naysayers was more deliberate. Dissenting analysts were either excluded permanently from company events; reported to their seniors (whose companies would be threatened with loss of Steinhoff corporate work) or encouraged to alter their views.

The result of the above was that Steinhoff was able to prevent adverse views on the company from being propagated more openly in the market. What survived was therefore skewed to predominantly positive views. Proof: According to Bloomberg broker forecasts, on 1 November 2017 (a month before Steinhoff's collapse) of the 11 published broker recommendations, 7 were BUY recommendations and 4 were HOLD recommendations, with NO SELL recommendations at that date.

Questions to pose/ warning signs to look for:

- How balanced is the range of published recommendations on the stock – is there an excessive number of buys?
- Does management quieten and dismiss difficult questions in public forums?
- Is there a record of analysts being excluded from company events; or being pressured for retractions in publishing adverse views on the company

Using hindsight to improve foresight

Given the failure itself cannot be fully reversed, the next best thing that should come out of the Steinhoff fiasco and loss suffered is to ensure we use these costly lessons to identify future problematic investments and avoid or cure them before they result in potentially permanent losses for clients.

While perhaps none of the features we have identified above could have, in isolation, pointed to something specifically untoward in Steinhoff, it's the messy cocktail of having them all present in one company that significantly heightened its inherent risk.

We concede the very nature of investing has components of risk and uncertainty. Uncertainty we expect in virtually every investment, for it is the nature of assumptions and future expectations. It is risk that we truly want to grasp – most particularly the risk for permanent loss of capital.

When all is said and done, for ultimate savers some of the most important takeaways from the Steinhoff story are that no company is too big to fail; no high profile shareholder is too wealthy to necessarily know better; and no institutional investor is too large or historically successful and trusted to ensure an avoidance of major investment mistakes.

Investing is not simply an endeavour of complex financial models, accurate forecasting and detailed investment analysis but it requires the judgement to discern when and why even the most orchestrated of outcomes, simply doesn't add up.

We hope the South African investment value chain never has to see an investment failure of the size and extent of Steinhoff again; and we hope in part this will be because we will all actually see it coming.

YOU HAVE TO KNOW ACCOUNTING'S LIMITATIONS

Lonwabo Maqubela
Portfolio Manager

"*Double-entry bookkeeping was a hell of an invention. Obviously, you have to know accounting. It's the language of practical business life. It was a very useful thing to deliver to civilization. I have heard it came to civilization through Venice, which of course was once the great commercial power in the Mediterranean. However, double entry bookkeeping was a hell of an invention. And it's not that hard to understand. But you have to know accounting's limitations...*"

Charlie Munger

Earnings matter

Fundamental investors use earnings and/or cash flow to establish what companies are worth. Momentum investors tend to focus on potential earnings' surprises in making investment decisions. However, as we know and in the words of Charlie Munger, accounting has limitations. In order to adjust for these limitations, investors can and should use cash generation to gauge true earnings. However, even this can be subject to anomalies, although to a lower degree and certainly not over long periods.

Earnings seasons always reveal interesting accounting treatment

Table 1 below shows real-life recent examples where we have observed "interesting" accounting treatment.

Table 1: Examples of "interesting" accounting treatment

1. A domestic industrial group reported earnings that were better than expected. The improved earnings were attributable to a lower depreciation charge. This was because the company lengthened the estimate of its assets' useful life. We have seen this accounting gimmick a few times too many.	**3. Over the last few years, a domestic life insurer has recognised some R1.2bn in additional value by lengthening the modelling term for its existing policies.** Whilst this is not significant relative to the insurers' Embedded Value (EV), it is in the context of other aggressive accounting policies.
2. Another diversified industrial group (until June 2017) used to report both headline and core headline earnings. Core headline earnings were 10% higher. The difference was due to acquisitions and related depreciation of intangible assets. The industrial group is a serial acquirer of businesses. Consequently, the acquisition related costs were core. We note that for its latest results to December 2017, the company has stopped reporting core earnings.	**4. A domestic food retailer with exposure to Africa reported profits that were stronger than expected in 2016.** This retailer benefited from very high inflation in its key markets. The exchange rates used to repatriate these earnings are pegged to the US dollar. These exchange rates were artificially too strong and were not reflective of true conditions. As a result, this retailer showed extraordinary earnings growth in 2016. However, having created a high base, coupled with depreciating exchange rates, this retailer was unable to match this demanding base in its 2017 results.

Sometimes it's the fault of the accounting standard

Sometimes, it is a weakness in the accounting standard which results in distorted earnings, as opposed to management's interpretation of it. Below are some examples of this:

1. To capitalise or expense?

Under US Generally Accepted Accounting Principle (GAAP), companies are required to expense Research and Development (R&D) in the year in which they incur it. International Financial Reporting Standards (IFRS), which we use in South Africa, allows companies some leeway in that the company can capitalise R&D if they can prove that some value is recoverable in future years and to expense it in those future years. This means that if we consider the same company, the R&D amount expensed under US GAAP and IFRS is likely to be very different. Consider Qualcomm[1] as an example. Qualcomm is a US semiconductor and telecommunications equipment company that designs and markets wireless products and services. Its chip designs are dominant in much of the wireless technology behind smartphones and tablets.

Qualcomm's market capitalisation is around \$80bn and it earns \$6bn p.a. As per US GAAP, it expenses \$5bn's worth of R&D annually. This R&D expense equates to nearly 70% of the company's profits and 20% of revenue! Clearly this R&D will be of value for years to come and expensing it all at once results in an understatement of the company's earning.

In addition, Qualcomm has assets worth \$50bn on its balance sheet. On the face of it, Qualcomm generates a return on assets of 12%. However, \$30bn of the \$50bn comprises cash and marketable securities. So, it is on the remaining \$20bn of assets that Qualcomm generates \$6bn of profits! This results in a return on assets is 30%. Clearly, this is a case of the company's true assets being under-recognised by accounting standards. Qualcomm's real assets are its intellectual property and US GAAP requires that this asset is immediately expensed.

These earnings are clearly depressed if one considers the accounting policies. Qualcomm's share price trades on 14x its earnings. We consider these earnings to be understated.

2. Relying on management judgement and changes to accounting policies

The International Accounting Standards Board introduced IFRS 39 in 2005. This standard dealt with accounting for financial instruments. This included financial assets arising from contractual arrangements such as debtors. Determining when and how to recognise bad debts is amongst the most subjective exercises in accounting. IFRS 39 removed this subjectivity moving away from companies using the expected loss in the financial year to the actual incurred loss.

Simply put, when expensing bad debts, the credit provider was required to reflect only losses they had incurred at reporting date. Prior to this standard, credit providers tended to use an expected loss. The introduction of the IFRS 39 standard created much uncertainty in the banking community. The reality of IFRS 39 was that banks reporting lower than average bad debts during the good times and considerably higher bad debts during the bad times (case in point financial crisis). In other words, this led to an increased cyclicality of earnings – which is something both investors and regulators both dislike.

In January 2019, IFRS 9 will replace IFRS 39. Accounting treatment will essentially revert to the expected loss method. Due to IFRS 9, four of the top five South African banks (excluding FirstRand) estimate that they will have to adjust their book values down by approximately R13bn over the next few years. In addition, future bad debt provisions should be less cyclical.

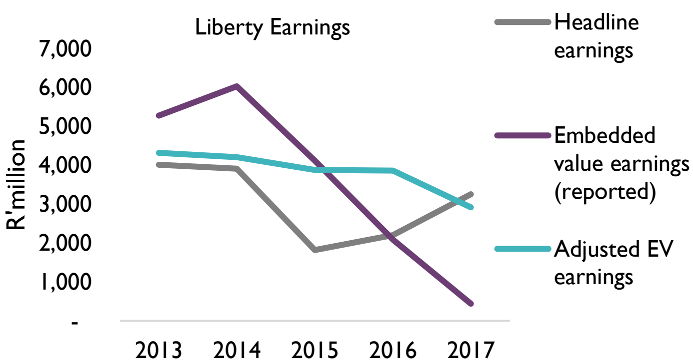
3. An attempt for accuracy hides true reflection of operations

To improve accuracy, some accounting standards have resulted in it being more difficult to assess how well an organisation's operations are actually performing. This is best illustrated with the fair value adjustments required under IFRS. Insurance companies are required to report Headline earnings. However, these earnings can be materially impacted by market returns. This is commonly known by fundamental investors. Insurance companies are also required to report embedded value profits (EV earnings). These are more reflective of the underlying performance of the business. However, this still has imperfections. Internally we prefer to focus on adjusted

[1] Qualcomm is an American multinational semiconductor and telecommunications equipment company.

embedded value earnings. Below we illustrate how Liberty's headline, embedded value, and adjusted embedded value earnings have fluctuated and differed over the last five years.

Figure 1 Liberty headline versus embedded value earnings



Source: Bloomberg

The adjusted embedded value earnings are less volatile. The accounting treatment for EV earnings is accurate. The reason for differences between embedded value earnings and adjusted embedded value earnings are a function of the following practises:

1. Actual experience will differ from the assumptions used by actuaries, for example people may live longer than expected. This will result in a difference between the expected profit on a policy when it is written versus the expected profit given new experience. This benefit however cannot continue indefinitely, hence we adjust for it.
2. Actuaries may also decide to make changes to the model if they deem experience changes to be of a permanent nature. This will have a once-off effect on earnings.
3. EV earnings allow for actual investment returns generated as opposed to the returns used in the model. These can differ substantially from year to year. Clearly sustainable earnings should be adjusted to be more reflective of normalised expectations as opposed to the gyrations that result from financial markets.
4. Life companies are required to fair value their non-life insurance businesses such as their asset management businesses. Changes to these valuations are reflected in embedded value earnings. In any single year there may be significant changes to that fair value.

These adjustments need to be considered when estimating the sustainable embedded value earnings of an insurer rather than using the reported embedded value earnings.

The market needs to pay more attention to the limitations of accounting

The market dislikes earnings volatility. The accounting treatments mentioned in the article, often result in share price changes that are not reflective of the business' sustainable earnings. This creates opportunities who seek to understand the fundamentals.

There are many examples that we could use to highlight flaws with current accounting treatments.

However, in some cases, alternatives would not result in significantly better outcomes. At Perpetua, when valuing companies, we:

1. Seek to normalise earnings for all the anomalies that we can quantify, given the inherent nature of the company and industry in which it operates.
2. Apply the company's free cash flow generation factor to the earnings to determine an appropriate multiple to apply to those company's earnings.
3. Augment our valuations with other valuation methodologies.
4. Require a margin of safety before we invest.

Through these actions we believe we can materially adjust for accounting's limitations. In the short term, the market does not pay attention to these anomalies. However, over longer periods, the failure to generate cash eventually catches up with the company.

Should you have any feedback or queries regarding this commentary please contact **mahesh@perpetua.co.za**