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ECONOMIC OVERVIEW AND OUTLOOK JOHANN ELS	4
INVESTING WELL IN TIMES OF ABUNDANCE AND SCARCITY ZUKISA PITYANA	8
SOUTH AFRICA FROM A GLOBAL INVESTOR'S PERSPECTIVE URVESH DESAI	14
ATTRACTING LONG-TERM PRIVATE EQUITY OPPORTUNITIES CHUMANI KULA	18
OPENING THE DOORS OF LEARNING IN SOUTH AFRICA KELLY JOSHUA	20







ECONOMIC OVERVIEW AND OUTLOOK

JOHANN ELS | CHIEF ECONOMIST

ABOUT THE AUTHOR

As Chief Economist, Johann is responsible for all local and global macroeconomic research. Specific focus areas include the rand, inflation, interest rates and fiscal matters.

KEY TAKEOUTS

- THE IMPACT OF THE PROLONGED AND RAPIDLY ESCALATING TRADE WAR HAS DAMPENED THE GLOBAL ECONOMY.
- EFFORTS TO STABILISE BUSINESS SENTIMENT HAVE RESULTED IN POLICY EASING BY CENTRAL BANKS ACROSS THE GLOBE.
- THE WEAKER-THAN-EXPECTED LOCAL ECONOMY HAS MEANT A HUGE GAP IN NATIONAL TREASURY'S TAX REVENUE.
- POSITIVE LOCAL GDP GROWTH IS EXPECTED IN THE NEXT FIVE YEARS.



GLOBAL ECONOMY

It may not be quite accurate to describe the third quarter of 2019 as dismal, at least not as far as the global economy is concerned. However, for a South African thinking back to the confluence of global and local bad news over the past quarter, that description is probably spot on. While global events certainly contributed to this significantly depressed sentiment, it has not been quite as downbeat as in South Africa.

The global economy can no longer be expected to be “more balanced and more synchronised” as per my base case outlook at the start of the year. The impact of the prolonged and rapidly escalating trade war (based on the rhetoric during the past few months) put an end to that expectation. As we discussed previously, the actual higher trade tariffs have a relatively limited impact on growth. It is rather the damage to business sentiment that hurts growth through lower business spending. It seems the impact on goods producing industries (manufacturing purchasing manager indices (PMIs) having slipped substantially) has started to spill over into slower job growth. Now, while this is risky for the outlook – as it could impact on consumer spending – at least it also seems that manufacturing output is stabilising at these lower levels, rather than weakening further.

One factor helping to stabilise business sentiment has been the further policy easing by central banks across the globe. The second quarter saw an easing policy bias steadily building across the world and this trend extended to more rate cuts in the third quarter. There have now been 31 rate cuts since April – with 22 of those in the third quarter. These include multiple cuts in some countries, namely Australia, New Zealand, India, the Philippines, Indonesia, Brazil and Chile. Apart from the two cuts in the USA, the European Central Bank also cut rates deeper into negative territory and restarted their QE policy. While China has not yet cut the main policy interest rate, some interest rate liberalisation and reserve ratio requirement rate cuts have been added to some fiscal easing to support the economy.

A large part of this policy action – at least in terms of messaging – was the two rate cuts in the USA. While the Federal Reserve Board (the Fed) initially labelled their July interest rate cut a “mid-cycle policy adjustment” and “not the start of an easing cycle”, the evolving data and events through the third quarter changed this in the minds of the members of the Federal Open Market Committee (FOMC) and they cut rates again in September. Another cut is likely before the end of this year, while incoming economic data and events around the trade war will determine if there will be further cuts.

While easier policy will certainly help the global economy, it will not be enough on its own to engineer a stronger economic recovery. Confidence will only recover sufficiently once the trade war has been resolved. Despite the volatile messaging around the trade war, it still seems that both sides want a deal.

Outlook for the global economy: Recession risks have heightened over the past quarter, but a recession is still unlikely. Ongoing policy support should help to stabilise sentiment and growth prospects. However, a trade deal is needed to lift growth prospects.

SA ECONOMY

As I hinted at in the first paragraph of this overview, most South Africans have probably felt a lot of despair recently. Not only has the world economy become riskier – as a reminder, it's very difficult for South Africa to do well when the global economy is not supportive – but local events have not exactly turned out the way we would have wanted. In fact, most local events have been downright nasty.

Many of us assumed – perhaps unrealistically – that policy reform would happen far quicker after the May elections than has been the case. In actuality, we have not seen any significant structural policy adjustment. On the contrary, most policy changes have been perceived as negative – i.e. the National Health Insurance scheme, debt relief regulations and the prescribed asset talks come to mind.

The weaker-than-expected economy has also meant a huge gap in National Treasury's tax revenue, while the financial challenges at Eskom were found to be bigger than even the worst-case scenarios and therefore needed even more money from Treasury to survive. Consequently, the outlook for the budget deficit is now significantly worse than expected. A deficit of around 6% of GDP is now likely as opposed to the 4.5% estimated at the time of the February Budget.

This, combined with the lack of growth-enhancing policies and no news on a restructuring plan for Eskom and its debt, has raised fears that Moody's could potentially downgrade its outlook statement from stable to negative this November. Equities, bonds, the rand and business confidence seem to have priced a large portion of these risks.

There has been some positive news – albeit mostly obscured by the bad. This includes a stronger-than-expected rebound in the second quarter GDP growth; a rate cut by the South African Reserve Bank (SARB) in July; the publication of Treasury's economic plan to lift growth (while not implemented yet, it has crucially restarted the policy debate); Treasury's instruction to government departments to cut expenditure in the medium-term expenditure plans by 5% in 2020/21, 6% in 2021/22 and 7% in 2022/23; stronger mortgage credit

extended to households over the last few months; continued strong car exports; a stronger leading indicator in the latest reading; some early indications of a tentative profit growth recovery in the manufacturing, finance and retail sectors and the latest wholesale sales data, which could perhaps indicate some early signs of inventory rebuilding.

We should also not forget that the slow process of rebuilding the state under the new administration, the corruption fight and the strengthening of SA's institutions are ongoing. The lights have remained on over the last several months, growth has picked up from the dismal first quarter, inflation remains low and interest rates could potentially be lowered again later this year. So, despite all the despair and uncertainty, I still believe the "Winds of Change" investment theme is on track. Thus, the next five years are very likely to be better than the past five (average growth from 2015 to 2019 will end up at less than 1% per annum). While we are unlikely to experience the 5.2% average annual growth SA registered from 2004 to 2007 again anytime soon, a more sustainable growth uplift towards 2.5% (even 3%) is very likely by 2022/2023.

Inflation remains muted, with almost no evidence of second-round price pressures despite significant cost increases in areas such as electricity and petrol. A

more dovish global monetary policy stance, combined with local growth downside surprises and muted inflation, has led to an easier policy stance at the SARB and they duly cut rates in July (a reversal of the policy error that was the November 2018 rate hike). The Bank did not cut rates at the September policy meeting due to the risks around Eskom, the Budget and a potential Moody's outlook change. Should these risks unfold in a positive manner, a rate cut in November seems likely.

Outlook for the SA economy:

While a general sense of despair has set in over the last few months, I still believe that the renewal and rebuilding of the state, the corruption fight, the strengthening of SA's institutions, the policy debate and other smaller changes will gather momentum and get some traction with respect to building confidence and lifting growth. Given all the changes of the last 20 months, I expect the next five years to be better than the past five.





INVESTING WELL IN TIMES OF ABUNDANCE AND SCARCITY

ZUKISA PITYANA | ANALYST

ABOUT THE AUTHOR

Zukisa focuses his analysis on shares in the industrial sector. He gained experience at several distinguished South African corporates including AngloGold, Ernst & Young, SCAW South Africa, MMI Holdings, and Nozala Investments.

KEY TAKEOUTS

- THE SOUTH AFRICAN CONSTRUCTION SECTOR HAS EXPERIENCED SOME HIGHS AND, MORE RECENTLY, BUSINESS RESCUE LOWS.
- SOUTH AFRICAN CONSTRUCTION BOOMED IN THE 1970S WHEN NEW POWER STATIONS AND THE JOHANNESBURG CBD WERE GROWING ON THE BACK OF CONSISTENT 7% GDP GROWTH.
- WBHO – THE LAST MAN STANDING – IS THE BIGGEST WINNER IN A TOUGH OPERATING ENVIRONMENT BEGINNING TO SHOW SIGNS OF A BRIGHTER ECONOMIC FUTURE.





The story of Joseph in Egypt and of the seven fat and the seven lean years has passed into the homely wisdom of the ages; but our economic thinking seems to have lost contact with so simple and basic (an) approach to prudent management of a nation's welfare.
— Benjamin Graham



In the story Benjamin Graham refers to above, Joseph predicted seven years of abundance followed by seven years of famine. The story of the South African construction industry is similar, not in predictability but in cyclicity. The South African construction sector has experienced some untouchable highs (fat years) and, more recently, business rescue lows

(lean years). Joseph advised the Pharaoh to be prudent during the years of abundance and save a portion in order to have something in the years of famine. In the SA construction industry, there's only one company that follows this advice – Wilson Bayly Holmes-Ovcon (WBHO).

THE HISTORY OF THE SOUTH AFRICAN CONSTRUCTION SECTOR

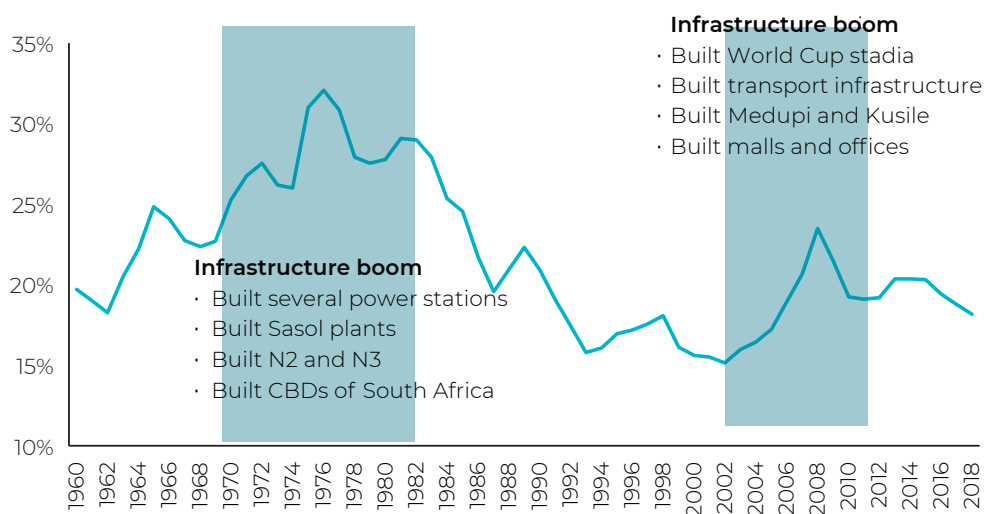
South African construction boomed in the 1970s when the power producers were building new power stations and the Johannesburg Central Business District (CBD) was growing on the back of consistent 7% Gross Domestic Product (GDP) growth. It marked the South African adoption of high-rise towers after the Johannesburg city council approved additional height on qualifying buildings. This is a period that gave birth to many

construction companies, one of which being Wilson-Holmes, in 1970 founded by John Wilson and Brian Holmes. The lean years followed as South Africa transitioned from apartheid to a democratic South Africa. A reduction in government spending and the suspension of building new power stations saw limited growth in the industry, and capacity reduction.

The next boom, over the period of 2003 to 2010, was driven by the mining super-cycle; World Cup stadia building projects; improving transport systems; and the construction of Medupi and Kusile power stations. Given the limited capacity, construction businesses enjoyed high margins and volumes with sizeable order books.

The economically stunted years that characterised the Jacob Zuma administration followed

SOUTH AFRICA: GROSS FIXED CAPITAL FORMATION AS A % OF SALES



Sources: World Bank, OME Research

and had an adverse influence on the abundance the sector previously enjoyed. Subsequently, the larger companies went on a quest for growth and opportunities beyond the borders of South Africa.

THE OPPORTUNITY – LAST MAN STANDING

The analogy displays an important economic lesson of saving, where at the end of the years of abundance, Joseph’s advice to store crops during the years of abundance paid off. Egypt stored enough to supply its own citizens and even sell to other nations that weren’t as prudent during their years of abundance. In the same vein, listed construction companies have since sold their building and infrastructure businesses, like Murray & Roberts, or gone into business rescue much like Group Five and Basil Read. At the end of it all – the peaks and troughs in the sector – the net beneficiary of these exits has evidently been WBHO, who we see as the last man standing. The biggest winner in a tough operating environment that is beginning to show light of a brighter economic future, compared to the lean Jacob Zuma years.

A BRIGHTER ECONOMIC FUTURE

Since President Cyril Ramaphosa took office and set the tone with a call to South Africa to “thuma

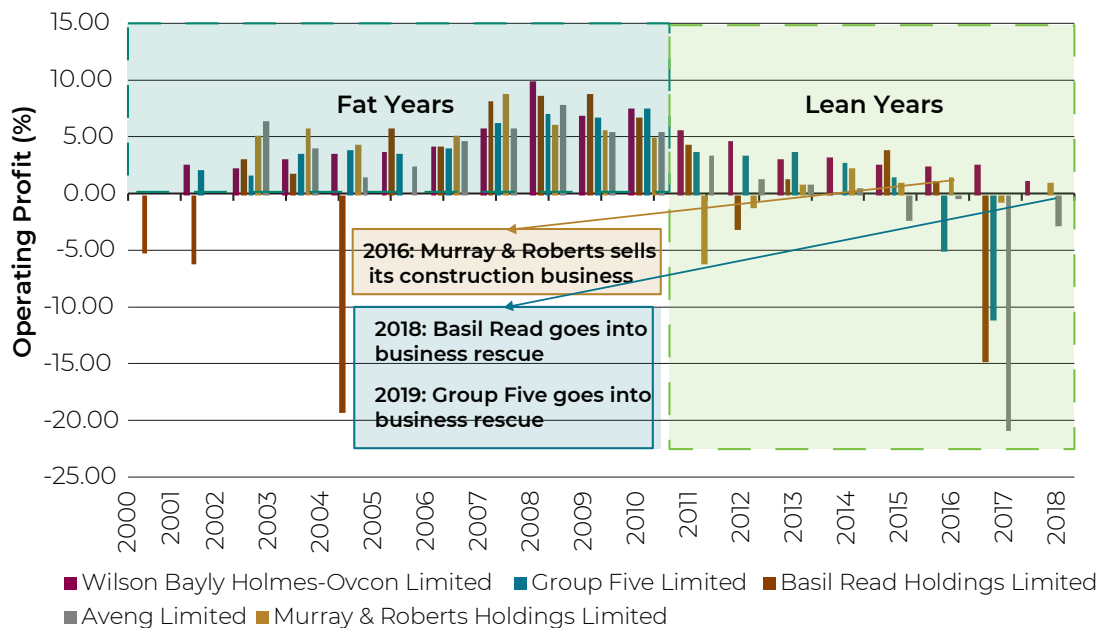
mina”, he has followed through with some decisive action over the past 18 months. Notably, replacing the boards of several state-owned enterprises (SOEs) – a subject of disgruntlement expressed by many. From a construction perspective, these actions are only beginning to bear fruit now.

Unfortunately, construction is not a discipline that generates money overnight. It can take more than a year before the first brick is laid for a building project. Before a contractor is invited to bid for the work a list of requirements is fulfilled – procedures and approvals; architect designs; structural designs from civil engineers; electrical designs from electrical engineers; and plumbing designs – all submitted to council for approval. Small-scale projects with fewer stakeholders undergo less regulation compared to larger, infrastructure-related projects that often have longer lead times.

TENDER REFORM BOOSTING SA CONSTRUCTION ACTIVITY

The recent reviews of the procurement policies and budget tightening appear to be in final stages as SOEs start inviting contractors to tender for strategic projects.

PROFITABILITY OF LISTED SA CONSTRUCTION



Sources: FactSet and OME Research

The South African Roads Agency (SANRAL), who had issues with National Treasury around the much-contested e-tolls in Gauteng and procurement policies, is inviting contractors to tender for the N2 and N3 expansion valued at more than R28 billion – of which R8.3 billion is out for tender. The Civil Industry Development Board (CIDB) is a body where private sector and state-owned entities register projects above R200 000 and R10 million, respectively. The CIDB has different grades, which allows contractors to bid for tenders of a certain quantum, based on certain criteria. To promote transformation and to accommodate the lower grade CIDB contractors, road maintenance projects are being divided into smaller pieces. To bid for a tender upwards of R120 million, a contractor is required to be a registered CIDB grade 9. Two companies we own, WBHO and Raubex, are part of a select few with grade 9 capability and strong balance sheets for large contracts like the N2 and N3 expansion.

The Airports Company South Africa (ACSA) has invited contractors to tender for approximately R5 billion for the following three projects – Cape Town International Airport realignment of a runway; renovation of the Cape Town International Airport International

terminal; and the temporary relocation of the Cape Town International Airport International terminal.

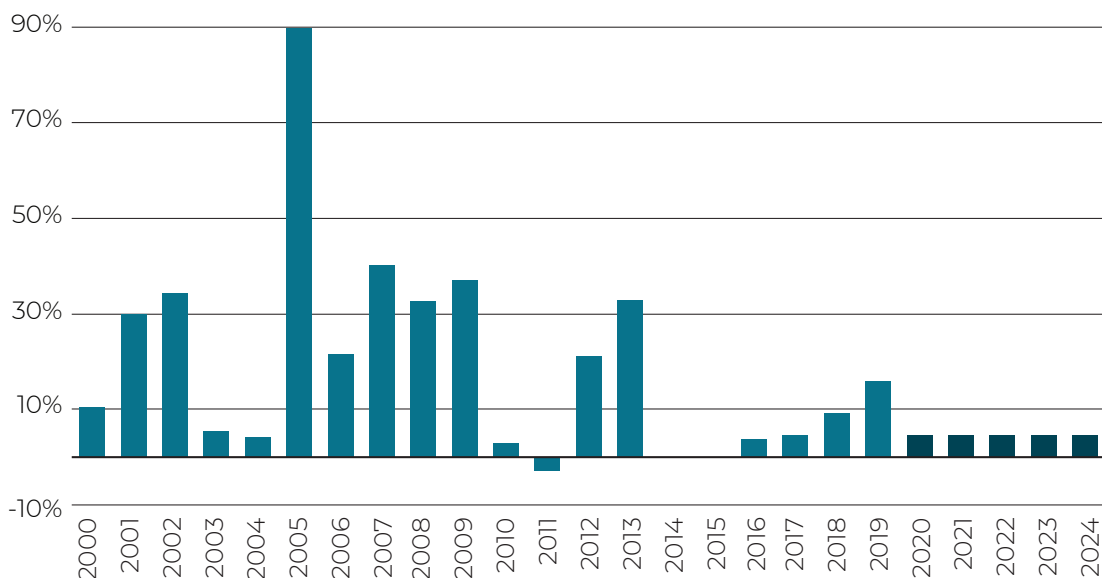
Lastly, Transnet is inviting contractors to re-tender for the expansion of the Durban port terminal valued at R5 billion after the tender award was challenged and overturned. Eskom requires new ash dams valued at R900m each.

WHY ARE WE INVESTING CLIENT CAPITAL IN WBHO?

The opportunity to buy a competitive company like WBHO at attractive valuations doesn't often avail itself. We flagged WBHO because of the dramatic sell-off triggered by losses made by the newly acquired businesses in the United Kingdom (UK) – Byrne Group and Russell Construction – and a AU\$50 million loss provision for one of their projects in Australia. The drop may be pronounced by the trend of construction firms going into business rescue. We built our position in WBHO at an average price of R118 per share and we have already seen some positive returns since investing.

Part of our investment process is to understand what the market price implies and if there is merit to the consensus point of view. The price after the sell-off

SALES GROWTH



Source: HOLT

implied the following, in our view, unlikely factors:

- Below-inflation sales growth (suggesting that the number of contracts WBHO wins would decline consistently);
- An earnings before interest, tax, depreciation and amortisation (EBITDA) margin falling to 2%;
- A return on investment that fails to beat its cost of capital in perpetuity; and
- A cut or suspension of the dividend.

BELOW-INFLATION SALES GROWTH

Through a long-term lens, the South African business cycle is at a low point. The closing of SANRAL, among other SOE taps, meant that the short-term issues were not structural as projects start to emerge from SOEs across the board. We assume an inflation figure of 5% in the medium term; therefore, to expect sales to grow below inflation implies a weaker order book going forward. We view this as unlikely.

FALLING EBITDA MARGIN

EBITDA is a calculation we use to measure profitability of a company from an operations perspective, before taking into account any capital related income and expenses. It gives us a sense of the operational health of a business. To have WBHO's

EBITDA margin drop down to 2% (the lowest it has ever been) consistently over five years implies the losses made in Australia and the UK would persist over the medium term. The meticulous and cautious culture that WBHO leverages in South Africa to negotiate contracts makes this view further unlikely. It is, however, reasonable to assume that contractors will price competitively at the expense of profitability in the short term following the drought; but it quickly becomes unsustainable for low margin construction businesses if this pricing strategy is employed longer than it should.

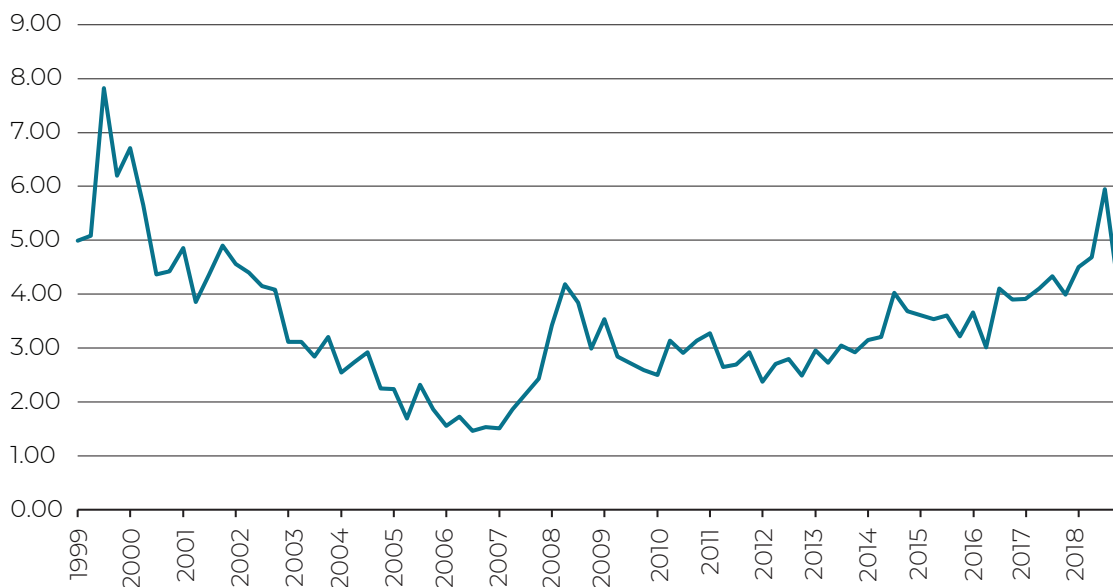
BELOW COST OF CAPITAL RETURN ON INVESTMENT

WBHO has had a cash return above cost of capital, over the last 10 years. There are very few companies globally that achieve these returns, regardless of industry. During the same period, the average construction company has been a cost of capital business at best. Effectively, if WBHO falls into a space where it becomes a typical construction company at global standard returns, it would at least get back to cost of capital status.

DIVIDEND AT RISK

We also consider the dividend yield measure – an estimation of the return the company generates –

WBHO – DIVIDEND YIELD – NEXT TWELVE MONTHS

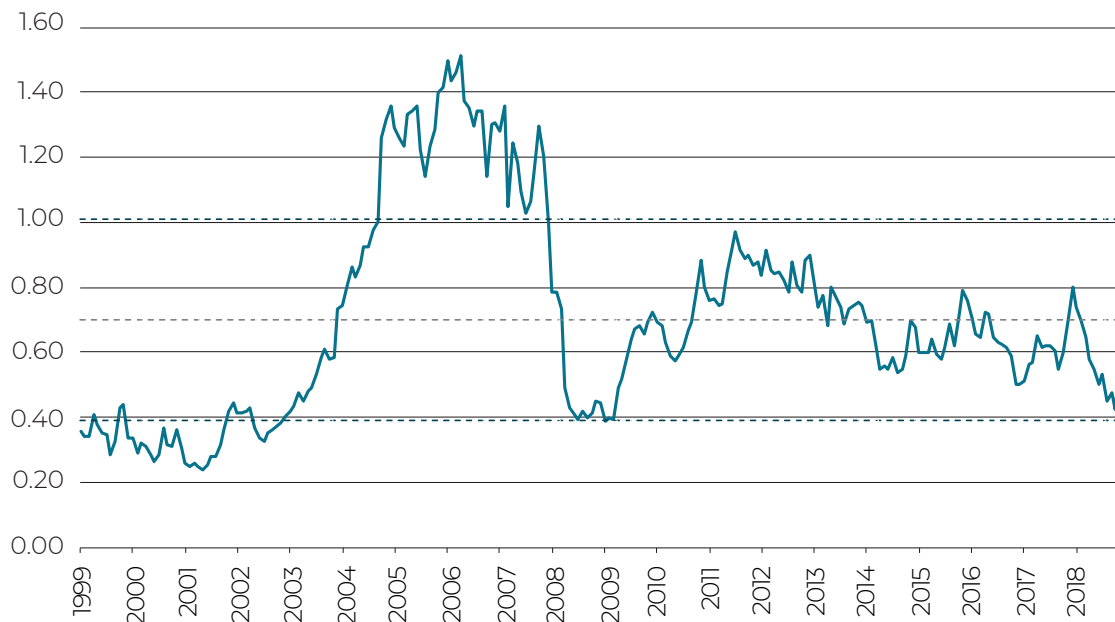


Source: FactSet

assuming a dividend-only return. High dividend yields often imply that the business will grow less. Given WBHO's investments in the UK and strategy to grow in Australia, the idea of less growth than the last 10 years comes across as unreasonable, more so given the unique "last man standing" position in the South African large project environment. A high yield can also imply that the dividend is unsustainable and is likely to be reduced or suspended at the next reported results. WBHO, at the time, had over R5 billion cash reserves and low financial gearing, which made the idea of a dividend reduction or suspension unlikely.

Finally, WBHO looked cheap relative to its peer group, trading at a discount on a price earnings (P/E) basis relative to its historic performance. WBHO, being a best-in-class construction company, has room to command a premium to its peers and has had better financial leverage and a higher cash generation ability in recent times.

WBHO PE RELATIVE TO PEERS (NTM)



Source: FactSet

CONCLUSION

We believe in cycles and seeing the turnaround point of a cycle during the lean years is difficult. Our in-house economic view is that the South African construction industry has been moving backwards for the last few years and that there will be more investment over the next three years. The outlook of a better future, supported by a marginal improvement in GDP, suggests that we're moving out of the years of famine. We built our position in WBHO after the sell-off, with the view that there are noticeably few competitors in the league of WBHO who have a prudent management culture and a strong balance sheet, and this encourages our view to remain invested in this company. The attractive absolute and relative valuation made WBHO a glaring buy from our perspective. We look forward to "abundant" returns for our clients.



SOUTH AFRICA FROM A GLOBAL INVESTOR'S PERSPECTIVE

URVESH DESAI | PORTFOLIO MANAGER

ABOUT THE AUTHOR

Urvesh contributes to MacroSolutions' overall investment strategy, having been with MacroSolutions since its inception honing his primary focus – the boutique's global capabilities.

KEY TAKEOUTS



- THE RATE OF CHANGE CAN BE AS IMPORTANT AS THE LEVEL – WE EXPECT SOUTH AFRICA'S ECONOMIC GROWTH GOING FORWARD TO BE BETTER THAN IT HAS BEEN MORE RECENTLY.
- IF A COUNTRY BORROWS TOO MUCH, IT CAN BECOME TRAPPED IN A DEBT SPIRAL WHERE IT DOES NOT HAVE THE GROWTH (AND HENCE THE REVENUE) TO PAY BACK THAT DEBT.
- SOUTH AFRICA NEEDS TO AVOID LARGE DEFICITS AND THIS IS WHY OUR ABILITY TO GROW THE ECONOMY THROUGH GOVERNMENT SPENDING IS SEVERELY CONSTRAINED.
- WE NEED TO ENTICE FOREIGNERS TO INVEST IN OUR HIGHER-YIELDING FIXED INTEREST INSTRUMENTS, TO MITIGATE A POTENTIALLY WEAKER CURRENCY.

SOUTH AFRICA FROM A GLOBAL INVESTOR'S PERSPECTIVE

At MacroSolutions, we often say perspective is important. Having the right perspective can mean the difference between making an informed decision – and a mistake. It's with this in mind, that I thought it would be good to look at South Africa (SA) from the perspective of a global investor. Living here, being absorbed in the day-to-day noise, it's easy to forget that SA does not exist in a vacuum. Like the old saying – it's difficult to see the wood for the trees, especially when you're standing in the middle of the forest.

GROWTH: A BETTER TRAJECTORY ON THE HORIZON

It's no secret that SA has gone through a challenging period in terms of economic growth. Whether comparing us to

emerging markets (traditionally our peers) or developed markets, by comparison our growth has been decidedly lacklustre. Over the 10 years to 2018, the average calendar year real GDP growth of SA has been 1.5%. The only countries with a lower average growth rate than that have been Greece, Russia, Argentina and Brazil – all of whom have been through a major economic crisis in that 10-year period. Even when one leaves out heavyweights like India and China and the fast-growing ASEAN (Association of Southeast Asian Nations) bloc, the more "developed" emerging markets like Taiwan and South Korea managed to achieve growth of around 3% over this period. Clearly, SA has not been a high growth economy. While it may be tempting to have this lead one to despair, it's important to remember that the rate of change can be as important as the level. We expect SA's economic growth going forward to be better than



it has been more recently – and this contributes partially to our thinking on the SA Winds of Change theme you would have heard about from MacroSolutions.

BUDGETARY CONSTRAINTS AND FISCAL POLICY

We have heard ad nauseam in the media, how critical the constraints are on SA's government spending, especially given the risks that state-owned enterprises (SOEs) in general and Eskom in particular have presented. As of 2018, SA's budget deficit stood at 4.5% of GDP. Not many countries in the

emerging markets (EM) space had a worse situation than this, with a key exception being Brazil – which stood at 7.1%. The risk of running large budget deficits is the potentially unsustainable need to borrow in order to fund expenditure. If a country borrows too much, it can become trapped in a debt spiral where it does not have the growth (and hence revenue) to pay back that debt. The result is ever higher borrowing costs for the government, a weaker currency and usually much higher interest rates – all of which lead back to much lower

growth, and so the vicious circle continues. This is why SA needs to avoid large deficits and this is why our ability to grow the economy through government spending is severely constrained.

MONETARY POLICY: IN LINE WITH EMERGING PEERS

In the event that fiscal policy is constrained, monetary policy (in the form of interest rates set by the SA Reserve Bank) is expected to do the heavy lifting. By cutting interest rates, private spending can be stimulated – and so grow the economy. We have had an

interest rate cut of 25 basis points in the last six months. Brazil, Russia and Turkey have cut interest rates by 100, 75 and 750 basis points (bps) respectively – all from much higher levels. Mexico has cut 50bps, India 85bps and the Philippines 75bps. Thailand, South Korea, Malaysia and Peru have also cut 25bps each. So SA does not distinguish itself in terms of the monetary stimulus being applied either.

EXTERNAL VULNERABILITY

There is, of course, good reason why the SA Reserve Bank (SARB) has not embarked on more aggressive interest rate cuts. SA's current account deficit – largely how much more we import than export goods and services – stood at 3.5% of GDP. More importantly, this has remained persistently negative over the

years – which means we have to rely on foreigners to fund our additional spending. This leaves the rand in a precarious spot – especially as it is so openly traded, it is used as a high beta proxy for global risk sentiment. Thus we need to entice foreigners to invest in our higher-yielding fixed interest instruments, to mitigate a potentially much weaker currency. This tight monetary policy is good for investors in SA bonds but less so for SA equity investors. In fact, SA stands out as very cheap relative to other countries from a fixed income and government bond perspective.

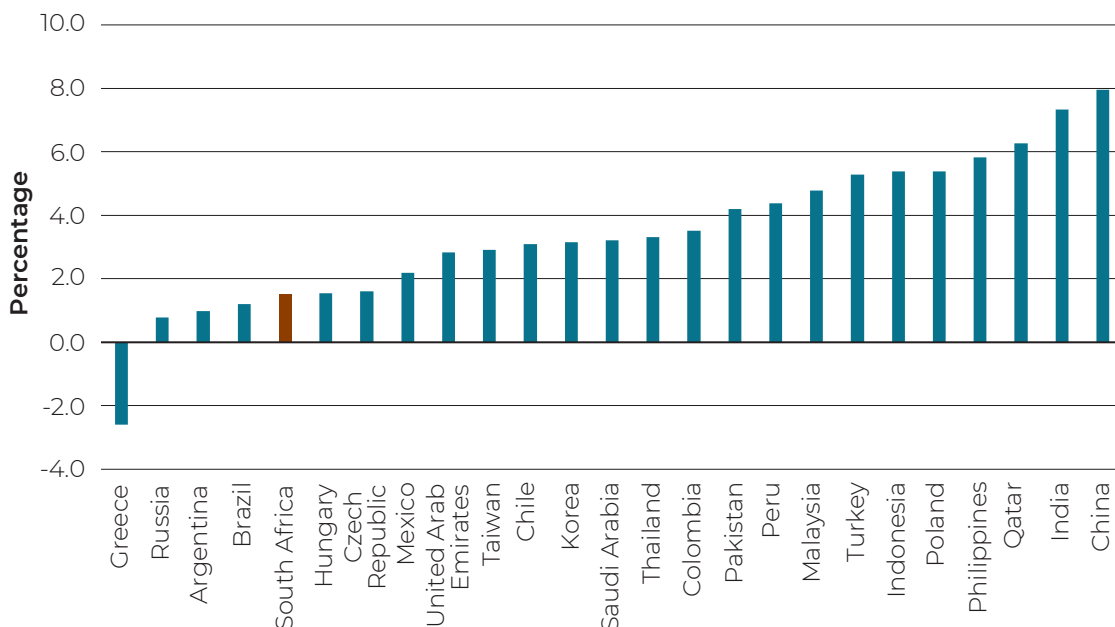
EQUITY MARKET

We therefore have an economic environment that is in no way distinguishing itself from global peers with significant constraints and vulnerabilities. However, economies and markets are

not the same – especially in SA. When we look at the market for SA, it is also important to realise that global investors see SA very differently to how local investors view our own market. This difference in view is typified by two equity indices for SA – the FTSE JSE Capped Shareholder Weighted Index (the index used by local investors) vs the MSCI SA Index (how global investors view the SA equity market).

On a valuation basis, MSCI SA is not in the bottom half of countries on a price-to-book basis and the market produces a return on equity that is lower than the global index average. Over the next 12 months, earnings growth in US dollar terms is forecast to exceed the global index average. However, due to the composition of this growth and the future path of the rand, there remains a lot

AVERAGE CALENDAR YEAR REAL GDP GROWTH OVER THE LAST 10 YEARS



Sources: FactSet, MacroSolutions

of uncertainty attached to this. Admittedly, this talks to aggregate data of many different companies. Nonetheless, it remains difficult to see how these attributes attract global investors.

THE EXAMPLE OF BRAZIL

Brazil has been mentioned earlier in this article. Brazil is an example of an emerging market country that faced very similar challenges to SA a few years ago – spiralling debt, which caused a currency crisis and a very deep recession. Brazil is now emerging from this and is embarking on a reform path that aims to cut its expenditure by making tough social funding choices, implementing labour reforms and privatising state enterprises. While on the same path as SA, it seems like Brazil is a few steps ahead. Combine this with interest rates that are coming down sharply

and a large relatively insulated domestic economy, this paints the picture of why we are overweight to Brazil – rather than SA – in MacroSolutions’ Global Macro Equity Fund.

In SA, on the other hand, we see the probable path of reform as just beginning. While the reforms are necessary to ensure long-term sustainable economic growth for SA, in the short term they are likely painful for growth. We therefore see the Winds of Change theme for SA as much more beneficial for our local fixed income assets than local equity. In fact, SA bonds are one of our most favoured asset classes in our balanced funds.

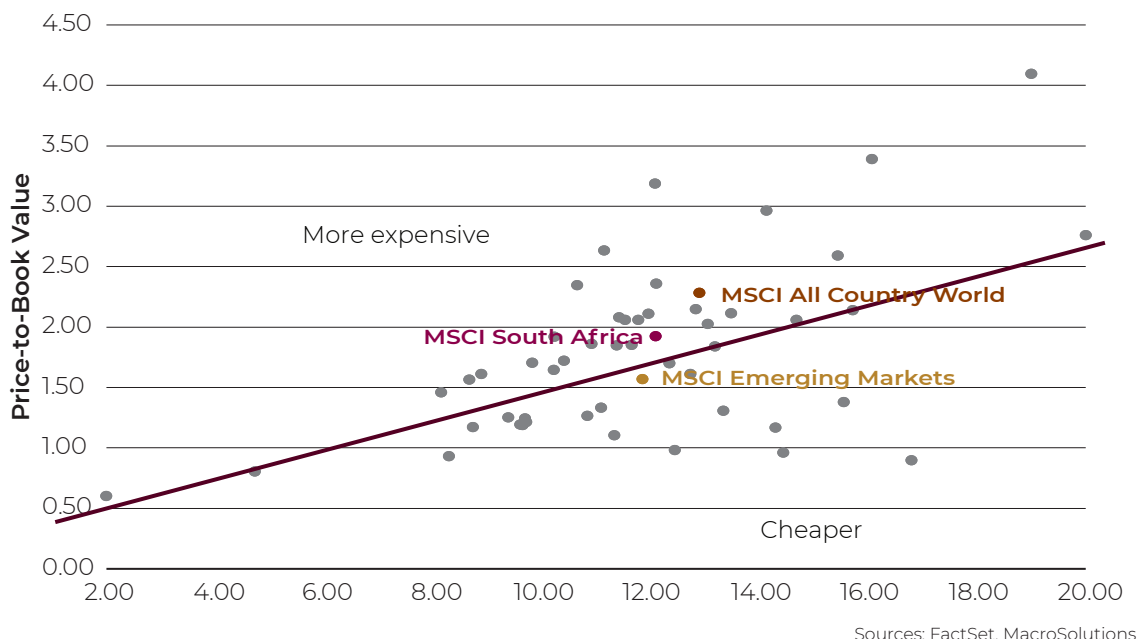
GLOBAL RISKS

It is also important to realise that SA (being a small economy with a very tradable currency) is often buffeted by the fortunes of the global economy. The

significant slowdown in global manufacturing brought about by the trade war started by President Trump in the US, has heightened the very real risk of a global recession unfolding. In this scenario, it is very unlikely that SA will emerge unscathed.

Although this makes for a challenging environment for SA investors, it’s in such times when sticking to long-term investment goals and incorporating appropriate diversification strategies in a portfolio are often the best investment strategies. As you’d expect to hear in a MacroSolutions article, a balanced fund is often the best place to balance risk in one’s investments. Here, you are able to navigate choppy waters guided by investment professionals at MacroSolutions.

RETURN ON EQUITY



ATTRACTING LONG-TERM PRIVATE EQUITY OPPORTUNITIES IN SOUTH AFRICA

CHUMANI KULA | CO-HEAD: OLD MUTUAL PRIVATE EQUITY

ABOUT THE AUTHOR

Chumani manages the investment process and strategic direction, also looking after the operational side of the private equity business. Currently serving on the boards of MoreCorp, Medhold, Footgear and Phembani.



KEY TAKEOUTS

- WE ARE OPTIMISTIC ABOUT THE LONG-TERM MARKET OPPORTUNITY IN PRIVATELY HELD COMPANIES, PARTICULARLY IN THE MID-MARKET SPACE.
- THE ULTIMATE TEST IS TO BE ABLE TO SUCCESSFULLY EXECUTE INVESTMENT STRATEGY REGARDLESS OF THE OPERATING ENVIRONMENT.
- THE MESSAGE WE ARE EMPHASISING TO INVESTORS IS THAT WE WILL CONTINUE WITH OUR PROVEN STRATEGY.
- THE ECONOMIC ENVIRONMENT IS RIPE FOR IMPROVEMENT AND WE EXPECT IT TO FARE BETTER OVER THE NEXT FIVE TO TEN YEARS, COMPARED TO THE LAST FIVE YEARS.



Old Mutual Private Equity (OMPE) is optimistic about the long-term market opportunity in privately held companies, particularly in the mid-market space. To this end, OMPE has recently fully deployed its fourth fund, the OMPE Fund IV – a 2014 vintage fund invested in eight high quality businesses, with five of eight businesses in the mid-market category. The fund has shown significant resilience in a very tough operating environment over the past five years, which have arguably been the toughest five years in South Africa since the advent of democracy. The ultimate test for any respected private equity manager is to be able to successfully execute its investment strategy regardless of the operating environment. In this context, we are pleased with OMPE Fund IV, which has been able to craft and build a fund comprising eight high quality investments (which represent our top eight ideas over the past five years), and has already realised one very successfully. OMPE Fund IV is now entering its harvesting phase over the next three years and we look forward to successfully delivering market-beating returns in a very tough market.

The OMPE Fund IV is fully deployed, now raising OMPE Fund V, which is targeting a financial commitment of approximately R5 billion, with its first close being 31 December 2019. The message we are emphasising to investors is that we will continue with our proven investment strategy utilised in the OMPE Fund IV. This involves focusing on proprietary and exclusive deal flow in the mid-market space on companies with strong management teams and market share growth strategies. In addition, including large buyouts that position us with a distinctive edge over other bidders. We believe the economic environment is ripe for improvement and we expect it to fare better over the next five to ten years compared to the last five years – further benefiting prospects for the OMPE Fund V.

Regardless of the environment, OMPE has a solid track record in delivering top-tier performance. Our experience has also taught us that it is in challenging operating times where astute investment decisions can unlock sizeable opportunities. Our recent investment in Footgear is one such example. Whilst

the retail space in general has been challenging, there are still pockets of opportunity. OMPE Fund IV backed the Footgear management team to acquire Edgars Active, which was deemed to be non-core to the broader Edcon Group. Edgars Active has doubled Footgear's store footprint, affording Footgear the opportunity to triple its store footprint instantly and replicate its winning formula across a much larger footprint at a fraction of the cost it would otherwise have incurred to roll out the footprint itself. The point is that this opportunity would perhaps not have been available in a seemingly better operating environment.

So yes, we are definitely pro SA for good reason – we believe there are significant and justified long-term market opportunities, particularly in the mid-market arena, which will benefit the OMPE Fund V in a more favourable economic environment. Nevertheless, regardless of what the future holds, the OMPE team has the experience, expertise and track record to deliver attractive returns on the OMPE Fund V, similar to its predecessor funds, where all four of them have been top performers in their vintages.



OPENING THE DOORS OF LEARNING IN SOUTH AFRICA

KELLY JOSHUA | INVESTMENT PROFESSIONAL

ABOUT THE AUTHOR

Kelly is responsible for originating and managing investments in the Schools and Education Investment Impact Fund (Schools Fund). She has 12 years of work experience in asset management, across both the listed and unlisted investment space.

KEY TAKEOUTS

- AFFORDABLE, QUALITY EDUCATION PLAYS A KEY ROLE IN ADDRESSING THE INEQUALITY IN SOUTH AFRICA.
- IMPACT INVESTING IS AN EFFECTIVE CHANNEL FOR THE PRIVATE SECTOR TO CONTRIBUTE TOWARDS ADDRESSING THE IMBALANCE IN THE EDUCATION SECTOR WHILE ACHIEVING A RISK-ADJUSTED RETURN ON THEIR INVESTMENT.
- PUPILS IN WELL-RESOURCED SCHOOLS, NO MATTER THE LOCATION, PERFORM WELL.



*K*elebogile lives in the sprawling township of Soshanguve. Since she started Grade R five years ago, she has been waking up at 3.30am to get picked up by a minibus at 4am to be dropped off at school in the Pretoria suburbs before 7am. And in the afternoons, the same minibus picked her up to have her home by 5pm. She hated that she couldn't stay after school to play any sports. And she always felt so tired before lunchtime – she always needed to refuel around that time to recover from her break-of-dawn start to the day. However, she knew her mother, a teacher herself, had worked hard to give her the best education possible. And until this year, that has meant a school over 30km away. Well, this year her life is different. She is now attending an affordable school right in Soshanguve, which means she now wakes up at 6am and still makes it to school at 7am. She has joined the netball team and drama class. She's even thinking of joining the robotics club – she loves technology and her science teacher is encouraging her to broaden her interest in it.

Due to the country's history, schooling in South Africa has provided vastly different experiences for different learners. The aforementioned snapshot is but one such experience; the deep inequalities carved by apartheid are still present. Where a child lives, even if the family has some resources, can create barriers to them receiving a worthy education. This is where independent, affordable schools can play a significant role.

RICH SCHOOL, POOR SCHOOL

The juxtaposition of “township schools” (historically black) against the former model C (historically white) schools, with their multiple sports fields, well-equipped laboratories and libraries, highlights the enduring infrastructure disparity in South Africa's education system. Many of the former often function in a state of disrepair, forcing those parents looking to provide quality education for their children to look towards the suburbs. The continued strong growth in the private education sector is being driven by, among others, population growth, growing demand from the emerging middle class, and a lack of capacity in existing schools and tertiary institutions.

Investing in affordable, quality schools located in areas that service previously disadvantaged communities can address much

of the building blocks for SA's inequality. For us to reach the inclusive society we strive for, we need to invest in all corners of our country. And given the scale of the country's education deficit, we must find and scale innovative and transformational models that bring excellence into the schooling system.

To address the education and infrastructure backlogs, and support improved education in South Africa, we have been investing in affordable, quality education since 2011, by raising and investing R1.4 billion through the country's first education impact fund, the School and Education Investment Impact Fund of South Africa (Schools Fund). In partnership with our school operators, the Schools Fund has committed itself to the “redress of past injustices in educational provision” by affording a quality school to those communities that have not had access previously.

WHAT OUR SCHOOLS FUND SCHOOLS DO:

- Provide learners with an affordable and a high-quality education
- Are dedicated to ensuring each learner's ongoing growth and development through the provision of a holistic approach to education
- Work harder, often employing extended day/extended year format of instruction, in order

- to change the trajectory of their learners' lives
- Prepare learners for higher education
- Are affordable, to provide low-income families with the opportunity to enrol learners.

These schools have been performing well. The 2018 matric pass rate of 94.4% compared favourably to the national average of 78.2% and the university exemption of 50.2% outperformed the national average by more than 16%. The results illustrate that schools in the townships that are well managed and adequately resourced perform better. Old Mutual Alternative Investments is currently raising its second education fund pursuant to the success of the Schools Fund. This will alleviate the growing education sector demand and continued shortcomings of public sector supply, and leverage the growing participation from the private sector to contribute towards addressing the imbalance in the sector. Its primary objective is to deliver sustainable investment returns while also providing investors with an opportunity to contribute towards making a positive social impact.

SEEDS OF CHANGE IN SOUTH AFRICAN EDUCATION

The picture of education in South Africa as it is unfolding on school grounds and in classrooms across the country, is complex, messy and often not easy to witness. What should give us hope for the potential of our children? Well, we believe to move through the current crisis in education, South Africa must adapt, adopt and scale workable models.

High-impact, value-for-money and quality-assured education offerings will increasingly be demanded in South Africa, especially given the tough economic climate and high unemployment rate in the country. Human capital theory argues that education should be viewed as investment (rather than consumption) which brings rates of return to individuals and societies. Societies that provide education for their members are able to develop their economies by having better prepared workers, and they reap social benefits as well in terms of healthier, more prosperous citizens. Investing in affordable, accessible and quality education pays off.

MARKET INDICATORS

AS AT 30 SEPTEMBER 2019

	DY %	P/E Ratio	1 Month %*	12 Months %*
FTSE/JSE All Share Index	3.8	15.8	0.2	1.9
FTSE/JSE Resources Index	4.4	12.2	-1.1	7.9
FTSE/JSE Industrial Index	3.4	15.6	-0.7	1.8
FTSE/JSE Financial Index	5.7	12.3	3.5	-4.2
FTSE/JSE SA Quoted Property Index	9.3	10.8	0.3	-2.7
ALBI BEASSA Bond Index			0.5	11.4
STeFI Money Market Index			0.6	7.3
MSCI World Index (R)			2.0	9.7
MSCI World Index (\$)			2.2	2.4

* Total return index percentage change.

Economic Indicators		Latest Data	Previous Year
Exchange Rates			
Rand/US\$	September-19	15.14	14.15
Rand/UK Pound	September-19	18.61	18.44
Rand/Euro	September-19	16.50	16.42
Rand/Aus\$	September-19	10.22	10.22
Commodity Prices			
Gold Price (\$)	September-19	1490.3	1192.4
Gold Price (R)	September-19	22536.0	16821.2
Oil Price (\$)	September-19	60.8	82.9
Interest Rates			
Prime Overdraft	September-19	10.0%	10.0%
3-Month NCD Rate	September-19	6.8%	7.0%
R186 Long-bond Yield	September-19	8.3%	9.0%
Inflation			
CPI (y-o-y)	August-19	4.3%	4.9%
Real Economy			
GDP Growth (y-o-y)	June-19	1.0%	0.7%
HCE Growth (y-o-y)	June-19	1.5%	1.9%
Household Consumption Expenditure (HCE) Growth (y-o-y)	June-19	-0.4%	-1.8%
Gross Fixed Capital Formation (GFCF) Growth (y-o-y)	July-19	-2.4%	1.6%
Manufacturing Production (y-o-y) (seasonally adjusted)			
Balance of Payments			
Trade Balance (cumulative 12-month)	August-19	\$6.8	\$8.8
Current Account (% of GDP)	June-19	-4.0%	-3.8%
Forex Reserves (incl. gold)	August-19	\$761.1	\$733.6

Sources: JSE, Iris, I-Net

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Old Mutual Investment Group (Pty) Ltd. Physical address: Mutualpark, Jan Smuts Drive, Pinelands 7405. Telephone number: +27 21 509 5022

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