



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

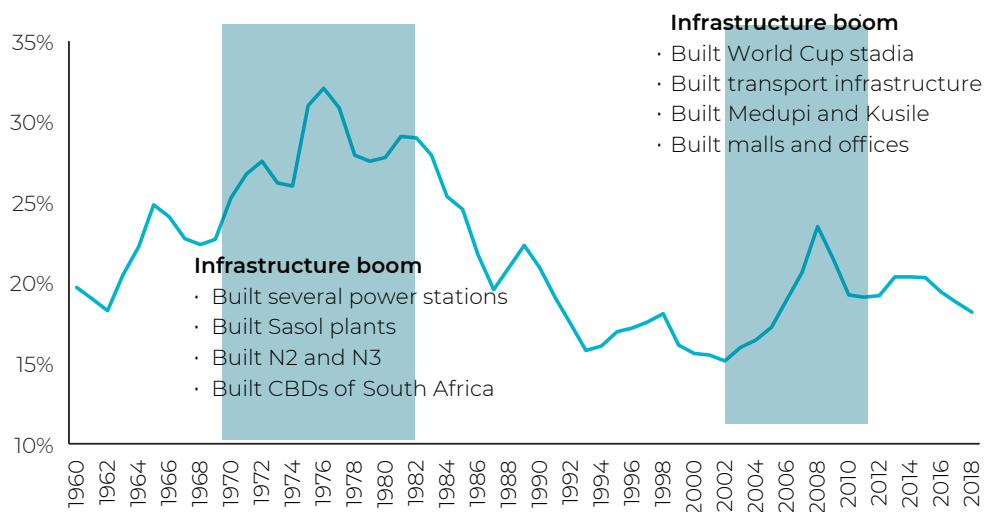
South African construction boomed in the 1970s when the power producers were building new power stations and the Johannesburg Central Business District (CBD) was growing on the back of consistent 7% Gross Domestic Product (GDP) growth. It marked the South African adoption of high-rise towers after the 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

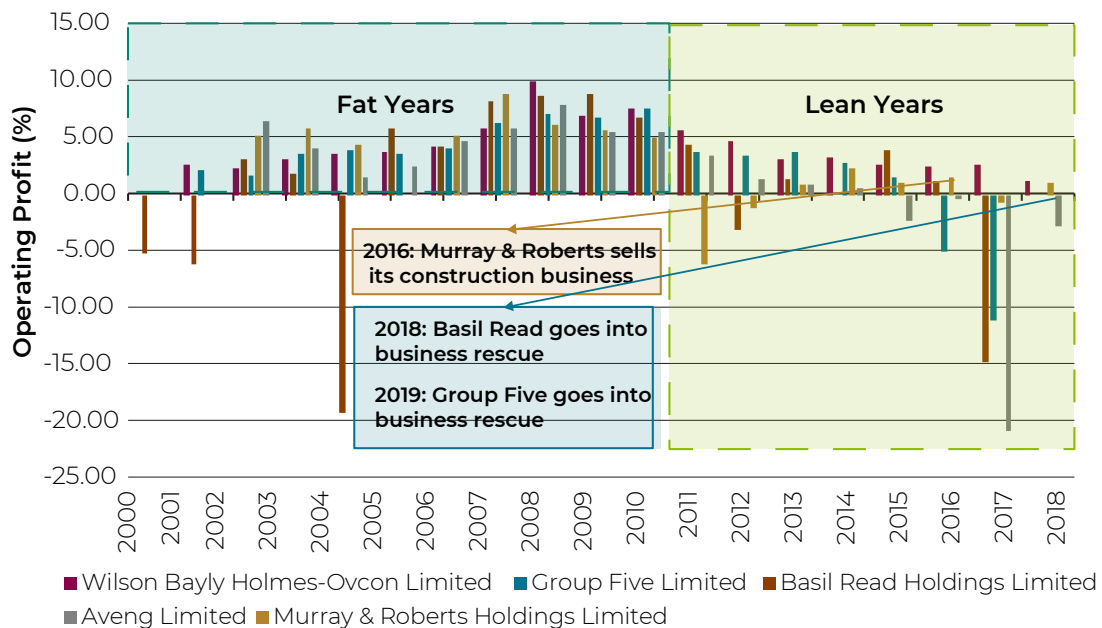
mina”, he has followed through with some decisive action over the past 18 months. Notably, replacing the boards of several state-owned enterprises (SOEs) – a subject of disgruntlement expressed by many. From a construction perspective, these actions are only beginning to bear fruit now.

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.

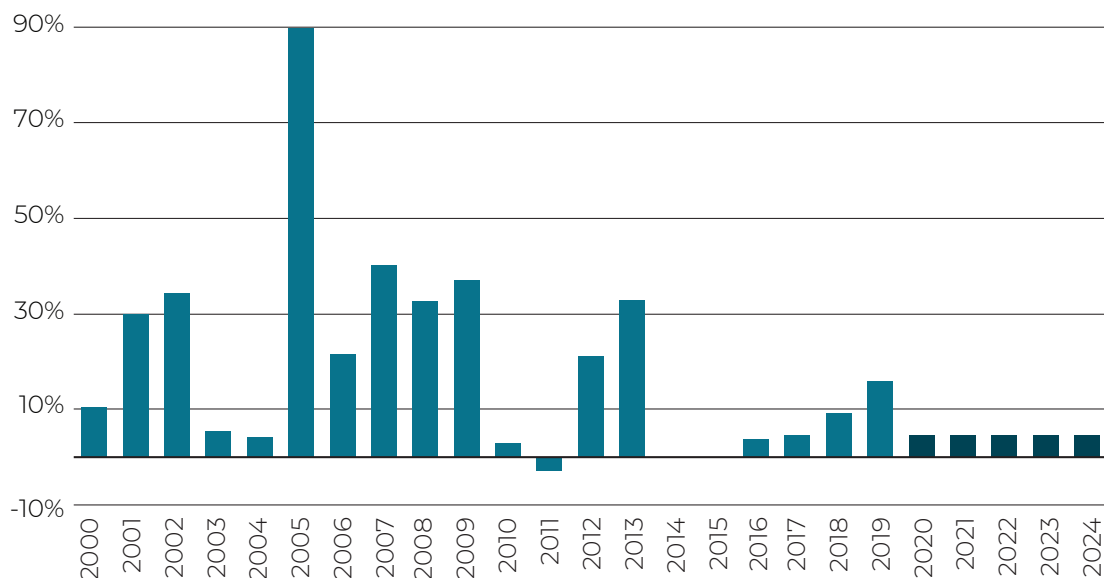
Lastly, Transnet is inviting contractors to re-tender for the expansion of the Durban port terminal valued at R5 billion after the tender award was challenged and overturned. Eskom requires new ash dams valued at R900m each.

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.

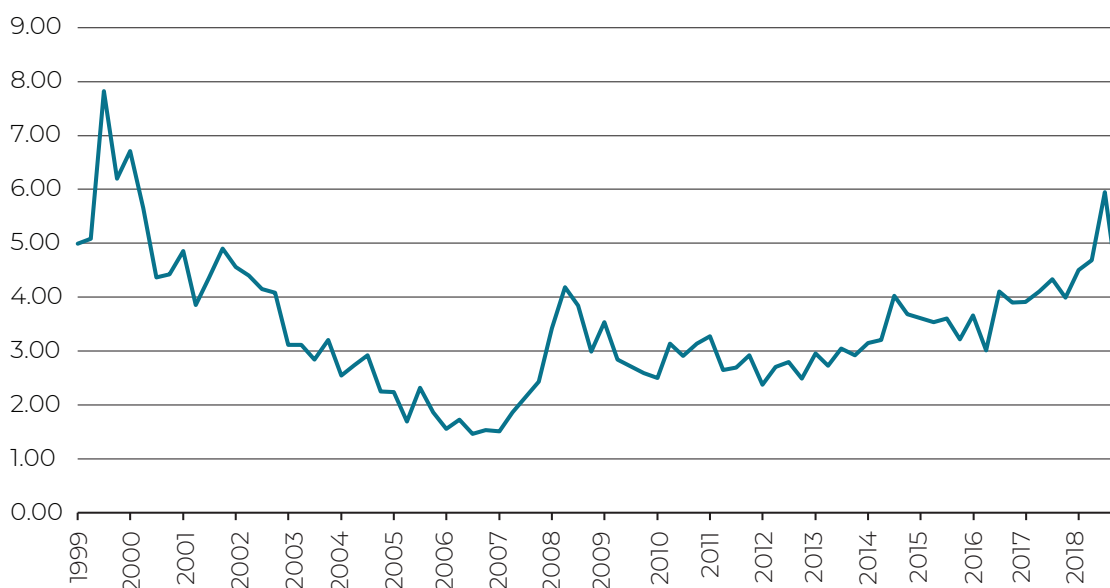
BELOW COST OF CAPITAL RETURN ON INVESTMENT

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

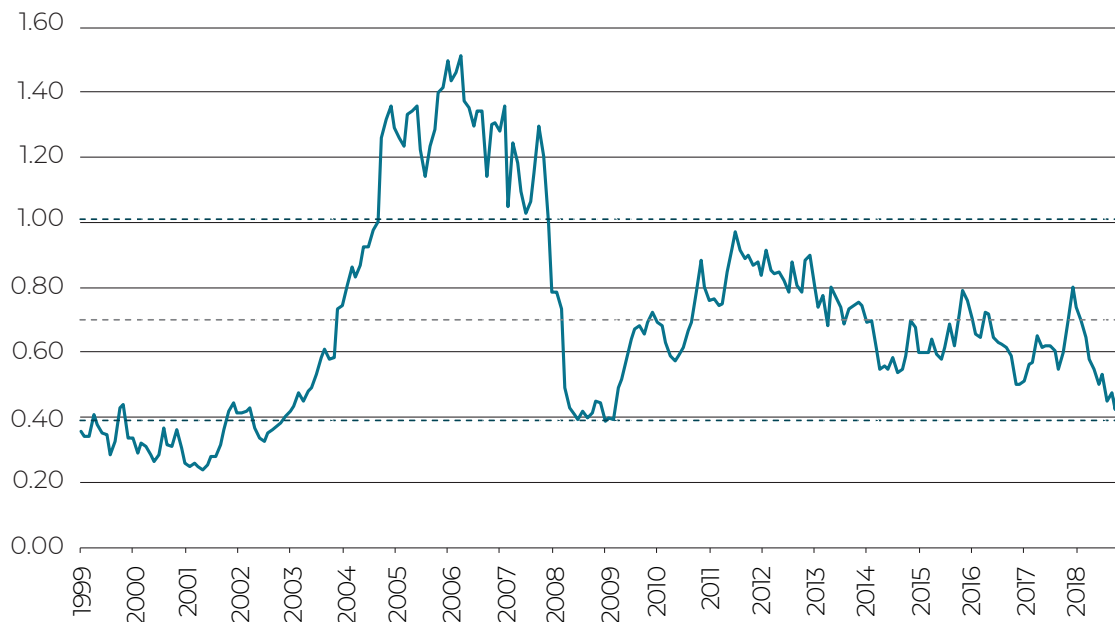


Source: FactSet

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.