There Are Still Great Stories Out There – Bidvest…One Year Later

A little over a year ago, Bidvest announced that it would be unbundling its Food Service division, BidCorp, the internationally focused food business. Below the graph that we included in our note last year detailing the transaction, highlighting the immediate value unlock for shareholders around the time of the unbundling – *shareholders got a 14% kicker in their combined holding on the day!*

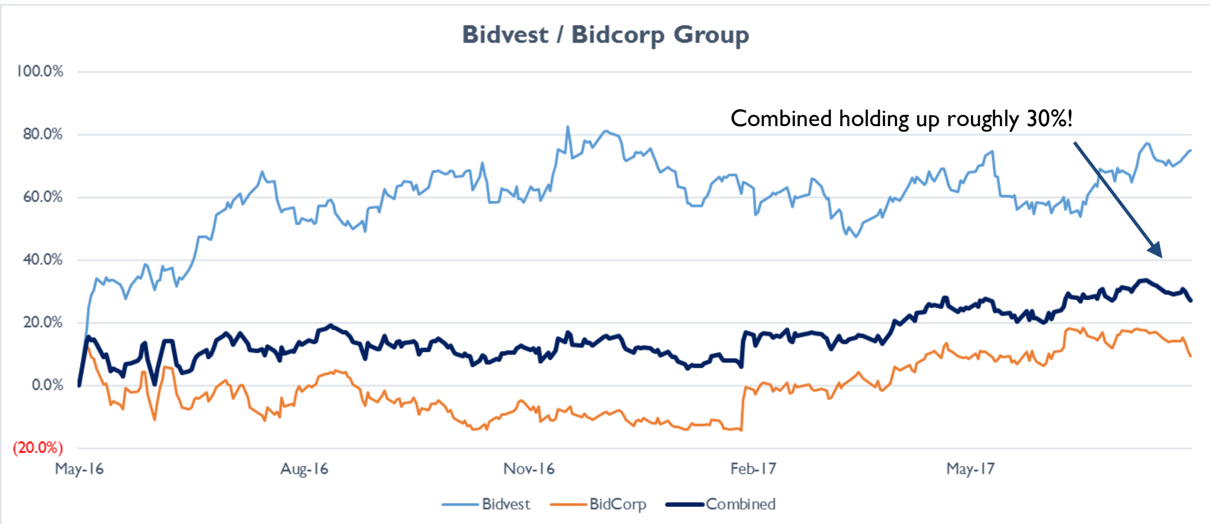
Bidvest @ Friday 27 May 2016 R370.33

Unbundling of Bidcorp resulted in immediate value uplift for shareholders of 14.1%

Bidvest & Bidcorp Combined @ Monday 30 May 2016 R422.55

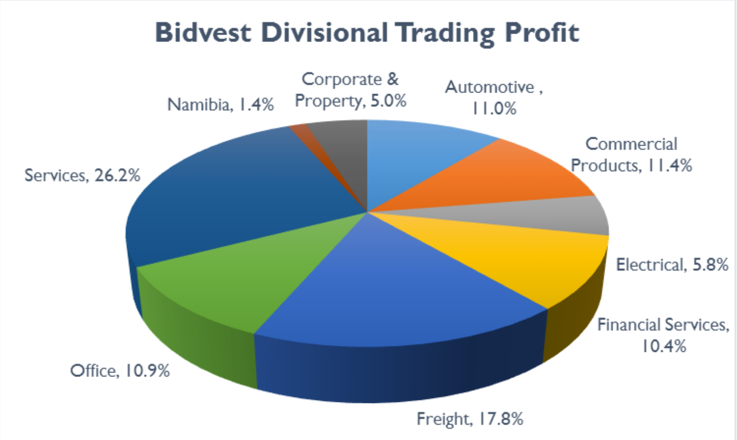
In the period since, which has included significant political and economic headwinds, both businesses have continued to operate strongly within their respective geographies and recent results out of both Group's tell a very positive story – one of growth and another of a very consistent and solid investment. Surprisingly, Bidvest, the SA focused business, has returned some 75% since the unbundling of its bigger brother while Bidcorp has increased roughly 10% - all in an environment and over a period that saw the market up only 4.7%. Important to note too that while Bidcorp made what seems like many acquisitions (13 to be exact), these contributed very little to its overall result, highlighting the strong organic growth of the business, while Bidvest seemed to make the larger acquisitions, more recently the Irish services business, Noonan – *Might we see a change of roles over the next 12 to 18 months?*

Excluding the substantial negative impact of rand translation on reported results, Bidcorp had an exceptional year. On a like for like basis, revenue increased 8% with every business unit in the portfolio improving over the period in local currency terms, with the exception of Turkey and the UK Logistics business. On a constant currency basis, headline earnings per share increased by 19%, a very strong result. The deliberate and continual exit of low-margin or even loss-making contracts, in addition to having a favourable impact on trading margins, also frees up distribution capacity and management attention. Local currency revenue growth in the UK is expected to be impacted by either the phased exit of more contracts in the logistics business or preferably, an outright sale of the business. The Australasian business now has a cleaner base from which to grow, and Europe is expected to generate the highest level of trading profit growth in FY18, supported by strengthening Eurozone economies, particularly in eastern Europe. Bidcorp made 13 acquisitions during the year, the biggest of which was the acquisition of Guzman in Spain for R1.1bn – management have indicated that this is an exciting market for them, where significant opportunity exists for consolidation in the industry – *this is what they are good at and it plays right into their strategy of bolting businesses onto their platforms and infrastructure!*



There Are Still Great Stories Out There – Bidvest…One Year Later (Continued)

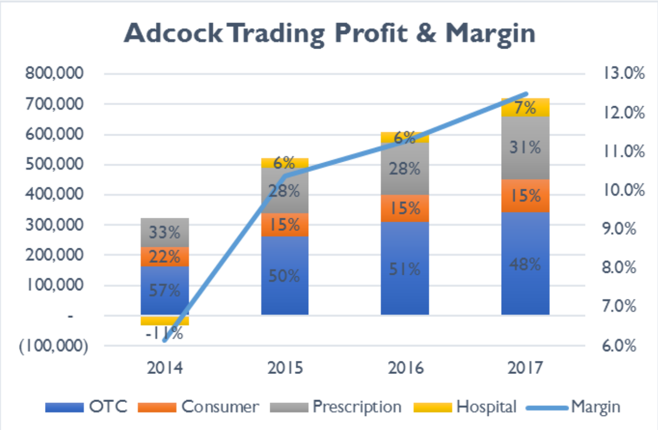
So where does the opportunity lie? Based on a peer group average EBITDA (earnings before interest, tax, depreciation and amortization) margin of 8%, Bidcorp currently trades at 5.1% - *lots of runway here!* More exciting is the opportunity for further expansion by the Group, and while its peers sit on an average 17% net debt to market capitalization, Bidcorp is well below this at only 1.6% - *lots of room for a continuation of bolt-on acquisitions or something game changing?*



On the other hand, operating in an environment of heightened poltical uncertainty and very low growth, Bidvest reported HEPS (headline earnings per share) up 5% for the year, a commendable result. This again demonstrates the resilience of the Group to weak GDP growth. Bidvest, as it does so well, acquired Brandcorp as a bolt-on acquisition in October 2016, which contributed 2.5% to revenue and 3% to trading profit. Group net debt amounted to R5.6bn at year-end, with significant headroom for further acquisitions. In addition to its debt capacity, Bidvest holds non-core investments in Adcock (38.4%), Comair (27.2%) and Mumbai Airport (6.8%), all of which can be sold and used to expand in its areas of expertise. Based on latest closing prices for Adcock and Comair and the latest management valuation for Mumbai Airport, the sales of the stakes in these businesses could generate just short of R6bn in pre-tax proceeds for the Group. As we have come to know Bidvest and the exceptional way in which its businesses are run, it's no surprise that a signifcant portfolio of 103 properties, in which many of its businesses are housed, underpins its operations. These can further be used to raise cheap financing for expansion or sold off / unbundled to shareholders – *despite the environment in which it operates, management seem to have extensive firepower of needed!*

In its first international foray after unbundling its global food business, Bidvest recently announced the acquisition of Noonan, a Republic of Ireland-based facilities management services and solutions provider, for €175m (R2.7bn). Noonan derives 60% of its revenue from the Republic of Ireland and 40% of revenue from the UK, and offers services that range from cleaning and security, to building services and facilities management. Bidvest provides similar services through Bidvest Steiner, Prestige and Protea Coin in South Africa. The acquisition is expected to add less than 5% to Group trading profit on a full-year basis but clearly illustrates Bidvest's intention to expand its operation abroads, focusing on businesses aligned to its Services and Commercial Products division – *it did this with its food business and is now doing it with its other businesses – just further value unlock to come for shareholders!*

Linked to and following a strong pursuit by Bidvest last year, Adcock put together a new management team, culminating in what has been an extremely successful turnaround of its operations. The ongoing improvement in Adcock's trading performance continued during the last year, with Group HEPS up 37% - this in an environment of significant de-rating in the prices of global pharma stocks.



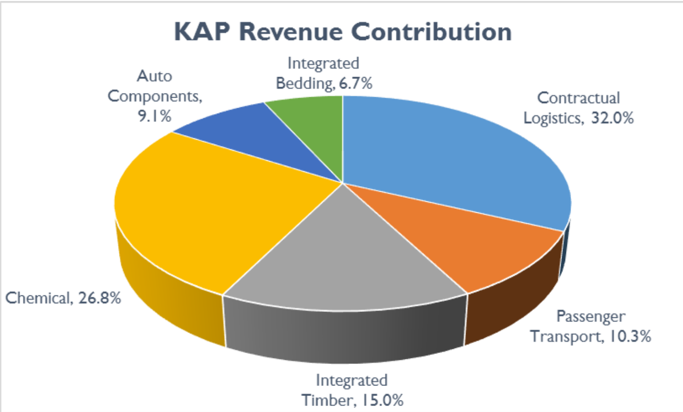
Margin growth was a key driver of the performance, driven by Single Exit Price (SEP) increases of 5.5% on aggregate, as well as the significant easing of the the currency headwind experienced in the prior period – *a strong Rand is good for Adcock as it imports a fair amount of what it uses in it medicines.*

There Are Still Great Stories Out There – Adcock / KAP (Continued)

Adcock's focus on unregulated segments, Consumer, and to a lesser extent, OTC (Over-the-Counter), which account for 63% of trading profit, were a major benefit during the period. Adcock remained the largest Schedule 1 and 2 pharmaceutical company in South Africa, holding a 22% share of the OTC market. Downtrading and an increasing shift to smaller pack sizes were a feature of the OTC and Consumer markets during the year while Prescription pharmaceutical sales benefitted from the 5.5% average SEP increase – Simply put, the Single Exit Price (SEP) is a mechanism introduced and regulated by government that prescribes a maximum price that can be charged for certain medication. Dispensers may then charge an addional dispensing fee depending on the price of the medicine.

The private sector business grew sales 10.6%, with volume growth underpinned by higher sales of Trivenz, Adcock's triple-combination ARV. Trivenz is now the largest brand in the division and second-largest ARV in SA, contributing 13% of divisional sales. Should exchange rates hold close to current levels, coupled with another favourable SEP increase of 7.5% in February 2017, expected HEPS growth over the next year should be strong.

Following the divestment of the Indian sales and marketing business in October 2016, Adcock is in a strong financial position, holding net cash of R335m at year-end in addition to R2bn in available facilities. Stated areas of future growth potential include personal, baby and home care products / brands. Additionally, there remains upside potential with regards to the South Africa Pharmaceutical Regulatory Affairs Association (SAPRAA) taking over registration and approval of new medicines from the Medicines Control Council (MCC), which has a substantial backlog of applications outstanding. To put this into perspective - Adcock has ~300 applications pending at the MCC and historically, newly approved products added between R50m and R150m per annum in additional revenue. Even if the 300 product applications generate relatively low revenue, accelerated approval of these products would provide a material boost to expected revenue over the next two to three years.



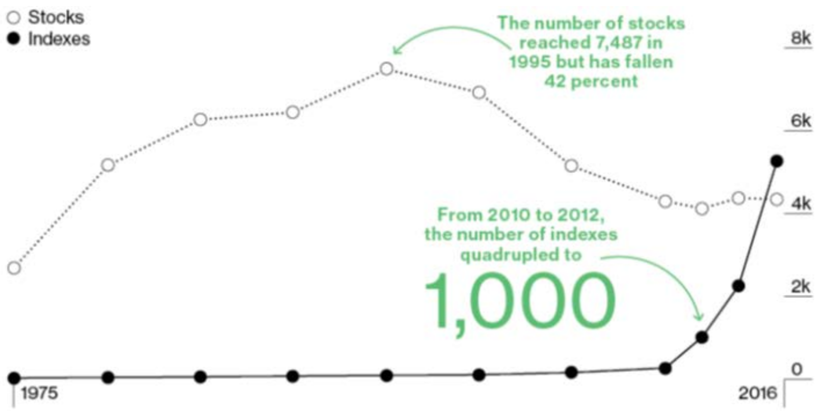
Following our introduction of KAP Industrial in the January newletter, the Group continues to perform above expectations, reporting strong results recently, boosted by the recent acquistion of Safripol – the maker of components used in the maufacturing of plastics. Revenue was up 23% to R19.8bn while HEPS from continuing operations grew 15%. The business is now split into three segments – Diversified Industrials, Diversified Logistics and Diversified Chemicals. Some of the recognisable brands within the Group that have shown resiliance in the current environment include PG Bison (timber), Feltex (vehicle components) and Restonic (bedding) in the Diversified Industrials segment; Unitrans, Intercity and Gautrain Bus Feeder in the Diversified Logistics segment; and Hosaf (PET manufacturer – used in fibres for clothing and containers for liquids and foods – it's the plastic that buddy bottles are made of) in the Chemicals business. Common themes throughout the Group's businesses are vertical integration, high barriers to entry and leading positions in their respective markets – *It's a very positive story this, despite the almost impossible trading environment!*

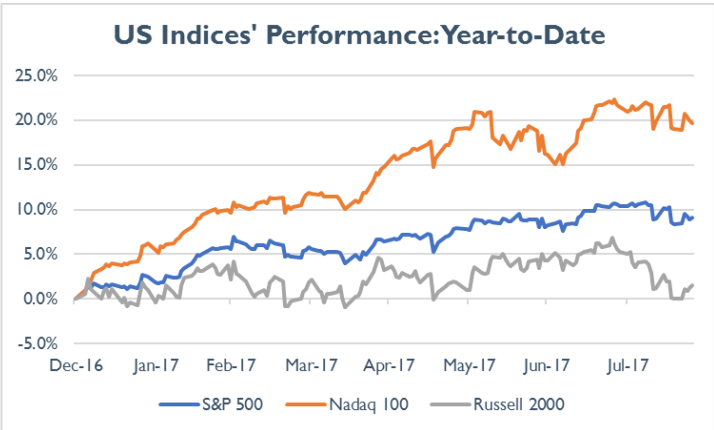
KAP continues to drive margin growth across its Industrial and Chemicals divisions through increasing levels of product specifications, upgrading and modernising of its manufacturing facilities and increasing capacity. In addition to now manufacturing three of the five polymers that underpin the plastics industry, KAP is also the only manufacturer of PET resin in Sub-Saharan Africa. The Group is ~90% complete with its PET resin capacity expansion and commissioning is expected late in September of this year. The expansion will increase capacity from 128 000 tonnes to 240 000 tonnes / annum. South Africa's PET resin consumption was 230 000 tonnes in 2016. As a result, the expansion will not only boost revenue through higher production volumes but margins too, through greater scale and the substitution of higher cost imports. Despite topline headwinds, KAP is expected to grow operating profit strongly over the next two years as it reaps the benefits of its vertical integration strategy and the upgrading and expansion of existing facilities. KAP's businesses are relatively defensive owing to its vertical integration, high barriers to entry and specialised product slate.

Pieces that Caught our Attention

There are now more indices than stocks! Put another way – there are now more funds / index trackers buying stocks than there are stocks available to buy.

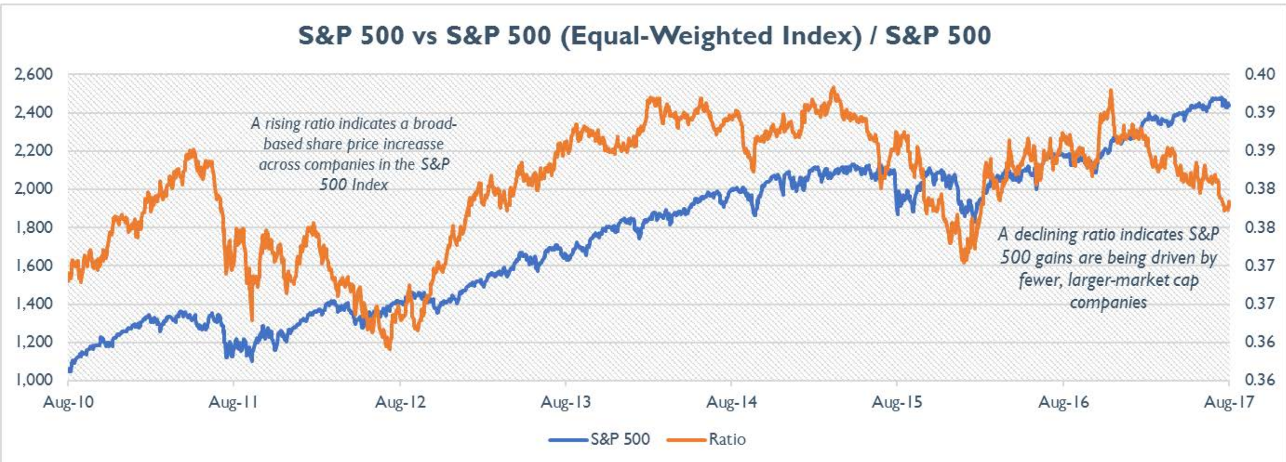
This leads into the graph we highlight below and as we mentioned in our previous newsletter – as certain stocks become more expensive and larger components of an index, index trackers are required to buy more of them OR sell more of them should the trend reverse….





It's an experience we are having at home too with Naspers and Richemont (to a far smaller extent) driving the bulk of the index return over the past 12 months – the graphs alongside and below highlight, despite what seems like an environment of low returns, the general market continues to power ahead.

Alongside, the Russell 2000 index is a representation of some of the smallest companies in the US and which would not include the likes of Amazon, Google and Facebook, to name a few. The tech heavy Nasdaq index clearly illustrates the outsized performance of the tech sector this year – despite already stretched valuations.



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INVESTMENT COMMENT

September 2017

Pieces that Caught Our Attention (Continued)

Yes, British American Tobacco (and to a greater extent, Altria, the holder of the Marlboro brand in the US), has been under significant pressure recently on the announcement of potentially more regulation in the US – but the graph below however points out the profitability that lies in that market….

*Income defined as GDP per capita ('000) / average pack price (US$)

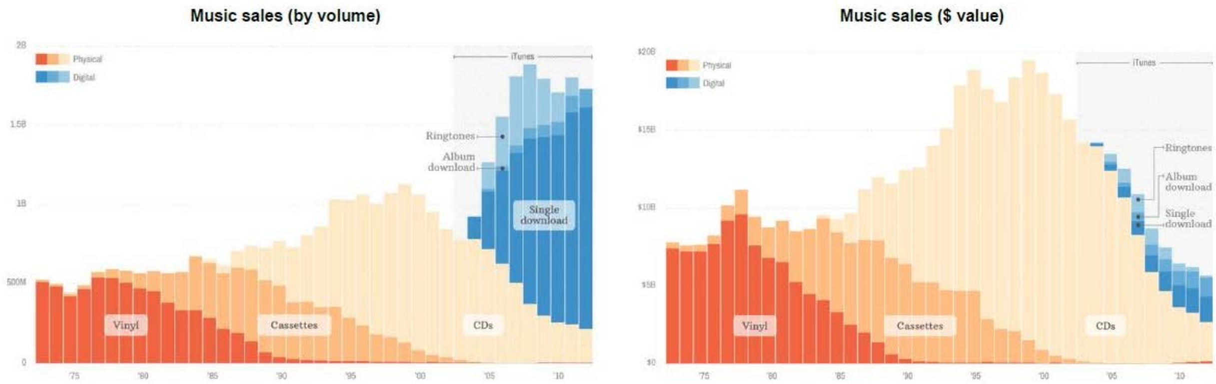
Alphabet Statistics	
100 billion	Number of visits Google helps drive each month to business websites.
3 billion	Number of visits Google helps create each month between businesses and their consumers.
82 billion	Number of Google Play apps downloaded in the last year.
2 billion	Number of active Android devices around the world.
200%	Growth in the number of people watching YouTube on TV screens in the last year.
1,5 billion	Number of YouTube monthly viewers.
100 million	Number of devices Google Assistant is available on since launching last year.
60 minutes	Average time each person spends watching You Tube each day.
1,2 billion	Number of photos and video backed up each day on Google Photo.
500 million	Number of Google Photo monthly users.
75,606	Alphabet staff headcount.
$ 94,7 billion	Value of Alphabet's cash and marketable securities of which approximately $57.9 billion or 61% is held overseas.

Source: Independent Securities Research, Alphabet

The immense power of a brand – need we say anything more….to put into perspective the extent of Google's cash and marketable securities of almost $95bn – it could buy our six banks (Absa, Firstrand, Standard Bank, Nedbank, Investec and Capitec) and still have some change for Shoprite and Spar!

A reminder about the benefits of technology – as this graph below shows (and probably applicable to many) – we are buying almost double the amount of music (volume) at what looks like a fraction of the price ($ value)

How music has been sold since the 1970s



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Article of the Month – The Unsolvable Puzzle

This one really makes you think!

The Unsolvable Puzzle
By Morgan Housel

Leo Szilard was one of the smartest people of the 20th Century. He conceived the idea of nuclear energy, patented the process of using it in a power plant, and helped Albert Einstein write the letter that sparked the Manhattan Project. All in his 30s. Like any genius, Szilard's curiosity was diverse. After World War II he became a biologist, attracted to a field that hadn't been explored as deeply as physics. The new field didn't just change what he learned, but *how* he learned. Szilard spent hours a day in the bathtub, solving physics problems in his head. Biology ruined that routine, because, as Szilard later said, he constantly had to get out of the tub to look up a fact. Physics is guided by rational laws that have never, and will never, change. A master like Szilard could reason his way through problems like nuclear energy with only his mind as a tool. If an idea in his head followed the laws and reason of physics, it would in real life, and would continue working forever. That's how a guy designed a nuclear bomb in the bathtub. Biology is different. It's guided by things like accident and mutation, so specific behaviors sometimes defy logic and can change entirely as evolution bulldozes the past. The flu virus has killed 731,000 Americans in the last 40 years – more than died in World War II – and not for lack of effort by the medical community. A virus that mutates and evolves means a vaccine that might work today won't work tomorrow. And since the mutation itself is an accident, researchers are kept in perpetual scramble. Like an unsolvable puzzle. The physics vs. biology analogy is relevant in investing. Too many investors view their field like a physicist in the bathtub, searching for something that's logical and permanent, while not enough view it like a virologist, needing to update their knowledge and tactics to evolve with the chaos of what happens to work now.

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Benjamin Graham's book The Intelligent Investor was published almost 70 years ago, and is still one of the best-selling investment resources. It sells because so much of its message is timeless. But investing evolves, and Graham's book did, too. It went through four editions before his death in 1976. Jason Zweig, who annotated Graham's book, once wrote about using it as a practical guide in modern times: Graham was constantly experimenting and retesting his assumptions and seeking out what works — not what worked yesterday but what works today. In each revised edition of The Intelligent Investor, Graham discarded the formulas he presented in the previous edition and replaced them with new ones, declaring, in a sense, that "those do not work anymore, or they do not work as well as they used to; these are the formulas that seem to work better now." One of the common criticisms made of Graham is that all the formulas in the 1972 edition are antiquated. The only proper response to this criticism is to say: "Of course they are! They are the ones he used to replace the formulas in the 1965 edition, which replaced the formulas in the 1954 edition, which, in turn, replaced the ones from the 1949 edition, which were used to augment the original formulas that he presented in Security Analysis in 1934." Ben Graham's brilliance was grasping what part of investing was timeless and what part required revision. His philosophy was rooted in principles of investor behavior that rarely change, but for tactical matters he wasn't afraid to get out of the tub and look up new facts. Just before he died, Graham was asked whether detailed analysis of individual stocks – a tactic he became famous for – remained a strategy he favored. He answered: In general, no. I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, 40 years ago, when our textbook was first published. But the situation has changed a great deal since then. What changed was: Competition grew as opportunities became well known; technology made information more accessible; and industries changed as the economy shifted from industrial to technology sectors, which have different business cycles and capital uses. Admitting this in real time is a hard skill. And it's rare, because abandoning past strategies feels like defeat, and creates anxiety over what to do next. Obliviousness and denial are more common responses. But it's a mandatory skill in any field where competition hacks away at the existence of outperformance, and social and regulatory forces evolve. Think about the investment factors that have changed in just the last 20 years. Private equity assets have gone from $600 billion to more than $5 trillion. The number of public companies has halved. Index funds have attracted effectively all public equity asset flows. Annual reports went from being sent in the mail to being scanned for keywords by supercomputers. The cost of storing industrial amounts of data went from millions of dollars on rack servers to thousands of dollars in the cloud. Social media connects what used to be walled off. Stocks went from being traded by humans to high-frequency traders, and now the HFTs have competed themselves down to zero profits.

Article of the Month – The Unsolvable Puzzle (Continued)

The Federal Funds rate averaged 6.5% from 1960 to 2000. Now it's been below 1% for 105 of the last 188 months. Looks what's changed just this year: ICOs have raised more money for startups than venture capital funds. SoftBank launched a fund that is larger than all U.S. IPO proceeds raised from 2010-2012. I've heard rumors that things are unusual in Washington. Buying stocks for less than hard book value worked, until it didn't. A dividend yield below Treasury yields was a sign of an overvalued stock, until it wasn't. Discounted cash flow models were an edge, until a spreadsheet could make one. Convertible bond arbitrage was profitable, until other investors realized just how profitable. This doesn't happen in a field like physics. Gravity doesn't get arbitraged away due to popularity. It's hard to look at how much markets evolve and expect a successful investing strategy to remain stagnant over time. There's an irony in the number of investors who expect the companies they invest in to adapt and keep up with competition, but they, themselves, expect to invest like a physicist in a bathtub. We solved the nuclear energy puzzle, the how-to-put-a-man-on-the-moon puzzle, and the send-information-around-the-world puzzle. But we will never permanently solve the investment puzzle, because solutions have shelf lives, and expiration dates that are usually only obviously in hindsight.

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There will come a day when investing strategies and norms that work today will grow old and expire. Two groups will form: Those who embrace the reality of the industry's chaos and adapt, and those who stay in the tub, embracing a world that adheres to the logical rules stuck in their head. The hard part is that most of investing is stable over time. Most tactical changes are regretted. It's difficult to tell, without hindsight, whether a strategy is expired or just temporarily out of favor. Long-term investing tends to work specifically because all strategies go out of favor from time to time, testing investors' wills at the cost of returns. Distinguishing a paradigm shift from a temporary cycle is what separates good investors from momentarily lucky investors. The investing industry is filled with brilliant people and terrible results. The reason is that the field has less to do with the kind of knowledge that makes a good physicist, and more to do with the rare intellectual flexibility and nimbleness that makes a good flu vaccine researcher. Leo Szilard once said: "If you want to succeed in the world, you don't have to be much cleverer than other people. You just have to be one day earlier."