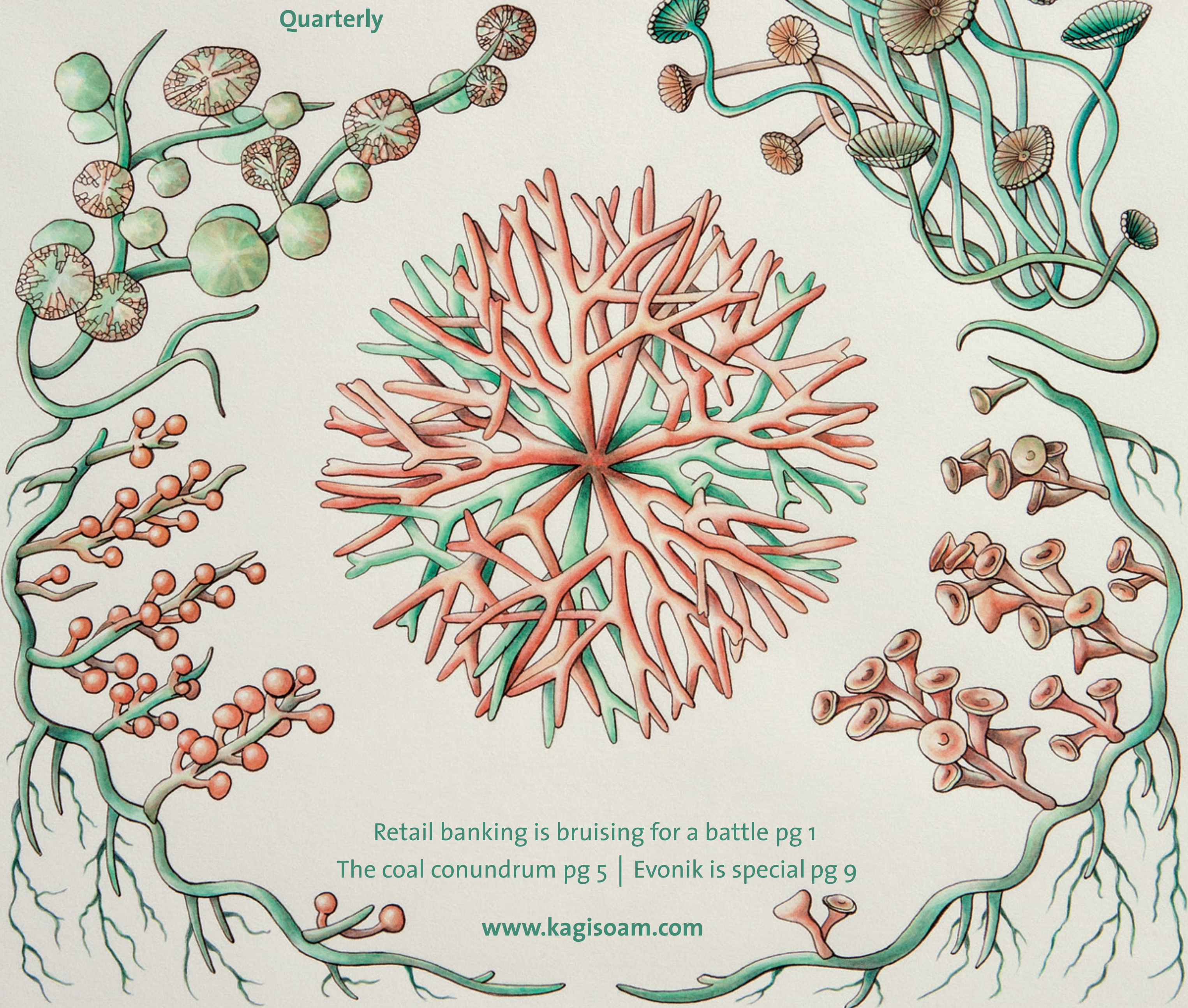
UP

October 2019

Kagiso Asset Management

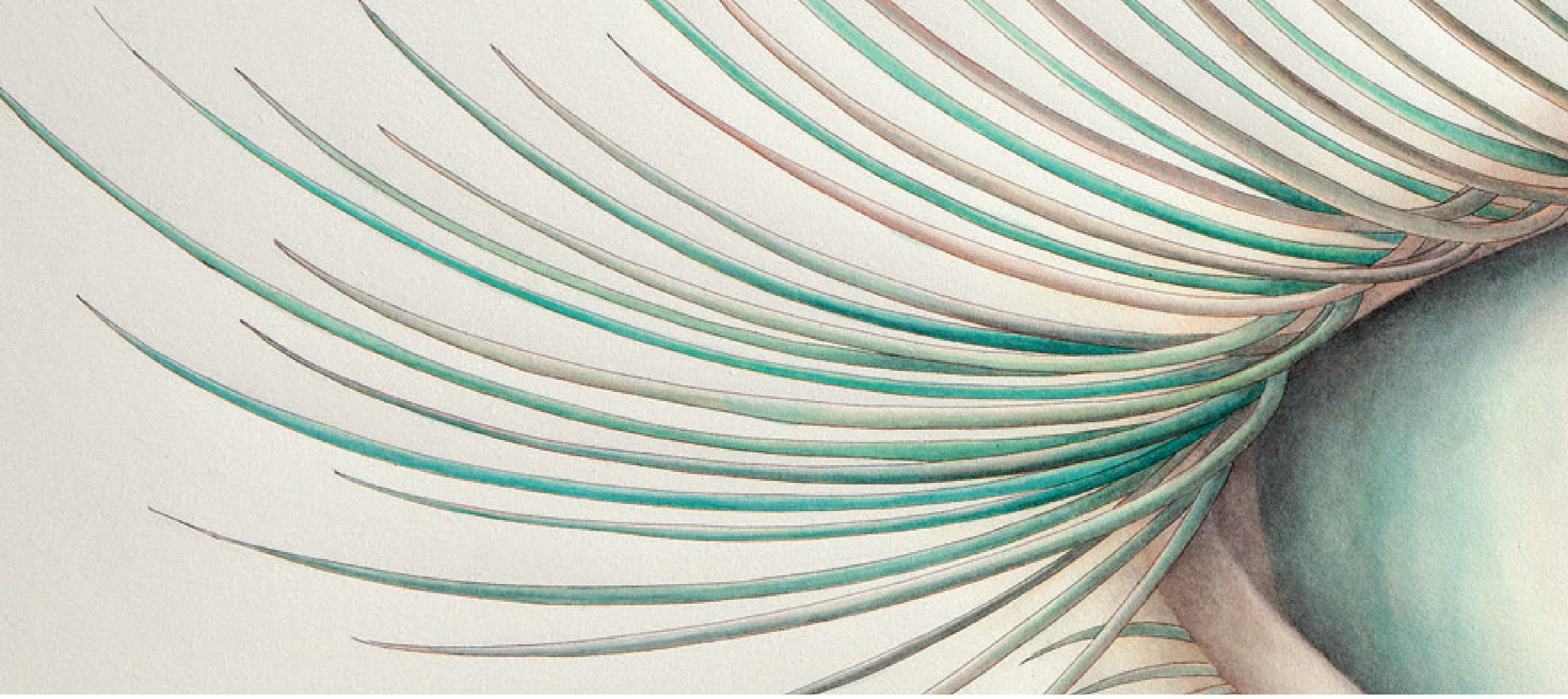
Quarterly



Retail banking is bruising for a battle pg 1

The coal conundrum pg 5 | Evonik is special pg 9

www.kagisoam.com



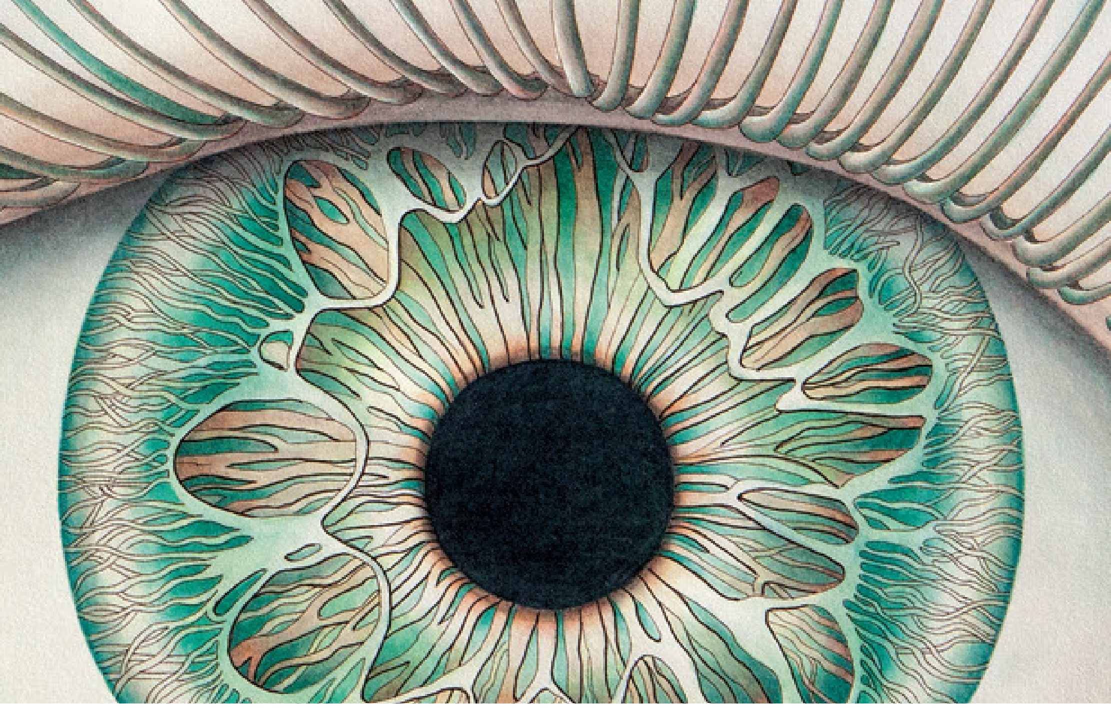
1 Retail banking is bruising for a battle Meyrick Barker

5 The coal conundrum Mandi Dungwa

9 Evonik is special Jihad Jhaveri

13 Clicks and mortar malls of the future Rahgib Davids

17 Performance table



Retail banking is bruising for a battle

Meyrick Barker - Investment Analyst

> "The African continent is one of the fastest growing and most profitable banking markets of any global region. Dynamic innovation, particularly within retail banking, is delivering solutions to remedy low levels of penetration and a historic reliance on cash. Advances in technology are helping to address sparse credit bureau coverage and limited branch and ATM networks, while significantly reducing the cost to serve customers."

Retail banking is bruising for a battle

By examining the rising disruptors in retail banking, it is evident that now is a great time to be a customer. However, should large bank management teams fail to adapt to evolving technological innovations and customer preferences, they will be increasingly penalised.

The disruptors' target

South African banks stand out relative to global competitors for a high reliance on retail transactional account fees, as is evident in the right chart below. Their profit contribution from retail transactional activity is approximately three times that of global banks[1] - the change in the composition of this R42 billion revenue pool over the past three years is shown below left.

New entrants targeting this revenue pool have emerged on several fronts. These include insurers muscling into banking (Discovery and Old Mutual), unsecured lenders offering transactional accounts (African Bank), and the launch of completely new brands (TymeBank) - with Postbank and Bank Zero still to come.

Not all disruptors have acquired their own banking licences, as is the case with Old Mutual, who uses Bidvest Bank's licence. There are also subtle differences in product offerings, target markets, and pricing and distribution strategies. Although all new entrants have ambitions to extend credit, TymeBank currently offers no lending products, while the remaining players only offer unsecured loans. Discovery, targeting a higher income customer, offers a reward-rich, higher-priced transactional account incentivising customers to buy multiple financial products across the group. On the other hand, TymeBank and African Bank provide simple, but compelling low-cost propositions.

African banks have the second highest cost-to-asset ratio of any region in the world, at 3.6%[2]. South African banks (other than Nedbank) fare no better and, to date, high margins have tended to protect African banks' bottom lines. In the face of this inefficiency, South African banks have increased banking fees by 1% in excess of CPI[3], since 2008.

Limited mobile money use

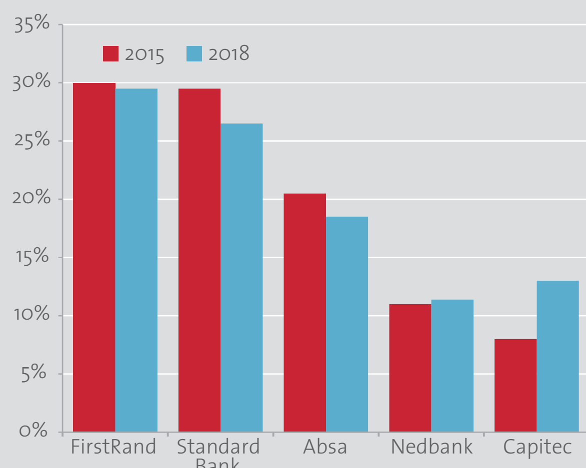
These high margins have also caught the attention of several non-bank competitors. Retailers (eg PEP Money/Shoprite Money) and telecommunication companies (eg MTN Mobile Money) have, to varying degrees of success, launched mobile money solutions to disrupt the transactional revenue pool.

Despite high mobile phone penetration, these accounts have achieved limited success in South Africa as regulatory limitations force these solutions to be offered in partnership with a bank, reducing both profitability and flexibility. Also, mobile money solutions don't operate across providers, therefore limiting

[1] Citigroup Global Markets Inc.

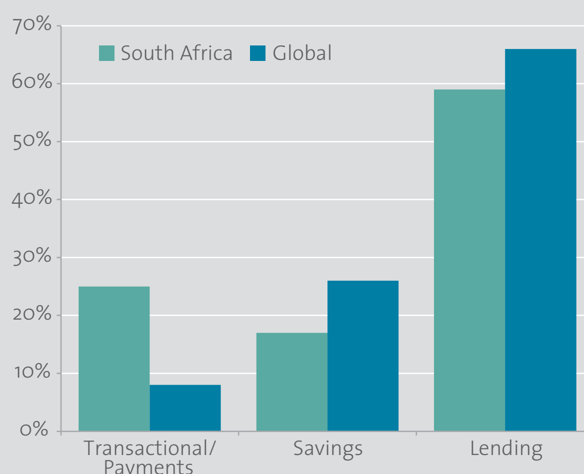
[2] McKinsey & Company [3] Statistics South Africa

Market shares of retail banking revenue*



*attributable to transactional (non-lending) retail franchises
Note: Limitations in disclosure likely overstate Standard Bank's share of the SA retail revenue pool
Source: Macquarie research

Retail banking profit breakdown by product



Note: Limitations in disclosure limit the exact profit allocation between products
Source: company annual reports, Citigroup Global Markets Inc. research

"network" size. Furthermore, financial inclusion - measured by the share of the population that has a bank account - is fairly high, reducing the need for mobile money accounts, relative to countries like Kenya, which have low formal banking penetration.

Digital innovations change the game

Other than Capitec, South Africa has seen no banks of scale enter the market since the consolidation of the industry in the early 2000s. That is not to say some haven't tried. *"Operating without the costs of branch infrastructure or high staff numbers, we can offer exceptional interest rates and low fees"* sounds like the rallying cry of a new 2019 banking entrant, but in fact was the pitch of 20Twenty upon launch in 2001. Despite offering fanatical customer service and value for money, its ill-fated ownership by Saambou, limited client acceptance of digital channels at the time, combined with dated Microsoft-based IT (information technology) systems, contributed to its ultimate demise.

Digital technologies are now fundamentally changing the way the customer is served and reached. The ability to process large amounts of data at low cost together with the advancements in machine learning and artificial intelligence, and affordable means to automate processes through robotics, is enabling the creation of new competitors. Consequently, they offer compelling customer propositions at a fraction of the cost of the established banks. Quicker product innovation is also easier to deliver.

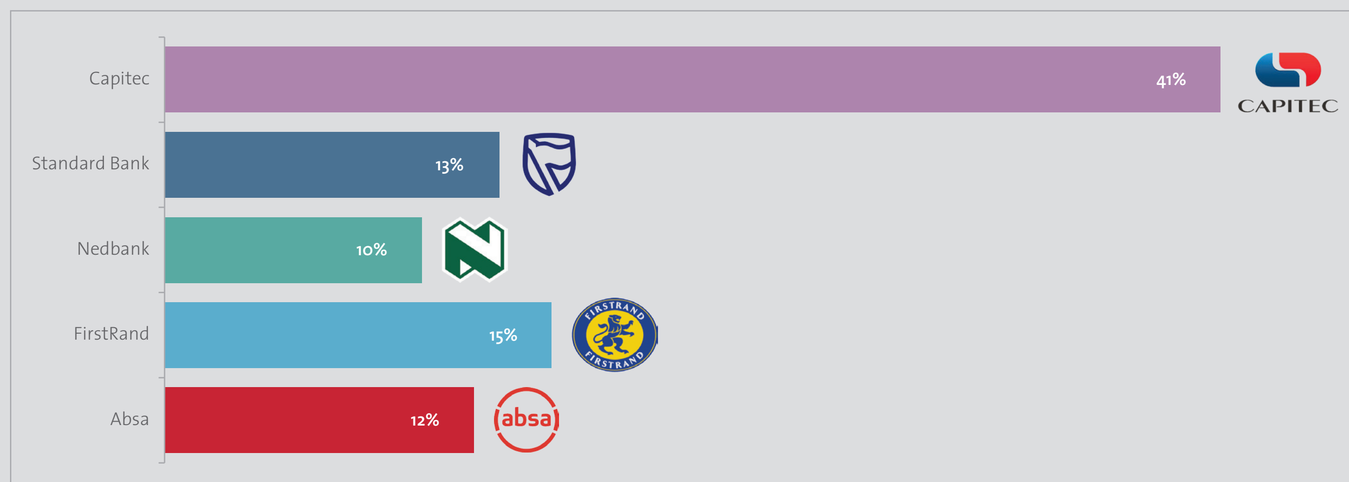
Affordable distribution at scale is no longer the stumbling block it once was. New entrants can grow their customer base and interact directly without the need to develop costly branch networks and hire significant numbers of staff. TymeBank, for example, has deployed easy-to-use kiosks across the Pick n Pay store footprint, using fingerprint biometrics to open an account and receive a debit card within minutes. It has grown to 1 000 000 customers within nine months of launching, while employing less than 170 full time staff - one of the fastest known global rates of banking customer acquisition. In comparison, Capitec took nearly six years and employed over 2 100 employees before achieving similar numbers.

The significant changes in bank business models enabled by new technology, means that even Capitec (a recent disruptor itself) is at risk of disruption. New challengers have undercut transactional fees, offer higher interest rates on savings and, while still unproven, communicate an ability to price loans more keenly. The chart below reflects retail transactional revenue contribution to group revenues.

Incumbents are not lying down

In response to these threats, bank incumbents are devoting significant resources to develop alternative revenue streams, reduce manual processes, improve digital solutions and cut costs. Despite successfully migrating millions of customers to lower

Contribution of retail transactional revenue to group revenues after credit losses



Note: The respective banks are not consistent in what they consider a "retail" client, thus distorting the disclosure above
Source: company annual reports

cost digital solutions and an increasing ability to reduce headcount, the reality is that it remains quicker and simpler to start a bank with off-the-shelf software solutions rather than simplifying existing large incumbent bank IT infrastructure and branch networks.

IT is one of the biggest areas of cost for large incumbent banks. Over the last five years ABSA, FirstRand, Nedbank and Standard Bank have spent in excess of R185 billion on IT. While the product set is not comparable, the newly revitalised African Bank restricted their IT spend to below R500 million for their recently launched transactional account offering.

Bank customer switching rates in South Africa are low and, while such inertia means that change is gradual, it permits the big banks time to copy ideas. A lack of trust of financial start-ups often limits customer switching - TymeBank's decision to partner with Pick n Pay helped mitigate this impediment.

From a client offering perspective, incumbent banks have launched lower cost transactional account offerings, but large existing profit pools make them reticent towards aggressively promoting these products. Incumbent banks are increasingly partnering with new "fintech" companies to reshape their cost bases and better serve customers (eg Standard Bank's investment in Merchant Capital). Although costly to maintain, established branch footprints do retain value, even in a digitized world, serving as an important sales channel.

You expect us to pay for deposits?

New entrants also pose a threat to incumbent bank funding costs, ie the low deposit rates banks offer clients. African Bank, TymeBank and Discovery Bank have all followed in Capitec's footsteps by offering attractive interest rates on "lazy deposits" (cash kept in ordinary transactional bank accounts) - something incumbents do not do. If the incumbents are forced to match such high "lazy deposit" pricing, up to 10% of their profit base may be eroded.

The customer is king

New banks are increasingly positioning themselves on the side of the customer. Banks used to charge customers punitive fees for making "mistakes". For example, instead of alerting customers to a potential cash shortfall on their account, they would allow a scheduled payment to put the client into overdraft and then charge a significant fee. New disruptor banks are abolishing these practices.

Discovery Bank actively markets itself as a "behavioural bank", with the intent to encourage "good" behaviour, such as increased savings, to improve the financial health of the customer. The bank, in turn, benefits through reduced credit losses. TymeBank's TymeCoach initiative, still in development, also signals its ambition to manage more of its customers' financial lives.

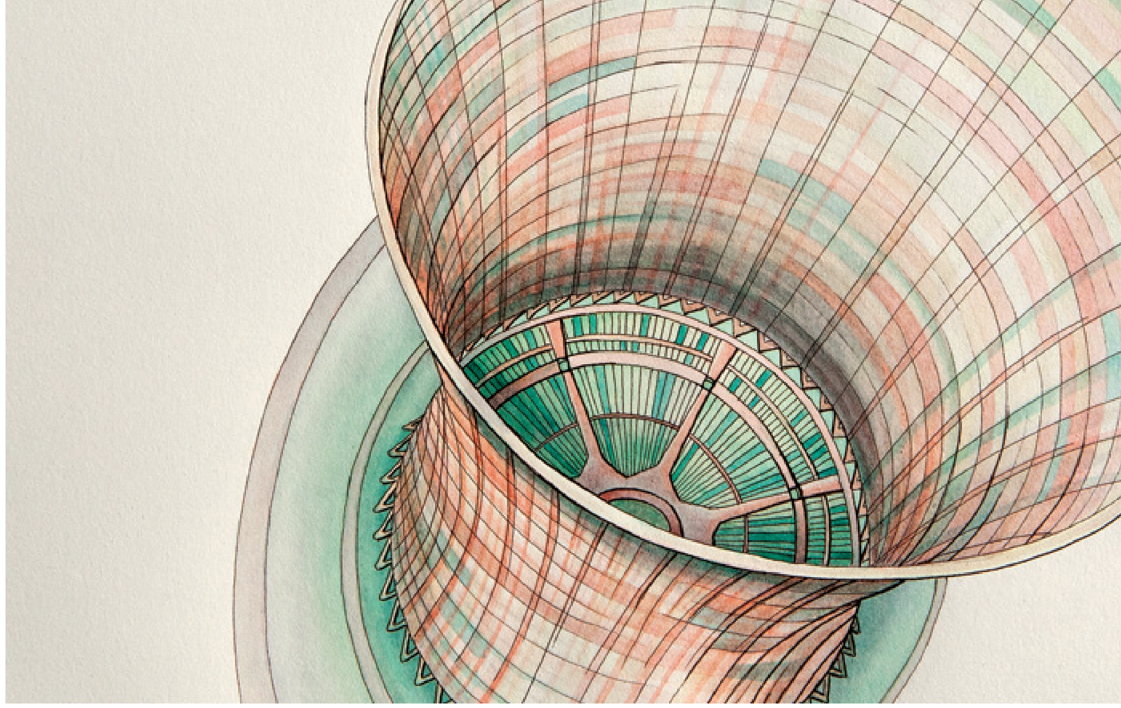
Platform plays - the new norm

While challengers have launched with a limited product set, the ultimate goal is to use insights garnered by processing customers' banking transactions to develop a broader set of products and services. What sets TymeBank apart is its willingness to sell third-party products. This is similar to the likes of Starling, a UK challenger bank that links customers to partner products ranging from accounting solutions, to investments, to mortgage broking. Conceptually, this could extend to a credit card offering being funded by a third party, meaning loan growth need not be constrained by deposit growth. The platform creates value by efficiently connecting producers of financial products with consumers, enabled by top-notch data analysis. Locally, FirstRand and Discovery are most progressed in adopting an ecosystem mindset.

More than just retail banking at stake

Aside from developments in retail banking, other profit pools are also at risk. We expect a number of innovative SME business banking solutions to be launched in coming years that will threaten what has to date been a profitable, but sometimes poorly served market.

While the ultimate success of challenger banks and their disruptive impact on the SA financial services sector will not be known for some time, it is apparent that new banking models will increase competitive pressures in the market. Certain banks, such as FirstRand and Capitec, appear better placed to fend off these risks. Regardless, industry returns on capital for incumbent banks should compress over time. UP



The coal conundrum

Mandi Dungwa - Portfolio Manager

> "While there is no question regarding the steady need for coal supply at present, the local sector is plagued by Eskom's procurement and debt challenges, and the export market is trying to balance the costs associated with renewable energy innovation ahead of the 2050 global warming targets."

The coal conundrum

Coal is one of the largest and most affordable sources of energy, responsible for 38% of electricity generation globally. In South Africa, coal provides 83% of the power generated by Eskom, as well as being used as a heat producer in industrial processes such as in the manufacturing of cement, paper and steel. It is also turned into liquids and gases, used as fuel, or processed into chemicals to make other products. We unpack the dynamics of the South African coal mining sector.

South African coal

South Africa is endowed with an estimated 30 billion tonnes of coal, making up 3.5% of the world's coal resources. SA miners make up 3.7% of global annual coal production. The 253 million tonnes of coal that SA produced in 2018 were used as follows (graphed below):

- 120 million tonnes in the generation of power by Eskom;
- roughly 40 million tonnes in the creation of gas, liquid and chemical products by Sasol;
- 70 million tonnes were exported; and
- other domestic industrial processes used the remaining 23 million tonnes.

Eskom's procurement picture

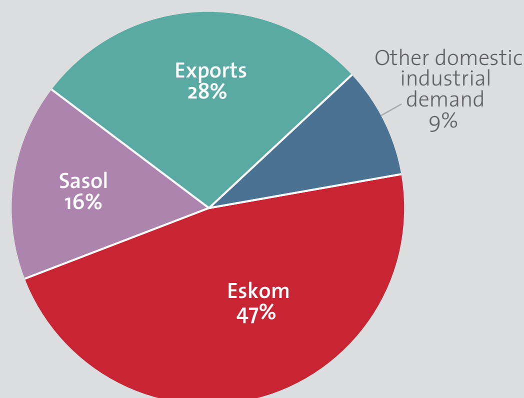
Eskom currently has 13 operational coal-fired power stations and a further two under construction. More than 80% of coal produced in the country is mined in Mpumalanga with the rest mined in Limpopo, KwaZulu-Natal and the Free State. 11 of Eskom's stations are based in Mpumalanga, within close proximity to coal mines, thereby minimising costs for coal transportation.

The domestic price of coal is mainly determined by Eskom (given its dominance in this market) who utilises three different contract structures and pricing mechanisms in purchasing coal. 33% of coal volumes are sourced via cost-plus coal contracts, 25% from fixed price coal contracts and 42% from short-term contracts (right chart below).

Cost-plus contracts (currently with Exxaro, Seriti Resources and South 32) are typically very long-term in nature, effectively holding Eskom responsible for ensuring the sustainability of the coal mine. Eskom pays for the cost of running the operation and the capital required, with a margin paid to the coal miner for operation and management. These mines are directly linked to the power stations, with some having conveyor belts running between mine and station to ensure a more optimal cost outcome.

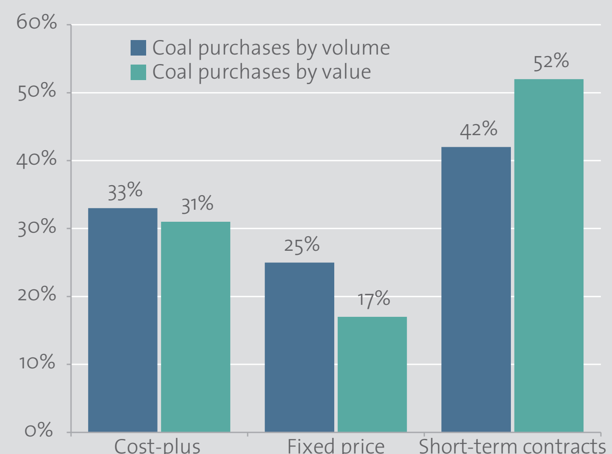
Fixed price, long-term contracts are based on an agreed fixed or commercial price for coal and ensure the delivery of agreed volumes to Eskom. Here, the costs to run the operation are borne by the mine owner, as well as the capital needed. Eskom compensates the miner for the coal, with a margin that should

South African coal demand



Source: company reports, Minerals Council of South Africa, Kagiso Asset Management research

Eskom's coal procurement mix



Source: Eskom 2019 integrated annual report

compensate them for the operational and capital cost, however, there is pricing risk borne by the miner.

Short-term contracts were created to enable the government's ambition for transformation, whereby the state was seeking to procure coal from majority black-owned miners. These contracts are similar to fixed price contracts but tend to be short-term in nature.

Eskom's cost problem

Eskom reports that 52% of coal costs are made up of short-term contracts, contributing 42% of volumes. These contracts are much more costly for Eskom than the alternatives. Higher logistical costs are one of the predominant reasons. Mines belonging to new entrants in the industry are generally located further away from power stations that utilise their coal, with significantly increased transportation and logistical costs as a result.

Eskom is currently discussing reverting back to a lower cost option - where the bulk of volumes are sourced via long-term coal contracts - with a preference for coal delivered by conveyor. It is, however, not clear what will become of the new entrants that have been incentivised to enter the coal sector over the last while and may not be sustainable under such new arrangements.

Eskom requires an additional 1.3 billion tonnes of coal to cover all coal-fired power stations for a period of roughly 10 years. This is not catered for via the current contracts, which have reportedly secured sufficient coal supply until 2021. Eskom will need to recapitalise its cost-plus mines to ensure the security of coal supply at an optimal cost.

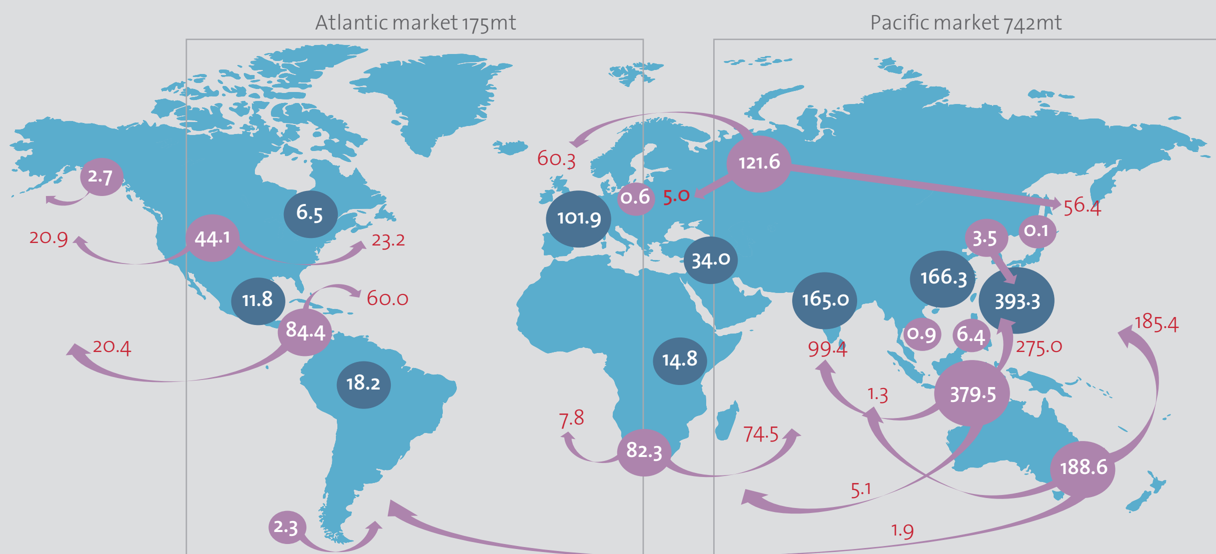
With Eskom facing a mounting debt burden, capital spend on coal mines has been reduced over the last number of years to meet debt servicing costs. Yet, as mining is a capital-intensive sector, any underspend on capital means that significant catch-up will be required to meet power station demands in the near future.

Sasol and other industrial demand

Sasol uses coal to manufacture liquid fuels and other chemical products through an integrated value chain. Its own mines produce around 40 million tonnes of coal and it acquires a further five million tonnes from third party producers. Sasol currently has enough coal supply from its own operations to meet its requirements until 2050.

The South African iron and steel industries also use coal, yet only 13% of coal produced globally can be used in steelmaking. This 'special' coal - referred to as coking coal - has a high calorific value.

Seaborne thermal coal supply and demand (2017)



Source: Glencore

The coal conundrum

Coking coal prices are primarily determined by global supply and demand dynamics and they are significantly higher than prices for the thermal coal utilised in electricity generation. The largest local consumer of coking coal, Arcelor Mittal, is in the process of restructuring its South African assets and is uncertain of how this will affect their future coal demand.

Climate change and future demand for coal

Thermal coal used in energy production has a major shortcoming in that this process is responsible for a third of global carbon dioxide emissions.

To meet the Intergovernmental Panel on Climate Change's global warming target, all coal-fired power plants need to be closed by 2050. This implies that over a third of global power needs will switch from coal to other energy sources. These developments have significant implications for the 28% of South African coal supply that is shipped to the rest of the world.

The global thermal coal market can be split between the Atlantic and the Pacific, making up 20% and 80% of seaborne demand respectively (chart on previous page).

In the Atlantic market, coal is currently being displaced by lower carbon emitting substitutes for energy generation. The discovery of shale gas in the US has accelerated this displacement in favour of lower cost natural gas. In Europe, coal demand has declined over several years as old coal-fired plants are replaced with more renewable and nuclear power plants.

In the Pacific, coal-fired power generation is relatively new, with the average age of coal plants less than 15 years old, compared to most in the Atlantic that are over 40 years old. Even with the current stated objectives of reducing carbon emissions, an additional 1.4 billion tonnes of coal will be required to meet increased demand from coal-fired power plants that are currently planned by governments in this region. Pacific demand growth results from strong regional economic growth and the emergence of a large, growing Asian middle class with increasing energy needs.

To ensure compliance with emission targets, Asian power producers are installing High Energy, Low Emissions (HELE) technology. This technology has the capacity to reduce up to 40% of carbon emissions (or up to 90% if the not currently commercially viable carbon capture is factored in). HELE technology has been successfully used in China and Japan to reduce carbon emissions. Coal, together with HELE technology, could become the lowest cost energy option for the Pacific, and far less harmful to the environment than current options.

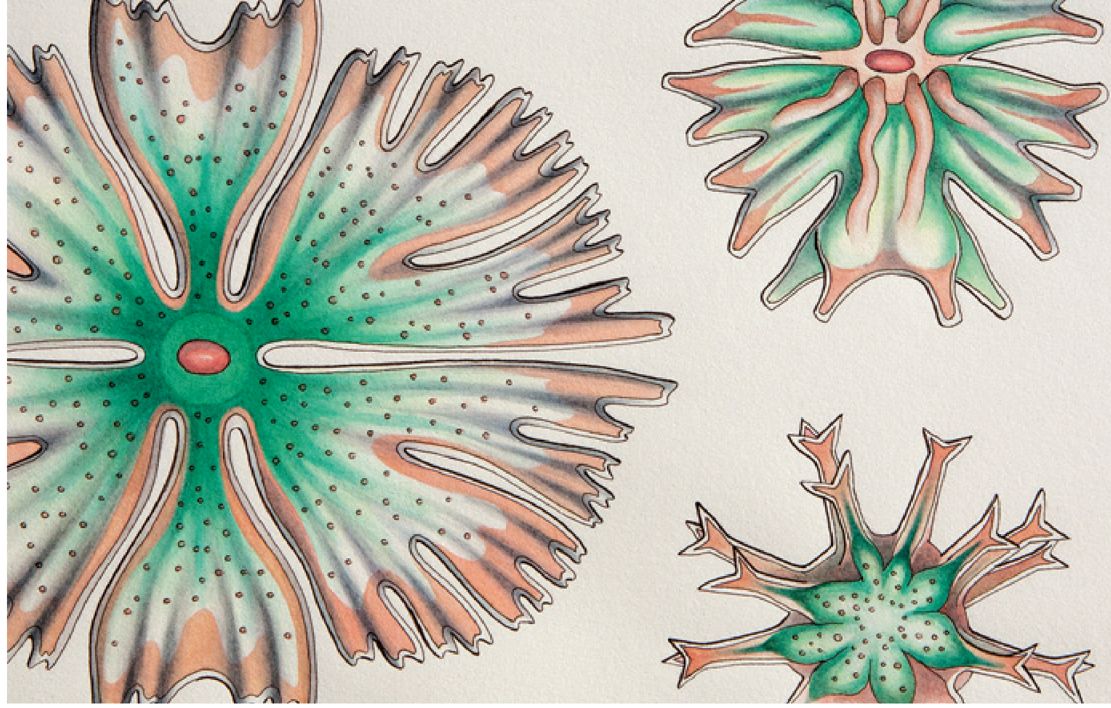
HELE technology requires the use of higher quality thermal coal and South Africa predominantly produces low quality thermal coal, as is required by Eskom. While South Africa's "good quality" coal is exported, it is not on par with Australian coal quality, which also benefits from a location advantage.

Exports from South Africa only make up 28% of production at present, but account for around 50% of coal miner profits as domestic coal is priced at a significant discount to the seaborne market.

Investment implications

The export market is navigating the requirement for a growing demand for electricity, while also endeavouring to reduce carbon emissions. Although this need has led to some innovation (HELE technology), this is an ever-evolving area and renewable energy continues to have the best environmental impact, albeit at a higher cost.

The South African coal sector is dominated by Eskom's domestic procurement strategies. Eskom seems to be taking a longer-term view to coal procurement but is in significant financial distress and has limited ability to recapitalise the sector. Considering these dynamics, we have limited exposure to coal miners in our portfolios. However, Eskom's strategic shift towards long-term coal contracts could present a positive opportunity for low cost domestic producers. UP



Evonik is special

Jihad Jhaveri - Head of Process

"RAG-Stiftung, a remnant of the largest coal mining conglomerate in Germany, is a foundation with the primary purpose to fund ongoing mine closure costs in the Ruhr region. The asset funding these liabilities (after many years of portfolio pruning) is RAG's 64.3% stake in Evonik Industries. Evonik is a company that houses a portfolio of chemical businesses, many of which trace their roots back to technological breakthroughs in the nineteenth century."

Evonik is special

Ever-evolving Evonik

Following the shedding of its smaller real estate and energy holdings, shortly after its listing in 2013, Evonik embarked on a strategy from 2017 that aimed at:

- Achieving material cost savings - given that central costs were high compared to competitors due to the historically sprawling nature of the business; and
- Recasting the portfolio away from commoditised chemicals towards specialty chemicals.

Higher returns on investment - stemming from superior pricing power - are generally expected from producing specialty (as opposed to commoditised) chemicals. Specialty chemicals are, however, not well defined and management teams in chemical companies are generous in the classification of their own portfolios - given the higher market ratings investors place on specialty exposures. In addition, over long periods of time, specialty products may become more commoditised as customer specifications become standardised, competitors erode intellectual property advantages, and entrenched players build too much capacity.

Methionine

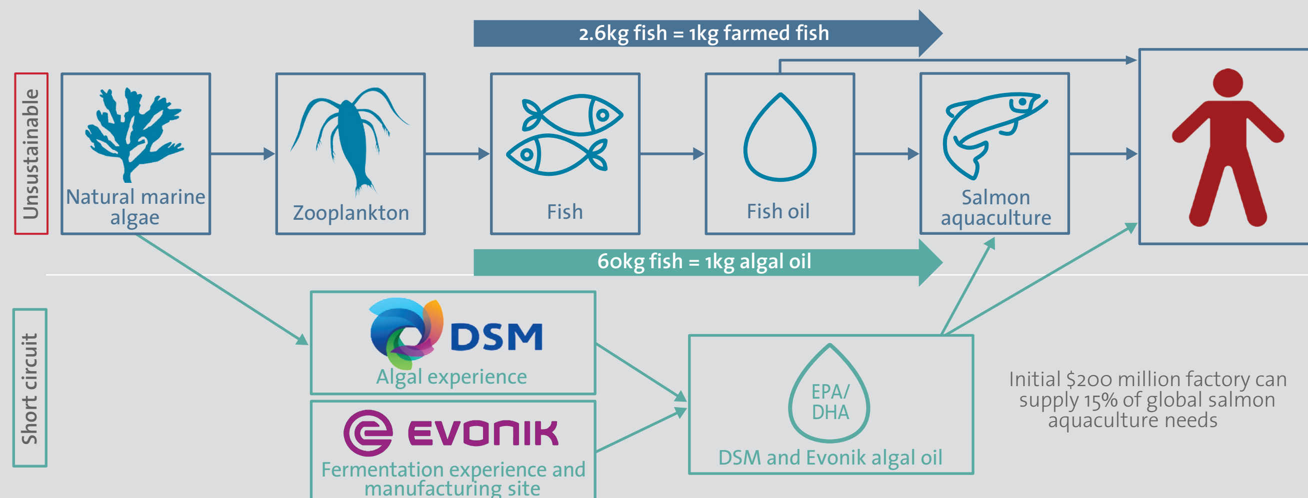
Essential amino acids help build the proteins that make up the tissues and organs of the body. They cannot be synthesized by the body and must therefore come from the diet. Methionine is a sulphur-based amino acid found in many proteins. It produces several important molecules essential for proper cell function and is commonly deficient in poultry and bovine diets. This makes methionine an extremely useful animal feed additive, yielding significant feed productivity (up to 23% in the case of poultry). Growing human populations, urbanisation and increasing incomes has led to greater meat consumption, and consequently, healthy methionine demand growth of 5-6% per annum in recent years.

After World War 2, in an effort to eleveate the malnutrition problems in Europe at the time, an Evonik predecessor company created the first commercial processes to synthesize methionine. This head start is now evident in Evonik's current 40% global market share in the product.

The complicated production process and the difficulties in its transportation and storage, means that vertically integrated methionine producers such as Evonik, are advantaged. Despite this, too much supply has entered the market in recent years, leading to significantly reduced pricing power (commoditisation).

With depressed prices beginning to squeeze out non-integrated competitors and planned new capacity projects being cancelled, it appears that we are close to the cyclical trough and Evonik's low cost relative position should benefit them in the higher price environment that is coming. Furthermore, the completion

Natural marine algal oil is a sustainable alternative



Source: Evonik, DSM, Kagiso Asset Management research

of a massive new Evonik facility in Singapore will support a 25% increase in Evonik's capacity, replacing older high cost capacity and consequently delivering market share gains.

'Special' omega-3 - a sustainable prize

Omega-3, an essential fatty acid that plays an important role in maintaining a healthy body, must also be derived from the diet. An increasing human demand for omega-3 is contributing to a greater demand for fish, which is a rapidly shrinking resource. The graphic below shows the current unsustainable flow chain of omega-3 feed to salmon aquaculture.

In a collaborative breakthrough, Dutch specialist chemical company DSM, has combined its algae know-how with Evonik's specialist large scale fermentation manufacturing technology to produce a natural marine algae omega-3 oil alternative. It is estimated that 1kg of this algal oil can replace 60kgs of wild catch fish needed to produce a similar amount of fish oil. Following a $200 million joint investment, commercial scale production has ramped up and has considerable future growth potential.

The silica revolution

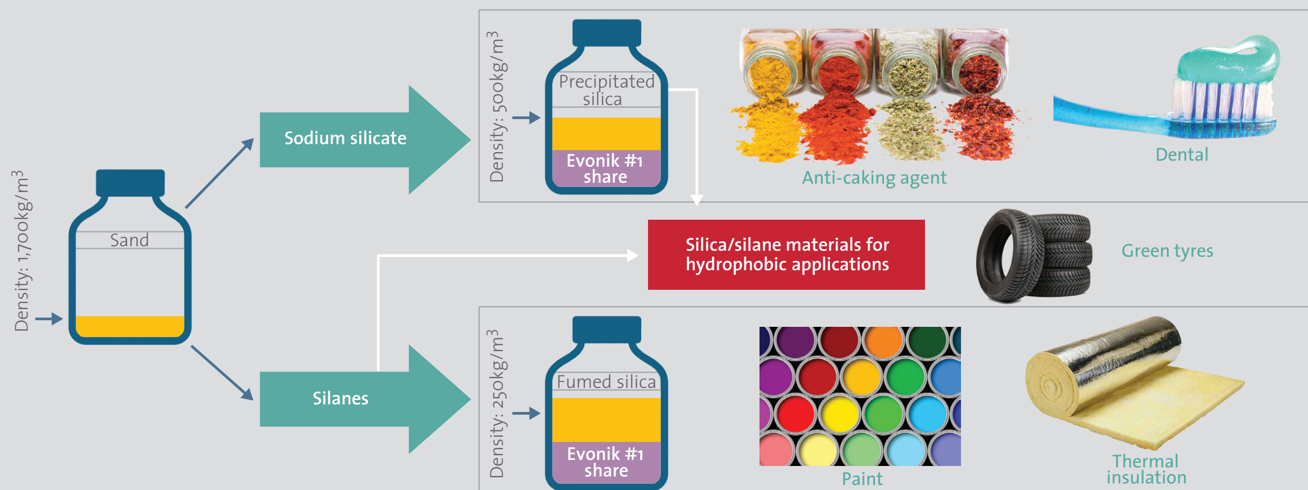
Silicon (the second most abundant element in the earth's crust after oxygen) is too reactive to be found on its own in nature and usually occurs together with oxygen, as natural silica - loosely referred to as sand.

When silica is manufactured synthetically to a high level of purity and a low density, it becomes an excellent additive for improving other materials by enhancing and altering flow characteristics, increasing flexibility and strength (rubbers and silicones), reducing moisture (sachets used in food packaging), and preventing settling and caking (solutions and powders). This has led to a wide array of applications in everyday products as shown below.

Despite the abundance of the required raw materials, the manufacturing process lends itself to creating strong competitive advantages due to scale and location, manufacturing know-how, and developing new applications and niche high margin variants. Consequently, the production capacity is extremely concentrated. With over seven decades of experience, Evonik is the largest producer, with many of its factories entrenched in on-site "fence-to-fence" partnerships with customers.

Evonik's silica business has achieved huge success in the development of new applications for its customers. An example is "green tyres", where Evonik pioneered the research that overcame the long-standing issues with the binding of fumed silica (hydrophilic) with tyre rubbers (hydrophobic). Green tyres have lower roll resistance, meaning greater fuel efficiency, superior abrasion resistance, and wet grip. They make up 45% of global tyre sales (from 10% in 2011).

The manufacturing of silica renders varied applications



Source: Evonik, DSM, Kagiso Asset Management research

Evonik is special

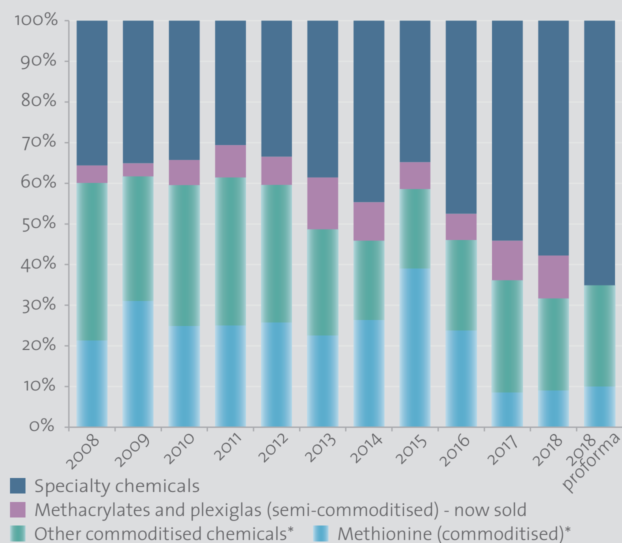
Specialist products from fresh air

Evonik also produces hydrogen peroxide, which is mostly used in traditional bleaching applications such as in the whitening of cellulose paper, and in laundry, dental and hair care applications. It is increasingly used in new growth markets such as food, cosmetics and electronics. Key inputs are hydrogen and atmospheric air. As with silica, the required complex manufacturing process lends itself to very strong competitive advantages. The hydrogen peroxide business is expected to be much larger in the mix going forward - especially post the proposed $625 million acquisition of US competitor PeroxyChem. We expect this to be value accretive due to a complementary US footprint and as Evonik's superior manufacturing know-how is transferred to the acquired assets.

PEEK polymer performance

Evonik's polymer business is skewed heavily to ultra-specialised, high-demand products like PEEK ('king' of the polymers), Nylon 12 and polymers used in composite materials. Trading at five to seven times the price of other high-performance polymers, PEEK's temperature resistance, strength, superior chemical resistance, and light weight make it a better input than steel in many applications, including chemical processes with corrosive environments. It is also biocompatible and an ideal material for human body implants.

Estimated Evonik profits mix



Source: company reports, Baader Helvea equity research, Kagiso Asset Management research

There are only three companies that are capable of producing high quality PEEK at scale in its resinous form. The powder form of performance polymers is even more specialised (and costly) than the resin form and Evonik has a significant cost advantage in doing this due to substantial investment over the years. Positively, Evonik is investing heavily in Nylon 12 powders to increase capacity by 40% in the face of a healthy demand from 3D printing. Nylon 12 powder has very good sintering properties resulting in excellent durability from finished 3D products.

Innovation is key

Our main concern for Evonik is that the period over which specialty chemicals become commoditised is rapidly shrinking due to:

- End demand shifting towards Asia where intellectual property is being eroded at a more rapid rate and better-quality variants are currently not as appreciated relative to developed markets.
- Large new sources of feedstock are now available in new geographies, which is quickly weakening previously entrenched location advantages.
- Research and development efforts in chemicals have yielded few new "blockbusters" in the last decade (outside of crop protection).[1]

Despite this, our view is that Evonik is at an advantage in that their absolute spend on research and development is very significant (top five global spender) with increasing visibility on the strength of their future product pipeline (the omega-3 venture and the rate of new patent applications). The percentage of sales emanating from products less than five years old has started to slowly increase from 11% to a targeted 16% by 2022.

Although profitability by product line is not disclosed, we have estimated that an increasing proportion of profits are emanating from specialty products. The chart shown left indicates that:

- the commoditised methionine exposure is cyclically depressed; and
- the Plexiglass business sold in 2019 at a very favorable price and at a relatively high point in that chemical's profit cycle.

We believe this positive exposure mix towards specialty chemicals is not fully appreciated by the market and that this provides our clients with an attractive investment opportunity. UP

[1] McKinsey & Company (2017)

Clicks and mortar malls of the future

Rahgib Davids - Investment Analyst

"Retail property in developed markets benefits from healthy consumer spending power but is hugely challenged by the way online retail advancements are changing consumer behaviour. As a result, the sector has underperformed over the last few years. This is forcing shopping malls to adjust the way in which they serve customers - particularly in the UK and the US, where online retail penetration is highest."

Clicks and mortar malls of the future

In South Africa, the retail property market faces challenges stemming from prolonged weak economic growth, constrained consumer spending power and an oversupply of malls that is struggling to be fully absorbed.

We discuss the evolution of shopping malls and unpack what it means for locally listed retail property shares and Hammerson.

Goodbye convenience, hello experience

The traditional shopping mall concept (pioneered in the US in the 1950s) revolutionised the shopping experience by providing:

- Increased transactional convenience - a concentration of the marketplace in one area; and
- Increased lifestyle experiences - customers could shop as well as socialise, dine and be entertained.

Today, the most convenient transactional shopping experience is provided by your smartphone. Online shopping offers transactional convenience, effortless product searches, easy price comparability and a host of other logistical advantages that are attractive to the busy consumer. Shopping malls struggle to compete.

With online retail challenging the concept of convenience, mall owners and tenants have had to shift their focus to the social, lifestyle and experiential potential that retail environments can offer customers - opportunities not provided by smartphones.

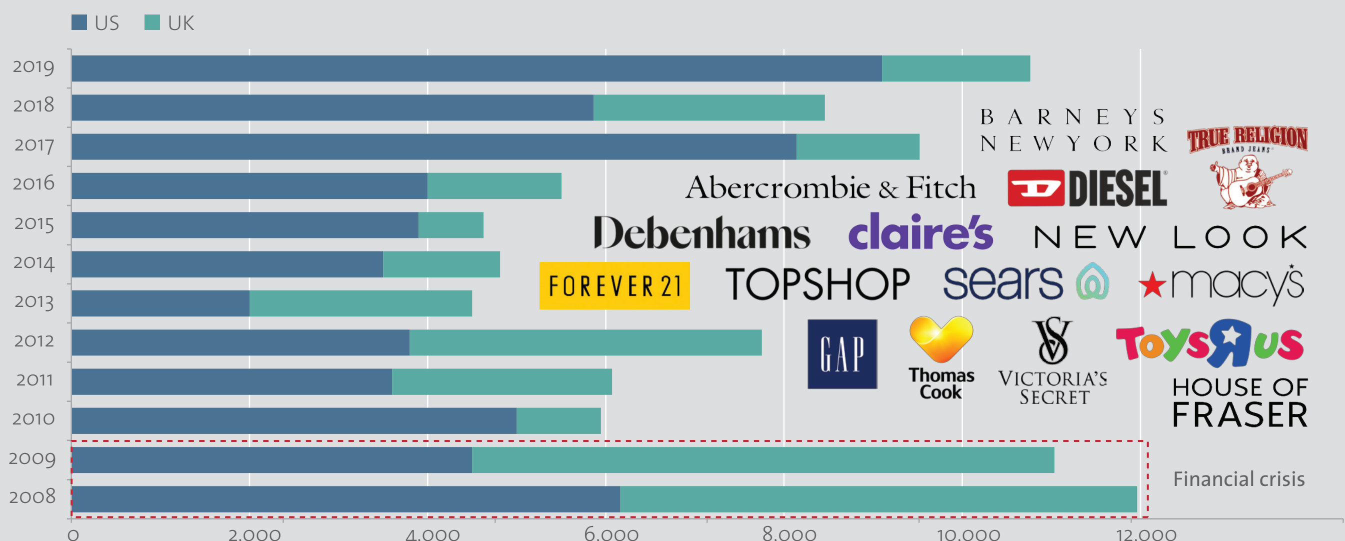
Malls of the future

The shopping malls of the future will need to be quite different in the following ways:

- **Flexible leasing and brand curatorship:** Long-term leases are a sore point for retailers who have suffered from declining store profitability with the rise of online sales. Many large retailer brands have been forced into financial difficulty and even bankruptcy, which has enabled them to break their lease agreements and close some stores. As shown below, store closures in the US and UK over the last two years have almost reached the record levels of the financial crisis of 2008/9. These include big brands such as Macy's, Debenhams, JCPenny, Barneys and House of Fraser, who leave behind large empty spaces that are difficult to re-let.

  This has inspired flexible space usage concepts as introduced by one of the US's largest premium mall owners, Macerich. Their "Brandbox" concept divides empty units into mini-stores using modular walls that can accommodate several brands, depending on the size of the spaces needed. Each brand rents space for a short-term period (6-12 months), meaning a quick turnaround of offerings, thereby keeping customers interested and engaged. Furthermore, Brandbox provides store fixtures, marketing and technological support (radio frequency identification tags for real-time

Store closures at levels close to those of the financial crisis of 2008/9



Source: Centre for Retail Research, Cbinsights.com, PwC UK 2019 Retail Store closures report, Cushman and Wakefield research

stock tracking and point of sale machine and foot traffic tracking devices) that is sold as a packaged deal. This is ideal for online businesses who wish to grow their business by leasing physical store space for the first time, without the hindrance of a long-term lease agreement.

'Flexible leases' are increasingly becoming the norm and, as a result, the landlord-tenant relationship is evolving to one of mutual cooperation where landlords have to actively curate retail brands to ensure the most attractive, differentiated offering for their customers. The graphic below contrasts this with the 'old', passive long-term lease relationships.

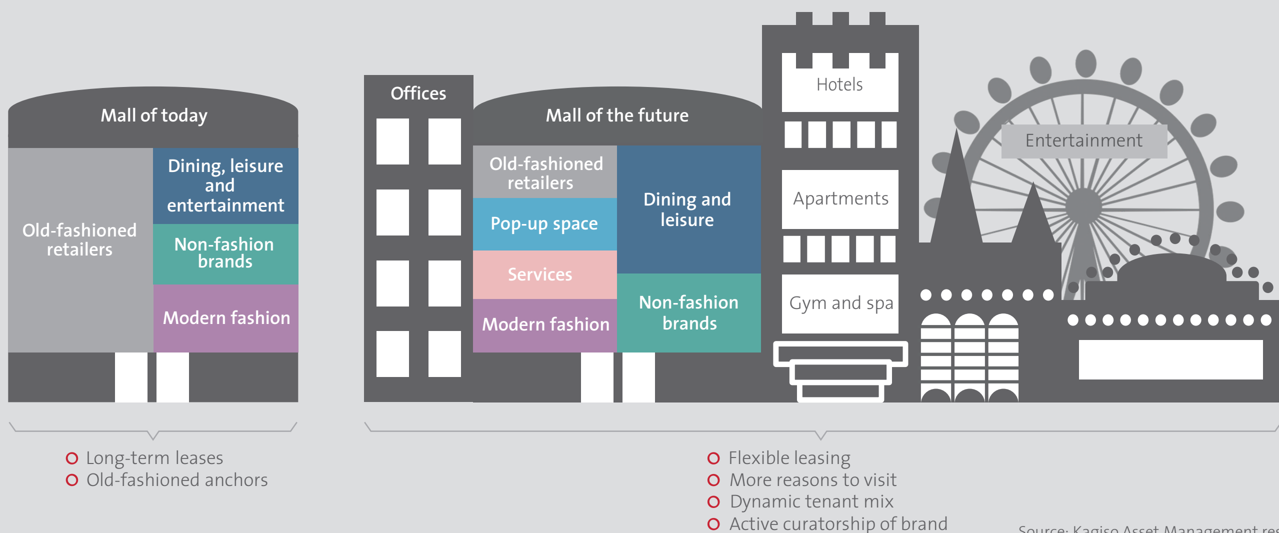
- **Mixed-use precincts:** Increasing urbanisation, coupled with the consumer's need for convenience and a growing interest in urban locales that provide various amenities in close proximity to each other, means that the malls of the future will not be exclusively retail focused. Integrated spaces where people can live, work, shop and play are becoming increasingly common. More retail property owners are densifying land in and around their shopping malls to include a mix of residential property, hotels, offices, educational institutions, gyms, health spas, art galleries and public parks.

In efforts to enhance the customer experience, mall owners are also critically reassessing how existing space is used, including offering more varied and more exciting entertainment. The Mall of America in Minnesota, for example, boasts an underground aquarium, a Nickelodeon theme park and a 5D virtual reality cinema.

Services will also become an important occupier of space. Doctors, dentists, hair salons, childcare and municipal services are required on a regular basis and their presence in malls should translate to increased footfall. A good range of restaurants is deemed equally as important, along with improved tenant mixes, whereby older, less relevant retailer brands are replaced with modern businesses, such as:

- Zara and H&M, who are taking up larger spaces to house their new, digitally empowered flagship stores that provide customers with the full omni-channel experience (an online content strategy that is used to improve the user experience);
- Car brands such as Tesla and Mercedes are using retail space as showrooms for their latest models; and
- Online brands are opening physical stores to further customer engagement and grow their brands more dynamically (the halo effect), for example Amazon books, Morphe and Sofa.com.

The evolution of the shopping mall



Source: Kagiso Asset Management research

Clicks and mortar malls of the future

- **Only the best will thrive:** Retailers are using smartphones to better engage with customers - the omni-channel experience. This allows customers to seamlessly interact with the physical and digital world of the store. For example, H&M's photo powered garment search engine, which uses a photograph to search for matching items in-store. It allows the customer to purchase the item via their smartphone or directs them to the nearest store.

  Retailers transitioning to this model are more selective in where they choose to have physical store presence, opting for locations where footfall is highest - usually shopping malls that have successfully transformed into experience-led, mixed-use destinations.

  Mall owners are also offering free wifi, which keeps customers lingering for longer and allows owners to track customer movements and obtain valuable data insights into shopping behaviour. This is enhanced through innovative mobile phone applications such as those which 'ping' when a customer passes a store hosting a sale.

  In the UK and US, only 10% of existing shopping malls meet the criteria of being considered prime destinations with a reasonable chance of thriving in the future. This will result in a high degree of mall redundancy, a source of heightened risk for investors.

Hammerson - bringing people and brands together

Hammerson is a high-quality, retail-focused property company with 40% of assets located in the UK, where retail conditions are exceptionally tough. UK retailers are not only battling with the disruptions posed by online retail but also with excessively high occupancy costs (wages, rent and business taxes). Fortunately, most of Hammerson's UK assets consist of some of the country's prime shopping malls that are well positioned to thrive in this omni-channel future.

For years, Hammerson has been defensively investing in their malls by reinventing spaces through the inclusion of new experiential offerings, while aggressively improving their tenant mix. They are well into the process of transforming their malls into integrated mixed-use precincts.

Outside of the UK, 60% of Hammerson's assets are located across continental Europe and Ireland where online retail has had less of an impact. Here, Hammerson has flagship malls and owns stakes in highly desirable premium outlet centres located outside numerous major European cities.

Premium outlets are tourist-focused shopping destinations where one can purchase off-season branded fashion at discounted prices - an experience that is difficult to replicate in the digital space. These high-growth assets produce some of the top trading densities in the world.

South Africa is slow on the uptake

In South Africa, the impact of online retail has been limited, largely due to expensive data, underdeveloped infrastructure, poor fulfilment capabilities and a widely dispersed population. As such, shopping on foot will likely remain relevant for some time. However, in categories such as household appliances and electronics, the impact of online retail has already been significant, as reflected in the persistently weak sales performance delivered by Massmart's Game stores over the last three years. In addition, as with the overseas experience, old fashioned department store formats are under pressure (Edcon Group has struggled and Stutterfords has failed).

Although South Africa is behind the curve (with only 1% of retail sales currently made online), the local online retail revolution has begun. We have already seen major changes and remain vigilant regarding other possible disruptions.

A mixed bag

The race is on for mall owners in South Africa to ensure that their assets are relevant as they compete to attract a shrinking pool of retailers. The current situation in South Africa of a proliferation of malls relative to the potential target market size is not a good starting point to tackle the transition to a more online and omni-channel retail world. UP

Kagiso Asset Management Funds

Performance to 30 September 2019	1 year	3 years[1]	5 years[1]	10 years[1]	Since launch[1]	Launch	TER[2]	TC[3]
Unit trust funds[4]								
Equity Alpha Fund	10.5%	6.1%	5.4%	10.8%	16.0%	Apr-04	2.11%	0.45%
SA Equity General funds mean	-1.8%	1.1%	2.4%	8.7%	12.1%			
Outperformance	12.3%	5.0%	3.0%	2.1%	3.9%			
Balanced Fund	8.9%	6.5%	6.3%	-	8.9%	May-11	1.58%	0.46%
SA Multi Asset High Equity funds mean	2.0%	3.7%	4.8%		8.0%			
Outperformance	6.9%	2.8%	1.5%		0.9%			
Protector Fund	9.4%	7.5%	6.7%	7.3%	9.8%	Dec-02	1.57%	0.38%
CPI + 4%	8.3%	9.2%	9.7%	10.0%	10.5%			
Outperformance	1.1%	-1.7%	-3.0%	-2.6%	-0.7%			
Stable Fund	10.3%	7.2%	7.5%	-	8.4%	May-11	1.51%	0.47%
Total return of CPI + 2% pa	6.3%	6.6%	6.3%		5.9%			
Outperformance	4.0%	0.6%	1.2%		2.5%			
Institutional funds[5]								
Managed Equity Fund (SWIX)	13.9%	6.0%	4.7%	10.8%	11.2%	Sep-06		
FTSE/JSE SWIX All Share Index	0.2%	2.6%	4.6%	11.5%	10.9%			
Outperformance	13.7%	3.4%	0.1%	-0.7%	0.3%			
Managed Equity Fund (Capped SWIX)	12.2%	-	-	-	6.9%	Jan-17		
FTSE/JSE Capped SWIX Index	-2.4%				1.9%			
Outperformance	14.6%				5.0%			
Domestic Balanced Fund[6]	12.4%	7.0%	5.8%	9.2%	8.4%	May-07		
Peer median[7]	1.4%	4.0%	5.1%	10.1%	8.7%			
Outperformance	11.0%	3.0%	0.7%	-0.9%	-0.3%			
Global Balanced Fund[8]	10.4%	8.2%	7.7%	-	9.5%	Jul-13		
Peer median[9]	-0,5%	4.4%	5.7%		8.2%			
Outperformance	10.9%	3.8%	2.0%		1.3%			
Bond Fund	11.8%	9.9%	-	-	9.3%	Aug-15		
BESA All Bond Index	11.4%	8.9%			8.3%			
Outperformance	0.4%	1.0%			1.0%			
Money Market Fund	8.2%	8.5%	8.2%	7.1%	7.9%	Jan-04		
Alexander Forbes STeFI Composite Index	7.3%	7.4%	7.1%	6.5%	7.4%			
Outperformance	0.9%	1.1%	1.1%	0.6%	0.5%			
Sharia unit trust funds[4]								
Islamic Equity Fund	1.6%	6.6%	5.1%	-	10.7%	Jul-09	1.43%	0.22%
SA Equity General funds mean	-1.8%	1.1%	2.4%		9.8%			
Outperformance	3.4%	5.5%	2.7%		0.9%			
Islamic Balanced Fund	2.0%	5.4%	4.5%	-	6.6%	May-11	1.51%	0.16%
SA Multi Asset High Equity funds mean	2.0%	3.7%	4.8%		8.0%			
Outperformance	0.0%	1.7%	-0.3%		-1.4%			
Islamic Global Equity Feeder Fund	-	-	-	-	Not available	Jan-19		
Global Equity General funds mean								
Outperformance								
Islamic High Yield Fund	-	-	-	-	Not available	Mar-19		
Short-term Fixed Interest Index (STeFI)								
Outperformance								

Highest and lowest monthly fund performance	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest
Equity Alpha Fund	4.2%	-5.5%	6.6%	-6.0%	8.2%	-6.0%	8.2%	-6.0%	11.9%	-9.0%
Balanced Fund	3.9%	-4.8%	4.8%	-4.8%	5.5%	-4.8%	-	-	6.2%	-4.8%
Protector Fund	3.3%	-2.6%	3.3%	-2.6%	3.4%	-4.2%	4.8%	-4.2%	9.5%	-5.3%
Stable Fund	2.5%	-1.3%	2.5%	-1.3%	3.8%	-3.5%	-	-	4.0%	-3.5%
Islamic Equity Fund	2.9%	-3.9%	5.3%	-3.9%	7.3%	-4.6%	-	-	8.1%	-4.9%
Islamic Balanced Fund	2.7%	-2.8%	4.0%	-2.8%	4.6%	-3.0%	-	-	8.2%	-5.4%

Footnote and disclaimer follow overleaf.

Kagiso Asset Management (Pty) Limited

Fifth Floor MontClare Place
Cnr Campground and Main Roads
Claremont 7708

PO Box 1016 Cape Town 8000

Tel +27 21 673 6300 Fax +27 86 675 8501

Email info@kagisoam.com

Website www.kagisoam.com

Kagiso Asset Management (Pty) Limited is a licensed financial services provider (FSP No. 784).
Reg No. 1998/015218/07.

Footnote: [1] Annualised (ie the average annual return over the given time period); [2] TER (total expense ratio) = % of average NAV of portfolio incurred as charges, levies and fees in the management of the portfolio for the rolling three-year period to 30 September 2019; [3] Transaction costs (TC) are unavoidable costs incurred in administering the financial products offered by Kagiso Collective Investments and impact financial product returns. It should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of financial product, the investment decisions of the investment manager and the TER. This is also calculated on the rolling three-year period to 30 September 2019; [4] Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [5] Source: Kagiso Asset Management; gross of management fees; [6] Domestic Balanced Fund benchmark returns are an estimate for September; [7] Median return of Alexander Forbes SA Manager Watch: BIV Survey; [8] Global Balanced Fund benchmark returns are an estimate for September; [9] Median return of Alexander Forbes Global Large Manager Watch.

Disclaimer: The Kagiso unit trust fund range is offered by Kagiso Collective Investments (RF) Limited (Kagiso), registration number 2010/009289/06. Kagiso is a member of the Association for Savings and Investment SA (ASISA) and is a registered management company in terms of the Collective Investment Schemes Control Act, No 45 of 2002. Kagiso is a subsidiary of Kagiso Asset Management (Pty) Limited [a licensed financial services provider (FSP No. 784)], the investment manager of the unit trust funds. Unit trusts are generally medium to long-term investments. The value of units will fluctuate and past performance should not be used as a guide for future performance. Kagiso does not provide any guarantee either with respect to the capital or the return of the portfolio(s). Foreign securities may be included in the portfolio(s) and may result in potential constraints on liquidity and the repatriation of funds. In addition, macroeconomic, political, foreign exchange, tax and settlement risks may apply. However, our robust investment process takes these factors into account. Unit trusts are traded at ruling prices and can engage in scrip lending and borrowing. Exchange rate movements, where applicable, may affect the value of underlying investments. Different classes of units may apply and are subject to different fees and charges. A schedule of the maximum fees, charges and commissions is available upon request. Commission and incentives may be paid, and if so, would be included in the overall costs. All funds are valued and priced at 15:00 each business day and at 17:00 on the last business day of the month. Forward pricing is used. The deadline for receiving instructions is 14:00 each business day in order to ensure same day value. Prices are published daily on our website. Performance is based on a lump sum investment into the relevant portfolio(s) and is measured using Net Asset Value (NAV) prices with income distributions reinvested. NAV refers to the value of the fund's assets less the value of its liabilities, divided by the number of units in issue. A feeder fund is a portfolio that invests in a single portfolio of a collective investment scheme, which levies its own charges and which could result in a higher fee structure for the feeder fund. Figures are quoted after the deduction of all costs incurred within the fund. Individual investor performance may differ as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. Kagiso may close a portfolio to new investors in order to manage it more effectively in accordance with its mandate. Please refer to the relevant fund fact sheets for more information on the funds by visiting www.kagisoam.com