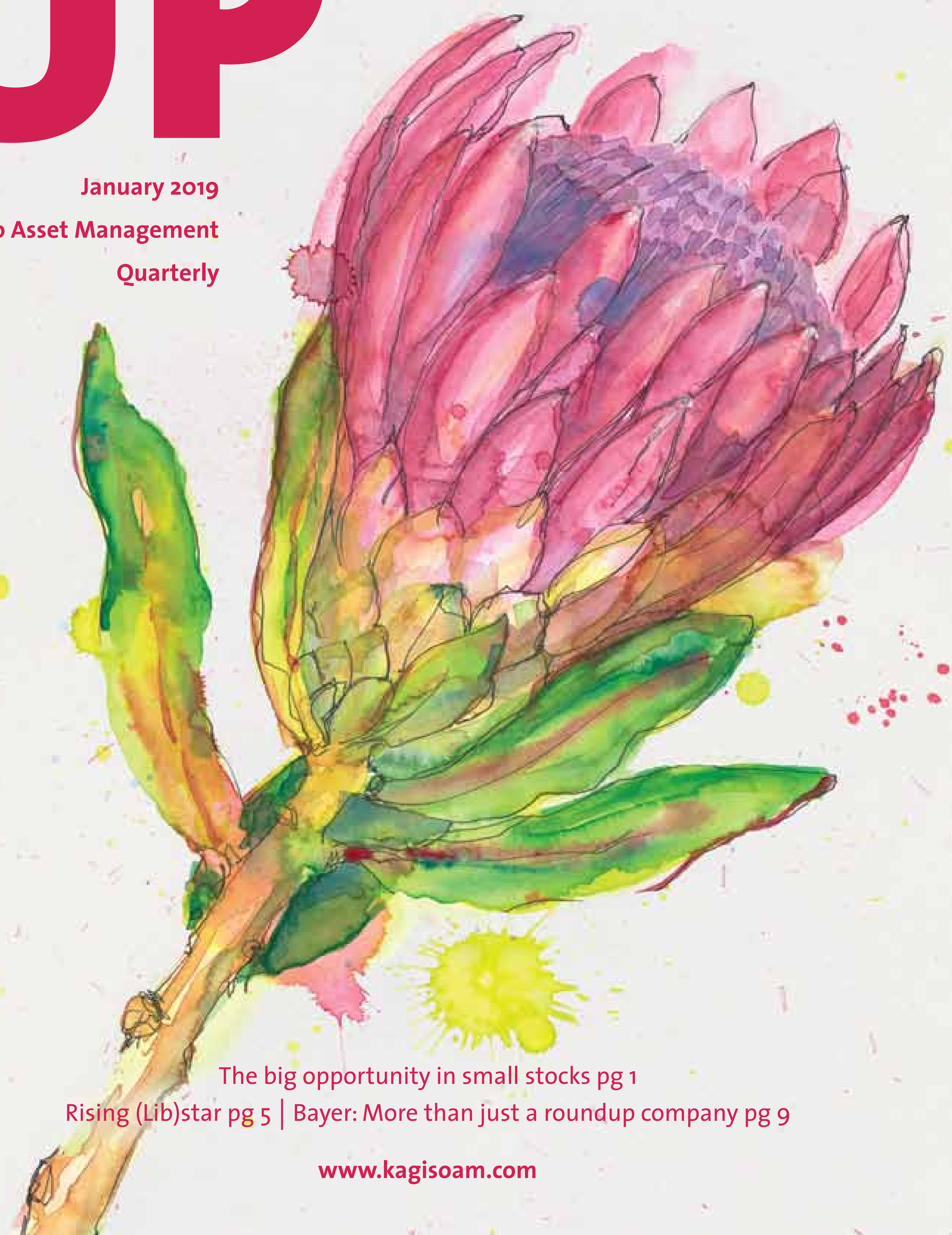
UP

January 2019

Kagiso Asset Management

Quarterly



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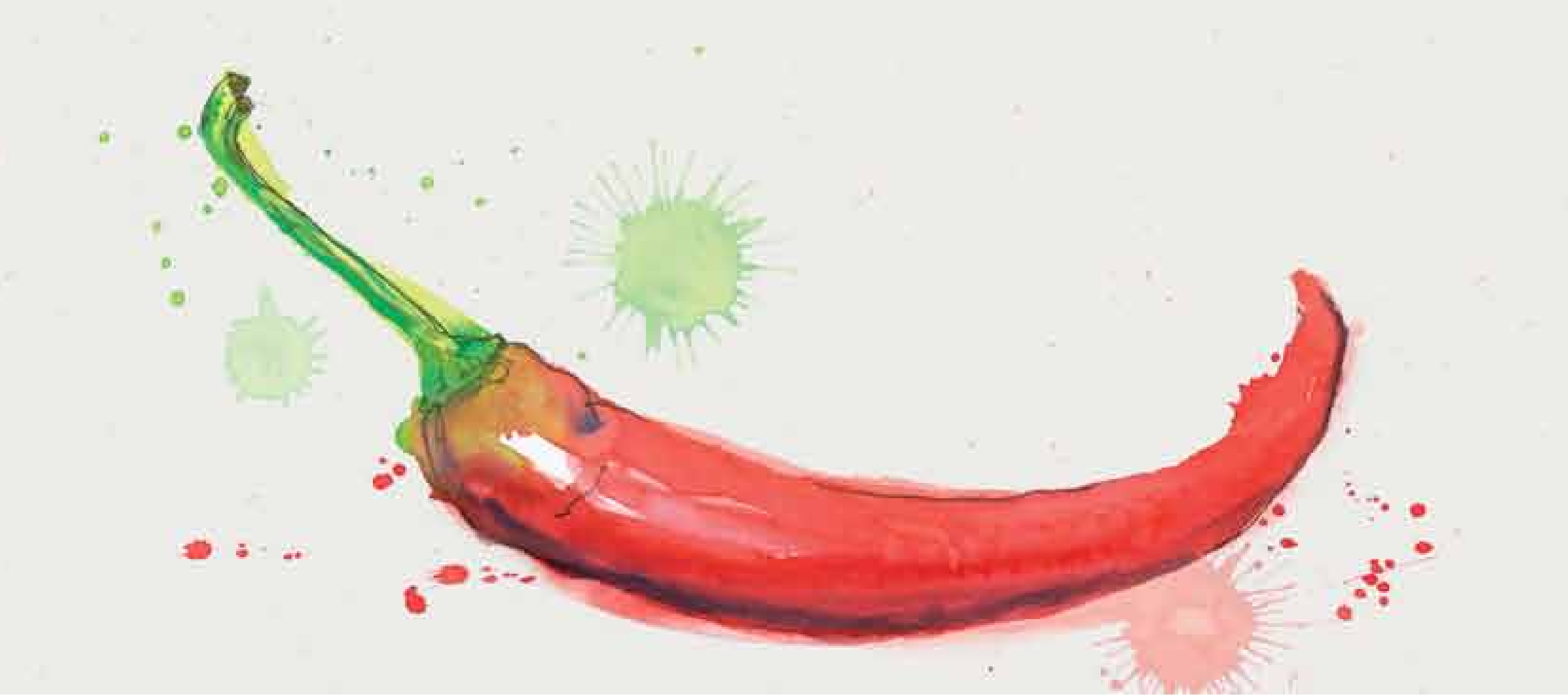

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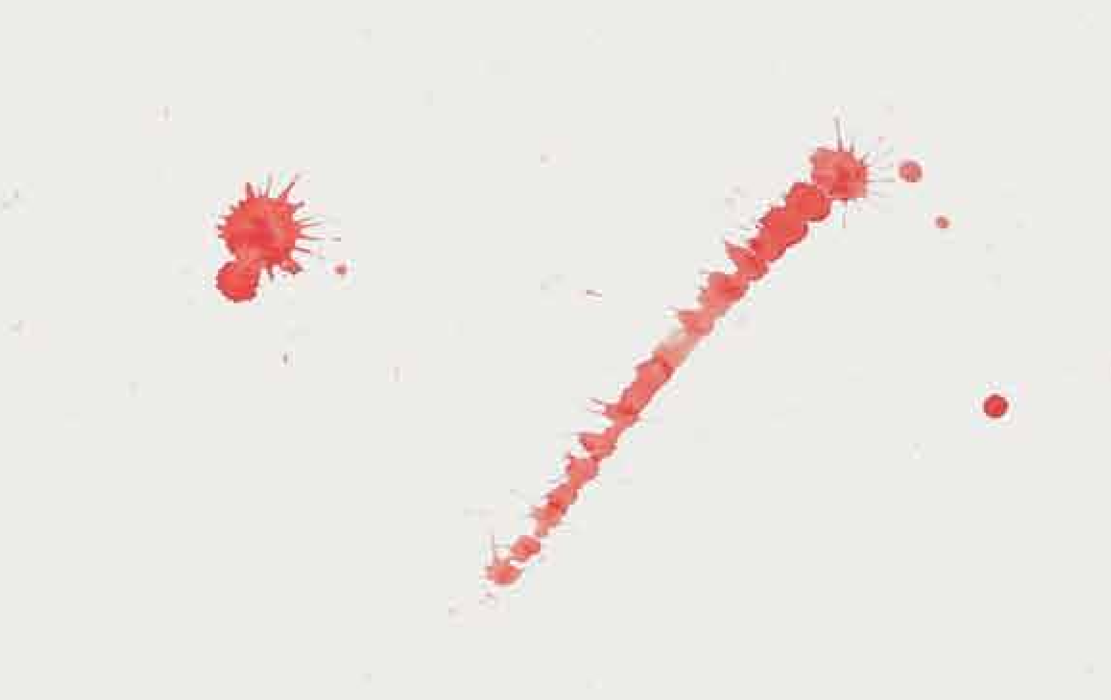


The big opportunity in small stocks

Gavin Wood - Chief Investment Officer

> A diversified portfolio of smaller company shares typically outperforms a portfolio of larger company shares over the long term. We believe that much of this outperformance comes from pricing anomalies resulting from less widespread scrutiny of smaller companies, often together with superior earnings growth.

The big opportunity in small stocks

We believe that the South African market is particularly materially mispricing smaller companies at the moment, and identify some of the potential reasons for this below. If we are correct, this presents the clients of skilled, contrarian, medium-sized asset managers with an unusually attractive (perhaps temporary) opportunity for high, market-beating returns from here on.

The size effect

Academic studies in the US and many other countries have consistently found that smaller stocks outperform larger stocks through time. There are many potential explanations - often of investor inattention due to insufficient information on these shares. Some studies argue that this outperformance is compensation for higher risk or increased transaction costs, although this is debated.

Our fundamental view on the causes in the South African context (graph below) revolve around faster earnings growth potential and relative investor neglect.

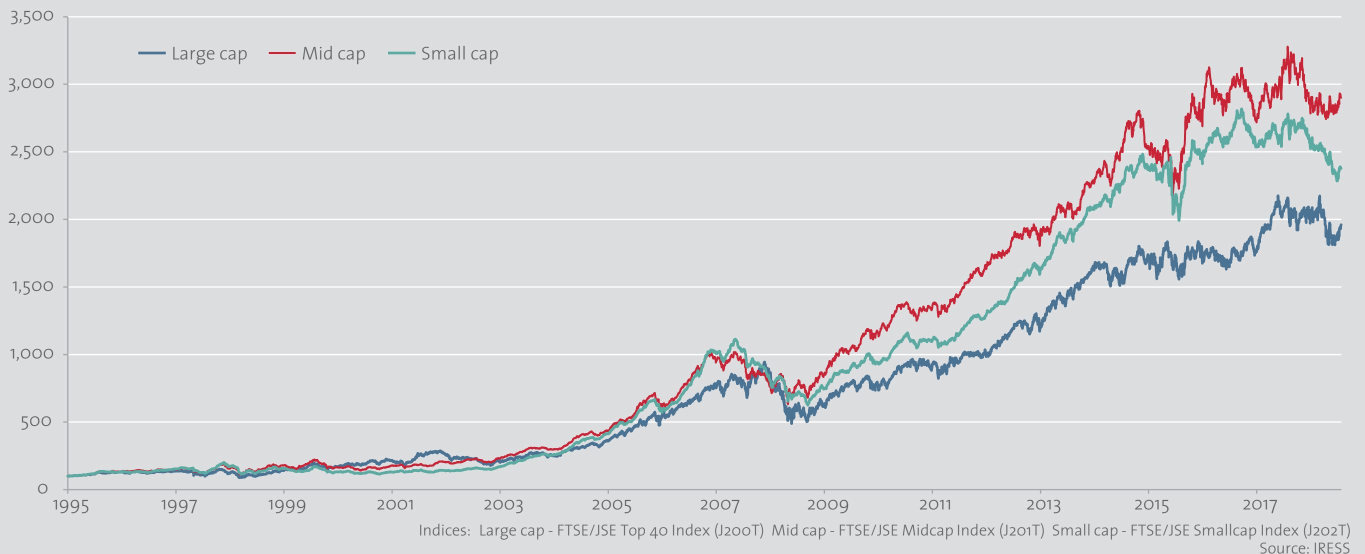
Faster earnings growth potential

In many cases, a successful smaller company is able to grow its earnings faster than a successful large company simply because it has a low base. Such a growth company may have a large, as yet untapped, addressable market or it may be winning market share from larger competitors. It may also meet less of a competitor reaction while its profile remains low. This is clearly not always the case, but it is incrementally harder to grow, the larger you are in any given market and the more pervasive your product or service is in the economy. These “growth” style shares are usually well appreciated by investors and rated very highly (high share price). Consequently, they often do not deliver superior investment returns.

A smaller company may also have a low earnings base because its earnings have fallen significantly below what it historically generated. The decline can be for transitory reasons, eg cyclical downturns in sales that will reverse when the cycle turns, temporary setbacks in activity and/or abnormal expenses that will not recur. It may also be due to poor operational execution that is reversible with a new strategy and/or new management. These “value” style shares are often accompanied by very lowly-rated share prices and consequently, very high potential investment returns if the earnings and rating rebound.

The earnings decline can, of course, be permanent, for example if due to a structural change or irreversible damage from management actions. Such shares may be best avoided.

Small and medium caps outperform large caps



Indices: Large cap - FTSE/JSE Top 40 Index (J200T) Mid cap - FTSE/JSE Midcap Index (J201T) Small cap - FTSE/JSE Smallcap Index (J202T)
Source: IRESS

Less efficient pricing in "neglected" smaller shares

Typically, smaller companies are less thoroughly researched than larger companies because they do not offer worthwhile opportunities for large financial services players. There is materially less value traded in smaller shares, and therefore, less trading commission revenue to be made by stockbrokers who cannot justify deploying expensive sell-side analysts to cover them. Additionally, given the low potential materiality in large manager portfolios (discussed below), very little research effort is worth the high cost of buy-side analysts' time.

This lower research scrutiny leads us to believe that, structurally, one may be able to find mispriced shares more often among smaller companies. This is especially the case where the smaller company presents a complex, idiosyncratic investment case that requires detailed research, or where it is a recent listing that is very new to market participants.

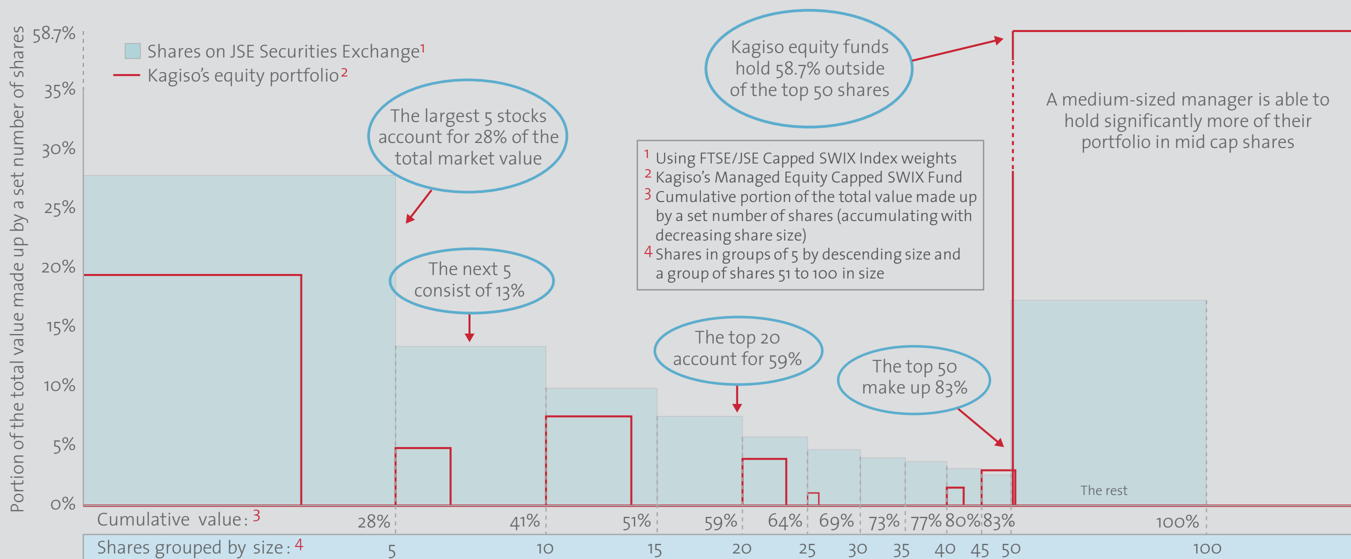
Larger companies are more efficiently and accurately valued than smaller companies and provide less of a fertile hunting ground for stockpickers.

Reasons for material current mispricings

It is our view that there is currently a particularly large and lucrative mispricing opportunity in smaller South African equities due to a number of recent market developments that have seen smaller stocks fall even further out of favour than is normally the case. These are:

- The prevalence of global emerging market (GEM) investors in South Africa has massively increased since the financial crisis. Typically, their universe is restricted to MSCI Emerging Market Index constituents and/or stocks with minimum average daily value traded. Smaller companies are necessarily excluded from this list and therefore, suffer from a far smaller potential investor base.
- The GEM investor universe has outperformed at the same time as (and partly because of) the increased foreign flows into South African equities. This seems to have led to some large South African managers giving up on smaller company exposure - pressuring share prices even further as they exit.
- Increasingly, more investors appear to pursue short-term investment strategies, into which smaller companies do not easily fit, despite clear value emerging for observant, patient investors. Such investors may either lack the patience to wait for investment cases to unfold; dislike the low beta in rising, momentum markets; or be averse to the impediments to short-term trading posed by smaller companies' lower liquidity.

SA's concentrated equity market



Source: IRESS, Kagiso Asset Management research

The big opportunity in small stocks

- The proliferation of recent corporate disasters and disappointments has left many investors biased towards "quality" shares. "Quality" may be defined by attributes such as: management reputation, financial returns, operational momentum, governance standards and often company size. It is therefore behaviourally very difficult to be contrarian and take a lonely position on the share register of a smaller company.

Pitfalls and risks

While there are potentially high returns on offer from smaller shares, it is important to have a deep understanding of the company in order to avoid those that have poor prospects and those facing potential risks. It is vital to assess risks arising from:

- The potential lack of diversification in a smaller business.
- The ability to adequately fund cashflow needs via debt and equity and the cost of this capital.
- The ability of the management team to execute on their stated strategy of growth or turnaround.

In our experience, some of the largest risks from smaller South African companies stem from weak governance at board level. This often manifests in excessive management remuneration and value destroying deployment of company capital. It is frequently necessary for us, on behalf of our clients, to pursue an activist approach to improve governance and mitigate these risks.

Clients of large managers are not exposed

Given that the South African equity market is so concentrated (graph on previous page), it is mathematically self-evident that large asset managers are unable to offer their clients material exposure to smaller stocks.

Even with a large stake in a smaller company, the portfolio exposure a large manager is able to gain can only be small. For example, a 10% stake in a R10 billion size company can only be 0.4% of a R250 billion firm-wide equity portfolio. That same shareholding amounts to (a much more meaningful) 2.5% of a R40 billion firm-wide equity portfolio.

This presents a clear competitive advantage for a skilled medium-sized asset manager, who can offer clients exposure to both larger and smaller shares, depending on where the opportunities lie.

How value is unlocked

A common counterargument against inexpensive smaller companies that seem to have lacklustre share prices and low responsiveness to general market momentum appears to be the lack of visibility on how value will emerge (informed by recency bias). A longer-term perspective is needed to see that there are multiple ways value may be realised, including:

- Most simply, high cashflow generation (relative to the share price) results in high income distributions to patient shareholders, via normal or special dividends (or even share buybacks).
- Inexpensive companies may be acquired at premiums to market prices by private equity investors (and delisted), or by larger companies that see synergy or strategic value.
- As growth or turnaround strategies prove successful, smaller companies attract attention and make it into larger portfolios, thereby unlocking value when such investors need to pay ever higher prices to build such positions.
- Late in a bull market cycle it is not uncommon for smaller stocks to substantially outperform and become very expensive (as in the late 1990s). This often coincides with high profile small company retail funds becoming popular and attracting large inflows - thereby fuelling the path towards excessive valuation.

Given the above, we have high conviction that our clients will earn unusually high equity returns from the smaller shares that we have selected for them. Our portfolio weight in a diversified mix of smaller companies, informed by detailed due diligence, is clearly illustrated in the graph on the previous page. UP

Rising (Lib)star

Dirk van Vlaanderen - Associate Portfolio Manager

> Founded in 2005, Libstar is South Africa's largest private label producer. This focus provides a unique opportunity for investors to gain exposure to the continued growth of private label brands in South Africa.

Rising (Lib)star

The rise of private label

The South African private label market has developed and grown substantially over several decades. The term refers to brands which are owned by a retailer and produced by a third party on the retailer's behalf, traditionally offering consumers a cost-effective alternative to conventional branded products. Consumers benefit from the cheaper option and retailers make a higher, or similar gross margin as the goods can usually be sourced more cheaply than the branded alternatives.

The South African market has become increasingly sophisticated, with retailers moving into an array of categories in addition to food products - from personal care to pet products. Tiered private brand strategies mean that private label products are no longer simply imitations, but are category disruptors and increasingly trusted, and even preferred, by consumers.

Broadly, private label brands fall into two categories:

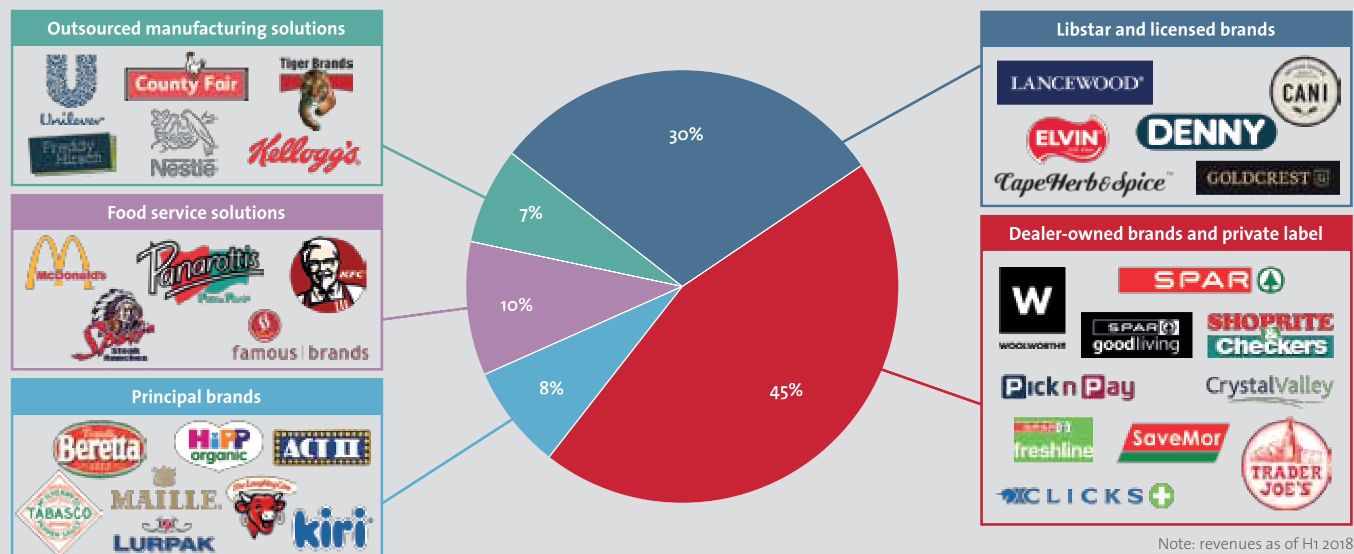
- **Private label** - Relatively simple branding carrying the retailer's name (eg Pick n Pay's "No Name" or Shoprite's "Ritebrand").
- **Dealer-owned brands** - These brands have more sophisticated packaging and brand design and generally trade at higher prices than private label (eg Pick n Pay's "Ultra" brand in home care, Shoprite's "Crystal Valley" in cheese or Massmart's "Camp Master" brand in outdoor goods). To the consumer, these look more like branded products than traditional private label.

Tapping into South African private label growth

Libstar is South Africa's fifth-largest food producer when ranked by earnings. It is a diversified group that operates across 27 business units manufacturing a range of food and beverage, as well as home and personal care products across five key segments (graph below):

- **Dealer-owned brands and private label** represents 45% of Libstar's revenue. Libstar produces a range of fresh and shelf-stable foods, beverages and home care products on behalf of retailers. Its largest customers are Woolworths, Shoprite and Pick n Pay.
- **Own and licensed brands** represent 30% of Libstar's revenue and include the ubiquitous Lancewood brand in hard (eg cheddar, gouda) and soft (eg cream/cottage cheese and dips) cheeses as well as Cape Herb & Spice, which produces a range of spice products for local and export markets. Denny is a leading brand in fresh mushrooms and shelf-stable sauces, and Goldcrest is a well-known participant in the honey category.
- **Principal brands** contribute 8% to revenue. These are brands that Libstar distributes on behalf of third parties, leveraging its distribution scale and retailer relationships.

Libstar's revenue split by product offering



Note: revenues as of H1 2018
Source: company reports

- **Food service solutions:** Libstar produces a range of products (eg meat, sauces and tortilla wraps) for the South African fast food and restaurant sectors, adding another unique and attractive avenue for growth.
- **Outsourced manufacturing:** A relatively small part of the group where Libstar manufactures products for some of the large consumer companies.

The high contribution of private label, and the diversified nature of Libstar's revenue streams, make it unique among its manufacturing competitors. While listed competitors such as Rhodes Food Group, RCL Foods and Pioneer Foods do manufacture a blend of branded and private label foods, the average exposure to private label for these producers remains below 15% of revenue.

Creating category champions

Libstar has developed strong positions across several categories where it can effectively offer the retailers a "category solution". The best example is cheese. Lancewood is the market leader in hard and soft cheeses, and Libstar also manufactures private label cheeses for retailers. Combined with the Kiri and Laughing Cow brands, and other specialty cheeses, Libstar dominates the cheese category at most supermarkets and is able to capture the consumer at all price points. Other examples include the dry Italian goods category that it sources for Woolworths (such as pastas, pestos and olive oils) and the Woolworths nuts and related snacks category.

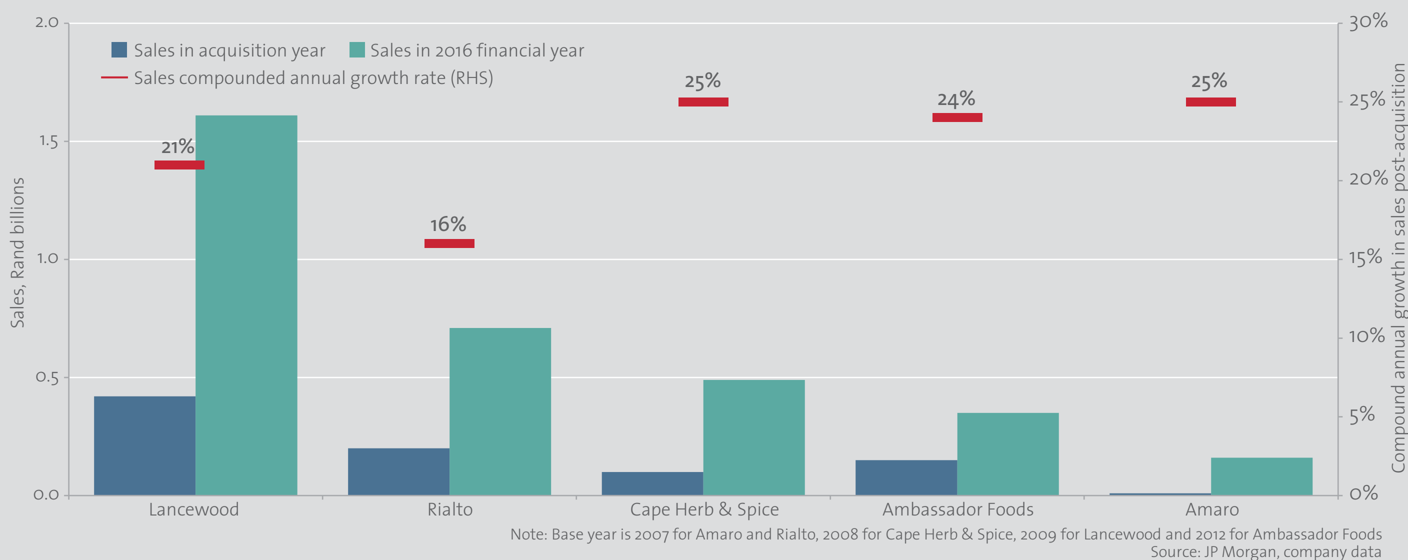
A platform for growth

Libstar runs a decentralised business model, giving its underlying businesses significant autonomy to deliver on strategy and in-market execution. The Libstar head office provides support and oversight across various functions including finance, accounting and governance, sales and marketing, manufacturing and technical capability, supply chain optimisation, human resources and information technology. This is similar to the Bidvest model, where the centre embeds good processes across the group and provides close oversight on cash flow, budgeting and results, intervening quickly if needed.

Organic and acquisitive is part of the DNA

Libstar has made a number of astute acquisitions over the last decade. The company has repeatedly proven its ability to enable material post-acquisition organic growth from the efficacy of its decentralised model, national scale and access to growth capital. The graph below highlights Libstar's ability to scale up smaller businesses. The acquisitions shown below have grown at more than 20% a year since acquisition.

Libstar's acquisitions have delivered strong organic growth



Note: Base year is 2007 for Amaro and Rialto, 2008 for Cape Herb & Spice, 2009 for Lancewood and 2012 for Ambassador Foods
Source: JP Morgan, company data

Rising (Lib)star

A recent example of this is Millennium Foods (a small manufacturer of ready-meals for Checkers in the Western Cape) which Libstar acquired in late 2017. Following the acquisition and further capital investment, Libstar has tripled the capacity of the business and will soon be in a position to supply Checkers nationally.

A strong culture of innovation and proactive brand and category management is also at the heart of these success stories bolstering the prospects for these businesses into the future.

Following a global trend

Globally, private label products have consistently taken market share from branded manufacturers. In the UK and German markets, 35% of packaged food is now sold under private label brands. In the US, private label penetration levels are behind this at 17% of packaged food sales (left graph below). We believe this high European penetration level is the result of the success and widespread presence of hard discounter chains in Europe and the UK, such as Aldi and Lidl. These chains almost exclusively sell private label products at low cost and have grown quickly.

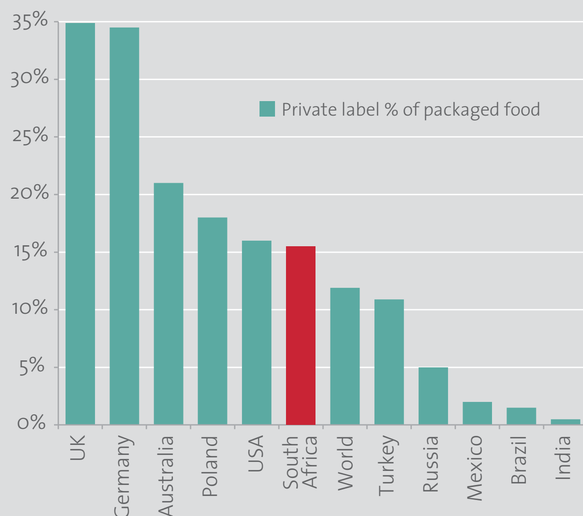
South African penetration is now at 15% of total packaged food sales, up steadily from 12% in 2011. Improving consumer perceptions, greater focus from retailers to develop the category and economic pressure on consumers has resulted in a faster growth rate for private label versus branded packaged food products over this period (13% per year versus 8% per year respectively (right graph below) - a trend expected to continue.

A similar growth differential is expected in the medium term as major South African retailers, particularly Shoprite and Pick n Pay, plan to increase their focus on private label and dealer-owned brands. Both of these retailers have become savvier in their private label strategies, improving on quality and introducing a wider range of products. Spar and Woolworths have historically enjoyed successful private label strategies and we expect this to continue.

Invested in this structural theme

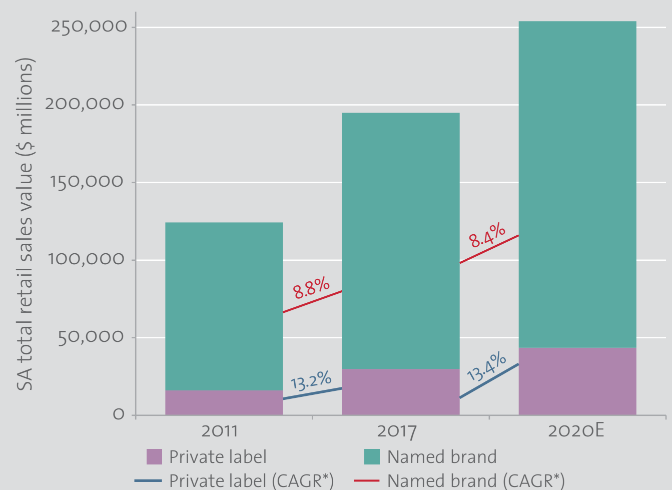
In light of the expected continuation of market share growth and adoption of savvier strategies, we believe Libstar is well placed to benefit from this trend and is likely to grow ahead of the branded food producers. The current low market value does not accurately reflect the bright growth prospects for Libstar, for which our clients are well positioned. UP

Private label penetration by country (2017)



Source: Euromonitor, Bank of America M-L

Private label growth to outpace branded growth



*Compound annual growth rate
Source: Euromonitor, SBG Securities analysis and estimates

Bayer: More than just a roundup company

Abdul Davids - Portfolio Manager

"For many years, the name Bayer has been synonymous with pharmaceutical products such as Aspirin and Berocca as well as chemicals like Bayer Advanced insecticides. More recently, the group's takeover of US-based Monsanto has made headlines - for all the wrong reasons."

Bayer: More than just a roundup company

Bayer was founded in 1863 by Friedrich Bayer and Johann Friedrich as a dyestuff and textiles company. The initial products of the company included Fuchsine (a magenta dye) and Aniline (the precursor to polyurethane). In 1925, Bayer was part of a six-company merger to form IG Farben, the world's largest chemical and pharmaceutical company. In 1951, IG Farben was split back into its six constituent companies and then into three separate companies: BASF, Bayer and Hoechst.

Following numerous mergers, acquisitions and demergers, including the recent spin-off of Covestro and the takeover of Monsanto, Bayer now comprises four divisions (graph below): Pharmaceuticals, Crop Science, Consumer Health and Animal Health (earmarked for disposal).

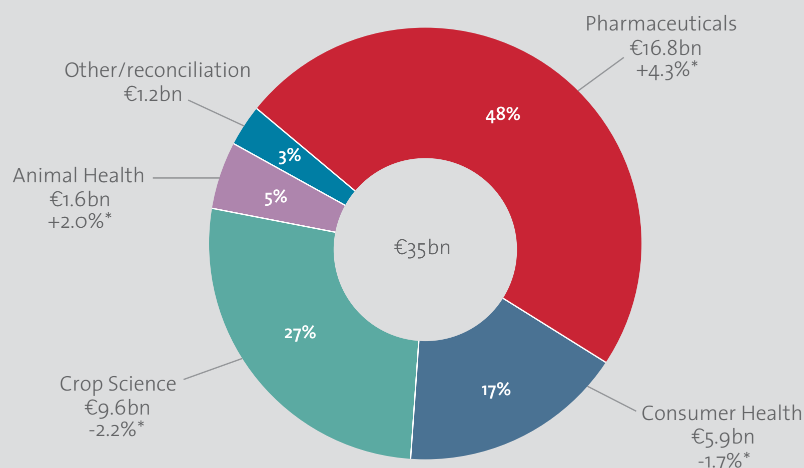
Pharmaceuticals - the heart of Bayer

Friedrich Bayer's son (also named Friedrich) was a chemist by training and introduced pharmaceuticals to the group after his father's death. In 1897, Friedrich Jnr and the company's team of scientists began investigating acetylsalicylic acid as a replacement for common salicylate medicines, which tended to cause an upset stomach. Bayer identified a new way to synthesize acetylsalicylic acid, and by 1899, Aspirin was on sale around the world. Today, Aspirin is the most widely used medication globally with more than 100 billion pills consumed annually. A pharmaceutical product less well-known for being Bayer's is heroin, the highly addictive drug that is illegal in most countries. Bayer marketed heroin as a cough suppressant between 1898 and 1910 under the Heroin trademark.

In 2017, pharmaceutical products comprised just under half of Bayer's €35 billion in total revenue. Its top-selling products include:

- **Kogenate**, a recombinant version of a clotting factor, a deficiency of which causes the abnormal bleeding associated with haemophilia type A.
- **Xarelto**, a small molecule inhibitor of a key enzyme involved in blood coagulation (clotting). In the United States, the Food and Drug Administration (FDA) has approved Xarelto for 1) the treatment for the prevention of strokes in people with atrial fibrillation or abnormal heart rhythm, 2) for the treatment of deep vein thrombosis and pulmonary embolism, and 3) for the prevention of deep vein thrombosis in people undergoing hip surgery.
- **Betaseron**, an injectable form of the protein interferon beta used to prevent relapses in a form of multiple sclerosis. Betaseron competes with other injectable forms of interferon beta, glatiramer acetate, and a variety of newer multiple sclerosis drugs, some of which can be taken orally.

Bayer and Monsanto combined full-year sales to June 2018



*Year-on-year change (currency and portfolio-adjusted), Euro billions
Source: Bayer Investor Presentation, June 2018, Monsanto Acquisition update

- **Nexavar** is used in the treatment of liver, kidney and certain types of thyroid cancer.
- **Cipro** (Ciprofloxacin) was approved by the FDA in 1987. In 2010, over 20 million outpatient prescriptions were written for ciprofloxacin, making it the 35th-most commonly prescribed drug, and the 5th-most commonly prescribed antibacterial in the US.
- **Rennie** antacid tablets are one of the biggest selling branded over-the-counter medications sold in Great Britain, with sales of £29.8 million in 2016.

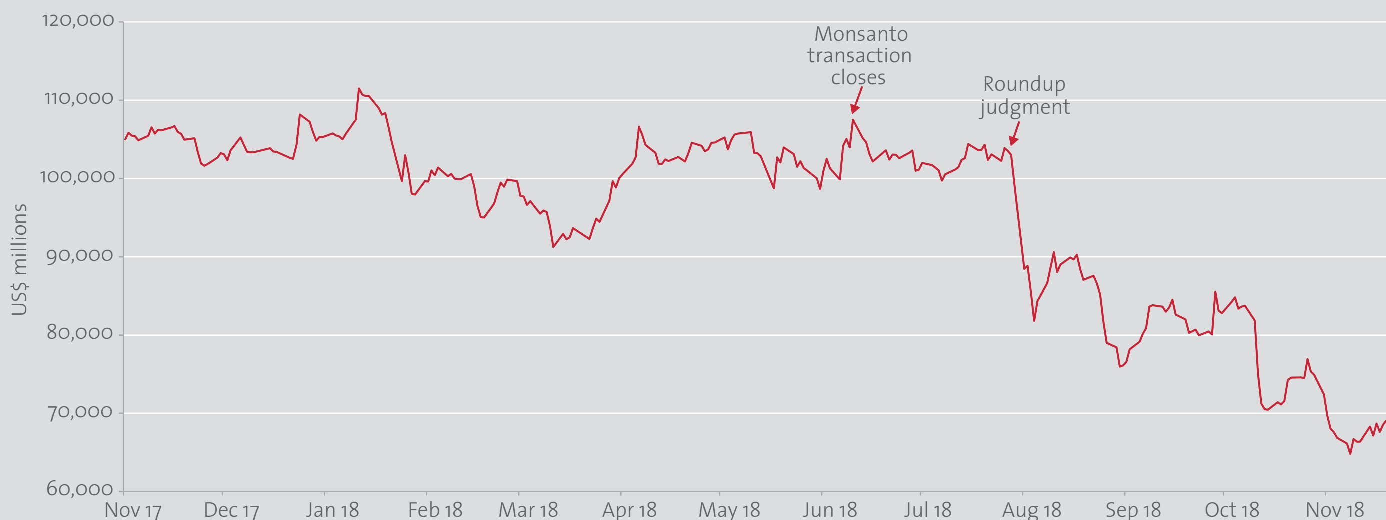
Xarelto is Bayer's blockbuster product. The anti-coagulant was launched in 2011 as a safe and effective medication to prevent strokes and other cardiovascular conditions. It contributed €5 billion in sales in 2017, making it one of the most profitable drugs in Bayer's Pharmaceuticals portfolio. Xarelto's sales are expected to peak at around €7 billion in 2021 (operating profit contribution of around €5 billion in 2021) before the drug goes off-patent in 2023, resulting in a significant decline in revenues and profits as cheaper generic alternatives start gaining market share. We expect an almost zero contribution to Bayer's revenues and earnings from Xarelto by 2030. Bayer has been very proactive to counter-balance this by expanding the company's investment in its clinical development programme with key results expected in late 2018 and early 2019.

Rounding up Monsanto

In addition to its expansive clinical development programme, Bayer's recent take-over of US-based Monsanto is intended to reduce the group's reliance on Xarelto and the pharmaceutical division. However, less than two months after the Monsanto transaction was completed, a jury in San Francisco awarded Dewayne Johnson, a school groundskeeper, a record grant of $289 million (subsequently reduced to $78 million in October 2018) for exposure to Monsanto's blockbuster weed-killer, Roundup. The grant came as a huge shock to Bayer management and shareholders and resulted in a significant sell-off in the company's share price.

The jury found the main ingredient in Roundup, a chemical called glyphosate, to be a probable human carcinogen. Bayer's US litigation risks include personal injury claims made by an estimated 9 300 consumers around the company's glyphosate-based herbicides causing cancer, exposing Bayer to hundreds of billions of dollars in potential liability. Settlement value of the cases, however, could fall between $5 billion and $10 billion, with major court cases expected to begin trial in February 2019. Bayer has consistently and vehemently denied that glyphosate causes cancer and claims to have numerous scientific studies that support its views.

Bayer market capitalisation



Source: Bloomberg

Bayer: More than just a roundup company

Since the initial Roundup verdict, Bayer has lost close to $30 billion in market value (from $100 billion at the end of August 2018 to $70 billion at the beginning of December 2018) - substantially more than even the most pessimistic expert view on potential civil claims (graph on previous page).

Notwithstanding the Roundup issues, Bayer sees significant growth potential in the crop sciences market and together with Bayer's existing portfolio of crop protection products, the combined Bayer-Monsanto group dominates the global agricultural chemicals market (right graph below).

The below graph (left) shows how dominant the Bayer-Monsanto group has become, with combined sales of almost €20 billion in 2017, well ahead of its nearest competitor ChemChina AG - itself a result of a consolidation and take-over of Swiss seed company Syngenta by China National Chemical Corporation (ChemChina) in a $45 billion transaction that closed in September 2018. Third-placed DowDuPont AG (a merger between Dow Chemical and Du Pont) plans to spin off and list its agri -chemicals business, Corteva, in 2019.

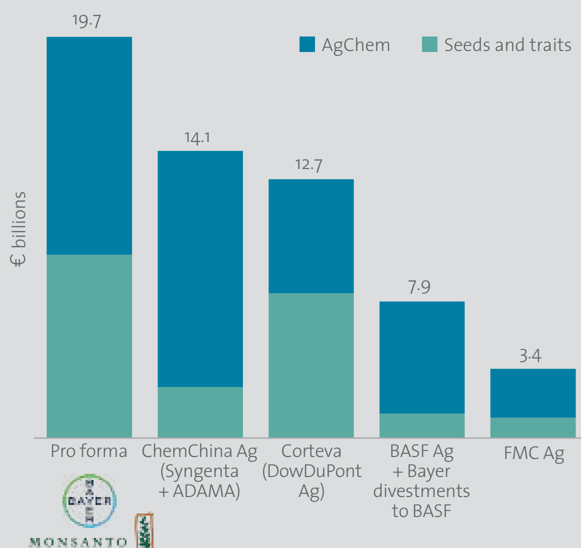
This consolidation in the seeds and agri-chemicals market follows recent years of poor performance as a result of unpredictable weather globally, along with an oversupply of crops in certain regions of the world. The below graph (right) highlights the volatility in growth rates experienced by the crop protection and seeds markets over the last few years.

Bayer's bullish thesis on the seeds and crop protection market is that population growth, fixed land supply and declining availability of arable land are key variables that will drive the increasing use of genetically modified (GM) seeds and better crop protection chemicals. Bayer argues this is a necessity to satisfy a world that increasingly consumes meat and related protein. While the use of GM crops is controversial and not approved in many countries, Monsanto has been at the forefront of producing GM crops in the US and Bayer has demonstrated the value of crop-protection chemicals to enhance yields amid extreme and unpredictable weather.

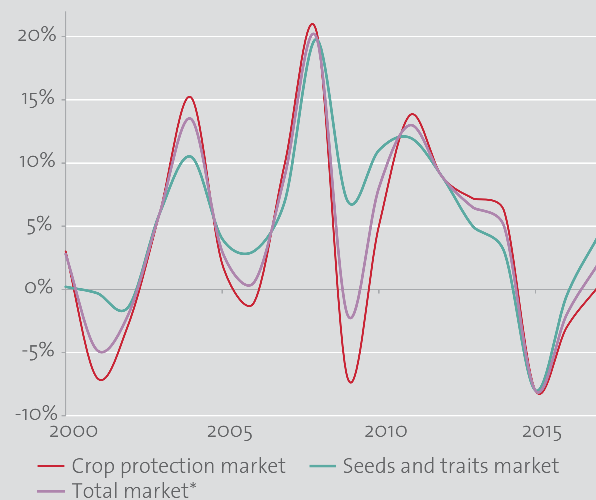
Outlook

Bayer has entered a challenging period in its 155-year history, facing an unprecedented number of lawsuits and substantial competitive threats to its revenues and profits. However, even taking the most pessimistic view on the outcome of these challenges, the recent reduction in the value of Bayer shares has opened a valuation gap, with most of the negative news more than discounted in the share price. Bayer could be a rewarding investment for patient long-term investors. UP

Pro forma sales (2017)



Annual market growth rates



*Crop protection + Seeds and traits

Source: 2000-2017 Phillips McDougall March 2018; in nominal USD terms; 2017 data preliminary

Woolworths: form is temporary

Simon Anderssen - Portfolio Manager

"When a London merchant with a rapidly expanding Australian retail business agreed to send a shipment of best-selling goods to Cape Town, South African entrepreneur, Max Sonnenberg, decided to adopt the Australian store's name. With this, Woolworths South Africa was founded in 1931, with its original store on Plein Street. It proved an immediate success."

Woolworths: form is temporary

Although there is now no association with the namesake Australasian business that continues to trade, the JSE-listed Woolworths generates a third of its profits from clothing businesses owned in Australia (graph below). Further diversification of profit comes from the company's local food business.

SA clothing has endured many cycles

After World War II, Sonnenberg developed a friendship with Simon Marks, son of the founder of London's Marks & Spencer. This led to a long association between the two, which was instrumental in shaping Woolworths' success. During the early years, the London business provided Woolworths with exclusive access to merchandise, shared technology and processes, and facilitated co-operation with supplier relationships. The relationship endured and strengthened into the 1980s. Even after Marks & Spencer had sold its shares in Woolworths, it enabled access to world-leading fabric technology that was adopted locally for Woolworths' exclusive benefit. As a result, the Woolworths department store became synonymous with affordable, high-quality clothing among middle and upper-income families and an anchor tenant in major shopping malls throughout South Africa.

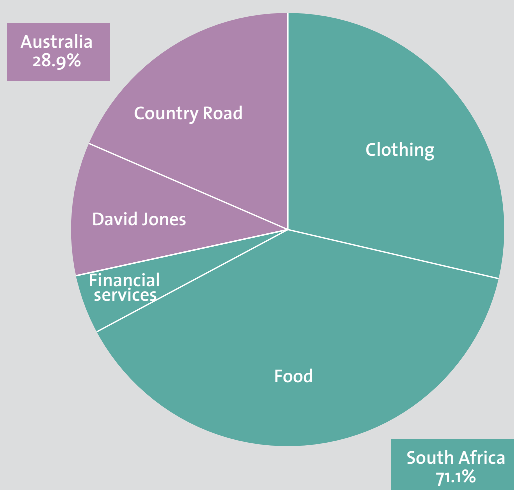
Over the two decades since Woolworths has been separately listed, it has grown sales slightly ahead of South African nominal consumption growth (graph opposite).

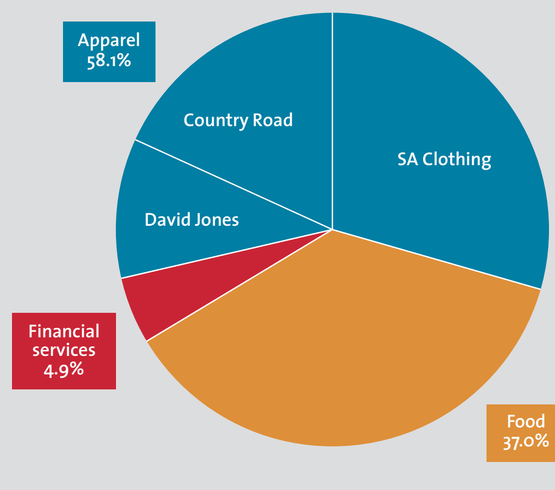
It is not a coincidence that the last time South Africa experienced protracted low growth (in 2009), Woolworths underperformed. At the time, the company cited as the cause, merchandise that had drifted from its core market and become too expensive. The business refocused internally on processes and products and over the subsequent seven years grew sales faster than the market, trebling profits.

Similarly, Woolworths clothing division's underperformance over the past two years has coincided with an extended period of low economic growth. Sceptics may argue that this is because the competitive environment has changed in South Africa, with the entrance of new physical and online competition. While these threats cannot be dismissed, history shows that profits for a clothing retail business like Woolworths are cyclical.

Businesses seldom survive seven decades without overcoming numerous challenges and Woolworths has repeatedly demonstrated the capacity to recover from challenging trading environments. We expect the clothing business to do so again

Operating profit by country (2018)





Source: company reports

in the near future as management's internal focus to reconfigure merchandise and customer experience becomes evident in stores.

Reinventing food retail

Woolworths is now arguably better recognised in South Africa as a leading food retailer, having transformed its fledgling food business from a top-up delicatessen in the early 2000s, to a priority shopping destination today. Over this period, sales growth has exceeded nominal household spending almost every year, as it has captured many upper-income consumers' food baskets with a selection of premium prepared meals and fresh produce.

The basis for this success can be traced to the group's relationship with Marks & Spencer and decades of sharing knowledge and expertise between dedicated teams of food specialists. The recipe for a consistent and distinctive quality advantage included pioneering exclusive partnerships with farmers and producers, often providing support to small producers to invest in growth opportunities.

We recognise the improving offer from competitors encroaching on Woolworths' high-end market, but we believe the prospects for Woolworths Food to grow earnings remain favourable.

A long, successful legacy in Australia

Woolworths started its operating presence in Australia with the 1998 acquisition of a controlling interest in Country Road, an apparel and homeware brand that portrays a relaxed Australian lifestyle. Loss-making at the time, the business designed and manufactured the Country Road brand for its own retail stores and wholesalers, mostly national department stores.

While it has become a cliché to mock corporate South Africa's lack of success in Australia, Woolworths' investment in Country Road is a notable exception. Over the two decades under Woolworths' control, Country Road has grown organically and through the acquisition of retail brands including Trenery, Witchery and Mimco. Today, the Country Road Group contributes more than R1 billion to group operating profits and is a stable source of cashflow.

A big bet on David Jones

David Jones is a chain of department stores in Australia with a legacy dating back to the 1830s. It sells a premium range of leading international and local brands, and an offering of private label clothing, homeware and foods from 40 stores across Australia. The business has underperformed for a number of years as the department store format has come under threat from online competitors and new entrants.

Woolworths' sales growth reflects economic cycles

Source: company reports, Bloomberg

Woolworths: form is temporary

Woolworths spent R21 billion to acquire David Jones in 2014 but has, since then, failed to deliver on the synergy benefits that justified the 25% premium it paid to the then market price. This culminated in a R7 billion impairment in 2018, an admission that Woolworths overpaid.

We believe that current uncertainty regarding the future prospects for David Jones is the leading cause of negative investor sentiment towards Woolworths. This is evident in a market value for the group that is currently on par with the value before Woolworths issued shares to buy David Jones in 2014 (graph below).

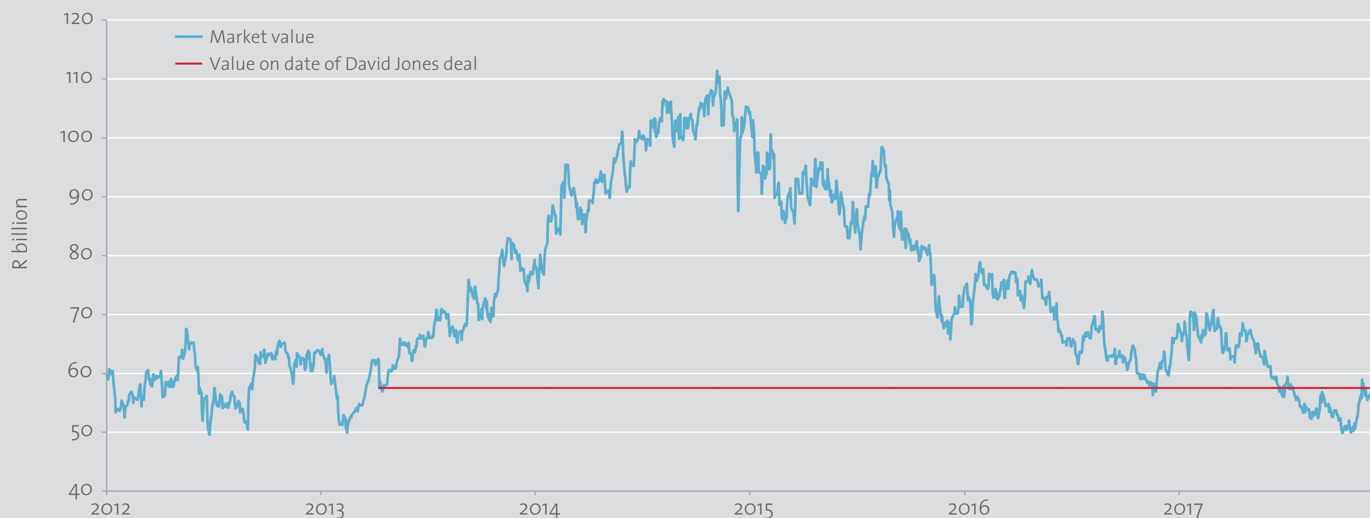
We do not ignore the challenges confronting this business in a mature retail market that is rapidly evolving towards specialist and online formats. Instead, we believe the results should be viewed in the context of the operational issues that account for some of the disruption to trading performance and profitability. These include the simultaneous upgrade to merchandising systems, relocation of the head office, roll-out of an expanded food offering and the ongoing refurbishment of the flagship store in Sydney. We argue that it is a mistake to project the business' performance during this period into the future, and an improvement is likely as these operating issues stabilise.

We are encouraged by improving momentum in sales growth over the last 12 months and the company's plans to reduce its retail footprint by nearly a fifth over the next five years. The latter is significant because it signals an acceleration in efforts to reduce operating costs as online sales, through davidjones.com, displace sales through physical stores. Finally, the company is displaying discipline by pausing its endeavour to replicate its successful South African food business in Australia until a handful of trial stores prove the concept.

Undervalued pedigree

Over many decades Woolworths and David Jones have demonstrated the ability to adapt to evolving retail markets, and to recover from periods of underperformance. In an environment where many investors prefer to pay a premium for other cyclical clothing businesses (where earnings are cyclically inflated), we hold Woolworths in clients' portfolios because we believe that it has more favourable future earnings prospects than competitors and offers better value for investors. UP

Market value of Woolworths



Source: Fact Set

Kagiso Asset Management Funds

Performance to 31 December 2018	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	-4.5%	7.3%	4.5%	12.2%	16.0%	Apr-04	1.93%	0.45%
SA Equity General funds mean	-9.2%	1.7%	3.3%	10.1%	12.5%			
Outperformance	4.7%	5.6%	1.2%	2.1%	3.5%			
Balanced Fund	-1.5%	7.4%	5.4%	-	8.3%	May-11	1.54%	0.51%
SA Multi Asset High Equity funds mean	-3.7%	2.4%	4.8%		7.9%			
Outperformance	2.2%	5.0%	0.6%		0.4%			
Protector Fund	3.4%	8.3%	6.0%	7.5%	9.6%	Dec-02	1.58%	0.40%
CPI + 4%*[5]	8.8%	10.1%	10.1%	10.3%	10.5%			
Outperformance	-5.4%	-1.8%	-4.1%	-2.8%	-0.9%			
Stable Fund	7.7%	9.9%	7.3%	-	8.2%	May-11	1.53%	0.51%
Total return of CPI+2% pa[5]	6.6%	6.4%	6.0%		5.8%			
Outperformance	1.1%	3.5%	1.3%		2.4%			
Institutional funds[6]								
Managed Equity Fund (SWIX)	-6.5%	6.4%	3.4%	12.0%	10.7%	Sep-06		
FTSE/JSE SWIX All Share Index	-11.7%	3.7%	5.9%	13.0%	11.2%			
Outperformance	5.2%	2.7%	-2.5%	-1.0%	-0.5%			
Managed Equity Fund (Capped SWIX)	-5.3%	-	-	-	3.7%	Jan-17		
FTSE/JSE Capped SWIX Index	-10.9%				1.9%			
Outperformance	5.6%				1.8%			
Domestic Balanced Fund[7]	-0.8%	9.0%	4.8%	10.2%	8.0%	May-07		
Peer median[8]	-6.3%	5.0%	5.5%	11.2%	8.7%			
Outperformance	5.5%	4.0%	-0.7%	-1.0%	-0.7%			
Global Balanced Fund[9]	0.4%	8.7%	6.5%	-	8.6%	Jul-13		
Peer median[10]	-2.3%	4.1%	6.4%		8.4%			
Outperformance	2.7%	4.6%	0.1%		0.2%			
Bond Fund	9.1%	12.2%	-	-	8.8%	Aug-15		
BESA All Bond Index	7.7%	11.1%			7.6%			
Outperformance	1.4%	1.1%			1.2%			
Money Market Fund	8.2%	8.4%	7.8%	7.2%	7.8%	Jan-04		
Alexander Forbes STeFI Composite Index	7.2%	7.4%	6.9%	6.7%	7.3%			
Outperformance	1.0%	1.0%	0.9%	0.5%	0.5%			
Sharia unit trust funds[4]								
Islamic Equity Fund	1.7%	10.0%	5.6%	-	10.9%	Jul-09	1.47%	0.25%
SA Equity General funds mean	-9.2%	1.7%	3.3%		10.2%			
Outperformance	10.9%	8.3%	2.3%		0.7%			
Islamic Balanced Fund	0.8%	6.7%	4.9%	-	6.5%	May-11	1.51%	0.17%
SA Multi Asset High Equity funds mean	-3.7%	2.4%	4.8%		7.9%			
Outperformance	4.5%	4.3%	0.1%		-1.4%			

Highest and lowest monthly fund performance	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest
Equity Alpha Fund	3.8%	-6.0%	8.2%	-6.0%	8.2%	-6.0%	10.9%	-9.0%	11.9%	-9.0%
Balanced Fund	3.0%	-3.0%	5.5%	-3.5%	5.5%	-4.2%	-	-	6.2%	-4.2%
Protector Fund	2.3%	-2.3%	3.4%	-2.4%	3.4%	-4.2%	7.8%	-5.3%	9.5%	-5.3%
Stable Fund	2.4%	-0.9%	3.8%	-0.9%	3.8%	-3.5%	-	-	4.0%	-3.5%
Islamic Equity Fund	3.9%	-2.4%	7.3%	-3.8%	7.3%	-4.6%	-	-	8.1%	-4.9%
Islamic Balanced Fund	3.6%	-2.4%	4.6%	-3.0%	4.6%	-3.0%	-	-	8.2%	-5.4%

[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 31 December 2018; [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 31 December 2018; [4] Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [5] CPI for December is an estimate; [6] Source: Kagiso Asset Management; gross of management fees; [7] Domestic Balanced Fund benchmark returns are an estimate for December; [8] Median return of Alexander Forbes SA Manager Watch: BIV Survey; [9] Global Balanced Fund benchmark returns are an estimate for September; [10] Median return of Alexander Forbes Global Large Manager Watch.
*CPI + 4% from 1 May 2018 (previously: Risk adjusted returns of an appropriate SA large cap index). Disclaimer follows overleaf.

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