# UP

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Kagiso Asset Management

Quarterly

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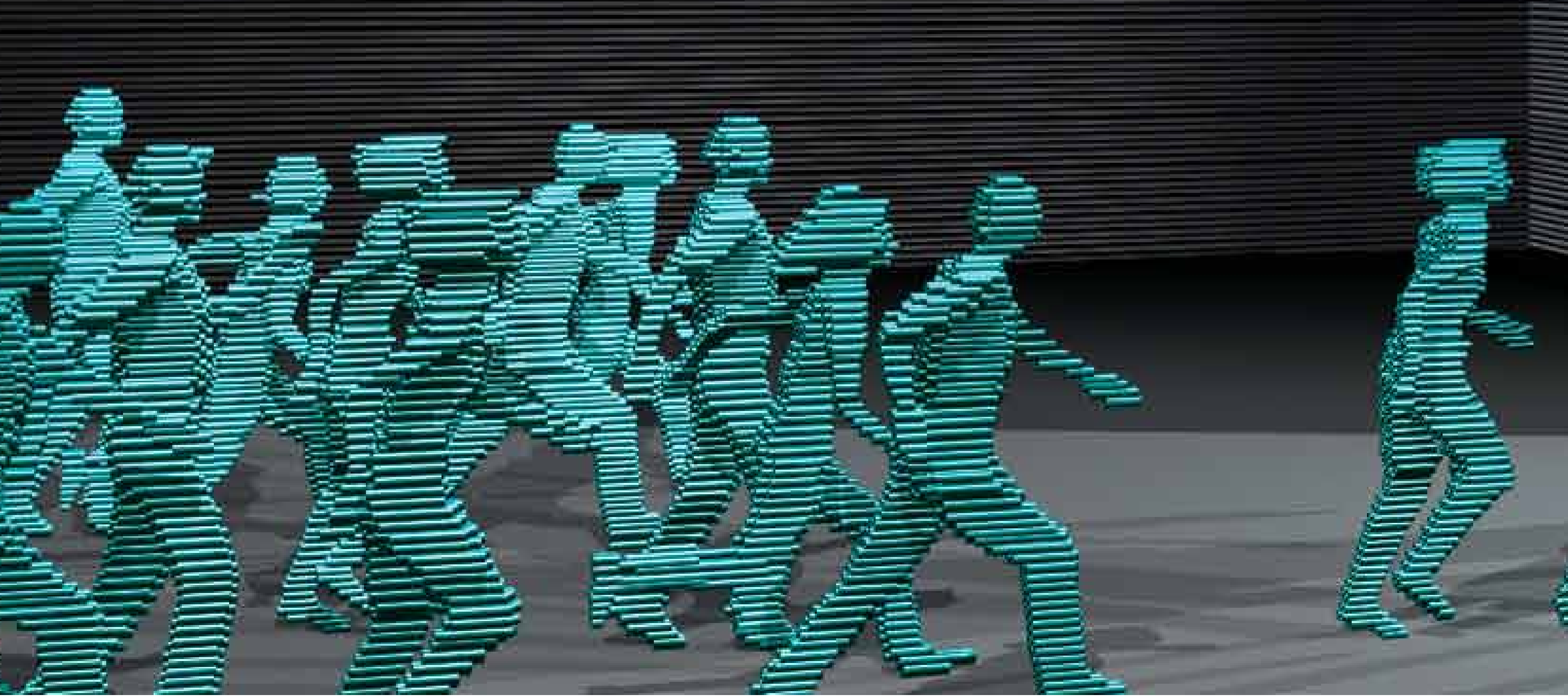
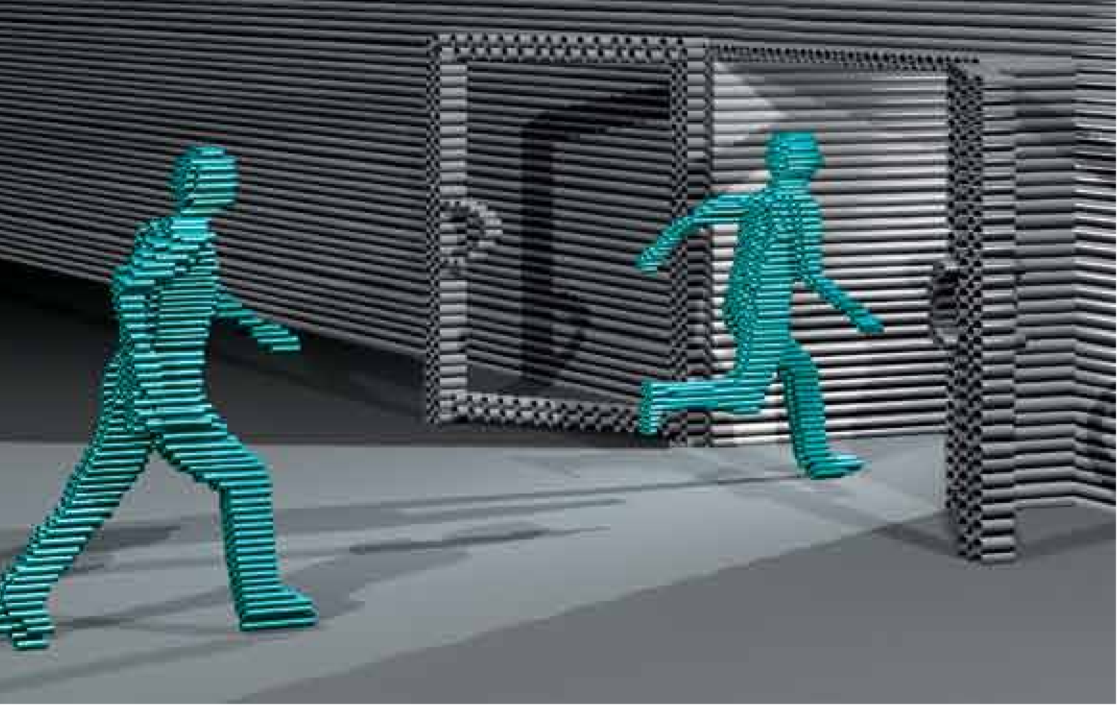


# Ongoing change amid elevated markets

Gavin Wood - Chief Investment Officer

"As we enter 2016, investors can look back on a volatile year and the weakest start for financial markets in decades amid a tepid, but by no means weak, global economic outlook. We set out below some thoughts on the global economy, asset price distortions from price-insensitive investors and implications for markets."

# Ongoing change amid elevated markets

**Reflecting on an eventful 2015**

In 2015, the US saw its first interest rate hike from the Fed since 2006, a stronger dollar, strong employment gains and generally weaker equity markets (except for large favourites: Facebook, Amazon, Netflix and Google). China experienced an equity boom and bust, a government struggling to balance central control and the operation of markets, slowing growth and capital outflows. Europe, which almost jettisoned Greece mid-year, saw a very modest economic upturn, introduced negative interest rates and maintained strong QE stimulus. Japan struggled along despite record central bank asset purchases and (slow) structural reforms.

Emerging markets, especially commodity producers such as South Africa, Brazil and Russia, saw massive currency weakness, capital outflows, weak growth, rising inflation and very weak equity markets. India stood out as an economy that continues to improve.

**Economic outlook: low growth and low inflation for most**

Global economic growth is expected to remain weak relative to history, with the US, Europe and Japan improving but sub-trend, China slowing (with risks to the downside) and emerging markets generally weakening as they adjust to the weak commodity environment and battle with high debt levels.

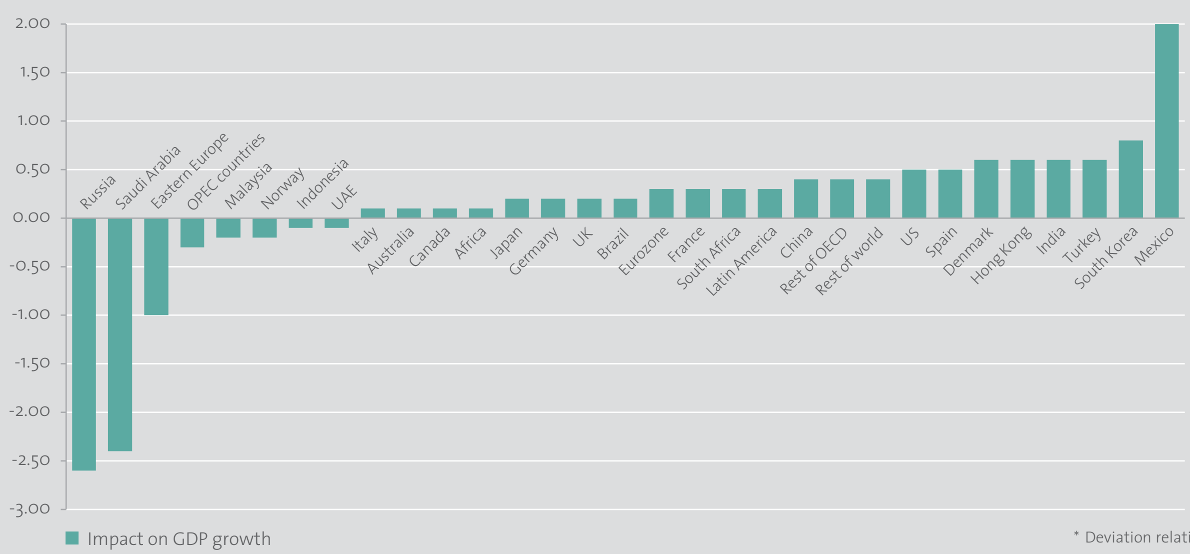
Developed market consumers should be strong, with lower fuel prices and stronger wage prospects, but manufacturers look to be struggling. Global inflation remains stubbornly low, exacerbated by substantially weaker commodity prices and significant global economic slack. The low oil price, to the extent that it remains low, should be a significant boost for most countries (graph below).

South Africa, in contrast, faces a very weak economic growth outlook, rising inflation and the threat of large capital outflows, especially if it loses investment grade status. The SARB rate hiking cycle continues and fiscal policy remains tighter as the government attempts to contain debt levels. The substantially weaker rand should provide some relief for the current account deficit, which should moderate from elevated levels. The political outlook is particularly uncertain, with weakening urban support for the ruling party and a fractious union environment.

**Asset prices follow the price-insensitive investors**

In the last 15 years there has been a material increase in market participation by parties who buy securities in situations where expected return is not the predominant motivation for doing so (eloquently covered by the 2Q 2015 GMO Quarterly Letter). This has caused broad price movements that are difficult to justify by analysing the fundamentals and helps explain why general asset prices are well above 'normal' levels, despite a subpar economic outlook.

**Impact on GDP growth* of a US$20 oil price decline**




* Deviation relative to 2016 baseline
Source: UBS, OEF

The following are important examples of these price-insensitive buyers:

- Emerging market central banks have, since 2000, built up substantial currency reserves (graph below) to ensure currency stability (or suppression). These have largely been invested in developed market (mostly US) bonds without regard to the price paid.
- Developed market central banks have, since the financial crisis, bought substantial volumes of bonds with the aim of providing liquidity, forcing down long-term interest rates and boosting asset prices - to stimulate the real economy.
- Banks, insurers and pension funds have been substantial buyers of bonds as a result of regulatory pressure to match liabilities or to hold sufficient liquid assets.
- Passive funds and ETFs - by definition price insensitive investors - have gained significant share over recent years and accumulated vast portfolios of assets without regard to the high prices they are paying in many cases. It is particularly worrying that specialist ETFs are now focusing on less liquid and smaller markets, and unduly influencing prices.
- Momentum investors buy and hold investments purely because prices have risen. They have regard to price movement, but not to the expected return implied by the price paid. Investors who consciously employ this strategy have been richly rewarded with further client inflows as have those who have held key 'momentum stocks'.

The first three factors above have caused bond yields, particularly in the US and Europe, to remain at extremely low levels. The latter two have had a particular impact on equities, especially large benchmark weight stocks and stocks in benchmarks of less liquid markets, eg South African stocks in the context of Global Emerging Market (GEM) funds.

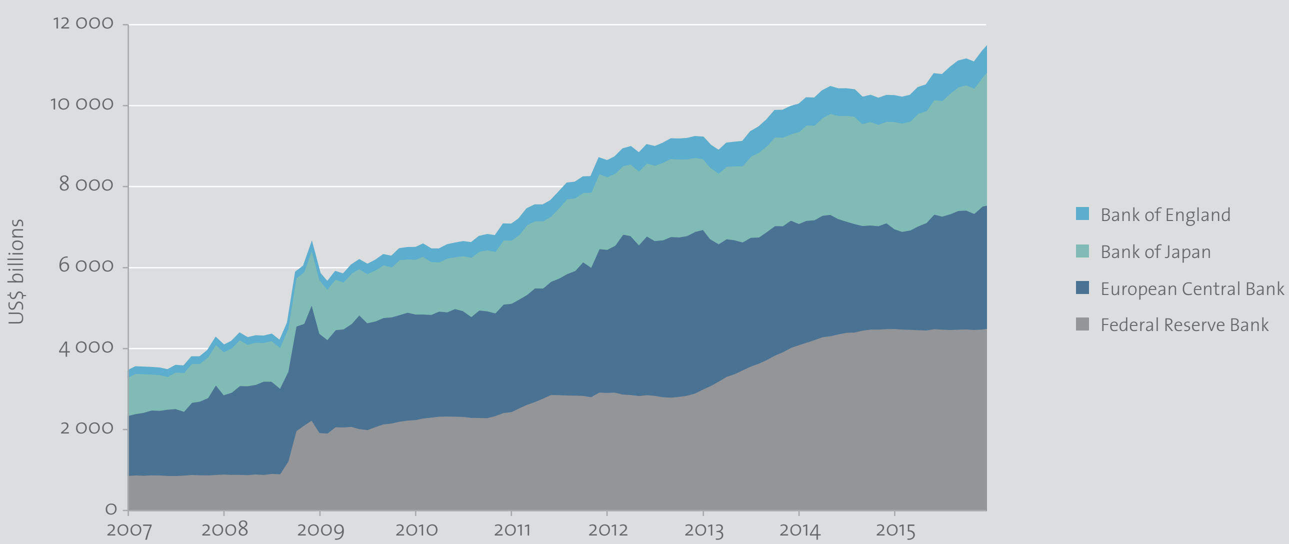
Additionally, there is an interplay between these market participants, which can be due to:

- investors exploiting apparent relative value, eg buying 'bond-like' equities (such as defensive consumer staples stocks) at high prices; and
- companies taking advantage of cheap debt financing to lever up and buy back their own shares or undertake expensive acquisitions (such as the purchase of SABMiller by AB Inbev at an extremely high price) - both forces which elevate equity prices.

In contrast, price-insensitive sellers seem to be in operation in other instances - consequently highlighting assets which are perhaps inexpensively priced at present. Important examples are:

- Commodity investors: pension funds, dedicated commodity funds and traders, who bought commodities while prices rose, but are now unwinding positions as prices fall.

## Central bank assets of developed countries




Source: Bloomberg

# Ongoing change amid elevated markets

- Underperforming asset managers who face outflows and therefore have to sell inexpensive stocks at low prices.
- Passive funds and ETFs in a situation where a security exits a benchmark.

The effect on asset prices of all these price-insensitive buyers and sellers has been huge, self-reinforcing and enduring, given that some of the largest balance sheets in the world are participating. Particularly in the South African equity market, price-insensitive buyers seem to have bought domestic industrial shares and global consumer staple shares up to very high price levels. Price-insensitive sellers continue to indiscriminately sell cyclical shares, especially commodity producers, at very low prices.

**Outlook for markets**

With a sluggish global economy and very weak South African outlook, we have been very surprised at how high our equity market has risen outside of the resources sector. We think the large presence of price-insensitive investors is somewhat to blame. When asset prices rise well ahead of the economic reality, it is not surprising when they retreat as they have done at the start of 2016.

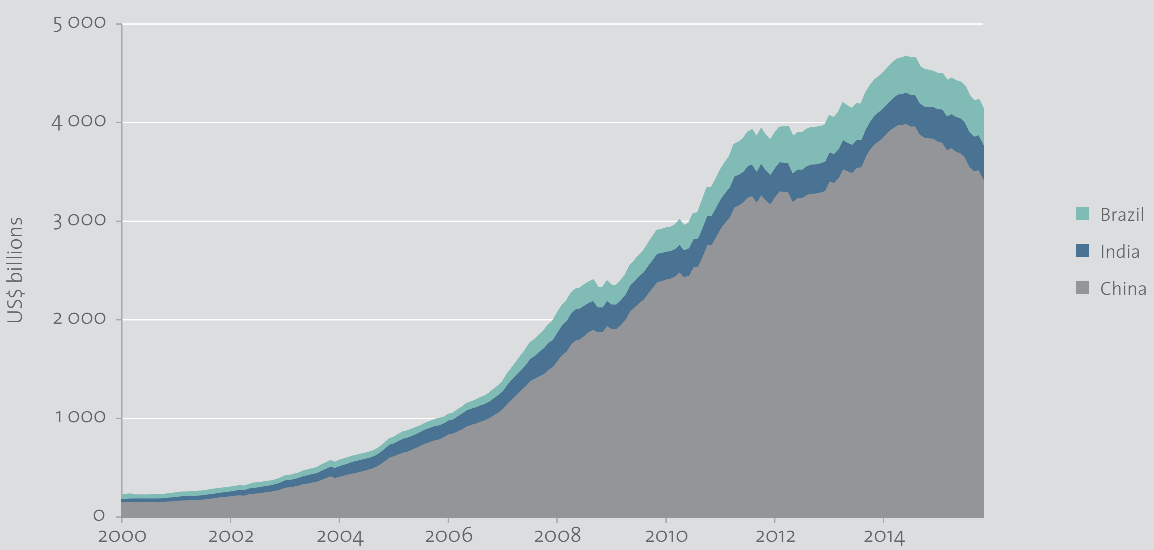
Despite little change in fundamentals, previously price-insensitive buyers may decelerate or begin selling, resulting in large asset price moves due to, for example:

- the Federal Reserve's ending of asset purchases;
- GEM fund outflows due to negative returns;
- oil producer sovereign wealth funds liquidating due to budget deficits, given the oil price fall;
- China's currency reserve reduction due to capital outflows; and
- changing sentiment among momentum investors.

With equity market levels still elevated in South African industrials we see room for further weakness, despite the pullback we have seen. This will be especially pronounced if the rand strengthens from very weak levels and causes global industrials on the JSE to decline. However, there appears to be good value in many of the South African financials and some of the resource companies. South African bonds look to be offering appealing real returns but are over-owned by foreigners and may be weak if there is a rating downgrade and foreign selling. Global bonds remain very expensive in our view, but we have identified many attractive global stocks for our portfolios that have a global component.

With great discipline and substantial research effort, we are positioning client portfolios in a diversified mix of undervalued assets and are avoiding overvalued assets. We aim to be the very opposite of a price-insensitive investor. UP

**Foreign exchange reserves of large developing countries**




Source: Bloomberg

# How Westlake is profiting from low oil prices

Mellony Spark - Analyst Associate

"The relatively recent tapping of the wellspring of shale gas reserves in North America precipitated a massive decline in US gas prices. This, in turn, prompted traditional pure energy players such as Sasol to embark on US petrochemical projects aimed at exploiting this abundance of cheap gas."

# How Westlake is profiting from low oil prices

Our careful scrutiny of Sasol's North American chemical project - the largest investment by a non-US company within the US - included a detailed analysis of the competitive landscape in the US. Our research unearthed a few companies trading at very attractive valuations, with chemical facilities already in place, and benefitting from the record low gas prices in the US. One company in particular, Westlake Chemical, stood out due to its scale and proximity to Sasol's planned operation in Lake Charles, Louisiana.

Westlake's operations focus on the production of the molecular building blocks of plastic (broadly falling under the petrochemical families known as olefins and vinyls) derived from natural gas liquids. These products are used in the automotive and aerospace (tyres, paint and coatings), construction (piping), housing (flooring, roofing, fencing, decking) and the Fast Moving Consumer Goods (plastics and films) sectors. They are transformed into the kind of end products we see and use in our daily lives, including Polyvinyl chloride (PVC)[1] pipes, plastic film and polyethylene terephthalate (PET)[2] bottles.

**Background**

The US shale oil revolution has resulted in the substantial production of ethane, a primary component in natural gas, which is released as a by-product of the hydraulic fracking process. When ethane is harvested and 'cracked' in a pressurised, super-heated steam process, 'lighter' hydrocarbons such as ethylene are created. The abundant availability of ethane in recent years has created a market opportunity for US-based chemical producers ready to exploit the cost advantage. Ethane-fed 'crackers' deliver significantly higher margins compared to the relatively more expensive naphtha alternative at current and expected feedstock prices.

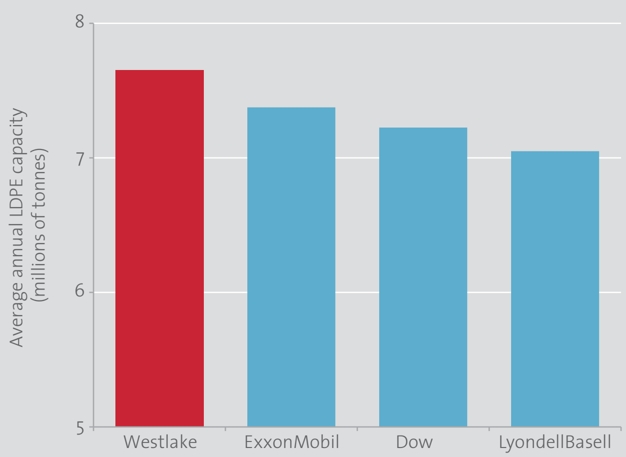
Traditionally, naphtha, a liquid chemical derived from the crude oil refining process, has been used as the feedstock for producing ethylene. However, the ethylene yields from the cracking of naphtha are significantly lower than those derived from ethane cracking. Currently, over 80% of European and Asian produced ethylene is naphtha-fed, whereas ethane-fed ethylene offers a 40% increase in profitability.

US ethylene end products are highly cost competitive and producers use the export market to compete with the higher cost naphtha-fed producers. Westlake, which has representation in Asia, Europe and the US, has exploited this opportunity. Switching from naphtha-fed to ethane-fed crackers is a costly

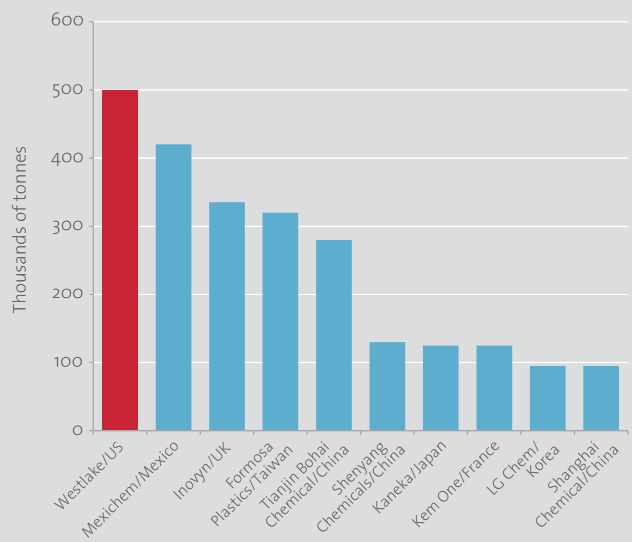
[1] Polyvinyl chloride (PVC) is the third most widely produced synthetic plastic polymer. It comes in two basic forms - rigid and flexible - and can be used for piping (construction), bottles, cards (bank cards), plumbing, electrical cable insulation, imitation leather and signage.

[2] Polyethylene terephthalate (PET) is the most common thermoplastic polymer resin of the polyester family and is used, among other areas, in fibres for clothing, containers for liquids and foods, and in manufacturing.

**Total annual North American LDPE company capacity**




**Top global speciality PVC company capacity**




Source: IHS Chemical

business, with the capital investment needed to build a greenfields, world-scale ethane cracker operation estimated to be in the region of US$10 billion.

Westlake currently owns and operates ethylene and polyethylene (PE)[3] plants in the US with a combined capacity of around 2.3 million tonnes per annum. It is also the largest US manufacturer of low density polyethylene (LDPE)[4] and one of the largest US producers of PVC.

## Olefins

In its pre-fabricated products segment, Westlake buys ethane from North American natural gas suppliers and produces ethylene, which is the smallest building block used to make PE. In 2013, the US alone consumed about 25 million tonnes of ethylene and global PE demand is forecast (by IHS Chemical) to rise by about 4% pa between 2013 and 2018.

Westlake's largest product segment focuses on a particular niche within the PE market, LDPE, which provides the properties of melt strength, flexibility and good adhesion to many interfaces. These properties lend themselves to a range of applications - from bakery bags to milk cartons and from high clarity film to moulded parts. Westlake is the largest producer of LDPE in the Americas, with an annual capacity of 7.5 million tonnes (left graph on opposite page).

## Vinyls

Westlake's second competitive edge in the petrochemicals market is its market-dominant position in its vinyls business segment globally and in the US (right graph on opposite page). The vinyls business is a leading producer of PVC, which is created via the chlorination of ethylene. The rigid form of PVC is used in construction and housing, while its good mechanical properties and resistance to corrosion make it ideal for sewage and plumbing piping. In addition, its lightweight durability, cost effectiveness and relatively low maintenance requirement make it an attractive alternative to traditional materials such as glass, metal, wood and other plastic materials used in housing applications.

Westlake has two PVC resin manufacturing facilities in the US that benefit from the cost savings of vertical integration as the raw feed material is produced at both Westlake plants. The group recently expanded its PVC offering into Europe through the 2014 acquisition of Specialty PVC producer Vinnolit, establishing production facilities in Germany and the UK, with a combined capacity of 6 million tonnes per year.

[3] Polyethylene (PE) is used in most of the consumable plastics available today in housewares and can also be used for piping.
[4] Low density polyethylene (LDPE) is the low density version of PE and has less hardness, stiffness and strength but better ductability. It is used for packaging like foils, trays and plastic bags, both for food and non-food purposes.

## Head to head: Westlake vs Sasol's US project

| Operation | Westlake | Sasol's Lake Charles project |
|---|---|---|
| Ethylene and polyethylene plants | 1.35 mt* Lake Charles | 1.5 mt Lake Charles |
| Polyethylene plants | 0.55 mt Longview | |
| Vinyls and PVC plants | 1 mt Calvert City | |
| Chlor - alkali, VCM and PVC | 0.74 mt Geismar<br>1.6 mt in Germany | |
| Ethylene pipeline infrastructure | 320 km MontBelvieu | |
| Net cash | US$90 million | |
| Total market value (Westlake)/capex(Sasol) | US$7 847 million | US$8 900 million |
| Current profitability | US$706 million | N/A |

*mt = million tonnes
Source: Kagiso Asset Management research

# How Westlake is profiting from low oil prices

### Why Westlake and not Sasol?

Westlake is a well-run, cash generative business, producing returns on investment in excess of 20%. The group's products are popular in end-markets such as the construction industry, which is reflected in consistent growth in the group's sales volumes. While the company's impressive cash generating ability has benefitted shareholders, it has also been able to take advantage of acquisitive opportunities in a highly fragmented chemicals sector ripe for consolidation.

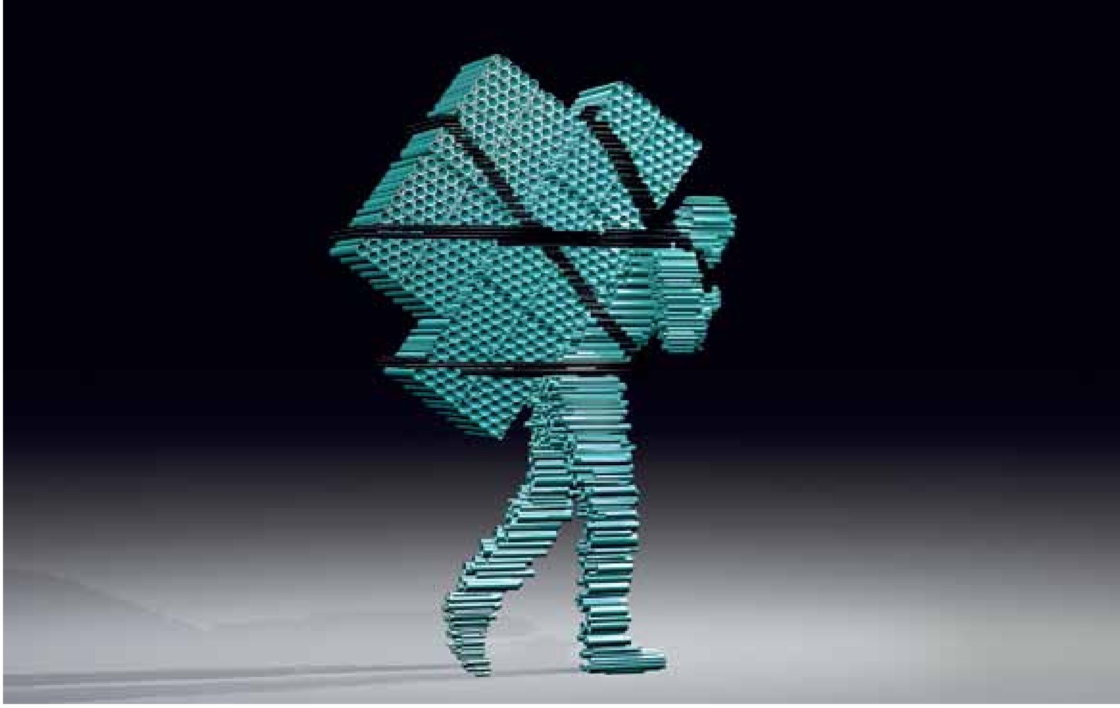
The group owns several facilities in various geographies, has an extensive pipeline network that connects these facilities with suppliers and customers, and an established global client base. It also own naphtha crackers as part of its European operations. Therefore, while the cost advantage of the ethane-naphtha price gap is set to improve as oil prices normalise upwards, Westlake will still benefit from current low naphtha prices in the short term.

Sasol is now laying down the groundwork for its US$8.5 billion Lake Charles cracker project, with a capacity that slightly exceeds Westlake's. It is doing this at a price that exceeds the entire value of Westlake today. Sasol still faces substantial execution risk on its facility that is only expected to start operation in 2018. The value proposition is highlighted in the table on the previous page.

### Petrochemicals: here to stay

Petrochemicals, in all their varieties, are undeniably a part of modern life and here to stay. For those positioned in the chemicals sector, niche products, cost advantages and a diverse and loyal customer base are the deciders of who the winners and losers will be in this highly competitive environment.

Sasol's recent makeover as a petrochemicals player attracted our attention to the dynamics of the ethane-ethylene stream. As a result, we found Westlake, an asset-rich US incumbent already profiting handsomely from the same strategy with none of the same execution risk that Sasol faces. We therefore hold Westlake as part of our global portfolio. UP



# SA banking credit loss cycle: is this time different?

Jihad Jhaveri - Investment Analyst

"South African banking shares decreased markedly in the final quarter of 2015 due to concerns around a worsening economy and, importantly, the prospect of rising interest rates and the associated rise in credit losses. In this article, we look back at past interest rate cycles and argue that this cycle will be less severe than normal."

# SA banking credit loss cycle: is this time different?

South Africa has delivered another year of weak domestic economic activity, with GDP growth for 2015 expected to be even lower than the 1.5% registered in strike-affected 2014. Worryingly, existing structural problems (such as strained electricity supply, South Africa's long-term deindustrialisation and the aftermath of excessive personal loan growth) have been compounded in 2015 by the sharp slowdown in economic growth in China, the country's largest trading partner. The growth outlook for 2016 and 2017, which is unlikely to exceed 1.5% pa, is also poor.

Against this low economic growth backdrop, interest rates need to continue to normalise higher to contain inflationary pressures that are building (largely driven by weaker currency). This will present a tougher environment for the consumers and corporates to whom banks lend. Investors in banks need to budget for a deteriorating credit loss cycle as credit losses are expected to increase in tandem with rising rates.

## Consumer balance sheets: unhealthy but stable

Our view remains that South African consumers have not used the recent extended period of real disposable income growth and low interest rates to sufficiently reduce debt. However, very subdued consumer credit expansion (retail loan growth has been running at below 5% for the last two years) has allowed household financial health to stabilise. In an environment of low economic growth, real disposable income growth is expected to slow further and, as interest rates rise, there will be increased consumer financial stress (charts below).

## Corporates: distressed areas of the economy will yield casualties

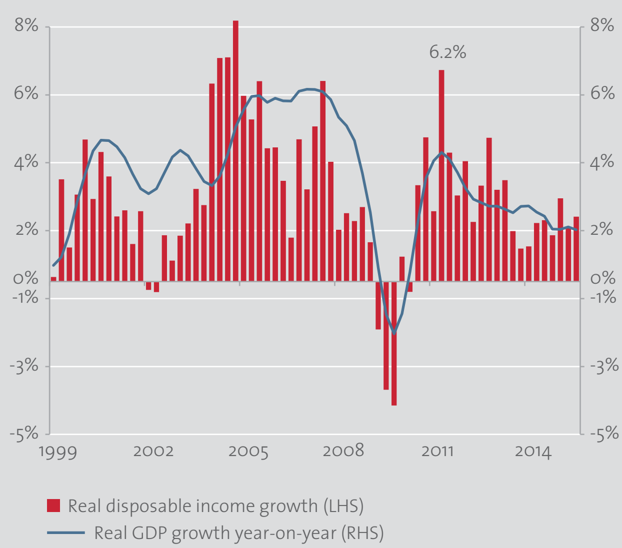
On the corporate front, historic indicators (such as insolvencies, liquidations and defaults) are low relative to history. However, hidden within the country's poor average growth figures are serious stress areas (eg in the mining, construction and drought-affected agricultural sectors). Credit risks for the banks stem not only from the big industry players but, more importantly, from loans granted to the small and medium sized companies throughout the long value chains in these sectors.

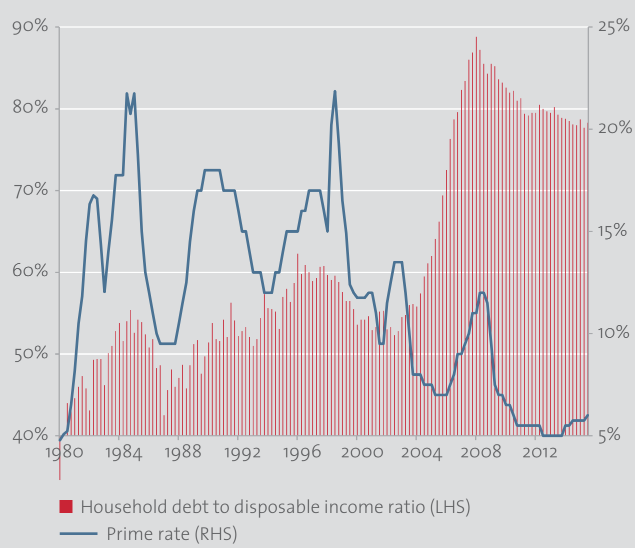
## Banks' credit loss cycle

This cycle is not different from previous cycles in that credit losses are expected to rise from unsustainably low levels. Our view is that the current cycle will be structurally less severe than in the past due to the different characteristics that this interest rate hiking cycle has.

The table on the opposite page, which outlines the key characteristics of past interest rate cycles, should be viewed together with the accompanying graph (over the page) of

## Household financial health




Source: StatsSA, SARB

Standard Bank's bad debt ratio over the long term (we have used Standard Bank as it has the longest available corporate history among the four major banks).

The following important observations can be made:

- Interest rates in South Africa have adjusted to structurally lower levels in the 2000s with the Reserve Bank's successful implementation of inflation targeting, and inflation expectations have become less volatile. Consequently, the absolute change in interest rates per cycle has also moved structurally lower through time.
- The average hike in interest rates per month is a key factor in assessing the impact of rate increases on borrowers. Sharp increases over a short period of time lead to heightened stress on borrowers and higher credit losses, as seen during the 1998 emerging market crisis. The average 0.4% increase per month that we will experienced in the current cycle is not extreme versus prior cycles. We expect further interest rate increases in the current cycle to continue at a moderate pace. However, it is possible that - given the fragile state of the economy - an unexpected macroeconomic shock could result in a sharper and quicker normalisation to higher rates (and possibly in a temporary overshoot).
- A rough gauge of the cash flow impact of changes in interest rates on borrowers is the proportional change in the interest rate itself, which - in the current cycle - has so far been comparatively low.
- The most important factor within each period is the amount of credit growth experienced leading up to the start of the hiking cycle. In past cycles, exuberant loan growth from the banks prior to the first interest rate hike was the source of subsequent poor economic returns. This was because banks, at a late stage of the cycle, relaxed credit granting criteria and priced poorly for risk as they competed for loans. By contrast, credit extension in the current cycle has been subdued and carefully controlled by the banks.

The above high level factors suggest that the current interest rate hiking cycle should be less severe in terms of credit losses to banks than many of the past cycles.

### Increased regulation means healthier banks

The financial crisis resulted in a heightened regulatory focus on the banking system and a continuous pipeline of ever-tightening regulations. These changes have, and will continue to depress banks' profitability due to higher compliance

## Past credit cycles

| Cycle start | Jan 81 | Jun 83 | Jan 88 | Sep 94 | Jun 98 | Jan 02 | Jun 06 | Jan 14 |
|---|---|---|---|---|---|---|---|---|
| Cycle end | Mar 82 | Aug 84 | Oct 89 | Nov 96 | Aug 98 | Sep 02 | Nov 08 | Dec 16 |
| Start rate | 9.50% | 14.00% | 12.50% | 15.30% | 18.30% | 13.00% | 10.50% | 8.50% |
| End rate | 20.00% | 25.00% | 21.00% | 20.30% | 25.50% | 17.00% | 15.50% | 11.80% |
| Average hike/month | 0.70% | 0.73% | 0.39% | 0.19% | **2.42%** | 0.44% | 0.20% | 0.40% |
| Absolute increase | 10.50% | 11.00% | 8.50% | 5.00% | 7.20% | 4.00% | 5.00% | 3.25% |
| Proportional change | **110.5%** | 78.6% | 68.0% | 32.7% | 39.3% | 30.8% | 47.6% | 38.2% |
| Compound annual growth rate in private sector credit extension | | | | | | | | |
| Three years prior to first hike | 18% | **23%** | 14% | 11% | 17% | 11% | 17% | 7% |
| Two years prior to first hike | 21% | 21% | 13% | 12% | 16% | 12% | **23%** | 8% |

Source: HSBC estimates, SARB

# SA banking credit loss cycle: is this time different?

costs, higher levels of required capital and higher levels of costly liquidity required.

Globally, the purpose of the regulatory burden is to decrease risks in the banking system as a whole by increasing the required levels of capital and liquidity. In South Africa, there has been an added focus on consumer protection via debt counselling processes, maximum interest rates and insurance price limits, and the enforcement of affordability testing criteria for clients.

A positive implication of the regulatory focus has been that it has forced the banks to pay more attention to two valuable resources at their disposal: capital from their shareholders and liquidity from their deposit franchises.

In home loans in particular (which represent around 35% of the total loan book) post the financial crisis, there has been a strong focus on pricing appropriately for risk. Regulation is forcing banks to reduce liquidity risk when making these long duration loans by increasing the period of the corresponding funding. This has decreased the banks' credit appetite and, consequently, loan growth in this large category has been benign in recent years (since 2009, Nedbank and Barclays have had negative average home loan growth).

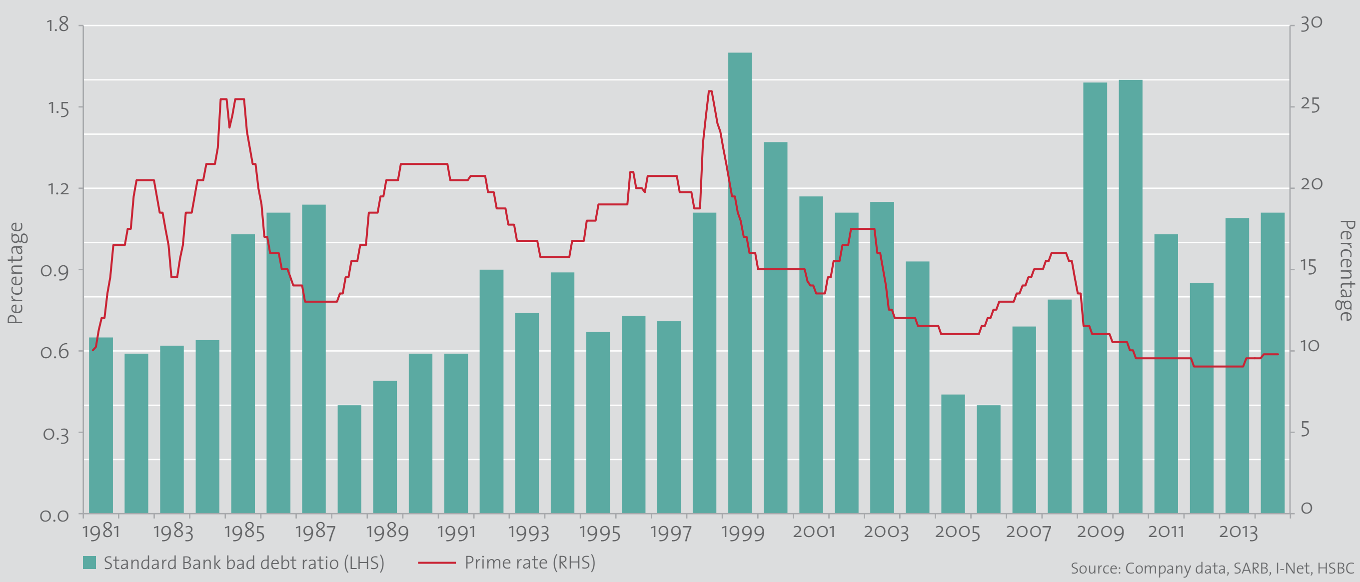
In turn, the decreased supply of new credit into the housing market has helped keep housing supply in check and has improved the health of the housing market. We expect banks' credit losses in this category to increase from extremely low levels but are confident that the normalisation higher will be a lot less severe than in past cycles.

**Banking stocks: attractive upside in an expensive market**

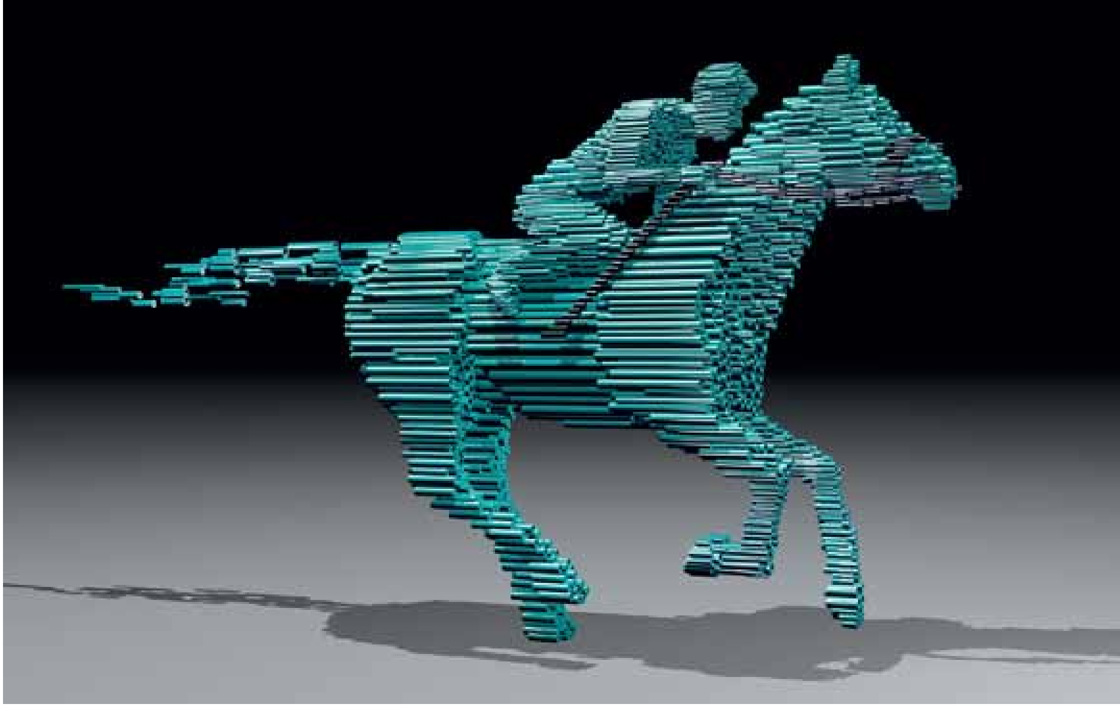
While we expect a milder credit loss cycle than in the past, we are critically aware that the interest rate cycle could quickly unfold in a far more extreme manner given the fragile state of the economy. Even under more stressful conditions, our view is that the current market prices of banks are attractive.

Our preferred exposure in this tough operational environment is FirstRand. FNB (FirstRand's retail and business bank) has outperformed on the innovation and client service front, leading to a sustained financial outperformance of peers. FirstRand is now focussing on maximising value from its large incremental retail client base through increasing cross selling throughout its services and, importantly, by adding new services (like insurance and wealth management). It also has a relatively strong balance sheet, reflected in higher capital levels than its peers and higher bad debt provisioning levels. UP

**Standard Bank bad debts over interest rate cycles**




Source: Company data, SARB, I-Net, HSBC

# SA gambling: may the odds be ever in your favour

Dirk van Vlaanderen - Investment Analyst

"The first ban on gambling in South Africa was imposed by the Dutch in 1673 and this legacy of restriction continued until 1965, when the South African government permitted betting on horse racing.

In the apartheid-era, casinos were operated in the homelands of Bophuthatswana, Ciskei, Transkei and Venda, but it was only in 1996 that the National Gaming Act formalised a legal system of national casinos, other forms of gaming and the national lottery."

# SA gambling: may the odds be ever in your favour

Today, online gambling is illegal in South Africa but online betting, such as sports betting, is permitted.

In this article we discuss the history, trends and industry players in the different modes of gambling within South Africa.

The majority of gross gaming revenue (GGR) is derived from casinos, which contribute 72% of South Africa's GGR. Betting (horse racing, sports betting and other) contributes 14%, bingo 5% and Limited Payout Machines (LPMs) 9%. The chart below (left) highlights the recent rise of LPMs and bingo, both categories that have grown from virtually nowhere to currently account for 14% of the country's GGR.

Gambling is a game of chance and the chart below (right) highlights the average return to player depending on the mode of gambling. In the case of casinos, the players receive back an average of 92% of what they bet, hence the old adage 'the house always wins'.

The 8% kept by the house is then reduced by gaming levies paid to the various provincial (and national) gaming boards and VAT. However, as the graph below also shows casinos return more to players than the other main modes of gambling.

**Casinos: a maturing growth profile**

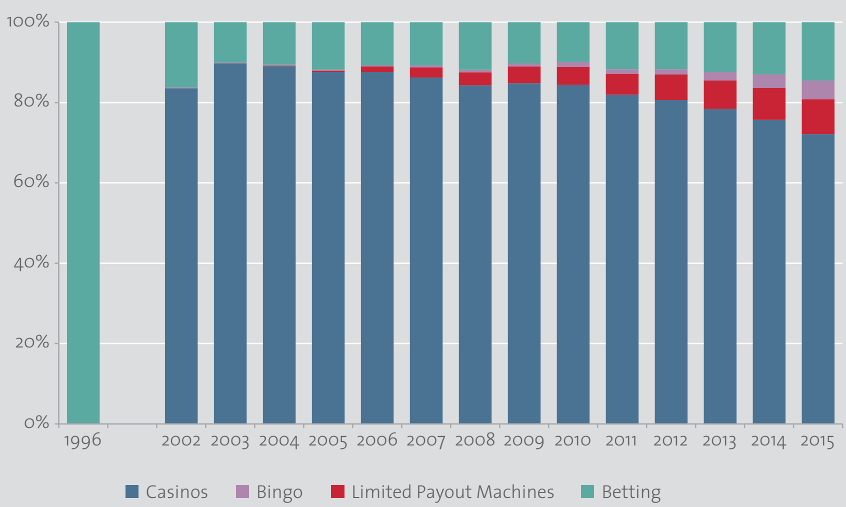
Casinos generate revenue from both tables (where games include black jack and roulette) and slot machines. Minimum bets are normally lower on slot machines (5 c to R100) than tables (R50 to R500). The pay-out on both these forms of gambling is not capped.

The National Gaming Act legislates for only 40 casino licenses in South Africa. This maintains very high barriers to entry as the number of licenses is finite and the distinct locations of these casinos ensure effective geographic monopolies. As shown in the graph on the opposite page, the growth in casino GGR in the 10 years after the formalisation of gaming was stellar - averaging 17% per annum. This was mainly due to new casinos opening, a buoyant economy and a confident consumer.

Since the global financial crisis, casino growth has slowed to an average of just 4% as the industry matured and slower economic growth and weaker consumer sentiment has dampened this form of discretionary spend.

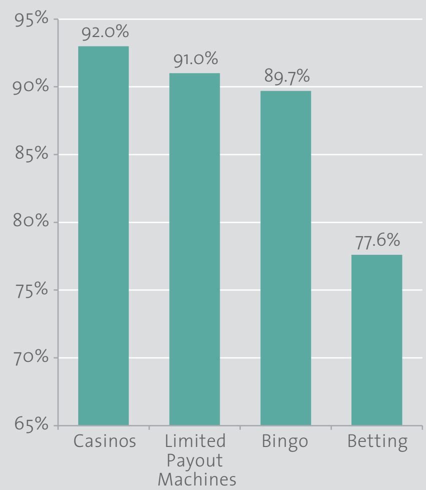
Sun International and Tsogo Sun Holdings are the largest local casino operators and are listed on the JSE. While both companies are also large hotel operators, the casino businesses are core

**Gross gaming revenue mix per mode**




Source: National Gambling Board, Kagiso Asset Management estimates

**Average return to player per mode***




*Year end March 2015

Source: National Gambling Board

to their operations, contributing over 75% of both groups' EBITDAR[1]. Tsogo's casinos are all based in South Africa, while Sun International has diversified its geographic exposure by entering the higher-growth Latin American gaming markets (Chile, Colombia and Panama), which now contribute around 11% of its EBITDAR.

### Limited Payout Machines: growth not limited

LPMs are a fairly new gambling mode in South Africa. Overall progress in the roll-out, which started in 2003, has been very slow with only 10 279 active machines currently compared to the initial expectation of 50 000.

LPMs look and feel like slot machines, but differ as follows:

- Unlike casino slot machines, LPMs have a stipulated maximum stake and prize (R5 and R500 respectively for one spin).
- Generally, LPM venues may only have licences for five or fewer machines and therefore offer convenience gambling rather than the destination-type opportunities at the larger casinos.
- Net Gaming Revenue from the machines is split 60/40 between the route operator (owner/operator of machine) and the site owner (eg the bar owner).

[1] EBITDAR is earnings before interest, tax, depreciation, amortisation and rent.

There has been significant consolidation in the industry in recent years with Vukani Gaming Corp (owned by JSE-listed Niveus) now the largest LPM route operator in the country (holding 13 000 licences). Grand Slots (owned by JSE-listed Grand Parade Investments) and Goldrush are also significant industry players.

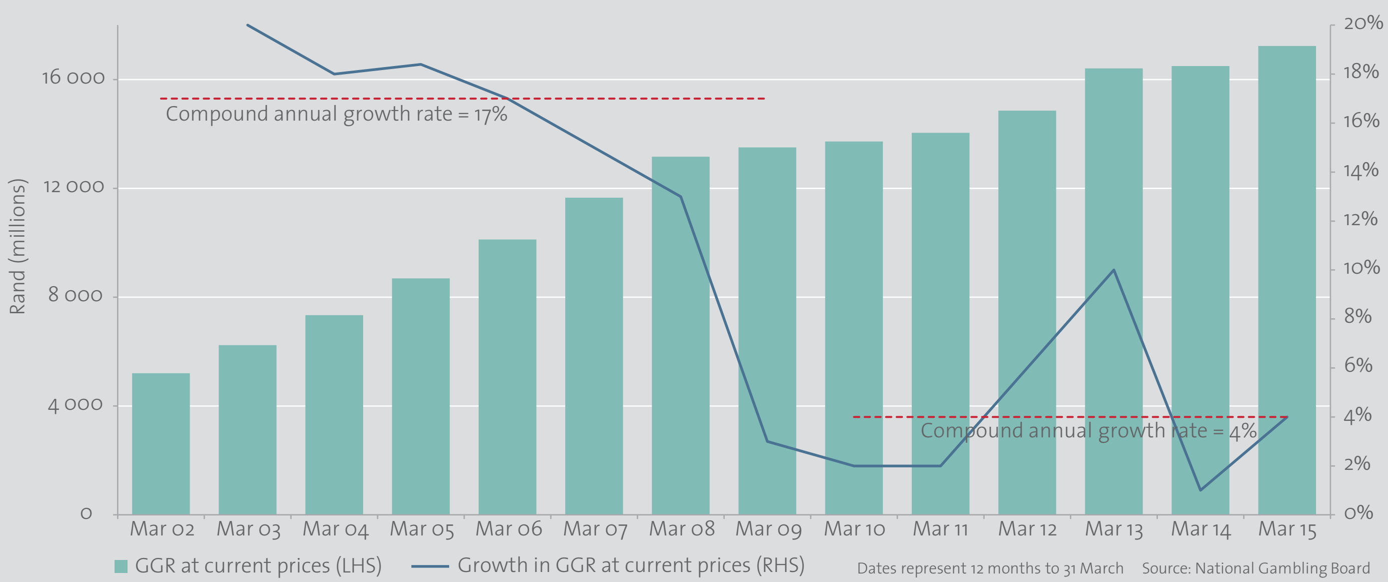
The Western Cape is the most mature LPM market, reflected in the highest 'GGR per machine per day' at around R1 000 (left chart over the page). Growth in the industry is mainly due to the fast pace of new machine roll-outs, which looks set to continue. We believe this growth will be further supported by a maturing of the 'GGR per machine per day' levels in other provinces towards those seen in the Western Cape.

### Betting: exciting prospects for sports betting

This segment incorporates betting on horse racing and the fast-growing sports betting market. Both of these areas can be divided between the more traditional bookmakers and the totalisator operators (right chart over the page).

While the horse racing industry has experienced a mini-renaissance in recent years, the big growth area has been in sports betting. In only seven years, sports betting has grown to be nearly twice as big as horse racing for the bookmakers and is showing no signs of slowing. Sports betting involves

### Casino gross gaming revenue




Dates represent 12 months to 31 March Source: National Gambling Board betting on the outcome (and other aspects) of sports matches, both locally and internationally. Phumelela Gaming is the only listed company with direct exposure to betting and, together with Gold Circle (unlisted), is one of two national horse totalisators.

### Bingo: an uncertain road ahead

Traditional bingo, whereby players need to match random numbers to pre-printed bingo cards, has advanced through technology to include electronic bingo terminals (EBTs), where each player uses a terminal to play a variety of games. Denomination starts from as low as 2c per game and there are often a large variety of games on offer.

In South Africa, bingo - like LPMs - is an immature gaming mode with the significant growth seen in recent years due to new machine and license rollouts. There are currently 9 813 licensed positions, with Gauteng the province with the largest exposure (close to 3 000), followed by the Eastern Cape and KZN. Currently, there are no bingo licenses in the Western Cape, Northern Cape, Free State and Limpopo. The largest player in the local bingo market is Galaxy Gaming (owned by Niveus).

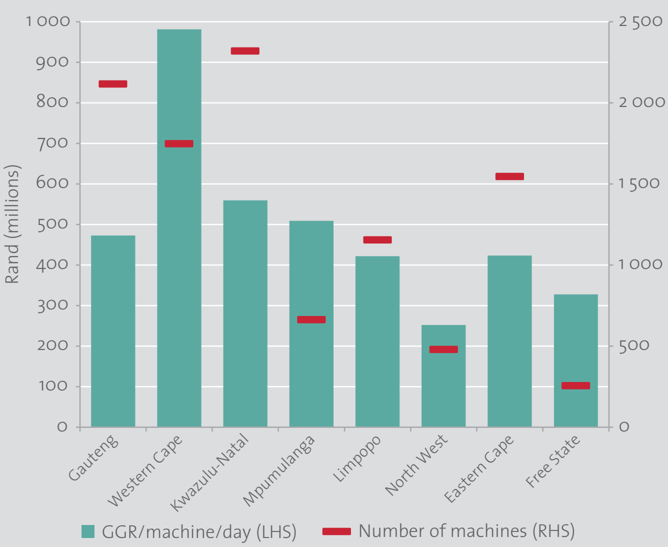
In 2014, the Minister of Trade and Industry put a moratorium on new bingo licence awards. This was due to the similarity of EBT's to traditional slot machines and the alleged impact they have had on existing casinos, as well as due to the social concerns of essentially having 'mini-casinos' in shopping malls. This suspension is in place until a full review of the social and economic impact of new bingo licences has taken place. While the demand clearly exists, the future of the industry remains unclear.

### Investment prospects

We believe that gambling has some defensive qualities. However, the industry is not immune to a weaker economy and low consumer confidence, and has struggled in recent years. We expect a good growth trajectory for the immature forms of gambling in South Africa, such as sports betting and LPMs, while EBTs' future is in the hands of the regulator.

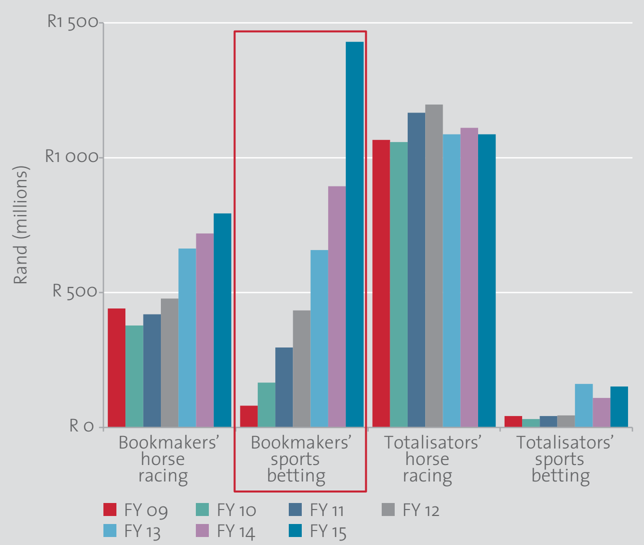
Traditional casinos, although more mature, remain well positioned for an uptick in economic growth and consumer spending, although this is not expected in the near term. This is particularly accentuated by the high fixed cost nature of casinos, which means that revenue growth causes leveraged profit growth. Clients in our portfolios have exposure to the gambling sector through our holdings in Sun International and Grand Parade Investments. UP

### Limited Payout Machines (year end March 2015)




Source: Provincial gambling boards and Kagiso Asset Management estimates

### Betting GGR by mode




Source: National Gambling Board

## Kagiso Asset Management Funds

| Performance to 31 December 2015 | 1 year | 3 years[1] | 5 years[1] | 10 years[1] | Since launch[1] | Launch | TER[2] |
|---|---|---|---|---|---|---|---|
| **Unit trust funds[3]** | | | | | | | |
| **Equity Alpha Fund** | -6.6% | 8.0% | 8.9% | 13.3% | 18.3% | Apr-04 | 1.5% |
| South African Equity General funds mean | 1.4% | 10.2% | 10.8% | 11.7% | 15.4% | | |
| Outperformance | -8.0% | -2.2% | -1.9% | 1.6% | 2.9% | | |
| **Balanced Fund** | -3.6% | 7.9% | - | - | 8.9% | May-11 | 1.5% |
| South African Multi Asset High Equity funds mean | 7.6% | 11.6% | | | 11.6% | | |
| Outperformance | -11.2% | -3.7% | | | -2.7% | | |
| **Protector Fund** | -2.8% | 5.7% | 5.1% | 7.9% | 9.9% | Dec-02 | 1.6% |
| CPI + 5%[4] | 10.2% | 10.3% | 10.5% | 11.1% | 10.6% | | |
| Outperformance | -13.0% | -4.6% | -5.4% | -3.2% | -0.7% | | |
| **Stable Fund** | -2.1% | 6.6% | - | - | 7.1% | May-11 | 1.6% |
| Return on large deposits* | 4.9% | 5.1% | | | 5.2% | | |
| Outperformance | -7.0% | 1.5% | | | 1.9% | | |
| **Institutional funds[5]** | | | | | | | |
| **Managed Equity Fund** | -8.7% | 7.2% | 9.2% | - | 12.2% | Sep-06 | |
| FTSE/JSE SWIX All Share Index | 3.6% | 13.0% | 14.2% | | 13.7% | | |
| Outperformance | -12.3% | -5.8% | -5.0% | | -1.5% | | |
| **Core Equity Fund** | -4.7% | 9.6% | 11.4% | 13.9% | 17.2% | Nov-04 | |
| FTSE/JSE SWIX All Share Index | 3.6% | 13.0% | 14.2% | 14.7% | 17.9% | | |
| Outperformance | -8.3% | -3.4% | -2.8% | -0.8% | -0.7% | | |
| **Domestic Balanced Fund[6]** | -7.2% | 5.9% | 7.6% | - | 7.9% | May-07 | |
| Peer median[7] | 4.3% | 11.2% | 12.5% | | 10.4% | | |
| Outperformance | -11.5% | -5.3% | -4.9% | | -2.5% | | |
| **Global Balanced Fund[8]** | -0.1% | - | - | - | 8.7% | Jul-13 | |
| Peer median[9] | 10.0% | | | | 14.5% | | |
| Outperformance | -10.1% | | | | -5.8% | | |
| **Sharia unit trust funds[3]** | | | | | | | |
| **Islamic Equity Fund** | -7.4% | 6.2% | 6.5% | - | 11.4% | Jul-09 | 1.3% |
| South African Equity General funds mean | 1.4% | 10.2% | 10.8% | | 14.4% | | |
| Outperformance | -8.8% | -4.0% | -4.3% | | -3.0% | | |
| **Islamic Balanced Fund** | -2.5% | 7.4% | - | - | 6.4% | May-11 | 1.5% |
| South African Multi Asset High Equity funds mean | 7.6% | 11.6% | | | 11.6% | | |
| Outperformance | -10.1% | -4.2% | | | -5.2% | | |

| Highest and lowest monthly fund performance | Highest | Lowest | Highest | Lowest | Highest | Lowest | Highest | Lowest | Highest | Lowest |
|---|---|---|---|---|---|---|---|---|---|---|
| *Equity Alpha Fund* | 7.6% | -4.7% | 8.1% | -4.7% | 8.1% | -4.7% | 10.9% | -9.0% | 11.9% | -9.0% |
| *Balanced Fund* | 4.6% | -4.2% | 6.2% | -4.2% | - | - | - | - | 6.2% | -4.2% |
| *Protector Fund* | 2.5% | -4.2% | 4.8% | -4.2% | 4.8% | -4.2% | 7.9% | -5.3% | 9.5% | -5.3% |
| *Stable Fund* | 2.9% | -3.5% | 4.0% | -3.5% | - | - | - | - | 4.0% | -3.5% |
| *Islamic Equity Fund* | 5.7% | -4.6% | 8.1% | -4.9% | 8.1% | -4.9% | - | - | 8.1% | -4.9% |
| *Islamic Balanced Fund* | 4.5% | -2.6% | 8.2% | -5.4% | - | - | - | - | 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 12-month period to 30 September 2015; [3] Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [4] CPI for December is an estimate; [5] Source: Kagiso Asset Management; gross of management fees; [6] Domestic Balanced Fund and benchmark returns to 30 November 2015; [7] Median return of Alexander Forbes SA Manager Watch: BIV Survey; [8] Global Balanced Fund and benchmark returns to 30 November 2015; [9] Median return of Alexander Forbes Global Large Manager Watch. *Return on deposits of R5 million plus 2% (on an after-tax basis at an assumed 25% tax rate).

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