UP

July 2018

Kagiso Asset Management

Quarterly

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Covestro is leading the future of premium plastics

Abdul Davids - Head of Research

"Headquartered in Leverkusen, Germany, Covestro is an industrial chemicals company responsible for some of the most innovative developments in high-tech plastic materials over the last century. Though you may not have heard of it, you likely use its products daily."

Covestro is leading the future of premium plastics

Covestro was unbundled from the Bayer Group (a leading German healthcare, chemicals and agricultural chemicals business) in 2015. Its history as the Bayer Material Science division dates back to the 1900s, and includes the invention of premium plastic composites with properties that outperform many metals.

The business has three segments: Polyurethanes (54% of 2017 sales), Polycarbonates (26% of 2017 sales), and Coatings, Adhesives and Specialties (15% of 2017 sales). These segments work complementarily to produce thousands of custom materials and products.

Polyurethanes division

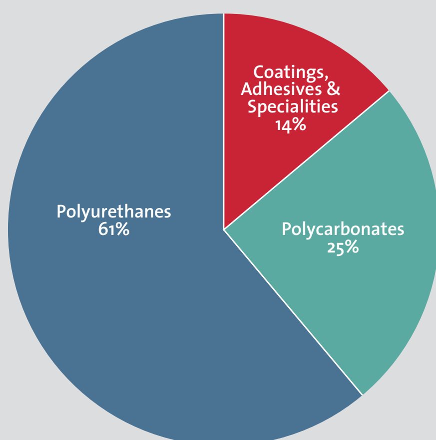
Invented by Otto Bayer in 1937, polyurethanes are a versatile range of plastic materials produced in a variety of forms and used in diverse industrial applications. As a rigid foam, it is a uniquely effective insulation material used in buildings and in almost all refrigerated appliances. Even space suits contain polyurethane insulation layers that prevent astronauts from freezing in outer space temperatures. As a flexible foam, it is used in quality mattresses, car seats and upholstered furniture. As a thread, it is combined with nylon to create spandex, giving sports clothes flexible and sweat-wicking properties, and stretch jeans their stretch. Thermoplastic urethane, a derivative of polyurethane, can be found in most electronic devices and sports equipment.

Covestro is a global market leader in the development, production and sale of polyurethanes - producing around 1.2 million tonnes a year. It develops new components - and combinations of these ingredients - to enhance particular properties to meet the needs and specifications of different clients and products. For example, surfboards made from polyurethane are built to be light but strong, while the polyurethane materials used for rollerblade wheels are designed to emphasize resistance. The 'recipe' might be adapted to modify the stiffness of a soft foam or the size of the foam's pores.

Polycarbonates division

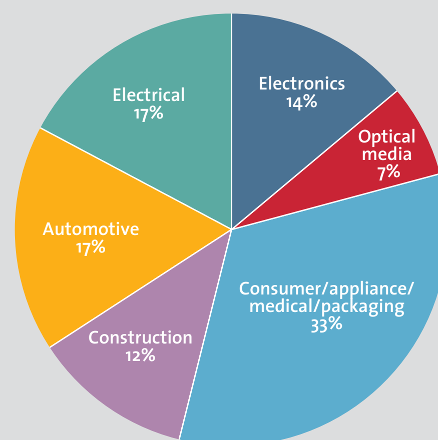
Polycarbonate is a high performance plastic first discovered by Bayer Group scientists in 1953, and adopted commercially in the 1970s. It is extremely lightweight, virtually unbreakable, easily moulded and modified, cost-effective, heat-resistant, and can be transparent. As a result of these superior characteristics, polycarbonate materials have replaced glass, fiberglass and other plastics in a diverse array of industrial and consumer product applications.

Covestro's 2017 earnings by product segment



Source: company reports

Polycarbonates: global demand by application in 2017



Source: company reports

Polycarbonates are processed mainly via extrusion and injection-moulding operations and are often blended with other polymers to achieve different characteristics. Typical blends include rubber-modified polycarbonate that improves the impact properties of the product, and polyester blends that retain toughness at lower temperatures and have improved weather resistance.

Covestro's blends are used in various automotive components including advanced lighting applications, such as headlamp bezels and lenses, which require high heat and impact resistance and excellent light transparency. They are also used in panoramic roof panels, tailgates, roof bezels, side windows, air vents, airbag covers and consoles. Its polycarbonate resins are used for exterior body parts such as radiator grilles and bumpers. Weighing around 50% less than glass, these materials offer considerable weight reduction benefits, contributing significantly to fuel economy in conventional cars and battery life in electric vehicles.

The use of polycarbonates in electric vehicles in particular is expected to triple from current levels, adding considerable demand to the market as the electric vehicle market expands in the coming decades.

In addition to its weight advantage, polycarbonate offers design freedom enabling car designers to go beyond what is currently possible with conventional materials. Covestro has gone as far as to trial a vehicle body built entirely from polycarbonate materials, including windscreens and windows, and extremely lightweight sensors for autonomous driving functions.

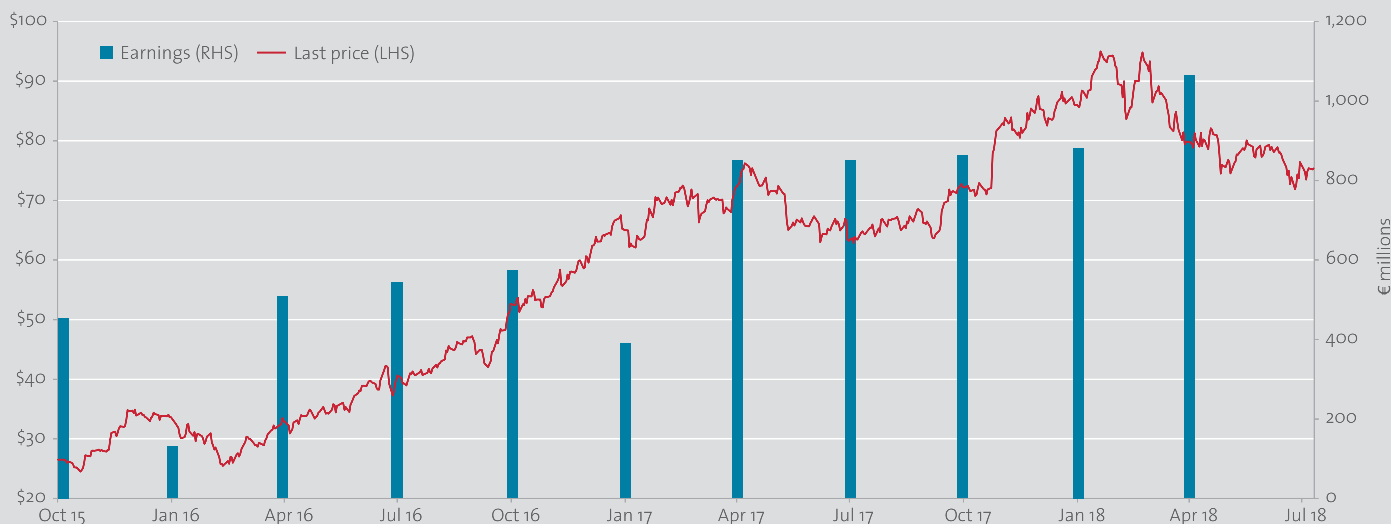
Covestro's blends are also used widely in electronics, making ultra-lightweight but well-protected laptops, tablets and smartphone devices. It is also found in protective hard hats, optical media and printers, ski equipment, televisions, LED lights and specialist medical equipment such as dialysis machines.

The global polycarbonates market is dominated by two major players, holding a combined 54% of the market as of 2017. Covestro's polycarbonates division is the market leader, with 29% market share. Saudi Basic Industries Corporation (SABIC) is its major competitor with 26% of the market and the rest is made up of over 20 companies, each holding between 1% and 5% market share.

Coatings, Adhesives and Specialties division

This segment develops and supplies substances that make end products more attractive and durable. It is the smallest of Covestro's divisions by sales, but like the other divisions, holds a leading global market share.

Covestro's share price has recently come under pressure



Source: Bloomberg, company reports

Covestro is leading the future of premium plastics

A stabilising market

Over the last two years, Covestro's net income increased almost four-fold from €580 million in its 2015 fiscal year to €2.2 billion in its 2017 fiscal year. This growth in net income was primarily due to strong growth in its polyurethanes division, which now accounts for almost two-thirds of Covestro's net income (left pie chart).

Rapid demand growth for polyurethane materials, particularly from China, has resulted in substantially higher prices and strong profit growth for Covestro in recent years.

Prices have been further supported by supply constraints, partly as a result of limited production capacity in the market, and partly due to shortages in the supply of raw materials. Polyurethane is produced from derivatives of the crude oil refining process. Increased reliance on US shale over the last decade has reduced the volume of crude oil being refined, decreasing the supply of these raw materials.

This tight supply and higher price environment has prompted chemical producers, including Covestro, to invest in additional supply capacity to satisfy the strong demand. Covestro has even succeeded in using a plant-based raw material to manufacture the key chemicals required for polyurethane production. However, the increased capacity should see prices stabilise, and we therefore expect the polyurethane division's margins to decline somewhat from 2017 levels.

As a result of market fears around this incremental increase in supply, Coverstro's share price has retreated to below €80 from a January 2018 peak of €96 (graph on previous page). However, we believe that earnings losses from the polyurethane division will be more than off-set by continuous strong growth in the polycarbonates division.

The new growth engine for the business

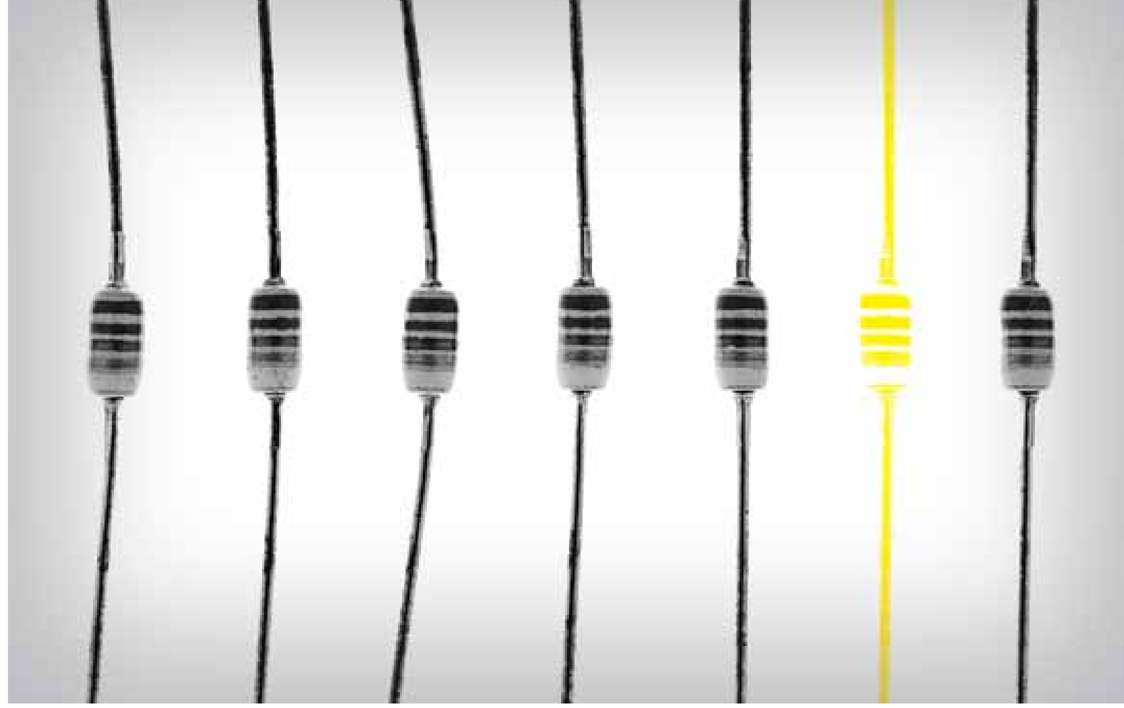
For the last eight years, the polycarbonate market has grown at almost 10% a year. We expect that the market will continue to grow at above 5% a year for some years to come as a result of the continuing development of entirely new uses and applications for these materials.

Global polycarbonates demand was an estimated 4.4 million tonnes in 2017, with the largest markets being consumer appliance, automotive and electronics (right pie chart).

Covestro, like many of its competitors, is adding additional polycarbonate capacity. By 2020, the total annual supply is expected to increase by 600 kilotonnes (13% of total 2017 supply). However, demand for polycarbonates is expected to grow to 5.4 million tonnes by 2021, driven by electrical components and electronic products demand growth.

Outlook

Covestro's recent share price weakness reflects market concerns around the incremental new supply and the potential negative impact on Covestro's earnings. However, our analysis indicates that the market demand growth is substantially robust and should absorb the additional supply. Instead we regard an investment in Covestro as an ideal opportunity to invest in the market leader in a fast evolving, growing market where innovation will ultimately be rewarded with higher levels of profitability and returns to shareholders. UP



Altron: primed to reap rewards

Meyrick Barker - Investment Analyst

"Allied Electronics Corporation (Altron) is today a streamlined holding company delivering compelling information and communication technology (ICT) solutions to its clients. Commencing in 2015, after a period of significant losses in certain divisions, the business has undergone a major restructure and strategic realignment. Three years on, Altron is positioned to deliver significant growth as it reaps the benefits of its refined strategy."

Altron: primed to reap rewards

Founded in 1965 as an electronic components manufacturer and distributor, Altron embraced an acquisitive strategy to expand its product offering. Although initially successful in delivering increased shareholder returns, the business gradually distanced itself from its original core competencies. This created an unnecessarily complicated group structure, servicing a range of disparate industries and making the business difficult to manage and complex for both investors and customers to understand.

First the phoenix burned

Poor capital allocation decisions and undisciplined expense management resulted in significant impairments and an increasingly constrained balance sheet. In 2015, with a share price floundering 90% below its prior decade highs, the board initiated a thorough strategic reform. It centred on the disposal of non-core businesses, a reorganisation of the capital structure and a shift away from the company's family-owned culture.

The board has been reconstituted and strengthened and extensive changes to management have been made. The introduction of a significant shareholder with private equity expertise in 2016 helped accelerate the changes and reorient the company. See the graph below highlighting key restructuring initiatives and the initial positive impact these have had on growing Altron's market cap.

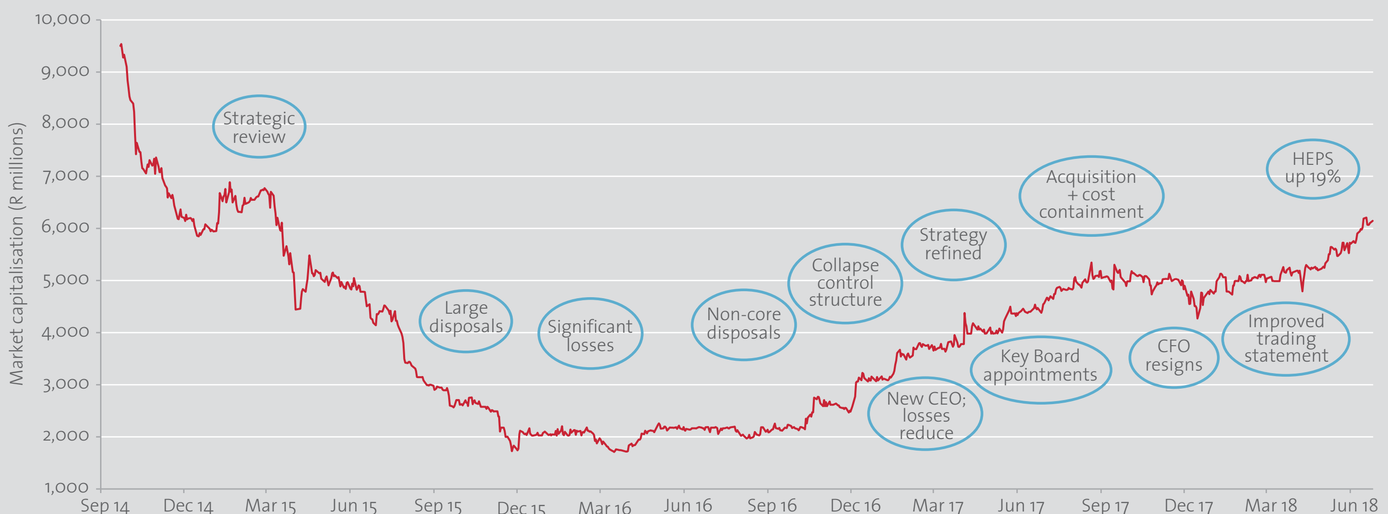
A streamlined structure

Altron has mostly concluded disposing of its capital intensive manufacturing businesses, the Powertech companies, in which it had limited competitive advantages. In turn it has focused on expanding its capital-light ICT expertise. South Africa still remains core to the group, generating approximately 65% of group revenue, with the balance thereof largely earned in the United Kingdom. The charts opposite capture the expected increasing dominance of the ICT sector's contribution to group earnings before interest, tax, depreciation and amortisation (EBITDA) as the non-core manufacturing assets are successfully disposed of, and capital has been recycled to already-completed offshore acquisitions.

The restructuring process has seen the remaining businesses that operate under the Altech and Bytes brands, now grouped under three focus areas:

- ICT: Specialised hardware, software and services largely tailored for medium and large businesses. The comprehensive offering includes the distribution and maintenance of Xerox equipment, bank ATMs and point-of-sale devices; software solutions to ensure transactions are securely processed in the financial, retail and healthcare industries; managing of client firms' software licences to ensure they remain up to date and

Milestones in Altron's turnaround



Source: company reports

optimised; converged network solutions (ie combined telephony, data and multimedia communication); and business process outsourcing and training within the ICT sector.

- Fleet management: This division comprises the Altech Netstar business which provides vehicle recovery and telematics services for over 600 000 vehicles in South Africa and Australia.
- Electronic component distribution: designing, sourcing and supplying a variety of electronic components. This includes the distribution of products which feature in household water and electricity meters, LED lighting solutions and electric garage door mechanisms.

There are a number of successful businesses across these units, operating in the targeted growth sectors. Some deliver services developed off strong in-house intellectual property. Others benefit from key strategic alliances established with global software and hardware vendors to help meet client needs. Recent astute acquisitions directly aligned with the group's existing businesses will improve market share and boost earnings.

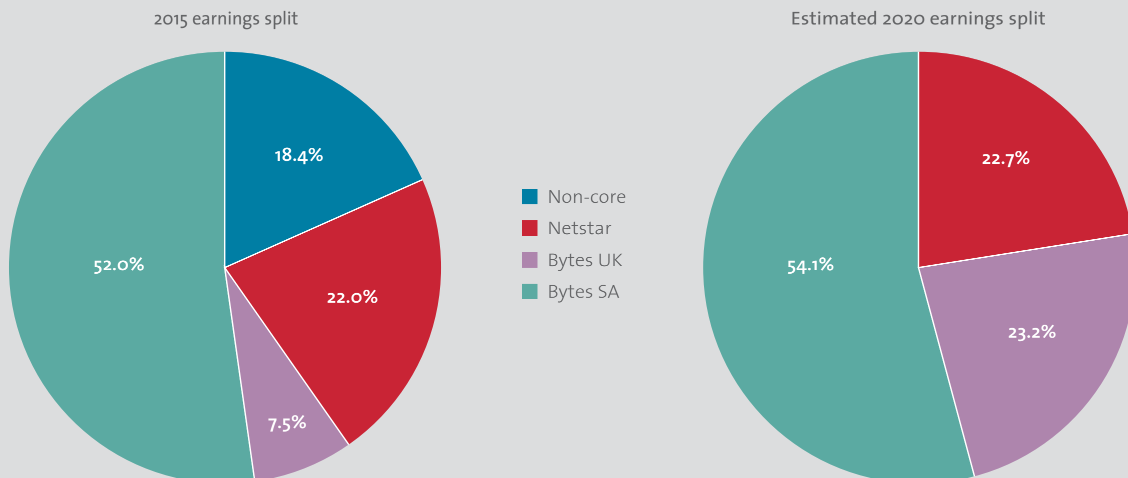
This new structure and improved alignment across the group's businesses has reduced redundant processes and costs by pooling scarce and specialist resources. It has enabled greater collaboration across business units, improving customer service and retention, and increasing cross-sale opportunities to capture a greater portion of customers' total ICT spend.

ICT: the growth engine

Core to Altron's refined strategy is a focus on delivering a range of high quality solutions in four key ICT growth segments: safety and security; cloud services; internet of things; and data analytics. Examples include the following:

- Altron's Med-e-Mass and MediSwitch software makes it easy for thousands of doctors and pharmacists across South Africa to manage patient records, share data with medical providers, and submit electronic claims to medical aids on their patients' behalf. These solutions handle in excess of 7 million electronic healthcare transactions per month across medical schemes in South Africa.
- Altron has partnered with large medical aid schemes such as Medscheme, to develop software solutions that help improve chronic disease management and reduce the number of hospitalisations through the design of integrated care plans for individual patients. The care plan is readily accessible to doctors and can integrate with patients' health and fitness devices and incorporate patient-generated healthcare data, such as blood pressure and glucose readings

Expected earnings shift as ICT strategy progresses



Source: Kagiso Asset Management estimates, company reports

Altron: primed to reap rewards

and sleep patterns. This helps build a comprehensive, real-time picture of a person's health, instead of the snapshot usually available at a doctor visit. Any anomalies are highlighted, alerting both the doctor and patient to take action, resulting in improved care and healthier patients.

- To enhance its financial services offering, Altron has partnered with US-based technology and software companies that allow it to provide point of sale devices for card transactions, ATMs and even trial self-checkout solutions at retailers. The related software allows schools, retailers, or restaurants to securely collect a card initiated payment (from a point of sale device or online) from a bank account.
- Altron's solutions assist banks in moving routine transactions away from human tellers to cheaper self-service options, helping banks contain cost growth and enabling clients to quickly and efficiently complete transactions.

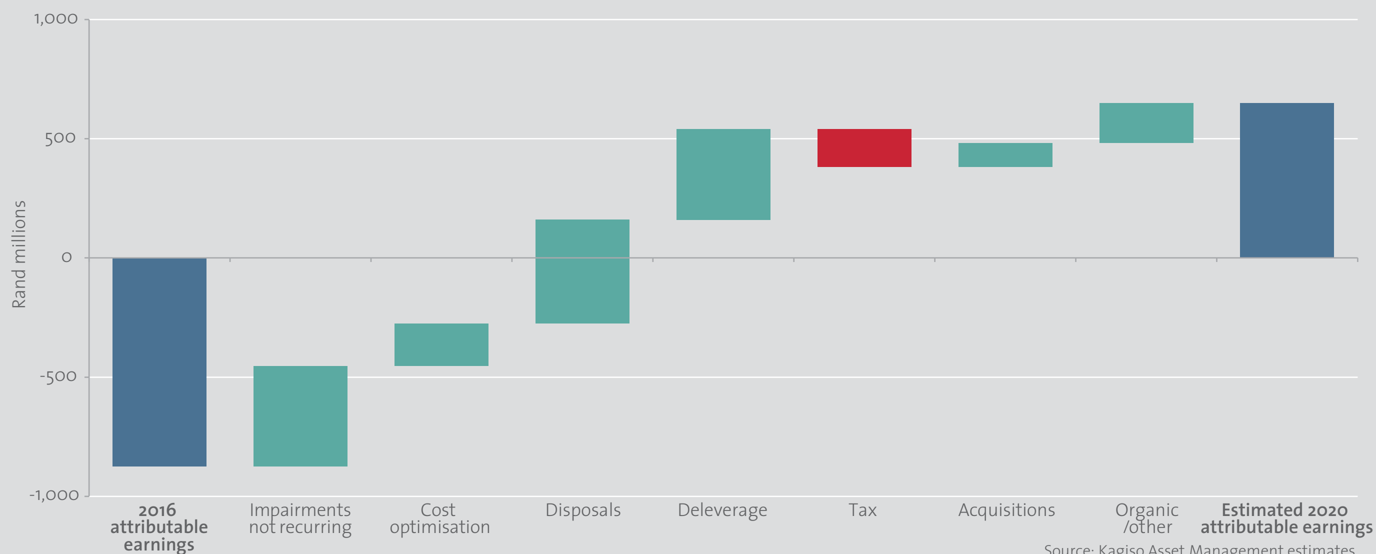
A valued customer offering

On the back of Altron's strong customer service and technical expertise, we are confident that Altron's earnings will grow from its restructured base. The remaining negative earnings impact of underperforming non-core businesses will drop off as they are sold, cost optimisation opportunities will be realised, interest savings will come through as the group deleverages, recently completed acquisitions' earnings contributions will annualise and the improved revenue trajectory resulting from the refined sales strategy will take effect. Our expectations for these cumulative earnings enhancements over the four-year period starting in 2016 are shown in the graph below.

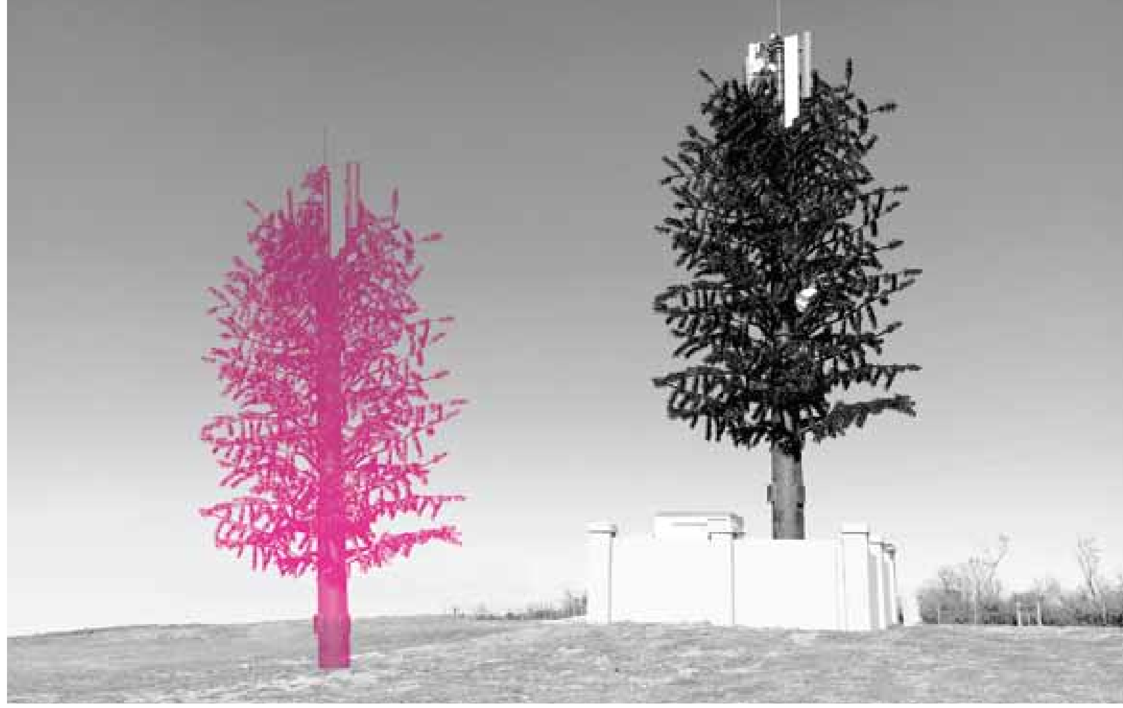
Benefitting from the continuing evolution

We are still early in the journey of Altron's reinvigoration. The new management team and revitalised board have been in place for just over 12 months. Despite the significant steps already taken, we are yet to see the full benefit of these changes reflected in the group's earnings. Investors in our funds have already benefitted from the rally in the share price since early 2016. Altron remains a key holding on behalf of our clients. UP

Restructuring increases sustainable earning (2016-2020)



Source: Kagiso Asset Management estimates



Telkom is positioned for growth

Masechaba Makhura - Associate Analyst

"Despite many decades of highly profitable monopoly over South Africa's fixed-line infrastructure, Telkom faced challenges as it struggled to adapt to a rapidly changing telecommunications landscape. In 2013, a new management team was appointed to execute a strategic turnaround, positioning Telkom to offer integrated products and services, and achieve growth."

Telkom is positioned for growth

South Africa's first telephones were installed in Cape Town in 1878, two years after Alexander Graham Bell filed patent for an "apparatus for transmitting vocal or other sounds telegraphically". Initially, the South African Post Office was responsible for the country's telephone services under the South African Posts and Telecommunications department. In 1991, a separate telecommunications entity was formed: Telkom.

In 1997, 30% of Telkom was sold to a strategic partner (a joint venture between Telekom Malaysia and AT&T) to raise capital to modernise the company's infrastructure. In June 2004, the strategic partner reduced its shareholding and in 2005, sold its remaining 15.1% to the Public Investment Corporation. In 2004, a further 20% of Telkom was listed on the JSE in an additional capital raise.

A poorly run monopoly no more

Telkom's historical monopoly over South Africa's fixed-line infrastructure was the result of the significant barrier to competition posed by the high cost of copper infrastructure. However, the use of fixed-line copper technology is now rapidly declining.

Over the last 10 years, the number of fixed lines has halved from a peak of around 5 million to 2.5 million today (see right chart opposite). Simultaneously, the rise of mobile telecommunication networks has fundamentally changed the South African telecommunications market, and the decreasing cost of newer fixed-line fibre technology has enabled the entrance of new competitors in the fixed-line market.

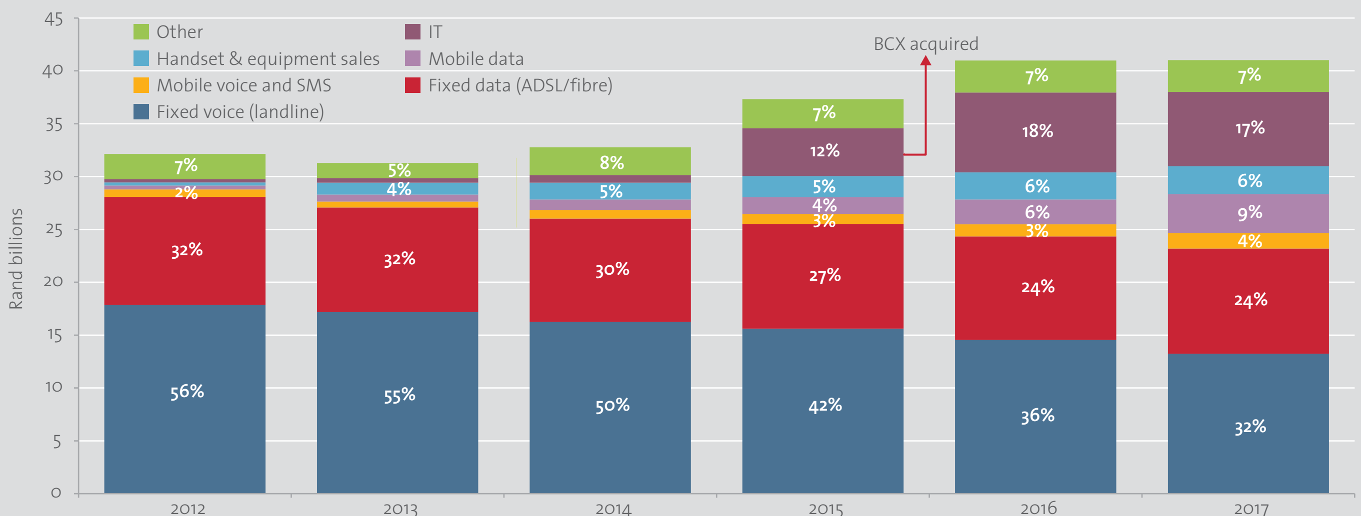
Despite its historical advantages, Telkom has struggled to adapt to these structural changes in the market. Many years of mismanagement, poor customer service and bad capital allocation led to dwindling earnings and a significantly depressed share price.

As a result, a new management team was appointed in 2013. To achieve strategic turnaround, the new management focused on improving customer service, increasing the utilisation of Telkom's vast infrastructure network and diversifying its revenue streams away from the declining fixed-line voice sources (chart below).

Productivity and customer service

Improving staff productivity and reducing Telkom's unsustainably high employee numbers have been core elements of the turnaround strategy. Since 2014, 9 054 employees have accepted voluntary early retirement or retrenchment packages, costing the business approximately R450 million in 2016 alone. The projected wage savings of R3 billion over five years (see left chart opposite) has seen the business's staff cost-to-revenue ratio decrease from 29% in 2014 to 24% in 2018.

Telkom's shift in sources of revenue



Source: company reports, Kagiso Asset Management research

Telkom has attempted to address its historically poor customer service and brand issues by shifting the business mindset from an engineering-focused culture to a consumer-focused culture. This shift has paid off for its mobile business in particular, which, in 2017, was listed in second place on the list of mobile networks South Africans were most likely to recommend to family and friends, according to the annual Net Promoter Score. It was listed after Vodacom but well ahead of both Cell C and MTN.

A repositioned mobile business

Telkom launched its own mobile business, originally called '8ta', in 2010, requiring significant capital investment in mobile connectivity infrastructure. The division was initially unsuccessful and highly loss-making as a result of poor marketing, little product differentiation, and a poor distribution strategy which made its starter packs difficult for customers to access.

In 2013, Telkom's new management team rebranded the business to Telkom Mobile, restructured its costs, and refocused its marketing and distribution strategy.

Telkom Mobile's ability to defend Telkom's falling fixed-line voice revenues by increasing data revenues has improved significantly, and the business has made meaningful market share gains (graph over page). The team implemented a data-focused strategy that provides innovative bundle packages at competitive prices.

This has been underpinned by an expansion of Telkom's network through network sharing agreements with other operators such as MTN, and continued investment in connectivity infrastructure. Telkom Mobile has grown rapidly, from 1.8 million subscribers at the time of rebranding to more than 5.2 million today. Although it remains dwarfed by Vodacom, MTN and Cell C in size, this rapid growth could see the operator becoming the third largest network in the next five to 10 years.

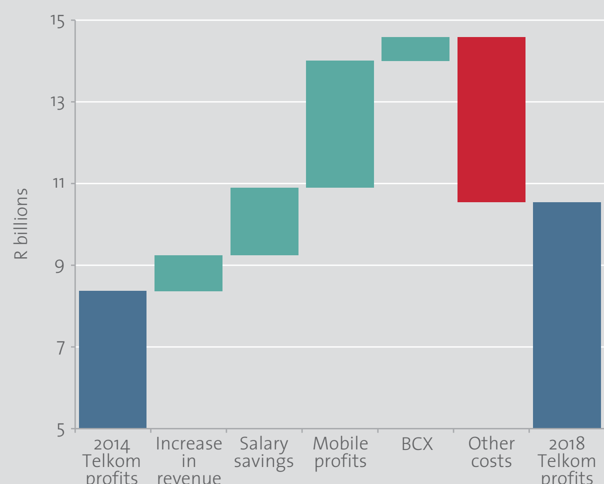
Going forward, this growing scale will significantly increase the mobile business's contributions to group profits.

Investment in network & systems

Telkom's vast fixed-line network remains a key competitive advantage. Since 2013, Telkom has spent a total of R25 billion on network infrastructure, network spectrum and technology upgrades (from copper to fibre and 3G to 4G) to compete for market share in connectivity services.

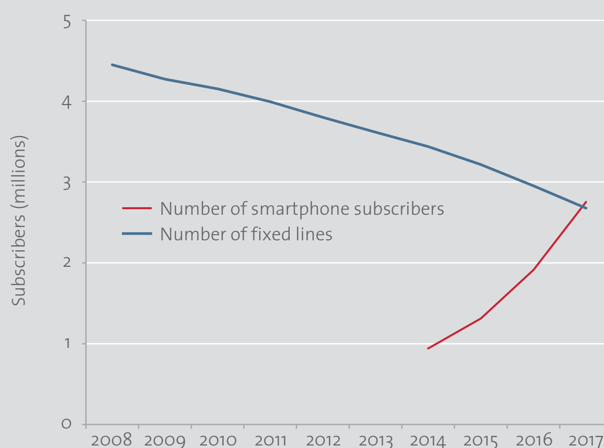
Newer technologies such as fibre are more productive and cost less to maintain than copper. Barriers to entry for competitors are therefore lower and new independent fibre providers such as Vumatel and Octotel have emerged. Telkom remains the

Telkom's profit evolution (2014-2018)



Source: Kagiso Asset Management estimates

Migration to smartphone



Source: company reports

Telkom is positioned for growth

dominant fixed-line provider, however, with a leading market share in outlying areas of the country.

Enhanced IT solutions offering

In 2015, Telkom acquired JSE-listed IT group, Business Connexion (BCX). The merger enabled Telkom to significantly expand its capabilities in IT management, cloud-based services, big data analytics and internet security solutions.

Still operating under the BCX brand, the business has given Telkom entry into the high growth IT market and is fundamental to Telkom's convergence strategy (its plan to use the breadth of its offerings to provide products which seamlessly meet customers' complete telecommunication and connectivity needs). Under this strategy, Telkom will introduce the first bundled mobile, fixed and IT solutions product to the South African market. Telkom believes it can compete for a much larger share of the R141 billion annual ICT spend in South Africa.

Gyro: the new independent property portfolio

In April 2017, Telkom formed a division to manage and develop its extensive property portfolio. The division, named Gyro, currently consists of 1 440 managed properties, 40 unused technical, commercial and industrial properties, and 6 500 mast and radio towers currently unutilized by Telkom.

Key focus areas for the manager of the Gyro portfolio include optimising and commercialising the portfolio within three to five years. Gyro's value has not yet been disclosed and therefore the scale of the opportunity remains unclear, however, these are typically very central properties with reasonable commercial value.

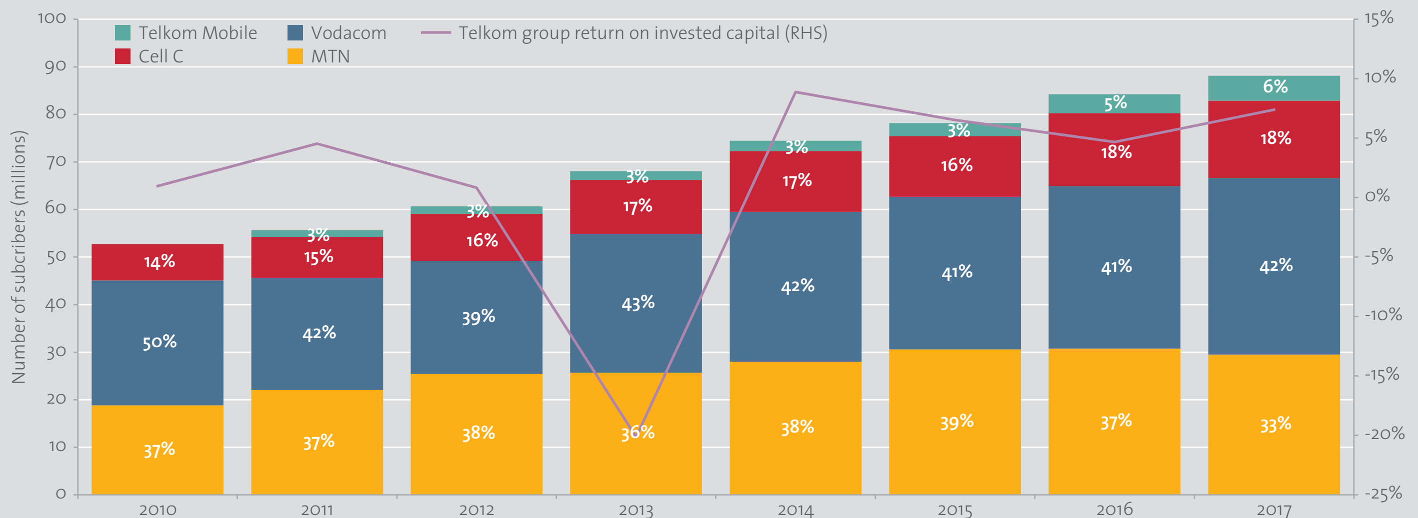
Looking ahead

Telkom's management team has successfully executed significant changes over the last five years, meaningfully improving Telkom's credibility and diversifying its income streams.

Looking forward, we expect Telkom Mobile to add material continued growth and see significant potential for cost rationalisation in BCX. These developments will support profitability against declining fixed-line revenue, further improving earnings over the long term, while the Gyro property portfolio should unlock further value for the group.

We believe that Telkom is well-positioned to grow cashflows in the years ahead as it continues to transform and improve competitiveness in the face of a rapidly changing telecommunication landscape. UP

Mobile subscriber market share



Source: company reports, Kagiso Asset Management research

Special situations: uncovering value in complexity

Justin Floor - Portfolio Manager

"As an active, investment manager, we believe that the key opportunity for us to outperform the market is to identify undervalued securities after careful research and analysis. To do this we must separate noise from signal, filter 'false positives' and identify true value with a reasonable likelihood of delivering superior investment returns.

We are, of course, competing with other well-resourced and intelligent market participants and self-evidently, undervalued securities do not remain so for long where there is broad scrutiny by other market participants."

Special situations: uncovering value in complexity

Some areas of the market tend to be particularly well followed, thoroughly researched and characterised by a high degree of disclosure and transparency. A typical example would be large-capitalisation equities with large weights in closely-followed indices.

Conversely, there are areas which are less widely followed and more inefficiently priced. With hard work, attention to detail and a sceptical eye, these areas can be a productive hunting ground for deeply undervalued securities, because fewer investors pay them due attention. Such areas can be the result of 'special situations' arising from a range of corporate events which are not part of day-to-day market activity, and are each unique and complex, but can offer significant opportunities for diligent investors. We discuss how special situations occur and highlight some of the related compelling investment ideas currently in our portfolios.

Spin-offs

A spin-off, or de-merger, is the creation of an independent company from an existing business or division of a parent company by distributing new shares to the parent's shareholders. Companies tend to pursue spin-offs because they believe a subsidiary's true value is being obscured and therefore undervalued in the existing share price. To realise this value, the subsidiary is unbundled to operate independently.

The intention is that two separate, different businesses will attract different investor constituencies and therefore a higher market rating than they did combined. These businesses may have different growth trajectories, capital requirements, cyclicality or yield potential.

In certain cases, companies spin-off challenged divisions which may be dragging down overall growth, have poor or risky long-term prospects, or contain potential liabilities (eg possible litigation, regulation, patent expiry or competitive threats). These spin offs may be less attractive long-term prospects. Overall however, spin-offs have on average been lucrative for investors in the past (graph below).

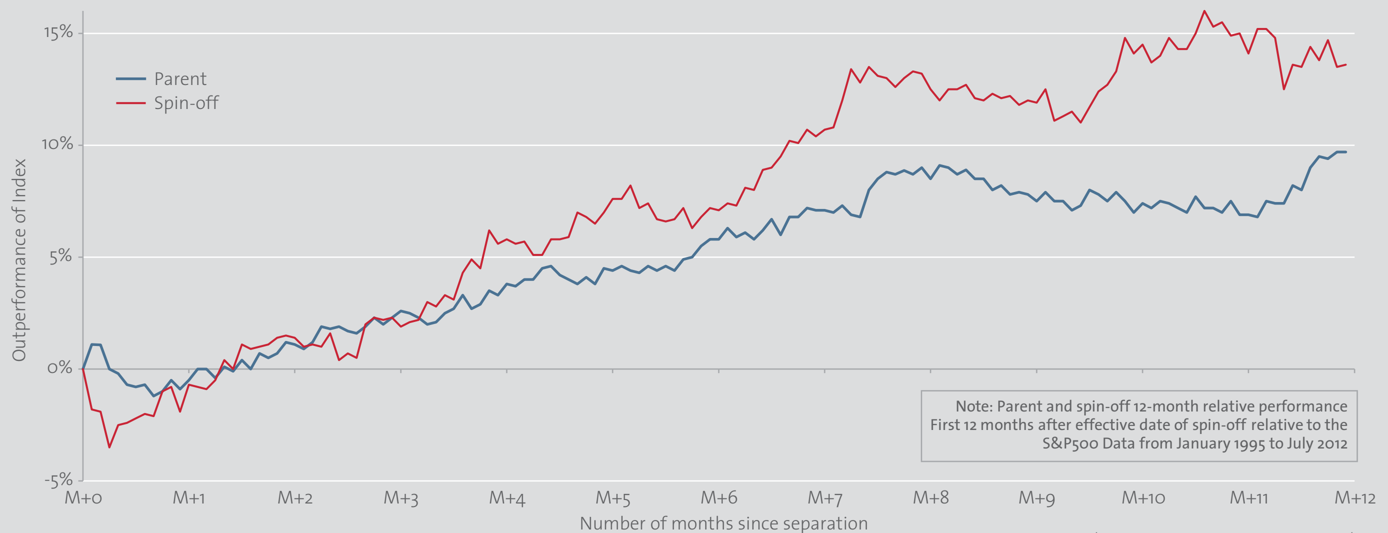
The period directly following a spin-off event can result in price weakness, presenting a buying opportunity. This can arise from:

- Forced sellers: some investors may be forced sellers (especially if the 'child' entity is relatively small or unknown).
- Limited coverage: media and market analyst coverage may be narrow.
- Complexity: there is complexity involved in understanding a new business, which may deter investors at first.

There have been several spin-offs in the South African market. Not all have been successful, but notable successes include:

- In 2007, paper and packaging company Mondi was unbundled

The historic outperformance of spin-offs within the S&P500



Source: : Credit Suisse Quantitative Equity Research

from Anglo American. Mondi later unbundled Mpact in 2011.

- The Bidvest de-merger of 2016 was a clear example of what should have been an efficiently priced large-cap share massively outperforming after splitting into two (chart below).

Our clients are currently invested in several holdings with plans for imminent unbundling or separation events which we believe have the potential to make significant value apparent:
Old Mutual is midway through separation into a SA-focused life insurance company, a SA bank (Nedbank) and a UK wealth management company (Quilter).
Capital & Counties is a London-based real estate company which will separate into a West End retail real estate investment trust (Covent Garden) and a more speculative mixed-use development asset (Earl's Court).
Dow du Pont: US-listed chemical giants Dow and Du Pont merged in 2015 and are now set to separate into a chemical commodity company (Dow), an agricultural sciences and chemical company (Corteva) and a specialised products company (Du Pont).
BGC Partners is a small, under-followed capital markets business. It is unbundling Newmark, a rapidly-growing commercial real estate broker and services company.
Prudential plc is separating into a pure UK life and wealth company and an international (US, Asia and Africa) business.

We think that this will shine a spotlight on the fast-growing Asian franchise.

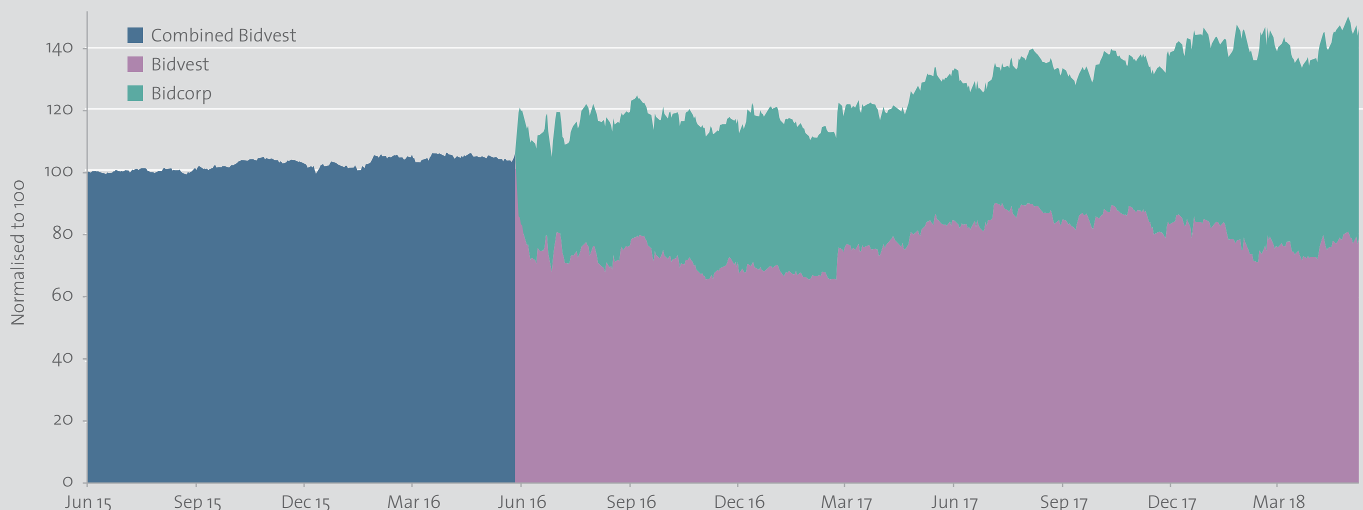
Recent spin-offs our clients have benefitted from include:
Gocompare: a UK-based price comparison internet business spun out of direct motor and home insurance company Esure in 2016.
Ingevity: a specialty chemicals company spun out of US paper and packaging company Westrock in 2016.

Corporate restructures

Corporate restructures involve rearranging a company's capital structure or removing a sub-optimal control structure. Examples include:

- Addressing shares with different rights attached. Hospitality Property Fund, Pick 'n Pay and Distell/Capevin all collapsed inefficient control structures that inhibited optimal governance and capital allocation.
- Recapitalisations can act to restore an appropriate capital structure if a healthy company has suffered under too much debt. This often takes the form of a rights issue. While not a panacea for a low quality underlying business, it can be helpful for a good business.
- In extreme examples, bankruptcy reorganisations can present opportunities as the capital structure is reset. For example,

The Bidvest spin-off of Bidcorp added huge value



Source: Kagiso Asset Management research, Bloomberg

Special situations: uncovering value in complexity

the new African Bank emerged from curatorship of parent company African Bank Investments Limited (Abil) with injected capital and strong shareholders (the SARB, PIC and the large SA banks). At some point the equity may list again, in the meantime its bonds are listed and offering attractive yields.

Transaction-based opportunities

Sometimes opportunities arise ahead of proposed corporate transactions. These can take the form of buying or selling smaller divisions or large merger and acquisition activity. An example of the former is Datatec's disposal of its Westcon Americas subsidiary to US-listed IT distributor Synnex last year. In our view, it successfully monetised a low-quality business for an extremely good price. Datatec is also undergoing an attempted operational turnaround in its very troubled Westcon International subsidiary. This complicated activity is diverting investors' attention from Datatec's Logicalis business, which is significantly undervalued by implication from Datatec's share price.

Our clients with global exposure have benefitted from two acquisition events recently. European online luxury company Yoox Net-a-Porter was acquired at a large premium by Richemont earlier this year and 21st Century Fox has risen due to a bidding war between Disney and Comcast.

Unconventional instruments

Sometimes companies raise capital by issuing unconventional securities with very unusual features, and therefore different potential risks and rewards to vanilla equity and debt instruments. Examples include:

Preference share funding: the Zambezi preference share (held in our funds) is part of an innovative BEE funding deal undertaken by Northam Platinum in 2014. It carries a generous coupon which accumulates and is payable at the end of 10 years. The future payoff is guaranteed by Northam itself.

Instruments are sometimes issued with embedded optionality: common examples are convertible bonds which have both debt and equity features[1]. Our clients are investors in Royal Bafokeng Platinum convertible bonds, which we believe presents a compelling risk-reward profile with reasonably secure capital, some interest income and the potential to participate in any equity appreciation.

[1] Technically it is a corporate bond plus a call option on the equity

These situations require careful analysis and astute application of equity, debt and derivative investing frameworks and skills, but the risk-reward characteristics can make them worthwhile.

Market liquidity events

Certain events can disrupt the usual supply and demand situation for a security. These events can lead to temporary distortions or inefficiencies in pricing, offering opportunity for investors with a long-term perspective and an informed view on the security's value.

Initial Public Offerings involve previously privately-held businesses being brought to listed exchanges. In certain cases (eg if a company has no clear peer comparative or is not well understood by the market), these can present attractive entry points. However, investors should generally be wary as such businesses are sold by astute sellers and are commonly accompanied by marketing hype, investor education and management 'story selling'.

Secondary share placings occur when existing shareholders dispose of a large block of shares in a single transaction, causing a mismatch between demand and supply and therefore attractive pricing (eg at a discount in a bookbuild process).

Special dividends can be a powerful method of forcing the market to more accurately value the underlying business, especially if the market had been implicitly valuing the cash at a discount.

Large, one-off share buybacks have the potential to introduce net new demand and can be a powerful source of unlocking value if cash on balance sheet (or debt) is used to permanently reduce shares in issuance and if the shares are bought back at a price below intrinsic value.

Prescribed mandate changes for price-agnostic investors can create temporary shocks to the supply-demand equilibrium. For example, index inclusions or exclusions can force passive investors, such as ETFs and index funds, to buy or sell that security irrespective of its true value.

Conclusion

Special situations are not guarantees of successful investments and can prove to be disappointing. They are, however, times when market pricing inefficiencies may arise because investors must interpret complex, new information. We remain vigilant for these opportunities and are excited by the potential of our current investments as events unfold in the months ahead. UP

Kagiso Asset Management Funds

Performance to 31 June 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	4.3%	4.6%	8.4%	10.1%	16.6%	Apr-04	1.89%	0.50%
SA Equity General funds mean	7.7%	2.6%	7.9%	8.3%	13.4%			
Outperformance	-3.4%	2.0%	0.5%	1.8%	3.2%			
Balanced Fund	5.0%	6.1%	8.2%	-	8.9%	May-11	1.51%	0.49%
SA Multi Asset High Equity funds mean	7.3%	4.7%	8.0%		9.0%			
Outperformance	-2.3%	1.4%	0.2%		-0.1%			
Protector Fund	3.2%	5.8%	7.4%	6.1%	9.8%	Dec-02	1.59%	0.35%
CPI + 5%[5]	9.3%	10.2%	10.4%	10.4%	10.6%			
Outperformance	-6.1%	-4.4%	-3.0%	-4.3%	-0.8%			
Stable Fund	3.7%	6.2%	7.6%	-	7.8%	May-11	1.53%	0.50%
Return on large deposits*	7.0%	6.4%	6.0%		5.8%			
Outperformance	-3.3%	-0.2%	1.6%		2.0%			
Institutional funds[5]								
Managed Equity Fund (SWIX)	3.7%	3.1%	7.3%	9.6%	11.2%	Sep-06		
FTSE/JSE SWIX All Share Index	11.7%	5.3%	11.1%	11.2%	12.4%			
Outperformance	-8.0%	-2.2%	-3.8%	-1.4%	-1.2%			
Managed Equity Fund (Capped SWIX)	1.0%	-	-	-	3.7%	Jan-17		
FTSE/JSE Capped SWIX Index	8.2%				6.3%			
Outperformance	-7.2%				-2.6%			
Domestic Balanced Fund	3.2%	4.5%	6.5%	8.7%	8.0%	May-07		
Peer median[6]	9.4%	6.3%	9.2%	10.9%	9.7%			
Outperformance	6.2%	-1.8%	-2.7%	-2.2%	-1.7%			
Global Balanced Fund	6.7%	7.4%	9.3%	-	9.3%	Jul-13		
Peer median[7]	9.9%	6.9%	10.2%		10.2%			
Outperformance	-3.2%	0.5%	-0.9%		-0.9%			
Sharia unit trust funds[4]								
Islamic Equity Fund	12.0%	8.5%	9.1%	-	11.7%	Jul-09	1.46%	0.23%
SA Equity General funds mean	7.7%	2.6%	7.9%		11.6%			
Outperformance	4.3%	5.9%	1.2%		0.1%			
Islamic Balanced Fund	9.0%	6.7%	8.0%	-	7.1%	May-11	1.47%	0.16%
SA Multi Asset High Equity funds mean	7.3%	4.7%	8.0%		9.0%			
Outperformance	1.7%	2.0%	0.0%		-1.9%			

Highest and lowest monthly fund performance	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest
Equity Alpha Fund	6.6%	-6.0%	8.2%	-6.0%	8.2%	-6.0%	10.9%	-9.0%	11.9%	-9.0%
Balanced Fund	4.8%	-3.0%	5.5%	-4.2%	5.5%	-4.2%	-	-	6.2%	-4.2%
Protector Fund	2.5%	-2.3%	3.4%	-4.2%	3.4%	-4.2%	7.8%	-5.3%	9.5%	-5.3%
Stable Fund	2.1%	-0.9%	3.8%	-3.5%	3.8%	-3.5%	-	-	4.0%	-3.5%
Islamic Equity Fund	5.3%	-2.4%	7.3%	-4.6%	7.3%	-4.6%	-	-	8.1%	-4.9%
Islamic Balanced Fund	4.0%	-2.0%	4.6%	-3.0%	4.6%	-3.0%	-	-	9.0%	-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 30 June 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 30 June 2018; [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] Median return of Alexander Forbes SA Manager Watch: BIV Survey; [7] Median return of Alexander Forbes Global Large Manager Watch.* Total return of CPI+2% pa from 1 January 2018 (previously: Return on deposits of R5 million plus 2% (on an after-tax basis at an assumed 25% tax rate). # CPI + 4% from 1 May 2018 (previously: Risk adjusted returns of an appropriate SA large cap index).

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