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Kagiso Asset Management

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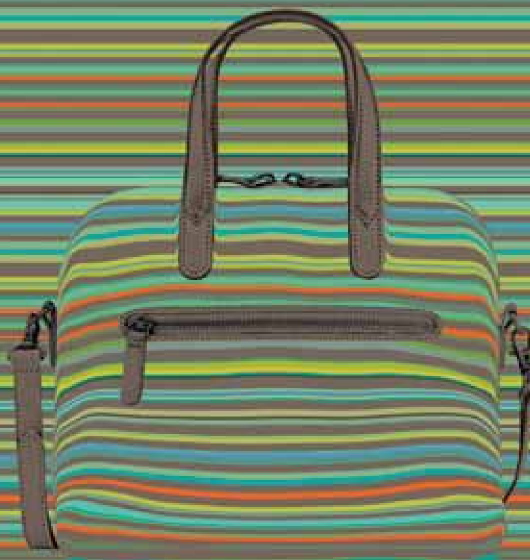

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# Capital and Counties: a unique opportunity

Justin Floor - Portfolio Manager

Capital and Counties (Capco) is a dual-listed real estate company that offers exposure to two unique locations in Central London: Covent Garden and Earls Court. We consider what makes the Capco model unusual and highlight the potential we see to invest in a slice of coveted London real estate at a very attractive price, following the UK's vote to leave the EU.

# Capital and Counties: a unique opportunity

## Key central London assets

The company was formed in 2010 when Liberty International Holdings demerged, splitting into Capital Shopping Centres Group (now Intu) and Capco. In contrast to traditional property developers, Capco's emphasis is on assembling strategic land, securing planning commitments and shaping the positioning of an area to increase the rental value. Once land value is maximised, properties under development may be sold and the value creation realised.

The chart below demonstrates the impressive value growth delivered since 2010 and highlights the significance of the Covent Garden and Earls Court assets within the portfolio.

## Covent Garden rents are growing

Covent Garden is a retail district on the eastern fringes of the West End, between St Martin's Lane and Drury Lane, in close proximity to the theatres of the West End and the iconic London Royal Opera House. The estate attracts more than 43 million visitors per year for an average 90 minutes per visit (of single international premier locations, only New York's Times Square has more visitors). For centuries it was home to some of the city's central fruit and vegetable, and flower markets but over the years the tone and positioning has shifted towards high-end prime retail.

London is a top global destination for luxury goods shopping, generating £9 billion per year - on par with the likes of Hong Kong and Paris. Prime retail locations within the city are sought after as they benefit from wealth concentration and strong tourism flows. Covent Garden has transformed considerably to reach its current incarnation as a premier shopping and dining destination, with increasing exposure to fashion and luxury retail. A key turning point was the 2010 introduction of an Apple retail store (the largest globally at the time), drawing high-end shoppers in droves. The progress has been impressive, with average rents in Capco's properties growing at 16% per year since 2011. By comparison, Central London prime rents have increased at just under 10% per year over the same period.

Despite the progress, the remaining opportunity is substantial. The chart over the page shows the evolution in Covent Garden Zone A rents[1], with current rents being charged at just over half the value of those in Central London prime locations. The progress at James Street in particular has been remarkable and the opportunity for further value creation, by increasing rental levels in other streets, is compelling.

## 'Place-making' in Covent Garden

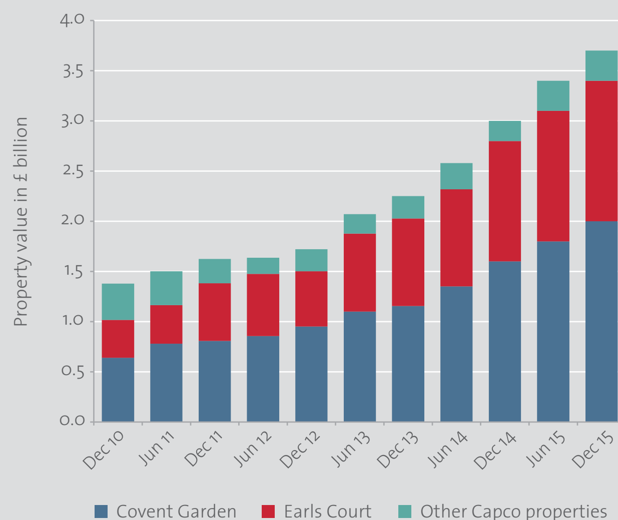
Capco has a targeted value creation approach for each street under its 'place-making' strategy. Central to the strategy is a focus on tenant mix and the introduction of higher-value retailers. For example, the vision for Henrietta Street is to create a compelling men's fashion avenue. Progress has been good, with lettings in recent years to Chanel, Dior, Burberry, Clinique, Kiko Milano and Club Monaco.

Dining is seen as core to the place-making initiative and strategic focus is placed on introducing interesting and unique dining options to increase footfall, dwell time and overall sales across the estate.

Management's focus is twofold: firstly, to grow retail sales across the estate and, secondly, to increase the rent as a percentage of the sales. On average, London prime retailers pay 10% of sales as rent, which is considerably lower than comparable space in New York and Hong Kong.

[1] A British measure of rents, introduced in the 1950s, whereby shop premises are divided into a number of zones, each with a depth of 20-30 feet. Zone A closest to the window is regarded as the most valuable.

**Capco's assets show steady compounded growth**




Source: company reports

Total Covent Garden property is currently valued at £2 billion, underpinned by the rental earnings power of the estate. Our assessment is that the management team still has substantial opportunity to grow rents and continue their impressive track record of transformation.

### Earls Court residential development

Capco has successfully assembled 70 acres (280 000 square metres) of land at the intersection of Kensington, Chelsea and Fulham. Out of the 32 strategic sites in London identified for future residential development in the mayor's London Plan, only five or six are possible to develop during the next five to 10 years. Of these, Earls Court is the only one located in central Zone 1.

The opportunity is underpinned by the Earls Court Masterplan which, critically, has been given planning permission. The plan earmarks 85% of the gross development area for residential development, designed to tap into the high (and potentially growing) demand for prime housing in Central London. The remaining 15% is outlined for complementary commercial space such as retail, office and parking (an increasingly valuable commodity in London).

The plan outlines 7 500 new homes, of which 1 500 (20%) are classed as affordable (a compromise to facilitate planning permission). We believe it is likely that Capco will negotiate increased density, which would require further compromise on affordable housing but will offer improved overall value.

The asset is valued independently by external valuators and key factors include total inhabitable floor space, prevailing house prices and estimated building costs. The short-term outlook for house prices is uncertain, especially after the UK referendum vote.

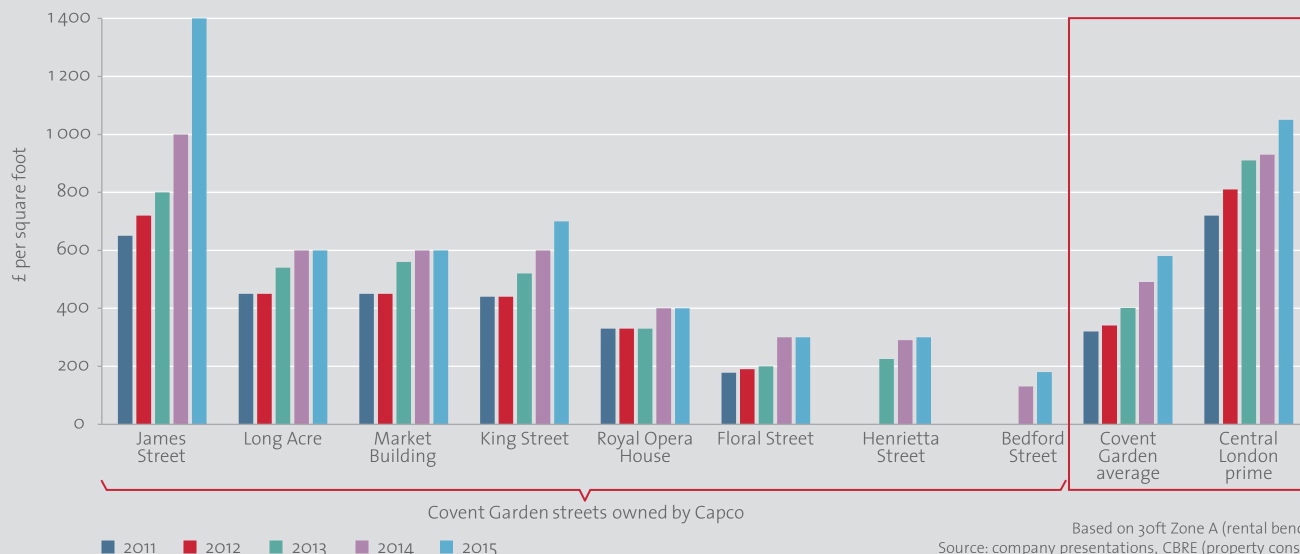
### London property prices are high

The left graph over the page highlights the extraordinary growth in London house prices, which have grown at 8.8% per year since 1973, accelerating to 9.4% per year since 2009. By comparison, the UK grew house prices in aggregate at 7.4% and 4.1% during these respective periods.

This has led to concerns that the London housing market is unsustainably high. It has become a political issue, with many young individuals priced out of the city. The right chart on the next page shows that while the average London home is certainly expensive (at 8.5 times median income), it is by no means an outlier in the context of global cities.

London's population has grown by 14% (1 million people) in the last decade and is forecast to rise by a further million in the next decade. Housing supply is constrained, limited by land

### Covent Garden rental opportunities




Based on 30ft Zone A (rental benchmark)
Source: company presentations, CBRE (property consultants)

# Capital and Counties: a unique opportunity

availability and notoriously difficult planning permissions. The London Plan targets just over 40 000 new homes per year but the current rate of supply has struggled to exceed 20 000 per year. The city has the lowest ratio of house building to expected population increase of any large city globally. According to property consultants CBRE, the current supply rate will meet only 20% of future housing needs.

We see the long-term fundamentals of London as positive. Nevertheless, we remain cautious around short-term risks, given an elevated housing market and possible political intervention. The referendum result injects considerable short-term uncertainty into the outlook, increasing the likelihood of weaker demand for prime residential accommodation until confidence returns. Our evaluation of the Earls Court value takes into account a conservative house price trajectory towards normal levels.

**Outlook**

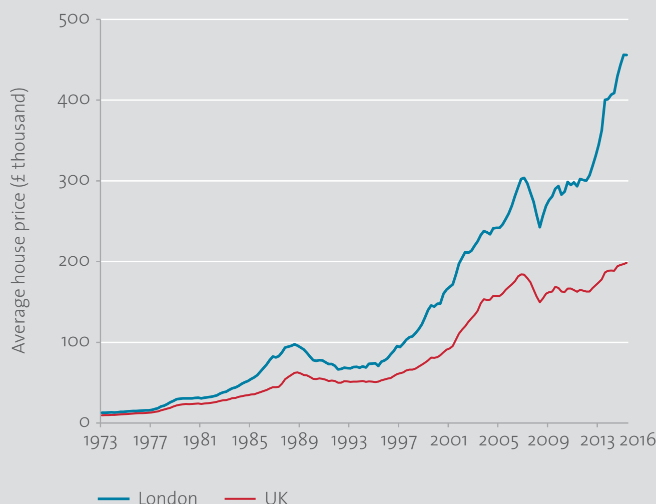
The outcome of the UK's June referendum (a 52% vote to leave the EU) has resulted in significant media and investor speculation on the implications for the British economy, the outlook for London as a premier financial centre and the knock-on impact for real estate. This uncertainty has caused Capco's share price to follow UK property shares sharply weaker.

Capco investors own two unique and well-positioned real estate assets, both with substantial opportunity to grow long-term value in excess of the company's hurdle rate of 10% to 15% per year.

Capco's current market value is at a significant discount to what we see as a conservative net asset value pricing in a large and permanent fall in property valuations. The company has a fortress balance sheet and abundant liquidity, along with funding head room to take advantage of opportunities.

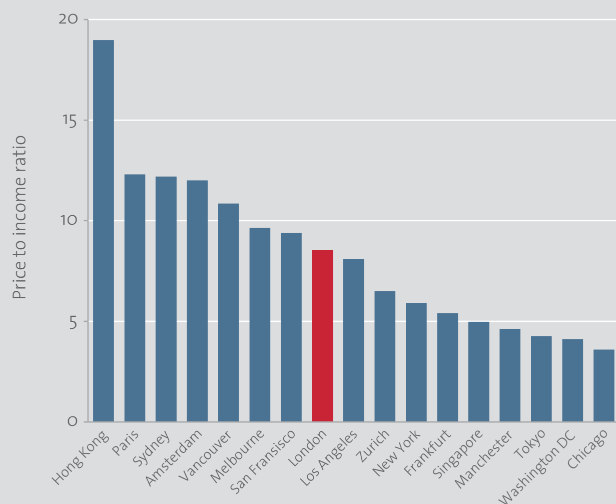
Real estate is a long-term investment proposition and London is a premier world city that has appreciated in value over centuries and through much change and uncertainty. We see opportunity for Capco's property value to grow in the years ahead. Consequently, we have used the share price weakness to increase our exposure to Capco in our client funds. UP

## UK house prices




Source: Nationwide Building Society

## House prices relative to median income




Source: Demographia 3Q2015 survey, UBS

# SA foodservice: a smorgasbord of opportunity

Dirk van Vlaanderen - Investment Analyst

"Iconic brands such as Wimpy, Spur and Steers are ingrained in the South African psyche and continue to resonate with consumers. In this article, we look at the local foodservice industry, highlighting key players, trends and opportunities. Come hungry!"

# SA foodservice: a smorgasbord of opportunity

The foodservice sector incorporates a diverse mix of outlets, including cafes, bars, full service restaurants, fast food, street stalls and home delivery. The industry as a whole has shown consistent growth of nearly 8% per year since 2006, with takeaway and fast food expanding at 10% per year, outpacing restaurant growth of 6% (left chart below).

This expansion has been fuelled by a sharp increase in the number of foodservice outlets which, in the last nine years, have increased at 7% per year from roughly 76 000 outlets in 2006 to around 123 000 today. A significant number of these outlets (70%) are in the informal sector (mainly street vendors), with the remaining 30% split roughly equally between cafes/bars, full service restaurants and fast food outlets.

Given the current poor economic environment and weak consumer sentiment, we expect a short-term softening in growth trends but we believe there is significant room for long-term upward momentum in the local foodservice industry.

### The future looks tasty

The scatter chart highlights that, as GDP per capita (an indicator of average annual income) increases, consumers spend a greater proportion of their total food expenditure on eating out. Over the last decade, additional factors, such as lifestyle trends towards convenience, more eating out and an increasingly diverse restaurant offering have contributed to a sustained increase in foodservice spend globally. Other factors have included greater efficiency of foodservice companies making meals more affordable and more two-working-parent households.

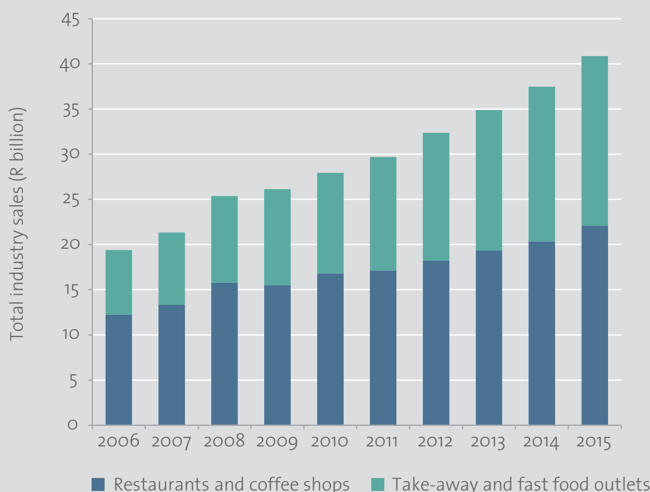
On average, South Africans spend only 10% of their food bill on eating out. This is well below the level of other markets shown, which average 30% (scatter chart below). As the economy develops in the long term, we believe higher income levels will translate into an increased spend on eating out and that the future for foodservice spend remains bright. This is despite current local constraints on income growth and spending power.

### Local landscape

The fast food and restaurant sector consists of a blend of home grown and international brands. The biggest international player in the market by store count is KFC, owned by global giant, YUM Brands. KFC has 828 outlets, followed by McDonalds with 238. While international players certainly have a solid and expanding presence, the graphic oppostite highlights the strength of local home grown brands.

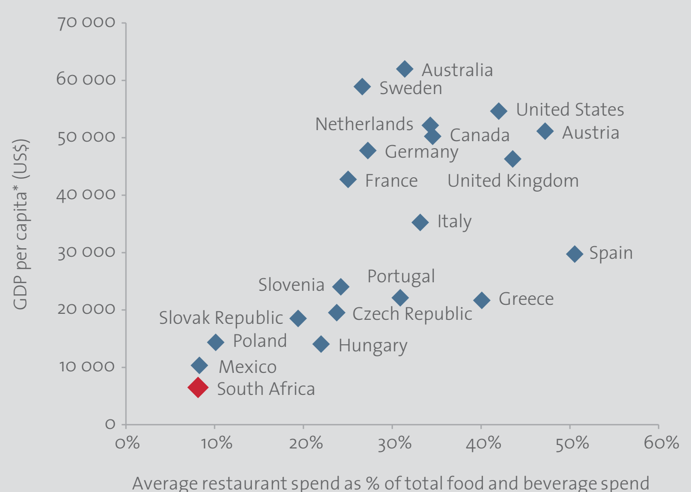
JSE-listed Famous Brands is the home of several local iconic fast food brands such as Wimpy, Steers and Debonairs. The Spur Group has established the Spur brand as a household name and continues to achieve success with Panarottis.

## South African restaurant sector growth




Source: Stats SA, Merrill Lynch

## Restaurant expenditure versus income




* Indicator of average annual income per person

Source: OECD, Stats SA, World Bank, Kagiso Asset Management estimates

## Industry and category developments

Chicken remains the largest fast food category, accounting for nearly 50% of the total fast food market, followed by burgers (25%), fish (10%) and pizza (5%). While all categories have experienced good growth in recent years, the burger and pizza categories have done best due to faster store roll-outs and the arrival of international brands.

Recent trends in the foodservice industry include:

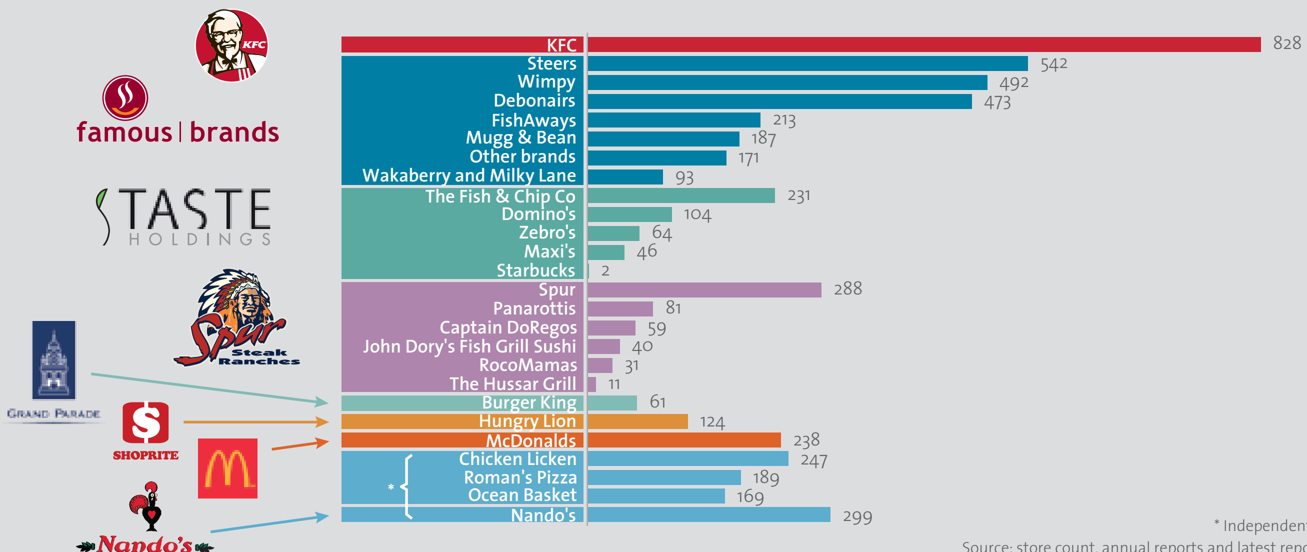
- **Incoming international brands.** Grand Parade Investments brought Burger King to South Africa and has plans to roll out Dunkin' Donuts and Baskin Robins stores. Taste Holdings is already converting its St Elmo's and Scooters outlets to Dominos and has opened two Starbucks stores this year. Pizza Hut recently re-entered the country.
- **Increasing the value offer.** With consumers under pressure, brands have offered more affordable meals, often incorporating smaller portion sizes to boost sales and maintain margin.
- **Re-focus on casual dining.** Famous Brands has introduced a casual dining experience focus to its traditional fast food mix, with the acquisitions of Tashas, Lupa Osteria (Italian), Salsa Mexican Grill and Mythos (Greek). Other groups, such as Spur, have been very successful so far in the gourmet burger category through their acquisition of Rocomamas.
- **Increasing the eating out occasion opportunity.** This mostly includes a breakfast offering, which is now standard in most fast food chains.
- **Rolling out smaller format outlets.** This extends the brand in a cost-effective way to previously untapped areas, such as petrol forecourts. An example is the roll out of 'Mugg & Bean on the Move' as an extension of the larger format outlets.

## Franchising fuels growth

In a traditional company-owned restaurant model, a company uses its own capital to fit out the restaurant and then to operate and fund its day-to-day running. This is markedly different to a franchise system, where a third-party franchisee invests the capital for set up and day-to-day running of restaurants. The franchisor provides the recognised brand and product, along with marketing, training and quality standards support, and takes a percentage of revenue in return.

The franchise model has fuelled the rapid roll-out of fast food and full service restaurant chains in South Africa in recent decades, enabling franchisors to grow with almost no capital constraints and with start-up logistics handled by their franchisees. This capital light structure also means that a well-run franchise model generates significantly higher returns on capital for the franchisor than a traditional owner-managed store.

## Number of South African outlets




* Independently owned

Source: store count, annual reports and latest reported data

# SA foodservice: a smorgasbord of opportunity

Famous Brands and Spur operate a franchise-dominated model through their portfolio of brands, while KFC, McDonalds, Taste Holdings and Grand Parade Investments have a blend of company-owned and franchise stores.

**The unseen value creator**

Famous Brands has enjoyed phenomenal success over the last 15 years, increasing its restaurant numbers from 453 in 2001 to 2 614 today through acquisitions and organic roll outs. The less visible element of the Famous Brands success story is the degree of vertical integration within the group's operations. The company also manufactures, supplies and delivers the majority of its franchisees' food and non-food requirements - from burger rolls and patties to napkins and plastic spoons - at competitive prices.

The manufacturing and logistics division's profits have grown ahead of the core franchising business. This supply chain currently contributes 44% of group profits, up from 22% in 2005 (right chart). This is due to the strong profit growth and higher margins created as there were more franchises to supply and the range of goods manufactured was expanded. The group's scale also enables it to run its own distribution of goods to franchisees, which differs from competitors, who generally outsource this function to a third party.

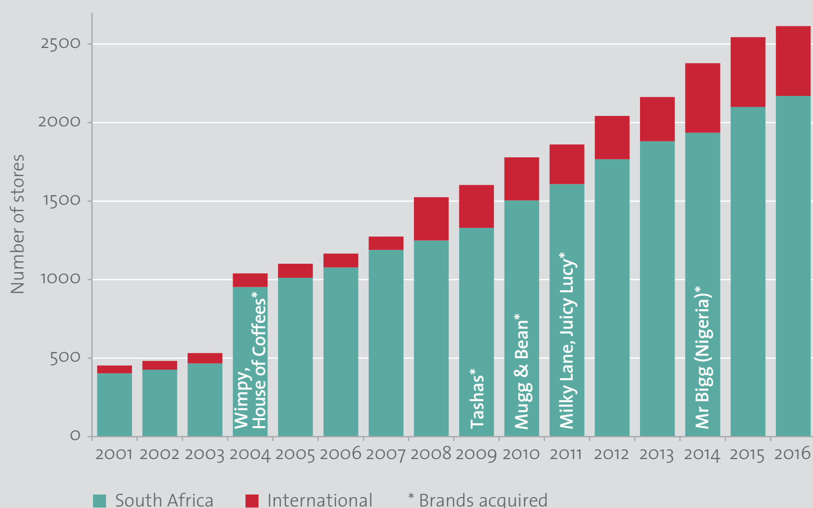
The other listed foodservice companies are looking to replicate this model, but none has yet reached Famous Brands' level of integration. Spur generates 30% of its profits from manufacturing, while Taste Holdings and Grand Parade Investments have integrated some key food and non-food categories. This will be a source of potential value creation as these companies continue to vertically integrate and gain scale.

**Outlook**

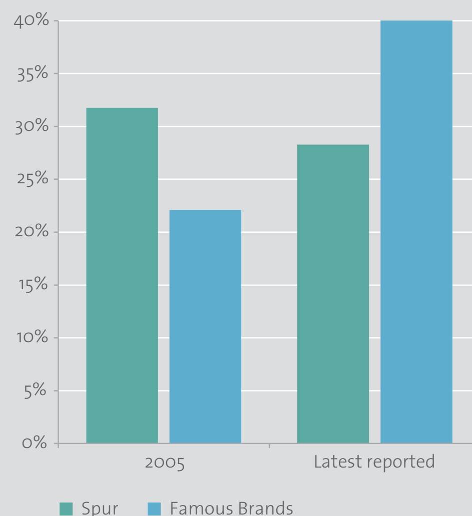
The South African foodservice industry remains an exciting one, with strong brands and world-class local companies. Despite the economic headwinds the country is facing, which will likely curtail consumer spend in the short term, we believe the medium-term prospects for further industry growth remain bright.

The success enjoyed by Famous Brands and Spur Group in recent years has resulted in relatively high market prices for now fairly mature businesses. Our clients have exposure to the sector through our investment in Grand Parade Investments, which is in the early stages of creating a vertically integrated food platform and is rolling out globally iconic brands such as Burger King. UP

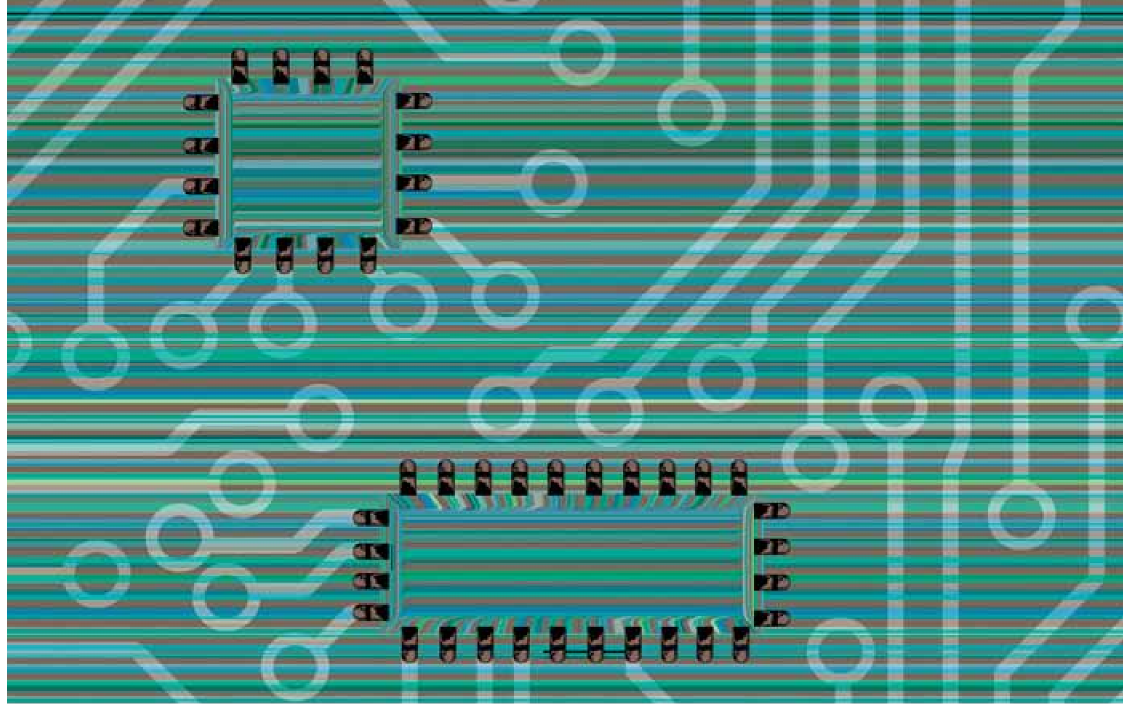
**Famous Brands store count over time**




**Supply chain profit as % of total profit**




Source: company reports



# Standard Bank's systems for the future

Jihad Jhaveri - Head of Process

"Over the last 20 years, banks have been transformed from branch- and personnel-heavy businesses into modern, technology-driven digital service providers, which offer clients sophisticated internet-based application platforms."

# Standard Bank's systems for the future

Information technology (IT) has become a significant component of operational costs for the industry and investors need to evaluate how each bank's IT strategy and spend will impact on its potential outperformance of competitors.

In this article, we compare the current IT positions of South Africa's four largest banks, with a particular focus on Standard Bank, as it reaches the end of a major system overhaul. Its IT project has been poorly managed and expensive but we believe that, in the longer term, Standard Bank will be significantly advantaged and competitors will need to make substantial future investments to remain in the same league.

### Dated systems constrain SA's banks

The graph below compares annual IT spend as a percentage of total operational spend over the past three decades at Standard Bank, FirstRand, Barclays Africa Group and Nedbank. The trend is clear: IT spend is an increasingly large component of costs.

To date, banks' IT developments have focused on the creation and upgrade of client-facing 'front-end' software and systems (such as banking apps) as well as 'middleware' operational systems[1]. This has enabled the rapid digital evolution of the industry. However, the core banking IT backbone - the platform off which these operations and customer systems are built - has largely remained unchanged, becoming significantly dated.

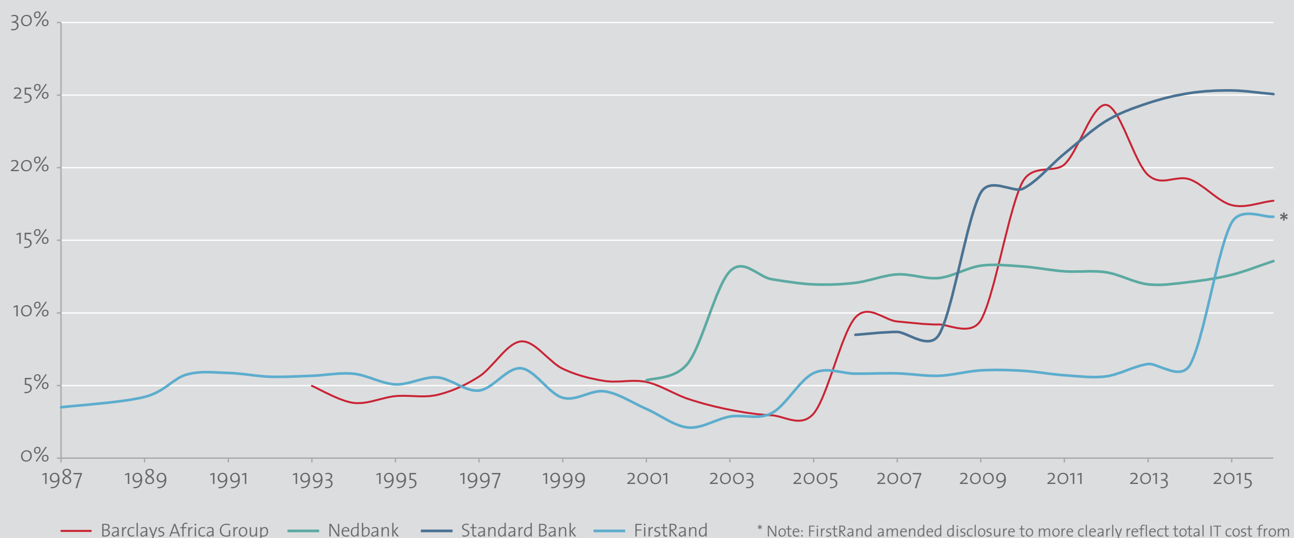
In the case of some banks, these backbone systems have been patched together from disparate software additions over a period of up to 30 years. As a result, these systems have become increasingly difficult and costly to maintain, as the complexity of integrating middleware and front-end applications increases. A further practical challenge is that the programming skills for early generation computer languages, such as COBOL, are dwindling with time.

Dated backbone IT systems are paper-heavy and decentralised. They rely on in-branch manual inputs, requiring large back office capacity. Updates from branches to the central banking system are processed inefficiently in batch runs, with no integrated central real time processing possible.

A further challenge of these dated backbone IT systems is their lack of integration across banking divisions and product categories. As IT evolved in South Africa, separate systems were developed for each product category (such as home loans, credit cards and transaction accounts). The result is that banks cannot easily view a complete picture of any one customer's information because, for example, their home loan information is stored separately from their transaction account information.

[1] The software that enables clients' transactional data to be structured and mined for business insights.

**IT operational expenditure as share of total operational expenditure**




* Note: FirstRand amended disclosure to more clearly reflect total IT cost from 2014

Source: UBS, Kagiso Asset Management research

This represents significant inefficiency and lost opportunities for cross-selling and product development.

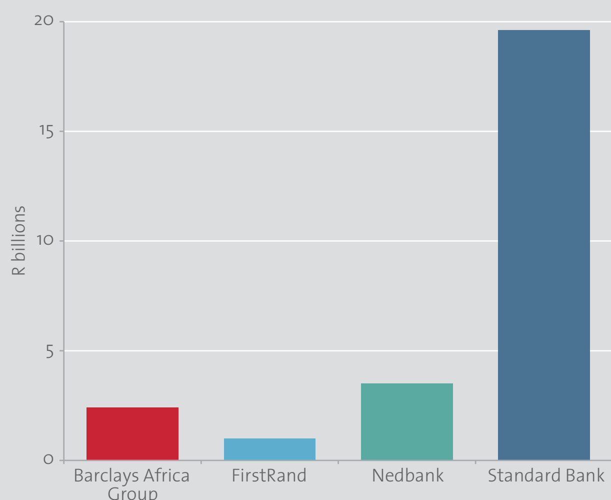
In short, these outdated backbone systems are now poorly suited for the needs of a modern banking business.

## Standard Bank's IT project: an expensive start

As the previous graph shows, Standard Bank has experienced exponential IT cost growth since 2006. This is when it embarked on a major project to overhaul its backbone system - a strategic response to the challenges outlined above. The project has been ongoing for 10 years and is scheduled for completion in 2018. Software provider SAP is the vendor for most of the new systems. Once complete, Standard Bank will have major advantages over its competitors, including improved efficiency, reduced maintenance costs and rich data analytics capacity. However, the process has been a financial strain for investors and, so far, the financial effects of the project have been negative.

The capital spend for the project has thus far been in excess of R20 billion, which is dramatically more than its competitors' IT spend over the same period as seen in the chart below. This represents a substantial sacrifice by its shareholders, who have essentially forfeited dividends to fund this.

**Accumulated intangible IT assets* (financial year 2015)**




* Excludes physical IT assets such as computers and hardware
Source: Kagiso Asset Management research

The project remains a substantial drain on Standard Bank's income statement for three key reasons:

- expensive specialist external IT consultants' costs;
- dual costs are being incurred as both old and new systems are run in parallel to ensure a careful and risk-managed transfer to the new system;
- accounting convention requires captured costs to be gradually amortised as the new systems are brought into operation.

The cumulative impact of these income drains amounted to a 3.1% reduction on the group's 2015 return on equity (ROE[2]), reducing it to 15.3%.

Our analysis of a similar project at Commonwealth Bank of Australia, which also used SAP software, reveals that the Australian bank's project was executed over a much shorter period and without a marked increase in IT costs. It therefore appears that Standard Bank's execution has been sub-optimal and, problematically, that shareholders weren't easily able to hold management accountable due to limited transparency.

## The risk of information asymmetry

A major risk for investors and company management in an IT project like Standard Bank's is the risk of information asymmetry. This arises when company management has access to more complete information than shareholders, who need to assess progress made on the project and hold management to account for returns on the investment.

## Comparing the 'big four'

We compare our assessment of the relative competitive position of the IT infrastructure at the big four banks in the table over the page. Scores are subjectively based on information provided through interactions with the banks over a number of years.

Looking at current IT cost strain, Standard Bank is at a significant disadvantage and scores very low. Over the longer term, however, once the bank's project is complete, obsolescence risk will be negligible and there should be multiple areas for cost savings. These include maintenance costs, an improvement in

[2] ROE is a measure of a corporation's profitability which shows how much profit a company generates for every rand that shareholders have invested.

# Standard Bank's systems for the future

cash flow as project outflows end and the removal of the dual costs associated with running parallel systems.

FirstRand, which uses the HOGAN Core Banking System, last upgraded its backbone in the mid-1990s. This was significantly more recent than the upgrades at the other banks and therefore the system and its components are less dated. FirstRand's strategy was to invest heavily in excellent middleware systems and this has enabled it to design customer-centred front-end interfaces that are not constrained by backbone restrictions. This advantage, coupled with an excellent data analytics culture, means that FirstRand is strategically well positioned.

Nedbank and Barclays Africa Group have much older backbone systems. The complexity and obsolescence risk around their core systems is compounded by the fact that both banks were formed by the amalgamation of a number of smaller banking entities over the last 20 years. Until the recently announced Barclays Plc divestment of Barclays Africa Group, we would have scored the group higher due to the significant front-end advantages it enjoyed as part of the global group (including IT procurement advantages, innovation and better project risk management). Our view is that both Nedbank and Barclays Africa Group will need to spend considerable amounts on upgrading their core banking systems in the future.

### Set to pay off

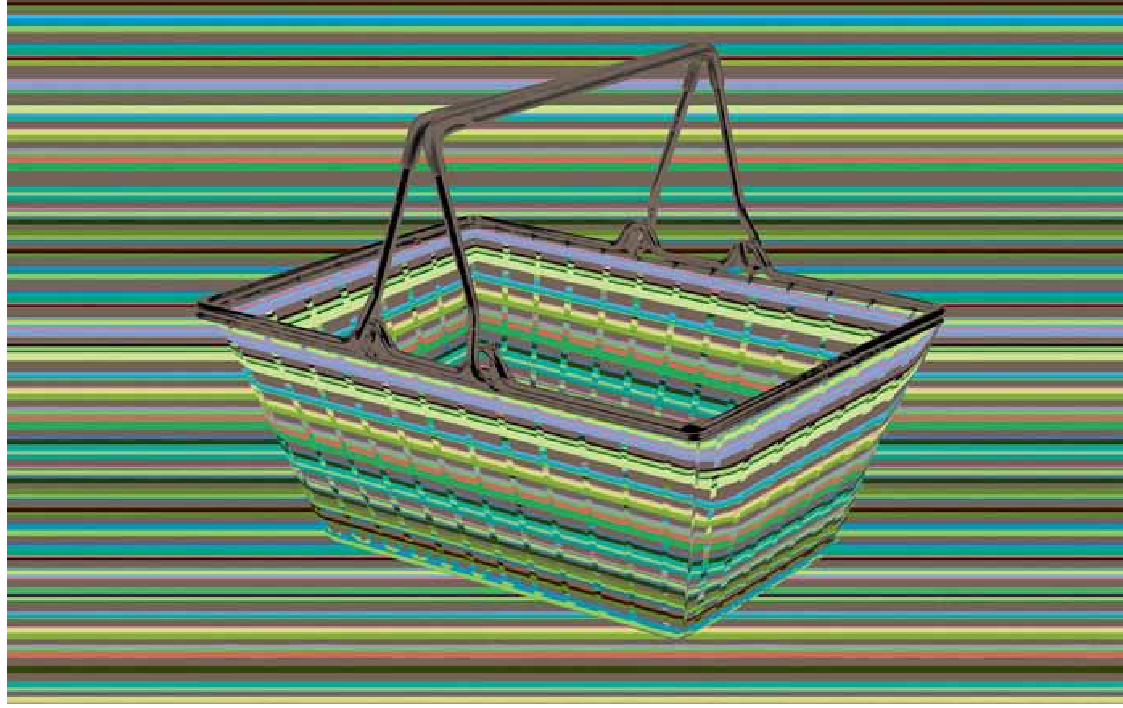
Despite Standard Bank's sub-optimal management of its IT project, we expect the capital invested in the project to deliver excess returns versus its competitors. Once the bank manages to successfully execute its transition to the new system, we believe it will be in a strong position relative to the other major banks.

Our clients benefit from exposure to the two banks we believe are best positioned for the evolving IT requirements of the modern banking business: Standard Bank and FirstRand. UP

## SA banks' IT competitive position scorecard

| | FirstRand | Standard Bank | Nedbank | Barclays Africa Group |
|---|---|---|---|---|
| Core banking obsolescence risk | 4 | 5 | 3 | 3 |
| Advantage in middle/frontware | 5 | 4 | 3 | 3 |
| Data analytics culture | 5 | 4 | 3 | 3 |
| Short-term IT cost strain | 3 | 2 | 3 | 3 |
| Medium-term cost cutting opportunity | 3 | 5 | 3 | 3 |
| **Overall IT score** | **4** | **4** | **3** | **3** |

Source: Kagiso Asset Management research



# Retailing in a time of food inflation

Simon Anderssen - Investment Analyst

"South Africa's current high food inflation is primarily the result of the severe drought affecting large parts of the country, particularly in the maize producing inland regions.

The unpredictable nature of rainfall and temperatures make food inflation among the more volatile sub-components of inflation. The current experience has been compounded by a weak rand, resulting in higher prices for imported grains."

# Retailing in a time of food inflation

A common investment view holds that above-average food inflation is positive for food retailers' earnings. The retailer is seen to be able to pass on the higher food prices to its customers and thereby grow its turnover faster than its operating costs, which are usually more closely linked to general inflation. This difference between turnover and expense growth leads to rapid profit growth because a food retailer usually has a high proportion of fixed costs and low operating margins[1].

We believe this theory is unlikely to hold in the current cycle because consumers are under severe financial stress and competition across food retailers is intense.

### Consumers are stretched

Food inflation has breached the 10% level five times over the last two decades and it was consistently above 10% in the preceding decades. However, it is necessary to understand the circumstances of the period in which an inflation spike takes place in order to take a view on how shoppers may react and what this may mean for food retail companies.

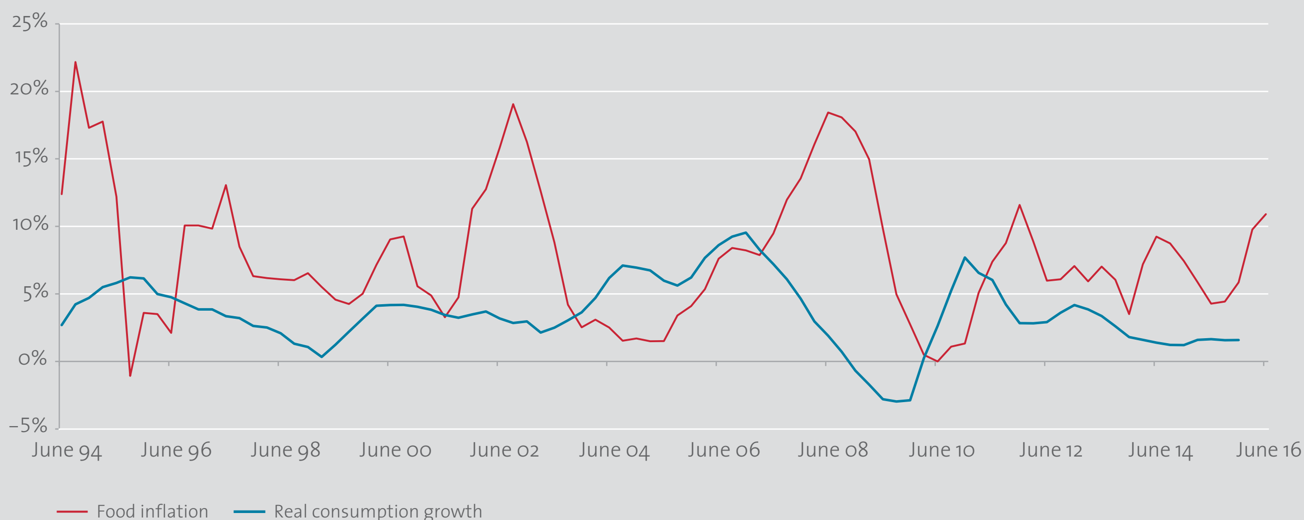
Consumers entered the last three food inflation spikes in 2001, 2007 and 2011 experiencing robust real income growth: at least 3.5% over the preceding 12 months in each of those years and as high as 7.5% in 2007. This meant that household incomes were capable of absorbing the pressure from food prices without adjusting quantities purchased or buying behaviour. However, when food inflation pierced 10% in April 2016, from a low of 4.4% 10 months earlier, real consumption growth[2] had wallowed below 2% for nearly two years as real spending power inched higher (graph below).

It is also worth noting that consumers' ability to use short-term credit to support consumption expenditure has changed meaningfully since earlier bouts of inflation. Total unsecured credit[3] as a share of disposable income has increased sharply, from 10% in 2011 to 15% at the end of 2015.

Further evidence of shoppers' stress is the significant decline in consumer confidence in the last 12 months, to levels not previously witnessed during South Africa's democracy. The broader outlook for wages and employment growth is not encouraging and strained disposable income and indebtedness levels make it more difficult for households to absorb higher food prices, which, in the case of many basic items, are significant (chart opposite).

[1] A measurement of what proportion of a company's revenue is left over after paying for expenses.
[2] The change in consumption spending, adjusted for inflation
[3] Includes credit cards, overdrafts and personal loans

**Previously inflation spiked when consumption growth was strong**




Source: I-Net

## Consumers tighten their belts

Shoppers today have an intense focus on promotions and scour advertisements for the best offers across multiple stores. Retailers often sell these items at or below cost to attract consumers in the hope that they may purchase the rest of their basket in store.

Another consumer response to the current high food inflation environment is to change the frequency of food shops. For example, some shop more often for daily essentials as and when wages are received, while others choose to consolidate purchases in a large, monthly shop to benefit from keener pricing on bulk purchases or pack sizes. This change in pattern is a challenge for store management because it makes it more difficult to plan stock levels, schedule staff and maintain service levels.

Finally, consumers are adjusting their basket. They either buy fewer items, smaller pack sizes, cheaper competitor brands or cheaper substitutes. Evidence of this can be seen in the divergence between the official rate of food inflation published by Stats SA and the average rate of inflation disclosed by the major food retailers (graph over page).

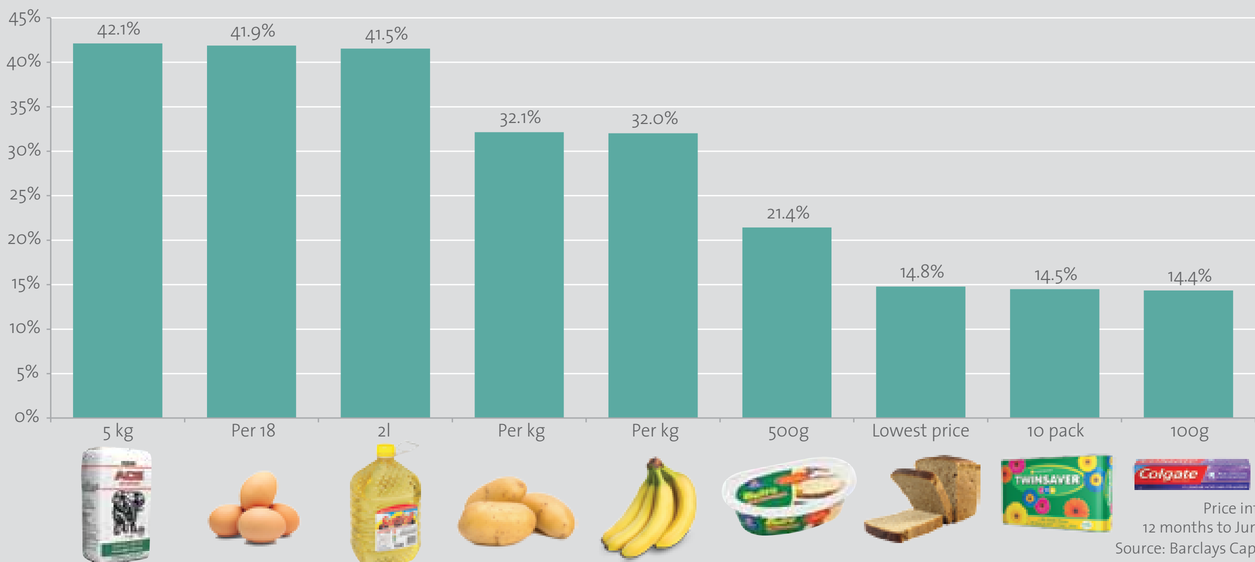
Stats SA calculate inflation based on a fixed basket of foods. It therefore represents the price increase a consumer would experience if they bought the same goods every month.

However, we know that customers adapt and that the shopping basket is not a fixed selection of products. The retailers' reported inflation measure captures this change in the mix of products that customers include in their shopping baskets.

To show this, consider a scenario where all products in a store increased by 10% versus a year ago. If all customers responded by buying a cheaper substitute for each product in their basket, say private label instead of branded washing powder, then the actual change in the value of the customers' total basket will be less than 10%. This is because private label products are generally cheaper than their branded substitutes.

The divergence between the two measures therefore suggests that customers are mitigating the full effect of inflation by opting for cheaper substitutes and/or foregoing higher priced goods. This buying behaviour corroborates the income stress outlined above and makes it more difficult for food retailers to grow sales faster than operating costs.

### Price inflation for a selection of groceries and fresh produce




Price inflation:
12 months to June 2016
Source: Barclays Capital Inc

# Retailing in a time of food inflation

**Retailers are competing more fiercely**

Most consumers will attest to the proliferation of food retail stores over the last 10 years. Many of these have been smaller, more convenient formats that have surfaced in suburbs and at key transport locations, bringing food retail closer to customers' homes or workplaces. This trend reflects the retailers' ongoing efforts to create the most convenient shopping experience, motivated by the knowledge that convenience typically determines which retailer captures the largest share of shoppers' spend.

New entrants include Massmart (through the expansion of its low-end chain of Cambridge stores and the introduction of food into Game stores) and Botswana-based retailer Choppies. Non-traditional food retailers, such as Clicks, have increased their food and confectionary offering, while independents such as Food Lover's Market have grown substantially. A further source of competition today is the informal retail segment, including spaza shops, sidewalk vendors and small independent supermarkets, where greater coordination and sophistication are making these operators more competitive in low-income retail markets. The rate of market share gains by the listed food retailers has slowed sharply over the last five years and is evidence of intensifying competition from other retailers.

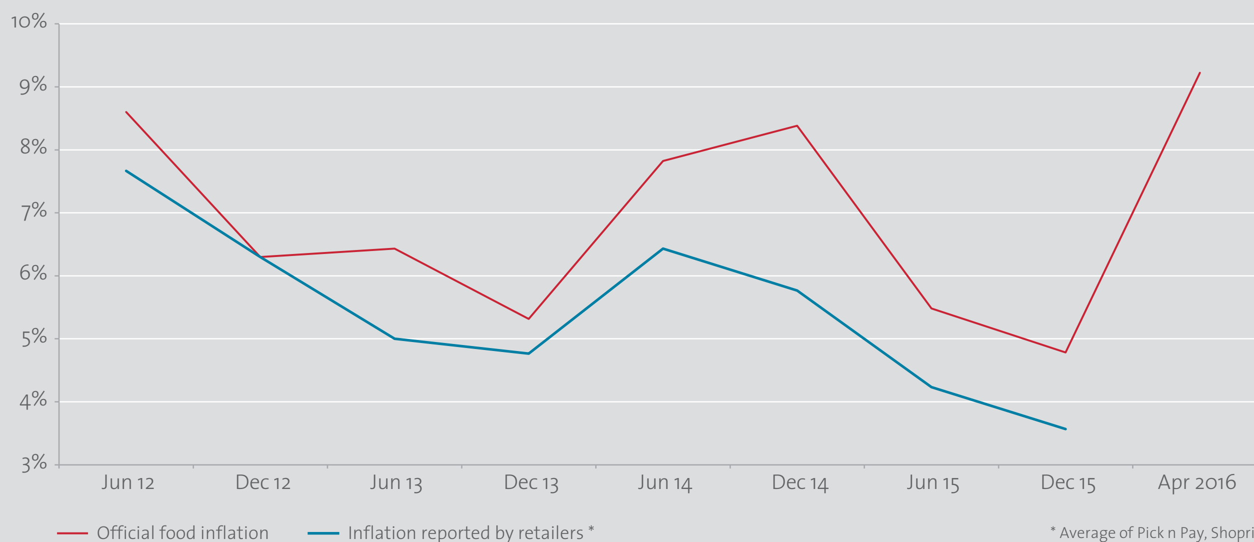
When overall sales are slowing, smaller gains in share relative to competitors is an indication that offerings are becoming more homogenous, with fewer points of differentiation to consistently attract customers away from a competitor. Intensifying competition when consumers are acutely aware of price and likely to buy fewer goods is a threat to profitability for all food retailers.

**On the side lines**

The sharp acceleration in food inflation, at a time when our economy is shedding jobs and individual real income growth is slowing, means that consumers are under increasing financial stress. We expect shoppers to respond by spending less, which will challenge retailer profitability as competition intensifies.

The current high market valuations of the listed food retailers do not reflect this concern for future earnings growth. We do not believe these shares offer an attractive risk-adjusted return and therefore hold very low food retailer exposure in our funds. UP

**Comparison of food inflation**




* Average of Pick n Pay, Shoprite and Spar

Source: Deutsche Bank, company reports, Stats SA

## Kagiso Asset Management Funds

| Performance to 30 June 2016 | 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** | 2.1% | 10.2% | 10.8% | 12.8% | 18.5% | Apr-04 | 1.5% | 0.3% |
| South African Equity General funds mean | 1.4% | 11.2% | 11.8% | 11.0% | 15.2% | | | |
| Outperformance | 0.7% | -1.0% | -1.0% | 1.8% | 3.3% | | | |
| **Balanced Fund** | 5.2% | 9.2% | 10.5% | - | 9.9% | May-11 | 1.5% | 0.3% |
| South African Multi Asset High Equity funds mean | 5.3% | 10.5% | 11.4% | | 10.9% | | | |
| Outperformance | -0.1% | -1.3% | -0.9% | | -1.0% | | | |
| **Protector Fund** | 2.1% | 7.2% | 6.5% | 7.5% | 10.1% | Dec-02 | 2.0% | 0.3% |
| CPI + 5%[5] | 10.3% | 10.5% | 10.5% | 11.2% | 10.7% | | | |
| Outperformance | -8.2% | -3.3% | -4.0% | -3.7% | -0.6% | | | |
| **Stable Fund** | 6.8% | 8.7% | 9.3% | - | 8.5% | May-11 | 1.6% | 0.5% |
| Return on large deposits* | 6.0% | 5.5% | 5.4% | | 5.4% | | | |
| Outperformance | 0.8% | 3.2% | 3.9% | | 3.1% | | | |
| **Institutional funds[6]** | | | | | | | | |
| **Managed Equity Fund** | 1.5% | 9.7% | 11.0% | - | 12.8% | Sep-06 | | |
| FTSE/JSE SWIX All Share Index | 4.1% | 14.8% | 15.7% | | 13.8% | | | |
| Outperformance | -2.6% | -5.1% | -4.7% | | -1.0% | | | |
| **Core Equity Fund** | 0.5% | 11.4% | 12.9% | 13.3% | 17.2% | Nov-04 | | |
| FTSE/JSE SWIX All Share Index | 4.1% | 14.8% | 15.7% | 14.0% | 17.7% | | | |
| Outperformance | -3.6% | -3.4% | -2.8% | -0.7% | -0.5% | | | |
| **Domestic Balanced Fund[7]** | 0.4% | 6.1% | 8.2% | - | 8.7% | May-07 | | |
| Peer median[8] | 4.7% | 9.5% | 12.0% | | 10.4% | | | |
| Outperformance | -4.3% | -3.4% | -3.8% | | -1.7% | | | |
| **Global Balanced Fund[9]** | 5.5% | - | - | - | 11.3% | Jul-13 | | |
| Peer median[10] | 8.6% | | | | 13.8% | | | |
| Outperformance | -3.1% | | | | -2.5% | | | |
| **Sharia unit trust funds[4]** | | | | | | | | |
| **Islamic Equity Fund** | 4.5% | 8.3% | 8.2% | - | 12.1% | Jul-09 | 1.3% | 0.3% |
| South African Equity General funds mean | 1.4% | 11.2% | 11.8% | | 14.1% | | | |
| Outperformance | 3.1% | -2.9% | -3.6% | | -2.0% | | | |
| **Islamic Balanced Fund** | 4.7% | 8.2% | 7.6% | - | 7.0% | May-11 | 1.5% | 0.2% |
| South African Multi Asset High Equity funds mean | 5.3% | 10.5% | 11.4% | | 10.9% | | | |
| Outperformance | -0.6% | -2.3% | -3.8% | | -3.9% | | | |

| Highest and lowest monthly fund performance | Highest | Lowest | Highest | Lowest | Highest | Lowest | Highest | Lowest | Highest | Lowest |
|---|---|---|---|---|---|---|---|---|---|---|
| *Equity Alpha Fund* | 8.2% | -4.7% | 8.2% | -4.7% | 8.2% | -4.7% | 10.9% | -9.0% | 11.9% | -9.0% |
| *Balanced Fund* | 5.5% | -4.2% | 5.5% | -4.2% | 6.2% | -4.2% | - | - | 6.2% | -4.2% |
| *Protector Fund* | 3.4% | -4.2% | 3.4% | -4.2% | 4.8% | -4.2% | 7.9% | -5.3% | 9.5% | -5.3% |
| *Stable Fund* | 3.8% | -3.5% | 3.8% | -3.5% | 4.0% | -3.5% | - | - | 4.0% | -3.5% |
| *Islamic Equity Fund* | 7.3% | -4.6% | 7.3% | -4.6% | 8.1% | -4.9% | - | - | 8.1% | -4.9% |
| *Islamic Balanced Fund* | 4.6% | -3.0% | 4.6% | -3.0% | 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 June 2016; [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. [4] Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [5] CPI for June is an estimate; [6] Source: Kagiso Asset Management; gross of management fees; [7] Domestic Balanced Fund and benchmark returns to 31 May 2016; [8] Median return of Alexander Forbes SA Manager Watch: BIV Survey; [9] Global Balanced Fund and benchmark returns to 31 May 2016; [10] 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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