UP

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Kagiso Asset Management

Quarterly

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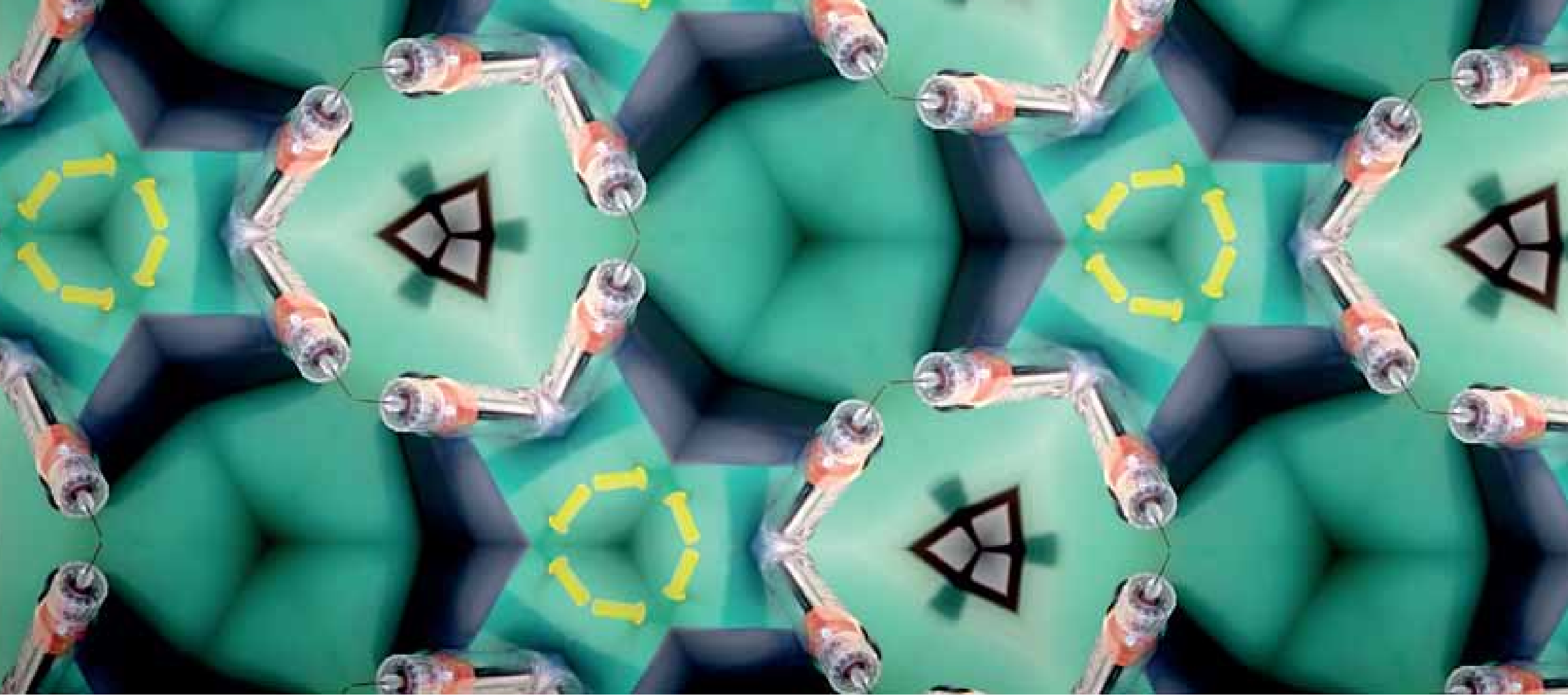

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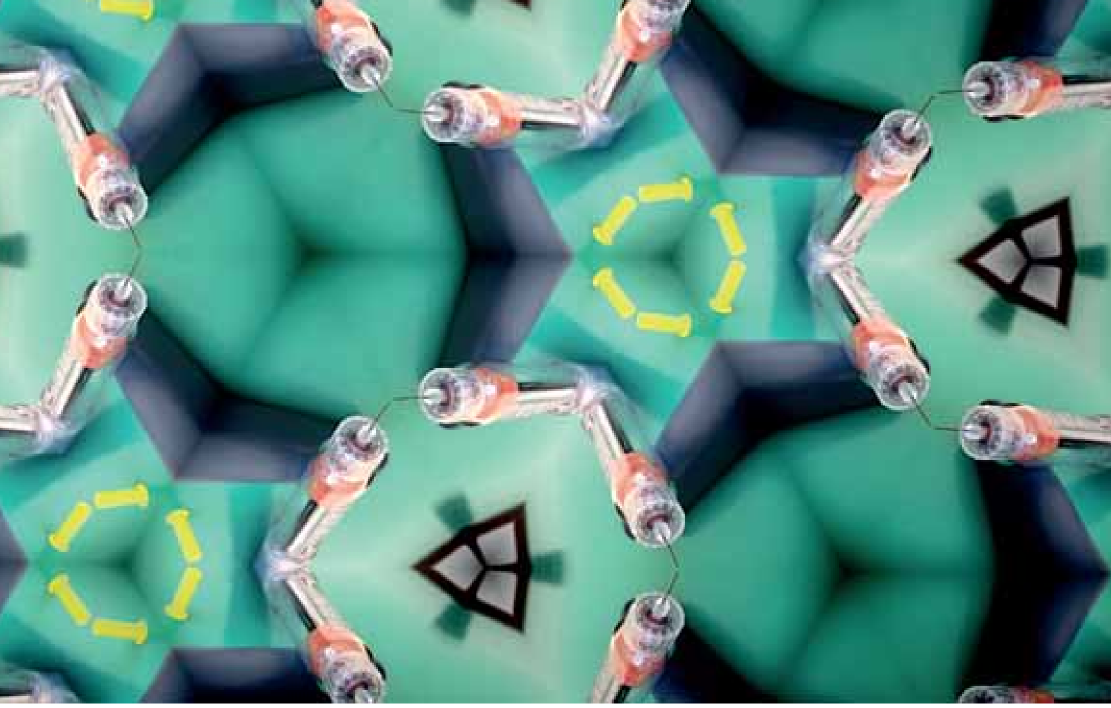


Chronic illness is a growing market for Novo Nordisk

Aslam Dalvi - Associate Portfolio Manager

"Denmark-based global healthcare company Novo Nordisk traces its origins to the first pioneers in insulin production and distribution. A year after the discovery of the hormone, by two Canadian researchers in 1921, the founders of Nordisk Insulin Laboratorium in Copenhagen obtained permission to manufacture and sell insulin in Scandinavia."

Chronic illness is a growing market for Novo Nordisk

In 1925, another laboratory, Novo Terapeutisk laboratorium, launched the first self-dosing injectable syringe with its own brand of insulin. This innovation enabled diabetic patients to manage their own treatment for the first time.

The two laboratories competed fiercely in the global market for more than 60 years until 1989 when they merged to form Novo Nordisk.

Today, the company manufactures, markets and sells products across a portfolio of chronic disease categories. These include diabetes, haemophilia, growth hormone therapy, hormone therapy, obesity and weight management. It remains the market leader in diabetes care, with more than 27% of global market share by volume. This market-leading position in an industry with high barriers to entry is a significant attraction for investors.

Structural strengths

As incomes rise and urbanisation accelerates around the world, sedentary lifestyles and Western diets are increasing obesity rates and the incidence of diabetes and other lifestyle diseases. This drives the demand for diabetes treatment which is already among the fastest growing therapeutic categories globally.

The company's consistent innovations in quality treatments which deliver superior patient outcomes are underpinned by its decades of accumulated institutional expertise and its history of high research and development spend (see left graph below), along with its first mover advantage in the field.

Its global reach exposes Novo Nordisk to attractive high-growth markets in Latin America, Africa and China where the growing per capita spend on diabetes treatment (currently still low) and improving diagnoses pathways should ensure double digit growth in demand for diabetes treatment over the next decade.

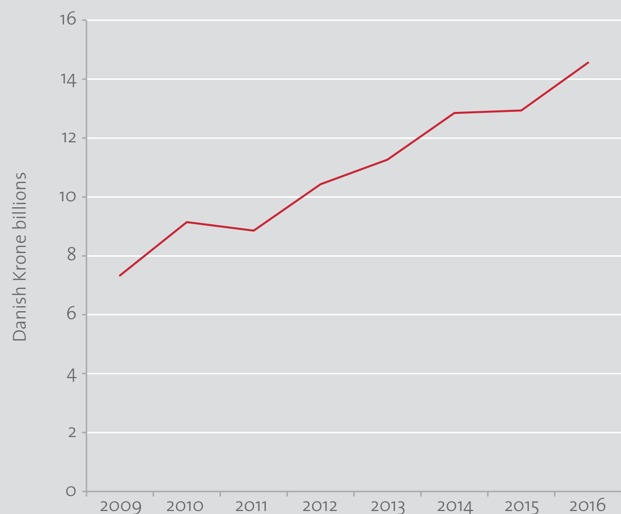
Novo Nordisk has a global manufacturing footprint across eight sites worldwide, supporting product distribution in 165 countries. Large insulin market shares across all regions, typically between 40% and 50%, enables the business to benefit from significant manufacturing scale.

Combined with a forward-thinking management team, these factors have translated into a strong operating history, delivering consistently high returns on investment, as reflected in the consistent growth in earnings per share (see right chart below).

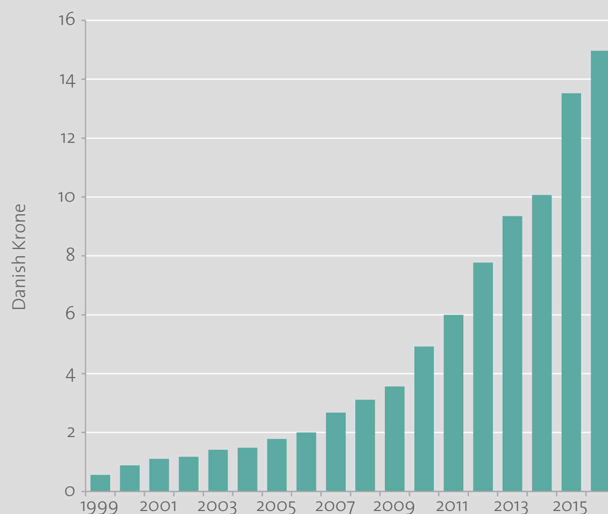
Disease and therapies

Type 2 diabetes can develop at any age, most commonly during adulthood, though incidence among children is increasing. While it can be hereditary, lifestyle factors such as diet, obesity and lack of activity are strong contributing risk factors.

Novo Nordisk's steady research & development spend



Novo Nordisk's earnings per share



Source: company reports

The first diabetes treatment was animal-derived insulin, often bovine, and created many unpleasant side effects. The advent of gene sequencing in the 1960s allowed the human gene for insulin to be inserted into bacteria or yeast, for the first time enabling industrial scale production of human insulins. While the patient experience was vastly improved, these second generation insulins were still far from ideal as formulations did not closely mimic the release profile that is characteristic of naturally secreted insulin.

Novo Nordisk has invested heavily in research and development (see chart below) and its modern innovations have focused on insulin engineering to develop solutions that mimic the natural profile of insulin in the blood, vastly improving patient outcomes and experience. The company's research and development superiority has brought about sustained market share gains since 2006 – rising from 20% of the total diabetes care market to more than 27% in 2016. Further evidence of its product development strength is reflected in its products, which have demonstrated superior patient outcomes to competitor products in several head-to-head trials.

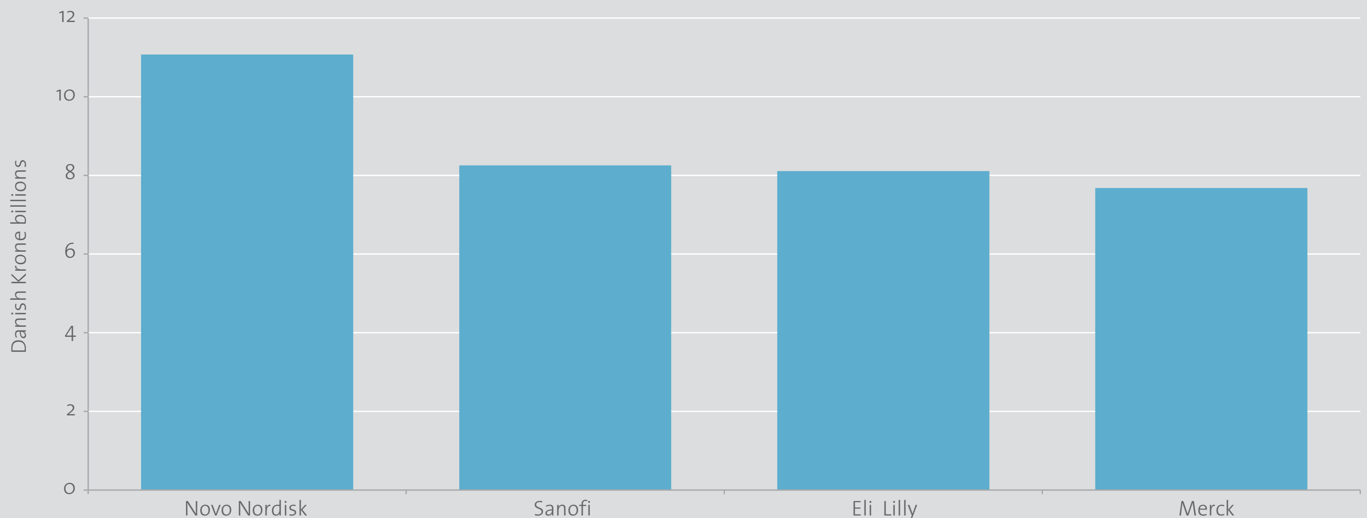
A pipeline of market-leading products

Insulin therapies are not the only diabetes treatment in the market. Non-insulin therapies can be prescribed at the onset of the disease or when a patient is responding poorly to a prescribed insulin regimen. The most sophisticated of these are incretin therapies.

Novo Nordisk's Victoza, a daily treatment, is arguably the best incretin product on the market, having fewer side-effects in comparison to its nearest competitor offering. The treatment's appetite control effects also offer significant opportunity for weight-reduction. The drug has been approved as a treatment for obesity management and is marketed under a different product name. With more than 35% of the US adult population categorised as obese, this opens a new market for Novo Nordisk and demonstrates how its efficient use of research and development not only opens new product categories but also new markets and treatment areas.

Novo Nordisk has a strong, rolling pipeline of products (see chart over page) which ensures that there is a steady supply of quality innovations ready for market as older product patents in its portfolio reach their end of life. For example, the successor to Victoza, a weekly dosage version, is currently in phase III trials and is setting a new standard in anti-obesity products. In addition to significant weight loss, trial data has shown the drug significantly reduces the risk of occurrence of cardio-vascular disease and related events (non-fatal stroke

Research & development spend on diabetes*



*Three year average   Source: company presentations, Kagiso Asset Management estimates

Chronic illness is a growing market for Novo Nordisk

events and death). This is significant as cardiovascular disease is the leading cause of death in people with type 2 diabetes. The game changer for incretin therapies will be the successful launch of an oral version of the drug, which Novo Nordisk currently has in development in a race to market.

The future gets sweeter

The future of diabetes care promises to deliver solutions that more closely mimic the body's natural release of insulin. Along with competitors Sanofi and Eli Lilly, Novo Nordisk is in a race to be the first to crack "smart-insulin" - insulin which will activate automatically according to the level of glucose in the blood. This will enable a patient's blood sugar to stay within safe levels without monitoring, mistakes or any need for additional insulin, significantly reducing the stress of managing the disease and treatment.

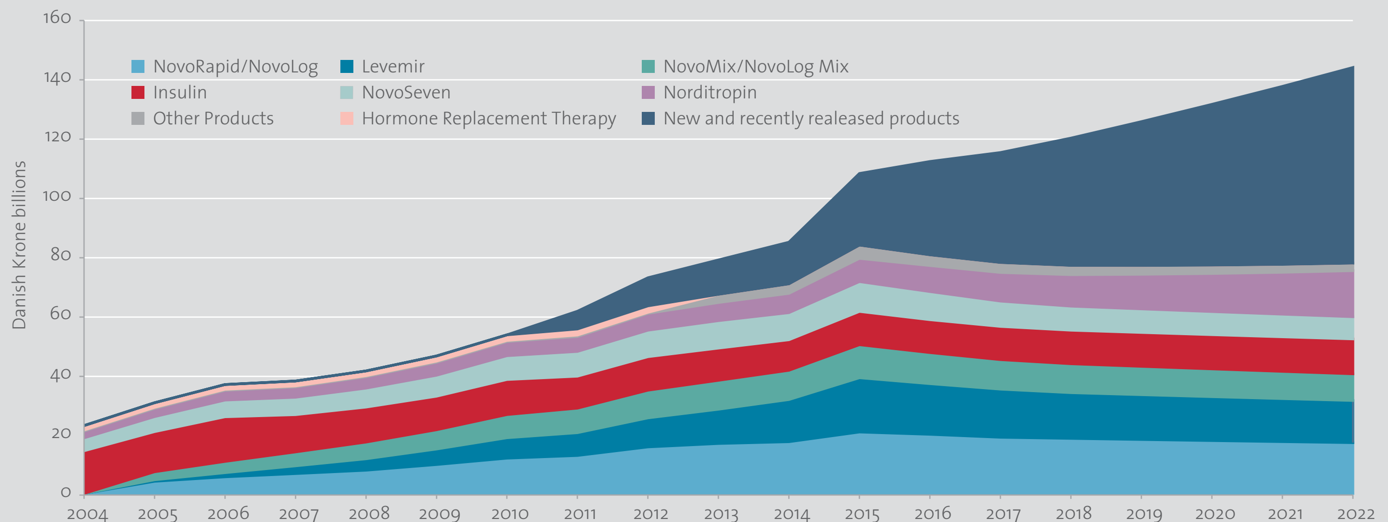
Novo Nordisk has recently announced a partnership with healthcare digital technology startup, Glooko. Using personalised digital tools combined with intelligent computing, the partnership is developing a 'virtual diabetes manager' for use on smart devices connected to smart insulin injectable pens in order to log, monitor and make dosing recommendations.

This should dramatically reduce the hundreds of thousands of insulin-related hospitalisations which still occur each year as a result of incorrect dosage.

Recently there has been negative sentiment towards the stock as a result of speculation around US drug price cuts under the Trump administration. However, we believe that this poses only a short-term risk to value. Novo Nordisk's exposure to strong growth vectors and several fundamental strengths should allow the company to defend its market share and make Novo Nordisk the long-term winner in global diabetes care.

Investors in our funds with global exposure have significantly benefitted from our holding in this high quality company. UP

A healthy pipeline: new and recently released products should bring about revenue growth



Source: company reports

The commodity pot at the end of the rainbow

Abdul Davids - Portfolio Manager

"Over the last 18 months, volatile commodity prices have resulted in extreme moves in the share prices of South African mining companies. Diversified miner African Rainbow Minerals (ARM) has been no exception, and while most mining companies have experienced a reasonable recovery in 2017, ARM's market valuation remains significantly depressed."

The commodity pot at the end of the rainbow

With a current market capitalisation of R22 billion, ARM's entire market value is less than the combined value of its 50% stake in iron, chrome and manganese miner Assmang, and its roughly 15% stake in Harmony Gold. This suggests that the market is assigning a negative value to the remainder of the assets in the ARM portfolio. It is a complex company and, partly due to its relatively small size, it is not well analysed. We believe that while the company has challenges, its complexity obscures the value of some high quality assets, and the market is significantly undervaluing these as a result.

The origins of ARM

Founded by South African businessman Patrice Motsepe in 1997, originally as ARMGold, ARM is today a diversified mining company akin to Anglo American and BHP Billiton, though significantly smaller than these competitors. Its underlying companies mine and beneficiate iron ore, manganese ore, chrome ore, platinum group metals (PGMs), mining copper, nickel and coal. It also produces manganese and chrome alloys, and has an investment in gold through its shareholding in Harmony Gold.

The group's current operations and locations in South Africa are illustrated in the visual below. The majority of its assets are owned in joint venture companies (JVs) with established mining partners such as Glencore and Amplats, with ARM providing strong BEE credentials and the more established mining partner providing significant capital. This approach has enabled ARM to own a diverse set of assets.

Understanding the portfolio

ARM comprises six divisions: ARM Platinum, ARM Ferrous, ARM Coal, ARM Copper, ARM Exploration and Gold (Harmony Gold).

The ARM Ferrous interests are held in a 50% stake in Assmang. The other 50% is owned by JSE-listed Assore Limited which jointly controls the company with ARM. Using Assore's JSE share price as a proxy, after making appropriate adjustments for Assore's additional income streams, it is possible to attribute a market value to unlisted Assmang. In addition, the value of ARM's roughly 15% stake in Harmony Gold can be calculated using the Harmony Gold share price.

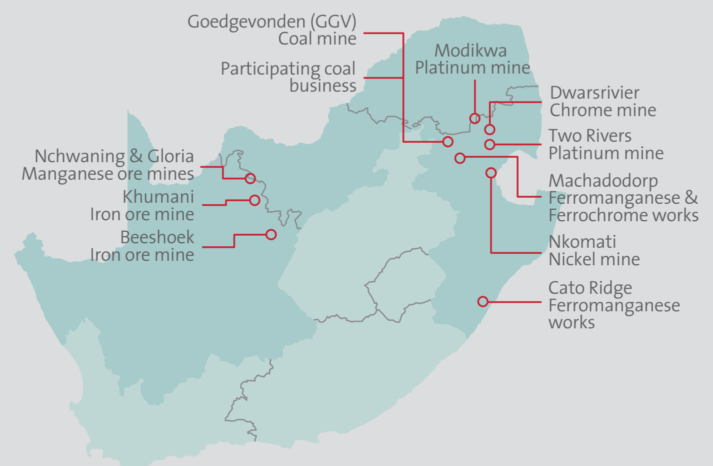
Assmang's iron ore mines, Khumani and Beeshoek, are located in the Northern Cape. They have a combined annual iron ore production volume of around 16 million tonnes, the bulk of which is exported to China. Manganese ore is mined at Black Rock mine in the Kalahari Basin in the Northern Cape - home to the largest and richest manganese deposit in the world. The bulk of Black Rock's annual manganese production is also exported to China but a portion is supplied to two ferromanganese smelters within the Assmang group for the production of manganese alloys.

The Sakura Ferroalloys Project is Assmang's Malaysian venture in ferromanganese. Assmang owns a 54% stake in the JV and has partnered with Sumitomo Corporation (27% stake and a large buyer of ferromanganese) and China Steel (19% stake). The project commenced construction in 2014 and is projected to reach full production in 2017. The venture aims to exploit the advantage of proximity to customers in China and has a cost advantage through a contract for low energy-price escalations.

The rump - what does minus R19 buy?

Subtracting the implied value of ARM's holdings in Assmang and Harmony Gold from the ARM market capitalisation results in the market's implied value of ARM's non-listed assets (the rump). The derived value of the rump is based on an

ARM's South African assets



Source: company reports

assumption that Assore's market value is a fair representation of its intrinsic value. However, we would argue that Assore is currently over-valued and consequently we use a lower value for Assore in our sum-of-the-parts valuation of ARM. Notwithstanding our valuation, the market continues to price Assore at a premium to our valuation and has been doing so for an extended period of time.

The graph below highlights the value of the rump on a per share basis over time. The rump value peaked at R180 per ARM share in 2008 at the height of the commodity bull market, when the ARM share price was around R280 per share.

The rump's implied value has been negative for most of 2017, with an all-time low value of negative R29 (negative R7 billion in total) in March 2017. Currently the implied value of the rump is negative R19, or just under R4 billion, and we believe that this negative value reflects investors' concerns around the future profitability of the rump assets as well as negative sentiment towards the South African mining industry.

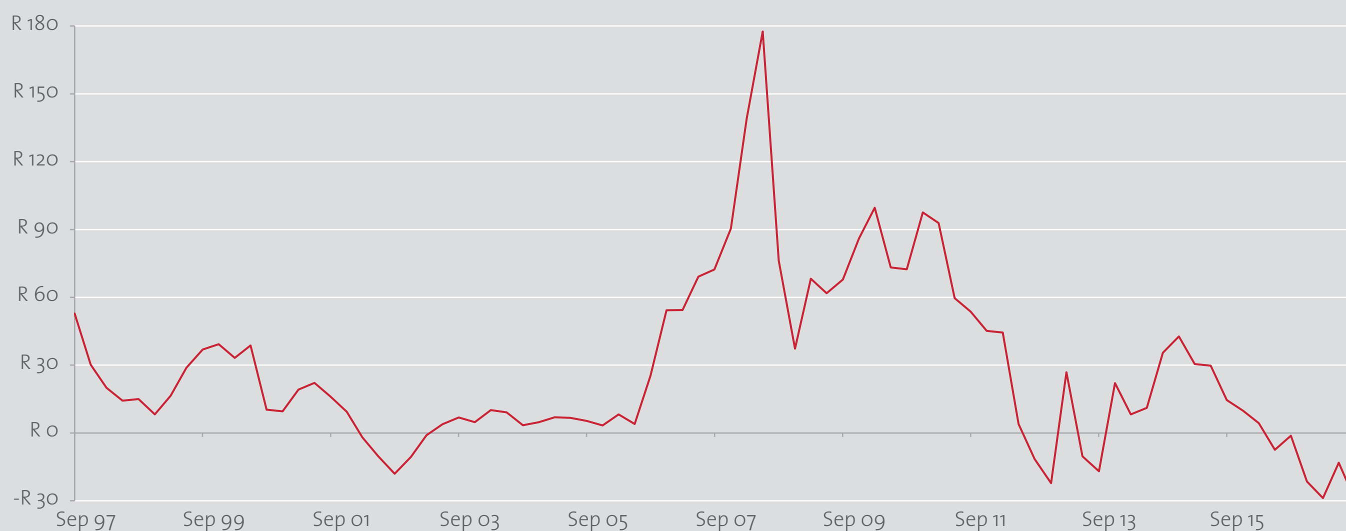
These rumps assets include:
Nkomati Nickel mine - a 50% JV with the world's largest nickel producer Norilsk - located near Machadodorp in Mpumalanga. It produces around 10 000 tonnes of nickel and 78 000 PGM ounces a year and has one of the largest nickel reserves in South Africa. Persistently low nickel prices resulted in a focus on shallow ore that has now largely been mined out. Further mine development is now required, which will necessitate increased capital expenditure, and Nkomati Nickel is therefore reliant on higher nickel prices to remain viable.

ARM Coal produced around 5.2 million tonnes of coal in 2016. The bulk of production (around 80%) was exported, with the balance sold locally, mainly to Eskom. The recovery in coal prices has boosted profitability, but ARM's access to coal profits is restricted due to the onerous funding arrangements put in place by Glencore.

Modikwa platinum mine is a joint venture between Anglo Platinum (50%) and ARMMinerals (41.5%) and the surrounding communities (8.5%). The operation employs a hybrid of conventional and mechanised mining methods in a hard rock, underground mine with annual production of around 300 000 PGM ounces and a reserve base of 7 million PGM ounces.

The mine's recent production history has been marred by safety stoppages, strike action and declining productivity that has led to cost escalations and operating losses. Management believes it can restructure the asset to be profitable at current PGM prices. The mine has spent capital to increase flexibility and, as volumes increase, this should result in a more productive asset.

Market implied value of ARM's unlisted assets (per share)



Source: Kagiso Asset Management research

The commodity pot at the end of the rainbow

With production costs in the top 50% of PGM mines, Modikwa is a high cost operation. We believe that ARM could unlock substantial value in the event of a sale of its JV interest in the asset.

In contrast, **Two Rivers** is a low cost, fully mechanized PGM mine with a reserve base of around 5 million PGM ounces and annual production of around 400 000 PGM ounces. The operation is a 54%:46% JV operation between ARM and Impala Platinum. Despite receiving a lower share of revenues than Impala as per the JV agreement, Two Rivers remains highly profitable for ARM. It is well placed as one of the most profitable PGM mines in the industry.

Two Rivers generated just under R900 million in free cash flow (operating cash flows after capital expenditure) in 2016 and is one of the most profitable PGM mines globally (see chart below). ARM recently acquired adjacent mine Kalkfontein, which will be incorporated into Two Rivers, increasing the life of the mine to 40 years.

The value of Two Rivers is further strengthened by its significant exposure to chrome profits, which contributed 28% of operating profit in the first half of 2017. Used in the production of high quality steel, chrome is in high demand from China offering valuable commodity diversification and lessening the impact of low PGM prices on Two Rivers.

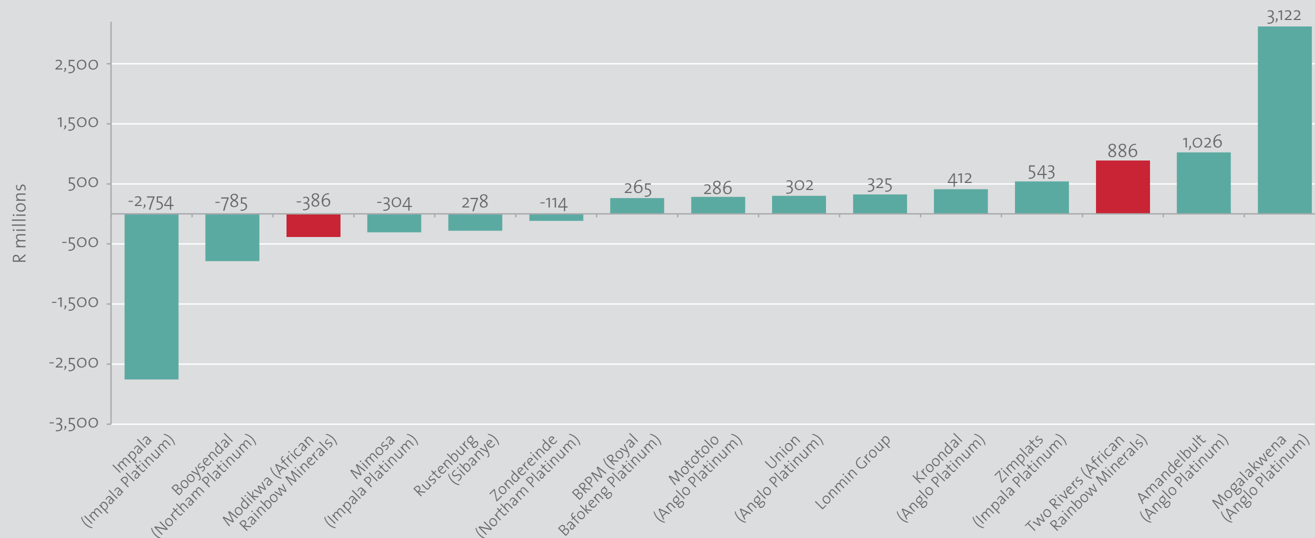
In a South African PGM sector where 70% of the mines are currently loss-making and many require substantial capital expenditure to improve their profitability, Two Rivers is a rare asset.

In conclusion

ARM offers a unique portfolio of assets, some better quality than others, but many with inherent value beyond the company's current level of profitability. The recent sale of a loss-making copper mine in Zambia will add a significant cash injection to the ARM balance sheet, and the company is considering further asset disposals in order to simplify its structure and unlock value from assets currently valued below zero by the market.

Two Rivers is a unique PGM mine that is fully mechanised, highly profitable and is only available via an investment in ARM or Impala Platinum. This asset alone justifies a significantly positive value for ARM's rump. UP

Free cash flow before taxes and financing (2016)



Source: company reports as per financial year-end 2016

A future with electric cars

Mandi Dungwa - Investment Analyst

"One might be surprised to learn that battery electric vehicles have been around since the 19th century. The first electric vehicle was invented in 1891 and by 1900, electric vehicles had a 28% market share in the United States (horse-drawn carts making up the balance of vehicles at the time). This market share was quickly lost with the creation of Henry Ford's gasoline powered Model T vehicle in 1908."

A future with electric cars

This early end to the electric vehicle's market dominance was the result of various factors, in particular the fact that, as road infrastructure developed, drivers required increasing range (longer travelling distances on a single charge). Worldwide discoveries of large petroleum reserves meant that petrol was widely and cheaply available to refuel internal combustion engine vehicles. A further challenge was that electric vehicle technology of the time offered limited torque and speed.

Fast forward to 2017, and the current electric vehicle still has to find solutions to some of the same problems. We consider the future uptake of these vehicles and the likely impacts for associated industries.

The electric vehicle returns

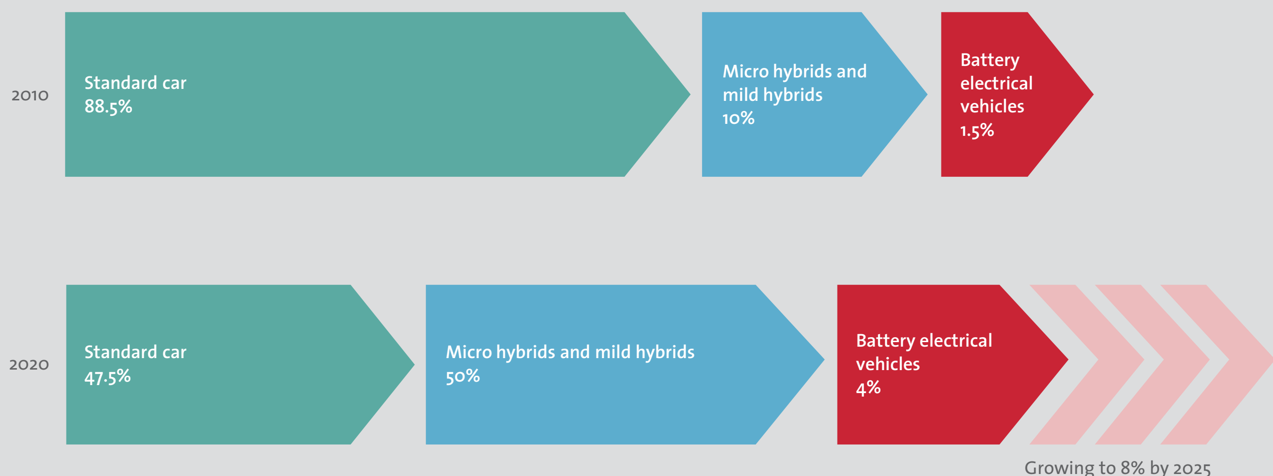
In recent years, tightening emissions control regulation has increased the cost of producing internal combustion engine vehicles, while major advances in battery technology have significantly improved electric vehicle range and reduced the costs of battery production. With policy and lobbying driving greater adoption in major markets, prospects for mass battery production are to further reduce production costs.

European governments have in particular increased subsidies for electric vehicles to incentivise a rapid increase in usage. The Chinese electric vehicle market has grown five-fold between 2014 and 2016, due to the help of government subsidies. The Chinese government has implemented a quota system that will be implemented from 2019 requiring that between 2% and 5% of vehicles produced in China will be electric vehicles, increasing to 2.4% to 6% by 2020. China is already the largest market for battery electric vehicles globally, with 331 000 units sold in 2015 (a 53% global market share). The Chinese government has a target to reach 2 million electric vehicles by 2020 and 6 million by 2025.

Due to the drive to reduce pollution in Chinese cities and the consequent electric vehicle subsidies and restrictions on conventional vehicle purchases, we expect the Chinese vehicle market to remain the global leader in electric vehicle adoption.

As the global market grows, economies of scale will reduce production costs for electric vehicles, which will ultimately result in lower electric vehicle purchase prices. While electrical vehicle sales through to 2025 will likely remain relatively low, we expect an inflection point in adoption between 2025 and 2030, as electric vehicles become economical on a total cost of ownership basis across mass-market vehicle classes (chart below).

Projections for market penetration of battery electrical vehicles



Source: Avicenne Energy, UBS estimates, Deutsche estimates

Battery vehicle challenges

The battery component of the battery powered electric vehicle is currently the single largest cost contributor. In recent years, vehicle manufacturers' research and development efforts have focused on reducing battery costs, with a 75% reduction achieved since 2010, with the cost reducing from $1000/kWh to between $200/kWh and $300 per kWh today. Despite this significant reduction, this is still not enough to reach cost parity with internal combustion engines as shown in the chart below.

A further impediment to global adoption is the availability of charging infrastructure, closely linked to the related challenges of vehicle range per charge and the time required to fully recharge. Range for current electric vehicles can vary between 150 kilometres on a single charge to as much as 520 kilometres for high-end models. These ranges are a function of the capacity of the battery, so a 24 kWh Nissan Leaf has a range of 199 kilometres while a Tesla model S at 60kWh has a range of 400 kilometres. However, the Tesla is three times more expensive than the Nissan Leaf, so the higher the capacity or range on single charge the more expensive the vehicle.

Battery charge times vary from between seven to 20 hours for at-home and standard recharging, and three to four hours at some super-charging stations. This is a major inconvenience relative to the few minutes required to refill a tank of petrol or diesel. Longer distance trips could require an overnight stop for recharge, making out-of-city electric vehicle trips less practical.

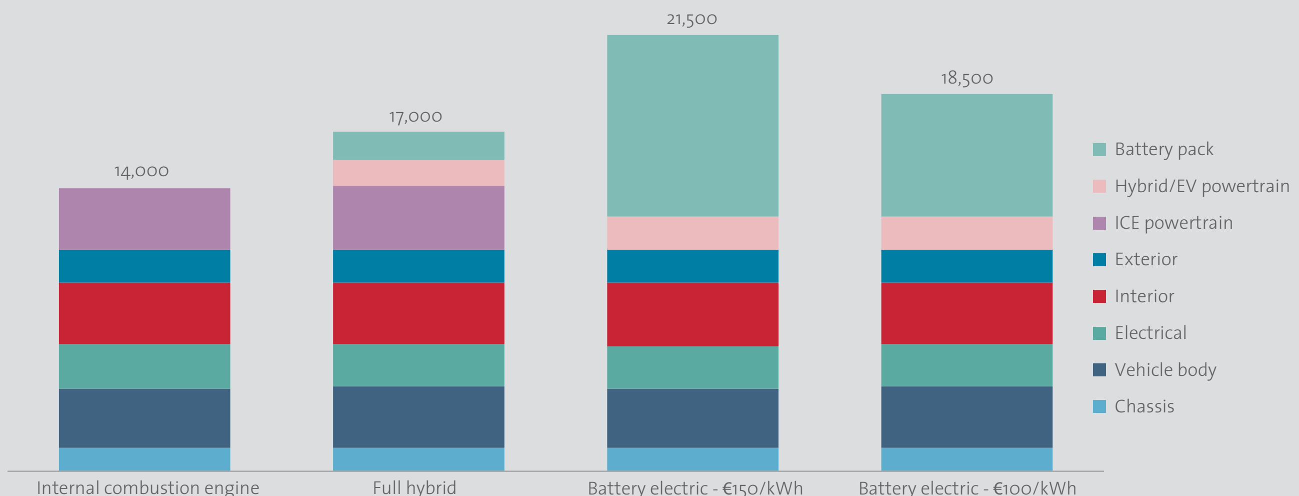
The internal combustion engine lives on

The rebirth of the electric battery powered vehicle does not necessarily mean the imminent death of the internal combustion engine. The solution for many consumers requiring a low emission vehicle that can travel longer distances unbroken is the hybrid vehicle. Hybrid vehicles use both battery and internal combustion engine technology, allowing drivers to use electricity as often as possible and refuel with petrol or diesel if needed.

We believe that in the medium term, as environmental emissions regulations become tighter, and governments continue to push towards a goal of zero emissions, the hybrid vehicle will gain meaningful market share.

There are also categories of vehicles which, for the time being, are not suitable for transition to current electric vehicle technology. Heavy commercial vehicles used for haulage transport, for example, are predominantly diesel trucks as they have to travel long distances and diesel continues to be the most fuel efficient technology for long distance travelling. A battery large enough to ensure sufficient range and torque for long-distance haulage has not yet been developed.

Component cost per car (€)



Note: Battery cost assumes 60kWh battery at €150/kWh
Sources: Technische Universität München, ICCT, EPA, CARB, NHTSA, company data, Morgan Stanley Research estimates

A future with electric cars

Impacts of a more electrified vehicle market

Increasing adoption of the battery electric vehicle will cause fundamental shifts in many related industries while leaving others largely unaffected. Some impacts we foresee include the following:

- Electricity demand will increase significantly as growing electric vehicle penetration increases recharging demand. This demand may well be a concentrated requirement at popular charging times of day. Much of this electricity needs to be generated from renewable sources to keep the total carbon emissions from electric vehicle usage lower than those of existing cars.
- Decreased demand for fuels derived from oil, with resultant impacts on the oil industry. Lower oil prices are likely to retard the pace of electric vehicle adoption as conventional cars become relatively cheaper to run.
- Reduced demand for vehicle components specifically linked to the internal combustion engine. For South African platinum group metal (PGM) miners, this ultimately means reduced demand for their precious metals as fewer autocatalysts (a component of the catalytic converter which transforms pollutants from the combustion of fuel into harmless gases) will be sold. Our sense is that such lower demand is a very long way off as hybrid gasoline car usage will continue to grow for the foreseeable future. Additionally, increasing environmental standards for heavy duty diesel vehicles will grow demand for PGM-rich autocatalysts in years to come.
- Increasing demand for raw materials used in batteries such as lithium, copper, cobalt and nickel.

To take advantage of these changes, investors in our funds have exposure to companies and sectors well placed to benefit from these changes or experience minimal impacts. Such companies include Metair, the Johannesburg-headquartered battery manufacturer which is well positioned to supply batteries for hybrid cars.

The Japanese group Nisshinbo offers exposure to manufacturers of various car components such as seats, tyres, lights and brake pads. Demand for these components will remain stable irrespective of changes in drivetrain technology. In South Africa, low cost PGM miners will benefit from higher metal prices as current pessimism regarding the future of internal combustion engine vehicles gives way to realism about the continued market share of hybrid cars for long into the future. UP

The little bank that could

Meyrick Barker - Investment Analyst

> This year, Capitec's market value surpassed that of Investec and Nedbank and exceeded R100 billion for the first time. For a company that was worth just R2.5 billion a decade ago, this rise has been nothing short of exceptional (see graph overleaf).

The little bank that could

From payday lender to reputable bank

In 1992, interest rate caps for small loans - imposed by the Usury Act - were eliminated. Now able to charge interest rates of up to 360% a year on small value loans, microlending industry profits trebled between 1995 and 1997 to R10 billion. South African retail banks quickly developed microlending strategies, muscling in on a domain previously dominated by mashonisas and pawnbrokers.

Investment holding company, PSG, entered the sector in 1998 when it established PSG Specialised Lending as a means to evaluate investment opportunities in the industry. The beginnings of what would later evolve into Capitec were born.

PSG acquired two branches of Louhen Financial Services, the original proponent of the now illegal card-and-PIN practice[1], rebranding it PSG Smartfin. The branch footprint was rapidly expanded and by February 2001, PSG's microloan businesses were trading out of 300 branches. The acquisition of The Business Bank (TBB) in 2000 gave PSG access to a banking licence and enabled the launch of PSG's retail banking offering under the Capitec brand.

In the late 1990s in a different corner of the financial services industry, Christo Wiese brought in top management talent to resuscitate his newly acquired Boland Bank - recruiting Michiel le Roux and Riaan Stassen, both formerly at Distell. Le Roux and Stassen's dream of building a paperless bank with a retail-inspired customer focus was scuppered when Wiese moved to merge the recovering bank with former building society, NBS, and niche financial services company, BoE. Disillusioned with the merger, the senior Boland Bank management team, including le Roux, Stassen and current Capitec CFO André du Plessis, all left to join PSG's microloan business. These leaders were central in developing Capitec's innovative retail banking strategy and customer-centric vision.

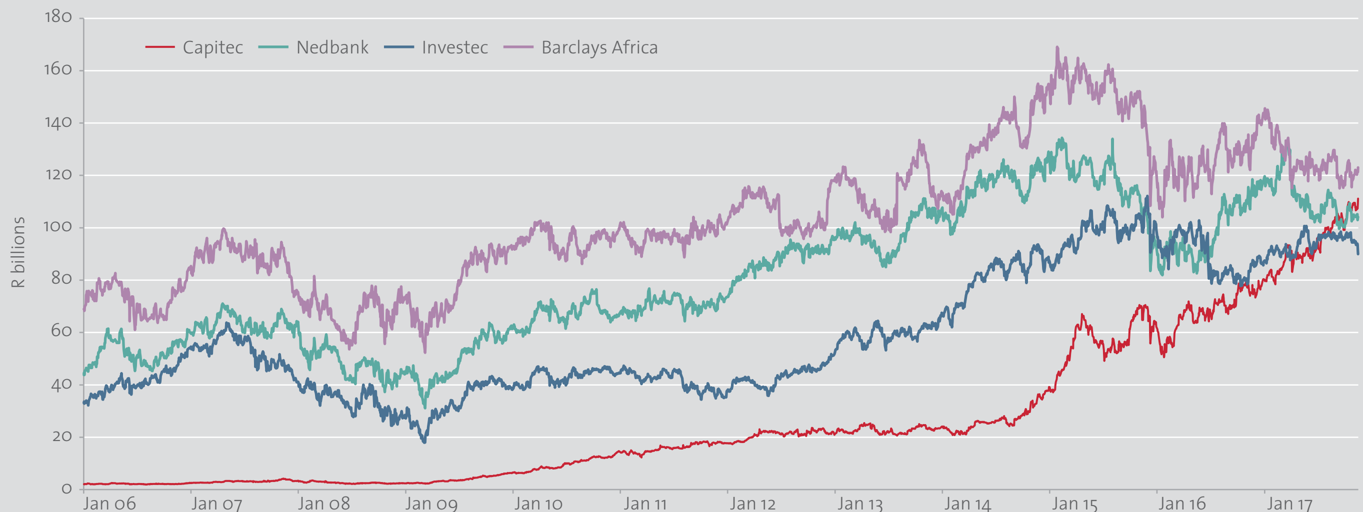
"Simplicity is the ultimate sophistication"

Capitec has disrupted a conservative banking market by revolutionising the experience for the customer with a simplified approach to banking and transparent, low-cost pricing. PSG's early value proposition for Capitec to "be the financial friend of the people of South Africa" is not just a hollow platitude. Based on what was perhaps a surprisingly obvious vision - banking designed around the needs of its customers - Capitec has introduced a range of industry firsts.

At a time when other banks were actively discouraging customers from using branches, Capitec designed its branches

[1] They retained a borrower's debit card and PIN number, which allowed them to withdraw the instalment owing as early as possible on payday.

Capitec's market capitalisation versus select competitors



Source: Bloomberg

to be more welcoming, offered extended weekday and weekend hours, and positioned its branches near commuter stations to improve accessibility. With almost no cash kept on site, staff were free to interact directly without bullet-proof glass barriers. The use of biometrics reduced the risk of fraud, helped increase trust in the bank and improved efficiency.

Capitec's one-stop Global One account - a single transaction, savings and borrowing account (and a recently added credit card facility) for all customers, regardless of income level - is a fundamental differentiator from the multiple and complex products offered by other banks. The account's pay-as-you-go fee structure dramatically undercut traditional industry offerings and paid interest on any positive balance.

The simple product structure not only improves the customer experience, but can also be serviced by less skilled, and therefore less expensive, staff. Staff costs typically represent up to 50-60% of a bank's operating expenses.

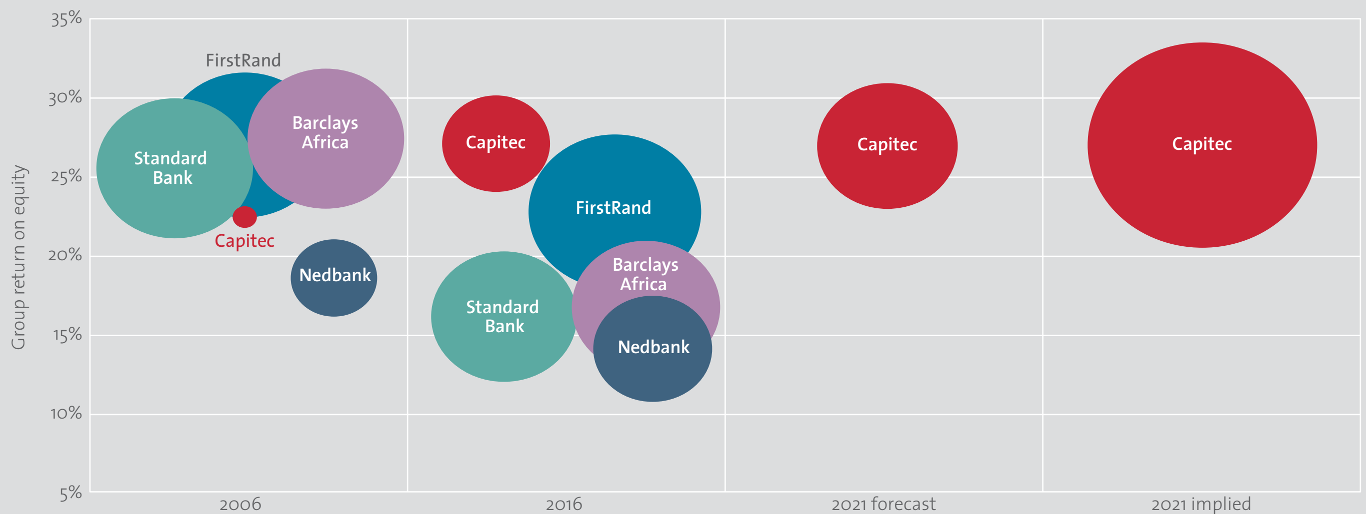
The traditional banks' failure to understand their clients' needs resulted in complacency, leaving a great opportunity for Capitec's strengths to manifest themselves. Having now attracted 9 million clients, Capitec exceeds all but Standard Bank's South African customer base.

New bank, new systems - lower cost business model

Poor strategic execution, coupled with legacy systems has constrained the traditional banks' ability to successfully limit the threat posed by Capitec. Mainframe computer systems cobbled together from multiple bank amalgamations, expensive large branch formats rolled out before the days of centralised administration and a more costly staff complement trained to sell complex banking products, resulted in inflated cost bases for the large banks. High costs and limited competition, led to high bank fees. Capitec's success is therefore partly a function of when it started - its lack of legacy systems and consequent lower cost base allowed it to penetrate the retail banking market with a lower fee proposition.

A bank's computer systems are integral to its success. Bank systems have historically been built in product silos with limited interaction across the different product types. Interacting with a bank was thus frustrating when, despite already being a client, each product application often meant you had to resubmit your personal information. Bank turnaround times were slow as they battled to access historical information from their different systems. Capitec's IT infrastructure avoids this web of disparate systems. They have a single client record allowing them to quickly and easily decide whether to offer a customer additional credit.

Capitec's profit growth versus competitors



Size of bubble denotes retail headline earnings. Midpoint of bubble reflects Group RoE.
Source: UBS and Kagiso Asset Management estimates

The little bank that could

Astute credit risk management is vital for a sustainable unsecured credit lending business. Capitec's ability to successfully manage risk far better than its competitors saw certain competitors adopt reckless lending strategies in an attempt to outgrow Capitec. Peers' resultant bad debt spikes have seen their credit appetites being subsequently curtailed and, in extreme cases such as the old African Bank, have even resulted in bankruptcies. Capitec's sophisticated pricing models and superior provisioning has allowed it to capitalise on these opportunities.

Market share gains

Over the past two decades, the banking sector has enjoyed strong customer growth as banking services have been extended to many more South Africans. Having now captured the vast majority of clients who can be profitably serviced, customer gains by any particular bank are increasingly driven by customer losses from a competitor. This implies that instead of the total retail banking profit pool growing as more clients are served, the allocation of the total profit pool now increasingly shifts between banks, dependent on the success of their respective strategies.

From an investor's perspective, the expected success of any particular bank therefore negatively impacts the outlook for the growth of other banks' South African operations. Banks with poor operational momentum, suffering distractions posed by shareholder changes, and that have not adequately invested in their IT infrastructure to date, risk continued customer losses to Capitec.

Still able to capture more of the SA retail banking profit pool

Capitec's potential growth is limited by its product offering. If a customer has complex banking requirements, or requires a secured loan, then Capitec is unlikely to be a viable option. Such customers are, however, a small portion of the total South African population - approximately 2 million South Africans have mortgage accounts.

An expansion of Capitec's product offering to accommodate medium-sized businesses is possible, but unlikely in the short term as it would be disruptive to the current business model. More complex products (eg trade financing / debtor factoring) would be difficult for its low-cost staff complement to service.

Priced for perfection

While we believe that Capitec still has a strong medium-term growth outlook, we think that the current share price implies that Capitec will capture too large a portion of the existing retail profit pool relative to what is practically possible. While the large banks have arguably responded poorly to date, they are fully aware of the continued risks that Capitec poses. They are devoting significant capital to improve customer experiences and reduce the cost of banking. The entrance of new competition by way of Discovery Bank, Postbank and TYME, will further impact profit pool reallocations and impact Capitec's ability to grow.

The chart on the previous page reflects the current profits of each of the main SA banks' retail operations. We demonstrate Capitec's expected growth over the next four years, as well as the required growth to justify the current share price. While Capitec may exceed our expectations if its expansion into Eastern Europe gains significant traction, we believe that its current share price requires investors to pay for the unproven international expansion of the business model.

For this reason, we do not hold Capitec in our investors' portfolios but remain very focussed on understanding the threat of net customer losses posed to the large banks. Although it is tempting to want to back strong management teams and high growth companies, our investment process focuses on choosing companies that are inexpensively priced. UP

Kagiso Asset Management Funds

Performance to 30 September 2017	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	8.3%	5.6%	10.8%	9.6%	17.7%	Apr-04	1.65%	0.48%
SA Equity General funds mean	4.2%	4.3%	9.7%	7.8%	14.1%			
Outperformance	4.1%	1.3%	1.1%	1.8%	3.6%			
Balanced Fund	8.7%	6.9%	10.1%	-	10.0%	May-11	1.53%	0.53%
SA Multi Asset High Equity funds mean	6.0%	6.3%	9.8%		9.8%			
Outperformance	2.7%	0.6%	0.3%		0.2%			
Protector Fund	9.7%	6.8%	8.2%	6.6%	10.2%	Dec-02	1.61%	0.35%
CPI + 5%[5]	10.2%	10.3%	10.5%	11.0%	10.7%			
Outperformance	-0.5%	-3.5%	-2.3%	-4.4%	-0.5%			
Stable Fund	4.8%	6.9%	8.5%	-	8.4%	May-11	1.54%	0.55%
Return on large deposits*	6.4%	6.0%	5.6%		5.6%			
Outperformance	-1.6%	0.9%	2.9%		2.8%			
Institutional funds[6]								
Managed Equity Fund (SWIX)	6.1%	3.9%	9.9%	9.7%	12.2%	Sep-06		
FTSE/JSE SWIX All Share Index	7.0%	7.4%	12.8%	10.6%	12.9%			
Outperformance	-0.9%	-3.5%	-2.9%	-0.9%	-0.7%			
Managed Equity Fund (Capped SWIX)	-	-	-	-	9.2%	Jan-17		
FTSE/JSE Capped SWIX Index					7.4%			
Outperformance					1.8%			
Domestic Balanced Fund[7]	7.4%	5.2%	8.2%	-	8.7%	May-07		
Peer median[8]	8.8%	7.4%	10.7%		10.1%			
Outperformance	-1.4%	-2.2%	-2.5%		-1.4%			
Global Balanced Fund[9]	10.4%	8.0%	-	-	10.6%	Jul-13		
Peer median[10]	7.9%	7.7%			10.9%			
Outperformance	2.5%	0.3%			-0.3%			
Sharia unit trust funds[4]								
Islamic Equity Fund	11.3%	5.6%	10.2%	-	12.3%	Jul-09	1.43%	0.23%
SA Equity General funds mean	4.2%	4.3%	9.7%		12.5%			
Outperformance	7.1%	1.3%	0.5%		-0.2%			
Islamic Balanced Fund	8.8%	5.0%	8.7%	-	7.5%	May-11	1.48%	0.17%
SA Multi Asset High Equity funds mean	6.0%	6.3%	9.8%		9.8%			
Outperformance	2.8%	-1.3%	-1.1%		-2.3%			

Highest and lowest monthly fund performance	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest
Equity Alpha Fund	4.8%	-4.1%	8.2%	-4.7%	8.2%	-4.7%	10.9%	-9.0%	11.9%	-9.0%
Balanced Fund	4.0%	-3.5%	5.5%	-4.2%	6.2%	-4.2%	-	-	6.2%	-4.2%
Protector Fund	2.4%	-2.4%	3.4%	-4.2%	4.8%	-4.2%	7.9%	-5.3%	9.5%	-5.3%
Stable Fund	1.7%	-0.8%	3.8%	-3.5%	4.0%	-3.5%	-	-	4.0%	-3.5%
Islamic Equity Fund	3.9%	-3.2%	7.3%	-4.6%	8.1%	-4.9%	-	-	8.1%	-4.9%
Islamic Balanced Fund	2.6%	-2.1%	4.6%	-3.0%	8.2%	-5.4%	-	-	8.8%	-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 September 2017; [3] Transaction costs (TC) are unavoidable costs incurred in administering the financial products offered by Kagiso Collective Investments and impact financial product returns. It should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of financial product, the investment decisions of the investment manager and the TER. This is also calculated on the rolling three-year period to 30 September 2017; [4] Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [5] CPI for September is an estimate; [6] Source: Kagiso Asset Management; gross of management fees; [7] Domestic Balanced Fund benchmark returns are an estimate for September; [8] Median return of Alexander Forbes SA Manager Watch: BIV Survey; [9] Global Balanced Fund benchmark returns are an estimate for September; [10] Median return of Alexander Forbes Global Large Manager Watch. *Return on deposits of R5 million plus 2% (on an after-tax basis at an assumed 25% tax rate).

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