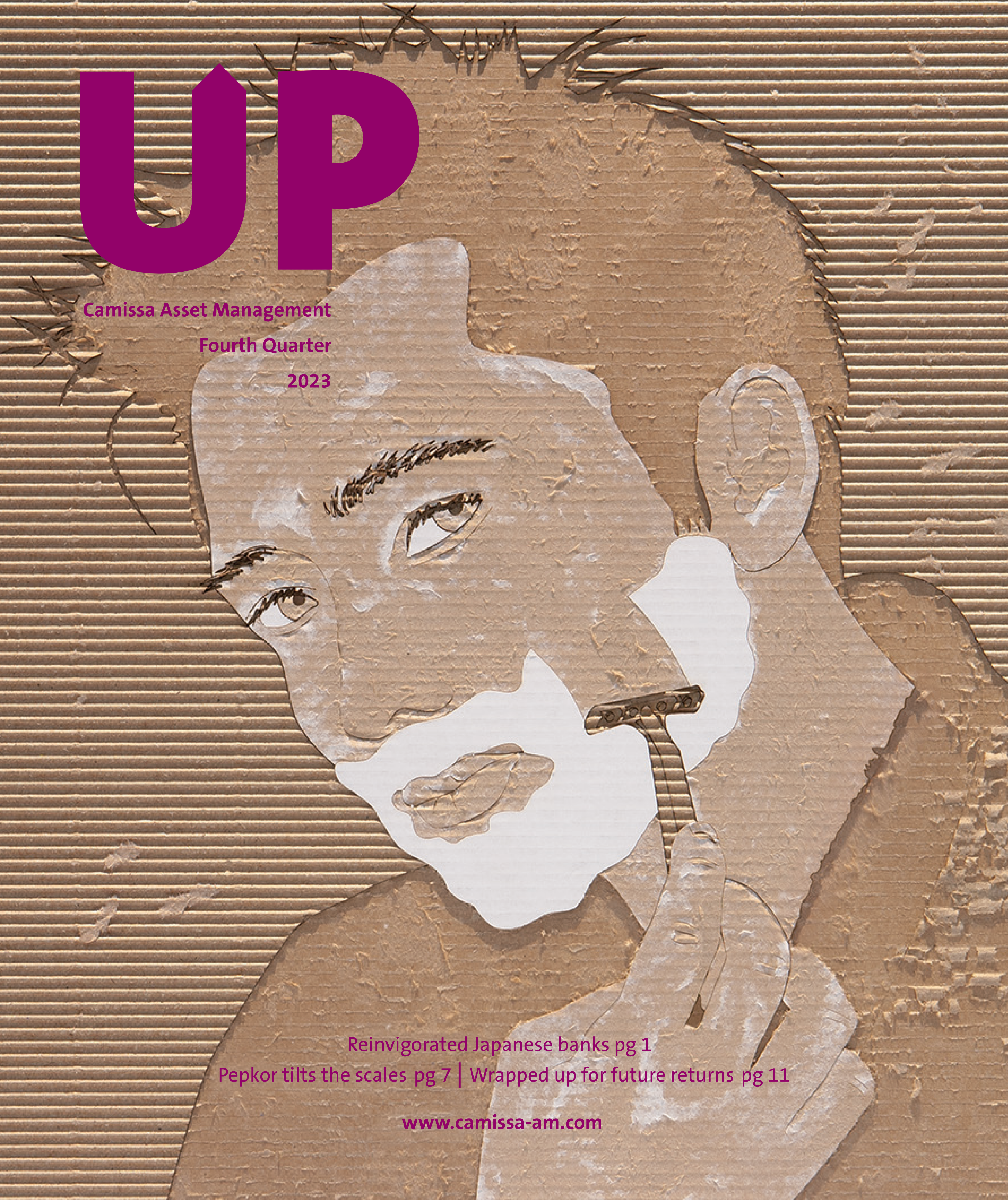

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Fourth Quarter

2023

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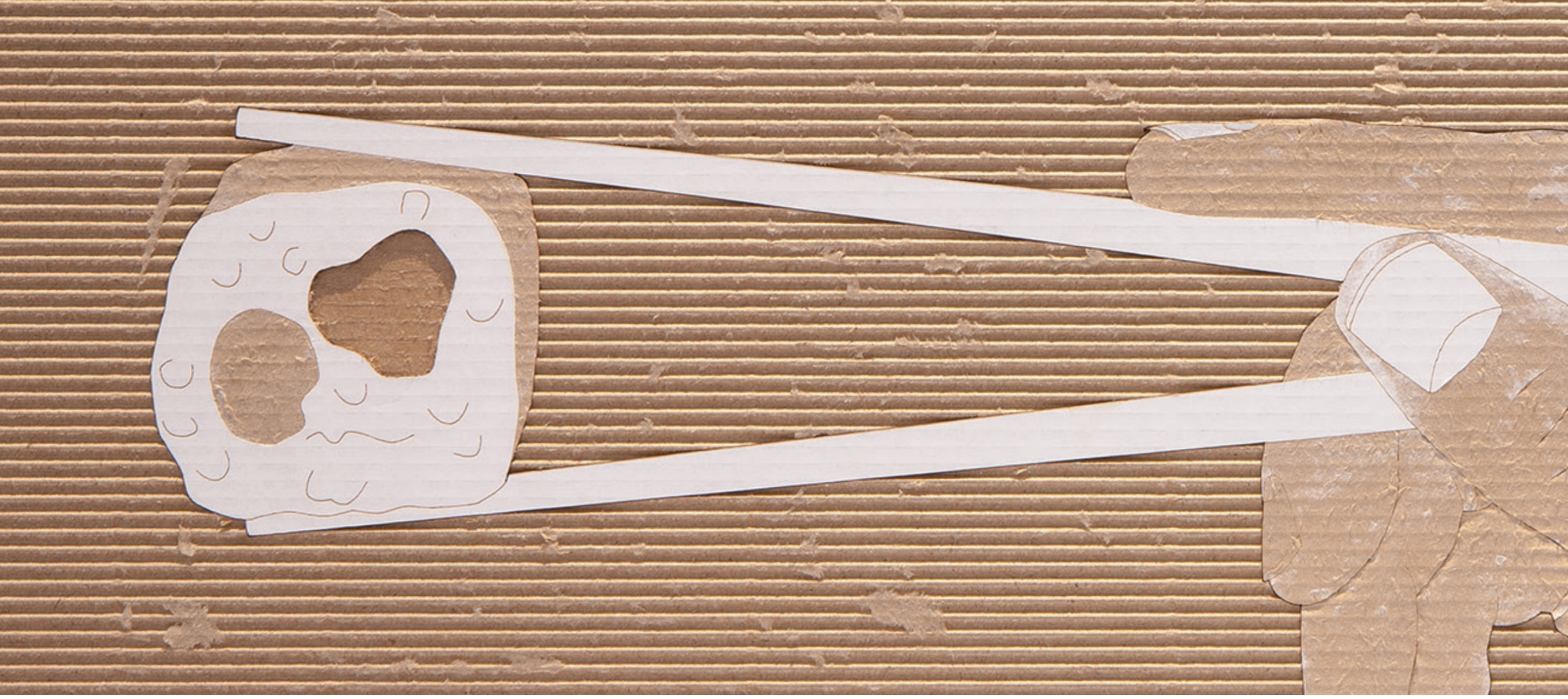


Reinvigorated Japanese banks

Meyrick Barker - Investment Analyst

"Japan's economy has suffered low growth and low inflation since the speculative excesses of the real estate and stock market asset price bubble burst in the late 1980s. A painful deleveraging process followed. Havoc wrought by high inflation is often well understood, but an environment of little to no inflation can be problematic as it reduces the desire to spend and invest."

Reinvigorated Japanese banks

The gradual return of inflation in Japan could rekindle its economy's long suppressed 'animal spirits', potentially manifesting in increased private sector consumption and investment. Such investment activity should boost productivity and further spur economic growth. Japanese banks, two of which are explored herein, are at the forefront of benefiting from this potential turn of fortune.

Repressed by the Central Bank

Although it remains the world's fourth largest economy, Japan's economic growth in real and nominal terms has stagnated over the past three decades. As one of the first industrialised countries to grapple with population decline and enduring national debt levels well exceeding global norms, Japan has long been a laboratory for the adoption of unconventional economic policy.

It first adopted a zero-interest rate policy in the late 1990s as the country grappled with the continuing fallout from its earlier systemic financial crisis. Inflation remained absent despite the massive stimulus and the Bank of Japan (BoJ) introduced even more drastic measures. Yield curve control[1] was started by the BoJ in 2016 and first used by the US Federal Reserve Bank during the Second World War. The BoJ not only adopted negative short-term policy rates, but also managed 10-year government bond rates to be at 0%.

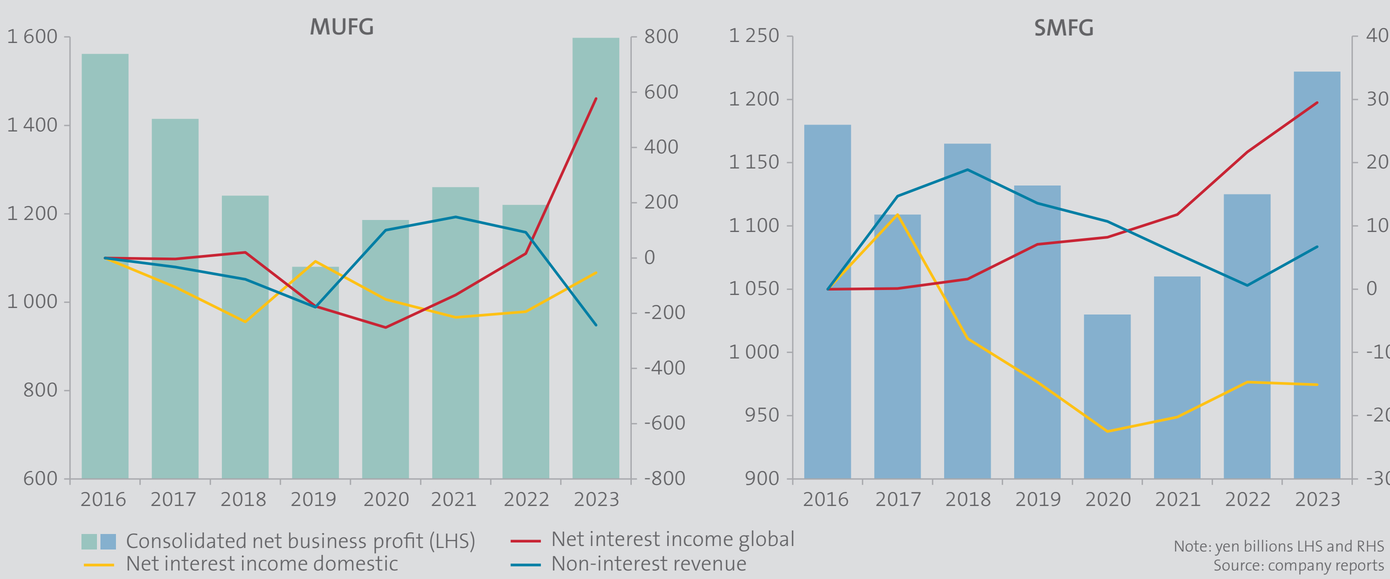
One way that banks generate profit is by borrowing (from customers) via lower cost, generally short-tenure liabilities such as deposits, and investing in higher-yielding assets like home loans, credit card debt and vehicle finance. They earn an interest rate spread between the loan and deposit rates (the net interest margin, or NIM) out of which they must absorb any credit losses. This is done while ensuring that no significant mismatches occur between the average duration of a bank's assets and liabilities. To the extent that the outstanding term of the assets do exceed that of the deposits, a term spread may also be earned.

The prevailing negative policy rates in Japan meant that Japanese banks were unable to make much interest rate spread, given that deposit rates cannot practically be lowered too far below zero and asset yields earned were little above zero. Additionally, they are effectively charged for the assets they are forced to retain with the Central Bank - earning below zero rates. Yield curve control of long rates also meant that term premiums were eroded.

Japanese banks earned very low profits during this time. The *charts below* show profitability metrics for two of the largest

[1] In an attempt to further stimulate an economy, the Central Bank purchases longer-term government bonds to reduce longer-term rates in the economy. Low long-term rates lower the cost of capital for longer-term investments.

Annual company profits and changes in specific income statement components (relative to 2016)



Note: yen billions LHS and RHS
Source: company reports

banks, Mitsubishi UFJ Financial Group (MUFG) and Sumitomo Mitsui Financial Group (SMFG). The bars demonstrate annual company profits, whereas the lines indicate the change in respective income statement line items per company, relative to 2016. Neither bank has managed to grow their domestic net interest income since the BoJ's policy changes in 2016. Business-related lending comprises roughly 70% of the domestic loan books of both banks. SMFG is more focused on retail customers and small to medium-sized businesses compared to MUFG.

A transitioning economy

The slight return of inflation over the past year has gradually seen the BoJ allow 10-year government bond rates to increase, while maintaining negative short-term rates. Early signs that this inflation may endure and perhaps increase towards BoJ targets have spurred expectations that a normalisation in monetary policy will see banks earn materially higher interest rate spreads. From a zero-rate starting point, assets will reprice higher far more than funding costs will rise. As interest rates gradually rise, the current significant gap that exists between the NIM generated by Japanese banks and foreign banks, should narrow. The *chart below* compares a selection of bank NIMs grouped by country.

In addition, higher economic activity should spur loan growth and generate higher bank non-interest revenues, due to more transactional activity on which fees are generated. These expected changes and very low starting bank share prices, have resulted in Japanese banks delivering strong capital gains over the past year.

Mind the turbulence

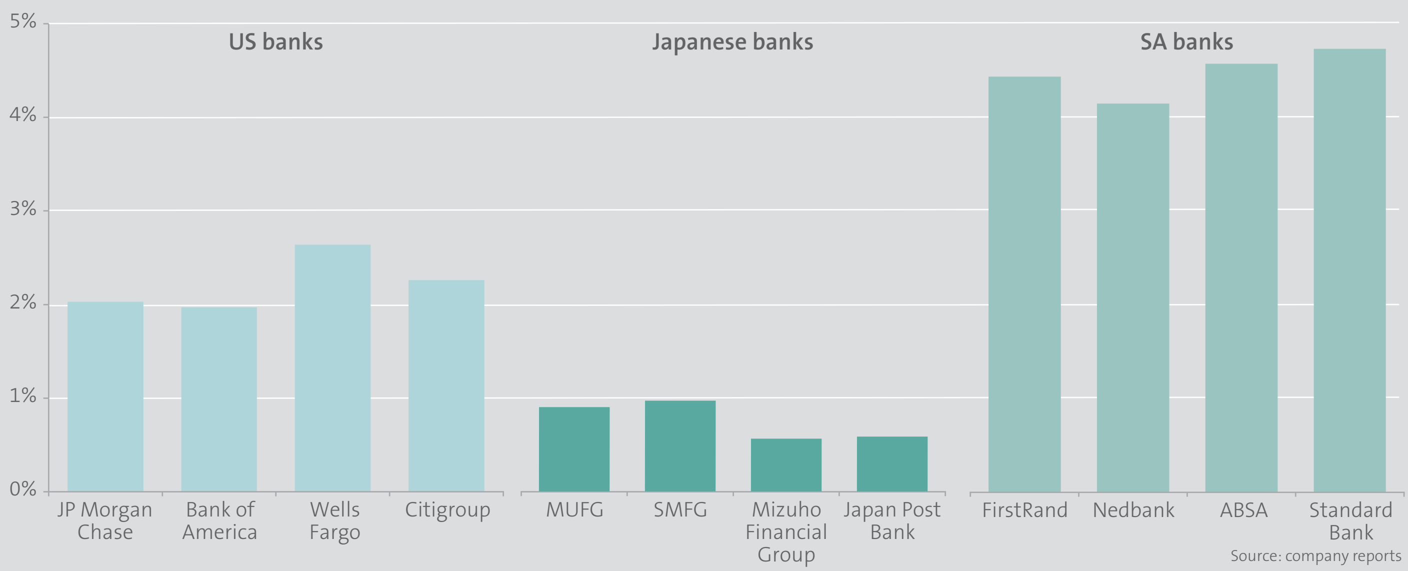
A faster growing Japan is positive, but higher Japanese interest rates will generate higher credit losses on bank loans as more borrowers come under financial pressure and default on repayments. We continue to closely monitor any evidence of emerging risk, which has not surfaced to date.

Improving returns and corporate governance

Corporate management teams in Japan are increasingly focused on generating returns that exceed their cost of capital and those of the banks are no exception. MUFG and SMFG are growing higher-return parts of their business, divesting from businesses that generate inadequate profits and returning excess levels of capital to shareholders via buybacks and increased dividend payout ratios. Cost efficiency also remains a focal point for both banks in pursuit of higher returns on capital.

Japanese banks have historically been very closely affiliated to related groups of companies. It was common for

A comparison of net interest margins for select US, Japanese and SA banks



Source: company reports

cross-shareholdings among companies to be maintained, led by a Japanese bank that provided financial services to the broader group. Depending on how these were structured, they were known as keiretsus or zaibatsus. For example, MUFG is considered one of the 'Three Great Houses' of the Mitsubishi Group, together with Mitsubishi Heavy Industries and Mitsubishi Corporation. These corporate relationships and the consequent friendly financing of related conglomerates often resulted in sub-optimal capital allocation decisions. With greater emphasis being placed on improving capital returns and free market behaviour, these investments are gradually being unwound, to the benefit of the bank shareholders.

Among the largest

Both SMFG and MUFG were formed through mergers of existing Japanese banks in the early 2000s. Their total assets place them within the world's fifteen largest banks. Their market share of Japanese domestic loans is approximately 10% each. Being large global megabanks, they offer the full range of traditional banking services, in addition to trust banking, brokerage, investment banking and asset and wealth management.

The proportion of SMFG's and MUFG's loan books in foreign countries has gradually increased over the past decade, now nearing 40% as they have tried to allocate capital to higher-yielding economies. Asia (excluding Japan) and the US are their largest foreign markets. Although its domestic asset base exceeds those they have in global markets, given the disparity in interest rates between Japan and the rest of the world, net interest income generated by MUFG outside of Japan in 2023 was 10 times higher than that generated in-country.

Both groups also own stakes in foreign financial services entities. These include MUFG owning 22% of Morgan Stanley and SMFG having a 5% stake in Jefferies.

A potential massive inflection in returns

A bank's performance is significantly impacted by monetary policy. As inflation returns to Japan and interest rates normalise somewhat, Japanese banks are well placed to generate substantially higher returns. The balance sheets of MUFG and SMFG are positioned to be able to positively navigate this significant change in economic environment and generate materially higher earnings in Japan in the years ahead. After substantial share price gains, these two banks continue to be modestly valued in relation to the cash flows they should generate in future years, and our clients remain invested. UP

Pepkor tilts the scales

Mohamed Mitha - Investment Analyst

"In South Africa's robust retail market, Pepkor stands out from competitors as the pre-eminent discounter. Armed with a strategic scale advantage and expansive operations, the group is positioned as a market leader in apparel, with considerable roots in other markets with growth opportunities. We delve into the key elements of Pepkor's success, its scale advantage, the iconic PEP and Ackermans formats and the significant cellular business."

Pepkor tilts the scales

The Pepkor empire comprises over 5 700 stores across various market segments (*charted below*) in South Africa and neighbouring countries - the most extensive of any local retailer. The Foschini Group (TFG) has the second largest South African store presence with 3 644 stores.

Virtuous cycle of discounting

Pepkor enjoys unrivalled sourcing power as the largest South African garment buyer and therefore procures items at significantly lower input prices than competitors - passing most of these savings on to customers, resulting in higher volumes sold. This virtuous cycle of low markups and high-volume sales has solidified Pepkor's position as the leading discounter in South Africa.

PEP talk

The benefit of Pepkor's scale advantage is most apparent in the flagship PEP chain. Stocking everyday replenishment items at very low prices allows PEP to cater to price-sensitive customers, mainly residing in townships and rural areas, where PEP is often the only formal apparel retailer available. PEP is the price leader in 95% of their products on offer, with a comparable competitor price gap of 25%. PEP sells in excess of 690 million products annually across their 2 590-plus stores.

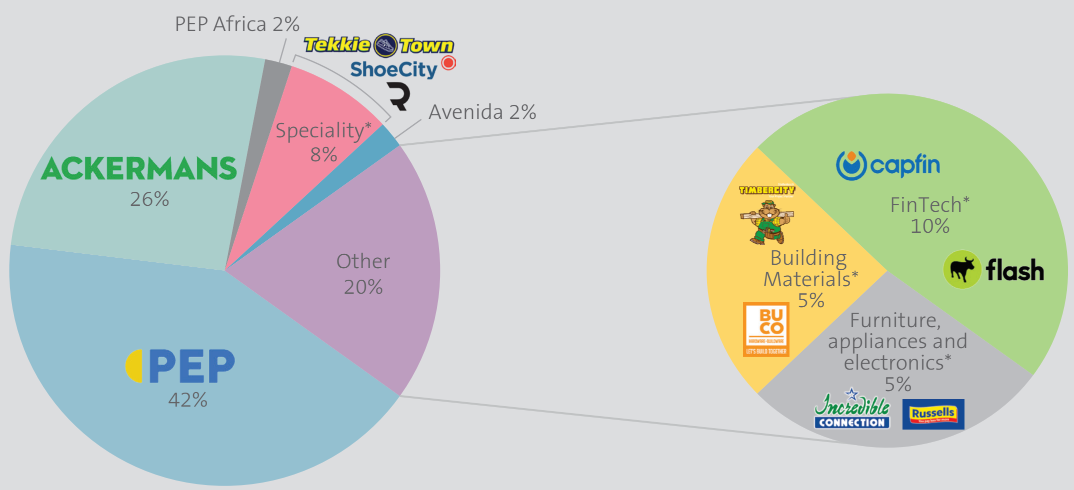
PEP's 'no frills' approach is characterised by simple store formats that allow for a straightforward shopping experience, with the emphasis on affordability. Stores are mainly located in close proximity to their core customer base or public transport hubs, supporting the concept of affordability as customers save on travel costs. These locations have low store rentals in line with PEP's low-cost operating model, boosting profitability for the group.

As *illustrated on the next page*, PEP has the biggest skew towards entry-level price points compared to competitors - 98% of their products are priced under R200, with an average price point of just R48. Loyalty for the PEP brand has enabled extensions into new formats such as PEP Home and PEP Cell, that have enjoyed quick and significant success and offer future growth potential.

Many of PEP's customers are government employees, who have strong job security and have seen above average wage increases over the last decade. It is estimated that half of PEP's customers earn less than R5 000 per month, with 40-50% of their customer base being social grant recipients, who similarly have reasonable income security, although at a very low level. PEP also has high exposure to informal economy participants, who are adaptable and resourceful in a tough economic climate.

While their customer base is reasonably resilient and PEP's product range of basic items at entry-level price points offers

Pepkor group operating profit split by business (2023)



*Speciality: Tekkie Town, Dunns, Refinery, Shoe City, CODE, SPCC | *FinTech: Financial services (Tenacity, Connect, Abacus, Capfin), Informal Markets (Flash) | *Building Materials: BUCO, Timbercity, Tiletoria, Floors Direct, MacNeil, Cachet, B-One, Buchel, W&B Hardware, Buildware, Citiwood, Brands 4 Africa | *Furniture, appliances and electronics: JD Home (Russells, Bradlows, Rochester, Sleepmasters), JD Tech (Incredible Connection, HiFi Corp)

Note: Ackermans and PEP figures are estimates

Source: Company data, Camissa Asset Management estimates customers some relief in tough economic times, the reality is that the lower-end consumer remains severely financially challenged at present due to high food and transport costs. We have seen the impact of this manifesting in lower-than-normal sales growth in recent PEP results, but we remain sanguine about the prospects for this highly cash-generative business as the consumer cycle begins to turn. Additionally, PEP benefits from consumers trading down when real incomes are squeezed.

The people's champ

As a group, Pepkor dominates the schoolwear market in South Africa, with 75% market share. A local PEP factory manufactures 11 million school garments annually and, consequently, a complete school uniform for a grade 1 child can be purchased at PEP for as little as R120. While schoolwear is a low margin business for PEP, the offering builds a loyal customer base and promotes store footfall with cross-product shopping opportunities. High sales volumes optimise revenues relative to its overhead costs (store rentals and employee costs) and enable PEP to benefit from holding stock only for short periods.

Unparalleled customer reach

Pepkor's extensive countrywide store footprint enables them to reach customer nodes that are inaccessible to other retailers. Coupled with a highly efficient distribution network, this has opened other opportunities for the group. PAXI, PEP's parcel delivery service (started in 2015), is an example of this. It offers the lowest courier fees in South Africa for consumers and small businesses and there are currently over 2 800 PAXI points located in all PEP, Tekkie Town and Shoe City stores across the country. This service uses the existing infrastructure of the group and therefore comes with little incremental costs to Pepkor.

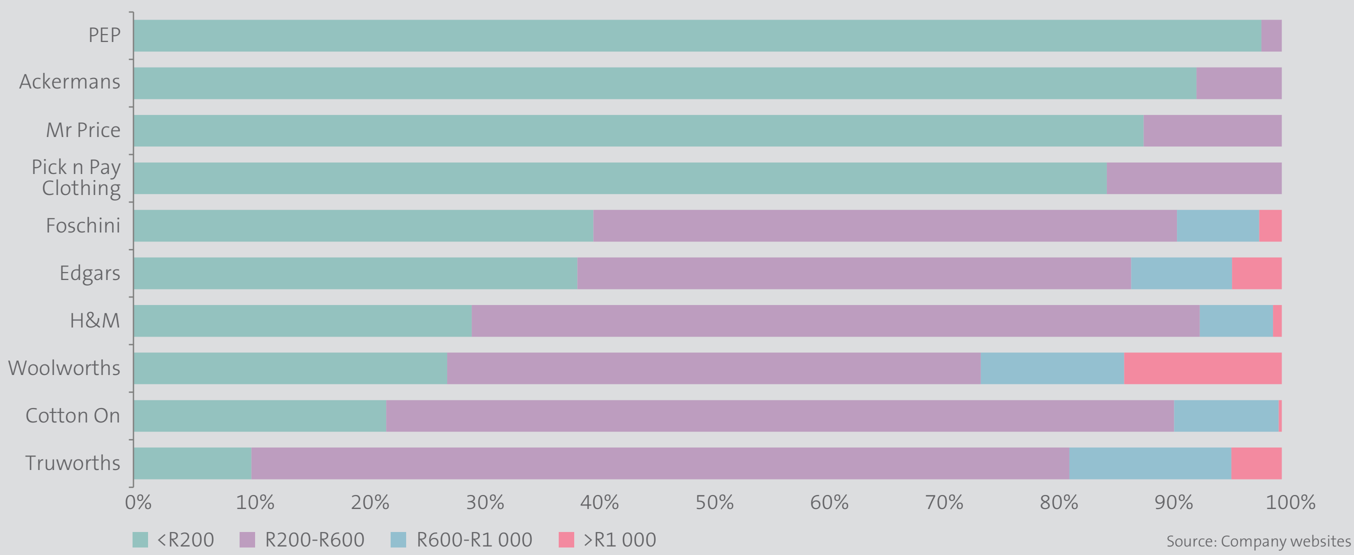
PAXI's growth since inception has been steady and, in 2023, it completed just under five million deliveries, with 24 000 businesses making use of the services. While this is a relatively small contributor to group profit at present, it is proving advantageous by boosting store footfall and strengthening overall customer brand loyalty.

Cellular sales soar

Notably, Pepkor is the largest distributor of cellular phones in South Africa, selling an average of one million prepaid handsets per month alongside a staggering 50 million SIM cards per year. This line of business accounts for approximately 20% of group earnings. Currently, Pepkor sells the equivalent of 70% of all prepaid handsets in the country, 57% of which are now smartphones.

Pepkor's far-reaching store footprint enables network providers to effectively reach the market for cellular phones and SIM cards,

Pricing profile of apparel retailers (January 2024)



Source: Company websites

Pepkor tilts the scales

making Pepkor an obvious partner of choice. Each handset is sold with an associated SIM card on behalf of a network provider. While the handsets generate a relatively low margin, most of the income derived from this arrangement is through recurring revenue. For each SIM card that Pepkor registers on behalf of the network providers, they earn a percentage of the airtime loaded throughout the active life of the SIM card, irrespective of where the airtime purchase is made. In future, we see Pepkor benefiting from the ongoing migration to smartphones and the associated increase in data spend that this brings.

Ackermans - beyond basics

Together with PEP, the Ackermans chain forms the heart of the Pepkor stable. These brands sell one in every two kidswear garments purchased in South Africa and two out of every three baby garments. Maintaining a strong commitment to value, Ackermans attracts and caters to a slightly more affluent customer base than PEP, with their stores mainly located in malls.

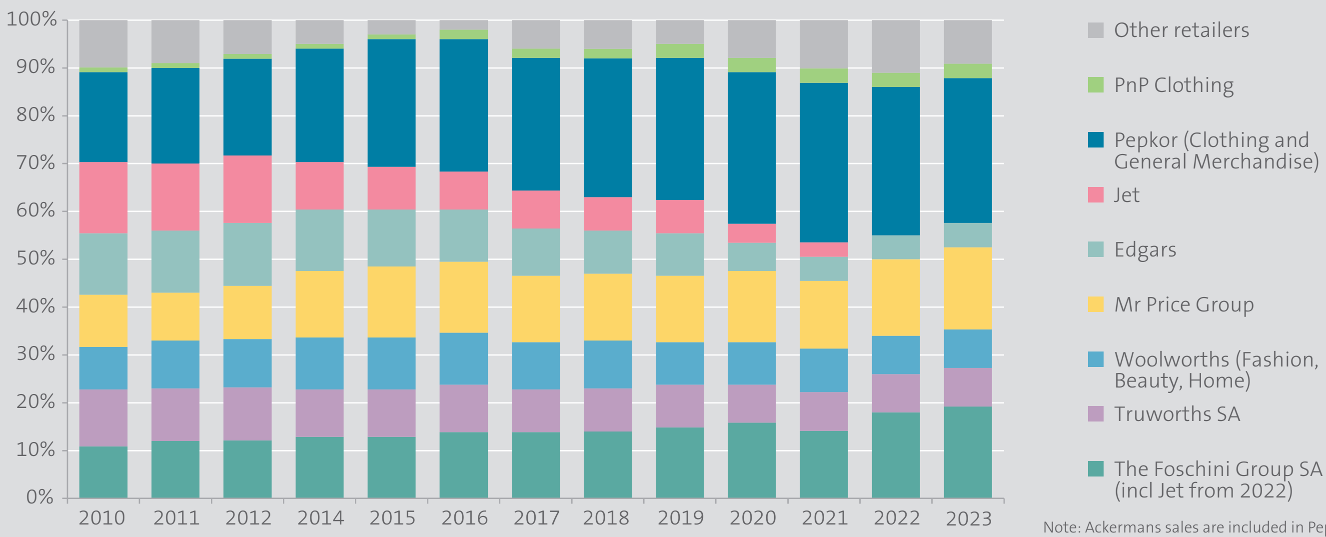
In the period since 2007, the Edcon group (mainly Edgars and Jet) - then the largest local retailer - performed very poorly and shed significant market share to its competitors. The weakened competition allowed Ackermans to gain meaningful market share (*shown below* from 2010) from Edcon's chain of Jet stores where they competed head-on in key categories including kidswear. Edcon's constrained access to capital under private equity ownership enabled Ackermans to secure prime retail locations and make strategic expansions with reduced competitive pressure. Today, Ackermans is the leading kidswear retailer in the country, with more than 900 stores.

With Jet falling under The Foschini Group umbrella since 2020, access to capital has no longer been a concern and they have returned as a far stronger competitor to Ackermans despite their smaller store base of 450. While we certainly acknowledge the heightened competition facing Ackermans, we remain positive about their growth prospects and they continue to be the dominant retailer in kidswear and infant clothing, with a strong store presence and brand affiliation as a leading value player in the market.

Discounted discounter

Pepkor's core offering is relatively defensive and benefits hugely from their unrivalled customer reach and scale. We anticipate growth from the newer segments within the group and a consumer that benefits from lower expected inflation. Additionally, Pepkor's recent Avenida acquisition in Brazil is still small but is growing rapidly and offers interesting and potentially material optionality. All this is not adequately represented in Pepkor's share price and our clients are therefore exposed to this upside potential. UP

Apparel retailers market share



Note: Ackermans sales are included in Pepkor
Source: Company data, RMB Morgan Stanley research

Wrapped up for future returns

Dirk van Vlaanderen - Portfolio Manager

"Clay, papyrus and wood were used in some of the earliest forms of packaging, but the advent of more modern formats such as paper, glass and plastics have resulted in a global industry with annual revenues currently estimated at $1.1 trillion. Packaging is a vital component of the consumer and industrial product value chain and should continue to deliver good growth in tandem with the ongoing global demand for goods."

Wrapped up for future returns

We discuss three South African small-cap packaging companies, namely Bowler Metcalf, Transpaco and MPact. These businesses have excellent management teams, niche product portfolios and enduring track records of generating strong cash flows and returns for shareholders. All three have navigated several challenging years for the South African manufacturing sector, emerging stronger and well-positioned to continue delivering good shareholder returns.

Bowler Metcalf

Bowler Metcalf (Bowler) began operations in 1972 and listed on the JSE in 1987. They grew organically and acquired businesses in the plastic packaging industry over the years. Their focus on niche, customised production (mainly for personal care and pharmaceutical customers) and smaller batch runs allowed the company to enjoy profit margins higher than its more commoditised competitors.

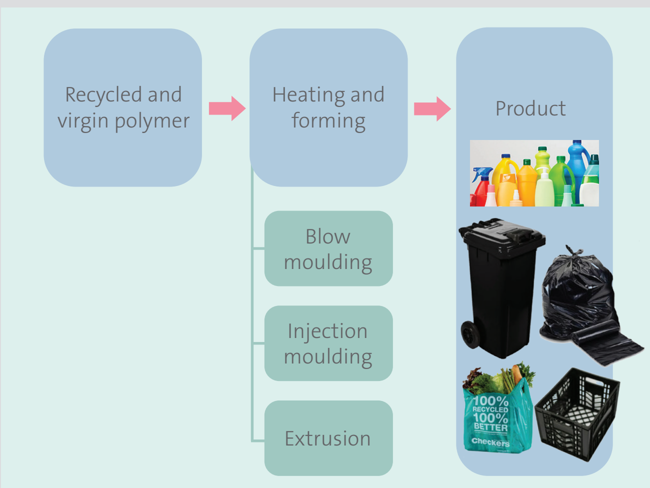
For many years, Bowler was also a large shareholder in the Quality Beverages business, which operated and grew the successful "Jive" soft drink brand in the Western Cape. Bowler supplied plastic bottles to this business and was therefore one of the early vertically integrated soft drink bottlers in the country. After the merger of Quality Beverages with Durban-based, Shoreline, to form SoftBev in 2014 - Bowler sold this beverages investment in 2018. A portion of the resulting R400 million-plus windfall was returned to shareholders and the business retained a large sum for investment into the plastics division.

Plastics unwrapped

Plastic packaging is produced by heating different recycled or virgin polymers such as polyethylene terephthalate (PET) or high-density polyethylene (HDPE) to a molten form and then shaping the molten plastic using various moulding techniques (*left chart below*):

- **Blow moulding** creates hollow shapes with thin walls (ie beverage bottles and home and personal care containers). Compressed gas blows the molten polymer against the sides of the mould, where it cools before being released. Bowler mainly produces blow moulded packaging products.
- **Injection moulding** inserts molten polymer into a mould cavity, where it cools and conforms to the shape of the mould. This is commonly used for thicker, more rigid plastic products such as crates, wheelie bins and bottle closures.
- **Extrusion** is a process used to form continuous, uniform plastic shapes. Molten polymers are extruded into a roll of plastic that can then be pushed through a mould to form pipes or gutters, or stretched to produce a thin film used to make plastic bags.

Plastic packaging manufacturing process



Mpact's paper value chain

Source: Camissa Asset Management

The South African plastic packaging manufacturing industry has struggled in recent years, with very high polymer prices impacting profitability. Shipping constraints and port congestions have negatively impacted the availability of key raw materials, adding further stress to supply chains. In addition, loadshedding has been devastating for the energy intensive process of heating and moulding plastic. Sudden process interruptions are particularly negative as cooled plastic needs to be removed from moulds, which consumes substantial time and incurs additional costs. Loadshedding has also impacted customers' ability to manufacture consistently, making demand planning for packaging products unpredictable.

As *charted below*, challenges faced by the plastic packaging industry are evident in the reduction in Bowler's profit margins. The business has responded by reconfiguring its operating model to accommodate unstable electricity supply and installing solar and other back-up power sources where needed. Positively, following several years of disruptions, Bowler is again growing and is investing in new capacity to service suppliers to the informal market in South Africa where high growth is evident.

Transpaco

Transpaco has been listed on the JSE for 36 years and has also grown organically and through acquisition. Today, it houses several businesses that manufacture and distribute plastic and paper packing products, predominantly in South Africa.

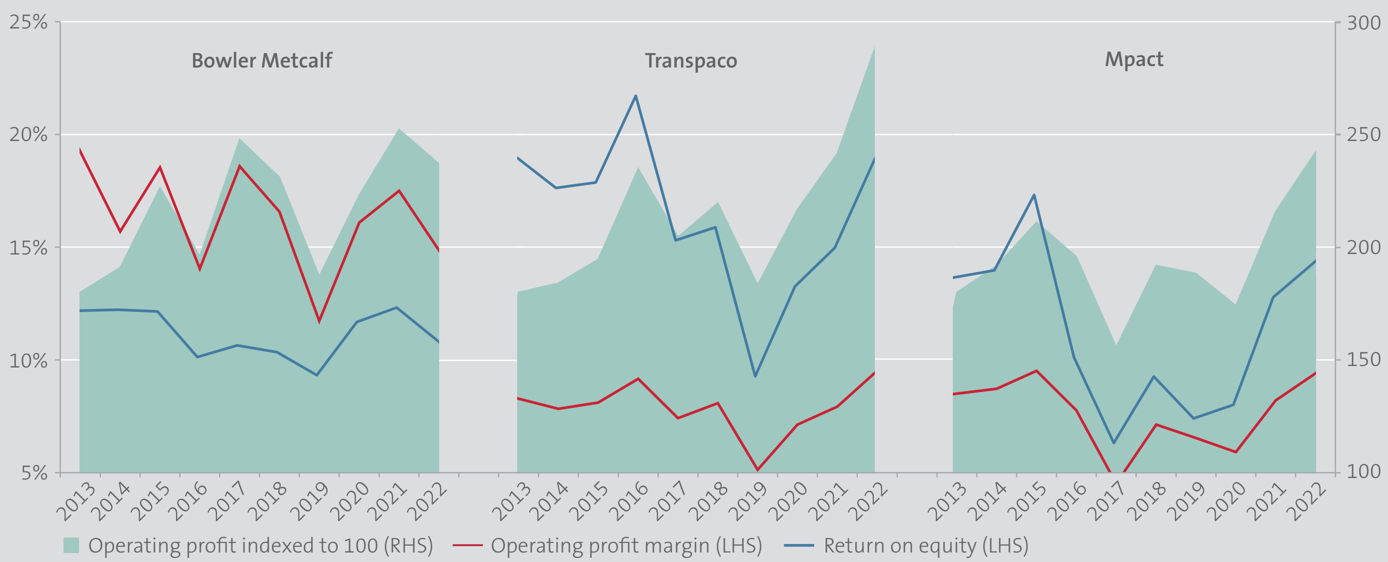
The majority (53% of revenue) of plastic products are produced via extrusion. Products are manufactured across the following divisions:

- **East Rand Plastics** was acquired in 2015 and is the market leader in the production of black refuse bags under the 'Garbie' brand and other house brands for various retailers.
- **Specialised Films** produce various grades of plastic film used predominantly for pallet wrap.
- **Flexibles** is the largest producer of retailer shopping bags in South Africa and also produces a range of school stationery.

The paper division contributes 47% to revenues and consists of:

- **Cores and Tubes** that was acquired from Nampak in 2010 and manufactures tubular cardboard cores, dividers and various products used in the wine, paper and other industries.
- **Britepack** produces high quality printed folded cartons and inserts mainly used in the pharmaceutical industry.

Profitability and return metrics for packaging companies



Source: company reports, Camissa Asset Management

Wrapped up for future returns

- **Packaging** supplies and distributes a full range of stationery, servicing a broad range of the local economy. This is a lower margin business, yet it has a very low capital requirement, which allows it to generate a good return on capital.

Transpaco is a very well-run business. CEO (and significant shareholder) Phil Abelheim has stood at the helm since 1977, establishing himself as a good operator and a shrewd capital allocator. There is a strong focus on key operational metrics including cash generation and return on capital, which has resulted in Transpaco delivering very good profit growth (*middle chart previous page*), with return on equity (ROE) trending back to 20% and regular dividend payments to shareholders.

MPact

MPact was unbundled from Mondi and separately listed on the JSE in July 2011. It is a vertically integrated recycled containerboard (paper division) and plastic packaging manufacturer. The integration of recycling, paper manufacturing and paper packaging production is a key competitive advantage in capturing the whole margin across the value chain - ensuring consistent supply at the best price. Mpact's contribution to the circular economy in South Africa highlights that what is good for the environment can also be good for business.

The paper division generates 65% of business revenue and consists of three segments (*right chart previous page*):

- **Recycling** - Mpact is the largest recycler in the country and collected 716 tonnes of recyclables in 2022 (83% paper, 6% plastic and 11% other). MPact collects paper surplus for its raw material needs and sells the rest to external customers.
- **Paper making** - Out of its three mills in Felixton (KZN), Springs (Gauteng) and Mkhondo (Mpumalanga), the business produces a range of paper and board from recycled and virgin (tree) fibre. Paper is made by adding water, chemicals and heat to create a pulp before being dried and turned into rolls of paper. Mpact uses around 25% of its paper products internally for conversion into packaging products and sells the rest outside of the group.
- **Converting** - Paper and board is converted into a range of corrugated and other paper packaging products. Mpact has a particularly high share of the boxes used in the agricultural market.

The plastics division constitutes 35% of revenue and consists of three main businesses:

- **Bins and Crates**, where MPact produces injection moulded packaging that includes wheelie bins and bins for the agricultural market, plastic pallets and crates used by retailers and beverage companies.
- **Fast Moving Consumer Goods** produces injection and blow moulded rigid plastic packaging such as bottles, jars and containers for food, beverage and home and personal care companies.
- **PET Preforms and Closures** manufactures plastic bottle tops and PET pre-forms for bottles and jars.

Since unbundling in 2011, Mpact has consistently invested in its asset base to provide capacity for growth and to improve underlying operating efficiency. It has recently embarked on a significant capital expansion plan, investing in:

- low-cost capacity in the bins and crates division;
- increased paper capacity at its flagship Felixton mill; and
- a project to produce specialised virgin paper out of its Mkhondo mill to meet the packaging deficit expected from the increase in fruit export volumes.

These investments in niche growth markets will depress cash flow in the short term but should yield good returns thereafter. As indicated in the chart, Mpact has delivered good growth and profitability over the past decade, with return on equity currently at a healthy 15% pa.

Wrapped up for future returns

The three businesses discussed have long track records of delivering excellent returns to shareholders. Their solid management teams have successfully navigated the most difficult of operating conditions in the past four years. Current share prices do not adequately reflect the quality of their business models and the future cash flows we expect them to deliver. We therefore hold all three companies in our client portfolios. UP

Clicks and its enduring competitive edge

Ntokozo Magagula - Associate Analyst

Over the past two decades, Clicks has strategically evolved from a beauty and wellness outlet to the only fully vertically integrated health, beauty and wellness retailer in South Africa. Since the 2003 amendment to the Pharmacy Act, Clicks has amassed significant market share in pharmacy, with a widespread national footprint of 711 pharmacies from its 950 retail outlets. We explore Clicks' competitive advantages and growth ambitions through further expansion of the store base.

Clicks and its enduring competitive edge

Corporate retail pharmacies rise

Prior to 2003, only licensed pharmacists were allowed to own pharmacies in South Africa. This resulted in a fragmented industry comprising many small, independent pharmacies. Legislation passed in 2003, aimed at providing more affordable medicines with a wider access to the public, allowed for corporate ownership of retail pharmacies. With greater access to capital and massive economies of scale owing to the centralising of many functions (eg procurement, landlord relationships, marketing, loyalty schemes and IT systems), corporate-owned pharmacies have grown substantially and now constitute 53% of the market. As *shown below*, the main beneficiaries, Clicks and Dis-Chem, account for around 48% of domestic pharmacy revenue.

The Clicks growth path

Clicks began incorporating a pharmacy offering through the acquisition of Link Pharmacies in 2003. Growth has since been exponential and the current 24% market share has been attained through acquisitions of independents, the buying of hospital pharmacies and the opening of new pharmacies - resulting in the in-store pharmacies now making up 80% of Clicks-branded stores.

Complementary Clicks business divisions

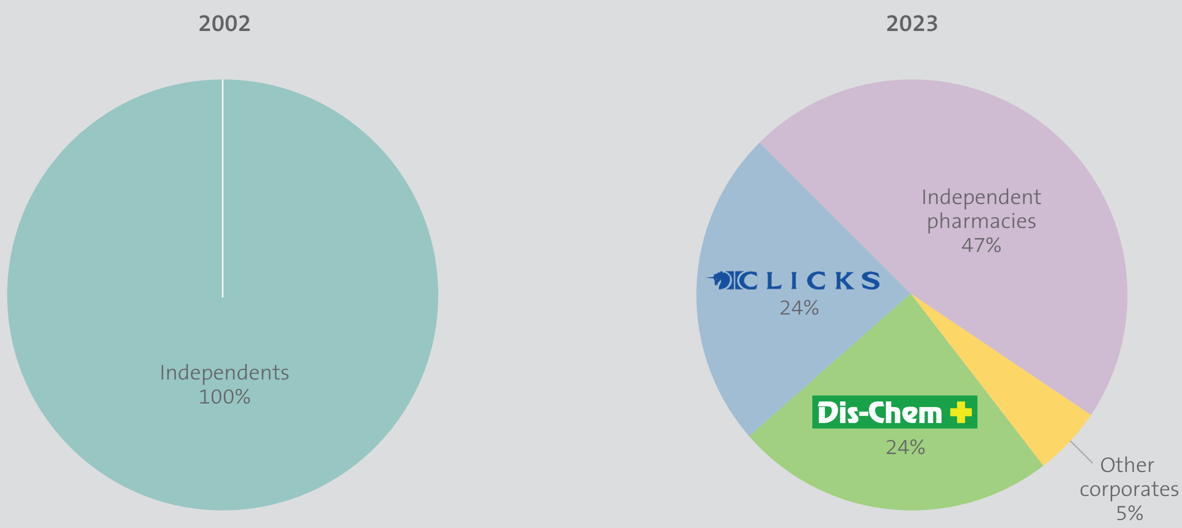
Clicks consists of the retail division and the pharmaceutical wholesale and distribution division. Currently, retail accounts for 65% of business revenue and is further divided into two segments - pharmacy and front shop. Front shop sells product categories such as beauty and personal care, and general merchandise.

Clicks and Dis-Chem achieve far larger contributions to revenue from the non-pharmacy front shop sales than the independent pharmacies do - as *charted on the next page*. Clicks' largest front shop segment, beauty and personal care, enjoys huge procurement scale benefits and thus negotiates very favourable terms with suppliers. This allows Clicks to consistently offer competitively low prices and attractive promotions to customers.

Pharmacists generate income by charging a fee on medicines dispensed, which is a function of medicine pricing and is determined by the regulator. Dispensing fees have, however, been driven lower due to the increased availability of, and demand for, generic medicines. Generics are priced significantly lower than the original medicine and now constitute the majority of medicines dispensed.

To combat the effects of these declining revenues, in 2011 Clicks established its own generic medicine importer to exclusively supply its retail stores: Unicorn Pharmaceuticals. Unicorn products make up 11% of Clicks pharmacy sales but 13.3% of pharmacy volumes and, by our estimation, 19% of overall group pharmacy profits.

Pharmacy market share split



Source: Company reports, Camissa Asset Management

The ability to source affordable generics coupled with the high levels of profitable front shop sales makes it difficult for independents to compete with Clicks. Furthermore, the low corporate pharmacy dispensing fees are favoured by major medical aid schemes looking to reduce costs. Clicks and Dis-Chem are therefore preferred suppliers over independent pharmacies by these large healthcare funders.

Healthy positioning but not immune to competition

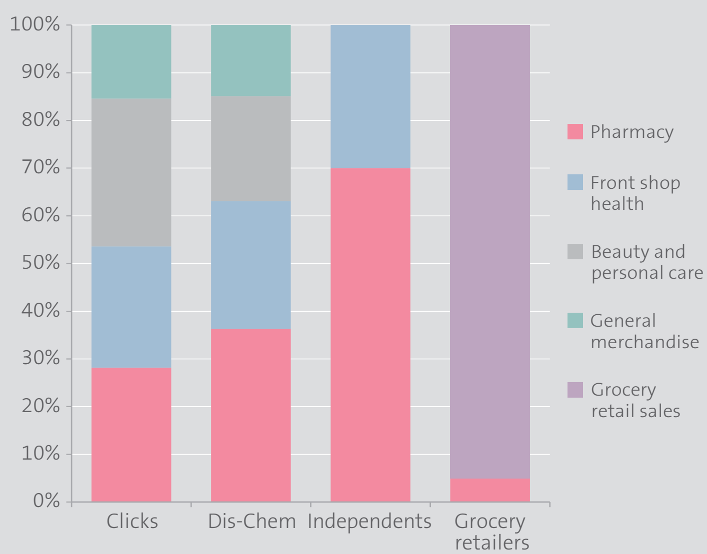
While Clicks and Dis-Chem currently dominate the corporate pharmacy market in South Africa, grocery retailers such as Shoprite (with Medirite) and Spar (Pharmacy at Spar) are fast becoming competitors through their growing in-store pharmacy offerings. Pick n Pay sold its 25 pharmacies to Clicks in 2021 to focus on its core grocery business. What differentiates grocery retailers from independents is that they have sufficient scale to compete with Clicks in the front shop domain and can achieve many of the other competitive advantages of centralising shared functions. The pharmacy category is currently an insignificant revenue contributor for the grocery retailers, but it presents an area they are actively looking to grow.

More for less

Promotional activity remains a key sales strategy for Clicks' front shop. The Clicks Clubcard, with more than 10 million active members, is currently the largest and longest-running loyalty rewards programme in South Africa. These members generate up to 80% of Clicks sales. The Clubcard attracts customers into stores via its discounts and its effective communication of special offers.

Additionally, Clicks increases the profitability of their front shop through their extensive offering of private label products, which also provides further value to customers. It sources and produces these at a lower cost than comparable branded products. This currently makes up 30% of front shop sales - the highest private label retail contribution in South Africa (Dis-Chem is at 20%).

Revenue split per category contributions



Source: Company reports, Camissa Asset Management

South African medicine pricing

The entire pharmaceutical value chain is regulated by the Medicines and Related Substances Act. Key issues governed by this Act include the issuing of pharmacy licences, the registration of new medicines and the pricing of scheduled medicines. The Act also prescribes the Single Exit Price (SEP) for scheduled medicines. The SEP considers the following pricing elements:

- the manufacture price, which is the proposed price by the manufacturer or importer of the scheduled medicines, and is reviewed and approved by the Department of Health;
- the logistics fee, which is payable to wholesalers, distributors and manufacturers for the processing and distribution of medicines to dispensing authorities; and
- Value Added Tax (VAT).

These components add up to the fixed price at which the medicines may be sold. Pharmacists and dispensing officials may additionally charge a regulated dispensing fee. This is calculated as a percentage of the SEP and is endorsed by the Department of Health. The price that the consumer ultimately pays is the combination of the SEP and the dispensing fee.

A sophisticated distribution network

As *illustrated on the next page*, Clicks participates in a large portion of the pharmacy value chain and therefore generates profits at many stages. This is a key differentiator and competitive advantage.

United Pharmaceutical Distributors (UPD) is the pharmaceutical wholesale and bulk distribution business owned by Clicks, that caters to Clicks' value chain. It is responsible for transferring pharmaceutical goods from product manufacturers through to distributors, wholesalers and retailers.

Clicks and its enduring competitive edge

The wholesale chain is further segmented based on ownership of inventory. ‘Pre-wholesalers’ take ownership of medicines and break-pack large quantities into appropriate amounts for individual pharmacies, whereas ‘fine wholesalers’ transport product from manufacturer to retailer without taking ownership. The pre-wholesale process garners higher fees as more infrastructure is required to hold and process medicines. Wholesale and distribution are low margin, capital intensive and competitive operations, but perform a strategically important function for the Clicks retail business. Through UPD, Clicks participates in both segments of wholesale activities. This results in superior profitability, relative to its corporate competitors.

Continued growth

With a vertically integrated business and impressive expanding store footprint of 950 retail outlets, Clicks (and its corporate competitors) continue to take market share from independents. In developed markets, corporate pharmacies typically make up 60-70% of the market, while in South Africa they are currently at 50%. This may indicate that there is further market share available to Clicks over the medium to long term, despite increased corporate pharmacy competition.

The thorn in Unicorn

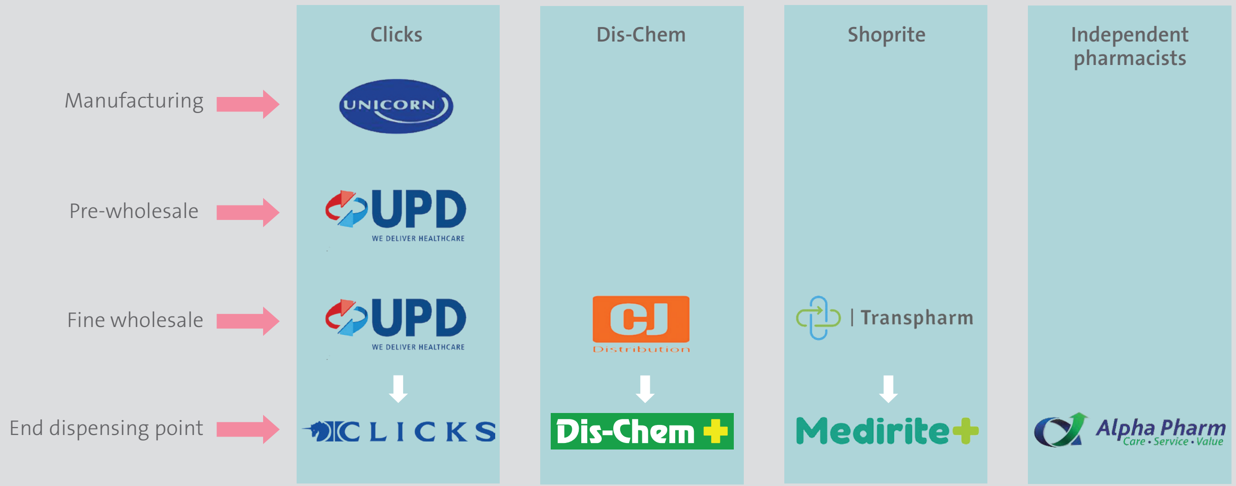
Unicorn Pharmaceuticals has been the subject of a seven-year legal battle with the Independent Community Pharmacy Association (ICPA), based on the law that states that a retail pharmacy cannot also manufacture its own medicines. The ICPA believes that the ownership of Unicorn constitutes a conflict of interest for Clicks as their pharmacists may be incentivised to recommend Unicorn generics to customers above other options. This may be against the best interests of customers in pursuit of greater profits for Clicks.

The South African Constitutional Court’s recent ruling in favour of the ICPA, sets out that Clicks is yet to reach a resolution with the Department of Health to resolve the inherent conflict. While the matter remains unresolved, Clicks is unable to obtain any new pharmacy licenses before they resolve this issue, hampering their growth ambitions. Potential recourse may be to strategically divest their majority shareholding in Unicorn, which is likely to negatively impact profitability.

A bright future despite the challenges

Clicks has successfully delivered consistently strong profit growth over the past two decades. With its aggressive growth ambitions to open over 200 new stores in the medium term and expand its in-store private label brand offering, there remains plenty of opportunity for expansion. With an outstanding management team and proven execution capability, we believe Clicks will continue to thrive, albeit with heightened competition and the Unicorn challenge to deal with. Unfortunately, we believe all these factors are more than priced into the current Clicks share price, which is very high. UP

Clicks value chain vs competitors



Source: Company reports, Camissa Asset Management

Camissa Asset Management Funds

Performance to 31 December 2023	1 year	3 years[1]	5 years[1]	10 years[1]	15 years[1]	Since launch[1]	Launch	TER[2]	TC[3]
Unit trust funds[4]									
Equity Alpha Fund	4.0%	11.4%	12.0%	8.2%	12.1%	14.9%	Apr-04	1.77%	0.35%
SA Equity General funds mean	7.4%	12.0%	9.2%	6.2%	9.8%	11.6%			
Outperformance	-3.4%	-0.6%	2.8%	2.0%	2.3%	3.3%			
SA Equity Fund#	2.5%	-	-	-	-	4.0%	Sep-22	1.52%	0.36%
SA Equity General funds mean	7.4%					10.5%			
Outperformance	-4.9%					-6.5%			
Global Equity Feeder Fund	28.2%	9.0%	-	-	-	8.0%	Nov-19	1.94%	0.20%
FTSE World Index	33.1%	15.5%				15.5%			
Outperformance	-4.9%	-6.5%				-7.5%			
Balanced Fund	12.8%	10.8%	10.5%	7.9%	-	9.2%	May-11	1.51%	0.27%
SA Multi Asset High Equity funds mean	12.2%	10.3%	9.1%	7.0%		8.4%			
Outperformance	0.6%	0.5%	1.4%	0.9%		0.8%			
Protector Fund	9.5%	10.3%	9.5%	7.7%	8.2%	9.6%	Dec-02	1.56%	0.21%
CPI + 4%	9.1%	10.0%	9.0%	9.6%	9.8%	10.2%			
Outperformance	0.4%	0.3%	0.5%	-1.9%	-1.6%	-0.6%			
Stable Fund	7.2%	12.1%	8.8%	8.1%	-	8.4%	May-11	1.47%	0.28%
CPI + 2%	7.1%	8.0%	7.0%	6.5%		6.2%			
Outperformance	0.1%	4.1%	1.8%	1.6%		2.2%			
Institutional funds[5]									
Managed Equity Fund	3.8%	12.5%	12.4%	7.9%	12.1%	11.2%	Sep-06		
FTSE/JSE Capped SWIX Index	7.9%	12.7%	9.4%	7.7%	11.8%	10.7%			
Outperformance	-4.1%	-0.2%	3.0%	0.2%	0.3%	0.5%			
Domestic Balanced Fund	5.4%	12.2%	11.5%	8.1%	10.6%	9.0%	May-07		
Peer median[6]	8.1%	11.9%	9.0%	7.4%	10.5%	8.9%			
Outperformance	-2.7%	0.3%	2.5%	0.7%	0.1%	0.1%			
Global Balanced Fund	14.2%	12.3%	12.0%	9.2%	-	10.2%	Jul-13		
Peer median[7]	13.4%	12.0%	10.4%	8.4%		9.4%			
Outperformance	0.8%	0.3%	1.6%	0.8%		0.8%			
Bond Fund	8.3%	8.4%	8.5%	8.3%	8.3%	8.4%	May-07		
BESA All Bond Index	9.7%	7.4%	8.2%	8.0%	7.9%	8.1%			
Outperformance	-1.4%	1.0%	0.3%	0.3%	0.4%	0.3%			
Money Market Fund	9.6%	7.5%	7.5%	7.7%	7.3%	7.8%	Jan-04		
Alexander Forbes STeFI Composite Index	8.1%	5.7%	5.9%	6.4%	6.4%	7.0%			
Outperformance	1.5%	1.8%	1.4%	1.3%	0.9%	0.8%			
Shariah unit trust funds[4]									
Islamic Equity Fund	5.1%	11.7%	10.2%	7.9%	-	10.7%	Jul-09	1.50%	0.18%
SA Equity General funds mean	7.4%	12.0%	9.2%	6.2%		9.9%			
Outperformance	-2.3%	-0.3%	1.0%	1.7%		0.8%			
Islamic Global Equity Feeder Fund	19.6%	7.9%	-	-	-	9.4%	Jan-19	1.85%	0.11%
Global Equity General funds mean	30.4%	10.8%				15.0%			
Outperformance	-10.8%	-2.9%				-5.6%			
Islamic Balanced Fund	6.9%	10.4%	9.9%	7.4%	-	7.8%	May-11	1.50%	0.12%
SA Multi Asset High Equity funds mean	12.2%	10.3%	9.1%	7.0%		8.4%			
Outperformance	-5.3%	0.1%	0.8%	0.4%		-0.6%			
Islamic High Yield Fund	6.6%	7.6%	-	-	-	7.2%	Mar-19	0.59%	0.04%
Short-term Fixed Interest Index (STeFI)	8.1%	5.7%				5.9%			
Outperformance	-1.5%	1.9%				1.3%			

Highest and lowest monthly fund performance	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low
Equity Alpha Fund	10.1%	-5.4%	11.7%	-5.4%	12.6%	-21.6%	12.6%	-21.6%	12.6%	-21.6%	12.6%	-21.6%
SA Equity Fund	9.9%	-5.9%	-	-	-	-	-	-	-	-	11.5%	-5.9%
Global Equity Feeder Fund	14.5%	-7.0%	14.5%	-8.2%	-	-	-	-	-	-	18.1%	-15.6%
Balanced Fund	9.5%	-3.8%	9.5%	-4.5%	9.5%	-15.7%	9.5%	-15.7%	-	-	9.5%	-15.7%
Protector Fund	7.6%	-3.0%	7.6%	-3.7%	7.6%	-13.9%	7.6%	-13.9%	7.8%	-13.9%	9.5%	-13.9%
Stable Fund	7.1%	-4.4%	7.1%	-4.4%	7.1%	-11.4%	7.1%	-11.4%	-	-	7.1%	-11.4%
Islamic Equity Fund	7.4%	-5.7%	7.4%	-8.9%	9.6%	-14.3%	9.6%	-14.3%	9.6%	-14.3%	9.6%	-14.3%
Islamic Global Equity Feeder Fund	10.2%	-7.8%	10.6%	-7.8%	-	-	-	-	-	-	14.6%	-8.4%
Islamic Balanced Fund	5.3%	-4.1%	5.3%	-6.2%	8.0%	-9.3%	8.0%	-9.3%	-	-	8.2%	-9.3%
Islamic High Yield Fund	1.6%	-0.4%	1.8%	-1.2%	-	-	-	-	-	-	2.7%	-2.4%

Footnotes and disclaimer follow overleaf.

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Footnote: [1]Annualised (ie the average annual return over the given time period); [2]TER (total expense ratio) = % of average NAV of portfolio incurred as charges, levies and fees in the management of the portfolio for the rolling three-year period to 31 December 2023; #over 12 months to 31 December 2023. [3]Transaction costs (TC) are unavoidable costs incurred in administering the financial products offered by Camissa Collective Investments and impact financial product returns. It should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of financial product, the investment decisions of the investment manager and the TER. This is also calculated on the rolling three-year period to 31 December 2023 # over 12 months to 31 December 2023. [4]Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [5]Source: Camissa 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.