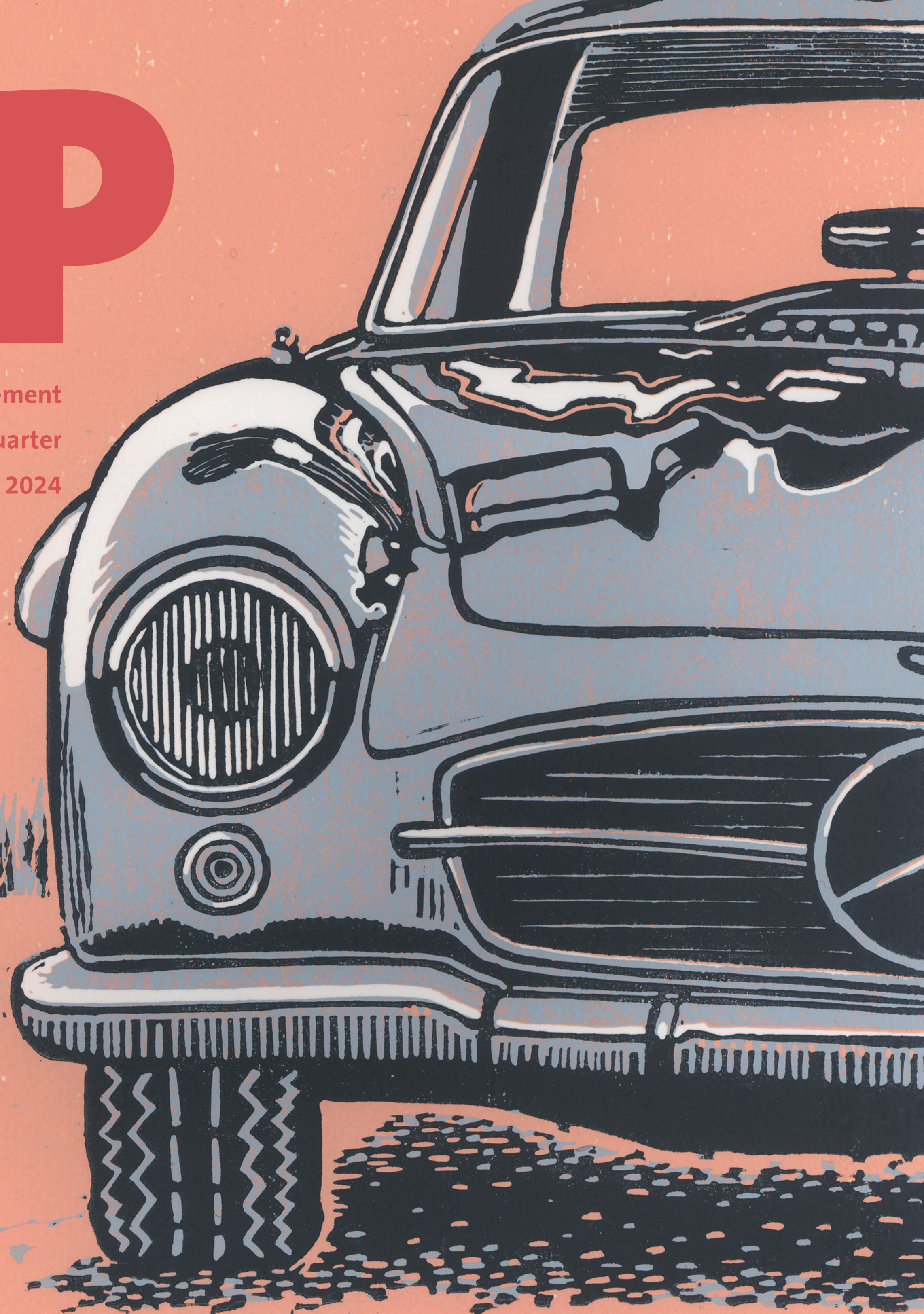
UP

Camissa Asset Management

Second Quarter

2024



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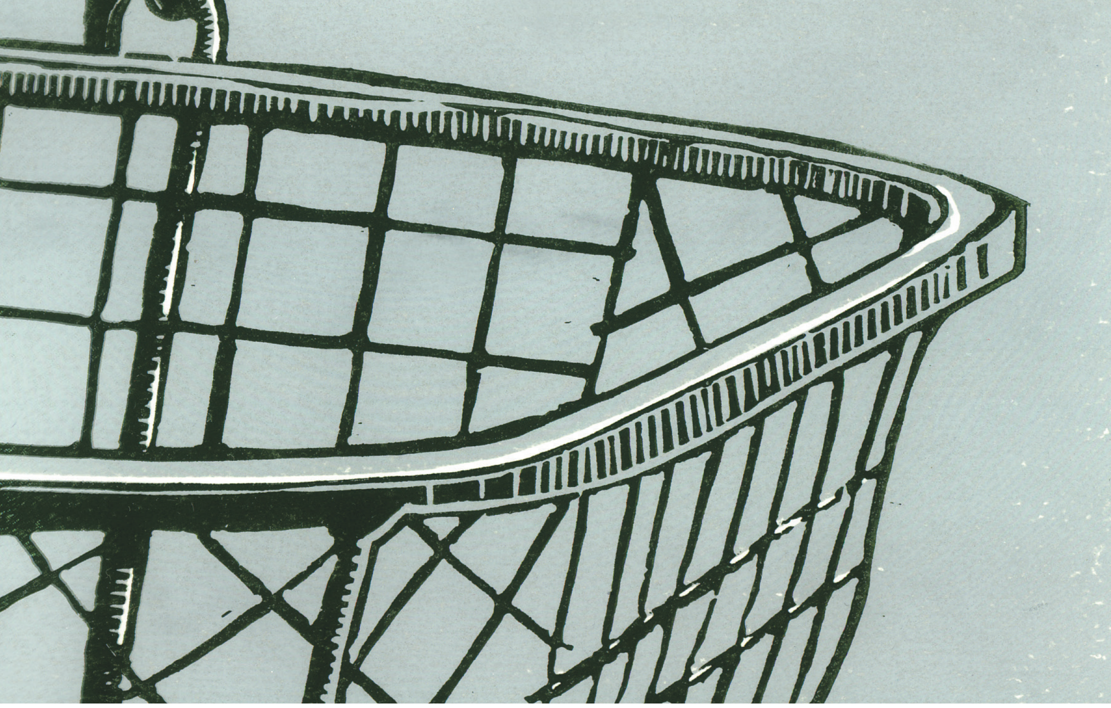


SPAR: gritty comeback in store

Mohamed Mitha - Investment Analyst

"SPAR has been a key player in the South African retail landscape since 1963, known for its shopping convenience, quality products and community-focused stores. With around 2 000 grocery and liquor stores nationwide, they have the second-largest customer reach among South African food retailers. Historically a consistent compounder of earnings, SPAR has hit troubled times - the dynamics of which we explore by looking at their distinctive business model, offshore ventures and prospects."

SPAR: gritty comeback in store

Solid structure built on strong brand base

SPAR's unique business model has roots in the Netherlands. Its name is a Dutch acronym translating to "through united cooperation everyone profits equally" - a value upheld in the way it does business today.

The SPAR Group acquired the rights to use the brand in Southern Africa from Netherlands-based SPAR International - the global custodians of the SPAR brand. The group now owns the rights to use the brand in nine countries, the most notable being South Africa, Ireland, Switzerland and Poland (*charted below*). The core Southern African division operates six grocery distribution centres (DCs), one Build-it DC (building materials) and one pharmaceutical DC.

Among the major food retailers operating in South Africa, SPAR distinguishes itself by functioning (almost exclusively) as a wholesaler and distributor to independent stores operating under its brand, as opposed to trading as an integrated retailer that owns and operates its own stores. Its voluntary trading system allows independent retailers the flexibility to source better deals from other wholesalers and to stock products not supplied by SPAR. The proportion of products purchased by retailers from SPAR historically averages around 80% in the key grocery division.

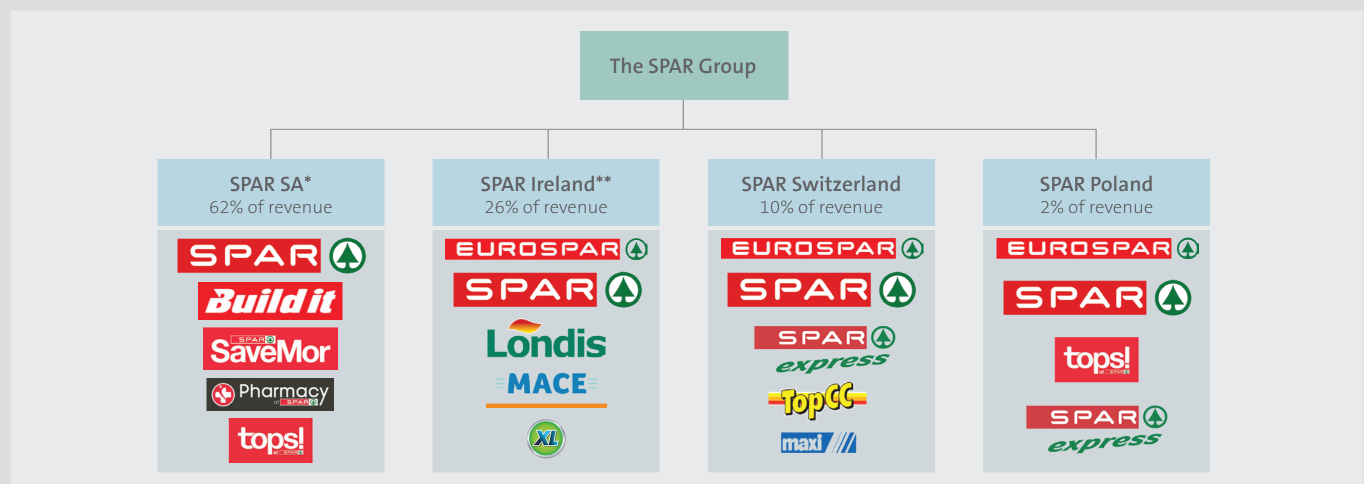
The magic in the model

SPAR's business model of independent store ownership offers strong financial incentives to store owners who directly participate in their operational success. This is a strong motivator given that the financial upside is uncapped, unlike for corporate-owned grocery store managers. Owners have the freedom to tailor operations, customise their store's appearance, offer high levels of service and adapt stock to local needs. A store in an affluent area might, for example, offer a range of unique imported products. Additionally, SPAR stores can operate without union complexities, supporting simpler staff structures.

A strong brand name and centralised buying power allows SPAR's independent retailers to be competitively positioned against larger integrated retailers. The model promotes profitability for SPAR and its member stores through fair wholesale pricing, shared marketing costs and operational efficiency. As retailers cover the costs of store openings and refurbishments, SPAR benefits from a capital-light model, whereby scale increases with minimal capital investment beyond maintaining DCs and truck fleets.

This model has proven to be consistently successful, exhibiting strong historic comparative store sales growth, stable profit margins, an impressive 30% return on capital and above-average

Simplified SPAR group structure



*Includes South Africa, Botswana, Mozambique and Namibia
**The SPAR Group owns BWG Group, which incorporates SPAR's operations in Ireland and South West England
Source: company data, Camissa Asset Management estimates

cash conversion. The key negative is that store expansion is generally slower compared to corporate-run retailers, as store growth depends on retail operator availability and financial resources. In addition, financially weaker store owners are severely impacted in periods of economic downturn or when local market conditions change adversely, leading to potential store closures and bad debts for SPAR. SPAR will often elect to buy struggling but viable stores, turn them around and then resell them.

Unfortunate acquisitions abroad

Buoyed by local success, the SPAR Group ventured offshore in 2014, capitalising on low European debt costs to acquire operations in Ireland and later Switzerland. The Irish business has performed well, nearly tripling profits in eight years, to deliver a return above its cost of capital.

The Swiss operations, however, have fared poorly. Due to the high cost of living and price of groceries, many Swiss residents resort to cross-border trips to shop in neighbouring countries, where prices are lower. The result has been anaemic sales growth, declining profitability and minimal cash flow to service the debt that financed the purchase.

The 2019 Polish acquisition has been the group's most problematic to date. Purchased for just one euro, the group took over the existing debt and invested heavily in the ailing business. SPAR Poland has had low retailer loyalty and operates a sub-scale DC - generating significant losses and high interest costs from its mounting debt burden. With fewer than 200 stores and under 2% market share, management overestimated their ability to turn the business around and grow it. With an unclear path to profitability, the SPAR Group plans to sell the Polish business in late 2024.

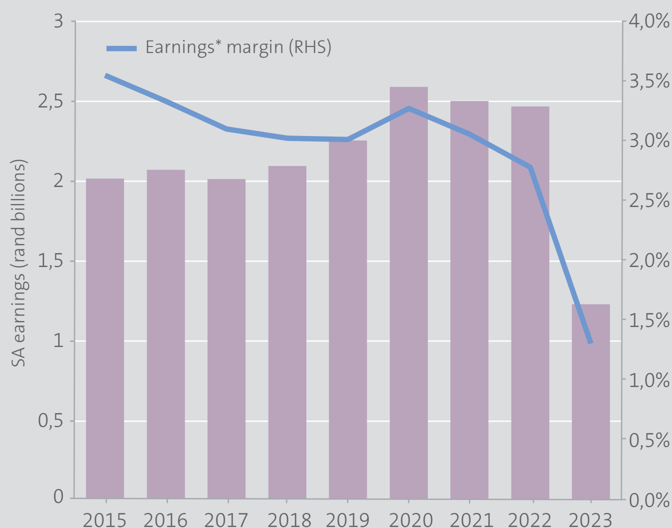
The strain from the high debt balances of the Swiss and Polish operations have been exacerbated by the higher interest rates in Europe. Additionally, the offshore debt has ballooned (in rand terms) as the rand has sharply weakened and the debt has recourse to SPAR Group's South African cash flows.

The perfect storm

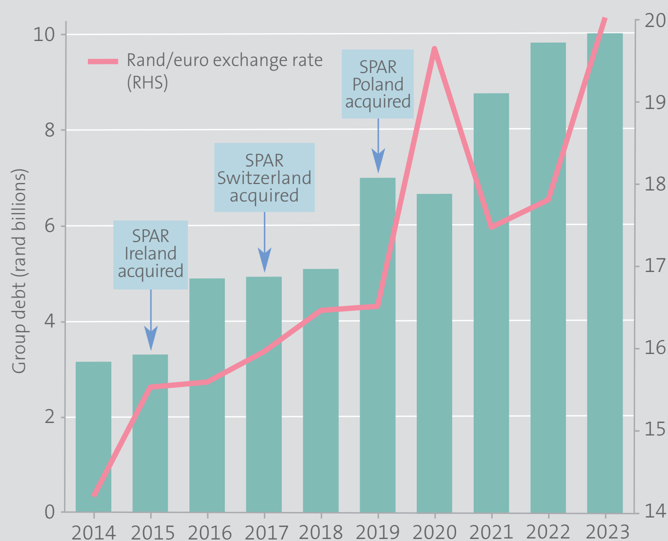
In 2023, amid the foreign currency debt strain and heavy losses in Poland, the SPAR Group undertook a major IT overhaul in South Africa, their most profitable region. This involved the replacement of an archaic 30-year-old AS400 IT system, used to run several SPAR DCs, with SAP[1]. Deemed crucial as the old system was reaching the end of its life and lacked technological support - posing significant risk to the business - the new SAP system was implemented at SPAR's largest DC in KZN.

[1] An enterprise retail planning system by a German software provider.

SPAR SA earnings*



Group debt



*Earnings before interest and tax
Source: company data, Camissa Asset Management estimates

SPAR: gritty comeback in store

While some disruption was expected, the change of IT platforms resulted in colossal challenges for SPAR at its KZN DC. Among many integration implementation problems, difficulties with the transferral of master data caused cost prices to be incorrect and a loss of visibility of stock levels and locations. Fulfilling orders to retailers was extremely challenging as a result, compounded by staff being inadequately trained to deal with such a scenario. SPAR South Africa had to resort to encouraging their KZN retailers to source products from other suppliers, leading to a drop in loyalty. Some bigger SPAR retailer groups opened accounts at rival wholesalers, business that SPAR is still fighting to win back.

The timing of this was disastrous. The sharp drop in earnings from their core South African business (*previous page left*), combined with growing foreign currency debt in rand terms (*previous page right*), and massive losses in Poland, led to the group breaching their debt covenants. To preserve cash, the company was forced to suspend its dividend.

While operational issues have somewhat stabilised, SPAR South Africa does not yet have a clear line of sight into unit cost prices - hindering sensible pricing decisions. They are now installing a different IT warehousing system to manage stock levels, orders, picking and sorting. This is essentially an updated version of the old AS400 system, which should allow for easier data migration and user adoption.

Stiff local competition

Market leader, the Shoprite Group, has shown remarkable self-reinforcing momentum over the last five years, buoyed by strong merchandising, the effective use of customer data (enabled via SAP) and immense bargaining power over suppliers. They have consistently gained market share in a challenging trading environment. The Checkers brand has thrived, with the success of Checkers Sixty60 and the launch of smaller store formats like Checkers Foods. These initiatives challenge SPAR's convenience proposition. Yet, a perpetually weak Pick n Pay has been a source of market share gains for SPAR and other grocery retailers. As Pick n Pay reduces its store footprint and grapples with deep-rooted operational challenges, we expect them to continue losing market share.

Addressing SPAR's challenges

The SPAR Group is taking decisive steps to repair their weakened balance sheet. Disposing of their Polish operations should stem annual losses (R500 million in 2023) although the associated R2 billion debt will remain. They can raise cash by selling non-core properties or conducting a sale and leaseback on their local DCs and truck fleet, potentially releasing up to R2.4 billion. The underperforming Swiss business is also under strategic review, which could further reduce group debt if sold.

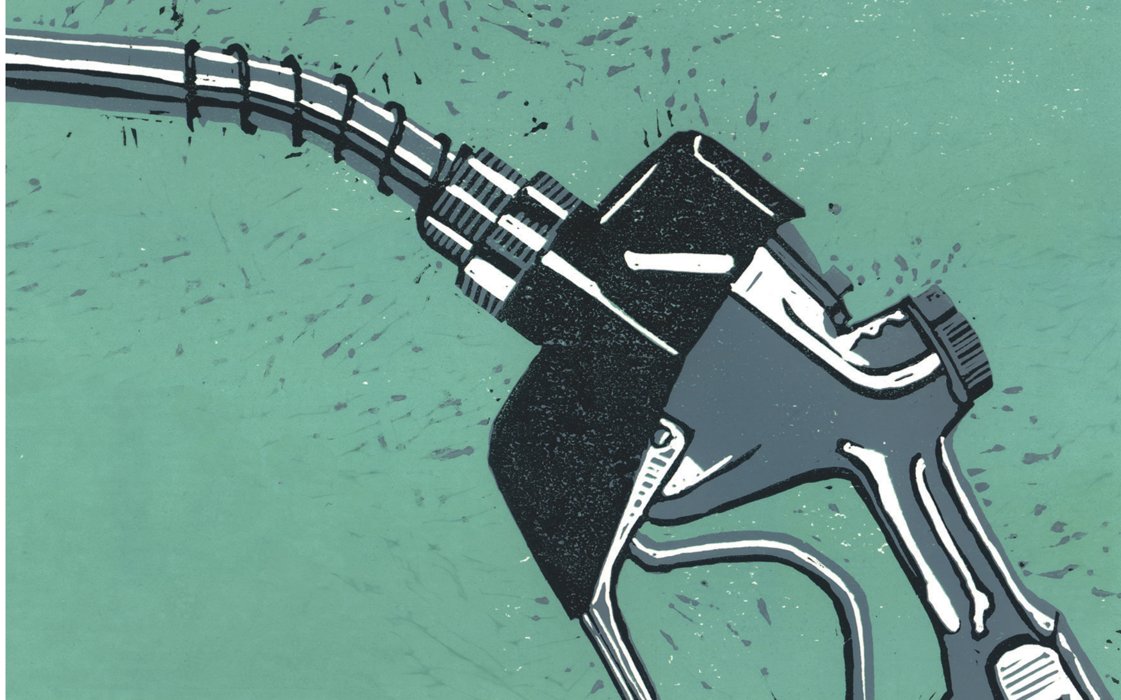
SPAR's new management is also taking steps to improve performance in their core South African grocery division. They are focusing on changing unwarranted consumer perceptions of high pricing. New product ranges, including the premium Signature Collection and value-focused SaveMore range, have been launched together with a revised customer rewards platform. Additionally, new store concepts such as a standalone pet offering and a discount store are being evaluated.

Despite the intense competition and operational difficulties at warehouse level, SPAR South Africa's like-for-like store sales growth has remained strong, keeping up with the formidable Woolworths Foods when indexed to 2019. This is testament to the tenacity of independent retailers, good store locations and the relevance of the SPAR format.

Improvement ahead

We are encouraged by the recent strengthening of SPAR's board, that has addressed governance issues such as conflicts of interest and previously ignored whistleblower complaints, while making good headway in repairing relations with aggrieved store owners. With capable new leaders now in key positions, we are optimistic that SPAR should navigate the current challenges and refocus on core strategic strengths, thereby restoring balance sheet health and profitability.

Our clients have materially benefitted from the recent share price rebound. UP



Corpay's evolving payment solutions

Ammaarah Tarmahomed - Trainee Analyst

Fleetcor Technologies, established in 2000, re-branded to Corpay in March this year to reflect the evolution of their core competencies from fleet management to corporate payment and expense management services. We unpack their transformation over time to command a leading position in the global payments market and highlight their future growth vectors.

Corpay's evolving payment solutions

Fleet management beginnings

Corpay began as the first company in the US to offer fuel cards to long-haul truck drivers to pay for vehicle-related expenses. Compared to traditional credit cards, fuel cards offer the benefits of improved spend control, fuel efficiency monitoring and real-time tracking to prevent fraudulent transactions. Importantly for fleet managers, these cards entitle users to discounted fuel rates and mark-downs on vehicle-related purchases at any of the four million hardware and convenience stores within Corpay's merchant network. This results in significant cost savings and predictable billing cycles supporting strict operating cash flow management for their fleet-operating customers.

Scale in mobility payments

Corpay's extensive merchant network creates a strong and reliable selling system, that keeps existing merchants loyal and attracts new ones. With a network four times the size of their closest competitor, Wex, Corpay's scale and long-standing entrenched retailer relationships make it impossible for competitors to offer the same level of benefits and support without enormous capital investment. Moreover, their established presence and expertise in navigating the complex regulatory landscape provides a competitive edge that protects market share and profitability in a fragmented industry.

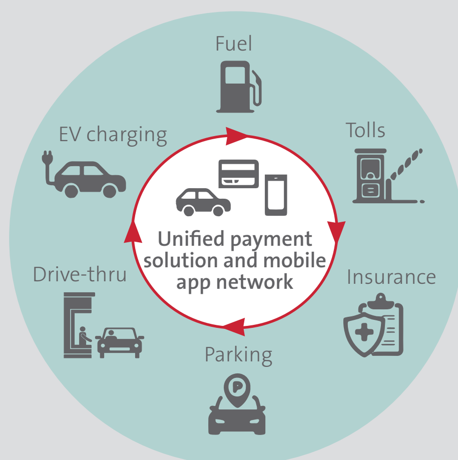
Over time, the company has expanded beyond fuel cards to create a unified vehicle-centric payments nexus (*below left*), powered by an internally developed payments processing mobile application. Corpay solutions use radio frequency identification (RFID) technology, which is a barcoded sticker that can be attached to a car windshield. The barcode communicates with RFID readers installed at toll booths, parking lots and fuel stations, capturing and authenticating the tag's information before processing the related payment as the vehicle passes. This contactless solution enables seamless transacting on the road - streamlining the checkout process, reducing waiting times and providing a real-time mechanism for vehicle tracking.

Toll services and fuel-related products comprise about half of Corpay's revenues (*below right*). Complimentary to its vehicle-related services, the business expanded into workforce travel solutions, providing access to a wide chain of hotels at discounted rates. Borrowing from their fuel card strategy, Corpay contracts with lodging providers for lower room rates in exchange for capturing large volumes of customers across their established network of blue-collar field workers, pilots and flight attendants.

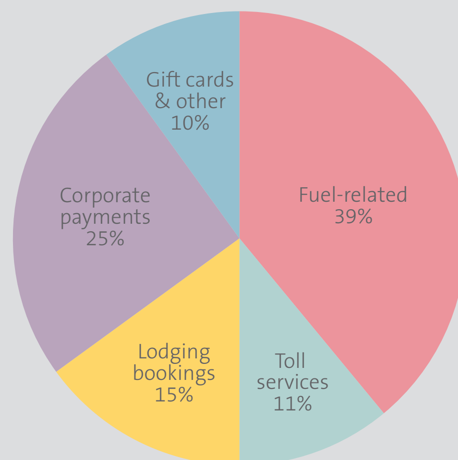
Network advantage in corporate payments

Corporate payments refer to the disbursements that businesses make to their suppliers and employees - amounting to $80 trillion

Unified payments nexus



Corpay revenue by spend category



Source: company reports

per annum globally. Corpay's value proposition is rooted in simplifying these transactions, enabling systematic spend control for their clients. This turnkey solution (*illustrated below*) generates purchase orders, sends approval notifications to account managers, audits invoices and executes virtual payments, without requiring manual input. Clients benefit from the resultant saving on administrative expenses (like data capturing and account reporting), ultimately enhancing financial oversight.

Corpay's cross-border solutions enable fast and secure international payments to mid-sized businesses (typically underserved by large banks), with minimal transaction fees. The company leverages global banking networks to trade currencies and develop hedging products to protect against unfavourable currency exchange rate moves, which offers customers a convenient and versatile mechanism to pay suppliers in different countries and currencies.

Currently the largest non-bank, cross-border payment processor in the world, Corpay handles over $110 billion in foreign currency annually. They typically earn a fee on the total value of transactions processed, a margin on the difference between the rate at which they buy the currency and that at which they sell it to the customer, and additional service fees for expense tracking services. Unlike prominent payment processing competitors such as Visa and Mastercard, Corpay offers an inexpensive, easy-to-use solution covering a wide range of financial, operational and administrative services. This eliminates cost redundancies involved in running multiple systems.

New name for an evolved business

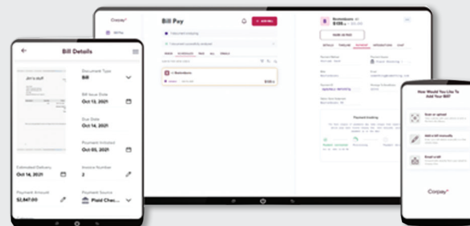
After more than a decade of building vast customer interchanges across adjacent industries, the business has evolved far beyond their fleet-based origins. The rebrand to Corpay not only better reflects their core competencies, but also serves to strengthen their brand positioning and improve the return on marketing spend. Corpay aims to capture a large cross-sell opportunity in their customers' overlapping needs for vehicle-related and corporate payment solutions. For example, businesses with frequent travel needs can be offered virtual cards with cross-border payment capabilities, fuel and lodging discounts, spend limits and expense tracking. By bundling offers in this way, Corpay can expand services provided to their existing customer base to achieve further revenue growth, without having to invest additional capital.

Early mover in EV fleet management

The complexities involved in electric vehicle (EV) fleet management pose unique challenges to managers. These include lifetime battery health, charging infrastructure, location and route planning. Battery replacement is the highest single cost factor in an EV, as its lifetime can be shortened by improper

Turnkey transaction solution

Create purchase order ► Approval workflow ► Invoice capture ► Payment execution



Payments automation

Electronic workflow for all payment types

Invoice & AP automation

Streamlined automation for faster processing

Procure-to-pay

Modular platform customised to your needs

Multi-card

All-in-one purchasing, fuel and T&E cards

Expense management

Reduces paper processes & improves visibility

Cross-border

Global payments & currency risk management

Source: company reports

Corpay's evolving payment solutions

charging habits, temperature variations and inefficient usage patterns. Charging costs can also vary depending on location and time of use. For instance, public charging during peak hours can be up to six times the cost of at-home charging.

Corpay's ChargePass solution - currently deployed in the UK - offers a one-stop mobile application for route mapping, discounted public charging rates and EV cards, with merchant discount benefits. Their at-home charging products can integrate with smart electricity meters to accurately measure usage and pay the related utilities directly - effectively eliminating the pay and reclaim process. Employees are therefore never out of pocket. Fleet owners can also monitor battery health in real time, analyse detailed reports on total electricity used and optimise cost per charging session - enabling valuable control over the health of, and expenses relating to, their electric fleet.

The EV card market is still nascent and controlled by a handful of players, who focus solely on charging infrastructure, with limited fleet management tools. For Corpay, the economics of EV fleets are better than their legacy fuel card business because of the additional complexity associated with charging and battery health, thereby offering them opportunities for higher revenues from value-added services. This includes a profit share on public charging sales, installation and service fees for at-home charging, and subscription fees for maintenance and expense reports. EV cards already represent half of Corpay's vehicle-related revenues in the UK, with a long runway for growth as EV adoption accelerates.

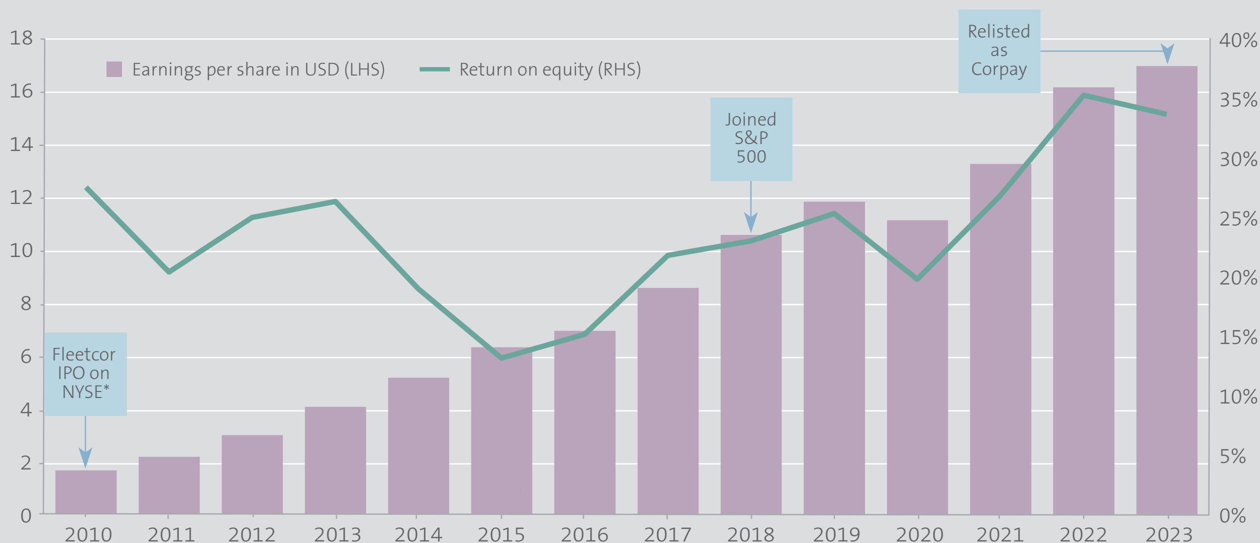
Underappreciated growth

The combination of Corpay's efficient selling system - aided by deep and wide network advantages - and their expansion into complementary product verticals, has resulted in strong organic revenue growth since inception. A predictable fixed cost base also enables high operating leverage, which has translated to a tripling of per share earnings over their listed history - as seen in the *chart below*.

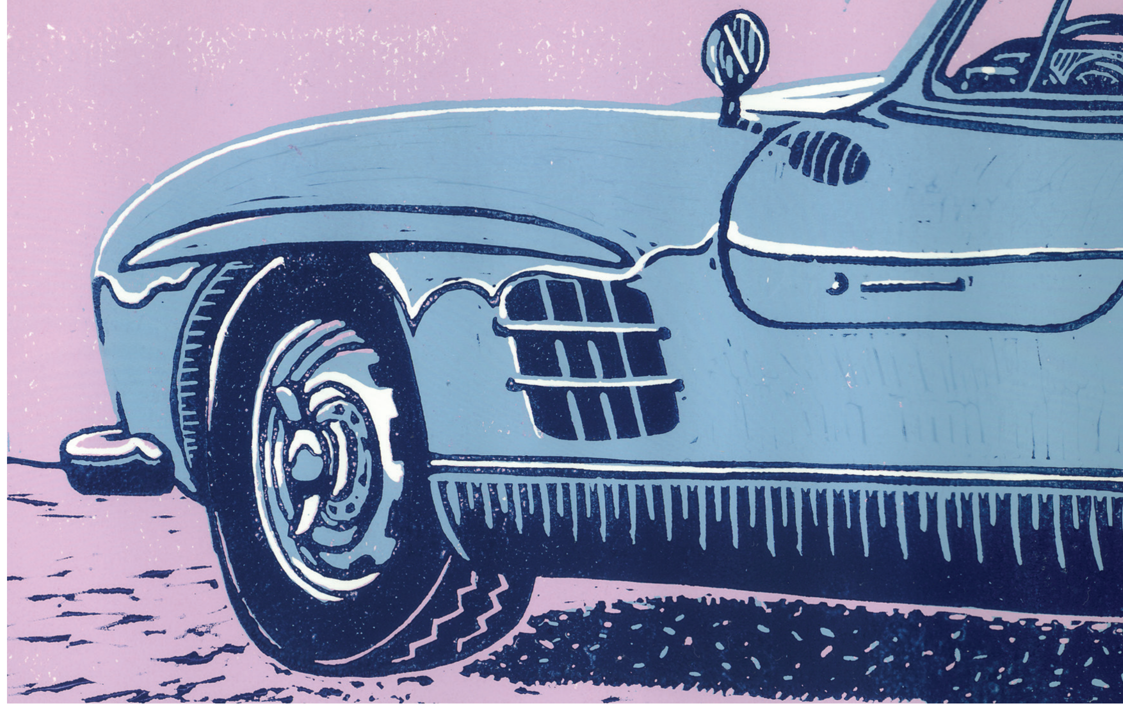
As a capital-light, software-focused business, Corpay's maintenance costs are low, making it highly cash generative. Payouts to equity-holders, special dividends and share buybacks have increased commensurately with earnings. Corpay's healthy balance sheet provides the company with ample resources to invest in new growth opportunities and further expand services offered to their deep, propriety networks.

With a large addressable market in vehicle-related and corporate payments, we believe that Corpay is well-positioned to expand profit per customer, while growing their earnings in EV management solutions as EV's gain market share. Our clients with global exposure are benefitting from the market's undervaluation of these prospects.

Corpay earnings and returns history



*New York Stock Exchange
Source: Bloomberg



Continental is positioned for evolution

Mandi Dungwa - Portfolio Manager

> Founded in 1871, Continental was the first manufacturer of grooved vehicle tyres. Today, it is one of the largest tyre and automotive component suppliers in the world and develops pioneering technologies and services in the mobility sector.

Continental is positioned for evolution

Having deftly navigated the transition from horse drawn carriages to internal combustion engine (ICE) vehicles over time, the business faces its next challenge: the global movement towards battery electric vehicles (BEVs) in support of net zero emissions targets. We investigate Continental's positioning for this.

Net zero demands a powertrain shift

Significant changes are in store for the automotive sector as the world steers toward the goals set by The Paris Climate Agreement in 2015. This will see an increased market share of BEVs in the passenger vehicle segment relative to the now dominant ICE-powered vehicles. The shift in powertrain[1] will necessitate new, different transmission component parts and far fewer of them, which will materially alter the sales prospects for parts suppliers. To power a vehicle, BEVs employ a mechanically simple electric motor with few component parts, whereas ICE vehicles contain multiple components within the engine and propulsion system.

Continental's products

While Continental remains a prominent tyre manufacturer (for passenger vehicles, trucks, bicycles and motorcycles), it is positioning itself to benefit from the changing market. It is also one of the most prominent producers of automotive components and related software. As *charted below left*, the company is structured into three divisions.

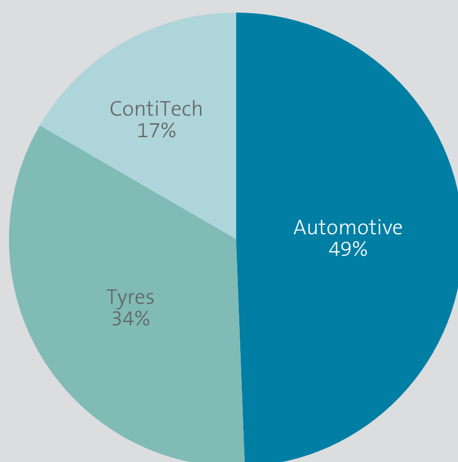
ContiTech manufactures specialist rubber products for many industries. Rubber hoses have numerous applications in vehicles including power steering, air conditioning, brake systems, radiators and fuel tanks. Conveyor belts are used to move material (eg in mining) and drive belts are used in power transmission systems.

This business makes up 17% of group revenue and is currently the second largest generator of profit (*below right*). Products sold into the automotive industry are highly commoditised, therefore Continental has no clear competitive advantage relative to other suppliers. To combat this, ContiTech has shifted its focus away from the automotive sector and towards other industries (energy, agricultural, construction and mining), where it can offer unique products with longer lifecycles to generate higher margins and more sustainable revenue.

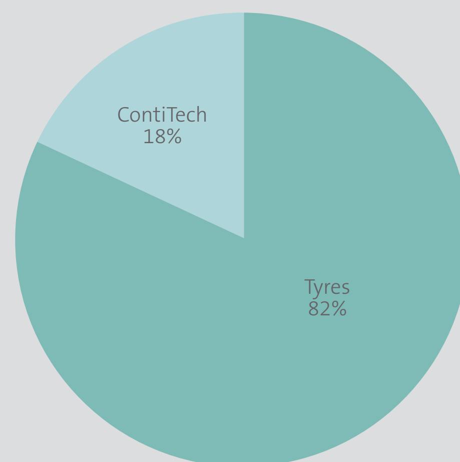
Continental Tyres makes up 34% of sales and over 70% of group profits. The bulk (over 70%) of tyre sales are made in the more profitable replacements segment, while new vehicle production accounts for the balance. Tyre demand is linked primarily to total distance travelled, regardless of drivetrain, as it is a necessary component for all vehicles. BEVs need higher

[1] The mechanism that transmits the drive from the vehicle engine to its axle.

Continental revenue contribution (2023)



Operating profit contribution (2023)



Source: Continental

value tyres designed to support a heavier vehicle weight due to the battery, and the replacement cycle of these tyres is shorter given the increased wear and tear from a heavier vehicle. Therefore, not only will the tyre industry stand to benefit from drivetrain electrification, but the drivetrain transition is set to materially increase revenue and profitability.

Continental Tyres is well represented in the European market (over 50% of sales), the Middle East and Africa. It is also currently building capacity in under-represented regions, including Asia and the Americas, anticipating strong growth due to market share gains given their competitive technological advantages.

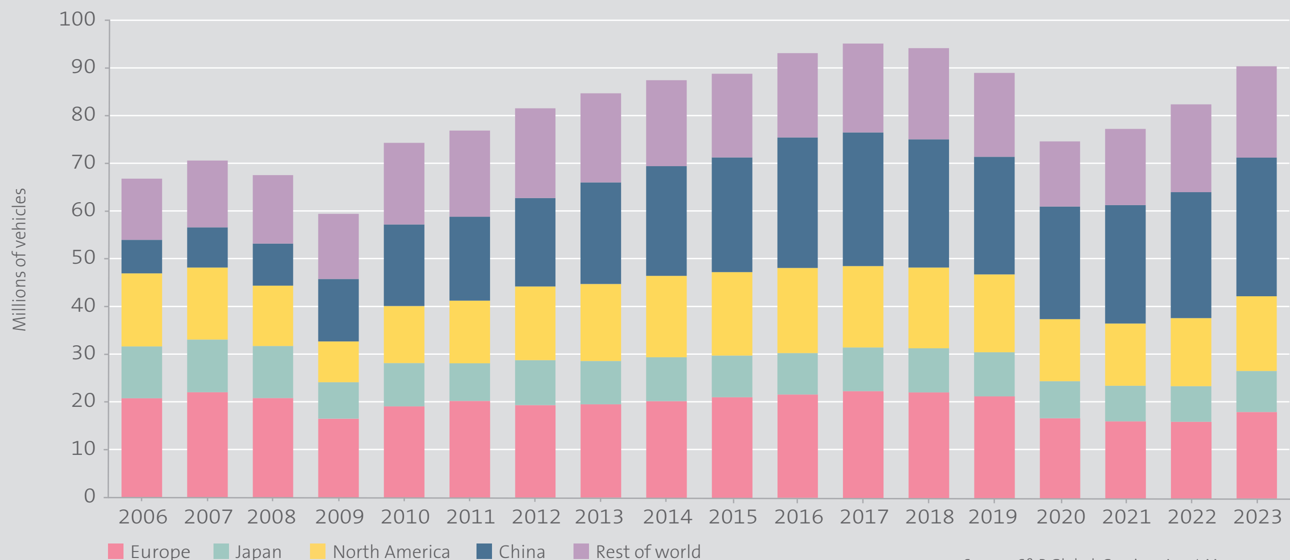
Continental Automotive manufactures technologies related to vehicle safety and innovative solutions that support automation, communication and connectivity. Despite being the largest division (49% of group sales), it has not been profitable since the supply chain crisis that followed the pandemic lockdowns and hugely impacted global automotive production. This business supplies hardware and software components to auto manufacturers in Europe and North America (markets that are still operating well below pre-Covid levels) and has identified the importance of competing in the Chinese market, where sales are growing.

We believe that Continental Automotive's profitability stands to benefit from powertrain-related developments in high-growth key focus areas, such as:

- **Autonomous mobility** supports automated/assisted driving and autonomous vehicles with products like high-resolution cameras for parking/driving assistance, sensors and radar systems. This segment is heavily reliant on semiconductors, which were in short supply and highly priced post-pandemic - decimating margins.
- **Safety and motion** specialises in passive safety technologies and vehicle control systems including airbags, brakes and tyre sensors with low-pressure early warnings.
- **Architecture and networking** aids vehicle connectivity to cloud or other software-based interactions. Products include digital key systems, smartphone integration devices and on-board computer systems.
- **User experience** focuses particularly on vehicle display screens and dashboards.

In addition to renegotiating contracts that are currently loss-making, this business is firmly focused on remaining competitive in an increasingly complex and evolving manufacturing environment. Positively, the demand for specialist products and technologies is on the rise.

Global vehicle sales by region



Source: S&P Global, Camissa Asset Management research

Continental is positioned for evolution

Automotive market dynamics

As *indicated on the previous page*, the global automotive production peak of 2017 was followed by a marked decline in 2020 due to the pandemic slowdown and subsequent industry supply chain complications that led to severely constrained levels of production. The market has rebounded strongly in China, now the world's largest, while production in Europe, North America and Japan remains well below pre-pandemic levels.

European manufacturers and suppliers, including Continental, have experienced significant increases in costs particularly with respect to energy, wages and freight rates, while revenues have declined due to low production levels. Consequently, earnings are severely depressed.

Chinese manufacturers, particularly in BEVs, have contained costs through economies of scale as they have expanded, the vertical integration of supply chains, low energy costs and lower labour costs - all aided by significant government subsidy support. Lower production costs allow Chinese vehicles to be significantly lower priced than those of Western competitors. Substantial excess capacity in China has enabled material exports of its lower cost vehicles into Europe and other parts of the world. In response to this strong competition, Western countries have implemented protective measures, such as imposing hefty import tariffs on Chinese vehicles to try safeguard their local automotive industries.

Still recovering European car manufacturers make up a significant portion of Continental's sales (64% at present). Such depressed market conditions have seen the company strategically focus on cutting costs, transitioning its loss-making automotive business towards profitability and providing quality products that can compete with those made in China. This means continuously investing in technology.

Software is increasingly disruptive

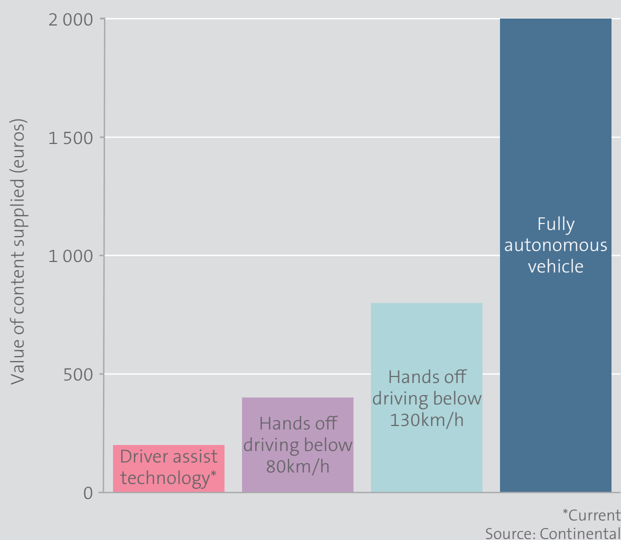
Powertrain developments and the increasing reliance on software in vehicles present an opportunity for new industry entrants to take market share and disrupt markets for incumbents. With a competitive advantage in software development, Huawei and Xiaomi are prominent new entrants despite being new to auto manufacturing.

Continental's automotive division has invested extensively in software development and is looking to increase its share of the vehicle software market. Coupled with the development of a software subscription revenue base, this should significantly add to the profitability of the business. Continental's competitive advantage is its ability to integrate software and hardware, given that it produces both. As *shown here*, this would result in increasing the value of its content supplied to auto manufacturers, in turn significantly boosting profitability.

Substantial growth and recovery ahead

Despite new competition in the market and a rapidly evolving industry, Continental is competitively advantaged through its very profitable and resilient tyre business and the significant investment made in its automotive technology business. We believe that the current market price undervalues Continental's prospects for growth, expansion in profitability and recovery in its automotive division. UP

Software and hardware content supplied per vehicle



*Current
Source: Continental

South African long bonds: shedding over-pessimism

Satish Gosai - Head of Fixed Income

"South African nominal bonds recently rebounded dramatically after a period of pronounced weakness, leading up to the formation of the government of national unity. The market was pricing in extreme pessimism about the country's prospects, with yields on the 20-year bonds peaking above 13%. This is in extreme contrast to just five years ago, before the pandemic, when these yields were around 10%. The subsequent improvement in the bond market has seen this yield move down to around 11%, resulting in a capital gain on the 20-year bond of 26% in a few short months."

South African long bonds: shedding over-pessimism

We delve into the elements that are considered for rating South Africa's creditworthiness as an issuer of bonds. We then consider three broad possible scenarios for the country's economic future and highlight the importance of maintaining a long-term perspective when valuing government debt.

Sovereign risk assessment factors

Bond yields - the annual return to an investor if the bond is held to maturity - reflect, among other things such as inflation risk, expectations for the possibility of the borrower defaulting on the loan. As markets are inherently forward looking, current market yields may price in credit risk that is different to yields implied by current, historically determined, official credit ratings from ratings agencies.

At the very high levels prevailing prior to the elections, bond yields were pricing in a material worsening in the country's credit ratings and thus in the outlook for the possibility of its default.

Moody's is a highly regarded global credit rating agency known for its in-depth research and robust methodologies and we use their framework in what follows. Moody's focuses on four categories when evaluating a country's credit profile. These are rated individually and then aggregated to determine the final assessment of a country's overall credit profile. The categories are:

- **Economic strength**: This is a key facet of a country's credit evaluation, measurable through an analysis of prospective growth, size of economy and sources of revenue. South Africa's economic strength assessment comprises a mix of positive and negative factors. While South Africa's real GDP growth rate is low, its credit rating benefits from the sizeable level of GDP, relatively high GDP per capita and positive economic diversification. Currently, these strengths result in an assigned investment grade category rating.
- **The strength of institutions and governance**: This is the next important rating factor and, in particular, the stability of the country's legal and regulatory framework is a vital consideration. Historically, global experience has shown a clear relationship between institutional weakness and sovereign defaults. According to Moody's, South Africa has high-quality core institutions, resulting in a positive investment grade rating for this category.

Moody's appears to somewhat emphasize policy effectiveness over the quality of institutions, with the former negatively weighing on this category's assessment. For South Africa specifically, the effectiveness of fiscal policy - managed by The National Treasury - is regarded as a weaker area, while the operation of monetary policy - the responsibility of the South African Reserve Bank - is highly rated.

Moody's category ratings

	Economic strength	Institutions & governance strength	Fiscal strength	Susceptibility to event risk
Investment grade	Brazil, Indonesia, Egypt, China, **South Africa**, Hungary, India, Malaysia, Mexico, Peru, Phillipines, Columbia	Brazil, Hungary, Indonesia, India, China, **South Africa**, Malaysia, Peru, Phillipines, Columbia	China, Phillipines, Peru, Mexico, Hungary	Brazil, Malaysia, China, **South Africa**, India, Columbia, Hungary, Mexico, Indonesia, Phillipines, Peru
Non-investment grade		Mexico, Egypt	Malaysia, India, **South Africa**, Indonesia, Brazil, Egypt, Columbia	Egypt

Source: Moody's

- **Fiscal strength**: This factor attempts to measure a country's ability to sustain its debt burden - a significant area of weakness for South Africa resulting in a category rating that is below investment grade. The impact of this is meaningfully negative on the country's overall sovereign rating and is effectively the sole factor dragging us below investment grade. According to Moody's, important measures of fiscal strength include ratios for debt affordability and debt burden. In both measures, South Africa rates poorly.

  Moody's does, however, acknowledge the ratio of government financial assets to GDP as a positive factor, mitigating the above negatives somewhat. It is understood that countries with high levels of financial assets can buffer large shocks through asset liquidation if needed. Such assets would include cash deposits, contingency reserve funds and foreign currency reserves.

- **Susceptibility to event risk**: The final factor aims to measure a country's resilience to shocks that might impact fiscal stability, particularly risks that influence the economy and its institutions. An example would be factoring in the effect of stress on the banking sector. Here, Moody's rates South Africa as investment grade with notable strengths, highlighting the deep and diversified financial sector, low foreign currency denominated debt levels, flexible exchange rate and the ease at which the government can raise funding.

The *chart on the previous page* compares South Africa's category ratings to a select group of other emerging market countries. Our current rating factor assessments, albeit determined in the past, are generally in line with this peer group of countries and are in some cases, better.

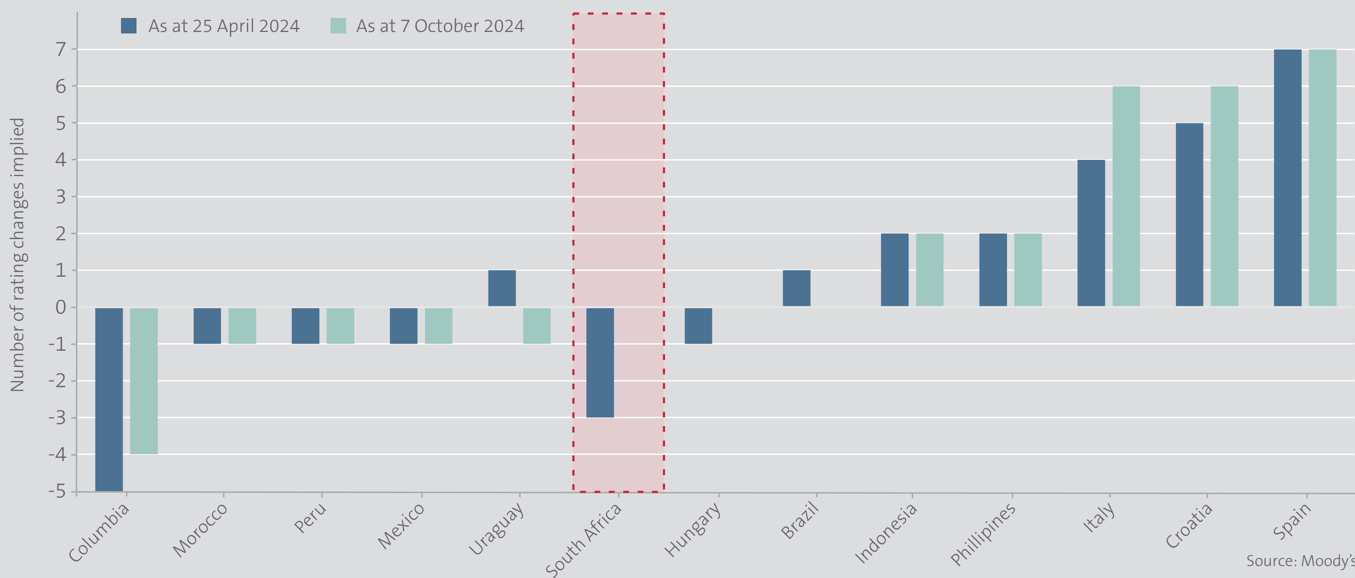
What may lie ahead

A general illustrative description of three contrasting economic futures for South Africa, and thus its possibility of defaulting on its borrowings, may be as follows:

A **low road** scenario, where the economic and governance situation for South Africa worsens, may see a deterioration in its key strengths, for instance: unexpected weakening in institutions, declining economic strength or higher vulnerability to event risks. Such an outcome will result in rating downgrades.

A positive **high road** scenario may incorporate a quickening in the growth rate of the country's economy and consequent improvements in the fiscal position, particularly in reducing debt burden and better debt affordability. Tax revenues will be higher, lowering the fiscal deficit and the debt balance will be a smaller percentage of the larger economy. This scenario should prompt a credit rating upgrade.

Bond implied rating gap



Source: Moody's

South African long bonds: shedding over-pessimism

In the case where the current economic trajectory is similar to the recent past, whereby existing credit strengths and weaknesses endure, this might be regarded as a **middle road** scenario. Economic growth would remain weak, fiscal consolidation may occur only gradually and to a muted extent, and South Africa's credit rating may remain unchanged at two notches below investment grade.

Accurately calibrating the probabilities for these scenarios is difficult. Given the economic challenges South Africa is facing and its extensive structural weaknesses, our view is that the middle road is most likely, followed by the low road, with the high road scenario being far less probable. However, the probability of the high road has risen post the formation of the new government after this year's elections and given the early economic reform momentum shown by the presidential ministry.

What the market was telling us

The Moody's analytics tool uses market signals to determine the credit rating implied by the bond market. The output indicates what the market expectation is for South Africa's future credit rating. The *chart on the previous page*, indicates a comparison of other emerging market and southern European countries, showing the market-implied rating changes at present and before the South African general elections. Current yields suggest investors are anticipating South Africa's credit rating to remain constant. Notably, prior to the elections, market pricing indicated that the country's rating would deteriorate by a further three notches. At that time, we argued that elevated bond yields already priced in a low road scenario and were going to pay a 13% per annum yield for the next 20 years, even if the three notch downgrades were to happen. Clearly there was a possibility of default and of the deterioration of inflation management, which we do not intend downplaying.

Our view was that these risks were far lower than the market feared and we still believe in a greater probability of a middle road scenario somehow unfolding. In this event, bond yields were way too weak and one could not only bank 13% per annum for 20 years, but also a substantial capital gain as rates fell to reflect a better outlook, albeit still weak. Additionally, in the event of any quicker than expected improvement in the fiscal position, which we viewed as an unlikely high road, the main drag on South Africa's credit profile would be reduced and bond yields could move considerably lower.

Substantial gains to date and more to come

This substantial and highly asymmetric return profile is rarely offered to investors and has already proved extremely lucrative for our clients. Developments in the country since the elections have been materially more positive than even the most optimistic forecasts from earlier in the year. We have a stable government of national unity, populist parties have been marginalised, reform momentum has strengthened and load-shedding has not occurred since March.

No doubt the future will present problems and setbacks. The country's substantial structural problems, such as its vast unskilled and unemployed population, failing public services and organised criminal activity, loom large. However, as Moody's highlights in its country assessment, there are many structural positives too. We believe real yields are still too high, although substantially less so than earlier in the year, and our client portfolios are positioned accordingly. UP

Camissa Asset Management Funds

Performance to 30 June 2024	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%	6.7%	9.9%	7.2%	11.5%	14.6%	Apr-04	1.70%	0.32%
SA Equity General funds mean	9.6%	9.5%	8.8%	5.8%	9.9%	11.6%			
Outperformance	-5.6%	-2.8%	1.1%	1.4%	1.6%	3.0%			
SA Equity Fund#	5.2%	-	-	-	-	3.0%	Sep-22	1.50%	0.35%
SA Equity General funds mean	9.6%					10.7%			
Outperformance	-4.4%					-7.7%			
Global Equity Feeder Fund	2.6%	5.5%	-	-	-	7.3%	Nov-19	1.91%	0.18%
FTSE World Index (ZAR)	16.7%	15.8%				16.4%			
Outperformance	-14.1%	-10.3%				-9.1%			
Balanced Fund	7.1%	7.7%	9.1%	7.4%	-	9.0%	May-11	1.51%	0.25%
SA Multi Asset High Equity funds mean	10.3%	9.0%	8.8%	6.8%		8.5%			
Outperformance	-3.2%	-1.3%	0.3%	0.6%		0.5%			
Protector Fund	8.0%	7.3%	8.5%	7.4%	8.1%	9.5%	Dec-02	1.55%	0.19%
CPI + 4%	9.2%	9.9%	8.9%	9.3%	9.7%	10.1%			
Outperformance	-1.2%	-2.6%	-0.4%	-1.9%	-1.6%	-0.6%			
Stable Fund	10.2%	8.9%	8.3%	7.8%	-	8.4%	May-11	1.47%	0.23%
CPI + 2%	7.1%	8.0%	7.0%	6.6%		6.3%			
Outperformance	3.1%	0.9%	1.3%	1.2%		2.1%			
Institutional funds[5]									
Managed Equity Fund	6.7%	8.0%	10.1%	6.8%	11.6%	11.0%	Sep-06		
FTSE/JSE Capped SWIX Index	10.0%	10.1%	8.7%	7.1%	11.9%	10.7%			
Outperformance	-3.2%	-2.1%	1.4%	-0.3%	-0.3%	0.3%			
Domestic Balanced Fund	9.1%	8.7%	10.2%	7.5%	10.2%	9.0%	May-07		
Peer median[6]	11.0%	10.1%	9.0%	7.1%	10.6%	9.0%			
Outperformance	-1.9%	-1.4%	1.2%	0.4%	-0.4%	0.0%			
Global Balanced Fund	8.6%	9.2%	10.6%	8.8%	-	10.0%	Jul-13		
Peer median[7]	10.8%	10.4%	10.1%	8.2%		9.5%			
Outperformance	-2.2%	-1.2%	0.5%	0.6%		0.5%			
Bond Fund	14.7%	8.1%	8.4%	8.7%	8.9%	8.6%	May-07		
BESA All Bond Index	13.7%	7.6%	7.8%	8.2%	8.6%	8.2%			
Outperformance	1.0%	0.5%	0.6%	0.5%	0.3%	0.4%			
Money Market Fund	10.1%	8.3%	7.6%	7.9%	7.3%	7.8%	Jan-04		
Alexander Forbes STeFI Composite Index	8.6%	6.5%	6.1%	6.6%	6.4%	7.0%			
Outperformance	1.5%	1.8%	1.5%	1.3%	0.9%	0.8%			
Shariah unit trust funds[4]									
Islamic Equity Fund	4.5%	5.9%	8.7%	6.9%	-	10.3%	Jul-09	1.51%	0.17%
SA Equity General funds mean	9.6%	9.5%	8.8%	5.8%		9.9%			
Outperformance	-5.1%	-3.6%	-0.1%	1.1%		0.4%			
Islamic Global Equity Feeder Fund	-0.8%	5.5%	8.0%	-	-	8.6%	Jan-19	1.84%	0.10%
Global Equity General funds mean	14.8%	10.6%	13.8%			15.3%			
Outperformance	-15.6%	-5.1%	-5.8%			-6.7%			
Islamic Balanced Fund	4.2%	6.1%	8.7%	6.6%	-	7.5%	May-11	1.51%	0.11%
SA Multi Asset High Equity funds mean	10.3%	9.0%	8.8%	6.8%		8.5%			
Outperformance	-6.1%	-2.9%	-0.1%	-0.2%		-1.0%			
Islamic High Yield Fund	9.7%	7.3%	7.3%	-	-	7.3%	Mar-19	0.58%	0.04%
Short-term Fixed Interest Index (STeFI)	8.5%	6.5%	6.1%			6.1%			
Outperformance	1.2%	0.8%	1.2%			1.2%			

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%	-4.7%	-	-	-	-	-	-	-	-	11.5%	-5.9%
Global Equity Feeder Fund	12.7%	-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%	7.6%	-13.9%	9.5%	-13.9%
Stable Fund	7.1%	-2.8%	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	8.8%	-7.8%	10.6%	-7.8%	14.6	-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%	2.7%	-2.4%	2.7%	-2.4%	-	-	-	-	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 30 June 2024; #over 12 months to 30 June 2024. [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 30 June 2024 #over 12 months to 30 June 2024. [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.

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