Korner Perspective
From Graeme's Desk
A Bruising Week

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I must confess that the past week or two have been some of the most difficult I have had in my nearly twenty years in the market, possibly even more difficult than the unravelling of the GFC (memories are short however).

Firstly, the political backdrop is extremely charged, with a palpable tension ahead of the ANC's elective conference in just a few days' time, but also with more angst in global politics.

Secondly, the shock revelations of the accounting scandals at Steinhoff not only pummeled the Steinhoff (and broader Wiese) group share prices, but created a mood of real apprehension in the market.

The third contributor was more allegations of wrong doing by corporate South Africa (most notably levelled at Naspers' Multichoice). This has caused many investors to ask who else may be guilty of wrongdoing.

Finally, we saw weakness earlier in the week in global asset markets (e.g. some commodities and technology stocks).

These issues combined to create a market in which investors (mainly locals) were (and remain) very wary to commit capital, especially to small and mid-cap companies, with a big jump in volatility in many locally listed shares.

We will briefly discuss a couple of individual shares that have caused us (and our clients) angst.

Steinhoff

We refer you to our detailed note on Steinhoff for a more detailed analysis on the disaster that is Steinhoff. Click Here

All that is to be said here is that the sheer scale of the value destruction is almost incomprehensible (well over R 200 bn. of market cap has been wiped off the JSE), and that it did not just affect Steinhoff itself, but all group companies, being Steinhoff Africa Retail, PSG and KAP, as well as all other Christo Wiese assets (mainly Brait, but also Stellar and Invicta) and the mood in the broader market.

The real damage inflicted by Steinhoff is far greater than the loss in market cap as it:

1. Caused many investors to profoundly question the system, for example how financial statements could be manipulated for years and the role played by auditors and the board in ensuring that financial statements are accurate, and

2. May well have a longer-term impact on the perception of South Africa in global markets. This is especially true given the other allegations of corrupt/ inappropriate behaviour by corporate South Africa.

Naspers

Naspers quickly came off its record highs, on the combination of weakness in their anchor NAV underpin Tencent and allegations of corrupt behavior at subsidiary Multichoice.

We are becoming concerned about Naspers for five reasons:

1. Naspers has become an effective proxy for Tencent. While Tencent has performed incredibly well, both in share price (it recently displaced Facebook as the world's 5th biggest company) and operationally, we sense that any relative disappointment will result in a significant correction, given the demanding rating, given the lofty 51 x PE multiple.
2. Its operations (ex Tencent) are not performing well, evidenced by the continual cash burn in ecommerce and an increasingly deteriorating outlook for pay TV (both in South Africa and the rest of Africa).
3. The allegations of non-commercial levels of support of ANN7 and acquisitions of paying the SABC to influence government's broadcast policies cast serious questions over the ethics of South Africa's biggest market cap. Also of concern was the 'nonchalance' of the CEO and chairman on the Multichoice issues.
4. Naspers represents almost a quarter of the weighting of the Top 40 index. Any major weakness in Naspers could have a significant impact on the JSE, more so on indices (e.g. tracker funds) than the broader market, and
5. The allegations of the 'corrupt' behaviour at Multichoice have made the market very jumpy about the pervasiveness of such behaviour. This anxiety was clearly seen in the price action of EOH.

Our overriding concern is that Naspers has simply become a Tencent proxy, with concerns growing about operational performance of the rest of Naspers.

This not only makes Naspers itself potentially vulnerable, but also makes the Top 40 index itself vulnerable to a reset in the Tencent price.

Our assessment is that it is appropriate for us to continue trimming Naspers in those portfolios that hold it, as it has done very well, and it is irresponsible for us not to trim the position to under 10% of portfolios.

EOH

EOH (the share at least) had a terrible week, evidenced by the share at one point on Friday trading at under R27 per share, from a level of over R 80 a week ago.

We ascribe this price action to:

1. A general lack of buyers, given the apprehension of the market to back local counters (especially smaller caps).

2. Rumours that the company had been guilty of corrupt behaviour. The market was especially sensitive to this given the Multichoice allegations.
3. Our suspicion that someone is deliberately trying to create panic in the share, evidenced by the way selling took place. In short, we believe that someone has been building a big short position in EOH.
4. Derivatives related selling, and
5. The lack of an initial response from management to the price action.

While we prefer management to focus on running their business than worrying about the share price, there are times where we feel management must communicate with the market (not just anchor shareholders), especially where the price action is not reflective of the operational performance or management need to dispel malicious rumours.

We recently met with management and remain confident in the investment case for EOH. A big part of our investment case is ironically based on our view that EOH is a maturing business/ business model, with:

- A huge client/ contract base and a world in which technology has become mission critical to almost all organisations.
- Their future being less driven by acquisitions than in the past.
- Generally lower revenue and profit growth levels than the 40% seen up to this point, and
- Lower, but more predictable EPS growth than the past.

We continued to engage the company last week and were pleased to see that a SENS announcement was released late on Thursday.

We also see the allegations of corrupt behaviour (against previous group companies, such as Forensic Data Analysis (FDA)) as overdone as these transactions have been cancelled and these were very small parts of a group that has R 15 bn. turnover, over 12 000 staff and some 5 000 clients.

While we believe that EOH does truly uphold high ethical standards and do not condone any form of corruption within their ranks, we also feel that the company must (as it grows) place greater emphasis on governance to prevent the FDA type issues ever occurring. Comments from the chairman on Friday have provided further comfort that the company is indeed making progress in this regard.

It is pleasing to see the EOH price, as I finished this piece on Monday at over R 50 per share.

Putting things in context

As one reflects on all that happened over the past few weeks, it is easy to lose perspective.

At this time though, we need to also reflect on the performance of some of our bigger equity holdings to see the bigger picture.

Firstly, although the JSE Top 40 shows a one-year capital gain of 17.7%, this performance is not a true reflection of the broader market, with over a third of the Top 40 constituents posting negative capital returns and Naspers alone contributing 18% to the Top 40 on a one-year view.

If we then look at the one-year capital returns for some of our bigger equity holdings (excluding Naspers as we have not bought it for some time), we see discovery up 35%, BidCorp up 27%. British American tobacco up 19.8%, Standard Bank up 15.2%, Anglo up 13%, Reinet (adjusted) up 11.5% and Sasol up a little over 10%.

Sadly, as investors we don't now have the luxury of time to wallow is self-pity or self-doubt (as we work through our emotions of the Steinhoff fiasco), as we will need to make important investment decisions in the coming weeks once we have a picture of how South Africa will look after the ANC elective conference.

So, while we will need to learn from the 'mistakes' of the past, we must also remain true to our investment philosophy and continue to actively look for good opportunities.

A positive outcome to the ANC elective conference for example could create a very supportive environment which could create great opportunities given the heavily selloffs we have seen among locally focused and small and mid-cap companies (e.g. retailers or City Lodge).

Alternatively, a bad outcome to the elective conference will force us to look for Rand hedge shields and upweight foreign focused shares (e.g. Aspen or Reinet).