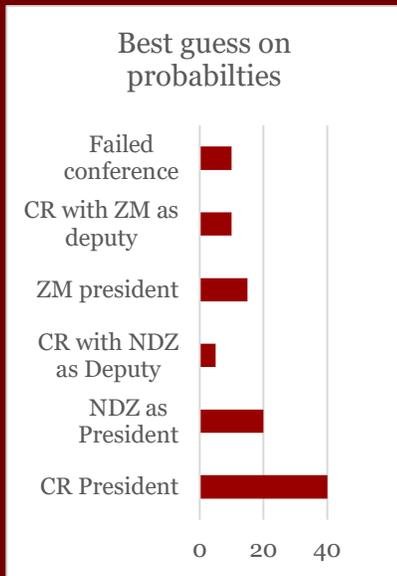


Korner Perspective South Africa in 2018

Return to the high road or a doomsday scenario?

NOVEMBER 2018



“South Africa and the ANC
are not in a good place”

Cyril Ramaphosa

Interesting times

Ask any economist, investor or regular citizen how they see South Africa in 2018 (and beyond), and they will almost certainly start their response with...”It all depends on what happens at the ANC conference in December”.

People rightly see the coming weeks as a watershed, as the outcome of the ANC’s 54th elective conference is guaranteed to have a profound impact on South Africa’s future (at least for the next five years).

Many would see a Ramaphosa victory as a silver bullet for the country (essentially allowing SA to get back onto the miracle path it was on before 2008), whereas a Dlamini-Zuma victory is widely seen as a doomsday scenario, in which South Africa will slip further into economic chaos, with corruption and non-performance the order of the day. Time however will see if these assumptions are accurate.

While the BREXIT vote and the Trump victory highlighted the risks of making political predictions, we nonetheless see it as vital for us investors to carefully (as rationally as possible) consider the more likely scenarios that could play out at the ANC’s December conference and the impact this could have on SA incorporated and our asset markets.

We normally write articles to build to a conclusion, but have turned this article around and present below our conclusion with the detail analysis after (to spare you 5 pages of detail).

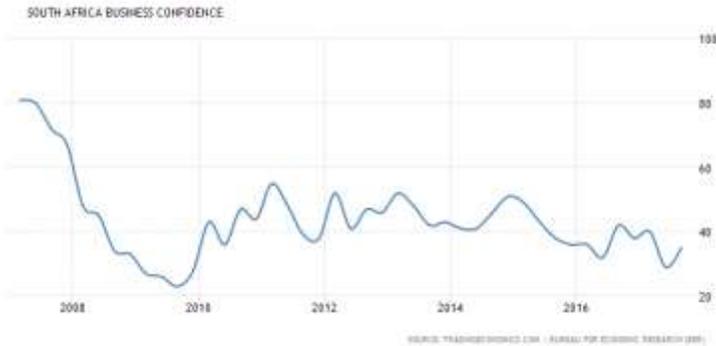
Conclusion - 2018 could be a lot better

We fully recognise the risks inherent in South African politics, but conclude, after consideration of the different scenarios, that there is a very real possibility that 2018 may usher in a much steadier and more enabling political environment than we have experienced for some time.

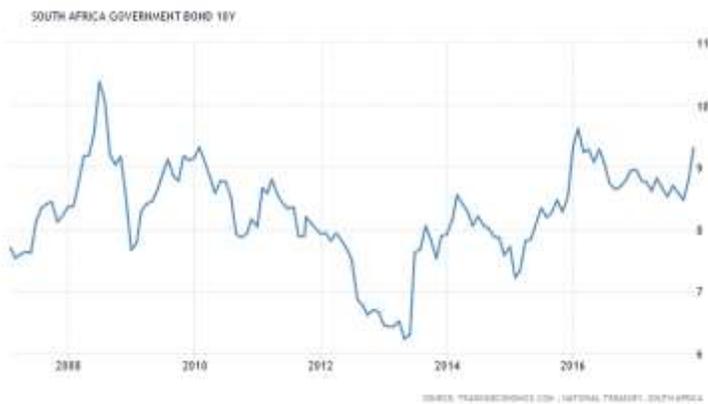
This is important as we also sense that there is a fairly significant build-up of economic energy (deferred orders, delayed capital expenditure etc.), evidenced by the cash on corporate balance sheets for example, and that this could be unleashed quite quickly.

When succession is not managed properly, results become disastrous (Gwede Mantashe 10 Oct 2017)





So, while we are all anxious about the future and very few people want to commit to (or even take a positive view on the future), it would appear as though, on balance of probability, that 2018 could very well be a decent year (also supported by the global upswing). This is especially true as we have already priced in quite a bit of bad news (e.g. rating downgrade to junk and anemic economic growth).



This is important as there are many locally oriented shares that have been hit really hard, with about a third of the all share are down by 10% or more on a one-year view, in part because foreigners have (often) been selling and in part because most local investors are either too scared to buy these shares or are rather looking for opportunities outside SA.

In short, there are possibly a fair number of shares that one could see as real winners in a modestly improved economic environment, with examples including those exposed to consumer spending (e.g. the retailers, banks), travel and gaming stocks (e.g. City Lodge or Tsogo), construction and materials stocks (e.g. WBHO) and even those linked to the general economy (e.g. Bidvest or Imperial or IT companies, such as EOH).

The ideal, as always, is to find shares that offer decent fundamentals even in a tough environment, with significant upside participation in a higher growth scenario. Shares that seem to tick these boxes (ignoring price for now) include EOH, Ethos Capital (a number of their underlying investments qualify), City Lodge, WBHO, Barclays Africa, The Foschini Group, STAR (Steinhoff Africa), Bidvest, Distell, Pioneer Foods, and Standard Bank.

It goes without saying that the final consideration must be to pay a sensible price for the growth you are buying.

We must stress that we are **not** advocating a wholesale rebalancing of portfolios away from the likes of BAT, Reinet, BHP Billiton, Steinhoff, Aspen, Sasol or Discovery, but are merely suggesting that opportunities may well present themselves over the coming month or so and that investors should consider adding a few beaten down local economy stocks if and when the opportunity presents itself.

Our take on the upcoming ANC Conference

What we know

We must start with what we know. The known facts are:

- The two leading contenders for the position of president of the ANC are Cyril Ramaphosa (CR) and Nkosasana Dlamini-Zuma (NDZ). Consensus (a dangerous thing) currently suggests around an 80% probability that one of these contenders will become president of the ANC before Christmas. CR has announced his 'winning team' slate, with Naledi Pandor as his deputy.
- A number of provinces failed to meet the deadlines for branch general meetings (BGM) in time, with a number of complaints lodged about the validity of BGM meetings.
- At least 70% of the ANC branches are required to attend the conference. ANC secretary general Gwede Mantashe has made it clear though that they would like this number to be much higher, probably as a lower turnout could question the legitimacy of the results. Currently, over 90% of branches will attend and vote.
- The tripartite alliance has effectively disintegrated, evidenced by the SACP's decision to contest the local elections in the Free State. The alliance partners have formally endorsed CR.
- There is tremendous turmoil within the ANC, not only in so far as the support of the two leading candidates, but also on how to deal with issues such as State capture.
- There are disputes (within the ANC) about the legitimacy of provincial leadership in key provinces (the Eastern Cape and KZN). While the courts ruled that the current KZN leadership (seen as backing NDZ) is not 'legitimate' and that the Eastern Cape PEC (seen supporting CR) is legitimate, (ANC) internal processes may reach different findings or direct how the voting of these provinces are treated at the conference.
- There have been a number of incidents of violence in KZN, with over 20 ANC members (mainly officials) killed since January 2016.
- There are a number of individuals that could prove instrumental in determining the outcome. Examples (excluding the highly influential Zweli Mkhize (ZM)) include:
 - The so called premier league (most notably David Mabuza (Mpumalanga premier), Ace Magashule (Free State premier) and Supra Mahumapelo (North West premier). While highly fluid, it is increasingly looking like the premier league support of Zuma and NDZ is waning, and
 - Key personalities, such as Lindiwe Sisulu.
- The ANC has lost significant support in KZN over the past few years, and it is agreed that the next president of the ANC must be able to ensure increased support of the ANC in KZN.
- The outcome of the December conference is likely to have a significant impact on the 2019 national election results, with many fearing that the 'wrong' candidate will not only further divide the party (causing a possible split), but will result in a massive loss of support in the 2019 elections.
- The tensions discussed above are increasingly driving the agenda of the need for a new, unity (or compromise) candidate, such as Zweli Mkhize.

What we think we know (what seems to be happening)

The current environment is highly fluid. This is how we read the situation right now:

- The support of the premier league for NDZ seems unclear at present.
- We sense that CR may need to consider altering his slate to include someone Lindiwe Sisulu as his deputy.
- We sense that the NDZ campaign is losing momentum and that ZM has made up considerable ground over the past month or so, not only at the expense of NDZ, but also probably somewhat at the expense of CR.
- While there is a very real need for a greater focus on unity within the ANC (i.e. a case for unity vote), we sense that most branches are more focussed on getting their preferred candidates elected than on unity.

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- While CR, NDZ, ZM and Lindiwe Sisulu have all stated their intention to go for the top job, we sense that they will probably (in the face of defeat) accept a deputy role or other top 6 position.
- This means that progress could actually be made in unifying the ANC without the need for a ‘unity candidate’.
- We believe that the disputed provinces (mainly KZN and the Eastern Cape) will not prove too damaging (e.g. resulting in a conference that is unable to elect its top six) to the final result. At this stage, the Eastern Cape appears overwhelmingly in favour of CR, with NDZ well in the lead in KZN, but markedly less than she would have wanted/ need, and
- A failed conference (one marred by infighting, the inability to elect a new leadership or disputed results) would do massive damage to the ANC, and as such we believe that every effort will be made to avoid this.

Our best guess assessment of what will happen

Our best guess is that the 54th ANC conference will ultimately (after a lot of horse trading) elect a new NEC, with the probability of a failed conference fairly low (e.g. 10%).

We believe that CR will probably be elected as the new president of the ANC, but that the rest of the top 6 will look quite different to CR’s slate.

We think it quite likely that ZM will ultimately be elected deputy president (slates are for campaigning) in spite of him having a clear preference for the presidency.

We would also not be surprised to see David Mabuza taking one of the top posts.

How we reached our conclusion

1. Articulate the likely scenarios.
2. Estimate (guess really) the probability of each scenario.
3. Guess the likely impact of each scenario (on the economy and the market).
4. Try to establish whether the ‘market’ is accurately projecting the more likely outcome/s, and finally
5. See how this could impact asset prices and if there are any opportunities.

We have illustrated below, our assessment of the six most likely scenarios, with what we see as a realistic probability of each scenario (we concede that the whole situation is highly fluid and unpredictable).

Scenario	Best guess Probability	Likely near-term impact on economy & markets
CR as President with most of his slate	40%	Very positive
NDZ as President with her own slate	20%	Quite negative
CR victory with NDZ as deputy	5%	Largely positive
ZM as President (winning unity vote)	15%	Uncertain. Probably fairly positive
CR as president with ZM as deputy	10%	Very positive
Conference fails to elect new leadership	10%	Very negative

In short, we see roughly a 70% probability of an outcome that would be fairly to very good for the South African economy and market, and a fairly low probability of a negative to really bad outcome.

This is not only important for the wannabee political analyst, but also as this could see a very rapid turnaround in the local economic landscape quite early in 2018. The irony though is that, while this is probably the best guess of most market players, this is not actually flowing through to asset markets, with local economy stocks still under pressure.



Scenario 1 – A Ramaphosa (CR) victory

A CR victory is widely seen as the most probable outcome right now, given the branch nominations, polls and the recent developments in KZN and the Eastern Cape.

A CR win, with many of his slate (we expect some changes to the slate, e.g. a shift to Lindiwe Sisulu as his deputy) getting the other key NEC positions is broadly seen by the market as the best possible outcome.

CR's experience in business and largely untainted reputation will probably result in a strong economic recovery in early 2018, given our assessment of a significant deferral of investment and spending decisions by businesses and consumers given the current political angst.

Once the initial euphoria is over however, the key will be how CR as the ANC president will deal with President Zuma and the extent to which power shifts to the NEC (CR more particularly).

There is a fairly significant risk of a fairy tale hangover (where markets become quickly disillusioned) say six to nine months after the conference if no real progress is made on issues such as State capture, cabinet changes in critical roles or a coherent plan to tackle the country's fiscal challenges.

Another key issue will obviously be the extent to which the CR camp will be able to unite the ANC.

We believe that a CR victory would require the following (not necessarily all but most):

- Strong support from the Eastern Cape.
- CR to get a fair number (e.g. 300 or more) of the KZN branch votes.
- Branch representatives to vote as guided by the members.

We sense that the explicit support of the likes of David Mabuza would effectively assure CR of victory.



Source: Businesslive.co.za



Source: the Citizen



Source: www.timeslive.co.za

Ramaphosa is widely seen as the “market’s” preferred candidate

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Source: buzzsoutafrica.com



Source: SABreakingnews.co.za



Source : The Citizen

Scenario 2 – A Dlamini-Zuma (NDZ) victory

We would expect the economy (e.g. business and consumer confidence) and asset markets to react quite negatively to a NDZ victory.

Potentially hardest hit (on the short term) would be the Rand and local economy stocks.

While this is not seen as a favourable outcome by the markets, markets (and the economy) will probably settle down after a few weeks or months after which they will take their cue from the actions of NDZ.

We frankly don't think that an NDZ victory would unite the ANC factions, as many rank and file ANC members (possibly differently to their branch representatives) seem frustrated with the current state of the ANC and determined for the party (and the country) to take a different path.

We find it interesting that David Mabuza (proposed by many as NDZ's deputy) has been one of those calling for a unity/consensus candidate.

Scenario 3 - CR victory with NDZ as deputy

President Zuma suggested that the loser between CR and NDZ should become deputy president, supposedly in an attempt to create unity within the ANC.

We don't see this scenario as likely for 3 reasons:

1. The new process of voting starts with a vote for the president, allowing lobbying for other top 6 roles.
2. We believe most branches are strongly divided by the candidates, making a 'truce' difficult, and
3. There would be many good contenders for the position of deputy, splitting the votes.

That said though, a CR victory with NDZ as his deputy would probably be well received by the markets help unify the ANC.

Ramaphosa is widely seen as the "market's" ideal choice

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Scenario 4 – A Mkhize (ZM) victory

While many (including us previously) discounted this scenario as highly improbable, it could become a reality in the event of:

- Neither CR or NDZ gaining the support required to be declared the victor, or the sense that a win by either would cause further damage to the ANC, or
- The decision by the NDZ camp to combine with ZM (e.g. if they feel it unlikely to beat CR in a head to head race), or
- If ZM gains real support within the branches, possibly in recognition of the need for unity, and only if he gets the full support of the premier league.



Source : News24.com

While largely an unknown force, ZM is probably the most likely candidate to really create unity in a very fragmented ANC and is seen by many to be willing and able to take the ANC forward.

Many see this as a good reason for him to lead the ANC.

ZM was historically a keen supporter of Jacob Zuma, but this clearly changed in the past year or so, with ZM a vocal critic of the president at times, for example after the cabinet reshuffle in which Pravin Gordhan was removed.

We sense the markets will respond positively to a ZM victory.

Longer term though (e.g. into the 2nd half of 2018) markets (and joe public) will look for progress on issues such as appointing a new president (and cabinet) and some real policy progress in key areas.

Scenario 5 – CR as president with ZM as deputy

We believe that ZM is very keen on the top job and will campaign hard for this.



Source : IOL.co.za

We do however feel that ZM may actually get a fair number of votes as deputy (probably more than for president), in which case the conference could elect him as deputy president.

While a fairly small probability right now, it is a scenario worth considering, and one that we would see as a very good outcome for South Africa. This would probably be good for the economy and markets.

Scenario 6 – A failed or inconclusive result

Widely seen as the worst possible outcome would be one in which the 54th conference is unable to elect a new NEC, either due to intense infighting or procedural problems.



Source : Moneyweb.com

While this is not a very likely outcome, it is quite possible in the event of no acceptable resolution in the problem provinces (KZN and the Eastern Cape), or if no single candidate emerges with a clear majority.

This is the worst possible outcome for the ANC and the country and would probably lead to further declines in the Rand, business confidence and a sure return to recession in 2018.

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