SCM Steyn Capital Management

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Dear Investor

Our SA equity long only strategy returned 0.07% gross for the quarter vs. the JSE Capped Swix TRI performance of 1.16%.

Our "SA Inc." names were a headwind to performance this quarter. We have been selectively increasing exposure to these businesses given how attractive the current opportunity set is. The negative sentiment towards South Africa, exacerbated by the extent of load-shedding, has plumbed new lows this year. Valuations, incredibly, are back at Global Financial Crisis levels. While loadshedding is certainly a crisis, it is one that we believe will be largely resolved in the next 24 months by the wave of investment in private generation, and the return of large portions of Eskom's fleet. We cannot believe that markets are making the same mistake, so shortly after Covid, by extrapolating the current crisis into perpetuity. We would argue that the situation this time around is far more certain, given the technology to privatise power production is already available, and the momentum is evident. This is in stark contrast with the situation during Covid, when it was impossible to know the long-term effects of the virus, and whether a vaccine would even be found.

While there are clearly other serious challenges facing South Africa, we believe the apathy of local and international investors, reflected in the going valuations of high-quality "SA Inc." businesses, discounts a very dire outcome indeed. The risk/reward proposition given the balance of probabilities is thus incredibly attractive, and we believe (as we did in Covid) that it bodes exceptionally well for forward investment returns. Wallace Barnes recently wrote an insightful article entitled "A Failing State?" which puts the current crisis in a historical context, and discusses how the market's discounting mechanism can result in the sometimes-counterintuitive relationship between depressing news headlines and excellent prospective investment returns. We think this is the situation we currently face. We've attached the article to this letter and encourage interested readers to visit our website to read other recent articles we've written (https://steyncapitalmanagement.com/news/).

The nervous investor sentiment this year has seen those stocks reporting bad or disappointing news being brutally punished (case studies include Spar Group, Pick 'n Pay and Transaction Capital - all of which we avoided in our long-only funds and were short in our hedge funds). On the other hand, there are a number of stocks (particularly in the "SA Inc." and small and mid-cap cohort) that have been performing admirably in the current environment, but which have received limited investor enthusiasm. As we did in Covid, we have further concentrated our portfolio into these best ideas, which balance resilience with attractive quality and value. We are very enthusiastic about the current portfolio and the opportunity set.

Individual Contributors and Detractors for Q2 2023

Top 5 contributors	Contribution to performance	Top 5 detractors	Detraction from performance
FirstRand	0.63%	Sun International	-1.59%
Tsogo Sun Gaming	0.44%	Aveng	-0.40%
Glencore	0.37%	Anglo American	-0.35%
Adcock Ingram	0.32%	KAP Industrial Holdings	-0.27%
Quilter	0.20%	ABSA Group	-0.25%

Contributors

The biggest contributor to portfolio performance in the quarter was our holding in FirstRand, in our opinion the highest quality SA Bank, which continues to deliver on guidance and recently guided ROE to the top-end of its 18%-22% target with the cost of risk expected to be below its long-term guided range. Other quarterly contributors included our holding in Tsogo Sun Gaming, a high conviction position we've discussed previously, which notwithstanding the environment, recently reported earnings per share growth of 38% and exceptional cash generation, which we expect to continue. Glencore, a commodity producer and trading business, also traded up somewhat alongside its commodity basket at quarter-end. We used the strength to trim the position post quarter-end.

Detractors

The biggest detractor to performance this quarter was our holding in Sun International, which along with Tsogo Sun Gaming (discussed above) dominates SA's duopolistic gaming market. The stock traded down on no news this quarter, even as its peer reported exceptional earnings growth and cash generation. We believe both stocks are severely undervalued, and our proprietary revenue model shows both continue to trade at pre-Covid levels, but on significantly reduced cost bases. This is translating into significant free-cash generation, which we expect to be returned to shareholders over time. Other detractors in the quarter included our holding in Aveng, which traded down after providing an update on a problematic contract in South-East Asia. We expect the related provisioning will negatively impact near-term profitability, but continue to see the stock as an exceptional value opportunity, with net cash exceeding its market capitalization. The February earnings report also showed the core businesses are performing strongly, with a 15% increase in revenues, and a 73% rise in backlog.

Strategy and Positioning

Notwithstanding our enthusiasm for the opportunity-set in selected "SA Inc." companies, the portfolio remains appropriately diversified with approximately 40% of the portfolio invested in companies with Rand-hedge characteristics. While each of these holdings is included in the portfolio based on their stand-alone attractiveness, they provide a hedge against any future domestic economic or currency weakness. The current macro environment is very difficult to anticipate, but we believe the portfolio is well positioned for a variety of outcomes, and on a bottom-up basis, we have rarely been as excited.

Business update

During the quarter we completed an extensive recruitment process for our 2023 Graduate Trainee Analyst Program, involving around 1400 applications, 100 case studies and 30 interviews, ultimately resulting in two very talented graduates joining our team. We are delighted to introduce Akhona Tyhaliti, B.Bus Sci (Finance) and Preneshen Naicker, BSc Applied Mathematics and Mathematics *(Cum Laude*).

As always, if anything is unclear, or if you wish to discuss our operations further, we welcome your questions.

Sincerely,

André Steyn, CFA
James Corkin, CA(SA)
Wallace Barnes, CA(SA)
Zintle Twala, CFA

A failing state?

Wallace Barnes, CA(SA)
Analyst, Steyn Capital Management

For many, living in South Africa has not been an endeavour for the faint-hearted. Confronted daily with severe inequality, rampant crime, and a state that seems unable to provide even the most basic of services, it's often hard to see anything beyond problems. The past decade has also shown little cause for optimism, with GDP per capita implying the average citizen is no better off now than they were at the start of the 2010s.

The best analogy I've come across for how this country was run during the Zuma-administration, probably spilling over into the current administration, is reflected in the 23rd episode of the hit TV series The Sopranos. In it, a store-owner foolishly becomes indebted to the mob. In order to repay those debts, the mobsters take control of his store, and proceed to utilise and exhaust every one of the store's credit lines to buy expensive merchandise, which they subsequently unload for their own benefit. The end result is of course an insolvent store, and a few very wealthy mobsters.

What we tend to forget, however, is that our history is filled with apparent existential crises. This is not the first, and definitely not the worst, economic crisis in our history. To get a better perspective, it is valuable to take a look into the past.

The year is 1985.

Foreign capital is fleeing South Africa at an unprecedented level, with international economic sanctions becoming a question of "when" and "how severe", rather than "if". The government, seemingly having settled on a scorched-earth policy, has announced its renewed commitment to the system of apartheid, cemented in the infamous Rubicon Speech. Protests and unrest are becoming increasingly violent, as the people continue to struggle against a government ruling for the benefit of a minority within the minority.

As if things in the political sphere weren't bad enough, the economy is in a severe recession – the worst since the 1930s. Inflation rages at 16%, undeterred by the 20-25% interest rates on offer. The value of the rand has dropped almost 40% over the last year, with 10% overnight plunges becoming a frequent occurrence. The government is scrambling to apply plasters to gunshot wounds, periodically suspending trading on the rand.

In summary, things were very, very bad.

This was a dark time in South Africa's history. As I'm sure many will agree, the situation today is nowhere near as disastrous, which of course is a point in itself.

So, 1985 must have been a terrible time to invest into the country? Well, let's say you invested R100 into the JSE ALSI at the start of 1985, and held until the end of 1989. In ZAR, your R100 would be worth R379 at the end of 1989, for a 31% annualised return. But what about the raging inflation? This averaged 16% p.a. for the period, leaving you with a 15% annualised real return. In USD, the 31% annual return would reduce to 24%.

This isn't to say the economic doomsayers were wrong in 1985. In fact, GDP per capita dipped significantly in 1985 (-26%), and ended the decade below the levels of 1980.

While the economists weren't wrong about the issues at the time, Mr Market was wrong in pricing those problems into perpetuity.

Our problems as a nation back in 1985, as I believe is the case with our problems at present, will not continue forever. This is not to say things will turn around quickly. Boom-and-bust cycles work in decades, while investors often think in quarters.

Where government has however repeatedly shown its inability to solve our problems, private industry has consistently stepped up to the plate (if allowed). Whether it be healthcare, security, housing or transport, the private industry has shown that it can fill the gaps. For many, healthcare is covered through private medical aid, their houses are protected by private security companies, while transport is generally a service provided not by public trains or busses, but largely through the private taxi industry.

To a large extent, our current problems boil down to a lack of jobs, and a lack of public services. While I've been quite negative on the government's ability to rectify these issues, there are green shoots emerging. The government's increasing openness to allowing private industry in, is massively positive. From private-partnerships for the operation of our ports and railways, to enabling private power generation and getting rid of vanity projects like SAA, there is definitely a push in the right direction.

Looking at the data, for example, it's clear to us that there is a huge wave of renewable power generation capacity coming from the private sector. It's only a matter of time, perhaps 12-24 months, until we believe the private sector, together with the return of critical power generation units at Kusile and Medupi, will have resolved a large proportion of the current load-shedding.

SA Inc shares are currently trading at valuation levels similar to those seen in the Global Financial Crisis of 2007-8.

Never one to disappoint, Mr Market has again been busy extrapolating our current issues forward into perpetuity. We believe this offers an attractive entry point for select high quality, cash flow generative, SA Inc businesses.

The stampede of capital out of SA is also clear in the data. Local balanced funds, taking advantage of the increase in offshore allocation limits from 30% to 45% – effective Feb'22 – have been running for the exit, with their offshore allocation now around 40%. Foreign investors, being the marginal buyers and sellers, are one-third underweight SA vs the respective emerging market benchmarks. The proportion of SA government bonds held by foreigners has almost halved over the last 5 years, now approaching 25%.

Mr Market is, to some extent, pricing us to become the next Zimbabwe, Venezuela or Argentina. While this is possible, we believe it to be improbable, and only one of multiple, more likely paths going forward. If things turn out not to be that bad, maybe just OK, it calls for a significant upwards re-rating of current valuations.

While many may not believe in the future of this country, history shows us that it is not a smart move to bet against its people. I know where my money would be.