Benguela South Africa Capped SWIX Composite Commentary: 2Q2023

Portfolio: Benguela SA Capped SWIX Composite
Benchmark: FTSE/JSE Capped SWIX Index

02 August 2023

2Q2023 Fund Performance Overview

The SA Capped Swix ALSI delivered a return for the quarter of 1.126%, 3.62% year-to-date, and 13.28% over the past 1-year period. The Benguela Capped Swix Composite Portfolio delivered 0.803%, 5.0% and 12.498% over the respective periods. The relative performance for the quarter, the year-to-date and the past 1-year is -0.32%, +1.39% and -0.78%, gross of fees.

While the Fund is lagging marginally over the past quarter and the past year, we are encouraged by the outperformance for the year-to-date and believe the Fund is well positioned to build on this foundation moving forward.

Key drivers of performance in Q2 2023

Notable sector allocation contributors

Financials (UW - positive contribution):

Portfolio Tactical Strategy: We maintained an underweight exposure to the sector as a whole, we have gradually added to our existing holdings through the quarter. Our specific allocations within financials have been a positive contributor.

Within the sector we have been increasing our bank exposure through the quarter to an overweight in banks and remain slightly underweight insurers.

Banks: Banks have remained a defensive haven in the face of a slowing SA economy. On balance they are well provisioned and have not yet reached the tipping point between the positive endowment effect of rising rates and the negative credit loss ratio increases resulting from these rising rates.

Given the economic challenges SA faces, we continue to hold most of our exposure in what we regard as the highest quality banks. We prefer banks that have higher lending standards or are more conservative in their provisioning as they will be better able to absorb the expected increase in credit loss ratios (CLRs) and generate a net profit from the rising net interest margins and income.

There is large-scale capex being invested throughout South Africa to drive the shift to renewable and alternate energy sources. Whether it is by independent energy providers (IPPs), corporates or retail investors, banks are a natural beneficiary of such activity through increased advisory fees and book lending growth, as they will likely fund most of the capex investment particularly to corporates and IPPs. The rapid retail expansion into solar is for the most part bank financed as well.

On balance we see banks as attractive through conservative provisioning, cheap valuations and upside gearing to an economic recovery.

Insurers: While we are marginally underweight, we are constructive on the outlook for the quality insurers as claim rates continue to normalise post-covid. Lapse rates are under pressure but through the cycle are expected to normalise providing a tailwind to earnings. Looking forward. we believe this sector offers relative value in a difficult economic environment.

Communication Services (OW - positive contribution):

The telecommunications sector contribution benefitted from a recovery from a very low valuation base and the fact that we did not hold Telkom, a company we view as poor quality.

We view the Nigerian developments of structural reform and exchange rate deregulation as net positive for the Nigerian economy in the longer term but in the medium term it will provide upward pressure on inflation through rising fuel and energy prices and ultimately hurt the consumer. We see this as a net negative for MTN with their large exposure to the Nigerian consumer even if it takes some time before impacts earnings.

Materials (UW - negative contribution):

Materials have been our largest sector underweight throughout the year and Q2. Our view has been consistent: the persistent and aggressive global rate hiking cycle will lead to a meaningful slowdown (if not a recession) in some of the major global economies that will outweigh the Chinese reopening impetus to commodities. Consequently, the windfall like profits and margins seen from the mining sector last year is unlikely to be repeated.

This view has largely played out as expected and we have seen significant retracement in most major commodities feeding through into much lower earnings and inflation driven margin pressures across the spectrum.

In the miner's favour are the vastly improved balance sheets and self-restraint with regards to new capex plans, which means they are likely to weather this cyclical downturn better than in previous periods and any major further weakness may present opportunities to reduce the underweight.

Our underweight in the gold sector was the main contributor to the negative allocation effect. Considering the significant geopolitical risks in Russia-Ukraine, US-China and North Korea, we reduced this underweight during the quarter from a portfolio risk-reward balance perspective.

Consumer Staples (OW - negative contribution):

We continue to hold an overweight in local and global high-quality consumer staples. The ongoing challenges faced by the SA consumer - under pressure from inflation, rate hikes and loadshedding – is expected to continue the transfer of wallet share from discretionary to non-discretionary retailers and we expect to remain overweight the sector.

The sector contribution of food producers was dragged lower by the impact of loadshedding, input price pressures, and selling price pressure (private label substitution and retailer rejection). The sector has been unable to pass on all the significant cost increases it has endured and has been unable to capitalise on the expected benefits of falling input costs at this stage.

Global staples have been a safe haven as consumers have used excess savings to spend on service experiences such as dining out.

The Fund is overweight food retail which is more defensive in the face of inflation and cost pressures but has had a higher loadshedding burden. We have observed a growing divergence between the high-quality businesses and the peer group as conditions have worsened, a trend we expect to continue as economic conditions remain strained.

Stock Level Performance Drivers

Overall, our stock selections detracted marginally from performance in Q2 2023 with two significant underperformers.

Issue Name	Active Bet	Effect	Issue Name	Active Bet	Effect
Impala Platinum	UW	0,26%	Spar Group	OW	-0,78%
Sibanye Stillwater	UW	0,24%	Gold Fields	UW	-0,69%
Capitec	UW	0,17%	Prosus	OW	-0,12%
Firstrand	OW	0,15%	Anglo Platinum	OW	-0,11%
Sanlam	OW	0,13%	Equites Property	OW	-0,08%

Top contributors

Impala Platinum and Sibanye Stillwater

Our long-held position that PGM miners profit margins would come under pressure from the highs of 2022 (30.2%) continues to play out. The Platinum Group Metal prices, in particular Rhodium (down over 70% from its 2021 high) and palladium (down 61% from its 2022 highs and over 20% for the year in ZAR terms) have meaningfully corrected and continue to put margins under pressure.

The PGM miners have faced production and refining volume pressures caused by loadshedding, significant cost inflation and challenges in getting production to port. For as long as miners are faced with these challenges along with falling sales prices, the sector will remain fundamentally challenged until we move closer to a global economic recovery, which we do not see until at least 2024.

Capitec

While Capitec is a high-quality business, key to our quality philosophy is we do not overpay for companies. We have held the view that Capitec was expensive in the context of the rapid rise in interest rates and the slowing SA economy, especially given the expected pressure on Capitec's credit loss ratios relative to its banking peers and have been underweight for some time. We have been reducing our underweight into weakness as the valuation has fallen while the core business is still quality and has several new growth vectors such as insurance and corporate banking that could drive superior long-term income growth.

FirstRand

We view FirstRand as the highest quality bank in the sector and it remains our top pick. Their consistently superior ROE of above 20% and relative to the big four support this view. Management is conservative with new lending and their loan book has held up well in the face of the difficult economic environment.

Banks are generally offering defensive exposure to the SA economy as they remain well provisioned and are still capturing the benefit of the endowment effect as rates are nearing peak cycle. We will continue to hold our overweight in FirstRand as they maintain superior ROE, their CLRs appear most likely to remain within their through the cycle range, and the valuation remains undemanding trading at a discount to its 5 and 10 year long term averages and our fair value.

Top detractors

Spar Group

Spar has been through a tumultuous 8 months. We built our position early in 2023 post the significant share fall in the share price due to bad press and questionable corporate governance while we believe the business represented a deep discount to the core value of its South African business.

In its most recent update Spar reported a much larger than expected fall in earnings due to loadshedding, market share losses and IT implementation issues. AT the same time the foreign denominated debt ballooned on the weakening Rand. This sudden spike in debt to EBITDA to over 2.75x, coupled with ongoing losses in Poland caused another sharp drop in the share price.

We have constructively engaged with management around exiting Poland, consolidating the debt and refocusing on the core South African business in the face of fierce competition. The current share price of approximately R110 does not reflect the fundamental value of this cash generative business and we believe that significant value can be unlocked by proactive and decisive management.

We will continue to engage with management and monitor the developments around this holding.

Gold Fields

As a quality investor, gold stocks do not stack up well from a fundamental point of view due to the lack of earnings visibility, (highly volatile selling prices, cash flows and lack of fundamental drivers).

Our underweight in gold came with an opportunity cost as gold continues to hover near its recent highs. The fundamental demand for gold may remain elevated considering the following:

- The current geopolitical climate with the ongoing Russian war, the US-China tensions and other flash points such as China-Taiwan and North Korea.
- The demand for dollar-alternative by China and its allies will be sustained as the world polarises. We can see this to some extent by elevated central bank purchases.

We have subsequently reduced the majority of our underweight in gold through buying Gold Fields, which we believe to be the highest quality operator with an improving quality relative to its peer group.

Macroeconomic environment and outlook

Macro landscape

Without arguing for or against a recession, our base case for a further slowdown in the global economy remains intact. The extent and timing of the shallow slowdown so far has surprised many. We believe the full effects of the rapid series of rates hikes thrust upon global economies has not yet fully worked its way through the system for several of reasons, including:

- The lag between rate hikes and the full economic impact can take up to 9-12 months. To put this into context, the US federal funds rate was 1.75% in June 2022 versus 5.25% today – the economic flow-through of current interest rates is a long way from completing the typical lag cycle.
- The US consumer has remained very resilient, relying on the excess pandemic savings of $2.1 trillion accumulated in 2020, easy access to credit, and plenty of jobs to sustain spending habits even in the face of high inflation. Considering consumer spending accounts for roughly two thirds of the US GDP this is an important contributor to the surprising economic strength. (We note also that the excess pandemic savings and high employment has been a feature of most major economies).

When we look at key leading economic indicators such as ISMs, PMIs, consumer sentiment and credit, coupled with the long-inverted yield curve, we find it hard to believe that there will not be further slowdown in the US economy.

Inflation

The rate of disinflation in core CPI globally has increased the likelihood that we are near the global rate cycle peak.

China is bordering on deflation with most recent data reflecting yoy CPI at 0.5% and PPI at -4.5%. The US is lapping the turning point in the largest constituent of core-CPI being shelter (housing and owners' equivalent rent) and Europe is following the US trend lower.

The risk to this trend remains the tight labour markets which we think will ease somewhat over H2 as the US economy slows further. It is possible that the structural challenges of developed market labour shortages and ongoing fiscal stimulus plans may result in a structurally higher long term inflation base, but we do not see this impact becoming clear until more time has passed.

China

While China's post-reopening recovery has been a disappointment to many, it is still expected to deliver 5.5-6% GDP growth for 2023. Key challenges for China are the need to manage the debt riddled property market while providing further stimulus to support the flagging growth and offset the greater reluctance of Chinese consumers to spend versus their developed market counterparts.

We expect global geopolitics to continue the drive by Western companies and investors to look for investment opportunities outside of China and diversify capital risk exposures. At the margin we believe China is going to see a drag on FDI growth as the global supply chain reorganisation and trend towards friend-shoring and reshoring and gathers momentum.

A resilient US will continue to slow.

The US is facing two powerful but opposing forces in central bank monetary and liquidity tightening, versus fiscal stimulus and consumer spending. The massive government packages such as the CHIPS act and the Inflation Reduction Act are fuelling a wave of reindustrialisation of the US (sectors like automotive, semiconductors), keeping the job market tight and counteracting much of the monetary tightening. This partly explains the shallow and delayed economic reaction to date and is likely to support the prospects for a future slowdown in whatever form it takes (recession or no recession) to be less severe.

A weakening dollar

Over the next 12 months we expect much of the dollar strength to unwind as rates peak and global growth begins to recover. The added urgency of the China-led bloc striving for de-dollarisation will add to expected weakening however the process is likely to be slow and protracted as roughly 80% of global trade is still priced in dollars, if not traded in dollars.

As the US led the global rate hiking cycle on the way up, they will most likely lead it on the way down. Europe has very much been a follower and their lagged rate cutting cycle along with falling yield curve expectations will add pressure to any dollar weakness.

We note with caution that a weakening dollar will increase the level of imported inflation into the US and may complicate the outlook for rate easing over the next 12 months.

South Africa

Despite the doom and gloom experienced so far in 2023, we remain cautiously optimistic. Looking ahead over the next 9-12-15 months we see opportunities presenting themselves for patient investors as we believe we have moved past the point of peak pessimism.

The SARB is at or nearing the end of an aggressive rate hiking cycle that has seen the repo rate rise from 3.50% in 2020 to 8.25% in 2023 as inflation pushed well above its target range. In addition, the escalation of loadshedding in 2023 has hurt SA business and consumers alike with SA GDP growth estimates now ranging from 0% to 0.6%.

The South African corporate has unsurprisingly been under pressure - margins have been squeezed by rising inflation in their cost base and the challenges of passing costs on to a consumer being squeezed ever more tightly. They have also faced the burden of significant cost increases to run backup power, and many have been rolling out alternate energy solutions.

The combination of a stagnant economy, loadshedding and high inflation led to a significant devaluation of most south African companies, with many trading back to the lows last seen in the 2008 GFC.

Looking out over the next 12 months, through the economic cycle, we believe this combination of factors above is providing us with an opportunity to buy high quality South African businesses at attractive valuations which have priced in a lot of negativity. If inflation remains within the target band of the SARB as expected, the prospect of rate easing moving into 2024 will improve consumer sentiment and economic prospects.

Tailwinds and headwinds

Loadshedding and internal cost inflation has established a high-cost base from which we think things can improve as loadshedding and the hiking cycle ease looking out 6-12 months.

- Marginal improvements in loadshedding will reduce the net spend on diesel which has now formed a high base.
- Falling input costs will ease the pressure to pass on increases.
- High alternative energy capex will have been embedded in this year's cash flows.
- Improving consumer sentiment on prospects of easing rates in H1 of 2024

Stock picking will matter even as inflation falls. High inflation has fuelled nominal revenue growth for some companies able to pass on increases. Businesses with pricing power could benefit from falling input costs if they can defer passing the full decrease to customers while others will struggle to grow revenue as prices soften without a commensurate increase in sales volumes.

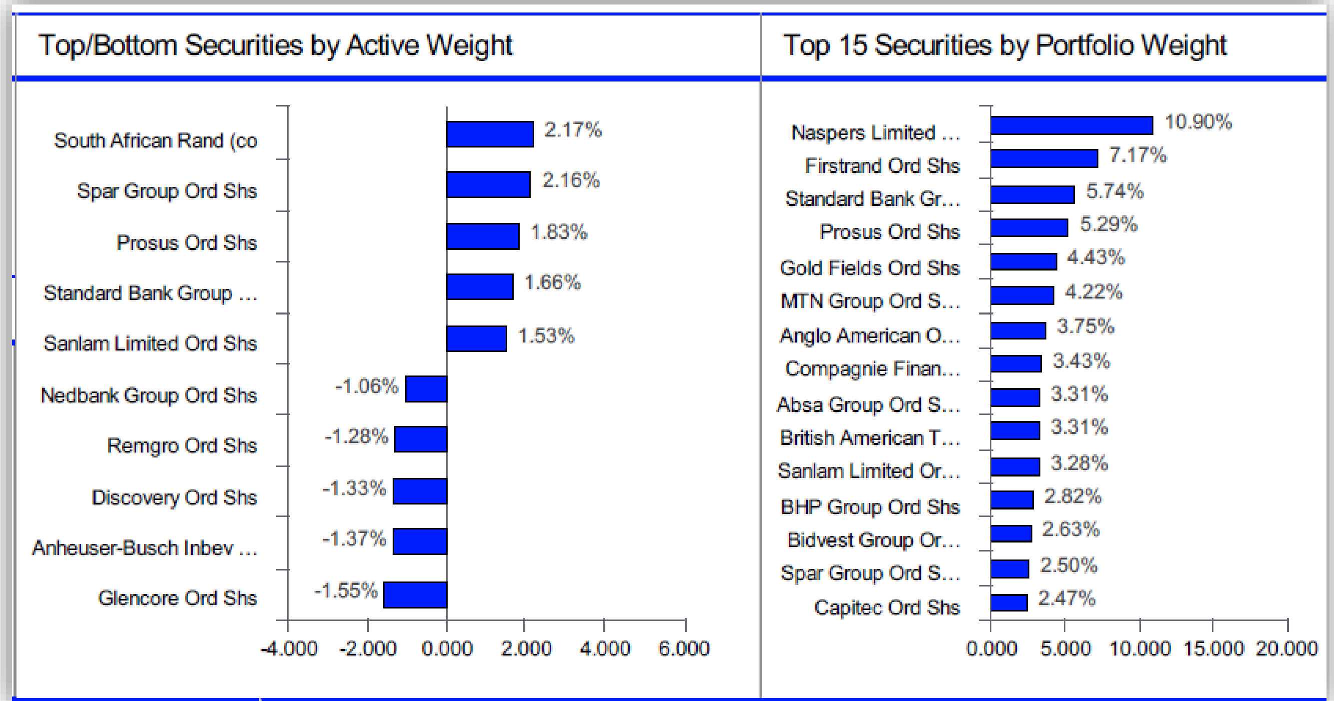
We have maintained for some time now that the heavy capex rollout being implemented by corporates, IPPs and even homeowners could have an underappreciated benefit (notwithstanding the well know negatives). Job support in the private sector, bank lending books and investment banking income to name a few.

Portfolio outlook and closing remarks.

Within the challenging operating environment, we have seen the higher quality businesses consistently deliver better operating performance than their peers. We have been migrating our portfolio toward the quality long-term value we see in certain South African companies, particularly in banking and retail) and reducing our exposure to some of the global industrials that have performed well and are approaching what we see as fair value.

We retain our underweight position in commodities due to the expected slowdown in the global economy.

As at 30 June 2023 our most significant portfolio positions and key portfolio characteristics were as follows



Characteristics

	Portfolio	Benchmark
Dividend Yield	4.64	4.91
Price To Cash Flow	7.53	6.53
Price To Book	1.77	1.49
Trailing P/E	9.71	8.55
Forward P/E	9.72	8.99
EPS Growth - Forecast 12-Month	22.446	20.510
EPS Growth - Long Term	9.250	8.032
Net Profit Margin	31.55%	27.58%
Operating Profit Margin	5.58%	5.76%
Refinitiv Style Score (2.0)	-4.21	-6.54
Refinitiv Size Score (2.0)	12.98	6.49
Refinitiv Global Size Score (2.0)	15.55	8.79
StarMine ARM Global Rank	39.544	40.201
StarMine Relative Value Global Rank	64.661	66.919
StarMine Value Momentum Global Rank	61.185	62.758

BENGUELA GLOBAL
FUND MANAGERS

Kind regards,

Zwelakhe Mnguni

Chief Investment Officer

Grant Nader

Portfolio Manager

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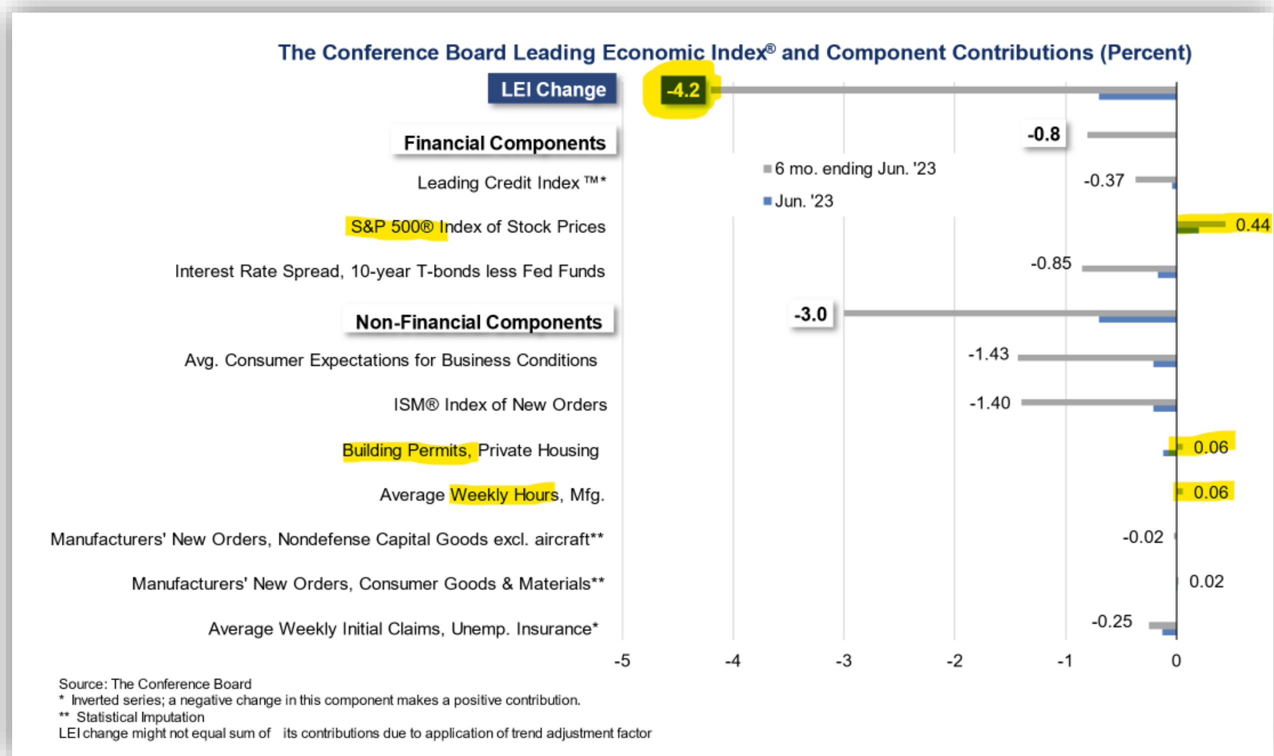
BENGUELA GLOBAL
FUND MANAGERS

Appendices

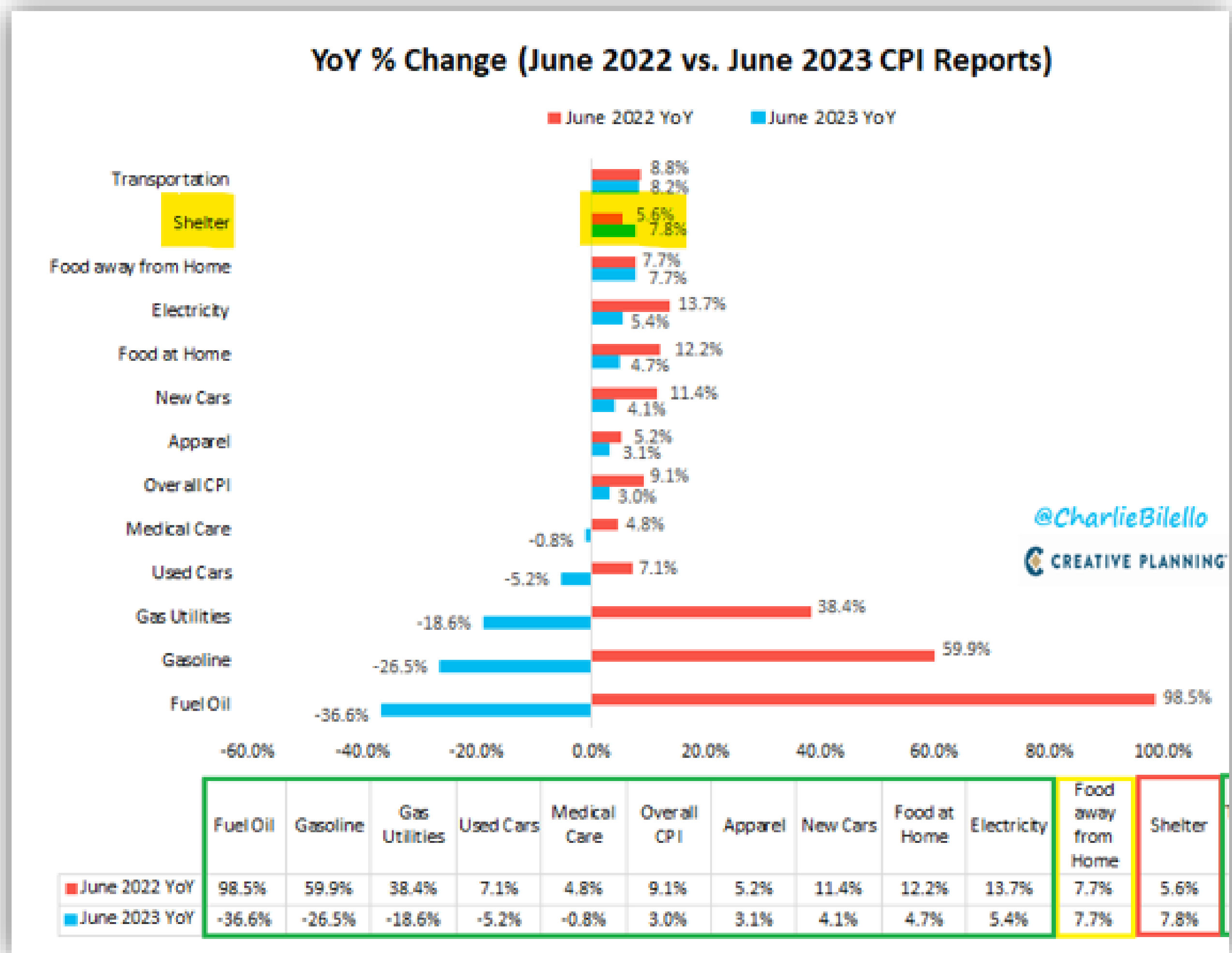
Appendix 1:

US leading indicators have declined for 5 months in a row and all forward looking metrics bar two point to further slowing (if not a mild recession) in the US economy.



Appendix 2: US CPI Inflation

Shelter is the largest year-on-year increase and this trend is about to change as increases in rentals and home prices are flat to negative.



	Fuel Oil	Gasoline	Gas Utilities	Used Cars	Medical Care	Overall CPI	Apparel	New Cars	Food at Home	Electricity	Food away from Home	Shelter
June 2022 YoY	98.5%	59.9%	38.4%	7.1%	4.8%	9.1%	5.2%	11.4%	12.2%	13.7%	7.7%	5.6%
June 2023 YoY	-36.6%	-26.5%	-18.6%	-5.2%	-0.8%	3.0%	3.1%	4.1%	4.7%	5.4%	7.7%	7.8%