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HARVARD HOUSE

We understand your need for FINANCIAL INTEGRITY

Empowering offshore knowledge and insight exclusively from the Harvard House Group.

OUR ECONOMY: A BRIEF RECESS OR REAL RECESSION?

Willie Pelser

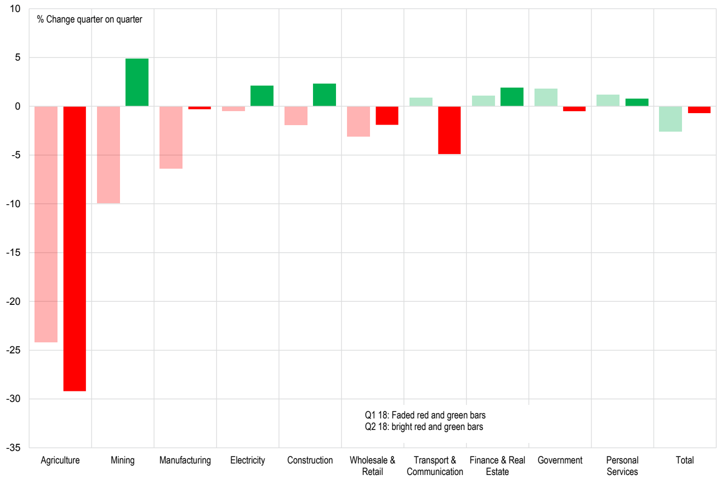
Statistics South Africa released the second quarter national accounts data. The data gave us a factual update on the state of the economy, i.e. the spending patterns, investment flows and our net trade with the rest of the world.

The newspapers were full of scary headlines, such as: "SA in a technical recession", "Fragile economy…", and "Economists are divided on state of SA's Economy." Unfortunately, statistics can often lead to confusion. For example, two consecutive quarters of negative GDP growth is by definition a recession – there is nothing technical about it. However, we have been saying for some time that the loss of momentum in economic growth in SA is by itself a recessionary force. In a previous newsletter, we highlighted that GDP growth averaged 4.1% for the first decade of this century. That growth rate has decelerated to 1.4% over the past ten years. For the first two quarters of this year, growth was -2.6% and -0.7% respectively.

It almost appears that since the end of last year the country broke for a recess or a siesta, but has never returned. What has contributed to the current state of affairs?

- We cannot ignore the impact of the recent droughts – firstly in the summer rainfall areas, and then in the Cape. The agricultural sector contracted by -29.2% in Q2 (after a -24.2% contraction in Q1). Although the sector only contributes around 4% to the broader economy, the multiplier effect is enormous in terms of wages earned and spent, inputs such as fertilizers, machinery and packaging, and exports.
- Secondly, we are increasingly concerned that SA has also stopped manufacturing anything. The manufacturing sector is firmly in decline, which in itself has knock-on implications for the wider economy.
- This is highlighted by the fact that the only sectors showing any consistent growth are finance, real estate and personal services. These are all service sectors.
- Mining made a positive contribution to growth last quarter, but the monthly mining production numbers suggest that this growth will be very short-lived. Once again, we have failed to capitalize on stronger global growth and demand for commodities, due to the lack of clarity with regard to the Mining Charter.

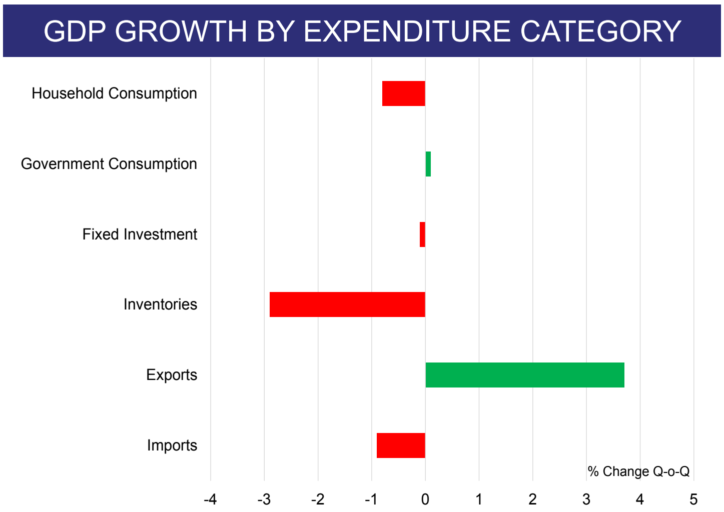
GDP GROWTH BY SECTOR



Whilst growth in Q2 was stronger than Q1, there is little to get excited about when analyzing the SA economy.

The prior analysis analyzed GDP by economic sector. If we analyze GDP by expenditure category, it reinforces the gloomy outlook. The chart below shows the breakdown. Household consumption expenditure – traditionally a strong component of our economy - has turned negative. We all know the reasons. The traditional resilience of this sector is supported by the fact that over the last 20 quarters of GDP data, personal consumption expenditure has only shown negative growth on three occasions - Q2'15 of -0.3%, Q1'16 of -2.0% and the latest reading of -1.3%.

Government consumption expenditure was positive, but marginal at that. Worryingly, fixed investment remains negative, which implies that we are not adding to our productive capacity in the economy. In contrast to what we expected at the start of the year, inventories were a net drag on growth. In other words, there was a general drawdown of inventories, off an already depleted base. One of the factors that we believed would be a catalyst for growth this year was restocking – the building up of inventories. This has not materialized due to weak consumer spending and a lack of both business and consumer confidence. Finally, the only respite came from trade as we produced a net trade surplus for the quarter.



Weakness is broad based, with the only respite coming from net exports during the quarter.

On balance, five of the ten measured sectors showed positive growth last quarter, versus only 4 sectors in the first quarter. Furthermore, one can argue that a contraction in the government sector is a welcome development given the pressure on revenues from an excessive wage bill and wasteful expenditure. If one excludes agriculture and the impact of the droughts, growth would have been marginally positive. But this does not detract from the fact that our economy is stagnant and unlikely to gain sufficient momentum in the near term to address the social challenges that the country is facing.

Unfortunately, our forecasts do not project that our growth rate will reach the required 6% to make inroads into unemployment. We maintain a very low GDP forecast for the remainder of the year, although we do see growth for the full year edging into positive territory. This is due to the positive impact of the pledged “grants” (or loans) from abroad, and some form of local stimulus, although there is a huge question mark over how this will be funded. SA is facing a classic “chicken & egg” situation: do we stimulate (using loans) and grow, or do we “tax” and reduce debt, and then grow.

We, and the rest of the investment community, are awaiting the Medium-Term budget speech in October to get more clarity. In our opinion, Government has very little flexibility with regard to both spending and taxes. But it can make a big difference by announcing serious policy reform to stimulate growth. This is where the hope lies. Already there is an indication that they are reviewing visa requirements to boost tourism, and trying to fast-track the finalization of telecoms legislation in an effort to license spectrum and bring down data costs. These would be a good start, given that they should have been finalized years ago. But more needs to be done. Our hope is that there will be announcements on SOEs as well. If that is the case, it may well lay the foundation for a much better 2019. If not, we face further stagnation until next year’s elections.

LISTED PROPERTY: TRENDS FROM RECENT RESULTS

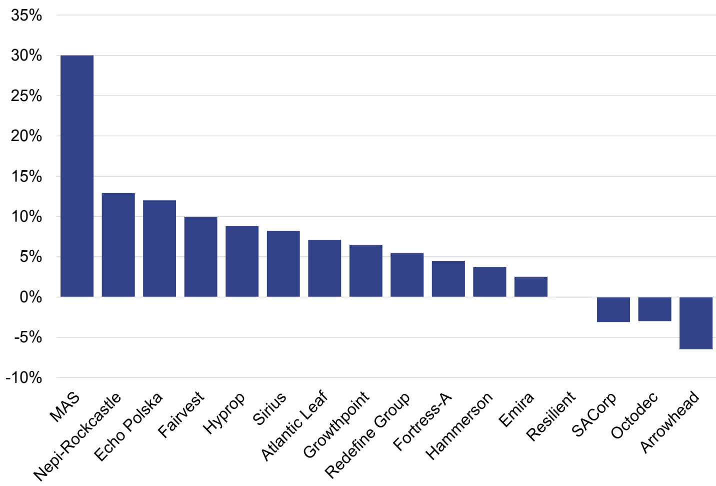
Roy Lamb

The South African listed property sector has had a torrid 2018. The sector’s main benchmark index (SAPY) has declined by -24% for the year so far. The reasons for the drop are numerous, but it all started with the Resilient debacle in January which we have covered in a number of earlier publications. This set the tone for a relatively vulnerable sector where a number of companies were trading at excessive premiums to their underlying asset value, and which ultimately left little place to hide when coupled with negative investor sentiment and a very weak local environment.

This weak local environment is due to a confluence of issues. Predominantly, it all stems from the very low economic growth rate in SA over the past few years. (Willie touched on this issue in the prior article.). This in turn has resulted in high unemployment and thus lower discretionary spending. The consequence has been lower retail sales, which has given landlords little room to manoeuvre in the face of higher vacancies, higher municipal costs and the continued construction of new space.

A number of companies have reported results in the past month, and they affirm the predicament in which the sector finds itself. The distribution growth to which investors have become accustomed has dropped significantly, now averaging around 6% versus double-digit growth in prior years. We have also seen vacancies increasing from a number of the higher-profile local operators as would be expected in this trading environment. This is reinforced by comments that all sectors of the property market are facing an over-supply. This seems to be most evident in the office sector and predominantly in the Sandton node.

12M GROWTH IN DISTRIBUTIONS



Rates of distribution growth has slowed, but have generally been higher for those companies with foreign exposure.

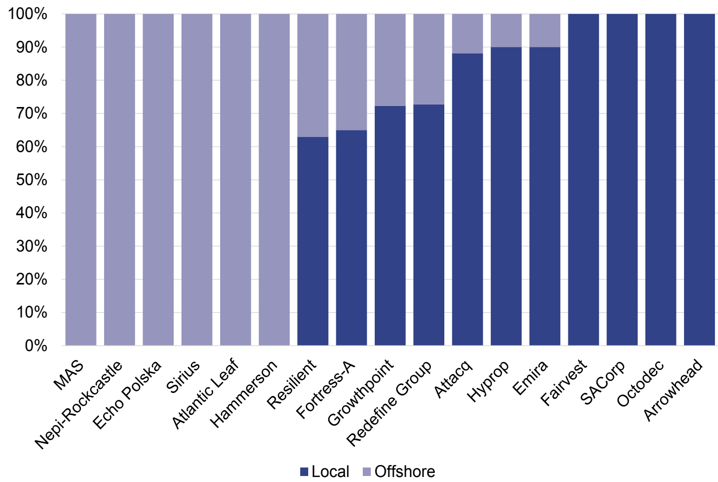
Companies seem to be taking up less space when moving premises, perhaps driven by the increasing popularity of flexible hours and the trend towards 'hot-desks'. The weak economic situation is also seeing a contraction in demand for space as companies cut back on staff, and rentals are weak as tenants are spoilt for choice with excess supply coming on stream.

In the retail sector, Edcon is in the process of meaningfully reducing their store foot print across the country. In addition, Stuttafords closed down mid last year and the foreign retailers have slowed their expansion plans due to the weaker economy. Together, these factors have left a number of mall operators with limited options to retain rentals, let alone try to push through higher rentals as leases expire. Tax, petrol prices, the increase in VAT and high levels of unemployment are all mentioned as culprits in squeezing the consumer.

The good news is that many locally listed property companies have diversified their revenue stream into geographies that are showing stronger economic fundamentals and these companies are therefore able to generate higher distribution growth.

In addition, we also have access to pure foreign property companies on our exchange giving one an easy option to diversify into stronger developed and emerging markets. We can invest into the Australian market directly via the locally listed Investec Australia Property Fund or indirectly into Growthpoint Australia through Growthpoint. The Central and Eastern European (CEE) property market has a number of routes to entry either through NEPI-Rockcastle, Echo Polska or MAS Real Estate. Other options include a 50/50 split between the UK and France via Hammerson or solely the UK through RDI Reit or Intu. Finally, there is the 100%-German operator, Sirius, that has been very successful in the flexible office work space. This list is not exhaustive, but the bottom line is that investors are able to invest in alternative geographies which are benefitting from stronger global growth whilst still giving above inflation (local) hard currency distribution growth.

OFFSHORE EXPOSURE OF VARIOUS FUNDS



Local funds have diversified over the years in response to a weaker local environment, which is helping to mitigate the impact of the current malaise in SA.

geographic profile of the property stocks in which they are invested, as those with the best quality properties will have that much more bargaining power during these difficult times. It has become imperative to have some exposure to counters that offer access to faster-growing economies, and a degree of protection against a weak currency.

However, an improvement in our own economy would be hugely beneficial to quality local companies who have been forced to become "lean and mean" over the past few years. Stronger growth would quickly manifest itself in improving vacancies and higher rentals. Most local companies offer an income yield in excess of 9% or 10%, which is attractive. Now is a good time to buy quality assets on the cheap. It is also the reason why we tend to have diversified and balanced property portfolios for clients – to blend the growth from offshore with the high income yield available locally. In this way, we can meet income requirements, whilst still growing the income from year to year, and being patient for the better times.

FOSCHINI GROUP: HOLDING ITS OWN

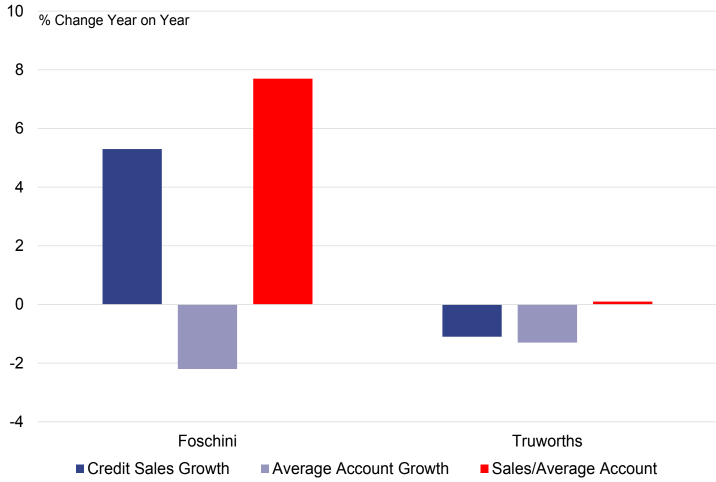
Nick Rogers

In 1924, a Russian entrepreneur by the name of George Rosenthal arrived in SA and founded Foschini, named after an old Italian family that he knew! Initially he imported women's clothes from the US and in 1941, the company became the first clothing retailer to be listed on the JSE. Fast-forward to 2018: its portfolio has grown to encompass 28 retail brands across clothing, jewellery, homeware & furniture, cellphones and cosmetics. There are 4,034 outlets across 32 countries spanning five continents. The likes of @home, Markhams, American Swiss, Sterns, Total Sports & Due South also fall under its umbrella as well as newer overseas brands such as RAG, Phase Eight & Hobbs. Foschini aims to be the leading lifestyle retailer in Africa whilst simultaneously growing its international footprint.

Firstly, let's analyze the geographical breakdown of revenues and profits. TFG Africa contributes the lion's share of both revenues and profits - 70% and 83% respectively. This is followed by the UK at 19% & 9% respectively. Australia makes up the balance. Foschini has invested R6 billion into acquisitions over the past three years in an ambitious diversification drive. SA Retailers have had a mixed track record of diversifying overseas, with many returning with their tails between their legs. But so far, Foschini's management have executed well on its offshore acquisitions and the hard currency earnings are helping to provide a diversified revenue stream going forward.

Revenue growth for their last financial year to March of 6% in SA was relatively impressive in a competitive and tough environment dominated by high levels of discounting. Strong cost control helped increase margins which led to an increase in profit of 6.6%. The Group's revenue is split between credit sales (34% of the total) and cash sales (66%). Foschini, along with Mr Price and Truworths, recently took the National Credit Regulator (NCR) to court over the imposition of stringent credit regulations and won, which has boosted sentiment in the credit retail sector. The CEO said that the recent court ruling on the Affordability Regulations signaled an improved outlook for the South African credit environment with the negative impact now in the base. Consequently, the number of

FOSCHINI VS TRUWORTHS

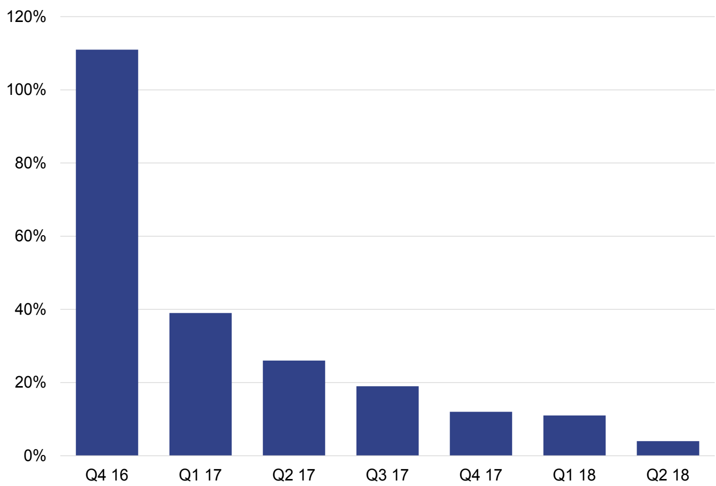


Foschini is outperforming its main rival with regard to in-store credit accounts.

credit accounts grew 1.1% versus -5.4% in 2017.

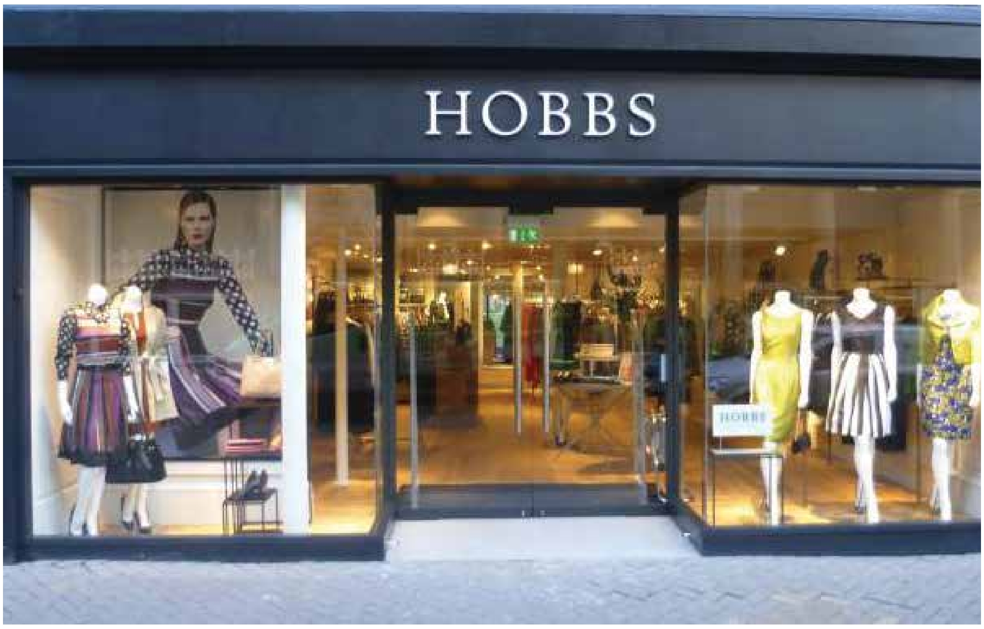
Nonetheless, the company is fully aware of the current macro environment so new account openings are scrutinized and management have retained their strict criteria despite the NCR ruling, to mitigate risks in this weak economic environment. SA retail sales data for July showed growth of just 1.3% over the same period last year, although clothing & footwear (+3%) and household furniture (+6.9%) were two of the strongest categories. Unfortunately, consumers are likely to remain under pressure for the rest of this year, or until there is a change in the economic trajectory. The arrival of overseas retailers such as Zara, H&M and Cotton-On has been a disruptor for local companies over the past few years but as the chart below illustrates, they are not immune to the weak economy. Foschini, and others, are now holding their own given their ability to respond quickly to global fashion trends at an affordable price.

H&M SALES GROWTH



Sales growth is slowing for global retailers in SA given the weak economy and the end of the honeymoon period.

In the UK, Foschini acquired Phase Eight in 2015, Whistles in 2016 and upmarket women's retailer Hobbs in late 2017. Phase Eight operates 157 stores and 416 concessions in the UK and Ireland with a further 22 stores and 636 concessions in 18 other countries. Hobbs will add 188 stores and concessions. A new strategy to streamline the UK businesses will be the key driver for reducing costs and any positive BREXIT outcome would be favourable to the embattled UK retail sector.



Hobbs, the British, affluent-focussed women's retailer, is now part of Foschini.

Foschini ventured into Australia through the acquisition of that country's largest menswear retailer, Retail Apparel Group (or RAG), for R3 billion in July 2017. RAG had achieved double-digit growth rates since 2010 and management's strategy is to grow the number of stores from 400 to around 700 over the next 5 years. Interestingly, while it is common knowledge that women are fashion's biggest spenders, menswear is now growing at a faster rate, and this trend is forecast to continue for the foreseeable future. RAG focuses on menswear in the "mid-to-value fashion conscious" segment. Like so many other countries, this is a profitable niche. They achieved an enviable gross margin of 65.5% in their last set of results, which has vindicated the acquisition. This year has also started on a positive note. Turnover for the first 20 weeks of the year is up 15% which is in contrast to David Jones (owned by Woolworths) who have struggled Down Under. The Group will also be launching one of their SA branded stores in Australia shortly. So far, Australia is exceeding management's expectations.

The largest upheaval in global retail is the shift from shopping at physical stores to online/e-commerce. Foschini is well placed to capitalize on this growth and recently launched a unique online platform where customers can shop across all its African brands and only check out once with various payment options. In the UK, online turnover continued to grow at a fast pace to offset the declining footfall in physical outlets. In Australia, the arrival of Amazon has heightened the importance of having an e-commerce platform. Australian retail sales grew by 2.6% over the past 12 months, and 60% of that was from online sales. Foschini has demonstrated its ability to effectively compete online, which is reassuring given the rapid pace of change.

One of the most important aspects of fashion retail is speed to market – in other words, how quickly you can get a new product into the shops. Last December, we were invited on a tour of Foschini's Prestige Clothing factory & Design Centre outside Cape Town. Assembly time has dropped from 15 days to 4 days since they acquired Prestige in 2012, whilst manufacturing costs have largely remained unchanged due to the many efficiencies created and resultant cost savings. Foschini produces 6 million garments per year and is judged independently as matching and often exceeding global best practice. A key strategic business objective is to optimize its supply chain capabilities to offer customers a wider range of in-demand fashion products. The overall impact of this quick response capability is a key differentiator for the Group versus its peers, especially in a world where fashion changes by the week. The result is that the long lead-times using traditional sourcing from Asia are kept to a minimum.

In conclusion, our Cape Town tour was just prior to their December sales update and the ANC Elective Conference, both of which were positive. The share price promptly raced to R240 – a gain of 50% over the ensuing three months. It has since retraced back to the mid-R160's as the economy has faltered and emerging markets have fallen out of favour. We feel that Foschini's management are implementing their clear strategy of diversification across geographies and products and the Group is well placed to benefit from any upturn in all the retail environments in which it operates. With the PE ratio now at a reasonable 14.5x, coupled with a dividend yield of 4.6%, we feel that the current share price offers investors a good entry at attractive valuations into a well- managed business.

3RD PARTY INSURANCE: WHAT YOU NEED TO KNOW

Mark Wheatley

Comprehensive vehicle cover is obviously the best cover to have for your car, because, subject to various conditions and your prescribed excesses, it covers you for all losses in an accident, for theft, as well as for perils such as hail damage and fire. But it is also the most expensive type of cover. Insurers offer lower levels of cover for your car to improve affordability – typically, these are limited to cover for third party, fire and theft, and third-party-only cover.

These types of policies may be attractive to you especially if a) you have an older, low-value vehicle, and it is paid off; and/or b) you don't drive the car very often or very far.

For example, you may be retired with a 10-year-old car worth R20 000, and use it only to drive to your nearest shopping centre a couple of times a week. If you do opt for limited cover, however, you need to know exactly what is covered and what is not. Importantly, third-party cover will protect you financially against the potentially crippling costs of causing damage to someone else's vehicle, especially if it is an expensive model.

Who is the third party?

The third party in an insurance claim is the person who has suffered a loss because of your actions and who lodges a claim against you. The first party is you, the person insured, and the second party is your insurance company, which is responsible for settling the claim. The third party is anyone, apart from you, to whom you have caused damage. It extends beyond natural persons to juristic persons, such as businesses. In vehicle insurance, the third party is most likely to be the driver of the other car in an accident that you caused, but it may be a retailer, for example, if you drove your car through a shop window. Some policies may exclude certain people in their definition of third party, such as members of your household.

What does it not cover?

Third-party insurance does not cover your loss if you have an accident. In other words, any damage to your own car or other property of yours is not covered, and you would have to pay for it out of your own pocket. If the accident is not your fault, however, you can claim against the other party. Often, fault does not lie entirely with one party or the other. For example, even though fault may lie mostly with you – you reversed out of a driveway without looking, for example – the driver who crashed into you may also be partly to blame, by not taking evasive action. The insurer will apply the principles of Apportionment of Damages and pay out according to these principles. The apportionment of the damages will indicate the amount of damages payable in relation to the amount of fault which rests on each of the two parties.

What is the difference between what insurers cover and what the Road Accident Fund covers?

The Road Accident Fund (RAF) covers your liability in the case of a third party being injured – in other words, it covers personal injury to the other party, but not damage to material possessions such as his or her car. Your third-party insurance policy covers you for the other party's material damage, but it extends to personal liability cover for an event outside South Africa. It will also cover you for an "emotional shock" claim against you by a party, who is not directly involved in the accident, something that is not covered by the RAF.

Insurance for your car is not an option but there are choices to be made.

INSIGHT SEMINARS

It has been a challenging year for the local stock market. In this edition of our Insight seminar, we will ponder at the outlook for 2019 and identify the opportunities and the risks investors are facing.

Please RSVP to Clare Mitchell on 033 3302164 or clarem@hhgroup.co.za.

NATAL MIDLANDS

Topic:	The market outlook for 2019
Date:	4th of December 2018
Venue:	Fernhill Hotel Midmar / Tweedie Road (almost opposite entrance to Midmar
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

JOHANNESBURG

Topic:	n/a
Date:	n/a
Venue:	n/a
Evening Time:	n/a

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