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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 EMOTIONS BETRAY US

Robin Gibson

In the last 10 days I have had occasion to listen to some of the brightest minds in the country: JP Landman (Political & Trend Analyst), Ferial Haffajee (Associate Editor at Daily Maverick), Lindiwe Mazibuko (former head of DA) and Chris Holdsworth (Head: Equity Research at Investec Asset Management). What struck me about these individuals is that they all know the key role players by name and by history. One may argue that this is their job, but what was definite in listening to them was that they were in a far better place than most to distinguish between fact and fiction, emotion and cold hard logic.

I was left with a number of impressions after these engagements. Firstly, South Africa produces, and continues to produce, some incredible people. Secondly, in Cyril Ramaphosa, we have a president who is playing a long game for the benefit of South Africa and not just some short-term political career highlight. Thirdly, that cool heads and patience are going to be required by many South Africans in the days that lie ahead. Fourthly, that we can expect worse news headlines than what we have already seen as the consequences of the last 10 years are revealed. Fifthly, there are significantly better-informed people than me that see a positive future in South Africa in spite of the negativity that surrounds us.

Hearing these individuals and digesting their words has made me reflect on many of the engagements we are having with our clients. The daily dose of bad news is acting like a slow poison that makes most give up and flee for safety and certainty. There are repeated calls to move all your cash out of South Africa (not helped by revelations by corporates such as Omnia and Tongaat!) and abandon the JSE. The ridiculous public announcements by individuals who should know better - like Ace Magashule and his 'Quantity Easing' comments of early June - reinforce our pessimism. We cannot see any hope on the horizon. The allure of cash at a yield of 8% or the British Pound even at R18.75 each is overwhelming.

Then I came across this excerpt by a gentleman called Bill Miller, an American asset manager writing about investor sentiment post the financial crisis in 2007-2009 (can you believe that it was 10 years ago!)

"The Financial Crisis was so financially and emotionally devastating for so many that it left the typical investor, whether individual or institutional, risk and volatility phobic, determined to avoid a repeat of that catastrophe and subsequently doomed to leave a lot of money on the table in the search for safety. This is similar to the impact of the Great Depression of the 1930s on the public. That shock was so severe, following the long and often exuberant prosperity of the 1920s, that it induced a high degree of financial conservatism and desire for safety compared to what had gone before. Economic conditions change, but human psychology is pretty consistent in how it reacts to stress and loss."

(Bill Miller is the principle at Miller Value Funds and this is an excerpt from his Quarterly Commentary Q1 2019)

It struck me that this description very accurately describes where the South African equity investor now sits. Investors see no hope of recovery or future investment return, and this is going to cost them a lot of money in the future.

I recently engaged with a client who had lost a significant amount of money in the 1987 stock market crash. This led to this individual (a very successful individual, who is a captain of industry in a major South African institution) avoiding the stock market for the next 20 years. His first foray back in to any significant degree was 3 years ago and he is seriously disillusioned with the stock market. However, in discussion he started to reference a colleague or friend who had been very successful over the same time period. Of course, that individual had endured the '98 Emerging Markets Crisis, the '00 Dotcom Burst, the '01 World Trade Centre contagion and the '07/'08 Financial Crisis which this client had missed but significantly, his colleague had enjoyed every other major growth cycle the market had delivered and saw bear markets as part of a normal investment cycle.

Sadly, it is our emotions that betray us. We are driven by sentiment and that sentiment together with our emotions is what drives our behaviour. Bill Miller had a further quote in his newsletter:

"An additional difficulty facing macro forecasters is that markets do not just reflect the current and expected path of the economy, they affect it. This is what George Soros calls reflexivity."

This statement also applies in South Africa today. As a result of poor sentiment and the feeling like there is no future, most people are sitting on their hands (or more specifically their cash). Cash as a percentage of GDP is at a multiyear high (refer to the chart from Willie Pelser's April

Insight presentation). There is cash out there, but nobody is spending it or investing it into the economy. The markets are thus affecting the economy.

This is exactly why we continue to encourage clients to stay the course. Markets are reflecting extreme pessimism. Consequently, share prices on many high-quality companies are trading at big discounts to their potential or the value of the underlying enterprise itself. When optimism comes (and it may be very mild to start with) it will start a shift in sentiment that will see an aggressive shift in investor behaviour (led by professional investors both locally and internationally). This move is likely to be swift and decisive and investors who have sought safety will be the last to act and will miss out on the reward of patience, which will have made their most costly act the point of abandonment, not the events that led them to it.

Of course, what will be the events and when will they happen? I cannot tell you, even though I might be able to construct a plausible scenario. Some high-profile individual may call it perfectly, leading us to believe that they know all that others don't, but in closing, I would like to quote Bill Miller's publication one last time:

"That is precisely the same problem active equity managers face. It is not that active equity managers lack skill, it is that they are all skilled, but no one is so much more skilled than all the rest as to assure persistent outperformance over time."

If that applies to asset managers, there is surely a corollary for investors. The ability as an investor to choose a better asset manager must be just as difficult, so maybe it's better to stick to what more than a 100 years of financial market trends have taught us:

- Invest in equity and stay invested through the cycles.
- Minimize the cost of investing.
- Live on dividends, not capital returns (or for growth clients, compound, compound, compound!)

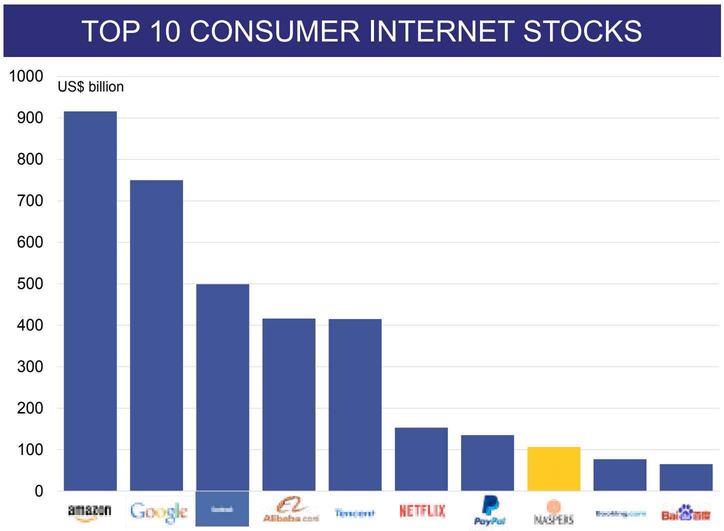
https://millervaluefunds.com/wp-content/uploads/pdf/Bill-Miller-Commentary.pdf

NASPERS: IMPLICATIONS OF THE NEWCO LISTING

Michael Porter

From humble beginnings as a local media company dominating the printing industry, Naspers has morphed into a completely different animal. A very judicious investment into Tencent, then a largely unknown Chinese internet company – has delivered rewards far in excess of anything imagined at the time. That success, together with the insight from the then CEO and chairman, Koos Bekker, has seen Naspers diversify into various global internet assets. It now ranks amongst the top 10 consumer internet businesses in the world. Furthermore, only 4% of its revenues come from SA.

That success has not come without its challenges. The dominance of Naspers on the JSE has become a hotly debated topic amongst asset managers and investors alike. Six years ago, Naspers' weighting in the JSE All Share SWIX index was a very palatable 5%. BHP Group, Anglo, and Richemont exceeded this. However, due to the strong performance of its major subsidiary, Tencent, that weighting has now risen to well over 20% - a level that is causing problems for institutional shareholders as they bump up against regulatory limits imposed to limit concentration in any one share. This has forced large

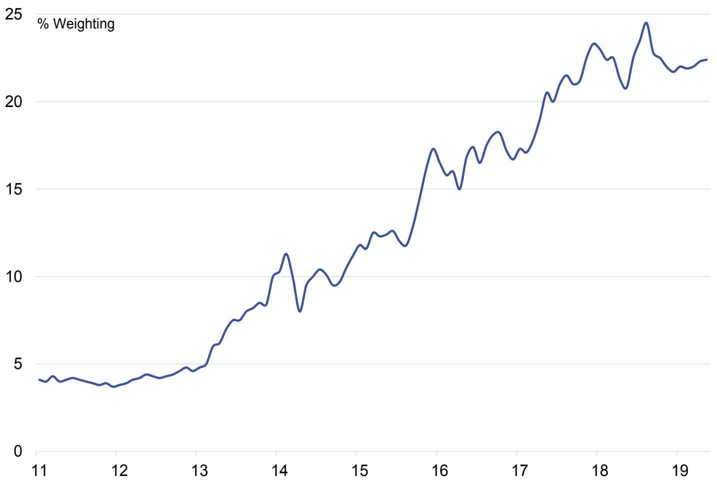


Naspers is rubbing shoulders with some of the largest tech companies in the world.

shareholders to be continual net sellers of the share, and consequently for the discount at which Naspers trades to Tencent, to widen. The chart below shows the value of Naspers' investment in Tencent, as a percentage of Naspers' own share price. Whilst it has reduced slightly, the value of the Tencent investment alone is worth 25% more than the whole of Naspers.

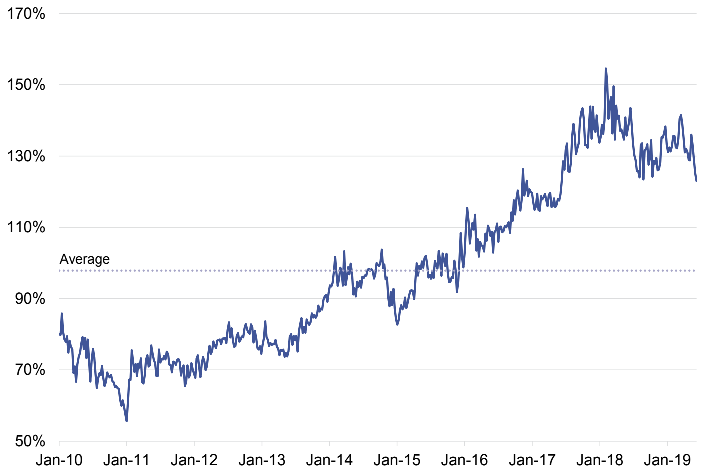
Naspers management has been under increasing shareholder pressure to address the widening discount,

NASPERS: WEIGHTING IN ALL SHARE SWIX INDEX



Due to the growth in Tencent, Naspers now dominates the Index, which is causing regulatory issues.

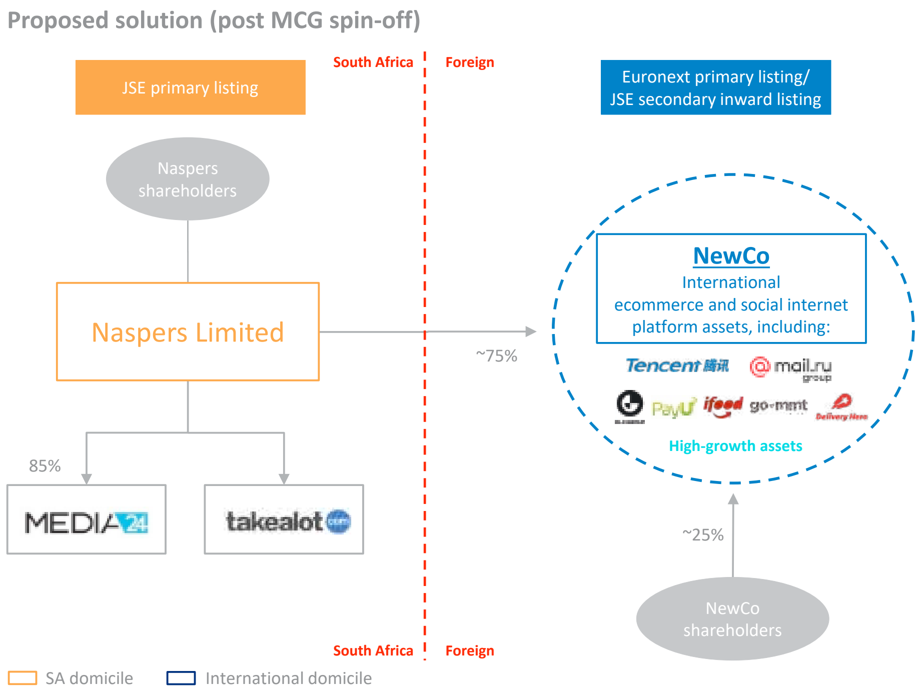
TENCENT AS % OF NASPERS



Tencent is the dominant asset within Naspers. Investors are ascribing no value to the rest of the portfolio.

especially given that management remuneration has now been linked to this metric. Hence the decision to unbundle and list Multichoice separately in March. Despite Multichoice being a significant business in its own right, that has done little to reduce the discount. That has prompted Naspers to announce a further restructuring of its assets.

Next month, Naspers will list all their internet assets on the Euronext Exchange in Amsterdam, through a new holding company, Newco. (The official name is yet to be announced.) The only assets that will remain in Naspers are its South African assets, namely Media24 and Takealot.com, as well as a 75% stake in Newco. The balance of Newco shares will be held by outsiders, including existing Naspers shareholders. The diagram below shows the expected structure of the new company.



Importantly, Newco will have a primary listing in Europe, but will have a secondary listing on the JSE, so local shareholders will be not be prejudiced.

Naspers management has been under increasing shareholder pressure to address the widening discount, especially given that management remuneration has now been linked to this metric. Hence the decision to unbundle and list Multichoice separately in March. Despite Multichoice being a significant business in its own right, that has done little to reduce the discount. That has prompted Naspers to announce a further restructuring of its assets.

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What is the rationale for the move, and will it work?

As already discussed, the main objective is to ultimately reduce the discount at which Naspers trades to its underlying investments. (Remember that Naspers consists are so much more than its investment in Tencent. It has numerous investments spanning payment technology, online classifieds, online food delivery, etail, and new ventures. No value is being ascribed to these investments, despite some of them being listed in their own right, and trading at significant valuations.)

The rationale for the transaction is as follows:

1. By listing Newco in Amsterdam, its size will no longer be a constraint.
2. It will be eligible for inclusion in a number of new indices, thereby attracting passive ETF-linked investors.
3. Investors based in developed markets who were previously prevented from investing in Naspers because it is an emerging market stock, will now have the ability to invest in the company.
4. Together, it is hoped that these factors will ultimately force the discount to narrow, thereby releasing value for Naspers / Newco shareholders. Naspers estimates that for every 5% reduction in the discount, the value of the company increases by almost $9 billion. That is equivalent to approximately R300 per share

The big question is whether it will work? Intuitively, by eliminating the size constraint and opening up the Group to new shareholders, one would expect the discount to narrow, especially given that Europe has very few large tech companies. However, what is less clear is what will happen to Naspers shares post the transaction. There is a chance that the discount within Naspers actually widens further, rather than reduces, for the reasons listed below:

1. Newco will be a new holding company that will sit between Naspers and all the underlying investments. So now there will be two holding companies. One would expect Newco to trade at a discount, given that offshore investors themselves are more able to invest directly into some of the larger, listed investments – such as Tencent, Mail.ru, and Delivery Hero.
2. Will moving 25% of Naspers market capitalization to Newco really solve the problem? Newco will have a secondary listing on the JSE, and investors are likely to consider Naspers and Newco as one entity, given that they ultimately own the same pool of assets. So, we are not sure that index weights will actually reduce.
3. On a long-term view, Newco is likely to be favoured over Naspers, given that this is where the growth assets are held, and where further transactions will take place to unlock value further. Whilst Media24 and Takealot.com are successful businesses, there are not where the real excitement and value lies. The preference for Newco over Naspers could see additional selling pressure on Naspers, leading to a widening of the discount, rather than a narrowing thereof.

Ultimately, we think the discount in Newco will narrow, as more and more assets reach profitability, and are listed separately. If one takes Naspers and Newco together, this is certainly a step in the right direction. But as is so often the case, there is a rather unsavoury sting in the tail.

What does this mean for Naspers shareholders?

Existing Naspers shareholders will be forced to make a choice about how they want to participate in the unbundling of Newco.

1. Option A is to receive 1 share in Newco for every 1 share held in Naspers. This is the default option should no explicit choice be made.
2. Option B is to receive additional shares in Naspers (in the ratio of 0.37 new Naspers shares for every 1 share owned.)

Based on our discussion above, it would seem logical to opt for the new shares in Newco, if that is where the bulk of the value lies, and where any future unlocking of value will take place. We would agree. However, the sting in the tail is that electing Option A is deemed to be a Capital Gains Tax (CGT) event, and it will trigger a "deemed sale" on 25% of your Naspers shareholding. Depending on the duration over which a shareholder has held the Naspers shares, this could lead to a substantial CGT liability – similar to the liabilities generated by the SABMiller and NEPI Rockcastle mergers. Avoiding the CGT by opting for Option B will increase the exposure to Naspers, which might underperform given what we think will be a natural tendency to migrate to Newco over time.

Our recommendation:

Based purely on the outlook for each entity post the transaction, our natural choice is to elect the Newco shares for every shareholder, so that an existing Naspers shareholder ends up with an investment in both Naspers and Newco, which can then be rationalized over time.

This will trigger a CGT implication. Given the fact that each and very client is different, we will be undertaking extensive calculations to determine whether the election of Newco shares will create a prejudicial tax liability and whether there are other investments in the portfolio that can be realized to mitigate such a liability. In instances where tough decisions need to be made, we will be in contact with individual clients to discuss the options and possible solutions.

GETTING TO GRIPS WITH THE INFORMAL SECTOR

Nick Rogers

South Africa is a land of contrasts, epitomized by the sprawling townships that lie adjacent to suburban town houses and secure estates. Parallel worlds yet worlds apart. On a recent Informal Immersion tour into Alexandra and Soweto, I gained first-hand insight into this vast, vibrant economy worth over R100 billion that accounts for almost 20% of all money spent in SA (Nielsen Research). It's an "invisible" economy, born out of necessity & survival but it is teeming with entrepreneurial spirit that defies the recent -3.2% contraction in GDP. Huge opportunities await those who embrace the informal economies across SA.

Our minibus taxi weaved through streets bustling with people of all ages, accentuating the 27% unemployment rate, as men sat in small groups sipping "quarts". At 9am, we arrived at Makoti Supermarket, Alexandra. South African-run Spazas historically sold expensive products with limited brands So, when the likes of Shoprite (USAVE), Pick 'n Pay (BOXER) & SPAR (BuildIT/Tops) began infiltrating the townships via shopping malls that sprung up adjacent to shacks, price and brand competition led to their near demise. As the disbursement of social grants surged – R278 billion will be disbursed in 2019, with 44.3% of households receiving one or more (Stats SA) - business-savvy foreigners began renting the old Spaza stores from relieved SA landlords. The Somalians, Malawians, Bangladeshi & Pakistani traders (85% foreigners) that run approximately 100,000 Spazas turn over between R85,000 and R200,000 a month. How do they compete with the Retailers?

GG Alcock (author of Kasi-Economics) describes informal traders as "highly sophisticated," acutely in tune with their client's individual needs and wallet size. If one can only afford to buy 1 cigarette you will pay R2 for a "loose" at Makoti's. They also sell individual nappies, tampons, toilet paper, and medicine (e.g. Grandpa sachets) - a niche that formal retail has not embraced. Along neatly packed, clean aisles, one could buy 50% of our own household products here. Locals love AVI's Bakers biscuits, Frisco or "premium" Ricoffy; Tiger Brands' KOO beans where taste and quality over-ride cost and Pioneer's "White Star" mielie-meal, most definitely the people's choice. Brands are important despite circumstances. Coca-Cola made a costly mistake by assuming that a switch to cheaper 1.5 litre bottles would suit locals. Enter Kingsley Soft Drinks, who gained market share as township folk snapped up their low-cost Cola, Ginger Beer & Cream Soda in preferred 2 or 3-litre bottles. Individual cheese slices caught my attention as well. GG Alcock helped Parmalat grow a cheese empire worth R1.5 billion (85% market share) pointing out a niche for their individually wrapped slices with the Township Kota (Quarter loaf). It is estimated that the Township fast food market is worth R90 billion annually. The "Kota" Industry is worth R10 billion of that versus just R3 – R4 billion for KFC. Due to food's strong connection to local culture, the informal fast-food sector is dominated by South Africans with Shisa-Nyama (Braai'd Meat) outlets on every corner, totaling c50 000 in total across SA. Makoti thus also stocks bags of charcoal, "Aatcha" sauce sold by the scoop and polystyrene take-away containers to meet insatiable demand. Abraham Mdlalose dropped out of his food science course and now sells Kotas ranging between R15-R35, highlighting the potential of this meal to formal traders.

Innovation is key and multi-purpose products are essential for stretched budgets. Green Sunlight soap-bars (ranked as the 2nd-biggest FMCG brand in Africa) are left in the sun to dry, increasing longevity. They are used for cleaning the hands, face, clothes, hair, dishes, windows - and the perfumed ones as roll-on deodorant! Many ladies we spoke to mix candle wax with a burnt match - voila, eye-liner - whilst light-brown Nugget shoe-polish is used widely across SA as a foundation base! That said, Nivea's market research showed that the modern woman expects to see the same quality displays in Spaza shops as one would find in Clicks. Thus, one has to really understand the behaviour of consumers at every level to compete effectively. With the backing of the Dept of Trade & Industry, mSPAZA intends to build 500,000 tax-compliant, modern, digitally driven, and solar-powered spaza stores across the country, creating 2.5 million jobs within five years! Change is afoot.

Another crucial competitive advantage is distance. Customers will pay a premium to have bulk products delivered to their door whilst paying cheaper prices than Shoprite on smaller products like tea-bags to reduce the overall costs. Most do a monthly bulk shop at a formal retailer, with the balance of their salary (normally about 50%) being spent at Spazas. We spoke to three sisters who mentioned that they will sometimes "Uberize" at month end. A single taxi fare can cost R10 plus an extra R10 when laden with groceries. So, three people will pay R60 for a one-way trip home. One click with their cell phone & UBER, which offers 4 seats plus a boot for groceries, can cost as little as R20 from the mall to home!

Because social grants are drawn from formal shops and banks, people have to travel into town and wait for hours at an ATM, taxi-rank or shop. Removing "pain-points" is also key to success. The "single mom's club" is one of the largest markets in SA. Time is money so taxis now offer a VIP ticket, allowing working mothers to pay a small premium not to queue. Increased infrastructure development has seen many people choosing to live in townships. For example, a high income (LSM 8-10) consumer can live in a R500,000 mansion in Soweto, right next to the low LSM 1-3 shacks yet still have access to fibre internet. Interestingly, many of the wealthier inhabitants will often travel to the suburbs to avoid issues such as being constantly searched at local malls or being targeted by criminals.

"Black-on-black bad service" is a growing complaint that formal retailers need to get to grips with, or they will face the wrath of "Black Twitter". An example would be where checkout ladies may gossip and talk rudely in front of locals in their native tongue, whilst the modern informed consumer wants to be treated with respect like everyone in the suburbs.

Financial Services also need to be innovative to compete. Many of Makoti's clients do not have FICA documentation – excluding them from more formal banking channels - so the Somalian manager offers interest-free loans on food items to regulars. For larger loans, many accept paying exorbitant levels of interest to loan sharks - R500 interest for a loan of R1000 - to avoid bank debit orders that are automatically processed when social grants are paid. That said, almost every person we spoke to had an account with low-cost Capitec, but the Big 4 banks are catching on quickly. For example, Standard Bank had an ATM at Makoti where "Cash is King". Furthermore, every person we interviewed owned a funeral policy. In African culture, it is of utmost importance to put the dead spirits to rest. If not, their culture dictates that your future will be affected. So, hugely expensive funerals (ranging between R15,000 - R100,000) are actually an investment in the future and not in the past. An unemployed man, whose home we visited, paid R228 for a funeral policy to Santam, who use local door-to-door salesmen. He also chose to drink Heineken and buy items of clothing at Woolworths due to the quality and importance of brands, much to our surprise. When pressed on how he could afford this, he mentioned that his wife washes clothes for neighbours (R300 per week), they rent 2 rooms (R800-1500 per month each) and can earn R150 per night offering a taxi service using a friend's car. He also told us that "electricians" had bridged his electric box, so amazingly, R50 of electricity lasts for 3 months! No one paid for water. The street vendor that we interviewed had stood in the same street since 2003, yet is not on any employment records.

Alcock mentioned a city vendor who sells 3,000 vetkoeks every single morning for R1 each as well as R500 worth of tea, coffee, polony etc. That equates to a profit margin of R1,000 per day or R25-30,000/month, in cash! He also calculated that each informal tuck-shop lady, with a stall outside one of the 10-12,000 township schools, will make between R3-6,000 per month. This solid evidence is very encouraging & illustrates the resilience and ability of people in the Informal sector to survive. Enabling easy access and reducing wholesale input costs is where the formal retailers can get involved directly.

In conclusion, this experience opened my eyes to a few of the millions of people across our country who, despite their circumstances, rise up and overcome adversity by creating a sustainable income flow with an entrepreneurial spirit second to none. If this spirit is harnessed in the right way, starting with understanding the specific needs & cultures within townships, formal retailers are in a position to offer mentorship, support, efficient distribution channels and ultimately cheaper input costs to vendors. There are thus endless opportunities for more interaction between our parallel economies to join forces at a time when every unit of economic growth is crucial.

INSIGHT SEMINARS

Last year we hosted our first panel discussion, inviting members of the audience to ask and debate issues with our team of asset managers. We will be hosting a similar event for our next seminar, where clients are invited to ask the team any question on their minds.

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

NATAL MIDLANDS

Topic:	Panel discussion: Answering your questions
Date:	8th of August 2019
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:	Updating our market outlook
Date:	24th of July 2019
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Morning Time:	7am for 7:30am

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For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

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