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IN THIS EDITION:

HARVARD HOUSE

We understand your need for FINANCIAL INTEGRITY

THE BUDGET: HOPE AFTER ALL?

HH Team

There was an enormous amount of pressure on Finance Minister Mboweni's shoulders ahead of this year's annual Budget speech. Never before in our living memory has the mood been so downbeat, and the cry for change so acute. After years of false promises, reckless spending, and corruption, our country is on its knees. Investors and commentators were expecting the worst. Everyone expected substantial tax increases coupled with a vague promise to cut spending. Those promises have been made before, and broken. Consequently, most investors have priced in a downgrade to our sovereign credit rating by Moody's at the end of March. After the Medium-term Budget in October last year, where Mr Mboweni painted a grim picture of revenue shortfalls, expenditure overruns, and soaring debt, expectations for the Annual Budget were at rock-bottom – and for good reason. The biggest concerns following endless bailouts to failing SOEs was that the poor SA public would be taxed to the hilt. Herein came the first surprise!

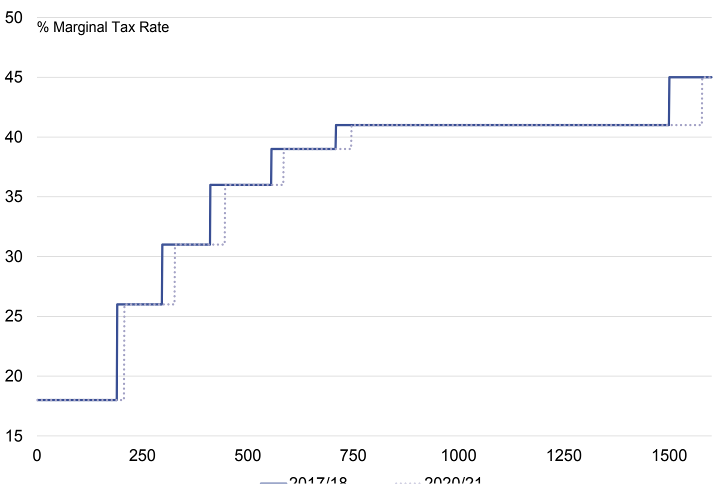
Revenue

In Mr Mboweni's words: "To support growth, we propose no major tax increases. Indeed, there is some real personal income tax relief." This statement contained two surprises in one. Firstly, it was widely expected that income tax brackets would not be adjusted, thereby effectively raising personal income tax. This has been turned upside down. Brackets have indeed been adjusted, offering tax relief to all brackets of income earners. Bear in mind that last year, brackets were not adjusted, and tax relief in the few years prior to that was marginal. The second surprise was the acknowledgement that we need to support growth. South Africans were bracing themselves for the worst – higher taxes and reduced spending – which would have stifled growth and probably tipped us into another recession. By offering tax relief, Government is acknowledging that one way to solve our problems is to encourage growth – something that has been sorely lacking for years.

Total revenue is forecast to remain largely unchanged at R1.58 trillion. As we noted above, there are no major tax increases, but at the fringes, there are a few areas where taxes will rise:

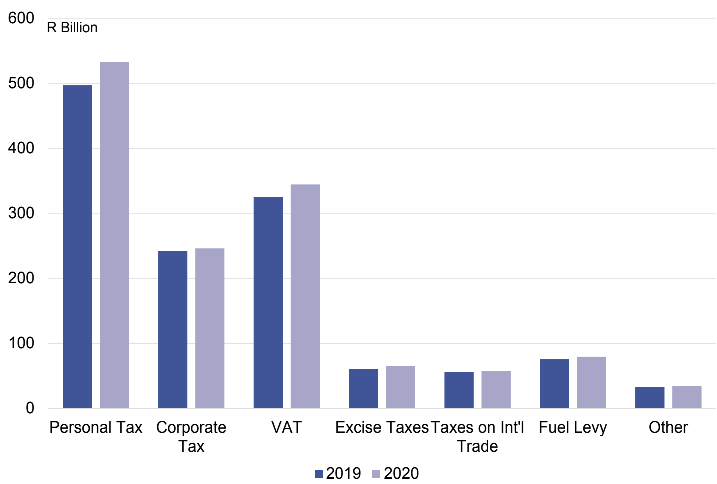
1. Extra fuel levies of 25c per litre, split between National Revenue of 16c per litre, and an extra 9c per litre to the Road Accident Fund. Mr Mboweni outlined a proposal to make 3rd-party insurance compulsory, which would make the RAF redundant. Given its constant mal-administration that would be a positive development.
2. Sin taxes will rise, as usual, but the increases are relatively modest (between 4.5% and 7.5%)
3. Changes will be made to corporate tax to limit base erosion (where companies shift revenues between

PERSONAL INCOME TAX BRACKETS



Rather than raising taxes, the Budget has proposed modest personal income tax relief, across all income groups.

COMPOSITION OF TAX REVENUE 20/21



Income tax and VAT remain the largest contributors to tax revenue.

subsidiaries for the purpose of lowering their tax) and limit the ability to utilize prior year tax losses. This may well push up corporate tax rates for a number of companies, which in turn may depress future profits. We see this having the biggest impact in cyclical sectors such as mining.

Once again, it was a relief that the Budget contained no nasty surprises, and encouragingly, an important concession for personal investors:

1. There was no change to the rate of Dividends Withholding Tax. It remains at 20%.
2. There was no change to the inclusion rate for Capital Gains Tax. It remains at 40%.
3. In a surprise move, the Minister announced an increase in the annual contribution allowance towards Tax-Free Savings Accounts (TFSAs) to R36,000 (from R33,000 previously.) This is welcome, and we would encourage all clients to continue saving through these vehicles.
4. Furthermore, in line with the adjustments to the tax brackets referred to above, there were small increases in the primary rebates for personal income tax.
5. There were also small increases in the thresholds for Medical Tax Credits. Combined, these all serve to provide some tax relief in an effort to stimulate growth.

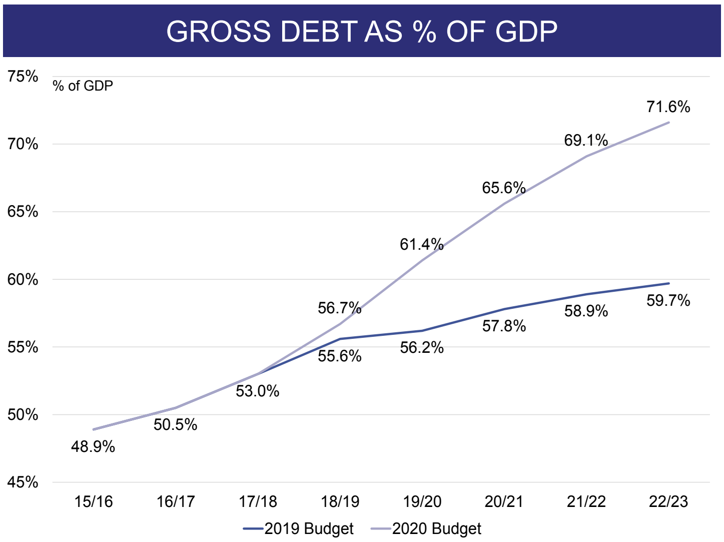
Expenditure

The second surprise is the proposed lowering of the Government's wage bill. SA has consistently been warned to reduce both the headcount and salary bill of excessive state departments.

Like everyone else, we were very sceptical that we would see any action on this crucial item. But we were in for a surprise. The proposal is for adjustments to the wage bill of about R160 billion over the next 3 years. Negotiations with unions will be a large part of the wage settlement on which the fiscal prognosis hinges. We believe those negotiations are unlikely to be concluded before the mid-term budget in October when the first real update will be given on the progress. We are under no illusions how difficult this will be to achieve. Before the ink was dry on this article, the unions were already declaring war! Nonetheless, we are cautiously optimistic that government will largely achieve its desired outcome, though the risks to the projected R160 billion of savings over the three-year forecast period are obviously biased to the downside.

To put things into context, Treasury noted that the public sector wage bill now comprises 35% of government expenditure. Furthermore, it has grown by more than 40% in real term over the past 12 years. This has begun to crowd out spending on capital projects for future growth and items that are critical for service delivery on all fronts. In an attempt to mitigate the crowding out effect, funds amounting to R33.5 billion have been reprioritized over the forecast period mainly for service delivery and infrastructure. The bulk of spending is allocated to learning, social development, health and community services.

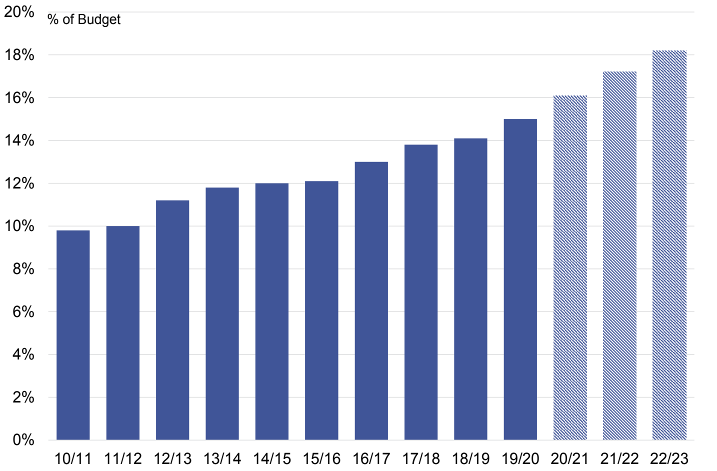
Of course, it was not all good news. A huge area of concern remains the cost of servicing our debt. Whilst we are encouraged by the efforts to rein in spending, debt will continue to grow, and is projected to now reach 71% of GDP by 2023 (vs a projected rate of 59% by 2023 made in last year's Budget.) That is a serious deterioration. However, we are encouraged by the fact that Government is using realistic assumptions in its forecasting. GDP growth rates have been revised lower. In the past, Treasury always used "pie in the sky" growth forecasts only for those forecasts to be adjusted downwards 2 to 3 times over the respective tax years. How nice would it be in two years' time for the GDP estimates to be revised upwards!



Gross debt will rise dramatically, but Treasury is finally using realistic growth assumptions. It is also acknowledging that there are two ways to solve the problem: reduce debt or grow GDP. This Budget tries to achieve a bit of both.

Getting back to the cost of servicing our debt, this is the fastest area of expenditure growth. Debt service costs is the fastest-growing expenditure category – by 12.3% in 2020 – to R229.3 billion, representing 15.2% of the R1.95 trillion Budget. This represents an acceleration in the trend, given that debt service costs were R158.2 billion in 2015/16. The trend is shown in the chart below.

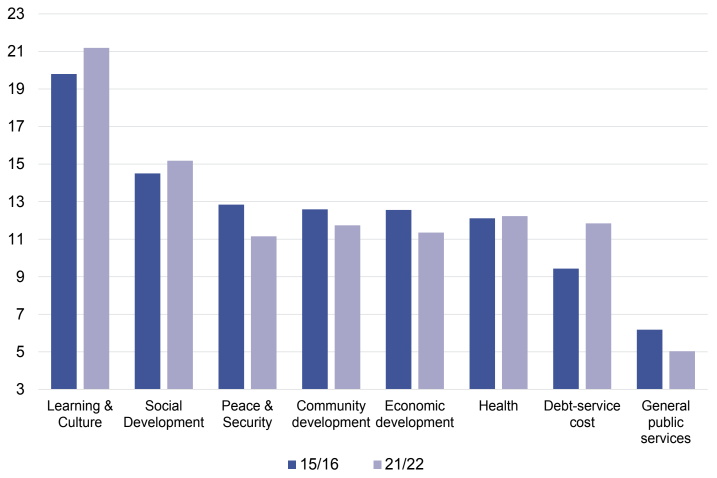
DEBT SERVICING COSTS AS % OF BUDGET



The amount of money spent on servicing debt will continue to rise over the next few years.

The chart below details the breakdown of how your precious taxes are spent. Each category is expressed as a proportion of R100, and the chart compares the breakdown of spending in the 2015/16 year to that projected for the year ahead. It is noticeable how the allocations towards social development, learning and interest costs have risen.

EXPENDITURE BY FUNCTIONAL GROUP



The chart is anther illustration of the rise in interest costs, and the negative impact it has on other expenditure categories.

Another welcome development was the commitment by Government to curb perceived wasteful expenditure. In relation to wasteful expenditure by Government and its employees, the minister announced: “The abolishing of the current wasteful subsidence and travel system, replacing the cell phone policy and requiring economy class travel for all domestic flights for employees.” Once again, this is small in the context of Government’s total expenditure, but it sends another signal that the “gravy train” is slowing down.

So why did we entitle this article, “Hope after all?” The debt levels remain elevated and if we have learned something from South African corporates in recent years, it is those companies with excessive levels of debt whose share prices have suffered the most. Debt to GDP is at 60% of GDP and is expected to increase to 71% in 2022/23. South Africa cannot afford to skip a beat on growth or any form of wasteful or extra expenditure.

We have no illusions that South Africa still has a long road to travel. However, our investment premise for the year is that despite weak growth and a tough economy, this could be the year in which sentiment starts to turn for the better. We now believe that there is only a 50% probability of Moody’s downgrading us in a month’s time. It appears that this Budget has taken the first step to address some of the ills of the past. Let us hope that Government follows through on its promises.

Tito Mboweni, the finance minister, delivered a broadly positive budget.

INVESTING AT RETIREMENT: LESSONS FROM THE RWC

Robin Gibson

In the years leading up to the 2019 Rugby World Cup in Japan, South Africa had slumped to No. 7 in the world rugby rankings – our lowest ranking since they were initiated in 2003. There was not really much hope in the broad South African public that the Springboks could realistically bring home the William Webb-Ellis trophy for a third time. Much like people's faith in the stock market, expectations were at an all-time low. Nobody really wanted to say it, but many thought it, "this was likely to be the All Blacks 4th World Cup win, and the third on the trot!"

The Springboks came together as a team and delivered for South Africa despite many people having doubts about their ability to do so.

Enter Rassie Erasmus, a wily coach who had shown himself to have a good rugby brain. Who could ever forget the light system he initiated to send messages of strategic instruction to his team when he coached the Free State Cheetahs? Was he what South African rugby sorely needed? Hopes lifted dramatically as the Springboks lifted their first Rugby Championship trophy since 2009. To achieve that title, they trounced Australia, held the All Blacks to a 16-16 draw and managed a sound victory against Argentina in their own back yard. Much excitement was created by an exciting young scrumhalf called Herschel Jantjies, who scored multiple tries against both Australia and New Zealand. Spirits lifted, and South Africans believed, nay hoped, that we might finally have the team to give it a good shot.

The next step was our opening game against the All Blacks at Yokohama Stadium in Tokyo on the 21 September 2019. Expectations ran high as the day approached, and we certainly came out the blocks looking like we had arrived on the day. Then, for 10 minutes halfway through the game, the Springboks went missing. Their defense was appalling and they let in two soft tries. They never recovered and lost the game by 23 -13. The victory for the All Blacks implied that they would probably finish the pool stages at the top of the Group, with potentially the easier quarter-final (versus Scotland) rather than against Ireland that the Springboks would now meet.

The Springboks secured safe wins against Namibia, Italy and Canada – but no-one thought they were nearly as impressive as the All Blacks equivalents. We didn't put more than 50 points over Italy and barely scored in the second half against Canada in spite of both these opposition teams having players sent off for red cards. The only highlight was Cobus Reinach's hat-trick of tries against Canada. After that display, many believed that his performance would be enough to dislodge the ever-kicking Faff De Klerk at scrumhalf, and we might finally enjoy some expansive rugby.

A team that did surprise was the Japanese. They beat the hapless Irish. Even the Scots, who knew they stood between Japan and a quarter final berth, couldn't dislodge the plucky hosts. Beyond all expectation, the Brave Blossoms found themselves in a quarter-final against South Africa. Having scored nearly 50 points against the Japanese in the last warm-up match before the tournament, fans expected nothing less. Largely they were disappointed, and rather looked at the demolition of the Irish by the All Blacks as evidence that we were not up to the World Cup task (Side Note: I was fortunate enough to attend both games. Do not underestimate the Japanese supporters and how much they spurred their men on. It was phenomenal. The Irish failed to come out the tunnel against the All Blacks, so much so that after 20 minutes their fans had turned to drinking the sponsor's ale in vast quantities rather than shouting for their team.)

As we know, SA made the semi-finals, and no-one but Rassie said the Wales game would be close. After all, we are the Springboks. All the while social media raged on about 'Drop-it' (Willie Le Roux) and 'Skop-it' (Faff De Klerk) – pleading for them to be replaced by some of the younger, newer heroes. Despite all the noise, Rassie stuck to his task and his strategy.

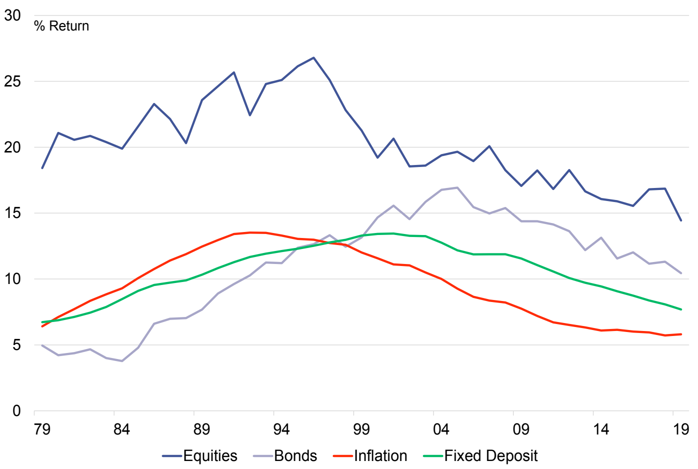
We all know what happened in the final. A resounding victory and a 3rd World Cup Title. Rassie had produced a coup that even the fans weren't sure he could. The strategy was consistent, the patience immense, the spoils sweet. What in heaven's name does that have to do with investment? We believe quite a lot actually.

1. **Build a team that can go for the long term, not just for quick flashy wins.** From Day One, Rassie built a team with the intention of going all the way to the final. He wasn't worried about looking like the team playing the most attractive rugby. He had a long-term goal in mind and never got distracted from it.

   Investing is no different. The Chart below reflects 20-year returns of 3 major asset classes and inflation between 1960 and 2019. Each point on the chart reflects a 20-year return for each asset class, as well as the inflation over that 20-year period. It is clear that only one asset class consistently beats inflation over all market conditions over a long period. That asset class is equity.

   There are certainly short-term periods where different asset classes look more impressive. Investors are constantly reminding us how well cash has performed in the last 5 years! But ultimately, when inflation is the biggest killer of investment strategies, the right team is growth assets, and specifically equities.

ROLLING 20-YEAR RETURNS BY ASSET CLASS



Measured over every 20-year period since 1960, equities still deliver the best inflation-beating returns

2. **A team will always have underperformers.** However, a team is a selection of multi-skilled participants that work together to achieve a common goal. The South African rugby team is, by definition, a group of men with different abilities. No man can win on his own. He needs the group and all their skills. They work together to achieve the goal. It is highly likely that one or two players will go through a difficult period of underperformance, yet this is the very reason for a team.

   Investment portfolios are identical. We don't rely on a single company, but a team. Portfolios are diversified across industries and geographies. They have different strengths and weaknesses. However, they work together to cover each other to reach the end goal. Hard as it is to believe, an asset manager does not expect that every share will always perform. They expect disappointments. If that wasn't the case, then diversification wouldn't be necessary. Surprisingly, history shows that portfolios of equities reach their goal, even with individual failures along the way

   Faff De Klerk and Willie Le Roux were two of our most experienced players, yet they were constantly criticized on both social media and in the press. In fact, they earned the nicknames 'Skop-it' and 'Drop-it' for their perceived characteristic failings. Regardless of this criticism, Rassie backed them and they produced the goods. It is very amusing that the same critics who were so vociferous then couldn't get enough of our Springbok scrumhalf in his South African flag speedo!

   Shares occasionally disappoint and lag. Later they deliver strongly. A good, recent example is British American Tobacco, that underperformed for the last 3 years, but delivered strongly at the end of 2019 and into early 2020.

3. **Focusing on the goal means shutting out the noise.** The pressure on Rassie to play players other than his first choice must have been immense. Pressure to swap out Faff De Klerk for Herschel Jantjies or Cobus Reinach, scrumhalves who had demonstrated flair and skill in lesser games leading up to the final, was significant and widely called for. Rassie resisted.

   Likewise, investors are baying to abandon equities in favour of cash or even Bitcoin - assets that have shone in recent times. Unfortunately, while it would be correct to say that these have performed better over selected periods of time, they have never produced wealth ahead of inflation over the longer term – 20 plus years. Interestingly, many investors remind us that for them it doesn't matter because they are old. Reaching your mid-90's is very common these days – this means even Octogenarians need to invest to protect against inflation.

   The ability to stay your course is extremely difficult (as it must have been for the Springbok coach), and it is significantly affected by emotions within your environment (fear, uncertainty, volatility, political unrest). It is very easy to rattle off the old adage to "be greedy when others are fearful and fearful when others are greedy". However, we hardly see anyone keen to act on that philosophy right now – everyone is fearful!

The noise will come from many places. For the Springbok coach it came from social media, the press and the fans. For investors, it comes from competitor companies touting for their business, family, neighbours and even the press. Shutting out the noise to focus on the long-term established patterns will take a herculean effort, but it is necessary.

4. **How you do it may differ from everyone else – but play to your strengths?** Rassie Erasmus became famous for his "6-2 bench". He described this as his secret weapon. For those who know nothing about rugby, he loaded his reserves with big forwards that were good enough to start the game. He did this at risk with fewer backline players in reserve. His theory was that by the time he reached the World Cup Final, he would have a group of forwards who would have played significantly less rugby than the forwards of any other opponent. This in-built freshness would then make all the difference in the last 20 minutes of the game. It was a masterstroke that raised eyebrows initially but in hindsight it made all the difference. Along the way, he suffered criticism for boring rugby, and many were comparing this to the flair-filled rugby the All Blacks were playing.

   Investment is no different. You cannot chop and change investment styles. It will ultimately lead to disaster. We at Harvard House believe we have our own "6-2 bench" – Dividend Income. In the remainder of this article we will examine how this secret weapon is working for investors in these difficult times.

Illustrating with examples

Investors who have been with us for some time may recall that we constantly run a model portfolio which reflects the traditional approach to investing by the broader financial advisory community. The model simulates paying an independent adviser to place your funds on a platform and then investing equally in 3 of the top-performing Balanced Funds in the South African unit trust market. (As a matter of interest, these 3 Funds sit at ranking positions 1,2 and 5 out of 23 funds ranked over 15 years in the Balanced Fund sector). We first produced the comparison at Insight in June 2018 and looked at the period between July 2017 and June 2018. We have now updated this for the 18-month period that ended in December 2019.

The client initially invested R726,000 over 2005/2006. We have compared the actual Harvard House investment they made with the model portfolio they would have owned had they opted differently. All behaviour has been entered identically right down to the exact date. Consider the table below:

	Balanced Funds on a Platform	HH Approach
Initial investment (2005/2006)	R726,374	R726,374
Opening value (1 July 2017)	R1,567,289	R2,037,329
Distributions banked*	R95,148	R285,931
Platform fees	-R14,397	Nil
Advisor fees	-R21,595	Nil
Income drawn	-R348,700	-R348,700
Capital gain / loss	R99,235	-R74,370
Closing value (31 Dec 2019)	R1,372,894	R1,900,190
Capital used to fund income	R289,544	R62,769
Capital surplus / (shortfall) vs inflation at end 2019	-R225,219	R302,077

'* Investment income net of asset management fees

In the HH Portfolio, the client is exclusively invested in a combination of listed shares and property stocks, whereas the Balanced Portfolio comprises a mixture of shares, bonds and cash. Over the 11 years to July 2017, the Balanced Portfolio had grown to R1,567,289, whereas the HH portfolio had risen to R2,037,329. Over the last 18 months however, it really has been about income strength. The Balanced Portfolio only generated R95,148 after asset management fees. The client then still had to pay a total of R35,992 in additional fees for the adviser and platform administration. This meant that despite the portfolio actually growing in capital value by R99,235 over the 18 months, the client would have had to sell R289,544 worth of units (effectively depleting capital) to sustain their income. Had the client initially opted to invest that way in the beginning, they would have then found themselves with an investment valued at R1,372,894 at the end of December 2019. This means that their inflation adjusted market value would be less than their original capital!

In contrast, the HH portfolio generated R285,931 in dividend income after fees over the 18 months. The portfolio itself actually declined by R74,370 and we had to use R62,769 in capital to fund their income. This means that the client's portfolio was more volatile that the Balanced Unit Trust portfolio, but the net position is far better because the bulk of the income was funded by actual dividend flows. What is most pleasing is that the client's portfolio value is actually R302,077 better than the inflation-adjusted value of their original investment. This means that this client has seen the benefit of our equivalent of the 6-2 bench.

I am not an income client, I am a growth client

When we talk about income growth, growth-orientated clients somehow feel that income is irrelevant to them. This is by no means true. Consider the following statement by John Bogle, the founder of Vanguard:

"An investment of $10,000 in the S&P 500 Index at its 1926 inception with **all dividends reinvested** would by the end of September 2007 have grown to approximately **$33,100,000 (10.4% compounded)……….If dividends had not been reinvested**, the value of that investment would have been just over $1,200,000 (6.1% compounded) – an amazing gap of $32 million. Over the past 81 years, then, **reinvested dividend income accounted for approximately 95% of the compound long-term return earned by the companies in the S&P 500.**"

What growth investors seldom realise is that the compounding of dividends is critical. In addition, during that compounding process, declining markets are actually wealth creating opportunities. How can that be? Well, dividends are actually purchasing cheap shares that on recovery will show exceptional gains, and that contributes to long term returns.

Let's use an actual example again - a client who has invested close to R3 million with Harvard House in a portfolio on a growth basis. The portfolio was started in 2005. Let's compare it again to our Balanced Fund model on the same basis as before. In the early years, particularly over the Global Financial Crisis, the client would have been better protected in the Balanced Portfolio. The Harvard House portfolio fell in excess of 20% at the time. However, in the subsequent recovery, the HH portfolio grew fourfold versus a growth factor of 2.75x for the Balanced Portfolio.

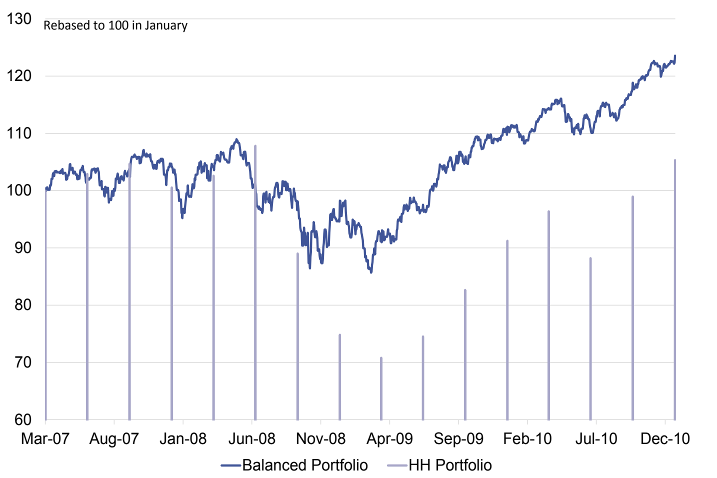
As at the end of December 2019, the Balanced Portfolio would have grown to just short of R5.4 million. The HH portfolio at the same date actually sat at R8.2 million, in spite of suffering a greater decline owing to recent market events.

We think that the more exciting aspect is the income – our "secret weapon". The Balanced Portfolio would have generated R145,145 in income to reinvest over the 2019 calendar year. The HH portfolio generated a staggering R349,840 in dividends for reinvestment, more than double. This just proves again that whether you are a growth client or an income client, the 3 pillars of the Harvard House investment philosophy apply:

- Invest in asset classes that grow income over time
- Minimise investment costs and
- Separate capital change and income in your assessment of investments

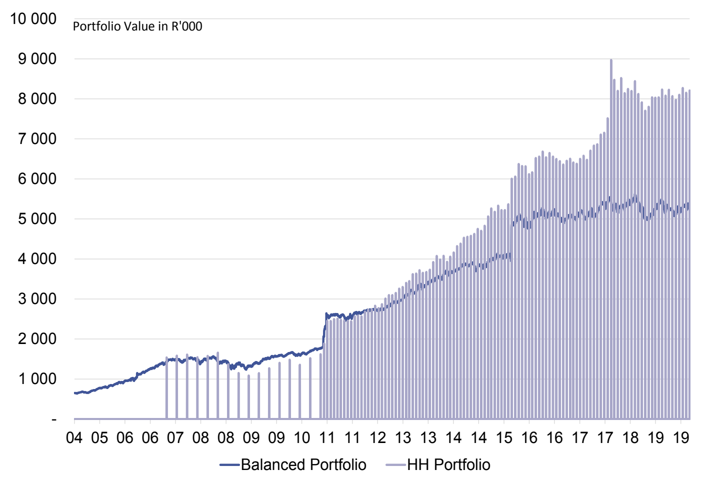
We know that there will be periods where by comparison others look better, but in the long term these investment pillars will "deliver the cup" to the patient investor.

HH PORTFOLIO VS BALANCED PORTFOLIO: '07 – '10



Initially, and over the Financial Crisis, the HH portfolio was more volatile and performed poorly relative to the Balanced Portfolio.

HH PORTFOLIO VS BALANCED PORTFOLIO: '04 – '19



However, over a longer period, the ability of equities to grow faster than inflation proved its worth, despite more volatility in recent times.

TONGAAT: SWEET OR SOUR

Michael Porter

In August 2018, Tongaat announced that its CEO, Peter Staude, would be retiring in October of that year. Included in the press release was the following comment from Mr Bheki Sibisi, the Chairman of the Board, "The Chairman wishes to express the Board's sincere appreciation to Mr Staude for his forty years of loyal service to the Group, the last sixteen as CEO. Throughout his tenure he exemplified integrity and commitment, and he served the interests of our stakeholders with distinction. We value the substantial contribution he made and wish him well with his future endeavours." Eight months later, that reputation lay in tatters after the share was suspended owing to accounting irregularities.

Coming so soon after the Steinhoff scandal, the discovery of accounting irregularities at Tongaat sent shockwaves through the SA investment community. Similar to Steinhoff, it does not appear that cash was embezzled, but rather that accounting rules were broken that grossly misstated the true performance of the company. In turn, senior management was rewarded for achieving certain targets, remuneration to which they were actually not entitled. To quote the PriceWaterhouseCoopers (PWC) forensic report, "It soon became clear that, over and above the operational difficulties facing Tongaat, there was insufficient accountability, governance and financial oversight."

The operational challenges to which they refer included weak sugar markets (thanks to the accidental removal of import tariffs, the introduction of the Sugar Tax, and record low world prices), weak property sales due to the weak and uncertain economic climate and Government's inconsistency with regard to land reform, and a volatile maize price (due to periodic droughts), which impacted on the starch operations.

To mask the impact of the above on the operational performance of the company, it appears that accounting rules were bent with complicity from senior management, including the CEO and CFO. Whilst some of the issues are quite complex, it a nutshell, they can be summarized as:

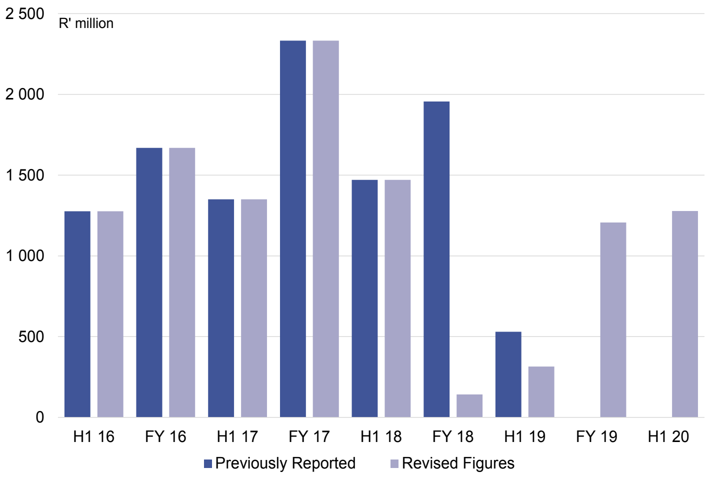
1. Misrepresenting the true state of property sales, by recognizing sales prior to contracts being signed or suitable deposits received.
2. The overstatement of the value of cane roots and existing cane crops, which implied that the sugar operations were more valuable than they truly were.
3. The overstatement of sugar sales in Zimbabwe.
4. The capitalization of costs relating to property development, which had the effect of making the property division appear more profitable than it really was.

Having uncovered the above irregularities, it is clear that remedial action was urgently required, especially around the governance of the company. In this regard, we believe that much has changed for the better. Actions taken include:

1. The appointment of a new CEO, Gavin Hudson, and new CFO, Rob Aiken;
2. A complete overhaul of the Board. All previous Board members, including the chairman, have been replaced, and the Board has been reduced from eleven to eight members;
3. Legal proceedings have been instigated against eight former members of senior management to recover bonuses and benefits paid based on the false information;
4. Internal and external controls have been greatly strengthened, and
5. New management is driving a change in the company's culture, away from one of deference and lack of challenge to senior management, to one based on ownership, trust and responsibility for the right behavior.

These are welcome changes, and will be crucial if the company is to prosper in future. Yet the real challenges lie in the financial statements. In aggregate, the accounting irregularities made the company appear far more profitable than it really was. This is highlighted in the chart below, which shows the operating profit earned per period. For the year ended March 2018, operating profit has been restated downwards, from a previously reported value of R1.9 billion, to a revised value of just R142 million.

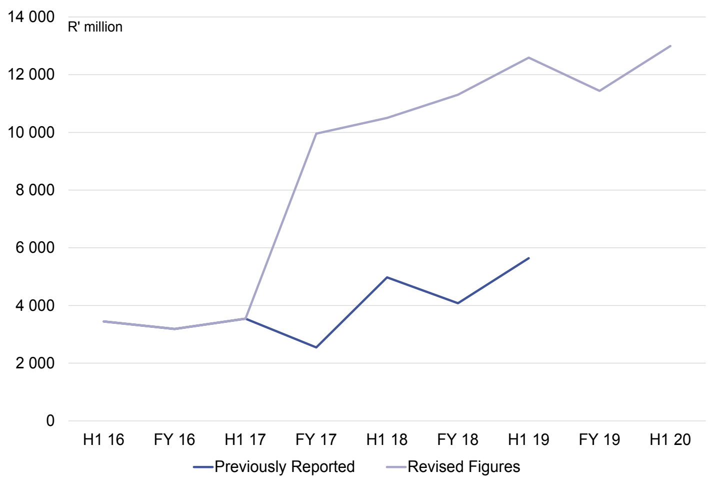
TONGAAT: OPERATING PROFIT



However, over a longer period, the ability of equities to grow faster than inflation proved its worth, despite more volatility in recent times.

Although the restatements are sizeable, a casual observer might conclude that operating profits have recovered over the past two reporting periods, and hence that the company was getting back to full health. Unfortunately, the above chart is only one cog in a complicated wheel. There are two other key metrics that have been restated, both of which have a huge impact on the health of the company.

SHORT-TERM BORROWINGS



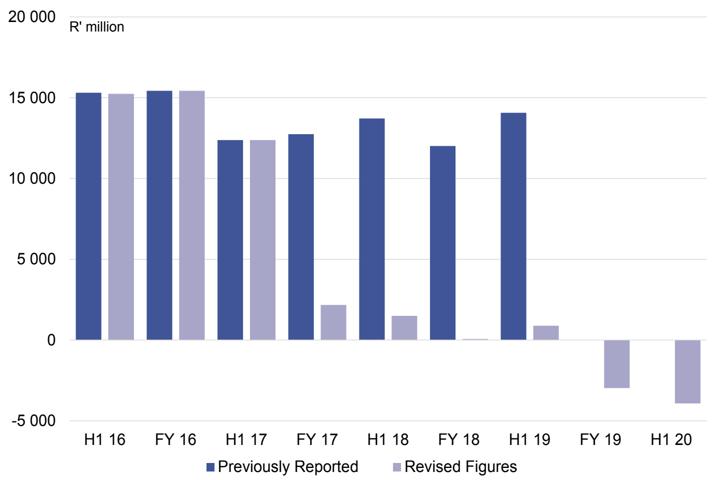
Borrowings are far higher than previously reported, at R13 billion.

The charts below show the trends for "Short Term Borrowings (or debt)" in the company and for "Shareholders Equity". As above, both charts show the difference between the previously reporting numbers and the revised numbers.

Debt levels are significantly higher than previously reported. In fact, actual debt at 30 September 2018 was double that reported. As of September 2019 (the last reporting period), debt had climbed even higher to almost R13 billion. At the same time, due to trading losses and the reversal of overvalued assets (such as cane and land), the net equity in the company has plummeted. Tongaat is now in an unenviable situation where it has a negative equity balance. In other words, the company is technically insolvent, as its liabilities exceed its assets. The dramatic turn in these two metrics forced the company to engage with its lenders and implement a debt standstill agreement that gives it time to remedy the situation without the banks calling in the loans and forcing the company into liquidation. Knowing the true facts (as restated in the charts below) would have dramatically altered our opinion and investment case for Tongaat. The deterioration in the Company's financial position would have raised a number of flags, and we would have behaved differently.

The rapid rise in the level of borrowings has seen an equally rapid rise in finance costs – essentially the amount of interest that the company has to pay on that debt. This has risen not only due to higher levels of debt, but also because the banks have upped their interest rates due to the higher level of risk. So, despite a recovery in operating profits referred to above, the company is actually in a loss-making position. The headline loss per share for the period ended Sept 2019

SHAREHOLDER'S EQUITY



Simultaneously, shareholder's equity has plummeted due to losses and the proper revaluation of assets. The implication is that the company is technically insolvent.

was 233c, an improvement on the restated figures for the prior year, but a loss all the same. It is therefore no surprise that the company has suspended all dividend payments for the foreseeable future.

Now that we understand what has occurred, what does the future hold? Operationally, we believe the company is on the road to recovery. Sugar operations are recovering in the crucial SA market, thanks to a higher sugar price and higher production. Conditions in Zimbabwe and Mozambique will remain tough over the next six months, but the new refinery in Mozambique is expected to deliver substantial benefits in the years ahead. The starch operations are solid, and probably the jewel in their crown, whilst land sales appear to be recovering off a very weak base.

"Operationally, we believe the company is on the road to recovery. Sugar operations are recovering in the crucial SA market, thanks to a higher sugar price and higher production."

Unfortunately, a strong operational performance will be insufficient on its own to make a material dent in their debt burden, which is essential for the company's survival. For that to be achieved, the company is looking to sell non-core assets (even their historic headquarters are potentially up for sale) but it will probably also be forced to undertake a rights issue. This last point is the reason for the substantial weakness in the share price since it resumed trading in early February.

Management have hinted that they may need to raise R4 billion of new equity via rights issue to existing shareholders. The problem is the extreme weakness in the share price, which means that the company will be almost giving its shares away. Let me put this into perspective. Presently, the company has 135.1 million shares in issue. In order to raise R4 billion at the current share price, that implies the issuance of almost 900 million new shares – which implies a more than six-fold increase in the number of shares in issue. If we forecast a steady improvement in profits thanks to a better operational performance and a sharp reduction in interest paid, the share could be trading on a P/E ratio of 8x – 10x post the capital raise – very much in line with the rest of the mid and small cap sectors.

In conclusion, we believe that remedial action taken at the company under the stewardship of the new management team will ultimately ensure that Tongaat survives this turbulent period of its history. In our opinion, the rights issue will ensure that the company is viable, and self-help initiatives should result in a further improvement in profitability. But the ultimate path to recovery will depend, like every other company, on whether SA can drag itself out of its current malaise. On that basis, we believe shareholders have two options: either sell out or follow their rights and be patient for a recovery. Remaining invested and not following your rights would be a foolish option, and not one that we would recommend. As a rule, we would favour the latter, but as always, action will be taken on a case by case basis.

The global sugar price has improved giving a more positive outlook.

It has been a tough start to the year. Rolling loadshedding has soured the mood, and the emergence of the Coronavirus in China is rippling through the world economy. Locally, we have had the SONA and Budget to digest. Our investment thesis for the year acknowledges a tough year for economic growth, but importantly, a turn in sentiment that will start to drive a more virtuous cycle. Our next seminar will examine whether this stance is still valid.

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

Topic: **Viruses vs green Shoots; Is our outlook still valid?**

Natal Midlands	
Date:	Thursday, 16th April 2020
Venue:	Fernhill Hotel Midmar / Tweedie Road (almost opposite entrance to Midmar
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	Tuesday, 21st April 2020
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

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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