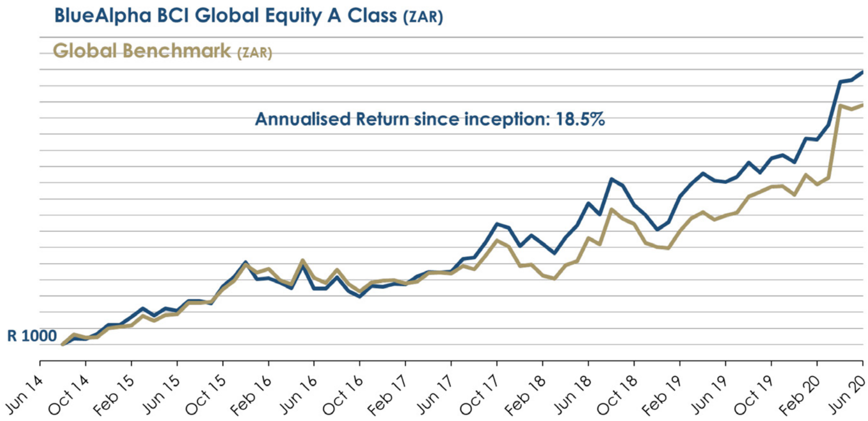
INVESTMENT QUARTERLY

BLUE ALPHA INVESTMENT MANAGEMENT

JUNE 2020

BLUEALPHA BCI GLOBAL EQUITY

OUR GLOBAL EQUITY PERFORMANCE



**Benchmark: 80% MSCI World Index, 20% USD Libor*
Inception: September 2014

Source: MoneyMate, Bloomberg

INVESTMENT OBJECTIVE

The primary objective of the BlueAlpha BCI Global Equity Fund is to offer investors a high long term total return by investing across global equity markets.

OUR GLOBAL EQUITY TRACK RECORD

Performance reported in ZAR	1 Year	3 Years (annualised)	5 Years (annualised)	Since Incept. (Sept 2014 - annualised)
BlueAlpha Return*	**34.0%**	**22.8%**	**17.3%**	**18.5%**
MSCI World Index	26.4%	17.4%	14.8%	14.9%
Out-Performance	**7.6%**	**5.4%**	**2.5%**	**3.6%**

**BlueAlpha BCI Global Equity A Class net of fees*

Source: MoneyMate, Bloomberg

Fund fact sheets (MDD's) available on www.bluealphafunds.com

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IN THIS ISSUE

INTRODUCTION TO OUR NEW PARTNERS: BlueAlpha is excited to introduce our new shareholders, **Crede Capital Partners.**

LOOKING BACK: We take a look at the history of a **featured company** to get a feel for where they started and how they got to where they are now. In this feature, we're diving into the story of **Eskom.**

INVESTMENT FOCUS: In this series, we tackle a new investment concept every quarter - from which valuation metrics to use for different types of businesses, to how companies can create value for shareholders. Today we explore **the changing nature of balance sheet assets.**

CHART FOCUS: This piece presents the most interesting or noteworthy chart that we've encountered over the quarter, exploring the Why's and Wherefores' of how that picture emerged. This time, we're assessing the **global banks and the challenges they are facing.**

RECOMMENDED READ: Each quarter, we give you access to our reading list. We recommend each book for a different reason, but the common thread is how the book's concepts can be applied to your investment well-being. The latest addition to our bookshelf is Gene Sperling's ***"Economic Dignity"***.

TAKE A LOOK

RAGING BULL AWARDS
WINNER

Find out more about BlueAlpha – who we are and how we invest – visit our home on the web: www.bluealphafunds.com

BLUE ALPHA
INVESTMENT MANAGEMENT

OUR NEW PARTNERS: CREDE CAPITAL

BLUEALPHA INVESTMENT MANAGEMENT IS PLEASED TO ANNOUNCE THAT CREDE CAPITAL PARTNERS HAS BOUGHT A MAJORITY SHAREHOLDING IN THE COMPANY.

This transaction makes us a majority black-owned investment manager and brings on board experienced investment professionals who will add to the already strong capability of our team. We take to heart the call for sustainability as seen through empowerment codes, by introducing diversity to our shareholding and our team.

Crede Capital is a black-owned and operated investment manager of alternative asset classes in infrastructure, private equity and private debt. Crede also has a significant debt advisory practice.

Sandile Sokhela, CEO of Crede Capital Partners, joins our board of directors. He brings a wealth of fund management experience encompassing leadership in traditional asset management, private equity and infrastructure funds. He is a CFA® charterholder and holds a BCom (Hons) from Wits, and a MDevFin from Stellenbosch.

Duzi Ndlovu, Principal at Crede Capital, also joins our portfolio management team. He is a CFA® charterholder and holds a BCom from Wits and a MPhil from Stellenbosch. His experience as a portfolio manager and investment analyst and leadership of investment teams is welcomed.

As we grow our AUM and team, BlueAlpha commits itself to making continuous improvements with regards to diversity in all areas and improving our BEE score card ratings.

BlueAlpha welcomes the opportunity to collaborate with our new partners in building our business through strategic development and responsible practices. We believe that our expanded team has exactly what it takes to grow into a substantial asset management business with:

- a strong and sustainable investment philosophy and process
- a highly experienced investment team
- consistent investment performance that has seen the Global Equity capability win the Raging Bull award for two years running
- top quartile performance in the specialist domestic equity category over 3 years
- a leadership team that has proven that it can be very decisive, adaptable and understands individual accountability
- a growth mindset

Sandile Sokhela,
CEO of Crede Capital Partners

Duzi Ndlovu,
Principal at Crede Capital Partners

CREDE
CAPITAL
PARTNERS

We ask all stakeholders to hold us to every promise that we make. We ask that you consistently demand the very best from us as we seek your support in growing BlueAlpha Investment Management together." - *Sandile Sokhela*

LOOKING BACK: ESKOM

ESKOM HAS A LONG AND RICH HISTORY, WITH ITS ROOTS AND GROWTH INTERTWINED WITH THE INDUSTRIALISATION OF SOUTH AFRICA. THIS QUARTER WE LOOK AT HOW ESKOM CAME TO BE AND THE CURRENT CHALLENGES FACING THE BIGGEST POWER PRODUCER IN AFRICA.

The first lightbulb was demonstrated in 1860 at the Castle of Good Hope - signalling the dawn of electric lightening in the country. It would however take another two decades before Kimberley proudly became the first town in South Africa with electrical street lighting and 16 lamps.

Electrical use was mostly limited to smaller mines and factories that were able to generate their own electricity. Use of electricity expanded with time, and eventually larger cities such as Cape Town, Port Elizabeth and Johannesburg constructed their own small generating plants to power public services like trams.

Streetlamps in Kimberley.

Electrical tram in Cape Town.

Gold was discovered in the Rand, necessitating the construction of bigger power stations. In 1906 the "Victoria Falls Power Company" (VFP) was formed to consolidate existing generating capacity and import power from Victoria Falls. With an abundance of mineable coal supplies, the Victoria Falls Hydro station plans were abandoned, but the VFP did obtain concessions to supply power to the mines and constructed multiple power stations and a network serving the mines.

By 1918 the South African Railways (SAR) considered the feasibility of using electrical power, rather than steam. The SAR commissioned a research report that was presented to government, resulting in the Electricity Act of 1922. Government appointed the brilliant Dr Hendrik Johannes van der Bijl to spearhead the widespread electrification of South Africa. His Task: "stimulate the provision, wherever required, of a cheap and abundant supply of electricity" And So ESCOM (Electricity Supply Commission) was born on 1 March 1923.

ESCOM proceeded to build power stations around the country. The first was a hydro station at Sabie River, followed by stations in Salt River for Cape Town and a further station near Witbank. During this time, VFP was a for-profit company that still had concessions and a monopoly in certain areas, while ESCOM was a state-owned entity created to facilitate industrialisation.

With the continued growth of the mining industry, it became clear that further generation capacity was needed. ESCOM raised capital in debt markets and contracted VFP to develop and operate further power stations on its behalf.

Numerous power stations were constructed or expanded in most regions around the country in the following years. During this time, ESCOM was financially strong and was able to repay the initial debt owed to government, raising further capital for planned projects.

By 1948 the concessions granted to VFP came to an end and ESCOM purchased all VFP assets, consisting of power stations, transmission lines and substations. In the post war years, economic growth was strong and during the 1950's ESCOM built a further 8 stations country wide, more than doubling existing capacity.

Economic growth, industrialisation and power needs grew throughout the 1960's and by 1972 ESCOM had establish a countrywide generation and transmission network that made it possible to export power from the coal rich Eastern Transvaal to Cape Town. An abundance of cheap coal in the north as well as scale and operational efficiency meant cheap and abundant electricity facilitating economic growth. During the 1970's - 1980's some of the biggest coal-powered plants in the world were constructed and currently still serve as the base load for South Africa decades later. The Koeberg nuclear power station was commissioned in 1984, marking a first for the continent.

By 1987 the Electricity Act was revised and ESCOM became known as ESKOM. During the 1990's with the advent of democracy, there was an increased focus on widespread distribution of electricity, with millions of citizens gaining access to electricity for the first time.

Widespread electrification and electricity supply to rural communities continued and Eskom's user base grew dramatically, but many smaller municipalities supplying the new clients were not financially viable. The first of Eskom's subsequent financial problems started with these municipalities not being able to pay Eskom for electricity delivered. The increased demand, without further building of generation capacity, also resulted in what would widely become known as "load shedding" in 2007.

The following decade was indeed tumultuous for Eskom, with numerous governance issues, management changes and allegations of corruption. Lack of generation capacity increased the need for more power plants. In 2008, construction started on the now infamous Medupi and Kusile power stations. Medupi and Kusile have been plagued by mismanagement, project delays, engineering faults and corruption.

Debt started increasing from 2008 with these new-build projects. A significant proportion of operating profit goes to service interest payments and the South African Government has made numerous capital injections since 2015. Eskom currently has approximately R450 Billion Rand of debt.

Eskom faces another challenge, in that operational and governance failures have a resulted in older generation plants falling into a state of disrepair. Although electricity tariffs have been increasing above inflation for the last decade, revenues generated by Eskom have not been sufficient to cover the replacement cost of existing assets.

Eskom finds itself in the unfortunate position of being lossmaking, highly indebted and without the financial capacity to replace assets that are reaching the end of their life in the next decade. With around 75% of Eskom's debt backed by government guarantees, and the country also facing a possible sovereign debt crisis, continued bail outs are not a feasible solution. Failure to address the current issues will have far reaching consequences. The success of the country is intertwined with the success of Eskom.

Kusile Power station construction.

Only time will tell if Eskom is able to address its numerous issues while keeping the lights on in a time of heightened economic distress exacerbated by the COVID-19 outbreak.

INVESTMENT FOCUS: THE CHANGING NATURE OF BALANCE SHEETS

THIS QUARTER WE LOOK AT THE HOW REPORTING ON BALANCE SHEETS HAS CHANGED DRAMATICALLY AND HOW THIS HAS AFFECTED THE PRICE TO BOOK (P/B) VALUATION METRIC.

Before we get into the details:

$$\frac{P}{B} = \frac{\textit{Market Cap}}{\textit{Book Value}} = \frac{\textit{Share Price}}{\textit{Book Value per share}}$$

$$\textit{Book Value}\ (\textit{Shareholder's Equity}) = \textit{Assets} - \textit{Liabilities}$$

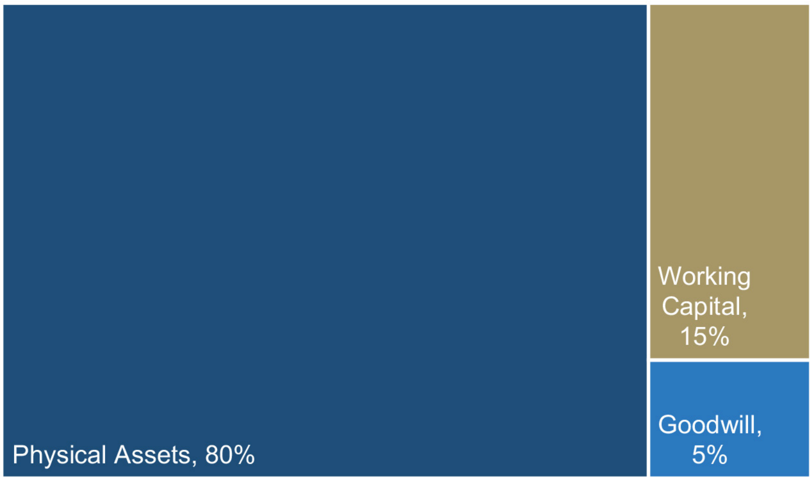
While Book Value intuitively seems like a good place to start when considering a company's value, recently it has been one of the most poorly performing metrics. In fact, the entire "Value" bucket has underperformed - for numerous reasons, including high leverage and slow growth, but of these reasons, the changing nature of Book Value is often overlooked.

Generally, companies' Balance Sheets are made up of Physical Assets, Goodwill and Working Capital on the asset side. On the liability side there is long- and short-term debt, and future obligations. The difference between these is the Shareholders Equity (Book Value). For our purposes, we will only focus on the asset side.

To examine this, we will compare four companies (Sasol, Datatec, Pick n Pay and Microsoft) in trying to understand how different their respective Balance Sheets look, and what these differences mean for valuations.

First, we look at companies whose assets are mainly plant and machinery – like Sasol (80% in fact). Sasol has some working capital - roughly 15% of total assets, and a very small 5% balance in Goodwill.

FIGURE 1: SASOL'S ASSETS

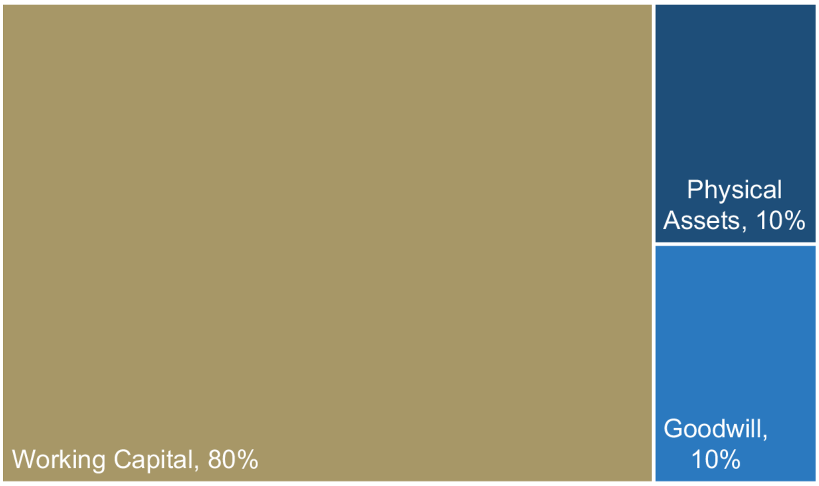


Source: Bloomberg

Accounting standards allow companies to capitalise the costs of plant, property and equipment as an asset on the Balance Sheet, which flows through the Cash Flow Statement, rather than being expensed through the Income Statement (remember this mechanism when we discuss Microsoft). Companies with similar asset bases include Nampak and Mondi. Given that the asset side is fairly straightforward, the P/B of Sasol reflects the market's assessment of return on capital and future prospects. Forty years ago, almost all companies' Balance Sheets looked like this.

The advent of middlemen led to the creation of companies like Datatec. Datatec distributes products on behalf of other companies. It uses financing to secure inventories and then hopes to sell them at a higher price, receiving payment at a later date. The asset side of the balance sheet looks like this: fixed assets 10%, goodwill 10% and working capital assets making up 80%. Working Capital is made up of inventory and receivables. Receivables in this case is some 40% of total assets.

FIGURE 2: DATATEC'S ASSETS



Source: Bloomberg

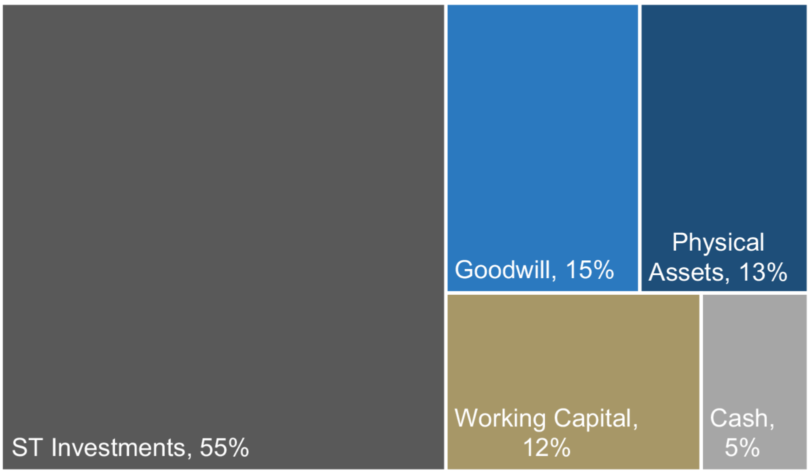
The owners of African Bank will tell you the dangers of paying a high multiple for receivables. As for inventory, it may or may not be sold for more than what is on the Balance Sheet. For this reason, Datatec will very rarely trade above a multiple of one. Most distributor models look like this. In general, at BlueAlpha we rarely buy these types of companies.

You will notice that we haven't included cash as part of assets. In general, this cash can't be accessed, so mostly we assume it is trapped. Steinhoff spoke glowingly about their cash balances.

In our next example, Pick n Pay is a bit of a hybrid. Physical long-term assets are some 50% of total assets. Inventories and receivables are split both 20% and intangibles only 10%. We've done this exercise using 2019 statements so as not to introduce leased assets. Like many companies with strong consumer brands, Pick n Pay has spent a considerable amount on building their brand. However, while its brand may be a considerable asset, it never appears on the Balance Sheet – rather it is expensed through the Income Statement. Not all expenses on advertising pay off, but in the case of Pick n Pay it has. So much so, that suppliers are willing to fund the inventory of Pick n Pay. This internally generated Goodwill also doesn't appear on the Balance Sheet.

Lastly, we look at Microsoft, which has even fewer physical assets. Plant and property assets are only 13% of total assets. Inventory is a measly 2% and receivables 10%. The balance is intangibles – mainly from acquisitions of 15%, and the rest is cash and short term investments (de-facto cash) at 60% of assets (this is one of the few companies where cash is not trapped). It generates so much cash and spends so little on capex that it really does have a surplus.

FIGURE 3: MICROSOFT'S ASSETS



Source: Bloomberg

So the question is how Microsoft can spend so little on capex but still make money? As it happens, Microsoft spends a lot on Research and Development (R&D), which according to accounting standards has to be expensed through the Income Statement (i.e. it doesn't reflect as an asset on the Balance Sheet like typical capex would). In fact, R&D spend will only reach the Balance Sheet via retained earnings if that research leads to a successful product. In a way this, Microsoft has a very conservatively struck Balance Sheet. It has no recognition for all the R&D it has done over many years.

Remember how Sasol spend mainly goes through the Cash Flow Statement?

As a reminder, figure 3 depicts each company's P/B ratios and asset breakdowns, which highlights the stark differences between them – most notably between Sasol (typical Industrial) and Microsoft ("new" economy). The more tech companies grow, the more this difference in Balance Sheet structure will matter in understanding the value of different businesses.

FIGURE 4: BALANCE SHEET ASSET BREAKDOWN 2019

	Sasol	Datatec	Pick n Pay	Microsoft
P / B	**0.37**	**0.55**	**8.16**	**13.67**
Cash	3.4%	12.7%	4.7%	46.7%
Receivables	5.0%	46.5%	0.0%	10.3%
Inventories	6.3%	12.2%	17.7%	0.7%
Other S-T Assets	2.0%	12.6%	14.2%	3.5%
CURRENT ASSETS	**16.6%**	**83.9%**	**36.6%**	**61.3%**
Property, Plant& Equip	76.9%	2.2%	50.7%	15.3%
L-T Investments/receivables	1.6%	0.8%	0.7%	0.9%
Other L-T Assets	4.9%	13.0%	12.0%	22.5%
NON-CURRENT ASSETS	**83.4%**	**16.1%**	**63.4%**	**38.7%**

Source: Bloomberg

Simplistically, the more a company expenses its business through the Cash Flow Statement (capitalising that spending on its Balance Sheet), the more the business will reflect Sasol and Nampak. When instead, your expenses are borne through the Income Statement, like advertising, salaries for highly skilled employees (human capital) and R&D, the less relevant Book Value becomes.

CHART FOCUS: GLOBAL BANKS

BANKS HAVE BEEN SOME OF THE WORT-AFFECTED BUSINESSES THIS YEAR, GIVEN MOVES BY CENTRAL BANKS TO CUT INTEREST RATES IN THE HOPE OF SUPPORTING ECONOMIES HARD-HIT BY COVID-19 LOCKDOWNS. WHILE THE EFFECTS OF QUANTITATIVE EASING HAVE CERTAINLY IMPACTED BANKS, THIS ISN'T THE ONLY PROBLEM. BANKS HAVE UNDERPERFORMED THE MSCI WORLD BY AN ANNUALISED TOTAL RETURN OF 4% OVER THE LAST 20 YEARS, MEASURED IN US DOLLARS. THIS QUARTER, WE EXPLORE SOME OF THE REASONS FOR THEIR UNDERPERFORMANCE.

FIGURE 1: WORLD BANK INDEX RELATIVE TO THE MSCI WORLD INDEX

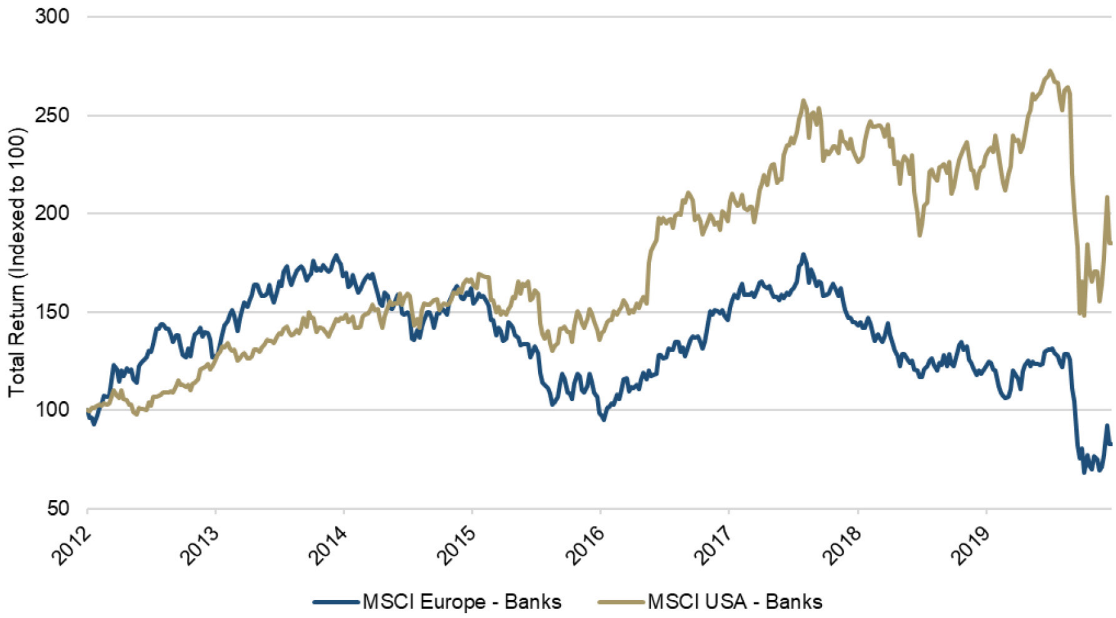
Source: Bloomberg

European banks have worn the last decade the worst. When compared to the US, there has been a marked divergence between the two regions; since 2012, European banks have been losing on average 2% a year, on an annualised basis. This equates to 20% in absolute terms over this time.

A real pressure point for banks is the net interest margin, a key measure of profitability for their core lending business. This is the difference between the interest banks pay on deposits held, and the interest earned on advancing loans. The European Central Bank's sustained effort to stimulate the economy since 2008 has delivered record low policy rates in the monetary union, in turn supressing margins.

Banks are also facing the slow but sure force of demographic aging. The lower level of consumption in these older populations weakens the demand for credit from the banks. This lower uptake on credit extension reduces the scope for banks to earn more from the interest charged on loans while remaining competitive.

FIGURE 2: EUROPEAN AND US BANK RETURNS



Source: Bloomberg

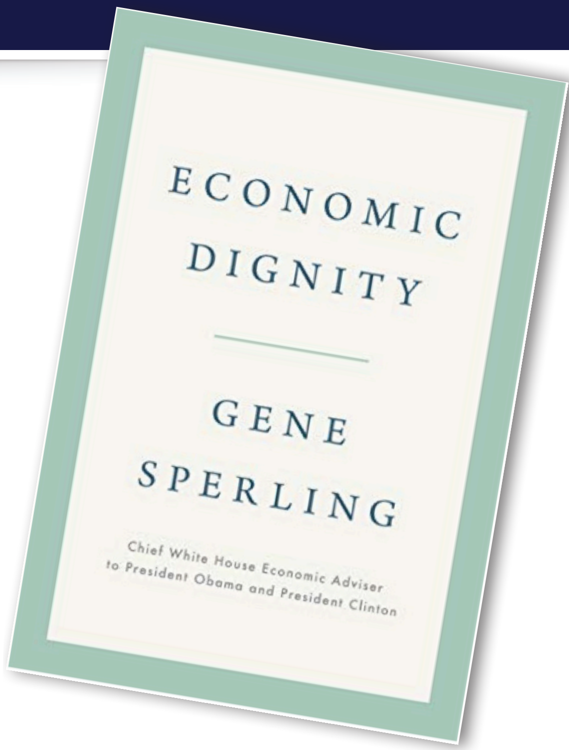
Lastly, banking regulations over the last decade have imposed stricter measures to account for the bank's supporting capital, constraining the capacity for global banks to grow into new markets and compete with local firms.

It is difficult to talk about the headwinds banking faces without also mentioning Deutsche Bank, that this year celebrates its 150th anniversary. The German bank is not only tasked with navigating this unfavourable environment but also taking strides in downsizing its operations - the bank most notably announced it would be pruning its total workforce by as much as a fifth in 2019. Rapidly reducing its footprint as the opportunities arising from a globalisation-led expansion are no longer as abundant as they were in the 1990s.

Banks find themselves in a challenging situation that has been exacerbated by the recent coronavirus. Given lender's relationship with every part of the economy, there may only be significant improvements in profitability once most economic sectors begin to show stability again. While banks stay positioned to benefit from this recovery, the symptoms stemming from restrictive regulation and low policy rates show no signs of alleviating anytime soon.

RECOMMENDED READ:
ECONOMIC DIGNITY - *by Gene Sperling*

GENE SPERLING WAS DIRECTOR OF THE NATIONAL ECONOMIC COUNCIL UNDER BOTH PRESIDENT OBAMA (2011–2014) AND PRESIDENT CLINTON (1997–2001). IN HIS LATEST BOOK, SPERLING LAYS OUT A FRAMEWORK FOR ECONOMIC POLICY THAT FOCUSSES ON PEOPLE'S WELLBEING, RATHER THAN THE PURE CAPITALIST TENETS OF PROFIT MAXIMISATION. GIVEN THE CROSSROADS THE WORLD FINDS ITSELF AT RIGHT NOW, IN THE CONTEXT OF A GLOBAL PANDEMIC THAT HAS LED TO THE GREATEST ECONOMIC CRISIS SINCE THE GREAT DEPRESSION, HIS THINKING HIGHLIGHTS A PATH OUT FOR POLICY MAKERS THAT WOULD LIKELY MEAN GREATER PROSPERITY FOR MOST PEOPLE - IF IMPLEMENTED.



Sperling illustrates three pillars of 'economic dignity' that should form a base-line for inalienable living standards – specifically, 1.) the capacity for all of us to care for family, 2.) pursue potential and purpose, and 3.) participate in the economy without enduring domination and humiliation.

To achieve these ideals, Sperling argues that instead of viewing policy and regulation as 'government interference in free markets', as many commentators might suggest, rather, that policy should be the guiding light in "structuring markets to reward competition principally on quality, price, and performance, and not race-to-the-bottom behaviour," which then "leads competitive actors to focus on delivering better products and services to consumers and society, without fear that dignified treatment of workers, consumers, and the environment will jeopardize their competitive advantage."

This book frames economic thinking in a very different light than your university textbooks, and asks important questions about our values and beliefs, and how we can achieve better economic outcomes for our societies.

As we all come to terms with the "new normal" that has come from the outbreak of COVID-19, it becomes increasingly important for us as a global community to start formulating a plan which would better support people out of economic hardship. By focussing on economic dignity, Sperling provides an important staring point from which we can begin imagining our economic future.

BLUEALPHA INVESTMENT OFFERING

OUR LONG TERM TRACK RECORD DEMONSTRATES OUR ABILITY TO CREATE WEALTH FOR OUR INVESTORS.

OUR DOMESTIC EQUITY PERFORMANCE – BLUEALPHA BCI EQUITY

	1 Year	3 Years (annualised)	5 Years (annualised)	Since Incept. (July 2014 annualised)
BlueAlpha Return	**1.2%**	**6.6%**	**4.5%**	**7.6%**
SA Equity – General Sector Average	-7.4%	0.9%	0.1%	1.6%
Benchmark**	1.9%	5.7%	4.3%	5.1%
Out-Performance to Benchmark	**-0.7%**	**0.9%**	**0.2%**	**2.5%**

** A Class, Net of Fees*
*** Benchmark: Composite of SWIX to 31/10/2017; 75% JSE Swix & 25% MSCI All Country World Index from 01/11/2017*

Source: MoneyMate, Bloomberg

With an experienced investment team which is recognised for outstanding investment performance in various fund classifications, we are able to offer both institutional and retail investors diverse products to meet their investment objectives.

For our **institutional investors** we currently manage South African focused equity and balanced mandates as well as a global equity product.

Our **retail** and **IFA investors** have the same access to the BlueAlpha investment process via our BlueAlpha managed unit trusts:

- **BlueAlpha BCI Equity Fund:** is our general equity fund, managed with exposure locally and globally. Its benchmark is 75% JSE Swix, 25% MSCI All Country World Index. The fund aims to provide long-run market out-performance. It has a high risk profile.

- **BlueAlpha BCI All Seasons Fund:** our longest running unit trust, started in 2005 and managed with a high equity exposure in the SA Flexible Sector, aims to provide investors with consistent long term capital growth.

- **BlueAlpha BCI Global Equity Fund:** our global equity fund provides investors with offshore equity exposure. The fund invests in developed markets with a focus on quality growth companies with a large market cap. For further details, see page 1.

- **BlueAlpha BCI Balanced Fund:** the newest addition to the BlueAlpha stable, this fund aims to achieve high capital growth through maximizing exposure to both local and global equity, as well as through sizable exposure to property. It is managed to comply with Regulation 28 and is therefore appropriate for retirement products. The fund has a medium risk profile.

INVEST WITH US

To find out more about our funds or invest with us please contact Kimberley on: 021 409 7100 or email: info@bluealphafunds.com