Investment Quarterly

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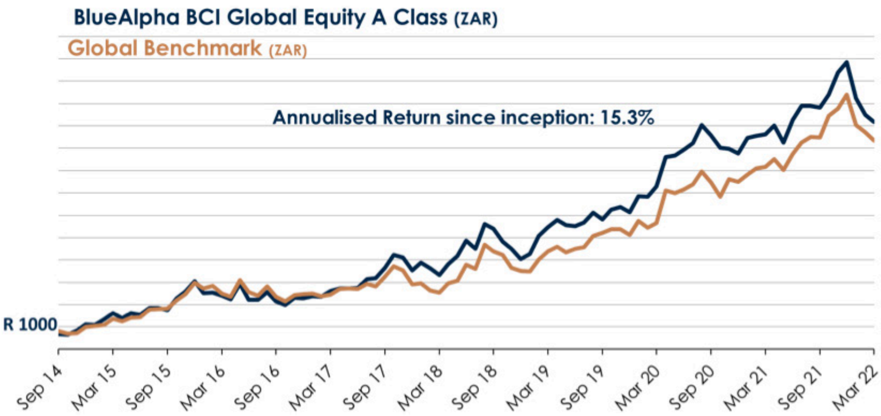
BLUEALPHA
INVESTMENT MANAGEMENT

BlueAlpha BCI Global Equity

Our Global Equity Performance



**Benchmark: 20% USD Libor, 80% MSCI World Index ZAR until 30/09/2020 and MSCI World TR index (in ZAR) from 01/10/2020*
Inception: September 2014

Source: Fund Focus (Iress), 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*	3.9%	13.8%	15.6%	15.3%
Fund Benchmark	9.2%	15.9%	14.8%	14.4%
Out-Performance	-5.3%	-2.1%	0.8%	0.9%

**BlueAlpha BCI Global Equity A Class net of fees*
Benchmark: 20% USD Libor, 80% MSCI World Index ZAR until 30/09/2020 and MSCI World TR index (in ZAR) from 01/10/2020

Source: Fund Focus (Iress), Bloomberg

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

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In this issue

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 **City Lodge.**

ESG Focus
This quarter we are looking at ESG investing, what works and what doesn't, more specifically we will look at **the cost of looking away from corruption.**

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. In this edition we look at **When Debt is the least of your problems.**

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 **Alchemy** *by Rory Sutherland.*

RAGING BULL AWARDS WINNER

Take a look

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

Looking Back: City Lodge Hotel Group

Through the vision of founder, Swiss-born Hans Enderle, and the financial backing of the Mine Pension Funds, the opening of City Lodge Randburg (now called City Lodge Hotel Bryanston) on 1 August 1985, became the catalyst for what today is South Africa's leading selected services hotel chain.

It was during a trip to the USA in the 1980s, when he came across select services hotels, that Hans had the idea of developing this concept in South Africa. Previously South African hotels tended to offer only luxury services and were all designed to be opulent, not making them accessible to those who needed to travel for business or wanted to take the family somewhere affordable. Hans developed his idea for a practical, home-away-from-home style of accommodation.

The group was officially incorporated in July 1986 and had since then diversified its offering. The Town Lodge concept, a second-tier hotel brand, was introduced in 1990. It went public on the Johannesburg Stock Exchange, two years after. Its budget brand concept 'Road Lodge' was launched in 1995 following the group's acquisition of the 50% stake in firms associated with upmarket chain Courtyard Suite Hotel. The remaining 50% interest in the hotel chain was acquired in 2015 from HPF Properties. The following years have seen City Lodge Hotel Group growing its portfolio from the acquisition of two hotels in Nairobi Kenya in 2013 to the development of Tanzania's City Lodge Hotel Dar es Salaam.

City Lodge Hotel Group currently manages 21 City Lodge Hotels, 23 Road Lodges, 5 Courtyard Hotels, 13 Town Lodges, and the Fairview Hotel.

It's been a tough few years

For the hospitality sector, as for many other parts of the economy, the 2020 and 2021 financial results will always be referred to as Covid Pandemic financials. City Lodge has been a solid performer over the years, but the company and its peers had absolutely no way of dodging the devastating impact of having to close their doors overnight, leaving them with costs aplenty and revenue reduced to a trickle.

Firstly, let's look at the revenue per available room. This number peaked in 2016/2017. Was this due to a slowdown in the economy or was it a sign that their growth strategy wasn't working? In 2016 they had 7072 hotel rooms, with an occupancy rate of 66%, by 2019 they had grown to 7600 rooms with 55% occupancy rate. Growing too fast? As at the end of 2021 they were sitting with 8070 rooms at 19% occupancy rate.

Another graph to pay attention to is EBITDA less Capex. It's a number where the higher it is the better. Anything below 3 is a problem. Although the pandemic increased the pain for City Lodge, the below graph shows the debt problem had arrived before the pandemic.

The company simply didn't generate enough revenue to pay off its interest.

The future of the Hotel Group

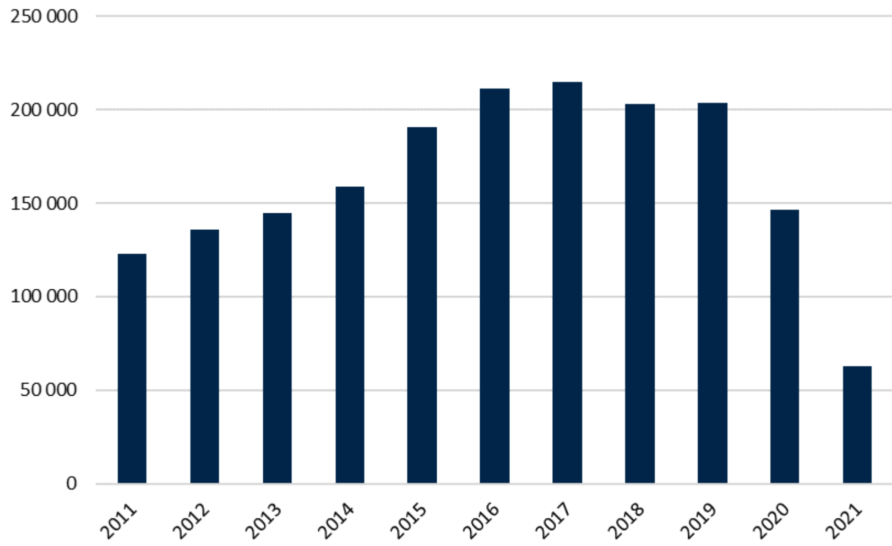
The impact of Covid illustrates why one should never take their eyes off the importance of a well-managed balance sheets and executives who can respond decisively.

City Lodge has mas shown that they can "self-help" They were innovative during lockdown offering rooms to people who have not mastered the work-from-home environment at R435 per night. The company went further to raise R1.2 billion in a well-supported rights issue during the Covid pandemic to improve the company's liquidity and pay off the corporate debt. In July 2021 they got rid of some "dead wood" to reduce its debt by selling its loss making hotels in Kenya and Tanzania. Another positive is the group owns 52 hotels out of the 63 hotels in its portfolio, if they leased all their buildings, they would be bankrupt by now.

Another positive is when looking at the economic returns of the company, we can see that it was able to maintain steady positive returns for the past decade until during difficult trading environments in 2020 and in 2021 they started making losses.

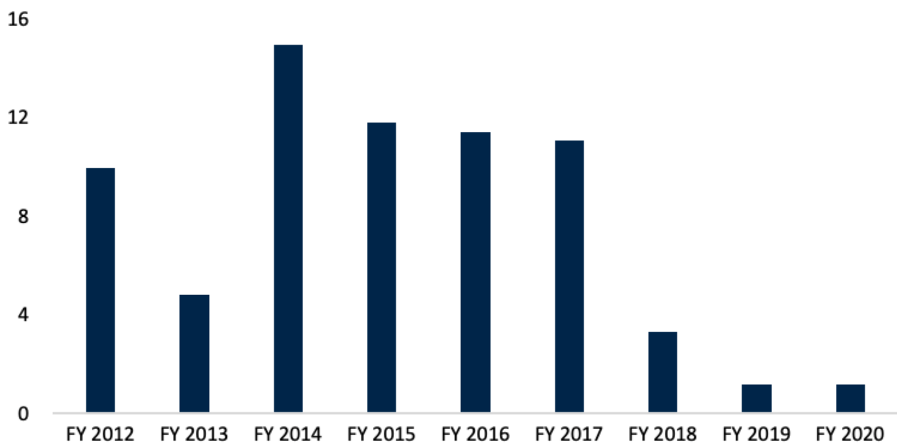
A company like City Lodge will benefit from a continued normalisation of economic activity, and now that South Africa has declared an end to its National State of Disaster, a return to normal is imminent. A lot depends on normalisation of the revenue per room, will this take 6 months or 3 years? If they can get back to 60% occupancy rate in the next 18 months then there is hope for a recovery. Let's see if City Lodge can negotiate their way out of this.

FIGURE 1: City Lodge Revenues per available room



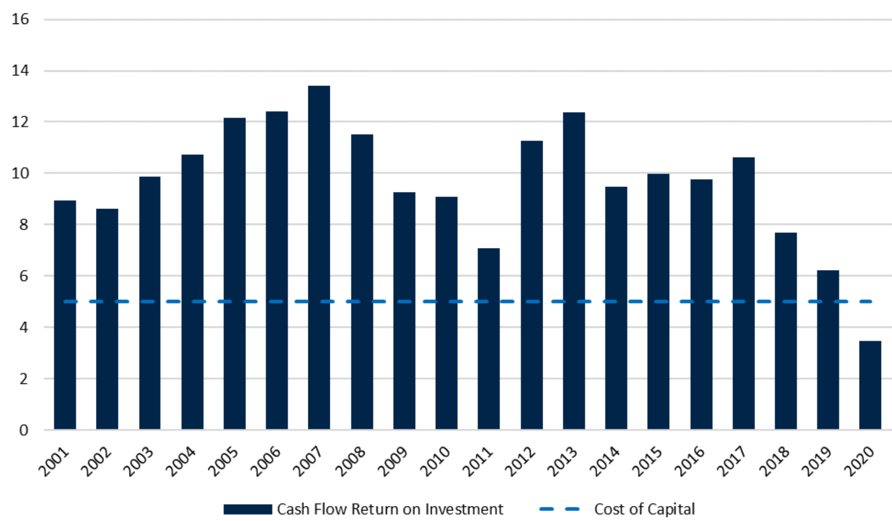
Source: Bloomberg

FIGURE 2: City Lodge EBITDA less Capex/Cash interest paid



Source: Bloomberg

FIGURE 3: Economic Returns



Source: Bloomberg

EGS Focus:
The Cost of Looking Away from Corruption

If you are only paying lip service to risk control measures and ESG principles (Environmental, Social and Governance) when choosing companies to invest in, it will eventually come back to bite you. Many investors think that risk = volatility but if you compromise your initial assessment of a company the risk can be crippling. The history of a company really tells you a lot that you need to know before investing. Who owns it? How do they make money? These questions are crucial to answer before looking at the usual metrics.

Russia – an uninvestable country

Autocracy risk cannot be ignored. It makes little sense to focus on a company's ESG policy and ignore the policies of the government. If a governments principles are poor, it doesn't really matter what governance is like on a company level. Absolutely anything can change without so much as a second thought.

Even if we take ESG investing out the story. The normal way of evaluating doesn't apply in countries like Russia because your entire investment case can be null and void overnight. One must remember that doing business in Russia isn't the same as doing business in the west. You cannot assume that the truth will be told by company managers or officials.

Russia's rap sheet warns of a hostile and unpredictable investing environment:

Russia's Misdemeanours in the last 25 years

1998	Russia defaults on its debt
2008	Russia Invades Georgia
2014	Russia Invades Eastern Ukraine
2014	Russia shoots down flight MH17 over Eastern Ukraine
2014	Organised Crime and Corruption Reporting Project describes how organized criminals and corrupt politicians in Russia allegedly moved more than $20 billion in dirty funds out of Russia using a network of offshore shell companies, banks, fake loans, and proxy agents.
2014	Annexed Crimea
2015	Supported the murderous regime of Syrian president Bashar al-Assad with direct military involvement.
2016	Litvinenko Inquiry - Aleksandr Litvinenko, a former FSB officer turned Kremlin critic, died in London in 2006 of acute radiation poisoning by Andrei Lugovoi, a former FSB officer and current member of the State Duma.
2020	Russian opposition figure and anti-corruption activist Alexei Navalny was poisoned
2022	Russia Invades Ukraine

Through the years Russia has imprisoned people for their political beliefs, such as oligarch Mikhail Khodorkovsky and Ukrainian filmmaker Oleg Sentsov

Companies who claim to invest using ESG principles but still invest in Russia makes little sense.
To quote Bill Browder "Russian stories never have happy endings."

Let's have a look at Russia's largest bank, where many investors recently got their fingers burnt.

Sberbank

Sberbank is Russia's largest and oldest bank, it is the successor to the savings division of the Soviet central bank. It was privatized in 1991 but still has close ties to the government. The company listed in 2004 and the National Wealth Fund, which is obviously controlled by Putin, has majority ownership (50% + 1 share). Herman Gref, a close friend of Putin's has been CEO since 2007.

SberBank's Misdemeanours

- In 2001 SberBank abruptly sold a third of their shares at a two-thirds discount, which severely diluted foreign investors holdings. It was not disclosed where this money went.
- Suleiman Kerimov, one of Russia's richest men benefited greatly from his relationship with SberBank management. In 2004, he acquired a 4 per cent stake in Gazprom, partly through a loan from Sberbank. He also bought a 6 per cent stake in Sberbank itself, using a loan from...Sberbank.
- **Many** Money Laundering allegations

A question for South African investors: If Zuma had 51% ownership in FirstRand, and the main source of income was from the Guptas, would you invest your money?

Play with Fire and you will get burnt

How do you end up owning Sberbank if you have an ESG and Risk Control department? This is a shining example of why doing ESG properly and not just ticking boxes is so important when assessing a company. Sometimes you have to walk away from a stock because despite attractive valuations, you don't actually know what's going on.

One company that stands out as getting ESG investing right is the central bank of Norway, Norges Bank. Recently they were concerned about human rights violations at Chinese Sports Company Li Ning Co Ltd. Li Ning did not respond to the Council of Ethics request for information surrounding the abuse allegations. Norges deemed this unacceptable and removed them from the Norwegian Government Pension Fund Global. To read the full statement: https://etikkradet.no/li-ning-co-ltd-2/

The ESG process as it stands, doesn't require much change from investors and many claim ESG compliance but carry on as usual. For ESG investing to have an impact, investors must be prepared to have a voice, take a stand, or withdraw from certain businesses. Margaret Thatcher's quote on Consensus is perfectly fitting:

"Consensus: "The process of abandoning all beliefs, principles, values, and policies in search of something in which no one believes, but to which no one objects; the process of avoiding the very issues that have to be solved, merely because you cannot get agreement on the way ahead. What great cause would have been fought and won under the banner: 'I stand for consensus?"

Investment Focus:
When Debt is the least of your problems

Often when a company gets into trouble the first thing people want to know is how much Debt it has. But many companies fail with seemingly little debt. Far less attention is paid to the assets that the company records, or its other liabilities.

It should also be said up front that the easiest number to audit is the Debt number as it is often listed, and banks have a habit of keeping the debt and cash number current.

Far more tricky are the other assets, like JV assets, Inventories and ST investments. If you remember Steinhoff's auditor counted one of Steinhoff's subsidiaries as being 100% owned by the company, when only 50% was truly owned.

Below is a semi entertaining look at Evergrande's Balance sheet to Dec 2020. A more serious part of the article is to show how certain Balance sheet items can show that a company is getting into trouble.

So first some high-Level numbers. At Dec 2020 Evergrande had $74 bn in Revenue and supposedly $350 Bn in Assets. (I could say supposed Revenue but that's for another article)

If we common size the Balance sheet to Revenue and Total Assets, we get the Table Below:

ASSETS

Short term	Common size to asset	Common to revenue
Cash	7.0%	
Inventories	62%	293%
Accounts Receivable	1.9%	
Prepaid expenses	8% (normally 0.5%)	
Misc ST assets	4% (normally 13%)	
Long term	**Common size to asset**	**Common to revenue**
PPE	11.4%	
Investments in Affiliates	4%	
Goodwill & other	1.7%	
Total Assets	**100%**	

LIABILITIES

Short term	Common size to asset	Common to revenue
Accounts payable	34.4%	162%
Deferred Revenue	8.1%	38%
Accrued taxes	8.3%	
Short term debt	14.7% (of which 10% are corporate bonds)	
Long term	**Common size to asset**	**Common to revenue**
Long term debt	16.6%	
Other	2.6%	
Equity	6.5%	
Monitor Equity	8.8%	
Total Liabilities	**100%**	

Let's take a look at a couple of interesting things.

Accounts payable

(liability) = 34% of assets

So, a total of 1.6 x their revenue has to be paid out to various suppliers. You can see why debt is the least of their problems. Of course, these poor suppliers don't really have lawyers. I know the debt owners think they are senior to this. We have yet to test a big restructuring in China so we will see. This is a form of soft financing for the company. Twelve years ago, this was 9% of assets. So it has gotten almost 4x worse.

Deferred Revenue

(liability) = 8.1% of assets

Quite a large number. This is people putting down a deposit or the total amount for a property but haven't been given the property. For most companies this is now a very small number, mainly because of the matching principal and also because most firms deliver goods or service upon receipt of payment. Ultimately what is happening in Chinese Property is that prospective homeowners are putting down a large sum to secure a home purchase.

Inventories (asset)

This would be the almost built apartments. The company up until 2013 used to disclose finished vs work in progress. Typically, 85% of inventories were Work in Progress. Declining disclosure is usually a sign of trouble. Now the crucial part. Inventories are 62% of assets and equity is only 6.5% ex minorities. A small error in evaluating the inventories would make the company insolvent. The company says it has $215 bn in inventories. How do you audit that? For perspective Sasol has $25 bn in total assets. Walmart's total asset base is $250 bn and its undepreciated Property number is $200 bn. One other point to digest. Property in China is the most unaffordable in the world easily topping the 12 Price to income ratio of Vancouver at some 35 times in the large cities of China. In my opinion I doubt this is an audited number.

Prepaid expenses (asset)

This is recorded as an asset. It is 8% of assets, once again a large number. This suggests that the company has paid for a service or a good before it has been delivered. I guess they told the auditor, look our cash balances would look a lot better if we hadn't prepaid $27bn of goods and services. Once again this is a completely made up number. This number used to average 0.5% of assets but is now 8%.

Cash (asset)

Most people always net cash off against debt to get a net debt number. I would advise against doing that. Three reasons for not netting it off. Year end balance sheet numbers can be made to look good. Secondly if you look at net interest paid vs Net debt the net interest paid line is always higher than the theoretical number. Thirdly companies just need a certain float to operate so you can never access that cash anyway.

There is an additional reason why I can sometimes be suspicious of a cash balance. That is when it is actually not your cash but your customers cash. In South Africa most of the cash on the balance sheet of a construction company belongs to the customer. As an update the Company said in March that Banks had taken $2 bn of this Cash balance as it belonged to customers.

So here is a company that if you look at the balance sheet it is either fraudulent, going bankrupt or a bit of both. One of the reasons we don't screen for companies using P/book is that these are the types of companies that can appear. If you start by first looking to see if it is credible, then see if it can create economic value. That should be ones starting point.

Recommended Read:

Alchemy *by Rory Sutherland*

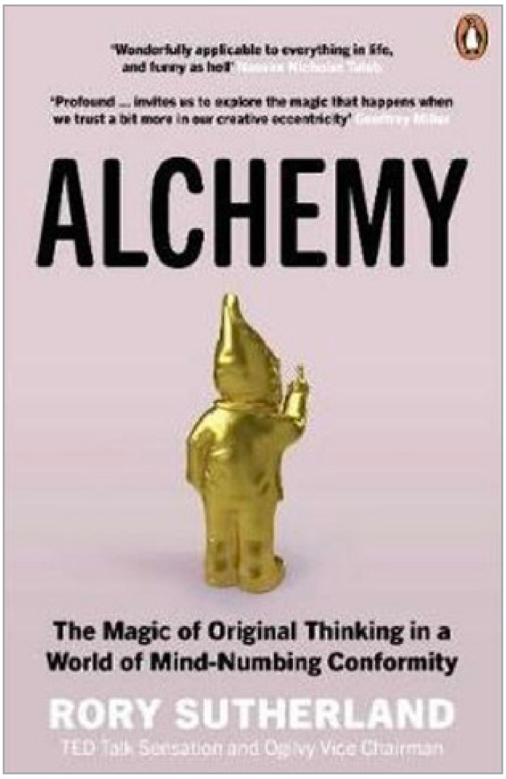
In 1992 hurricane Andrew moved quickly across Florida and the Gulf of Mexico, causing widespread damage to homes and infrastructure. In its wake it also damaged an aquarium close to the coast, one that housed fish not native to the local shores, and in a Hollywood-horror styled event caused a dozen of the poisonous lionfish to spill into the gulf. Otherwise only found in Indonesian waters, the new arrivals saw their populations rapidly increase, and caused the local fish population to dwindle.

Invasive species are a serious but not unusual problem. Typically, the solutions to such a challenge resemble something much like calling pest control, only on a larger scale. Unfortunately, these blunt approaches tend to have unintended consequences, in this case potentially threatening an already fragile ecosystem.

Advertising agency Ogilvy & Mather adopted a more focused approach. So instead they collaborated with local chefs to come up with new recipes for lionfish, some of which finding their way onto the tables of the most exclusive restaurants. This campaign entitled 'Terribly Delicious' drummed up demand for the lionfish, and incentivized local fisherman to target this fish. Years on, the lionfish population is under control and local fish numbers are returning to normal.

Reframing big problems like this allows us to access a much broader set of answers, and Rory Sutherland has been applying this line of thinking for 34 years in his roles at Ogilvy. His book is a crash course in the counter-intuitive lessons learnt in this time, presented in a concise and humorous style.

Among the tenets the author presents, is a critique against thinking 'too logically'. Maybe investors would find this difficult to digest at first but putting aside the most logical solutions does not mean we forego reason and critical thinking. The trap of rigid logic presents itself in investing too; often investments that may seem to make logical sense can often be crowded ideas, offering poor prospective returns. While winning ideas only reveal their "logic" when examined with the benefit of hindsight. In short, logic isn't sufficient when everyone else is competing on logic too.



When thinking about investing in innovative companies that will be industry leaders in the next ten or twenty years, one must imagine a world that hasn't existed before. And attempting to do so by narrowly defining what worked in the last decade is limiting. While investors will always need to rely on the foundations of rigor and due diligence, adding the counter-intuitive ideas presented in his book might just be the special ingredient.

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	**16.8%**	**10.1%**	**9.6%**	**9.5%**
SA Equity – General Sector Average	17.9%	11.8%	8.5%	6.7%
Benchmark**	11.4%	11.6%	9.5%	7.9%
Out-Performance to Benchmark	5.4%	-1.5%	0.1%	1.6%

** 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: Fund Focus (Iress), 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 Capped 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: 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.