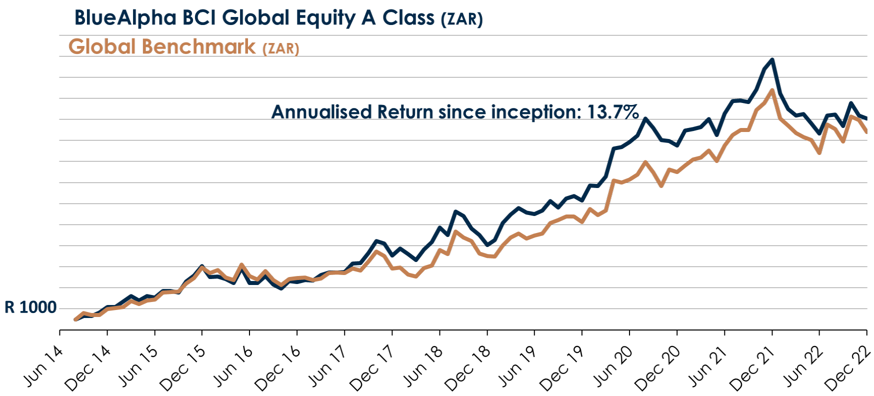
Investment Quarterly

December 2022 | Vol. 36

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*	-16.2%	11.0%	12.6%	13.7%
Fund Benchmark	-12.5%	12.1%	13.1%	12.9%
Out-Performance	-3.7%	-1.1%	-0.5%	0.8%

**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 **MultiChoice.**

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 **Consumer Confidence and Forward Returns.**

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 **HOLT – Economic Profit, the Value Creation Elixir**

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 **The Price of Time** *by Edward Chancellor.*

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: Multichoice Group

Multichoice was born out of the analogue[1] pay TV channel M-Net, as a subscriber manager of the company in 1993. M-Net was introduced to South Africa by Naspers in 1985, through Koos Bekker who, after writing a paper on pay TV during his MBA studies in the United States (US) figured he could replicate and bring the technology to Africa. Interestingly, this led to M-Net becoming the first subscription television services to be launched outside of the US and a decade later DSTV was introduced.

Digital television to Africa

Multichoice delinked from M-Net in 1995 and DSTV was launched, pioneering multi-channel digital satellite[2] television in Africa, starting with South Africa. For the rest of Africa a more affordable pay-TV model currently used is the Digital Terrestrial Television (DTT)[3], through their brand GoTV as well as satellite TV with DSTV channels. After being unbundled from Naspers, the Multichoice Group was listed on the JSE in 2019.

Group companies currently include Multichoice South Africa (MCGSA), Multichoice Africa (ROA - Rest of Africa business), Showmax Africa and Irdeto. Irdeto is a digital platform cybersecurity company that provides the group with content protection software. It services the security and anti-piracy needs of the group and other industry service providers. And recently added to the group is KingMakers, a sports betting company currently operating in 4 sub-Saharan Africa markets. Through this investment Multichoice seeks to move beyond video entertainment. Irdeto and KingMakers' contribution is still small in the mix.

Multichoice expanded to now having a presence in 50 markets in sub-Saharan Africa, providing local and international content to a diverse customer base across languages and entertainment preferences.

Multichoice provides varied bouquets of channels for a monthly subscription, to cater for customer preferences and budget.

Continued investment

Overtime Multichoice had continuously been upgrading their decoders to improve how they deliver entertainment to their customers from introducing dual view decoders – allowing more than one decoder to be linked to a single account. To Personal Video Recorders (PVRs), enabling customers to record and replay on demand. To recently, decoders that offer third party subscription video on demand (SVOD) services and now customers can bundle the likes of Netflix and Disney+ subscriptions in addition to DSTV bouquets.

[1] Video signal is transmitted via airwaves similar to radio signal (to be switched off in SA in 2023)

[2] Video signal is transmitted via a satellite dish

[3] Transmitters on the ground are used to broadcast the signal received using a TV aerial and set top box

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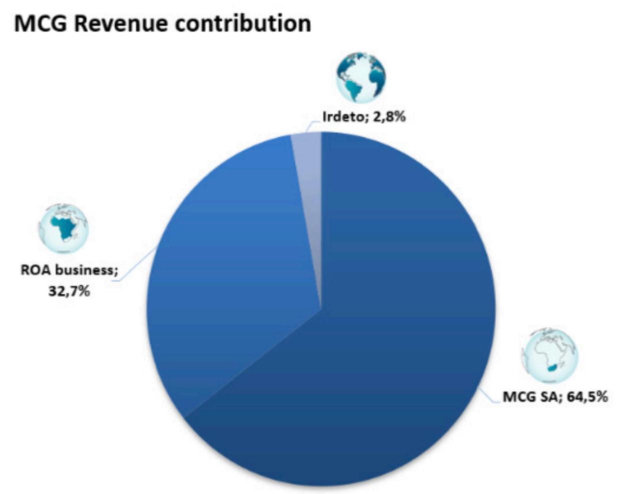
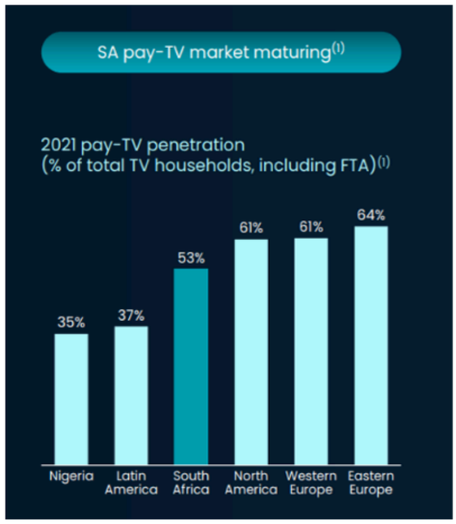
FIGURE 1: Multichoice revenue breakdown and global pay-TV penetration



Source: MCG company reports



Source: MCG, Digital TV Research Global Pay TV Forecasts 2022 edition

A maturing SA pay-TV market

As charted on figure 1 above, MCGSA continues making up most of the group's revenue, by end of financial year 2022, was 65% of group revenue and the ROA business contributed 33%. The SA pay-TV market is maturing, the group estimates 14.7m total addressable households and Multichoice have just over 60% market share. Their leading position and generally high barriers to entry to the Pay-TV market has historically ensured that Multichoice maintained high margins, returns and free cashflow.

A greater opportunity for growth exists in the ROA business, which currently sits on approx. 13m households with an estimated addressable households of close to 37m. This provides the group with a structural growth opportunity, however in the recent years some of the key markets such as Nigeria, Angola, Kenya and Zambia have faced macroeconomic headwinds. Among other, these include high inflation which has impacted disposable incomes and currency depreciation to the dollar which has slowed the anticipated accelerated revenue growth. SA revenue growth is to come from increased penetration in the mass market and driving adoption of Showmax. Since 2016, MCGSA has seen a compound annual revenue growth rate of 3.4% and the ROA business 2.1% to end of financial year 2022.

On demand entertainment competition

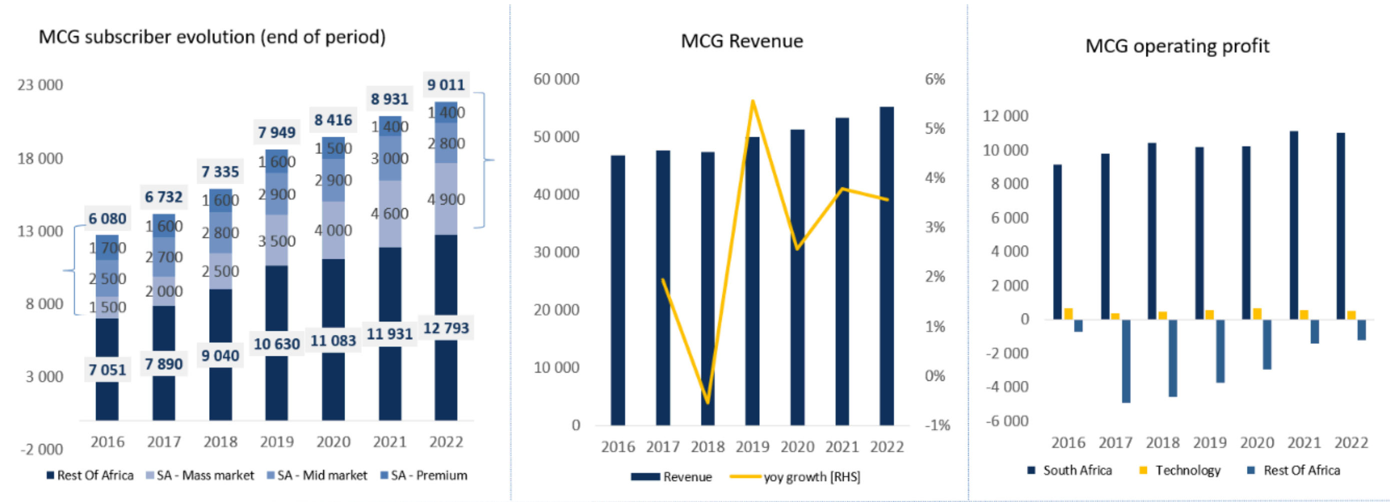
Besides a maturing market especially in SA, Multichoice's pay-TV has also faced some competition from SVOD platforms such as Netflix. The growth in on demand video has been driven by original/differentiated content offered, convenience afforded by the demand function, lack of advertising on these platforms and availability on multiple devices. South Africa had, for a long while lagged developed markets such as the US until the launch of Showmax in 2015 and later DSTV Now, among other streaming products introduced to provide convenience features and compete with some of the global players. The US is in the lead with well-known providers such as Netflix, Amazon prime, Hulu, Disney+ and HBO now.

Availability of fixed broadband and affordable smartphones are key enablers to the adoption of SVOD. While this will remain a challenge for the ROA business, the recent rolling out of mass market fibre in SA by some of the leading fibre to the home providers such as Vumatel and Openserve, address a long standing infrastructure challenge which should accelerate the adoption.

MULTICHOICE
ENRICHING LIVES

We expect to continue seeing a decline in premium subscribers, switching down to cheaper DSTV offerings or switching over to other SVOD platforms. Generally, in a context such as Africa with diverse consumer needs and affordability, there is opportunity for Pay-TV and SVOD to scale together in the medium term.

FIGURE 2: Multichoice subscribers, revenue and operating profit



Source: MCG company reports, Bloomberg

Leading with local content

Given the diversity of markets Multichoice operates, production of local content is crucial to meeting ongoing demand. Content is thus tailored to each country, capturing differences including languages and local entertainment preferences. From the recent results local content costs made up to 48% of content costs, highlighting the commitment to being a leader in markets they operate and ensuring subscriber retention. This strategy is expected to be more effective compared to historically being dependant on third party content. Multichoice also licenses a range of sports rights, on an exclusive basis and typically on multi -year contracts. Giving them a competitive advantage and ensuring that majority of costs are fixed.

As highlighted in figure 2 above, there has been a mix shift from the premium market, a higher priced offering compared to mid and mass market. This has had a dilutive impact leaving group revenue growth being dependent on subscriber growth. Between 2016 and end of financial year 2022, Multichoice achieved total subscriber annual growth of 9%[4] and revenue grew only 3% in the same period. Growth in mid and mass market subscribers has been driven by churn from the premium offering, ensuring that subscribers are still retained though at cheaper offerings, offsetting the impact. However, in the recent years the mid-market has also felt some pressure from the tough macroeconomic environment and also on a decline.

MCGSA operating profit has seen modest growth since 2016 and operating margins remain stable averaging 31% in the period. Currency headwinds and macroeconomic slowdown have impacted the ROA business since 2017 and Multichoice has been improving operating losses through driving subscriber growth and controlling costs. Management expected the business to reach breakeven by end of 2023 financial year, which is positive for group operating profit growth.

[4] Compound annual growth rate

Despite the opportunities that exist, we expect Multichoice to continue facing slower than achievable growth in revenue and earnings given a hard-pressed consumer across all their markets. Competition in the video entertainment space will also contribute to this challenge, as well as macroeconomic headwinds faced by the group.

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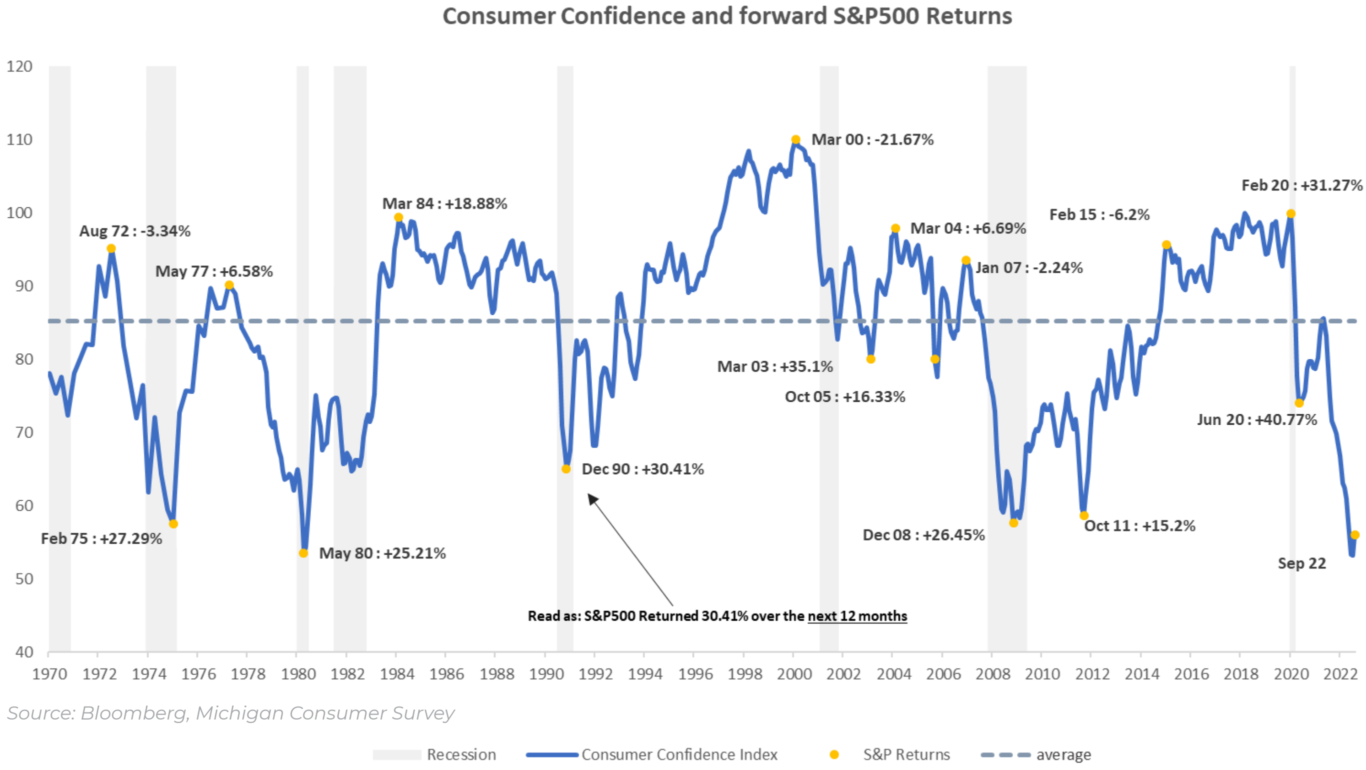
Chart Focus:
Consumer confidence and forward returns

A new low in a Consumer confidence index tells us what we already know; inflation and interest rates have rapidly altered the environment for spenders and savers. And yet at the same time, history still tells us to expect strong equity returns.

FIGURE 1: Consumer Confidence and forward S&P500 Returns



Source: Bloomberg, Michigan Consumer Survey

The University of Michigan Consumer survey has a long history of data on consumers' circumstances and expectations since the 1970s. Over the last 50 years the research has been able to show the prevailing level of consumer confidence neatly in one index - the level of which saw a multi-decade low in September of this year. And understandably so, mid-2022 delivered a 9.1% inflation reading, the highest levels in 40 years.

When overlaid with the next 12 months equity returns, it may then surprise many that some of the best times to be invested in the equity markets are periods following craters in consumer sentiment.

While periods in history are unique and their nuances require further study – there generally are some good reasons as why this is the case. If we accept excess consumer spending as being a precursor to rising inflation, those highs would register not too long before the restrictive dynamics take hold, be they interest rates or prices themselves. Similarly, sentiment lows would theoretically precede some marginal alleviation in the environment – a counter-cyclical policy setter would see the consumer as sufficiently demotivated and thereby easing conditions could uplift asset prices.

In practice calling the trough is messy business, sentiment can seemingly not move at all before jumping at some remarkably small positive change. Instead, what we can take away is that conditions are not getting any worse for now. It might serve investors well to start thinking about preparing themselves for better equity returns, and not necessarily wait until the consumer is feeling cheery again.

Investment Focus:
Economic Profit, the value creation Elixir

Before we unpack Economic Profit and the key role it plays in BlueAlpha's financial analysis of companies let's remind ourselves of the BlueAlpha Investment philosophy and process.

Our Investment Philosophy

BlueAlpha's investment philosophy and process are focused on identifying companies that have a track record of long run value Creation (Quality & Growth) We focus on businesses that generate high returns on invested capital, which translates into real economic profit (as opposed to accounting profit) These companies typically generate strong cash flows, which they can reinvest for growth.

Unpacking Economic Profit

The understanding of (trends and changes) Economic Profit is therefore key; it is the objective measure of quality and profitable growth and is the underpin to the intrinsic value of a company.

While the decision to invest in a company is not predicated on its so called "cheapness", the key drivers of valuation: changes in Economic Profit and the drivers thereof CFROI / ROIC and growth discussed in the previous newsletters are analysed and debated and are the key inputs to the investment decision.

The calculation of Economic Profit is quite simple:
Economic Profit = NOPAT minus a Capital Charge

NOPAT = Net Operating Profit after tax

Capital Charge = Invested Capital x Weighted Average Cost of Capital

Economic Profit is therefore the residual profit after accounting for the full cost of the assets (fixed assets and working capital) deployed to generate the profit. As we are concerned with the Operating Income Statement, we should also work with the operating Balance sheet. Surprisingly several analysts take short cuts and work with the funding side of the balance sheet – Equity + Debt.

As is the case with accounting it is important to apply the matching concept. Although the total number of Debt + Equity is the same as Total Assets, it requires a lot of work to unpack equity between operating and non-operating e.g. Equity Investments is typically non-operating of nature and is not included in operating profit and should therefore not be included in the Invested Capital calculation. Investments is typically a line item on the face of the Asset side of the balance sheet, while it is not easily isolated from Equity.

Economic Profit could also be calculated as follows:
Economic Profit = ROIC minus WACC x Invested Capital

ROIC = Return on Invested Capital

WACC = Weighted Average Cost of Capital

As can be seen from the above re-written formula ROIC is a key determinant of economic profit, it also provides a framework for evaluation company strategy, if a company's ROIC is above WACC it should grow (Increase its Invested Capital base) while growth when ROIC is less than WACC will destroy value. A simple yet robust way to interpret the efficiency of a company's strategy.

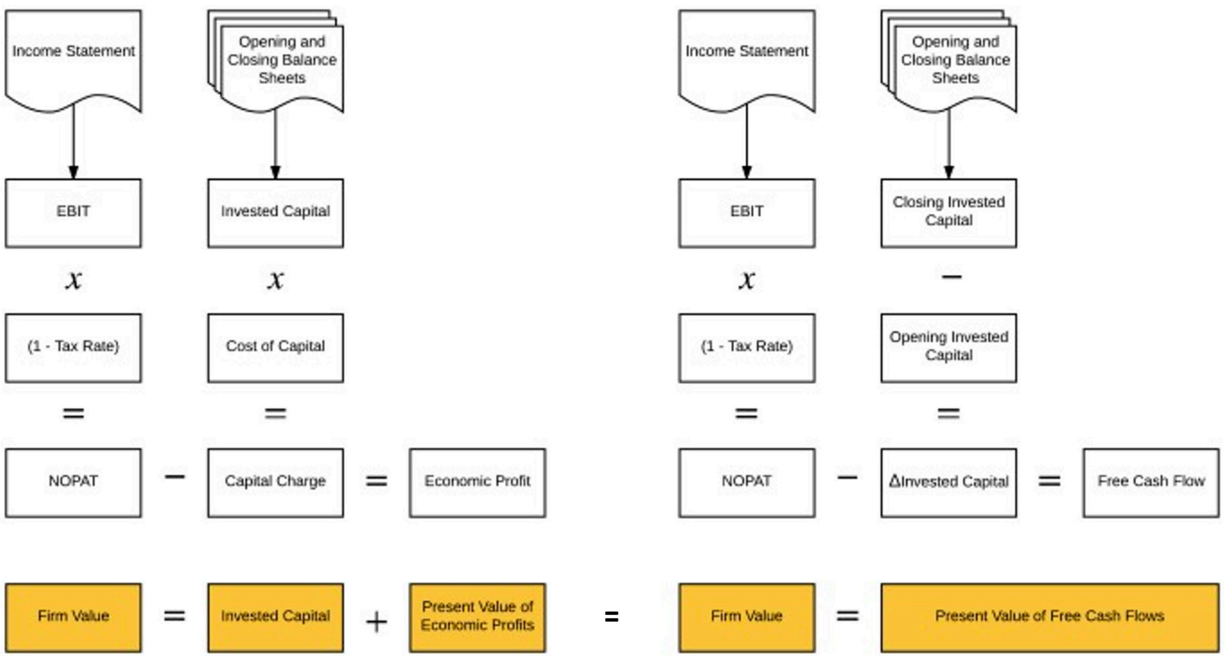
At BlueAlpha, we will be quite sceptical of a company that state it has a growth objective when their returns (CFROI / ROIC) are close to or below the cost of capital.

The above calculations show the calculation of economic profit for the typical service, industrial and mining companies but does not include financials, however with a few adjustments Economic profit can also be calculated for banks and similarly the valuation framework with also apply

Economic Profit –
The Relationship with Valuation

The beauty of Economic Profit apart from the ROIC & Growth drivers is the link to the Intrinsic value of a company. An Increase in Economic Profit drives an increase in intrinsic value and while the price at which a share trades on the stock market is influenced by several factors including sentiment, over the long run intrinsic value is a key determinant. An Economic Profit Valuation model also yields the same results as the traditionally used Free Cash Flow model as the graphic below depicts.

Flow Chart for an Economic Profit and Free cash flow Valuation

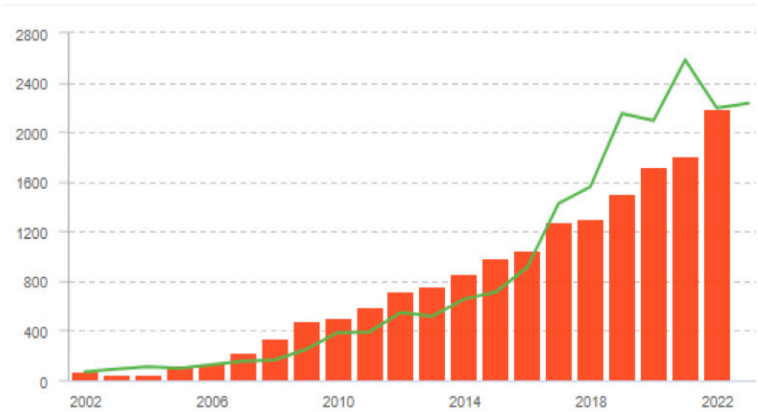


It makes sense that an Economic Profit Valuation and Free Cash Flow valuation would yield the same results as they are calculated off the same sets of (forecast) financial statements and use the same key drivers NOPAT, Invested Capital and WACC.

The benefit of an EP valuation is that it is tied back to Invested Capital (Book Value) if a company generates Economic Profit it will trade above book value and a company that does not will trade at a discount to book value, that makes it quite clear that trading at a discount to book is not an indication of "cheapness".

Practically what does that look like?
The graphic below shows the Economic Profit of Clicks over time (bars) and plots the company's Market capitalisation over time. (line)

Clicks is a poster South African company for value creation, Economic Profit steadily grows over time and so does its market cap. If an investor identifies a company like this, valuation and timing is secondary as long as management keep doing what they are doing time is your friend.



Further reading
For a more in-depth view of the topics covered in this and our previous two newsletters the flowing will be insightful.

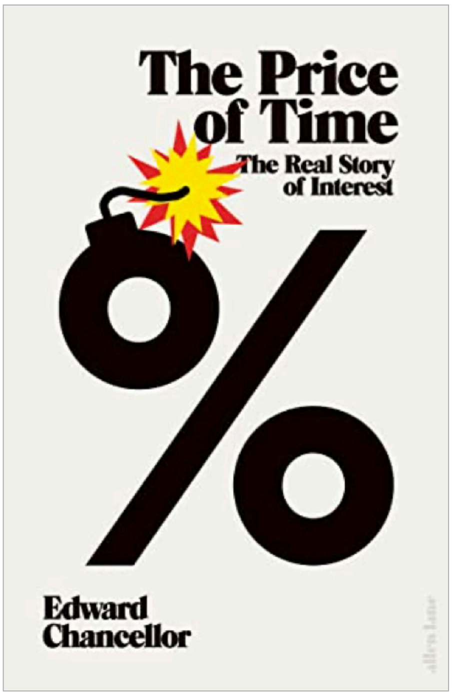
The bestselling book by McKinsey now in its 7th Edition Valuation Measuring and Managing the Value of Companies is required reading for the BlueAlpha Investment team.

Beyond Earnings Applying the HOLT CFROI and Economic Profit Framework by Holland and Matthews is a more technical book and what is practised by the BlueAlpha investment team.

Recommended Read: The Price of Time: The real story of interest rates *by Edward Chancellor*

A history of interest rates. This book is a very timely as we have probably seen the structural low in interest rates.

Interest rates can be a very dry subject and I can see the content putting a lot of people off. However, the anecdotes in the book make it very readable. The author explores the history of interest rates starting with a loan document from 24th century BC till 2021. The author had previously written a book on financial speculation called Devil take the Hindmost.



The first part explores the first origins of interest way back to Babylonian times when crops and farm animals were lent out to be paid back with said crop.

It introduces when usury rates were first introduced and the government's role in setting these rates. He explores cases of the first governments attempts to lower interest rates in the UK after the bubonic plague to kick start the economy.

What is fascinating is the debates between scholars and government about if interest should even be allowed. If so, what was the correct rate. It also examines the first really speculative era of low interest rates culminating in the South Sea bubble.

The second part deals with the influence of central bankers to not only set short interest rates but also to target long term interest rates. Of course, it all started innocently by first setting inflation targets to bring the long end down. This goal to influence the long end really accelerated after the Lehman crisis. What we now accept as quantitative easing the author reveals how uncertain current and past Central Banks are with this direction. It's fair to say that the author is not a fan. On a simplistic level he asserts that Central Bankers desire to lower interest rates across the curve so that money would flow to building productive assets has instead mutated into asset and financial speculation. From some of the quotes of well-regarded ex central bankers he is not alone in his criticism. Of course, we don't yet know if quantitative tightening can be achieved painlessly. But we do have occasions when small bouts of QT have been tried. His covering of these episodes gives us a taste of what to expect.

This is certainly not an academic book and for those interested in the intersection of rates, economy, and society this is a great book.

BLUEALPHA INVESTMENT MANAGEMENT

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	**-8.5%**	**6.4%**	**4.8%**	**7.1%**
SA Equity – General Sector Average	3.0%	10.5%	6.2%	6.0%
Benchmark**	3.7%	9.4%	6.4%	7.0%
Out-Performance to Benchmark	-12.2%	-3.0%	-1.6%	0.6%

** A Class, Net of Fees*
*** Fund Benchmark: Local section of the fund BM changed to 75% CAPPED SWIX (from SWIX) in March 2022.*

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.