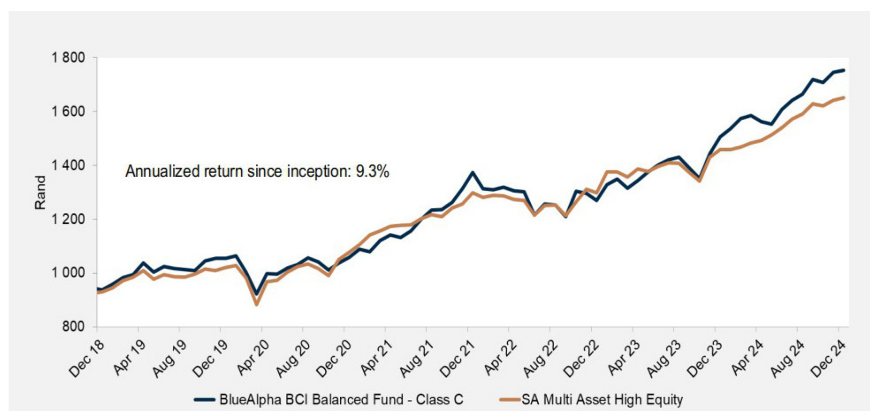
Investment Quarterly

January 2025 | Vol. 44

BLUEALPHA
INVESTMENT MANAGEMENT

BlueAlpha BCI Balanced Fund

Our Balanced 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

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

BlueAlpha Balanced BCI Fund

	1 Year	3 Years (annualised)	5 Years (annualised)	Since Inception (Sept 2018 - annualised)
BlueAlpha Return*	**16.5%**	**8.5%**	**10.7%**	**9.3%**
SA Multi Asset- High Equity	13.2%	8.4%	10.0%	8.2%
Out-Performance to Benchmark	**3.3%**	**0.1%**	**0.7%**	**1.1%**

** C Class, Net of Fees*

Source: Fund Focus (Iress)

Fund fact sheets (MDDs) available on www.bluealphafunds.com

BlueAlpha Investment Management (Pty) Limited is an authorised financial services provider
11th Floor Convention Tower, Cnr. Heerengracht St and Walter Sisulu Ave, Cape Town 8001
Tel: +27 (0)21 409 7100 · www.bluealphafunds.com

In this issue

Looking back

This quarter, we spotlight **AVI Limited**, a South African consumer goods company, has shown remarkable transformation and resilience. Their focus on returns on invested capital (ROIC), cost efficiency, and portfolio optimization has allowed them to outperform peers and achieve sustained growth, even in tough economic times.

Chart Focus

This quarter, we examine share buybacks and their impact on value creation, using **Naspers and Prosus'** 2022 strategy as an example. This strategy aimed to close the gap between Prosus' trading price and its net asset value. While promising, buybacks require strong earnings and cash flow to be successful.

Investment Focus

This quarter, we examine why falling inflation hasn't boosted consumer confidence in America. Despite inflation falling from over 9% in 2022 to 2.7% in 2024, and low unemployment, consumer sentiment remains gloomy.

Recommended Read

This quarter we spotlight Muitheri Wahome's "**Building Capital: A History of Asset Management in South Africa**" explores the industry's growth despite the challenges of apartheid and sanctions. A must-read for finance professionals and history buffs, it offers insights into South Africa's economic evolution.

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: AVI Limited

Founded in 1933 and initially part of the Anglovaal Group which was split into three segments: engineering services (Aveng), mining (Avmin) and consumer products (AVI), AVI was rapid in building its portfolio through strategic acquisitions and product innovation and eventually went on to list on the JSE in 1944.

The company continued to fortify its brand portfolio in the mid-1990s, with more focus on the food and beverage sector during the 1970s before expanding into the fashion and personal care markets in the 1980s. This culminated in a remarkable surge in the company's share price, which reached an unprecedented peak of 600 cents by 1995. Concurrently, relative earnings grew by 150 percent, achieving 150 cents over the same period.

What seemed like an ideal operating environment could not have been further from the stark contrast that followed in 1996. Lack of strategic focus, disruptions from the installation of computer systems and poor execution to merge the four divisions of National Brands (Biscuits, Tea, Coffee and Snacks) led to a 20% decline in Group earnings per share (EPS). This effectively negated all the gains that had been accumulated since 1990, leading to the share price falling by more than 600 percent to a decade low of 90 cents by 1998, as depicted in Figure 1.

This situation necessitated a strategic reassessment. In 1999, AVI unbundled its businesses into two distinct entities: AVENG, which focused on fixed investments, and AVI, which concentrated exclusively on consumer goods production.

FIGURE 1: AVI Price Chart 1994-1998

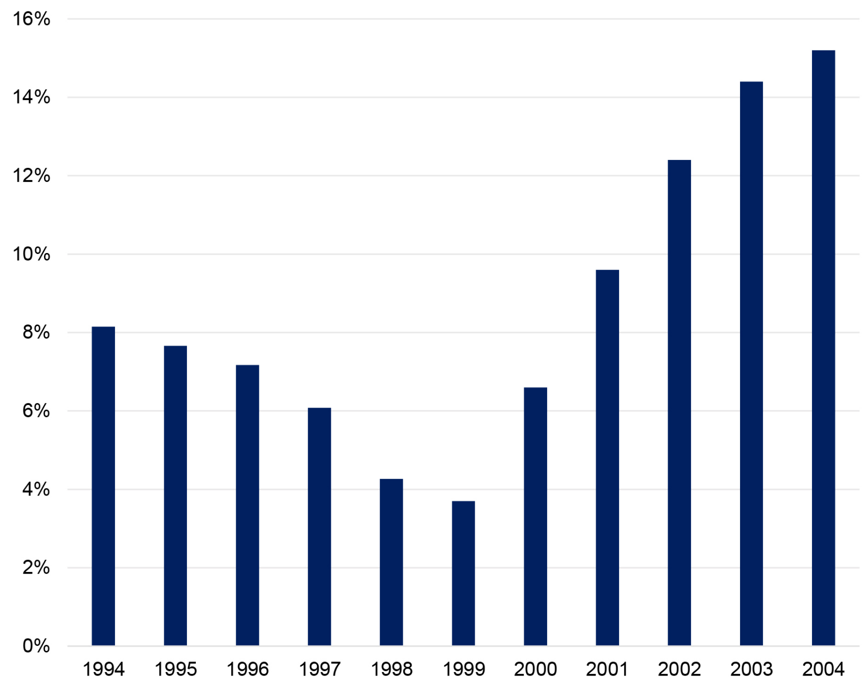
Source: LSEG Workspace

This unbundling represented a pivotal turnaround for the business, enabling AVI to refine its revitalized strategy, focusing on key drivers of fundamental value creation—returns on invested capital (ROIC) and growth.

Using the key ROIC drivers, particularly enhanced cost efficiency, capital productivity and continuous product innovation, AVI was set to revive operating margins which had plummeted below 4 percent in 1999.

Consistent application these drivers led to margins surging, growing from 6 percent in 2000 to almost double that by 2002 and eventually to the new highs of 15.2 percent by 2004 as evidenced in Figure 2.

FIGURE 2: AVI Operating margins before and prior strategy focus (1999)



Source: LSEG Workspace; Fleming Martin Research (2000)

With this strategic focus came the imposition of aggressive performance targets. One crucial portfolio requirement was that each of AVI's brands must either be a leading or a strong second-place brand with a significant market share in their respective categories. Failing this criterion, the brand would be excluded from the AVI portfolio. Consequently, several brands and business units within the AVI portfolio, such as Pronutro, Game, and Hinds (condiments and spices) failed to meet this criterion and were divested, with proceeds directed towards debt reduction.

The implementation of this strategy, however, was far from a simple acquisition and disposal of brands and business units; it required a rigorous assessment of brands in line with the fundamentals of value creation.

A clear illustration of this strategy can be seen in the case of Consol, AVI's glass and plastic manufacturing business, which arguably began this 1990s AVI operational crisis. Leading into the 1990s, Consol had over 75 percent market share in glass in South Africa. After realis-

ing it had not ploughed back sufficient capital into its core business Consol went on an extensive capital expenditure program of R1 billion over a 4-year period commencing in1994. At 6 percent of its sales, this was twice as more than the capital expenditure during a normalised period such as post 1998.

Poor execution in the process negatively impacted service levels, which, coupled with inadequate quality standards led to stagnant demand while depreciation and finance costs heightened, resulting in a 15 percent loss in market share.

Under the management of Simon Crutchley, Consol undertook a rigorous rationalization process, cutting costs by reducing the number of product lines by more than half and rightsizing overheads, which contributed to improved sales volumes, restoring Consol's market share by 2000. Consol continued to be the largest glass producer in Africa until AVI offered it to investors in 2005 shifting their focus more on its consumer products business.

Since implementing this value creation strategy, AVI has successfully grown its market capitalization from R3 billion to R39 billion, while also developing a sustainable competitive advantage that enables it to consistently generate returns on capital well above its competitors'. To see this, we analyse AVI's financial performance between 2018 and 2024 against its peers (Tiger brands, Astral Foods, Premier, Oceana, Libstar and RFG Holdings).

From the topline of the income statement, AVI incurs lower cost of goods sold (COGS), averaging around 60 percent of its revenues, compared to peers' average of 74 percent. This reflects in the 14 percent average gross margin premium over its peers in that period, underscoring AVI's cost advantage over its competitors.

BLUEALPHA
INVESTMENT MANAGEMENT

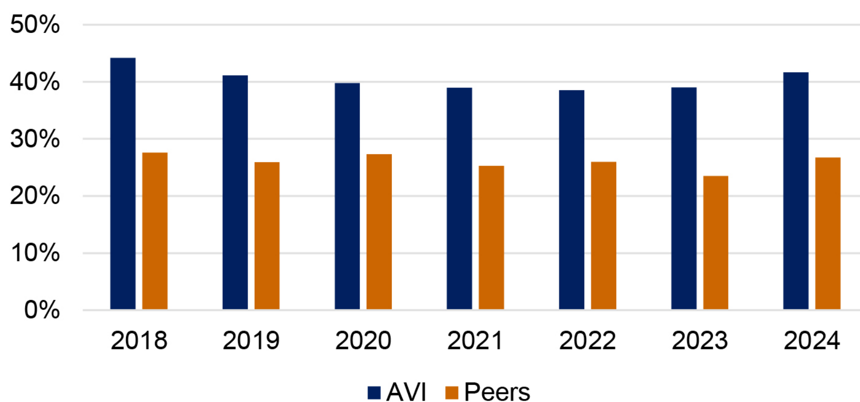
As a result of this cost advantage AVI incurs 10 percent less total operating costs and thus achieves better operating margins relative to its peers as shown in Figure 4. This highlights AVI's established productivity edge over its competitors.

Figure 5 highlights AVI's exemplary cost management, which has been one of its key ROIC drivers over the years. In 2018, both AVI and its peer group had returns exceeding 30 percent. However, this trend shifted in 2019 when logistic challenges began to emerge. While AVI's ROIC declined by less than 5 percent, that of peers fell by 13 percent and further deteriorated below 20 percent in the break of the COVID-19 pandemic.

For most of the peer companies, deterioration in ROIC came because of increased costs ranging from raw materials to labour costs while for others it was sales that plummeted most. AVI on the other hand, maintained sales levels due to its well-established brand portfolio and did not incur excessive costs due to its cost-efficient strategy. By 2021, AVI's ROIC had recovered to above the 25% level, while the peer group remained stagnant below 15%. This indicates that AVI is comparatively more efficient in generating cash flows and ultimately creating value.

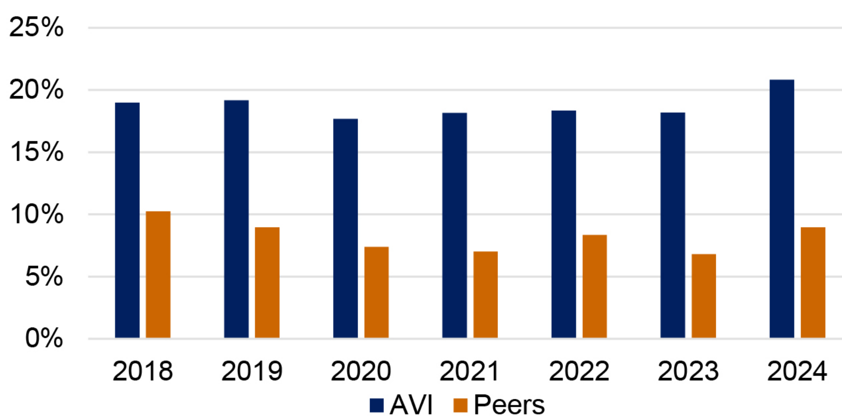
Reflecting on this narrative, we see the importance of implementing a strategy rooted in the fundamentals of value creation—returns on invested capital (ROIC) and growth. In this case, this involved leveraging the components of ROIC, particularly cost-cutting measures, which over time developed a sustainable cost competitive advantage over sector peers, which has proved quite effective in times. With that said, we continue to study AVI's progression and how it navigates challenges in the ever-changing economic landscape.

FIGURE 3: Gross profit as % of revenue



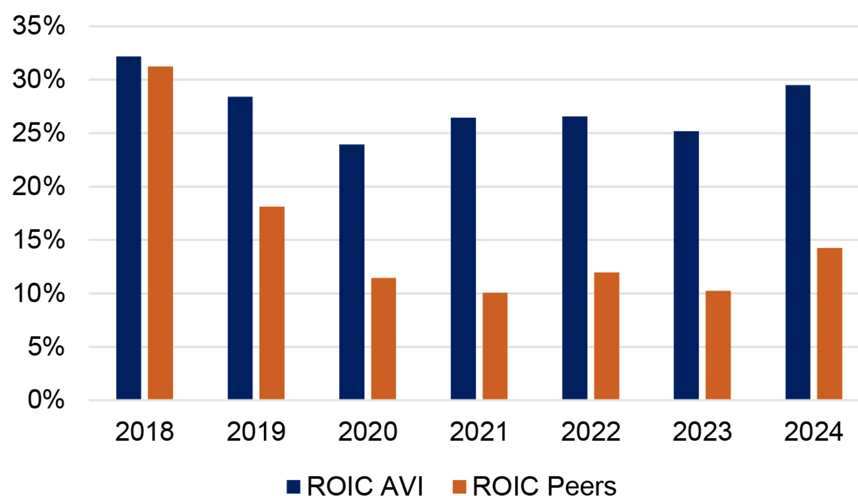
Source: LSEG Workspace

FIGURE 4: Operating profit as % of revenue



Source: LSEG Workspace

FIGURE 5: ROIC AVI vs Peers



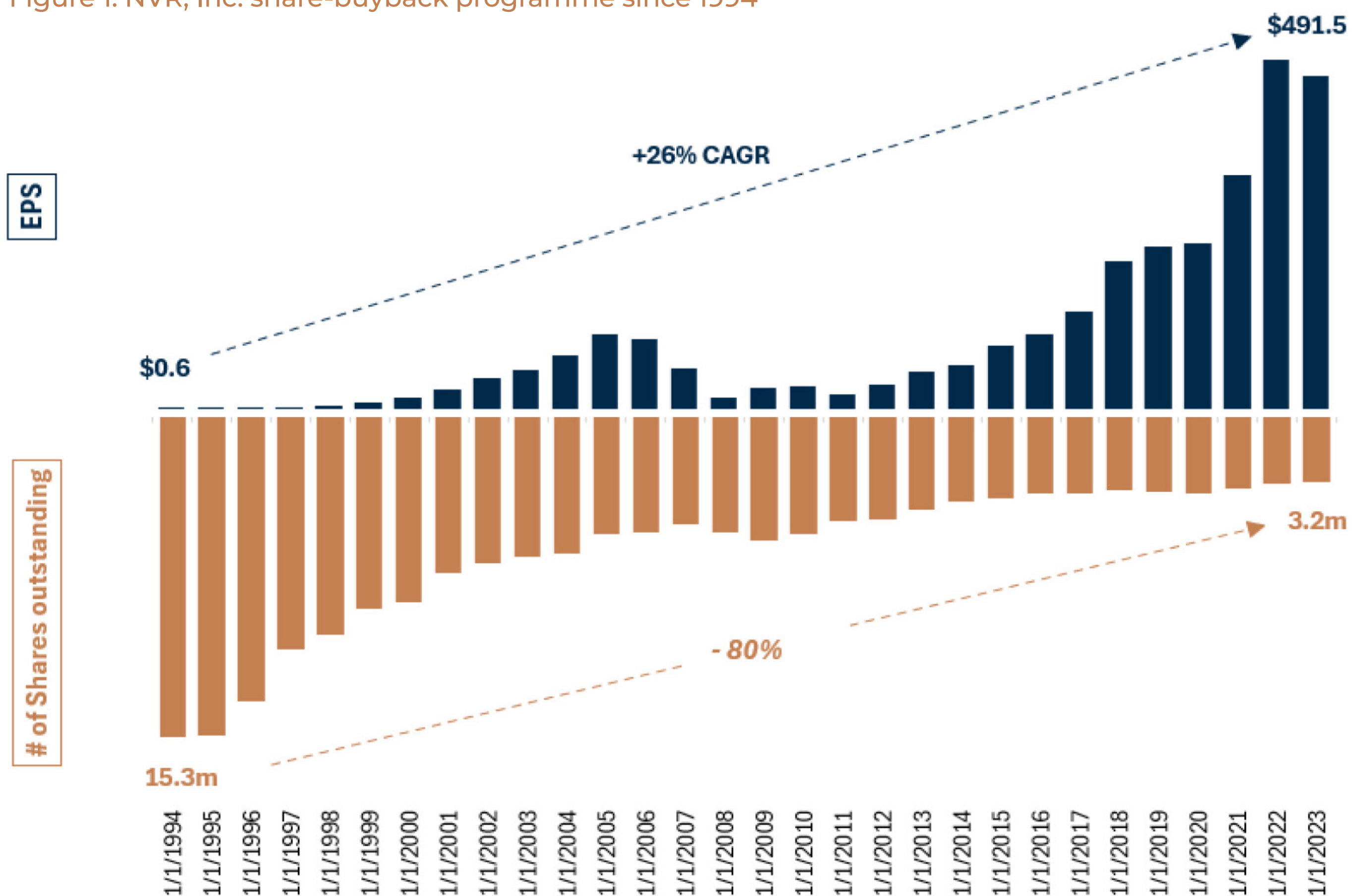
Source: LSEG Workspace

Chart Focus:
Impact of share buybacks on value creation

Naspers and Prosus launched a share buyback programme in mid-2022 to address the widening discount at which Prosus shares traded relative to their net asset value (NAV) and being part of a broader strategy to unlock value. Ideally, a successful buy-back programme must be backed by strong earnings and cash flow generation given that the exercise doesn't create value on its own, but a repurchase of (undervalued) shares transfers value to remaining shareholders.

An important distinction is whether the buyback occurs at the operating company level (opco) or the holding company (holdco) level. The buyback at the Opco level using cash from operations is preferred, and the benefits can be more straightforwardly measured via the increase in EPS. As illustrated in Figure 1 below, NVR is one of the examples of companies that have seen sustained EPS growth in the past 3 decades while generating high returns and positive free cash flows.

Figure 1. NVR, Inc. share-buyback programme since 1994

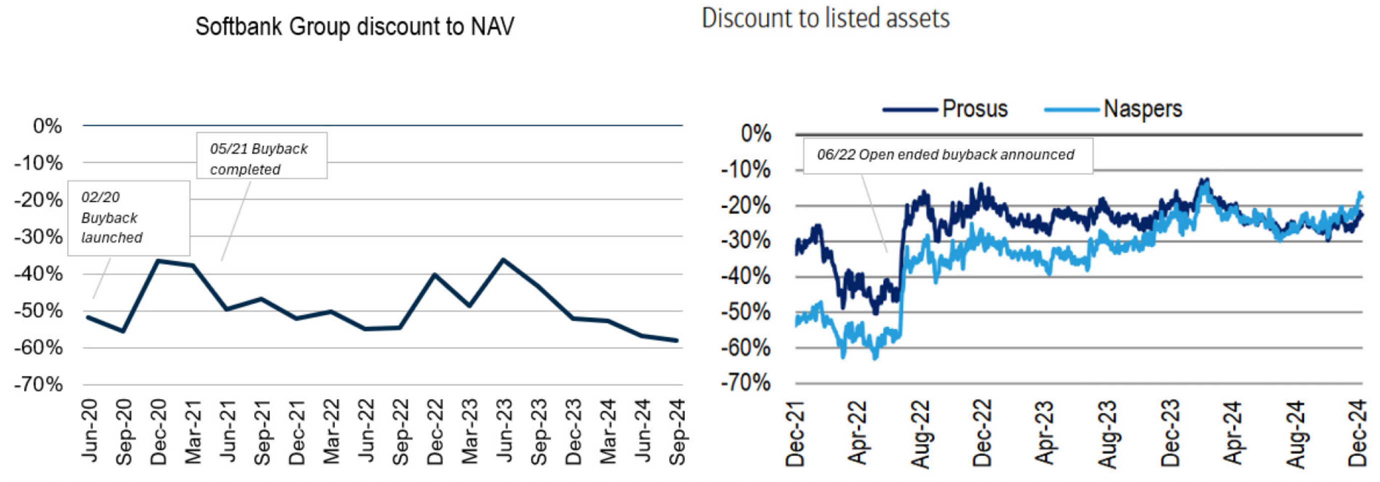


Source: Bloomberg , BlueAlpha research

However, Naspers has been selling down its shareholding in Prosus to buy back its shares, while Prosus has been selling down its Tencent shareholding. Though providing short-term liquidity for the buyback programme, the group will eventually own less of Tencent—currently its core and most valuable operating asset and whose dividend has been the main source of group cashflows. This move raises questions on the sustainability of this sale and long-term strategy, given the potential loss of future cash flow and value.

And since a company's value is the net present value of its future cashflows, combined with a strong cashflow generation, it ensures that the buyback reinforces the intrinsic value of the remaining shares. If not, the exercise risks being perceived as a short-term solution which fails to create long-term shareholder value, and once the share buyback stops, (short-term) progress made in reducing the discount to NAV is likely to reverse. Softbank, for example, charted below, had one of their largest buyback programmes so far between 2020 and 2021, and the discount reversed back to being greater than 50% post-completion of the programme (and the discount continues to widen despite buying back more shares since). Naspers and Prosus have an open-ended buyback programme in place and saw a material discount reduction post-announcement, and movement has been flat since then. Maintaining this momentum will require consistent improvement in earnings and cashflows of group companies to avoid similar reversals.

Figure 2. Softbank/Naspers/Prosus discounts



Source: Bloomberg, Deutsche bank, BlueAlpha research, BOFA

While share buybacks can be an effective tool to unlock shareholder value and reduce the discount to NAV, value creation depends on the ability to generate cashflows sustainably. Leveraging operating cash flow rather than selling assets (especially productive ones), provides a more sustainable model for buybacks.

Investment Focus:
Inflation is only half the story

In the aftermath of the pandemic, America's economy staged a swift recovery. Supply-chain disruptions collided with pent-up demand, sending inflation soaring above 9% in 2022. Central bankers responded with a series of rate rises, and the policy seems to have worked: by late 2024, inflation had retreated to 2.7%. Meanwhile, post-lockdown distortions in the labour market dissipated, driving the unemployment rate back down to a generational low of around 4%.

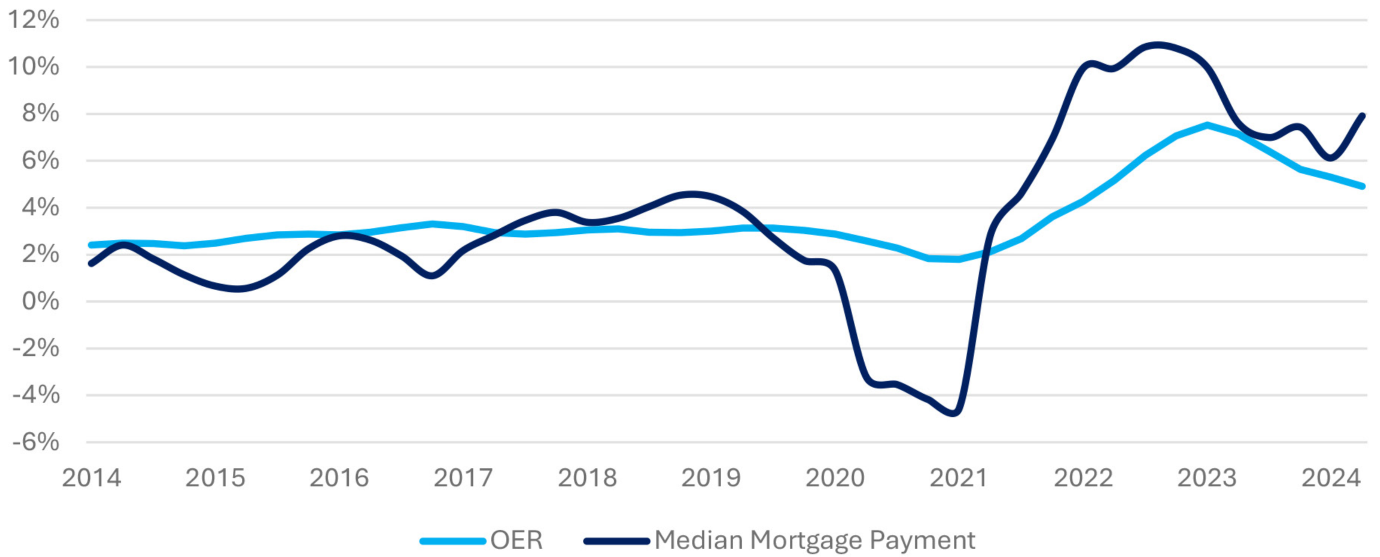
At first glance, these developments should allow for optimism. Historical albeit simplistic yardsticks, such as the "Misery Index" (the sum of inflation and unemployment), suggest conditions have improved markedly since the throes of the pandemic. Yet the University of Michigan's consumer-confidence gauge reveals a starkly different story. By that measure, consumers are far gloomier than the Misery index's recovery would imply.

No Misery but no Confidence

Part of the riddle lies in how inflation is calculated. Before 1983, the headline figure included finance costs— the majority of which are the mortgages paid by homeowners—making the consumer-price index (CPI) far more volatile. The Federal Reserve's rate decisions would swing the shelter component of CPI sharply by directly translating to financing rates. This threatened to overshadow slower shifts in other parts of the economy. Officials responded by introducing "Owners' Equivalent Rent" (OER), a more stable measure based on estimated rental prices for owner-occupied homes. This methodological tweak greatly reduced the volatility of the headline number.

BLUEALPHA
INVESTMENT MANAGEMENT

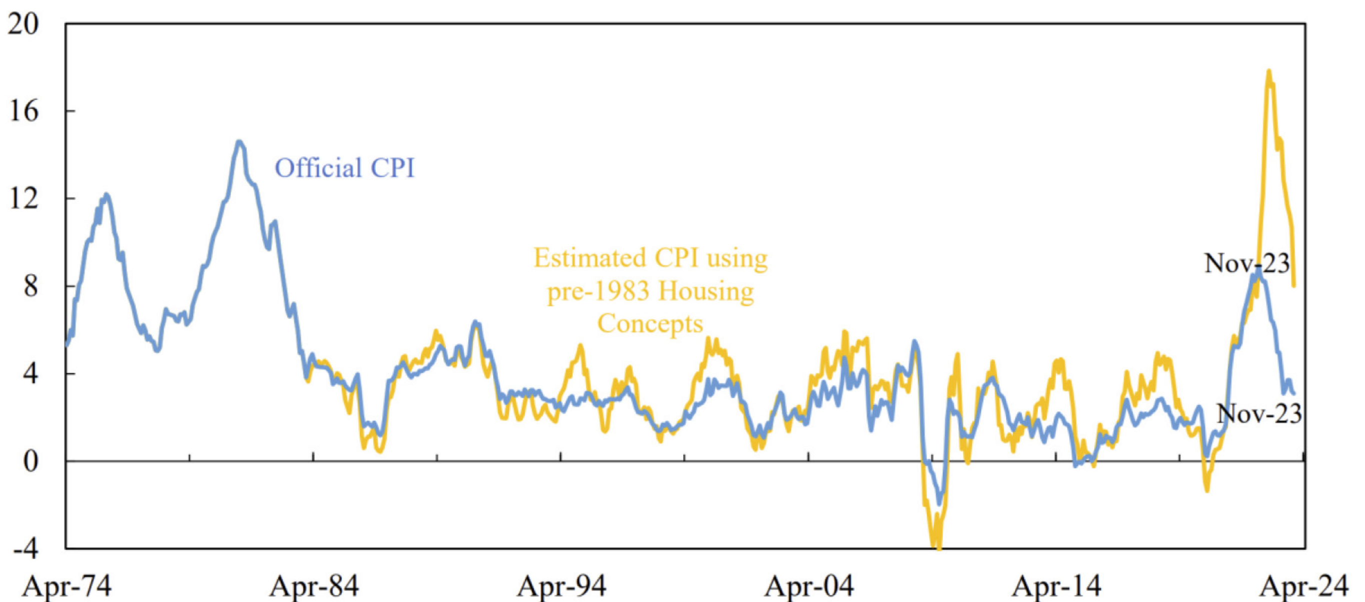
Mortgage Payments vs OER



OER remains a significant contributor to overall inflation—shelter accounts for roughly a third of the index, of which three-quarters stems from OER. This new approach is still responsive to changes in the market, but it hides actual finance costs for homeowners, particularly those locking into new, dearer mortgages.

One recent working paper from the National Bureau of Economic Research estimates that if America's inflation yardstick had clung to the pre-1983 formula, 2022's inflation would have peaked above 16%, driven in large part by higher rates for new loans.

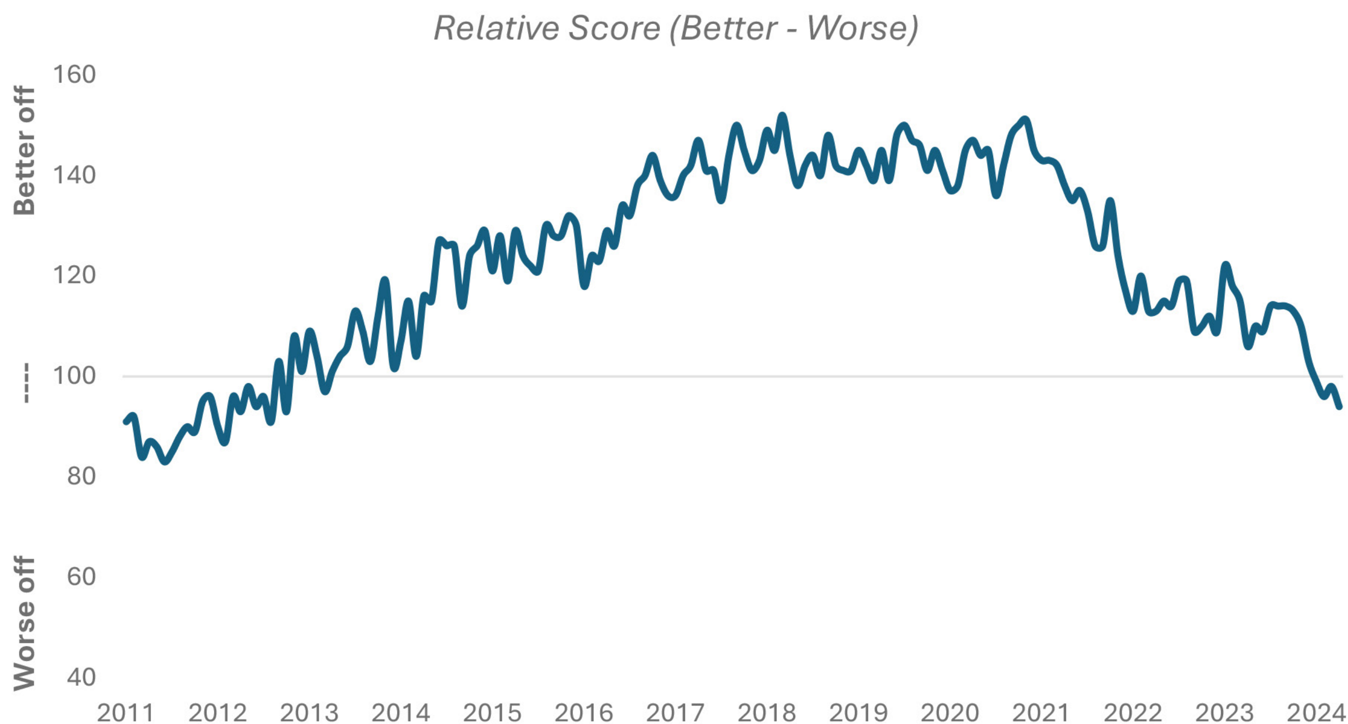
Official and Estimated CPI using pre-1983 housing methods, 1974-2023



Source: Bureau of Labor Statistics; Authors' Calculations.

With this is mind, consumers are understandably not as upbeat as economists expect them to be. Although most homeowners today carry less debt than the overstretched borrowers of 2008, many feel the pinch as they refinance at higher rates. In supplemental data from the Michigan survey, a majority of respondents say they are worse off financially than they were in 2019. That is not to suggest another housing bust looms. Rather, it highlights the extent to which official statistics, for all their improvements, can fail to capture the financial realities of households.

Households Current Financial Situation vs 5 Years Ago



Whether interest rates remain elevated or ease in the coming years, it is clear that rising mortgage costs are an invisible in terms of official data points. It is little wonder that, even as headline inflation tumbles, and the economy operates close to its full employment capacity many Americans remain far from thrilled about their economic prospects.

Recommended Read: Building Capital: A History of Asset Management in South Africa *by Muitheri Wahome*

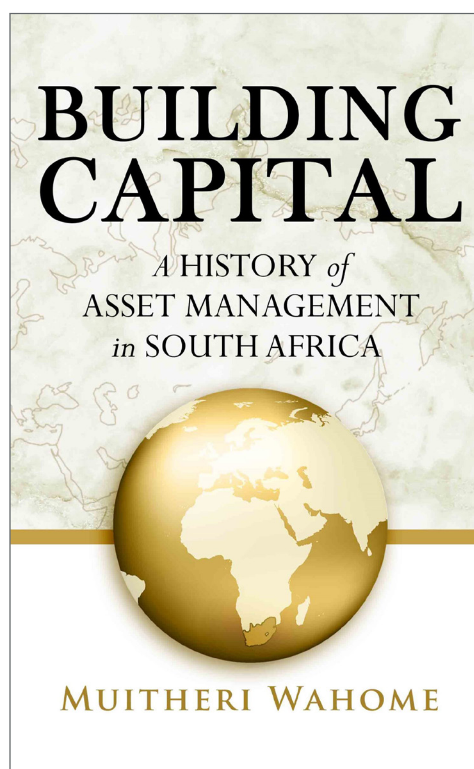
The book provides an in-depth examination of the origins of the asset management industry in South Africa, focusing on the how, when, why, and what of its development. It highlights how many skills and intellectual properties were imported from Great Britain, the United States, and Scotland. The author discusses the economic conditions during the apartheid era and the factors that contributed to an economic collapse due to regulations imposed by the apartheid government, the effects of which are still being felt in modern-day South Africa.

Muitheri starts by providing insights and facts about South Africa, including its ranking on the African continent and the international organizations it aligns with. She highlights that life insurance companies and pension funds emerged before asset management firms. Additionally, she points out that early settlers purchased life insurance out of fear of uncertainty in a world they had just entered and were unfamiliar with.

The book gives a detailed history of why South Africa was perceived as a high-capital-risk environment, a place for foreigners to invest and be rewarded. After diamonds were discovered in Kimberley, a few in the South African Union would go on to enjoy economic prosperity, with the GDP growth rate rising to record highs. This saw South Africa's trade grow exponentially.

Before the discovery of diamonds, insurance emerged as an industry that continues to play an important role in the development of South Africa. In those days, insurance was only reserved for people with steady incomes to cover them for any uncertainties. The author contends that Sanlam, one of the oldest insurers, used insurance products to uplift the Afrikaner community from poverty and encourage them to participate in the economy and self-sufficiency that would see them break away from the rule of Great Britain.

After World War II, there was a significant demand for products to rebuild the infrastructure of countries affected by the war. South Africa was well-positioned to supply those products. The government understood how to establish South Africa as a key player in the international economy, but the methods they employed ultimately led to its decline.



The establishment of the investment management industry was largely driven by the demand for mortgage investments in new homes for returning soldiers. Peter Bieber, a key figure in the industry, transformed Old Mutual's investment division into a research-based operation focused on fundamental analysis. Frequently, Old Mutual sent its investment team to the United States for training, which helped them acquire essential skills and provided a competitive advantage. Most independent investment firms that emerged after 1994 were founded by professionals who had previously worked for Old Mutual.

South Africa's economy faced significant challenges during the apartheid era due to government legislation Most companies were compelled to invest heavily in government bonds, leaving little room for international investments. The government utilized these funds to develop key infrastructure projects, such as Sasol, ISCOR, and ESKOM, aimed at boosting the country's production capacity. However, these restrictions and policies of the government of the day led to frustration among international financiers, resulting in many choosing to withdraw from the South African market.

With sanctions being applied to South Africa, local companies were compelled to invest in local securities and bonds, resulting in them acquiring majority stakes in many of the companies listed on the Johannesburg Stock Exchange (JSE) at that time. The sanctions had unintended consequences, as at least initially, they concentrated economic power in the hands of a few companies and individuals. Trade unions took initial steps to empower the majority as active participants in the economy by using their insurance policies as collateral when offering loans to their members.

Firms such as, Anglo America, Rembrandt, Sanlam, Old Mutual, and Liberty Life gained further prominence in the economy after buying the shares of the international companies that left South Africa. In the 1970s, the financial sector became concentrated.

Union Acceptances Limited (UAL) aimed to advance the asset management industry by innovating merchant and investment banking products and services. While it was a pioneer in this field, it was unable to fully realize the benefits of its innovations due to the constant poaching of its investment division personnel.

In conclusion, “Building Capital: A History of Asset Management in South Africa” is a well-researched and written account that sheds light on the evolution of the asset management industry in South Africa. The author's analysis and detailed narrative not only highlight the key milestones and figures that have shaped the industry but also provide a broader understanding of the socio-economic and political factors that were at play.

This book is an invaluable resource for anyone interested in finance, history, or the complex dynamics of South Africa's economic development. It serves as a testament to the resilience and innovation in the asset management sector, making it essential reading for both professionals and enthusiasts.

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 Inception (Sept 2018 annualised)
BlueAlpha Return	**16.4%**	**5.2%**	**9.0%**	**8.4%**
SA Equity – General Sector Average	13.5%	7.9%	10.6%	7.1%
Out-Performance to Benchmark	**2.9%**	**-2.7%**	**-1.6%**	**1.3%**

** 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.

BlueAlpha BCI SA Equity Fund: this is our newest fund that launched in February 2023. This fund is a domestic equity portfolio that aims to provide investors with high long term capital growth. The fund will invest only in South African equity securities and the equity exposure will exceed 80% of its net asset value. The funds benchmark is CAPPED SWIX

Invest with us

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

Privacy Policy Statement

Live Prosperously.

click here