Bateleur Flexible Prescient Fund

2019 first half report back

bateleur capital

Bateleur Flexible Prescient Fund ("the fund") – 2019 first half report back to investors

The fund returned 6.3% net of fees for the first half of 2019. After a solid first quarter, where the unit price increased by 6.2%, the second quarter proved more challenging with the fund's unit price ending broadly flat. Attribution by strategy and the top YTD contributors and detractors, are shown below.

Fund strategy	YTD
JSE listed holdings	2.8%
Direct foreign holdings	3.8%
Costs (net of interest)	-0.3%
Total	6.3%

Top contributors	Top detractors
Naspers	Capital & Regional
Dollar General	Sasol
PayPal	KAP
BHP Group	Biogen

Source: Bateleur, Measurement period from 1 January 2019 to 30 June 2019

Fund holdings with specific exposure to the SA economy – were a drag on performance. Following a poor first quarter GDP print and downgrades to full year growth estimates, the SA economy is clearly under pressure, despite the low base. This provides a challenging environment for corporates to grow earnings with demand muted and cost cutting initiatives largely exhausted.

The fund's domestic holdings; having further de-rated in the period, trade at increasingly wide discounts to their historic average P/E multiples and to our assessment of underlying value. Operating profit margins are in many cases at multi-year lows and provide large upside potential to future earnings growth should they normalise (which we expect). For this to occur, SA economic growth will need to improve from current depressed levels.

Core domestic holdings at period end include AECI, Adcock Ingram, Hudaco, Italtile, Mpact, Remgro and RMI, amongst others. These holdings were all part of the fund at the start of the year – reinforcing our view that the investment cases remain intact and that we are not being influenced by negative share price movements.

The announcement last week that global consumer goods titan PepsiCo is to acquire SA food producer Pioneer Foods for R24.4bn, at a 56% price premium, provides anecdotal evidence as to the value in the domestic equity market, although we would caution against expectations of further international deals materialising. However, we do expect the recent spate of JSE delisting's to continue - especially in the small and mid-cap space, as company insiders and private equity take advantage of depressed values.

The direct offshore fund holdings contributed positively to fund performance, with notable contributions from Dollar General, PayPal, Amazon, Disney and Laboratory Corporation. In addition, the fund's holding in the S&P 500 Index contributed to returns, benefitting from the strong market performance in the first half of 2019.

Low (and still declining) global interest rates continue to provide support for global equity market prices, even with leading indicators such as PMI's – pointing to sharply slowing global growth (chart 1). Global equity market valuations remain elevated while corporate operating profit margins are at record highs (chart 2). Consequently, the fund's 24.6% weighting in direct offshore equities is below the maximum allowed level and remains focused predominately on stock specific opportunities.

Chart 1: JP Morgan global composite PMI

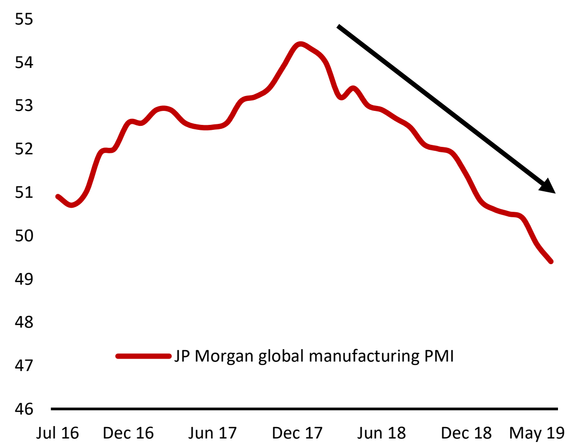
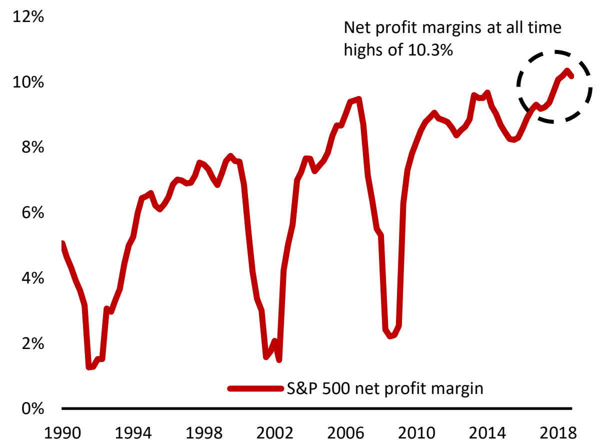


Chart 2: S&P 500 net profit margin over time



Source: Bloomberg, JP Morgan, Bateleur

The fund's domestic equity holdings (excluding Naspers) trade on an estimated weighted average forward P/E of 10.2 times* and a dividend yield of 5.1%*, a material discount to our assessment of fair value. A summary of the current fund positioning and top five holdings are shown below.

Current fund positioning	%
JSE listed holdings	61.4%
Direct foreign holdings	24.6%
Cash/ Money market	14.0%
Total	**100.0%**

Top 5 holdings as a percentage of fund NAV	
Naspers	Assore
British American Tobacco	Mpact
Alphabet	

Source: Bateleur

RMI – 3.2% fund weighting – Market capitalisation – R49bn.

RMI is an insurance investment holding company that has been held in the fund since September 2017. The company is currently the only way to access an investment into unlisted OUTsurance, the largest direct short-term insurer in SA.

Despite OUTsurance delivering consistently strong financial results, the share price performance of RMI has been disappointing. We believe a major reason behind this, is the inefficient corporate structure of RMI, where a large proportion of group value resides in listed companies that can be accessed directly by investors. We will provide details of what we believe is a clear path to unlocking value in RMI.

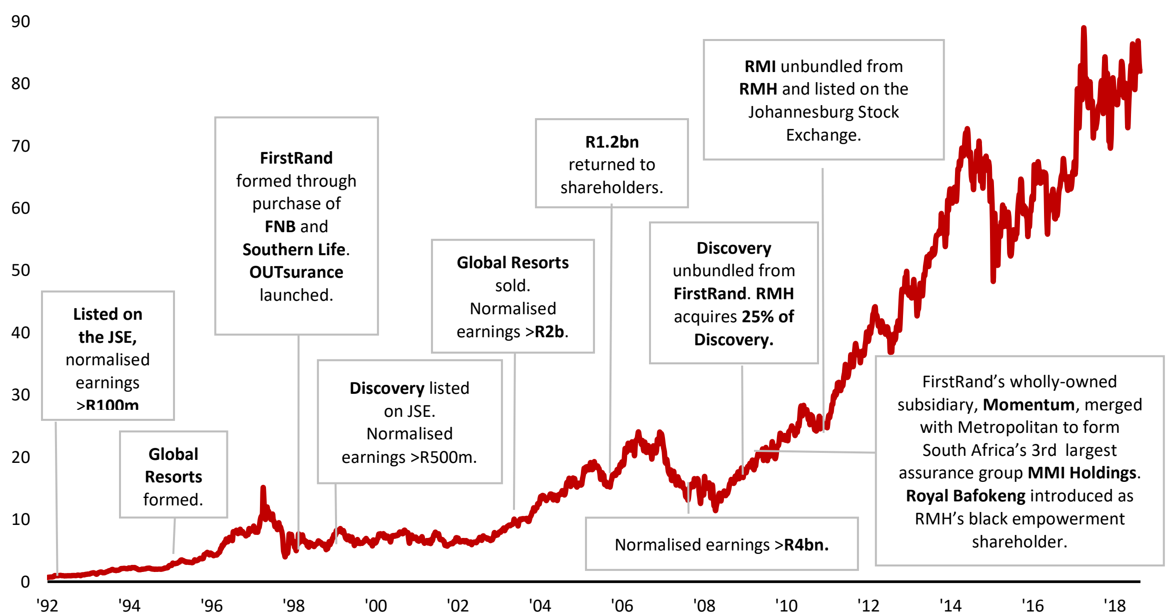
History

Since its formation as a niche unlisted investment bank in 1977, and under the stewardship of the respected founders (GT Ferreira, Laurie Dippenaar and Paul Harris), Rand Merchant Bank Holdings (RMH) undertook several acquisitions that, over time, transformed the business into a substantial player in the SA financial services industry.

* JSE listed equities only (i.e. excludes direct foreign holdings)

These transactions included the acquisition of life assurer Momentum in 1992, seeding and becoming a founding shareholder in health insurer Discovery in 1992, listing on the JSE in 1993, the game changing purchase of FNB and Southern Life to form FirstRand in 1998, and the launch of OUTsurance (chart 3).

Chart 3: RMH timeline and share price performance



Source: RMH financial statements, Bloomberg, Bateleur Capital

In 2011, RMH's insurance interests were unbundled and separately listed as Rand Merchant Investment Holding Limited (RMI). Since this date, RMH has been a dedicated investment vehicle into FirstRand, where it is a 34% shareholder, while also operating a small property investment business.

Shareholders who invested in RMH on listing in 1993 have benefitted handsomely from the association with the group and its founders. We calculate that inclusive of the dividends received and the unbundled RMI shares, investors have enjoyed an IRR of 29.8% per annum, over a twenty-five-year period (assuming the dividends were reinvested). This would rank amongst the best performing shares on the JSE over that measurement period.

RMI today:

RMI's major interests include an 89.1% shareholding in OUTsurance, 25% of listed health insurer and financial services group Discovery, 27.3% of listed life assurer MMI# (formed by the merger of Momentum and Metropolitan Life), and more recently, 29.9% of UK listed short-term insurer Hastings* which it acquired in 2017. RMI also has smaller investments in several unlisted fund management and fintech businesses – although these are immaterial in terms of overall group value.

MMI was renamed Momentum Metropolitan Holdings (share code MTM) effective 22 July 2019. In this report to avoid confusion, we have continued to use MMI when referencing the group and the underlying share. *15.2% of Hastings is held directly by RMI and 14.7% is held directly by OUTsurance. Therefore, on consolidation RMI owns 29.9% of Hastings.

OUTsurance

OUTsurance is the largest direct personal lines insurer in SA when measured by annual premiums. Personal lines insurance covers motor vehicle and household contents for individuals. The company has also successfully expanded its presence into the Australian direct insurance market via the Youi brand. The group currently has approximately 850 000 policies in force in SA and 1 050 000 policies in Australia and New Zealand. Although SA has fewer policies it is currently a more profitable market for the group.

A traditional short-term insurer's business model is straightforward. The insurer generates revenue by collecting monthly insurance premiums from policyholders. In return for this revenue, the insurer undertakes to pay out the policyholders when legitimate damage or loss occurs to their insured property.

As claim pay-outs can potentially exceed premium income – especially in the early years of operation, the insurer needs to have enough capital available to meet the prospective claims liability. It may also look to offset some of the risk by re-insuring a portion of premiums received to a re-insurer. The minimum amount of capital a short-term insurer is required to carry is promulgated by law and overseen by the relevant industry regulator. Aside from statutory capital, an insurer requires no other major capital expenditure other than for IT systems and to fund future growth.

An insurer's expenses can be grouped into three categories. Claims from policyholders, marketing and administration costs (largely advertising and employee costs) and commissions paid to broker intermediaries to generate new policy sales.

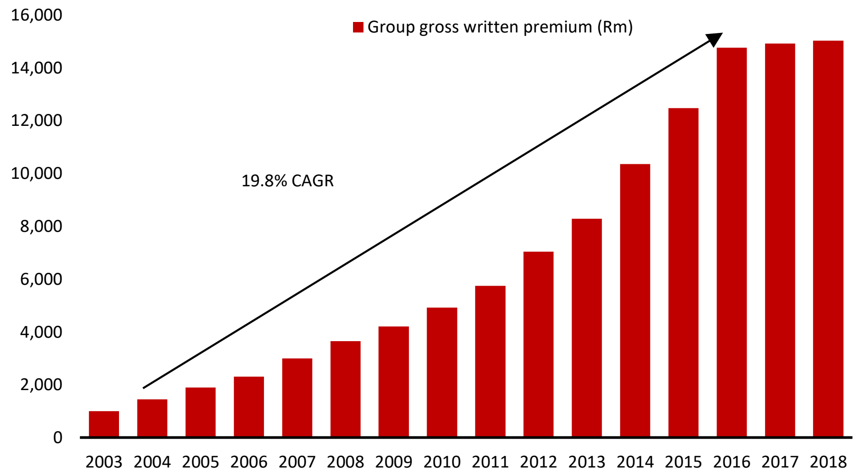
The underwriting margin or profitability of the traditional insurer is simply premiums earned less policyholder claims incurred, less broker costs, less marketing and administration costs – expressed as a percentage of premiums earned.

The direct insurance business model such as that developed by OUTsurance - uses a call centre and digital platforms to communicate with clients directly, and therefore the need for the broker or intermediary is made redundant. Assuming the insured risk is priced appropriately, and business scale is achieved, the direct insurance model can be highly profitable as a large portion of traditional short-term insurance costs (that of the intermediary or broker) is eliminated.

Direct insurance is more suited to simple insurance products like motor and household for individuals. More complicated insurance products such as commercial lines, liability or agriculture require specialist intermediaries and more regulatory capital as the claims can be substantial. Because of the increased risk they also command far higher premiums.

OUTsurance have been remarkably successful in rolling out their direct insurance model since their formation in 1998. The group now generates in excess of R15bn in annual premiums. Over the last fifteen years – premiums have increased at a CAGR of 19.8% - an impressive number, although more recently growth rates have started to slow (chart 4).

Chart 4: OUTsurance group – annual gross written premiums (Rm) since 2003



Source: OUTsurance financials, Bateleur Capital

We attribute some of the group's success to the following:

Leveraging off the entrepreneurial culture of the RMH group in the early years. OUTsurance was built organically from the ground up. This required seed capital from RMH, an appropriate incentive scheme where executives could earn more than traditional insurance executives if they delivered on ambitious targets. RMH also provided a sounding board for strategy and mentoring.

Embracing the use of technology. Because OUTsurance was built from scratch it was not encumbered by expensive legacy IT systems. Internet-based IT systems were installed that were cheaper, faster and more dynamic. This assisted claim recording, processing and monitoring as well as the functioning of the call centre. In turn, this enabled the company to better price for risk based on actual claims experience to the benefit of underwriting margins.

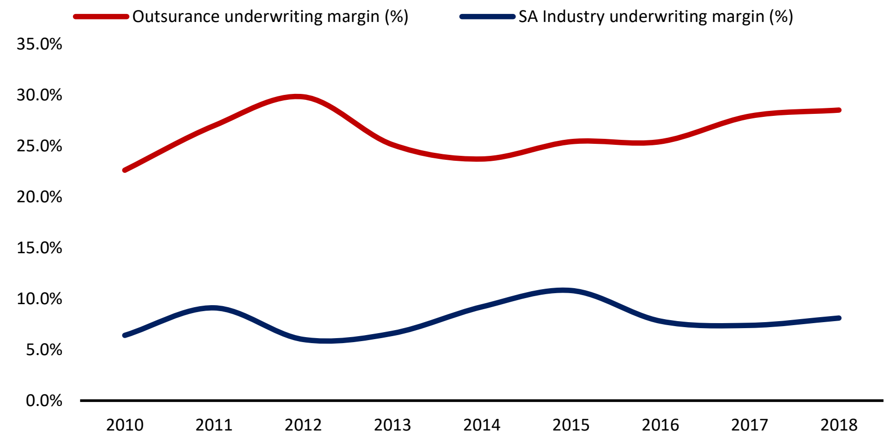
Pioneering the no claim bonus in SA. This effective loyalty scheme known as OUTbonus assisted in reducing policyholder churn. Short term insurance has always been considered a grudge purchase. Customers are fickle and regularly move between insurance companies based on one main factor, price.

The introduction of the no claim bonus partially changed this. if a policyholder didn't initiate a claim for a period of three years, then as a reward they received a percentage of their premiums back in cash. This meant that the company retained its low risk (and more profitable) clients and additionally attracted new clients (who also wanted to receive a premium rebate). It also led to policyholders adopting better behavioral practices. Nowadays, many other direct insurers also offer no claim bonuses, but in its early years, this was a competitive advantage for the company.

Aggressive marketing and advertising campaigns. Based on Nielsen's data, OUTsurance are one of the top ten advertising spenders in SA across the various media platforms. This aggressive but targeted marketing assisted in the generation of strong new business growth over many years as OUTsurance gained market share from their competitors.

The benefits of the direct business model, scientific risk underwriting, and economies of scale are clear when comparing the underwriting margin of OUTsurance to the SA short-term industry average. OUTsurance underwriting margins have averaged 26.2% over the past nine years. This compares to the average for the SA short-term insurance industry of 7.9% (chart 5). The industry average includes the full ambit of SA insurers encompassing traditional, direct and credit life. OUTsurance's underwriting margins are consistently high through the cycle, having never been lower than 22.6% since 2010. Santam, which is the largest 'blue chip' full-service short-term insurer in SA – targets an underwriting margin of 4% to 8% through the cycle.

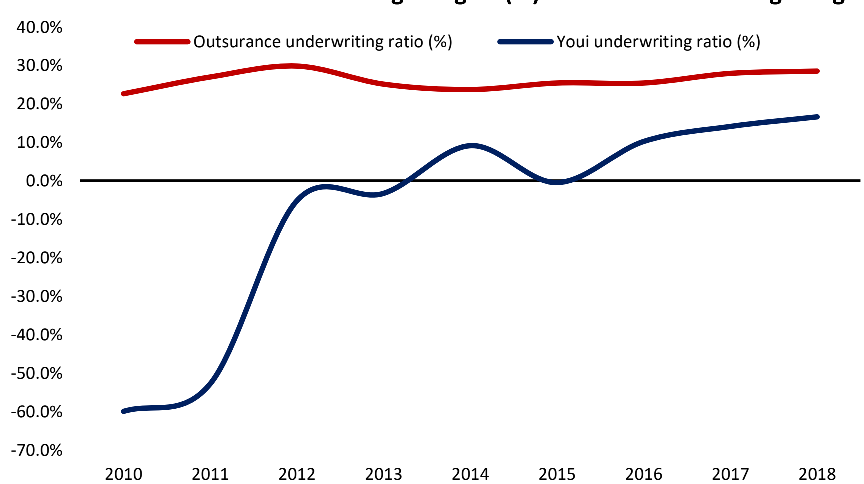
Chart 5: OUTsurance SA underwriting margins (%) vs. SA industry underwriting margins (%)



Source: 2017 FSB Insurance division – Short term insurance results; UBS

In the competitive Australian market, Youi has managed to gradually improve its underwriting margin as the business scaled up and policyholder count grew. Youi's underwriting margin reached 17% in 2018 from an underwriting loss six years ago – although the company may recently have become too rigid on pricing at the expense of policyholder growth. Under new management, we expect underwriting margins at Youi to decline to more normalised levels of c12% as the company resumes its strategy to grow market share (chart 6).

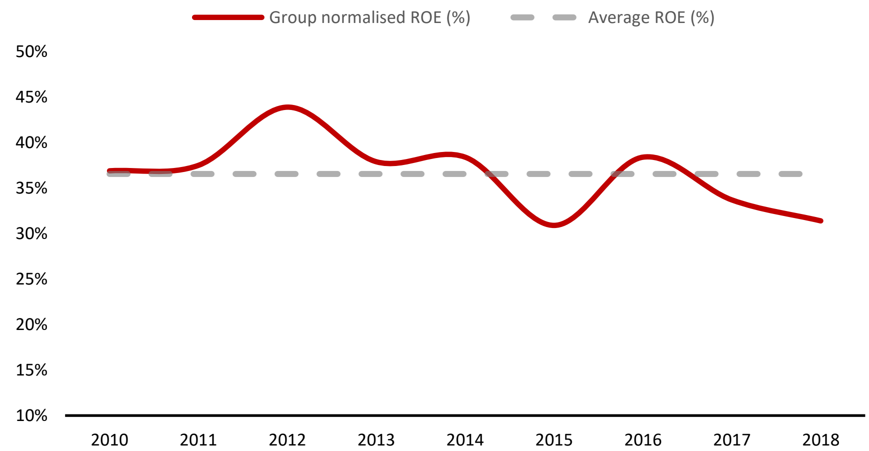
Chart 6: OUTsurance SA underwriting margins (%) vs. Youi underwriting margins (%)



Source: 2017 FSB Insurance division – Short term insurance results; UBS, OUTsurance financials

The attractive underwriting margins of OUTsurance has resulted in the group generating very high ROE's (chart 7). Over the past nine years, OUTsurance's ROE has averaged 37%. In 2018 this declined to a still respectable 31%, primarily due to a build up of equity relating to the acquisition of a 14.7% minority stake in Hastings.

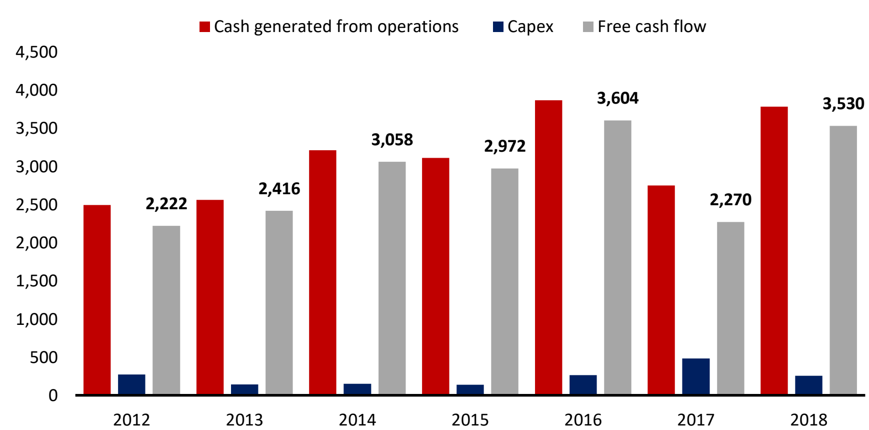
Chart 7: OUTsurance group normalised ROE (%) over time



Source: OUTsurance financials, Bateleur

OUTsurance has limited capital expenditure requirements aside from regulatory capital, new business development and IT related expenditure. This has led to the group generating substantial free cash flow each year. The total value of property, plant and equipment (PPE) on the balance sheet at the end of the 2018 financial year was only R1.1bn. This is substantially less than the <u>annual</u> free cash flow generated by the group in 2018 of R3.5bn (chart 8).

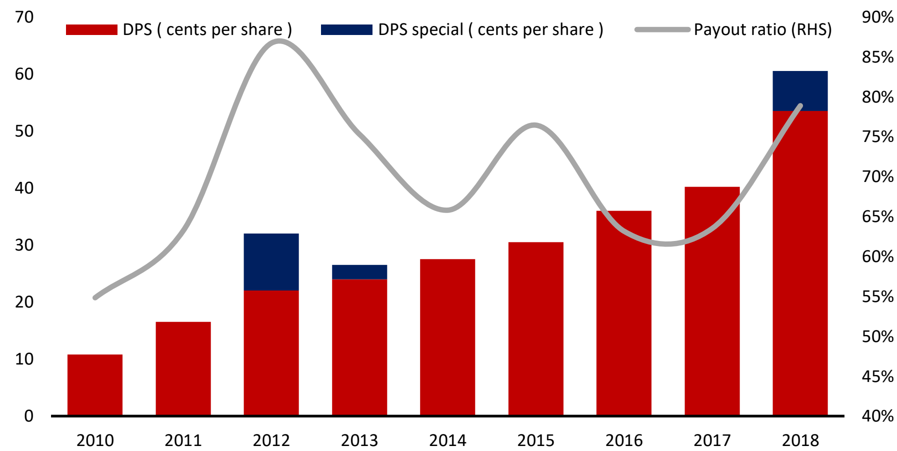
Chart 8: OUTsurance cash generated from operations, free cash flow and capex by year (Rm)



Source: OUTsurance financials, Bateleur

The strong free cash flow generation has enabled OUTsurance to steadily increase its dividend pay-out ratio, as well as pay special dividends from time to time (chart 9). In 2018, 79% of normalised earnings were distributed to OUTsurance shareholders (mainly RMI) through both regular and special dividends.

Chart 9: OUTsurance group – DPS over time (c) and pay-out ratio (%)

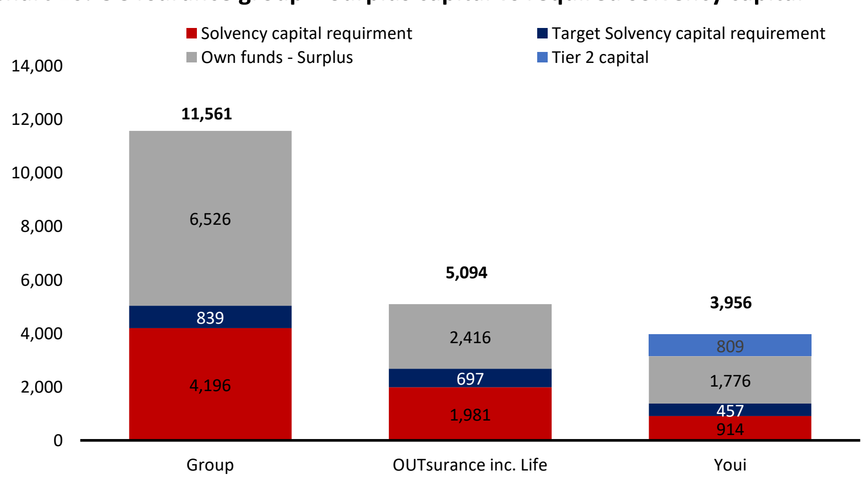


Source: OUTsurance financials, Bateleur

Despite the high pay-out ratio in recent years, OUTsurance still holds surplus capital, well in excess of what is required for statutory purposes and new business initiatives. This excess capital, which is held in cash and similar liquid instruments, dilutes group profitability ratios. The extra capital buffer may have been needed while Youi was incurring underwriting losses and going through the J curve – but this is no longer the case with Youi now comfortably self-funding.

At group level in its latest annual report, OUTsurance had R11.6bn in shareholder funds backing a statutory capital requirement (SCR) of R4.2bn (chart 10). A further buffer of 20% or R839m is targeted by the group to arrive at an optimal capital position of R5.0bn. This would imply that the group has in excess of R6.5bn in surplus capital, that could be distributed to shareholders. To put this into context, the total dividend in 2019 (regular and special) on a 79% pay-out ratio, amounted to R2.0bn.

Chart 10: OUTsurance group – Surplus capital vs required solvency capital



Source: OUTsurance financials, Bateleur

OUTsurance is in a mature phase of its life cycle in SA. It will be challenging for the group to grow premiums faster than nominal GDP plus a percent or two in the direct personal lines market. This is one of the reasons why the company has expanded into adjacent markets such as commercial lines and has established an agency force. Recently, it has also set up a presence in the competitive funeral policy market. However, the premium growth outlook in Australia is far more promising as the market is substantial and Youi's current market share is small.

The rise of autonomous vehicles and the continued proliferation of ride sharing apps are expected to place pressure on motor vehicle premium rates in the long term. This is because motor vehicle accident rates are expected to reduce as these disruptive innovations gain traction. Although some way off, it does have the potential to reduce motor vehicle underwriting profits. This has necessitated the group to speed up its diversification into adjacent financial services categories – the success of which is not guaranteed.

Despite these competitive pressures – OUTsurance remains a highly profitable, cash generative business with an exceptionally strong brand, especially in SA. It has an excellent track record of consistent long-term growth, and a respected leadership team with considerable experience in running the business and adapting to changing market conditions.

Our DCF derived fair value for OUTsurance today is R44.3bn inclusive of the investment in Hastings. Excluding the Hastings investment, we value the group at R41.3bn. On a P/E measure, our valuation equates to a historic multiple of 15.3 times. This would imply that RMI's 89.1% investment in OUTsurance is worth R39.5bn including Hastings and R36.8bn excluding Hastings.

Valuing RMI

The most common method of valuing investment holding companies is a sum-of-the-parts approach. In the case of RMI this comprises the value of the listed holdings at current market value plus 89.1% of our valuation of OUTsurance, plus the value of the affiliate fund management and fintech businesses, less net debt at the centre to obtain an overall group value. Our sum-of-the-parts value for RMI is R64.0bn or R41.80 per share (table 1). This is 30% above the current share price.

Table 1: RMI – Sum-of-the-parts valuation

Component	Shares held	Price (R)	Value (Rbn)	% of Value
Discovery (25.0%)	165	136.2	22.4	35%
MMI (27.3%)	401	18.0	7.2	11%
Hastings (29.9%)	197	34.7	6.8	11%
Non-controlling interest of OUTsurance in Hastings	10	34.7	-0.4	-1%
Other investments			0.8	1%
Net debt			-9.8	-15%
OUTsurance - (89.1%) excluding Hastings			36.8	58%
Group value		**41.8**	**64.0**	
RMI	1532	32.1	49.2	100%
RMI discount to sum-of-the-parts		-23%		
Upside if discount gets unlocked		**30%**		

Source: Bateleur, Bloomberg, pricing as at 25 July 2019

There is no reason to invest in RMI to obtain access to the listed investments of Discovery, MMI and Hastings when these can be accessed directly by investors. At current prices, these investments comprise a substantial R36.1bn or 56% of group value.

In valuing RMI, we apply a portfolio discount of 20% to the listed holdings, as it represents an inefficient holding company structure. Discovery, MMI and Hastings are all established businesses with their own independent board of directors, governance structures and elected executives – that do not require a minority investment from RMI to function more optimally. After applying a portfolio discount on the listed holdings, a more realistic fair value of RMI under the current capital structure is R37.10 per share (table 2). This would indicate upside potential of 15%, still attractive, but significantly lower than the 30% upside potential should no portfolio discount be applied.

Table 2: RMI – Sum-of-the-parts valuation incorporating portfolio discount

Component	Shares	Price (R)	Value Rbn
Group value before portfolio discount		41.8	64.0
20% discount on listed investments		-4.7	-7.2
Revised group value		**37.1**	**56.8**
RMI	**1532**	32.1	49.2
RMI discount to sum-of-the-parts		-13%	
Upside		**15%**	

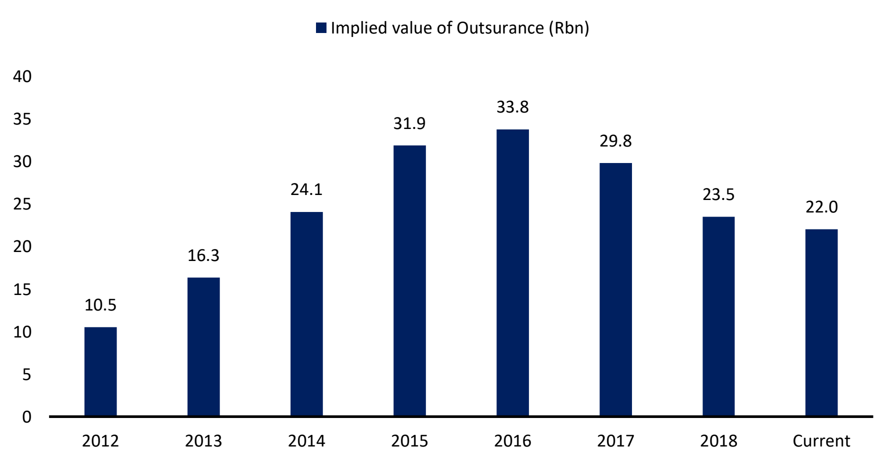
Source: Bateleur, Bloomberg, pricing as at 25 July 2019

Calculating an implied value of OUTsurance

An implied value on OUTsurance can be determined by subtracting the value of listed assets from the current market capitalisation of RMI (net of debt). Although this method is flawed in that it assumes that the market does not apply a discount to the listed investments, it is an important indicator of how the market value of OUTsurance has changed over time.

Under this method, the market is currently valuing RMI's investment in OUTsurance at R22.0bn compared to R33.8bn in 2016 highlighting that a substantial de-rating has occurred. (chart 11). This is surprising as OUTsurance's normalised headline earnings in 2016 were R2.0bn vs. R2.6bn* in 2018.

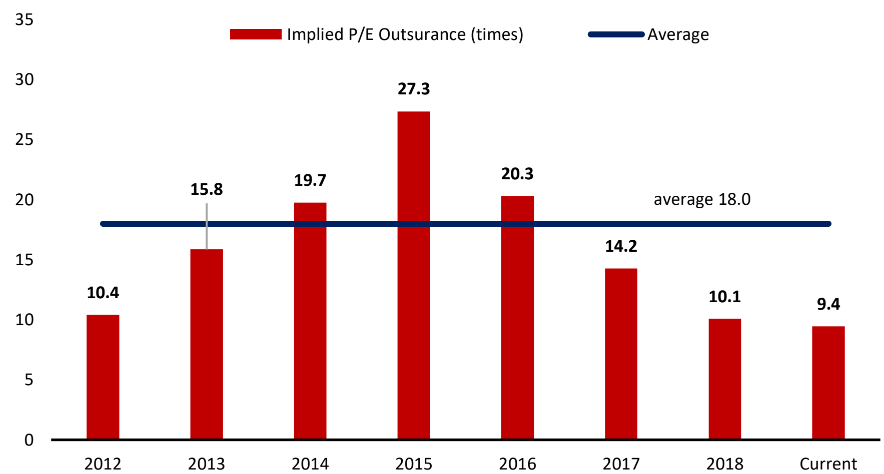
Chart 11: Market implied valuation of RMI's investment in OUTsurance (Rbn)



Source: Bateleur, Bloomberg, pricing as at 25 July 2019 *Excluding the contribution from Hastings

Viewed differently, the implied P/E of OUTsurance has declined from a peak of 27.3 times in 2015 to 9.4 times currently, the lowest in our measurement period (chart 12) – indirectly emphasizing the attractiveness of RMI, especially under a more efficient corporate structure.

Chart 12: Market implied P/E of OUTsurance (times)



Source: Bateleur, Bloomberg, pricing as at 25 July 2019

<u>Proposal to unlock value:</u>

RMI is the only way to access an investment into unlisted OUTsurance, a valuable business. We currently value 100% of OUTsurance at R44.3bn including its investment in Hastings, or R41.3bn excluding Hastings.

By deduction, we value RMI's 89.1% investment in OUTsurance at R39.5bn including Hastings, or R36.8bn ex Hastings.

We estimate that OUTsurance is currently <u>undervalued by R14.8bn in RMI.</u> However, this value will only be unlocked if RMI's capital structure is addressed. If RMI's capital structure does not get addressed, the value trap will remain.

Our initial proposal is that the listed investments of Discovery and MMI are unbundled from RMI. This will immediately unlock in excess of R6bn of value, assuming no tax leakage.

Our second proposal is that any new investments or capital injections into either the affiliate fund management business or fintech start-ups are curtailed. These businesses consume management time, are non-controlling interests, are cumulatively loss making, and will not 'move the needle' of RMI even if their prospects improve materially.

Our third proposal is that a special dividend be declared from OUTsurance out of the available surplus capital. This special dividend could be up to R6.5bn (gross) resulting in R5.8bn (gross) flowing up to RMI. The proposed special dividend proceeds could be used to reduce the current net debt position at RMI of R9.8bn. It is however RMI's view that a more prudent approach to capital management is needed due to the multiple geographies in which OUTsurance operates.

Once the discount has narrowed sufficiently, RMI could then acquire the 10.9% of OUTsurance it does not already own by issuing new shares in RMI as consideration. It would be important that this transaction is non-dilutive to existing RMI shareholders.

RMI would then own 100% of OUTsurance, 29.9% of Hastings and have limited debt. RMI could then be renamed OUTsurance Holdings. At this stage, a decision could be taken as to the strategic merits of the Hastings investment.

OUTsurance would become a listed short-term insurance operational company and the RMI head office and related costs could be reduced.

We believe these steps could cumulatively unlock R14.8bn and provide 30% upside to the existing price of RMI. More importantly, investors would have direct access to a unique, highly profitable, cash generative business with negligible debt on a still compelling P/E multiple of approximately 15.3 times. Assuming a 75% dividend payout ratio, investors would receive a 5% dividend yield directly. A portion of the OUTsurance dividend would no longer be trapped in RMI and investors could decide for themselves on how best to utilise the dividend proceeds.

We would encourage the RMI board to review our proposal and again consider whether its listed stakes, capital structure and strategy are best serving the company's stakeholders.

Sincerely

Kevin Williams

Fund Manager

James Easterbrook

Head: Distribution

30th July 2019

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