Bateleur Flexible Prescient Fund

Third quarter 2020 commentary

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Bateleur Flexible Prescient Fund – 2020 third quarter report back to unitholders

The fund's NAV per unit increased 13.0% YTD to the end of September. Over the same nine-month period, SA equities (JSE All Share Index) declined 2.5%, SA bonds (ALBI) increased 1.8%, while cash (STeFI) returned 3.6%. Fund attribution and the top contributors and detractors are shown below.

Flexible Fund – Attribution by strategy and top contributors/detractors – YTD to 30 September 2020

Attribution by strategy	YTD to September 2020
JSE listed equities	1.1%
Foreign listed equities	13.0%
Fixed income	0.0%
Costs (and other)	-1.1%
Total	13.0%

Contributors	Detractors
Naspers/Prosus	Tsogo Gaming
ARI/Assore	Sasol
Dollar General	Adcock Ingram
Amazon	Anglo American
PayPal	Mpact

Source: Bateleur

The top contributors YTD were predominantly global shares, boosted by a healthy weighting in select technology shares (Amazon, PayPal, Alibaba, Microsoft and Sony) and sound stock picking outside of the technology space (Dollar General, Swedish Match and Johnson & Johnson).

The strong rally in technology shares and recent flood of new listings has, in several instances, led to inflated valuations. We have used this exuberance to reduce the fund's weighting in certain technology names where prices now trade ahead of fundamentals.

Earlier this month, the US House of Representatives issued a 449-page report targeting Amazon, Google, Facebook and Apple for anti-competitive behaviour. More recently, the US Department of Justice has filed a civil anti-trust lawsuit against Google. This high-profile targeting by powerful regulatory bodies against the dominance of 'big tech' is anticipated to keep news flow negative for the foreseeable future and may partially curb frothy valuations.

Proceeds from the reduced weighting in technology shares have been selectively recycled into more defensive companies whose businesses have proven resilient in the current economic climate. These holdings include Johnson & Johnson, Procter & Gamble, Altria and Dollar General amongst others.

We view these companies as attractively priced, especially in the current low interest rate environment that is expected to remain accommodative over the medium term. Altria for example trades on a historic dividend yield of 8.5% compared to US 10-year treasury yields of only 0.8%.

The fund's offshore exposure remains at its maximum allowed weighting of 30% (before market movements). With developed market cash, bonds, and property offering unattractive risk/return profiles, this offshore exposure is held exclusively in equities.

Turning to JSE listed equities, the fund benefitted from a healthy weighting in Naspers/Prosus and limited exposure to domestic cyclicals (banks, insurance companies and large capitalisation industrials).

The fund continues to hold a meaningful stake in select domestic mid capitalisation (‘mid-cap’) companies in a variety of industries. As a collective, this has been a detractor from fund returns YTD.

There is no ‘theme’ to these mid-cap investments. Each holding was acquired following in-depth fundamental analysis at valuations that were considered attractive at the time of entry.

While many of these companies’ short-term results have been negatively affected in the current COVID environment, they all enjoy dominant or competitive market positions in their chosen fields. For the most part, the selection of mid-caps have: 1) strong balance sheets (certain of them in net cash positions); 2) above average long-term financial metrics; 3) low capex intensity; 4) regarded management teams; and 5) have safely navigated previous crises (such as the financial crisis of 2008).

We still expect that material value will be unlocked in the mid-cap portfolio over time through one of three scenarios: 1) shares will re-rate based on earnings growth or when renewed interest or improved liquidity occurs in the sector. This scenario has been temporarily pushed out by COVID but remains the preferred method of value unlock. 2) increased M&A activity as private equity, trade buyers or existing owners take advantage of depressed valuations. 3) material increases in share buybacks as companies with strong balance sheets take advantage of shares trading at deep discounts to book value or discounted cash flow value.

During 2020 YTD, corporate activity has materialised in three of the fund’s mid-cap holdings. In March, bulk miner Assore was taken private by the Sacco family at a premium of 84% to the ruling price at the time. In May 2020, specialist property company Atlantic Leaf was acquired by Apollo fund management at a premium of 33%. Lastly, in October, industrial gas provider Afrox announced that it is to be acquired by parent Linde, at a premium of 43% to the ruling price.

In each of the corporate actions described above, we believe that the acquirors obtained unique assets at very attractive levels. Both Assore and Afrox had substantial net cash balances which will be used by the acquirors to partly fund the acquisitions. We estimate that based on current bulk commodity prices, the Assore payback will be less than three years, while Linde paid only 10.6 times normalised earnings for Afrox (excluding net cash).

Minority shareholders (including funds managed by Bateleur) were ‘squeezed out’ despite the publicised ‘substantial’ offer premiums. The local fund management industry (specifically the large fund managers who hold the swing vote) need to be more vocal and aggressive in commanding higher take out premiums to compensate for the loss of future capital appreciation, especially at this depressed stage of the business cycle.

Importantly, when viewed collectively, significant upside potential still exists in the fund’s remaining mid-cap holdings. Recent company share buy-back activity would tend to support this. During October, paper and packaging producer Mpact repurchased 5% of its shares outstanding in a single transaction. Pharmaceutical company Adcock Ingram has also repurchased significant shares during 2020, while its controlling shareholder Bidvest recently increased its holding in the company through buying shares in the open market.

In the quarter under review, the fund acquired a sizable holding in SA government bonds for the first time since inception in 2010. The bond holding (exclusively in the longer dated SA 10 yr.) was funded out of domestic money market holdings.

The rationale for the switch was that following the 300bp cut in interest rates during 2020, the yield gap between long dated bonds (generic 10 yr. at 9.3%) and corporate money markets (currently 4.4%) was too large at 4.9%, and provided an attractive entry point into bonds. Importantly, the bond position was acquired for income yield and not for capital gain.

A summary of the current fund positioning is shown below.

Current fund positioning by strategy	**%**
JSE listed equities	48.8%
Domestic facing holdings	*19.7%*
Dual listed/ Rand hedge	*29.1%*
Foreign listed equities	31.6%
Total equity exposure	**80.4%**
Gold (held via Newgold ETF)	3.5%
SA government bonds (10 yr.)	7.3%
Cash & money market	8.8%
Total	**100%**

Sincerely,

Kevin Williams

Fund Manager
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Bateleur Capital (Pty) Ltd

Authorised financial services provider
FSP no 18123
—
SG109 Ground Floor, South Wing
Great Westerford Building
240 Main Road, Rondebosch
7735
—
T +27 (0)21 681 5060
F +27 86 649 1794
—
E funds@bateleurcapital.com
W bateleurcapital.com