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Kagiso Asset Management

Quarterly

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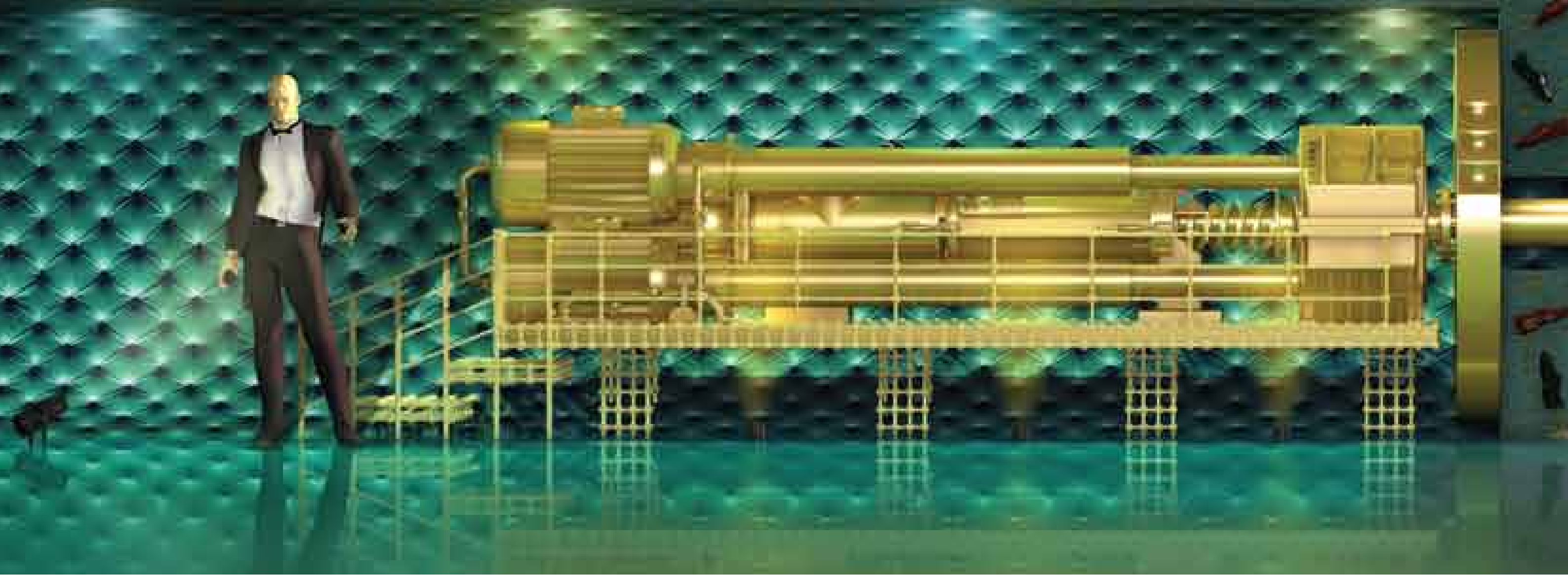

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Boring to depth

Simon Anderssen - Associate Portfolio Manager

> Mining services companies are often tarred with the same attributes as their customers: significant commodity price risk and highly cyclical earnings. Yet there are a handful of service providers that are able to generate a stable earnings stream during the most challenging commodity cycles. We consider Master Drilling one of these few.

Boring to depth

Master Drilling is a global drilling solutions business specialising in raise bore drilling. It listed on the JSE Securities Exchange in December 2012 and raised R430 million. The capital has been employed to expand capacity by designing and building new raise boring machines.

Over the last four years, the company has delivered consistent earnings growth during one of the most severe commodity downturns, in which aggregate earnings of the JSE resources companies declined 70%. This defensiveness is evidence of a robust demand for the company's drilling, its diversification and the financial health of its clients.

Raise boring explained

Master Drilling generates 80% of its revenue from raise boring, a method of mechanically boring a shaft between two levels (diagram opposite). It first entails sinking a pilot hole approximately 350 millimetres wide from the upper to lower levels. Once through, the pilot hole is reamed to a larger size by attaching a reamer head to the end of the drill rods and mechanically pulling and turning this reamer head to the surface. Debris and rock falls to the lower level, and is removed using existing infrastructure. The reamed shaft can be as deep as 1 000 metres and up to 4.5 metres in diameter.

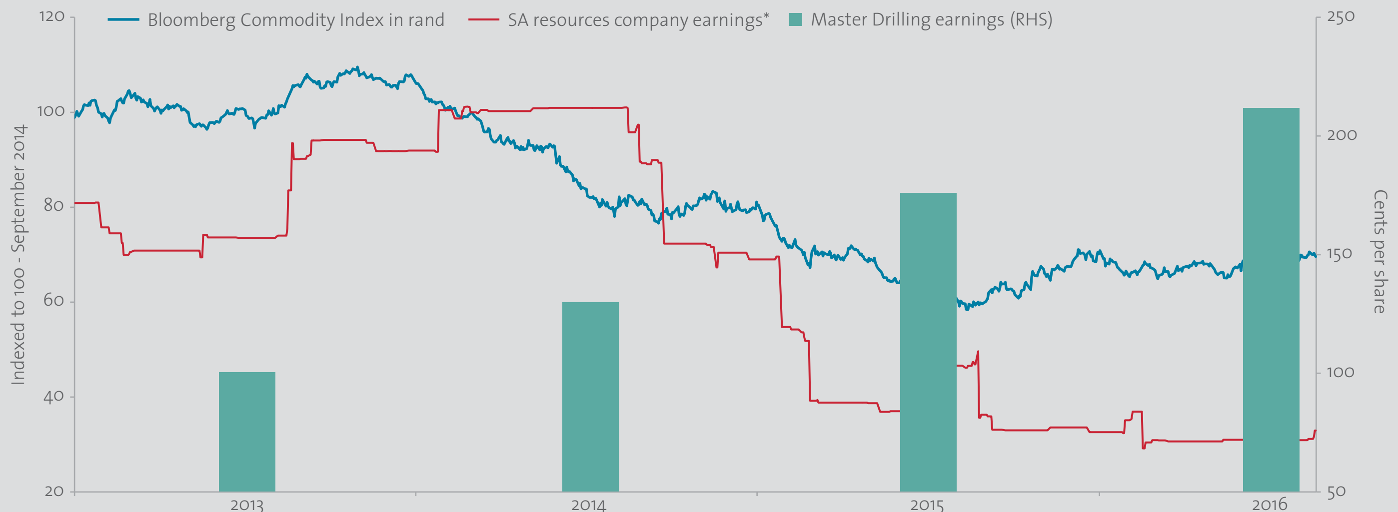
Raise boring is used in mining for ventilation shafts, ore passes or access shafts[1]; in civil construction for underground tunnelling, commuter metro rail networks or infrastructure projects; and in hydro-electric plants for pressure shafts. Master Drilling is active in each area but the majority of its exposure is to mining. The company competes directly with a number of regional players.

Raise bore drilling has multiple advantages over the alternative approach of blast sinking using explosives. Since the machinery does most of the work, raise boring is less labour-intensive and improves safety as it removes personnel from the unstable rock face. Its financial advantages are also compelling: a raise bored shaft can be completed in approximately half the time and at a 30% to 40% saving versus conventional methods for sinking a comparable shaft.

Mining is an extractive process and requires underground infrastructure to be continuously developed further away from existing shafts to sustain output levels. Therefore, stay-in-business spending on infrastructure, such as ventilation shafts and ore passes where raise bore drilling is utilised, is a relatively stable element of total mining capital expenditure. This is a fundamental reason for Master Drilling's steady earnings delivery.

[1] Ventilation shafts are vertical passages to move air underground. Ore passes are vertical openings used to dump mined ore to the lowest point in the mine. Access shafts are vertical passages to transport personnel and material to an underground mine.

Defensive earnings growth



*Companies included in the Resi 10 Index only

Sources: Bloomberg, company reports, Kagiso Asset Management research

A global footprint

The group's origins and headquarters, in the unassuming town of Fochville, an hour's drive south-west of Johannesburg, belie a global footprint and a diversified commodity basket.

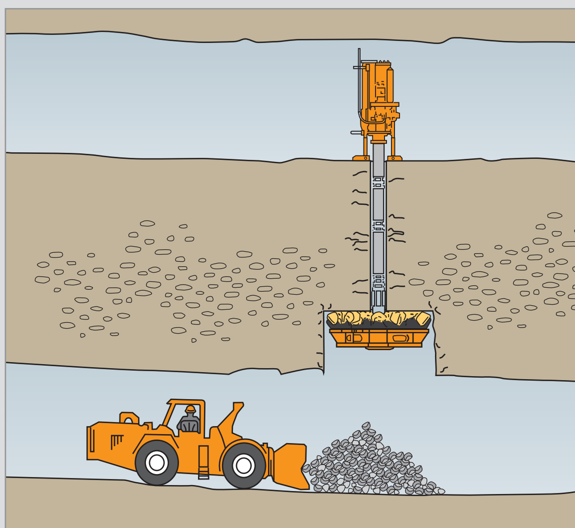
In 2016, South Africa accounted for just 25% of group revenue and other African projects another 20%. The remainder of revenue was primarily generated in Latin America, particularly Brazil, Chile, Columbia and Mexico.

The group actively seeks dollar-denominated contracts in most geographies but accepts local currency risk in regions where the quality of the counterparty or size of the project mitigate this risk. Operating costs are predominantly paid in local currency.

The company has been able to expand geographically on a project-by-project basis by shipping its raise boring machines - which can weigh up to 110 tonnes - in containers and assembling on site. The fleet's mobility allows the company to redeploy assets in line with demand changes, and maintain high utilisation levels and operating margins.

Diversification by type of commodity further reduces operational and commodity risk. Projects at gold mines across multiple countries account for a third of revenue. Copper, concentrated in Chile, and polymetalic (lead/zinc/silver) mining projects each contribute a quarter.

Conventional raise boring



Source: Master Drilling

Innovation drives automation

Safety and cost considerations will direct the global mining industry towards greater automation and mechanisation in the future. Master Drilling's innovative track record and project experience suggest it is well positioned to contribute to, and benefit from, this transition.

The company's achievements include, respectively, the world's widest, deepest and most accurate raise-bored holes, highlighting its ability to extend the boundaries of raise boring. This is accomplished through constant innovation and re-design of equipment throughout the drilling process. Over many years the company has developed the capabilities to design its own machines, drill rods and cutters for project-specific conditions. This gives Master Drilling structural advantages on costs and shorter lead times for equipment compared to its competitors.

The company's pursuit of incremental efficiency improvements includes an automated drill-rod handler that loads and unloads drill rods, and an automated drilling control system. The latter allows raise boring machines to operate uninterrupted for a short period during operator shift changes that coincide with mandatory evacuation of all on-mine personnel during blasting, when noxious gases are released. The company aims to maximise the automated operating times over a 24-hour cycle and thereby reduce personnel functions and interventions.

Further examples of its internally-developed technology include remote operated shaft inspection and support systems and a gripper machine that is designed to bore diagonally. The gripper is being trialled at a South African gold mine.

Raise boring laid flat

In recent years Master Drilling has experimented with a horizontal application of raise boring and has announced the successful completion of a trial at an SA diamond mine. The trial saw them drill a 180-metre-long tunnel, 4.5 metres in diameter, through very challenging Kimberlite.

The term horizontal raise boring (HRB) oversimplifies the engineering feat. Boring horizontally requires counterbalancing the downward gravitational pull of the reamer on the raise boring equipment, up to 180 metres away, to ensure the tunnel is level. A further challenge was debris removal from the reamer

head. In a vertical application, this falls away with gravity. In this project, water could not be used for flushing, because it would compromise the stability of the surrounding Kimberlite, and a suction system had to be developed to remove debris.

The advantage of HRB machinery over traditional tunnel boring machinery is that it can be disassembled into smaller components, making it easier to transport within existing mining infrastructure.

The opportunity for HRB could be immense. At most underground mines, for every metre of vertical shaft sinking, there are approximately three to four meters of horizontal tunnels developed to transport personnel, equipment and ore. We expect HRB to be an appropriate method for some of these tunnels, which could materially increase the scope for Master Drilling's services. It is too early to include this new business opportunity into our expectations for the company but we will closely follow HRB's commercial acceptance and re-evaluate if necessary.

Boring blind

Master Drilling's ambitions extend further: it has announced plans to develop a blind shaft boring system that does not require access from the bottom level. This would effectively enable shaft sinking using mechanised boring instead of traditional blast sinking with explosives. As with raise boring, there would be substantial time and cost savings in accessing the orebody this way. It would improve the value of new projects, perhaps even making previously unviable projects profitable.

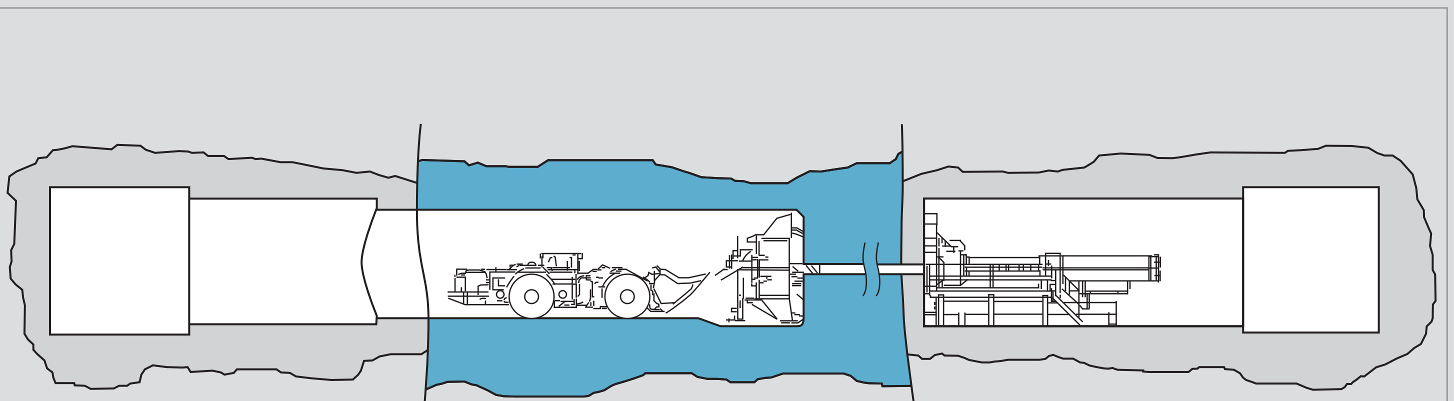
The company is patenting a system to sink an access shaft 1200 metres deep and eight metres wide, capable of carrying personnel and equipment. This project is a number of years away from being proven, but could be a game-changer for the mining industry in terms of efficiency gains.

Nothing boring about the return to shareholders

The share price has more than doubled since listing as the company has steadily grown earnings. Looking forward, we expect the group's free cash flow to improve significantly as its expansion phase draws to an end. This will reveal the strong cash generative qualities of the business model and provide management with the resources to pursue its HRB or blind-boring projects that will sustain growth in the future. Early evidence of this emerging free cash flow was the declaration of a maiden dividend in March 2016.

We are positive about the prospects for Master Drilling and believe our investment in the company offers exceptional value for our clients who, after management, are the largest shareholders in the company. UP

Horizontal raise boring



Source: Master Drilling

A new age for luxury

Sarah le Roux - Associate Analyst

The personal luxury goods market has stubbornly fought the shift to online retailing. High-end luxury consumers demand an experience that mirrors the quality of the goods they purchase. As such, they are not easily swayed by the lure of convenience that typically leads to a preference for online. Brand owners similarly resist the shift, fearing a loss of the exclusivity that defines their brand power.

Italian headquartered Yoox Net-a-Porter Group (YNAP), however, has pioneered the move of the luxury experience online, paving the way for a new era of personal luxury goods sales.

A new age for luxury

The world of personal luxury

High-end clothing, shoes and accessories form the core of the personal luxury goods industry. Global sales of personal luxury goods reached €249 billion in 2016. However, only 8% of this revenue was generated online - a small percentage relative to other online retail categories.

This low online penetration is due to the unique nature of luxury sales, where the purchase for the luxury consumer is not simply about the item, but the premium experience surrounding the sale. This experience is difficult to replicate in the online space given the impersonal nature of such transactions. Further, the accessibility of online is at odds with the perception of exclusivity that defines top luxury brands, causing brand managers to fear irreparable damage to brand image.

Online is growing

Despite these obstacles, the shift to online has started to gain traction. In 2016, online luxury sales grew 13% while the total size of the personal luxury goods market remained relatively stable.

There are several reasons for this changing trend. Social media is becoming the new High Street - the place to see and be seen with your purchases - with posts generating potentially hundreds or even thousands of views. Society as a whole is also increasingly opting for convenience as modern lifestyle choices amplify time constraints. The ability to view a wide range of products and brands simultaneously online saves time and broadens choice. Further, brands that were previously inaccessible in certain countries are now within reach thanks to advancements in shipping networks. Most importantly, technological innovations have made it possible to blur the boundaries between offline and online and to offer an experience equivalent to that offered by a luxury boutique.

The origins of YNAP

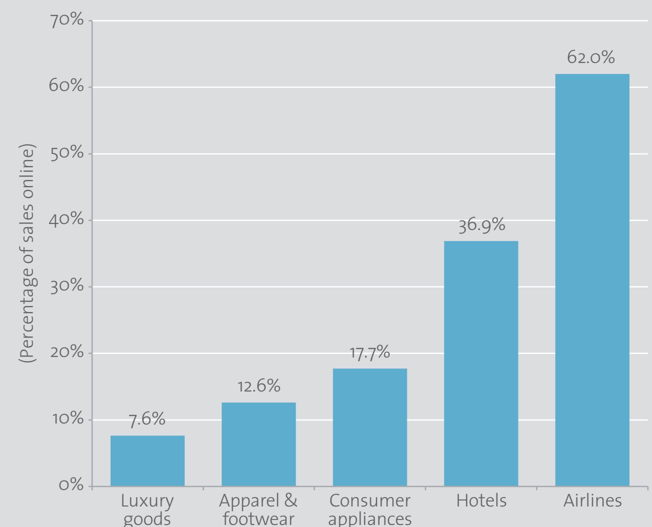
In 2015, two of the leading online luxury aggregators, Yoox and Net-a-Porter, announced that they would merge to form the Yoox Net-a-Porter Group. The combined group consists of two in-season platforms offering the very latest fashion (Net-a-Porter for ladies and Mr Porter for men), and two off-season platforms (Yoox and the Outnet). Each platform has a separate website and its own feature-rich native app. The platforms are complementary as they are able to share the same distribution network and we therefore expect significant cost savings to be realised from the merger.

A full range of personal luxury goods are available on the platforms, with clothing, shoes and handbags making up the bulk of sales. YNAP's multi-platform approach allows it to target customers across luxury consumer segments: the in-season platforms primarily attract the ultra-wealthy (the 0.7% of the global population that have more than US$1 million in wealth) and the off-season platforms target the aspirational luxury consumer (the 7.5% that have between US$100 000 and US$1 million). To illustrate, a newly released Fendi handbag retails for around €4 000 on Net-a-Porter. This same handbag would only become available on Yoox the following season at a marked down price, in a similar fashion to old cell phone models.

Why aggregate?

There are many arguments in favour of online aggregation. A wider selection of brands attracts more customers. A superior distribution network allows for more timely delivery and returns, enhancing the customer experience and reducing the need for mark downs as items go out of season. Finally, the investment in experience-enhancing functionality and digital content demonstrated by YNAP is not financially viable for a single brand, particularly the smaller boutiques.

2016 global online penetration by category



Sources: Euromonitor, Bain & Altagamma, Kagiso Asset Management estimates

Luxury brands tend to be wary of aggregators due to the potential for excessive discounting and resultant damage to brand image. There is also an incentive to limit the number of stockists in order to retain the perception of exclusivity. YNAP's established relationship with brands across its platforms therefore provides a key competitive advantage and acts as a barrier to entry for would-be rivals.

Translating the in-store experience to online

The in-season platforms are designed to mimic the in-store luxury shopping experience with the platform functioning as a virtual shop assistant. An expert team of photographers and stylists are used to create product shots that are akin to fashion shoot images and detailed editor's notes for each product. These notes provide a unique description of the product, highlighting the inspiration behind the creation, notable design features and fit guidelines as well as what to wear with it. Returns and exchanges are geared towards convenience with a personalised service offered for premier customers.

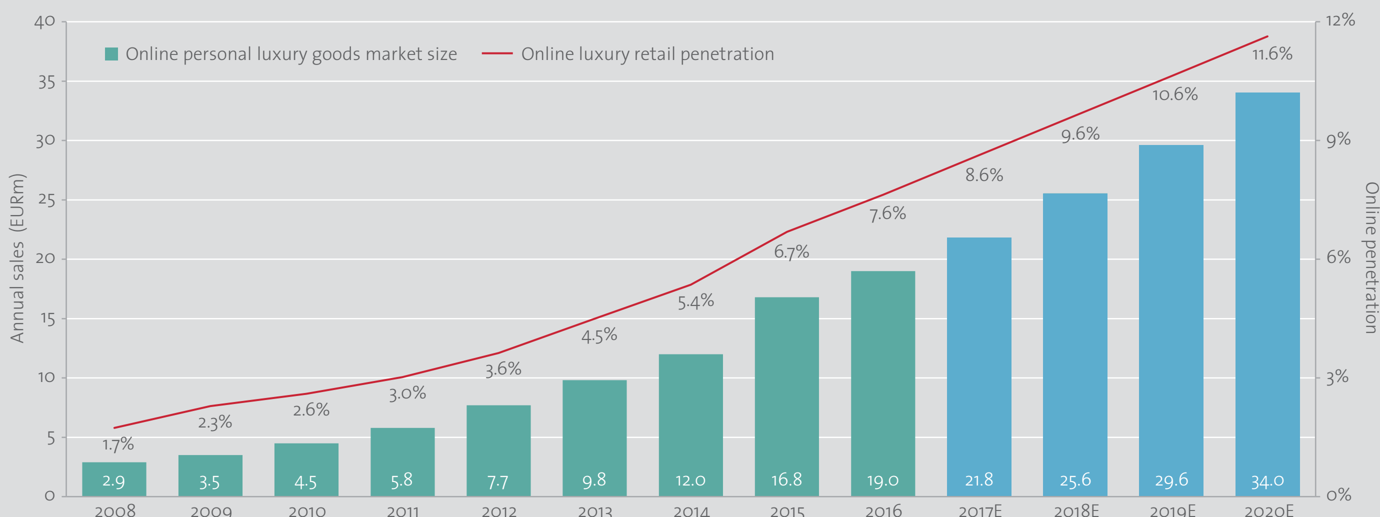
The next element is packaging. Similar to the Tiffany jewellery box, Net-a-Porter's packaging is unique, classy and instantly recognisable. An elegant black box tied with a silver-etched ribbon houses a purchase nestled in a bed of scented tissue paper. A hand-written card with the customer's initials emblazoned on the front completes the look.

Customers with annual orders in excess of €10 000 a year are referred to as Extremely Important Persons (EIPs). These EIPs are typically individuals who subscribe to the transient nature of fashion, frequently replenishing their wardrobes with the latest collections as they are released. They tend to spend around three times as much per order and order twelve times as often as regular customers, and are duly singled out for special attention. Perks include a one-on-one relationship with a personal shopper who acts as the point of contact and advises on purchasing decisions; sneak previews of new collections before they are released; and invitations to exclusive shopping events. In this way the in-season business is able to transcend the boundary between online and offline, providing the kind of service high-end luxury consumers have come to expect.

Unrivalled digital content

YNAP employs a highly skilled editorial team to produce premium digital content. Net-a-Porter offers a weekly online magazine (EDIT) and bi-monthly fully shoppable print and online magazine (Porter). Mr Porter has a daily fashion and lifestyle feed (the Daily), a weekly magazine (the Journal) and a

Global online luxury market progression



Sources: Baub & Altagamma, Kagiso Asset Management estimates

quarterly print newspaper (Mr Porter Post). This content is designed to inspire readers to 'shop everything you see'. For example, feature articles on celebrity style icons have click-through links on the clothing worn, enabling customers to 'shop the look'.

The purpose of this content is not to generate revenue on a stand-alone basis, but rather to direct traffic to the in-season sites and to build the brand image and reputation of Net-a-Porter and Mr Porter as leaders in style and personal luxury sales.

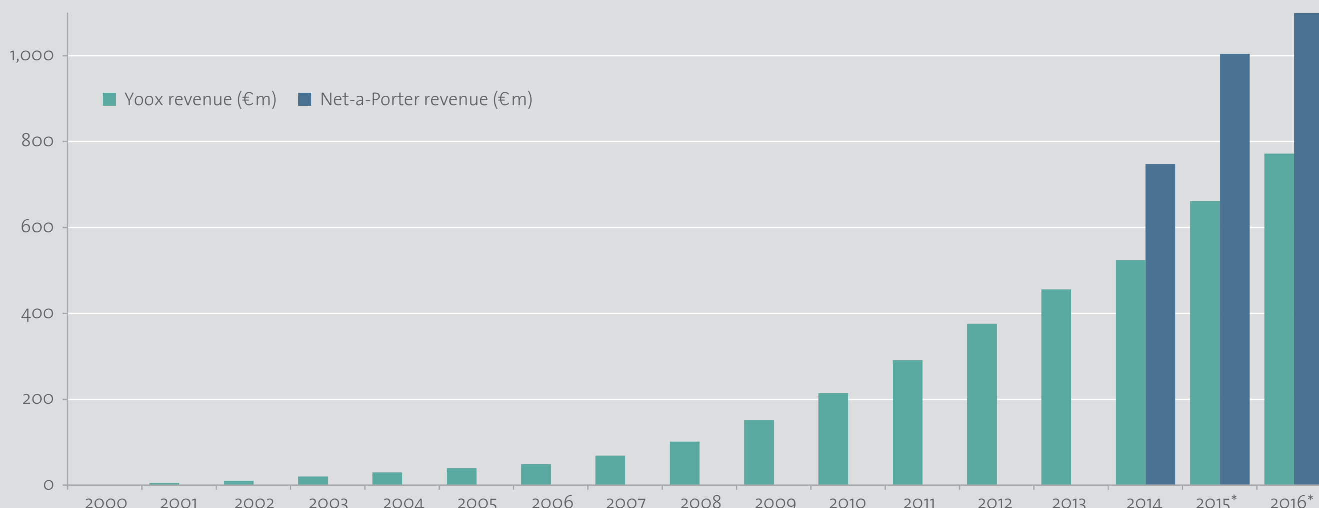
With the launch of its social media app in 2015, YNAP has gone further still in merging content and commerce. 'The Net Set' was created to build an online high-end fashion community. Like Twitter, users are able to tailor content on their news feed by choosing who they follow, what they love and which style tribes they join. Image recognition technology powers the 'Style Ideas' functionality on the app which allows users to find matching products based on colour, pattern and texture. Additional functionality is incorporated to make the app shoppable. For example, where a product has been tagged, the tag links directly to an interface that mirrors that of the Net-a-Porter shopping app.

A self-reinforcing platform

The net result of YNAP's efforts is the creation of a virtuous cycle of growth. Leading online luxury platforms provide a base upon which to build an unrivalled experience, driven by superior customer service and rich digital content. This experience generates more sales which in turn leads to more brands joining the platforms, thus strengthening the value of the platforms themselves.

The power of this virtuous cycle is demonstrated by the impressive growth in revenue to date (chart below), a trend that we believe will continue over at least the next decade. Our clients gain exposure to this growth through the inclusion of YNAP in our foreign equity holdings. UP

Impressive history of growth



*Note: *2015 and 2016 split according to Kagiso Asset Management estimates. Note 2: No disclosure for Net-a-Porter revenue prior to 2014.
Sources: company reports, Kagiso Asset Management estimates

Steinhoff: is bigger better?

Dirk van Vlaanderen - Associate Portfolio Manager

From its humble beginnings in the 1960s - when German founder, Bruno Steinhoff, began sourcing Eastern European furniture for import to Western Europe - Steinhoff International has grown into one of the world's largest furniture retailers.

The group has undergone significant change over its 40-year history and, in more recent years, has become a significant player in the European, North American and South African furniture and general merchandise markets. We consider the group, its history, changing strategy and the challenges we see in investing in an acquisition-led growth model.

Steinhoff: is bigger better?

Steinhoff evolved from a pure manufacturing company by acquiring several retail businesses in the late 2000s. By 2014, it was still predominantly a European furniture manufacturer and retailer with a small exposure to South Africa through local furniture retailer JD Group. Following several large acquisitions, the group today looks very different both in geographic spread and category exposure. In 2017, it will generate 38% of its revenue from European furniture retail, 17% from selling beds in the United States (Mattress Firm) and 29% from the sale of general merchandise (Pepkor and Poundland) in Europe and Africa (chart below).

Vertical integration is a competitive advantage

For its first 40 years, Steinhoff was focussed on establishing a global manufacturing, sourcing and distribution business - a vertically integrated supply chain across the group - which remains the backbone of the business. Today, the integrated supply chain division accounts for about 18% of group earnings before interest and tax, and provides a full suite of services to the Steinhoff Group as well as third parties. With very few vertically integrated retailers in Europe (other than retailing giant IKEA), this gives Steinhoff an advantage versus its retail peers.

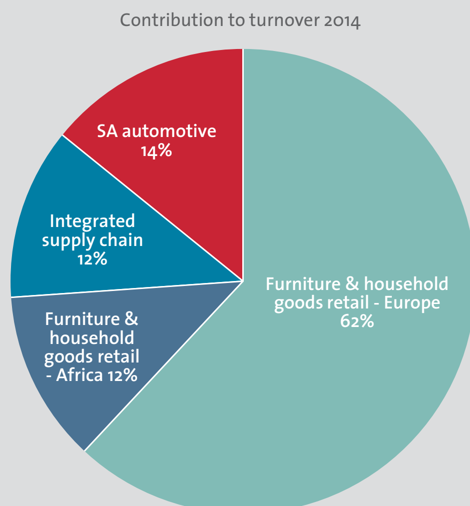
Details of the different divisions within Steinhoff's integrated supply chain are set out below:

- **Manufacturing:** Steinhoff owns and operates 21 furniture and household goods manufacturing facilities in Europe, the UK and Australia. The majority of these were established in low cost jurisdictions (mainly in Eastern Europe) allowing the group to manufacture at competitive prices.
- **Sourcing:** The group has eight sourcing offices in Eastern Europe and Asia and this division sources manufacturing inputs as well as finished goods at the best possible price by leveraging the group's buying power.
- **Logistics:** This division efficiently manages the movement of goods across the globe. Steinhoff operates 50 distribution centres in Europe and the UK.

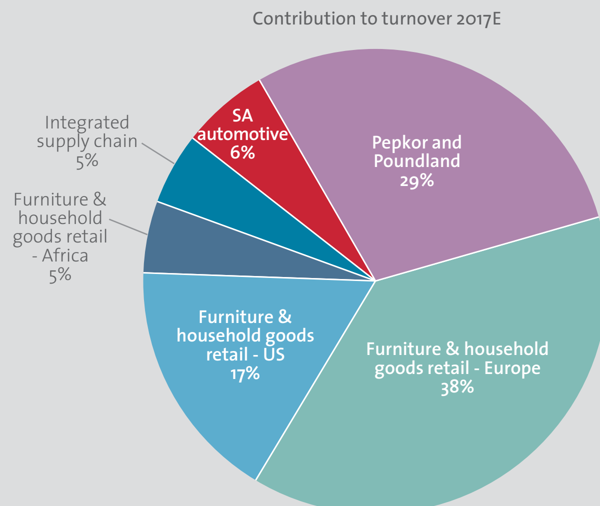
This vertical integration offers Steinhoff both flexibility and efficiency, enabling it to sell products at the lowest possible price. In the value retail segment, this is vital to remain competitive and retain profitability. Economies of scale from enhanced buying power and higher manufacturing throughput, along with a careful balance between own-manufacturing and externally sourced products, makes the company nimble in the face of changing input prices and volatile exchange rates.

Changing shape of Steinhoff

Contribution to turnover 2014



Contribution to turnover 2017E



Sources: company data, Credit Suisse estimates

Acquisition-led growth agenda

The chart below highlights the acquisitive nature of the Steinhoff business, showing the total cost of acquisitions as a percentage of the average annual market value since 2002. On a cumulative basis, we estimate that acquisitions have totalled around 400% of Steinhoff's average market value.

With its manufacturing base established, the deals since the late 2000s have been largely centred on expanding the retail footprint of the group with the first major acquisition in this space being European Retail Management (ERM) in 2008. This acquisition brought in the Poco and Lipo brands (focussed on the German market) and was followed by the 2011 acquisition of large furniture retailer, Conforama, in France. The 2014 Kika Leiner acquisition continued Steinhoff's strategy of consolidating the European furniture market - expanding the group into Austria and some Eastern European countries. Consolidating the fragmented European furniture market to gain scale and further leverage its already established platform has sound strategic rationale.

The acquisition of Pepkor in 2015 for R68 billion saw Steinhoff change strategic tack and enter the general merchandise category in South Africa and Eastern Europe. This was followed in 2016 with the acquisition of Mattress Firm in the US. Although this deal was in the familiar furniture category (bedding), it represented a shift from Steinhoff's stated focus on Europe.

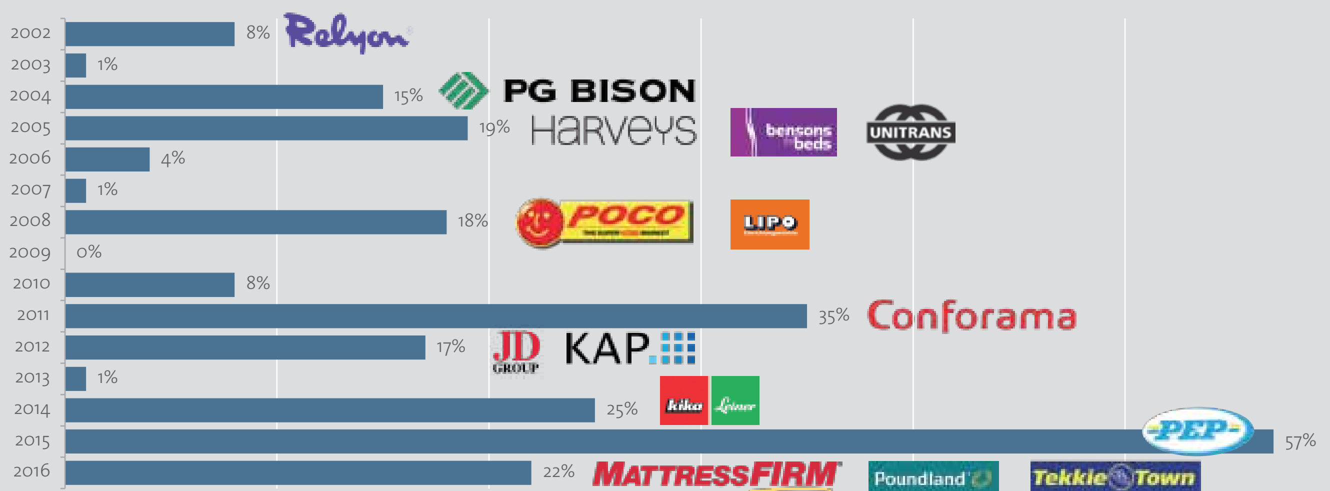
Improving cash flow, diminishing returns

Prior to its Pepkor acquisition, the group's free cash flow conversion (a measure of the proportion of net profit that is converted into actual cash flow after maintaining or expanding assets) averaged a lowly 30%. Pepkor's strong free cash flow generation was one of the attractions of the deal and has helped boost the group's overall free cash flow conversion (chart over page). 2016 deviated from this trend due to large, but temporary investment in working capital.

A more qualitative measure of a company's performance is Return on Capital Employed (ROCE) as this looks at the returns the company is earning on capital invested in the business. It is possible to grow the numerator (ie operating profit after tax) via acquisition or expansion, but this ratio looks at the capital cost of this growth. It is this measure that highlights the challenge of an acquisition-led strategy and the challenge of creating shareholder value versus simply 'getting bigger'.

In Steinhoff's case, the chart highlights that ROCE has nearly halved since 2005, from around 14% to 8% currently. The chart masks acceptable returns on historical deals as they are

Acquisitions as a percentage of average annual market value*



*Steinhoff's aggregate acquisition spend per year divided by the average market value of the company in the same year.
Sources: company data, Credit Suisse research, Thomson Reuters, Kagiso Asset Management research

Steinhoff: is bigger better?

bedded down over subsequent years, but we see no improvement in ROCE at a group level as larger and expensive (thus more ROCE-dilutive) deals have followed in quick succession.

Valuation challenges

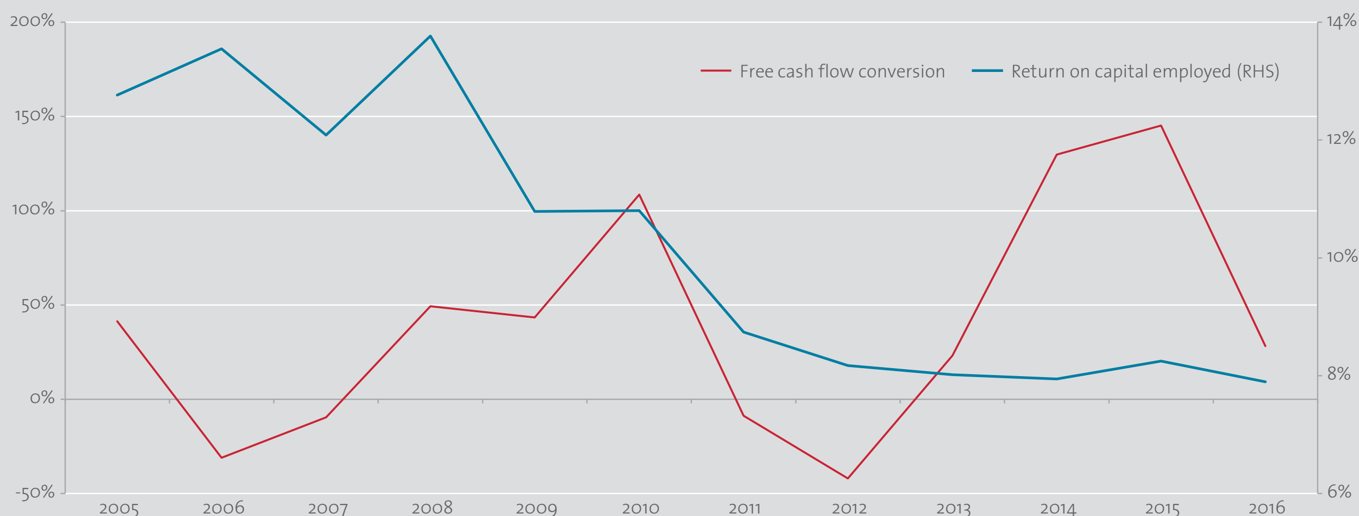
Consumer-facing companies with reasonably stable end-demand drivers - such as retailers and food producers - are typically relatively more straightforward to value with a degree of confidence. The margin for error is inherently lower than it is when valuing a very cyclical industry, such as mining. Steinhoff, however, has its own nuances which we believe make it difficult to value with confidence.

- **M&A-led growth strategy:** Our first concern relates to an acquisition-led strategy in general. Such a strategy has its own set of risks, including overpaying for assets (the seller always knows more), execution risk and, lastly, the need to always do larger deals to meaningfully impact growth. It is impossible for us to credit the company by putting a value on deals that have not yet happened. We believe current ROCE trends at Steinhoff do not instil a high degree of confidence that returns on acquisitions will necessarily improve in the medium term.
- **Changing shape of the group:** Steinhoff has made some significant category and geographic portfolio choices since deciding to pursue a retail agenda in the mid-2000s. These include a move into general merchandise through the acquisition of Pepkor, entering the US through Mattress Firm and the recent suggestion of a tie-up with Shoprite, which would have seen the group become a meaningful player in food retailing. In 2014, the company rhetoric was a focus on consolidating the European furniture market, but this has changed considerably in just three years. These may all turn out to be astute strategic moves, but we simply don't have high conviction over the ultimate direction of the group five to 10 years from now.
- **Other factors to consider include:** The regularly changing disclosure and segmental restatements as a result of acquisitions, which makes consistent analysis difficult, as well as a corporate tax rate of 15% that appears unsustainably low.

Difficult to rest easy

Steinhoff's aggressive growth strategy has seen it gain a lot of interest and exposure on the international retailing stage. While the strategy may prove to be a winning one in the long term, falling returns keep us wary on the acquisition-led growth story and where the dust will finally settle on the group's ultimate shape and exposure. As such, we do not hold a meaningful position in Steinhoff shares within our funds.

Steinhoff's free cash flow and return on capital employed



Sources: company reports data, Kagiso Asset Management estimates

Equites: boxing smart

Rahgib Davids - Associate Analyst

"Equites Property Fund is the only industrial-focussed real estate investment trust (REIT) listed on the JSE Securities Exchange. The company provides high quality, modern logistics facilities and distribution warehousing to national and international clients. It has assets in prime locations in Cape Town and Gauteng, and, more recently, in the Midlands region of the UK."

Equites: boxing smart

Since listing in 2014, Equites has provided a total shareholder return (including dividends) of 74%, outperforming the South African Listed Property Index which provided 34% over the same period. Its clients - both retailers and logistics companies - include Puma SA and The Foschini Group in South Africa, and Amazon and Tesco in the UK. With a property portfolio worth just under R6 billion, its growth and performance has been impressive. We believe the company is well positioned to continue to benefit from its focussed strategy and the opportunity presented by industry dynamics that are driving demand for distribution logistics in the retail sector.

The rise of the 'big box' warehouse

In recent years, South African food and clothing retailers have made significant investments to improve their supply chain management by implementing centralised distribution systems. Where previously suppliers delivered directly to individual stores, they now deliver to a retailer's central warehouse facility from where the retailer delivers optimised loads to its network of stores.

This system significantly simplifies the distribution process (diagram opposite), with multiple benefits for the retailer:

- cost savings from optimised and significantly reduced number of deliveries to each store;
- reduced working capital holding from better stock management control;
- more expensive storage space at individual stores can be reduced, or trading area increased; and
- improved stock availability increases customer satisfaction.

Unscrambling supply

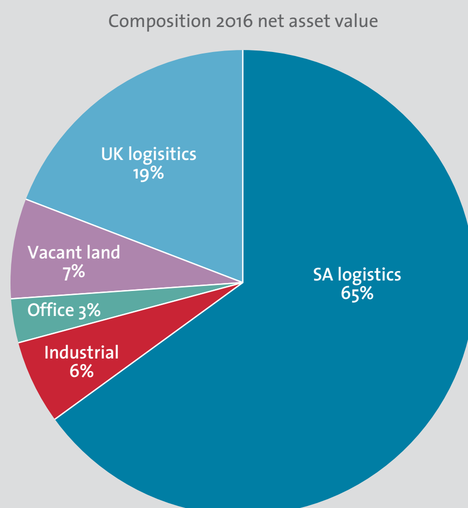
This shift presents a significant opportunity for Equites given its strategic focus on providing the warehousing facilities required for this growing logistics need.

Equites entered the UK market in 2016, where the rapid growth of online retail is quickly growing demand for large modern logistics facilities. Industry leaders, such as Amazon, are leading with low-cost or even free same-day and overnight deliveries, and many online retailers and logistics providers are rethinking their supply chain strategy to attempt to keep up.

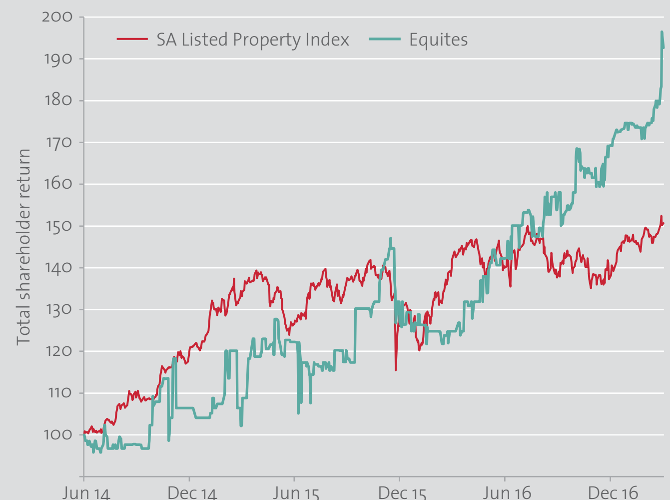
Demand for urban warehousing close to customers is high. However, with urban densification placing significant pressure on land use, previously industrial-zoned land is increasingly being rezoned for residential or office use. As a result, demand for warehousing in these areas significantly exceeds supply and many tenants have to take warehouse space outside of the central metropolitan areas.

To compensate for additional delivery times and to maximise efficiency, tenants often fit these warehouses with sophisticated automation systems to improve speed and accuracy in the

Equites' portfolio composition



Strong shareholder returns



Sources: company reports, Kagiso Asset Management estimates

stock retrieval, sorting and packing processes (diagram over page). Significant economies of scale are required to make these systems cost effective, driving demand for 'big box' warehouses built on massive scale - anywhere from 10 000m² to 40 000m² - and often with multiple stories for different functions.

Prime logistics offers attractive yield

In the current global low interest rate environment, the yield spread (the gap between the annual income yield on a property and the yield on long dated government bonds) offered by prime logistics properties is attractive relative to the spreads in the SA and UK retail and office sectors. This means that the sector's asset prices should fare better if there is a general increase in interest rates. The yield gap also means that the sector will attract additional development capital, ultimately increasing supply. However, specialist developmental skills needed in this sector and the sourcing of scarce, well-located sites by early players will make this a gradual shift.

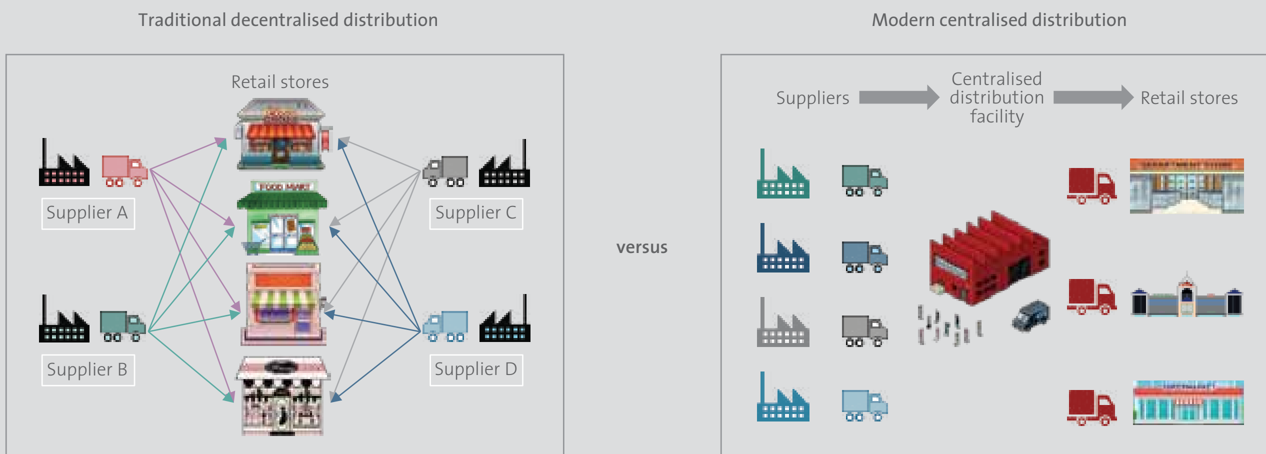
Equites' strategy

Equites' ability to offer clients bespoke logistics property solutions is a key advantage in the SA market. While many local competitors are largely developing generic warehouses, Equites designs and develops a big box warehouse tailored to a client's specific functionality requirements. Ten-year leases are signed by tenants for new specific developments, whereas five-year leases are typical for generic developments. Recent examples of completed specific developments include the new Foschini Group distribution centre in Gauteng, and the new Puma facility in Cape Town which consists of a head office, distribution centre and fashion showroom.

It is the tenant's responsibility to equip the warehouse upon occupation, and to restore it to the original condition once vacated. Most tenants require such bespoke solutions and invest significantly to equip warehouses for specific functionality, making tenant retention particularly sticky. Building a strong partnership with clients also means a strong pipeline of future developments because large industrial customers build warehousing capacity in a modular fashion, often securing adjacent land in advance of future requirements.

Equites controls approximately 36 hectares of strategically selected vacant land in prime logistics hubs in Cape Town and Gauteng. The company is able to develop new assets quickly and efficiently using the 'tilt-up' construction method which uses prefabricated steel reinforced concrete panels instead of brick. Although steel is more expensive than brick, it is significantly stronger, requires less maintenance and looks better. The method is also less labour intensive and the use of prefabricated concrete slabs significantly decreases construction time.

Optimising distribution



Source: Kagiso Asset Management research

Equites: boxing smart

The Equites portfolio asset mix is shown in the pie chart on the previous spread. Its assets range from between 10 000 m² and 40 000 m² in size. Equites' portfolio fundamentals are very strong with overall vacancies at 0% and weighted average lease term of approximately six years. A key advantage of managing industrial tenants is that typically there is only one tenant per property, whereas retail and office properties have many tenants. Industrial tenants generally sign triple net lease agreements, making tenants responsible for paying all property related costs such as rates, water and electricity in addition to their monthly rental payments.

Value adding deals

Since inception, Equites has completed two transformative deals contributing significantly to its growth prospects. The first deal was its 2015 merger with local logistics development company, Intaprop. Equites effectively acquired a R1.9 billion industrial portfolio and 21 hectares of prime industrial zoned land in the Western Cape and Gauteng.

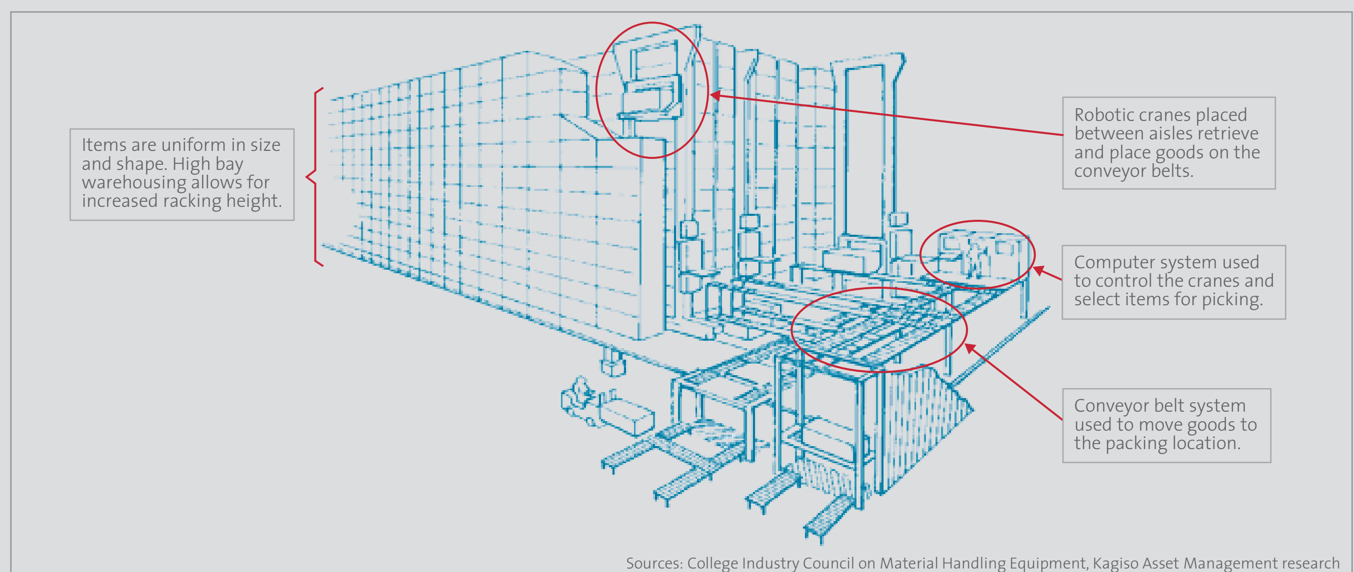
The second major deal enabled the group's UK expansion when Equites acquired three prime logistics properties located in the Midlands. Also known as the 'Golden Triangle', the area is the logistics and transport hub of the UK - home to more than 1 500 logistics businesses. The location is a short drive from all major ports and less than one hour from London by rail. Critically, it is less than four hours' drive from 90% of the UK population. According to UK law, this is the maximum allowable drive time for goods and passenger vehicles without requirement for a break.

The UK is one of the world's leading markets for online retailing and therefore has an advanced distribution warehousing sector. The imbalance between demand and supply of prime logistics property and land are key dynamics behind strong capital and rental growth prospects. The assets acquired by Equites are occupied by blue chip tenants, which include Tesco, Amazon and DSV (international logistics provider). Lease terms are all 10-year triple net leases, with a five-year rent review cycle, providing significant rental upside potential.

Strong prospects

Equites' balance sheet is strong, with low levels of financial leverage providing ample flexibility to act on new opportunities. Management own 30% of the company and bought their shares on the initial capital raise on the same terms as public investors. We believe management are strong and well aligned, with the ability to make accretive deals that increase shareholder value. This is evidenced by strong dividevnd growth and share price performance relative to the sector. Equites provides a compelling story and currently trades at a 7% dividend yield with exciting prospects for dividend growth at low risk. We expect it to continue to add considerable value to our clients going forward. UP

Automatic storage and retrieval system



Sources: College Industry Council on Material Handling Equipment, Kagiso Asset Management research

Kagiso Asset Management Funds

Performance to 31 March 2017	1 year	3 years[1]	5 years[1]	10 years[1]	Since launch[1]	Launch	TER[2]	TC[3]
Unit trust funds[4]								
Equity Alpha Fund	10.9%	4.7%	10.4%	10.2%	18.0%	Apr-04	1.51%	0.46%
SA Equity General funds mean	1.1%	4.3%	9.9%	8.0%	14.3%			
Outperformance	9.8%	0.4%	0.5%	2.2%	3.7%			
Balanced Fund	10.3%	6.1%	9.7%	-	9.8%	May-11	1.54%	0.50%
SA Multi Asset High Equity funds mean	2.2%	6.2%	10.0%		9.7%			
Outperformance	8.1%	-0.1%	-0.3%		0.1%			
Protector Fund	13.4%	6.7%	8.1%	7.1%	10.3%	Dec-02	1.63%	0.35%
CPI + 5%[5]	11.2%	10.5%	10.7%	11.4%	10.8%			
Outperformance	2.2%	-3.8%	-2.6%	-4.3%	-0.5%			
Stable Fund	12.6%	7.9%	8.7%	-	8.8%	May-11	1.55%	0.56%
Return on large deposits*	6.4%	5.9%	5.6%		5.5%			
Outperformance	6.2%	2.0%	3.1%		3.3%			
Institutional funds[6]								
Managed Equity Fund	8.9%	3.2%	10.1%	10.1%	12.4%	Sep-06		
FTSE/JSE SWIX All Share Index	1.6%	7.1%	13.3%	10.6%	12.8%			
Outperformance	7.3%	-3.9%	-3.2%	-0.5%	-0.4%			
Core Equity Fund	3.9%	3.1%	11.1%	10.0%	16.3%	Nov-04		
FTSE/JSE SWIX All Share Index	1.6%	7.1%	13.3%	10.6%	16.6%			
Outperformance	2.3%	-4.0%	-2.2%	-0.6%	-0.3%			
Domestic Balanced Fund[7]	10.9%	4.0%	8.0%	-	8.7%	May-07		
Peer median[8]	6.9%	6.8%	10.9%		10.0%			
Outperformance	4.0%	-2.8%	-2.9%		-1.3%			
Global Balanced Fund[9]	11.0%	6.9%	-	-	10.3%	Jul-13		
Peer median[10]	4.5%	7.7%			10.8%			
Outperformance	6.5%	-0.8%			-0.5%			
Sharia unit trust funds[4]								
Islamic Equity Fund	14.4%	5.1%	9.7%	-	12.5%	Jul-09	1.51%	0.46%
SA Equity General funds mean	1.1%	4.3%	9.9%		12.7%			
Outperformance	13.3%	0.8%	-0.2%		-0.2%			
Islamic Balanced Fund	8.5%	4.7%	8.6%	-	7.3%	May-11	1.48%	0.14%
SA Multi Asset High Equity funds mean	2.2%	6.2%	10.0%		9.7%			
Outperformance	6.3%	-1.5%	-1.4%		-2.4%			

Highest and lowest monthly fund performance	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest	Highest	Lowest
Equity Alpha Fund	4.8%	-4.1%	8.2%	-4.7%	8.2%	-4.7%	10.9%	-9.0%	11.9%	-9.0%
Balanced Fund	3.1%	-3.5%	5.5%	-4.2%	6.2%	-4.2%	-	-	6.2%	-4.2%
Protector Fund	2.6%	-2.4%	3.4%	-4.2%	4.8%	-4.2%	7.9%	-5.3%	9.5%	-5.3%
Stable Fund	2.5%	-0.8%	3.8%	-3.5%	4.0%	-3.5%	-	-	4.0%	-3.5%
Islamic Equity Fund	3.9%	-3.2%	7.3%	-4.6%	8.1%	-4.9%	-	-	8.1%	-4.9%
Islamic Balanced Fund	2.4%	-2.5%	4.6%	-3.0%	8.2%	-5.4%	-	-	8.2%	-5.4%

[1] Annualised (ie the average annual return over the given time period); [2] TER (total expense ratio) = % of average NAV of portfolio incurred as charges, levies and fees in the management of the portfolio for the rolling three-year period to 31 March 2017; [3] Transaction costs (TC) are unavoidable costs incurred in administering the financial products offered by Kagiso Collective Investments and impact financial product returns. It should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of financial product, the investment decisions of the investment manager and the TER. This is also calculated on the rolling three-year period to 31 March 2017; [4] Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [5] CPI for March is an estimate; [6] Source: Kagiso Asset Management; gross of management fees; [7] Median return of Alexander Forbes SA Manager Watch: BIV Survey; [8] Median return of Alexander Forbes Global Large Manager Watch. *Return on deposits of R5 million plus 2% (on an after-tax basis at an assumed 25% tax rate).

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