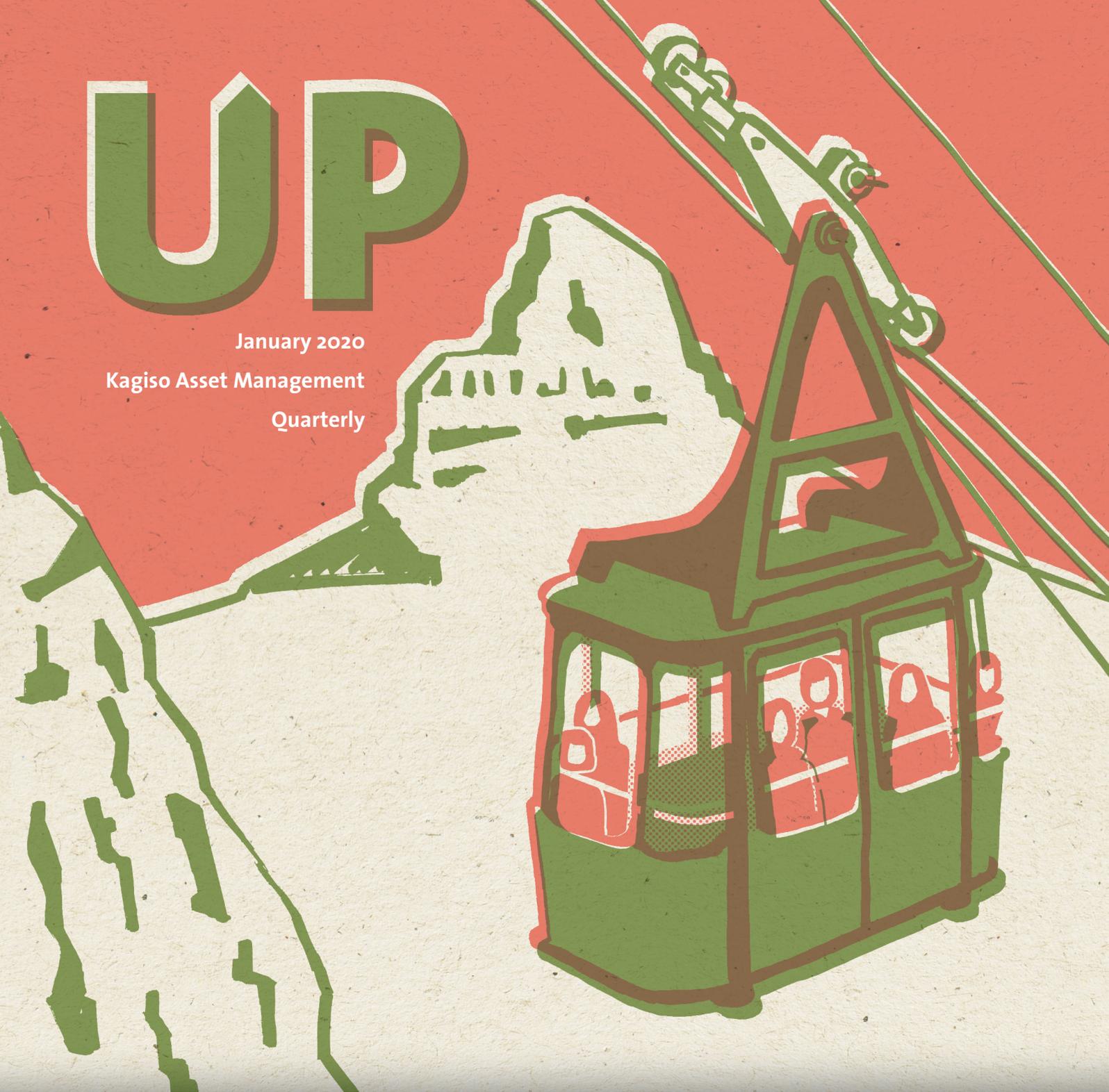


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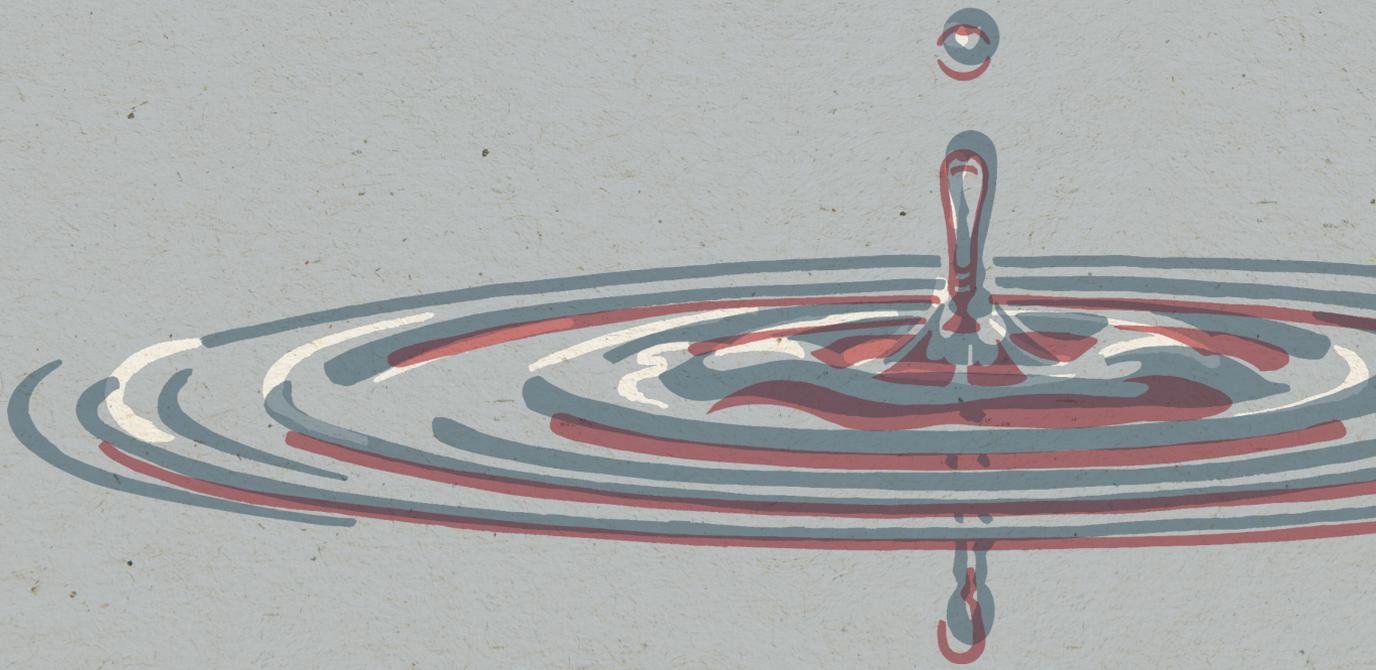
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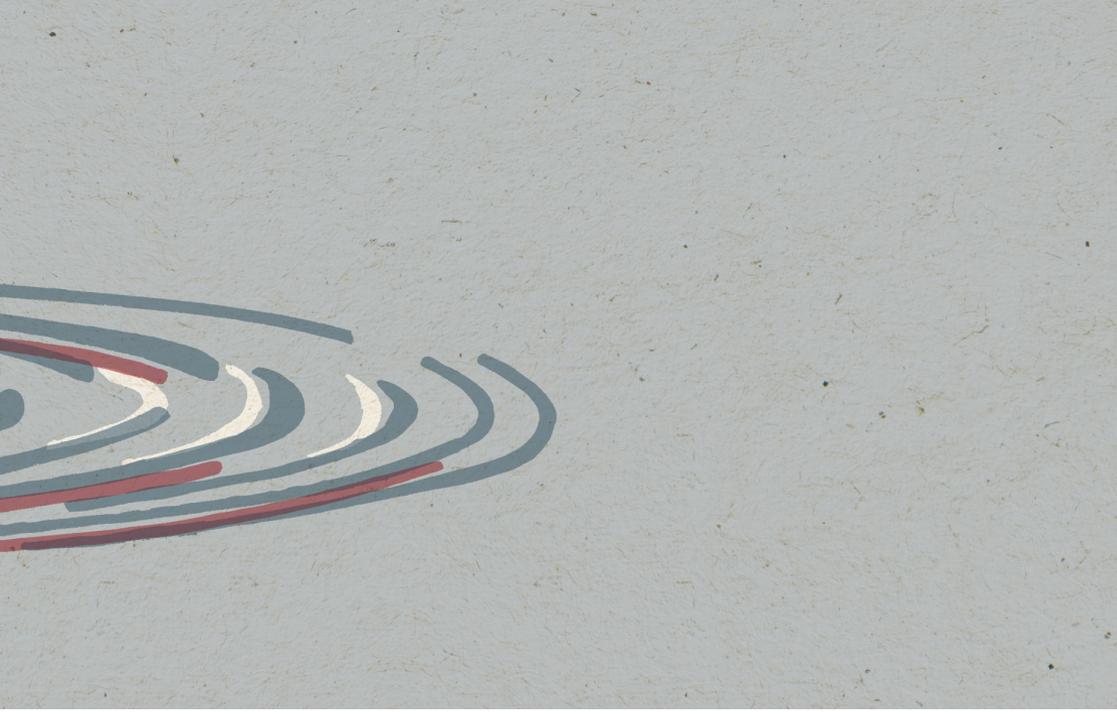


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Curro - class of 2030

Simon Anderssen - Portfolio Manager

“Every parent wants a better future for their child and most are willing to make sacrifices to achieve this, but the reality in South Africa is that very few can afford to do so. With our consistently poor scoring in global benchmarking studies, it is no secret that the South African government school system is largely in tatters.”

Curro - class of 2030

Curro is currently South Africa's largest independent schooling operator offering a range of options for parents seeking feasible alternatives to public schooling. We discuss why we are positive about Curro's prospects and believe its share is deeply undervalued.

Ready, aim, fire!

Curro is an entrepreneurial success story that began when a group of schoolteachers started offering classes in a local church hall. They went on to scrape together enough funding (including their personal life savings) to build the first Curro school campus in Durbanville, in the northern suburbs of Cape Town. Believing that they were onto a good thing, they secured a long-term capital partner in PSG, the Stellenbosch investment company.

Curro listed on the JSE in 2011, with a fantastical vision of building 80 schools for 80 000 students by 2020. Six rights issues later, raising R4.6 billion in new equity capital, Curro begins this decade with 76 schools and 63 000 learners.

Low-fee opportunity

Curro offers a range of schools to meet different income levels. The original business model was centred around a school for mid-to-upper income families, with average fees of R4 500 per month. Today, there are 38 500 students attending this type of school, compared to 10 000 learners in 2011.

More recently, increased learner numbers has largely come from a lower-fee model called Curro Academy. Fees at these schools range between R1 900 to R2 900 per month. The lower fees are achieved by having slightly larger classes, fewer academic options in higher grades and less ancillary facilities.

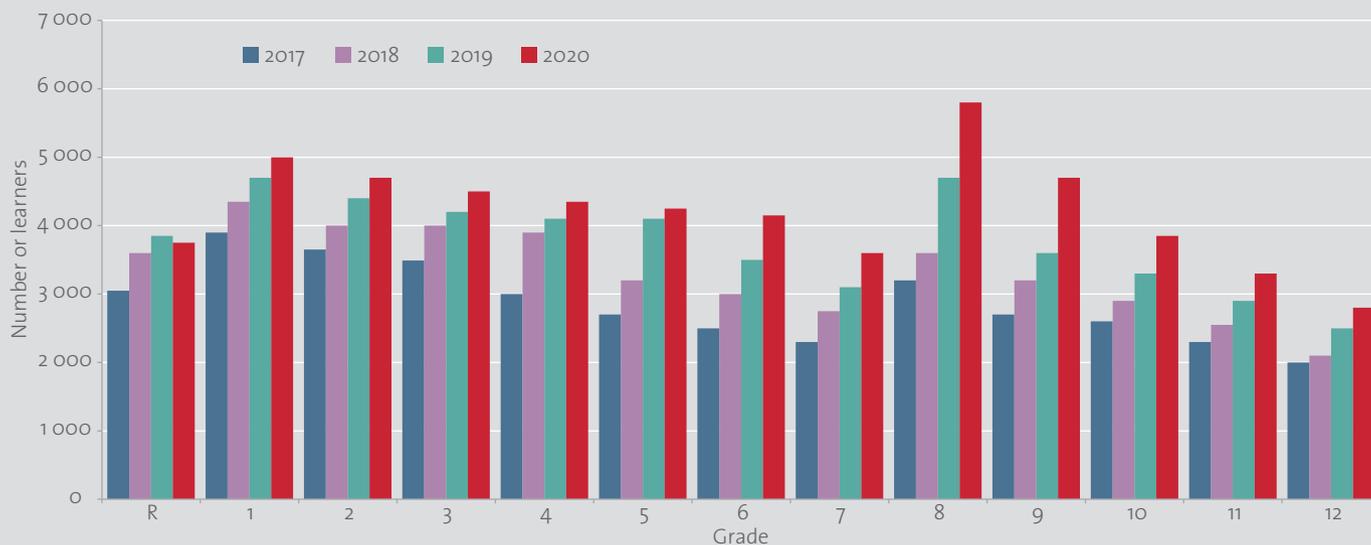
The collective matric pass rate at the Curro Academies is high, at 92.4% in 2019, compared to the national average of 81.3%. The success of this model is opening up a large new market of growth for Curro and there are now 13 of these Academies across the country.

The business of schools

Owning a school is capital intensive and a considerable amount of money is invested before there are any learners sitting behind desks. Thereafter, it costs the same to run a classroom with one child in it, as it does with 20.

The Curro school business model is planned around a "J-curve", which shows the progression of schools through time. The business approximately covers its costs, including teachers and overheads, once it has 20 learners per class - regarded to be the breakeven point. Learner number 21 begins to generate a surplus to pay the capital providers, lenders and shareholders. Ideally, classes will reach 30 learners. If a school is able, it may add another class to that grade, however, it is then back in the

Learner numbers per grade



Source: Curro

position where it has two unprofitable classes of just 15 learners until it can attract another 10 learners to the grade, and so on.

As the school grows, more capital is spent on employing additional teachers, improving technology, or upgrading facilities. It is regarded reasonable to fund schools with a sizeable amount of debt to reduce the overall cost of funding. In recent years, Curro has relied more on debt than shareholder equity to fund its growth, which has led to higher interest payments that have been a drag on profit growth. Nevertheless, Curro initiated a dividend in 2018 - an indication of its maturing business model.

A slippery slope

We would be naive to suggest that private schooling is not a discretionary household expenditure item - many South African families do not even have the means to keep their children in a government school. After years with little to no household income growth, mounting job losses, run-away electricity tariffs and municipal rates, and uncertainty about the future, households are particularly stretched.

Evidently, at the margin, this is not a positive environment for Curro's revenues and any declines are magnified in profit declines as fixed costs must still be covered. In order for Curro

to grow the number of learners at a school, it must first replace the child whose family has chosen to emigrate or drop out. This is made all the more difficult if the departing learner was in grade 10, which is not a common entry point for learners into a new school. Or, in the case of a family experiencing financial difficulties and if the learner is a good student, it may be prudent to offer the family a discount on fees as the incremental cost of a learner is low. Any additional fee revenue is positive, providing other families continue paying their fees in full.

Programmed growth

The weak economy has resulted in a slower than expected growth rate in learner numbers at Curro schools. We believe these factors may continue to dampen growth, but there are clear indications that a reasonable level of increased learner numbers is somewhat assured over the next few years.

Learner numbers at key entry grades, one and eight, paint an encouraging future picture. The chart on the previous page shows that learner numbers in these grades are higher than subsequent grades. Grade eight enrolments, in particular, have increased significantly. If this trend continues and Curro can retain the majority of its students in these grades, the knock-on effect continues as successive years retain larger classes.

Learner numbers and profitability increase over time



Source: Curro and Kagiso Asset Management research

Curro - class of 2030

Historical performance provides a clear indication that profitability improves as average class sizes increase. The chart on the previous page indicates that the average number of learners increases predictably as the school ages. Profitability consistently improves as the school grows.

Opportunity in a downward spiral

Because of the weak environment, now is a good time to buy schools. An organisation the size of Curro, with committed shareholders, access to capital and a valuable school management platform, is relatively well placed to weather the effects of weaker income growth and a stagnant economy.

However, this differs for 'solo' schools in the current environment, where single campus schools are not able to pool resources or streamline costs across campuses. Furthermore, management structures migrate with the cohorts of learners through the school, as parents invest in the school when their children are in attendance, but typically stop when their children leave the school. Consequently, there is seldom a long-term orientation in solo schools. In addition, if schools run into financial difficulty, this may result in the quality of education slipping, which in turn makes parents anxious. Students then leave, and the school finds itself in a negative spiral.

Curro has found an opportunity here, acquiring a number of established schools for less than what it would cost to build a new school and carry it to a break-even point. Curro then invests in facilities and staff, causing school confidence to improve and learners to remain and even return - all indications that are supportive of healthy returns on investment.

A digital future for schools

Falling prices for devices such as iPads and laptops are supporting a global trend towards digitally-enabled learning. This ranges from distance schooling for all grades, to digitally-enabled classrooms. The spectrum of impact that the internet and digital content is having on schools, is vast. There are many models across the world that are being trialed and, while we don't know what will work best for South Africa, it is clear that the classroom of the future is very likely to look quite different to today.

Curro's financial scale and breadth of operations are a strength when it comes to innovation. Launched in 2019, its DigiEd model provides learning through online tools and videos at lower cost than its traditional schools. It builds on content from its best teachers and subject matter experts across its schools. The DigiEd model is specifically designed to be an on-site learning model that maintains the social development of learners. Longer operating hours also ensure that children are safe and kept busy on campus during office hours for working parents. The model has been very successful to date and three new campuses will launch in 2020 with strong enrolments.

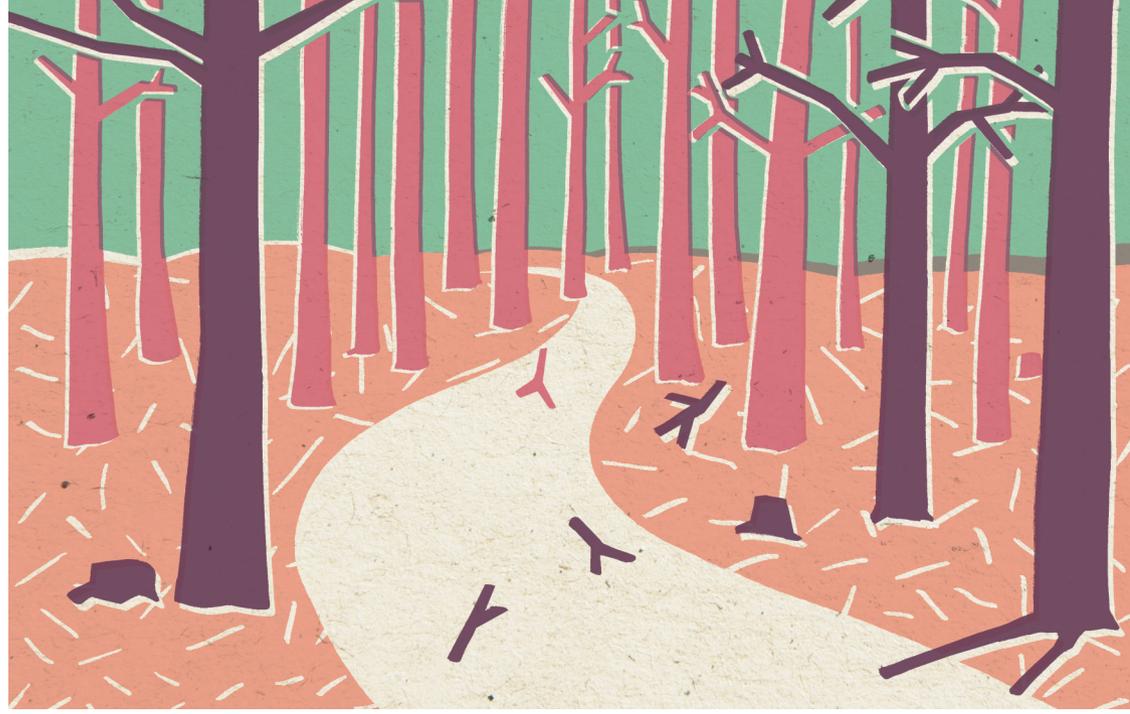
Patience will be rewarded

Curro's overall shareholder returns are not particularly impressive at present. Investing in a host of new schools, including buying seven in the last year, has caused debt to increase faster than its operating profit. This has left investors negative, with the share price at a multi-year low.

To mitigate concerns, management have scaled back on investment plans, choosing to expand only into existing schools to accommodate the learner growth that is already 'programmed'. It will also invest in recently acquired schools, spending money where learner growth is practically assured or where assets have been acquired inexpensively.

Given how schools are designed, it is no surprise that the current returns are low. Viewed as if it were one large school, Curro is currently operating at 70% capacity, which for a class of 30 learners, is 21 pupils. With the average age of a Curro developed school being 6.5 years, in school parlance this means that Curro is still in primary school. Therefore, it is simply too early to expect returns to be peaking.

Unless a better operator of independent schools steps into the picture (unlikely in our view) or learners are lost to emigration or unaffordability, today's grade one Curro learner will be approaching matric in a decade's time. Consequently, Curro classes will be fuller, its economics will be significantly better and shareholders with a long-term orientation will be richly rewarded for taking advantage of today's depressed share price. **UP**



Sappi skids from magazines to clothing

Abdul Davids - Portfolio Manager

Originally a South African forestry and paper milling company, Sappi is today a global leader in sustainable woodfibre products and solutions. Their acquisition-led global growth strategy, however, provides a sobering view of how a company can misread its market, destroying substantial shareholder value in the process. Sappi's South African business is therefore still their biggest profit generator and a renewed source of growth. We outline their journey.

Sappi skids from magazines to clothing

From humble beginnings to an acquisition frenzy

Founded in South Africa in 1936, Sappi started producing pulp and paper at a single mill in Springs, Gauteng. Over the following decades, Sappi invested in, and acquired, numerous mills and farms around South Africa. They currently own and lease plantations in KwaZulu Natal, Mpumalanga and Swaziland - spanning 379 000 hectares.

In 1988 Sappi acquired Saiccor, which then was the world's largest producer of dissolving wood pulp (DWP). This is a purified cellulose pulp made from the cell walls of green plants (mainly from eucalyptus trees). It is suitable for further chemical processing into a range of products and is either spun into textile fibres, processed into a film or regenerated into a sponge-like material.

Between 1990 and 1997 Sappi expanded their international footprint, spending close to \$3 billion on acquisitions outside of South Africa:

- 1990 - acquired five fine paper mills in the UK
- 1991 - acquired Germany's largest coated fine paper producer (making Sappi one of the top European producers of coated fine paper used in magazines and brochures)
- 1997 - Sappi shares listed in London, Frankfurt and Paris
- 1994 to 1997 - acquisitions mainly in North America resulted in Sappi becoming the world's largest producer of coated fine paper

- 1998 - Sappi lists on the New York Stock Exchange
- 2000 - acquired Potlach mill in the US for \$480 million
- 2006 - acquired M-Real mill in Europe for 750 million euros
- 2010 to current - acquired mills in Switzerland and Canada

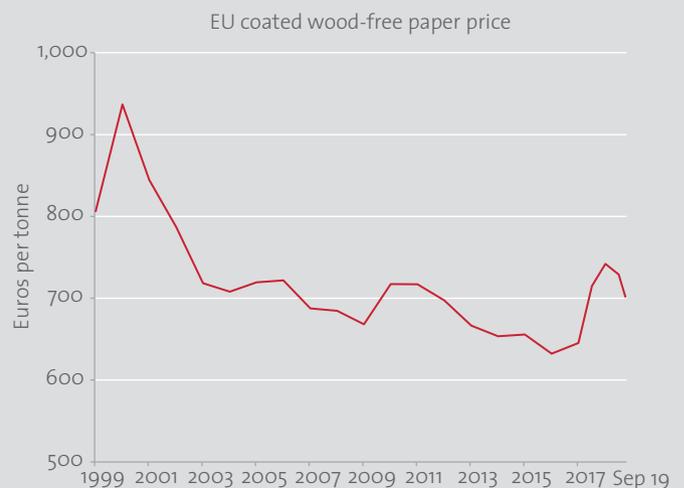
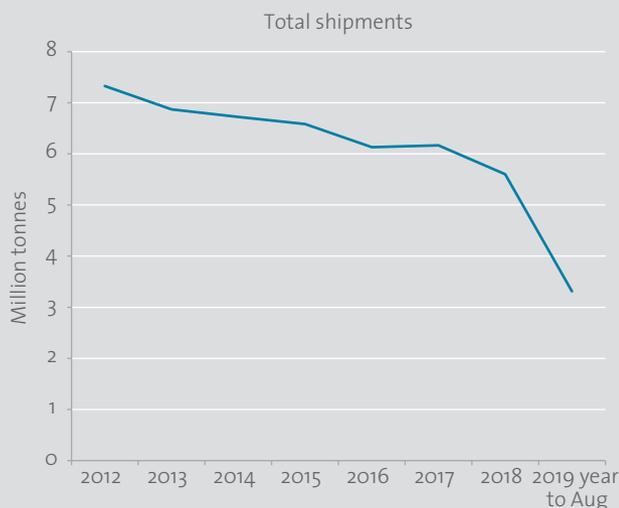
Sappi's current market value of only \$1.5 billion is evidence that most of these acquisitions were ill-considered, leaving the legacy of a debt-laden balance sheet and a significant consequent interest burden.

Sappi's folly

Sappi's glossy paper business accounts for half of its annual sales, but only around 10% of its profits due to the weak state of this business. Their acquisition spree in the glossy paper department failed to identify the looming threat of technological advancements, including the advent of smartphones and tablets, which accelerated the decline in magazine and newspaper sales. The inevitable drop in coated fine paper demand, coupled with the fixed supply of glossy paper mills (overhead costs still need to be covered even if mills are running at a loss) resulted in an oversupplied market and lower prices for glossy paper (charted below).

Paper prices have declined from just above 900 euros per tonne in 2000 to below 630 euros in 2017. Although prices for coated paper recovered briefly in 2018/2019, following significant

Multi-year decline in coated wood-free paper demand and prices



closures of paper capacity by European competitors, the price trend resumed its decline in June 2019.

In response to the rapidly declining market, Sappi's current CEO, Steve Binnie, embarked on a strategy to reduce unprofitable glossy paper capacity by diverting production to higher value, niche paper grades and converting certain paper mills to produce DWP (in South Africa and North America).

While Sappi has lost its leadership position in the glossy paper market, these mill conversions have restored profitability to the overall group and expanded its capacity in the faster-growing DWP market.

Clothing the world with DWP

Roughly 70% of DWP is used in the production of viscose staple fibre (VSF) for the manufacturing of textiles. The other 30% is higher quality dissolving pulp that is used in the production of acetate and ethers, which are in turn used in speciality applications. Viscose (made up of cellulosic fibres) competes for market share alongside other textiles, such as cotton and polyester. Compared to these, viscose scores well on all qualitative fronts, except for 'wash and wear' as it tends to be weaker. This makes for a good blending textile, ideal for the manufacture of apparel such as denims and sportswear.

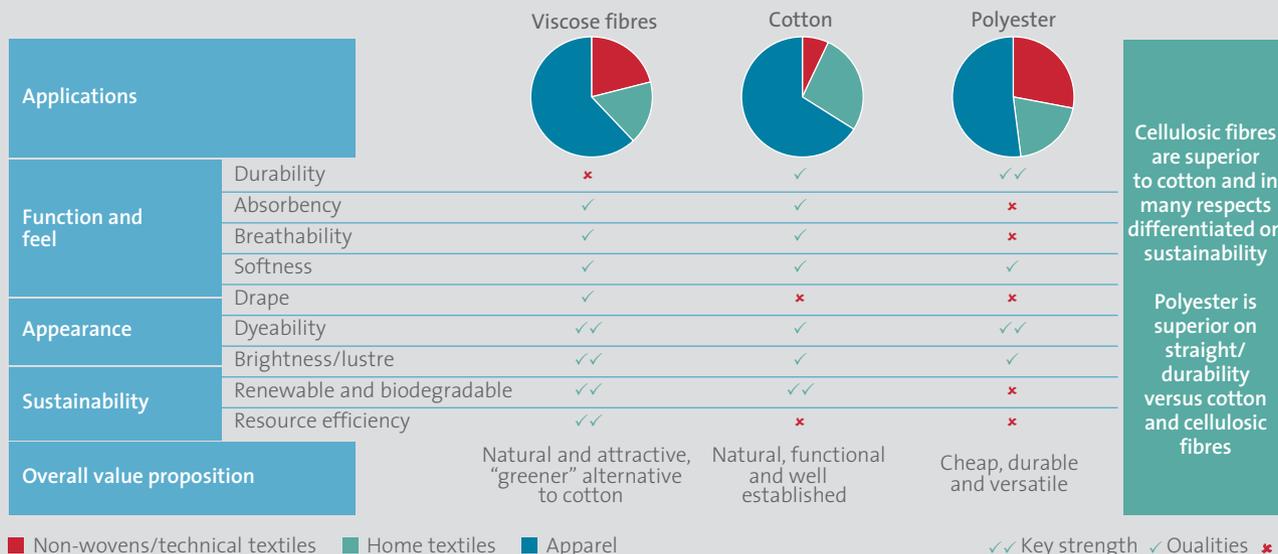
The chart below highlights the superior fibre properties of DWP in viscose compared with cotton and polyester, indicating why the viscose share of the total fibre market is expected to grow at a faster rate than polyester and cotton. Currently, viscose fibres only account for 6% of the total textile market (90 million tonnes per annum) in comparison to 63% for polyester and 25% for cotton.

Sappi has not only become the single largest producer of DWP but also one of the lowest cost producers, with production facilities in North America and South Africa. While their DWP business contributes only 20% to their sales, this amounts to 60% of profits due to the higher profitability of DWP compared to paper. Expansions at Sappi's production facilities at Saiccor, coupled with mill conversions at the Ngodwana mill in South Africa and the Cloquet mill in the US, have resulted in their DWP production capacity increasing from around 300 thousand tonnes in the early 1990s, to 1.4 million tonnes at present (charts on following page).

Supply, demand and sustainability cycles

Wood production has a clear cost advantage in South Africa and Brazil, which structurally benefit from fast tree maturity timelines because of temperate growing conditions. This results in a lower harvesting radius, and consequently,

Cellulosic fibre properties are superior to cotton and polyester for many textile applications



Source: IHS Global, RISI, Hawkins Wright

Sappi skids from magazines to clothing

lower logistical costs for wood. Additionally, labour costs in South Africa and Brazil are substantially lower than in Western Europe and the US.

Dissolving pulp demand is a function of global viscose production capacity and the supply of the alternative fibres. The viscose market was stimulated in 2011 when cotton prices spiked due to cotton supply shortages. This increased the demand for viscose and dissolving pulp, resulting in a huge increase in installed dissolving pulp capacity (dissolving pulp demand was at two million tonnes in 2006 and almost five million tonnes in 2016).

China has continued to dominate global viscose demand, constituting 32% of demand in 2006 and 55% by 2016. In 2017, this was negatively impacted by environmental restrictions imposed in China due to poor environmental practices by viscose producers in the country. Furthermore, Chinese authorities added polyester to their list of 'over-capacitated' industries, which has resulted in the idling of a substantial percentage of global viscose capacity over the last three years.

Constraints on supply, changing consumer patterns and improvements in the qualitative characteristics of polyester has caused cotton to lose market share to polyester and viscose. Cotton supply is expected to continue to decline over

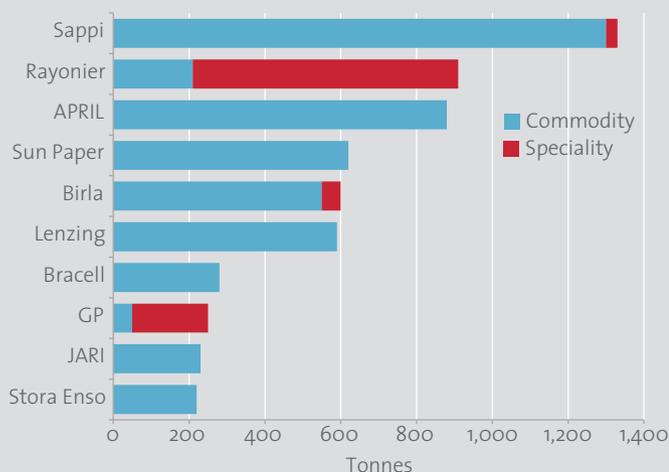
the next few years as farmers increasingly favour competing crops that offer better economic returns. Supply may also come under pressure from the increased incidence of droughts or floods across the major producing regions.

The trade war has hurt

As indicated, the DWP price has risen steadily since 2011 - from \$800 per tonne then, to peak at almost \$950 in 2019. However, a perfect storm of rising viscose capacity coincided with a substantial decline in the Chinese textile market because of the tariffs imposed by the US on Chinese textile imports. The result has been a precipitous decline in DWP prices to levels below \$650 per tonne. This has very negatively impacted on Sappi's profits and caused a commensurate drop in the Sappi share price.

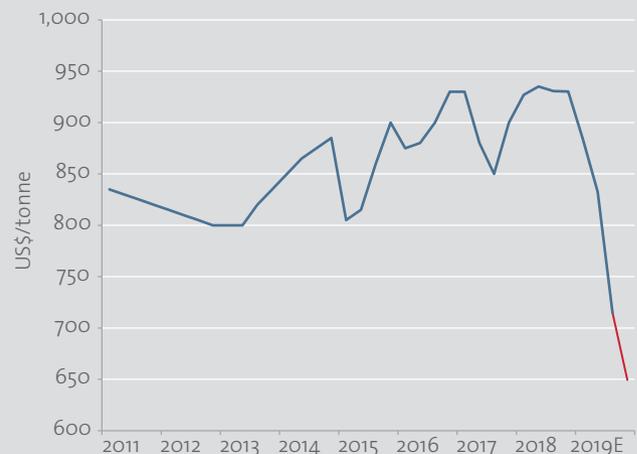
Despite current DWP prices being very low, which appears unsustainable as an estimated 40% of DWP producers are making substantial losses, Sappi should remain a profitable player in the DWP market. The outlook is dependent on how the situation is resolved, but it is our view that a normalisation in global trade relations will bring about a rebound in the demand for VSF from China and a corresponding increase in DWP prices. Sappi is well positioned to benefit from this recovery. **UP**

Global DWP capacity estimates (2019)



Note: Commodity is viscose grade only and excludes fluff pulp
Source: Hawkins Wright

Price of Sappi's key DWP grade product



Source: Precient Securities, Kagiso Asset Management research



Fast fashion: if you're not first, you're last

Sarah le Roux - Investment Analyst

For fashion retailers, speed and flexibility are increasingly important. Instant gratification has become the norm and clothing retailers are in a race to bring the latest trends to market. As a result, traditional bulk, bi-annual ordering is being replaced by regular, small batch replenishment.

Fast fashion: if you're not first, you're last

We examine why the accompanying quick response manufacturing (QRM) has been slower to take off in South Africa and the implications for local fashion retailers.

The fashion buying cycle

The success of fashion retailers is determined by their ability to accurately predict which colours, fabrics, prints and garment styles are likely to be popular ahead of actual demand. Buyers for local fashion retailers travel to Europe and America to attend fashion shows, visit stores and select samples. Combining this research with lessons learnt from previous seasons, local retailers design their range and place orders with suppliers.

To minimise costs, the fashion buying calendar traditionally ran over a six to nine-month period with only two major planning cycles a year. Bulk orders were placed well in advance, but long lead times resulted in very little flexibility for these retailers to react to changing customer preferences once the season had begun.

The rise of fast fashion has placed this model under pressure. As fashion buying cycles worldwide have shortened and social media has made it easier to identify the latest global fashion trends, local consumers have come to expect more than last season's winners from the Northern Hemisphere. The entrance of international fashion brands, such as Zara and H&M, has

placed further pressure on local fashion retailers to refresh their offering more frequently. However, shortening the buying cycle is not a simple task.

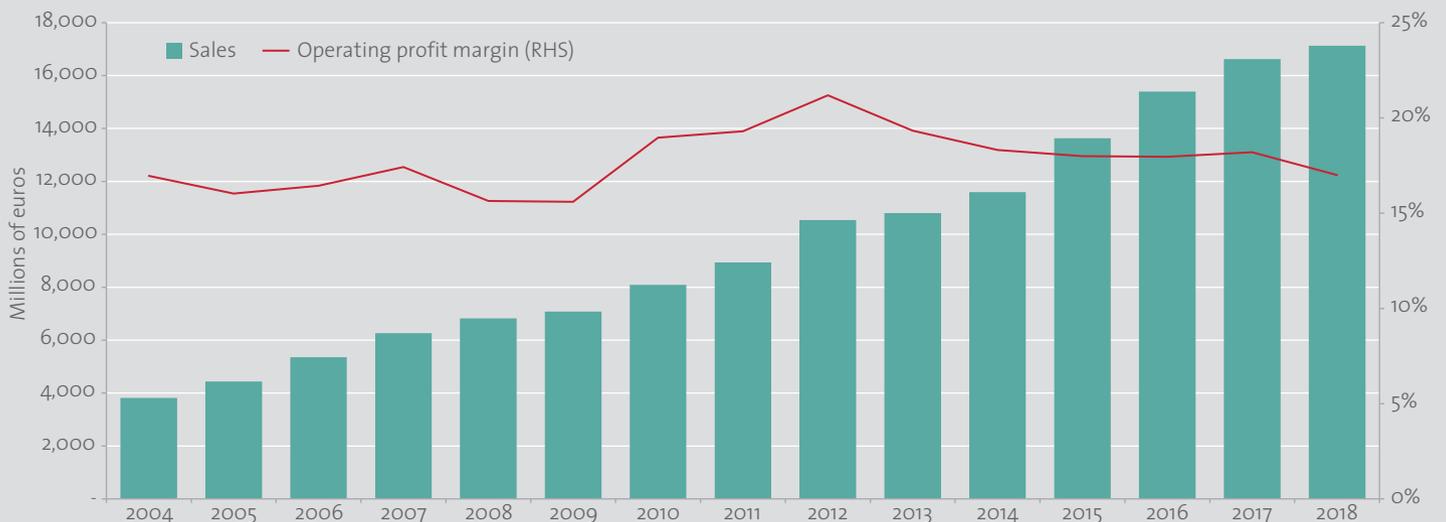
Zara's success with quick response manufacturing

QRM is the process of producing smaller batches more frequently - where speed and adaptability is prioritised over cost. Zara is considered to be the most successful global example of quick response retail (as indicated below) and has become renowned for the speed at which they are able to execute on the latest fashion trends. Products tend to sell out before demand peaks, incentivising their customers to visit stores more frequently to avoid disappointment.

The key to Zara's success involves vertical integration across the value chain, from design through to end distribution into stores. Core manufacturing facilities are located close to their distribution headquarters in Spain, allowing for the flexibility required to introduce new designs to stores around the world twice a week. It takes Zara less than two weeks to identify a new trend and to have their own interpretation available in the majority of their stores worldwide.

However, even for a leading fast fashion retailer such as Zara, relying solely upon the QRM model does not make sense. Around 60% of all Zara products are manufactured in close

Financial performance of the Zara brand over the last 15 years



Source: Inditex annual reports, Kagiso Asset Management estimates

proximity at a higher per unit cost. This is specifically the case for high fashion items that require speed and smaller batch sizes to maintain a scarcity element and reduce the level of markdowns needed to clear excess stock. The remaining 40% is made up of low-risk basic items that inherently follow a more predictable sales pattern. Low risk items can be ordered well in advance at a cheaper price, typically from low cost factories in Asia. The net result is an enviable long-term track record of sales growth and profitability for the brand.

The South African clothing manufacturing industry

There are structural limitations to implementing QRM in South Africa. A lack of cost competitiveness in the face of cheap imports and an absence of trade protection measures led to a sharp contraction in South Africa's clothing and textiles manufacturing sector during the 1990s. Over the last two decades, clothing manufacturers have continued to struggle despite government's efforts to stem the decline (chart below).

There are very few fabric mills or dye houses left in the country. As such, the bulk of material required for clothing manufacture needs to be sourced in finished product form from overseas, attracting import duties of up to 22%. When coupled with a higher cost of labour and lower order volumes, local

manufacturers are largely unable to compete with Asian manufacturers on cost. The sale of illicit imported clothing, upon which no duty has been paid (or the value has been understated), places additional pressure on retail pricing - further impacting local manufacturers' ability to compete.

Declining industry profitability and scale has led to a lack of investment and a resultant loss of valuable skills. Consequently, the competency gap relative to international manufacturers has widened over time. Local manufacturers generally lack the skills and machinery required to make technical pieces, such as those involving beadwork, or to work with more complex fabrics. For example, winter jackets and denim clothing are almost exclusively imported. In short, the range of clothing that can be produced at scale in South Africa is limited, particularly that which is made using locally produced fabric. Therefore, even when local manufacturing is possible, fashion calls regarding the fabric to be used, largely need to be made well ahead of the season.

Despite these challenges, the benefits of increased flexibility to adapt to changing trends in-season has begun to outweigh the additional cost involved. Although unit costs may be higher, smaller order volumes reduce the amount of excess stock at

Decline in clothing and textiles manufacturing volumes in SA*



*Textiles, clothing, leather and footwear
Source: Stats SA, SARS, Cotton South Africa, Kagiso Asset Management estimates

Fast fashion: if you're not first, you're last

the end of season that needs to be sold at marked down prices. Therefore, on a net basis, profitability can be higher.

To own or to partner?

The Foschini Group (TFG) is the only local fashion retailer that is substantially vertically integrated into manufacturing. Around 32% of TFG Africa's apparel is manufactured locally, with 22% produced by their own TFG Design and Manufacturing supply chain. Their average lead time is six weeks and in-season replenishment can be achieved within three weeks. The amount of apparel they will manufacture in South Africa is expected to almost double over the next five years, with QRM as a proportion of own manufactured apparel increasing from 66% to 100% over this period. In order to achieve this, TFG has committed to investing a further R1 billion into local manufacturing.

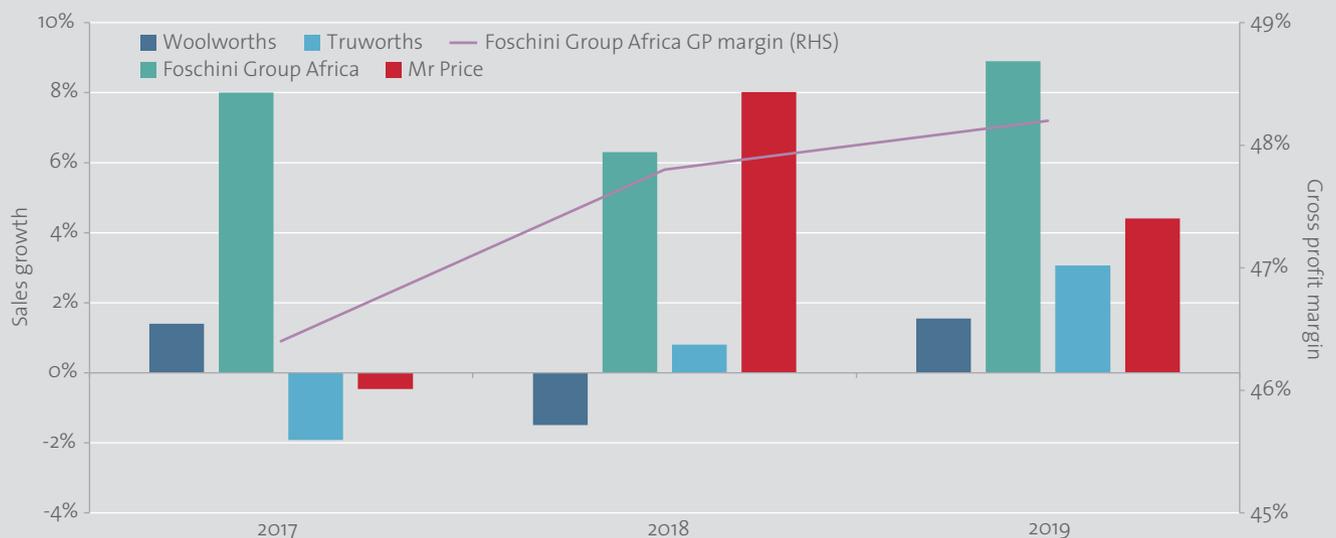
Although Truworths, Mr Price, Woolworths and Edgars each source a proportion of their product locally, they all rely on third party manufacturing relationships. Truworths has the highest proportion of locally manufactured clothing (around 50%) and has been actively working with its South African supplier base to improve QRM. By sourcing locally, Truworths' design team can make colour and styling changes up to four weeks prior to delivery, although typically this occurs around 8-10 weeks prior. In-season replenishment can be achieved within 3-4 weeks.

Vertical integration may not be the only answer, but it certainly appears to be paying off for TFG (chart below). Over the past couple of years, TFG's South African operations have gained market share and achieved sales growth ahead of competitors, while gross profit margins have been on the rise. This implies that they are doing a better job (relative to their competitors) in tailoring their offering to actual consumer preferences.

What lies ahead

Ultimately, by forcing retailers to increase their proportion of locally sourced product, the shift to fast fashion and the resulting need for QRM capabilities could prove to be the saviour of the South African clothing manufacturing industry. Over time, technological advancements have the potential to bridge the skills gap, thereby further improving the attractiveness of local production, provided there is sufficient investment over the medium term. Through the development of a clothing and textile masterplan, government, trade unions and the private sector are actively working together towards this common goal. This presents a genuine opportunity to increase the relevance of local manufacturing going forward and improve the performance of those retailers who successfully embrace this opportunity. **UP**

Sales performance of local fashion retailers



Source: company results presentations, Kagiso Asset Management estimates



Still lots of room at the inn

Dirk van Vlaanderen - Associate Portfolio Manager

The South African hotel landscape boasts many large, home-grown brands that have managed to remain relevant despite the arrival of several international hotel groups over the last 20 years. We discuss the South African hotel industry, its challenges and opportunities, and the outlook for two JSE-listed entities - City Lodge Hotel Group and Tsogo Sun Hotels.

Still lots of room at the inn

Hotel economics

Despite their terrestrial orientation, hotel economics are rather similar to airlines in that they have a fixed number of openings (rooms) that need to be filled. Revenue received by hotels is therefore a function of the occupancy experience (how full they are) and the rate charged per room. When demand (occupancy) is high, room rates will typically increase in tandem to maximise the revenue from each available room - much like the expensive last seat on an aeroplane. In times of weaker demand (lower occupancy), prices will typically decrease in an effort to fill as many rooms as possible.

Like airlines, the cost base of hotels mainly comprises fixed costs, which are incurred regardless of occupancy, as shown below (left) for Tsogo Sun Hotels. This highlights that around 70% of costs are fixed, with the largest being employee costs, property costs and depreciation. The variable costs would include room expenses (eg laundry and cleaning), food and beverages.

In South Africa, two-thirds of hotel bookings are business-related, therefore weekday occupancies tend to run at the 70%-80% level, while weekend occupancies average 40%. This results in an average industry occupancy of around 60%.

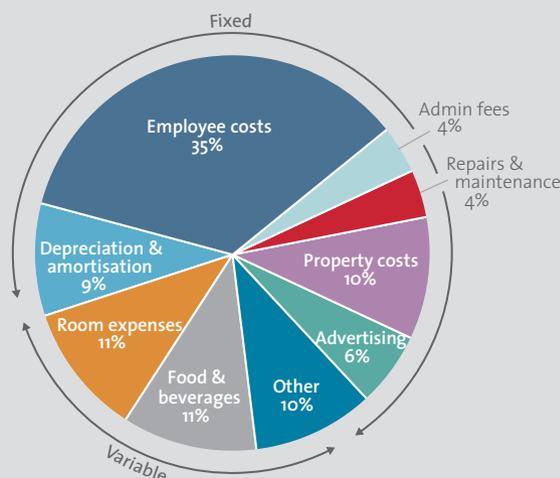
The South African hotel industry

Locally developed hotel companies including Tsogo Sun, City Lodge and Protea dominate the South African hotel landscape. Sun International owns the iconic Sun City resort and Table Bay Hotel, but the rest of its portfolio comprises mainly smaller hotels associated with its various casinos. The last 20 years has seen several of the large international hotel groups expand their footprint in South Africa:

- Marriot has been the most aggressive, acquiring Protea Hotels in 2014 for \$186 million. Some of its other brands include the African Pride Collection and The Westin.
- The International Hotel Group has presence with its Holiday Inn, Crowne Plaza and Intercontinental brands.
- Accor acquired the Mantis hotel chain in 2018 and owns the Mercure hotel collection.
- The Raddison group of hotels includes Raddison Blu, Red and Park Inn.

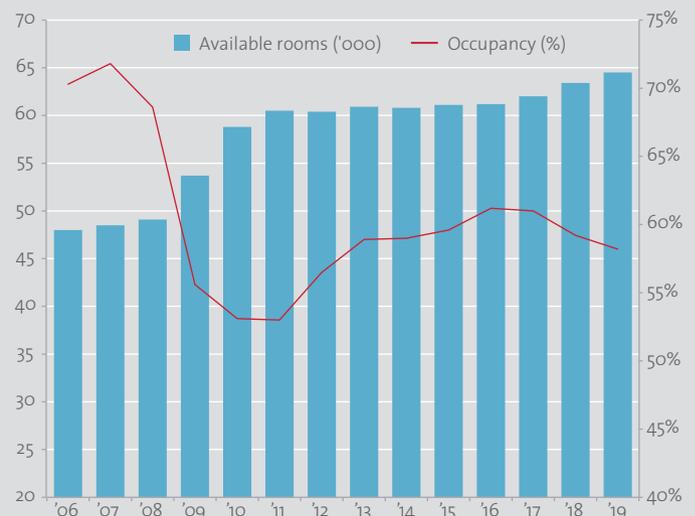
For the 15 years post 1994, the hotel industry saw a steady increase in new hotels opening, which was matched by a greater demand for rooms as the South African economy expanded at a healthy rate. This resulted in occupancies averaging 70% and the industry operating at strong profit margins. In the build up to the 2010 FIFA World Cup, significant new capacity was

Tsogo Sun Hotels costs breakdown



Source: company reports, Kagiso Asset Management estimates

Available rooms and occupancy for SA hotel industry*



*Combined City Lodge Hotel Group and Tsogo Sun Hotels rooms and occupancy as a market proxy
Source: company reports, Kagiso Asset Management estimates

created, resulting in a 9% increase in total rooms available for 2008 and 2009. This coincided with a period of weaker economic growth in 2009 and, as a result, occupancies plummeted to below 60% and hotel profitability contracted materially (previous page right).

Demand remained healthy in the post-2010 period and little new capacity was established. As such, occupancies began to rise as the market slowly absorbed this new capacity. Combined with rising daily room rates (chart below), this saw hotel profits recover meaningfully from the 2011 lows.

In the last three years, a new wave of capacity has come at a time when the economy has slowed. Additionally, various other temporary factors have contributed to a weaker demand outlook. These include water shortages in the Western Cape, lower government spend on travel, and new laws requiring minors to travel with unabridged birth certificates (now reversed). Consequently, the industry has seen occupancies revert to near trough levels once again, although room rates have still managed to increase, albeit at below inflation rates. We expect total hotel room growth (new capacity) of 1.3% for the next three years, which should be filled in a somewhat improved economic environment. Therefore, we foresee occupancies normalising higher as some of these factors reverse.

Average daily room rate for SA hotels



Source: PricewaterhouseCoopers

Technology disruption

- **OTA's - friend or foe?** Online travel agencies (OTA's), for example Booking.com, Trivago, Agoda and Expedia, enable customers to book various travel-related products online - but they charge a 15%-30% commission fee to the hotel where the booking is placed. While these websites help hotels to fill rooms, the commissions significantly lessen the hotel's profit per OTA-booked room.

The convenience, user experience, higher marketing spend, customer reviews and additional functionality means that OTA's are gaining the acceptance of customers, which presents a challenge for hotels. Globally, the OTA share of total bookings for hotel groups varies between 15% and 25%, up from 5%-10% seven years ago. This has provided a significant cost headwind to hotel businesses.

The response from most hotel groups has been to push their own loyalty schemes and to try to capture direct bookings through their own websites. Hilton famously launched its "Stop Clicking Around" campaign in 2016 to encourage more direct bookings.

To date, South African hotel operators have avoided extensive use of these OTA's, but we believe OTA's are likely to be a source of hotel margin pressure in the future as South Africa follows international trends.

- **Airbnb - making the village bigger:** Airbnb has added a new dimension to the scale and variety of travel accommodation available globally. It allows any of its members to list their property for rental. Airbnb has seen a significant increase in properties listed with over three million presently available worldwide, which is rising daily. Locally, Cape Town alone has 40 000 listed Airbnb properties.

Although we have seen only a partial impact of Airbnb on the South African hotel landscape, we believe that it may have a marginally more negative impact for the limited service, budget and 3-star options - given that the services and prices are more comparable.

Still lots of room at the inn

Local is lekker

Two of South Africa's largest hotel groups, Tsogo Sun Hotels and City Lodge Hotel Group are listed on the JSE Securities Exchange. The table below highlights the number of rooms and various brands operated by the two companies.

City Lodge Hotel Group caters predominantly for the business traveller, with a focus on a more affordable, no-frills offer. Its City Lodge and Town Lodge brands sit mainly within the 3-star category, offering limited services such as restaurants and conference centres, while the Road Lodge caters for the cost-conscious traveller.

Within South Africa, City Lodge's hotels are predominantly based in Gauteng, which houses around 50% of its rooms. The company has recently invested significantly into its African footprint, with two new hotels in Kenya and one each in Mozambique and Tanzania. This has complimented the group's existing footprint in Namibia, Botswana and Kenya. The initial trading of these new hotels has been disappointing, and the associated debt and related interest expense has seen group earnings compress significantly in recent periods.

Tsogo Sun Hotels owns and operates a broad hotel portfolio throughout South Africa, across a range of star grades. Its recent

unbundling from the larger Tsogo Sun Gaming (casino) business in July 2019, has resulted in Tsogo Sun Hotels now being a pure-play hotel owner and operator. While Tsogo Sun Hotels is also dependent on the business traveller, it has a greater bias to the Western Cape (50% of revenue) and the tourist market. Its full-service offer caters well for larger groups and conferences, making it less dependent on the transient traveller than the City Lodge Hotel Group.

Although results outside of South Africa (14% of total rooms) have also been indicative of tough times, Tsogo Sun Hotels has a well-established presence in Africa (ex-SA) and the Middle East.

Waiting for the cycle to turn

Both hotel groups have not been immune to South Africa's weak economic environment, with low occupancies and pressure on earnings. City Lodge Hotel Group has been more affected due to its higher business exposure and disappointing African expansion. However, as both businesses are well-run, cash generative and have strong local brands, we believe that they will benefit significantly from any improvement in occupancies and room rates when these inevitably come to pass. **UP**

Hotel brands by star grade

	Tsogo Sun Hotels	City Lodge Hotel Group
Total number of rooms:*	16,211	7,600
5-star	     	
4-star	 	
3-star	   	 
Budget		

* Total number of internally managed rooms at company's last reporting date
Source: company reports, Kagiso Asset Management estimates

Kagiso Asset Management Funds

Performance to 31 December 2019	1 year	3 years ¹	5 years ¹	10 years ¹	Since launch ¹	Launch	TER ²	TC ³
Unit trust funds⁴								
Equity Alpha Fund	23.1%	10.7%	7.3%	11.0%	16.4%	Apr-04	2.19%	0.48%
SA Equity General funds mean	8.0%	3.4%	2.9%	8.4%	12.2%			
Outperformance	15.1%	7.3%	4.4%	2.6%	4.2%			
Global Equity Feeder Fund	-	-	-	-	Not available	Nov-19		
Global Equity general funds mean								
Outperformance								
Balanced Fund	18.5%	9.8%	7.2%	-	9.5%	May-11	1.58%	0.46%
SA Multi Asset High Equity funds mean	9.5%	5.1%	4.8%		8.1%			
Outperformance	9.0%	4.7%	2.4%		1.4%			
Protector Fund	15.1%	9.6%	7.3%	7.5%	9.9%	Dec-02	1.57%	0.35%
CPI + 4%	8.0%	8.8%	9.7%	9.9%	10.4%			
Outperformance	7.1%	0.8%	-2.4%	-2.4%	-0.5%			
Stable Fund	12.5%	9.1%	7.9%	-	8.7%	May-11	1.51%	0.44%
Total return of CPI + 2% pa	6.0%	6.3%	6.1%		5.8%			
Outperformance	6.5%	2.8%	1.8%		2.9%			
Institutional funds⁵								
Managed Equity Fund (SWIX)	24.6%	10.7%	6.5%	11.0%	11.7%	Sep-06		
FTSE/JSE SWIX All Share Index	9.7%	5.5%	4.8%	11.1%	11.1%			
Outperformance	14.9%	5.2%	1.7%	-0.1%	0.6%			
Managed Equity Fund (Capped SWIX)	23.0%	9.8%	-	-	9.8%	Jan-17		
FTSE/JSE Capped SWIX Index	6.8%	3.5%			3.5%			
Outperformance	16.2%	6.3%			6.3%			
Domestic Balanced Fund⁶	18.3%	10.7%	6.8%	9.4%	8.8%	May-07		
Peer median ⁷	7.1%	4.7%	5.0%	9.7%	8.7%			
Outperformance	11.2%	6.0%	1.8%	-0.3%	0.1%			
Global Balanced Fund⁸	19.8%	11.4%	8.6%	-	10.2%	Jul-13		
Peer median ⁹	7.0%	5.3%	5.6%		8.2%			
Outperformance	12.8%	6.1%	3.0%		2.0%			
Bond Fund	10.6%	10.3%	-	-	9.2%	Aug-15		
BESA All Bond Index	10.3%	9.4%			8.2%			
Outperformance	0.3%	0.9%			1.0%			
Money Market Fund	8.4%	8.5%	8.3%	7.2%	7.9%	Jan-04		
Alexander Forbes STeFI Composite Index	7.3%	7.4%	7.2%	6.5%	7.4%			
Outperformance	1.1%	1.2%	1.1%	0.7%	0.5%			
Sharia unit trust funds⁴								
Islamic Equity Fund	10.7%	7.7%	6.4%	-	10.9%	Jul-09	1.43%	0.20%
SA Equity General funds mean	8.0%	3.4%	2.9%		10.0%			
Outperformance	2.7%	4.3%	3.5%		0.9%			
Islamic Global Equity Feeder Fund	-	-	-	-	Not available	Jan-19		
Global Equity General funds mean								
Outperformance								
Islamic Balanced Fund	10.2%	6.6%	5.4%	-	6.9%	May-11	1.48%	0.15%
SA Multi Asset High Equity funds mean	9.5%	5.1%	4.8%		8.1%			
Outperformance	0.7%	1.5%	0.6%		-1.2%			
Islamic High Yield Fund	-	-	-	-	Not available	Mar-19		
Short-term Fixed Interest Index (STeFI)								
Outperformance								

Highest and lowest monthly fund performance	Highest	Lowest								
Equity Alpha Fund	4.8%	-5.5%	6.6%	-6.0%	8.2%	-6.0%	8.2%	-6.0%	11.9%	-9.0%
Balanced Fund	3.9%	-4.8%	4.8%	-4.8%	5.5%	-4.8%	-	-	6.2%	-4.8%
Protector Fund	3.3%	-2.6%	3.3%	-2.6%	3.4%	-4.2%	4.8%	-4.2%	9.5%	-5.3%
Stable Fund	2.5%	-1.3%	2.5%	-1.3%	3.8%	-3.5%	-	-	4.0%	-3.5%
Islamic Equity Fund	3.4%	-3.9%	5.3%	-3.9%	7.3%	-4.6%	-	-	8.1%	-4.9%
Islamic Balanced Fund	3.0%	-2.8%	4.0%	-2.8%	4.6%	-3.0%	-	-	8.2%	-5.4%

Footnote and disclaimer follow overleaf.



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Footnote: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 December 2019; 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 December 2019; ⁴ Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; ⁵ Source: Kagiso Asset Management; gross of management fees; ⁶ Domestic Balanced Fund benchmark returns are an estimate for December; ⁷ Median return of Alexander Forbes SA Manager Watch: BIV Survey; ⁸ Global Balanced Fund benchmark returns are an estimate for December; ⁹ Median return of Alexander Forbes Global Large Manager Watch.

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