

# UP

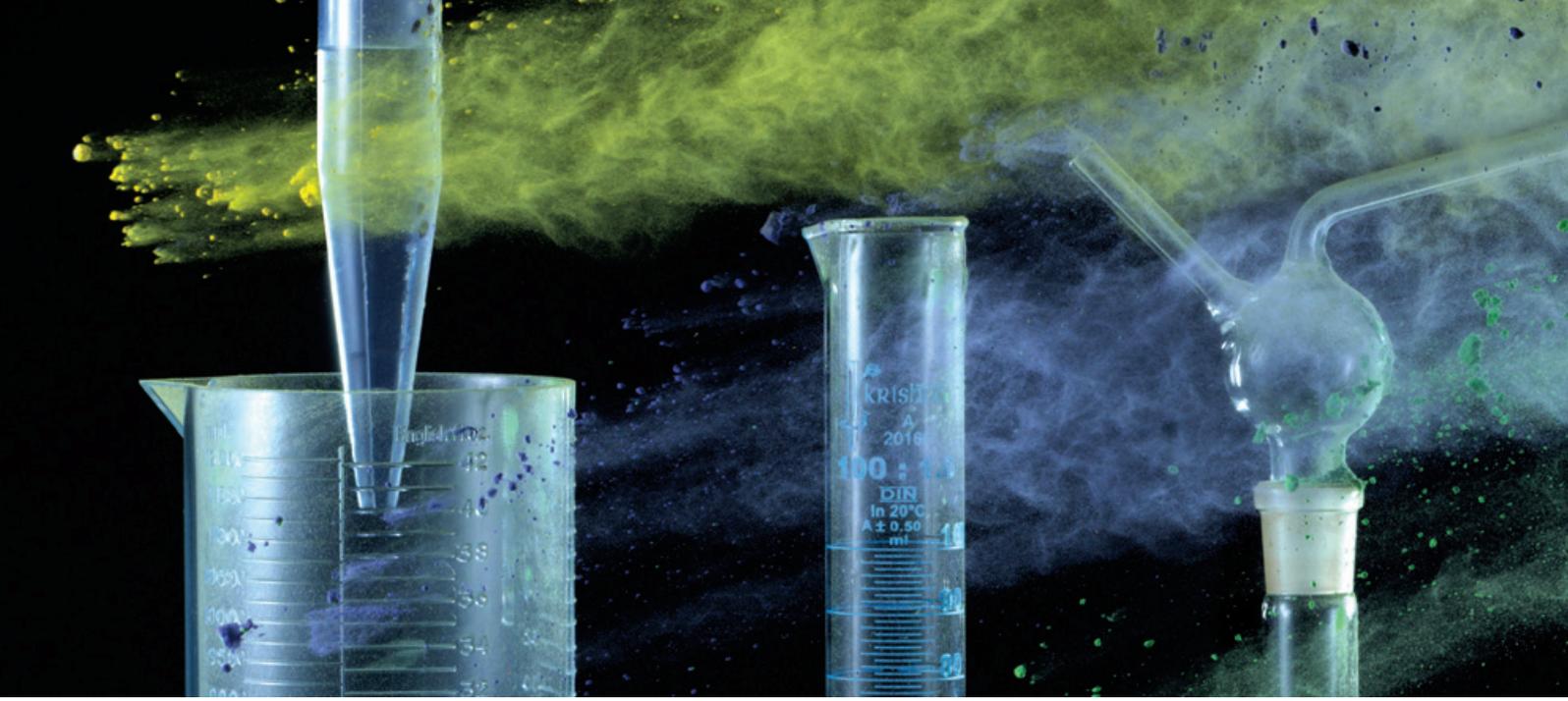


April 2020

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## Opportunity in Omnia

Aslam Dalvi - Portfolio Manager

Omnia is a diversified group that supplies chemicals and specialised services to the chemical, mining and agricultural sectors in Africa. Although the company has generally delivered good returns over the long term, recent earnings have been weak. Omnia has made considerable capital investments over the last five years, which are expected to result in meaningful cost savings in the future.

# Opportunity in Omnia

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Omnia underperformed materially in 2019, owing to cyclical headwinds in several of their end markets coupled with a weak balance sheet (following years of heavy investment and poor working capital management). In the same year, the company was forced to undertake a rights issue and the proceeds were used to reduce debt and substantially strengthen capital structure.

The rights issue presented an attractive opportunity to build a meaningful Omnia position in our clients' portfolio. We see that Omnia continues to be a dominant player across key markets and we set out below where the future opportunities lie across the group's divisions.

## **A differentiated agricultural business**

Regarded as South Africa's leading fertiliser producer, Omnia has a relatively new and sizeable low-cost manufacturing footprint, providing them with a competitive edge against local importers and blenders.

The company manufactures and sells ammonium nitrate-based fertilisers as opposed to low-cost urea-based fertilisers that are preferred in many emerging markets. Compared with the latter, ammonium nitrate-based fertilisers have proven agronomic benefits, such as reduced soil acidification, improved water efficiencies and better root development. Ammonium nitrate is also a basic building block in the production of explosives and Omnia's existing fertiliser scale gives it a key cost advantage compared to its competitors, as the fixed cost base is spread across two end markets. This results in a lower unit cost of production in both businesses and better returns on capital.

Fertiliser consumption in South Africa has been relatively static over the past decade, however, competition has recently intensified, placing pressure on Omnia's margins. Although there appears to be a large growth opportunity in Africa - where fertiliser application rates per hectare are very low - challenges around a lack of funding for small and medium-sized farmers, and the slow shift to more modern farming methods, has limited the size of the opportunity.

In response to challenging local fundamentals, Omnia has shifted their focus to bio-agricultural products and services.

Unlike traditional fertiliser products that are largely commoditised, bio-agricultural products are highly specialised and need to be registered in each country they are sold. This offers a significant barrier against competition.

With farmers increasingly looking for safer and more environmentally-friendly fertiliser and crop protection solutions, the bio-agricultural market is growing rapidly. Omnia is well positioned to capitalise on this shift, especially with its recently acquired Oro Agri business.

## **Meaningful value in mining**

Omnia's mining division comprises two separate businesses: BME (manufactures explosives) and Protea Mining Chemicals (supplies specialised niche chemicals to customers in the mining industry).

BME operates throughout Africa (with a strong presence in the Southern and Western parts of the continent) and is a market leader in bulk emulsion and blended bulk explosive formulations for the opencast mining industry. Omnia's key competitive advantage in explosives stems from their proprietary double salt emulsion formula that allows them to use a high percentage of used oil in the manufacturing of explosives. Emulsions in explosives typically contain oil that can either be diesel, a derivative of diesel or used engine oil. Omnia's double salt emulsion is very stable compared to competitors and BME has successfully produced emulsions containing 80% used oil. This is beneficial in that it lowers the cost of production and greatly assists mining companies in safely disposing of significant amounts of waste oil.

Blast safety and efficiency have become the primary concerns for most mining customers, resulting in the development of more sophisticated blasting techniques. Again, Omnia is well positioned here given the significant investment into their world class AXXIS™ suite of products. Mines are now able to design, simulate and optimise blast patterns by using software exclusively developed by the business. Furthermore, this software can be paired with Omnia's AXXIS™ detonators and Centralized Blasting System, which initiates blasts from a remote location, thereby substantially reducing safety risks and blast costs.

### Chemical cluster is challenged

Omnia's third and smallest division is its chemicals business (largely a chemical trader), which procures speciality chemicals globally and resells them into the local and sub-Saharan Africa markets. While operating margins are low at around 3% and working capital tends to be high, the division houses several attractive niche and high-margin businesses in the water treatment and consumer chemical markets.

The chemical division has struggled to deliver a reasonable return on capital over the last decade despite multiple attempts to restructure the cost base. There are no definitive synergies between this business and the rest of the group. However, with new management at the helm and amid a broader group restructure, we see potential for its disposal, which could unlock meaningful value.

### World class asset base at a deep discount

With a rich asset base of over 50 manufacturing sites in South Africa and abroad, the Omnia Group has built up a network of 11 world-class chemical and agriculture laboratories in five countries, including an extensive global distribution network.

Omnia is the largest nitric acid manufacturer in South Africa, with two nitric acid plants. The newest plant (built at a very

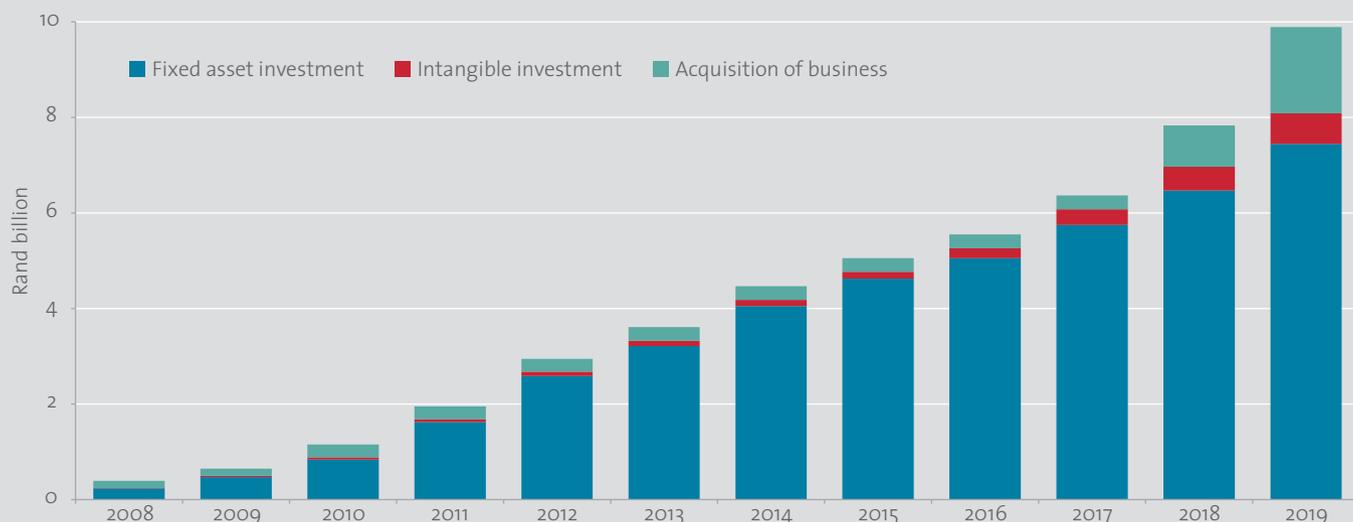
low capital cost relative to similar global projects) enjoys a large competitive advantage locally. The company has negligible exposure to carbon tax on emissions due to prior investment in world-class nitrogen oxide (NOx) abatement technology and key plants have ample capacity for future growth. Additionally, the plants are younger and more efficient than those of competitors, providing a lower cost of production.

While the latest plant was built for R1.7 billion in 2011, the current replacement cost is much higher. Polish fertiliser company, Orlen SA, recently announced the build of a similarly sized nitric acid plant with the same kind of abatement technology, for over R5.1 billion.

Another key investment has been in the construction of a new nitrophosphate plant, which further strengthens the company's competitive position and lowers the cost of fertiliser production more.

Omnia currently procures phosphorous (an important ingredient in fertiliser blends) from Foskor at very high prices. Foskor has the local monopoly due to its control over the Phalaborwa Igneous Complex, the larger of only two commercially viable onshore phosphorous deposits in South Africa. However, Omnia's new nitrophosphate facility allows them to substitute more expensive phosphoric acid purchased from Foskor, with

### Cumulative investment in fixed and intangible assets



Source: company reports

# Opportunity in Omnia

cheaper phosphate rock. In addition, the plant will produce calcium nitrate liquid, which is a key input into products produced by the explosives and speciality fertiliser businesses. The plant started production in late 2019 and is expected to deliver significant cost savings in addition to large working capital benefits.

As charted on the previous page, Omnia has invested heavily in its business over the past decade and we estimate the replacement cost of the asset base to be well in excess of R10 billion. This compares to a current market value of only R3,5 billion, allowing investors to buy a world class asset base at a deep discount.

## Large cost opportunities

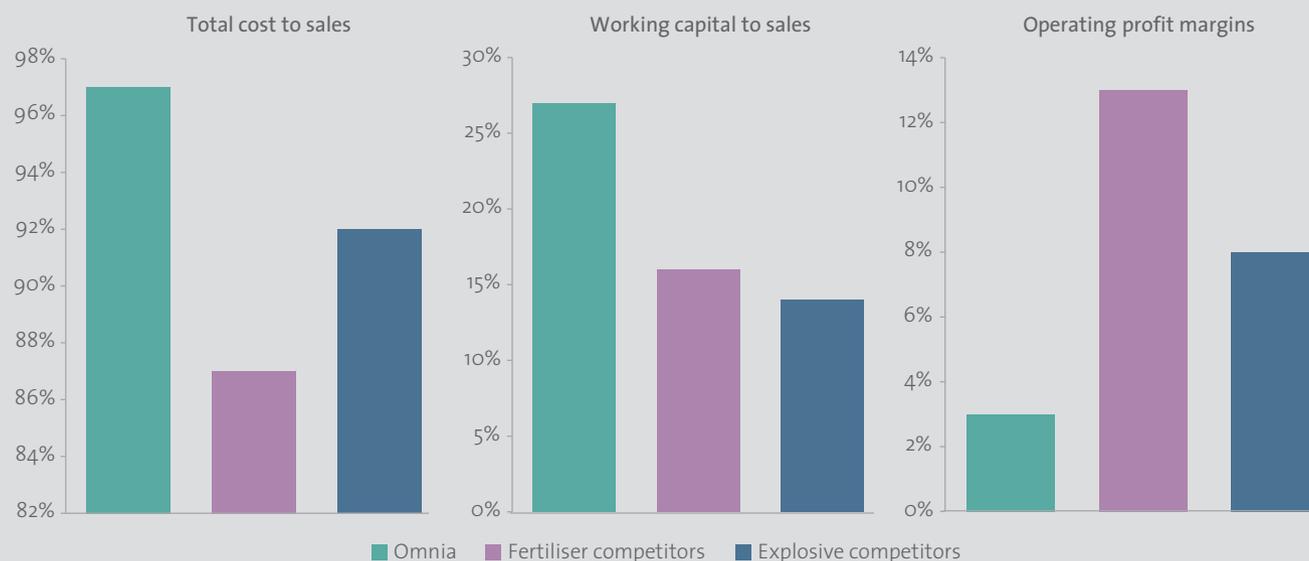
Omnia's earnings today are well below what we consider normal, owing largely to an aggressive growth strategy between 2017 and 2019, which resulted in significant cost

growth, cyclical headwinds across key end markets and poor working capital management.

While the company's growth strategy and investments to date have not yet delivered the requisite value to previous shareholders, a comparison of Omnia's key financial metrics (relative to its global and local competitors) highlights significant potential to reduce costs and working capital intensity, and improve profitability (chart below).

The rights issue in 2019 presented us with a unique opportunity to buy a business with some enduring strengths at a deep discount to its asset value. Under new management, a leaner and more focused business has the potential to deliver significant medium-term earnings growth. While the turnaround may take some time, there are several large opportunities available to unlock value and we believe that patient investors will be well rewarded. **UP**

## Comparison of Omnia's financial metrics vs competitors



Source: Bloomberg, company reports, Kagiso Asset Management research



## Is the sun setting on South African gold?

Mandi Dungwa - Portfolio Manager

South Africa is well known for its abundant commodity endowment with massive reserves of chrome ore, platinum group metals (PGMs), diamonds and, most prominently, gold. Over a century of mining gold in South Africa has resulted in many mines reaching depths of over four kilometres, where natural rock temperatures frequent 50°C and rock pressure is high - increasing susceptibility to seismic activity.

# Is the sun setting on South African gold?

These structural issues and consequent risks have led to declining gold production as the cost of mining has increased significantly, relative to the gold price. South Africa has now become one of the most expensive gold mining regions in the world.

## A rich history

In 1886, the discovery of the Witwatersrand Basin initiated the biggest gold rush in world history, along with the establishment of “Egoli” (‘City of Gold’), or Johannesburg as we know it today.

This elliptical basin stretches 400km across the Free State, North West and Gauteng provinces, and is the largest gold ore deposit ever discovered. It has produced over 1.5 billion ounces of gold to date, representing over a third of cumulative global gold supply. An additional 1 billion ounces of ore (11% of total world reserves) still lies in the ground as at the end of 2019 (chart below).

## Gold mining in South Africa is tarnished

The deep-level labour-intensive nature of conventional South African mining results in structurally higher mining costs than the rest of the world. Over 70% of costs are related to labour (costs have risen faster than inflation) and electricity (prices have trebled over the last seven years). In contrast, large Australian gold mines operate at lower costs as they are

mechanised and shallow, therefore attracting additional investment and further exploration. Australia currently has the largest reserves of gold in the world.

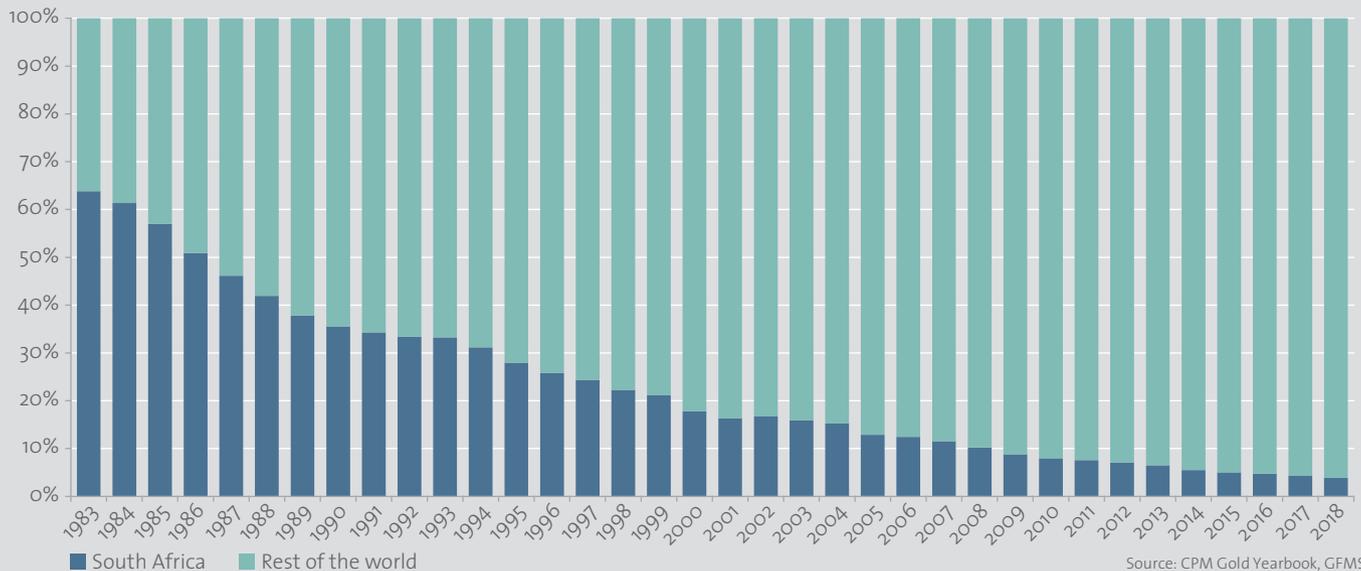
The steep cost of mining in South Africa has been exacerbated by declining grades, meaning that for every tonne of ore mined, fewer ounces of gold are extracted. Furthermore, seismic activity is more prevalent in deeper mines where increased ground falls pose greater safety risks for workers. South Africa continues to have some of the highest mining-related injury and fatality rates in the world, which together with poor safety conditions, impacts overall productivity and adds to the already high structural costs.

At the present run rate of production, it is estimated that the local gold mining industry will see the last ounce of gold mined in approximately 11 years’ time. Interventions that could prevent or decelerate this decline include:

- research and development around more efficient ways to mine at great depths;
- the introduction of mechanisation to improve productivity and safety; and
- stabilising electricity pricing and ensuring consistent long-term supply by using sustainable, cheaper alternatives.

These options, however, require upfront investment that the industry cannot afford at present and which are not assured of success.

## Global gold supply



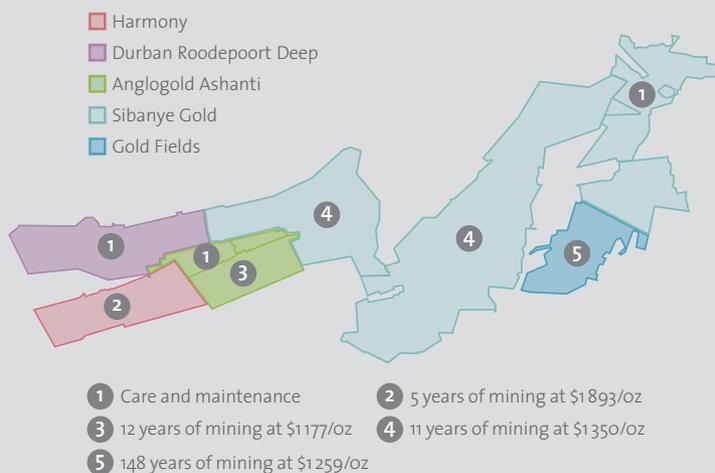
## A sunset industry carries an added cost

South Africa's life-of-mine forecasts are dependent on various assumptions including the future gold price and mining costs. If these assumptions prove too optimistic (higher than expected costs and/or lower than expected gold prices), mines could face earlier closure as they become unprofitable. The act of closing a mine, though, is complex and costly.

To close a mine, employers need to retrench and pay all employees. With the gold industry currently employing over 95 000 people, this prospect carries a staggering price tag. Once a mine has stopped operating, the site must be decommissioned and safely returned to its original, natural state. This involves the removal of waste and hazardous materials, the reinstatement of indigenous vegetation and ensuring that underground water quality is normalised.

In South Africa, a further complication is the underground interconnectedness of a multitude of gold mines and the challenges posed by the abundant underground water reserves found in the western region of the Witwatersrand Basin, near the town of Carletonville. The chart below indicates the various mining companies operating in this region. Some mines have stopped operating and been placed on care and maintenance (limited operations where mostly rehabilitation and decommissioning is conducted) while awaiting closure.

### West Witwatersrand Basin (Dec 2019)



\*Note: Stated life-of-mine based on current reserves and running costs based on latest reporting in \$/ounce as at Dec 2019

Source: Gold Field company reports, Kagiso Asset Management company reports and assumptions

Working mines ensure that the mine is dewatered (removal of groundwater) so that employees are safe when working underground, with the water used elsewhere in operations. Closed mines can be safely flooded due to the absence of workers on site. However, if a neighbouring mine believes that this may impact the safety of their employees, they can interdict the closure of the other mine for safety reasons. A successful interdict means that the mine owner must continue dewatering the mine for the benefit of, and until the closure of, the neighbouring mine.

With each mine operating at different cost levels this presents a significant consideration for mining companies. It could potentially necessitate merger and acquisition activity of neighbouring mines for the purpose of reducing closure liabilities.

South African mining companies are required to prepare for closure by building up funds for the decommissioning and rehabilitation of the mine. These funds are only available if a closure certificate is granted by the government, in which case the mining company passes the dewatering charges on to the government if the rehabilitation funds are insufficient to meet the requirements. Recent amendments to mine closure legislation state that companies will be liable for environmental rehabilitation costs regardless of having been issued a closure certificate.

Mines placed on care and maintenance do not generate cashflow, yet still need to cover hefty rehabilitation and decommissioning costs that must be funded by other cash-generating mining operations. Furthermore, the social impact of mine closures in South Africa is hugely negative as every mine employee typically supports approximately ten dependents.

## Gold prices are now moved by sentiment

Though South African mines structurally now operate with such high costs, it is still possible that they can make great cashflow-generating investments if the rand gold price can remain high enough for the foreseeable future - in order for them to produce strong profits for shareholders. In formulating a long-term gold price outlook to interrogate this possibility, we look to assess the fundamentals of the gold market: annual primary demand (eg for jewellery or industrial uses) relative to primary mined supply into the future.

# Is the sun setting on South African gold?

Presently dominating these fundamental, somewhat quantifiable economic forces, is the build-up and release of above ground stocks of gold. This primarily takes the form of movements in private gold investment (ie bars and exchange traded funds) and official gold holdings of central banks - investment demand. The degree of producer hedging (selling in advance) also affects gold prices, sometimes materially.

Gold does not tarnish or decay and almost all the gold ever mined still exists today. A large proportion of this stock does come back to the market on an annual basis. At the right price, above ground stock is incentivised to be sold to meet annual demand. As shown below, around 26% of annual gold supply currently comes from recycling. Above ground stocks are capable of meeting 58 years of primary gold demand, rendering primary mine supply unnecessary.

Industrial demand for gold is reasonably price-inelastic but is currently relatively insignificant and has somewhat cyclical drivers and some substitutes. Jewellery demand is price-elastic, as seen in the 10 years between 2002 and 2012. The rising gold price environment saw jewellery as a proportion of demand, decline from over 70% to less than 50%. This was due to high levels of investment demand over this period, spurred on by the prospect of an increasing gold price, which displaced much of the physical jewellery demand.

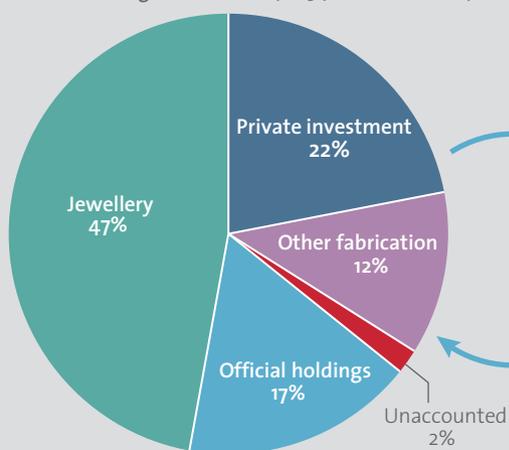
We find investment demand almost impossible to predict other than to posit that it has some momentum to it, ie higher prices from increased demand create more demand and may lead to higher prices still. "Conventional wisdom" suggests that gold is a useful inflation hedge, but there is little evidence for this other than in the unique period of the late 1970's. Gold bulls, without any inflation around, currently argue that gold outperforms when real interest rates are low. Another argument is that it is an essential hedge against the large monetary stimulus experiment being undertaken by developed market central banks. However, we find little credence to these arguments and see far better hedges against those scenarios elsewhere.

We believe that a more sustainable and predictable gold market is where the physical jewellery demand is the dominant driver and, given the price sensitive nature of this market segment, this could well mean a market with lower gold prices that incentivise jewellery demand growth again.

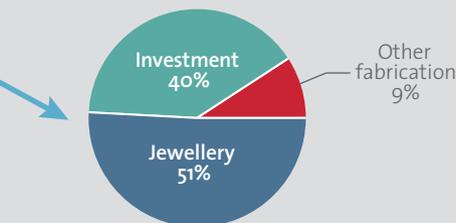
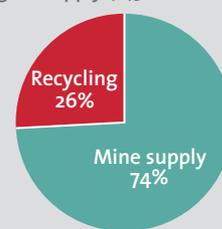
Based on an unpredictable and seemingly elevated gold price, and the current high costs of running a gold mine in South Africa, coupled with future closure cost realities, we find South African gold shares unattractive. Our clients, therefore, currently have very limited exposure to South African gold mines in our portfolios. **UP**

## Gold supply and demand

2018 total above ground stocks (6,234 million ounces)



2018 gold supply (145 million ounces)



2018 gold demand (129 million ounces)





## The behemoths of US banking

Meyrick Barker - Investment Analyst

“The evolving COVID-19 pandemic has wrought havoc on the global economy and banks find themselves in the eye of the storm. Their funding lines have been disrupted, many of their customers will struggle to repay their debts and, as interest rates and customer transactional activity declines, their income will reduce.”

# The behemoths of US banking

Bank shares have been some of the worst performing stocks for the year to date. However, despite the uncertainty, we consider the indiscriminate selling of banking shares to have resulted in a number of compelling investment opportunities, particularly in some of the large American franchises. We explore four of the larger US banks, namely: Goldman Sachs, JPMorgan Chase, Citigroup and Wells Fargo.

## The giants take shape

Up until the 1980s, many American states prohibited banks from operating across state lines. Relaxing these laws unleashed a wave of consolidation across the industry, halving the number of US banks over the two decades that followed.

The onset of the 2008 financial crisis stalled bank combination plans, as they became inwardly focussed on containing their own credit challenges. Bank failures, however, provided an opportunity for those that were stable to acquire large competitors. Some of these included JPMorgan Chase's acquisitions of Bear Stearns and Washington Mutual, and Wells Fargo's acquisition of Wachovia (the fourth largest bank holding company in the US at the time).

The top 10 banks in the US today control roughly two-thirds of industry assets, with the balance split across almost 5 000 other banks.

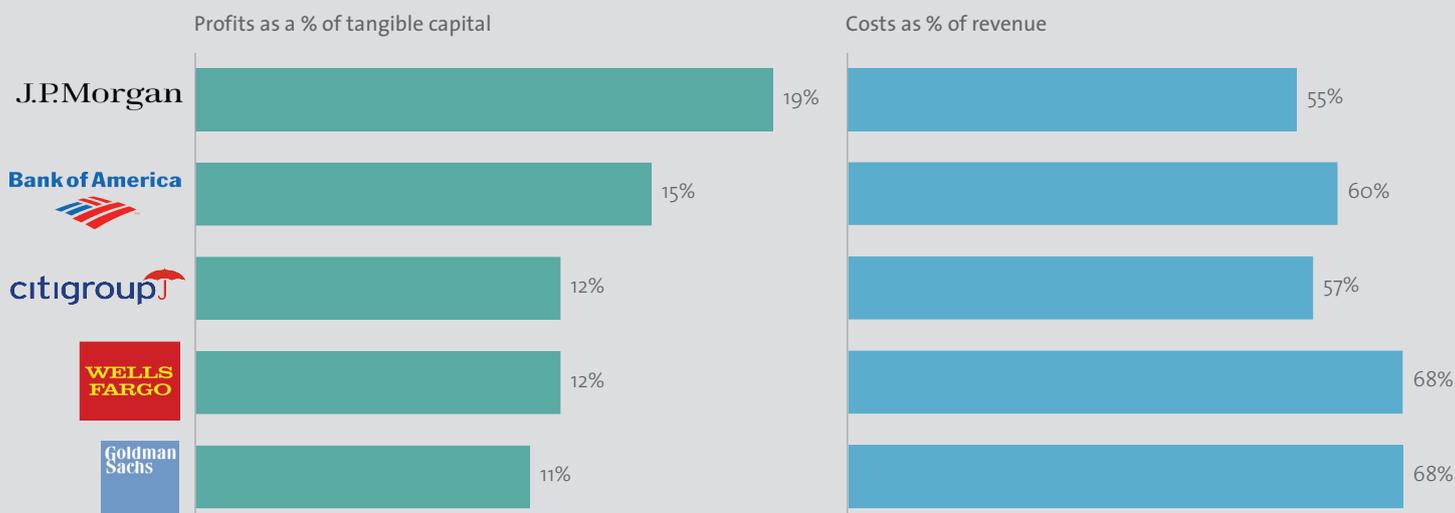
## Goldman Sachs: going mainstream

Goldman Sachs has long been the pre-eminent investment bank, providing advice on the largest, most profitable corporate finance transactions. Yet, despite the glamour associated with the industry - particularly prior to 2008 - post-crisis shareholder returns have proven disappointing as regulatory actions that followed the crisis impeded profitability. In response, Goldman is broadening its service offering.

Without relinquishing their long-standing dominance in investment banking, Goldman is pivoting towards a more traditional banking model – less volatile retail and commercial banking, and a focus on growing the existing wealth and asset management businesses.

In 2016, Goldman launched “Marcus”, a digital deposit-taking and consumer lending business offering attractive savings rates to the general public (a sector they viewed with disdain just years before). This has proven successful in gathering retail deposits at far cheaper rates than the bank's historic funding cost. Furthermore, the acquisition of United Capital, an advisory business targeting the wealthy (but by no means the top 1%), broadens Goldman's wealth management services. They are also initiating transactional banking services to corporate clients and recently launched their first credit card offering in conjunction with Apple.

## Comparison of cost efficiencies and profitability of large US banks



Source: respective company annual financial statements

While in the early stages and with more than half the bank's capital still tied up in its investment bank trading business<sup>1</sup>, Goldman is yet to prove its ability to compete in these less familiar, highly competitive traditional banking markets. These are very big markets and Goldman is optimistic that by gaining a small share thereof, together with cost cutting initiatives, their return on capital should significantly improve.

### JPMorgan Chase: outspending on technology

Both JPMorgan and Citigroup are full-service banks offering everything from vanilla lending and borrowing services to investment banking-related functions, such as underwriting initial public offerings.

Slick digital banking offerings matter more today than ever before and JPMorgan spends more than any other bank on information technology, racking up \$11 billion in annual expenditure. This level of investment in the technology arms race makes one wonder whether smaller regional banks can compete in this digital age (despite their typically better local knowledge of small clients). The large national banks appear to be winning, with the top three - Bank of America, JPMorgan and Wells Fargo – gathering more than double the annual deposit inflows than the 20 largest regional banks.

<sup>1</sup> Basically, buying and selling bonds, equities and derivatives on behalf of clients

This technology investment enables JPMorgan to better serve customers and generate industry-leading cost performance and returns on capital (charted on previous page). JPMorgan has the second largest branch network in the US after Wells Fargo and, while branch numbers in the US continue to shrink in totality, they are one of the few banks rolling out branches (over 500 nationwide) to aid in capturing market share.

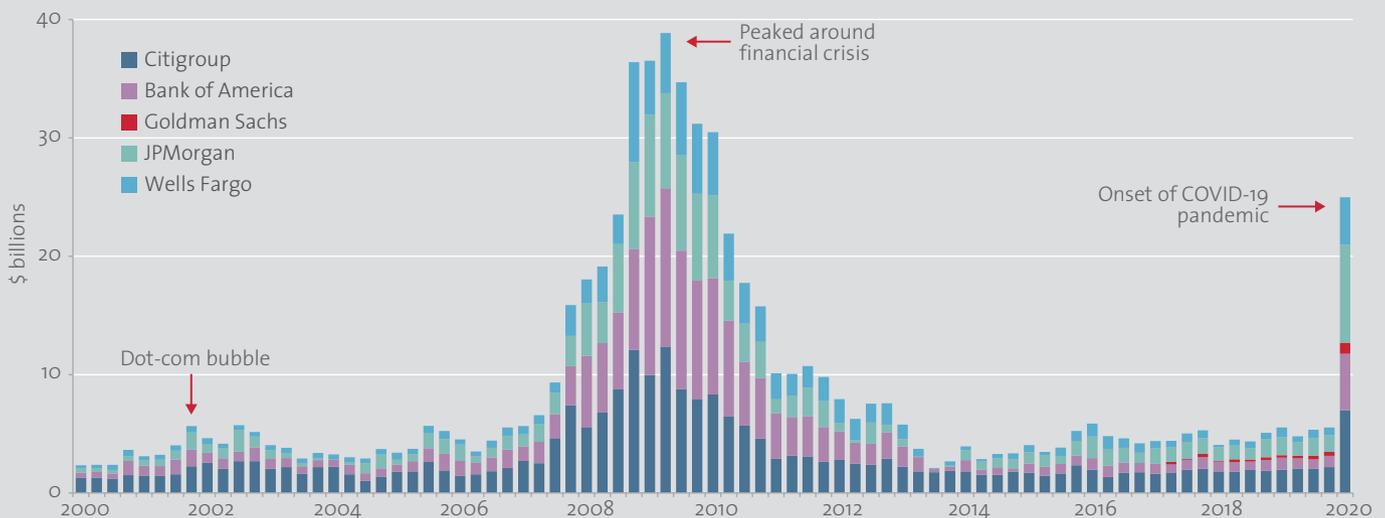
With the leading global investment banking and markets businesses, complemented by a large wealth management business, JPMorgan produces far greater non-interest revenue than competitors, which materially supports the bottom line in the current low interest rate environment.

### Citigroup: credit card extraordinaire

Citigroup was the recipient of America's biggest bank bail-out during the financial crisis, requiring a government guarantee in excess of \$300 billion to survive. Its prior poor credit underwriting performance continues to taint its share price rating today.

Citigroup's loan book is three-quarters of the size of that of JPMorgan or Wells Fargo (each at \$1 trillion). However, Citigroup offers the most diversified global exposure of the banks we discuss here, with a presence in roughly 100 countries - earning more than half of its revenues outside of the US. Over a third of

## Quarterly credit losses of large US banks



# The behemoths of US banking

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Citigroup's business is conducted in emerging markets, with a strong presence in Asia.

Citigroup issues a greater proportion of unsecured credit than its competitors. Although not the first to grant bank-issued credit cards (that honour belongs to Bank of America), they do have the second-largest card business in the US (after JPMorgan) and are the world's largest credit card issuer. In addition to Citigroup-branded credit cards, private label cards for the likes of American Airlines and Shell are also issued.

Although Citigroup serves US retail clients nationwide via its mobile app and credit card offering, the bank has the smallest domestic branch footprint among the big US consumer banks. Branches are concentrated only in New York, Chicago, Miami, Washington DC, Los Angeles and San Francisco. A third of profits are generated by the consumer bank, with the balance generated by the institutional business. Notably, Citigroup has one of the larger investment banking operations and their bond-trading unit is ranked first in the world.

## **Wells Fargo: a bumpy ride**

Wells' stagecoach emblem dates back to the days when the company's coaches traversed America delivering gold and packages. When the government nationalised the delivery service in 1918, Wells was forced to reinvent itself and grow its nascent banking service, which gradually extended into a full banking offering. Part of this transition was achieved through being a serial acquirer, mopping up well over 12 000 entities.

Wells is a leading retail and commercial bank, but with minimal exposure to investment banking. They are a US-focused lender with an extensive branch network across the country (very few US banks have a national branch network), serving one in three American households. Compared to competitors, their loan book has a higher exposure to mortgages (originating up to a third of the country's retail mortgages) and the bank has a high cost base. A drawback of the product mix is that Wells is more adversely impacted by low interest rates.

Just five years ago, Wells was vying for the title of 'the world's most valuable bank', but today - after some material missteps - they are not even the highest valued US bank (currently claimed by JPMorgan).

Part of their success stemmed from excelling at incentivising employees to increase product penetration within their client base. However, ever-increasing sales targets led to staff opening fake accounts, mis-selling products and signing up customers for products without their consent. There was an unfortunate fall from grace, for a bank that survived the financial crisis largely unscathed. Penalties imposed for these scandals prevent Wells from growing its balance sheet, consequently hampering profit growth and impeding their ability to respond to disruptive changes impacting the industry. It remains unclear as to when the penalty cap will be lifted.

## **Compelling long-term proposition**

With the full extent of the economic impact of the COVID-19 pandemic and consequent containment measures still unknown, it is uncertain whether the bank's reserves will be large enough to survive and protect the real economy. There is no doubt that this period will stretch the banking system to its limits - more than likely causing some to fail.

First quarter loan losses across the largest US banks (Bank of America in addition to those discussed here) are already up 3.5-fold compared to the first quarter of 2019 and exceed \$25 billion (charted on previous page). However, unprecedented monetary and fiscal actions by US authorities are containing some of the immediate risks and regulatory concessions will assist the banks in navigating the adverse economic environment. Additionally, banks provide less than 25% of corporate credit in the US and most higher-risk corporate credit does not sit on bank balance sheets.

Considering the above, it is clear that each of these large banks specialises in slightly different lines of business. Although it is impossible to be certain of the impending credit performance of any one particular bank amid this severe COVID-19 stress scenario, all of the above banks are well-capitalised, have strong franchises, benefit from enormous economies of scale, are gaining global market share from weaker European banks and typically generate high returns of capital for shareholders. Therefore, we believe that the basket of positions we have established across these counters at very low share prices will, in time, collectively generate attractive returns for our clients. **UP**



## Investment in motion

Nicole Maduray - Associate Analyst

Bearings are mechanical devices that enable motion between two parts by reducing the frictional forces between objects and providing a surface to roll on - enabling faster, smoother and less energy-intensive movement. From large manufacturing equipment to roller skates, ceiling fans to bicycles, bearings are found in almost anything that has moving parts.

# Investment in motion

Svenska Kullagerfabriken (SKF), founded in Sweden in 1907, is an international bearing manufacturer, providing bearings, seals, lubricants, and maintenance and optimisation services to over 40 different industries worldwide. We discuss the enduring demand for these seemingly simple parts and how SKF has grown to be the world's leading ball bearing manufacturer.

## The evolution of bearings

The use of bearings can be traced back thousands of years and, for centuries, humans relied on their own strength to push and pull large objects over the earth.

One of the earliest attempts at reducing sliding friction between surfaces was recorded around 3 500 BC, when the Mesopotamians developed a primitive form of the wheel.

A bearing made of leather or wood was placed where the wheel and axle touched, and then lubricated with animal fat. In the late fifteenth century, Leonardo da Vinci incorporated drawings of bearings into his designs for a helicopter-like machine - the first recorded use of bearings in aerospace design (tabled below).

During the Industrial Revolution (1760 – 1840), steel began to be produced at large scale and products that had once been painstakingly crafted by hand were now mass-produced by machines in factories. Bearings played a pivotal role in this period, enabling greater machine efficiencies.

In 1907, Sven Wingquist, an engineer and founding member of SKF, designed the self-aligning ball bearing. Over the next decade, he marketed and distributed the company's bearings throughout Europe and set up sales offices in the USA, marking the beginning of SKF's global operations.

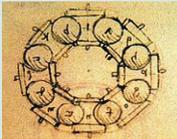
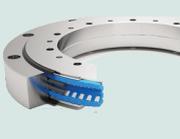
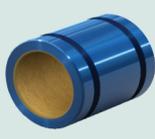
By the twentieth century, innovation in bearings progressed hand-in-hand with advances in the automobile, machine and military industries. The choice of rolling elements (the internal parts of bearings) expanded from balls to rollers, tapered rollers and spherical rollers that could support greater loads.

Today, the global bearing market is highly competitive with an estimated annual value of USD100 billion, which is expected to grow by 9% annually over the next five years. While SKF is the current market leader, with 27% market share, there are five other prominent international players who supply large industries worldwide and collectively represent around 33% of the market. They include: the Schaeffler Group, Timken, NSK, NTN and JTEKT.

## Industrial market dominance

SKF has developed a significant presence in various large industries including aerospace, energy and rail. Their experience and broad offering have resulted in an extensive distribution network with over 17 000 distributor locations globally.

## Evolution of bearings

1498-1500	1883	1898	1907	1934	1983
					
Drawing of a ball bearing by Leonardo da Vinci - the first recorded use of bearings in aerospace design	Friedrich Fischer developed an approach for milling balls of equal size - crucial for the manufacturing of bearings	Henry Timken patented the tapered roller bearing, which can support heavy loads due to a larger contact area	Sven Wingquist patented the modern self-aligning ball bearing design that allows for angular misalignment of moving parts	Erich Frank invented and patented the wire race bearing, which can be large yet lightweight and narrow	Robert Schroeder invented the first bi-material plain bearing that combines two materials

The company supplies bearings predominantly to the automotive and industrial markets. The latter accounts for around 70% of SKF's sales (charted below) and 90% of operating profits, with the remainder from the automotive industry.

The automotive market has become less lucrative over the years, with vehicle bearings becoming more commoditised and cheaply priced. Additionally, the growth of the automotive bearing market is becoming more commoditised by the increasing electrification of vehicles. Electric vehicles require fewer bearings than their conventional fuel-based counterparts, and therefore, SKF has decreased its exposure to the lower margin (typically around 4.5%) automotive market and focused on the higher margin (around 14.7%) industrial market where they dominate in the rail, heavy industry and industrial distribution arenas.

### Enduring demand

In the industrial market, bearings are less commoditised as they are generally more specialised, designed for specific functions and often regarded as critical components that are required to keep equipment running well. Industrial operators cannot risk the high cost of bearing failure by opting for cheaper alternatives to the brands known for quality. Consequently, bearings are priced higher in this market.

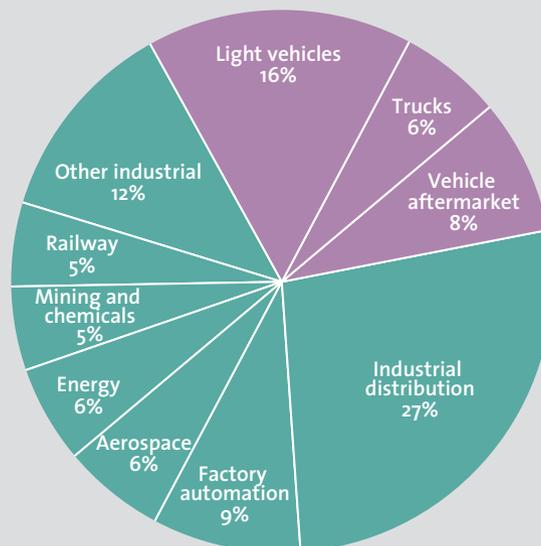
The lifespan of a bearing is dependent on the load it carries and the operating speed. While most bearings last between eight and 12 years, high-speed, high-load industrial bearings tend to have shorter lifespans, needing to be replaced more frequently. For example, in the paper industry, bearings are crucial in keeping paper mills rotating. If a bearing breaks down, the paper mill stops, potentially resulting in costly machine damage and extended operational downtime. Smooth industrial operations, therefore, involve the regular replacement of bearings (approximately every two years), which results in continuous demand.

### Full-service model captures more value

In a market challenged by commoditisation, SKF has responded by adapting its full-service offering to add more value to customers. Aside from providing the aftersales industrial market with bearings, lubricants and seals, SKF delivers technical advisory support, preventative maintenance services and conditioning monitoring. This allows customers to select the right bearings for their needs and to monitor and optimise performance.

Furthermore, digitisation has become a growth driver for SKF in recent years as they supply bearings fitted with sensors that enable the online monitoring of key operating statistics.

## SKF sales breakdown



# Investment in motion

Based on resulting analysis, machine maintenance can be adjusted and performed as required. Running times are improved and costs are reduced, while spare parts are ordered and dispatched automatically.

## Strategic investments for sustainable growth

Over the last three years, SKF has invested a significant 8.4 billion Swedish Krone (SEK) in state-of-the-art manufacturing technologies aimed at accelerating the modernisation of their factories and increasing manufacturing efficiency. This investment is proving to boost productivity as well as reduce lead times and the consumption of energy and raw materials, which in turn, enables more cost-effective bearing production.

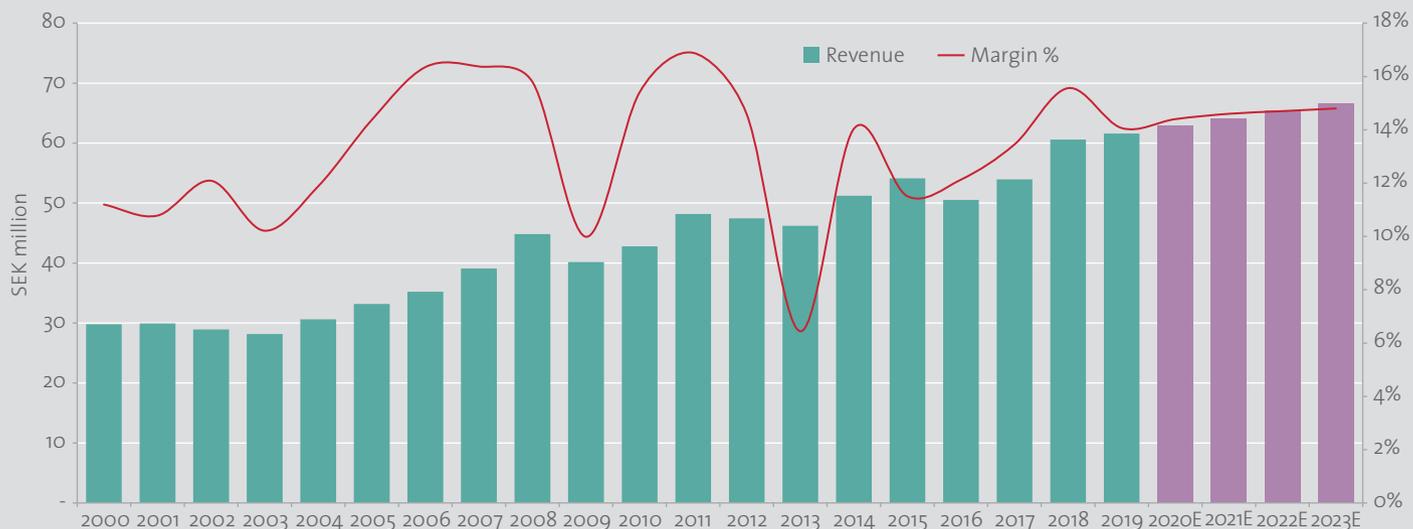
The company's investment scope is widening to include technologies that support fee-based business models. Systems are being introduced to ensure minimal wastage, resulting in

cost reductions for their customers and stable, regular revenue streams for the business. As indicated below, the enduring demand for bearings from the industrial market, coupled with greater factory efficiencies (and subsequent lower operating costs), will provide a solid platform for widening profit margins and lead to increasing sustainable revenue growth for SKF.

## Continued forward movement

Bearings are not only a vital part of every industrial process involving motion, they also need to be maintained and replaced on a regular basis, ensuring ongoing growth in demand. SKF is well positioned in an attractive market segment, with high intellectual property and a full-service offering. Consequently, we are positive about the company's long-term prospects and our clients hold SKF in funds with global equity exposure. **UP**

## SKF industrial revenue and profit margin



Source: company reports and Kagiso Asset Management estimates

## Kagiso Asset Management Funds

Performance to 31 March 2020	1 year	3 years <sup>1</sup>	5 years <sup>1</sup>	10 years <sup>1</sup>	Since launch <sup>1</sup>	Launch	TER <sup>2</sup>	TC <sup>3</sup>
<b>Unit trust funds<sup>4</sup></b>								
<b>Equity Alpha Fund</b>	-21.2%	-3.9%	-0.2%	6.5%	13.6%	Apr-04	2.27%	0.50%
SA Equity General funds mean	-21.3%	-6.0%	-3.3%	5.2%	10.2%			
Outperformance	0.1%	2.1%	3.1%	1.3%	3.4%			
<b>Global Equity Feeder Fund</b>	-	-	-	-	Not available	Nov-19		
Global Equity general funds mean								
Outperformance								
<b>Balanced Fund</b>	-13.2%	-0.3%	2.1%	-	6.3%	May-11	1.57%	0.46%
SA Multi Asset High Equity funds mean	-10.5%	-0.7%	0.9%		6.1%			
Outperformance	-2.7%	0.4%	1.2%		0.2%			
<b>Protector Fund</b>	-11.1%	0.4%	2.8%	5.1%	8.5%	Dec-02	1.56%	0.36%
CPI + 4%	8.2%	8.5%	9.6%	9.9%	10.4%			
Outperformance	-19.3%	-8.1%	-6.8%	-4.8%	-1.9%			
<b>Stable Fund</b>	-7.8%	2.1%	4.3%	-	6.5%	May-11	1.51%	0.44%
Total return of CPI + 2% pa	6.2%	6.5%	6.3%		5.9%			
Outperformance	-14.0%	-4.4%	-2.0%		0.6%			
<b>Institutional funds<sup>5</sup></b>								
<b>Managed Equity Fund (SWIX)</b>	-20.8%	-3.8%	-0.7%	6.6%	8.6%	Sep-06		
FTSE/JSE SWIX All Share Index	-21.9%	-5.0%	-2.2%	7.5%	8.6%			
Outperformance	1.1%	1.2%	1.5%	-0.9%	0.0%			
<b>Managed Equity Fund (Capped SWIX)</b>	-23.1%	-5.4%	-	-	-3.2%	Jan-17		
FTSE/JSE Capped SWIX Index	-24.5%	-7.4%			-6.2%			
Outperformance	1.4%	2.0%			3.0%			
<b>Domestic Balanced Fund</b>	-16.5%	-1.1%	1.2%	5.9%	6.3%	May-07		
Peer median <sup>6</sup>	-14.0%	-1.8%	0.8%	7.3%	7.1%			
Outperformance	-2.5%	0.7%	0.4%	-1.4%	-0.8%			
<b>Global Balanced Fund</b>	-12.3%	1.1%	3.4%	-	6.1%	Jul-13		
Peer median <sup>7</sup>	-14.1%	-1.2%	1.3%		5.3%			
Outperformance	1.8%	2.3%	2.1%		0.8%			
<b>Bond Fund</b>	-1.9%	6.5%	-	-	6.8%	Aug-15		
BESA All Bond Index	-3.0%	5.3%			5.6%			
Outperformance	1.1%	1.2%			1.2%			
<b>Money Market Fund</b>	8.3%	8.5%	8.3%	7.2%	7.9%	Jan-04		
Alexander Forbes STeFI Composite Index	7.2%	7.3%	7.2%	6.5%	7.4%			
Outperformance	1.1%	1.2%	1.1%	0.7%	0.5%			
<b>Sharia unit trust funds<sup>4</sup></b>								
<b>Islamic Equity Fund</b>	-19.3%	-2.9%	1.3%	6.2%	8.0%	Jul-09	1.41%	0.22%
SA Equity General funds mean	-21.3%	-6.0%	-3.3%	5.2%	7.2%			
Outperformance	2.0%	3.1%	4.6%	1.0%	0.8%			
<b>Islamic Global Equity Feeder Fund</b>	-2.1%	-	-	-	5.4%	Jan-19		
Global Equity General funds mean	2.0%				12.9%			
Outperformance	-4.1%				-7.5%			
<b>Islamic Balanced Fund</b>	-10.7%	0.0%	2.3%	-	4.8%	May-11	1.50%	0.16%
SA Multi Asset High Equity funds mean	-10.5%	-0.7%	0.9%		6.1%			
Outperformance	-0.2%	0.7%	1.4%		-1.3%			
<b>Islamic High Yield Fund</b>	1.3%	-	-	-	1.6%	Mar-19		
Short-term Fixed Interest Index (STeFI)	7.2%				7.2%			
Outperformance	-5.9%				-5.6%			

Highest and lowest monthly fund performance	Highest	Lowest								
Equity Alpha Fund	4.8%	-21.6%	6.6%	-21.6%	8.2%	-21.6%	8.2%	-21.6%	11.9%	-21.6%
Balanced Fund	3.9%	-15.7%	4.8%	-15.7%	5.5%	-15.7%	-	-	2.7%	-15.7%
Protector Fund	3.3%	-13.9%	3.3%	-13.9%	3.4%	-13.9%	4.8%	-4.2%	9.5%	-13.9%
Stable Fund	2.5%	-11.4%	2.5%	-11.4%	3.8%	-11.4%	-	-	4.0%	-11.4%
Islamic Equity Fund	3.4%	-14.3%	5.3%	-14.3%	7.3%	-14.3%	-	-	8.1%	-14.3%
Islamic Balanced Fund	3.0%	-9.3%	4.0%	-9.3%	4.6%	-9.3%	-	-	8.2%	-9.3%

Footnote and disclaimer follow overleaf.



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**Footnote:**<sup>1</sup> Annualised (ie the average annual return over the given time period); <sup>2</sup> 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 2020; <sup>3</sup> 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 2020; <sup>4</sup> Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; <sup>5</sup> Source: Kagiso Asset Management; gross of management fees; <sup>6</sup> Median return of Alexander Forbes SA Manager Watch: BIV Survey; <sup>7</sup> Median return of Alexander Forbes Global Large Manager Watch.

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