Bateleur Flexible Prescient Fund

First quarter 2023 commentary

Bateleur Flexible Prescient Fund – 2023 first quarter report back to unitholders

The fund made a steady start to the year returning 4.0% net of fees for the first quarter.

As comparatives, the JSE All Share Index appreciated 5.2% including dividends reinvested but before fees. A basket of SA bonds (ALBI) gained 3.4%, while cash (STeFI) returned 1.7%.

Fund attribution by strategy as well as the average exposure by strategy is shown in Table 1. JSE listed equities contributed 3.0% to fund returns while foreign listed equities added 0.9%. SA government bonds and cash contributed a combined 0.5%.

Table 1 – Q1 2023 Fund attribution by strategy

Attribution by strategy	Q1 2023	Average exposure (%)
JSE listed equities	3.0%	51.0%
Foreign listed equities	0.9%	27.3%
SA bonds	0.3%	9.7%
Cash & money market	0.2%	12.0%
Costs (and other)	-0.4%	
Total	4.0%	100%

Source: Bateleur

The top individual fund contributors and detractors are shown in Table 2.

Table 2 – Top individual fund contributors & detractors*

Top contributors	%		Top detractors	%	
Naspers/Prosus	1.1%		African Rainbow Minerals	-0.5%	**Increased**
Bidcorp	0.9%		Glencore	-0.4%	
Bidvest	0.5%	**Reduced**	AkerBP	-0.3%	

Source: Bloomberg, Bateleur *Refers to individual stock contribution to, or detraction from, overall fund return

Naspers rebounded following the re-opening of the Chinese economy and a solid 2022 fourth quarter set of results reported by its main investment, Tencent. Tencent guided to an improving 2023 outlook in its advertising and fintech businesses, while the licence approval of several new games indicates a thawing regulatory environment in China.

Bidcorp reported an excellent set of results for the 2023 interim period – well ahead of market expectations, buoyed by the return to out-of-home dining in many of its core international markets. The company remains well positioned to continue its growth trajectory in food services as it gains share in a highly fragmented industry.

Sister company Bidvest also reported record results for the six-month period to December 2022, comfortably ahead of consensus estimates. The SA freight, branded products and services divisions all surprised to the upside against a lacklustre economy. Bidvest's share price has re-rated above our assessment of fair value, and we have lightened the holding accordingly.

On the detractor side, African Rainbow Minerals (ARI) sold-off on weakness in the PGM and thermal coal markets. However, the company also has significant iron ore and manganese operations where prices have held up well.

At spot commodity prices, we estimate that ARI is trading on a P/E multiple of less than 5.0 times and a forward dividend yield in excess of 10%, both compelling. The company has a robust balance sheet with an estimated 25% of the market cap in net cash (R12bn). ARI's 12% interest in gold miner Harmony is worth an additional R6bn at current prices. We further increased the fund's holding in ARI during the quarter.

Glencore retraced some of its 2022 gains over the first quarter of 2023 with the drop in thermal coal prices negatively impacting sentiment around the stock. From accounting for close to 60% of group profits in 2022, thermal coal now accounts for roughly one-third of earnings at spot prices.

Notwithstanding the coal price decline, Glencore remains inexpensive, trading on an estimated spot P/E multiple of 7.2 times. The investment case for Glencore resides in its sizable exposure to the 'transition' metals of copper, nickel and zinc (in excess of 50% of group earnings at spot) and its substantial marketing business spanning several commodities, including oil. The company recently made an unsolicited bid for Canadian copper miner Teck Resources, to further progress its copper business.

Norwegian oil company AkerBP retreated on lower gas prices and generally lower enthusiasm for energy companies into slowing global growth. We continue to like the optionality in AkerBP for its numerous exploration licences and growing long-term oil production profile. The company retains a strong balance sheet with almost no debt (0.2 times net debt to EBITDAX[1]) and trades on an estimated forward P/E multiple of approximately 6.3 times with a dividend yield in excess of 7.0%.

<u>New investment – Alibaba</u>

Following three years of covid-related lockdowns, the Chinese economy is set to rebound in 2023. The Chinese government is targeting GDP growth of "about 5%" in 2023[2], a substantial improvement on the 3% growth delivered in 2022.

With Chinese households having amassed a record Rmb17.8 trillion[3] in savings during 2022, the stage is set for a consumption-led recovery. This bodes well for the Chinese e-commerce market, which is expected to return to double-digit growth in 2023 following a material slowdown in 2022[4].

Led by its flagship platforms *Taobao* and *Tmall*, Alibaba's *China Commerce* segment is the largest and most profitable player in the Chinese e-commerce market (Chart 1). Rising competitive intensity has been a feature of the Chinese e-commerce market, and Alibaba has so far managed to navigate this dynamic environment.

Examples include the launch of platforms such as *Taobao Live* (livestream commerce), *Taocaicai* (fresh and groceries) and *Taobao Deals* (rural e-commerce). Importantly, Alibaba has expanded into these adjacencies whilst maintaining best-in-class profitability in the core *China Commerce* segment.

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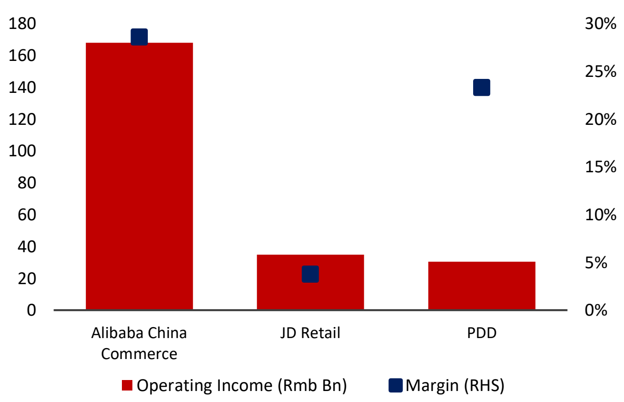
[1] EBITDAX - Earnings before interest,tax,depreciation,amortisation and exploration.
[2] 2023 Government Work Report – delivered by outgoing Premier Li at the China People's Congress in March 2023
[3] Peoples Bank of China, Financial Times, 24 January 2023 – equivalent to 15% of 2022 GDP versus an average of 9% in the 2018-2021 period
[4] Morgan Stanley see China ecommerce sales growth recovering from 7.9% in 2022 to 10.9% in 2023 and 11.2% in 2024.

Alibaba's focus on efficiency extends beyond the core *China Commerce* segment. This is illustrated by the improvement in operating losses reported at five out of six of Alibaba's other business segments in the nine-months to December 2022 (Chart 2).

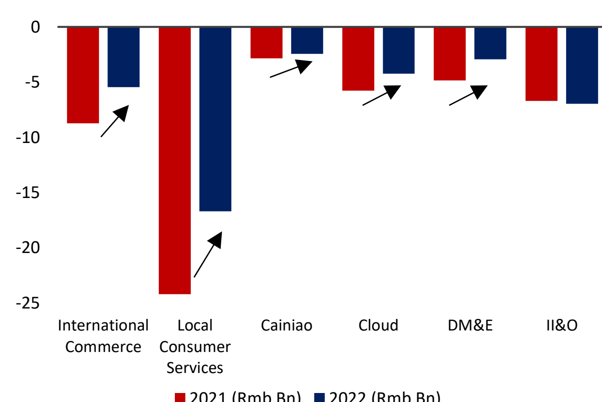
Reduced losses in other segments should serve as a source of earnings growth over the medium-term. With an improving macroeconomic backdrop and focus on margins, we are confident on the prospects for profit development at Alibaba through the remainder of 2023.

Chart 1: Alibaba has higher margins than peers.



Source: Company disclosures, 12m to Dec 2022; Bateleur

Chart 2: Alibaba's other segment losses reducing.



Source: Company disclosures, 9m to Dec 2022; Bateleur

In addition to improving prospects, Alibaba has a strong balance sheet**.** Net cash and investments of Rmb795 trillion (US$114 billion) were reported at 31 December 2022. The group has over US$21 billion[5] in share repurchase authority remaining through the end of March 2025, which should also support earnings per share growth.

There are further key initiatives underway aimed at enhancing shareholder value**.** Most notable is the recently announced restructuring plan, effectively splitting the group into six distinct business units, each with their own independent board of directors. This will pave the way for the potential future listings (IPO's) of these businesses. Management also indicated a willingness to monetise certain passive investments to unlock value.

With a market capitalisation of Rmb2 trillion (US$258 billion), Alibaba's stock trades at just over 11 times expected earnings over the next twelve months[6] – below historical averages and not far off trough levels.

The combination of improving fundamentals, a solid balance sheet and discounted valuation provides an attractive investment opportunity. This is supported by upside potential emanating from the pending organisational restructure and monetisation of passive investments.

[5] Company disclosures, Bateleur
[6] FactSet consensus

New investment – Heineken

Heineken has a long history dating back to its formation in 1864. Headquartered in Amsterdam, it is the world's second largest brewer (after AB InBev) with over 300 brands across more than 190 countries. The Heineken® brand is one of the world's most recognisable and valuable beer brands, and accounts for approximately 20%[7] of group annual revenues.

Heineken has impressive financial metrics and generates high quality cash earnings. However, it is the potential for operating profit margins to improve from current levels that excites us about this investment opportunity. We expect "premiumisation" and lower input costs to lift margins and drive profit growth over the medium-term.

"Premiumisation"

Global beer consumption has not meaningfully increased over the past decade and is unlikely to do so going forward. Demographics and societal changes that promote healthier lifestyles play a part in this, but growing incomes have also given rise to a more sophisticated consumer who prefers quality over quantity. This "premiumisation" is a well-established trend that can be observed across many consumer products but is particularly strong in the alcoholic beverage industry.

Heineken has capitalised on this trend by gradually shifting more of its sales into premium categories (such as the Heineken® brand) that attract higher operating profit margins. The company discloses that in excess of 40%[8] of group revenues are derived from premium category beer sales, which has two to three times[9] higher margins than mainstream beers.

Our research identifies that over time, Heineken has benefitted more than its peers from the global "premiumisation" trend which we attribute to its strong brands, and marketing excellence being ingrained in the company's DNA. This differs from key competitor AB InBev, who has relied on large, complex and expensive acquisitions to facilitate revenue and market share growth.

Declining input costs

Prices of important input costs for brewers (such as malt, barley and aluminium) have been exceptionally high over the past two years in part due to supply chain disruptions and commodity inflation. This has hurt operating margins across the beverage industry (Chart 3).

However, these input prices have retraced sharply from their highs. Heineken's CEO indicated at a recent investor conference that cost inflation is no longer a headwind and is more likely to be a tailwind for operating margins into financial 2024.

With lower input costs and Heineken's premium focused brand portfolio able to retain price momentum, the business is set up for a strong recovery in operating profit margins, cash flows and earnings growth (Chart 4).

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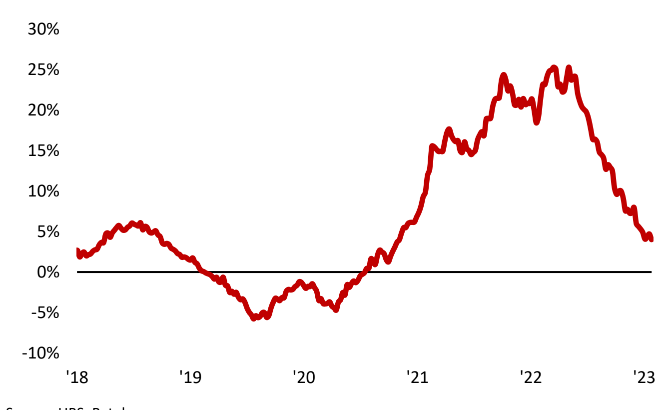
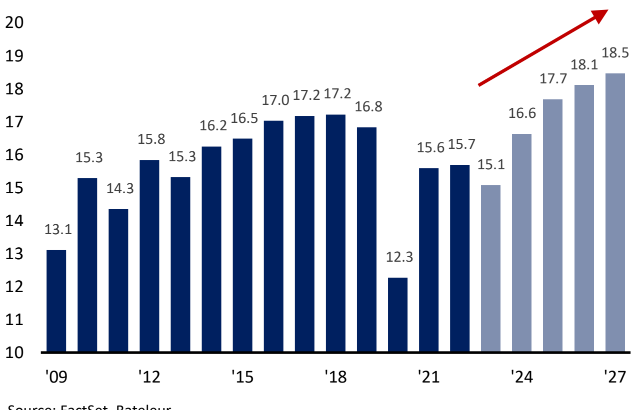
[7] Heineken 2022 financials
[8] Heineken 2022 results presentation
[9] Heineken 2018 capital markets day

Chart 3: Brewer cost of goods index (% change yoy)



Source: UBS, Bateleur

Chart 4: Heineken operating profit margins (%)



Source: FactSet, Bateleur

<u>Current fund positioning</u>

Fund positioning has not changed materially since the start of the year and remains conservative against the backdrop of high interest rates, quantitative tightening, negative corporate earnings revisions and fair-to-full global equity valuations.

12.1% of fund value is invested in money market instruments – earning an average income yield of 7.2%.

SA government bond exposure of 9.2% predominantly resides in the January 2030 maturity. The average yield on the bond portfolio is currently 10.3%.

Taken together, 21.3% of the fund's value is held in highly liquid instruments – a portion of which is available to be deployed into equities when appropriate.

Foreign equity exposure is currently 29.1%, an increase from the start of the year (25.2%), largely due to the recent inclusion of Alibaba and Heineken in the fund. Although improving, the risk/reward set up on global equities and bonds is not yet sufficiently favourable to materially upweight toward the maximum allowed 45% level.

Foreign equity holdings include quality defensives (Philip Morris, J&J, Heineken and Comcast), compounders (Dollar General, Universal Music, LabCorp and Accenture), quality growth (Amazon, Alphabet, Visa, Sony and Alibaba), and the energy sector (Total Energies and AkerBP).

The fund's JSE listed exposure is currently 49.6% – broadly split between dual listed/Rand hedge stocks (23.6%) and domestic facing holdings (26.0%).

The dual listed/Rand hedge component includes resource (Glencore and African Rainbow Minerals) and technology companies (Naspers and Prosus). Both groups should benefit from the reopening of the Chinese economy.

Domestic facing holdings include select mid-cap's (AECI, Italtile and Adcock Ingram), financials (FirstRand), food retail (Shoprite) and investment holding (Remgro).

The fund recently initiated a position in physical copper through an equity traded note ('ETN'). This was premised on the attractive demand outlook for copper and lack of major new supply coming on-stream over the medium-term.

A summary of the current fund positioning by strategy is shown below. The forward P/E multiple of the combined equity (JSE and foreign) portfolio is estimated at 10.6 times. Our assessment of the fair value of the fund's equity holdings is significantly above current levels.

Current fund positioning by strategy	**%**
JSE listed equities	49.6%
Domestic facing holdings	26.0%
Dual listed/Rand hedge	23.6%
Foreign listed equities	29.1%
Total equity exposure	**78.7%**
SA government bonds	9.2%
Cash & money market	12.1%
Total	**100.0%**

Sincerely,

Kevin Williams
24 April 2023

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