Bateleur Flexible Prescient Fund

Third quarter 2023 commentary

bateleur capital

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

The fund returned 8.1% net of fees for the nine months to end September 2023. As comparatives, the JSE All Share Index appreciated 2.2% including dividends reinvested, but before fees. A basket of SA government bonds (ALBI) gained 1.5%, while cash (STeFI) returned 5.7%.

Attribution by strategy as well as the top contributors and detractors are shown in Table 1. Foreign listed equities added 4.6% to returns assisted by technology holdings and rand weakness. JSE listed equities contributed 3.5 %, while government bonds and cash delivered a combined 1.1%.

The top individual contributors were Bidcorp, Amazon, AECI, Alphabet and Bidvest. Except for African Rainbow Minerals, detractors were limited in terms of magnitude.

Table 1: Fund attribution by strategy and top contributors and detractors - YTD to 30 September

Strategy	Return (%)	Ave. exposure (%)	Top contributors	%	Top detractors	%
Foreign listed equities	4.6%	30.0%	Bidcorp	1.1%	African Rainbow Minerals	-1.6%
JSE listed equities	3.5%	47.0%	Amazon	1.0%	Growthpoint	-0.4%
Cash & money market	0.6%	12.0%	AECI	1.0%	Italtile	-0.4%
Government bonds	0.5%	11.0%	Alphabet	0.8%	Alibaba	-0.3%
Costs (and other)	-1.1%		Bidvest	0.7%	Heineken	-0.3%
Total	8.1%					

Source: Bateleur

Continued strong employment data from the US and higher than expected core inflation have led markets to price in a 'higher for longer' interest rate environment. This resulted in a challenging quarter for both stocks and bonds, but especially longer duration bonds, where yields spiked – causing sizable mark-to-market capital losses.

Only minor alterations were made to the composition of the portfolio over the past quarter (Table 2). Our philosophy is to resist making wholesale investment changes based solely on short-term market gyrations and macro 'noise'.

Table 2: Fund portfolio changes by strategy between Q2 and Q3 2023

Strategy - Q2 2023	(%)	Strategy - Q3 2023	(%)
JSE listed equities	46%	JSE listed equities	44%
Domestic facing holdings	23%	Domestic facing holdings	23%
Dual listed/Rand hedge	23%	Dual listed/Rand hedge	21%
Foreign listed equities	31%	Foreign listed equities	33%
Total equity exposure	**77%**	**Total equity exposure**	**77%**
SA government bonds	10%	SA government bonds	10%
US 2yr T-Bills	2%	US 2yr T-Bills	3%
Cash & money market	11%	Cash & money market	10%
Total	**100%**	**Total**	**100%**

Source: Bateleur

<u>JSE listed equities:</u>

Between the June and September quarter, the fund's JSE listed equity exposure reduced marginally from 46% to 44%. <u>No new holdings were added</u>. Holdings were lightened in Adcock Ingram and Bidvest following a period of strong share price appreciation.

Weightings were increased in African Rainbow Minerals ("ARI"), Mondi and Shoprite in the latter part of the quarter following price weakness in all three companies.

ARI's share price has sold off as if it were a pure platinum group metal ("PGM") play. It isn't. The company has substantial iron ore and manganese assets – and recently completed a R10bn multi-year expansion of its Blackrock and Gloria manganese mines in the Northern Cape.

ARI additionally owns 20% of Glencore's SA coal operations, has chrome interests, a large marketing business, and a 12% interest in gold miner Harmony. ARI's balance sheet is robust with an estimated net cash balance of R12bn.

On spot commodity prices (which are well below trend), ARI trades on an estimated P/E multiple of less than 4 times, which significantly undervalues the business.

Mondi recently sold its Russian integrated paper interests and has already banked 70% of the proceeds. The remaining proceeds will be received by the end of December 2023. The company has indicated that it will return all net proceeds from the disposal to shareholders as the group's balance sheet is underleveraged. If this takes place through a special dividend, it will yield 10% on the current Mondi share price.

Notwithstanding the disposal of the profitable Russian facility, Mondi remains a well-run, high-return European paper business. We estimate that the share trades on a P/E multiple of approximately 12 times on cyclically low earnings – which is considered an attractive level to add to the fund's weighting.

The recent sell-off in Shoprite's share price post its full year results - was in part due to investor concerns over the group continuing with its heavy investment program (both expansionary capex and price discounting) and the negative impact this would have on near-term earnings growth.

This is short-sighted. With Spar overly indebted and suffering from IT implementation issues, and Pick n Pay reeling from a poorly executed market segmentation strategy, now is the ideal time for Shoprite to increase its 34%[1] market share and widen the yawning gulf to its peers through targeted investments.

Shoprite already leads the market in distribution efficiency, market segmentation, technology, online delivery and loyalty cards. There is still ample market share up for grabs in liquor, clothing, pet, outdoor, private labels and, at the premium end, in fresh produce.

The group should further benefit from the full integration of the recently acquired 94 Massmart stores (rebranded to Shoprite) and reduced loadshedding costs in financial year 2024. Generator diesel costs (fully expensed) were R1.3bn in 2023 – a sizable 11% of group trading profit.

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[1] Source: NielsenIQ 52-week period to end June 2023.

Foreign listed equities:

The fund's foreign listed equity exposure increased marginally over the quarter from 31% to 33% partly bolstered by rand weakness. One new holding was added – French road and airport concessions operator Vinci, which offers steady and predictable earnings growth and an attractive dividend yield.

Holdings were lightened in Accenture, Berkshire Hathaway and Visa following strong price gains.

Weightings were further increased in Alibaba, Aker BP, Amgen, Universal Music ("UMG") and Amazon.

We have detailed our investment case in prior report backs on both Alibaba (value unlock through restructuring) and Aker BP (increasing oil production profile through to 2028 with best-in-class operating costs). The investment rationale for both remains intact.

Following a protracted battle with the US Federal Trade Commission ("FTC"), Amgen's USD 28bn acquisition of Horizon Therapeutics (leaders in the treatment of thyroid eye disease) was approved in early September. The transaction provides an additional growth vector to Amgen's existing biologic pipeline and should be earnings accretive from financial year 2024.

UMG is the world's leading music label that houses artists including Taylor Swift, Billie Eilish and Elton John. The business is a high-quality, capital-light compounder, well positioned to benefit from the increased consumption (through the continued growth of streaming subscribers) and improving monetisation of music (through an increased share of the streaming revenue wallet).

UMG has delivered an impressive average return on invested capital of 25%[2] per annum between 2019 and 2022. Looking ahead, the company is targeting high single-digit annual revenue growth, further margin expansion and consistent double-digit earnings growth.

Amazon 'over earned' from excess e-commerce demand during the pandemic era. When this reverted to trend growth, the company quickly found it had surplus capacity in its warehouse and transportation infrastructure (fulfilment) and too many employees - which negatively impacted group profitability.

Under the impressive Andy Jassy, Amazon has now right-sized its operations for more normalised demand patterns, while also targeting profitable growth in the key areas of third-party seller services, advertising and Prime membership.

These efforts are starting to bear fruit, with Amazon's US e-commerce business showing a marked improvement in cash generation in the second quarter of 2023. Operating profit margins are still a very low 1.0%[3], with material upside forecast over the medium-term.

On the cloud front, market leader Amazon Web Services ("AWS") recent revenue slowdown appears to be inflecting – with the company well placed for the ongoing structural tailwinds of cloud migration, increased digitization, and the adoption of new AI technologies.

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[2] Bateleur capital estimates based on UMG financial disclosures.

[3] Trailing twelve months to June 2023 – Source: Amazon quarterly results disclosures.

Government bonds and income yielding assets:

Longer duration bond yields have risen in SA (chart 1) but especially in the US (chart 2) as investors contemplate inflation and interest rates remaining elevated for longer. Mark-to-market capital losses further out the curve have led to another poor total return performance from government bonds YTD.

Chart 1: SA government bond yield curve

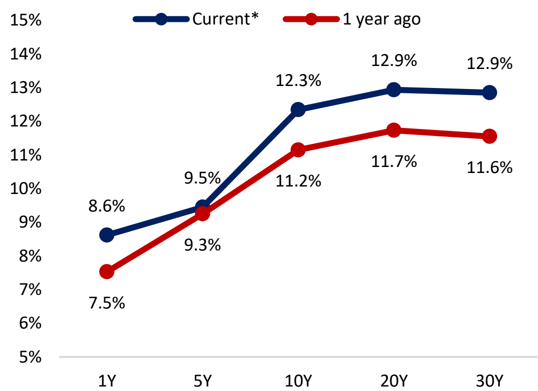
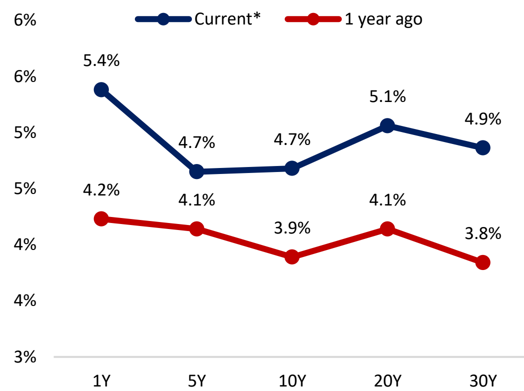


Chart 2: US government bond yield curve



Source: Bateleur; Bloomberg *as of 10th October 2023

For the YTD period to the end of September, the world government bond index has declined 2.7% in US dollars. This is on the heels of the record 18.3% drawdown in 2022. Similarly, a basket of SA bonds has returned only 1.5% in rand YTD.

The fund's domestic government bond exposure predominantly resides in the January 2030 maturity that currently yields 10.8%. Our intention is to hold this bond through to maturity. Fund investors will recollect our reason for initially investing in these bonds back in 2020 was due to the substantial yield differential at the time (approximately 5.7%) between the 2030 maturing bonds and short-term interest rates. This relative trade (out of cash into bonds) has worked well over the three-year period since implementation.

With respect to foreign bonds and specifically US Treasuries – our previous communication is unchanged – namely that the 5.25% increase in the Fed Funds rate over the past eighteen months will ultimately be sufficient to slow the US economy and tame core inflation to around the 3% level. As a result, we see good value in the short end of the curve that is not subject to the same capital risk as longer duration bonds.

The fund's cash weighting reduced marginally from 11% to 10% over the quarter and provides a suitable buffer to market volatility as well as providing firepower should market opportunities materialise.

Sincerely,

Kevin Williams
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