Bateleur Flexible Prescient Fund

First quarter 2024 report back

bateleur capital

Bateleur Flexible Prescient Fund – 2024 first quarter report back to unitholders

The fund appreciated marginally (+0.7%) over the first quarter of 2024. As comparatives, the JSE All Share Index declined 2.2%, a basket of SA government bonds (ALBI) fell 1.8%, while cash (STeFI) returned 2.0%.

We would consider the first three months of the year as too short a measurement period to draw any meaningful conclusions on the fund's performance.

For completeness, the fund's quarterly attribution by strategy and top contributors and detractors are displayed in Table 1. Foreign listed equities added 3.7% to returns, JSE listed equities detracted 2.9%, while bonds were broadly return neutral.

Table 1: First quarter 2024 - Fund attribution by strategy and top contributors and detractors

Strategy	Return (%)	Top contributors	%	Top detractors	%
Foreign listed equities	3.7%	Amazon	0.8%	African Rainbow Minerals	-0.9%
JSE listed equities	-2.9%	TSMC	0.6%	Remgro	-0.8%
SA Government bonds	-0.1%	ASML	0.5%	FirstRand	-0.5%
US 2YR T.Bills	0.2%	Microsoft	0.4%	AECI	-0.4%
Costs (and other)	-0.2%	Nvidia	0.4%	Shoprite	-0.3%
Total	0.7%				

Source: Bateleur

The top individual contributors were exclusively offshore technology companies that continue to benefit from AI driven momentum.

The sustainability of this outperformance is dependent on these companies ongoing ability to generate superior long-term revenue and earnings growth once the current AI hype recedes.

In this regard, we are unsure as to the sustainability of Nvidia's recent extraordinary revenue growth rates and elevated operating margins. This led to the fund exiting this holding in the quarter.

In the semi-conductor space, both ASML (lithography machines) and TSMC (advanced chips) earnings are forecast to benefit from the general upturn in the global semi-conductor cycle in addition to incremental AI chip demand.

Amazon (the fund's largest holding) and Microsoft remain well positioned in the rapidly evolving AI landscape, especially in cloud infrastructure, where AWS (Amazon) and Azure (Microsoft) dominate.

Amazon's vast retail business (annual revenue run rate of approx. USD500bn) has additional margin uplift potential through both revenue initiatives (growth in advertising, prime membership fee increases, third party fulfilment, international regions reaching profitability inflection) and efficiency gains (move to regional delivery hubs, eliminating loss-making businesses, increased workforce productivity).

The top detractors were all JSE listed equities – reflecting the broad malaise of the SA economy and dearth of investor interest in SA public markets.

Domestic underperformance has been accentuated by foreign investor selling. Since 2016, foreigners have sold a net R850bn in SA listed equities (Chart 1), to levels where the foreign active emerging market equity allocation to SA has declined to a measly 2% from a peak of almost 12% in 2005[1].

Local fund managers have also been steadily increasing their offshore allocation toward the upper allowed institutional limit of 45% (Chart 2), largely funded from domestic equity and bond sales.

Chart 1: Foreigners selling of JSE shares (Rbn)

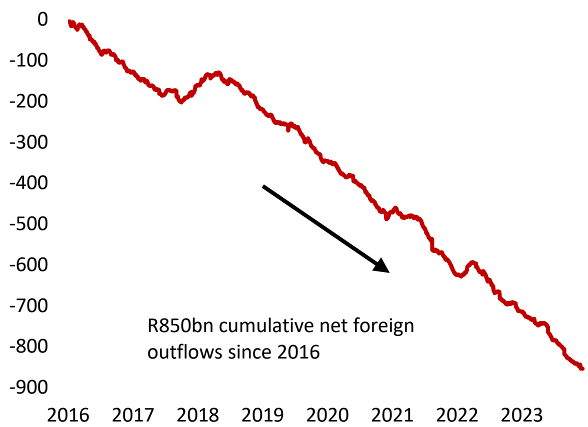
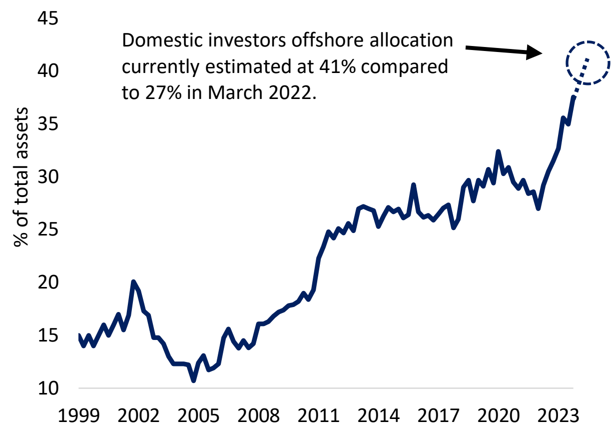


Chart 2: SA institutions offshore allocation (%)



Source: Bateleur, Bloomberg, SBG securities

While there is consensus that SA listed equities and bonds are cheap, there is far less certainty over whether these assets are a value trap or will at some stage materially re-rate.

A slowdown in portfolio outflows (which should be nearing an endgame) coupled with a stable election period (and satisfactory outcome) could conceivably lead to a sharp short-term re-rating of both SA equities and government bonds.

However, a long-term sustainable re-rating is conditional on materially higher trend GDP growth in SA. This, in turn, is dependent on suitably functioning critical infrastructure and increased capital investment, both of which are reliant on sound government policy. Unfortunately, we are less confident on this scenario playing out favourably.

Using a disciplined investment approach and being cognisant of ruling exchange rates, the fund's allocation to offshore assets has steadily increased to 44% at the time of writing, well up from 36% at the start of the year. This increase has occurred through a combination of the fund's offshore portfolio outperforming the domestic portfolio (i.e. market movements) as well as new direct foreign purchases.

Although several global equity opportunities were identified and researched in the quarter under review, only three translated into new fund investments - Novo Nordisk, Safran and Merck. A detailed discussion on the Novo Nordisk investment case is followed by brief explanations on Safran and Merck.

[1] Source: SBG Securities

Novo Nordisk (‘Novo’)

Danish pharmaceutical (‘pharma’) company Novo is the largest listed company in Europe with a market capitalisation of USD552bn. Founded in 1923, the company has built an impressive leadership position in the treatment of diabetes – initially in the provision of insulin to the European market, and more recently via their game changing GLP-1 drugs.

First, a brief history to contextualise the current excitement sweeping through the global diabetes and obesity market.

For several decades, medical scientists have researched the hormones that help regulate the body’s blood sugar levels in pursuit of finding better treatment options for diabetes (other than injecting insulin).

In the early 1970’s a specific hormone was identified that is secreted in the gut after a meal to assist in regulating blood sugar in the body. This hormone, GLP-1[2] , boosts insulin secretion by the pancreas to keep glucagon production in check.

Pharma companies found over time, through extensive R&D, that certain manufactured drugs could mimic this hormone’s action in the body (suitably named GLP-1 drugs) and therefore effectively assist in the treatment of Type 2 diabetes. After receiving regulatory approval, Novo launched their first diabetes GLP-1 drug commercially in 2010, named *Victoza*.

During subsequent clinical trials to further advance the medication, a fascinating discovery was made. Participants that were treated for diabetes with GLP-1 drugs consistently showed meaningful weight-loss, largely due to appetite suppression.

It soon became clear that GLP-1 drugs did not only offer effective treatment for diabetes, but that they also successfully reduced obesity - widely regarded as one of the world’s largest health problems.

Novo was at the leading edge of this groundbreaking research and was the first pharma company to bring a blockbuster GLP-1 drug to the market that could effectively treat both diabetes and obesity, albeit under different brand names and different dosages (*Ozempic* for diabetes - commercially launched in 2017, and *Wegovy* for obesity – commercially launched in 2021).

The company has continued to invest heavily in new drug development and has an exciting pipeline of enhanced GLP-1 drugs in various stage clinical trials that display higher efficacy and improved tolerability over the current drugs on market.

At present, the substantial GLP-1 market for diabetes and obesity is split evenly between two pharma incumbents - Novo and its US competitor Eli Lilly (who shares a somewhat similar history to Novo but also produces a suite of drugs targeting other diseases). With insatiable demand for their GLP-1 drug offerings, these two company’s revenue growth rates are restricted only by supply constraints in the short-term.

2 “Glucagon-Like-Peptide 1”.

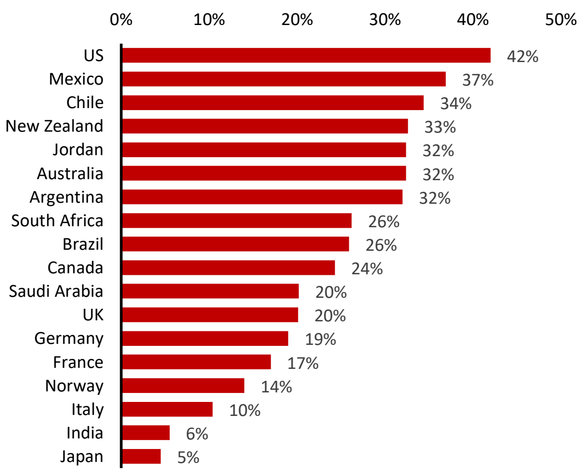
While other pharma companies (including Amgen and Viking Therapeutics) have also shown potential GLP-1 drug candidates and are likely to compete for market share, these new products are still in trial phase and will take time to bring to market and gain credibility.

At its recent capital markets day in March 2024, Novo provided several datapoints that clarify the enormous addressable market for the treatment of obesity and diabetes. For example, in the US the CDC[3] estimates that 111m people are classified as obese, which is a staggering 42% of the total US adult population (Chart 3). A further 36m adults in the US have been diagnosed with Type 2 diabetes.

To put this in context, only 700k patients in the US were treated for obesity with GLP-1 drugs in 2023 (up from 100k in 2022) which implies a lowly 0.6% obesity penetration rate. Some 2.9m patients suffering from Type 2 diabetes received treatment with GLP-1 drugs, which implies a slightly higher diabetes penetration rate of 8.1%.

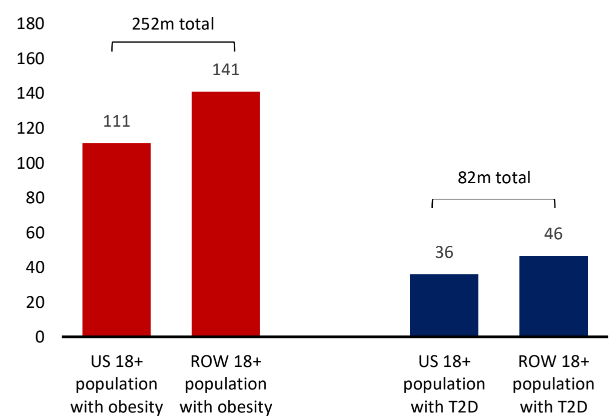
If the net is cast wider to include the global developed world population, the addressable market more than doubles to 252m adults who are classified obese[4] and 82m people with Type 2 diabetes (Chart 4).

Chart 3: Obesity % per country



Source: World Obesity

Chart 4: Obesity and diabetes addressable market



Source: WHO, Novo Nordisk

The current low penetration rates of GLP-1 drugs for obesity treatment can be explained by 1) the relative newness of the drugs, 2) supply constraints (lack of highly regulated manufacturing facilities that are currently being constructed), 3) the current lack of coverage by major medical aid schemes, and 4) the lack of affordability for uninsured people. In the US, the out-of-pocket cost for an uninsured person on *Wegovy* is as much as USD1,060 per month (or USD12,720 annually).

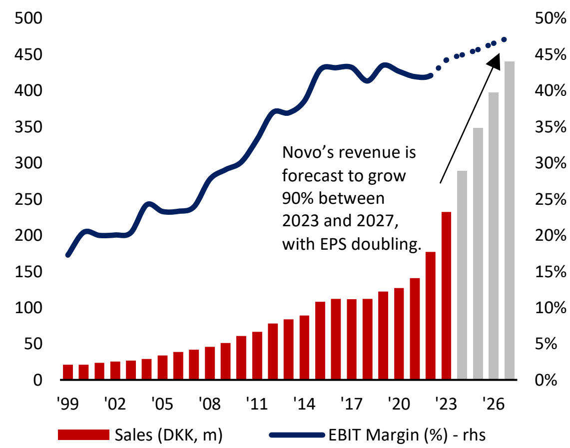
With an estimated 80% of obese people having co-morbidities[5], several ongoing trials are showing significant risk reduction in obese patients that suffer from added health issues such a heart disease, pulmonary hypertension, fatty liver disease and sleep apnea. Early clinical trial data suggest it may even lower the risk of Alzheimer's disease.

[3] Centres for Disease Control and Prevention.
[4] According to the WHO.
[5] Novo Nordisk Capital Market Day presentation March 2024

Positive trial outcomes in the successful reduction of co-morbidities could become a critical factor in providing wider accessibility to GLP-1 drugs as medical aid schemes become amenable to reimburse patients for obesity treatment.

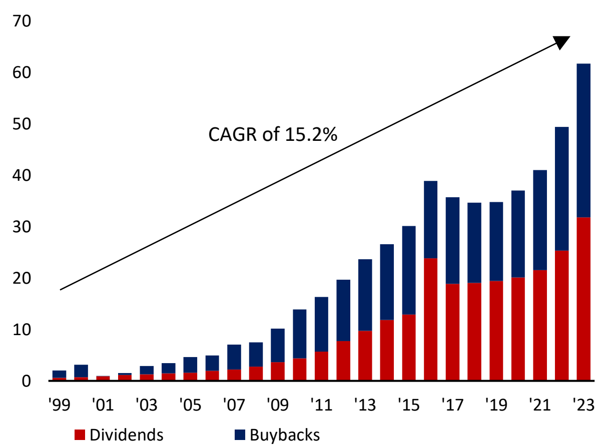
Despite the substantial growth opportunity in front of Novo, it is important to highlight the group's existing business, which boasts an impressive track record of strong revenue growth and industry leading margins (Chart 5), high quality cash earnings, and a conservative balance sheet with negligible debt. Novo has also proven to be a disciplined capital allocator that consistently returns surplus cash to shareholders (Chart 6).

Chart 5: Novo - revenue and EBIT margins



Source: Factset

Chart 6: Novo - consistent return of capital



Source: Factset

With robust market demand, a broad existing product line-up, and a healthy new product pipeline in place, Novo is well positioned to continue to deliver strong earnings growth (with EPS forecast to double by 2027 from 2023 levels), while generating outsized free cash flows and returning excess capital to shareholders.

Safran

French based Safran is the global leader (70% market share[6]) in single aisle commercial jet engines with an attractive growth profile driven primarily by the roll-out of its latest generation LEAP engines. The business operates in an oligopolistic market with pricing power that typically exceeds inflation. Importantly, more than half of the group's revenue comes from high-margin, cash generative after-market services.

We expect Safran to deliver a 3-year CAGR of 25% in earnings per share as the demand for air travel remains resilient, fundamentals at its customers (aerospace manufacturers and airline operators) continue to improve and the industry recovers beyond pre-covid levels.

Merck

Merck is a well-managed large cap US pharma business that holds the exclusive licences for the blockbuster cancer immunotherapy drug *Keytruda* (one of the top selling drugs in the world) as well as

[6] Source: Morningstar research 20 February 2024

the HPV vaccine *Gardasil.* These two products are expected to drive double digit earnings growth at Merck over the medium-term.

An encouraging drug development pipeline and investment in various therapeutic areas, for example *Sotatercept* in pulmonary arterial hypertension, also positions the business well for sustained long-term earnings growth – even when *Keytruda* loses its exclusivity licence. Merck trades on an estimated twelve-month forward P/E multiple of 14.2 times which we view as attractive considering the healthy earnings growth outlook.

<u>Conclusion:</u>

A summary of the fund’s current weighting by asset class is shown in Table 2 below.

Sixty-four percent of the fund’s NAV is globally focused – comprising foreign listed individual equities (37%), foreign government bonds (4%), foreign cash and money market instruments (3%) and JSE listed shares that are either dual listed or exhibit rand hedge attributes (20%).

The remaining thirty-six percent of the fund’s NAV is SA focused – comprising domestic facing JSE listed equities (18%), SA government bonds (8%) and SA cash and money market instruments (10%).

The weighted average twelve-month forward P/E multiple of the fund’s equity portfolio is estimated at 12.2 times – with the SA domestic segment at 7.8 times and the foreign segment at 16.8 times.

Table 2: Current fund positioning

Asset class	%
JSE listed equities	38%
Domestic facing holdings	18%
Dual listed/rand hedge	20%
Foreign listed equities	37%
SA government bonds	8%
US 2yr T-Bills	4%
US cash & money market	3%
SA cash & money market	10%
Total	**100%**

Source: Bateleur – data as at 12 April 2024

We remain confident in delivering on the fund’s investment objectives.

Sincerely,

Kevin Williams
22 April 2024

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