# Perpetua Perspectives

Summer Edition 2022

# Contents


3 **Opening Perspectives**
Kevin Dantu

5 **On my mind: Trust in government is low for South African businesses**
Delphine Govender

8 **Macro-economic overview: Inflation rising rates – a new world order**
Patrick Ntshalintshali

11 **Russia's invasion of Ukraine increases geo-political risk**
Graeme Ronné

15 **Platinum companies battle it out: Two is company, three is a crowd**
Lonwabo Maqubela

18 ***RI in Focus*: British American Tobacco vs ESG: how to reconcile**
Thomas Blamey

23 ***EXPLAINED*: Going beneath the "value" label**
Glen Heinrich and Kevin Dantu

**Read our 2021 Annual Stewardship Report here**

# Opening Perspectives

A few weeks ago, not many of us would have anticipated the dramatic escalation of the conflict taking place in Ukraine as Russian military forces began an invasion in late February, sparking humanitarian and economic devastation in the country which is a former Soviet republic. The resultant geo-political conflict and tension has heightened anxiety across the globe as various countries and regulatory authorities reacted with economic and travel sanctions against Russia, in order to put pressure on it to de-escalate its military attacks. This has naturally had an adverse effect on markets which were already grappling with the on-going COVID-19 pandemic, the prospect of slowing economic growth, and several developed countries facing rising inflation and consequently increases in interest rate following multi-decade year lows. Along with the rest of the world we hope and pray for an end to the invasion and conflict in Ukraine, and that a peaceful resolution is reached as soon as possible.

On 24 February 2022, The Financial Mail published an abridged version of the article by our Chief Investment Officer, Delphine Govender, titled "Corporate SA is losing trust". In this edition of our Perpetua Perspectives, Delphine expands on this topic by discussing the nuances likely to be prevalent in the upcoming release of JSE-listed **companies' financial results**, as well touching on Finance Minister Godongwana's **2022 budget speech** and the implications for businesses in South Africa.

Our macro-economic piece addresses the possibility of a stagflation environment and what this holds for investors. With several developed market central banks in uncharted territory trying to manage a scenario of **rising inflation and slowing growth**, we share our views on the global market outlook and how investors can adjust their portfolios in anticipation of this environment.

**Russia's invasion of Ukraine** sent a wave of panic, uncertainty and distress across the globe and markets. As an investor with exposure to Russian stocks, we share our views on the global response considering the sanctions imposed, the economic implications thereof and how we are managing the positions in our client portfolios.

In our Perpetua Perspectives Winter 2021 edition (July 2021), we wrote an article titled "Impala: Shareholders cannot have their cake and eat it too." In this edition we provide a follow-up with **our view on Impala's bid for Royal Bafokeng Platinum,** and how our client portfolios benefited from this transaction.

**Our Responsible Investing in focus or "*RI in focus*"** feature addresses the longstanding debate on how an investment manager that incorporates ESG into their portfolios can give grounds for owning a controversial

company like British American Tobacco. We provide our thoughts and insights with regards to how we engage with this debate.

Our *Explained* piece **digs beneath the label of value investing**, as we unpack what it means to be a value investor. We also discuss the current idiosyncrasies which exist in the valuation metrics of key constituents of the JSE Value and Growth indices and how they are not necessarily a reflection of the intended investment style.

We hope that you find this edition interesting and useful, and we look forward to engaging with you with regards to any of the contents.

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*By Kevin Dantu*

*Kevin is Perpetua's Head of Clients. Kevin has over 21 years' experience in investment management and holds a B Comm.*

# Trust in government is low for South African businesses

Over 20 JSE-listed companies are expected to release financial results over the next week or two. Their respective fortunes are expected to be mixed. The commodity companies like Sasol, Amplats, Anglos and Kumba will naturally be pinned to their underlying commodity baskets (which at spot prices don't look too shabby at all). The more domestically oriented companies like Spur, Woolworths, City Lodge, Curro and Motus will reveal a performance impacted by a variety of factors: whether benefitting (or not yet) from post COVID-19 business activity recovery; effects of necessary cost-cutting initiatives; business disruptions from both the pervasively unreliable electricity supply or in the review period of the more pointed July 2021 riots; sharply rising input costs; slow vaccine roll-outs and a constrained domestic consumer spending environment.

I can almost predict that these factors will be cited upfront in virtually all the investor presentations released along with financial results. This is not new. For the past few years now, these kinds of opening slides have become standard scene-setters for the macro-environment that businesses which operate in South Africa say they are expected to function within. The list is almost always one that cites mainly challenges (rather than opportunities or tailwinds) and also often accurately include additional points such as fragile consumer confidence; high unemployment; rising poverty and inequality levels; an increasingly onerous regulatory burden; a volatile currency; a deteriorating fiscal position; political challenges and an environment of policy instability and inaction.

*"The list is always one that cites mainly challenges…"*

## A predictable but understandably underwhelming Budget speech

With this multi-year mounting wall of challenges, it is hard to imagine any investor was optimistic that Finance Minister Enoch Godongwana could offer much by way of hope in his maiden national budget speech. "History doesn't repeat itself, but it often rhymes" is a very popular quote attributed to Mark Twain. A lessor-known but related quote is from Voltaire who said "history never repeats itself; man always does." This is perhaps where the Minister finds himself in an unenviable position. It is hard to imagine he is able to outline a compelling investor-inspiring budget that is different in substance to his recent predecessors.

*"…it is hard to imagine any investor was optimistic…"*

Just as any South African household's budgeting, spending and saving is ultimately evident in the family's income statement and balance sheet, so does the country's national budget function in exactly the same way. And just as is the reality for the average South African citizen who is at best employed

informally, with uncertain income and mounting debts simply to enable living, the country's financial situation is equally tenuous.

Fortunately, though for Minister Godongwana, he revealed in last week's Budget speech that, as expected, income was boosted by a material corporate tax windfall (>R60 billion compared to the Medium-Term Budget Policy Statement (MTBPS) expectations) from resources companies that benefitted from high commodity prices. In addition, other sectors such as financial services, property and insurance also started to recover their profits – and therefore their taxes - to take them closer to pre-pandemic levels. The minister further revealed that corporate income tax collections should continue to remain relatively resilient into 2022. This is definitely good news for the country's budget! However, the income overrun was met with an expenditure overrun too. To a large extent this was unavoidable given the extension of the COVID-19 relief grant (this will be extended even further to March 2023 at a cost of R44 billion). With approximately 45% of South Africans receiving some form of social grant (this is hard to believe!), it is not surprising the largest contributor to the cumulative expenditure overrun is social welfare payments.

*"Income was boosted by a material corporate tax windfall."*

Ultimately the finance minister's predicament remains stabilising and materially reducing the budget deficit. This is the only way to reduce the 70% debt-to-GDP ratios that remain the sticky and uncomfortable forecasts. Shifting this meaningfully is going to require some bold decisions from the minister going forward, starting urgently with the finalisation of a reliable wage settlement regime.

*"The minister's predicament remains stabilising and materially reducing the deficit."*

## Business needs certainty

While the finance minister announced the reduction in corporate tax rates from 28% to 27% in the budget speech, several more interventions are required to boost business confidence.

In President Ramaphosa's State of the Nation address earlier this month, he emphasised that "the state of the nation is linked inextricably to the state of our economy" and that the cause for the 2021 record levels of unemployment were directly as a result of low economic growth, which in turn was a result of a long-term decline in investment. The president emphatically conceded that it is business and not government that creates jobs, but for business to do so it is indeed the "key task of government to create the conditions that will enable the private sector – both big and small – to emerge, to grow, to access new markets, to create new products, and to hire more employees."

Minister Godongwana promised faster progress to implement structural reforms to ensure a more enduring economic recovery. However, given government's abysmal track record of implementation on some of the most important and critical economic issues, South African formal sector businesses (many of which are those represented on the stock market) have lost virtually all trust of operating within a supportive, let alone an enabling environment. Structurally declining or weak economies only present certain kinds of opportunities. Virtually every South African large business leader I have engaged with speaks of running their core domestic business with a

*"…the country needs its large businesses to operate at scale…"*

defence, and not an offence mindset. Yet the economy and the country needs its large businesses to operate at scale; which is when they employ at scale; have long production runs; generate meaningful operating leverage; build bigger factories and deploy additional capital. These same businesses don't see the inequality in our country purely as an insurmountable reality, but ironically an opportunity too. A country with our age demographics and low per capita consumption, whether of manufactured goods or financial products or general services, creates an exciting canvas for growth. Any businessperson or investor continuing to allocate capital to South African businesses has a sense of real faith in better days ahead, but tragically for now few trust that the actions of current decision-makers are able to make that genuine hope a reality.

*"…little trust that current decision-makers are able to make hope a reality."*

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*By Delphine Govender*

*Delphine is Perpetua's Chief Investment Officer. Delphine is co-founder of the firm and has been CIO since it started in 2012. She has over 24 year's direct investment management experience and is a CA (SA) and CFA charterholder.*

*An abridged version of this article appeared in the FM Special Budget Edition on 24 February 2022.*

# Inflation and rising rates - a new world order

As we warned in our 2021 Spring Edition of our Perpetua Perspectives, the world is facing a period of higher inflation, rising interest rates and a moderation in global economic growth after a strong, synchronized post-COVID-19 recovery achieved in 2021. The global economy is entering 2022 in a more precarious position than had previously been anticipated. The Omicron variant also took its toll on the global economy as rising infection rates led to restricted mobility and renewed lockdowns in key regions such as the European Union (EU), China as well as various countries across the world. The geo-political crisis triggered by Russia's invasion of Ukraine has certainly also significantly adversely impacted an already fragile global economy (for more on this please read our article: Russia's invasion of Ukraine increases geo-political risk

*"The global economy is entering 2022 in a more precarious position…"*

## Central banks are in unchartered territory

Should this period of rising prices or higher inflation persist for longer than envisioned, this will materially shift gears for the global economy and financial markets alike. Central banks are currently in unchartered territory in terms of managing monetary policy. It is worth bearing in mind for context - we have just experienced an unprecedented and extended period of massive liquidity being pumped into the global economy through various policy actions and tools, such as:

- Ultra-low interest rates
- Multiple quantitative easing programs
- Large-scale fiscal relief programmes
- Social transfers to citizens

These policy events also took place during a COVID-19 period that was mired by global supply chain shortages, rising commodity prices, and higher energy prices. As a result, there is a plausible scenario that monetary policy authorities in developed economies are running a risk of being behind the curve, meaning they have waited to increase interest rates for longer than they should have. Should they now act in an unexpected way by dramatically raising rates, this could cause panic and renewed volatility in financial markets.

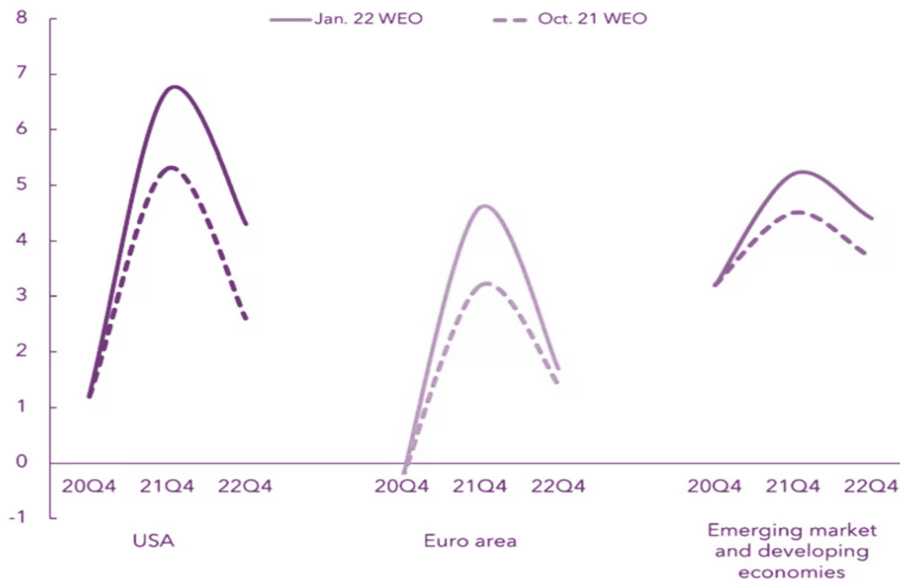
*"…monetary policy authorities are running a risk of being behind the curve…"*

## Inflation forecasts rise while growth prospects moderate

A recent analysis from an International Monetary Fund (IMF) paper warned that pricing pressures are expected to persist for longer. The IMF has indicated that the factors that are driving up the rate of inflation vary by country which makes it difficult for central banks to manage in a synchronised manner. As a result, the IMF decided to increase their inflation forecasts globally and downgrade global GDP growth (led by weaker growth in the US

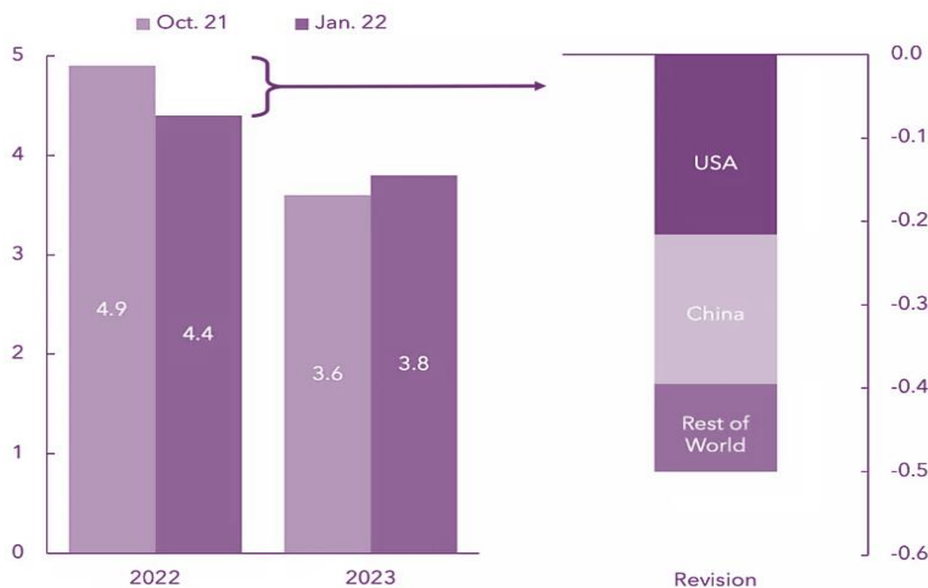
and China) [Figures 1 and 2]. These estimates were calculated prior to the Russia-Ukraine conflict and will have been worsened by this with the price of commodities, including oil rising sharply in recent weeks (Brent crude rose from the $85 per barrel level at the start of 2022 to more than $120 at the beginning of March).

**Figure 1: Inflation revised higher – price pressures are expected to persist for longer**




Source: IMF, World Economic Outlook, and IMF staff calculations

**Figure 2: A disrupted global recovery – global real GDP growth has been revised down for 2022**




Source: IMF, World Economic Outlook, and IMF staff calculations

## Policy decisions could trigger uncertainty

While it is now clear that the Federal Reserve System (Fed) in the US is now compelled to increase interest rates by March 2022, the question now remains as to how aggressively this tightening regime will be. Coming into 2022, consensus expectation was that the Fed would only raise rates in 2023 but over the past several weeks the market has had to swiftly adjust to the

accelerate reality. Investors are in the process of figuring what this scenario means for their portfolio positions, and how to adjust them appropriately. These transitioning thoughts have also led to other differing expert views about:

1. How long and deep inflation could persist?
2. By how much would major central banks increase interest rates and over what period?
3. What if raising rates is premature and a policy mistake that could damage the global economy that is reeling from COVID-19?
4. What are consensus expectations about inflation and interest rates and what expectations are already being discounted into prices?

We believe we can expect a period of heightened volatility in the next few months as investors grapple with attaching probabilities to which will be the most likely outcome. The bottom-line in that we are in a new world order in which policy-makers are having to manage inflation risks by raising rates, while also having to carefully balancing this against the effects of a global pandemic on economic activity and supply chain disruptions.

*"We can expect a period of heightened volatility…"*

## Proceed with caution

Against this backdrop it is unsurprising that our portfolios are structured in a way that seeks to take cognizance of the volatile environment while assessing fundamental opportunities from a bottom-up perspective. Following a strong year of absolute returns we are looking to reduce overall exposure in our multi-asset class portfolios. Within equities sectors such as consumer staples, energy, banking, and selective commodities that are in supply shortage, could perform better. Emerging market bonds look attractive right now and having some cash in balanced portfolios could help when taking advantage of potential overreactions in markets.

*"We are seeing challenges mounting from supply chain disruptions to tectonic shifts in labour markets, to inflation figures which are of concern to policy-makers and individuals alike. The year ahead is a crucial one to work together, rebuild trust and shape a better and more inclusive future for all."*

- Klaus Schwab, Founder and Executive Chairman of the World Economic Forum

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*By Patrick Ntshalintshali*

*Patrick is one of Perpetua's equity and balanced portfolio managers. He has over 26 years' investment management experience and holds a B. Comm (Hons) and EDP.*

# Russia's invasion of Ukraine increases geo-political risk

## Russia shatters the European peace agreement

On 24 February 2022 Russian President Putin launched an invasion of Ukraine and in the blink of an eye the world has changed for millions of Ukrainians. The tragic and senseless loss of life is hard for people around the world to come to terms with. Russia has shattered the European peace agreement that has existed for the last 30 years. In response, Germany announced plans to spend 2% of GDP on defence and an immediate €100 billion to modernise their military. This is a complete reversal of Germany's foreign and defence policy following decades of disarmament. The economic damage suffered on all sides of this conflict extends deep into Europe and their trading partners. Russia's invasion of Ukraine has united the European Union and The North Atlantic Treaty Organization (NATO) like no other time since the September 11 terrorist attacks.

*"The tragic and senseless loss of life."*

## Russian sanctions

Western countries have responded with the strongest co-ordinated set of sanctions placed on any nation to date. The latest and most severe include:

- Freezing the Russian Central Bank's foreign currency reserves held in the West.
- Blocking certain Russian banks from accessing the SWIFT financial messaging system.
- Placing travel bans and freezing foreign-held assets of prominent politicians, government officials and oligarchs.
- Banning western companies from doing business with Russian state-owned companies and freezing their foreign-held assets.

The top two sanctions above seemed almost unthinkable just two weeks ago but came over the weekend of February 26th and 27th. These sanctions are primarily designed to do four things:

1. To cut Russia off from the West financially
2. To make it harder for Russia to fund its war effort
3. To reduce the Central Bank's ability to defend the Ruble
4. To punish Russian oligarchs and Putin allies who benefit from their relationship with the Kremlin

The West is hoping that these sanctions will harm Russian oligarchs where it matters most and create sufficient despair among ordinary Russian citizens to pressure Putin into ending the war. In an even more surprising and compelling move, several Western multi-national companies announced plans to divest from Russia or cease operations within the country.

## Economic implications

The Ruble quickly depreciated by more than 50%. In an attempt to stabilise the financial system, the Central Bank of Russia raised the key policy rate to 20% and enforced strict capital controls. Russian exporting companies must sell 80% of their foreign currency receipts to the central bank. The Russian authorities temporarily closed the Moscow Exchange; ordered brokers to suspend short selling of Russian securities; and prevented foreigners from dumping Russian securities. The Moscow Exchange still remained closed at the time of writing. In the light of these extreme sanctions, it's likely that Russia will enter a deep economic recession and experience rising inflation. More importantly, this impact will be felt throughout Europe and global commodity markets.

*"The Russian Ruble has fallen 50% in a matter of days."*

While Europe will likely bear the brunt of the economic pain, the US is not going to be immune either. In this post-COVID period, rising energy and food prices were already posing a problem prior to the invasion of Ukraine and are now moving much higher as the threat to global supply chains intensify. Russia accounts for 12% and 17% of the world's oil and natural gas production respectively. Russia and Ukraine account for c.30% of global wheat exports. Brent crude hit $130 per barrel on 6th March, up >50% since the beginning of 2022, while wheat natural gas is up 38% to $4.93/Metric Million British Thermal Unit (MMBtu). Wheat is up 56% to $12.10 per bushel and Palladium rose to $2,990/oz. The S&P Goldman Sachs Commodity Index (GSCI) is just shy of its 2008 peak, up 80% since 2020 and 214% from the March 2020 lows.

Then there is the demand shock this crisis has sent around the world at a time when central bank policy rates are moving up from near zero levels. This would put downward pressure on consumer spending at the same time when the Western economies are facing significant fiscal drag. Could things get bad enough to push the EU and US into recession? Nothing is off limits now and the reality is that the implications are far reaching and definitely not just confined to the current conflict between Russia and Ukraine.

*"Could things get bad enough to push the EU and US into recession…"*

## Perpetua's exposure to Russian stocks going into the crisis

Client funds had exposure to two Russian companies prior to the invasion of Ukraine - Tinkoff Credit Systems (TCS) and Magnit. Both shares are held through listed Global Depository Receipt (GDR) programs on the London Stock Exchange (LSE). Both shares have naturally suffered significant declines in their share prices and at the time of writing were suspended on the LSE given the exchange's decision to maintain an "orderly market". The LSE decision, however, appears to have been after the fact as at the time the temporary suspension was instituted both shares had already been sold down in a dramatic fashion. Our assessment is that, notwithstanding the current temporary suspension of the counters, both companies have intrinsically resilient business models servicing the average Russian citizen, and we believe they will be able to ultimately weather even this most devastating storm.

*"Tinkoff is seen as a safe haven among Russian banks…"*

**Tinkoff** is Russia's second-largest credit card issuer and third-largest bank by active retail customers. Tinkoff is also the world's second-largest and most profitable digital bank with 15 million active customers. Tinkoff has grown rapidly since its founding in 2006 but still only commands less than 2% of retail banking assets in Russia. Despite starting out as a monoline credit card

issuer, today it has a full suite of banking products. It is a completely branchless fully digital bank with the Tinkoff Banking 'super app' at the centre of its lifestyle banking ecosystem. The company has not been named as one of the Russian banks under sanction and continues to trade normally but obviously under very challenging circumstances. Tinkoff has a solid capital position and went into this crisis extremely liquid with 41% of total assets held in cash and investments. Somewhat perversely, Tinkoff is seen as a safe haven among Russian banks given its domestic only operations relative to the large international and state-owned Russian banks under sanction. They have been attracting deposits as customers flee the incumbent banks.

Tinkoff's high-margin credit business, variable cost structure and large growing non-credit channel provide a material buffer against credit losses and rising cost of risk. Despite only 7.5x leverage, Tinkoff produces returns on equity north of 40%. They have a best-in-class management team with significant 'skin in the game' which, together with the founder and Chairman Oleg Tinkov, own more than 40% of the company. In our opinion, Tinkoff has a resilient, flexible and durable business model. It is no stranger to crises, having survived and thrived through the 2008 financial crisis, 2014 Russian economic and oil crisis, and 2020 global pandemic. We believe Tinkoff has the business model and management team to navigate the current turmoil.

**Magnit** is Russia's second-largest food retailer and largest by number of stores (c.26,000) and geographic coverage (67 regions). In 2021, Magnit reported $24 billion in sales and $6.8 billion net income. In five trading days following the invasion of Ukraine on February 24th, Magnit fell 99.99% from $10.96 to $0.01. This price places a value of just $6.3 million on the company currently despite its healthy sales and net income generation. Roughly 12.3 million GDR's representing 2.46 million ordinary shares or 2.4% of total shares in issue changed hands in those five trading days. It should be clear to most people that Magnit is worth materially more than $6.3 million and that the panic selling of its GDR's is more a reflection of technical factors (close of Moscow Exchange), EM fund redemptions and fear of not being able to exit. We believe the current share price is not a reflection of the underlying business fundamentals and appears to be pricing Russia to experience Zimbabwean or Venezuelan style hyperinflation and Ruble depreciation. Magnit has a solid balance sheet with no hard-currency borrowing; is highly cash generative and past the peak of its capital investment program. It sources only 8% of its product outside of Russia and is the only vertically integrated retailer with more than 17 production facilities and four agricultural sites. We believe Magnit has both the resilience and best-in-class management team to survive and strengthen its competitive position during these extremely challenging times.

*"…Magnit is worth materially more than $6.3 million…"*

*"The average investor earns less than 40% of the index…"*

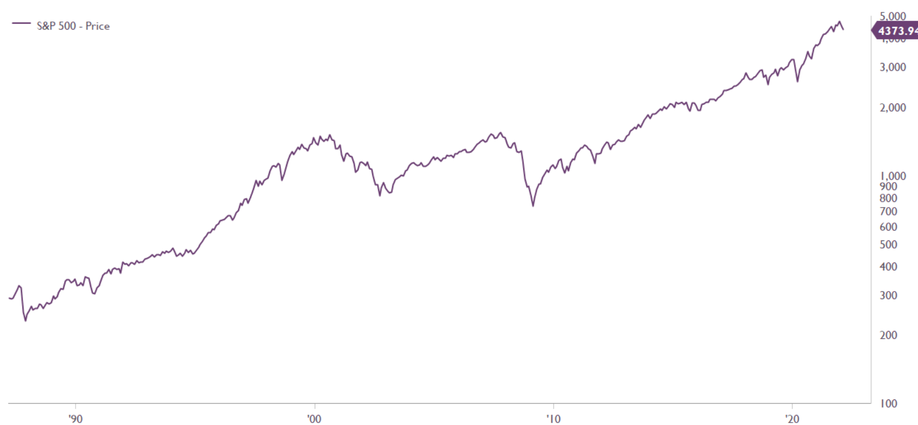
## Stay invested to preserve and grow value over time

Extreme uncertainty, fear and ultra-panic in respect of all Russian investments has certainly been the result of the range of geopolitical actions of the past two weeks. While current circumstances makes it feel like there is no potential for recovery in Russian shares, our view is that the entire world has too much to lose should Russia's invasion end up becoming a protracted war. For this reason, we believe our selected Russian investments have scope for

meaningful recovery from their current marked down prices. Having assessed the business model fundamentals and the target markets these companies ultimately serve (average Russians and not warmongering oligarchs) we believe our clients' financial interests are best secured by remaining invested based on our current view of the situation.

At times like this it is worth reminding ourselves that the average investor in equity mutual funds typically earns less than 40% of the returns produced by an index such as the S&P 500. In the US, the average investor earned 2.9% annualised over the last 20 years while the S&P 500 returned 7.5% annualised [Figure 1].

**Figure 1: S&P 500 price index**




Source: FactSet

One of the primary reasons for the lower-than-average return is that investors typically sell during times of panic and fear thereby realising 'paper losses' only to return after the stock market has gained substantially from the crisis lows. Another reason is that investors often sell short-term underperforming mutual funds to purchasing recent outperforming mutual funds, which typically go on to underperform in the next cycle. The temptation to 'time the markets' is alluring but has very low probability of success. The emotional pain investors feel from a sharp drawdown combined with uncertainty makes it hard for most people to stay invested. History, however, has shown that staying the course and remaining invested is most often the correct thing to do.

*"…the emotional pain investors feel makes it hard to stay invested…"*

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*By Graeme Ronné*

*Graeme is one of Perpetua's portfolio managers, with responsibility for global equity portfolios and research. He has over 16 years' direct investment management experience, holds a B. Com (Hons) and is a CFA charterholder.*

# Platinum companies battle it out: Two is company, three is a crowd

In our Perpetua Perspectives Winter 2021 edition (July 2021), we wrote an article titled "Impala: Shareholders cannot have their cake and eat it too." In that article, we opined that Impala's (IMP) low valuation multiple was appropriate because the business had to invest in significant mine life-extension initiatives. We held the view that the market was incorrect to expect a dividend bonanza from the company. We concluded the article with a comment to the effect that an IMP/ Royal Bafokeng Platinum (RBP) merger would be a credible alternative.

## Royal Bafokeng Platinum had been Perpetua's favoured bet

When the previous article was written in July 2021. Perpetua clients did not own IMP shares but held approximately 4% of funds in RBP shares. RBP has been a long-term holding in the fund. The company had spent the last decade building a new mine, Styldrift, and shareholders were poised to start enjoying materially higher free cash flows in a high platinum group metals (PGM) price environment. Our investment thesis was that RBP was a growth company that was trading at a value price. Internally we refer to these kinds of investments as an "unrecognised growth" thesis.

*"RBP was a growth company that was trading at a value price…"*

## PGM giants battle for prospects offered by RBP

Well, that article aged sooner than we expected! During the past quarter, IMP announced that it was in talks to acquire 100% of RBP. However, we did not expect that Northam Platinum Holdings (NPH) would respond by making a quickfire acquisition of Royal Bafokeng Holdings' (RBH) 33% stake in RBP for R180/share, nearly double the share price a month earlier. In addition to the share purchase, NPH entered into an option agreement with RBH to acquire an additional 3.3% of RBP. This could trigger a mandatory offer to minorities at R180/share in future.

Not to be outdone, 20 days after NPH's announcement, IMP announced that it had concluded agreements with RBP shareholders to acquire 24.5% of the company at an effective R150/share, to be settled in R90 cash and R60 in Impala shares. Given that we now had two potential exits for the RBP holding, we evaluated the scenarios and decided to accept the IMP offer based on the following factors:

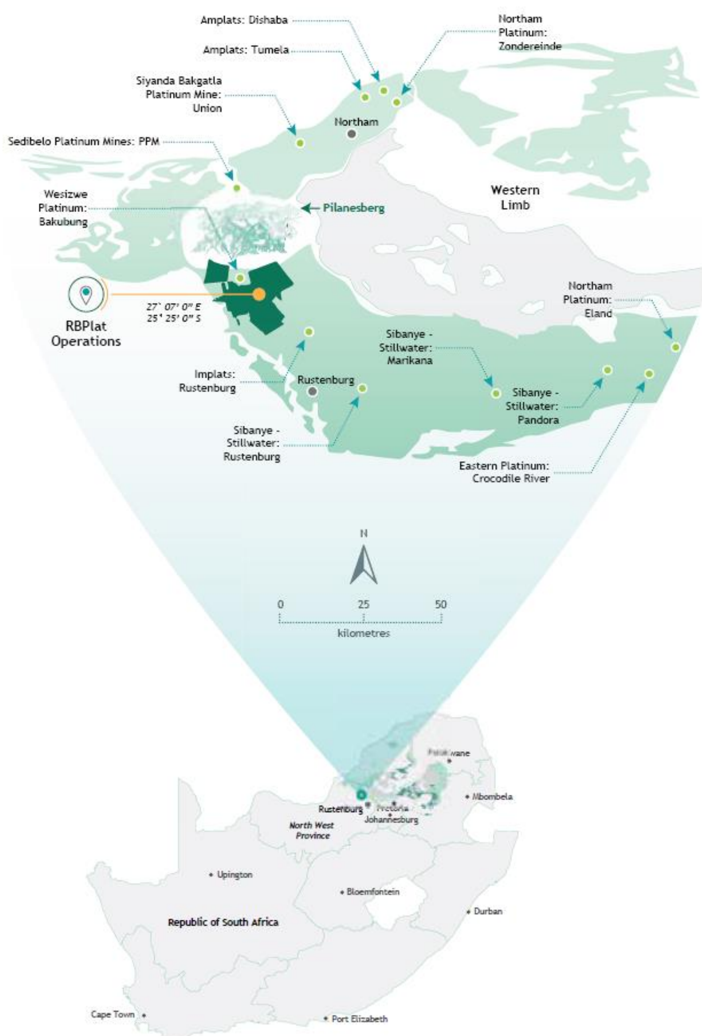
1. The R150/share was our value for RBP under our best-case assumptions.
2. Whilst NPH did not buy the 33% stake in RBP to end up with a minority stake in the company, at the time there was no subsequent counter-offer from NPH. NPH's share price declined by 15% on the day that it announced the acquisition of its 33% stake. This indicated the market's

dissatisfaction with terms of the acquisition on NPH. It was possible that this reaction would deter NPH management from pursuing RBP further.

3. After the acquisition of the 33% stake, NHM had net debt of approximately R11 billion, or 16% of its market capitalisation. As a result, any additional acquisitions would likely have to be equity funded. If the share price reaction to the first acquisition was anything to go by, the value of this equity funded deal would reduce meaningfully upon its announcement.
4. There were some large common shareholders in IMP & NPH. They would be averse to a bidding war. Some of these common shareholders had just accepted the IMP R150 offer. They would therefore not likely support an equity raise by NPH to acquire RBP. This would be an overhang over any NPH offer if it were to materialize.
5. IMP is the more natural owner of RBP, given that it neighbours its Impala mine – see Figure 1 There are likely significant synergies that can be extracted by IMP, but these are not similarly available to NPH. Consequently, we believed that if NPH makes a higher offer for RBP, IMP theoretically had better grounds to improve their offer. Furthermore, in the long-term there are potential job losses which could be averted with RBP in IMP's hands.

*"IMP is the more natural owner of RBP…"*

**Figure 1: Location of RBP operations**




Source: RBP Mineral resources and reserves statement 2020

6. Based on the sale agreement that we entered with IMP, if IMP improves its offer with a higher counter-offer, our clients will receive a top up on the R150/share offer. So, in essence our clients retained the option of a higher IMP offer.

## Perpetua client portfolios benefit from transaction

Post the transaction, we have received cash and IMP shares on our clients' behalf. We used the weakness in November 2021 to add to the IMP position. Historically our reservation with the company was that the flagship Impala mine was running out of reserves. By combining the two entities, IMP can better mine the border and increase the life of the Impala mine by accessing additional RBP ground from Impala's 20 Shaft. In addition, given its larger resources, IMP can access additional RBP resources sooner and thereby increase the life of the Impala mine. As a result, we have increased the life of the mine estimate for the Impala mine. The increased life of mine at Impala (30% of group production) has a compound effect as it also then makes the processing operations more viable in the long-term.

*"…our clients retained the option of a higher IMP offer."*

*"The increased life of mine at Impala has a compound effect"*

Another example of possible synergies is that Anglo Platinum (AMS) currently refines RBP's concentrate and RBP only receives circa 85% of the metal revenues. From around 2024, RBP could cancel half the off-take agreement. This we estimate could save the company some R1 billion p.a. in processing costs. After tax and additional variable costs, we value IMP's share of these synergies at R3.7 billion. Impala also recently announced projects aimed at increasing the life of mine at Marula and Two Rivers. These also previously also had an approximately 10-year life. As a result of these developments our assessment of IMP's fair value has increased.

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*By Lonwabo Maqubela*

*Lonwabo is co-head of Perpetua's domestic equity research process. Lonwabo is also one of Perpetua's equity and balanced portfolio managers. He has over 15 years' investment management experience; is a CA (SA) and CFA charterholder.*

# *RI in Focus:* British American Tobacco vs ESG: how to reconcile

A debate that has resurged over the past few years is how an investment manager such as ourselves that invests with Environmental Social and Governance (ESG) principles as a target can justify owning a tobacco company, British American Tobacco (BTI). In this article we look to provide some insights into how we engage with this debate.

To do so we need to also deepen the context and address some of the more fundamental background questions which includes what is ESG investing; how do we incorporate ESG into our investment process; and how ESG investing differs from ethical investing?

*"ESG investing differs from ethical investing"*

## What is ESG Investing?

Investors are increasingly applying ESG factors as part of the investment process to assess how responsible a company is, and whether the company is respecting their responsibility towards all their stakeholders and the environment in which they operate. An ESG framework can also help investors identify material risks as well as potential growth opportunities in the companies they invest in.

"ESG" describes three key factors used by investors to assess corporate behaviour:

- **Environmental**
  This concerns interaction with the physical environment, such as climate change, biodiversity, natural resources, carbon emissions, air and water pollution etc.
- **Social**
  This looks at how a company manages relationships with employees, suppliers, customers, and the communities where it operates, including human rights, health and safety issues, labour standards, product liability, privacy and data security etc.
- **Governance**
  This focuses on how companies are governed, including diversity, transparency, ownership, board independence, ethics, executive compensation etc.

*"We must foster positive impact and encourage sustainable behaviours…"*

## How does Perpetua incorporate ESG into our investment process?

At Perpetua, we believe our responsibility as an investment manager is to ensure that as investors, we consider long-term risks in our pursuit of managing and growing capital. At the same time, we must foster positive impact and encourage sustainable behaviours in companies in which we

allocate capital to. It is in this vein that we largely approach the consideration of ESG in our investee companies.

When considering ESG factors in the investment process, we do not seek to take a purely moral stance, but rather look to assess the investment holistically and constructively. In this way we will ensure we allocate more capital to companies that create value and/or minimise undue risks by respecting their responsibility to their stakeholders. This responsibility comes about because of the impact of the company's operations on those stakeholders, and it is only by reducing or mitigating any negative impact that they can both reduce costs and reduce potential reputational and other damage.

When analysing a company from an ESG perspective, we want to *inter alia* make sure that the management team acknowledges certain areas where the business needs to improve to help ensure the sustainability of the business far into the future. As long-term investors, we too want to be sure that the companies we are investing in are sustainable into the future, and part of our initial and ongoing analysis ensures a company sets appropriate ESG targets and then monitors their progress in achieving those targets. Where we feel a company is performing poorly with regards to their ESG responsibilities (whether it be failing to set certain targets; setting below par or unrealistic targets; or failing to make progress on set targets), we engage with management in order to influence their progress going forward.

*"ESG targets and then monitors progress…"*

## How ESG investing differs from ethical investing?

Ethical investing is about investing using ethical principles as a guideline. This often means filtering out certain types of companies or sectors which could be perceived as "unethical" in a societal context– these are commonly referred to as 'sin stocks' and include companies operating in gambling, tobacco, alcohol, defence, and cannabis industries. This type of investing will depend on an investor's views and morals in relation to those industries which the investor might believe is profiteering by exploiting human weaknesses or vices. Ethical investing gives investors the opportunity to allocate capital into companies whose practices and values match their personal morals and beliefs, whether these are environmental, political, or religious.

A key difference between ESG and ethical investing is that in ethical investing an investor will automatically avoid or intentionally exclude any investment which from an ethical point of view does not match the investor's morals. With regards to ESG investing, an investor could still invest in a company (even if that company operates in one of these "sin" industries) if the investor thinks the company is improving its ESG policies or if the investor believes that they can engage with the company to improve their ESG policies and impact going forward. It is also important to note that the ESG factors are considered alongside financial returns as part of ESG investing, whereas financial returns are typically ignored in ethical investing as the singular determinant is whether the company's values match that of the investor's [Figure 1].

*"…ESG factors are considered alongside financial returns…"*

**Figure 1: ESG-based Investing vs. Ethical-based Investing**

| | ESG-based investing | Ethical-based investing |
|---|---|---|
| Invests exclusively in companies that contribute to a sustainable transition | ✗ | ✗ |
| Screens out companies/industries based on moral principles | ✗ | ✓ |
| Engages with company to improve policies going forward | ✓ | ✗ |
| Ultimate goal is to generate financial returns | ✓ | ✗ |

Source: Perpetua research

## BTI and ESG

As BTI is a global manufacturer and distributor of tobacco and other consumer products, certain investors who have ethical concerns around tobacco companies (given the addictive nature of its core product, nicotine) will automatically exclude the company as a potential investment. As mentioned above, in our fully discretionary mandates, we at Perpetua do not seek to take a purely moral stance or purely ethical-based approach to investing, but rather look to assess the investment holistically. We would, however, exclude industries in specific client portfolios should a specific client mandate require an industry exclusion. In our approach, we consider all risk factors (financial risk, operational risk, competitive risk, regulatory risk, product liability risk, ESG risk etc.) we believe the company may face and weigh those risks up against the investment return we expect to generate from the investment.

*"…we do not seek to take a purely moral stance…"*

In terms of ESG, the major long-term risk facing BTI (and the tobacco industry) falls under the "Social" factor, which is the health harm caused to consumers by smoking cigarettes, and the financial effects of this which would be the potential banning of BTI's products by regulators. In the context of this existential threat to the BTI business model, the pertinent questions is: what gives us confidence that as investors that BTI will be able to operate sustainably over our investment time horizon? Based on what we currently know, we gain this confidence as follows:

1. **Transitioning to a reduced risk portfolio:** over the last few years the Group has taken measures to reduce the adverse health impact of their business by introducing a new category of tobacco, and smoking-related products, with evidence of reduced-risk potential (see timeline below). This category is referred to as reduced-risk products (RRP) and includes vapour, tobacco heating products and modern oral products. Research has shown that BTI's vapour products have 95% fewer toxicants emitted compared to conventional cigarettes; and in BTI's tobacco heating product, *glo* emissions are reduced by 90 to 95%, toxicity by 95% and indoor air quality improved by 95%; and for their modern oral products, chemical studies have shown that their modern oral products have even fewer and lower levels of toxicants than snus (a type of

*"BTI has taken measures to reduce the adverse health impact…"*

traditional oral tobacco), with epidemiological evidence showing it is considerably less risky than conventional smoking. BTI is gaining momentum in transitioning customers over to these new category products with the number of users now estimated to be c.17.1million as of September 2021, up from 11 million as of December 2019. The Group has targeted 50 million consumers by 2030 and £5 billion in revenue from these new category products by 2025 (equivalent to c.15 to 20% of Group revenue). We think management have chosen the correct strategy here, and it is encouraging to see the progress made thus far, but we believe more can and needs to be done – for example competitor Phillip Morris International currently generates c.29% of their revenue from smoke-free/new category products and are targeting more than 50% by 2025.

2. **Contribution to tax coffers:** while we are all aware of the negative press tobacco manufacturers get regarding the health impacts around smoking and the regulatory risk they are exposed to, what gets considerably less attention is the billions of dollars in taxes paid by these companies. From 2016 to 2020 BTI has paid c.£193 billion in taxes to governments around the world, and these taxes are an important source of income for governments and make a valuable contribution to local economies. In addition, regulation in this industry is a good thing because without regulation consumer demand may find its way to the black market, where counterfeit cigarettes pose an even greater risk to consumers as they are not manufactured to stringent product health and safety standards. The global illegal trade (illicit trade) in cigarettes already avoids paying governments around $40 billion in taxes each year, and these funds are often used to fund other illegal activities.

*"BTI has paid c.£193 billion in taxes to governments around the world…"*

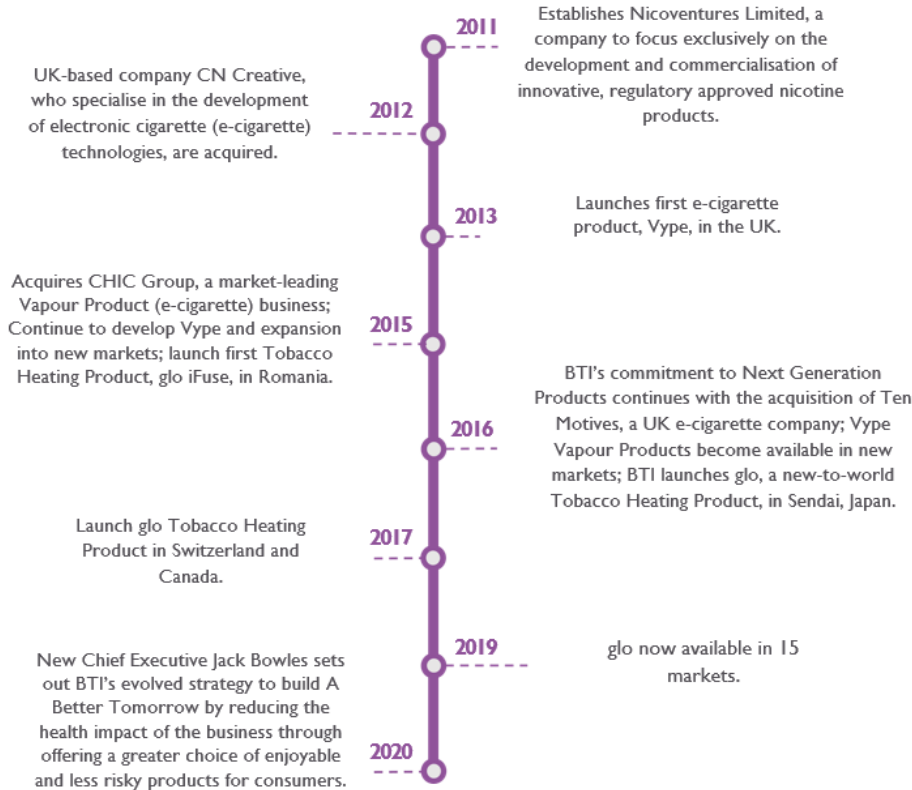
3. **Reducing carbon emissions:** with regards to other ESG targets, the Group aims to achieve carbon neutrality for Scope 1 and 2 emissions by 2030, and by 2050 for Scope 3 emissions; 100% renewable electricity in operations sites by 2030; Increase the amount of water recycled to 30% by 2025; 100% of operations sites to be zero waste to landfill by 2025; Eliminate unnecessary single-use plastic and make all plastic packaging recyclable by 2025; A zero-tolerance approach to forced labour while having a clear commitment to aim for their tobacco supply chain to be free of child labour by 2025; and Increasing the proportion of women in management roles to 45% by 2025.

4. **Seeking to be sustainable:** BTI is the only company in their industry listed in the prestigious Dow Jones Sustainability Indices, with an 86% score, representing the world's top 10% ESG performers. They have achieved inclusion in the indices for 20 consecutive years.

   As can be seen in Figure 2 below, BTI started making progress on their Reverse Repurchase Agreement (RRP) about a decade ago. Management have put a much greater emphasis on RRP's in the last couple of years, and we expect to see an accelerating transition going forward.

*"BTI is the only company in their industry listed in the Dow Jones Sustainability Indices…"*

Figure 2: BTI timeline on RRP's




Source: Perpetua research

## Conclusion

BTI has been operating for almost 120 years, and we believe the decisions made by management over the last few years will help give them the best chance at being a sustainable business for many more decades to come. We currently think BTI offers very attractive financial returns, and we believe that the company can generate these returns in a sustainable way going forward as they accelerate their transition to reduced-risk products. We believe an investment in BTI will allow us to generate better-than-market returns in a company that is crucially taking intentional steps to improve its ESG profile.

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*By Thomas Blamey*

*Thomas is one of Perpetua's equity analysts. He has 7 years investment analysis experience, holds a B.Comm degree and is a CFA charterholder.*

# *EXPLAINED:* Going beneath the "value" label

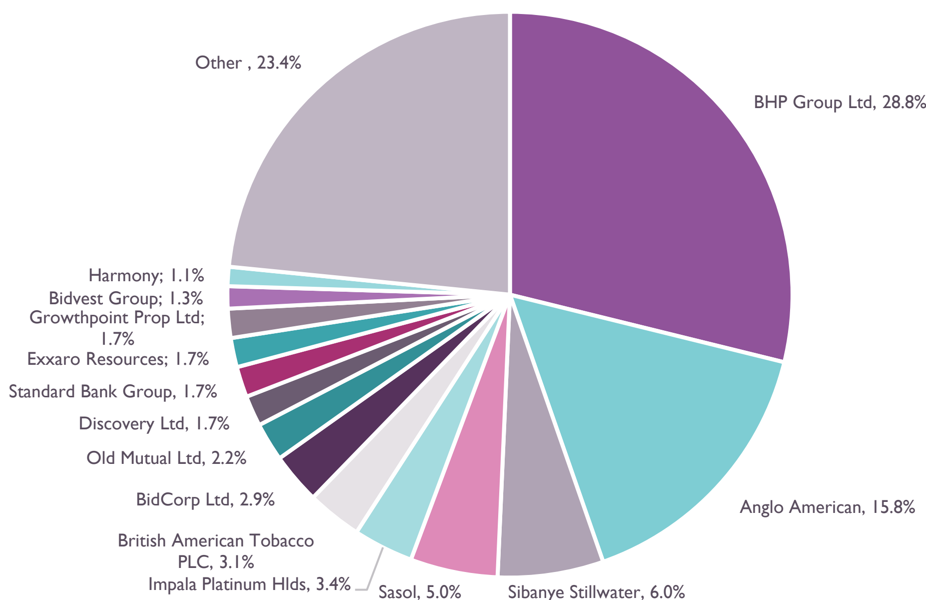
Ever since the publication of the work done by Eugene Fama and Kenneth French on the style factor influences in investment decision-making in 1992, asset allocators have been mindful of the impact of exposure to any particular style factors within their portfolios. More recently we have observed an unprecedented and extended period of growth and momentum factors outperforming value due to the influence of historically low interest rates as policymakers tried to resurrect economies following the global financial crisis (GFC) in 2008, and more recently the damage caused by COVID-19. As we approach an era of likely increases in interest rates, many market commentators opine that the value style will outperform as monetary policies normalise and greater emphasis is placed on the fundamentals of business. But what does it mean to be a value investor?

Fund managers are usually labelled based on the common styles of investing namely growth, quality, and value. What is often missed is that all investors would prefer to own high quality companies, that have excellent growth prospects at cheap valuations. The difference lies in what the main focus of the investment case is.

*"The difference lies in the main focus of the investment case…"*

If one has to follow the value factor attribute methodology used in the formulation of a value style index such as the JSE Value Index, then at this point in time it may look like the pie chart [Figure 1].

**Figure 1: Composition of JSE Value Index as at 14 February 2022**




Source: Johannesburg Stock Exchange

A look at the composition of the JSE style indices reveals a few interesting points. Two shares in the Resources sector, viz. BHP Billiton and Anglo American make up a significant 44% of the JSE Value Index, making it an extraordinarily concentrated benchmark. But even more revealing is the fact that while these shares might screen as value based on current valuation (with P/E ratios of 9.1x and 6.7x respectively), this is based on elevated earnings driven by higher commodity prices being experienced at present [Figure 2]. However, commodity prices are notoriously cyclical and the level of current earnings being sustained is therefore unlikely. It would therefore be imprudent to simply regard these shares as being 'value' shares when in fact on a normalised basis, their P/E ratios are closer to 19x and 16x [Figure 3].

*"…shares might screen as value based on current valuation…"*

This is certainly not necessarily value territory any longer.

**Figure 2: Historical profitability of BHP & AGL**

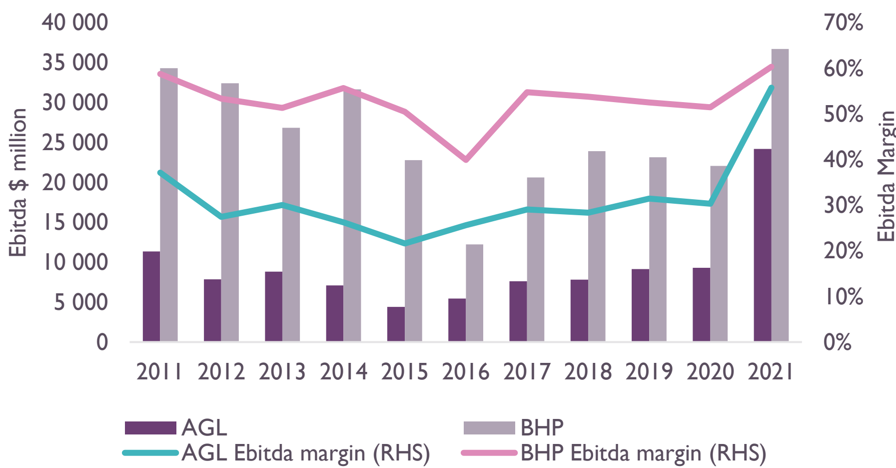
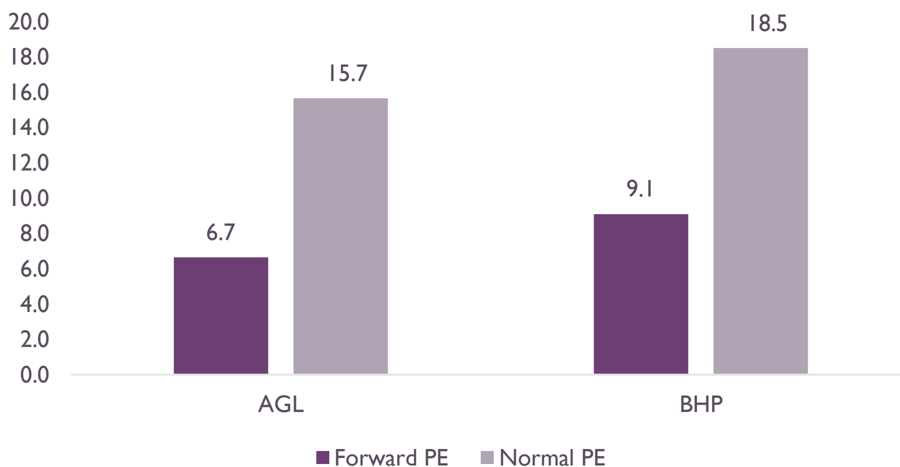



**Figure 3: Normalised PE vs Current Forward PE**



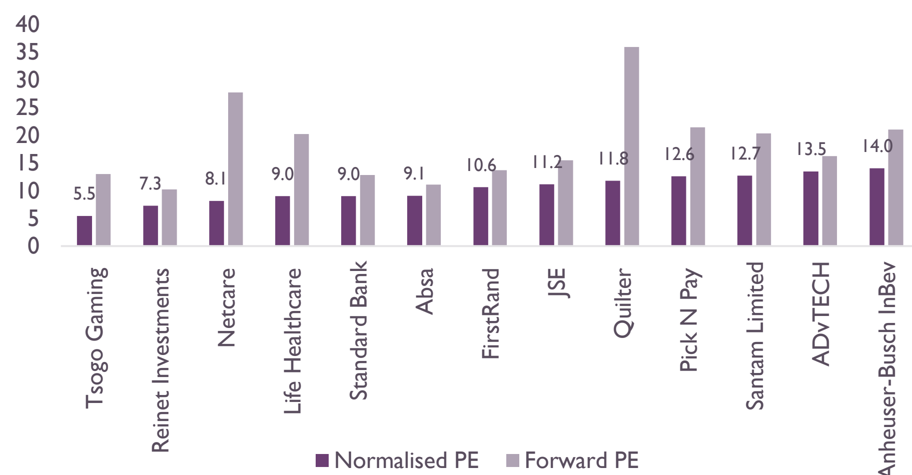

Source: Factset

In contrast, the JSE Growth Index includes a number of shares which could be viewed as attractively priced when taking normalised earnings into account. This includes some of the companies which were adversely affected by COVID-19 which caused their earnings to be suppressed such as Tsogo Gaming, hospital groups Netcare and Life Healthcare, consumer

stocks Pick 'n Pay and ABI, as well as a few financials [Figure 4]. These have already begun to recover and will benefit further from fewer lockdown restrictions and greater movement as activity normalizes. These shares can therefore arguably be regarded as value shares rather than growth as their thesis relies more on a reversion to their normal earnings as opposed to organic growth. One therefore needs to look beyond the typical valuation metrics at a point in time when trying to understand the investment thesis for a particular stock. It might therefore be the case that a value-oriented fund manager does sometimes hold shares in their portfolio which optically screen as growth, but it might actually lend itself more to a value unlock thesis.

*"…a value-oriented manager does sometimes hold shares which optically screen as growth…"*

**Figure 4: Normalised P/E vs Current Forward P/E**



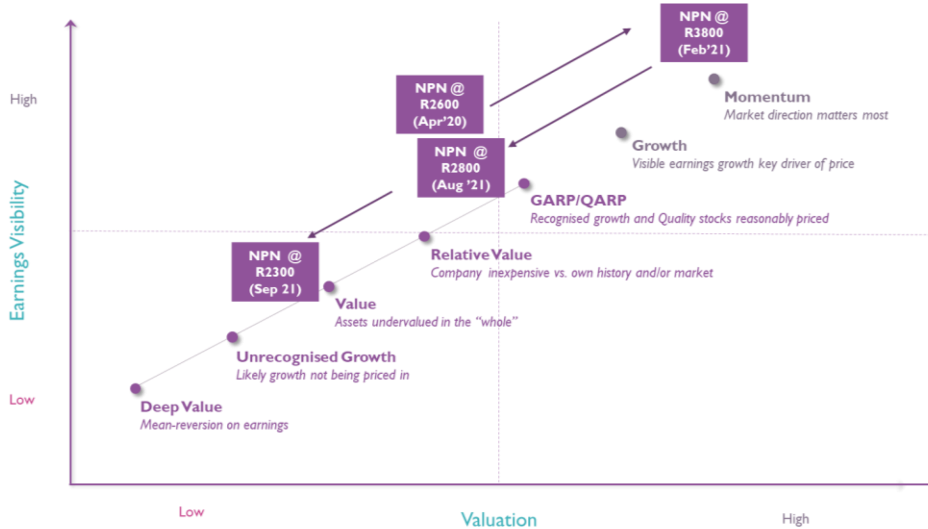

Source: FactSet

Another common misconception is that any particular share is either a value or growth share in perpetuity. In reality, all shares move along a valuation continuum over a period of time, and an investor will decide on whether to invest based on their own investment case. Simply put, a growth investor might be willing to pay a high valuation multiple (when the price of the share is high relative to current earnings), while a value investor will be wanting greater visibility on future earnings growth in order to justify the price being paid for the same share, or will buy the share if the price reduces to a level which offers adequate upside to its estimated intrinsic value.

*"…all shares move along a valuation continuum…"*

Naspers is a good case in point with the share having moved from displaying characteristics of a relative value thesis after the market decline triggered by COVID-19 in early 2020 (when it's P/E ratio was in the mid-teens), then re-rating strongly by rising 46% through to February 2021 (with a P/E of 35x) before coming back to a price level of R2300 in September 2021 and a P/E ratio of 14x [Figure 4]. Of course, some of this would have been caused by concerns over its exposure to Tencent and the impact of Chinese regulations on large tech companies. However, their earnings base remains solid but is now available at a cheaper multiple than it was previously.

**Figure 4: The changing investment thesis of a share**




Source: Perpetua research

At Perpetua we want to buy assets for less than what we think they are worth, to provide ourselves with a margin of safety in case we are wrong in our assumptions about future profitability. This means we can buy high growth companies or low growth companies, good quality businesses or poor businesses, as long as we can satisfy ourselves that the risk adjusted return we can earn makes sense over the long run. This is the essence of what might be termed as pragmatic value investing.

*"…the essence of what might be termed as pragmatic value investing."*

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*By Glen Heinrich and Kevin Dantu*

*Glen is co-head of Perpetua's domestic equity research process. Glen is also one of Perpetua's equity and balanced portfolio managers. He has over 15 years' direct investment management experience, holds a PhD (Chem Eng.) and is a CFA charterholder.*

*By Kevin Dantu*

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