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CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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Invest For The Future

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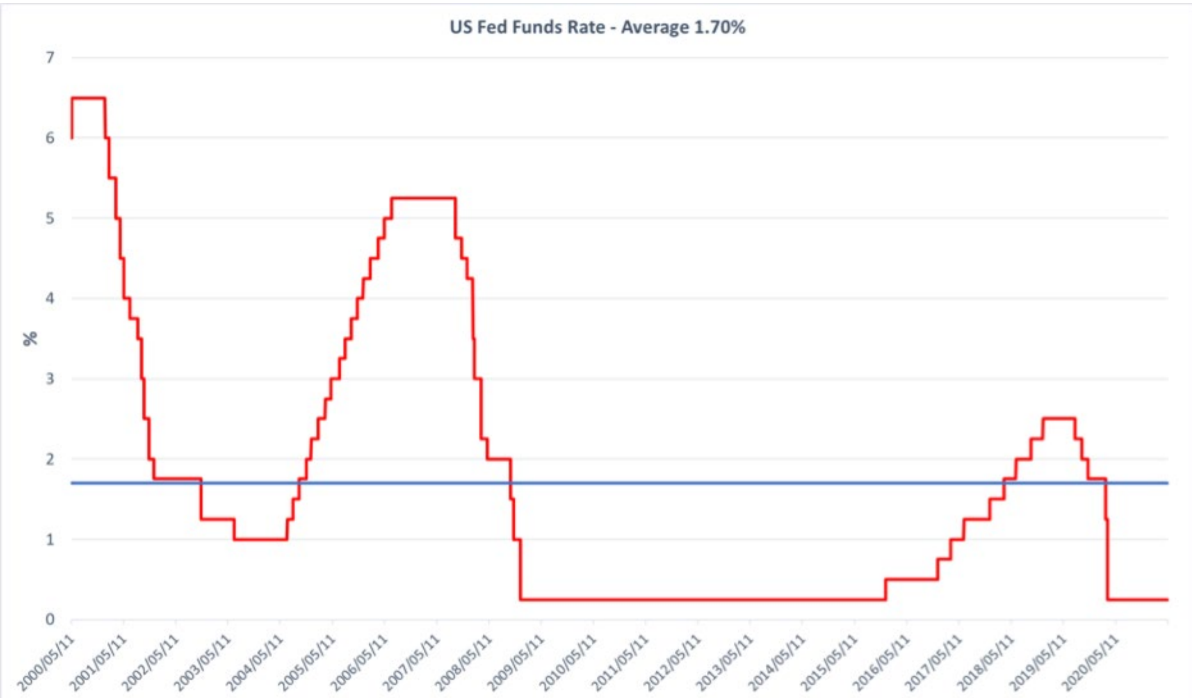
Making Sense of a Low Interest Rate Environment

It is said that low interest rate environments are meant to stimulate economic growth by making it cheaper to borrow money. In other words, borrowers benefit by paying back their loans at a lower rate of interest. Conversely, savers tend to lose out by receiving less interest on their invested capital.

A low interest rate environment can be described as an environment where rates of interest are lower than their historical average for a prolonged period. This definition is, however, inherently flawed as a 'prolonged period' could mean anything from weeks to months to years or more. In addition, there are many different measures of interest rates out there that may or may not conform to the 'definition' of a low interest rate environment.

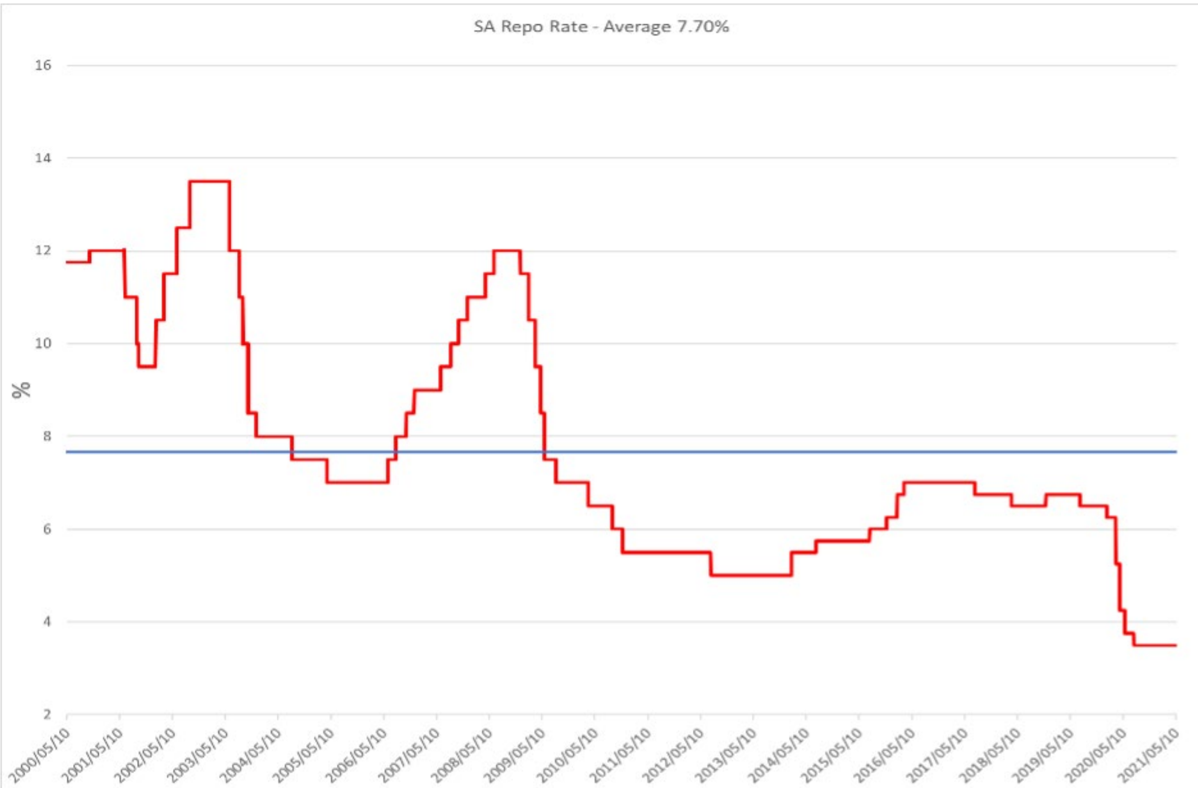
Nevertheless, rates have been cut by developed markets over the last decade to stimulate economic growth and prevent deflation. This most certainly gives us the feeling that we are in a low interest rate environment as the historical arithmetic average of the US Fed Funds rate is approximately 1.70% for the last two decades.



Source: Bloomberg

This strategy by the US Federal Reserve has improved growth, but not decisively so. Joblessness has declined, but it has failed to be inflationary for the US economy. The Covid-19 pandemic has also compounded the drive to keep rates lower for longer. Most central banks responded by cutting rates to prevent their economies from stalling during the crisis.

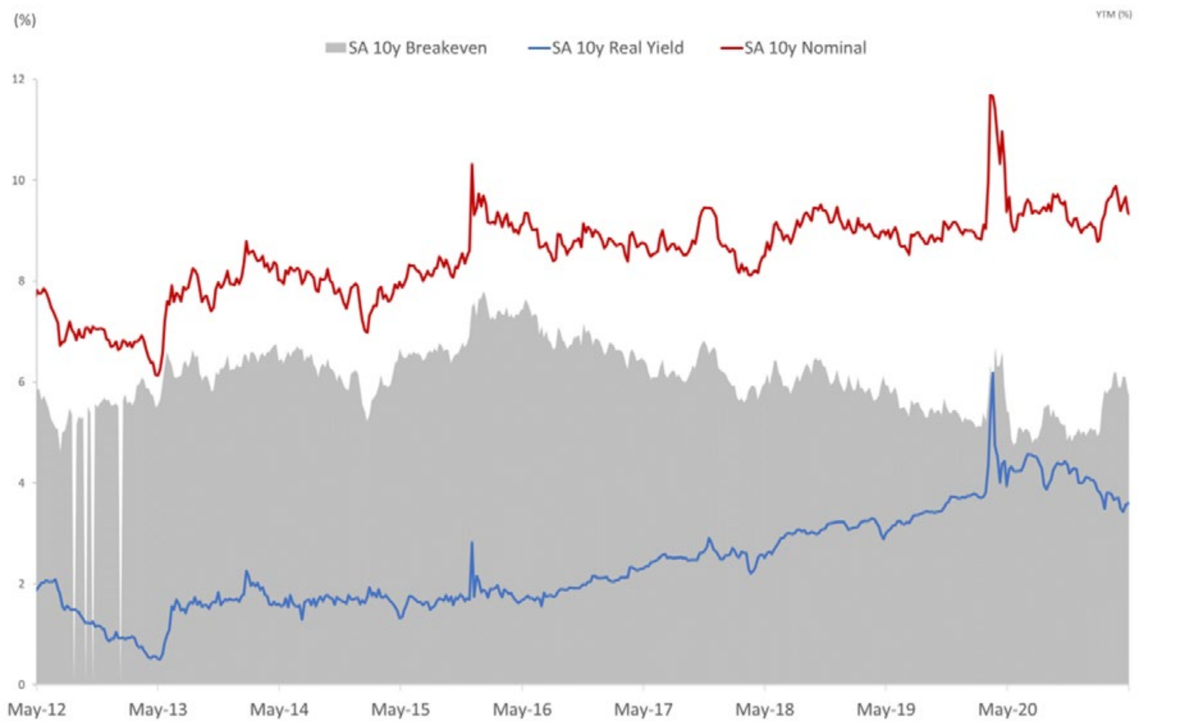
Locally rates have also been cut. The South African Repo Rate, the rate at which the central bank lends to commercial banks, is well below its twenty-year average of approximately 7.70%. This lends further credence to the sense that we are in a low interest rate environment.



Source: Bloomberg

Inflation expectations have increased, but not enough to drive any near-term rate changes. Demand remains weak, while real growth in the economy is still subdued.

Another way of looking at local interest rates is to examine our bond yields, commonly known as our nominal interest rates. In contrast, these yields have not declined in the last decade, but have remained relatively stable and may have even risen slightly over the period. Among other things, our nominal yields have remained elevated as a reflection of our declining sovereign risk status as an emerging market.



Source: ABSA, Bloomberg

This detracts from the "low interest rate environment" theme, but what does it all mean for investors?

Investing in a low interest rate environment can be very challenging. Savings and term deposits may not provide the necessary returns to beat inflation, thus eroding future purchasing power. The trick, therefore, is to find investments that provide real returns over time regardless of the interest rate environment. It is, therefore, essential that adjustments are made to absolute return expectations to accommodate inflation as the interest rate cycle changes over time.

Consider the risks carefully when choosing the asset classes available. Remain within the set risk parameters while always keeping the investment target, horizon, and benchmark in mind. In the end, it is all about attaining real returns after accounting for the effects of inflation within defined risk parameters.

Mr Price – First Class Fashion

About the business

Mr Price is a Southern African-based value fashion retailer, selling mainly own-brand products. The company is one of South Africa's largest clothing retailers and is made up of the apparel (65% of operating profits), home (24%) and financial services and cellular division (11%).

The value model is the core of the group's existence and being a fashion value retailer means lower mark-ups and selling higher volumes to enable the business to offer excellent value with everyday low prices. The group retails differentiated private label assortments that are dominant in the desired fashion items of the season. The business aims to provide customers with the best price for the quality and fashion offered. Customers' needs for fashionable items are satisfied through specialist trend teams, frequent international travel and applied research.

The group retails apparel, homeware, and sportswear through owned and franchise stores as well as online channels. The company is able to build stores at a cost aligned to its value model, while delivering an appealing store experience to customers. Occupancy costs are minimised through negotiation and a stringent lease renewal policy. The supply chain operations have been developed with the core focus being placed on customers to ensure that the product is shipped, fulfilled, distributed and delivered to the right place, at the right time and at the right cost.

The business has competitive advantages which make it unique

Economies of scale: Mr Price's large store base, which is in key locations with high accessibility to their target markets, creates a low-cost advantage that is the foundation of its economic moat. They are also able to use this store base to purchase large quantities from suppliers at discounted prices. The company's scale also generates bargaining power when it comes to negotiating with providers of advertising and occupancy costs.

Intangible brand asset: Mr Price is one of top 30 most valuable brands in the country. Through constant innovation and by staying on the pulse of international fashion trends, the brand has been able to make trend-led fashion accessible to customers at highly-competitive prices. The company has also been able to provide value and instil customer loyalty by passing along a portion of the savings to consumers in the form of everyday low pricing.

The investment case

As a critical part of our investment philosophy, we assess the quality of the business, the management team, the potential financial risk and the current valuation.

The business is of a high quality – Mr Price has been able to consistently deliver returns on capital of over 30%, which is well beyond the cost of capital to the company. The business has been able to do this due to its competitive advantages of economies of scale and branding. This has meant that the business has been able to have reasonably high operating margins for a retailer, coupled with an excellent asset turnover, comparable to a distribution business. The business is also extremely cash generative, with ~85% of sales being in cash, increasing the quality of earnings.

Management has been strong – The business has been operated well and management have managed to grow earnings by around 14%, compounded annually. By remaining a largely cash driven retailer, management has also been able to fund growth without incurring any debt and were able to grow the business without acquisitions. The newly acquired Power Fashion was the first acquisition in the last 25 years.

Low financial risk – Financial risk is not a concern when it comes to Mr Price. The unencumbered position of the group's balance sheet has allowed it to focus on growth as opposed to managing debt and the business currently finds itself in a net cash position of around R5bn, after accounting for the recent acquisitions of Power Fashion and Yuppiechef.

Valuation looks full – The counter has had a strong performance over the past year and has gained 46%. The surge in the share price has meant that the business is now trading on a price to earnings ratio of around 20x. While 20x is not historically high for Mr Price, the ten-year average PE is around 20x, the company is now looking fully valued, especially when considering that organic growth will be hard to achieve as the business already has some 1400 stores around the country and the company has already started acquiring businesses in order to help grow earnings.

Our position

While the business fundamentals are still strong and we currently remain invested in the business, the valuation at above 20x earnings starts to become demanding and if the share price continues its upward trend, we will rotate into another counter where the potential risk-return payoffs are more favourable.