FROM THE ANALYSTS: EQUITIES

REUNERT—SLOW AND STEADY

By Andrew Randles (Analyst)

History

Even though Theodore Reunert and Otto Lenz, formed "Reunert and Lenz" in 1888 by specialising in electric lighting, power and transmission, it wasn't until 1907 that the company made a name for itself by constructing a replacement steam-generated power plant for Johannesburg in a flabbergasting six weeks.

Today

The company we know today as Reunert is a manufacturing conglomerate with exposure primarily to South Africa, as well as smaller operations in Australia, Lesotho, Sweden, the USA, Zambia and Zimbabwe.

The Group's operations span high, medium and low voltage cable manufacturing that powers sub-Saharan Africa, tailored information communication technology (ICT) services and products catering to 55 000 customers, as well as a host of intellectual-property rich manufacturing businesses.

Capital Allocation

In 2014 Reunert's Management Team changed the fate of the company by selling-off the Nashua Mobile subscriber base for R1.79bn; leaving the business flush with cash (R2.7bn in 2015) and nascent opportunity.

We believe management teams are perpetually faced with the following capital allocation decisions - invest in their existing business, acquire outside businesses or return capital to shareholders via share repurchases or traditional dividend payments. The outcome of these decisions are measurable and reveal themselves in terms of the returns that shareholders receive on their capital invested.

Reunert's Management Team takes a pragmatic approach to capital allocation by not investing internally or externally below a 13.5% Internal Rate of Return (IRR) and adding higher hurdles for elements of risk including cyclicality, liquidity and size etc. An IRR acts as a hurdle that must be earned in order to invest shareholder capital in a project, higher risk projects demand higher rates of expected return.

Although the company has been deploying capital into pockets of opportunity in the existing businesses that show growth potential, what has impressed us is Reunert's management culture of conviction and rigidity in allocating capital over time. A case in point being the smart share buybacks of Reunert stock over time (2004, 2011 and 2017). Warren Buffett wrote about share buy backs in his 1980 letter to Berkshire shareholders: "If a fine business is selling in the market place for far less than intrinsic value, what more certain or more profitable utilisation of capital can there be than significant enlargement of the interests of all owners at that bargain price?"

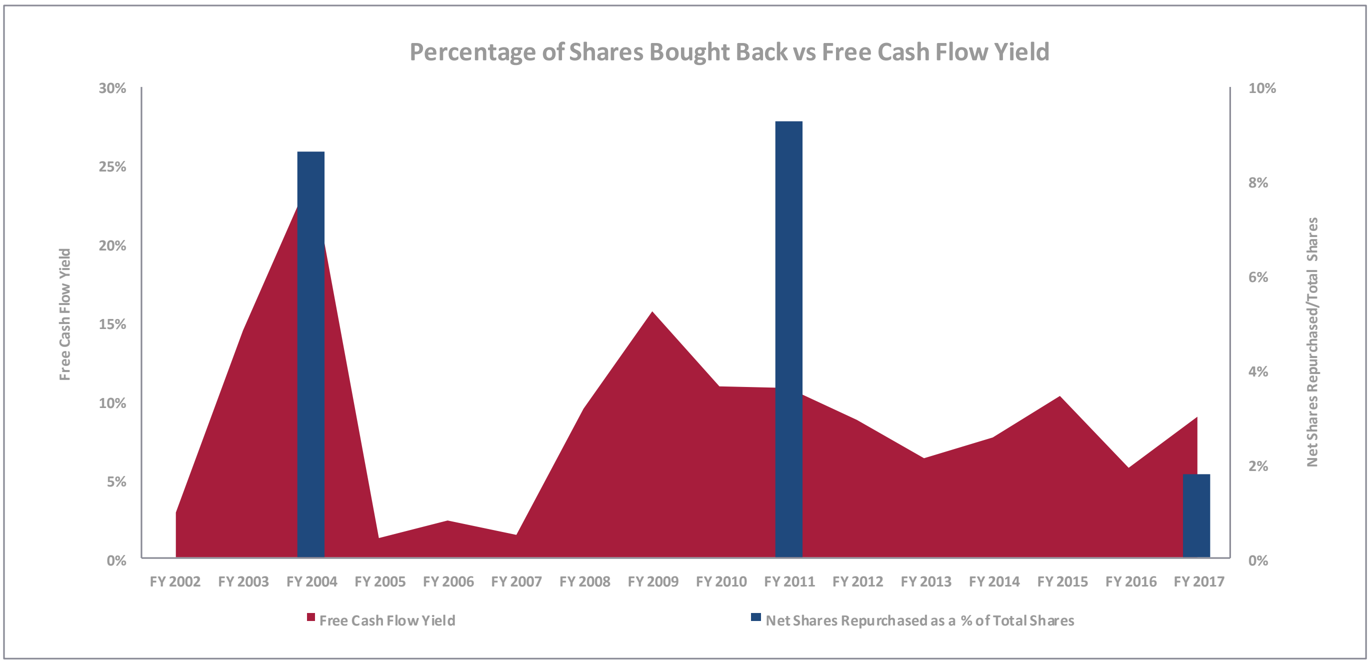

Figure 7. Percentage of Shares Bought Back vs Free Cash Flow Yield. Source: Northstar Asset Management.

Figure 7 shows the free cash flow yield of Reunert over time and when Management bought back shares as well as the yield that they bought these back at. Free cash flow is defined as the cash a company earns after paying for all the expenses and investments required to run the business. The free cash flow yield is free cash flow divided by the company's share price - the higher this yield, the better for shareholders. The graph depicts very clearly that Reunert bought back large amounts of shares when the share price was cheap/undervalued at a high free cash flow yield.

Patrick O'Shaughnessy, CEO of O'Shaughnessy Asset Management, statistically proves in his 2015 research piece "High Conviction Buybacks" that firms that buy back 5% or more of their shares at a time when free cash flow yields are high (high conviction buyers), tend to outperform the market by 4.7% annually, on a risk adjusted basis[1].

Acquisitions to Strengthen the Moat

In the various business segments, Reunert has been undertaking very specific and we believe well considered acquisitions to strengthen their business moats.

Electrical Engineering

The Electrical Engineering segment (37% of operating profit), which predominantly manufactures cables and circuit breakers has traditionally not had a competitive advantage/moat. Reunert created a relative competitive advantage for the business by acquiring ZAMEFA (Metal Fabricators of Zambia) in 2016, a cable manufacturer. This purchase has allowed them to process copper cathode into copper rod or finished cable onsite thus allowing for cost savings on transporting cable or raw materials to South Africa or to export partners.

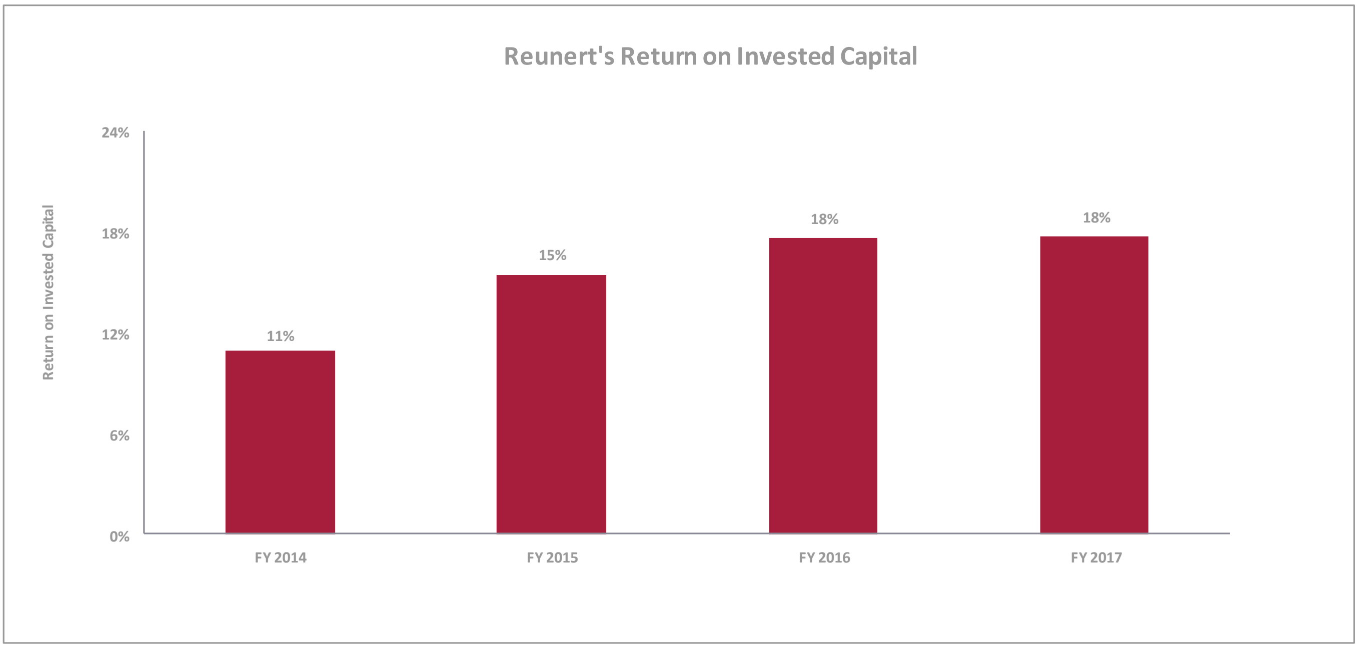

Figure 8. Reunert's return on Invested capital. Source: Company Financials.

In addition to the share buy backs, the Reunert Management Team have also paid an average dividend yield of 6.3% for the last 16 years and have been particularly generous with dividends while there was a shortages of investing opportunities either in the Group or through acquisitions.

Returns

Sound capital allocation with astute management of the firm, albeit within a very tough domestic economic environment has resulted in Reunert delivering impressive returns on invested capital over the years. Figure 8 is a visual perspective of this sound management of the business in favour of shareholders.

The Future

Since the sale of the Nashua Mobile subscriber base in 2014 the company has been acquiring a range of businesses that either strengthen their competitive advantage in a given segment or gain exposure to an area of the economy at an attractive price.

Information Technology Communications

Reunert's competitive advantage in their Information Technology Communication segment (53% of operating profit) is two-fold in our opinion. Firstly, the company has an asset-backed finance arm called Quince Capital, which offers favourable rates to customers in order to facilitate asset purchases (multi-purpose printers etc.). Financing hardware creates longer-term albeit tentative "hooks" into clients.

Secondly, the company is creating a one stop-shop for SMEs (Small and Medium Enterprises) for all of their ICT needs. This offering has been enhanced with the acquisition of SkyWire which offers broadband access. Large ICT operators are presently not servicing this segment of the market. Reunert has traditionally, through their copier business, had lengthy relationships with these clients.

Applied Electronics

The Applied Electronics segment (10% of operating profit) produces high tech products such as military grade radar and communication equipment. In recent years, the Group has acquired companies such as Rynonic Robotics, Nanoteq, Omnigo, and Terra Firma. New acquisitions have business models varying from providing robotics systems to developing cryptographic products and solutions to meet cyber security and cyber defence needs. These new additions are rich in intellectual property, are growing fast and should act to even-out the boom-bust cycle of defence manufacturing. Currently, the segment has a healthy order book.

A low-risk option on South African growth

President Cyril Ramaphosa has committed to bringing a target of R1.2 trillion in new investments into South Africa over the next 5 years. We believe that Reunert would prove a major beneficiary if this transpired, particularly if this new investment was accompanied by infrastructure development. However, our investment thesis for the company has in the past transcended this requirement and instead rested on Reunert's focused management culture, consistent long-term dividend-paying strategy, opportunistic share-repurchase program and smart investments in value accretive growth opportunities. Having owned the company for a while, the share price has risen considerably and at current levels, we believe the stock is fully valued!

[1] This analysis was conducted (U.S. Large Stocks Universe, 1987–2014) by O'Shaughnessy Asset Management, Report Titled: "High Conviction Buybacks", by Patrick O'Shaughnessy, CFA: August 2015

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