

Hidden gems



Andrew Randles
Analyst

While exposure to South Africa's beleaguered economy now seems something of a curse, local companies with business segments that are able to realise growth in new markets can still do well. We analyse two examples of these hidden gems to tease out their potential and explain how the value that could be unlocked will benefit Northstar investors.

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With South Africa's economy facing a significant growth challenge, many companies on the JSE are destined to follow the same path unless they can gain market share or find growth elsewhere. For investors, slow growth generally equals low returns.

One way active managers can add value is by identifying segments or businesses within companies that are not currently the main driver of profits, but that are growing fast enough to drive growth in the future. A rather extreme example of this, which has been very kind to shareholders, is Naspers's investment in Hong Kong listed Chinese tech conglomerate Tencent. Sometime in 2015 the market value of Naspers's holding in Tencent surpassed the market value of Naspers itself, effectively according the rest of Naspers's businesses a negative value.

The remainder of this article discusses two holdings in Northstar funds that we believe contain hidden gems. Of course, we don't expect these to turn out as well as Tencent did for Naspers, but would be delighted if they did.

Growth for Life Healthcare in medical scans and neuropharmaceuticals

Life Healthcare (LHC) is South Africa's second largest private hospital operator with more than 8 000 hospital beds in 49 facilities across Southern Africa. LHC's share price has been hit hard since March as the wave of COVID-19 patients has largely decreased, and regular hospital admissions have been slow to return to normal.

Going forward, South Africa's healthcare industry faces slow growth in insured lives due to the challenges in our job market. However LHC's international business, Alliance Medical Group (AMG), offers a far more attractive medium-term growth vector for the group.

AMG is a vertically-integrated imaging supplier providing medical scans such as MRI, CT and PET-CT scans in the UK and Europe. PET-CT scans analyse changes at the cellular level allowing them to pick up evidence of diseases such as cancer at an earlier stage than other scans. AMG provides around 70% of NHS PET-CT services in the UK by contract, and with volumes increasing and pricing largely fixed for the next six years, this creates a steady revenue stream for growth.

Life Molecular Imaging (LMI), which sits in AMG, is another potential profit generator for the group. It is a research and development company dedicated to the development and global commercialisation of innovative molecular imaging agents used in PET-CT diagnostics. LMI has a pipeline of novel imaging agents that help diagnose neurological, oncological and cardiovascular diseases, all of which have potential markets that are in the billions of dollars and growing fast.

LHC bought LMI for US\$1 in 2018, with an agreement to bring it to breakeven and thereafter share up to 50% of the cash generated up to a maximum of US\$200 million over the next 10 years. LMI broke even in 2020 and from here on out LHC has a free option on future growth in the company.

The early detection and treatment of neurodegenerative diseases, and Alzheimer's Disease in particular, represent a significant opportunity. LMI already has a diagnostic radiotracer to visualise β -amyloid plaques in the brain that is FDA approved and has the second largest market share in the US. They also have a next-generation tau tracer in phase II of clinical development. The presence of β -amyloid plaques and tau proteins in the brain are two early markers of Alzheimer's and potentially other neurodegenerative diseases.

The value of the LMI optionality was demonstrated early in November when it seemed likely that a new drug to treat Alzheimer's would be approved by the FDA, which would increase demand for scans using LMI's products. The news caused LHC's share price to jump 25% in two days, although the share retraced when the drug subsequently seemed unlikely to be approved after being reviewed by an independent panel of experts. We believe that AMG on its own is well-placed to grow strongly while a breakthrough in treatment for Alzheimer's could mean a pay-off for LMI that would eclipse the current LHC share price.

Growth in Africa looks good for Distell

Another company ravaged by COVID-19 for obvious reasons is Distell, which produces ciders, wines and spirits predominantly for the South African market. However, our analysis suggests that the current share price could be undervaluing the opportunities present in the rest of Africa.

GDP per capita in sub-Saharan Africa is growing strongly off a low base, economies are formalising and alcohol consumption increasing, particularly in the emerging middle class. Distell's proactive investments in routes to market in the region and the quality of their in-country strategic partners in certain geographies has seen strong growth in the rest of Africa, with organic volumes growing 28.6% in 2019. Although the impact of COVID-19 in the short term is uncertain, Distell's management previously indicated that the region could contribute R1 billion in profit by FY2024. Our research suggests that this growth opportunity is not yet fully reflected in Distell's share price.

Quality at a reasonable price

Northstar owns both Distell and Life Healthcare across all domestic equity and balanced fund mandates. Our research identifies sustainable quality businesses operating in bountiful industries with entrenched competitive advantages over their peers. We look to invest when these quality companies are available at a reasonable price. Teasing out the potential optionality within a business like LMI or the strong growth profile of Distell's African operations, provides far deeper insight into the price we are willing to pay and what value could be unlocked in the future.

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NORTHSTAR ASSET MANAGEMENT

Northstar Asset Management (Pty) Ltd
Registration No. 1996/001423/07 | FSP number 601
Suite 1A, Madison Place, Alphen Office Park, Constantia Road,
Constantia PostNet Suite #784, Private Bag X16, Constantia 7848
Tel +27 (0)21 810 8400 | Fax +27 (0)21 794 2885
info@northstar.co.za | www.northstar.co.za

SANLAM COLLECTIVE INVESTMENTS

Sanlam Collective Investments (RF) (Pty) Ltd
Registration No. 1967/002865/07
2 Strand Street Bellville, 7530 PO Box 30, Sanlamhof, Bellville, 7532
Tel +27 (0)21 916 1800 Fax +27 (0)21 947 8224
service@sci.sanlam.com, www.sanlaminvestments.com
Please refer to our website for directors & company secretary details

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