NorthStar Asset Management

First Avenue Investment Management

Market Report

QUARTER 2, 2024

Closer to the truth

Unlocking value in Woolworths and Richemont

Lo Giyose
Chief Investment Officer/Portfolio Manager (First Avenue)

Investors have allowed the management teams of Woolworths and Richemont to continually invest scarce resources (time and effort) into business lines (clothing retail and luxury watches) that not only produce sub-optimal returns, but also cause significant value leakage relative to best-in-class peers (Shoprite and Hermes respectively). BHP's recent efforts have catalyzed management of Anglo American to divest out of assets with a higher risk premium. What will it take for Woolworths and Richemont managements to do the same? Will Woolworths dispose of its clothing retail business when it contributes 5% of sales? What will the opportunity cost of that be if it is 15yrs down the line? The same for Richemont. What contribution to revenues makes the watch business irrelevant to the group? Woolworths trades at a discount of +20% structurally on a PE multiple basis to Shoprite. Richemont trades at half of Hermes' PE multiple structurally. Compounding those discounts over long periods of time leads to an opportunity cost so devastatingly large that it is difficult to stomach.

Some self evident truths in Woolworths Group and Richemont

BHP's bid for Anglo American pointed out some truths which, while self-evident, investors ignored for a long time, and were willing to continue with the status quo well into the future. The truth BHP pointed out is that the different businesses in Anglo American attracted materially different risk premia. Not only does the copper business in Anglo American have a lower risk premium than the diamond, PGM, coal, and fertilizer businesses; mines located outside South Africa were more attractive than mines located in the country.

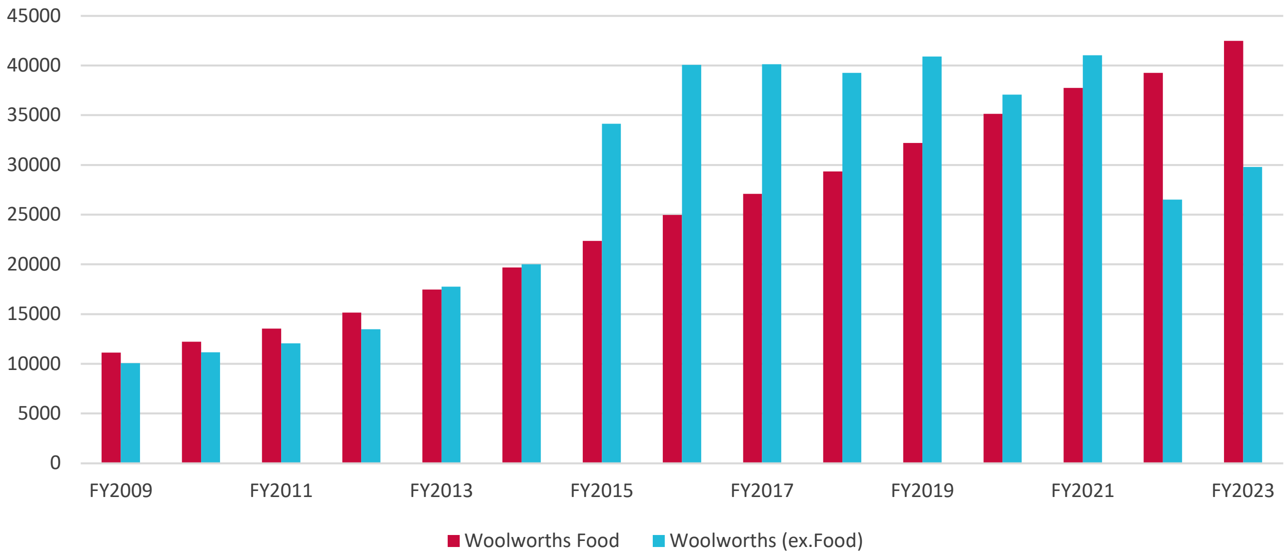
You can apply an analogous thought process to several JSE listed companies, including Woolworths and Richemont:

- That Woolworth's food business perennially and structurally outperforms the clothing business is as self-evident a truth as man being created equal.
- That, on the same basis, the Richemont jewellery business outdoes the luxury watch businesses is as self-evident a truth as man's pursuit of liberty.

Management teams of both have not purposely neglected their underperforming units, on the contrary they have invested significant resources in those divisions. However, the weight of evidence patently makes the case that Woolworths is far better at retailing food and Richemont's skills are superior at retailing jewelry.

Chart 1 on the following page shows the evolution of both food and clothing Woolworths revenue contributions since 2009. The ratio has gone from parity to overwhelming domination by food. Importantly, all food revenues are organic, derived in South Africa while clothing jumped after the acquisition of David Jones in Australia (2015 - 2021). Even with this boost clothing has simply been inglorious.

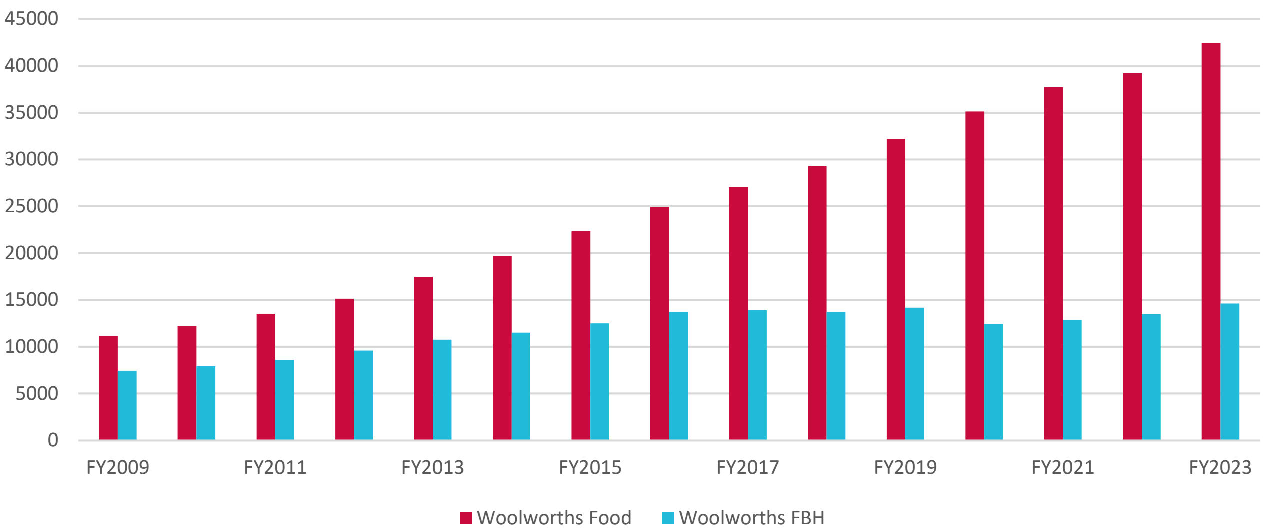
Chart 1: Contribution to Sales: Woolworths Group Food vs. Clothing Retail (2009-2023)



Source: Capital IQ, First Avenue-Northstar

Removing the impact of Australia shows just how much food retail has completely overwhelmed clothing retail in the same period.

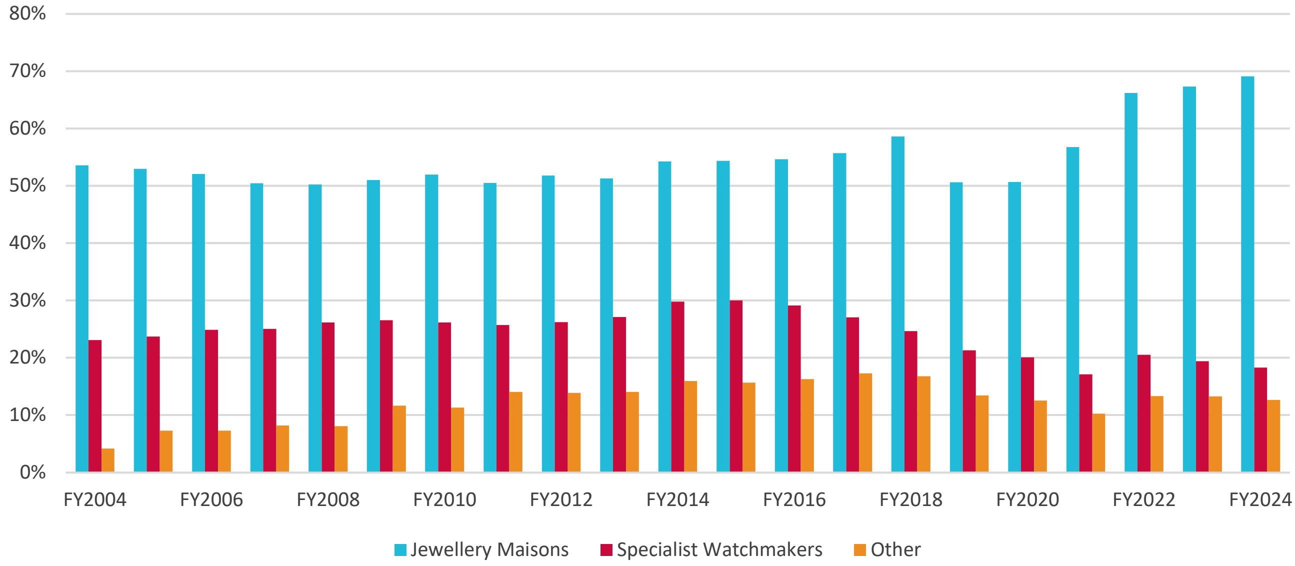
Chart 2: Contribution to Sales: Woolworths S.A. Food vs. Clothing Retail (2009-2023)



Source: Capital IQ, First Avenue-Northstar

Turning to Richemont, while the watch division has always contributed less than the jewellery division (23% vs 54% in 2004), the division's contribution to sales is now down to 18% (2023) while jewellery is up to 69%. The watch division is slowly being drowned out by jewellery. Again, this is despite Richemont acquiring a few watch brands along the way.

Chart 3: Contribution to Sales: Richemont Jewellery vs. Watches (2000-2023)



Source: Capital IQ, First Avenue-Northstar

Profitability

The trend of value diminution in clothing retail and luxury watches in Woolworths and Richemont respectively is also evident in operating margins.

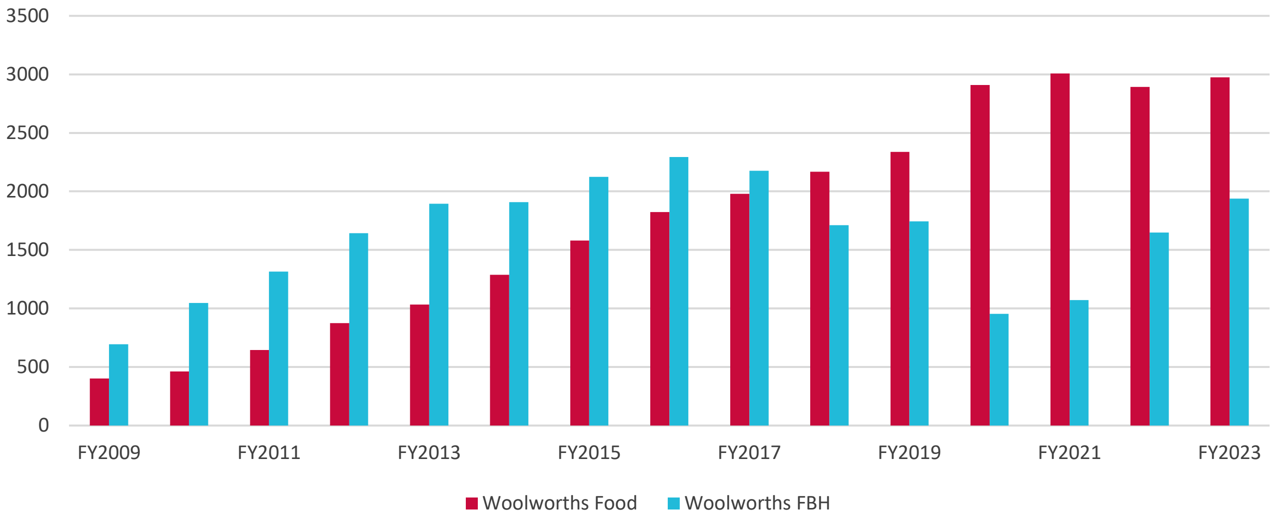
At a group level (S.A. and Australia), the operating margin for the food division has steadily increased –through organic growth we should mention) while clothing peaked in 2015 (due to the acquisition of David Jones in Australia) and then declined markedly since.

Chart 4: Operating Margins: Woolworths Food vs. Clothing Retail (2000-2023)

Source: Capital IQ, First Avenue-Northstar

Excluding the impact of Australia (which boosted clothing), profitability in food has as surely as the sun rises in the East and sets in the West, trounced profit contribution by the clothing business.

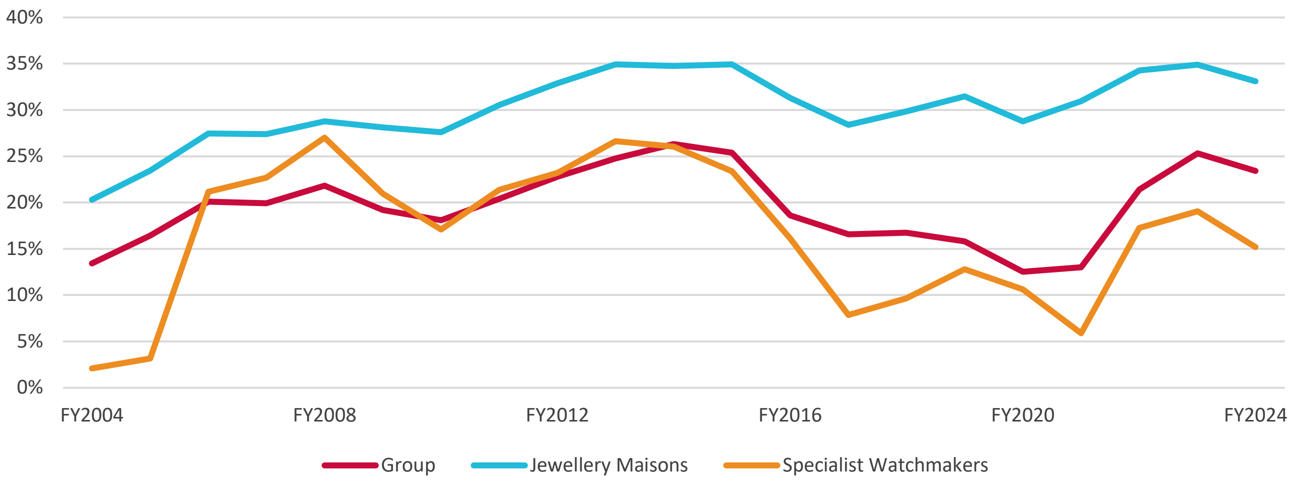
Chart 5: Operating Profit Margin S.A. Only: Woolworths Food vs Clothing (2009-2023)



Source: Capital IQ, First Avenue-Northstar

Turning to Richemont, the jewellery division has increasingly driven the company's profitability while the profitability of the watch division has languished in mediocrity.

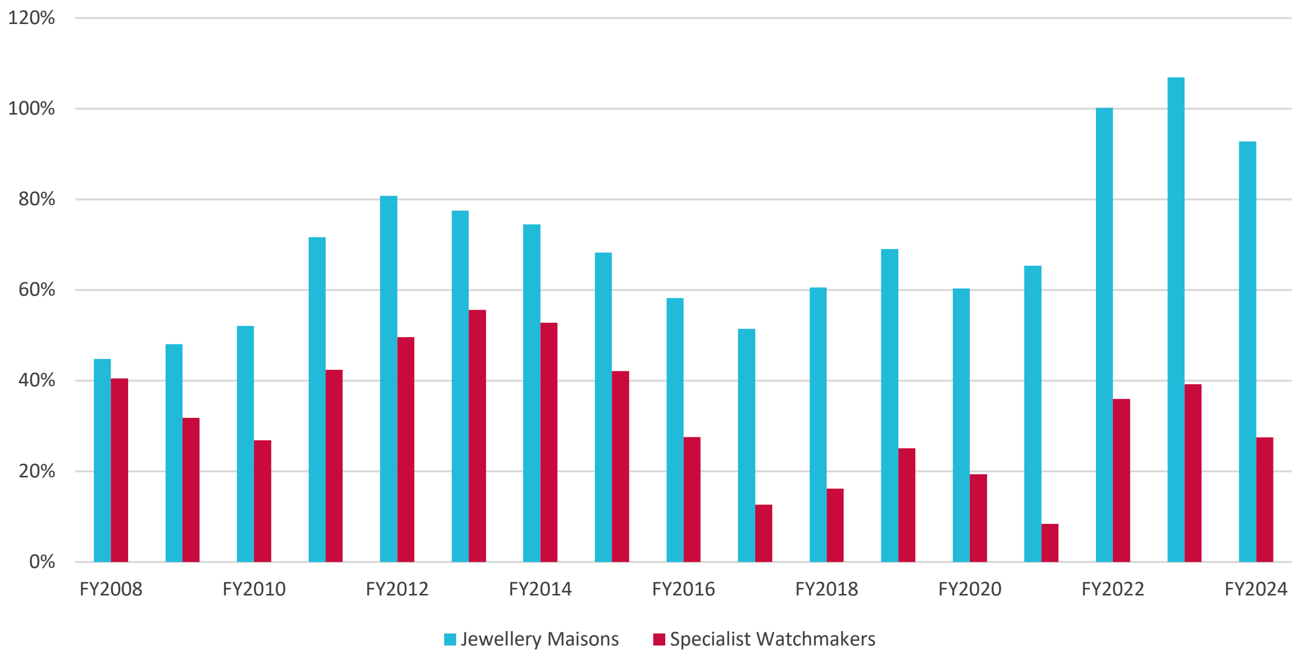
Chart 6: Operating Profit Margins: Richemont Watches vs. Jewellery (2000 – 2023)



Source: Capital IQ, First Avenue-Northstar

It really is hard to believe that both of Richemont's divisions once generated the same return on capital invested. Today, the return on capital invested in watches pales in comparison to that of jewellery.

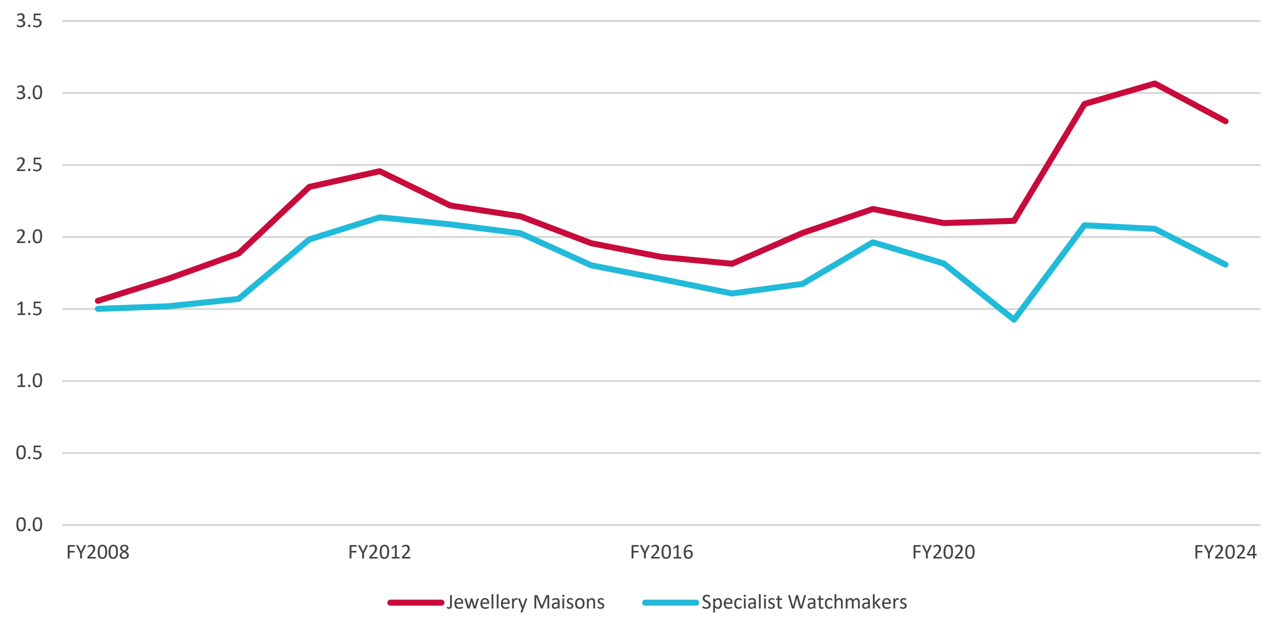
Chart 7: Richemont Divisional Return on Assets (2008-2024)



Source: Capital IQ, First Avenue-Northstar

The market appeal of jewellery relative to watches is further evidenced by the asset turnover (how many times assets in the division produce sales in a year). Richemont's jewellery is the marvel of the group, turning over 2.8x compared to 1.8x in watches. What's more, the asset turnover rate in jewellery improved markedly from 1.6x in 2008 to 2.8x in 2024 while that of the watch business has barely budged since 2008 (1.5x – 1.8x).

Chart 8: Richemont Divisional Total Asset Turnover (2008 – 2023)

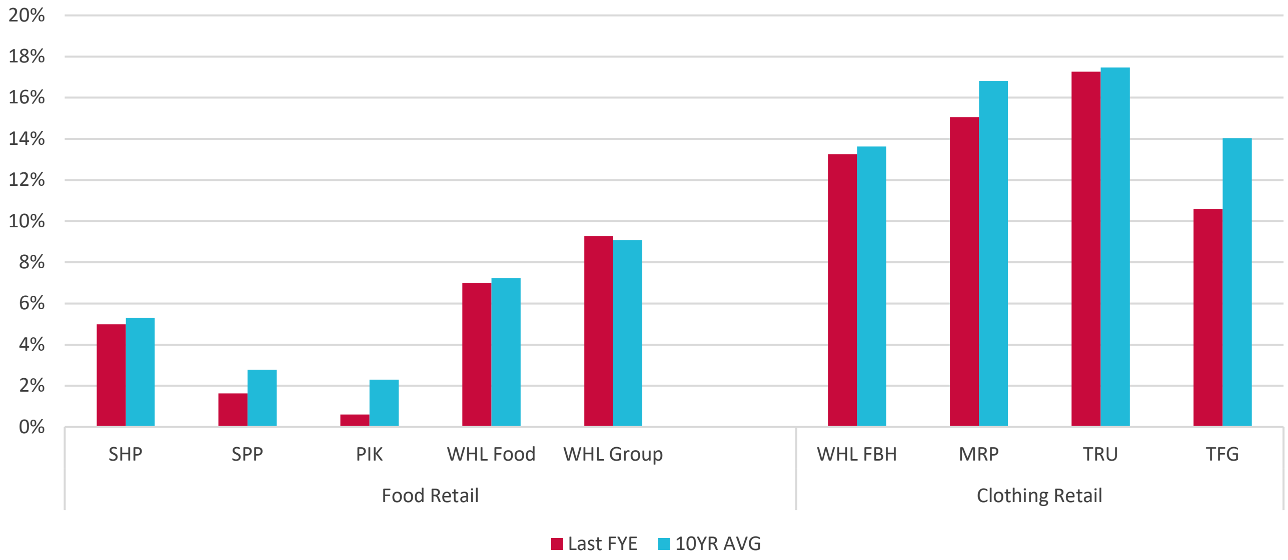


Source: Capital IQ, First Avenue-Northstar

Industry Peer Review and Valuation Optics

First, from an operating margin standpoint, Woolworths Food stands head and shoulders above Shoprite's, Spar's, and Pick n Pay's. However, in clothing retail, Woolworths comes third after Truworths and Mr. Price (The Foschini Group brings up the rear).

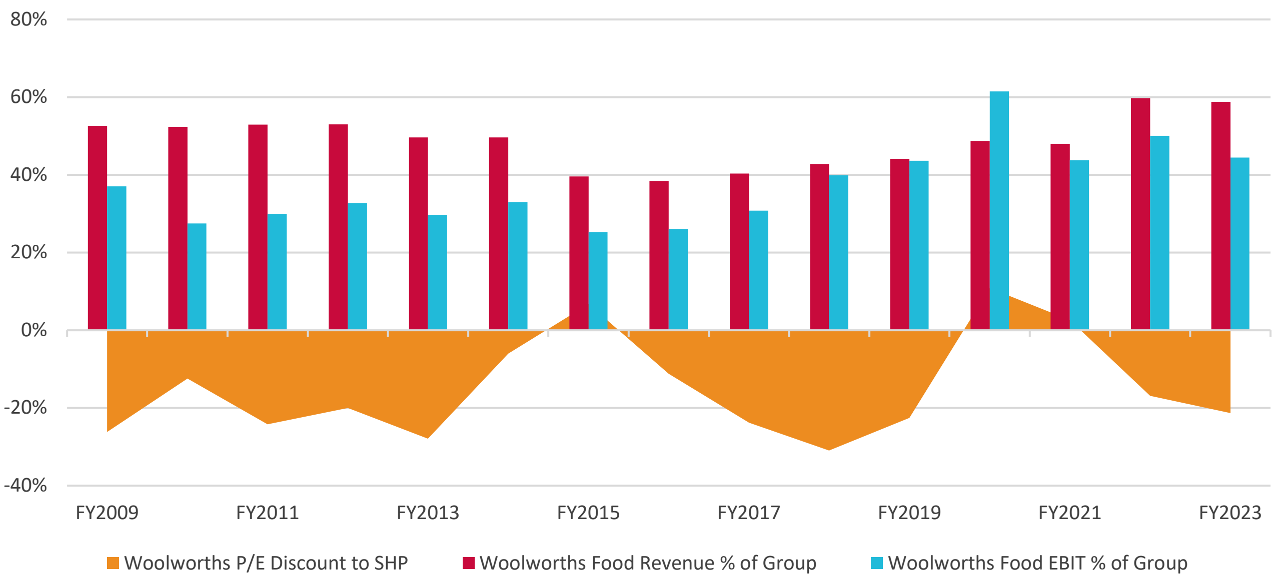
Chart 9: Peer Review: Woolworths Food and Clothing vs Peers



Source: Capital IQ, First Avenue-Northstar

The drag on valuation of the clothing retail division of Woolworths, as perceived by investors, is evident when comparing the valuations of the company to the best-in-class businesses in food and clothing retail sectors. In the consumer discretionary sector in South Africa, the food division gives Shoprite, the market leader in food retail in the country, a run for its money. Yet Woolworths' price to earnings multiple often trades at a material discount (+20%) to Shoprite's PE multiple. It makes one wonder if investors, and indeed management, have never wanted to capture that value uplift.

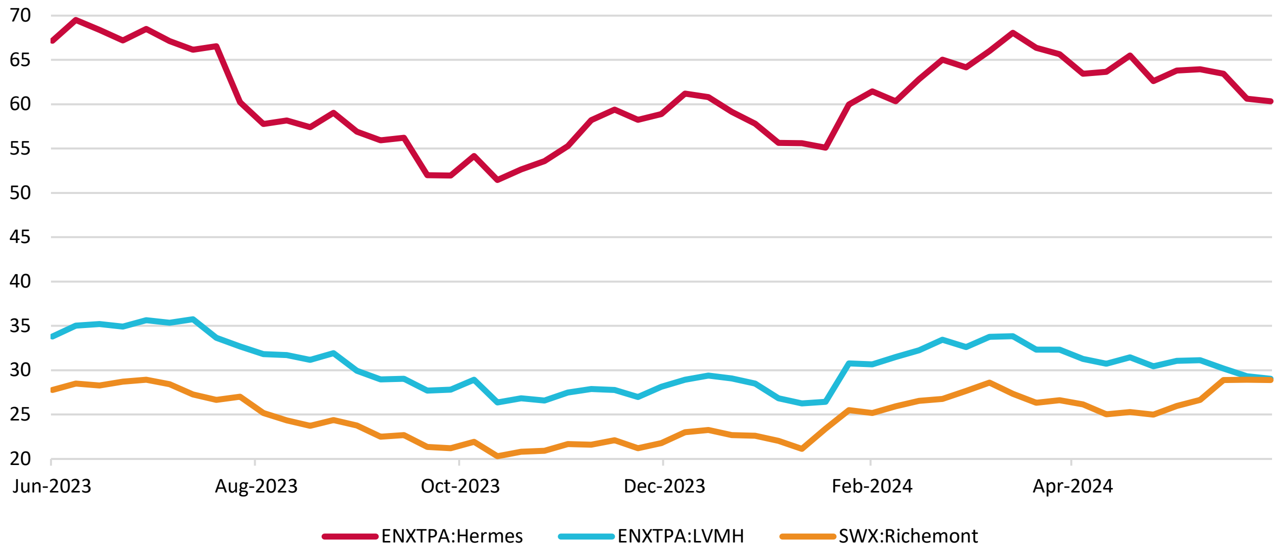
Chart 10: Woolworth's Structural Discount to Shoprite's PE Multiple



Source: Capital IQ, First Avenue-Northstar

For Richemont, there is a lot more of margin uplift to capture (30x multiple difference). The company has best in class jewellery. This is comparable to Hermes' best-in-class soft luxury (leather bags and scarves). Yet the difference in price earnings multiples is as wide as the Grand Canyon.

Chart 11: Richemont vs. LVMH vs. Hermes: Trailing 12m PE Multiples



Source: Capital IQ, First Avenue-Northstar

While the gap between LVMH and Richemont has closed, it is not that comforting a data point because LVMH is an even bigger conglomerate in the luxury segment with interests ranging from soft luxury, hard luxury, wine and spirits, high and mid-end luxury. The lesson here is that a luxury company has a better chance of attracting a very high multiple when it is best in class at a niche and specialist (Hermes) offering and not when it is diversified (LVMH). The reason Swatch does not attract a high multiple is that it is not best-in-class in luxury watches. Philipe Patek is.

Conclusion

Investors have allowed the management teams of Woolworths and Richemont to continually invest scarce resources (time and effort) into business lines that not only produce sub-optimal returns, but also cause significant value leakage relative to best-in-class peers. BHP's recent efforts have catalyzed management of Anglo American to divest out of inferior assets. What will it take for Woolworths and Richemont management to do the same? Will Woolworths dispose of its clothing retail business when it contributes 5% of sales? What will the opportunity cost of that be if it is 15yrs down the line? The same for Richemont. What contribution to revenues makes the watch business irrelevant to the group?

Are SA equities just cheap or is there more to it?

Marco Barbieri
Director SA Equities

Over the past decade, SA equities have significantly underperformed its global peers, as macro factors have significantly deteriorated in South Africa. The investment case for SA equities, as a result, has centred around a valuation argument rather than that of an improving structural story. In the article, we unpack such dynamics but propose four drivers of return, which we think are likely fuel a strong cyclical rebound for this asset class.

South African equities have fared particularly poorly over the past decade having underperformed the MSCI World Index, in US dollars, by 7% per annum over this period.

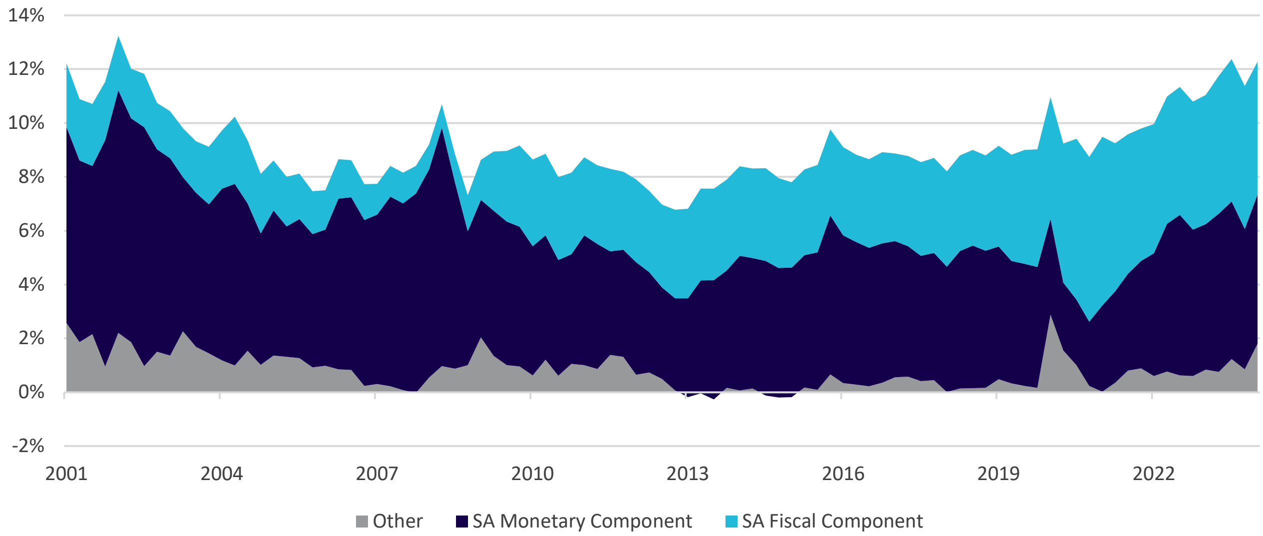
While this performance is broadly explained by deteriorating SA macro-economic factors, particularly in the post-Covid era, many South African investors appear to be turning positive despite no obvious improvement in medium-term expectations. At face value, the most common reasons for this center around technical factors (such as de-listings and corporate actions), cheap valuations and the concept of "how low can the market really go?"

On a three-year time horizon, empirical data shows that attractive valuations are generally a good entry point for JSE investors. At present, although there are significant opportunities because of this, we believe that the SA equity investment case has more to it than just valuation support.

The elephant in the room: SA's growth and fiscal position

South Africa's weak growth track record over the past decade highlights its deep structural constraints and the urgent need for significant reform. A good way of assessing the impact of this, and the deteriorating South African fiscal position on asset prices is to regress monetary and fiscal variables. These include the likes of debt-to-GDP and budget balances, thus evaluating their impact on the cost of capital, or as a proxy the South African 10-year bond.

Chart 12: South Africa 10 Year Bond - Regression Model



Sources: S&P CapitalIQ, Bloomberg and Northstar Asset Management (May 2024)

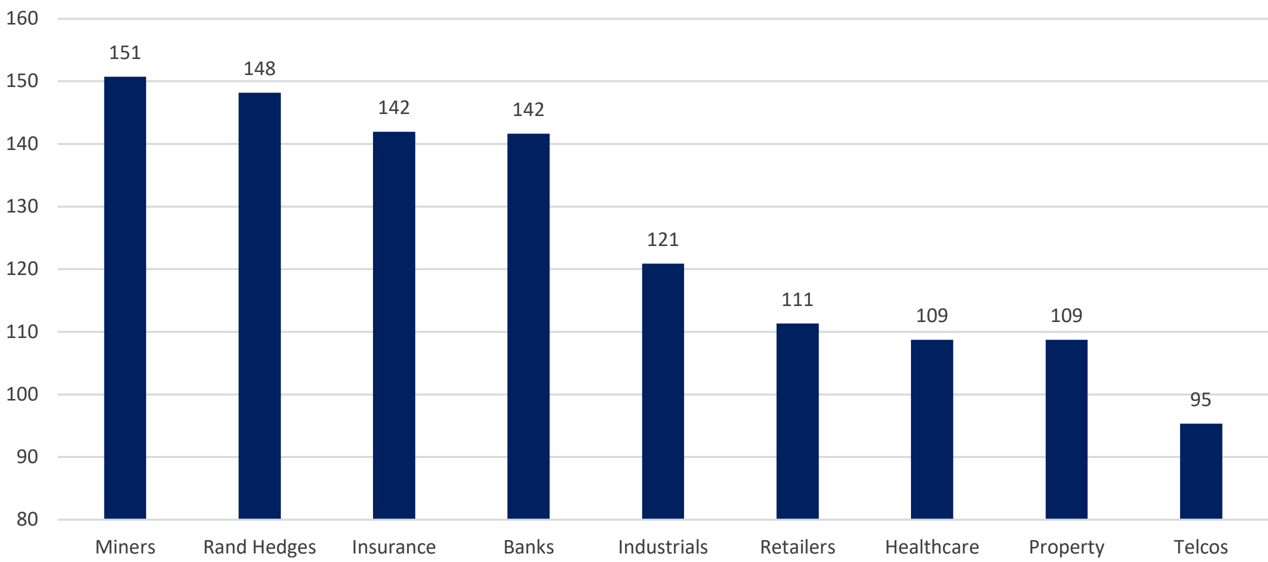
As expected, it is evident from Chart 12 that both monetary and fiscal factors have pushed yields higher since the "GFC", and more recently following the Covid pandemic. But while the impact caused by monetary effects tends to be more cyclical in nature, and has arguably peaked in this cycle, the impact caused by weak growth and higher sovereign debt levels is more structural and persistent. Based on national treasury's latest debt and budget balance forecasts, however, with debt-to-GDP now expected to peak in 2026 at 75.3%, and with debt service costs forecast to decline thereafter, we think the pressure on yields caused by fiscal dynamics could subside somewhat from current levels, and support asset prices.

The State, SA Consumers and Corporates

In a relatively stable fiscal environment, as modelled by national treasury, various cyclical tailwinds should provide significant impetus for SA sensitive assets.

Arguably the fiscal and monetary support provided during the Covid pandemic was not enough to help local consumers recover to the extent seen in other economies. The subsequent tighter monetary conditions (475bp of interest hikes), high inflation and load-shedding have further impinged upon consumer health, and expenditure. The lethargic post-Covid rebound in corporate earnings has reflected this slow recovery in consumption, and unsurprisingly sectors that benefit from global drivers have fared much better. In particular, precious and industrial metal miners have experienced a powerful profit rebound, whilst SA sensitive sectors such as retail, healthcare, property and general industrials have been weak as evidenced in Chart 13 below.

Chart 13: Average Profit Before Tax (indexed to 100 - Dec 2019 to Dec 2023)



Sources: S&P CapitalIQ and Northstar Asset Management (May 2024)

Four drivers of a potential cyclical rebound

There are four main bull case drivers for local equities, which are likely to have a strong positive effect on consumer health, corporate earnings and ultimately stock price returns.

Firstly, it is estimated that loadshedding alone shaved 1.5% from 2023 GDP growth numbers, and the SARB forecasts a 0.6% impact this year. Improvements over the past six months, with the return online of Kusile units, together with better-than-expected private sector investment in solar generation has seen various economist revise growth estimates higher.

Secondly, expected interest rate cuts later this year will significantly buoy both consumption and corporate health, and as previously noted the cost of capital. Whilst this cycle is expected to be rather “shallow”, with only a 1.0% to 1.5% cumulative cut forecast, we believe its effect, as inflation further moderates, to be meaningful.

Thirdly, the outcome of the SA national elections has had a far-reaching impact on local assets. There is no doubt that in the last year leading up to the elections, local asset prices suffered from abnormally high-risk premia. While we noted that there were binary risks to the election outcome, particularly in the event of an ANC/EFF/MK tie-up, the recent formation of a coalition government has added a new dimension of political stability and policy direction.

And finally, while not necessarily an economic driver, it is hard to disregard extremely depressed equity valuations, against, in our opinion, improving corporate fundamental prospects. In particular, this asymmetric return profile for “SA Inc.” equities presents an excellent medium term entry point for investors.

Meet The Team

Refiloe Modise
Trainee Analyst: Fixed Income

When did your interest in financial markets start?

My interest in the financial markets was shaped by early exposure to finance through various family members' career choices. This influence laid the foundation for my fascination with the financial world. Participating in job vacation programmes helped refine my interest in finance while revealing my lack of interest in accounting. My curiosity was further ignited by watching movies like "The Big Short" and various financial documentaries that offered a gripping portrayal of the complexities and dynamics of the markets. These experiences collectively fuelled my passion for understanding and navigating the financial landscape.

What did you study and why?

I pursued a Bachelor of Business Science, majoring in Finance and Accounting. While I enjoyed the subject of accounting, I was particularly drawn to the diverse opportunities that finance offered. I am currently pursuing a Master's in Business Analytics at the University of Bath. I chose this program to effectively combine my interests in finance and data analysis. Recognizing the pivotal role data plays in decision-making, I aimed to deepen my understanding of how data is used to inform and shape financial strategies. Additionally, staying abreast of the latest tools and software is crucial for me to add value to my team and firm, enhancing our analytical capabilities and overall performance.

What do you think equips you to do this job properly?

My educational background, paired with my commitment to advancing my analytical skills, equips me to do my job as a Fixed Income Analyst properly. The foundation built from my Bachelor's degree, combined with the advanced skills I am gaining through my Master's, enables me to blend financial expertise with modern data analysis techniques. This unique skill set allows me to delve deeply into the various elements that influence market conditions and economic trends. I am confident that these capabilities enable me to effectively analyse fixed income market movements and financial outcomes through various economic cycles.

What do you love about investing?

I love investing because it combines intellectual challenge with the opportunity to make a tangible impact. The process of analysing market trends, evaluating data, and modelling future expectations is both stimulating and rewarding. The ever-evolving nature of financial markets ensures that there is always something new to learn, keeping me engaged and passionate about my work.

What do you find the most challenging part of your role to be?

Balancing the need for thorough analysis with the goal of deriving positive outcomes or returns can be challenging, but it also makes the work incredibly dynamic and engaging.

Why do you think clients will do well at Northstar and First Avenue?

The companies share a unified culture, vision, and goals. Both firms are known for their hardworking teams and collective commitment to excellence. This shared ethos fosters collaboration and innovation, ensuring that clients benefit from a cohesive and dedicated approach to asset management. The synergy between the two firms enhances their ability to deliver superior financial performance and personalized service, ultimately providing clients with a stronger, more reliable investment experience.

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