

# COGNIZANT

3<sup>RD</sup> QUARTER 2022



THE ECONOMICS OF  
AN **ECONOMIC MOAT**

**S&P GLOBAL INC:** GREATER  
THAN THE SUM OF ITS PARTS

**SHOPRITE:** BIGGER AND BETTER

WHEN DO I BUY **HARD CURRENCY?**

**THE PCS GLOBAL EQUITY PORTFOLIO:**  
FOCUSED ON THE OPPORTUNITIES



**OLDMUTUAL**

**WEALTH**

# TABLE OF CONTENTS

THE ECONOMICS OF AN <b>ECONOMIC MOAT</b>	4
<b>S&amp;P GLOBAL INC:</b> GREATER THAN THE SUM OF ITS PARTS	10
<b>SHOPRITE:</b> BIGGER AND BETTER	16
WHEN DO I BUY <b>HARD CURRENCY?</b>	20
<b>THE PCS GLOBAL EQUITY PORTFOLIO:</b> FOCUSED ON THE OPPORTUNITIES	22



# INTRODUCTION

JEAN MINNAAR, MD: OLD MUTUAL WEALTH TRUST COMPANY (PRIVATE CLIENT SECURITIES | TREASURY AND ADVISORY SERVICES | FIDUCIARY SERVICES)

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only.”

Charles Dickens' fantastic start to *A Tale of Two Cities* reminds us, refreshingly, that the times we are living in are not new, and perspective has a great impact on outcome.

On a lighter note, it also suggests that the rules of grammar only apply to those who aren't gifted enough to defy them – a single sentence as a full paragraph. Yet, even to contemporary eyes, it reads clearly and easily. Why is it that the greatest always seem to stand the test of time?

In the world of business, we also find these uniquely gifted companies that are able to grow and defend, through the best of times and the worst of times. They don't just accept the status quo and operate within the economy and battlefield as defined for them. Rather, they seek to define it for themselves.

We actively seek, admire and invest in businesses that show wisdom and belief, turn hope into reality and live in a world where they operate like they have endless opportunities before them.

These businesses often have two characteristics. Firstly, they see the world differently and boldly face challenges with conviction. Secondly, they have built and actively maintain economic moats, which, much like medieval city states, allow them to defend themselves while they continue to prosper inside.

Economic moats allow companies to maintain structural sustainable advantages that protect them in the battlefield of business. And in times of ever-present technological disruption and intense competition, these modern-day moats remain as relevant today as they were in medieval times. In our feature article, Private Client Securities (PCS) Chief Investment Officer Andrew Dittberner discusses economic moats in more detail. He explains why identifying and understanding the source and nature of a company's moat is an important element in identifying great businesses that are able to generate sustainable returns. Andrew also gives us a useful snapshot of the various moat sources for the companies held within the PCS Global Equity and Core Equity Model Portfolios.

In our company-specific articles, PCS Research Analysts Victor Mupunga and Tasneem Samodien provide an interesting analysis of

the moats surrounding S&P Global and the boldness of Shoprite, key holdings within the PCS portfolios.

This year marks the eighth anniversary of the PCS Global Equity Portfolio, which offers clients the opportunity to invest in some of the largest, most successful businesses in the world. Despite gruelling market conditions, this portfolio has delivered strong investment results and we include a feature on the portfolio and its positioning.

We then round off this issue with an article by Wayne Sorour, Head of Old Mutual International: Sales & Distribution, addressing the ever-relevant topic of offshore investing and market and currency timing. Importantly, Wayne makes the point that trying to time the markets when the rand is at the “right” level will only lead to delay and regret.

To conclude, we wish to reassure you that, although this year has been incredibly challenging on numerous fronts, we remain focused on constructing and managing resilient investment portfolios that are geared to stand the test of time. We believe that companies with strong economic moats and bold management will adapt to changing economic environments and will not only survive, but thrive

I trust you will enjoy this issue.

All the best,  
Jean

# THE ECONOMICS OF AN ECONOMIC MOAT

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**ANDREW DITTBERNER**, CHIEF INVESTMENT OFFICER AT PRIVATE CLIENT SECURITIES



As with most facets of life, not all businesses are created equal. Irrespective of a management team's skill, certain businesses are able to sustainably generate high returns on invested capital, while others struggle to achieve this. In this way, certain businesses tend to have a competitive advantage over their peers that is not quickly eroded. And while it is the management team's responsibility to allocate resources to generate attractive long-term returns on investment, we as investors need to identify those businesses that, as a result of their competitive advantage, represent compelling investment opportunities.

Warren Buffett is credited with conceptualising the economic moat as a metaphor for competitive advantage. An economic moat can be visualised as a structural characteristic of a business that insulates it from unwanted competition – very similar to a moat surrounding a medieval castle. In an interview, Buffett once said, "If you have a castle in capitalism, people are going to try to capture it. You need two things – a moat around the castle, and a knight in the castle who is trying to widen the moat."

This quote not only helps investors understand what a moat is, but also indicates that moats require ongoing attention in order to sustain and widen them. Become complacent, and any economic

moat (irrespective of its width) will begin to narrow. Therefore, both the width and durability (or depth) of an economic moat is critical.

In an era of mounting technological disruption, competition is increasing across all industries, meaning that economic moats are becoming increasingly relevant. And just as technological advances have rendered traditional castle moats ineffective in modern day warfare, a similar trend can be expected in the battlefield of business. In this way, identifying and understanding the source of a moat and how wide and deep it is, will become ever more important in identifying great businesses that are able to generate sustainable returns.

## SOURCES OF ECONOMIC MOATS

Morningstar has developed a framework that defines four sources of economic moats that give companies a sustainable competitive advantage.

### 1. SWITCHING COSTS

The costs involved when switching between certain products or services, although never insurmountable, are often sufficient to motivate customers to remain loyal to their current service or product provider. Often considered as purely financial costs, anyone who has changed banks or cellphone providers will know that convenience – or rather inconvenience – plays a much larger role in the decision to switch.

Consider changing banks as an example. While the financial costs are likely minimal (provided that the new bank's fees are similar), there are a number of other 'costs' that come into play. There is a time cost that involves closing one bank account and opening another; a psychological cost in the uncertainty around whether the correct decision is being made and whether or not the new bank will provide a superior service; and finally, there is an effort-based cost of actually enacting the switch.

Familiarity also plays a key role in preventing customers from switching, and certain businesses employ deliberate strategies to prevent their customers from switching to competitors. The most obvious of these is a loyalty programme that ties customers to a specific business. FNB's eBucks is a great example of this and has played a key role in the business' success.

Interestingly, the QWERTY keyboard represents another example of high switching costs. Research suggests that the QWERTY keyboard is not the most efficient in terms of typing speed, with the DVORAK keyboard being better in this regard. However, very few people are willing to switch to the DVORAK keyboard because they are accustomed to the QWERTY version. This highlights that costs, financial and other, sometimes don't feature at all. If a product is good enough, switching away from it may represent too much of a hurdle.



## 2. NETWORK EFFECTS

Network effects were originally defined around 1900 by the president of Bell Telephone Company in its annual report. Simply put, every new user joining the telephone platform enhanced and strengthened it, resulting in additional value for the network participants as a whole. A telephone network with hundreds of users and multiple connections is far more valuable than one with just two users and one connection. The internet is another example of the power of the network effect. As more and more users join the internet, add content and exchange information, it becomes increasingly powerful and, therefore, valuable. Simultaneously, as the network effect grows stronger, so too does the economic moat that surrounds the business. Importantly, both businesses and consumers benefit from the power of network effects.

The value derived from a network effect comes from three sources. The first source of value is exchange. Every product or service subject to network effects creates some sort of exchange between users. The second source of value is staying power. Users of a network do not want to sign up for a product or service that is likely to disappear in the foreseeable future. Networks with a greater number of users suggests stronger staying power. Staying power is closely associated with switching costs. High switching costs complement and strengthen network effects and the value derived from them. The third source of value derived from a network effect is complementary products. As the name suggests, complementary products are products (or services) that are offered on a network that add additional value to it. Platform businesses are obvious examples of a network that offers complementary products.

Today's technology-focused businesses thrive on network effects, with Apple being a prime example. Apple has developed an ecosystem centred on the iPhone. After disrupting RIM's Blackberry phone, Apple was able to entrench itself through its app store. Not only were Apple-developed apps allowed to be sold on the app store, but outsiders were also allowed to develop apps for use on the iPhone. With hindsight, this was an obvious decision, but was fraught with risk at the time. Today, Apple's network captures all three sources of value from its network effect (i.e. exchange, staying power and complementary products/services) in abundance. In this way, network effects are arguably the most powerful economic moat source that a company can have.

### 3. INTANGIBLE ASSETS

Intangible assets are non-monetary assets without physical substance, yet they are identifiable and can be incredibly valuable. Value is only ascribed to a business's intangible assets if they have the ability to generate economic returns over the long term. Examples of intangible assets include goodwill, brand, relationships, and intellectual property such as patents, copyrights, regulatory licensing and trademarks. Software can also be classified as an intangible asset.

Certain intangible assets can be sold off separately (e.g. intellectual property), while others such as reputation, trust and brand are tied to a specific business. Intangible assets that cannot be transferred across businesses typically take a long time to cultivate and are therefore considered to be more valuable.

For intangible assets like reputation and brand to carry significant value, they must have the ability to both influence a customer's decision and provide the business with pricing power. Consider Nike as an example. The business has built up a formidable brand over many years, (very often with the assistance of famous athletes) and has also cultivated relationships with suppliers and distributors. These relationships give Nike negotiating power on the cost side, while their brand not only sways customers' purchasing decisions, but also gives them pricing power. If you want to be like Michael Jordan, Tiger Woods or Roger Federer, you have to pay up. For an upcoming apparel and leisurewear manufacturer, this is incredibly difficult to compete against.

Pharmaceutical companies are another example, yet their intangible assets are transferable and have a limited lifespan. Pharmaceutical companies spend a great deal of capital on research and development to test and manufacture medicinal drugs. These drugs are licensed/patented with an expiry date and thereafter, competitors can use the formula to produce generic drugs. Therefore, while their products are under patent, pharmaceutical companies benefit from an economic moat provided by their intangible assets, but this is quickly eroded through time.

### 4. COST AND SCALE

Size is a natural advantage. Being able to produce the same product or service at a lower cost than competitors is a significant advantage. As a business becomes bigger, economies of scale come into play. With an element of fixed costs, as more and more of the same product or service is produced, it becomes cheaper on a per unit basis. Economies of scale can also reduce variable costs within a business. As a company grows, its ability to negotiate lower prices from suppliers will improve, operational efficiencies are also likely to emerge, while logistical costs should decrease. If required, larger companies should also be able to raise capital at more attractive rates. In essence, there are many benefits to being larger that all contribute to reducing costs.

However, economies of scale do not only reduce costs. Importantly, they can also assist a business in producing better products. What is becoming evident today, particularly in technology-orientated companies, is that

more value is being derived from intangible assets, research and development, and even experience. For example, machine learning and artificial intelligence benefit from increased data input. A business with scale from a data

perspective will therefore be able to produce a more superior artificial intelligence product than a business without sufficient scale. Similarly, viewing scale from an experience perspective, even if a business is not large, it could have

a significant amount of experience in producing a product. This will give it a competitive advantage over a bigger, but less experienced business.

Economic moats built on cost and scale advantages require ongoing focus to ensure that they do not remain static, or worse, narrow. While such moats are viewed as the shallowest or least durable, they are not necessarily unsustainable, as demonstrated by a number of South African retailers. Mr Price and Shoprite thrive on their cost and scale advantages, and despite fierce competition, they have successfully protected their respective moats through innovation and agility and have delivered results ahead of their peers.

### DURABILITY VS WIDTH

While a wide moat is difficult to immediately infiltrate, given enough time, competitors' creative and persistent efforts often result in moats eventually beginning to erode. Consumer tastes and needs change, drug patents expire and new technology replaces old and complacent incumbents. However, there are always exceptions.

Although it may seem enticing to invest in businesses with more than one moat, it is important to note that four is not better than one. What matters is a company's ability

to maximise its moat by reinvesting to widen it. If a company can do this, then each rand of cash flow reinvested back into the business will earn an incrementally higher rate of return. This is not possible on a sustainable basis if a moat is static or narrowing.

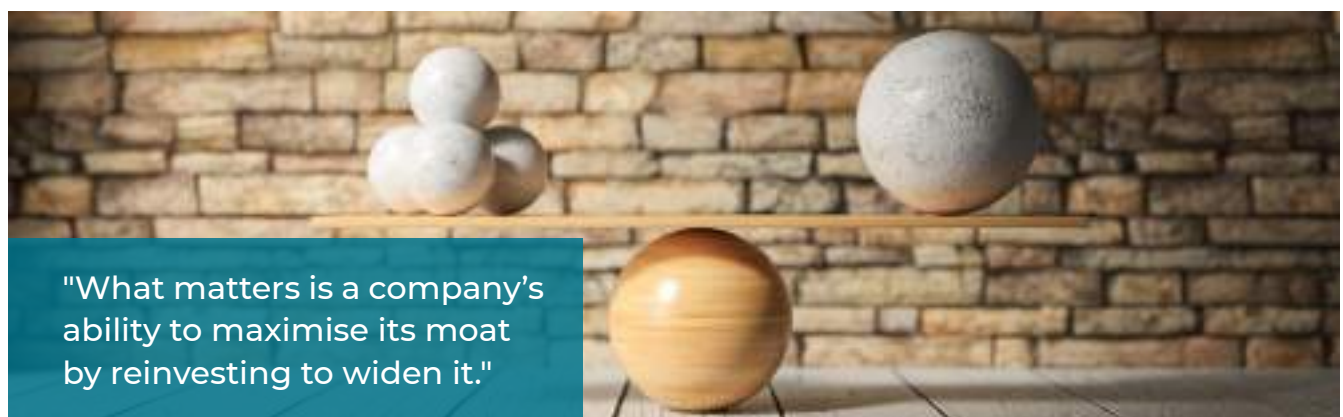
Businesses often succeed on the back of a talented management team, or a novel product or service. This success is not to be confused with a wide economic moat, and is certainly not due to a durable moat either. Such successes tend to be temporary, and just as quickly as the management team exits the business or the product falls out of favour, so will the perceived economic moat disappear.

A critical job of any management team operating within a wide economic moat business is to tirelessly maintain the moat in order to cement its durability. While a narrow moat business may thrive on excellent management or a single product, it will not provide protection during difficult times; only a wide and durable moat can do this. As Peter Lynch, who achieved remarkable success managing the Fidelity Magellan Fund in the 1980s, succinctly put it in his 1989 bestselling book *One Up On Wall Street*: "One should invest in a business that an idiot can run, because one day an idiot will."

### IDENTIFYING ECONOMIC MOATS

Identifying businesses with strong economic moats requires a firm understanding of a specific business from both a qualitative and quantitative perspective. This includes a thorough analysis of the business' operating model and sources of revenue, the industry within which it operates and the competitive landscape. Studying a company's financial reports is the simplest way to not only get a sense of whether there is an economic moat in place, but also whether it is widening or narrowing. Sustained revenue growth that is above the market average points to a competitive advantage that can play out in either higher volumes or higher prices (or both). Growing margins may suggest that a cost or scale advantage is present, which could be coupled with revenues growing faster than costs, as opposed to only costs decreasing. Levels of profitability and cash flow also give an indication of whether or not an economic moat is in place.

The accompanying table illustrates the various moat sources for the companies held within the PCS Global and Core Equity Model Portfolios. The most common source of economic moat in the portfolios is intangible assets. This



is unsurprising given that the portfolios consist of established, best-of-breed businesses. As a result, the businesses are backed by a solid brand and reputation. Cost and scale advantages are also fairly prevalent given that the majority of these businesses have significant scale. Network effects, on the other hand, appear to be the source that is hardest to obtain. This is expected given that network effects are rare and therefore perceived to be the most valuable source of moats.

## THE POWER OF ECONOMIC MOATS

Before partnering with Charlie Munger, Warren Buffett followed in the footsteps of his mentor by investing in cheap companies that very often deserved to be cheap. Over time, in partnership with Munger, Buffett came to realise that investing in great businesses at fair prices was a superior strategy to investing in fair businesses at great prices.

At Private Client Securities, our investment philosophy is built on the belief that great businesses have wide and durable economic moats that allow them to compound intrinsic value at faster and faster rates. They are also characterised by their ability to generate significant cash flows that allow them to self-finance, while also having sufficient cash to pay dividends, buy back shares or make acquisitions. Importantly, they have pricing power that allows them to raise prices sustainably over time without sacrificing volumes or market share. And it all starts with a company's economic moat.

## COMPANY AND ECONOMIC MOAT SOURCE

COMPANY	MOAT SOURCE			
	SWITCHING COSTS	NETWORK EFFECTS	INTANGIBLE ASSET	COST & SCALE ADVANTAGES
Accenture	X		X	
Alphabet	X	X	X	X
Amazon	X	X	X	X
Apple	X	X	X	X
Berkshire Hathaway	X		X	X
Danaher	X		X	
Givaudan	X		X	X
Honeywell	X		X	X
J&J	X		X	X
L'Oréal			X	X
Medtronic	X		X	
Microsoft	X	X	X	X
Nestlé			X	X
Nike			X	X
Reckitt Benckiser			X	X
S&P Global		X	X	X
Walt Disney		X	X	X
Visa	X	X	X	X
Zoetis			X	X
Anglo American				X
BHP Group				X
Bidcorp		X		X
FirstRand	X		X	
Mondi			X	X
Mr Price				X
Ninety One	X		X	
Prosus				X
Quilter	X		X	
RMI				X
Richemont			X	X
Sanlam			X	X
Shoprite			X	X
Sibanye Stillwater				X
Standard Bank	X		X	
Stor-Age				X
Vodacom	X		X	X



# S&P GLOBAL INC: GREATER THAN THE SUM OF ITS PARTS

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**VICTOR MUPUNGA**, SENIOR RESEARCH ANALYST AT PRIVATE CLIENT SECURITIES



Given the reputational and financial damage suffered by credit rating agencies for their part in the Global Financial Crisis, one may have expected seismic changes to the industry in the aftermath of the crisis. However, this has not been the case. In fact, the three dominant firms in the industry (S&P Global, Fitch and Moody's) continue to operate largely as oligopolies, with a combined market share of 95%. It is virtually impossible to find other industries that have been in existence for over a century where the dominant firms have remained largely unchanged. We hold S&P Global in our Global Equity Model Portfolio and believe that the fact that it has remained the dominant

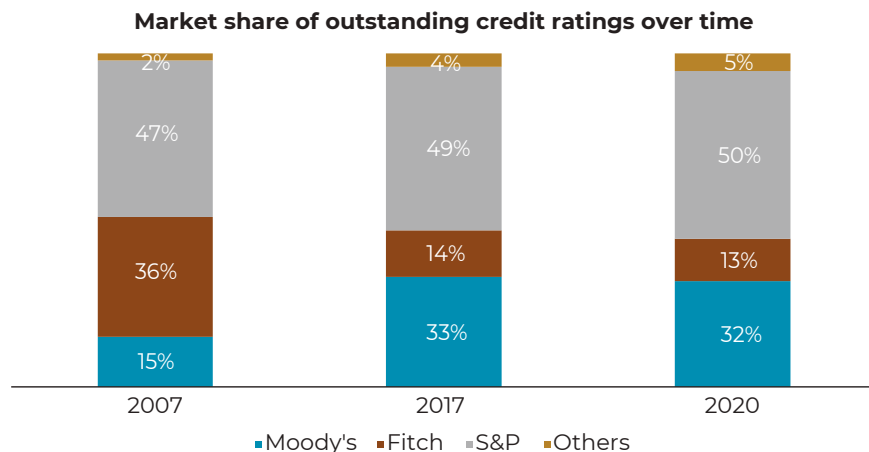
player in its highly attractive markets over decades, is the clearest indication of its moat.

### A PROVEN HISTORY

Despite being a diversified financial information services company, S&P Global is best known for its credit rating segment, which is the oldest division in the group. The origins of this segment date back to the 1860s. However, through a series of mergers and acquisitions, Standard & Poor's was formed in 1941 and was soon part of the already listed company McGraw-Hill.

Acquisitions, divestitures and innovation have always been an integral part of the group's strategy and so over the years, notable

acquisitions such as Capital IQ, IHS Markit and the introduction of the S&P 500 Index have driven growth. Today, S&P Global is well diversified and operates across six segments. With 75% of the group's revenue being recurring in nature, a common thread across each of the segments is the provision of data across industries, creating a wide moat that is hard to replicate. Through its segments, S&P Global services every single one of the Fortune 100 companies, a rare claim among corporates. When combined, we believe these segments offer investors an impressive information services business whose whole is greater than the sum of its parts.

Graph 1: Credit rating agency market share<sup>1</sup> trends

Source: Securities and Exchange Commission

## RATINGS: AN EXPANDING MOAT

In many respects, S&P Global's credit rating segment works like a toll road operator. For a small fee (an average seven basis points), it gives entities issuing debt access to investors who otherwise would not consider unrated bonds. While bond issuers could always avoid the 'toll fee', over time, it will cost more to issue unrated debt. On average, a rating by the large rating agencies reduces interest payments for the issuer by between 30 and 50 basis points per year, far exceeding the cost of receiving a rating. From an investor perspective, a bond rating adds value as it provides easier comparability across geographies and sectors. To access S&P's detailed ratings, investors too pay a fee, with more complex products such as structured and high-yield bonds attracting higher fees. This mutual benefit to both debt issuers and ratings users creates a strong **network effect** that makes S&P Global essential to the smooth functioning of global capital markets.

## FRIEND OR FOE?

Regulation is often cited as a significant risk for dominant businesses such as S&P's rating segment. However, we believe this

risk is more nuanced than often assumed. Take, for instance, the period after the Global Financial Crisis when the ratings industry had to contend with a slew of new regulations and fines. Apart from increased disclosures, not much has changed in how the rating agencies operate, particularly their dominance.

Perhaps this should not come as a surprise, as regulatory changes within the ratings industry dating back to the 1930s have often had the effect of strengthening the incumbents' position, rather than weakening them. One such practice is the requirement by most financial regulators to only consider the inclusion (or exclusion) of an entity's debt when at least two independent rating agencies have their ratings at the same level. While at face value this seems reasonable for regulators, in practice, it has meant that many debt issuers employ both Moody's and S&P Global to rate their debt. This has resulted in minimal changes in their market shares over time, as the largest firms are in many instances not competing against each other, but winning the same mandates. Rather than weakening, we see such regulation as having added another dimension – **scale** – to S&P Global's already

wide moat. The network effect combined with scale simply makes it harder for the company to lose meaningful market share.

## INDICES: AN INTANGIBLE MOAT

Despite only contributing 10% to group revenue, S&P Global's indices division is probably as well known as the rating segment that contributes three times more revenue. We believe this illustrates the index business' strong intangible moat – **brand recognition**. The indices segment includes some of the world's most referenced financial market barometers, namely, the S&P 500 and the Dow Jones Industrial Average.

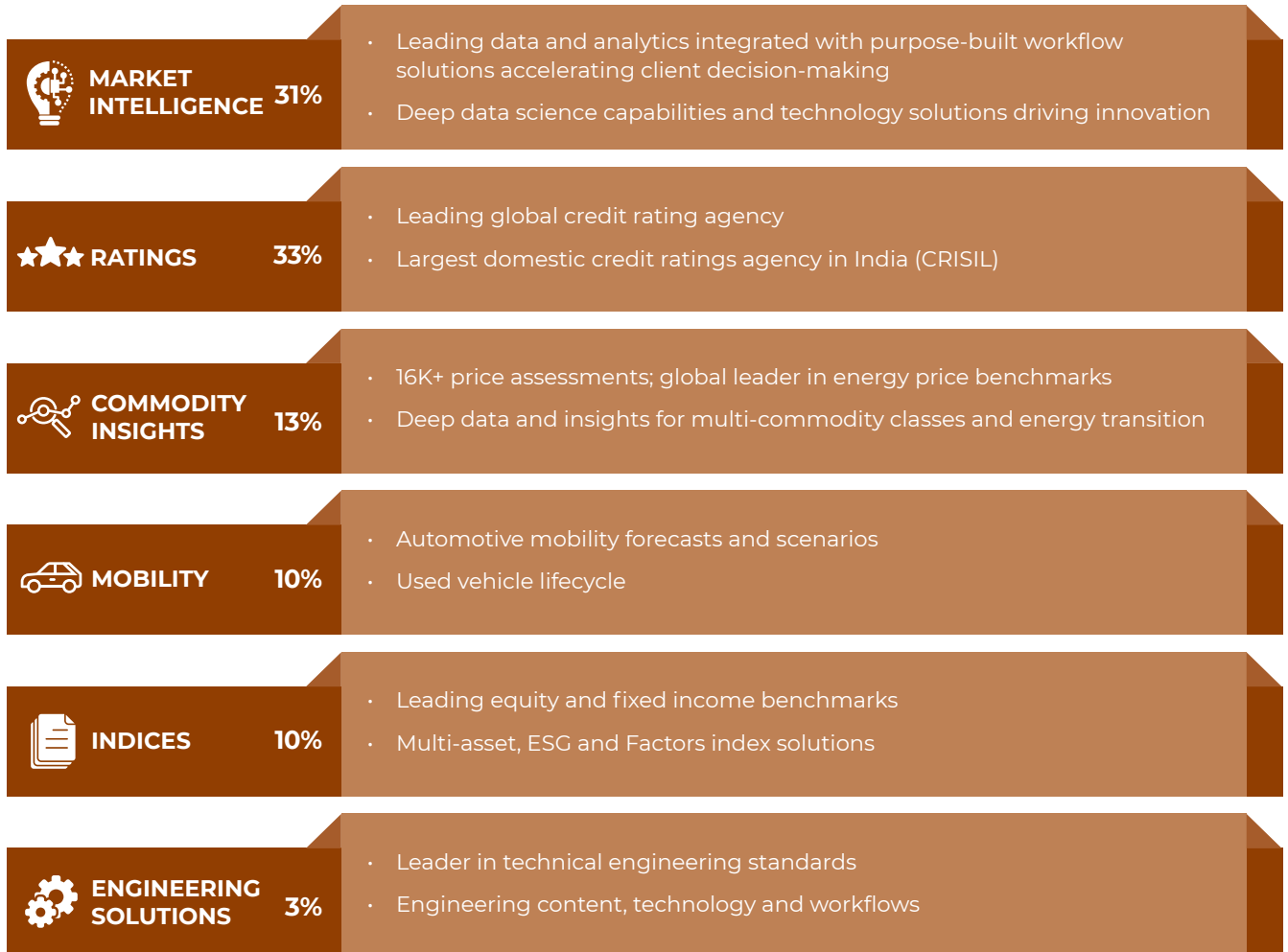
S&P Global earns revenue via index subscriptions, asset-linked fees and transaction royalties from funds linked to their indices. One of the most impressive qualities of this revenue model is that S&P Global benefits from any inflows (or transactions) to index subscribers with practically no incremental costs on its part. This results in a segment that enjoys large recurring revenues and high margins.

## A PRO AND A CON

Two other characteristics of indices are important to note. The first is that index benchmarks are critical to all market participants and as such, there is rarely any incentive to switch benchmarks. The second is the competitive dynamic within the industry. There are a few large competitors within this industry, the main ones being Bloomberg, STOXX, FTSE Russell and MSCI. The top three players have more than 75% market share and given the client 'stickiness', market share tends to remain stable. To somewhat circumvent this, each of the large index providers dominate a specific geography or asset class, which makes it almost impossible for new entrants to penetrate that market. MSCI, for example, focuses

<sup>1</sup>Market share based on total number of rated credits

## S&P Global Inc segments and revenue contribution



on emerging markets while S&P Global has a market share of over 90% in US equities. While this can be viewed as a positive in that there are high barriers to entry, it also limits any of the incumbents' ability to enter new markets that are dominated by another large player.

Fortunately for the index providers, outside of entering new geographies, there are several other tailwinds for the industry. The growth in passive investing and Environmental, Social and Governance (ESG) related indices are two such examples. S&P Global's management estimate that the latter opportunity could add as much as US\$600 million in annual revenue by 2025 across the

group. This would be in the form of ESG evaluations, ESG indices and price benchmarks for carbon and hydrogen. We believe these examples highlight how the group's widely recognisable brand allows it to benefit from changing investor trends.

### MARKET INTELLIGENCE & COMMODITY INSIGHTS: A DEEP MOAT

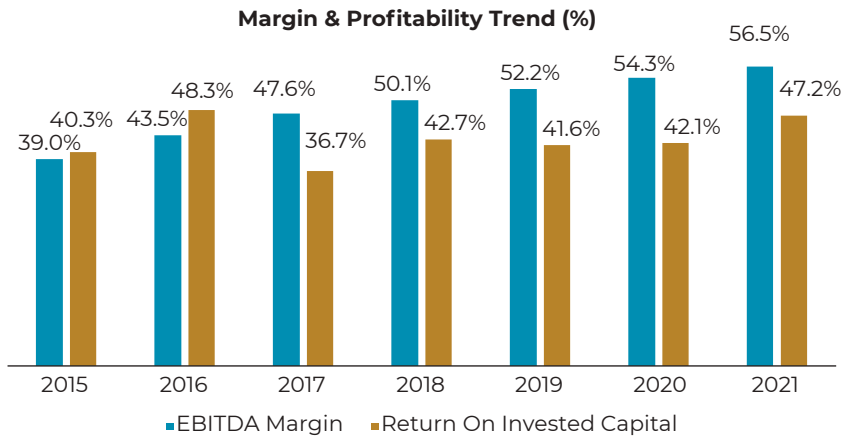
The group's lesser known, yet still attractive segments include Market Intelligence and Commodity Insights. These segments provide data, analytics, price assessments and industry publications to clients across industries. An example of the extensive data sets the group provides within its Commodity

Insights segment is the geological and production data for oil and gas wells dating back to the 1800s. This data treasure trove is near impossible for new entrants to replicate and creates a deep moat that players in the energy industry view as critical.

Across its information services platforms, the group competes with Bloomberg and Refinitiv, with S&P Global's offering enjoying wider usage among corporates and investment banks. Over 90% of the segment's revenues are from subscriptions with similarly high renewal rates.

Similar to how S&P dominates the US equities indices segment,

Graph 2: Incremental margins and profitability



Sources: Refinitiv; PCS Research

the Commodity Insights segment holds dominant positions in several energy benchmarks, most notably, Brent Crude. Through commodity benchmarks such as this, S&P Global receives revenue whenever Brent gets referenced in an oil contract. Over time, the group has expanded its services to include market pricing for gas, liquefied natural gas (LNG), electric power and coal shipping, among others. With barriers to entry in this business too high for new entrants, it leaves S&P Global to compete for marginal market share with other incumbents.

**STRONG METRICS**

S&P Global's diverse segments combine to drive the group's consistent organic growth, high incremental margins and impressive free cash flow generation. As such, the company falls into a select group of S&P 500 companies that have managed to increase their dividends in each of the last 25 years, i.e. the dividend aristocrats. S&P Global has increased its dividend in each of the last 49 years.

Having concluded the sizeable acquisition of IHS Markit earlier this year, management recently revised their capital allocation policy. With no acquisitions on

the immediate horizon, the group will now be returning 85% of free cash flow to shareholders by way of share buybacks and dividends. Furthermore, the group has a strong balance sheet, which, until the recent IHS Markit deal, had a net cash position of US\$2.4 billion. We view the group's strong financial metrics as indicative of the strong moats surrounding the business.

**A RARE COMBINATION**  
 The combination of high growth, profitability and scale is uncommon. A recent study from Barclays Research pointed to only nine publicly traded US companies that can be defined as highly profitable, fast growing and of scale<sup>2</sup>. We attributed S&P Global's inclusion within this group to the strong moats surrounding each of its segments, as well as management's ability to complement any gaps in the group with strategic acquisitions. While each segment has unique moats, when combined, the group offers a compelling long-term investment where the sum is greater than its parts.



<sup>2</sup>A screener of companies with a market capitalisation of over US\$100bn, growing organically by 5%+ and with EBITDA margins north of 45%.



# SHOPRITE: BIGGER AND BETTER

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**TASNEEM SAMODIEN**, RESEARCH ANALYST AT PRIVATE CLIENT SECURITIES



**W**hen considering competitive moats, the retail industry does not immediately spring to mind given that it is fiercely competitive with very low barriers to entry and virtually no switching costs. Yet, despite this, there are a few exceptional retailers that have managed to build enduring competitive advantages, with global juggernaut Walmart leading the pack. Walmart is a formidable fast-moving consumer goods retailer with a brand value in excess of US\$100 billion. Among traditional retailers, Walmart's procurement capability is unrivalled and its scale is unparalleled. However, while they have conquered the North American grocery market, and established a meaningful presence in Europe and Asia, their foray into South Africa has not been as successful. One of the many reasons is that the local market already has a well-established, competitive grocery retail industry, which is dominated by local retailer Shoprite.

## LOCATION, LOCATION, LOCATION

Amazon founder Jeff Bezos famously quipped that the three most important things in retail are "location, location, location". Shoprite understands this better than most, as very early on, they realised that in order to be the "family grocer" of choice, they would have to meet the consumer wherever they are at with an affordable offer. To meet these requirements, scale and ubiquity are key, and so just over four decades ago, Shoprite embarked on an aggressive two-pronged expansion strategy. Their first focus was on consolidating the market

and existing retailers were acquired, adding hundreds of stores to the Shoprite portfolio in a short span of time. The most notable were the acquisitions of Checkers in 1991 and OK Bazaars in 1997. The group's second step was then to open new stores in underserved areas. This strategy has seen the Shoprite group's footprint expanding from just eight stores in 1980 to well over 2 400 stores across Africa in 2022.

In addition to growing in scale, Shoprite has also grown in influence. Shelf space in a Shoprite store is increasingly coveted by suppliers, and management use this to negotiate for the lowest possible prices, which are then passed on to consumers. This has become a virtuous cycle, with low prices attracting high volumes of consumers, which further enhances the group's bargaining power with suppliers.

A further benefit of scale is that operational costs, particularly fixed costs, can be divided among a vast network of stores and a wide variety of products, thereby achieving cost leverage and reducing the overall cost per product. For example, retailers spend exorbitant amounts on advertising and other promotional activities in order to attract consumer traffic; however, Shoprite is able to spread this cost over a larger sales base relative to its peers. Cost savings from suppliers and operational cost leverage are then passed on to consumers, allowing Shoprite to charge the lowest prices in the industry without compromising on margins or returns. As shown in graph 1, despite charging lower prices, Shoprite generates a superior return on assets relative to Pick n Pay and Spar.

## SUPPLY CHAIN OPTIMISATION

Achieving scale was critically important in enabling Shoprite to become a leader in value, as it provided unrivalled procurement capacity in the industry. However, this is not enough, as scale is irrelevant if your shelves are empty. Getting the right products to the right places in the right quantities with the right quality at the right cost, is a far more complex undertaking.

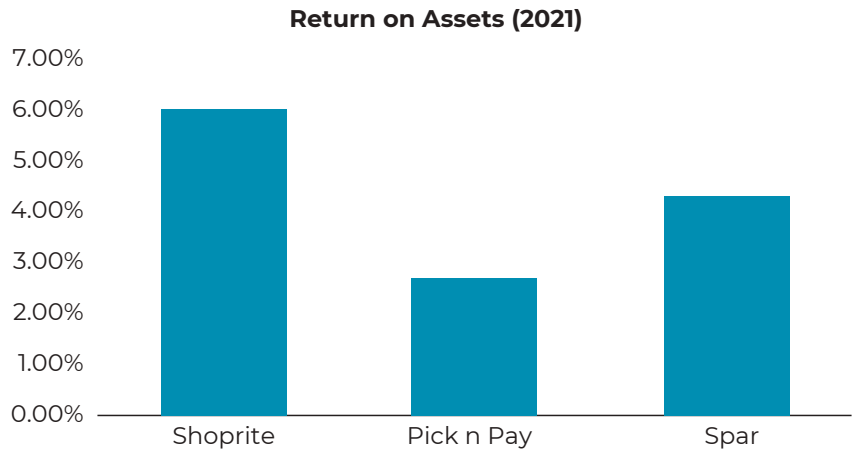
Supply chain management is part art, part science and demands an understanding of sales patterns, profit margins and seasonality, among other factors. In order to optimise their levels of inventory and ensure adequate stock availability in stores, Shoprite was the first of the food retailers to build a network of distribution centres and centralise their supply chain.

Shoprite manages 29 distribution centres, each strategically located close to suppliers in order to minimise transport costs, while also maintaining close proximity to stores in order to reduce the lead time of getting products into stores. Centralising the supply chain was essential in helping the group scale up in rural SA. With inventory being stored at the central distribution centres and not at stores, Shoprite was able to roll out smaller format stores in small towns and rural communities. Their logistics infrastructure and state-of-the-art digital supply chain management system underpins what is the shortest, most agile and responsive supply chain in SA. It is one of their most durable competitive advantages — one that competitors have found difficult to replicate.

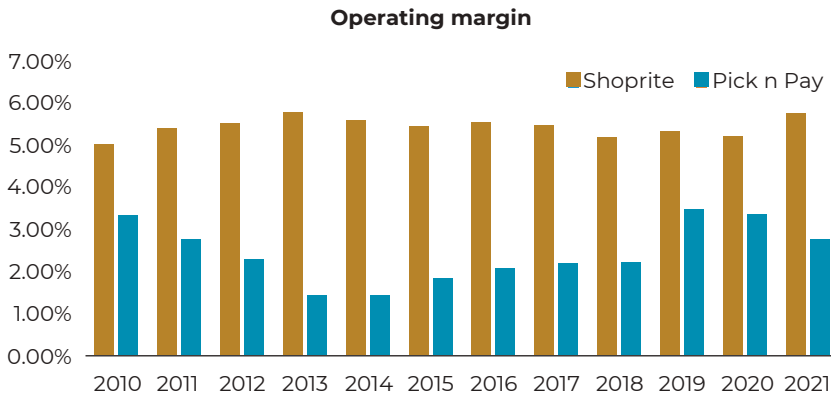
To illustrate this, the second largest grocery retailer in SA, Pick n Pay, undertook to centralise their supply chain in 2014 in order to improve efficiencies and improve stock availability in stores. In 2018, centralisation was at 68% and as at May 2022, their supply chain optimisation exercise remained ongoing. Pick n Pay’s efforts have not been in vain, as their operating margin (a measure of how efficiently a company is able to generate profit through its core operations) has nearly doubled since 2014 as depicted in graph 2. However, despite their efforts, this margin remains roughly half of what Shoprite is able to achieve — a testament to how efficient Shoprite has become after decades of investment and experience.

Another measure of retailer efficiency is their stock turnover ratio, which is a measure of how efficiently retailers manage their inventory from procurement to consumer sale. Theoretically, a higher stock turnover ratio means the company sells its products very quickly. However, a higher ratio may also mean that the company is missing sales opportunities as it is not carrying enough stock. Pick n Pay’s Achilles heel has been the poor availability of products in its stores. They have since improved, with their stock turnover ratio – as illustrated in graph 3 – decreasing from 13x in 2014 to 11x in 2022. However, their ratio remains in double digits relative to Shoprite’s 7x, so it is likely that Pick n Pay stores may still be running out of stock too quickly.

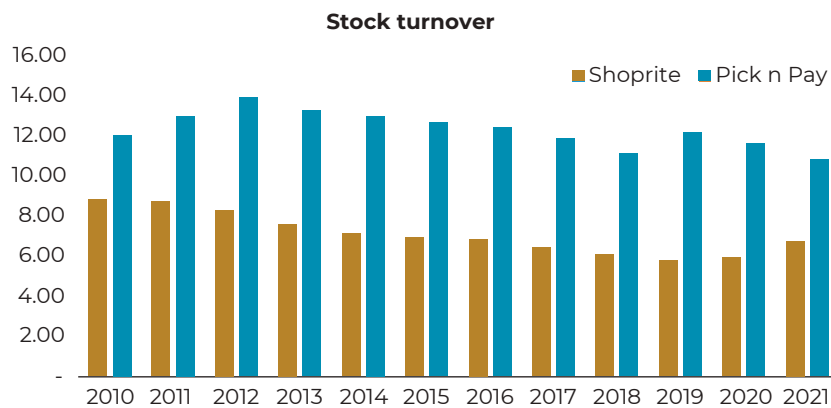
Graph 1: Return on Assets vs peers



Graph 2: Shoprite vs Pick n Pay operating margin



Graph 3: Shoprite vs Pick n Pay stock turnover



An efficient supply chain that minimises waste, eliminates unnecessary costs and optimises the stock available in stores, allows Shoprite to continue offering consumers a broad range of products at low prices, thereby complementing their scale in cementing their competitive position as a value retailer.

**WHAT'S IN A BRAND?**

In the local market, Shoprite's brand has become synonymous with value, and they've generated loyalty and trust with price-conscious consumers. While their brand was born out of scale and efficiency,

it has now become a competitive advantage in its own right. Valued at R15.7 billion in 2022, Shoprite uses its brand to maintain and deepen its existing competitive moats as well as expand its addressable target market. The value offer remains the core focus of the group, with Shoprite being their most valuable brand. However, the group has since leveraged this brand to launch their liquor retail stores (LiquorShop), a mobile network (k'nect) and over 300 private label food and merchandise brands. Their latest show of brand strength was successfully pivoting Checkers to target upper income consumers.

Expanding their target market and the breadth of services and products offered, further adds to their scale, which enhances their competitive position.

**FUTURE FIT**

Moats don't last forever and it is important to identify when a company's competitive advantage is dwindling. The COVID-19 pandemic posed a credible threat to traditional physical retailers, as it drove a change in consumer behaviour. Consumers were forced to shop for groceries and other fast-moving consumer goods online, thereby relying on delivery services. Traditional retailers were on the back foot as they hadn't committed sufficient capital to building an e-commerce presence or capability. Fortuitously, Shoprite had just launched a grocery delivery application, Checkers Sixty60, in November 2019. Leveraging their scale, brand equity, supply chain and logistics infrastructure, the service is now SA's most successful grocery delivery application. Their agility in navigating the COVID-19 pandemic and emerging stronger with greater market share demonstrates the durability of their competitive moats.

Looking ahead, Shoprite intends to use their unrivalled reach and deeply entrenched consumer loyalty to build a dominant consumer omni-channel ecosystem in Africa. We believe this will allow them to ward off global and local competition and see them maintain their position as the largest and most successful retailer in Africa.

# WHEN DO I BUY HARD CURRENCY?

**WAYNE SOROUR**, HEAD OF OLD MUTUAL INTERNATIONAL: SALES & DISTRIBUTION

**T**he decision to invest offshore is predominantly influenced by the search for superior returns in addition to stability against local and hard currency fluctuations and security of assets. The primary benefit of investing offshore is the diversification associated with investing in global asset classes.





# THE PCS GLOBAL EQUITY PORTFOLIO: FOCUSED ON THE OPPORTUNITIES

The PCS Global Equity Model Portfolio recently achieved its eight-year milestone and continues to deliver solid investment returns. This concentrated yet well-diversified portfolio invests directly into high-quality companies that have a track record of delivering consistent earnings growth and is used as a point of reference for investors seeking offshore exposure. Established in 2014 amid a relatively benign investment environment (low interest rates, very little economic volatility and generally rising asset prices), the past two years has seen the portfolio navigate extremely challenging conditions.

## THE CURRENT ENVIRONMENT

While COVID-19 and the subsequent global lockdowns are widely cited as the main reasons for the challenging investment environment we are currently contending with, the reality is that much of what we are witnessing had been brewing for a while. COVID-19 was perhaps just the catalyst that set the ball rolling.

The 2008 Global Financial Crisis unleashed an era of ultra-loose monetary policy around the world, which spurred asset prices higher. Consequently, valuations across a myriad of asset classes were pushed to lofty levels. Then in 2020, COVID-19 induced lockdowns saw governments relax fiscal policies by directly handing out

cash to citizens. Now, two years later, inflation levels are well above anything we have seen over the past 40 years. However, monetary and fiscal policy are not the only contributors, as complex supply chains and higher commodity prices – which have both been long in the making – are also playing a role.

While there is no shortage of speculation around how this will all play out, the truth is that no-one really knows. We can all have views, but just as any other time in history, uncertainty ensures that the path to the future is never straight forward.

## POSITIONED FOR PERFORMANCE

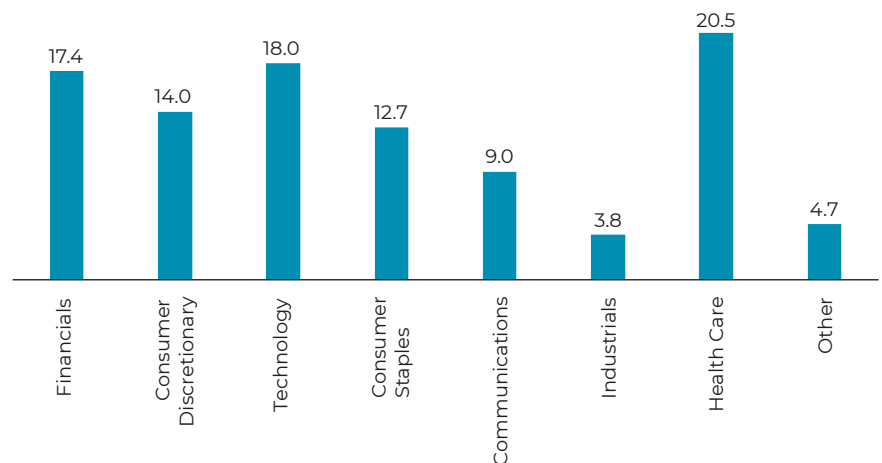
In line with our bottom-up investment philosophy and process, we construct well-diversified

portfolios that are invested in resilient businesses that can withstand the full economic cycle. Graph 2 highlights the diversified nature of our Global Equity Model Portfolio and clearly shows that it is not overly reliant on a specific sector or single investment theme.

## BALANCING DEFENSIVENESS AND INNOVATION

At just over 20%, health care is the portfolio's largest sectoral exposure and key holdings include Medtronic, J&J and Danaher. Global health care stocks have outperformed strongly over the past year, with the MSCI World Health Care Index returning -1.8% over 12 months to the end of June (versus the MSCI World Index's return of -13.9%). This is unsurprising given that

Graph 2: PCS Global Equity Portfolio Sector Allocation



Source: Old Mutual Wealth Private Client Securities

health care is viewed as a more defensive sector. However, not all health care is equal. In the current environment, pharmaceuticals (more defensive in nature) have performed superbly, while medical technology stocks such as diagnostics and medical devices (which have growth characteristics) have lagged, as elective procedures stalled in the midst of economic lockdowns. Despite this, we remain confident about the overall health care sector's future prospects and believe that it will benefit from favourable long-term trends. These include rapid innovation, an ageing population, changing lifestyles, a focus on prevention rather than cure and increasing life expectancy. In this way, along with protecting on the downside, the sector also provides strong future growth potential.

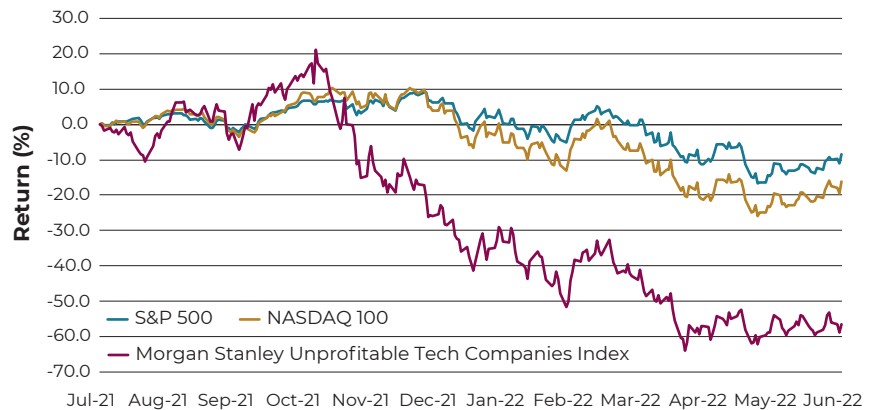
## SEPARATING THE WHEAT FROM THE CHAFF IN TECH

Technology is the portfolio's second largest exposure, with holdings in Apple, Alphabet, Amazon and Microsoft. Given how well the technology sector has performed over the last few years, we constantly review our positioning to ensure that the portfolio is not vulnerable in the event of a market pullback.

However, similar to health care, not all technology companies are the same. The businesses included in the portfolio are all well established, generate real revenue and earnings, are backed by strong cash flows, and are supported by solid balance sheets. As such, we remain confident around their abilities to navigate the current environment – and the results certainly indicate that they are faring well in this regard.

At the opposite end of the technology spectrum is a cluster of businesses that we have aptly named the COPS (crazy overpriced stuff). Many of these businesses have strong future aspirations, but

**Graph 3: The Morgan Stanley Unprofitable Tech Index, NASDAQ 100 & S&P 500**



Sources: Refinitiv Datastream; Old Mutual Wealth Private Client Securities

their profits also lie far in the future (should they materialise at all). As such, these unprofitable businesses are valued on hope, and have proven to be very vulnerable in this environment. The PCS Global Equity Portfolio has no exposure to such businesses. Graph 3 illustrates the extent of this vulnerability relative to the tech-heavy NASDAQ 100 and the S&P 500.

## UNDERSTANDING WHAT LIES BENEATH

While financials appear to be the portfolio's third largest exposure, on a look-through basis, this exposure is far more diversified than meets the eye. Visa and Berkshire Hathaway are the portfolio's two largest holdings and although they are classified within the financial sector, they operate very differently to traditional financial businesses. Visa is widely regarded as the market share leader in the global payments industry, which still has significant scope for growth as consumers, governments and businesses across the world increasingly migrate to electronic payments. VisaNet, Visa's proprietary transaction network, is the world's largest electronic payment network and we believe that this will continue to support strong earnings growth in years to come.

With its origins in insurance, Berkshire Hathaway is often regarded as a large collection of financial assets. However, under the guidance of Warren Buffett, Berkshire has successfully evolved and operates many businesses across a wide array of sectors, while also owning a very significant and diversified investment portfolio. As an example, Berkshire owns and operates more US-based infrastructure assets than any other US business. As such, it is far more than a collection of financial assets.

## THE BEST OF TIMES DURING THE WORST OF TIMES

While we do not know what lies ahead for markets, we are certain that the current environment has not diminished the quality of the businesses held within the PCS Global Equity Portfolio. So while investors may find the prevailing conditions uncomfortable and painful to endure, we view the current period as a great opportunity to gain exposure to superior businesses at attractive valuations. And as with most things in life, patience and time are required to achieve meaningful results.

# THE AUTHORS



## **Andrew Dittberner**

Chief Investment  
Officer at Private Client  
Securities

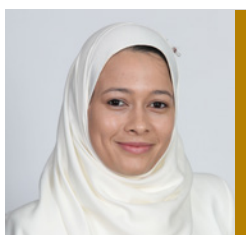
Andrew joined PCS in 2017 and was previously employed at Cannon Asset Managers. He joined Cannon in 2007 as a research analyst and during his tenure, he rose through the ranks to become a portfolio manager in 2011 and was then appointed CIO in 2014. Andrew has extensive knowledge of and insight into valuing businesses across multiple industries and identifying suitable investment opportunities. He holds a master's degree in Economic Science from the University of the Witwatersrand, where he lectured for a while. Andrew also holds a PhD in Investments and Securities from the University of Pretoria.



## **Victor Mupunga**

Senior Research Analyst  
Private Client Securities

Victor joined PCS in 2016 and was previously employed as an investment analyst at Maestro Investment Management, where in addition to equity research, he was responsible for managing a number of private client equity portfolios on a discretionary basis and managing the client relationships. Prior to that, he was a fund accountant at Investment Data Services where he prepared and reviewed valuations and accounting records of hedge funds. Victor graduated from the University of Cape Town with a Bachelor of Business Science (Hons) in Finance in 2007. He is also a CFA Charterholder.



## **Tasneem Samodien**

Research Analyst  
Private Client  
Securities

After graduating with a Postgraduate Diploma in Accounting in 2015, Tasneem joined the Old Mutual Chartered Accountant Training Programme in 2016. During the subsequent three years, she worked within various businesses in the Old Mutual Group, gaining valuable experience in functional areas such as internal audit, risk management, finance, group planning and investment analysis. In 2018, she was placed within Private Client Securities, first in the Finance team to assist with the annual financial statements and then in the Research & Investment team to assist with investment portfolio reviews. Tasneem successfully completed her articles at the end of 2018 and is a qualified Chartered Accountant (SA).



## **Wayne Sorour**

Head of Old Mutual  
International: Sales &  
Distribution

Wayne matriculated at Grey College in Bloemfontein. He obtained his BProc LLB at the University of the Free State and is an admitted attorney. He joined Old Mutual as a legal adviser and has spent many years in the financial services industry where he gained vast experience in sales, wealth management and the distribution side of asset management. Wayne currently holds the position of Head of Old Mutual International in South Africa and has been working in the offshore market for over 15 years. He also holds a CFP® qualification.

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