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OPINION

COBUS CILLIERS: Big growth potential for mid and small cap sector

These companies trade at low earnings multiples compared to their normalised, through the cycle earnings

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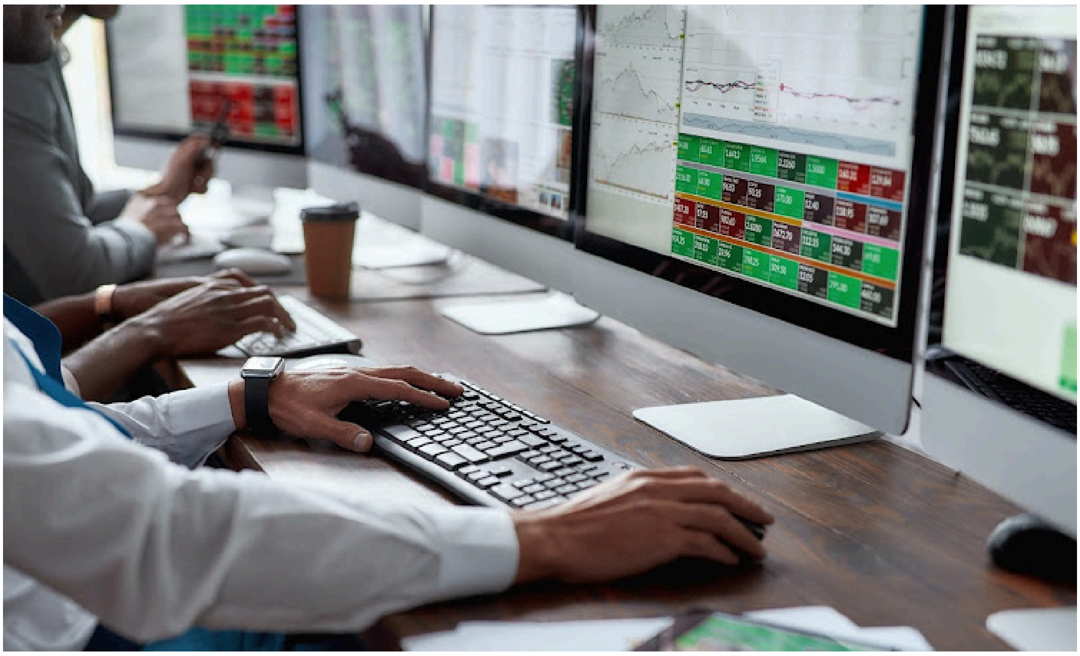
by COBUS CILLIERS



SA investors seem to be on track for better returns over the next few years. Picture: 123RF

What an interesting time to be invested in SA. Looking back over the first 10 months of 2024, we easily forget the substantial geopolitical noise and news flow the year has provided. The turmoil in the Middle East, ongoing war in Ukraine, elections in numerous counties, the two assassination attempts on Donald Trump and the US election. We can be forgiven for feeling a little fatigued.

At home, the recent events have caused a 180-degree turn in sentiment, from negative to decidedly optimistic. SA investors seem to be on track for better returns over the next few years. For the past decade, local companies had to navigate an exceptionally difficult macroeconomic backdrop. Up until the recent SA election, local corporations and consumers were experiencing anaemic GDP growth, high interest rates, high fuel prices, load-shedding challenges, port disruptions and congestion inefficiencies at

Transnet, supply chain disruptions and general negative sentiment towards the government. This made day-to-day operation challenging.

The SA-specific problems above were compounded by both lower earnings and lower price-to-earnings multiples for listed SA-focused companies, especially those in the mid-to-small cap sector. Equity market returns can be disaggregated into three components — earnings growth, the multiple applied to those earnings and dividends. Positive share price drivers going forward will mostly come from the first two components: (higher) earnings growth and also a higher multiple applied to those earnings, leading to significant share price increases.

There are several positive earnings drivers. Fuel prices have declined, just in time for the festive season. Interest rates are declining and are forecast to decline further. Inflation is at the lower end of the Reserve Bank's targeted bands. Load-shedding seems to be something of the past and has been a welcome absence from the daily lexicon.

Politically, the GNU has been well received by market participants and the public. The government has also approved legislation regarding the two-pot system, which allows consumers to access a portion of their retirement savings, a much-needed reprieve. This could add R50bn-R80bn to spending. These withdrawals are taxed, thus it will also increase SA Revenue Service revenue.

The positive GDP growth trajectory, in part due to the efforts around Project Vulindlela, is exactly what this country needs. Given the macroeconomic outlook for SA, these events could turbocharge returns for specific companies, especially those in the mid-and-small cap sector.

Looking back at the JSE mid-cap sector's performance in 2003 to 2006, we can see returns ranging from 24.8% to 38.3% a year. The strong GDP growth during this period, ranging from 2.9% to 5.6% a year, provides us with a clear conclusion. A decent GDP growth backdrop provides for a highly conducive environment for strong earnings growth and multiple expansion.

So which companies are equity analysts analysing to attempt to capture some of this alpha? Most look at companies in the consumer and industrial sectors. These include companies such as Famous Brands, Spur, Hudaco, Invicta, Reunert, Spar, Raubex, PPC, Lewis, Truworths, Southern Sun, Nampak, Zeda and Italtile.

What do these companies have in common? They all trade at low earnings-multiples compared to their normalised, through the cycle earnings. These range from single-digit to low-double-digits multiples, given their forward earnings.

These companies will also benefit from the positive events listed above. Though these factors will affect each company differently, one certainty remains. The anticipated macroenvironment over the next two years could turbocharge returns for these companies, if they are able to cease the opportunity.

Given the quality of the management teams at these companies, it is our view that they will rise to the occasion and indeed seize the day.

• Cilliers is senior equity analyst at All Weather Capital.

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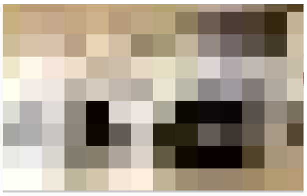

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