February 2017

Monthly newsletter

In this edition we review the SA equity market performance for February 2017.

The Legae Team welcomes your feedback and look forward to assisting you with your equity portfolio.

Equity Review

The FTSE/JSE All Share index ended the month down 3.7% as the stronger Rand weighed on commodity producers. The US dollar weakened against major currencies which helped the Rand appreciate 2.6% in February. The FTSE/JSE Top40 index (-4.5%) was also largely affected by the strong Rand as most companies in the index derive most of their earnings in foreign currency.

Impala Platinum (-19.8%) reported a R328 million loss for the six months to 31 December 2016 compared with a profit of R218 million a year earlier. This was despite revenue increasing by 8% on improved metal prices and higher production. Operating costs rose by 5% thus increasing cost of sales by 10% from the prior period albeit still lower than the 5.8% mining inflation.

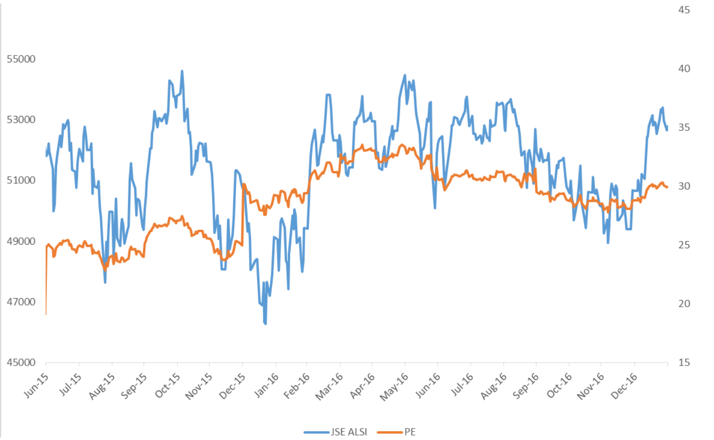
Murray & Roberts (+38.9%) shares jumped after two block trades went through the market at 34% premium of the previous day's closing price. The shares amounted to about 25% of the company's issued share capital worth about $132m. M&R later announced that Germany's Helmig family's investment company, Aton GmbH was behind the acquisition.

Hudaco's (+22.5) share price rallied after the company, in its FY16 results, stated that its turnover increased to R5.53bn from R5.23bn recorded in FY15. Headline diluted EPS rose 5.0% y-o-y, while profit before tax improved to R558mn from R527mn posted in FY15 .

Shoprite and Steinhoff ended talks to create Africa's biggest retailer after negotiations with shareholders broke down over terms. The parties were unable to reach an agreement on the share-exchange ratio that would have been applied to the proposed deal. Following the collapse, shares of both companies rallied with monthly gains of 5.3% for Shoprite and 4.1% for Steinhoff. Shoprite also reported a 15.5% increase in HEPS, turnover was up 14% and declared 180c dividend in its interim results.

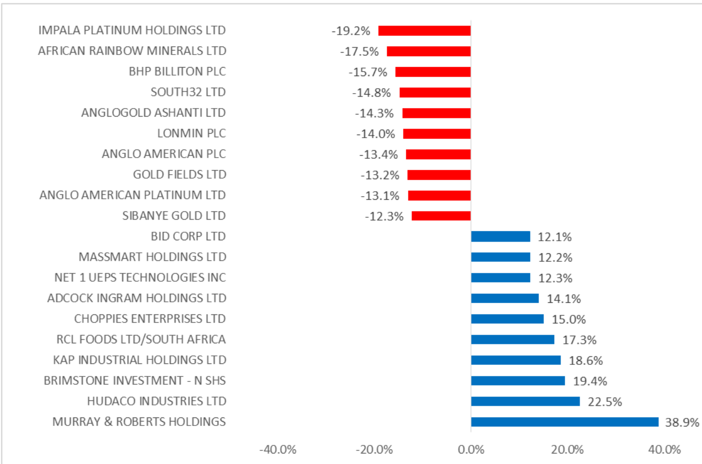
The Competition Commission referred a case of collusion to fix the Rand to the Tribunal for prosecution against 17 banks, including three of South Africa's big banks; Standard Bank (-0.3%), Barclays Africa (-2.9%) and Investec (-3.3%). The banks involved were under pressure for the month and brought the FTSE/JSE Africa Banks index down 0.14%. The case is still ongoing and fines are still to be officially levied.

Figure 1: AllShare Index performance (left axis) and PE (right axis)



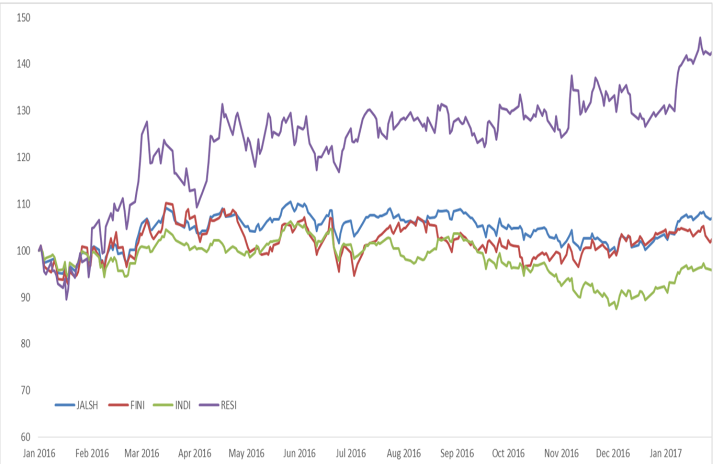
Source: Bloomberg

Figure 2: Winners and losers for the month



Source: Bloomberg

Figure 3: ALSI vs Fini15 vs INDI25 and RESI



Source: Bloomberg

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Economic Review

CPI rose 6.6% y-o-y and 0.6% m-o-m in January following a 6.8% gain in December and as prices increased at a slower pace for food and non-alcoholic beverages. The unemployment rate declined by 0.6% q-o-q to 26.5% in 4Q16 driven by job growth in the services sector, transport and manufacturing.

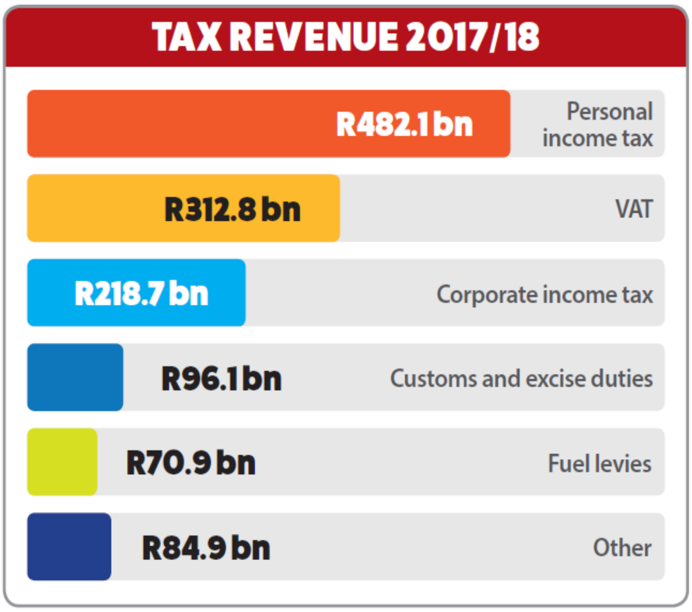
The biggest economic events in February were the president's State of the Nation Address (SONA) and the Finance Minister's budget speech. In both speeches the need for radical economic transformation was touted. However, it is still contentious how the government will bring about economic transformation. Below we outline some of the salient points from the Finance Minister's budget speech and how they may affect some sectors going forward.

The impact of the budget speech

With risks of further increase in the debt-to-GDP ratio and diminishing revenues due to higher unemployment and low economic growth, the Treasury was expected to increase taxes. The minister opted to increase personal income tax for taxable income above R1,5m per annum from 41% to 45%. Dividend withholding tax was also increased from 15% to 20% effective 22 February 2017. Companies paying dividends on or after the date will be liable to the new tax rate irrespective of when the dividend was declared.

The Minister pledged to narrow the budget deficit to 2.6% of GDP in the years through to March 2020, from an estimated 3.4% in the current fiscal year. The economy probably expanded at the slowest pace in seven years in 2016. While the minister has led efforts to keep spending in check and fend off a junk credit rating, he echoed the president's remarks to embark on radical economic transformation to tackle racial inequality and widespread poverty.

The Treasury expects to collect R1.14 trillion in taxes in the 12 months through March 2017, R30.4 billion less than it projected a year ago and the biggest shortfall in seven years. It anticipates raising an additional R16.5 billion from the new top tax bracket and also by limiting relief for inflation, an extra R6.8 billion from a higher dividend tax and R5.1 billion from increased fuel taxes and duties on tobacco and alcohol.



Source: National Treasury

The budget and transformation

In acknowledging the need for economic transformation the minister emphasised the need to work in partnership with the private sector to propel inclusive growth. He noted the below as the most important point this partnership can further the agenda:

- Improved education particularly the quality of basic literacy and numeracy
- Reform of technical and vocational education and training programmes
- Development in cities, improved public transport and industrial development
- Reform of domestic structures, promotion of competition, deconcentrating of monopolised industries and greater private sector participation in sectors dominated by public enterprises
- South Africa's integration with its regional neighbours which offers opportunities for enterprise growth and agricultural development

Improved education and reform of TVET colleges: The government expects to spend 17.5% and 5.5% of the budget on basic education and post-school education in this year's budget. Even with the government's efforts, education still remains a contentious subject in South Africa, one that the government still struggles to fix. This has seen growth in affordable private schools offered by Curro Holdings and Advtech Group. Curro continues to grow its campuses and students. Curro also has commenced with an expansion of its tertiary education business, a sector that is generally dominated by Advtech. The companies both expect growth in their tertiary-education business as the universities continue to take strain. Tertiary education contributed 36% in Advtech's past results and grew by 20%. Both companies have reported a significant earnings in the past year, HEPS increasing at 48% for Advtech and 55% for Curro however Curro looks stretched with a P/E ratio at 108x while Advtech's is 29x.

Promotion of competition, deconcentrating of monopolised industries: The government is committed to curtail uncompetitive practices by private sector companies. In his speech the minister made mention of the success the Competition Commission in reaching a settlement with the construction companies on the charge of collusion. An amount of approximately R117 million from the settlement will be used by the Department of Economic Development to establish a fund that will boost skills among black South Africans and support emerging enterprises. This again speaks to the point of the Treasury and government's commitment to transformation. With this in mind the government may investigate more industries and possibly levy bigger fines for anticompetitive behaviour.

Development in cities, improved public transport and industrial development: R18.4 billion was set aside for infrastructure improvements that prioritise water services. The minister also emphasised the need to improve township municipalities. This will support what has been an improving construction sector. The FTSE/JSE Africa Construction index is up 8.3% year-to-date. This has been better performance to date and the government's proposed infrastructure should help the sector out of the doldrums.

Global Outlook

US equity markets are still at record highs as hopes for tax cuts, a rollback on regulations and big federal infrastructure spending helped fuel the rally. On the US economic data front, 4Q16 GDP grew 1.9% weighed down by a bigger trade deficit despite US consumer spending showing a strong rebound. The probability of the US Federal Reserve raising interest rates in March has increased substantially. More political instability is expected as Mr Trump has yet to outline his plans in details.

The House of Lords voted to have a clause inserted on the Article 50 Bill insuring EU citizens will have the same full rights to live and work in the UK after Brexit. This may delay the triggering of Article 50 by another two weeks, but will still be in the Prime Minister's schedule to have it triggered by end of March.

In early February, China's central bank surprised markets by raising short-term interest rates, while on the economic front trade data showed a strong uptick in the trade surplus (to $51.2bn from December's $40.7bn) as exports surged (+7.9% y-o-y) in January. February factory growth also beat expectations as domestic and export demand improved.

Final Thought

As we head to the end of 1Q17, the plot has been sketched with the help of the direction from President Jacob Zuma in the State of the Nation address. The mechanics to answer the how have been articulated by the Minister of Finance Pravin Gordhan through the budget speech. Our overhang remains global political turmoil given the number of important elections this year. These include Germany, France, Holland, Iran, Chile, Zimbawe, Angola, DRC, Kenya, Rwanda, Senegal and Somalia. To add to the turmoil is the Brexit and the impact to the European Union. The new US President, Donald Trump is yet to get going with his new policies and this has added another dimension to market risk.

Looking ahead, we have a Equity Derivatives Futures Close-Out scheduled for the 16th March 2017 and an Index reweighting on the 17th March 2017. These events will be some of the key market drivers for the last month of 1Q17.