VIEW ON STEINHOFF AND IMPACT ON PRUDENTIAL PORTFOLIOS

PRUDENTIAL
INVESTMENT MANAGERS

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Steinhoff's share price has plummeted over the past few days following allegations of fraud, accounting irregularities and poor corporate governance. While many of these allegations are yet to be substantiated, evidence against senior management has continued to mount, sparking a significant sell-off of the stock. This has understandably left many unit trust investors concerned about their exposure and the effect this has had on performance. To help alleviate some of these concerns, below is a brief overview of our views on Steinhoff as well as a breakdown of our holdings in the stock leading up to us closing out our position on 6 December 2017.

Our view on Steinhoff

Prudential has maintained a high-profile negative view on Steinhoff over many years. Our key concerns related to its weak balance sheet, poor quality earnings that did not translate to cashflow, an extraordinarily low tax rate and a highly acquisitive strategy funded by the prolific supply of low cost debt and equity funding.

In November 2014, Steinhoff announced the acquisition of Pepkor. The combination of a bolstered balance sheet as a result of the issue of shares to partly fund this acquisition, and the cash-generative nature of Pepkor's operations diminished the contribution of the above issues to the overall Steinhoff group. This led us to adopt a marginally less negative view on the stock. In addition, the company grew to become a very large portion of SA equity market indices: at its peak it was 4.5% of the JSE SWIX All Share Index, making it the third largest share in that index at that time.

From a zero holding, we therefore accumulated a relatively small position in Steinhoff International whilst retaining a significant underweight exposure to the relevant indices/benchmarks against which we manage our clients' portfolios. This remained the case up to the shocking announcement on Tuesday evening (5 December) regarding accounting irregularities, the suspension of the release of Steinhoff financials and the resignation of CEO Markus Jooste.

While there are still a number of unknowns, we believe the announcement on 5 December has profoundly negative implications for the future of Steinhoff as a going concern. We therefore sold all Steinhoff shares across all client portfolios on the morning of 6 December 2017.

At the same time, Prudential client funds have never held any exposure to Steinhoff preference shares or debt; and also have no exposure to any Credit Linked Notes with underlying Steinhoff exposure.

Steinhoff international exposure

The events and media reporting around Steinhoff International are understandably concerning for our clients. The below table shows the exposure that we had in our unit trust portfolios as at 5 December 2017 and the level of exposure that we currently have as of today.

	Exposure at close of business on 5/12/2017	Current exposure
Prudential Balanced Fund	0.99%	0.00%
Prudential Dividend Maximiser Fund	0.63%	0.00%
Prudential Equity Fund	1.00%	0.00%
Prudential Inflation Plus Fund	0.23%	0.00%
Prudential Namibian Balanced Fund	0.56%	0.00%
Prudential Namibian Inflation Plus Fund	0.20%	0.00%

Prudential fund performance

Whilst the decision that we took to exit our Steinhoff position at less than our average purchase price detracted from performance, we would like to highlight that our overall returns delivered for clients this year remain commendable. The table below shows the performance, after all fees, for our A-class investors (being our highest fee class), relative to their benchmarks. All returns are for the period from 1 January 2017 to 6 December 2017.

	Performance YTD (6/12/2017)	
	Fund (A Class)	Benchmark (Peer group average)
Prudential Balanced Fund	11.48%	9.83%
Prudential Dividend Maximiser Fund	14.99%	10.01%
Prudential Equity Fund	14.92%	10.01%
Prudential Inflation Plus Fund	9.10%	8.33%

Media commentary

Certain passive fund managers have regrettably used the events of this week to launch a renewed attack in the media on active fund management. We find these comments extremely self-serving and misleading. We would highlight our performance above, which in all instances is significantly ahead of benchmark returns, after all fees.

Passive index funds have (by their design) held Steinhoff International at its full benchmark weight in the respective indices throughout these events. They will be forced to continue to hold Steinhoff as long as it remains in the respective indices, even if the Steinhoff share price was to fall further and even if it comes to light that fraudulent activities have taken place.

Ironically, these same passive funds may have to buy more Steinhoff International if the company is forced to issue equity to salvage the business. This inflexibility of passive investing brought about by rules-based portfolio construction is one of the severe drawbacks to passive management that we have been highlighting to clients.

As active managers we were able to hold an underweight position in Steinhoff and had the flexibility to exit the position as new information came to light thus materially limiting the losses for our clients.

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