Prudential Investment Managers

JULY 2021

Outperforming SA shares in a turbulent time

The local equity market was mostly flat in the second quarter of 2021, with the FTSE/JSE All Share Index (TR) returning just 0.05%, for the three months ending 30 June 2021. Yet in spite of this, Prudential's range of equity funds (the Prudential Dividend Maximiser, Equity and SA Equity Funds) were able to outperform their respective benchmarks and generate positive returns for investors over the period. In this article, we take a closer look at a selection of stocks and sectors our funds have been holding that have done well despite the testing times, contributing to fund returns over this period. More information about these, as well as other contributors to or detractors from performance, can be found in our quarterly review for each of our funds.

Textainer Group Holdings

Textainer is one of the worlds' largest shipping container leasing companies. Going into the pandemic, the business was in a strong position to take advantage of some opportunities that arose as global shipping continued to gear up following the Pandemic downturn. We have been exceptionally impressed with how the company's management has allocated capital. It has been able to take advantage of the abnormally low share price it reached during last year's market downturn to buy back a substantial number of its shares at extremely attractive prices, and we think this smart allocation of cash should further accelerate the improvement of shareholder returns. The container leasing market's fortunes have rapidly improved over the last year, and Textainer has managed to put a substantial amount of capital to work by buying a large amount of containers and leasing them out over the long term at very attractive rentals. Despite this large investment, we expect Textainer to also be able to resume dividend payments this year, which is indeed an exciting milestone for the company and investors.

South African banks

The pace of profit recovery and concerns over further bad debts arising from Covid-19-related constraints are still weighing on the share performance for South African banks, despite many banks resuming the distribution of dividends. We continue to believe that this might be a very good opportunity to buy banks in South Africa at very undemanding valuations, and for this reason, we have one of our larger sector overweights to the banking sector. While the Covid-19 shutdown resulted in significant concern over the potential for much higher bad debts to accrue in the banking sector, we believe that the associated share price falls were excessive and provide a substantial risk premium for investors. As such, we think there is a good opportunity to generate alpha by being overweight the relatively undervalued banks, including Standard Bank, ABSA and Investec, versus Capitec and FirstRand. While we do rate FirstRand and Capitec more highly in terms of quality, we cannot ignore that that they are substantially more highly rated than other banks in the sector.

MTN

The market has been very concerned about the risks of doing business in Nigeria, where MTN has a significant business, resulting in a depressed share price and valuation. While we do not disagree that investing in Nigeria requires a higher risk premium, we think that MTN presents excellent value. MTN is trading on a dividend yield of over 6%, which we think should be able to grow over the next five years. MTN has been steadily reducing debt levels on its balance sheet by realising non-core assets like their tower assets. We think that this process will not only ensure a stable and growing dividend but will also reduce any balance sheet risk.

The Foschini Group (TFG)

Within the industrial sector, domestic retail shares performed well in Q2 2021 on the back of better-than-expected trading. We have observed many SA-listed businesses that have emerged from last year's Covid-19-induced lockdowns in a stronger position than when they went in. One such company is The Foschini Group (TFG)*, which in our opinion will benefit substantially from its purchase of JET over the next three years. Foschini was able to buy JET at a bargain-basement price from the financially distressed Edcon Group last year. Although the share price of TFG has risen, we think that there is still substantial upside on a three-year view. In building up our overweight position to TFG, we believe that its low share price has built in too much concern over bad debts that might potentially arise on their credit book as a result of the pandemic.

South African equities

We remain optimistic regarding South African equity market returns over the medium term due to what we believe are the prevailing excessive levels of pessimism reflected in share prices and valuations. Going into the Covid-19 pandemic, the South African market, in our view, was already undervalued and has fallen to levels which we think are exceptionally attractive. The price-to-book value ratio of the JSE was close to 1.7X as at the end of June 2021, below its longer-term average of around 2.1X. Even as company earnings continued to improve over the period across a broad swathe of sectors (apart from listed property, which was steady), share prices did not follow suit.

Within the South African market, many commodity companies continued to experience substantial upgrades in their revenue and earnings, as the prices of platinum group metals, coal and iron ore remain very elevated. These strong commodity prices are generating high company cash flows, profit margins and prospective dividends. This is not only helpful to investors and the companies mining these commodities, but is also broadly growth-generative for the South African economy. We believe that earnings and dividends in South Africa should show a strong return to growth over the medium term. This growth in dividends is based mainly on a return to more normal dividends among the mining companies and banks, whose balance sheets are now very healthy.

These developments over the past three months are keeping us positive about investing in local companies compared to many of their offshore counterparts, even as conditions may be better globally than in South Africa. We would like to stress that, as value investors, it is more about the excellent value offered by some South African stocks, and their potential for outperformance of other stocks over the next three to five years, than about the current, short-term market conditions. Tough times are often the best times to invest.

For more information, please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.

**Not held in the Prudential Dividend Maximiser Fund.*