VEGA ASSET MANAGEMENT BATEBESTUUR

NEWSLETTER

April 2023 | www.vegacapital.co.za

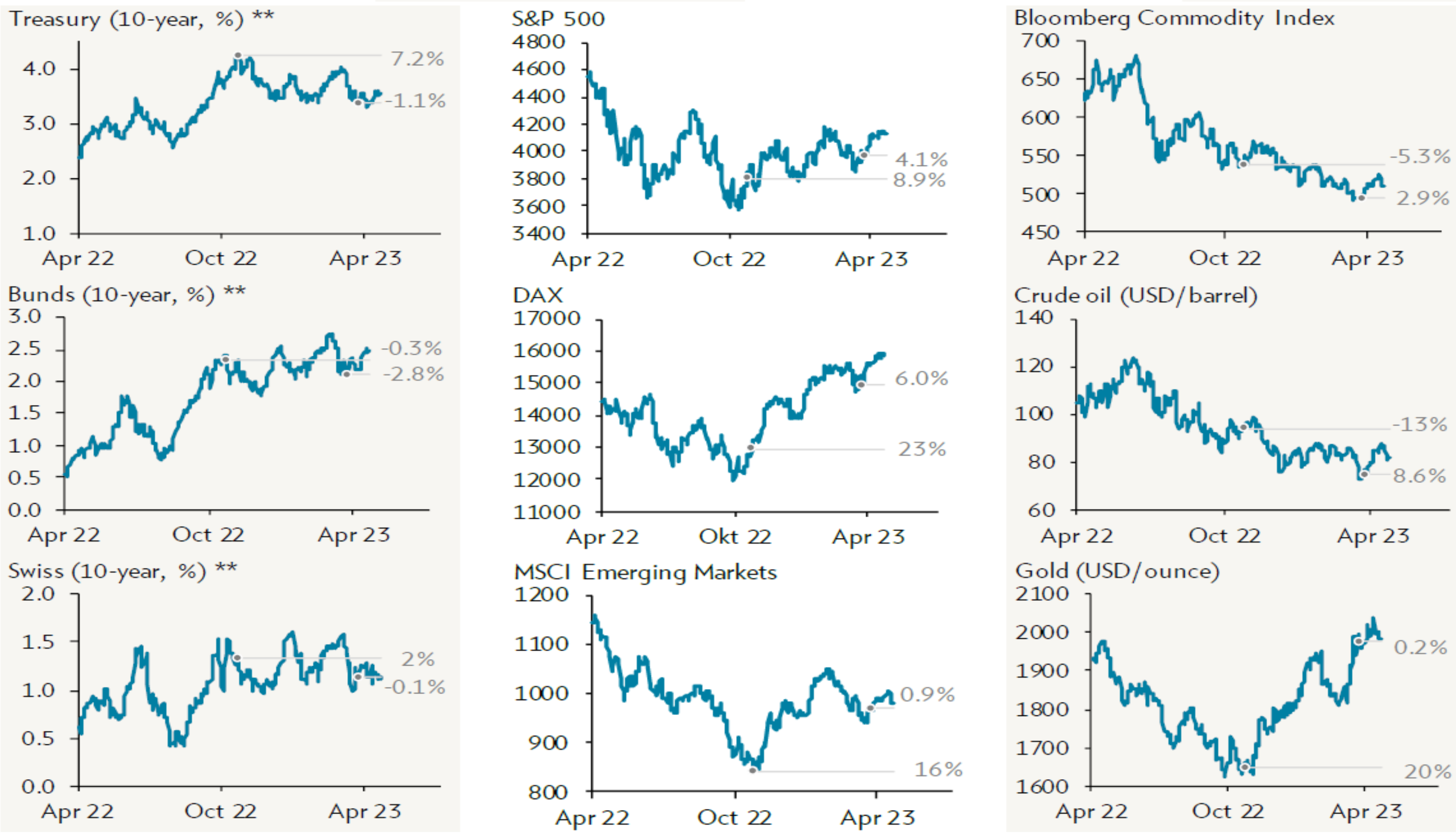
IN THIS MONTH'S NEWSLETTER

- Market overview
- Share focus: British American Tobacco
- Graph of the month

"The biggest risk of all is not taking one."
- Mellody Hobson

MARKET OVERVIEW

Review (1-month and 6-month performance)



Source: Julius Bear, 24/04/2023

30/04/2023	Last	Month %	YTD %	5Y ann. %
MSCI World	2836	1.8	9.8	8.7
S&P 500	4169	1.5	8.6	11.4
NASDAQ 100	12227	-0.5	16.8	12.7
EURO STOXX 50	4359	1.6	13.1	7.7
MSCI EM	977	-1.3	4.3	-0.7
HANG SENG	19895	-2.5	-1.2	-5.4
US Equities Volatility Index (VIX)	15.78	-3.0	-5.9	15.5

Source: Edmond De Rothschild

The Q1 2023 reporting season kicked off in April. Roughly two-thirds of the market capitalization has reported its quarterly numbers in the US. Overall, the results continue to surprise positively: 79% of companies have been able to surpass earnings expectations, significantly above the 5-year average of 74%.

Company earnings

Microsoft reported a strong fiscal quarter. For the March quarter, revenue grew 7% year over year or 10% in constant currency to almost $53 billion. Microsoft remains one of our top picks due to wide moat. Microsoft benefits from high switching costs because of its significant installed base and the fact that critical business processes are often centered around Microsoft Excel. It would be highly disruptive for a company to pivot to an office suite other than Office 365.

In addition, Microsoft's intelligent cloud segment has a competitive edge over its rivals. Most businesses already use other Microsoft software, making onboarding easier with Microsoft than with a competitor. Azure's cloud revenue increased 31% year over year. The stock is currently trading at a forward price-to-earnings multiple of 29, which is in line with its 5-year average and we believe it still holds considerable value.

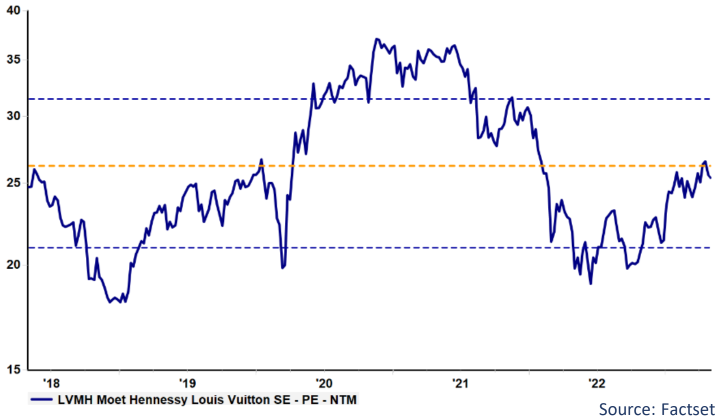
Figure 1: Microsoft's forward PE ratio

Source: Factset

LVMH, the largest luxury goods company globally, has once again exceeded expectations with its Q1 2023 revenue beating consensus. This was aided by strong growth in the fashion & leather goods division, which accounts for 51% of sales, and a faster-than-expected recovery in China.

Despite operating in a challenging economic environment, LVMH was able to grow sales and expand its margins, reaffirming its dominance in the sector. These results also highlight the sector's resilience during economic slowdowns. Currently trading at a price-to-earnings multiple close to its long-term average, LVMH is one of our top picks. The company's pricing power justifies its valuation and makes it an attractive investment opportunity.

Figure 2: LVMH's forward PE ratio

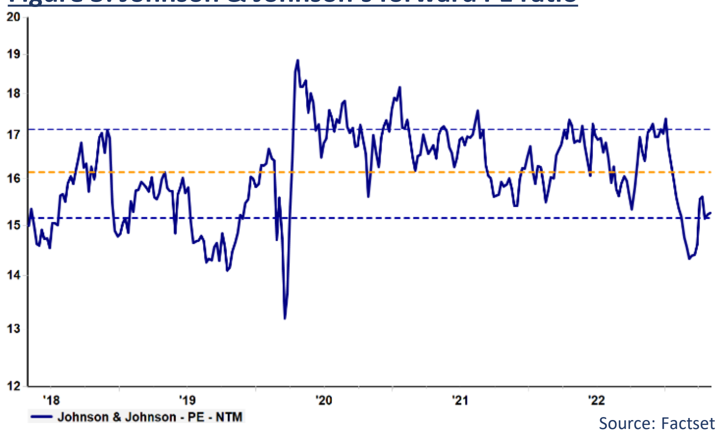


Source: Factset

Johnson & Johnson has exceeded the consensus on sales in all three divisions and group earnings. Consumer health sales experienced the most robust growth (+11.3%), with Medical Technology a close second (+11%), and pharmaceuticals coming in last (+7.2%). Moreover, Johnson & Johnson has increased its quarterly dividend by 5% to USD 1.19 per share, resulting in a dividend yield of 2.9%.

Despite its strong performance, the share is trading at a discount to its long-term average. Johnson & Johnson has solid margins and outstanding management, making it an attractive stock for investment. We recommend buying the share at current levels.

Figure 3: Johnson & Johnson's forward PE ratio



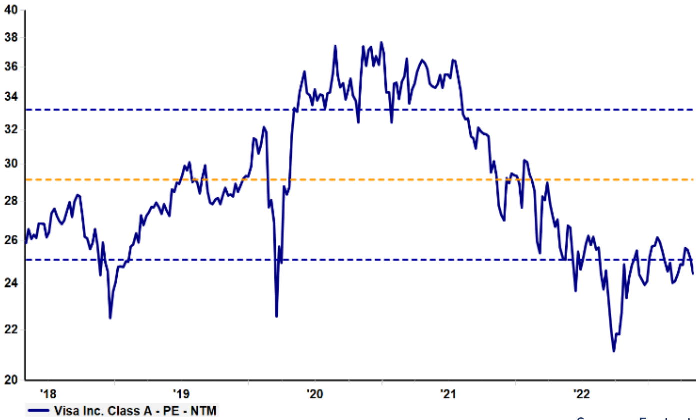
Source: Factset

Visa is a global leader in electronic payments, with a strong position in debit card transactions and a well-established network. Visa delivered impressive results, with earnings per share beating consensus by 5% and net revenues growing by 11% year over year.

The strongest growth trend remained at international transaction fees, growing 24% year over year, alongside robust travel spending. Management guidance for the next quarter is to grow revenue by low double digits. Visa's margins are exceptionally strong, confirming the robustness of its business model. The primary threat to revenue growth over the next year is a slowdown in global economic growth.

Despite this, Visa is trading at highly attractive levels, with its current forward price-to-earnings ratio being one standard deviation below its 5-year average (figure 4). Consequently, we recommend buying Visa at its current level.

Figure 4: Visa's forward PE ratio



Source: Factset

Intuitive Surgical (ISRG) is the maker of the Da Vinci system which makes them a market leader in robot-assisted surgery. Its established user base is an entry barrier and competitive advantage, as installed systems create recurring revenues from instruments, accessories and maintenance services. ISRG reported that revenues were up 14% year on year, surpassing consensus by 6%.

The procedure growth rate came in at 26% year over year, leading management to increase 2023 procedural guidance to 18%-21% year over year. The stock trades at an elevated level, with a forward price to earnings of 50x. This is in line with the 5-year average but at a higher premium than peers. We keep our buy rating on ISRG as we forecast the company to outperform the sector over the longer term.

Figure 5: Intuitive Surgical's forward PE ratio

Source: Factset

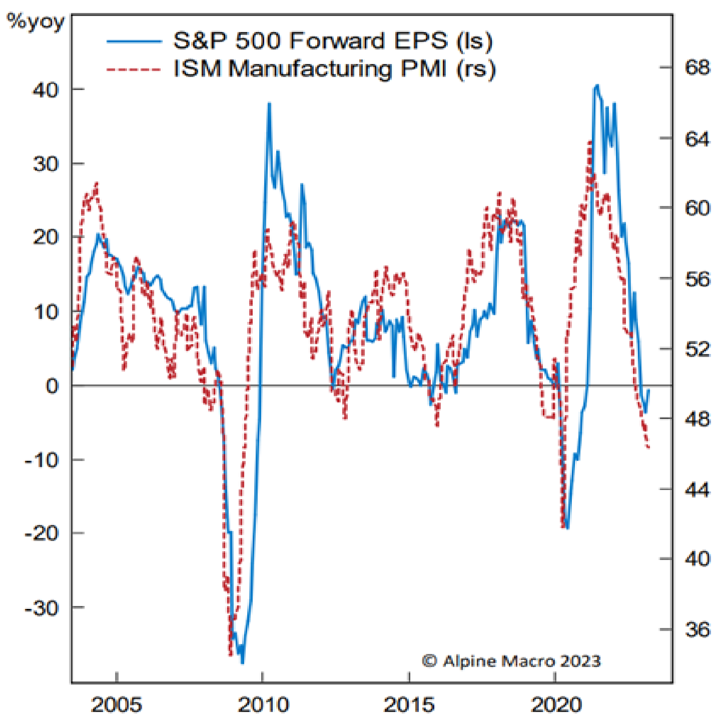
Outlook

When selecting investments for the coming year, several factors should be taken into consideration. Firstly, due to the banking crisis, credit conditions are likely to become more stringent, as outlined in the March newsletter. Historically, credit standards have preceded S&P 500 sales growth by approximately two quarters, indicating that sales growth is expected to further decelerate in the future.

Secondly, the tightening of credit conditions may contribute to a decrease in inflation, enabling the Federal Reserve to terminate interest rate hikes sooner, which would help alleviate the impact of the stricter credit conditions.

Thirdly, while there is a possibility of a recession in the United States, the market has already factored in an earnings recession, indicating that it should have a minor effect on stock prices. Chart 6, shows that the S&P 500 forward earnings per share are expected to decline.

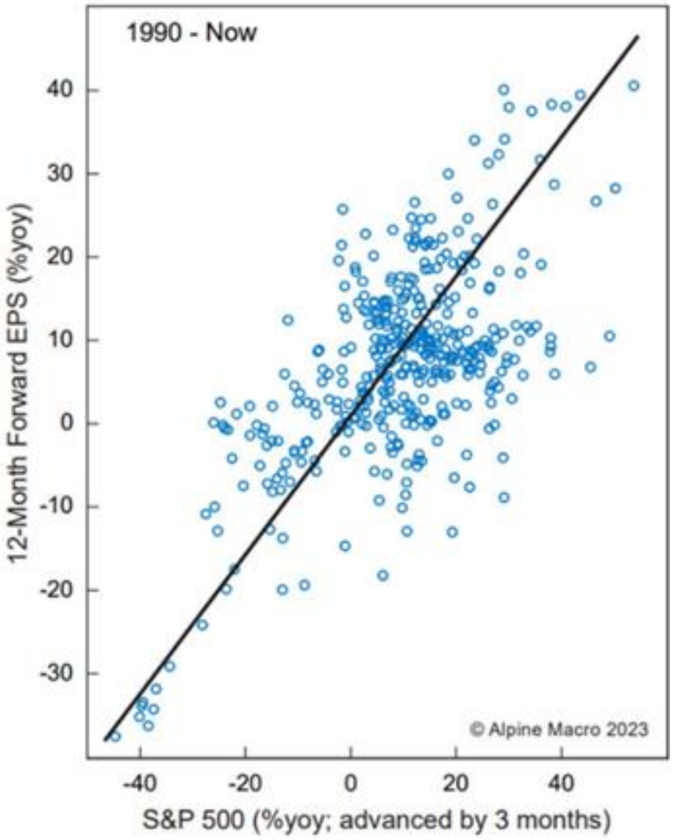
Figure 6: S&P 500 forward EPS expectations



Source: Alpine Macro

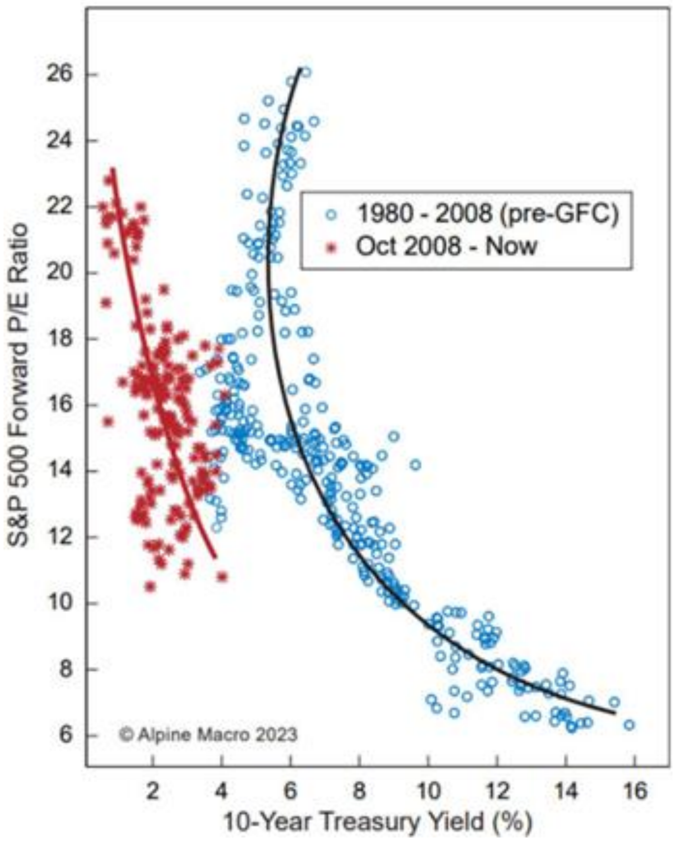
Furthermore, while the impact of earnings on stock prices is linear (chart 7), the effect of interest rates on stock prices is exponential (chart 8). Lower interest rates, despite the possibility of earnings declining over the next several quarters, will result in a higher present value for anticipated future cash flows when cash flows are discounted. Growth stocks will benefit more than value stocks because their earnings are discounted even further into the future. This is the polar opposite of what was taking place in 2021 when interest rates were predicted to rise rapidly.

Figure 7: Correlation between EPS and stocks



Source: Alpine Macro

Figure 8: Correlation between rates and PE ratios



Source: Alpine Macro

In conclusion, we anticipate that the United States will experience a period of disinflation, lower interest rates, and a weakening US dollar. While a recession is conceivable, we believe that it is already accounted for in valuations. We remain bullish on shares and bonds, but price volatility may remain elevated.

Extract from latest Fed minutes:

"Recent developments in the banking sector are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring and inflation... but the extent of the effects is uncertain... Against this background, **participants continue to be highly attentive to inflation risks.**"

Source: Edmond de Rothschild, 02/05/2023

30/04/2023	Last	Month %	YTD %	5Y ann. %
JSE All Share	78218	2.80	7.10	6.29
JSE Resources	69000	4.18	-0.43	12.58
South Africa 10Y Bond	10.165%			
Net Foreign Equity Flow	R2.0bn			
Net Foreign Bond Flow	R3.4bn			
USDZAR	18.4303	-3.46	-8.52	-8.08
EURZAR	20.2346	-4.50	-11.76	-6.24

Source: RMB

For the month of April 2023, the JSE Alsi returned 2.8% (+7.1% year-to-date), while the **rand weakened** by 3.5% and 4.5% against the dollar and euro, respectively. Notably, non-residents transitioned from net sellers to **net marginal buyers** of South Africa Inc. According to Bloomberg data, there was a monthly inflow of R2bn into the equity market and R3bn into the bond market. However, over the last twelve months, there hve been a cumulative outflow of R135bn and R319bn from the equity and bond markets, respectively.

The primary topic addressed in last month's newsletter was the possibility of a **banking crisis.** Figure 9 illustrates that South African banks are in a healthy position, with capital adequacy ratios that are significantly above the regulatory minimum requirements of 4.5% under Basel III.

Figure 9: South African bank's common equity tier 1 capital adequacy ratio

Bank	Capital adequacy
Standard Bank	13.5%
Nedbank	14%
Absa	12.8%
Capitec	34%
FNB	13.2%
Investec	12.8%
African Bank	43.3%

Source: Investec

President Ramaphosa's recent **cabinet reshuffle**, which increased the size of the government rather than reducing it, was deemed unsatisfactory. The latter failed to provide any assurance that the electricity crisis in South Africa would be resolved expeditiously. Clyde Mallinson, an expert in the energy sector, cautioned that unless Eskom markedly improves its power station performance, South Africa may face **stage 11 load-shedding** during the winter season. Mallinson developed a load-shedding forecast matrix that employs Eskom's coal-fleet energy availability factor (EAF) and the expected winter electricity demand. If Eskom's coal fleet **maintains** an EAF of over 45% in June, South Africa can anticipate stage 8 load-shedding in the winter. However, if the EAF declines to 40%, load-shedding will escalate to stage 11.

Company news

Northam (NPH): The group declared the withdrawal from the bid for Royal Bafokeng Platinum (RBP). Following the initial R17bn cash offer, platinum group metal (PGM) prices have considerably decreased, making the valuation of RBPlats appear excessively high. The announcement of the deal's termination was met with favorable reception by the market (+24% for the month). Northam is trading at a forward PE of 5.3x.

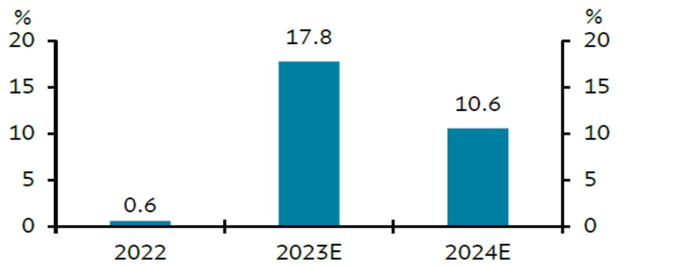
Richemont (CFR): The group's principal listing on the SIX Swiss Exchange prompted the termination of its South African Depository Receipt (DR) program, with the subsequent listing of its A shares and A warrants on the JSE as a secondary inward listing. In place of the DR program, Richemont 'A' shares were provided at a stock offer of **1 A-share for every 10 depositary receipts** that were previously issued. Richemont is currently trading at a forward P/E of 23x.

Capitec (CPI): The banking group has reported a substantial increase in its headline earnings for the fiscal year that ended in February 2023. Specifically, the earnings rose by 15% from R8.4 bn in the prior year to R9.7 bn. Moreover, the bank witnessed a notable surge in its customer base, which amounted to 20.1 million individuals as of February 2023. This indicates that approximately **one-third** of South Africa's estimated population of 60 million individuals currently have some form of banking relationship with Capitec. The group is trading at a P/B of 4.1x vs the group's 10-year average of 4.3x.

Outlook

According to the SARB, the country's **GDP growth rate** is expected to further moderate to 0.2% in 2023. Furthermore, it has been projected that **headline inflation** will continue to remain above the target band's upper threshold and will only move back to the midpoint in the final quarter of 2024. Nevertheless, SA Inc is poised for a substantial **earnings recovery**, building off a notably depressed base going into 2024. The potential rerating of this situation, which is already trading at heavily depressed multiples, could amplify this narrative. In terms of timing, this recovery is expected to coincide with central banks **cutting rates** and a **weaker Dollar**, which would act as a significant tailwind for the broader emerging market complex.

Figure 10: South Africa's expected earnings per share growth (YoY)



Source: Bloomberg, Julius Baer

SHARE FOCUS: BRITISH AMERICAN TOBACCO

Rating	: Buy
Target Price	: R810
Dividend Yield	: 8%
Forward P/E	: 7.4x

Company Overview

British American Tobacco possesses a strong franchise in the tobacco industry, formed by the aggregation of intangible assets and cost advantage. Tight government regulation has made barriers to entry almost insurmountable in the tobacco segment and has kept market shares stable. Consumer brand loyalty, particularly in premium price segments, has also become an intangible asset that is scarce in other consumer categories. The economies of scale provide large-cap manufacturers an edge in tobacco leaf procurement and distribution.

Tobacco contains nicotine, an addictive substance that suppresses the cessation rate. According to data from Tobacco Atlas, more than 60% of all smokers intend to quit and 42% have attempted to quit over the past 12 months. Yet in most markets, the smoking rate is only at a very modest decline, implying that the majority of smokers attempting to quit fail to do so.

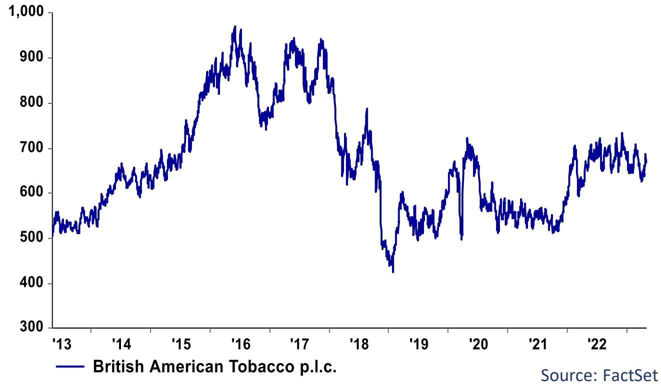
The addictive nature of the product forms a powerful competitive advantage when combined with very tight government regulation that over the years has served to dampen market share volatility and competition on price. British American Tobacco has been a true stalwart for income portfolios. It generates very consistent cash flows which enables the company to pay solid dividends. Although we do not project significant growth for the combustibles business, the combustibles segment holds the pricing power.

The growth in revenue will be driven by pricing power as volumes slowly decrease in combustibles, and increase in volumes in New Generation Products (NGP). The number of consumers of non-combustible products has grown by 30% per year over the last four years. NGP revenue constitutes almost 15% of total revenue and has grown by 33% per year over the same period.

Valuation

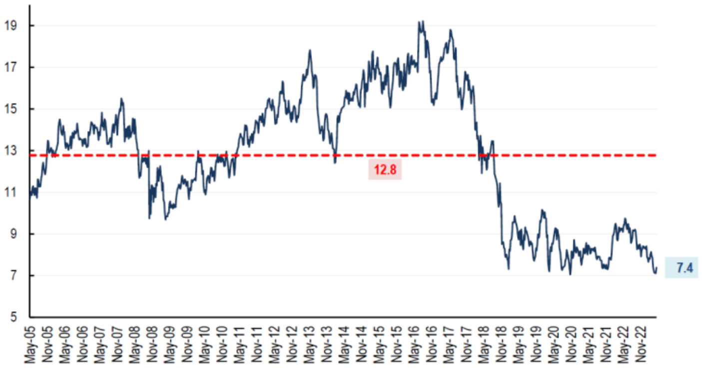
BAT has a very defensive business model which is great to have in uncertain times. The stock is trading at a price-to-earnings ratio of around 7, below its long-term average price-to-earnings ratio of around 12. The share also appears attractive relative to its competitors.

Performance



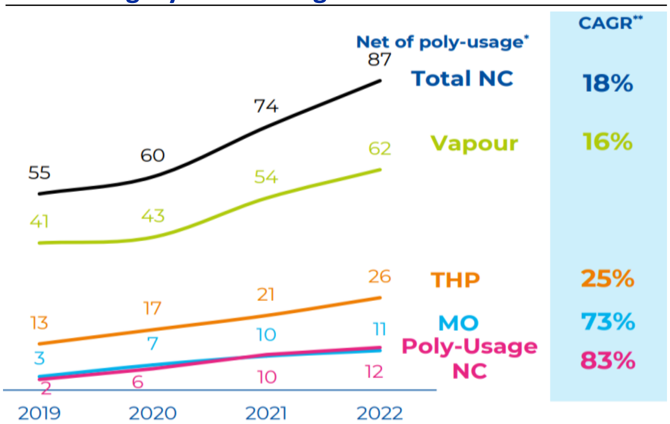
Source: FactSet

12-month forward P/E



Source: SBG Securities

New category consumer growth

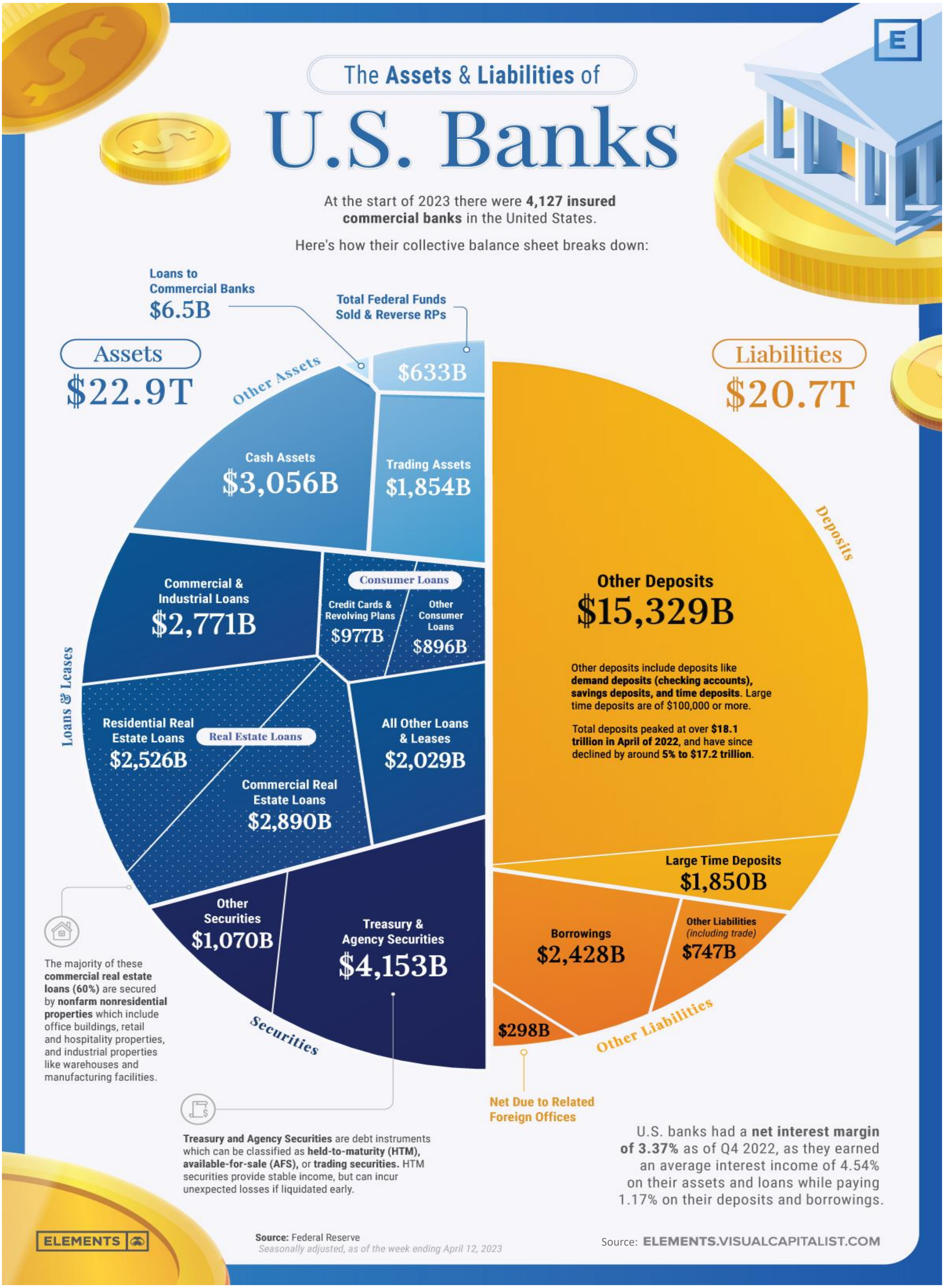


Source: FactSet

Financials

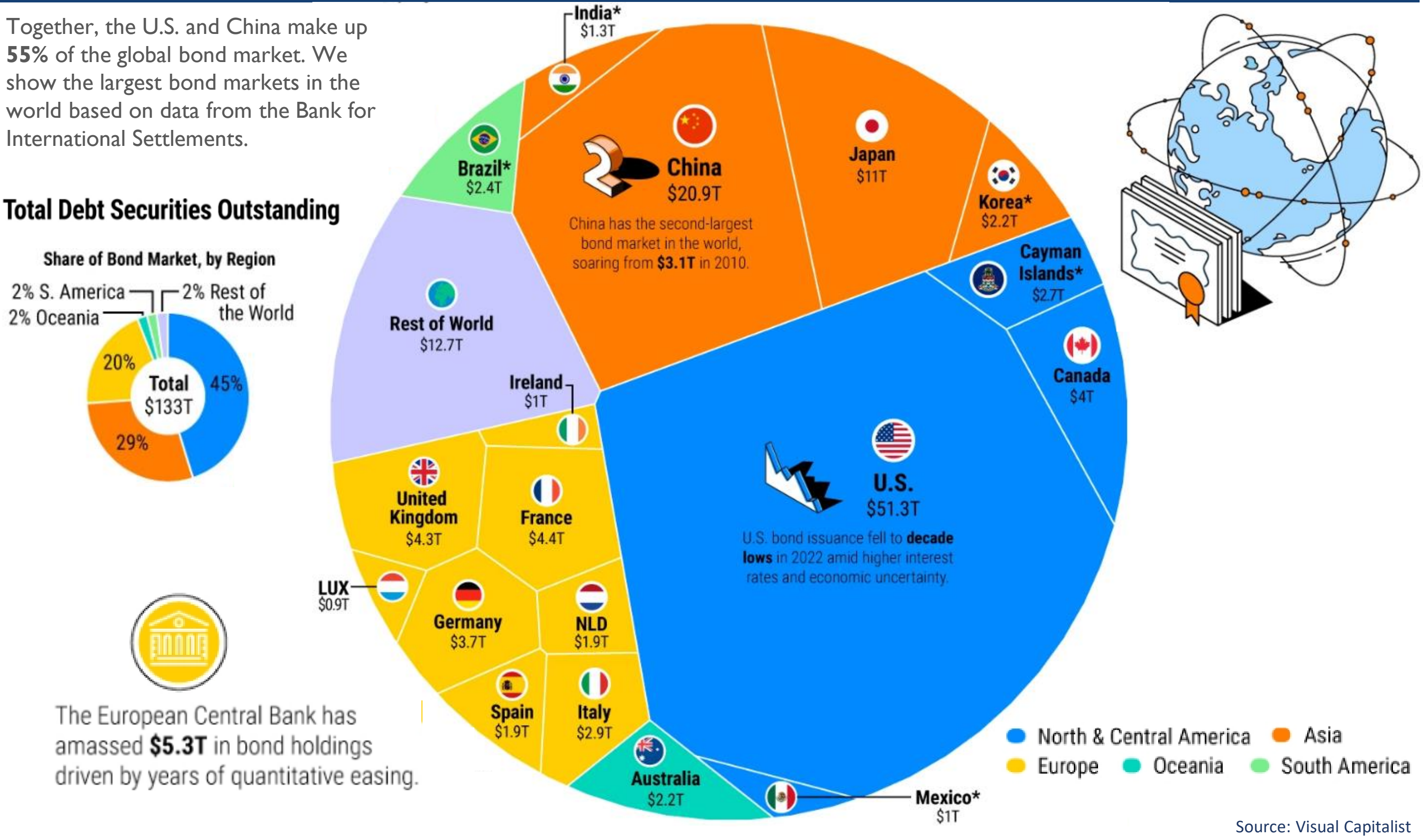
Key forecasts	Dec 20A	Dec 21A	Dec 22A	Dec 23E	Dec 24E	Dec 25E
Revenue (GBP m)	25,776	25,684	27,654	28,127	29,092	29,937
EBITDA (GBP m)	12,815	12,226	13,713	14,331	14,934	15,456
Net Income (GBP m)	6,564	6,974	6,846	8,903	9,473	10,056
Adj. EPS (GBP)	3.32	3.29	3.71	3.88	4.15	4.47
Prev. Adj. EPS (GBP)	3.32	3.29	3.71	3.91	4.19	4.47
DPS (GBP)	2.10	2.16	2.18	2.31	2.40	2.50
Dividend Yield (%)	7.8	7.9	6.6	7.9	8.2	8.5
PE (adjusted)	8.2	8.3	8.8	7.6	7.1	6.6
EV/EBITDA (adjusted)	8.0	8.3	8.4	6.4	5.8	5.4

Source: SBG Securities



The Assets & Liabilities of
U.S. Banks
At the start of 2023 there were 4,127 insured commercial banks in the United States.
Here's how their collective balance sheet breaks down:
Loans to Commercial Banks
$6.5B
Total Federal Funds Sold & Reverse RPs
Assets
$22.9T
Other Assets
$633B
Cash Assets
$3,056B
Trading Assets
$1,854B
Commercial & Industrial Loans
$2,771B
Consumer Loans
Credit Cards & Revolving Plans
$977B
Other Consumer Loans
$896B
Loans & Leases
Residential Real Estate Loans
$2,526B
Real Estate Loans
Commercial Real Estate Loans
$2,890B
All Other Loans & Leases
$2,029B
Other Securities
$1,070B
Treasury & Agency Securities
$4,153B
Securities
The majority of these commercial real estate loans (60%) are secured by nonfarm nonresidential properties which include office buildings, retail and hospitality properties, and industrial properties like warehouses and manufacturing facilities.
Treasury and Agency Securities are debt instruments which can be classified as held-to-maturity (HTM), available-for-sale (AFS), or trading securities. HTM securities provide stable income, but can incur unexpected losses if liquidated early.
Liabilities
$20.7T
Deposits
Other Deposits
$15,329B
Other deposits include deposits like demand deposits (checking accounts), savings deposits, and time deposits. Large time deposits are of $100,000 or more.
Total deposits peaked at over $18.1 trillion in April of 2022, and have since declined by around 5% to $17.2 trillion.
Large Time Deposits
$1,850B
Borrowings
$2,428B
Other Liabilities (including trade)
$747B
$298B
Other Liabilities
Net Due to Related Foreign Offices
U.S. banks had a net interest margin of 3.37% as of Q4 2022, as they earned an average interest income of 4.54% on their assets and loans while paying 1.17% on their deposits and borrowings.
ELEMENTS
Source: Federal Reserve
Seasonally adjusted, as of the week ending April 12, 2023
Source: ELEMENTS.VISUALCAPITALIST.COM

GRAPH OF THE MONTH 2: THE GLOBAL BOND MARKET



Source: Visual Capitalist

SOURCES

Sources: Bloomberg, BNY Mellon, Credit Suisse, Compound Advisors, Edmond De Rothschild, ETFMG, FactSet, Haver Analytics, JP Morgan, Julius Baer, Morgan Stanley, Refinitive, RMB, Statista, Sygnia, Strategas, UBS

CONTACT US

Francois Du Plessis, CFP

082 492 9199

fduplessis@vegacapital.co.za

Louis Storm, CFA

083 552 2343

lstorm@vegacapital.co.za

Abrie Smit

082 087 0883

asmit@vegacapital.co.za

You are more than welcome to pass this newsletter on to friends and family who may wish to learn more about investing. If you know of anybody who is interested in investing in local and offshore equities please do not hesitate to send them our contact details.

Disclaimer