CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

cadiz
ASSET MANAGEMENT

APRIL 2020

On a personal note to all our clients during this COVID-19 pandemic, we wish you good health, safety and fortitude.

Navigating uncharted waters requires a steady hand at the tiller

Benjamin Franklin once said, *"By failing to prepare, you are preparing to fail."*

In these times of uncertainty, one needs a guiding set of principles to steer the course through the unknown. This requires a disciplined and well-practiced process that keeps a focus on what is important and relevant, through the good times and the tough times.

During this global COVID-19 pandemic, we remain focused on protecting our clients from permanent capital loss, while investing in good businesses that should compound your wealth over time.

AT CADIZ ASSET MANAGEMENT, OUR FIRST RULE IS, 'DON'T LOSE CAPITAL'

This focuses our attention on where to start when analyzing any business. Understanding a business's balance sheet, its debt levels and when debt repayment is due is vital to understanding if a business will survive the tough times. During this global COVID-19 pandemic, as countries remain in lockdown and economic activity has largely ground to a halt, corporate balance sheets and liquidity needs are being tested like never before.

A case in point is Sasol. Entering 2020, we had no Sasol exposure as we deemed the financial risk too high as the Company failed to meet our investment criteria. During the COVID-19 pandemic and the subsequent collapse in the oil price, it became apparent that Sasol was going to struggle to pay its debt and interest costs due in the next one to two years. During March this year Sasol lost 70% of its value, announcing that it needed to raise capital, by a combination of selling assets, restructuring costs and holding a rights issue, in order to pay down its debt.

At Cadiz, we have re-interrogated the company's balance sheet for each of our investments, stress-testing their ability to manage their debt obligations and cash requirements under extreme operating scenarios. We are pleased to report that we are comfortable with the balance sheets for all the investments we hold.

INVEST IN QUALITY BUSINESSES, THAT HAVE PROVEN TRACK-RECORDS AND COMPOUND RETURNS OVER TIME

When equity markets fall as hard as they did during March, there is initially indiscriminate selling. As time goes on, investors start to distinguish between the quality stocks that are likely to survive these turbulent times and the poorer quality stocks that are often highly leveraged with weak business models. At Cadiz, we focus much of our attention on understanding the qualitative characteristics of a business, in order to assess the risks of whether a business will endure. We focus on understanding:

- How does the business make its money and what are its competitive advantages? Are these competitive advantages likely to persist, or could they be eroded over time?
- Does it have too much debt and can it repay the debt?
- Does it have a competent management team aligned to shareholders' interests?
- Does it have a proven track-record of generating superior returns on capital, and are these returns likely to persist?
- Where is the company in its business cycle - capital cycle and earnings cycle?

Good quality businesses usually trade at a premium. As equity prices have fallen during the COVID-19 crisis, however, we have used this opportunity to increase our exposure to these good quality businesses by either adding to existing positions or adding one or two quality counters to the portfolio. This will strengthen the portfolio's ability to weather the storm and compound returns over time when the world economy recovers.

MAINTAIN A DIVERSIFIED PORTFOLIO

With the sudden drop in economic activity, the demand for cash for companies to pay their staff, supply chains, rent, interest costs and taxes has been unprecedented. This has led to excessive disinvestments by companies and individuals from money market funds, income funds, bonds and equity funds globally. Foreigners have also repatriated their money out of South Africa. Consequently, this has caused the dollar-rand, credit, bonds and equity prices to fall, forcing correlations to rise towards one.

This is temporary, however and not all is bad news. For example, year-to-date, MSCI World USD has fallen -20%, while the rand has depreciated 27%. For a South African investor, the rand has more than cushioned the blow to foreign investments.

Our portfolios have also enjoyed the benefits of diversification in global businesses listed on the South African stock exchange and other rand hedge stocks. For example, Naspers and Prosus are predominantly exposed to Tencent, British American Tobacco, and AngloGold Ashanti. Besides these stocks, the portfolios are also exposed to defensive businesses, including Shoprite and Mediclinic, along with other US pharmaceutical and healthcare stocks (CVS Health, Gilead Sciences and Walgreen Boots Alliance). All these stocks have different growth drivers and have held up well during this crisis, providing good diversification for the funds.

When the world finally overcomes the COVID-19 pandemic and global economies recover, some industries will recover faster than others. While it is difficult to tell which industries or stocks will be winners in the short term, we believe that the portfolio of diverse businesses our clients are invested in have solid long-term growth prospects. This combined with highly attractive valuations, sets up our portfolios for good long-term returns. Markets can be very volatile over the short-term, but history has shown that those that are willing to be patient and invest for the long-term will be handsomely rewarded.

Inditex
When fashion meets logistics

Inditex is a high-quality fashion retailer with strong competitive advantages, low financial risk and is well managed. The company has always been expensively priced and with the recent downturn in the equity markets we have the opportunity to potentially own a great business at a reasonable price.

WHAT DOES THE BUSINESS DO?

Inditex is one of the largest fashion retailers in the world with over 7400 stores in 96 markets worldwide and 202 markets through its online platform. Inditex is the parent company to well known brands such as Zara, Pull & Bear and Berksha amongst others. The company operates a unique business model whereby instead of committing a large percentage of production for the next fashion season, like most other clothing retailers, the company commits a small amount and uses customer feedback and an efficient production network to replenish stores with new and different products weekly. New styles are prototyped in just 5 days and a large part of the manufacturing happens locally to shorten lead-times. By doing this Inditex changed the landscape of the retail fashion industry and pioneered what is known today as "fast fashion".

INDITEX IS A HIGH-QUALITY BUSINESS WITH A UNIQUE BUSINESS MODEL

The business has been able to sustainably create shareholder value by providing returns on capital consistently above 35%, which is much greater than the cost of capital for the business. They can do this as they have margins of a premium brand with the asset turnover capabilities of a distributor. Inditex harnesses the advantages of huge scale but has strong growth potential due to the ability to continue rolling out stores in most markets.

THE BUSINESS HAS SIGNIFICANT COMPETITIVE ADVANTAGES

Inditex's production and supply chain is widely regarded as the best in the fashion business. They can design, produce and deliver an entire collection to the shop floor within a couple of weeks. They are able to do this thanks to their vertically integrated supply chain and their use of proximate sourcing and manufacturing for items with a high fashion content. They also have a state-of-the-art central logistics operation which is fully automated and acts as an intermediary between the factories and the stores. The constant feedback between the distribution centers and the stores together with the speed at which they are able to get their product to store shelters them from making severe fashion mistakes. This has ensured that they have lower markdowns compared to the rest of the industry. Zara for instance makes 85% of the full price on its clothes while the industry average is 60-70%.

The brand has become more powerful as they have been able to make the transition to a global multi-channel leader. They have been able to access markets outside their primary European market with strong sales performance showing that their brands have 'travelled' well. Inditex don't have much advertising costs, they have a strong social media presence and their website has over a couple of billion views each year, the brands tend to speak for themselves, which is a strong competitive advantage versus competitors that have to spend billions on advertising each year.

WELL PLACED TO TAKE ADVANTAGE OF THE SHIFT TO ONLINE IN RETAIL

The online market is concentrated on speed to market and speed of delivery. Inditex production and delivery systems are already set up to adapt to these changing demands. The nature of the Inditex business model makes it easier to cope with increased online orders. This contrasts with peers who face significant capex costs in order to adapt both from a technology and distribution perspective.

HIGHLY CASH GENERATIVE WITH A STRONG BALANCE SHEET AND LOW FINANCIAL RISK

Inditex is in a healthy financial position with cash reserves on hand exceeding debt by over €8 billion. The business is highly cash generative thanks to cash sales and a negative working capital cycle, which means that suppliers are generally paid after the goods are sold. Inditex, like most other retailers has had to close most of it stores due to the Covid-19 crisis and the strength of their balance sheet will help them endure these tough times better than the rest of the industry, many of whom have high debt burdens and will be unable to service this debt as cashflow is reduced.

EXTREMELY CAPABLE AND FORWARD-THINKING MANAGEMENT TEAM

Management has historically been very good in building brands; they now have 5 brands with over €1bn in revenues. By using their existing distribution and supply chain structures management has been able to build brands with a strong global presence without spending money on advertising. The management team has been ahead of the curve in terms of using data analytics and technology in enabling better operating performance. Management have also positioned the business very well in terms of their multi-channel offering and have been much better prepared for the structural shift in retail to online.

While we sympathize with everyone who has become ill and wish the world a speedy recovery, the Covid-19 virus has caused a market sell off with even good businesses with solid balance sheets becoming attractively priced. This enables Cadiz Asset Management to invest your capital in businesses which meet our quality, management and financial risk criteria while still providing attractive long-term returns.