# Truworths – Priced well below true worth

Cadiz Asset Management seeks to find above-average quality businesses that are well managed, with low financial risk trading at an attractive price, which increases the likelihood of good long-term returns and low risk of permanent capital loss. Truworths can be classified as such a business.

## THE POOR RETAIL ENVIRONMENT HAS IMPACTED TRUWORTHS' PROFITS CAUSING INVESTORS TO SELL THE SHARE

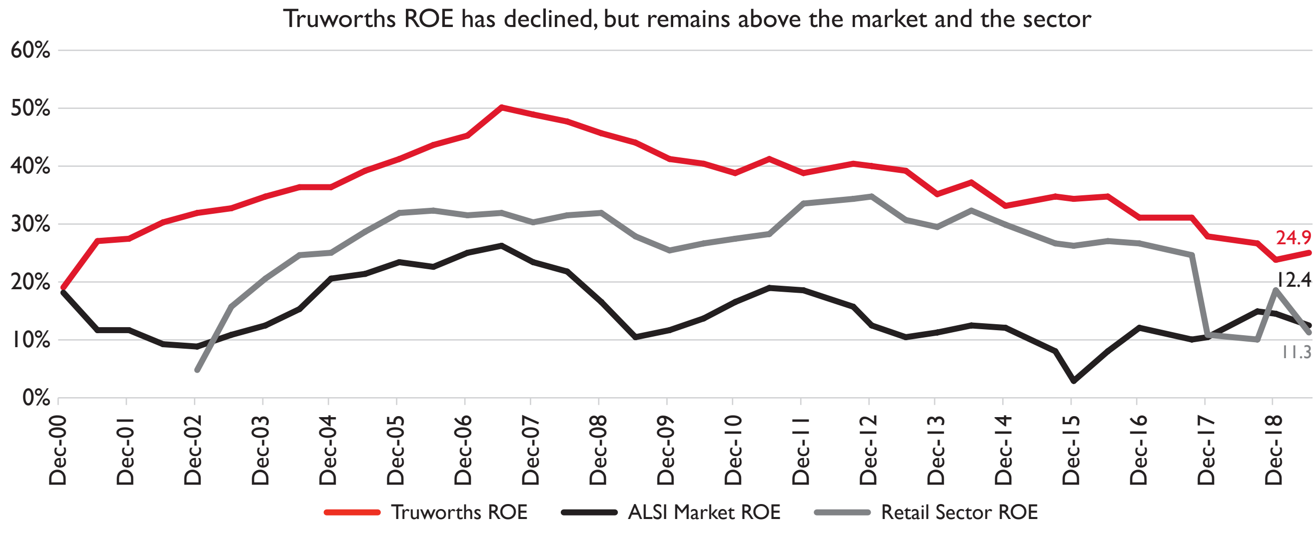
### Truworths Africa (97% of sales come from South Africa and makes up 73% of Group revenue)

Truworths Africa has been experiencing below-inflation revenue growth. This is due to the combination of a low economic growth environment, high unemployment, increased competition, rising living costs, and higher VAT that has constrained local consumers' disposable income and decreased their spending power.

### Truworths UK ("The Office" makes up 27% of Group revenue)

The UK retail environment is not much better. It has been impacted by continued uncertainty in the wake of Britain's decision to withdraw from the European Union which has resulted in a weak economy, low consumer confidence and a slowdown in consumer spending. This has resulted in decreased footfall into malls. At the same time, the growth of online shopping has also reduced physical store sales.

## TRUWORTHS INTERNATIONAL LONG-TERM RETURN ON EQUITY (ROE)




Source: Bloomberg, Cadiz Asset Management

The poor retail environment and fashion missteps has forced Truworths to discount products which has caused profits to decline. Despite this, returns on capital within Truworths Africa remain above the market and the sector. This is because management have managed costs well throughout the economic downturn.

## TRUWORTHS HAS AN OUTSTANDING LONG-TERM TRACK RECORD OF SUPERIOR RETURNS

Truworths has consistently generated return on capital greater than its cost of capital which indicates value creation for its shareholders. Additionally, Truworths has shown the ability to compound its revenue and net profit at impressive rates over the longer term. This has been achieved by sustaining higher margins relative to competitors.

We believe Truworths can maintain this premium margin due to their ability to source products at a lower price and astutely manage their operating costs. Historically, consumers have been willing to pay a higher price for Truworths products because of their perceived superior quality. Although there is increased competition, Truworths continues to invest in its Brand to maintain its market position.

## EXPERIENCED MANAGEMENT TEAM THAT HAS EXPERTLY GUIDED THE BUSINESS

The management team has been involved in Truworths for decades, so they have been through many business cycles and have a wealth of experience. They have a good track record in terms of capital allocation and have grown the business organically without engaging in value destructive merger and acquisition activity. Furthermore, they have shown time and again their incredible ability to contain and cut costs, which has protected the company's margins over time.

- **Investing in the company's online platform:** The management team has invested over R300 million in upgrading and improving Truworths Omni-channel capabilities, which positions the company favorably for the coming years as consumers increasingly shop online. Last year, online sales accounted for 10% of total sales for the Group, which continues to grow strongly and offsets muted physical store sales growth.
- **Improving trading densities:** Management are also rationalizing their UK store estate with store closures amounting to 6% last year and a further 7% of store closures expected this year. This shows how management are actively looking for ways to improve the profitability of The Office. They are cutting costs whilst simultaneously driving their online retail presence to take advantage of the shift to online shopping.

## FINANCIAL RISK IS LOW

Truworths has a strong balance sheet with little debt and is unlikely to go bankrupt. Truworths has the capability to trade through this difficult period, while continuing to invest in the business. This should put the business in a strong position to take advantage when the cycle turns and the retail environment improves.

## DIVIDEND YIELD OF 8% PROVIDES A 'CASH-LIKE RETURN', WHILE WE WAIT FOR THE CYCLE TO TURN

We believe that the current share price is low enough such that the probability of losing money is low, while any improvement in the business prospects could lead to excellent returns for investors. There is no certainty in investing, hence we seek opportunities where we are unlikely to lose money if a reasonable worst case scenario occurs but there is tremendous upside if the business is able to return to a reasonable level of growth. The current share price of R47 implies that Truworths earnings will only grow at 1% p.a. forever, which is well below inflation and is too pessimistic. While we wait patiently for the SA and UK retail environment to improve, the business should be able to pay a dividend (dividend yield of 8%), given its strong balance sheet and good free cash flow. When the environment does turn, we should be handsomely rewarded.

By Sahil Gyanda