overberg asset management

WEEKLY REPORT

OVERBERG MARKET REPORT

Tuesday 8th June 2021

IN THIS WEEK'S BOTTOM LINE

Contributed by Gielie Fourie

- We normally avoid the hotel industry as an investment option. City Lodge Hotels is an exception. We have invested in the group in the past and have recently invested in it again. Read more in the Bottom Line.

SOUTH AFRICA ECONOMIC REVIEW

Contributed by Kirk Swart/ Ingrid Breed

- The South African unemployment rate increased slightly from 32.5% in the fourth quarter of 2020 to 32.6% in the first quarter of 2021. This is the highest reading since Stats SA initiated the quarterly labour force data in 2008. The unemployment rate is better than the expected 33.4%. Economists expected that new job seekers in the form of school leavers and graduates will be entering the labour force. Instead, the jobless figure remained virtually unchanged from the fourth quarter at 7.2 million. A more alarming figure is the unemployment rate measured by the broad definition which considers workers that are discouraged and have given up looking for work. This figure increased marginally from 42.06% in the fourth quarter of 2020 to 43.02% in the first quarter of 2021. The number of discouraged workers increased from 2.9 million to 3.1 million effectively leading to the labour force participation rate to decrease.

- New vehicle sales jumped 198% year-on-year to 38 337 units in May of 2021, largely due to a low base comparison from the previous year when strict level 4 lockdown measures were in place. On a monthly basis, new vehicle sales rose 7%. Albeit a welcome jump, it came in below market expectations. Export sales continued their upward momentum during the month, consistent with the rebound in the global economy and consequently higher demand for vehicles in international markets. Looking ahead vehicle exports remain key to the viability of the domestic automotive industry as most original equipment manufacturers have grown their volumes substantially and produce a very high proportion of vehicles for the export market.

- The trade surplus for April came in at R51.2 billion which is mostly unchanged from the R52.6 billion surplus in March. It surpassed market expectations of R31 billion. The trade surplus is

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supported by robust exports. Exports increased 51.5% YTD annualised, while imports increased 11%. Exports to Asia, the country's largest export destination, declined by 1.4%. Imports from Asia fell 10.6%. The year-to-date (01 January to 30 April 2021) trade surplus of R147.83 billion is an improvement from the R4.41 billion deficit for the comparable period in 2020. Exports increased by 213.4% year-on-year whilst imports increased by 25.8% over the same period. The effect on the value of the rand has been impressive. A year ago, the value of the rand relative to the British pound was R21.30. Today it is R18.99, an improvement of 10.8%. Few people would have expected this. It proves the positive correlation between our trade surplus and the value of our currency.

- The seasonally adjusted Absa purchasing managers' index (PMI), which provides a measure of business conditions in the manufacturing sector, rose to its highest level since October 2020. The PMI rose to 57.8 in May from 56.2 the previous month. Four of the five subcomponents in the index were above the neutral 50-point mark, with only the employment index dipping back into negative terrain. The main positive contribution came from new sales orders (60.5 vs 58.7), notwithstanding a dip in export sales. The average PMI recorded in April and May is higher than the average PMI recorded in January and February. It suggests that the sector is on track to record another quarterly expansion. Looking ahead, despite the current business conditions that appear to have improved, the possible third wave of Covid-19 infections and the recent increase in load-shedding predicted for the foreseeable future could weaken activity within the manufacturing sector.

- After reaching a record high of 53.7 in April 2021, the IHS Markit South Africa PMI, which indicates the overall health of the economy and provide insights into other key economic drivers, edged down to 53.2 in May. Despite the slight contraction, it is still signalling that the South African economy continued to grow at a solid pace with new orders rising for the second month in a row, aiding a further solid rise in workforce numbers. Furthermore, output grew at the second quickest rate since October 2014. Despite this, rising cost pressures continued to increase, with input costs increasing at the fastest since June 2016 amid supply-side problems. Encouragingly, confidence towards future output was the second highest in over three years with firms largely expectant of a recovery in economic conditions over the coming year as the vaccine roll-out continues. Workforce numbers increased at the fastest rate since November 2012. The quarter-to-date averages of both the Absa and IHS PMIs are up from the first quarter, suggesting that the economic recovery momentum was sustained through May.

SOUTH AFRICA: THE WEEK AHEAD

Contributed by Leana Kruger

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- GDP Growth Rate, due Tuesday 8 June. GDP is forecast to have grown by an annualised 3.1% q-o-q, down from 6.3% in the last quarter of 2020. On a year-on-year basis, the rate of decline in GDP is forecast to moderate to 3% from 4.1% at the end of last year. From the supply-side of the economy, the momentum will come from mining (up over 16% q-o-q annualised) and domestic trade, accommodation and catering (up over 6%). Positive contributions are also expected from agriculture, forestry and fishing, manufacturing, general government and personal services. These gains are likely to be contained by lower output of electricity, gas and water, transport, storage and communications, as well as finance, real estate and business services. From the expenditure side of the economy, the boost will come from a strongly favourable net export position combined with moderate growth in consumer spending.

- Mining Production, due Thursday 10 June. High commodity prices, coupled with extremely low base effects from April 2020 at the height of South Africa's lockdown restrictions, are the main elements expected to have boosted annual mining production to 105% y-o-y in April. However, it is expected to have weakened 0.5% m-o-m to 4%, down from 4.5% in March 2021, due to seasonal effects, supply constraints and bouts of load-shedding.

- Manufacturing Production, due Thursday 10 June. Year-on-year numbers will be heavily distorted by the low base created by hard lockdown last year with a consensus increase forecast of 88.3% y-o-y. On a month-on-month basis, production is expected to have recorded a slight contraction of 0.3% to 3.1%, down from 3.4% in March 2021.

- The RMB/BER Business Confidence Index, due Thursday 10 June. South Africa's business confidence is expected to remain unchanged at 35 points. At 35 the RMB/BER BCI is a good 30 points higher than during the slump in confidence seen at the height of the Covid-19-induced lockdown in the second quarter of last year. However, business sentiment is likely to remain pressured because of ongoing load-shedding and in anticipation of the third wave of Covid-19 infections that is likely to result in subdued activity in most of the sectors covered.

GLOBAL

Contributed by Nick Downing

- In a historic breakthrough, finance ministers from the G-7 group of nations agreed to a minimum tax rate of 15% for multinational countries, to be levied in the countries in which they operate rather than where they are headquartered. The agreement, which has been worked on since 2013, will prevent businesses from moving their profits to low tax jurisdictions. It would especially benefit the US which loses significant potential tax from its multinational companies. These companies tend to locate their head offices in low tax

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jurisdictions such as Ireland, with a company tax rate of 12.5%. The agreement has been hailed by global leaders as a return to multilateralism. However, it needs to be ratified first by the upcoming G-20 meeting in July and thereafter by the broader Inclusive Framework comprising 135 countries. Some lower tax countries, such as Ireland, may be reluctant to follow the tax treaty. The large multinational technology companies may end up paying more tax but would be compensated by the simplicity of the new tax system, which would replace the wide spectrum of varied digital taxes levied by different countries.

NORTH AMERICA

Contributed by Nick Downing

- The May jobs report was disappointing. Nonfarm payrolls increased over the month by just 559,000 below the consensus forecast of 671,000. Although better than April's showing when just 278,000 jobs were created, the figure pales compared to the 785,000 jobs added in March. The culprits are continued anxiety over Covid-19, the need for childcare while schools remain closed and generous enhanced unemployment benefits of $300 per week, all creating a disincentive to work. While the unemployment rate reduced from 6.1% to 5.8%, many stayed out of the labour pool causing the labour participation rate, measuring the proportion of adults working or actively looking for work, to drop to 61.6%. It was at 63.3% as recently as February. Wages increased by 2.0% year-on-year and by a larger than expected 0.5% month-on-month, fuelling worries over rising inflation expectations. However, wage pressures are likely to be temporary and should ebb with continued vaccination and once enhanced unemployment benefits expire in September. The low labour participation rate indicates significant slack remains in the labour market, and despite the steady increase in payrolls, there are 7.6 million fewer payrolls than prior to the pandemic. In financial markets, the 10-year Treasury bond yield dropped from 1.62 to 1.56% following the release of the jobs data, signalling a paring back in economic growth and inflationary expectations.

- The Federal Reserve is expected to begin informal deliberations over reducing the pace of its purchases of Treasury bonds and mortgage-backed securities. The asset purchases, known as quantitative easing (QE), currently amount to $120 billion per month. According to a New York Fed survey, the consensus forecast from market participants is for the reduction in QE to start at the end of 2021 or early 2022. Last week, the Fed gave its first hint of reducing QE by announcing it would sell the corporate bonds and corporate bond exchange traded funds accumulated in its emergency Secondary Market Corporate Credit Facility, launched in March 2020. Although amounting to just $14 billion, which pales compared to the Fed's $7.3 balance sheet, the move indicates that the pendulum is slowly moving towards an eventual "taper". James Bullard, president of the St. Louis Fed, when discussing the outlook for tapering the Fed's balance sheet, said "This involves in my mind a judgement about when you think that the pandemic has come sufficiently under control that you can start to talk about changing the parameters of monetary policy. It does seem like we're getting close to that juncture." A taper of the Fed's QE programme would likely result in an increase in the 10-year Treasury bond yield, which would affect valuations across asset classes. The Fed will

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want the adjustment to be gradual and guided far in advance in order to avoid a repeat of the 2013 “taper tantrum”, when the 10-year yield spike higher by 100 basis points over just two months, prompting a riot in financial markets.

- The Beige Book, an anecdotal summary of business conditions across the US published eight times a year, was upbeat in its description of general business conditions in the period from early April to late May. According to the report the national economy expanded at “a somewhat faster rate than the prior reporting period. Several Districts cited the positive effects on the economy of increased vaccination rates and relaxed social distancing measures.” However, the report also described the adverse effects of supply chain disruptions, and labour and material cost pressures. Accordingly, survey “contacts anticipate facing cost increases and charging higher prices in coming months.” Domestic demand is expected to remain buoyant, potentially keeping upward pressure on prices, even after temporary supply chain disruptions are resolved. Business and household balance sheets are in rude health, helped by the wealth effect of government fiscal stimulus, and surging equity and residential property markets. Moreover, balance sheets were in good health when they entered the pandemic induced recession, a marked difference to usual cyclical recessions. Household debt service costs as a percentage of income are at their lowest since 1980. Banks are well capitalised, with their capital adequacy ratios at their highest since 1996.

JAPAN

Contributed by Carel La Cock

- Business conditions in Japan have kept the course set in March according to April’s Business Conditions Indices. The Cabinet Office kept its assessment of the coincident index, a measure of current business conditions, as “Improving” indicating favourable business conditions for the second consecutive month. All three composite indices; Leading (+0.6), Coincident (+2.6) and Lagging (+0.2) improved, whilst the diffusion indices, a measure of the proportion of indicators improving, Leading (77.8), Coincident (75) and Lagging (100) were all significantly above the key 50-level. The improvement, although broad based, weakened from the month before and echoed the latest survey results from the private sector services sector which also showed that the recovery slowed due to the resurgence in covid-19 cases and the stricter measures put in place. Businesses are confident that the pandemic will end in the coming year and IHS Markit forecasts that the economy will grow by 2.6% in 2021.

EUROPE

Contributed by Carel La Cock

- Eurozone inflation has overshot the European Central Bank’s (ECB) target of just below 2% for the first time in more than two years. The preliminary estimate released last week showed

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that inflation was 2% in May which has sparked debate amongst investors over a potential tightening in monetary policy. Christine Lagarde, ECB president, has allayed fears saying that the surge in prices will be temporary, a sentiment shared by many of the ECB policymakers. They predict that inflation pressure will ease by next year and that it would be premature to tighten monetary policy now. Much of the spike in prices was driven by a sharp rise in energy prices, rising by 13.1% year-on-year. Stripping out the volatile energy and food prices, core inflation was only marginally higher in May rising by 0.9% compared to 0.7% in April. Prices in the services sector, which has been more heavily impacted by resurgences in covid-19 infections, rose 1.1%. The pressure on wage growth remains weak due to widespread job losses during the pandemic and many employees being put on furlough schemes. Economists do not expect wages to rise significantly during the remainder of the year. Although unemployment has fallen in recent months there are still 1.3 million more people unemployed than a year ago. Inflation will be a hot topic in the months ahead, but for now at least the consensus view is that there is nothing to worry about, just yet.

UNITED KINGDOM

Contributed by Carel La Cock

- The effects of ever-increasing input delivery lead times in manufacturing and a global shortage in semiconductors are being played out in the second-hand car market in the United Kingdom. Prices have surged in recent months as demand for new cars has outstripped supply and consumers are turning to the second-hand car market to bridge the gap. For example, prices on 2020 petrol SUV models are now only 5% below the cost of new models compared to 18% below new models last year. The trend is also being observed in Germany and the US and economists fear that it will add to inflationary pressure. The phenomenon is partly fuelled by a surge in demand for luxury cars as many consumers who retained their jobs and were able to save more due to travel restrictions, are now splurging on luxury cars, but there is also a demand for additional vehicles in households wishing to avoid public transport. However, the shortage in chips used in many components of all vehicles has caused a significant drop in the supply of new cars. The semiconductor shortage has been exacerbated by increased demand for consumer electronics as well as incidents at some of the world's leading chip manufacturers. It is expected that car manufacturers will produce 1 million fewer cars globally this year as a direct result of the shortage in semiconductors. Carmakers are considering abandoning their "just-in-time" strategy in favour of stockpiling chips which will increase their input costs and potentially lower their margins. Elon Musk, CEO of Tesla, is considering pre-payment for chips to secure a steady supply and even looking at buying a chip manufacturing plant outright. The shortage of semiconductors is expected to last for another 12 months and any investment in new production capacity will only bring relief in two years as the facilities are extremely complex to build.

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KEY MARKET INDICATORS (YEAR TO DATE % AND LEVEL)

JSE All Share	+ 13.75	67575
JSE Fini 15	+ 11.82	13486
JSE Indi 25	+ 12.44	87592
JSE Resi 20	+ 14.27	65794
R/$	+ 8.75	13.51
R/€	+ 8.99	16.47
R/£	+ 4.84	19.15
S&P 500	+ 12.53	4226
Nikkei	+ 5.74	29019
Hang Seng	+ 5.71	28787
FTSE 100	+ 9.55	7077
DAX	+ 14.28	15677
CAC 40	+ 17.87	6543
MSCI Emerging	+ 6.92	1380
MSCI World	+ 11.56	3000
Gold	+ 0.19	1897
Platinum	+ 9.47	1171
Brent oil	+ 38.78	71.89

BOTTOM LINE

Contributed by Gielie Fourie

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- CITY LODGE HOTELS: In August 1985, at a time when even mentioning the words “budget hotels” was frowned upon, Swiss-born Hans Enderle opened the first City Lodge Hotel in Randburg, now called City Lodge Hotel Bryanston. This singular event, and a young Enderle’s vision of opening a chain of selected and limited services budget hotels, changed the face of the hotel industry in South Africa forever. Enderle executed his vision with Swiss precision. Little did he know that three decades later his first City Lodge Hotel would be the beginning of a truly exceptional hospitality success story. His financial backing came from the Mining Pension Fund. Enderle picked up the idea of limited-service hotels in the US. Locally he did his own research by talking to guests. He identified a gap at the bottom end of the pyramid - and took it.

- HANS ENDERLE: Enderle was a visionary and an outstanding motivator who set the highest standards and always applied them to himself first. He always treated his co-workers with high respect, obliging them to live up to his expectations. He was always enthusiastic and embraced new ideas, based on his professional knowledge, and he knew how to challenge his team to achieve ambitious goals. The most remarkable characteristic of Hans Enderle was his ability to bring out the best in others and his ethical consistency. His clever marketing slogan, "Why pay more?", proved that he knew what the market needed, and he made it happen. He made sure his success was the success of all who worked with him, never at their expense. Enderle passed away in 2019. The present CEO, Andrew Widegger (54), is only the third CEO in the history of City Lodge. He is a CA (SA) and has been with City Lodge for 26 years.

- EXTENDING THE CITY LODGE RANGE: City Lodge can be described as upper mid-scale three-star hotels. Enderle also opened two-star Town Lodges and one-star Road Lodges which were true economy class hotels. Two upscale hotel brands were also introduced, namely Fairview Hotels and Courtyard Hotels. The total number of hotels today are City Lodge 20, Town Lodge 14, Road Lodge 22, Fairview 1, and Courtyard 5. The total number of rooms is 7,902. There are two more hotels in the pipeline – a City Lodge Hotel in Maputo (it opened in February 2021, but 26 more rooms will be added after the Covid 19 lock-down) and a Courtyard Hotel at Waterfall City. Two hotels are up for sale – one in Nairobi, Kenya and one in Dar es Salaam, Tanzania. These two hotels are upmarket and are located in prime spots.

- CONSTRUCTION COSTS: On 12 March 2018 City Lodge shares traded at an all-time high of R169.00. Currently they are trading at R4.00 per share. With a market capitalisation of R2.4 billion and 7,902 rooms, this equates to R303,700.00 per room. The construction cost of a new three-star hotel room is at least three to four times this amount. The hotel industry is highly capital intensive. Hotels need an occupancy rate of around 60% to break even – they need “bums in beds” to survive. An empty room can only be sold tonight – it cannot be sold tomorrow night. The business sectors that are expected to benefit most from a reopening of the economy are Bookings, Entertainment, Accommodation, Cruises and Hotels (BEACH).

- THE IMPACT OF COVID-19: Covid-19 had a big negative impact on City Lodge’s trading figures. In the year to 30 June 2020 revenue was R1.16 billion (2019 R1.55 billion). Normalised diluted Headline Earnings per Share (HEPS) dropped from 613.4 cents to -26.3 cents, a drop of 104%.

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Dividends per share dropped from 366 cents to 153 cents, a drop of 58%. No dividends will be declared for the 2021 financial year. The total debt on 30 December 2020 was R530 million. Two four-star hotels in East Africa are up for sale. If they could raise R1 billion, the debt could be wiped out. On its own it is a big moat.

- FEEDBACK FROM MANAGEMENT: The CEO of City Lodge Hotels, Andrew Widegger, wrote the following in response to our question on his vision for the future: "Our short-term vision is to recover to profitability within the next 6 months and put ourselves on a sustainable path to pre-Covid profitability levels and beyond. We will continue with the roll-out of our new Best Available Rate philosophy and Artificial Intelligence (AI) predictive analytics tool to better predict demand so as to achieve optimal REVPAR (Revenue Per Available Room) yields, and we will continue with our increased focus of identifying new Food and Beverage revenue opportunities and leveraging technology to improve productivity and the guest experience".

- THE ROAD TO RECOVERY: For hoteliers and restauranteurs Covid-19 has rushed through the industry like a flood. Continued Covid-19 lockdowns are still negatively affecting the five BEACH industries. These industries are considered non-essential. Staff have been laid off - many hotels and restaurants have been put out of business. The road to recovery is vaccine dependent. The sooner government can get our population vaccinated and achieve herd immunity, the sooner the economy will recover. As hotels reopen, aggressively priced room rates to achieve high occupancy could negatively impact profitability. For hotels, hygiene and safety are non-negotiable – they are critical factors in generating future demand. We are confident that City Lodge Hotels will survive the pandemic and emerge from it better than its peers. Even after Covid-19 its balance sheet is still strong. It will take time to return to normality and profitability. In times like this, Hans Enderle's vision of budget hotels is more relevant than ever. At R4.00 per share there is much upside potential.

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