overberg asset management

WEEKLY REPORT

OVERBERG MARKET REPORT

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Global

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Generating returns when bonds fail

Bonds are not fulfilling their traditional role as risk diversifiers in balanced portfolios. The traditional balanced portfolio asset allocation between equities and bonds is 60:40. When equities tumble bonds usually rally, providing effective risk diversification. However, most government bonds such as US Treasury bonds, have become very expensive and are trading at negative real yields, which is a poor starting point for investors, especially when the Federal Reserve and other major central banks are about to embark on their most aggressive interest rate hiking cycle in 40 years. The imminent onset of quantitative tightening, when the Fed runs down its accumulated holdings of Treasury bonds by selling $100 billion per month onto the market, will apply further pressure on bond prices. Damage is already being wreaked on bond portfolios.

Year-to-date Treasury bond losses are the worst in decades, almost as bad as the 11% or so decline in the S&P 500 index, causing many strategists to question whether Treasury bonds may have lost their traditional role as risk diversifiers. Alternative asset classes can fill the gap left by bonds. A suitable alternative asset class is renewable energy. Renewable energy providers are especially favoured by the oil and gas supply shock stemming from the Ukraine war and Russian sanctions. Renewable energy prices have the added attraction of insulating against rising inflation as many pricing contracts are inflation linked. Moreover, global financial markets are placing a premium on ESG investments. Decarbonisation is expected to be a winning long-term investment theme over the coming decade.

Our clients' global balanced and income portfolios benefit from the inclusion of Greencoat UK Winds plc, which trades on the London Stock Exchange under the ticker UKW. UKW is the largest listed renewable energy investment company in the UK with a market capitalisation of around £2.5 billion and is a constituent of the FTSE 250 index. The company invests in land-based and offshore UK wind farms. Investors are rewarded by a healthy 5% dividend yield. In addition, management aims to preserve capital on a real basis by reinvesting excess cashflow and prudent leverage in additional wind power assets. The business model is in a sweet spot, benefitting from the acceleration in global decarbonisation and from the "reflationary" trade, with the prospects of rising global inflation suiting UKW's inflation-linked power contracts.

UK electricity prices have risen sharply in line with the surge in oil, coal and gas prices. The trend of rising inflation and power prices is expected to persist for some time. UK forward power prices for Summer 2022 and Winter 2022/23 are up significantly compared with just 4 months ago, by around 70% and 40%, respectively. A substantial portion of UKW's output is unhedged, which means it will benefit from the power pricing windfall.

How has the performance of UKW stacked up year-to-date versus the S&P 500 index, which at time of writing (25/4/22) has dropped 10.94%, and the iShares US Treasury Bond ETF, which has lost an astonishing 9.16%. With bonds and equities exhibiting unusual but potentially protracted positive correlation, generating positive returns that exceed cash is no mean feat in the current environment. The UKW share price has gained a solid 7.1% YTD, which excludes the additional 5% annual dividend yield. The share not only provides a refuge from increasingly over-valued equity markets with far better returns than cash but will also flourish from the drive towards decarbonisation, which the war in Ukraine will undoubtedly accelerate.

LOCAL

Gielie Fourie

Adding MTN to clients' portfolios

INTRODUCTION: We recently added MTN to our portfolios. The main motivations for our decision were MTN's strong performance in Africa, especially in Nigeria, its exit from Middle Eastern countries, its venture into fintech and its improved balance sheet. MTN is growing and management is making excellent capital allocations.

MTN AND VODACOM: MTN listed on the JSE in 1995 as the second cell phone operator in South Africa. Vodacom was our first cell phone operator. MTN would always play second fiddle. MTN realised that the telecoms business is very capital intensive - not dissimilar to mining. Having scale is important. Drastic increase of units (users) would drive down unit costs. MTN's strategy to reach more subscribers was to expand beyond our borders into Africa and the Middle East.

MTN STRATEGY: CEO Ralph Mupita says MTN's strategy is to be the number one or number two player in any market. An example is South Africa where Vodacom has 44 million subscribers, while MTN has 30 million subscribers. Cell C and Telkom together have only 29 million subscribers. Being number three in the industry makes it tough to make the economics work. Being number one or two in the industry provides a barrier to entry, or a moat around your business.

MTN IN AFRICA: Expansion into the rest of Africa was successful. MTN later listed in Nigeria, Ghana, Rwanda, and Uganda. Unfortunately, expansions to the Middle East were fraught with legal challenges and massive fines. MTN eventually divested from the Middle East. After MTN made the decision to exit the Middle East, its strategy was to grow its network in Africa and become an entirely Africa-focused operation. Nigeria is by far the largest country in Africa in terms of population, with more than 211 million people in 2021. In terms of Fintech, it is the market to be in. Given its large and developing population, Africa is currently an untapped fintech expansion opportunity. Compared to other regional markets, the rise of fintech is not disrupting established traditional banking and payment practices; instead, it is building a new system from the ground up. The future of telecoms lies in selling data, rather than cell phone time (voice), and entering the lucrative fintech business. MTN has obtained a full FinTech licence in Nigeria. MTN Nigeria's growth in both Data and FinTech business last year was 35%.

FINANCIAL: MTN was founded in 1994. Within 28 years it has grown into one of the biggest companies in South Africa. It is the eleventh biggest company on the JSE. It has a market capitalisation of R326 billion (bn). Some of the top ten companies on the JSE are more than 100 years old. In 2021 subscribers increased by 2.9 million. With 283 million subscribers it is the biggest cell phone company in Africa. Annual sales for 2021 were R181 bn. Profit after tax was R17 bn (2021). Its forward PE ratio is 13.4. The dividend yield is 1.7%. MTN is profitable. Headline earnings for 2021 were 987 cents per share, up 31.8% from the previous year. Return on equity (ROE) improved to 19.6% (up 2.6pp). MTN has a strong balance sheet. Interest debt is R65 bn. Cash is R40 bn, leaving a net debt of only R25 bn. The company makes an annual profit of around R20 bn, which should take care of the debt without problems. It is also in the process of selling non-core assets. The proceeds will be used to pay down debt. MTN's debt has an investment grade rating.

CONCLUSION: We feel MTN is fairly valued and has attractive growth potential in the 19 markets it operates in. Nigeria has the potential to deliver strong revenues. Both the FinTech business and fibre business (with 100,000 km of fibre) will be separately listed in 2022 and 2023 respectively. This will further unlock value.