OVERBERG MARKET REPORT

Tuesday 23 May 2023

Global Report

Nick Downing

A star performer in uncertain times

3i Group, London listed share and constituent of the FTSE 100 index, has been a star performer during these uncertain times. The share price is up 44% since the start of the year, 51% over the past 12 months and 133% over the last 3 years. 3i is a leading international private equity investment company, specialising in investments in Europe, UK, and North America. Its market capitalisation of £18.9 billion makes it one of the world's largest listed private equity companies. It listed on the London Stock Exchange in 1994.

The group's private equity investments are made from permanent capital, which means it has no need to raise additional funds. It has a strong balance sheet, and all running costs are covered by cash income, which puts the group in a strong position and allows it to take a long-term approach when selecting its private equity investments and holding back when appropriate. Only 5% of its current portfolio is made up of investments made during the excessively priced markets of 2020 and 2021.

The jewel in 3i's crown is Action, a European based non-food value-for-money retailer. Action used to comprise 25% of 3i's portfolio net asset value (NAV) as recently as December 2016. The strength and resilience of Action's franchise, the rapid rollout of new stores and margin expansion have steadily compounded its value so that it now makes up 66% of 3i's NAV. 3i's management refer to Action as a "compounder". It is easy to see why, posting an annual gross investment return of 57% over the 9-year investment period. However, the remainder of 3i's portfolio has also done well, posting an average annual gross return of 18% over the same time span. Portfolio investments are focused on the consumer value-for-money, private label healthcare and infrastructure sectors.

Recent results support the share price. In the financial year to 31st March 2023, 3i's NAV increased by 32% backed by strong underlying performance throughout the portfolio. Financial markets have been slightly sceptical of some private equity valuations especially in the current environment of rising interest rates and tightening credit markets. However, 3i has a long- and well-respected track record in its valuation approach, which is considered conservative. Recent investment disposals have been at consistent uplifts to reported value. In the financial year, two investments were sold at 50% and 45% respectively above reported value. Action is valued roughly in line with its US peer group, which is reasonable given its growth trajectory, while the bulk of 3i's remaining investments are valued at a discount to listed market peers, despite the faster growth that is anticipated from smaller private equity holdings.

Overberg Asset Management bought 3i for its private client global portfolios in January 2019. The share had long been on OAM's radar and the purchase coincided with a period of share price weakness when 3i was excluded from the Stoxx Europe 600 index and FTSE All World index from 21st December

2018 following its reclassification from a Specialty Finance Company to an Equity Investment Company. This resulted in the forced selling of a substantial number of shares by passive investment funds. The share price weakness, which ensued purely for technical reasons, created a unique opportunity to add the share to our clients' portfolios. It was a bargain at £8.24 compared with £9.53 just 4 months prior.

The share price is now £19.53 backed by a portfolio that is resilient to the cost-of-living crisis. 3i's price appreciation has made it the largest holding in OAM's client portfolios. It is now around 60% above model weightings across our Growth, Balanced and Defensive portfolios and begs the question: Should we continue to "run the winner" or is it time to rebalance portfolios and trim back to model weighting. Turning first to Action: Action is experiencing a consistent increase in shoppers and sales across all countries and categories. The value-for-money offering is appealing to customers and new stores are being rolled out at a rapid pace, generating strong sales growth and significant economies of scale. Action believes it can continue increasing the number of its stores at an impressive pace of 300 per year for the next 10 years.

There may also be other compounders in the future. 3i CEO Simon Borrows is confident about the outlook: "Our portfolio has been carefully assembled and its resilience and consistent financial performance in recent years reflects the benefits of thematic investing, disciplined pricing, and active asset management. No portfolio company reflects this approach better than Action, which continues to be 3i's largest and most resilient portfolio investment. We are now focused on developing a select number of other companies to fulfil their potential to also become long-term compounders for the Group."

3i Group shares have moved higher since the most recent results and while not as cheap as they were 6 months ago when still trading at an unusual discount to NAV, the current premium is only 10% compared with the long-term average of 15% and a higher premium may be warranted given the rapid growth in earnings of the underlying investments. Analysts have in the past projected fair value estimates for the share price of as much as 1.5x NAV. OAM would certainly rebalance the share's weighting if it approached that level, but in the meantime, we are happy to run the winner.

Local Report

Gielie Fourie

Transaction Capital

THE RISE OF TRANSACTION CAPITAL (TCP): TCP is a young company. It was founded in 1999 by Michael Mendelowitz, Jonathan Jawno and Roberto Rossi. The company initially focused on providing specialist lending to the taxi owners – in short, a specialist taxi financier. Over the years, TCP expanded its operations and diversified its offerings. It acquired various companies in sectors such as debt collections, credit risk management, and financial technology.

Nine years later, David Hurwitz joined them in 2008. In that year they approached African Bank, which owned SA Taxi. TCP's first big deal was acquiring SA Taxi in 2008 from African Bank. This made TCP big enough to lead to a listing on the Johannesburg Stock Exchange (JSE) in 2012. TCP was only 13 years old when it listed on the JSE through an initial public offering (IPO). The company focused on developing innovative technology-driven solutions to address the evolving needs of its clients.

The IPO allowed the company to raise capital and provided an opportunity for public investment. In 2012, TCP operated through its two main divisions: (1) SA Taxi and (2) Transaction Capital Risk Services (TCRS). SA Taxi provided a range of financial services to the minibus taxi industry, including vehicle finance, insurance, and maintenance solutions. TCRS specialized in credit risk management, debt collection, and related services across various industries not related to the taxi industry. On 1 July 2012 TCP was trading at R7.00 per share.

Eight years later, in September 2020, Transaction Capital did its biggest deal ever when it acquired 49.9% of WeBuyCars (WBC), an even younger company, from the Van der Walt brothers, Faan and Dirk for R1.8 billion. A year later, in September 2021, TCP acquired a further 24.9% for R1.6 billion giving them control over WBC. Transaction Capital has shown significant growth and expansion over the years, but WBC really fuelled growth post 2020. From 2012 to 2021 the share price multiplied more than seven times to R50.00, making it a seven-bagger stock.

WeBuyCars: WBC is a second-hand car dealership that was established by the two Van der Walt brothers, Faan and Dirk, in 2001. WBC managed to thrive in an otherwise unattractive industry by firstly focusing on the space between two markets (namely private sellers of vehicles and dealerships), and, later, expanding into complimentary activities and markets. By introducing activities that added value for customers and by removing transaction costs for customers, WBC created a "blue ocean" market for three different customer segments: sellers of cars, private buyers of cars, and dealerships that buy cars. WBC has been tremendously successful in the South African used car market; it has an extremely powerful and trusted brand and commands an 8% market share. Since its establishment in 2001, WBC has grown on average by 50 to 60% per annum for the last 19 years. WBC was so successful that it was the subject of a case study by students at the Harvard Business School in 2022.

BLUE OCEAN STRATEGY is the simultaneous pursuit of differentiation and low cost, to open a new market space and create new demand. It is about creating and capturing uncontested market space, thereby making the competition irrelevant. It is based on the view that market boundaries and industry structure are not a given and can be reconstructed by the actions and beliefs of industry players.

THE FALL OF SA TAXI: We expected Covid-19 to critically affect the economy. What we did not expect was how critically Covid would hit the taxi industry. The taxi industry was hit by a perfect storm of high inflation followed by interest rate increases, more expensive vehicles, increases in fuel prices, while consistent load-shedding has led to increased traffic congestion resulting in fewer trips. Covid regulations forced taxis to load fewer passengers per taxi. In addition, higher unemployment also leads to fewer passengers, who are highly resistant to fare increases. TCP has derated meaningfully over the past 12 months. Yet the directors did not share information with its shareholders.

It was only on 13 March 2023, after the markets closed, that the directors broke the news. They said they expected core earnings per share from continuing operations to fall by more than 20% in the half-year to end-March, but by no more than 50%. The share listed at R7.00 in 2012, it hit a high of R50.00 in April 2022, and is now back to R7.00. The impact of the perfect storm, combined with the directors' lack of communication, had significant repercussions for SA Taxi and its shareholders.

Shareholders have the right to be informed timely about the state of the company and any factors that may affect its financial health. It is generally expected that companies provide regular updates and disclose relevant information to their shareholders in a timely manner, especially during challenging times.

We hold TCP in our client portfolios. We have discussed the situation at length. TCP is now trading at R7.00. We feel that the downside is R7.00 and that all the unwelcome news has already been priced in. WBC is still a good business, but it is experiencing margin squeeze and more competition from more competitors. The lending business, now called NUTUN, (for Sir Isaac Newton) is healthy. Both businesses have good potential, and both have offshore exposure.

BOTTOM LINE: The market is panicking about the balance sheet. It will take time to recover. Perhaps the selloff was overdone. The directors showed their support for TCP by investing more than R60 billion in TCP shares since March 2023. While the company will continue to face near-term headwinds as it battles the simultaneous repositioning of SA Taxi and a downturn in the used vehicle market, we continue to view Transaction Capital as having a very strong growth profile longer term. We decided to keep TCP. Please use this information as a reference only, rather than as a basis for making investment decisions. You are welcome to contact one of our friendly consultants for a free consultation.