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WEEKLY REPORT

OVERBERG MARKET REPORT

Tuesday 17 October 2023

Global Report

Nick Downing

Enter the Dragon

We are in the year of the Rabbit, which for China's CSI 300 equity index has not been especially auspicious. The index has dropped 6.4% year-to-date, amid extreme negativity from global investors. The property market is depressed, Xi Jinping is steering towards increased socialism, and the post-Covid recovery has fizzled. Jinping cemented his leadership for an unprecedented third 5-year term last year. His most controversial policies include crackdowns on the private sector, in particular internet, gaming, and online education. He has also forced the deleveraging of China's all-important property sector, which comprises an estimated 74% of household wealth. The policy has burst China's property bubble. The pre-financing model used by property developers, which required prices to keep rising, has been broken. Property developers have been going insolvent, starting with the giant, Evergrande two years ago, and most recently Country Garden, the largest in the private sector with about $200 billion in liabilities is struggling to survive.

It is ironic that foreign investors have been clamouring for years for a restructuring of China's economy away from its dependence on property and infrastructure investment spending. Now that it is happening, there appears to be little applause despite the obvious tilt to a more sustainable consumer led economy. Foreign investors have been pulling out of China at a record pace. Yes, the property market is depressed. Housing sales are 22% down from last year and new housing starts down by 29%, while the inventory of unsold homes is at an all-time high, signalling a long adjustment ahead. Yet, property prices have not crashed. They are only 5-10% below their peak and while new home sales have collapsed, existing home sales are only down by 10-15% The deleveraging of China's property sector is far more controlled and less damaging than the US property crisis in 2008/09.

With the property sector in the doldrums, which traditionally comprises 25% of GDP it is no surprise the post-Covid recovery has been weaker than expected. Exports, key to China's growth, have also contributed little due to weakening global demand. This is a cyclical factor beyond China's control. Meanwhile domestic industrial and consumer demand is showing signs of picking-up. Official manufacturing and services purchasing managers' indices (PMIs) gained ground in their August readings: Manufacturing from 49.7 to 50.2, above the expansionary 50 level for the first time since March and Services from 51 to 51.7. Both the official and independent composite PMIs, comprising all economic sectors, have been in expansionary mode for nine successive months. GDP growth is on track to meet the government's 5% target in 2023. Next year's growth is expected to slow as the country continues to adjust to a more sustainable consumer led growth model. The World Bank and IMF forecast growth of 4.4% and 4.2% respectively in 2024, far slower than in previous years but nonetheless solid in the global context.

The greatest hindrance to investor sentiment must be government's ideological pivot from market-oriented growth to the "common prosperity" and increasingly isolated "new whole-nation system." Government's private sector crackdowns have undermined domestic business and consumer confidence, as well as foreign investor sentiment. It is clear though that Beijing cares very much about economic growth and like previous governments will not be too proud to admit past mistakes. Independent research firm Alpine Macro reminds us that "The Communist Party has engineered massive directional changes in its ideologies throughout history. Beijing is aware of the damage to the private sector and has been trying to revive business confidence. It is premature to conclude that the current left turn is permanent." Deng Xiaoping's famed "southern tour" in 1992 and Jiang Zemin's "Three Represents" theory in 2000 are key examples of policy adjustments that unleashed dramatic growth.

Xi Jinping's government is quietly promoting the stock market as an alternative source of wealth for households. There has long been a negative correlation between the performance of property prices and the performance of the stock market. They have rarely performed well at the same time but as one declines the other tends to pick up the slack. They have traditionally been competing asset classes. With property accounting for 74% of household wealth, above any other country in the world (US:52%), and financial assets making up only 11% of household wealth compared with an average of 30% or more in other countries, there is scope for a significant pendulum swing. There have been 200 new listings on the Shanghai Stock Exchange this year, with particular focus on new economy sectors, including semiconductors, biotech and electric vehicles, hi-tech manufacturing, and renewables.

China is already a global leader in Artificial Intelligence. AI is set to have a transformative effect on economic growth with the benefit of enhanced productivity. Today, Chinese technology giant Baidu unveiled the newest version of its generative AI model, Ernie 4.0, claiming that its capabilities are equal to those of ChatGPT's latest model. Meanwhile, China's renewable energy and Electric Vehicle markets are booming. China is the undisputed leader in the EV market representing 60% of global sales. 30% of the cars on China's roads are EV.

It is often worth considering a contrarian investment position, especially when there is such overwhelming negativity. Alpine Macro says "Recall lessons of the late 1990s Asian crisis: panic produces the best bargains long before the crisis ends… The best bargains were available in the first year of the crisis, 1997." As the year of the Rabbit ends on 9th February, the year of the Dragon, the rarest and most auspicious of all Chinese zodiac signs will be expected to usher in a period of luck, success, and good fortune.

Local Report

Gielie Fourie

October - Transport Month, and Motus Review

TRANSPORT MONTH: Since 2005, October is Transport Month in South Africa. Transport Month is about showcasing service delivery and reminding the nation of the significance of transport in our daily lives. Naamsa is a pre-eminent industry representative that represents the interests of local vehicle

manufacturers and assemblers. Naamsa hosted the South African Automotive Week (SAAW) from 11-13 October 2023 at the Gallagher Convention Centre in Midrand.

VEHICLE EXPORTS AND SALES: Various external business factors, including higher fuel prices, high inflation, ongoing challenges in transport logistics, Eskom's incapacity to meet industry's energy demands, the volatility in commodity prices, and the intricate external environment, have exerted significant pressure on the automotive industry. Despite these challenging conditions, the industry has displayed a modest yet commendable resilience from January to September this year. Vehicle exports for the year-to-date (YTD) are 8.3% ahead of the same period last year, at a total of 285 200 units. New vehicle sales for the YTD are 2.5% ahead of the same period last year, recorded at 401 315 units. Although the South African Reserve Bank maintained the repurchase rate at 8.25% in September 2023, the automotive industry continues to grapple with concerns over consumer affordability.

ECONOMIC CONTRIBUTION OF SA AUTOMOBILE INDUSTRY: The automotive industry contributes 4.9% to GDP. In 2022, the export of vehicles and automotive components reached a record amount of R227 billion (bn), equating to 12.4% of South Africa's total exports - the industry accounts for 21.7% of the country's manufacturing output. Vehicles and components are exported to 152 international markets. The industry is responsible for approximately 457 000 jobs.

MOTUS: We hold Motus for our clients. The year ending June 2023 was a special year for Motus. For the first time sales for the year crossed the R100 billion mark. Sales were R106bn for the year, up from R92bn the previous year. Motus sells Hyundai, Kia, Mitsubishi, and Renault vehicles. Toyota is by far the top seller in SA, Motus is second and Volkswagen (VW) third. Toyota sells more passenger vehicles than Motus and VW combined. YTD Toyota sold, with last year's figures in brackets, 104 300 (91 716) units, Motus 57 595 (69 077) units and VW 49 567 (52 810) units. This includes all vehicles from passenger and commercial vehicles to buses. Vehicle sales are cyclical and have been in a downward cycle for seven months, and the fact that interest rates and inflation were high did not help. At the end of September, on a 3-month moving average, total new vehicle sales were down 2.0%.

Motus has recently published its financial results for the year ending 30 June 2023. While Motus' results were mixed, they were achieved in a difficult financial year for the vehicle industry. There was a slowdown in vehicle volumes. Motus's slowdown in sales and high debt levels are a concern. Key financial highlights: revenue was R106bn, profit before tax was R4.3bn, 3% down from 2022, net asset value per share was R101.89, up 25% from 2022, diluted headline earnings per share were R19.63, a little up from R19.25 per share last year, and the dividend was R7.10 per share, the same as last year. Debt increased from R4bn last year to R12bn in 2023. The net debt to equity ratio is high at 77%, up from 36% last year. This is a concern – we prefer companies with low debt levels. The reasons for the significant increase in debt include higher working capital levels - up from R7bn to 14bn, re-fleeting of rental vehicles – rental vehicles were de-fleeted during Covid-19, and debt incurred to finance acquisitions and capex.

As indicated above, net debt to equity is high at 77% - it has doubled from 36% last year. To understand, and visualise debt better, we also compare debt with annual profits. Last year debt was standing at R4.2bn, while annual profits before tax was standing at R4.4bn. On paper, Motus could pay off the capital portion of its debt within one year. In 2023 profit is still R4.4bn, but debt has jumped by R8bn to R12bn. Although the debt-to-equity ratio has doubled, debt has tripled. On paper Motus now needs not one year, but three years' profits to pay off the capital portion of the debt. It

is a comparison that is easy to understand. The extra R8bn borrowed to grow the business did not generate additional profits. We will monitor Motus closely.

BOTTOM LINE: Transport is a big industry. Transport month is a commendable initiative – it covers four modes of transport – roads, railways, airlines, and shipping. Unfortunately, all four modes have been shoddily managed by government. Our sole investment in the transport industry is Motus. Motus supplies mainly entry level vehicles to the market. It is a big, lucrative market. Motus is much bigger than its listed peers, Combined Motor Holdings and Zeda, combined. In addition, it is the only company with offshore exposure. Motus must just watch its growing debt levels.

Sources: Naamsa, Motus.

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