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SHOPPING IN A STORM



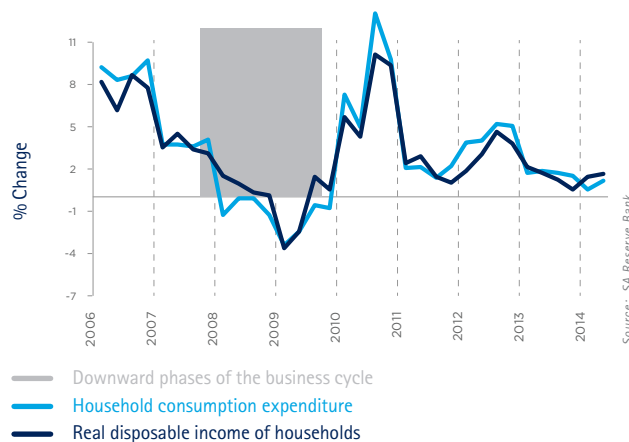
The past twelve months have proved to be challenging for most of the South African apparel retailers. They have had to navigate their way through difficult trading conditions, with the consumer caught in a storm of financial headwinds. High levels of indebtedness, lower levels of disposable income and a drying line of credit have all contributed towards a shrinking consumer wallet, and this has, in turn, directly affected retail sales. When asking retailers how trading has been, you're likely to be faced with the same answer: "tough".

Based on historical trends, the South African consumer has always displayed two key characteristics: a low propensity to save and a fondness for credit. Current stats from the SARB suggest that 78% of household disposable income is spent servicing debt. Real disposable income and consumer expenditure in South Africa has been slowing markedly, with growth trailing below 2% since 2013.

Consumers have faced a barrage of headwinds affecting their cost of living. This includes spiking electricity tariffs, higher transport costs, difficult employment prospects in the private sector, together with an upward movement in interest rates compounding their already high level of indebtedness. The demise of African Bank, Africa's largest unsecured lender, also removed an important line of credit for many consumers. All of these factors contributed to a shrinking level of disposable income for the consumer. It is estimated that the consumer wallet grew by 7.6% in 2014 before inflation, and this is estimated to be as low as 6.6% in 2015.

One of the few boons that consumers have been offered has been the welcomed drop in the petrol price with an almost 25% fall between October 2014 and January 2015. This gain, however, has proven to be short-lived. Since February 2015, the oil price has rebounded off its January low and the US dollar has strengthened by over 5% against the Rand. With April 2015's increase in the fuel levy and petrol price, virtually all the festive season gains have been eroded.

Chart 1: Real disposable income and consumption expenditure



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HOW HAVE THE LISTED RETAILERS BEEN FARING GIVEN THIS MARKET ENVIRONMENT?

Credit retailers such as Truworths and Foschini are symptomatically more vulnerable during downward phases of the credit cycle- especially in prolonged ones such as the current cycle. Truworths in particular has found this cycle to be especially unkind. Approximately 70% of Truworths' sales are made on credit, leaving them highly susceptible to the phases of the credit cycle. With their premium pricing strategy, off-the-mark merchandising, and their mass middle-income target market being under severe financial pressure, they have been caught in the eye of the storm. They have lost market share to new entrants such as Cotton On as well as their traditional rivals. Foschini has fared better, having adapted their business model by reducing their reliance on credit sales to approximately 56% in recent years.

One way of gaining more insight into the true strength of a retailer's sales performance is to analyze its same-store sales (SSS) figure¹. As can be seen from the chart alongside, all of the retailers, barring Mr Price, have either displayed declining or flat-lining SSS through recent reporting periods. After stripping away price growth (which is typically in the mid to high single digits) from these SSS growth percentages, it becomes apparent that most of the apparel retailers have experienced declining volume sales in recent periods, with Truworths faring particularly poorly. We expect tough trading conditions in South Africa to prevail in the short to medium term and believe that the apparel retailers will continue to find it difficult to deliver strong SSS growth on the back of a strained consumer environment.

We expect tough trading conditions in South Africa to prevail in the short to medium term

The exception to this has been Mr Price - undoubtedly the major success story amongst the SA apparel retailers in recent years. Their trendy fast-fashion offering at exceptional price points has resonated well with the consumer, especially during these economic times where middle income consumers typically trade down. Their strategy has allowed them to gain a significant market share, mostly at the expense of Foschini and Truworths, as well as the struggling Edgars chain. We regard Mr Price as a well-managed business which has carved out a good niche for itself in the market, but we find it difficult to see value in the stock's premium stock market valuation.

The past few years have seen the introduction of a number of iconic international retailers to the South African market. The likes of Zara, Topshop, Cotton On and others have all targeted emerging markets

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such as South Africa with the aim of offsetting their slowing growth in developed economies. Swedish fast-fashion retail giant H&M will soon be joining them in attempting to woo the South African consumer. These companies are all formidable competitors with a solid pedigree in retailing. While their entry would bring welcomed choice and variety for the consumers, existing retailers would have to compete harder for a share of the consumer's hard-earned Rands.

Of the international entrants, Australian retailer Cotton On has been the most aggressive in terms of its expansion into SA. Unlike Zara and Topshop who have been much more particular over new space, the Cotton On Group has already opened in excess of 100 stores in SA within 3 years.

Chart 2: Same Store Sales Trend - Apparel Retailers

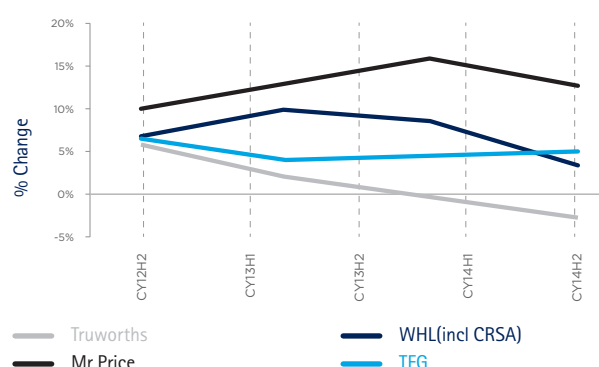
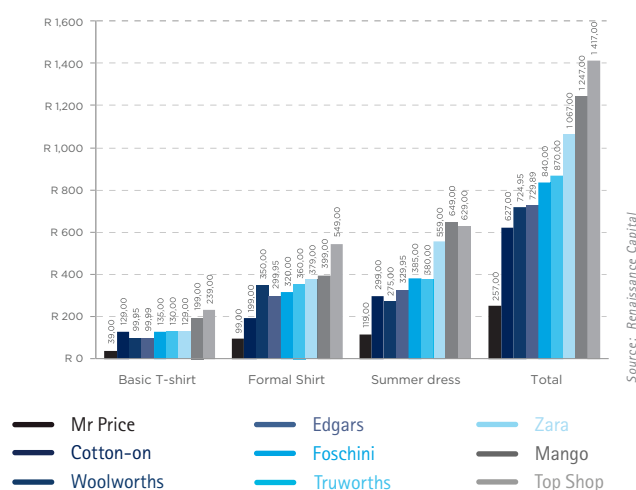


Chart 3: Pure prices points: March 2015, ZAR



¹ Same-Store-Sales figures give an indication of sales performance of existing stores, after excluding the effects of any expansions or acquisitions. Same-Store-Sales are comprised of the sum of price growth (typically inflation) and volume growth for existing stores.

GOING DOWN UNDER

In March 2014, Woolworths announced that they had made a A\$2.1bn offer to acquire the Australian department store, David Jones. This transaction would raise their Australian exposure to 45% and make them the second largest apparel retailer in the southern hemisphere. Analysts, including ourselves, were skeptical about this deal.

Department stores in Australia have been losing market share for a number of years and the Australian retail landscape has become more competitive with the arrival of many of the international retailers, all eager to gain a piece of the lucrative Aussie retail market. This begged the obvious question: "Why would Woolies offer to pay a hefty 24x price/earnings multiple² for a business operating in the ailing world of department stores?" A closer inspection of David Jones revealed that there was much more to this deal than immediately met the eye.

We back management to execute their plan and extract significant benefits from David Jones

The David Jones acquisition has many of the hallmarks of a private equity deal in terms of asset optimization and profit enhancement opportunities. After having a closer look under the hood of this business ourselves, it was genuinely surprising to see just how poorly it had been run. David Jones has archaic stock systems, poor merchandising, a badly managed (but very valuable) property portfolio, and unappealing store layouts, amongst other deficiencies. It became clear that Woolworths has plenty of levers to pull in order to extract significant gains from this business, easing our initial skepticism regarding this deal.

With such an ambitious transaction, one of the biggest risks is whether it can be executed. With Ian Moir at the helm, Woolies essentially have an insider into the Australian retail market. An Australian citizen himself, he has more than 20 years of retailing experience in the region and is credited with leading the successful turnaround of Country Road from the verge of liquidation before taking over the reins at its parent

company, Woolworths. Alongside him is a management team that is easily one of the best in its class. We back management to execute their plan and extract significant benefits from David Jones for at least the next five years.

The other divisions within Woolworths have good prospects as well. While the Woolworths SA Clothing business has not been entirely spared by the weak consumer environment in SA, it is better positioned than most to weather the credit cycle as it's a predominately cash retailer. Woolworths Foods continues to perform strongly and gain market share. Both of these divisions have aggressive expansion plans for the next three years. The Country Road Group has grown into a strong profit contributor and has room to substantially expand its brands' presence in both South Africa and Australia. Woolworths also plans to migrate David Jones' outdated stock systems onto Country Road's more sophisticated platform, gaining synergies along the way.



² The acquisition PE multiple of 24x reduces to 17x after excluding DJ's property portfolio.

OUR VIEW ON THE CREDIT CYCLE AND APPAREL SECTOR

Despite all the supposed doom and gloom in the retail sector, apparel share prices have re-rated since November 2014. Retail shares are currently trading near to the upper end of their historical PE valuations, implying that the market is already pricing in a recovery in the consumer environment and a positive change in prospects for the consumer. Foschini and Truworths have recently reported that debt collection has been improving and their rising bad debts have been tapering off. Furthermore, Transunion's Q4 2014 Consumer Credit Index (CCI)³ has edged over 50 (breakeven point) for the first time since Q2 2012, indicating a period of consolidation within the consumer credit industry.

However, we remain cautious over whether the cycle has truly turned the corner. We are of the view that while the consumer appears to have assimilated the shocks delivered over the past year and has stabilized (albeit at a precarious level) we don't believe the consumer is necessarily out of the woods. The SARB is likely to follow the US Federal Reserve and increase interest rates later this year, further straining the already precarious state of the indebted local consumer. We anticipate that the increase in the petrol price will end the recent inflation

descent, with NERSA's approval of a 12.7% electricity tariff increase also hitting the consumer wallet. Sources of credit are expected to remain dry for consumers in the short term, with the collapse of ABIL together with the NCA enforcing much more stringent lending criteria effective from March 2015.

Together with the negative backdrop of sluggish GDP growth forecasts and low consumer confidence we expect the consumer to come under further financial pressure, thereby exacerbating already tough retail conditions and curtailing a true recovery in consumer health. In light of this, together with the threat of increased competition in the sector and already heightened valuations, we take a cautious view on the listed apparel retailers with high exposure to South Africa.

Woolworths is currently our only pick of the retail sector. Woolworths currently trades on a 22.5x forward PE ratio – a multiple which we expect to unwind significantly over the next three years as Woolies begins to extract benefits and synergies from its David Jones acquisition, and de-lever from its net-debt position. We believe that their turnaround plan is achievable and we back management to deliver on this.

The SARB is likely to follow the US Federal Reserve and increase interest rates later this year, further straining the already precarious state of the indebted local consumer



³ The CCI index measures consumer credit health where 50.0 is the breakeven level between improvement and deterioration. It's an indicator of consumer credit health, measured through: Loan repayment records, Use of revolving credit, estimated household cash flow and Relative cost of servicing outstanding debt.