STONEHAGE FLEMING

SOUTH AFRICA

STONEHAGE FLEMING EQUITY MANAGEMENT

STEINHOFF: LESSONS FOR THE LONG-TERM INVESTOR

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The end of 2017 delivered a momentous market event when JSE and Frankfurt listed retailer, Steinhoff International, announced the resignation of CEO Markus Jooste due to allegations of accounting irregularities. This significantly impacted the Steinhoff International share price with the value of the company declining as much as 85% over the week ending Friday, 8 December 2017.

Whilst Stonehage Fleming Equity Management had no direct exposure to Steinhoff (only diluted exposures in the wider Group through some externally managed investment mandates) we take the following lessons from this experience:

CONCENTRATION RISK

Unfortunately it seems to take major corporate failures to highlight the virtues and merits of a diversified portfolio. Naturally, investment managers who potentially held such a failure in client portfolios, also choose to trumpet the benefits of a diversified portfolio at such times.

The subject of diversification also raises the active versus passive debate. One of the growing arguments against passive (or index tracking) investing is the inherent concentration risk in particular companies. In the case of the JSE All Share Index, it is Naspers at nearly 20% of the index (with Naspers, Richemont and BHP Billiton together constituting 34% of the index). Certain longer-term investors may be comfortable with such a concentrated exposure, but index investors need to be aware that although they may no longer be at risk of underperforming a particular index, they may be significantly increasing concentration risk.

LONG-TERM ORIENTATION

When investing in a listed company, investors are implicitly placing both their capital and their trust in the company and most importantly, in the company’s management team. Management are ultimately the stewards of shareholder capital and have a critical role to play in determining either the success or lack thereof of a particular investment.

In this regard, shareholder and management interests should be aligned in achieving long-term success. In a short-term oriented investment environment fixated on short-term peer rankings, industry awards and the pressures of chasing fickle inflows, achieving such alignment is increasingly difficult.

One important flag in the Steinhoff saga was of a culture of risk. Key management and executives entered into significant derivative positions and/or leverage to benefit from an increase in the company's short-term share price movement. Although the argument can be made that management had material 'skin in the game', we view this as a misalignment of interest. Management stood to benefit from an increase in the short-term share price, despite potentially exposing shareholders to excessive risk or value destructive deals over the longer-term.

UNDERSTANDING COMPANY CULTURE

It takes time to understand a listed company's culture. As outsiders, investors are reliant on management interaction, company disclosures or press reports and often an investor's opinion on a particular company's culture is based on accepting the status quo.

Paying close attention to a management team's response to/or treatment of a poor set of results, a particular deal that may not have gone as planned or potentially unethical internal behaviour can often give good insight into the company culture. One notable example was Steinhoff management and executive team's trading in Steinhoff shares leading up to the announcement of the acquisition of Pepkor from Brait in 2014. When later questioned on why the company was not under 'cautionary', Steinhoff's response was that the 'advice received was that no cautionary announcement was necessary'. To remain beyond reproach, and specifically to avoid after the fact questioning and insinuations, we would prefer management and companies to always take the most conservative option possible in such instances.

The ideal for the long-term investor is to find a company with a shareholder (both large and small) centric culture who understand and respect that they are ultimately custodians of all shareholders' hard earned capital.

An even more recent example is the case of a JSE-listed retailer's write-down of a recent overseas acquisition. Whilst the write-down was expected, the company recently altered their remuneration policy to incorporate 'return of capital employment' as a key metric. The write-down has the effect of boosting return on capital employed even if the company profits remain flat. Although the introduction of this metric may well be warranted on a longer-term view, the timing of the introduction in conjunction with the write-down is unfortunate. We have consequently placed our investment recommendation on the company under review.

THE ROLE OF INVESTMENT MANAGERS

In the same way company management are custodians of shareholder capital, investment managers fulfil the same role for clients' capital. Just as company management are held accountable in cases of corporate failure or poor allocation of capital, investment managers should also be held accountable for poor decisions. All investment managers make mistakes. When mistakes are made, Stonehage Fleming Equity Management spend time examining what investment process refinements could be made or what may have been missed. Accepting that a particular investment decision was a mistake is, in our view, the most difficult acknowledgement for the long-term focused investment manager (even more difficult than a decision to allocate investor capital to a particular company). Analysing and assessing the merits of a new investment is a methodical and process-driven decision, accepting a mistake and taking the appropriate action requires accepting short comings in one's research or process.

We do not agree that a failed company's management team or lack/quality of disclosure should be blamed when investment decisions do not work out. The responsibility of the long-term investor is to understand the company where they are allocating client's capital. As investors, we are quick to judge a management team for a poor deal and would not tolerate an excuse of 'lack of trustworthy information' and should therefore be held to the same set of standards as company management teams.

FOCUS ON ORGANIC GROWTH AND CASH FLOWS

We believe it is essential to differentiate between organic growth and cash flows as opposed to 'engineered' profit growth. Companies are able to grow short-term profits through one, or multiple, acquisitions which may or may not make strategic sense or be in the best interest of the long-term shareholder. The low interest rate environment experienced over the recent past has been particularly friendly towards acquisitive companies. When companies embark on corporate activity, our preference is for management to have a track record of successful activity and for the acquisition to fall within the acquiring company's 'core competency' (whether this competency is operational, technical or even regional related).

In Steinhoff's case, the company embarked on a series of global acquisitions over the past five years. The acquisitions, in conjunction with changes in segmental reporting and a change to the financial year end in 2016, made consistent analysis of underlying 'organic' growth near impossible. Further to this, it now appears very likely that cash flows and even profit numbers were inflated over the past few years.

FOR MORE INFORMATION

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Jean-Pierre is a Director in Stonehage Fleming Investment Management, South Africa, he assisted in the establishment of the South African direct equity offering. He has over 15 years experience in equity markets and oversees the direct equity portfolio management and equity research process in South Africa.

Prior to joining the Group in 2011, Jean-Pierre was Managing Director at a boutique asset management firm where he worked for seven years as an Analyst and Fund Manager. Jean-Pierre qualified from the University of Cape Town with a degree in Business Science (Finance Honours).