Special report

Stocks that could outperform in a strong domestic economy

What do WBHO, Hudaco, Tsogo Sun, Netcare, Barclays Group Africa and Remgro have in common?

Apart from being in the PSG Wealth SA Equity Portfolio, our analysts found that these six stocks could outperform in a strong domestic economy. Our head of equity research, Franco Pretorius, says sectors that are influenced by domestic demand performed well, especially following an improvement in sentiment after the outcome of the ANC elective conference in December. Data shows that financial stocks gained solid ground over this period.

Shares which are sensitive to interest rate movements were buoyed by expectations of a cyclical recovery, and the possibility of improved fiscal management following Cyril Ramaphosa's victory.

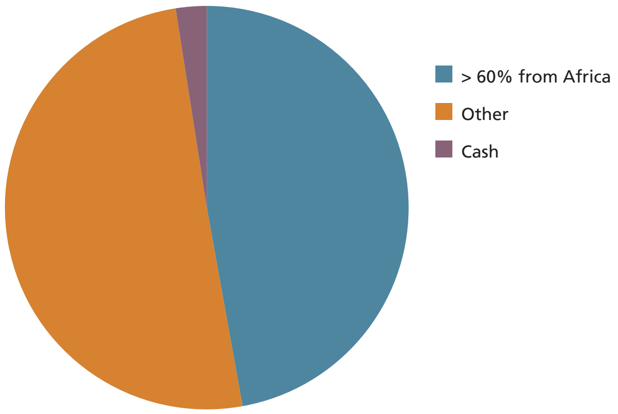
Despite this outperformance we continue to see value in domestically focussed investments, relative to expensive defensive stocks. While large-cap counters already price in some of the improvements, we feel that mid-cap counters could be strong beneficiaries.

This is especially the case when improved sentiment aides operating margins and capacity utilisation, a measure of the extent to which the productive capacity of a business is being used. This combined with a more supportive commodity environment should translate into earnings growth, which could be higher than expected.

We do not feel that current earnings projections reflect this possible shift yet, given that pro-growth structural reforms are likely to remain challenging and could take time to implement. Additionally, we feel that they are currently trading at lower earnings multiples than the rest of the market. We also expect earnings to grow at a faster rate over the next three years. The return on equity (ROE) for all six shares are also well ahead of the market average.

Portfolios with more than 60% exposure to domestic stocks performed well over the past three months

PSG Wealth SA Equity Portfolio



*As at 2 February 2018

Sources: PSG Wealth research team

The PSG Wealth SA Equity Portfolio currently has domestic exposure through:

Share	Price	12-month Blended forward P/E ratio*	Annualised revenue growth 3yrs forward*	Change in net margin 3yrs forward (bps)*	Next FY operating margin*	EPS growth 3yrs forward*	P/NAV	ROE (last FY)	Debt/equity	Dividend payout ratio (last FY)	Dividend yield
Barclays Group Africa	18199	9,4	4,57%	83	30,1%	5,8%	1,5	17,3%	n/a	59%	5,8%
WBHO	15949	8,5	0,01%	127	3,9%	20,1%	1,7	20,9%	no debt	31%	3,0%
Netcare	2600	14,9	6,15%	115	9,6%	12,5%	4,3	26,8%	77%	64%	3,7%
Hudaco	15300	10,8	n/a	n/a	n/a	n/a	2,1	18,9%	52%	45%	3,7%
Tsogo Sun	2475	11,9	4,86%	-45	27,7%	3,9%	2,1	20,6%	104%	50%	4,1%
Remgro	23259	12,7	5,57%	n/a	16,4%	18,9%	1,4	8,8%	10%	28%	1,6%
Average		**11,7**	**4,1%**	**n/a**	**n/a**	**13,8%**	**2,3**	**19,2%**	**n/a**	**44%**	**3,2%**
Market average		14,1	7,38%	n/a	n/a	16,2%	1,9	11,7%		52%	3,3%

* n/a in Remgro row means information not applicable. *n/a in Hudaco row means information not available.
*Based on Bloomberg consensus forecasts.

Sources: PSG Wealth research team, Bloomberg

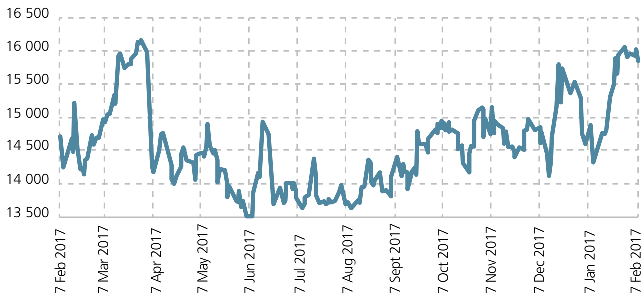
Special report

WBHO

Recently, the construction industry has grappled with weak economic conditions which were compounded by a struggling commodity environment. This resulted in weak pricing power and caused depressed operating margins. We believe this could improve going forward, given significant restructuring in the whole industry. Especially concerning traditionally higher margins for civil engineering divisions. The restrained environment pushed construction companies to focus on lower margin building contracts and cross-border contracts with a specific preference for Australia. A cyclical recovery locally, is likely to support higher order books and an improvement in operating margins, which are coming off a very depressed base. This could result in earnings growth ahead of current expectations.

The South African government can't delay infrastructure projects indefinitely. Especially because infrastructure spend is a critical part of the National Development Plan (NDP), to which the government has committed to. Demand from the commodity sector is also likely to improve, given higher commodity prices and the expectation of a more accommodative legislative regime. We feel WBHO is the premier counter in the construction sector. It has an established track record of strong cash generation and consistently high ROEs. WBHO successfully diversified many of its income streams geographically, from both a country and specific state/ province point of view. We feel this share offers value trading on a forward P/E of below 9 times and 1.7 times its NAV. The share is underpinned by a decent dividend yield of 3%.

WBHO 12-month share price movement



Source: Bloomberg

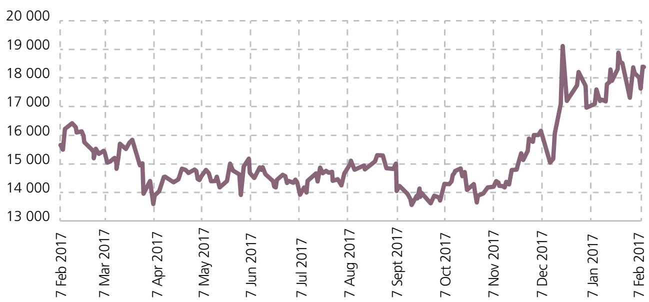
BARCLAYS GROUP AFRICA

Increased confidence in the domestic economy should be positive for banking counters, both for their balance sheets and the transactional side of the business. Although an acceleration in economic activity could take some time to come to fruition, higher levels of both consumer and business confidence could create more opportunities for lending and a rise in transactions which could result in more interest- and non-interest income. Our preferred counter in this sector remains Barclays Africa Group, given that it continues to trade at a discount to its peers.

> "Despite the offshore component of some of these shares, we feel these specific six stocks could outperform in a stronger domestic economy."

Barclays offers value trading at a forward P/E ratio of below 10 times and 1.5 times its net asset value (NAV). A historic dividend yield of 5.8% is another attractive characteristic of this stock. We have some concerns around the competitiveness of the retail side of the business, which has seen declines in customer numbers. However, we do not expect this to result in a material shock to the company's return on equity (ROE), which could impact the valuation of this share.

Barclays 12-month share price movement



Source: Bloomberg

Special report

NETCARE

After a disappointing year for domestic volumes in the healthcare sector, trading updates indicate a modest recovery in paid patient days (PPD). A stronger local economy is also likely to be a tailwind for volumes as higher employment should drive the growth in medical aid memberships.

We feel Netcare's share offers value, trading at a forward P/E multiple of below 15 times. This represents a 6% discount to its long-term P/E average and a 9% discount to its local peers, while earnings are off a depressed base. The share price is supported by an attractive historic dividend yield of 3.7%. Despite the group's local operations facing pressure from funders and regulatory risk, it seems as if the worst of these risks are already priced into the share price.

The group's UK operations remains a concern. However, our current valuation does not capture much value for the UK operations. A material recovery in this operation will likely provide further upside to our valuation. Management has indicated that the group will not invest more money in the UK, unless a rent reduction transaction which - will be beneficial to all parties - can be reached. High demand for the group's healthcare services in both its geographies are anticipated to increase. The increase is due to a higher disease burden, particularly in South Africa combined with an ageing population in the UK. The group has a well-balanced portfolio of healthcare businesses. It operates in a defensive industry which traditionally leads to high operating margins and ROE.

Netcare 12-month share price movement

Source: Bloomberg

However, regulatory pressures to provide greater access, and to reduce prices, are inevitable and may influence margins in the longer term.

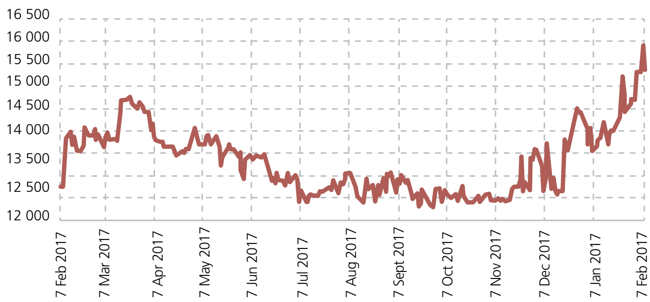
Despite the material change in Netcare's case-load mix (one towards lower margin NHS work) and a lower margin of private medical insurance (PMI) volumes, the group has been able to protect margins, which indicates management's ability to contain costs.

HUDACO

Hudaco is a decent quality company that boasts a consistently high ROE, decent operating margins and strong cash generation historically. The share does not seem expensive, trading at a forward P/E of below 11 times and two times its NAV. The share price is also underpinned by a healthy dividend yield of 4.1%.
Over the past two years, the group has right-sized its operations to lower activity levels. Currently Hudaco seems well positioned to benefit from an improvement in mining and manufacturing activity. Any improvements in economic activity could also lead to organic top-line growth prospects.

We remain optimistic that earnings will be supported by improved commodity prices, that could translate into more activity within this industry. The group has a widely diversified customer- and product base, which should assist in stabalising earnings. Extracting operating efficiencies and synergies from recent acquisitions will also support earnings growth. Management believes higher volumes due to a more supportive economic environment, will be sufficient to counter the pressure on pricing from a stronger rand.

Hudaco 12-month share price movement



Source: Bloomberg

Special report

TSOGO SUN

The local gaming industry is highly regulated, on both national and provincial level. This provides significant barriers to entry. Tsogo Sun's operations are very cash generative, but its balance sheet is more strained given investments the group made as part of its growth strategy. However, we feel the share offers value on an absolute and relative basis.

It trades at a forward P/E ratio below 12 times and is underpinned by an attractive dividend yield of 3.9%. Drivers of future growth includes any upsides from economic recovery, casino expansion and new gaming opportunities. These include the fourth license acquired for the Western Cape Metropole/Mpumalanga and access to limited payout machines (LPM) and electronic bingo terminal (EBT) markets through its Gameco acquisition. Its real estate investment trust (REIT) structure also aims to unlock value for shareholders and is being considered for gaming assets.

Given the group's high operational gearing, any improvement in consumer confidence will likely lead to higher earnings. The group's gaming operations are highly geared to the consumer market (in gaming) and corporate market (in hotels), and both groups are expected to benefit from a cyclical recovery. While gaming growth has been subdued recently, management indicated that footfall growth at group properties remained stable. This indicates the quality and attractiveness of its assets.

Tsogo Sun 12-month share price movement

Source: Bloomberg

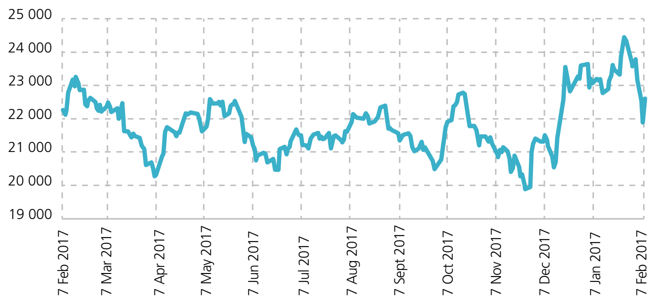
REMGRO

Remgro is a solid and diversified company with a proven track record of unlocking shareholder value. It also boasts a reasonably low risk profile. The group is currently trading at an approximate 13.5% discount to our estimation of its intrinsic value of 26 887cps. This discount is in line with its long-term average. We also feel the group's underlying investments offer value.

This share is exposed to high quality, sector-leading financial- and industrial investments, led by shareholder-aligned management teams. Its investments also feature credible growth prospects. The group's listed investments contribute 81.4% to its portfolio's intrinsic value, of which Mediclinic is the largest at 28%.

On a sector basis, it is most exposed to financials at 36% through Firstrand and RMI. Given the large listed component of its portfolio, equity market performance remains a significant contributor to movements in its intrinsic value over the short term.
The group has a large domestic component to its portfolio, but the international component has become material, primarily due to the international expansion of Mediclinic. The group's balance sheet is not highly geared, which should enable the group to support its investees to grow in a more supportive economic environment.

Remgro 12-month share price movement



Source: Bloomberg

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