



Melville Douglas

Quarterly Commentary

Global Equity Fund

/ Q2 2023

Take the cash or reinvest?

“Do you know the only thing that gives me pleasure? It’s to see my dividends coming in.”

John D. Rockefeller, world’s first US dollar billionaire.

Oil tycoon John D Rockefeller was the richest man on earth in the early twentieth century. As a devout Baptist, he led an abstemious lifestyle. He didn’t drink alcohol, overeat, play cards or smoke. He wasn’t too attached to his vast fortune, which he spent much of his later life giving away to worthy causes. But what he did enjoy was to receive a return on his investments via dividends.

The cash-in-hand allure of dividends has long appealed to investors. It is a tangible reward for money risked and time spent on an enterprise. It is a measure of success. In addition, the commitment to pay dividends represents an important signal about the viability and profitability of a business.

The caveat is delayed gratification. Deferring some of today’s dividend payments provides the internal funding to grow the company’s earnings power, enabling shareholders to receive even higher dividends in the future. This is especially true for the quality-growth companies held in the fund. But, as explained below, there is no one-size-fits-all dividend policy.

A key decision for company management is to determine how best to redeploy its profits. They have two choices: 1) return to shareholders or 2) retain in the business. Let’s examine each in turn.

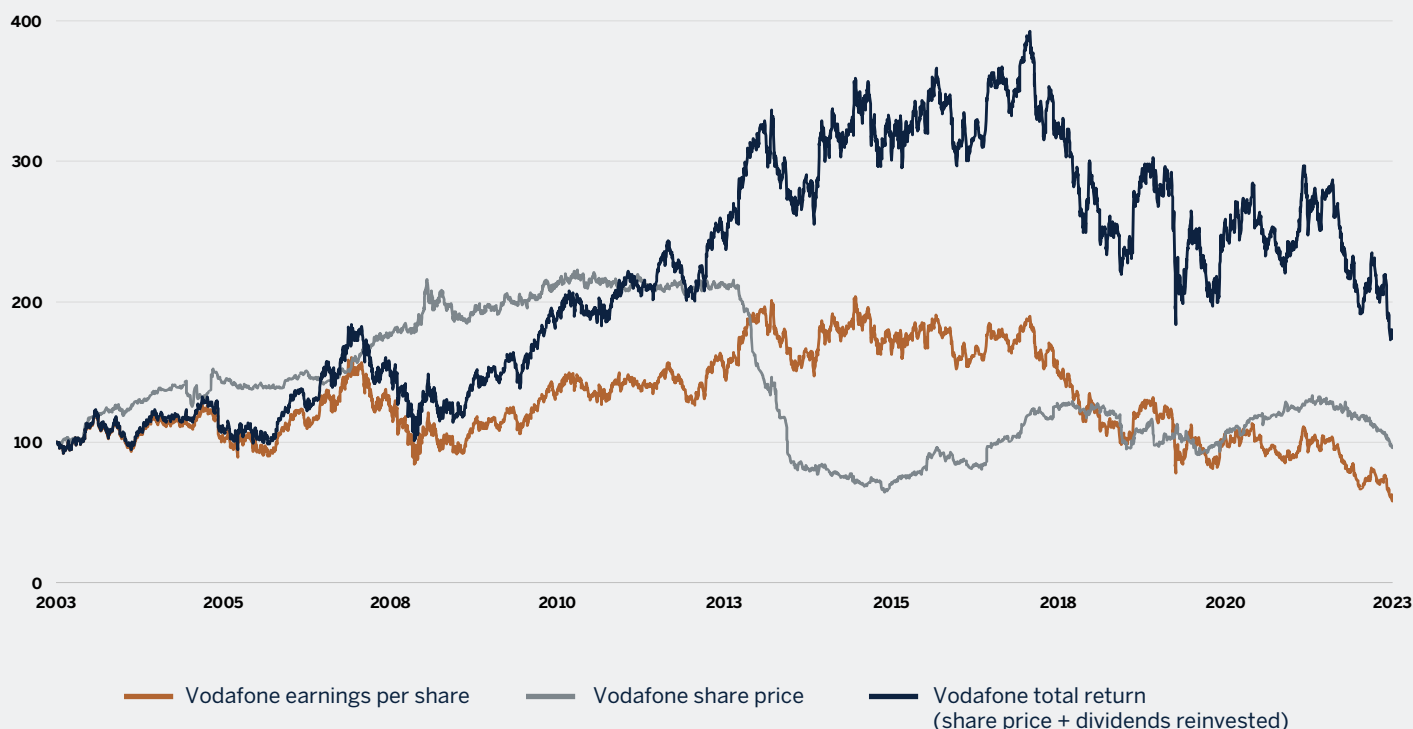
1) Return to shareholders

This is desirable for businesses with few, if any, value-creating opportunities. It is better for shareholders to skim off excess cash than see their capital destroyed through redeployment into low returning projects or expensive acquisitions. Shareholders can decide for themselves whether to use the dividends received to buy more shares in the same company or to invest elsewhere.

An example is the telecoms group Vodafone. The business has been a perennial disappointment over the past 20 years. A combination of intense competition, regulatory pressure and taxation issues, the need to constantly invest to keep up with technology changes and customer expectations and a lacklustre M&A track record has meant the business has struggled to make an attractive return on capital investment.

Earnings per share has flatlined over the two decades (chart 1). Over the past five years the business's average return on equity has been only 3%, which is well below investors' theoretical cost of capital hurdle rate of around 10%. At least the company has effectively recognised this by handing back most of its annual profits as dividends. As such, the -40% loss on the share price over the past 20 years equated to +75% return when the dividends received are included as a total shareholder return. Unfortunately, UK consumer prices are up +72% over the same period. Hence, an investment in Vodafone has preserved your wealth in inflation-adjusted terms, but it has not provided any above-and-beyond growth.

CHART 1: LOW ROE BUSINESSES - DIVIDENDS PLEASE



Source: Factset

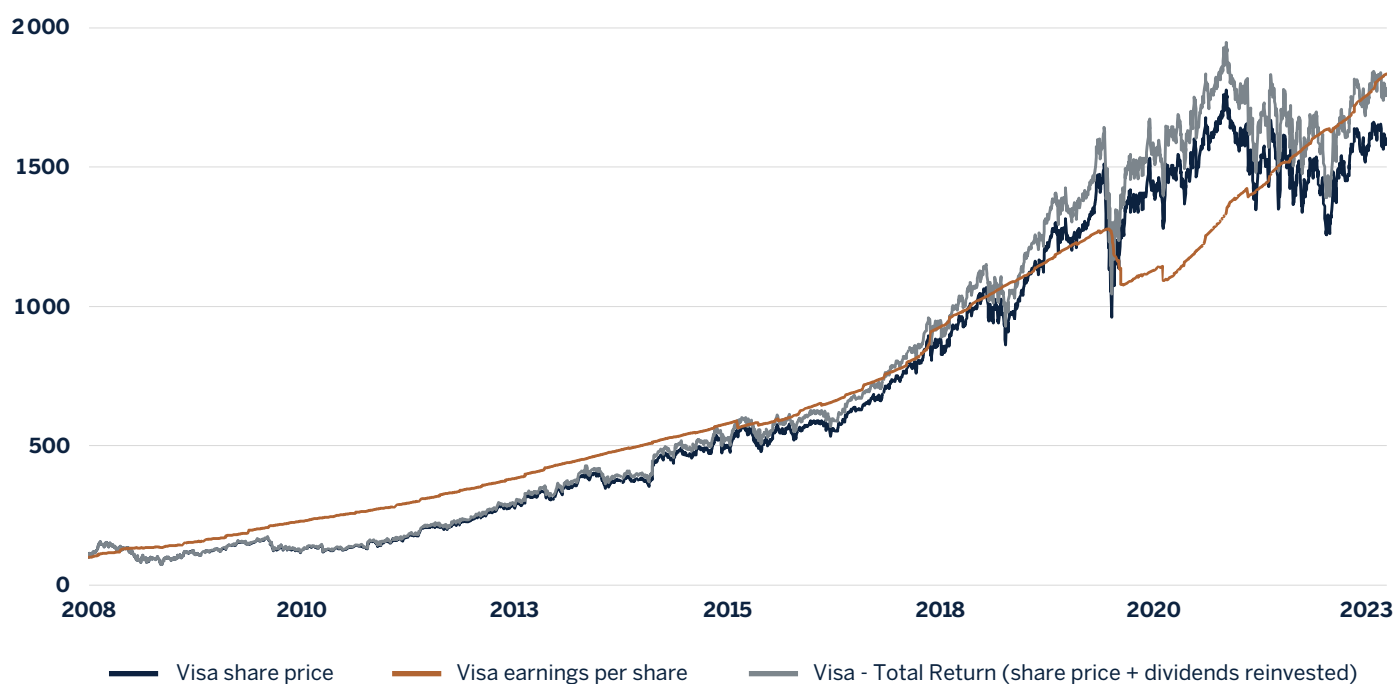
2) Retain in the business

There are numerous ways in which a company can utilise retained profits. It can pay down debt, leave it in the bank, fund new ventures, spend it on research & development, make acquisitions or buy back its own shares. As mentioned earlier, some of these options run the risk of destroying value if management make imprudent decisions. Nonetheless, reinvesting in attractive opportunities will enable it to afford to pay higher dividends in the future.

Ideally, high return on capital businesses operating in expanding addressable markets should only pay dividends that would otherwise sit lazily on the company balance sheet. The more the company retains, the higher the compound returns for the business owners (i.e. shareholders).

Payments processing network Visa is a case in point. Visa only pays 20% of its earnings per share as dividends. As shown in chart 2, its low dividend yield means the total return is not much different to the price return. However, investors have enjoyed a remarkable journey with the company via the share price, as it has reaped the benefits of greater usage of digital payments and higher consumer spending. As a duopoly with MasterCard, Visa's high 5-year average return on equity of 33% has not been competed away. The result is 20% per annum earnings growth that has underpinned a 15x increase in the share price since its initial public offering in 2008. We have been investors since the fund launch in 2012.

CHART 2: HIGH ROE BUSINESS – REINVEST CASH



Source: Factset

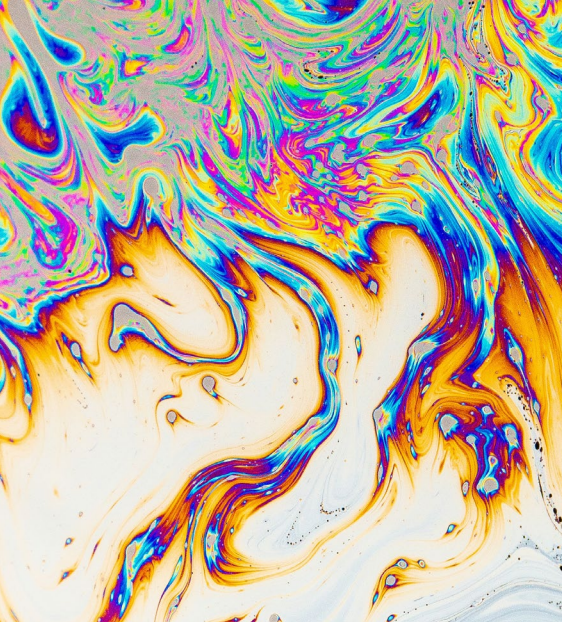
The fund is skewed to companies with sustainably higher returns on investment and attractive growth opportunities to reinvest in. As shown in table 1, the fund's average return on equity of 18% comfortably exceeds the broader markets as represented by the MSCI All Country World index. The dividend yield is slightly over one percentage point lower than the MSCI All Country World index. As in the past, we expect this lower level of income to be more than offset by higher-than-average earnings per share growth, which will in turn lead to better than average long term share price performance.

TABLE 1: REINVESTING ABOVE AVERAGE BUSINESS RETURNS

	MD GLOBAL EQUITY FUND	MSCI AC WORLD INDEX
Return on Equity	18%	13%
Allocation of shareholder capital		
Dividend yield	1.3%	2.4%
Dividend payout ratio	31%	63%

Source: Bloomberg data, 25th May 2023

In short, we prefer to own “Visas” rather than “Vodafones”. Dividends are comforting, but what gives us even greater pleasure is the power of compound returns.



From our **Fund Manager's Desk**

Our quarterly reports regularly explore the investment rationale of one of the companies we own in the Fund to articulate what we find compelling. This time round we have chosen Brenntag.

Better known as “cutting out the middleman”, disintermediation has reshaped the way suppliers of products and services interact with buyers. Technology-led disruption of traditional intermediary business models has made travel agents, insurance brokers and department stores less relevant. But not all industries are at risk. Brenntag is a case in point.

Greasing the chemical industry's wheels

Founded in Berlin in 1874, Brenntag is the world's leader in chemical distribution, connecting thousands of chemical producers and customers across the globe through a portfolio of more than 10,000 products. In essence it buys in bulk and then makes a turn on selling and distributing smaller quantities to the end-user.

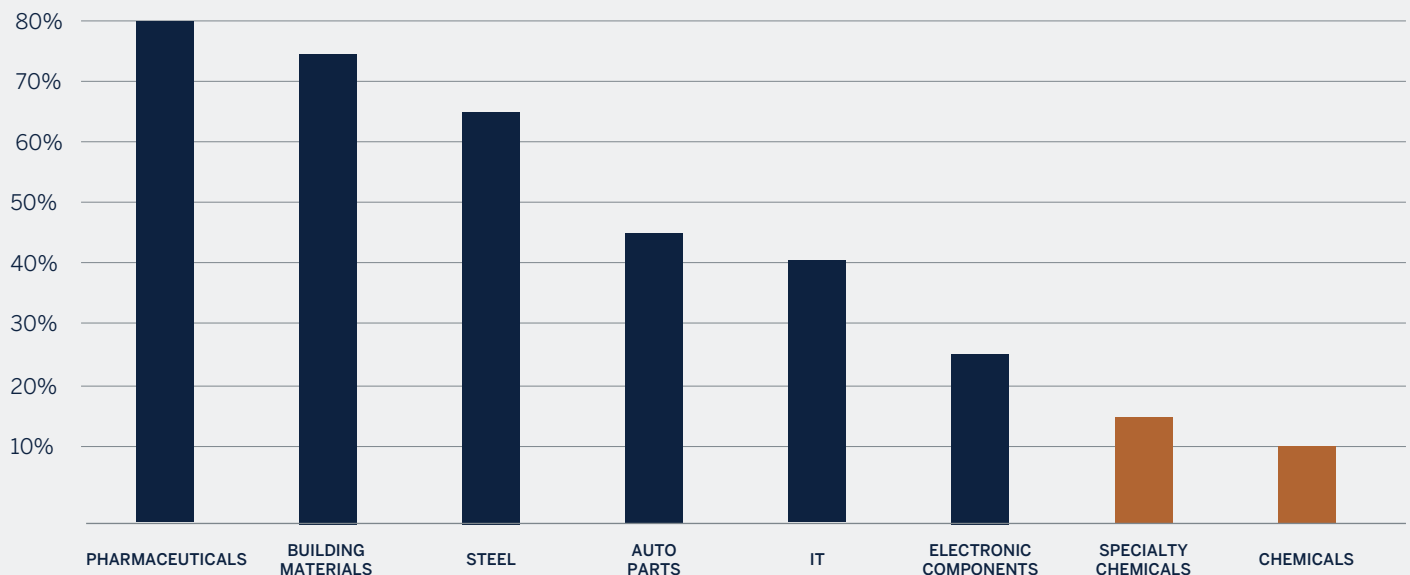
Chemical distribution involves dealing with hazardous materials in a highly regulated industry that requires deep knowledge around products and its application. This complexity, entwined with Brenntag's dense network of transportation routes and access to global supply, builds high barriers to entry that protect profits from being competed away.

Chemical producers admire scale but loathe complexity. Brenntag's global scale enables the likes of Bayer and Dow to reach a wide range of customers in a cost-efficient manner. For customers, the convenience of dealing with a single distributor with a broad product offering simplifies the ordering process, as does outsourcing their own formulation and blending.

As shown below in the chart from Bank of America, less than 20% of the industry's sales are serviced through third-party distributors. This is much lower than in other industries, providing ample runway for chemical distributors to grow share as chemical producers seek to save costs while maximizing sales.

SHARE OF SALES THROUGH DISTRIBUTORS

Share of sales via distributors is far lower for chemicals and specialty chemicals than for other industries.



Source: Bank of America, Boston Consulting Group June 2018

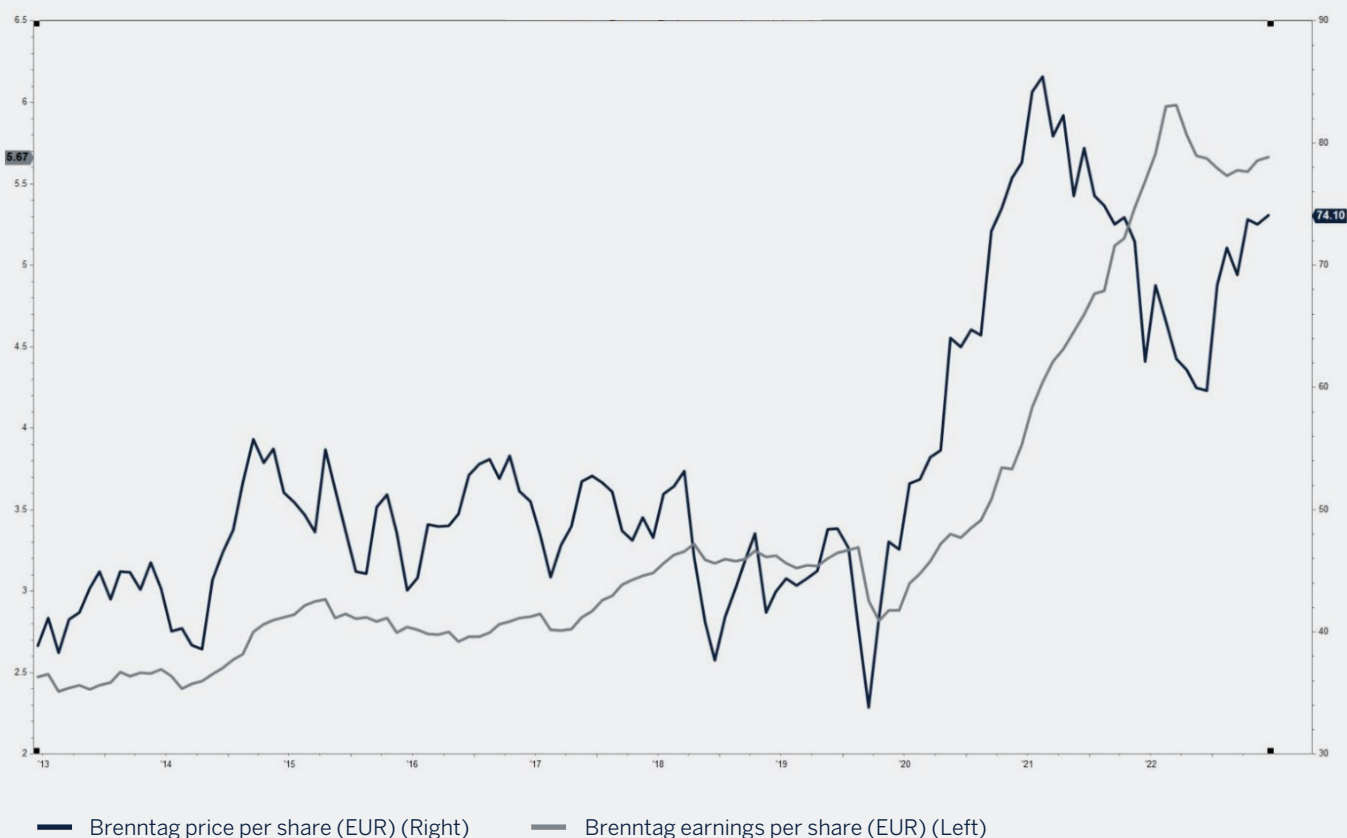
Adversity makes you stronger

The pandemic related supply chain challenges that wreaked havoc for most companies were a blessing in disguise for Brenntag. Their broad, multi-source access to inventory across the globe combined with their extensive distribution network provided surety of supply. Brenntag's customers – spanning a wide range of end industries – are willing to pay a premium for the flexibility, reliability, and quality of supply. The ability to purchase in smaller sizes (the average order size is EUR4,000) with shorter lead times helps with demand forecasting and cash flow management, a highly valued proposition regardless of the times.

The higher oil price – a key determinant of chemical prices – coupled with lockdown related supply shortages led to surging chemical prices during 2021 and 2022. Smaller distributors came under pressure as rising costs impaired their ability to compete effectively. Rising prices, surety of supply and limited competition elevated Brenntag's importance in the value chain, and with it, their pricing power. This – in combination with a solid demand environment - resulted in bumper profits for the company in 2021 and 2022.



RIISING CHEMICAL PRICES + SURETY OF SUPPLY = HIGHER EARNINGS FOR BRENNTAG



Source: Factset June 2023

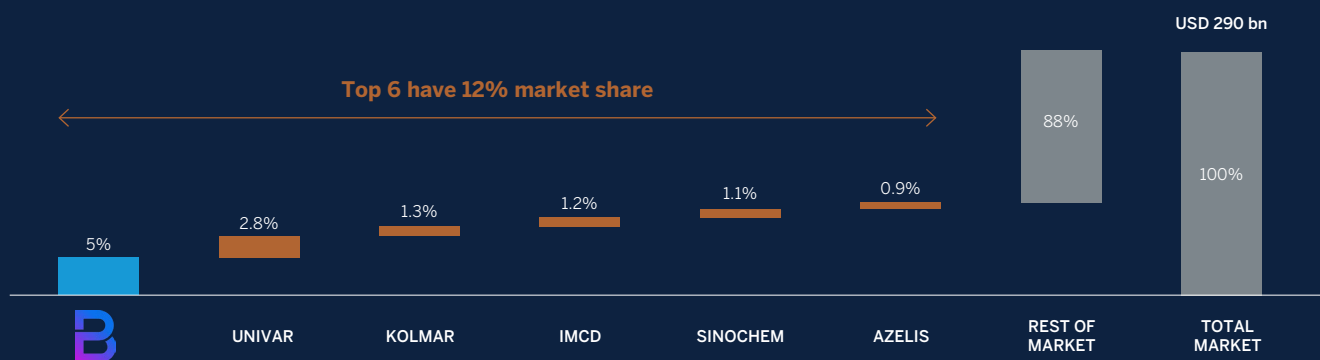
Not standing still

Brenntag has recently embarked on a multi-stage transformation program aimed at accelerating existing growth and capturing new opportunities. Part of the scope involves placing greater emphasis on its more profitable specialty chemicals division. This is expected to unlock significant value for investors. The specialties division grows at a faster rate to the bulkier, commoditized chemicals. Brenntag adds value to its clients through technical expertise on aspects such as product innovation to enhance performance, or new product formulations driven by a growing demand for sustainable ingredients. Through this expertised consultative process, Brenntag's specialties division is able to deliver higher profit margins as they

develop specific applications that require customized formulations. Often, contracts are exclusive between the supplier and the distributor, protecting profit pools for both parties involved.

Consolidating "mom-and-pop" distributors is another opportunity to capture growth. Brenntag is the market leader commanding only 5% share in a total addressable market worth USD 290 billion. As shown in the chart below, the industry remains highly fragmented. Brenntag's strong balance sheet provides plenty room to execute on their strategy as the leading consolidator, resulting in further scale benefits.

A SIZEABLE MARKET THAT IS RIPE FOR CONSOLIDATION
Chemical and ingredients distribution sales-based market share (%), 2021



Source: Brenntag Investor Presentation, May 2023

Increased outsourcing by chemical producers, a mix shift towards higher value-add services and industry consolidation underpin future growth.



Defensive offense – a quality cyclical

Brenntag forms part of the cyclical exposure in the fund. It is a unique blend in that it offers a geared play on economic growth while being relatively protected on the downside, as proven in past recessions.

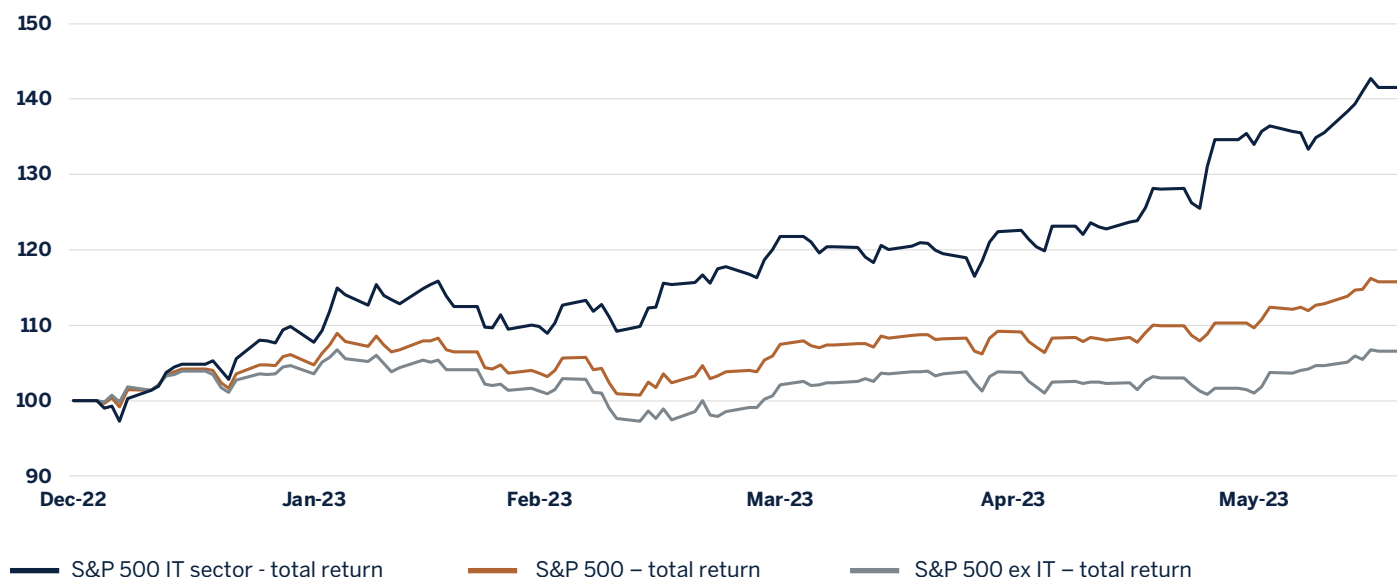
The structural tailwind supporting increased outsourcing, defensive-end markets within specialty chemicals, and small but frequent order sizes contribute to resilient sales. Costs are variable and ongoing productivity efforts laid out in its transformation program add additional earnings stability.

Combining this with the capital light nature of the business model produces far more stable returns on investment than a typical company operating in the materials sector. Investors have been rewarded with operating profits and dividends growing 9% per annum and 13% per annum respectively since the company publicly listed in 2010. Brenntag has found the right chemical formula for making money no matter where we are in the cycle.

The return of Big Tech (...and it is not just AI hype)

Stock market performance in the first half of 2023 has been unusually narrow. Positive contribution has been dominated by the “magnificent seven” monopolistic US Tech stocks (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta and Tesla). If you hadn’t owned a sizeable exposure to some of these names, it would have been difficult to keep up with benchmark indices. As shown below, the S&P 500 index excluding information technology stocks lagged the S&P 500 index by a massive eight percentage points.

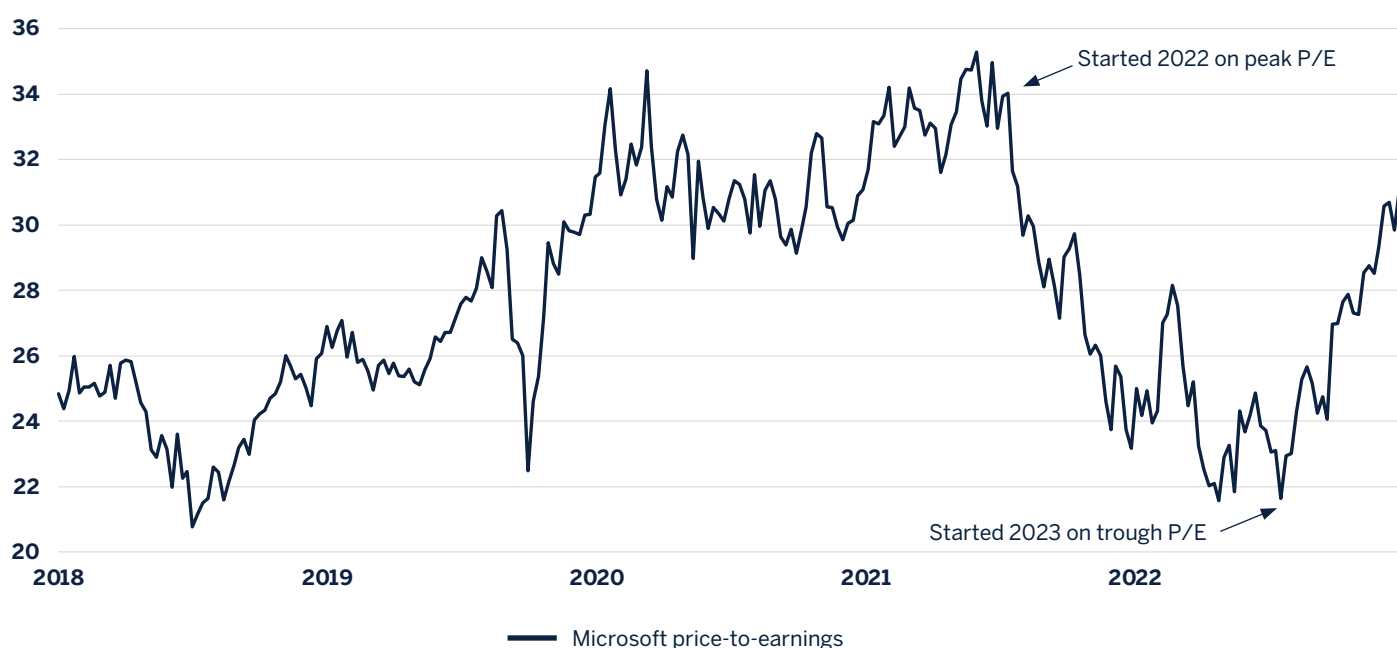
TECH VERSUS THE REST - YEAR TO DATE DOMINANCE



Source: FactSet data

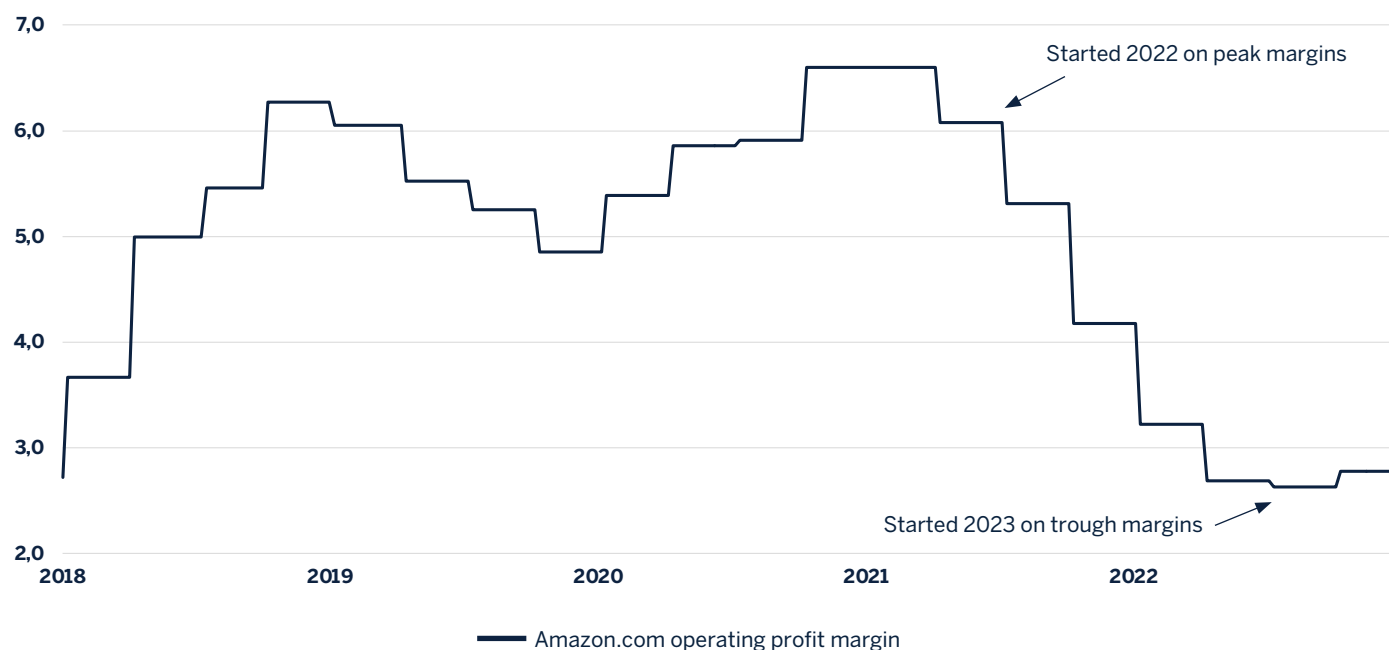
It was all so different six months ago. Tech was dead and buried at the start of the year after being hit in 2022 by an unravelling of the COVID demand surge and by their valuations being crimped by higher interest rates. The result were trough revenues and profit margins, and cheaper valuations. As shown below, Microsoft and Amazon.com were cases in point.

MICROSOFT PRICE-TO-EARNINGS RATIO – VERY DIFFERENT STARTING POINTS IN 2022 AND 2023



Source: Factset data

AMAZON.COM OPERATING PROFIT MARGIN – VERY DIFFERENT STARTING POINTS IN 2022 AND 2023



Source: Factset data

What has changed? There were three drivers behind the Big Tech rally:

1. Self-help

The first catalyst was a swath of job cut announcements as the Big Techs sought to demonstrate their Damascene conversion to cost efficiency. This was a U-turn from their earlier spending spurge when COVID pulled forward demand and there was a landgrab to garner more of the pie.

2. Macro

Second, came signs of stabilisation in ecommerce and digital advertising demand. The jury is still out on this if we lurch into a deep recession, but tepid growth is better than no growth. Big Tech's exposure to secular growth trends is perceived to be a safe haven amidst widespread nervousness about the business cycle, consumer spending and the health of US regional banks. As Big Tech was one of the earlier sectors to take their medicine in terms of valuation and earnings adjustments, they are arguably in a better position to weather the storm than other cyclically sensitive sectors.

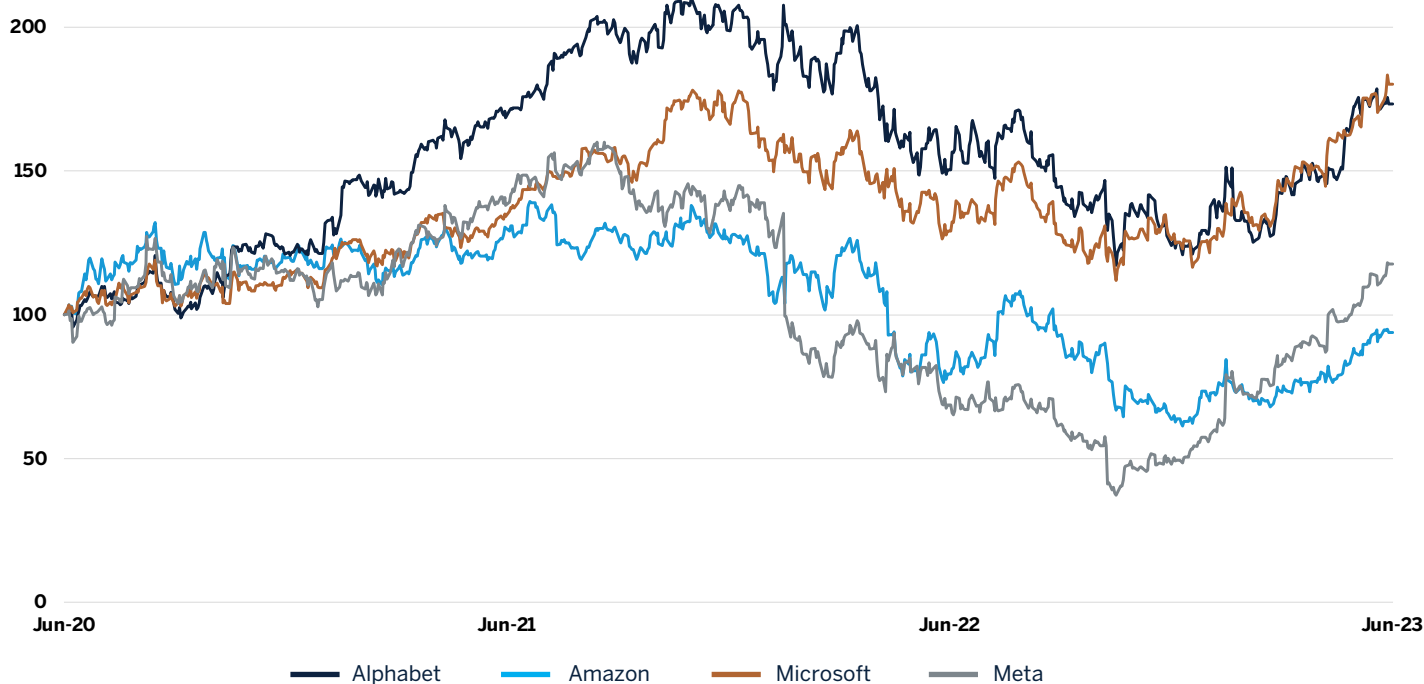
3. Chat GPT

Finally, AI chatter and related application launches provided the rocket fuel. Big Tech's billions of R&D investment and integrated solutions in this area put them in pole position to benefit.

Where to now for our holdings in Microsoft, Amazon, Meta and Alphabet?

Recent moves do not look stretched from a three-year perspective. Despite recent outperformance, all the shares are below their 2021/2022 peaks.

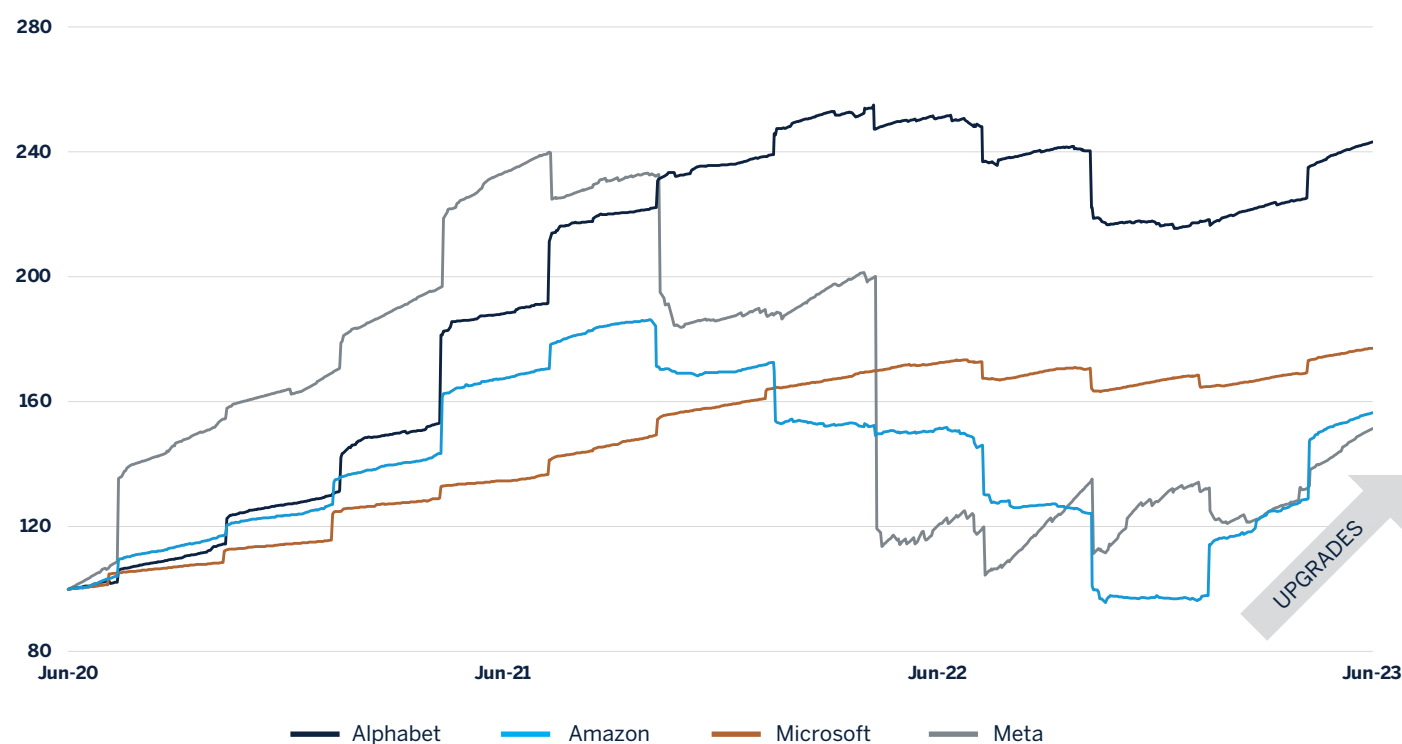
MICROSOFT, AMAZON, META AND ALPHABET - SHARE PRICE PERFORMANCE



Source: Factset data

And the recent rally is underpinned by ongoing earnings strength (Microsoft and Alphabet) or recovery as they roll off heavy investment years (Amazon and Meta). Although there are some clouds over the horizon (e.g. a more cautious approach by corporates on cloud computing spend), the fundamental backdrop is still supportive.

MICROSOFT, AMAZON, META AND ALPHABET – NEXT 12 MONTHS EARNINGS PER SHARE



Source: Factset data

The main caveat remains the economy. The Federal Reserve started raising rates over a year ago, and we are still waiting for the recession to happen or something else to break. This is the boiling frog scenario. Either too strong growth forces higher than expected rate hikes or we lurch into a deep recession. Neither is good for the stock market. At present this year's market has been factoring in a Goldilocks scenario ("not too hot, not too slow") as labour markets have largely been unmoved by monetary policy.

Fortunately, our investment style is not dependent on make heroic macro calls, but rather to act as long-term owners of high-quality businesses. Our Big Tech holdings continue to tick all our boxes on their ability to generate sustained compound earnings growth. It was the reason we kept hold of them during last year's hiatus in their share prices, knowing investors would return.

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