October 2020

Cautionary Tales of Offshore Investing

South African businesses have a strong history of successfully expanding their operations offshore and becoming well renowned global businesses. This has been done to access growth opportunities in offshore markets and to diversify away from a lower growth and higher risk domestic environment. While some companies have achieved success in their offshore pursuits, there are many that have struggled.

In this article we take a deeper look at two of these businesses, Woolworths and Sasol, and explore what lessons we can learn from their failures by relating it back to how we make our own investment decisions.

Woolworths: Paying too much

Woolworths is a classic example of a successful South African business that made a bold move offshore and struggled. In early 2010, the business was in a very healthy position and its management had a good reason to be confident. The business was growing; costs and inventories were being managed well; they had lots of cash available; and profits were up. They were also gaining market share in new high growth areas like online and food retail and their shareholding in the high-end Australian clothing brand, Country Road, was contributing nicely to their bottom line.

At the same time, the retail environment was changing with the growth in online retail, consolidation in the industry and the arrival of international retailers like Zara and H&M in 2011 and 2015, respectively. Local retailers had to innovate and build scale to remain globally competitive. Woolworths identified Australian listed retailer, David Jones, as an ideal opportunity to do just that, creating a "leading retailer in the Southern Hemisphere". This was unfortunately where their fortunes changed. While the rationale to go offshore and expand into a region with a common fashion season made sense, the execution of the strategy was found wanting.

In our view, there were three main challenges with the acquisition:

They spent a lot of money	They overpaid	They bought an average asset
This was a big acquisition. David Jones was Australia's second largest department store at the time. Woolworths paid R21.5 billion, equivalent to 35% of their market value.	Woolworths grossly overpaid, with their CEO (Ian Moir) admitting as much in an interview in 2019. David Jones had already received an offer from fellow Australian retailer Myers, and so Woolworths had to outbid the competition to settle on a 25% premium over the prevailing share price.	David Jones was not in the best shape. The retailer's profits had been declining for the three years preceding the acquisition and Woolworths had to spend billions to revamp stores and make the business more competitive.

Initially the acquisition looked like it was the right decision as Woolworths seemed to be doing well. As shown in Chart 1 below, revenue (the green dotted line) and operating profit[1] (the red dotted line) continued to rise in the years following the acquisition. However, operating profit could not keep up and started declining by 2016. Furthermore, they now had to deal with significant debt, which increased from less than R1 billion in 2014 to around R16 billion two years later.

The enormous debt burden and the realisation that the business may have spent too much on an underperforming asset weighed on the share price. Their woes were exacerbated in 2018 when Woolworths started writing off[2] their investment in David Jones. Between 2018 and 2019, Woolworths had to realise R12 billion in losses from writing off their investment in David Jones, equivalent to 60% of the initial purchase price.

Compared to 2014, Woolworths is now less profitable, has 16 times more debt and the share price is down 57%. Ian Moir was replaced as CEO of the group in February 2020 and moved to Australia to run David Jones.

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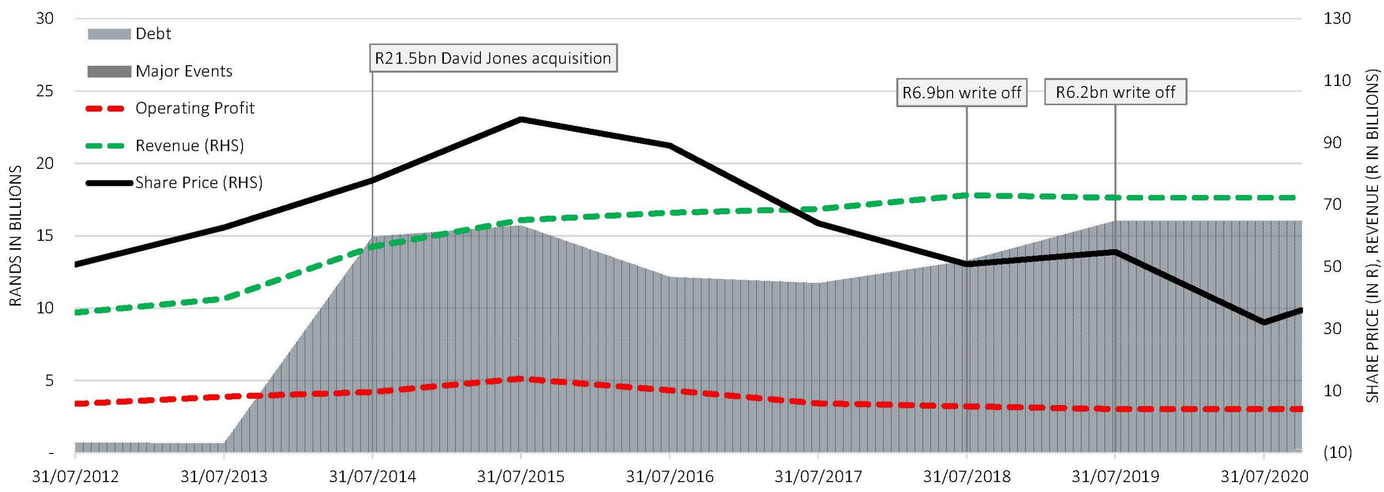
Chart 1: Woolworths's timeline of events, 2012-2020



Source: Refinitiv, Thomson Reuters Datastream

Sasol: Betting the farm

While Woolworths's issues began with an ambitious offshore acquisition, Sasol made a significant investment in the Lake Charles Chemicals Plant (LCCP) project in Louisiana in the US. The project commenced in 2014 with an expected completion date of 2018 and included the construction of an ethane cracker[1] and six downstream chemical manufacturing facilities. While Sasol's existing energy and chemicals businesses were performing relatively well in a difficult operating environment, their revenues remained exposed to movements in the oil price. The LCCP project provided Sasol with the opportunity to grow its chemicals business and diversify away from oil. However, the cost overruns, delays, and ballooning debt from the LCCP project, have taken a significant toll on the business over the last few years.

Once again, we have identified what we feel were the main problems with the project:

They also spent a lot of money	Poor project management
With an initial cost estimate of $8.1 billion, the project's cost equated to around 25% of Sasol's market value. This was a significant initial commitment because the project was only expected to start paying off years into the future when the plant became operational.	The LCCP project was poorly managed, with significant cost overruns and delays in getting the plant operational. The delays pushed out revenues from the project, forcing Sasol to carry the debt burden for longer than expected, leaving them overexposed to oil.

As we can see in Chart 2 below, prior to the investment in 2014, Sasol was a very healthy business. Debt levels were low, while revenue (the green dotted line) and operating profit (the red dotted line) were rising. However, progress on the LCCP project started to stall in 2016, which led to Sasol revising the total expected costs of the project to $11 billion and then again to $12.9 billion in 2019, while the estimated completion date was delayed to 2020.

To make matters worse, the fallout from COVID had a material impact on the already strained business as oil prices plunged, which led to concerns around Sasol's ability to repay its debt. The market value fell to a low of R23 billion at the end of March 2020, while debt ballooned to over R160 billion. Sasol recognised the deteriorating outlook of its investments by writing off R111.6 billion across the business in 2020, including R72 billion from the LCCP facility. They also undertook to sell a 50% stake in some of the units at the LCCP project to reduce their debt burden.

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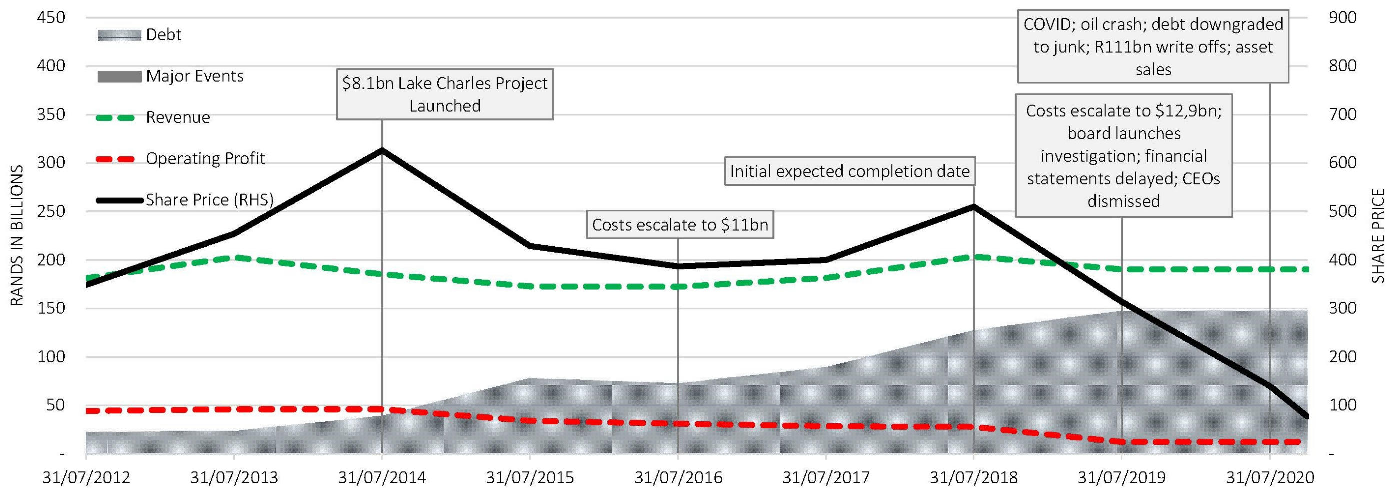
Sasol's operating profit is down 73% while long term debt is up 600% since launching the project in 2014. The result has been a significant decline in the share price.

Chart 2: Sasol's timeline of events, 2012-2020



Source: Refinitiv, Thomson Reuters Datastream

So, what can we learn from these two examples when deciding to invest offshore?

- Do not over-commit. Your offshore exposure should make sense in terms of your objectives and overall portfolio.
- Do not put all your eggs in one basket. Mitigate against single event risk by being adequately diversified across sectors and regions.
- Do not overpay. Be cognisant of valuation levels in both the currency and the offshore assets because Rand investors are dependent on both for returns.
- Ensure your time horizon is correct. Offshore investments are more volatile because of the currency impact. This means you need to have a longer timeframe to mitigate against unexpected short-term volatility.

Having offshore exposure is an important part of an investor's portfolio given the range of opportunities on offer. However, the exposure needs to be suitable to the investor's long-term needs. We believe it is important to commit to a financial plan that addresses risk and return objectives and the investment horizon, to help prevent overallocation, poor timing, and mitigate single event risk by ensuring adequate diversification.

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[1] Operating profit is what investors are left with after deducting all regular business expenses.

[2] Companies record the value of their investments as realistically as possible and adjust when their outlook changes. The adjustments are recorded as gains or losses in the financial statements.

[3] An ethane cracker turns natural gas into ethylene, a component used in the production of plastics, resins, adhesives and other synthetic goods.

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October 2020

data provided by Reuters and Datastream

31 Oct 2020

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-6.5%	-7.1%	-5.8%	-1.3%	2.2%	8.7%	14.6%	13.0%
FTSE/JSE SA Listed Property	ZAR	-18.8%	-50.9%	-51.6%	-26.5%	-14.7%	0.7%	23.3%	19.4%
SA All Bond Index (ALBI)	ZAR	1.7%	2.7%	4.8%	8.5%	7.5%	7.6%	8.8%	7.9%
SA Cash Index (SteFI)	ZAR	1.1%	4.7%	5.9%	6.8%	7.1%	6.4%	0.2%	0.3%
Balanced Benchmark	ZAR	-5.1%	-2.1%	-1.9%	2.2%	4.6%	9.8%	10.0%	8.6%
SA Inflation (1 month lag)	ZAR	1.7%	2.6%	3.0%	4.2%	4.6%	5.1%	1.3%	1.3%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	-0.1%	-1.0%	4.9%	6.5%	8.7%	9.2%	14.1%	13.6%
Emerging Markets Equity (Datastream EM)	USD	2.7%	1.1%	8.6%	2.3%	8.3%	2.8%	17.2%	17.6%
Global Property	USD	-3.8%	-14.8%	-15.1%	1.1%	3.4%	6.1%	14.3%	14.6%
Global Bonds (Barclays Global Bond Index)	USD	-0.8%	6.9%	6.0%	4.5%	3.9%	1.7%	5.4%	5.2%
Global Cash	USD	0.1%	0.6%	0.9%	1.8%	1.5%	0.9%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-6.5%	-7.1%	-5.8%	-1.3%	2.2%	8.7%	14.6%	13.0%
Global Equity (Datastream World)	ZAR	-4.6%	15.1%	13.2%	11.6%	12.3%	18.9%	17.0%	14.7%
Emerging Markets Equity (Datastream EM)	ZAR	-2.0%	17.5%	17.2%	7.2%	11.9%	11.9%	14.5%	13.4%
Global Property	ZAR	-8.2%	-8.6%	-8.5%	5.9%	6.8%	15.5%	16.9%	14.6%
SA All Bond Index (ALBI)	ZAR	1.7%	2.7%	4.8%	8.5%	7.5%	7.6%	8.8%	7.9%
Global Bonds (Citigroup)	ZAR	-5.4%	24.3%	14.3%	9.4%	7.4%	10.7%	16.6%	14.7%
COMMODITIES									
Gold (US Dollars)	USD	-4.8%	23.7%	24.5%	14.0%	10.5%	3.4%	13.4%	15.9%
Gold (Rands)	ZAR	-9.1%	43.7%	34.3%	19.4%	14.2%	12.6%		
CURRENCIES									
Rand / Dollar	ZAR	4.6%	-16.2%	-7.9%	-4.7%	-3.3%	-8.9%	17.1%	15.7%
Rand / GBP Pound	ZAR	6.0%	-13.4%	-7.8%	-3.8%	0.3%	-6.6%	17.8%	15.2%
Rand / Euro	ZAR	6.0%	-20.6%	-12.6%	-4.7%	-4.4%	-6.9%	15.9%	14.1%

Spot Rates		30-Oct-20	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	16.25	16.68	15.06	13.81	6.96	7.56
Rand/GBP	Rand	21.02	21.57	19.50	21.34	11.12	10.98
Rand/EUR	Rand	18.93	19.56	16.81	15.25	9.67	6.41
RATES							
Libor 6m $	US$	0.24	0.26	1.92	0.55	0.45	6.72
Repo Rate	Rand	3.50	3.50	6.50	6.00	6.00	12.00
Prime	Rand	7.00	7.00	10.00	9.50	10.00	14.50
All Bond Index Yield	Rand	11.64	11.64	9.63	8.72	7.89	9.74
COMMODITIES							
Gold ($/oz)	US$	1,880.77	1,899.84	1,510.23	1,141.05	1,347.40	264.45
Platinum	US$	852.00	884.00	936.00	988.00	1,700.00	584.00
Oil (Brent Crude) $	US$	37.54	40.99	60.21	48.45	82.60	31.25
INFLATION							
SA Inflation	%	3.0	3.0	3.7	4.6	3.3	9.4