

# Manager thinking

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## Why some things just don't make it to our portfolios

Investing in company debt — known as credit — is similar to mining: we have to dig through tons of rocks to find the one or two diamonds we are looking for.

A good example of this would be the current opportunities in the South African retail sector. Companies like fashion or food retailers issue bonds as a way to raise capital. Investors can then buy that debt and earn interest payments in return.

When we recently screened the sector at a high level, there was one retailer that seemed unloved and underpriced, but with a good history and track record. This is usually the type of investment we like — a quality company giving us an attractive price.

However, when we did a deeper analysis, it became apparent why this once blue-chip retailer has become so unloved. Our analysis highlighted several concerns based on the factors that we always look at before deciding to make any investment.

### Management team

Firstly, the management team of this company had been in place for a long period and had not been able to turn around years of poor performance. It was clear that new thinking and a new strategy were required and new leadership was needed.

### Rising costs

One thing in particular that the management team was not able to prevent was the escalating cost structure in the business. Some of the most significant costs were from spending on diesel during the dark days of load shedding, and the fact that the company had rising stock levels because their logistics were less than optimal.

### Capital structure

It also became clear that the company was running low on capital. A rights issue where shareholders were going to be asked to buy more shares was going to be needed to rescue the business. We did not think that this was going to raise enough money to fix everything. The company was also looking at the listing of one of its subsidiaries to raise more capital.

### Competitive environment

Our analysis showed that the company was not keeping up with its competitors when it came to things like online shopping and delivery. Their offering to the lower living standards measure (LSM) consumer market also did not have the footprint to take market share from the other large players. This has become an important area of growth for retailers, but this company was slow to move on this strategy.

## Debt ratios

Given the poor results and rising cost structure, the amount of debt the company was issuing relative to how much money it was making was becoming a concern. We did not think that a default was a high probability, but at the same time we were not comfortable with the overall strength of its balance sheet.

## ESG strategy

All companies now have plans to lower their carbon footprints. It was, however, not clear to us how this retailer was going to improve its carbon footprint given their dependence on diesel for backup power generation and the fact that they didn't have a clear strategy for moving to cleaner or renewable energy over time.

## Conclusion

Given all these factors, we decided unanimously not to invest in the debt of this company. Even though we were being offered good yields, we did not think this compensated us for the risks we saw.

While it may be disappointing to have to walk away from an investment that we initially thought would be good for our clients, our thorough process is in place for exactly this reason. Even though something may look attractive, we have to dig around to see what risks there might be that are not obvious at first glance. This is why we have to spend the time and effort to do a deep dive analysis of every company before we invest in it. Credit is such an interesting asset class and rewarding over time, but only if you put the hard work in.

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