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CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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From SONA to BUDGET

The South African economy is at a critical junction and the 2020 February budget will be a deciding moment in determining its future path. It now depends on how much of the resolutions and intentions presented in the medium-term budget policy statement (MTBPS) and National Treasury's economic transformation plan is adopted and implemented.

Earlier this month, President Ramaphosa delivered his state of the nation (SONA) speech despite disruptions from the EFF. His speech served as a precursor to the Budget outlining salient features of the economy while providing further clarity on issues such as energy policy, state owned enterprises (SOE's) and the infrastructure fund. He acknowledged that we are at a "decisive moment" in an economy that is in crisis.

The policy on energy focussed on the determination of new generation capacity from renewable energy, the acquisition of additional capacity from existing wind and solar plants and the allowance for municipalities to procure power from independent power producers. In addition, he acknowledged the problems facing the sustainability of public debt which will be dealt with by the Minister of Finance in the budget presentation. The plan by the CEO of Eskom, André de Ruyter, to restructure Eskom into three units (generation, transmission and distribution) was reinforced with each of these entities set to have its own boards and management structures.

The president emphasised support for smaller SOE's but stated the need for a process of rationalisation and the need for these entities to serve their strategic and development purposes. Measures will also be introduced to make business easier such as registration of a business within a day and a greatly reduced waiting period to process and issue water licences. Ambitious projects such as the establishment of a sovereign wealth fund, a state bank, a new university and a smart city begs the question as to where the funding will come from in a struggling economy. Nevertheless, the success of these ventures could very well nurture further successes and boost much needed confidence.

The market has now turned its attention to the national budget that will be presented by minister Tito Mboweni on 26 February 2020. A critical budget that hopefully will arrest, to some degree, the downward path of our fiscal health. Most market participants are expecting a consolidated budget deficit of about 6.5% of GDP. A number much wider than the 5.9% pencilled into the MTPBS.

While there is very little wiggle room on the revenue side, a concerted effort and commitment is required to reduce expenditure. Revenue-raising measures are constrained. The remaining avenues in this regard include the raising of indirect taxes such as sin taxes and excise duties, not adjusting personal income tax brackets for inflation, not adjusting medical tax credits and an increase in the VAT rate. All these measures combined are estimated to only produce increased revenue of about R30bn. A far cry from the estimated R150b needed to achieve sustainability in the fiscus. It is therefore incumbent on the government to address the expenditure side of the country's balance sheet. The elephant in the room is undoubtedly the enormous public sector wage bill which is expected to rise by between 7.1% and 6.0% over the next three years compared to inflation which is expected to average about 4.6% over the period. Now is the time to exercise the will to reduce expenditure which is constantly being exacerbated by the fiscal drag caused by bailouts provided to SOE's.

An inevitable downgrade by ratings agency, Moody's is looming which will see an outflow of capital as South Africa is excluded from the World Government Bond Index.

A challenging yet all important budget lies ahead that promises to provide for interesting reading and interpretation as political will, labour pressure and clinical economic logic is juggled to achieve the best possible outcome.

By Sidney McKinnon

Facebook: More than just a thumbs up

Ever since its inception in 2004, Facebook has changed the way people interact with each other and the world. The company, with Mark Zuckerberg at the helm, has gone from strength to strength, despite increasing public scrutiny and heightened regulation. When most people think about Facebook, they think about scrolling through friends' posts, liking the occasional photo and searching for long lost friends, but it is so much more than that. The company has continually reinvented itself, adding not only features, but also making strategic acquisitions which compliments Facebook's core business.

THE BUSINESS

Besides its social media platform and namesake Facebook, the business has also acquired Instagram, WhatsApp, Messenger and Oculus. Instagram focuses its attention on photo and video sharing, while WhatsApp and Messenger are complimentary messaging services. Oculus focuses on virtual reality hardware and technology. Through these collective businesses, Facebook has tried to emphasise community, building relationships and fostering meaningful interactions between users.

HOW THEY OPERATE

The key to Facebook's success has been advertising. Advertising is big business, with Facebook raking in USD69.66 billion in 2019 alone. They have continuously improved the way ads are delivered, and how individual users are targeted. This is important for advertisers, who want the most bang for their buck as the global consumer comes under pressure. Facebook has taken this a step further, helping advertisers strategically set up ads, ensuring that the ad doesn't only reach the right audience, but that the content of the ad is more targeted.

Facebook is also exploring other avenues to generate revenue.

- Take Instagram for example. Not only is it an excellent platform to advertise on, but what about click through sales? The idea is to advertise a piece of clothing on Instagram, if a person likes it, instead of being redirected to the product's website, they can buy it using Instagram itself. Suddenly, Instagram becomes a significant "retail outlet".
- WhatsApp is another avenue of untapped potential, with implications not only for advertising, but how businesses interact with their clientele. Instead of clients having to contact the business's call centre and listen to elevator music while waiting for help , rather, you can chat to a consultant directly via WhatsApp.

WHY FACEBOOK?

Facebook has a capital-lite business model that is scalable. It employs more than 44 900 people, and presently have 15 data centres globally to handle the more than 2.5 billion active monthly users (almost a third of the world's population). The average revenue generated per user reached USD29.25 in December 2019 from its core products, Facebook and Messenger services.

This enabled the business to achieve an adjusted operating margin in excess of 40% for the year ending 2019. This adjusted operating margin is expected to decline over time to what we believe is a more sustainable level of 35%. The moderation in the operating margin is due to new users predominantly being based in less affluent geographies, leading to less revenue per user. This is to be expected as developed markets become saturated and the pick-up in new users in those regions start to taper off.

In addition to its high operating margins the business also sits on a war chest of cash, in excess of USD54 billion. This can be deployed in strategic acquisitions or to buy back shares if the opportunity arises. This means that you get a business that is a well-oiled machine, without having to worry about balance sheet stress.

IN A NUTSHELL

At Cadiz, we are always on the lookout for well-run companies which show a history of superior returns with low financial risk. By investing in Facebook, we believe the risk of losing capital is low, while the potential for above-market returns is skewed in our favour. Despite heightened regulation and public scrutiny, we believe Facebook will be able to continue to deliver superior returns in the future, which should reward our patience over time.

By Johan Louwrens, CFA