CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

cadiz
ASSET MANAGEMENT

MARKET COMMENTARY
OCTOBER 2019

What not to do when stock markets go down

Unless you made a resolution not to read, listen to or watch the news during 2019, you would have noticed that world markets are still volatile. Indeed, one glance at the local headlines quickly reveals that our market is having another turbulent year.

With the market volatility we have experienced thus far, some investors may be considering getting out of the market. This is a mistake. History has shown that trying to time the market is nearly impossible and that staying the course has shown a significantly improved outcome.

Between 80% to 90% of the returns gained on shares occur in less than 10% of trading days. So, if you are out of the market when shares begin to move upward, your long-term returns may suffer significantly.

In a study on all bear markets since World War II, the Wall Street Journal reported that shares rose, on average, 32.5% in the 12 months following the bear-market bottom. If you missed the bottom by just a week, however, the return reduced to 24.3%. If you waited three months after the market had turned, your gain was reduced to just 15%. (Investopedia describes a bear market as a condition in which share prices fall and widespread pessimism causes the stock markets' downward spiral).

William Sharpe, a Nobel laureate, found that those clients trying to time the market would need to be correct a staggering 82% of the time to just match the returns gained by clients who followed a buy-and-hold strategy. While investors with a long-term investment horizon were sitting and doing nothing, those clients who were trying market timing were anxiously wondering when was the best time to get in or out of the market and then still not earning superior returns.

Time is much more important than timing when it comes to long-term stock market success. It is very tempting to "get out of the market now and return when things are looking better". The problem with this is that one never knows when things have improved until it is too late, and the shares have already skyrocketed.

STAYING THE COURSE

In times of market turmoil, we are tempted to focus on the short term. However, it is important to consider your long-term investment horizon and why you are investing, whether that be for or after retirement or for some other goal.

Market returns may vary over time, but, as long as the global economy remains healthy and companies continue to innovate and grow, we believe there is still a case for staying invested in equities for the potential growth we see ahead.

Most investors have significant investments in their home countries, which in the realm of behavioural finance is called home-country bias. So, for all investors, we believe there are sound reasons for diversifying across asset classes and markets to help protect against the negative impact of a single event.

Additionally, in times of volatility, we believe active management can prove its worth. So, during this volatile period we recommend that investors consult with their financial advisors to determine the most appropriate portfolio allocations for their situation.

The ongoing market noise has not changed our view of the world. Although additional volatility may follow, we remain optimistic about the coming year.

> *"The stock market is the only market in the world where customers run away during a sale."*
>
> **FT, LEX COLUMN**

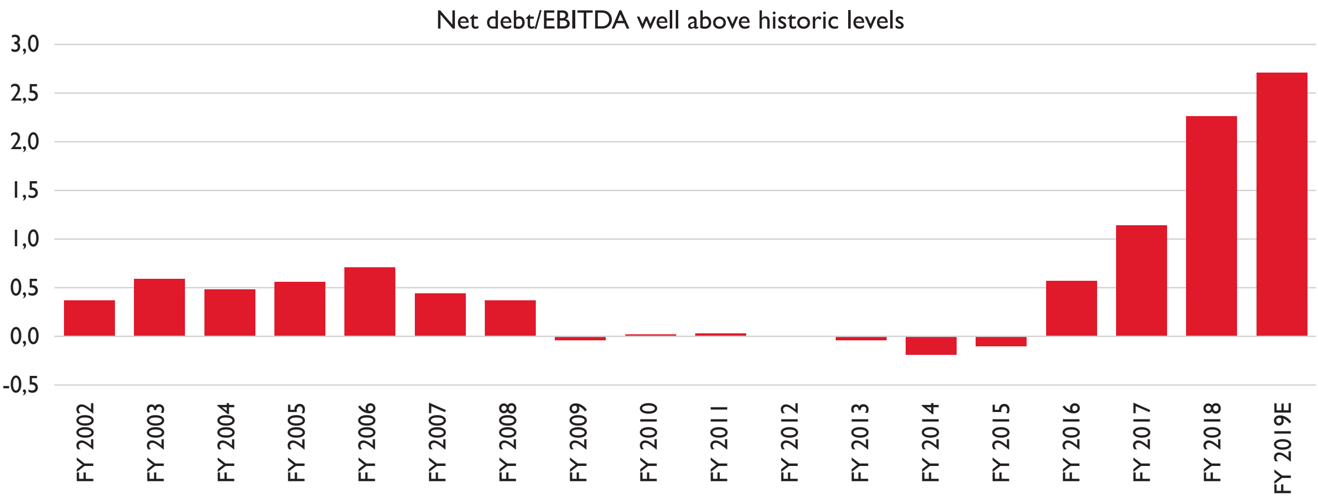
Sasol Limited – Is it time to kiss the dividend goodbye?

POOR CAPITAL ALLOCATION AND PROJECT EXECUTION

We have seen Sasol's share price decline as management has failed to deliver on the Lake Charles Chemical Project (LCCP), which is over budget and behind schedule. Sasol's management team have also delayed the release of their financial results as they investigate the weak control environment that led to the problems at LCCP. The project was initially budgeted to cost $8.9bn and be completed by the end of 2018. Management now expect the cost to be between $12.6-12.9bn with the majority of units operating by Q4 2019. Management have repeatedly over-promised and under-delivered. Capital allocation and project execution has been poor and the initial projected return of around 12% for LCCP has been severely impaired.

FINANCIAL RISK HAS INCREASED SIGNIFICANTLY

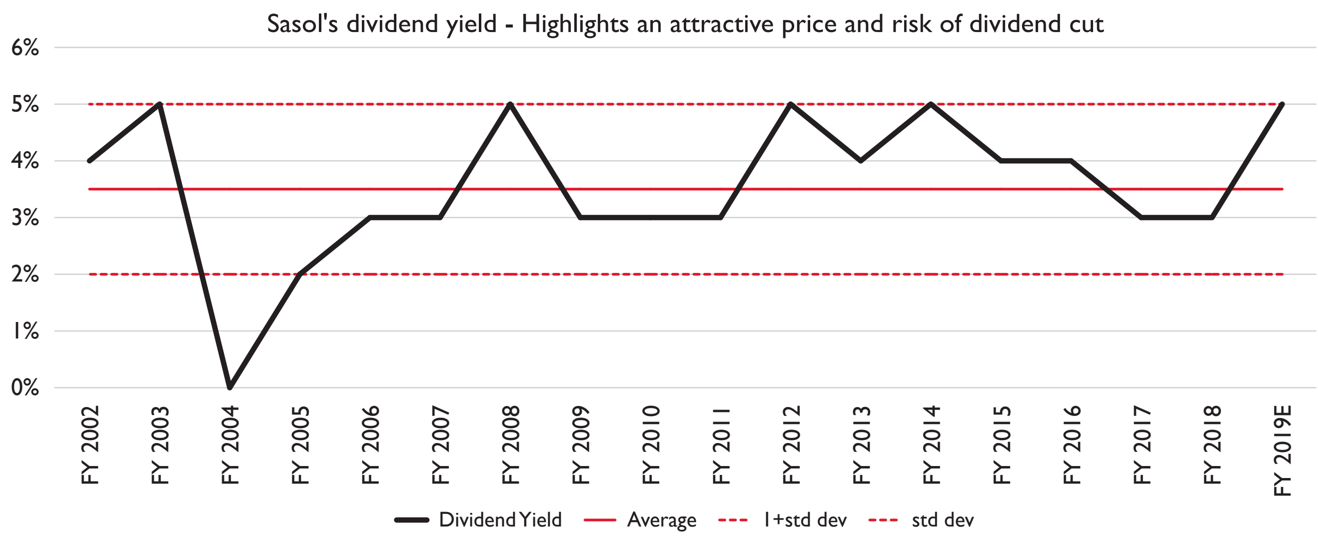
Management have significantly increased the financial risk of the business due to the investment into LCCP. Before the LCCP project, net debt was negative (positive cash balance of R10bn) and Sasol's ability to pay dividends was good. Presently, net debt has increased significantly with Net debt/EBITDA likely to hit 2.7x (see chart below).



Source: Bloomberg, Cadiz Asset Management

In order to avoid breaching various debt covenants, Sasol was able to increase its Net Debt/EBITDA covenant level to 3x from 2.5x. This increase in the covenant should provide sufficient breathing room for Sasol to narrowly avoid a rights issue, but the dividend will in all likelihood be cut. As production at LCCP ramps up over the next few years, free cash flow should improve allowing Sasol to reduce the debt load. However, the longer the project is delayed the longer it will take to lower the financial risk of the business.

HIGH LIKELIHOOD OF A DIVIDEND CUT



Source: Bloomberg, Cadiz Asset Management

Sasol's current dividend yield (chart above) is high at 5.2% compared to its long run average of 3.5%. In early 2016 when the dividend yield was at similar levels, Cadiz held an overweight investment position, as the financial risk was low, with the high dividend yield indicative of an attractive purchase price. We correctly assessed that an oil price of less than $40 per barrel, which was below the average cost of production, was unsustainable and a higher long-term oil price would be required to ensure continued oil production.

The current situation is quite different. The share price is low due to elevated financial risk and a lack of confidence in management. Repairing the balance sheet is a top priority which is likely to be achieved by cutting the dividend. In a worst-case scenario, a rights issue may be required.

Sasol has been a good contributor to Cadiz investment performance over the last 3 years. Cadiz have retained a small position in Sasol. We believe the current valuation is attractive, however, we are more cautious due to the high financial risk, likely dividend cut and further negative disclosures regarding LCCP. For now, patience is warranted until we have clarity on whether a rights issue can be avoided.

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