cadiz
ASSET MANAGEMENT

Shoprite – Quality on Sale

In the short-term, share prices can often become disconnected from what a business is worth as investors over react to recent news or market events. This gives an astute investor the opportunity to take advantage, and buy quality businesses at attractive prices that are likely to compound returns overtime.

SHOPRITE'S COMPETITIVE ADVANTAGES MAKE IT A QUALITY BUSINESS

Shoprite can be described as a high-quality business, with a history of consistently earning a return on capital greater than its cost of capital, thereby creating economic value for shareholders that compounds overtime. Shoprite's competitive advantages are their economies of scale, a more efficient supply chain and they have built up a first mover advantage in Africa.

- Economies of scale advantage

  Because of Shoprite's extensive store footprint throughout South Africa, and the large volume of goods that goes through these stores, Shoprite has been able to source goods cheaper than its competitors. Some of these cost savings can be passed onto its customers by charging lower prices. This generates increased loyalty and demand, leading to further scale advantages. Greater scale also allows the Group to spread its fixed costs over a larger number of products, effectively reducing the overall 'cost per unit'. The lower prices that Shoprite can offer customers helps prevent new entrants into the sector, as they struggle to compete.

- Supply chain advantage

  Shoprite was the first of the food retailers to set up distribution centres (DC's) and centralise their supply chain. The centralised supply chain has resulted in reduced transport costs for suppliers, while ensuring the quality of the product. The Group's fleet of trucks are used more efficiently to transport goods along optimised routes to the stores. This results in an improvement in the lead time of products to stores, and on-shelf availability. The DC's also enable better space utilisation within the Group's individual stores. The efficient use of space results in cost savings, and increased sales.

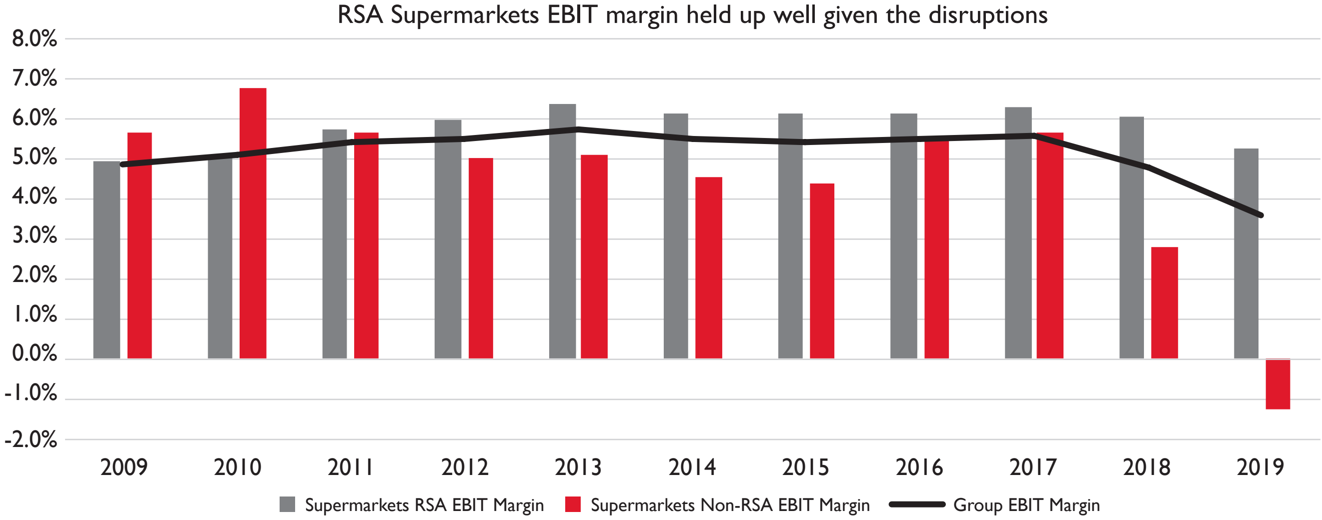
- First mover advantage in Africa

  Shoprite have been expanding in Africa for 20 odd years and the Group has 424 stores in 14 countries, with Angola and Nigeria being their largest operations. This early investment has been capital intensive and tough to execute at times. They have had to deal with varying regulatory requirements, poor infrastructure, and have had to, in certain instances, build the malls or shops for their stores. In order to get the goods to market, Shoprite have also had to establish an effective supply chain and transportation network. This has created a barrier to entry as new entrants are discouraged from competing due to the large amounts of capital, time and understanding of operating in Africa, that are needed.

SHOPRITE'S FINANCIAL YEAR 2019 RESULTS DISAPPOINTED THE MARKET BUT ARE TEMPORARY

Shoprite's trading margin for South Africa was down but not a disaster, while the African operations made losses which caused Group earnings to deteriorate in 2019, as shown in the chart below. We believe this is temporary and expect the trading margins to improve over the coming years.

RSA Supermarkets EBIT margin held up well given the disruptions



Source: Shoprite Annual Reports, Cadiz Asset Management

- **The South African operations** (~80% of Group revenue) were affected by a six-week service provider strike at their largest DC in Gauteng, in the first half of the year. At the same time, Shoprite had issues implementing their new IT system, which impacted the Group's ability to meet store demand. This resulted in the Group losing market share.

  Despite these issues, the South African Supermarkets division still managed to generate a 5.3% operating margin for the full year (which is about double that of competitor Pick n Pay). Shoprite has recently released an operations update stating that their local supermarket sales have increased by 10.3% in the first quarter of FY2020, indicating that they are well on their way to regaining lost market share.

- **The Rest of Africa division**, which makes up ~15% of the Group revenue, had a negative trading margin. This surprised the market. This was largely impacted by significant currency devaluation, import impediments and customer affordability. Management have stated that the division will most likely be loss making in FY 2020 as some of these headwinds persist.

  In the long-term however, we believe management will be able to return this division to profitability and position Shoprite to benefit from the high growth rates expected in Africa. The high barriers to entry will ensure Shoprite retains its competitive advantage in those markets.

We believe the market over reacted to Shoprite's poor FY 2019 results causing the share price to fall from R160 to R110 per share. This gave us an opportunity to buy a quality business at a significantly discounted price. Overtime we expect this investment in Shoprite will add significant returns for our clients.