



A more resilient than expected SA consumer presents select equity opportunities



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The fast view

- Despite formal job losses of 1.4 million in 2020, the Temporary Employer/Employee Relief Scheme (TERS) and COVID-19 special grant played key roles in sustaining SA consumers and retail sales.
- This benefited food and value-oriented retailers.
- The cumulative 3.5% cut in interest rates benefited those who had kept their jobs, as debt servicing costs decreased, and drastically improved consumer credit health.
- The decline in fuel prices and controlled food inflation also contributed to the SA consumer faring better than expected.
- There are further potential tailwinds for the SA consumer into 2021, with economists estimating the labour market to add 400 000 jobs and interest rates likely to remain supportive.
- Real household consumption is expected to rise by 3.2% for the year, which will benefit retail sales.
- The apparel retailers and hospitality industry are set to benefit from the reopening of the economy at the expense of the food retailers, furniture and home improvement retailers, which were the big beneficiaries in 2020.
- We have been actively increasing our exposure to apparel retailers since the second half of 2020. In particular, we found a compelling investment case to be made for the credit retailers, The Foschini Group (TFG) and Truworths.

South Africa is estimated to have seen formal job losses of 1.4 million¹ in 2020.

The COVID-19 pandemic made for an extremely tough 2020 globally, as the trauma manifested itself through the loss of loved ones, loss of jobs, and increased uncertainty about the present and the future. The pandemic further exacerbated the poor state of the South African consumer, who was already in a tough position at the outset of 2020. The unemployment rate was unsustainably high after a decade of anemic real GDP growth and even worse so at a real GDP per capita level. This forced the South African government to step in swiftly in an attempt to minimise the negative impact of the pandemic on South Africans, through measures such as the Temporary Employer/Employee Relief Scheme (TERS), and the increase in social grants, including the COVID-19 special grant of R350 per month, which has supported 6 million South Africans.

South Africa is estimated to have seen formal job losses of 1.4 million¹ in 2020. Unfortunately, these job losses impacted the lower paid employees without tertiary education. This is where TERS and the COVID-19 special grant played key roles in sustaining South Africans and subsequently supporting retail sales. Social grants as a proportion of total retail sales increased to a record 22.6% for 2020, versus an average of 18% in the prior 5 years². This support benefited the lower end of the market, with food and value-oriented retailers being the biggest beneficiaries. After realising the importance of the R350 top-up grant, the government agreed to extend the period of the grant until the end of April 2021.

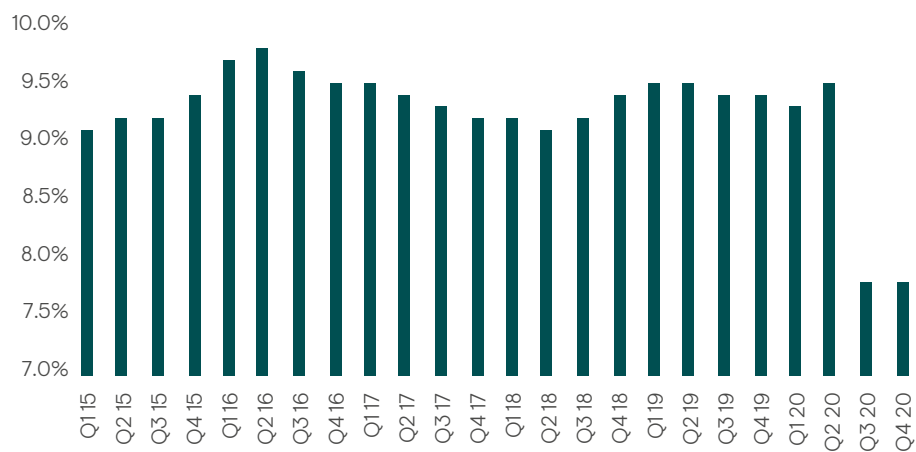
1. SA RB, RMB Morgan Stanley Research.

2. National Treasury, RMB Morgan Stanley Research.

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The South African Reserve Bank also played a key role in supporting the consumer with the cumulative 300 basis points (bps) cut in the repo rate to 3.5%. The interest rate cuts benefited those who had kept their jobs, as debt servicing costs decreased. As Figure 1 demonstrates, debt servicing costs as a percentage of household disposable income declined to approximately 7.7%³ by the end of 2020, from as high as 9.5% in 2019. In addition, the interest rate cuts drastically improved consumer credit health, with the Transunion SA Consumer Credit Index rising to a 10-year high of 58 in the last quarter of 2020 (See Figure 2).

Figure 1: Debt servicing costs to household disposable income (%)



Source: Stats SA, HSBC Research.

Several other factors also contributed to the South African consumer doing better than expected, including the decline in fuel prices throughout 2020 and controlled food inflation.

All the above points to the conclusion that if you were a South African that fell into a Socio-Economic Measure (SEM) range of 6 – 10 and had kept your employment, your financial position would have remained in reasonable shape; if you were a low income consumer, you would have had government support. As a result, consumer spend was more resilient than the market had expected.

Figure 2: Transunion SA Consumer Credit Index rises to 10-year high



Source: Transunion, 31 December 2020.

³ RMB Morgan Stanley Research estimates.

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Potential tailwinds for the SA consumer into 2021, but we're not out of the woods

There are still some potential tailwinds for the SA consumer into 2021. Economists are currently estimating the labour market to add 400 000 jobs⁴ in 2021, which will assist in driving real disposable income growth for the consumer. The government, combined with the private sector, needs to do more to drive job creation in the country and get more South Africans back into the labour force. President Cyril Ramaphosa's Economic Reconstruction and Recovery Plan that looks to create 800 000 public sector jobs over the next three years is a good example of government's commitment to do its part.

It appears likely that interest rates, while not declining further, will remain supportive for the consumer. This will continue to keep debt servicing costs down, and with rising household disposable income, debt servicing costs as a proportion of household disposable income will continue to fall. This should lead to continued improvement in consumer credit health and we would expect the Transunion SA Consumer Credit Index (Figure 2) to continue to rise, which bodes well for credit retailers.

However, the removal of the COVID-19 special grant will be negative for several low-income households. There is a big plea to government to continue these support measures at present, but no commitment on further extension has been made. Furthermore, fuel increases are becoming a headwind into 2021.

In combination, the above factors should support real disposable income growth for 2021, albeit at a low rate. More importantly, real household consumption is expected to rise by 3.2%⁵ for the year, which will benefit retail sales. The biggest losers of 2020 are expected to be the winners in 2021. The apparel retailers and the hospitality industry are set to benefit from the reopening of the economy at the expense of the food retailers, furniture and home improvement retailers, which were the big beneficiaries in 2020.

Finding opportunity in apparel retailers

We have been actively increasing our exposure to apparel retailers since the second half of 2020. In particular, we found a compelling investment case to be made for the credit retailers, The Foschini Group (TFG) and Truworths. After a muted credit growth trajectory over the last five years, with the consumer deleveraging and retailers becoming more stringent in rolling out credit, it appears that the cycle will start to support the credit retailers. Furthermore, 2020 was a year dominated by strong cash sales growth and weak credit sales growth due to two major reasons. Firstly, in times of crisis, consumers generally look to deleverage by actively paying down existing debt, and 2020 was no different, as consumers avoided taking on new debt. Secondly, due to the uncertainty of the period, credit retailers were less willing to open new accounts.

4. Stats SA, HSBC Research.

5. HSBC Research estimates.

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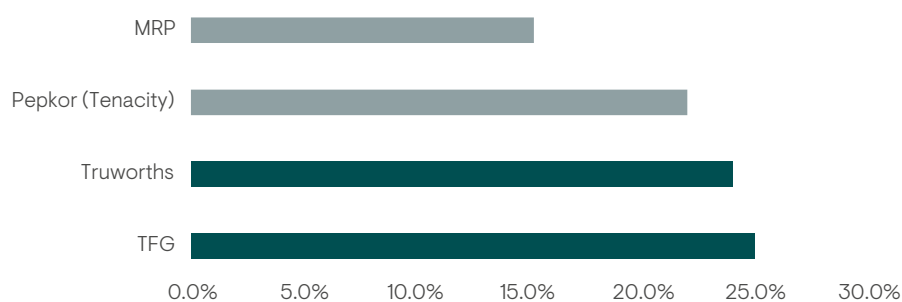
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Even though the retailers chose to hold back on new account openings, demand for their clothing accounts remained strong. Both TFG and Truworths reported a record number of applications in 2020. As both retailers made their acceptance criteria stricter, less applicants were risk approved, which led to a reduced number of new account openings. As the environment becomes less uncertain, we believe the credit retailers are very well placed to start slowly increasing the approval rate for new applications. This will support topline growth, as credit sales have the potential to grow faster than cash sales.

Another supportive factor is that both TFG and Truworths have credit books that are well provided for. The doubtful debt provision for Truworths at the end of December 2020 was 24%, while the provision for TFG at the end of September 2020 was 25%. Since the adoption of the accounting standard, IFRS 9, provision levels have averaged 20%. Both retailers increased the provision at the start of the crisis, with the expectation that consumer credit health would deteriorate and lead to a higher number of defaults. These expectations have proved to be too conservative, as collection rates have been much better than feared. As a result, a reduction in the provision levels going forward should also support earnings growth.

Within the 4Factor investment process, we construct portfolios using intensive fundamental research and bottom-up stock selection. We allocate capital to stocks where expected future earnings are being revised upwards, and we like to buy these at reasonable valuations. We believe what moves the share price for a particular stock from its current level is the market's change in earnings expectations – if these are revised upwards, it drives the share price higher, and similarly, if these are revised downwards, the share is likely to underperform. Both TFG and Truworths have positive earnings revisions profiles with reasonable valuations and are active holdings in our funds.

Figure 3: Doubtful debt provision on credit books (%)



Source: Company Financial Reports.

Conclusion

The South African consumer proved to be much stronger than expected in 2020 post the initial shock from the pandemic. Early signs in 2021 suggest that consumer health is most likely to continue to improve and we currently see more tailwinds than headwinds for 2021. We believe job creation will play an important role in driving consumption growth and offsetting the reduction in income for the lower end of the market due to the temporary grants falling away. In summary, improving consumer health supports our positive view on apparel retailers.

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