Robert Cowen Investments

Growing families' wealth since 1982

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Newsletter

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You are welcome to pass this newsletter on to friends who may wish to learn more about investment.
To be added to our email, contact alan@rcinv.co.za

"The most certain sign of wisdom is cheerfulness."
~ *Michel de Montaigne*

"The desire to get rich fast is pretty dangerous."
~ *Charlie Munger*

Visit our website: www.rcinv.co.za for back copies of the newsletter, background information, etc.

February 2019 was an excellent month in terms of investment performance. Local portfolios did well, helped by the rise in Naspers and British American tobacco. Off- shore, portfolios did well in dollars and were further enhanced by a 6% fall in the rand versus the dollar.

This resulted in our off-shore unit trust, RCI BCI worldwide flexible fund being one of the top performers of all South African unit trusts for the month.

Mike Gresty explains how Naspers split out MultiChoice this month and why we do not believe one should rush to sell MultiChoice.

Ross McConnochie considers "bracket creep" - how much extra that SARS is taking out of your pocket. Not much extra for 2019 but considerably more than five years ago. Do not pay more tax than you need to by inefficient structuring.

"The Saudis greatest fear: camels" an amusing little thought from a Saudi prince.

RCI BCI Flexible Fund closed February at 351.61c, up 4.41% for the month.

RCI BCI Worldwide Flex closed February at 114.39, up 7.11% for the month. This was one of the best performing unit trusts in South Africa during the month and is up 14.4% from a year ago.

MultiChoice - Avoid following the herd to the exit

by Mike Gresty

In February 2019, Naspers distributed to its shareholders its investment in MultiChoice, which owns and operates DSTV in South Africa and the rest of Sub-Saharan Africa – referred to as an "unbundling" transaction. Naspers shareholders received 1 share in MultiChoice for each 1 share they own in Naspers. As MultiChoice accounted for just 4% of the net asset value of Naspers, the unbundling had only a small negative impact on the Naspers share price – it fell 3.5% on the day the unbundling became effective but has subsequently risen to a price similar to that before the unbundling of MultiChoice. Investors in Naspers will find they now have a MultiChoice position in their portfolios. We think MultiChoice is a good, cash-generative business with a fair value of R150-R180/share. At the time of writing, MultiChoice shares are trading at just R96/share. It may take a bit of time for the fundamentals to assert themselves, but we would recommend patience here and to avoid being panicked into selling out at these levels.

Following its unbundling from Naspers, MultiChoice made its JSE-debut on 26 February. Ahead of the listing, what was notable was how divergent expectations for MultiChoice's prospects were among investors. In the first few days of trading, the bears certainly appear to have been in the ascendancy.

To summarise, this is the bearish view:

- Pay-TV/ linear television is a sunset industry which, if it is not already, will soon be in structural decline thanks to disruption from a growing range of content streaming services such as Netflix, Amazon Prime, Hulu, YouTube and so on.
- Pressure on consumers is leading to subscribers downgrading to cheaper packages or cancelling their subscriptions entirely.
- The cash-generative South African business is funding a loss-making pay-TV business in the rest of Africa (MultiChoice Africa). The timeline to return the rest of Africa segment to profitability is uncertain, as is the ability to reliably access cash from markets such as Nigeria and Angola (together accounting for almost 40% of MultiChoice Africa's subscriber base).
- Aside from selling by those that ascribe to the above bear-case scenario, we think the initial weeks of trade in MultiChoice shares will be heavily influenced by institutional investors who do not wish to hold MultiChoice for a variety of reasons. Those that invested in Naspers as part of a technology investment mandate may not be allowed to hold MultiChoice in terms of this mandate. Others may simply not wish to invest their resources in MultiChoice, which was not the reason they bought Naspers and is an immaterial part of Naspers' portfolio. The fact that MultiChoice will not pay a dividend for the year to March 2019, despite having been spun out of Naspers in a positive net cash position (if one excludes the finance lease obligations for satellites), is perhaps a further reason for these shareholders to cut and run.
- While it may be a bumpy ride in the short term, we think the sensible course of action is to hold fast and allow the fundamentals to assert themselves. The bearish case outlined above raises issues that investors will need to keep a careful eye on, but it also underappreciates the position MultiChoice has in Africa and the unique demands and challenges that this market presents.
- MultiChoice's competitive moat appears underappreciated at present - it is easy to become alarmed by those swapping anecdotes over craft beers in trendy Sandton pubs, as to how they are cancelling their DSTV subscription and moving to Netflix. This may well mirror the so-called "cord-cutting" trend in certain developed markets but in our view, it is not reflective of the broader realities in Africa.

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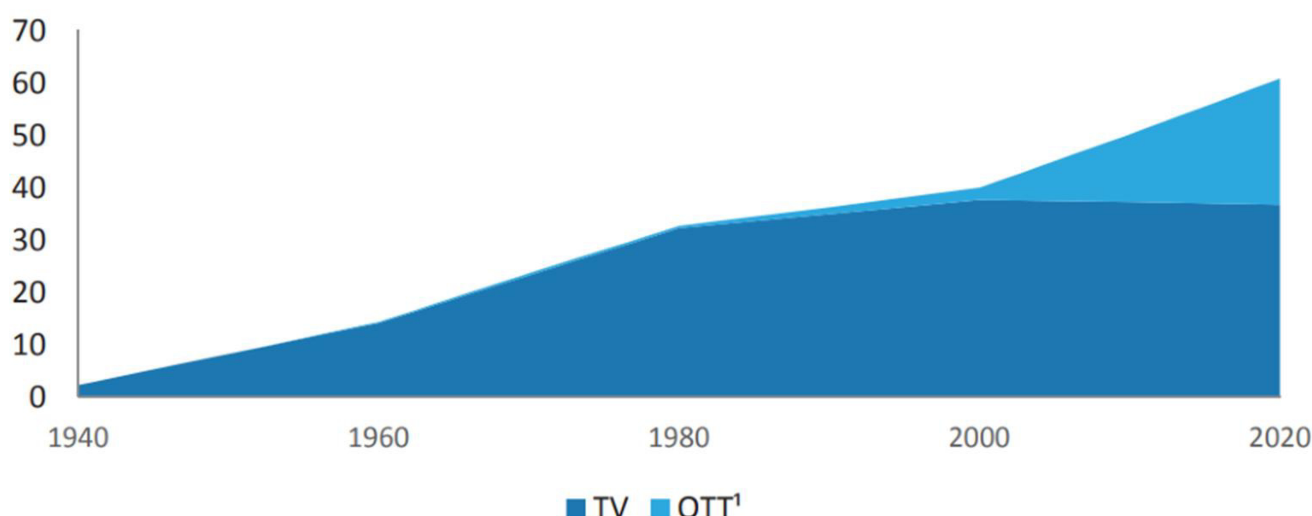
Arguments to suggest it is a little premature to be writing MultiChoice's obituary include: (1) limited reliable internet access – fibre broadband penetration is only expected to reach 12% of households in SA in the next 5 years, while in the rest of Africa it is considerably less; (2) the challenge of collecting payment for streaming providers, which rely on credit card-based payments; (3) the preference for local content production which is a strength of MultiChoice but not a focus for international over-the-top (OTT) content providers. To reinforce this MultiChoice points out that, while local content accounts for just 12% of what it broadcasts, it constitutes 26% of what people actually chose to watch; and (4) MultiChoice estimates that c. 70% of those subscribing to OTT services do so as an additional service on top of their existing pay-TV subscription. Indeed, we found the following chart (see *Figure 1*) from the MultiChoice's pre-listing statement interesting, with research suggesting that new viewing platforms are increasing overall video consumption globally, rather than simply substituting linear television.

Figure 1: Viewing habits (hours spent per week by media type)

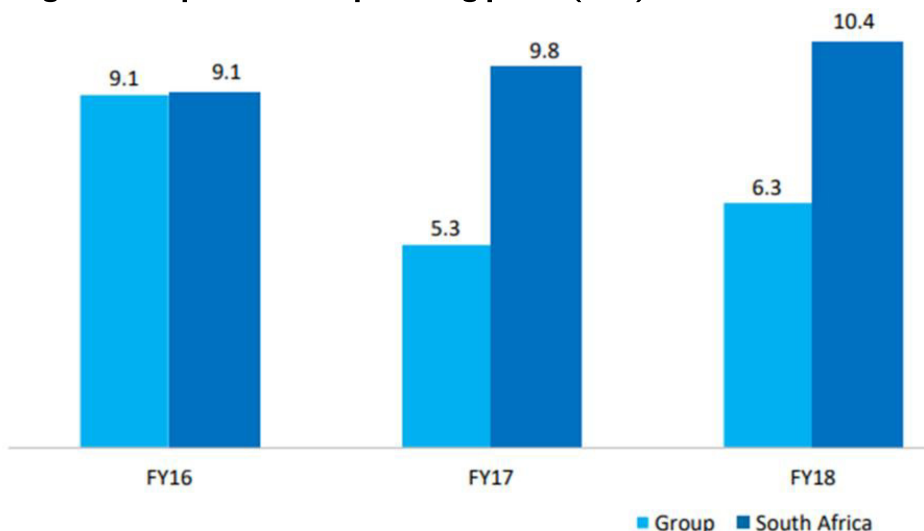


Source: Carat insight media survey, European Technographics Benchmark Survey: eMarketer

[1] *Note OTT includes online and mobile video*

- Losses in Africa may be eliminated faster than expected – The bearish camp is currently placing a negative value on the loss-making MultiChoice Africa division. With reference to MultiChoice's recent trading profit trend below, losses in MultiChoice Africa are responsible for the difference between 'Group' and 'South Africa'. We note that MultiChoice Africa was not always loss-making. The currency and macroeconomic fallout in Africa, from the decline in commodity prices (oil in particular) in 2015 pushed the division into a loss. Admittedly slow to respond at first, MultiChoice has been rationalising costs (stripping out unprofitable content, for example) and reconfiguring its bouquets to better align with affordability. The lumpy cost of the FIFA World Cup rights in the first half of the current financial year distorted the progress that MultiChoice Africa is making towards getting back to a break-even point. Full-year results may show MultiChoice Africa is making more headway than currently assumed by most forecasters, who are not expecting it to reach breakeven before at least 2022.

Figure 2: Reported Group trading profit (Rbn)



Source: MultiChoice

- **Attractive dividend potential in time** – MultiChoice has been spun out of Naspers with net cash on its balance sheet of R4.2bn (R9.60/share), excluding its capitalised finance leases for satellite equipment. Over the past few years, it has paid out dividends in excess of R5bn p.a. (>R11.00/share). As noted above, it will not pay a dividend this year and has committed to a R5.70/share dividend for the coming financial year (FY20). With major investment projects such as the rollout of its digital terrestrial television (DTT) network largely done, beyond this rather underwhelming short-term guidance, MultiChoice has the potential to be a very strong dividend payer.

Placing just the South African operations on a similar rating to international pay-TV peers, implies a valuation of c. R150/share. With MultiChoice trading below R100/share at the time of writing, it seems that the bears are firmly in control currently. Indeed, the "sunset industry" argument, combined with frequent stumbling from SA corporates in the rest of Africa (think MTN and, more recently, Shoprite), are hard to ignore. They are what is causing MultiChoice to trade well-below its fundamental fair value. While nerves of steel may be required in the short term, we think those that avoid getting caught up in the crush of sellers heading for the exit will be well rewarded over the next few years.

History of SARS bracket creep

by Ross McConnochie

We have long contended that the most valid way to consider your investments and your income, is on an after-tax basis. Today we focus on 'bracket creep' the way in which tax rates gradually creep up over time. You will note there was a big increase in 2015 but thereafter, the rate of increase has been about 0.4% per annum. This is not much but bear in mind that for most of you retired folk, the big tax (and one you don't even see) is the 20% deducted off your dividends (whereas this was only 15% before 2017) .

Summary

- Every year SARS increases the tax table brackets and rebates at a rate less than inflation. This consistently results in a stealth increase to your effective tax rate over time. Typically, it has been about 0.4% each year.
- Therefore, if you receive an inflation increase to your salary to compensate for higher living expenses, your after-tax salary increase has been lower than inflation because of bracket creep.
- The lowest income earners (18% tax bracket) had the smallest increase in effective tax and thus the lowest bracket creep over the past 4 years.

- The highest income earners (over R1.5 million per year) had the largest increase in their effective tax rates over the past four years.

Bracket creep occurs when your salary is increased by an inflationary amount (no real growth) but the SARS tax brackets and rebates are increased by a lesser amount. This causes a larger portion of your salary to fall in higher tax brackets and consequently leads to a higher effective tax rate. Your effective tax rate is the amount of income tax you paid SARS divided by your gross income.

For example, last year your salary fell into the 26% tax bracket category but this year you are in the 31% bracket. Since your salary was only increased by inflation you are no richer than last year in real terms but now must pay more tax and consequently have a higher effective tax rate.

How have the tax tables/brackets changed over the years?

There were major changes to the tax rates between 2015 and 2016 thus to be more consistent we started this analysis from 2016.

Also, we have included the prior years inflation to January each year - The last month end before the budget speech. So theoretically SARS should be adjusting each year's tax brackets by the change in prices over the prior year.

Tax Bracket		2016	2017	2018	2019	2020	CAGR
18%	Between:	-	-	-	-	-	
		181,900	188,000	189,880	195,850	195,850	
	Bracket Change:		3.4%	1.0%	3.1%	0.0%	1.9%
26%	Between:	181,901	188,001	189,881	195,851	195,851	
		284,100	293,600	296,540	305,850	305,850	
	Bracket Change:		3.3%	1.0%	3.1%	0.0%	1.9%
31%	Between:	284,101	293,601	296,541	305,851	305,851	
		393,200	406,400	410,460	423,300	423,300	
	Bracket Change:		3.4%	1.0%	3.1%	0.0%	1.9%
36%	Between:	393,201	406,401	410,461	423,301	423,301	
		550,100	550,100	555,600	555,600	555,600	
	Bracket Change:		1.4%	1.0%	1.3%	0.0%	0.9%
39%	Between:	550,101	550,101	555,601	555,601	555,601	
		701,300	701,300	708,310	708,310	708,310	
	Bracket Change:		0.0%	1.0%	0.0%	0.0%	0.2%
41%	Between:	701,301	701,301	708,311	708,311	708,311	
		Infinity	Infinity	1,500,000	1,500,000	1,500,000	
	Bracket Change:		0.0%	0.3%	0.0%	0.0%	0.0%
45%	Between:			1,500,001	1,500,001	1,500,001	
				Infinity	Infinity	Infinity	
	Bracket Change:				0.0%	0.0%	0.0%
	Average Bracket Change:		1.9%	0.9%	1.5%	0.0%	1.1%
	12m prior inflation	4.5%	6.2%	6.6%	4.4%	4.0%	5.1%
	Difference		4.3%	5.7%	2.8%	4.0%	4.0%

(CAGR – Compound average growth rate in the tax bracket since 2016)

Notes on the table:

- The 18%, 26% and 31% tax brackets have increased an average 1.9% per year since 2016 (Right hand column).
- The 36% tax bracket increased 0.9% each year.
- The 39%, 41% and 45% brackets have hardly moved over the years indicating the highest bracket creep.

- In 2019 the average bracket increase was 1.5% but inflation from the prior year was 4.4%. Thus, the difference of 2.8% indicates bracket creep.
- None of the tax brackets were increased for the 2020 financial year – thus this year had the largest bracket creep.
- Every single year the growth in the bracket was less than the prior year's inflation. Therefore, every single year everyone effectively paid a higher tax rate than the prior year.

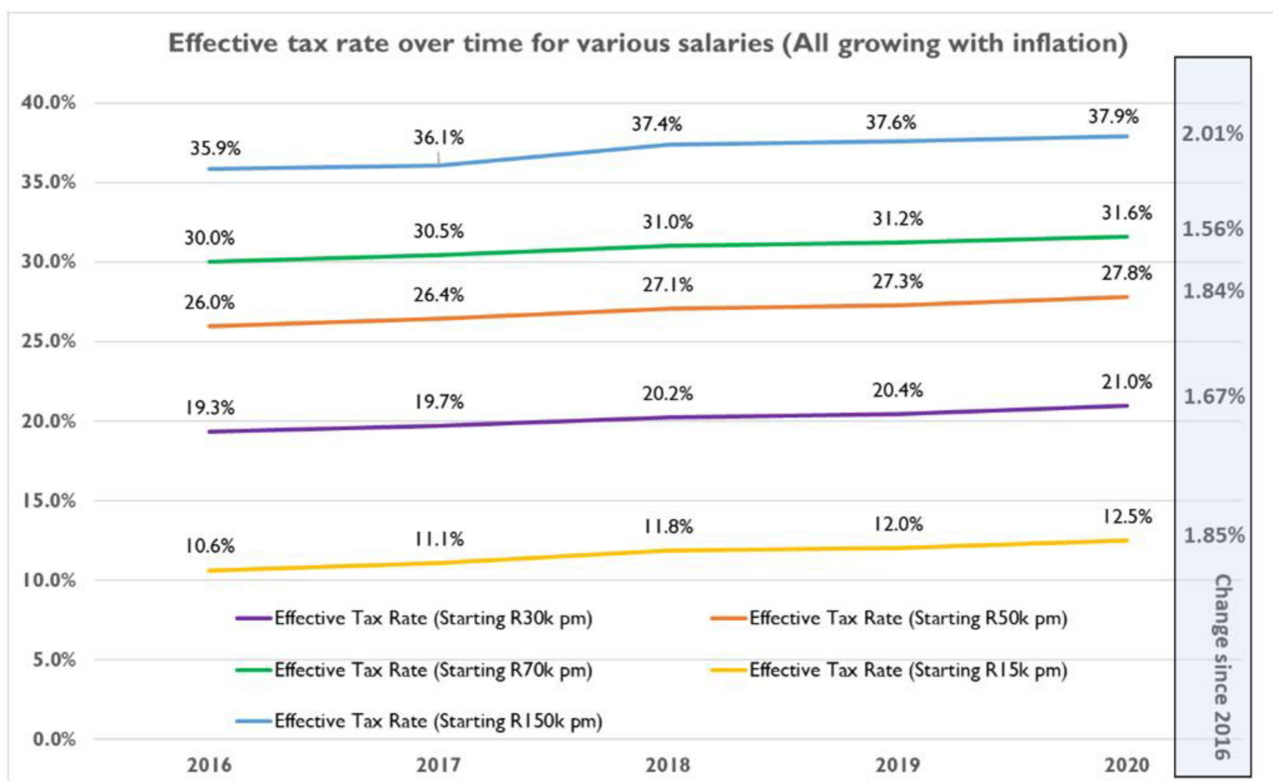
Rebates over the years:

	2016	2017	2018	2019	2020	CAGR
Rebate each year	13,257	13,500	13,635	14,067	14,220	
Change in Rebate		**1.8%**	**1.0%**	**3.2%**	**1.1%**	**1.8%**
12m prior inflation	4.5%	6.2%	6.6%	4.4%	4.0%	5.1%
Difference:		4.4%	5.6%	1.2%	2.9%	**3.3%**

The growth in the rebate is also important. If it isn't increasing at least the same rate as inflation, then this would also increase your effective tax rate. The lower your taxable income the more important the rebate is to you. I.e. the rebate is incredibly influential to people in the 18% tax bracket because it offsets a large percentage of their tax owed. To those individuals in the highest tax bracket it makes very little difference in their lives.

Effective tax rates of various salaries over time:

This graph shows the effective tax rate over time for five different individuals under the age of 65. The salaries range from R15,000 to R150,000 per month starting in 2016, each year the salary was grown at the prior 12 months rate of inflation.



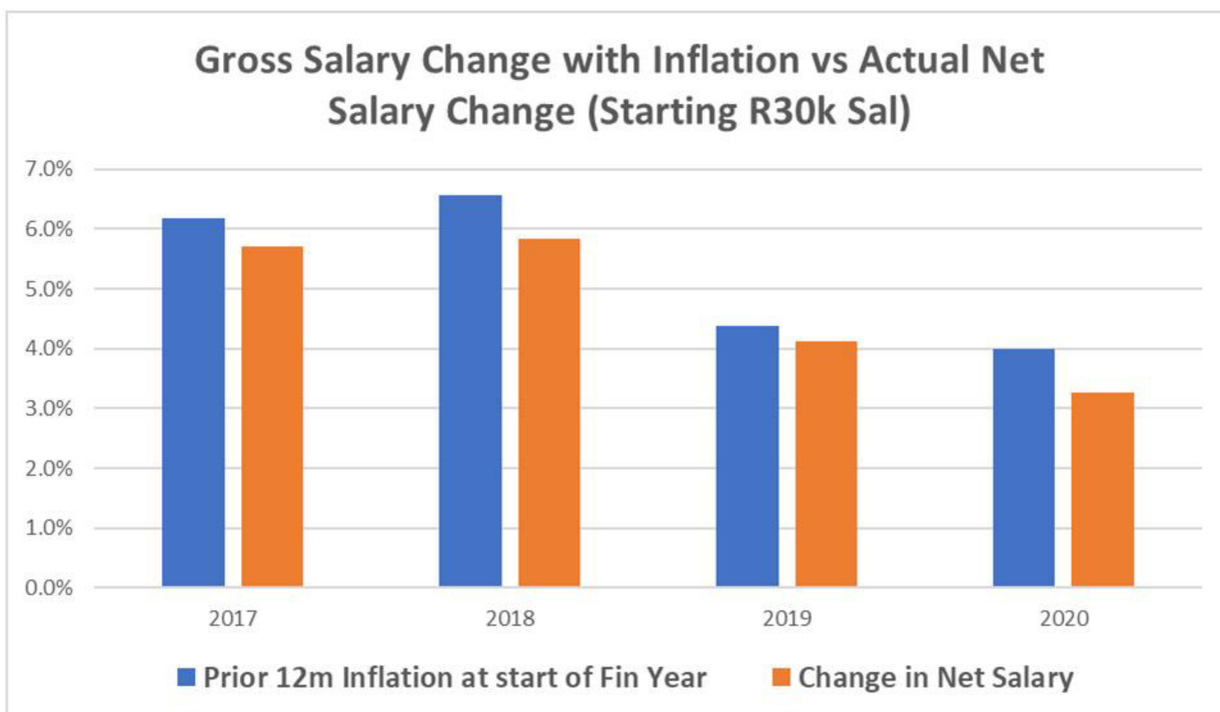
The yellow line represents someone who started with a monthly salary of R15,000 in 2016. This a gross annual salary of R180,000 and places that person in the 18% tax bracket and after the rebate had an effective tax rate of 10.6%. R180,000 is just below the threshold of moving into the 26% bracket in 2016. However, in the following year an inflation increase pushes the salary up into the next bracket. Between 2016 and 2020 the effective tax rate increased by 1.85% to 12.5%.

For the highest tax payers, the introduction of a 45% tax bracket in 2018 caused the largest increase to their effective tax over the years. Someone who earned an annual salary of R1.8 million in 2016 would have been in the 41% tax bracket and paid an effective tax rate of about 35.9%. Increasing at inflation this would have led to a taxable income of about R2.2 million in 2020 as well as moving up into the new 45% tax bracket. Between 2016 and 2020 the effective tax rate increased by 2.01% to 37.9%.

The lowest increase in effective tax would have been to those tax payers who remained under the 18% tax threshold. For example, someone who earned R13,000 per month in 2016 for total taxable income of R156,000 would have had almost an optimal salary in terms of smallest effective tax increase over the years. They would have had a starting effective tax rate in 2016 of about 9.5% and an ending rate of 10.6% in 2020. This is only a 1.08% increase. The reason why their effective tax rate went up at all is because of the rebate that lagged inflation. Remember the rebate offsets your tax owed and if it isn't keeping pace with your salary then it is offsetting less and less each year (in percentage terms).

An interesting observation is the impact to the middle-income earners. You would think that the increase in effective tax would increase consistently as you earn more and more income. This does not always appear to be the case. If you look at the orange and green lines representing a R50,000 and R70,000 salary respectively. The R50,000 salary had a larger increase in effective tax over the years. If we dig deeper the reason is purely because the R50,000 salary moved to a higher tax bracket whereas the R70k salary remained in the 41% tax bracket. So, it really depends on the quantum of your salary as well as whether you move into a higher tax bracket because of bracket creep.

<u>Another way of looking at bracket creep is comparing the inflation increase in your salary before tax to the increase in your salary after tax</u>:



The blue bars indicate the inflationary increase to a person starting with a R30,000 salary in 2016. The orange bars indicate the actual increase in their net salary after tax. In 2020 inflation was 4% but the increase in the salary after tax was only 3.3%. Every year the orange bars are lower than the blue bars. Every year your salary increase was eaten away by bracket creep.

To summarise if you have been receiving an inflationary increase in your salary or pension each year to compensate for more expensive living conditions then you have actually been getting poorer each year in real terms as your after-tax salary has been rising at a lower rate than inflation.

Is the Saudis' greatest fear coming true?

We extracted the following article from Wealth Daily as we found it most amusing:

By Keith Kohl, written Feb 20, 2019

"What is Saudi Arabia's greatest fear?

It's not being called out by the international community over murdering a journalist.

It's certainly not over the fact that women in the country were able to vote for the first time only a few years ago or were allowed to drive a car starting only last year.

The answer... is camels.

You see, neither of those first two things is more frightening to a young Saudi prince than the prophetic words spoken by the UAE's second prime minister, Rashid bin Saeed Al Maktoum, who ruled the emirate for over 30 years.

After watching his country's oil wealth explode once production began in 1969, he made his now-famous remark:

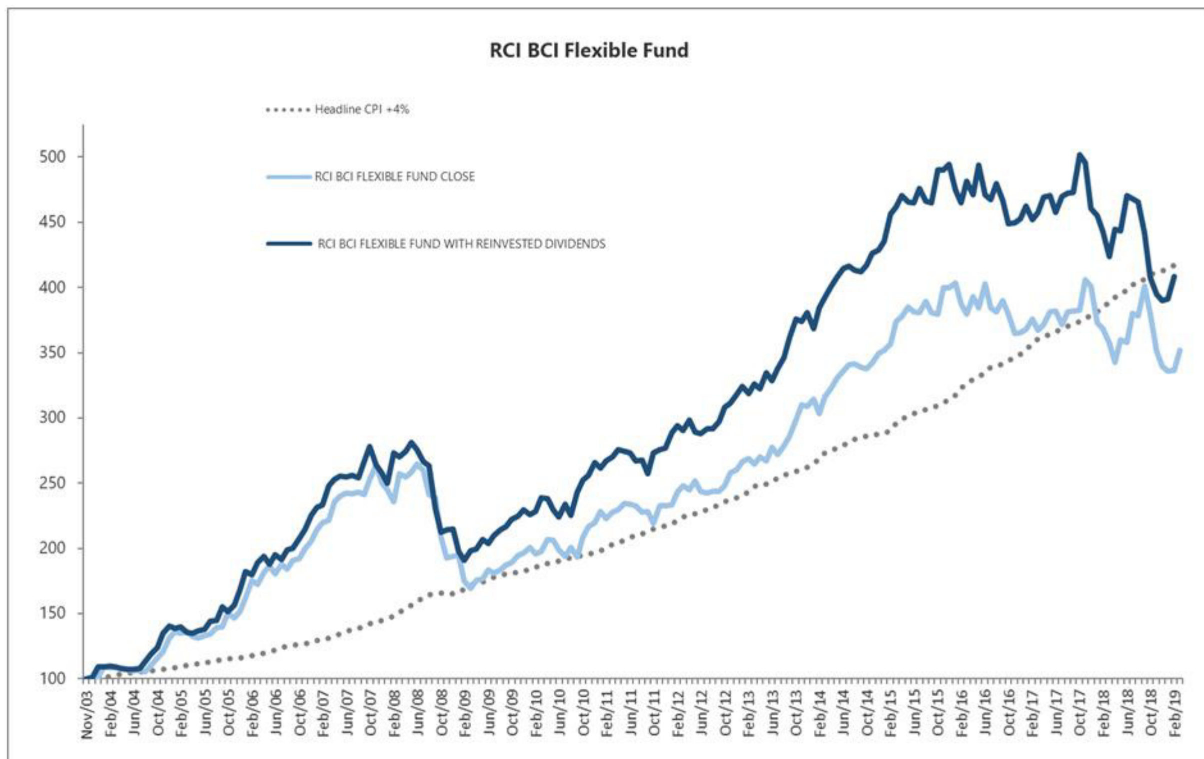
My grandfather rode a camel, my father rode a camel, I drive a Mercedes, my son drives a Land Rover, his son will drive a Land Rover, but his son will ride a camel."

The remark is a stark reminder that oil fortunes don't last.

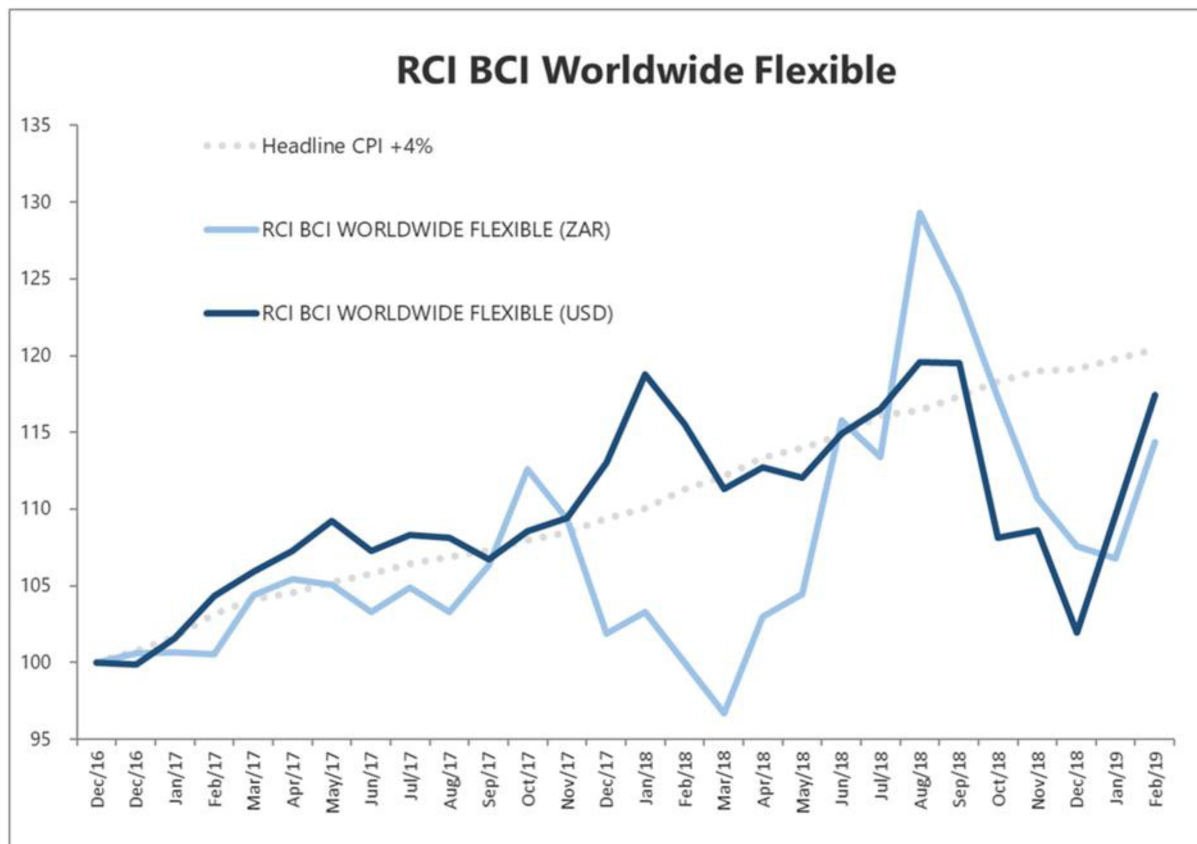
RCI Unit Trusts

Please contact Maggie on 011 591 0578 for any help on your unit trusts.

RCI BCI Flexible Fund closed February at 351.61c, up 4.41%. The rand weakened by 6% but we have now eliminated offshore shares from this portfolio towards the end of the month as you can invest directly into our offshore unit trust RCI BCI World Wide Flexible Fund. It is now back where it was about a year ago, better than the JSE over the same period.



RCI BCI Worldwide Flex closed February at 114.39c up 7.11% for the month. The rand fell by 6%, boosting the performance, as we had expected last month. **This was one of the best performing unit trusts of the month. It is now up 14.4% compared with a year ago!**



Unit trust has flexibility – happy to take small amounts

The unit trust has the flexibility to buy and sell shares and to change weightings more frequently than in an individual portfolio. We are happy to take small amounts into the unit trust (from R1 000 per month or lump sums of R25 000). As you will not pay commission to any agents there is no cost to get in and out of our fund. On selling, the amount you receive back will depend on our performance.

Collective Investment Schemes in Securities (Unit Trusts) are generally medium to long term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily a guide to the future. Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees and charges and maximum commissions is available on request from the company/scheme. Commission and incentives may be paid and if so, would be included in the overall costs. The portfolio is registered under the license of Boutique Collective Investments, a member of the Association for Savings & Investment SA. Forward pricing is used. More details are contained in a fact sheet that is available on request.

To conclude

It is fascinating how much your portfolios have risen in 2019. Much of the loss of 2018 has already been recovered. The trick, we believe, is to be invested in great quality companies which have a track record of paying a substantial and growing dividend. This should enable you not to have to sell shares when the market has had a sharp correction, while being able to trim the portfolio after a substantial rise if any of the companies are becoming fully priced. The 6% fall in the Rand against the dollar during February 2019 has magnified the increase in the dollar value of your offshore portfolio in Rand terms. If the rest of 2019 continues in the same vein, strong performance should be expected.

Another tax year has come and gone and in due course we will advise you of your capital gains which resulted in the year to February 2019. Taxation is becoming more complicated, with section 7C now resulting in donation's tax on loans to both local and offshore trusts. This matter is complicated and if you need advice please give us a telephone call.

The article on taxation bracket-creep shows precisely how much more the Fiscus is taking out of your pockets than a few years ago - do not pay more than what is due!

We hope to be the best family office in the country!

Best regards

Di, Alan and Mike