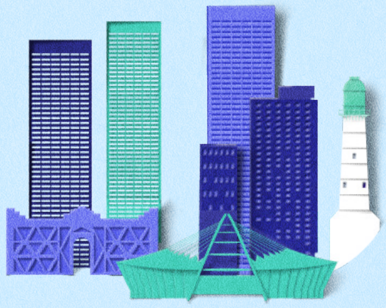
Steinhoff Update

December 2017



The corporate failure of Steinhoff has shocked even the most seasoned asset managers, and could well be the largest corporate failure on the JSE. Allegations of earnings manipulations, uncontrolled acquisition sprees and tax fraud are just the tip of the iceberg.

Off-balance sheet companies were set up to hide losses, executives collaborated with each other to defraud investors, and debt was taken on at a massive pace. The warning signs were all there - the most obvious of those was the cynical move by shareholders in PSG to, in a sleight of hand, swap their shareholding in PSG shares in South Africa for a suddenly-Frankfurt-listed Steinhoff, thereby externalising their wealth without the need for foreign exchange controls approvals. This alone should have been a strong indicator that one is not dealing with pillars of society. Many names are implicated, and it is likely that many more will follow.

Earlier this week, the company's auditor, Deloitte, would not sign off on Steinhoff's financial statements, but added that it would present the unaudited results as planned. From there on, events escalated with several senior executives resigning, led by the resignation of long-time CEO Markus Jooste. Further information has also come to light relating to accounting irregularities, with PwC asked to investigate further. This has delayed the presentation of results until January 2018.

The active investment management industry

The serious question to ask is how so many active asset managers in South Africa missed this. Priding themselves on meticulous research, scrutiny of balance sheets and income statements, backed by interviews with management, it should have been glaringly obvious at the outset that this was as close to a corporate-structured Ponzi scheme as one can get.

A cursory understanding of the company's financial statements reveal that the structure was obfuscated, that many financial items made no sense, that the acquisition spree was not underpinned by any logic and too frenzied to be well thought out, and that debt levels were out of control.

Sygnia has in the past been critical of many things in the investment industry, and this time we are going to push the envelope by testing the liability clause that most asset managers include in their management agreements, that of "gross negligence". Most asset managers interpret the clause as dealing with their operational risks and administrative failures. Our view however, is that "gross negligence" also covers negligence as far as management of the portfolios is concerned – as management includes investment research. We believe that the blind faith in the "Midas touch" of Christo Wiese made many asset managers oblivious to the obvious. The right questions were not asked, the corporate structures were not analysed with the level of scrutiny deserving of such a company, proper analysis of earnings versus debt exposures were not done, and management was taken at its word – all this against a backdrop of marketing exactly the opposite and charging savers and investors for the privilege. Hence, one can assume that marketing was at best a misrepresentation backed by incompetence, at worst a falsehood.

Net1, African Bank and Steinhoff – just three examples of where asset managers have missed the obvious, and the landscape is likely littered with more cases that have flown under the radar.

Sygnia exposure to Steinhoff

As with ABIL, exposure to Steinhoff needs to be assessed at both the equity and the corporate bond level. At this stage the impact on the bondholders is not yet known or easily determined.

Within Sygnia's passive equity portfolios, we do not make stock-level investment decisions and therefore would only have exposure to Steinhoff to the extent that the stock is included in the relevant equity index. The exposure to Steinhoff within the FTSE/JSE SWIX Index (which is the index that we track for most of our clients) as at 30 November 2017, was 2.3%. In the Sygnia's passive bond portfolios, there was no exposure to Steinhoff.

This exposure (2.3%) is, of course, diluted considerably within the multi-asset class portfolios, such as the Signature and Skeleton product ranges. In the Skeleton range, the exposure to Steinhoff within the equity and hedge fund components has been as follows:

PRODUCT	EXPOSURE ON 30/11/2017	EXPOSURE 7/12/2017 [ESTIMATED]
SKELETON 40 FUND	0.74%	0.20%
SKELETON 50 FUND	0.98%	0.25%
SKELETON 60 FUND	1.12%	0.28%
SKELETON 70 FUND	1.21%	0.31%

In the Signature product range, where we blend active and passive managers together, the domestic equity portfolio is currently split 50% index trackers and 50% actively managed. Our active equity managers have exposure to Steinhoff ranging from 0% to 4% (prior to the collapse of the share price). In terms of bonds, we use the Coronation Bond portfolio which had no exposure to Steinhoff debt. We have not included bond exposure in the numbers in the table, because it is difficult to determine the impact of what has happened on bondholders. The moment we have more information we will be in a position to advise you accordingly. The exposure to Steinhoff within the equity and hedge fund components is as follows:

PRODUCT	EXPOSURE ON 30/11/2017	EXPOSURE 7/12/2017 [ESTIMATED]
SIGNATURE 40 FUND	0.95%	0.29%
SIGNATURE 50 FUND	1.23%	0.37%
SIGNATURE 60 FUND	1.45%	0.43%
SIGNATURE 70 FUND	1.58%	0.48%

Final comment

We are taking this issue extremely seriously and have engaged with all the managers who held Steinhoff already. More meetings will follow in the coming days. At this stage certain asset managers have sold the shares they held due to concerns around the unknown risks, whereas others have decided, to wait as they believe that the market reaction has been overdone as each of the underlying businesses within the Steinhoff stable is independently run and value will be realised should the group be forced to unbundle.

As always with these types of situations, the benefits of a well-diversified portfolio, combined with a blend of passive and active managers, ensures that our portfolios are not overexposed to any one specific risk. This, however, does not excuse why so many asset managers were caught unaware. We are determined to get answers to this question as soon as possible, and will communicate those answers to you. We will also keep you informed as more details emerge about Steinhoff.

Please rest assured that we continue to monitor the situation very closely and are happy to address any queries directly.

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