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Safety first

Domestically focused South African equities have been subject to a multi-year bear market driven by continued economic stagnation and extremely negative sentiment. The structural challenges the country faces as a result of a decade of mismanagement are significant, leading investors to give up on companies reliant on the domestic economy. Smaller companies have fared even worse, given continued outflows in the sector and lack of interest and capital. While domestic South African shares are cheap, domestic small caps trade at a significant discount to their larger peers and offer an exceptional opportunity for patient investors. While most of the small cap sector in South Africa is mispriced, we remain selective and seek businesses of sound quality with strong and aligned management teams. We have a strong preference for owner-operators in all of our investments, but we think it is even more important in this space given the economic challenges.

Trellidor Holdings is a good example of the current opportunity set in small cap industrial shares. With a market capitalisation of under R400 million, it is uninvestable for most South African institutions, but is a solid business with a very strong brand and a disciplined management team. Trellidor has a proven track record of over 40 years in the physical barrier security sector, over that time having established a dominant brand in South Africa.

Their custom-made products are distributed through skilled owner-operated franchises in South Africa, Africa, the United Kingdom, Israel and Europe. The need for custom-made security gates remains high in South Africa and the core Trellidor business has been fairly resilient amidst the declining local economy. Their decorative blinds business, recently acquired Taylor Blinds, has been more cyclical and this has had a very negative impact on recent earnings. Management remains confident that there are strong revenue and cost synergies between Trellidor and Taylor that will be realised in the years ahead. We think that the Taylor business is likely to improve in time given management action and some improvement in the economy, but our investment thesis is largely based on the core Trellidor business given its strong brand, operational efficiency and franchise model.

Trading at 9 times depressed earnings it is not as cheap as some other small cap shares, but the quality of the business and management team are supportive of the investment case. The company has not wasted the economic recession and has focused on improving manufacturing efficiencies that position the Group well for any potential upturn in the domestic economy.

We rate management highly, led by CEO Terence Dennison and Chairman Mark Oliver, both of whom are significant shareholders alongside us. We are comforted by the fact that they are focused on margins, cash flows and return on invested capital. While they are always on the lookout for synergistic acquisitions, they have been more disciplined than many other South African management teams and have chosen to focus on internal organic opportunities and efficiencies. Their capital allocation has been sound and they are taking advantage of the undervalued share price to repurchase shares in the open market. During 2019 they repurchased R9.1 million worth of shares and have made further repurchases subsequent to the June year end. We view this as sound capital allocation given the current share price and strong financial position of the company.

The Group had a very tough 2019, largely on the back of the Taylor Blinds business. Earnings and free cash flow declined to close to 2016 levels. Like most domestically focused businesses you are currently buying a relatively low level of earnings.

	2016	2017	2018	2019
EBITDA	81.5	113.9	103.5	81.2
EBITDA Margin	26.0%	21.7%	19.2%	15.8%
Free cash flow	43.7	63.5	58.5	40
EPS	50.8	59.3	54.4	40

Based on these low levels of earnings the current valuation metrics are as follows:

- Price to Free cash flow 9X
- Price to earnings 9X

We make conservative assumptions in all of our company valuations. This is not easy in the current environment where the South African economy is in such a poor state. Our assumptions are based on the fact that local companies have already been through the equivalent of a depression/crisis, and that during the next 3-5 years there will be some improvement and that things in South Africa will be "less bad". That means we are by no means expecting a sharp rebound in activity, but for the decline in activity and sentiment to moderate somewhat as the country embarks on some much needed reform. We think that, conservatively, Trellidor will be able to produce earnings, margins and cash flows slightly above 2017 levels within the next 3-5 years.

Despite the current negative sentiment, we think Trellidor is an above-average company that warrants a reasonable valuation multiple given its strong competitive position and earnings metrics. We think the share offers significant upside should earnings recover to more normal levels and trade at a slightly higher multiple. This is further supported by a dividend yield of nearly 6%.

Investment risks

The key risk to the investment case is the state of the South African economy. We are very conscious of this risk, but our base case is that the economy will get "less bad" over the next 5 years. It is by no means a quick fix, but the new president has the interests of the country at heart and is slowly cleaning up after an extended period of mismanagement and corruption.

The size of the company and poor liquidity is seen by some as a risk, but we do not view it as such. If anything, it is what has created what we view as a very good investment opportunity. The size and liquidity is more than compensated for by the quality of the business, the management team and the very attractive valuation.

Summary

Negative sentiment towards South African assets is understandably at extreme levels. Within that, sentiment towards listed small cap shares is at even more extreme levels and there is no investor interest at all. For patient investors this has created an opportunity to invest in good businesses run by good people, at what we believe are very attractive prices. Trellidor is a well-established market leader in its industry. It is a well-run business with a strong and aligned management team that have executed well in a very tough environment. While the business focuses on products that protect their customers, we think investors are also well protected at current prices and we are happy to be part-owners of this great little business.