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Dear Lucri friends,

In this newsletter, we shall look at the merits of share buy-backs and a South African company that applies their share buy-back program masterly. Apple and Berkshire are two highly successful American companies that also perform intelligent share buy-backs.

On a lighter note

Life through John's eyes:

In the days before speeding cameras, when traffic officers where physically present at speeding transgressions, John was caught for speeding on the highway. The traffic officer approached with a sarcastic smile: "I was waiting for you the whole day!" John replied: "Honestly, I came as fast as I could!"

John need to appear in court for driving under the influence. Judge: "This is now the eighth time that you are appearing for the same offence in 10 years!" John: "Your honour, please, there is no need to get excited. It is NOT my fault that you have not been promoted in the last decade!"

John, with a full face mask on, approach a stranger and ask: "Do you see any police nearby?" The stranger responds: "No." So, John immediately pulls out a gun and demands: "Give me all your money!" The stranger pleads: "You cannot do that to me, I am an important politician!" John then changes his demand: "Ok, return all my money!"

After Warren Buffett became the richest man in the USA, he got the following question: "Mr Buffett, what is your next goal now that you are the richest man in the country?" Warren replied: "That's easy. To be the oldest man in the country!"

Quotes

"*There are free lunches in the market from time to time, but markets tend to return to efficiency, which causes the free lunch to disappear again."* Howard Marks

"*Success is a lousy teacher."* Bill Gates

Lucri agrees. Success tends to give you an idea that you know what you are doing. You are then not willing to adopt to new learning. Jason Way put it as follows: *"Being right is the enemy of staying right."*

"*Good judgement comes from experience. And experience? That comes from poor judgement…"* Anonymous

Listen to Warren Buffett on this topic: "*It is good to learn from your mistakes, but better to learn from other people's mistakes!"*

So, we should not talk or think too much about our success. Frank Ocean summarises it well: *"Work hard in silence – let success be your noise."*

We should be humble. CS Lewis put it as follows: *“Humility is not thinking less of yourself, it is thinking of yourself less.”*

“We shall never know when the best time to get into the market is because we cannot predict the future. And if you think about it, that makes sense. If the market is doing its job, prices ought to be set at a level where you experience some form of anxiety. It is unrealistic to think the market would ever offer an obvious time to get in. If it did, there would be no risk and no reward.” David Booth

This quote explains why “timing the market” is a strategy that does not succeed over the long term.

South Africa in perspective

Like most people in the world, South Africans also suffer from “home country bias”, where investors in a specific country invest the bulk of their money in their home country.

So, it may help if South Africans see the bigger picture in terms of listed companies in the various indexes:

S & P 500 index in the USA: about 500 companies

Nasdaq 100 (non-financial): 100 companies

These 600 companies represents 64% of the developed MSCI world index.

The rest of the developed MSCI world index: 1037 companies

South Africa all share index: 153 companies

The rest of the emerging MSCI world index: 1250 companies

Developed world, small cap index: 4263 companies

Emerging world, small cap index: 1640 companies

So, out of the 8943 companies above, South Africa has 153, which is 1.7% of the total number. If we look at the value of the companies (the market capitalisation), South Africa represents only 0.5% of the world market, because the South African companies are on average about three times smaller than the average company in the remaining 8790 companies.

So, as South Africans we should ask ourselves why we tend to invest the bulk in 0.5% and do not think about serious investment in the 99.5%.

Share buy-backs

There are two ways how a company can return cash to its shareholders. The first one is by paying dividends – regular readers of the Lucri newsletter will know that we talk about the importance of dividends quite regularly in these newsletters.

The second way, namely by buying back its own shares from its shareholders, have not been discussed in detail before. So, we shall now devote a bit of airtime to this method.

Why would a company perform a share buy-back? Well, there are good reasons and bad reasons to perform a share buy-back – this will not surprise Lucri readers who have been through the school of life. One of the bad reasons is that management try to prop up the share price by instilling investment confidence via share buy-backs – they want shareholders to think that they have a lot of confidence in the rosy futuristic picture that they have painted for the particular company. You can immediately test management's intensions by checking whether they also buy shares in the company with their own money!

Let us rather focus on the good reasons for share buy-backs. When a company is very lucrative (high yield on capital or high profit margin or both) and they do not experience heavy depreciation in capital intensive equipment, they tend to generate a very strong free cash flow stream. Free cash flow can be allocated to other areas without hurting the productive base of the company. Sometimes, the market where this company operates grows very fast. In such a case, the free cash flow can be invested profitably into expanding the existing business – this is probably the best utilisation of excess cash that any company can find.

But, most of the time, an industry with abundant free cash flow does not grow very fast. There are no profitable investment opportunities internally or in the same industry. In such a case, dividends can be increased, or the shares of the company can be bought back and then cancelled so that the amount of shares in issue reduces. When a company trades at a price far below intrinsic value (or far below net asset value), it will be very advantageous for the company to take cash out of the balance sheet and reduce the amount of shares outstanding. If the share price in the market trades below the net asset value per share of the company, the immediate result after the share buy-back will be an INCREASE in the net asset value per share without any other effect playing a role. Also, with less shares outstanding, it becomes easier to pay dividends, as the company now needs to serve a smaller amount of shares. The future dividends per share can be increased without paying more cash in total towards dividends.

You can think about share buy-backs as a way to concentrate the business of the company per share – as the existing business is now covering less shares. Think about a cake where the slices (shares) are less, so that each slice can be bigger or thicker than before. This is the exact opposite of issuing more shares to shareholders – which will cause dilution of the business per share, the cake needs to be divided into more slices (thinner slices) than before.

Now, let us take a look at a South African company that is currently mastering this technique to the benefit of shareholders (but without sufficient recognition (yet) from shareholders).

Lewis Group

Lucri had sung the praises of Lewis Group as an exceptional investment in January 2021, and again in July 2021. So, I shall not bore you this time with a long discussion about the characteristics of the Lewis Group. We shall focus on the superior capital allocation of Lewis management this time around, how they utilise a disciplined approach to buy back Lewis shares at a wide discount to net asset value per share.

Year end (March)	Shares in issue (million)	Share price at 31 March (cent per share)	HEPS (cent)	NAV (cent per share)	Dividend (cent per share)
2017	98.1	4150	400.1	6133	200
2018	92.6	4220	302.7	5779	200
2019	80.2	3110	376.2	6080	234
2020	76.9	1782	260.2	6126	185
2021	71.5	3071	616.5	6814	328
2022	62.3	4700	848.7	7527	413
2023	57.2	4100	856.9	8076	413
July 2023	54.2	4000			

In the period of six years covered above, the shares of Lewis Group made progress on many fronts, the dividend more than doubled, the headline earnings increased by 114%, the net asset value per share increased by 31% - but the share price moved nowhere at all! The price is currently about 4% LOWER than 6 years ago, and only about half of the net asset value per share.

I want you to please focus on the column reflecting shares in issue (million). A total of 98.1 million shares were in issue in March 2017, but only 54.2 million shares were in issue in July 2023! This tells us that Lewis management succeeded in buying back 43.9 million shares – which represents 81% of all the issued shares today, or 44.7% of the shares in issue in March 2017. Lucri regards this as a massive achievement, especially due to the fact that the company did not need to borrow in order to perform this buy-back. The current modest loan was used to increase the debtor's book only – it was not applied towards the buy-back.

This is an example of a disciplined, controlled buy-back, with masterly application of all the good reasons for performing a buy-back discussed above.

The productive base of the company was not reduced due to the re-allocation of cash flow, as the total count of shop outlets in the Lewis Group have increased from 636 in 2017 to 840 now. To put this into a different perspective: The market capitalisation of the Lewis Group (shares in issue times the share price) was 98.1 times R41.50 = R 4071 million in 2017. It was 54.2 times R40 = R 2168 million in July 2023. If we calculate the value that the market assigns to each Lewis store, we get the following:

In March 2017: R4071 million/636 = R6.4 million per store

In July 2023: R 2168 million/840 = R2.58 million per store

So, after the effect of inflation over more than a six year period, the market allocates a massive reduction of about 60% in the value of each Lewis store. When the market is blind and stubborn like this, it normally represents a buying opportunity for value investors like Lucri.

In the 2022/23 financial year, R 241 million was used to pay the 413 cent per share dividend to shareholders, and another R 310 million was used to buy shares back from shareholders. The dividend is already 10% on the year end price of R41, but without any buy-backs in 2022/23, the dividend could have been 944 cent per share, or 23% per share at the same cash outlay for Lewis.

Yes, a 23% dividend will be nice, but Lucri supports the buy backs rather than a higher dividend, as the buy-backs were performed at a massive discount to the net asset value per share. So, while it is a bit frustrating that the market does not (yet) reward the concentration effect of the buy-backs, it is also true that the ultimate value being created by the buy-backs will be maximised if the share price does not respond positively to the buy-backs for a long time. So, the current stubbornly low market price per Lewis share will enhance the final value per share. In the extreme case of an almost complete buy-back, the total value of the company will be concentrated on the few shares left in the market – shares that are held very tightly by value investors like Lucri, for example. In such a scenario, there will be no shares available for buy-backs, with the result that the dividend per share will shoot through the roof as dividends will be the only method left for Lewis to return capital to shareholders.

Also, the more shares are being bought back, the easier it gets to continue the buy-back momentum, as less money flows out in the form of dividends. Lucri is therefore watching the progression of the Lewis buy-back program with keen interest.

There are several ways to prove that Lewis shares are currently under value, but the most severe test remains whether the share price are lower than the so-called nett nett value per share, which is the liquidation value per share. As discussed in earlier newsletters, this is the nett current assets (current assets minus current liabilities) minus all other liabilities (or current assets minus total liabilities) calculated on a per share base.

In 2005, the nett nett value per Lewis share was R14.51, with the share price fluctuating between R41 and R28. So, the price moved in a range 282% to 192% in relation to the nett nett value. Ten years later, in 2015, the nett nett value per Lewis share was R36.46, with the share price fluctuating between R93 and R54. The price moved in a range 255% to 148% in relation to the nett nett value, not too different from the range 10 years earlier. Now, fast forward to 2023. The nett nett value per Lewis share is currently R49.61, with the share price fluctuating between R55 and R38. The price is now moving in a range 111% to 77% in relation to the nett nett value, which is vastly different from the range in all the years between 2005 and 2015 (Lucri calculated all the years in-between as well). Just to satisfy my curiosity, I calculated the point of best value that was presented by the market for Lewis shares. It was during Covid (no surprise there) at a market price of R12 in relation to the nett nett value of R43.12 at the time – only 28% of the liquidation value. This should surprise you a little, as the liquidation value is already the lowest possible value that can be assigned to any share.

In summary, intelligent buy-backs, in the way that the management of Lewis is performing it, is increasing the wealth of the remaining shareholders and should therefore be applauded by them. For some strange reason the market is not thinking rationally in the case of Lewis – and shareholders are not bidding the share price higher. This situation is strongly beneficial, because it provides ample opportunity for further highly profitable buy-backs.

Lucri housekeeping

Please always remember to tell me via SMS, WhatsApp, Telegram or e-mail when you move cash in or out of your account.

All comprehensive Lucri communication is only via e-mail. If you send an e-mail to streicher.simonj@gmail.com, I promise to answer in a few days.

Kind regards and enjoy "buy-back" investing,

Simon Streicher