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Conference Call transcript

29 January 2021

Q1 VOLUNTARY TRADING UPDATE

Operator
Good day ladies and gentlemen and welcome to the Barloworld Q1 voluntary trading update. All participants will be in listen-only mode. There will be an opportunity for you to ask questions later during the conference. If you should need assistance during the call, please signal for an operator by pressing * then 0. Please note that this call is being recorded. I would now like to turn the conference over to Dominic Sewela, the group CEO. Please go ahead, sir.

Dominic Sewela
Thank you. Good afternoon everybody. I hope most of you have had an opportunity to read the trading update. Just by way of introduction, on the call I have Nopasika Lila, the FD, with me. I also have Nwabisa Piki. Most of you might have met her, but some of you may not know her. She has just replaced Zanele, who is our Investor Relations Executive. I also have Quinton McGeer. It is important that if there are questions particularly on the trading update relating to Mongolia we could cover that. And I also have Chris on the line just to walk us through if there's a need just to talk about the current state of the motor retail business. Then I have Garth Macpherson on the line of Ingrain. We've had two months of trading with Ingrain and I think we've also included that in the update.

I think it's important just to say obviously year-end to September we've had a lot of exceptional items. We've also had a lot of expenses due to Section 189 or retrenchments. So it was very pleasing to actually release this update with trading. Obviously Logistics we still have challenges in that particular area. But I guess I'll open up to questions to allow you guys who have read the update to ask specific questions.

Operator
Thank you. Ladies and gentlemen, if anyone would like to ask a question you are welcome to press * and then 1 on your touchtone phone or on the keypad on your screen. If you wish to withdraw the question, you may press * and then 2 to remove yourself from the question queue. If anyone would like to ask a question, you are welcome to press * and then 1. Our first question is from James Twyman of Prescient Securities.

James Twyman
Hello. Thank you very much. I've got two questions. Thank you very much for this update. It's extremely helpful. The first question on Mongolia. That's obviously performing well. Could you give us some idea of what we're comparing it with, so what the profits and sales were in the previous year, so we know what this improvement is compared with? And then secondly on your rental fleet, could you give us some idea of what the size of that business is now compared with pre-COVID? Thank you very much.

Dominic Sewela
Okay, Quinton, I will ask you to answer Mongolia and then I'll answer the rental question.

Quinton McGeer
Thank you Dominic. Good afternoon to everyone. Yes, the first quarter in Mongolia is tracking definitely better firstly than expectations. We bought the business in a very difficult time when the country was basically in a

hard lockdown. Just as we acquired the business the country came out of lockdown. We had sort of a normal trading during the first quarter except maybe for the last part of December when the country went into a hard lockdown again. But despite all of that it was a very pleasing first quarter. Strong prime product sales. Good aftermarket sales. And comparing to prior years we don't have the breakdown by quarter as we didn't have that information. We just received information on an annual basis. But taking into account environment in which we operate, we are very happy in terms of the first quarter's results with a lot of activity currently in Mongolia.

The challenges between Australia and China from a coal perspective are also impacting the Mongolian coal sector positively. I think linked to that as well is the fact that Mongolia has embarked on putting a rail infrastructure in place. They have just secured $57 million locomotives which will also assist the Mongolian coal sector because currently coal is transported via the road. And when that rail infrastructure is in place that will increase export capability which will then also be positive for the economy and our business in totality.

Dominic Sewela
Thanks Quinton. I think in terms of the rental business last year around this time pre-COVID we were sitting close to 27,000 vehicles. We are currently sitting in the range of 13,000 to 14,000 vehicles. Thank you.

Operator
Thank you. Our next question is from Howard van der Merwe of SCM.

Howard van der Merwe
Thanks very much. On the sale of your automotive business to the JV partner, are you at liberty to tell us what your plans are with the proceeds?

Dominic Sewela
Not that I can say, but I think it's important to realise that the first thing is to prioritise returning the money to the shareholders, given the fact that if you look at our balance sheet even with the starch business we are still sitting very comfortable. So my view is that the priority would be looking at the board to authorise us to reinstate the dividend, because 2020 has been a difficult year for everybody including the shareholders. Thank you.

Howard van der Merwe
Thanks. And if I could just ask one more question. You did cover it in the update with regard to the purchase of starch. And it sounds like the business is doing well. But currently based on this new lockdown how are you seeing that business being affected by the alcohol restrictions currently in place?

Dominic Sewela
Okay. Thanks. I'm going to ask Garth to respond to that. Garth.

Garth Macpherson
Thanks Dominic. Yes, I think obviously there has been a ban on the sale of alcoholic beverages during the period. But unlike the very first lockdown that we had in April/May 2020, what has been allowed to continue at this point in time is for the brewing of alcohol and the movement of stock between DCs. So we have seen a decline in terms of normal levels of activity, but at this point in time it's not down to the levels that we saw last year. And we await obviously the announcements going forward from this particular sector.

Howard van der Merwe
Thank you.

Garth Macpherson
The other thing just to say as well is that when we went into this current lockdown stocks across all the major brewers and everything were at very low levels, so they have also taken this opportunity to rebuild their stocks within the system. And we expect to see very similar offtake that we saw coming out of lockdown in August and September where we've seen very strong recovery in demand.

Howard van der Merwe
Thanks.

Dominic Sewela
Thank you. Can I have the next question?

Operator
Thank you. Our next question is from Nomandla Duma of Allan Gray.

Nomandla Duma
Hello. Hi guys. I just wanted to ask as it relates to the sale of the automotive business. From your numbers what earnings multiples did you guys pay for the business? And the other question that I have is: is the long-term intention to exit the automotive business altogether? Thank you.

Dominic Sewela
Thank you. Chris, do you want to respond to the motor retail sale?

Chris Wierenga
Thank you Dominic. Good afternoon everyone. I think just to answer the question in terms of motor retail we had a very difficult 2020. But I think going backwards you would have realised that motor retail would have historically reported about R500 million worth of operating profit historically. I think in terms of that R500 million operating I just want to bring to your attention that about R300 million of that R500 million represented the motor retail business that we are selling today. The other R125 million of that number represented the 11 months of trading of NMI that was included while it was a subsidiary in the group.

And then the balance, just over R100 million, was made up of the contribution from our used vehicle and disposal business which includes SMD which sells the insurance vehicles on behalf of insurers and others that have been in motor vehicle accidents etc. So the subject of this transaction is only in the motor retail business that is going. And in the 2020 numbers we reported an operating loss of R12 million in the segment. R66 million was the loss in motor retail, and about R54 million of that was the profit that was generated out of SMD and the other used vehicle trading platforms that we have.

I'm giving you that context in the structure of how we look at the multiple going forward. The resultant multiple that we've worked out on the basis of a return to normalised trading environment with volumes recovering etc. would represent a PE of 10x to 12x on a forward look. And that obviously is taking into account the impact of the restructuring that we've taken and then a return to more normal levels in that business over the next year or two years. In terms of how we calculated the price we very much used the industry norm, which is a net asset value type valuation on the inventories, working capital and underlying plant and equipment in the dealerships plus a profitability premium to arrive at the R400 million premium for the business. Dominic, do you want to take the question on the longer term intentions on motor?

Dominic Sewela
Yeah. Thanks Chris. I think it's important to understand that Barloworld has got a multitude of OEMs in that motor space. So if we were to do an outright sale immediately it would complicate our lives. It would probably take forever to do the transaction. Given the fact that most of them are aware of the NMI partners being the Akoo family over this last 17 years, it's more palatable for OEMs to be able to agree to this transaction. And obviously it makes it easy then to do the second transaction thereafter. What I have said is that our view is to exit automotive and logistics entirely over the next three years or so. And largely it's because of the current conditions that we're finding ourselves. If you were to put a sales force for rent a car and leasing I don't think that would be accretive to shareholders. And we do take into account that logistics is not going to be an easy sale, but the process is ongoing. That would answer your question I hope. Thank you.

Operator
Thank you. Our next question is from Roy Campbell of RMB Morgan Stanley.

Roy Campbell
Thank you. A few questions from my side. Maybe just for Quinton on the Eurasia area where you were just talking about Mongolia and the base. In the note what I think it says is that Mongolia is up well above the comparative period. Maybe you can just talk through Russia in that case, just on a like for like basis. If you could just strip out Mongolia and discuss what Russia is doing, maybe the impact of the slowdown in the aftermarket. And then the second question is related to the operations in the Bartrac JV. Is the performance to date lower than what you were expecting? So, is it likely that this kind of market continues and so your expectations of a recovery this year have maybe changed? I've got another question if you don't mind, but I'll leave it there for now.

Dominic Sewela
Okay. Let me start with the DRC and then I'll get Quinton to answer your first question. You are correct. I think in terms of expectations as of this quarter we are still in a loss-making situation and our view is that we would have to actually take out costs in terms of people, close to 20% of the employees. And we expect those costs to come through between now and March. So come to March we think there won't be improvement. And I think we will begin to see the improvement in the tail lend of the calendar year, not so much so our year end. That's when we think the loss will be less. Largely it's because [unclear] is still under care and maintenance. And you also have new activity picking up with TFM. But what is currently carrying that is KCC. Our view is that it is lower than what we thought initially. Chris, do you want to talk about VT?

Quinton McGeer
Thank you Dominic. Yes, from a Russian perspective the first quarter has been very similar to the prior year in comparison from a revenue perspective, very close to the prior year. And then from a bottom line perspective after tax slightly better than prior year. So with the slowdown in aftermarket prime product sales have picked up, and that cushioned the revenue number. So with that as well the order book has grown as well from September quite substantially where we sit today. So despite the slowdown in aftermarket where it was driven by a little bit of the coal market that was depressed as well as the impact of COVID where there was a slowdown and companies did pull back a little bit on business practises, the overall result is satisfactory, in line with the prior year, and linked to that a positive growth on the firm order book.

Roy Campbell
Thanks Quinton. Sorry, you mentioned the rail infrastructure and the $57 million. The $57 million you referred to was that order intake or was that spend from a Mongolian perspective?

Quinton McGeer
That's not a deal that we did. It's a deal that we facilitated and were acting as an agent for the transaction. So it's not revenue that will be reflected in our books, but I think the positive part of it is it's a deal of locomotives with Caterpillar engines. And we acted as an agent, because that's not part of our product line, locomotives. And then the overall positive impact on the country, I think that's quite important for us.

Roy Campbell
Okay, great. Thank you. And then just maybe for Chris just two questions on the disposal of automotive. If you can just talk through some of the economics of the deal. Is there any recourse on Barloworld on the debt that will be raised within the JV? That's the one question. And then obviously the dealerships that you'd be selling into the JV would form part of the PropCo OpCo deal that was structured recently. Do those properties get sold with the operating companies? If you can maybe give us a bit of economics behind that.

Chris Wierenga
Thanks for the question, Roy. I think let's first have a look at the issue on the importance of the deal. I think we've seen that we've got capacity on NMI's balance sheet to introduce some leverage against their property portfolio. So we will be using that to fund the proceeds of the transaction. Currently Barloworld does have quite substantial guarantees out to the financial providers of the floor plan facilities which have been netted off in the number that we've shown as the tangible net asset value. So at 30 September that number was just over R1.1 Billion worth of floor plan funding that moves across with the working capital in this transaction.

So in terms of that we're aiming to negotiate with the funders, and we're currently in those discussions to transfer the floor plan to NMI. And in terms of our shareholders' agreement we do have a provision for proportional guarantees should the board of NMI deem them necessary. So I think our first prize here would be to obtain 100% release of all guarantees in respect of the facilities that move across, and probably our fall-back position would be to guarantee 50%. So in a worst case scenario we would release 50% of the guarantees that we currently have in place against those floor plan facilities.

And then turning our attention to the transaction, what we've negotiated at this point, Roy, is to cede and assign all leases, so both the internal ones with Khula Sizwe in the property restructure that we did as well as the third party leases. So those obligations are expected to transfer with their rentals currently intact into the joint venture. So there has been no talk of renegotiation of those leases to different rates or anything. They are part and parcel of the trading of the business and should move across with the business as a whole.

Roy Campbell
Thank you Chris. That's it from me. Thank you very much.

Operator
Thank you. Our next question is from Ross Krige of JP Morgan.

Ross Krige
Afternoon. Thanks everyone. Just three questions from me. Firstly on underlying profit growth at group level, operating profit growth. I realise there are lots of moving parts here, but if you could maybe comment if it's fair to conclude that underlying profit growth was positive in Q1. Secondly just on southern African equipment if you could just comment on the sequential change in the order book and perhaps some comments on the run rate in aftermarket post Q1. And then finally just on the logistics business and the planned disposal there if there has been any progress on that front. Thanks.

Dominic Sewela
Thanks Ross. Just on the first one around the profit, you are correct. I think you would see that we are positive on the profit for the first quarter. When we talk about the order book for the equipment business it is at the same level as it was in September because we've delivered between now and that period. As we deliver we continue to get an order book. We are seeing a mix change largely because the sales have been strong in the first quarter in favour of sales. And you will see the margins slightly lower in terms of equipment. And largely the bulk of the activity is coming out of the diamond industry as well as the coal industry in SA and platinum sector. There are other orders that we're picking up on the construction side and the contract mining activity, but I think mainly it was what I would regard as mining led in the first quarter. Thanks Ross.

Operator
Thank you. Our next question is from Shaun Bruyns of Mazi Asset Management.

Shaun Bruyns
Good day gents. I think my question has partially been answered by Chris just in terms of the recourse. Just maybe a further clarification. So if you go to your segmentals I think the operating assets for the retail business – and it's probably the total business – was about R3 billion and the NAV including the goodwill you get is about R950 million. If I take the goodwill, is the rest of it all debt that would transfer across? So if I take your operating capital less your equity, that difference there, is that third party debt that transfers across into the JV? I just want to maybe pick up from where you left with Roy.

Dominic Sewela
Chris can take that.

Chris Wierenga
Hi Shaun. It's a good question. Shaun, I think in the R3.6 billion that you're looking at there, there are a couple of other elements in there. First of all the investment that we hold in NMI-DSM is also accounted for in that line. So that represents about R650 million worth of investment in that line. And then the other element that sits in there as well is the balance sheet that supports the SMD [unclear] including their right-of-use asset which is about R500 million as well. So the balancing number that you're looking for – because the R1.1 billion is actually netted off against the working capital that sits in that line – includes the right-of-use assets which are about R1.6 billion in the segmental reporting that goes in. So we've actually stripped the right-of-use under IFRS 16 out of the tangible net asset value that we've disclosed for sale. But that's the balancing number that gets you to the R3.6 billion on the segmental reporting at 30 September.

Shaun Bruyns
So Chris, I guess where I was trying to get to is there's going to be just on a consolidated basis assuming that your recourse drops down to 50% of the floor plan there's quite a big swing in the aggregate debt at group I would think.

Chris Wierenga
Shaun, I think as you look at this what we'd expect to see at group level is the release of the floor plan facilities as well as the right-of-use liabilities applicable to this business. So those are going to be the two big numbers that are going to move out. If I take those two numbers together we're looking at somewhere between R2.5 billion and R3 billion worth of debt funding that should come off the group's balance sheet, albeit not all shown below the line in debt because some of those floors plans are shown in working capital. But from an overall looking at the debt levels in the business we should see a big reduction in them as a result of this transaction.

Shaun Bruyns
Thanks very much, Chris. I appreciate it.

Operator
Thank you. Our next question is from Paul Stevers of Bank of America.

Paul Steegers
Hello everyone. Just on logistics, given the tough trading conditions and fixed cost base, have you seen any cost savings in the quarter that have at least helped a little bit to offset the weaker trading? I'm just trying to get a sense of where you are relative to your budget and whether or not you'd still be looking to potentially break even for the logistics business. So any sort of colour on revenue, costs and margins and where you are relative to budget please. Thank you.

Dominic Sewela
I think when you look at logistics for the first quarter basically we are making a loss at the operating profit level. And this is largely due to three areas: what we call mega transport, which is the business that moves huge equipment – it also moves some of Ingrain's equipment – as well as general freight and global freight services. I think this speaks to the difficulty we still find ourselves in a COVID environment where freight inbound we start with clearing and forwarding. We are taking a lot of pressure in that area. And basically with the availability of trucks available it's not very competitive to actually keep some of the trucks on the move. So we have almost a fleet of that freight business parked and we are still carrying on the costs of the drivers. And basically similarly with mega trade. We are looking at probably taking even more action during this quarter over and above what we've done, because all the other businesses except for those three areas in logistics are actually performing better. What we've done has been good enough and we've seen the benefit thereof.

My view is that we will have to take more people out. And it will be mainly drivers in the logistics business. If you look at some of the interest that we've found, we've found that people are more interested in the pieces of the business, not the whole business. Some people are interested in looking at what we call global supply chain. Others are looking at transport. And obviously when we put out a proper sales process – because initially we're just looking at the bids – we will make sure that the business has been properly evaluated. And I think given our past experience with Section 189s and how robustly we run the process, this thing will be done by the end of March and we will officially put a sales process in place. These were unsolicited bids that we are reviewing. Thank you.

Paul Steegers
Thank you for that. Maybe just a follow-up question on the motor retail automotive sale, just on your budgets what you are getting in the proceeds, the discussion we've just had on the floor plan with debt, the movements there and the floor plan. And then also obviously we are all forecasting an improvement in operating profit for that segment this year, rightly or wrongly. Do you think this deal as it stands with you retaining 50% of the business is going to be earnings accretive or earnings dilutive? Thank you.

Dominic Sewela
Thank you. Chris, do you want to comment on that?

Chris Wierenga
I think those are all good points. I think let's start off with the business itself. Trading and the actions that we've taken I think are certainly supporting the underlying businesses. I think as we go into moving the deal into NMI-DSM and we look at the way that the deal is structured we should see an earnings accretion at the after tax level

from associates out of the business once it settles into NMI. So we're certainly not seeing it as being earnings dilutive at the associate level for NMI given what we're seeing in trading in the business right now.

Paul Steegers
Okay. Sorry, just to be clear, at the Barloworld net income level – maybe that's what you're saying – you expect this still to be accretive to group earnings. Is that correct? You just mentioned the associate line, but maybe that's your point.

Chris Wierenga
Yes. So by implication if the associate itself is profitable we should see those earnings come through in terms of our 50% on the associate line in Barloworld as well. And we're expecting it to be earnings accretive on that line as well.

Paul Steegers
Okay. Thank you.

Operator
Thank you. Ladies and gentlemen, just a final reminder, if anyone else would like to ask a question, you are welcome to press * and then 1 on your touchtone phone or on the keypad on your screen. If you wish to withdraw the question, you may press * and then 2 to remove yourself from the question queue. We have a follow-up question from Nomandla Duma of Allan Gray.

Nomandla Duma
Thank you so much. Dominic, just a question to ask you with your vision. So now that it's looking clear that you're looking to exit the automotive business, and you have a strong position I think in the equipment business, and now you've just bought the starch business, are you looking to find other new opportunities and acquire other businesses in different industries? Or are you at a stage of trying to consolidate the business, like exiting the loss-making businesses, the logistics and the difficult trading environment under the automotive business and focussing on starch and equipment going forward? Or are you still looking for other opportunities?

Dominic Sewela
I think this is basically it. Once we exit the entirety of the automotive – and I gave you the timeline if all goes well – the focus will really be consolidating on the equipment business. I think if you look at organically in these territories there is still a scope to grow. As I said previously, it's not easy to find other dealerships particularly in the areas we operate in. So if there are opportunities for bolt-ons in the equipment business to increase our services to existing customers, we will look at those. Similarly on the starch side our view is that in terms of the ingredients we will look at opportunities to say what else do we do at the food ingredient businesses to bolster our starch business. And that's about it. We won't be looking at any other acquisition.

Nomandla Duma
Okay.

Operator
Thank you. We have another follow-up question from Howard van der Merwe of SCM.

Howard van der Merwe
Thanks. The history of that starch deal is quite public and it looked like you withdrew from the deal with Tongaat, and you did so for various reasons. It went into arbitration and you lost the arbitration. Were there

reasons for not wanting to proceed with the deal? Are those reasons still ever-present, and what are your concerns then and now, now that you were forced to take on that particular asset? And are you happy that you are now being forced to take it over?

Dominic Sewela
I think the fact that this deal was public created a misconception from the get-go when we signed an SDA with Tongaat on the deal because it was a regulated transaction given the size of the deal. There were certain things that had to be done in public. So to secure our interests in the event or any eventuality there were certain clauses that we put in there like the MAC clause that you're referring to. We had similar provisions in the Mongolia transaction. What you don't know about Mongolia is we went through the same process, but obviously it was not a public transaction. Hence we've had a huge reduction of price on the Mongolian transaction. I think COVID to us did present a challenge and we felt with all we knew at the time that this meant that we should have to go through a process.

And by the very nature of MAC when you put that in place the other party disputes that for their reasons, because they understand the business. They run the business. And all we went through was all provided for in the SDA including the arbitrator who had to arbitrate on the transaction. And obviously this posturing because some of the people thought I'm trying to angle for a lower price. Certainly if indeed I was found to be right that the MAC had been triggered, I would have angled for a lower price. But the fact that it was not forced on me, it was the fact that when you lose the reason of a MAC you get the business, but it became clear that in fact Tongaat was right. This business is good, is defensive even with the COVID issues, with the alcohol ban. So to that extent if you look at the performance of the business in that period and what it is doing currently it's good that we bought that business. Sometimes we buy a business and we find problems underlying. With this one that MAC provided us an opportunity to test before we even bought the business. So it was not forced upon us. We bid for it and we think that the price that we paid was [break in audio]. Thank you.

Howard van der Merwe
Thank you very much.

Operator
Thank you. It seems we have no further questions on the lines, sir. Would you like to make any closing comments?

Dominic Sewela
Thank you very much, ladies and gents who participated on the line. We hope to see you pretty soon. I think we have an AGM on the 11$^{th.}$ And if there are any other updates it will probably be likely closer to March. But if most of you have any other questions, feel free to call Nwabisa or send an email and we will try to answer your questions as quick as we could. Thank you very much. Cheers everybody.

Operator
Ladies and gentlemen, that concludes this conference. Thank you for joining us. You may now disconnect your lines.

END OF TRANSCRIPT