CONTRARIUS

QUARTERLY INVESTOR COMMENTARY
31 MARCH 2018

CONTRARIUS GLOBAL EQUITY FUND

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The Fund aims to earn a higher Total Rate of Return than the average of the world's equity markets, as represented by the MSCI World Index, including the reinvestment of dividends net of withholding tax ("World Index"). It aims to achieve this without greater risk of loss, over the long-term. The Fund is an actively managed fund, and as such does not in any way seek to replicate its benchmark index, but may instead differ materially from the performance benchmark in order to achieve its objective.

CONTRARIUS GLOBAL EQUITY FUND AT 31 MARCH 2018

Total Rate of Return in US Dollars	Class	Since Inception on 1 Jan 2009	Latest 5 Years	Latest 3 Years	Latest 1 Year	Latest Quarter
			% Annualised		*% Not Annualised*	
Contrarius Global Equity	**Investor**	**19.2**	**13.6**	**13.4**	**12.8**	**0.7**
Contrarius Global Equity	**Institutional**	**19.7**	**14.0**	**13.9**	**13.4**	**0.8**
World Index		11.4	9.7	8.0	13.6	(1.3)

Past performance is not a reliable indicator of future results.

The Fund's Investor Class shares returned 0.7% for the quarter versus (1.3%) for the benchmark MSCI World Index, including reinvested net income. As we have highlighted previously, our investment philosophy is not benchmark cognisant and our portfolios would normally vary materially from the benchmark World Index. The Fund's returns are therefore likely to deviate from those of the benchmark. Investors are reminded that given the long-term, contrarian, valuation-based investment philosophy, there will be times when the Fund will materially underperform its benchmark in the short-term in order to achieve its objective of long-term outperformance.

The Fund remains overweight Consumer Discretionary, Materials, and Energy stocks. In terms of geographic exposure, the Fund continues to be overweight shares in North America and shares outside the major developed markets.

Sector Exposure 31 March 2018	Weighting (%) Fund	World Index [1]	Over/(Under) Weight
Energy	18	6	12
Materials	23	5	18
Industrials	0	12	(12)
Consumer Discretionary	36	13	24
Consumer Staples	12	9	3
Health Care	1	12	(11)
Financials	1	18	(17)
Real Estate	0	3	(3)
Information Technology	7	18	(11)
Telecommunication Services	0	3	(2)
Utilities	0	3	(3)
Total Shares	**98**	**100**	
Net Current Assets	2	-	
Net Assets	**100**	**100**	

[1] *Source: MSCI (attention is drawn to MSCI disclaimer in 'Notices')*

Geographic Exposure 31 March 2018	Weighting (%) Fund	World Index [1]	Over/(Under) Weight
North America	83	63	20
Europe	7	24	(16)
Japan	1	9	(8)
Asia ex-Japan	0	2	(2)
Other	7	3	4
Total Shares	**98**	**100**	
Net Current Assets	2	-	
Net Assets	**100**	**100**	

[1] *Source: MSCI (attention is drawn to MSCI disclaimer in 'Notices')*

BED BATH & BEYOND

Bed Bath & Beyond is the largest home-furnishings and homewares retailer in the US. It is about twice the size of IKEA US, its next biggest competitor. Target sells a comparable amount of household products, and Walmart appears to sell more, but both are general merchandisers rather than home specialists. Its shares returned 22% per annum for 21 years up to 2013, but have since fallen more than 70%. Bed Bath & Beyond has been rattled by the changing nature of retail, and it was slow to respond to the threats and opportunities of e-commerce. Many investors see it as a "value trap". We disagree.

The future of retail

Last quarter we expressed some scepticism of the "retail apocalypse". The rate of change may be unusually high for now, and those that do not adapt may not survive, but this is an *evolutionary* cycle not a *coup d'état*. To imagine the future of retail, consider what was important a few years ago, and what will be important in a few years' time.

<u>Availability</u>: When you had to find time while the children were at school to drive to the store, sit in traffic, and hunt down everything on your list, availability was critical. Retail supercentres sprouted all over the US so that you could get much of what you needed from just one parking lot. But when you can buy almost anything without disturbing the dog sleeping on your lap, on-site inventory is demoted far down the priority list.

<u>Price</u>: It is tempting to think that price is the kingmaker when hundreds of products can be compared in an instant. That may have been true in the early days of e-commerce, but these days competitive pricing is just the admission ticket. All major players are competitive, so it is not much of a differentiator. That is not to say that prices are identical—only that differences are small enough to have lost their prime status.

If *availability* and *price*—possibly the two historically most important attributes of mass-market retailing—will no longer be major differentiators, then what will be? Two things stand out to us: 'discovery' and 'engagement'.

<u>Discovery</u>: This is jargon for *"finding what you are looking for, even if you don't know what you are looking for"*. For example, if you want AA batteries, it's easy to find them online. But if you feel that your walls are a bit bland, searching for "wall décor" triggers a tsunami of possibilities (300,000 on Amazon.com alone). If you have not even narrowed down your search to walls and feel only that your home is too austere, you will have a tough time finding inspiration online. Humans are well known to be frustrated by more than a handful of options. Retailers that help their customers figure out what they want, and then guide them to it in a friendly and pleasant way, will be in demand. Moreover, if you're going to try something new, how painless is the returns process? Recommendation systems—the artificial intelligence behind those seemingly clairvoyant suggestions from, for example, Amazon and Netflix—can be powerful guides in the right circumstances, but tend instead to be shackles when you want fresh ideas.

<u>Engagement</u>: Even the most utilitarian shoppers typically prefer a sensory experience. This may be wandering around a three-dimensional space, seeing what catches your eye, and how those things look from different perspectives. It could be the feedback from discussing your particular issue with a person… *in person*. Or perhaps tailoring a gift registry with an expert who can prompt you for ideas as you sit across a desk. How much more satisfying is it to touch an item and examine its quality, especially when the product has aesthetic or personal value? The urge to see and feel is deeply human. Indeed, the relegation of so much of our lives to two-dimensional devices may make those offline interactions all the more powerful. In comparison, online shopping offers only rudimentary visual stimulus, and for the other senses it is even worse: touch and smell are entirely absent, and when there *is* sound you usually wish there wasn't. Retailers that offer attractive, relaxing, and immersive environments should have lasting appeal.

Online vs offline

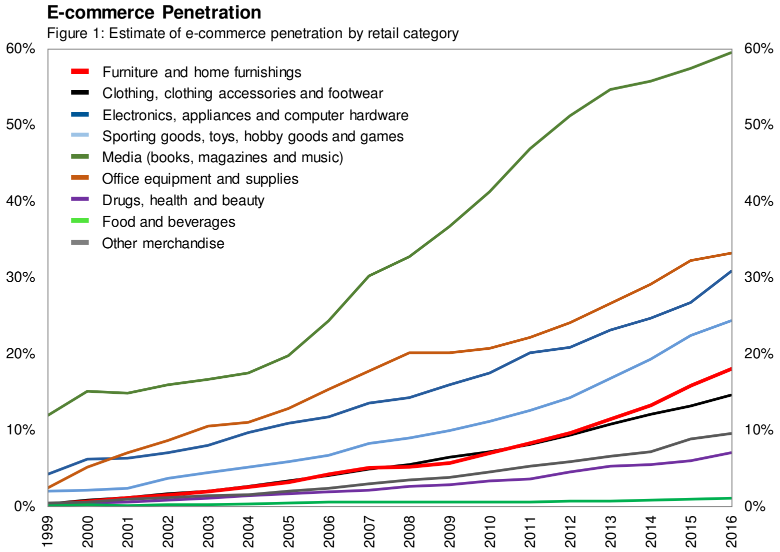
News and music are almost entirely "online" goods. Petrol and freshly brewed coffee are almost entirely "offline". But for a huge variety of goods in between, retailers that integrate both—"omnichannel" retailers—have great advantages. For example, are the following online or offline?

- You buy a top-of-the-range pasta maker for tonight's dinner party online and pick it up on the same day from your nearest store;
- You buy a cutlery set via a website and have it delivered to your house. Then you take it to a store to return or exchange;

- You see a bedside table in a store but then buy it via the app on your phone (because, for example, it is more convenient than waiting in line and carrying it home with you);

The distinction is becoming tenuous, and "online" looks like just another outlet "location" that works well for some types of goods (utilitarian products that are easy to compare) and less so for others (aesthetic or idiosyncratic items that come in many varieties). Homewares are personal, varied, and hard to describe, search for, and visualise. For a "silicone spatula" it is easy enough to browse through the 41 varieties on Bed Bath & Beyond's website, or in any number of online-only stores. But if you were looking for a "table lamp", Bed Bath & Beyond has 2,383 options. You may not be bothered whether your spatula is white with a black handle, or red with an aluminium handle, but the look and feel of the lamp *does* matter. Scrolling through two-dimensional out-of-context studio shots is neither pleasant nor productive.

Although we expect the online share of homeware sales to continue increasing for years, we do not expect the fallout seen in music and video, where the online share shot rapidly to nearly 60% (and increasing). Significantly, about half of e-commerce sales go to retailers with physical stores. The common assumption that online is cheaper than offline is questionable: stores do many jobs—they are advertising banners; they are mini warehouses, distribution points, and returns points—and the additional promotional and logistics costs for online retailers is considerable.



Source: US Census Bureau, Company Filings, Contrarius Research

Bed Bath & Beyond's predicament

Like many of its peers, Bed Bath & Beyond is under attack by the likes of Amazon and Wayfair. But it has fared worse than some competitors, such as Williams-Sonoma and RH, whose shares have fallen "only" 40% and 10% from their respective peaks. The difficulty has been, in part, because it was historically a "big box" retailer: warehouse-like, with high shelves and an enormous range of inventory clinging to every surface. The average store size is about 2,300 m^2 compared to 590 m^2 for Williams-Sonoma. That suits the old traditional priorities of *availability* and *price*, but less so *discovery* and *engagement*. So the legacy store design does not take advantage of the great omnichannel benefits that Bed Bath & Beyond naturally has over its smaller, fragmented competition.

Getting its house in order

This is changing. Bed Bath & Beyond is renovating stores to showcase interior design rather than being a home goods bazaar. There is more emphasis on display and curation and less on inventory, with visitors encouraged to buy in-store from mobile apps for home delivery. There are professional interior designers in store (and available by live chat online). Staff are being retrained as advisers, with new technological support for helping customers discover what they want. Bed Bath & Beyond is investing in guided selling tools, such as idea boards and interactive lists. The new Sunset Park (New York) store contains a full-service restaurant, hosts live events, cooking demonstrations, food sampling, a hair salon, and child-friendly activities.

Bed Bath & Beyond also differentiates itself in traditional ways. The renowned returns policy has no time limit. It can afford this because suppliers bear much of the cost, an unusual privilege that presumably comes from its buying power. It has brand cachet and about half of all items are exclusive. With modern amenities becoming ever more commoditised and modularised, the value of personalisation, exclusivity, and human interaction is elevated. We believe that this integrated experience is a formidable competitive barrier.

The market has thrown in the towel

But changing direction is hard, especially when it means renovating buildings, overhauling technology, and retraining staff. To moderate the operational and financial risk, Bed Bath & Beyond is staging the migration gradually. This means that expenses will be unusually high for a few years: firstly, because of the cost of refurbishment; and secondly, because of the doubling up of expenses to support two somewhat different store models (i.e. "big box" and "showroom"). Atypically among traditional retailers, in 2017 it opened more stores than it closed.

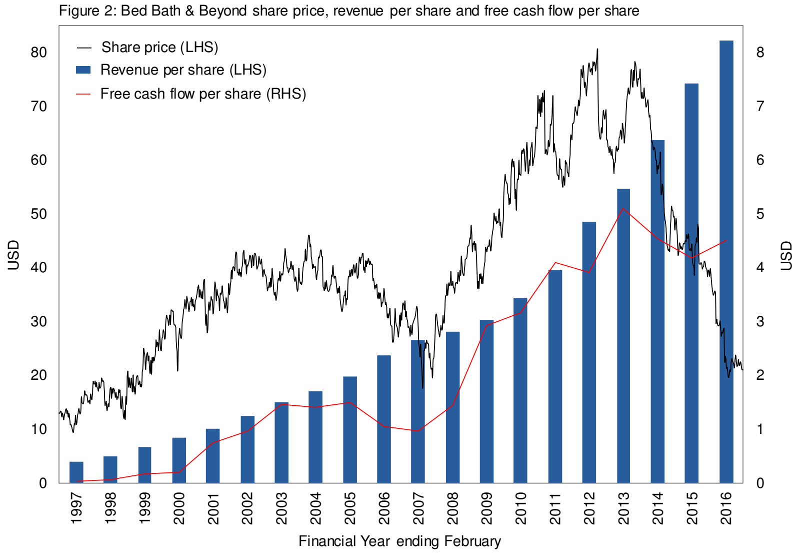
Many investors fear that the depressed margins are permanent. Many also worry about negative growth of same-store sales (that is, from the cohort of stores that were open a year ago). Patience wearing thin, investors have hung it out to dry: about 15% of shares are sold short.

Looking good beneath the covers

In the 27 years for which we have financials, Bed Bath & Beyond had negative free cash flow only three times (the last was in 1995 and was marginal). The income statement was profitable in every year. This is rare for any company, let alone one that grew its revenue 90 times. Although sales have flattened recently, they have been remarkably robust considering that e-commerce has been around for more than 20 years. The same-store-sales metric that worries many investors is of dubious value these days since online transactions in a store's catchment area bypass that store's sales line. Although we do not simply sweep Bed Bath & Beyond's challenges under the rug, we believe investors do not appreciate its intrinsic strengths, and we expect profits will recover over time.

Bed Bath & Beyond

Figure 2: Bed Bath & Beyond share price, revenue per share and free cash flow per share



Source: Bloomberg, Contrarius Research

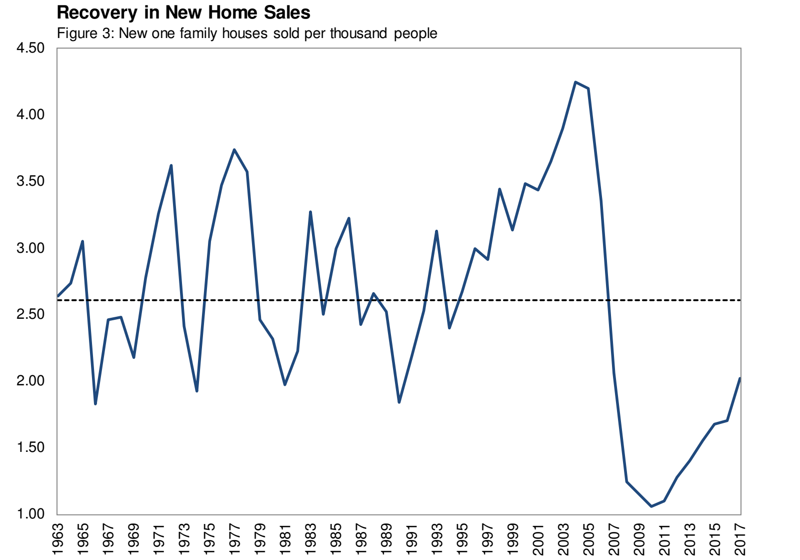
Bringing it home

At the current share price, though, a profit recovery is not necessary to the investment case. In the most recent twelve months, Bed Bath & Beyond generated $430m of free cash flow (compared to a market capitalisation of about $3.0 billion). The historic figures do not take into account the new US corporate tax rate (21% versus the previous rate of 35%). The balance sheet is strong, with only $939 million net debt, and most of the debt is due only in 2044. Unlike many competitors, it has the financial flexibility to invest in its stores.

Bed Bath & Beyond	Value US$'m	Years to maturity
Senior unsecured notes due 2024	300	6
Senior unsecured notes due 2034	300	16
Senior unsecured notes due 2044	900	26
Gross debt	1500	20
Cash and investments	(561)	-
Net debt	**939**	-

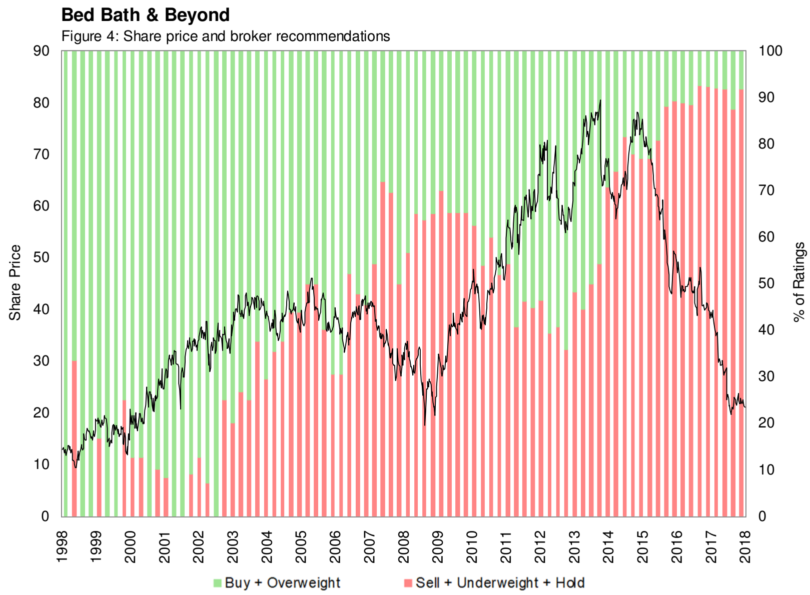
Source: Company Filings, Contrarius Research

Home sales are still recovering from the 2007/2008 financial crisis. We expect mobility and demographic changes to continue to be long-term drivers. Personal incomes are likely to rise, whether because of individual tax cuts, companies passing part of their tax savings on to staff, or a shortage of workers (except for the period from December 1999 until December 2000, US unemployment is the lowest in 49 years). Taken together, these are good signs for home spending.



Source: Bloomberg, Contrarius Research

Since we can buy the shares for about six times depressed profits, it should be no surprise that sell-side analysts are more scathing than ever. Given Bed Bath & Beyond's strong balance sheet, cash generation, and compelling offer to consumers, we think that they are too pessimistic. Despite Bed Bath & Beyond's challenges and volatility, this investment makes us feel very much at home.



Source: Factset, Bloomberg, Contrarius Research

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Performance (net, per calendar year, since inception)	Fee Class	Currency	Best Performance		Worst Performance		Inception
			Year	%	Year	%	Date
Contrarius Global Equity Fund	Investor Class	US$	2009	94.5	2015	(17.4)	01-Jan-09
	Institutional Class	US$	2009	95.1	2015	(17.0)	01-Jan-09

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Contact. Correspondence in relation to Contrarius Investment Management Limited's business can be addressed to 2 Bond Street, St Helier, Jersey, JE2 3NP, Channel Islands or clientservice@contrarius.com.