August 2011

Our current equity views

At Coronation we continue to prefer global equities over local equities, in particular high quality, large cap developed market shares. Preceding the market sell-off we found global equities to be reasonably attractively priced. The panic selling of good quality shares has made the value in these stocks even more apparent, while the flight to US treasuries has in our view only made an expensive asset even more expensive. We have therefore taken the opportunity to add to our equity exposure, and within equities marginally reduced our exposure to defensive equities to take advantage of the aggressive sell-off in cyclical businesses in both our domestic and offshore funds.

While we find more value offshore for the reasons explained in Part 1 below, we also continue to find opportunities amongst JSE-listed equities of which we discuss a few examples in Part 2 of this document.

Part 1: Can SA equities repeat their stellar historic performance?

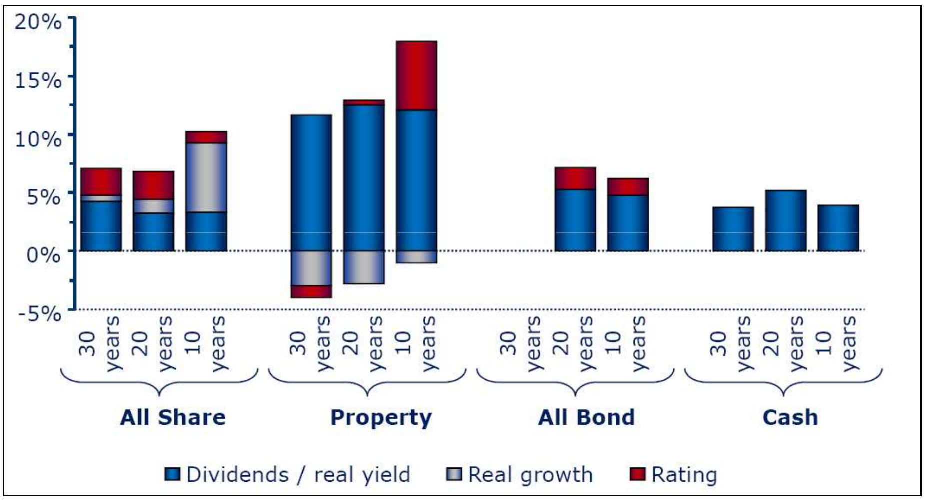
A number of positive factors contributed to the FTSE/JSE All Share Index delivering an above average return of 18% p.a. over the last 10 years.

1) Dividends from the past produced at a time when sub-economic prices were paid for the use of state assets (e.g. electricity).
2) The entire SA economy benefitted enormously from the commodity cycle, irrespective of whether or not you were invested in commodity shares.
3) The technology dividend: MTN and Vodacom, which are two of the biggest companies on the JSE, did not exist 15 years ago.
4) Tax rates have declined, benefitting the investor. Looking ahead, worldwide tax rates are headed northwards.
5) Structural decline in the risk discount rate driven by lower inflation.
6) Vast amounts of credit: Household debt to GDP went from 52% to 80%, causing asset prices to go up.
7) Real job creation predominantly led by construction. However real job creation is lacking at present.

All of these factors contributed to a highly profitable Corporate SA, which has grown its share of GDP over the past decade.

In terms of asset classes, the net result of these positive factors are illustrated in Figure 1, showing the four main classes and their total returns generated over the last 10, 20 and 30 years. The total returns are split into what was delivered from dividends (blue), real earnings growth (grey) and rating (red).

Figure 1: Historical real returns



Source: Coronation Fund Managers

The first very instructive point for an equity investor is that over a 30-year period, more than two thirds of the total return has been delivered by dividends. However, in the past decade over half of the total return came from real earnings, largely thanks to a highly profitable Corporate SA as mentioned above. We however do not believe Corporate SA can grow its share of GDP over the next ten years at it did in the prior ten. If anything, Corporate SA will do well to maintain its current share. If one just looks at our fiscal position, since the recession in 2009 government expenses have continued to increase while revenue has started to taper off. In an economy that is not growing strongly, government's only option to make the expenditure and revenue lines meet is by raising taxes – not by cutting back on expenditure. Higher taxes will ultimately increase government's share of GDP at the expense of Corporate SA.

Listed property is another asset class that has done particularly well over the past 10 years. What is clear from Figure 1 is that in the past decade, listed property has re-rated in large part thanks to the risk discount rate of SA government bonds coming down. Over the past 30 years, which captures a period of higher inflation, listed property suffered from a de-rating. Again, to see the same level of returns from listed property going forward, the risk discount rate would need to come down further. This is highly unlikely given that SA has already entered a rising inflation environment.

Part 2: Where are we finding value in the local market?

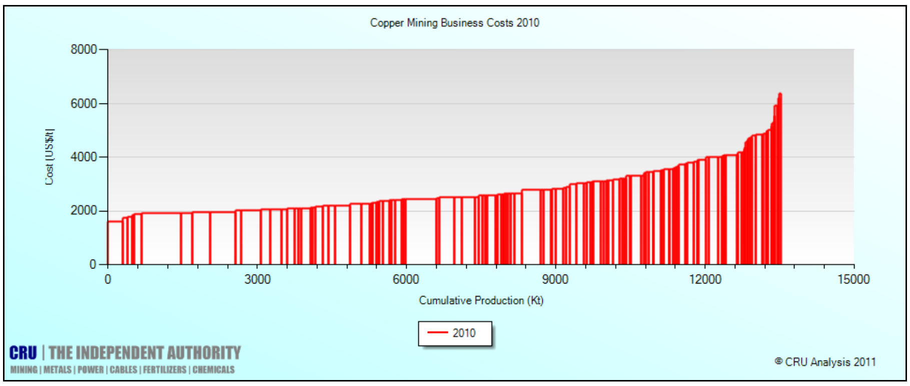
Resources

In 2008/2009, one of the key drivers of Coronation's good performance was being underweight commodity producing shares. We value commodities in the same manner that we value companies, and over the longer term commodities tend to reflect their cost of production, despite moving out of line over shorter periods of time. In 2008 we felt that commodity prices were very high and that commodity shares were already priced for the 'very good times'. This is what we call an asymmetric payoff profile: if the positive scenario played out, we didn't think there was much money to be made (as share prices were already high) and if the negative scenario played out, a lot of money would be lost. For us it was very obvious - we didn't want to be in resources, even though our view took some time to come through.

Today, commodity prices are still way above normal and we expect them to come down over time. We however believe that commodity shares are already priced for this drop and as such, from a valuation point of view, see them as attractive. It's true that some of the most dangerous words in the world are 'this time it's different', but in this case it is more or less what we are arguing around resources, certainly around valuations.

To illustrate our view that commodity prices will ultimately come down, let's examine the cost curve of copper (Figure 2). With the current price of copper lying close to $10 000 per tonne, copper producers are enjoying margins of around 80% (as represented by the grey area in Figure 2). We believe these margins are simply too high. As any good economics professor will tell you, the situation will correct over time as the fundamentals of demand and supply play out to bring the price of copper more or less in line with the cost of production.

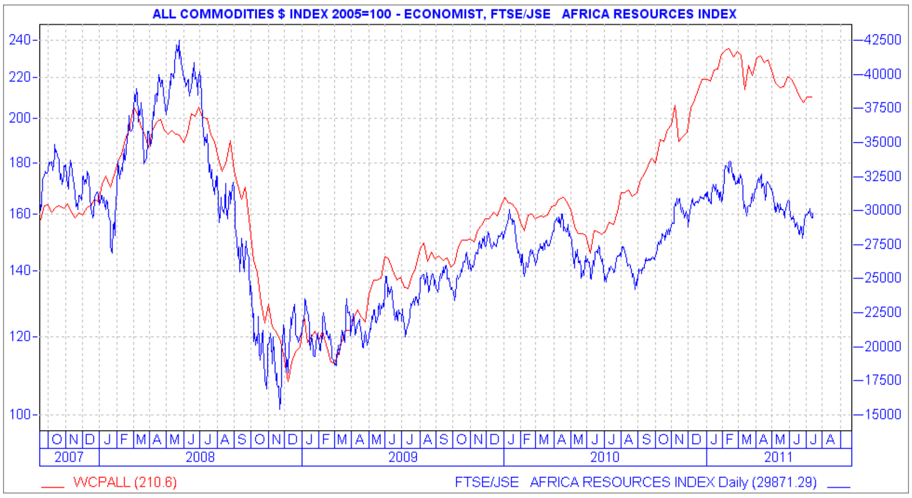
Figure 2: Cumulative cost production profile



Source: CRU Analysis

While in 2008 the price of commodity shares were also very high, we believe this time around the market is too sceptical and are therefore not valuing some of these companies appropriately. But it is not that straightforward. First, the rand is much stronger today than it was two years ago. So, the blue line in Figure 3 which represents the FTSE/JSE Resources Index (discounted for the rand) is not peaking as high as in 2008.

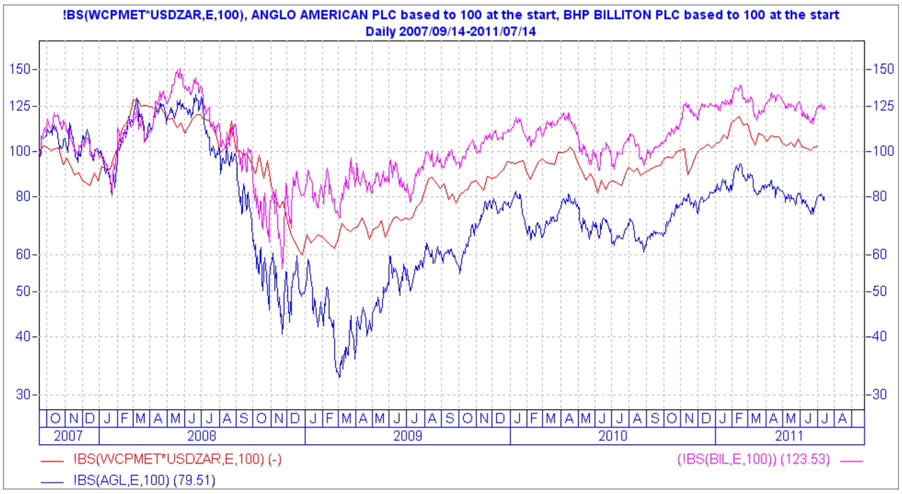
Figure 3



Source: I-Net Bridge

We also believe it's about differentiation between companies. The purple line in Figure 4 below represents the share price of BHP Billiton and the blue line Anglo American. Towards the end of 2008 the gap between these two companies opened up, which is reflective of two things. One, people have placed a management premium on BHP Billiton as no expensive acquisitions were made at the top of the cycle, whereas Anglo American paid a very high price for an iron ore asset in Brazil which, it was argued, destroyed a lot of value. And two, BHP Billiton has a fairly small presence in SA where there is the threat of nationalisation and Anglo American is very exposed to the local market.

Figure 4



Source: I-Net Bridge

But we believe a lot of this talk creates 'noise' and is not actually affecting the true valuation of those businesses. So what drives these businesses? How efficient or well do these businesses operate?

We have looked at both the base and bulk operations of Anglo American and BHP Billiton and found that by and large both companies are equally efficient mine operaters with similar assets. If you look at the bottom line in the majority of their operations, Anglo American is as efficient as BHP Billiton. So the management premium is not necessarily justified. Interestingly, BHP Billiton has just entered into a very expensive transaction, paying $16 billion for a gas business in the US, which we believe is a purchase that may come back to bite them when commodity prices come down.

As said, BHP Billiton is a high quality company, but we believe this is already reflected in its share price. It currently trades on 15 times normalised earnings, while Anglo American trades on 12 times. We think this 20% - 30% premium is just not justified and that Anglo American will be growing their earnings stronger over time.

A short note on nationalisation. Nationalisation is a fact of life if you are investing in a resource company, which is why we always place a discount on our valuation of a resources company. Because commodity companies ultimately mine the assets and resources of a particular country, they will always be at risk of government wanting access to a bigger share of the profits they generate.

We believe nationalisation can take many forms and is prevalent in other commodity producing countries. Australia, for example, introduced its Mineral Resources Rent Tax (MRRT) in 2010 which is a tax on profits generated from the exploitation of non-renewable resources.

AECI – finding opportunities in unusual places

We are also finding growth in interesting South African focused companies that do not necessarily make the headlines. One of these companies in which we have a significant holding is AECI. This business comprises three parts:

1) Explosives: AEL is a leading developer, producer and supplier of commercial explosives, initiating systems and blasting services for mining and infrastructure markets in SA.

2) Chemicals: AECI has been one of the great aquirers of businesses over the last ten years. They have done a large amount of mergers and acquisitions below the radar, slowly building one of the biggest chemicals businesses in this country with exposure to industries that are big consumers of chemicals, namely mining and farming.

3) Property Development: In the 1970s, AECI purchased massive plants outside of the cities for their explosives business. Over time cities grew around these properties, namely Somerset West and Modderfontein. AECI no longer use the operations but the value of the land is extremely high due to their prime locations. Somerset West is the fastest growing part of the Western Cape metropole and Modderfontein is in the middle of the Gautrain route with excellent access to transport links. A station has already been erected and the land is in the heart of where commercial property development is taking place.

If you add the value of AECI's chemicals and explosives business, we believe you get to the current value of its share price. And if you add the significant value of AECI's property (R3 - R4 billion) it is effectively your free option in the share price.