



# Equities: the good, the bad and the ugly

The global financial crisis gave birth to an unusual period, which in our view has created a number of unusual opportunities. Financial market dislocations present attractive entry points into good businesses as liquid shares (generally good businesses) are sold down more than illiquid ones. These periods, we believe, are very healthy for financial markets as they separate the good from the bad. They expose and cull the bad businesses, which may have appeared attractive during the market upswing, and allow the good quality companies that will be able to survive the storm to shine through.

The past 12 months have therefore presented us with a number of unusual opportunities to build positions in mispriced assets offering long-term value for our clients. Below we discuss what businesses we believe represent good investment cases, what's been exposed as bad and lastly, which businesses - while the environment in which they operate may have looked ugly - still offer the potential for the unlocking of value over the long term.

## The good...

What we consider to be a very good business is one with a defensive earnings stream. As an investor, you want to know that the earnings base will remain robust even in a cyclical downturn. Secondly, you ideally want to invest in a strong cash generator. The rationale for this is simply that at the time when companies' balance sheets were most stretched, the very same banks that handed out 'umbrellas' during the good times, stopped lending, making it very difficult for those businesses that need to consume cash (i.e. borrow) to grow. One would therefore want to invest in a business that can generate its own cash to fund growth.

A third consideration is high earnings visibility. This becomes particularly important when you want to forecast, with a high level of certainty, the future earnings that the company may generate three to four years out.

Fourthly, we believe that businesses maintaining wider margins offer better value than those with narrow margins - particularly in a volatile environment.

For example, if margins are in the region of 5% - 6%, a dent of 10% in the top line will push the business into loss making territory. Whereas if a business maintains margins of between 30% and 40%, a 10% revenue drop will not push it into loss making territory, allowing it to survive a downturn relatively unscathed.

Lastly, good businesses in our view generally have strong balance sheets. During times of uncertainty, businesses with strong balance sheets have the ability to increase market share by either buying out their competitors, or undercutting them through better pricing.

## Why we like MTN

### *Defensive earnings profile*

We believe that MTN exhibits the qualities of a good business. Its defensive earnings stream can be attributed to its large subscriber base of between 90 and 100 million, and the fact that very few people cut back on using their mobile phones during a recession. Very importantly for a business such as MTN is its geographic diversification across markets where the penetration levels are still low compared to developed markets. This geographic diversification also counts in MTN's favour as one of a mobile operator's biggest risks is regulation. Diversification across a number of markets, and not being overexposed to any

## Our investment philosophy:

As a single philosophy, stock-picking investment house we employ a common-sense, valuation-driven process that identifies mispriced assets trading at discounts or premiums to their long-term business values. These business values are determined using a longer-term outlook and assumptions that ignore 'noise' and other influences which we consider temporary in nature.

This approach enables us to construct concentrated, differentiated portfolios based on high degrees of conviction. It also supports the discipline required to remain committed to positions that are often materially different to what conventional wisdom will dictate.

## Equity performance:

Over the long term, our investment approach has led to exceptional returns for our investors. Since inception in 1993, our Houseview Equity portfolio for institutional investors has generated an annualised alpha of 3.6%.

	Coronation	Benchmark	Alpha
	Equity		
SI*	18.5%	14.9%	3.6%
10yrs	18.8%	15.1%	3.7%
5yrs	25.7%	22.1%	3.6%
3yrs	13.4%	9.3%	4.1%
1yr	3.2%	(5.4%)	8.6%

\*Since inception in June 1993  
Returns to end-July 2009

## Coronation Top 20

The **Coronation Top 20 Fund** is the best-performing domestic equity unit trust fund over 5 years to end-July, returning an annualised alpha of 8% since inception in 2001. The fund represents an amplification of the Coronation Houseview in that it will invest in only 15% - 20% of the top 50 listed companies on the JSE. The fund aims to deliver maximum total returns over the long term and is ideally suited for those investors seeking long-term capital growth and liquid, yet concentrated, exposure to the SA market.

The **Coronation Equity Fund** offers a slightly lower risk profile than Top 20 and has produced an annualised alpha of 5% since inception in 1996. The **Coronation Market Plus Fund**, which has the flexibility to invest in other asset classes when we believe equity valuation levels are unattractive, has produced an annualised alpha of 2.7% since inception in 2007, but at only 60% of market risk.

one market in particular, means that MTN's earnings are shielded against the impact of negative legislation in any particular region.

### *Strong balance sheet*

MTN's balance sheet continues to be strengthened by the robust growth in its subscriber numbers. MTN has licenses in 21 countries, of which five comprise close to 80% of the company's profitability – South Africa (25% of EBITDA), Nigeria (42% of EBITDA), Ghana (7% of EBITDA), Iran (4% of EBITDA) and Syria (4% of EBITDA). While South Africa is a highly penetrated market (97% penetration) MTN has still managed to grow revenues in this supposedly 'mature' market. Going forward, we however expect the real growth to come from the other four main operations which typically represent underpenetrated markets.

What is often not appreciated about the mobile phone industry is that in order to grow market share one needs to incur very high capital expenditure (capex) and therefore requires a strong balance sheet. While a mobile company may cut the price of its mobile phones, or the per minute call costs, it becomes irrelevant if they are unable to support the call/connection with an actual network. Because MTN has the firepower available to build scale in its operations, which many of its competitors are not able to do due to the difficult climate, the company is placed in a position to really dominate the markets in which it operates.

### *Dominant player*

MTN typically holds the no.1 or no.2 position in its respective markets; once they have become established in a new market, they tend to dominate. When you have two dominant players, it becomes very difficult for a third or fourth competitor to enter and challenge the dominant players' positions. Not only do the new entrants have to develop their own base station sites, they also have to convince existing subscribers to switch from a robust and solid operator to a new and unproven one.

### *Strong cash generator*

The investment case for MTN will remain robust as the business matures. It will become a strong cash generator and that cash will ultimately be returned to its shareholders. For example, when Vodafone in the UK matured as a business and started recording low growth figures, its dividend yield was an attractive 5.5% (in pounds) thanks to its strong cash generative capabilities.

### *A word on valuation and Bharti Airtel*

When evaluating whether or not a business exhibits long-term investment returns, it all comes back to valuation: What price am I paying for its value today?

When the potential of MTN's expansion into other West European and African markets became clear, the share price rose to R160. At that price level we felt that MTN was fully valued and as a result we didn't want to, nor did we own any shares.



Three or four months later, panic struck and the reasons why people wanted to own MTN (exposure to high growth areas such as Nigeria and Ghana) became the very reasons why they sold out. They were focusing on the short-term concerns about where the exchange rates for currencies such as the Naira were heading. As a result, the share price halved and bottomed at less than 8x earnings. At that point, we however believed the price offered exceptionally good value and we started to build a substantial position in MTN – today it is one of our top five holdings. We've since seen the share price re-rate, partly on good earnings, improvement in sentiment and partly on the renewal of the Bharti Airtel (Bharti) deal.

As a shareholder we fundamentally didn't like the deal. We believed that the price offered was too low and that MTN was just a far better business than Bharti, with excellent growth prospects and geographic diversification. Now that the deal has fallen away, we are comfortable that our original investment case still holds true.

### **The bad...**

From an investor's perspective, a bad company typically exhibits the exact opposite characteristics of a good company: its earnings are cyclical, earnings cannot be forecasted with a high degree of certainty, the margins are low and it generates poor cash flow.

To illustrate this we look at the construction sector which, in our view, generates a lower quality income stream which needs to be valued at a discount to the market. Construction businesses faced an exceptionally positive macro environment in the short term,

in part due to 2010 and the levels of historic underinvestment in the country's infrastructure. The favourable environment was ultimately reflected in the premium rating the market placed on the above average high earnings of these businesses. But people forgot about the long-term cyclical nature of the construction sector and that gross domestic fixed investment (GDFI) expenditure also has a fixed lifespan.

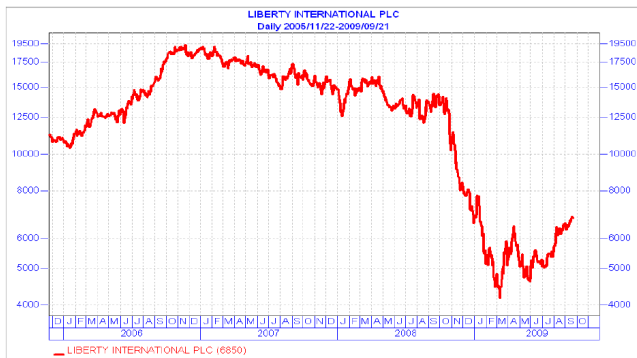
While at first these companies were able to charge very high margins due to constrained supply, sector history tells us that great demand will eventually be followed by low demand. Ultimately, the point arrives where these companies have to lower their margins in order to remain competitive.

Today, the macro environment has deteriorated. Capital projects have either been cancelled or suspended and in addition, funding has become much more difficult. It's also worthy to note that construction businesses have very little annuity revenue which makes them much more susceptible to individual client risk. Further, margins are much lower than for example in the mobile industry, making it very easy for construction businesses to take big knocks when the industry slows down.

To conclude, while the earnings base of construction companies were extremely high, this was largely due to the majority of companies benefitting from a period of abnormal spend. The construction sector, however, remains highly cyclical and as the amount of work dries up margins will come under pressure, ultimately impacting the profitability of these businesses.

### The ugly...

Subsequent to the unravelling of the UK commercial property market, Liberty International (Liberty) suddenly operated in a very ugly environment. Due to rising vacancies it faced declining revenue for the foreseeable future, a stretched balance sheet and uncertainty in terms of refinancing its debt - particularly its debt maturing in 2011. As the favourite and most shorted share in its sector, Liberty ended up having to seek capital in the market by means of a deeply discounted rights issue.



### What's in the price?

The dynamics of market efficiency meant that the poor newsflow was factored into Liberty's share price. Given that hedge fund activity resulted in the short selling of almost 30% of Liberty's market capitalisation, we believe the reaction to the bad news has happened and that it's fully reflected in the price. What is needed now is a slight improvement in the environment, which we believe will be followed by improved sentiment towards the share. Positive capital growth has already been recorded in July following years of being in negative territory.

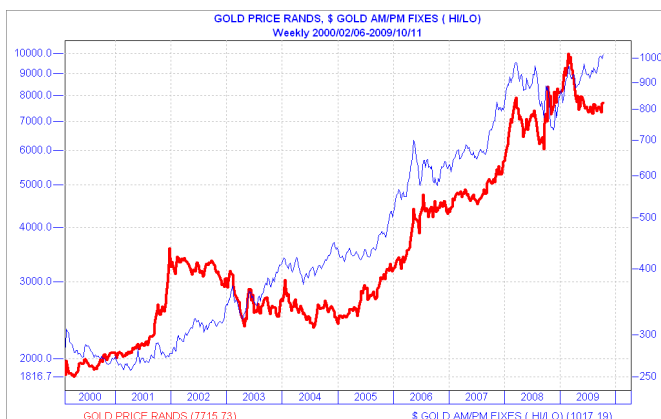
All things considered, the implied property valuations and risks in the share price do not reflect the true value of the underlying income stream. Management, in our view, continues to exhibit the ability to look through property cycles to create long-term shareholder value within its property portfolio of top quality assets in prime locations.

While investor sentiment continues to focus on the challenging debt market and tenant trading conditions, we believe Liberty is defensively positioned in both these areas and that the long-term value unlock potential is substantial.

### A word on gold...

We are currently experiencing the biggest gold bull market since the early 1980s, with gold reaching a record \$1,056.70 an ounce in early October. Over the past 12 months it has been the best-performing commodity due to a huge surge in investment demand, largely driven by the metal's safe haven status as an alternative to US dollars or US Treasuries.

South African investors have two ways to invest in gold - either buying physical gold (most effectively through an exchange-traded fund) or by buying shares in the gold miners.



### Physical gold

While many people talk about gold as a currency hedge, it needs to be remembered that the market for physical gold is very small compared to currency markets that trade in the trillions of dollars. In addition, there is no yield on gold; the only way to profit is to sell it to someone else at a higher price. As surely as the gold price rises when speculative money flows in, it will decline as that speculative money flows out in search of the next new investment idea. The first mistake is to be investing into an asset class *after* all the news has been consumed by the market. While buying gold a few years ago



may have been a good idea, it is perhaps not such a good idea now that it is clearly the consensus market trade.

As the famous allegorical tale of King Midas reveals, you cannot live off gold into perpetuity! The buyers of gold today will at some point be sellers as they use the gold to purchase other assets or to consume.

### *The gold miners*

Despite the biggest gold bull market in the past 30 years, South Africa's major gold companies have over the past then years been raising more cash in the market than they have been able to put back into the hands of their shareholders by means of dividends. This is, however, attributable to two reasons.

Firstly, production costs have increased dramatically in terms of higher electricity costs, wage increases and pressure to sharpen safety measures due to Government's drive to reduce fatalities in this industry. Secondly, in terms of profitability, the amount of gold extracted per tonne today is 40% less than what was extracted ten years ago. Coupled with the increased production costs, miners are effectively paying more to extract less gold. These high gold prices, we believe, are therefore only keeping the mines in business - rather than making them highly profitable.

### **Current positioning: Coronation Top 20 Fund**

We remain very cognisant of the fact that the global environment is tough. As a result we own businesses whose earnings are defensive in that they tend to hold up during cyclical downturns. These businesses, due to the irrational sell-off triggered by the global financial crisis, have been presented to us at very cheap levels. As a bonus they are still strongly cash generative despite tough economic conditions and are paying great dividends to their shareholders, giving a running yield which can be used for consumption or re-investing without the need to sell the shares while they are cheap.

We remain heavily invested in global stocks which happen to be listed on the JSE (Naspers, MTN, SABMiller, BAT, Liberty International and Richemont), light in resources, light in gross domestic fixed investment (GDFI) stocks and light in interest rate sensitive stocks. Overall we think valuation remains attractive as long as exposure is concentrated in good businesses in the right sector.