CORONATION GLOBAL EMERGING MARKETS FUND

Quarterly Portfolio Manager Commentary

CORONATION
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Please note that the commentary is for the retail class of the fund.

The Coronation Global Emerging Markets fund returned -2.7% for the first quarter of 2018, 4.2% behind its benchmark in what has been a challenging start to the year and indeed other shorter term periods. Since inception almost a decade ago, the fund has outperformed its benchmark by 2.2% p.a.

The biggest positive contributors for the quarter all came from fund positions that added positively, rather than underweight positions in stocks that performed poorly. The biggest positive contributor was Airbus, up 16% for the quarter and contributing +0.52%. We continue to believe that Airbus is very attractively valued, with 45% upside to fair value, and as such it remains a large position at 4% of fund. The second largest positive contributor was global sportswear group Adidas (c.55% of revenue from emerging markets), which was bought back into the fund earlier in the year after having previously sold it in 2015. Since the date of reintroducing Adidas to the fund up until quarter-end, the share price gained 22%, contributing +0.50% to alpha. As at end-March, it represented a 3% position in the fund. Other notable positive contributors were the #1 Chinese online classifieds company, 58.com (+11% return, +0.35% attribution) and the leading bank in Russia, Sberbank (+10% return, +0.24% attribution).

As mentioned, the largest new buy in the quarter was Adidas. We had previously owned only Nike, Adidas's perennial industry rival. At the time of purchasing Nike in late 2016, the share was unloved by investors due to concerns over its perceived dependence on the US market and the basketball category in general. At the same time, Adidas could do no wrong as product innovations and other general operational improvements led to market share gains in the US and a substantial improvement in brand equity in most operating regions. Other sportswear groups also seemed to be making headway at Nike's expense in the US, most notably Under Armour Inc, which at one point reached an earnings multiple in excess of 40x. Despite our attraction to the industry, we believed that Nike was substantially undervalued and Adidas looked expensive. Fast forward just over a year and Nike's share price has increased by close to 35%, while Adidas lagged significantly, having declined by 5% since March 2017 until time of purchase in January 2018.

The lag in Adidas created a buying opportunity, and the stock has performed very well in this short space of time. The purchase was partially funded by a reduction in the Nike position size, which has gone from over 2% of fund in recent months to just under 1% by end-March. Although both Adidas and Nike may appear optically expensive based on near-term multiples (c.24-25x forward earnings), we believe they have well above average earnings growth prospects in the years ahead, driven by changing consumer habits toward greater fitness and 'athleisure', whilst the companies themselves have identified several routes to raising margins. These include improvements in manufacturing (to lower wasted materials) and increased direct to consumer sales (where the retail markup is captured in addition to the usual wholesale margin). In addition to this, Adidas's EBIT margins at c.9-10% are still well below that of Nike at c.13-14%. In some developed markets, and eventually in most large markets worldwide, it is expected to become fairly straightforward for consumers to order a customised shoe or piece of apparel, and have it swiftly manufactured in their country or region via a robotic process, and delivered speedily to their door. The pricing potential, improvement in cost control and lower working capital requirements are all material contributors to our belief in the earnings potential of Nike and Adidas, which are not fully reflected in their respective share prices today.

Besides Adidas, the only other new buy was a 1% position in KB Financial, the largest financial services group (banking, insurance, securities, asset management and investment banking) in South Korea. Whilst banking is a relatively poor industry in South Korea in our view (mature, heavily regulated in favour of the consumer and low ROEs) in the case of KB Financial, we were attracted to the steps that new management had taken, and continue to take, in order to improve returns, including acquisitions in areas that have more attractive prospects (e.g. securities), acceleration of digital investment on the banking side, and headcount reductions. Since the appointment of a new CEO (and full new management team) in late 2014, ROEs have increased from c.5% to c.10%. Today KB Financial trades on 7x earnings, 0.7 Price/Book with a 3.5% dividend yield for a company that in our view can grow earnings by c.10% p.a. over the next 5 years.

Over the quarter we continued to reduce the fund's Chinese internet exposure as share prices rose and as such moved closer to fair values. We reduced the position in 58.com to 3% of fund – the share was up 11% in the quarter and would have been approaching a 4% position in the absence of any action. We also reduced other Chinese internet names – Baidu was lowered by 0.5% to 2.1% and JD.com by 1.5% to 4.1%. We also sold out of Alibaba as it reached our estimate of fair value, as well as Altaba – the former Yahoo whose main asset now is its stake in Alibaba. The combined Alibaba/Altaba position was close to 2.5% at the start of the year. Most notably for the quarter, we reduced our Naspers position by close to 3.5% to just under 4% of fund. This was driven predominantly by concerns over the valuation of Tencent, which is Naspers's single biggest investment. We also sold out of Aspen (given more attractive risk-adjusted opportunities elsewhere) and YUM China (due to valuation).

In terms of adding to positions, we increased the Ping An (largest private (non-State controlled) Chinese insurer) position size during the quarter by 1.5% to 3.9% and global tobacco group British American Tobacco from 3.7% to 5.9%, both as a result of share price weakness.

In terms of detractors, 2 stocks made up the bulk of the fund's underperformance: Magnit declined by 32% during the quarter (-1.41% attribution) and Kroton by 26% (-1.44% attribution). We have written extensively about both businesses in recent years and will thus just concentrate on incremental news as well as why the shares have been so negatively affected recently. Magnit had already been performing poorly relative to its previous high standards in recent quarters, with sales growth declining from mid-20s to single digits in recent quarters – and this was mostly driven by space rather than same store sales growth. The company's recent struggles seem to have eventually led the founder and CEO Mr Sergei Galitsky to give up and leave the business. He had been slowly reducing his position over time to fund his philanthropic work, but eventually came to the view that from a personal perspective staying around for a recovery in the business and share price was not worth it. The sale of most of his c.30% stake to VTB Capital (who will look to increase its value substantially for a resale) has led to meaningful changes in management and strategy that we believe will be beneficial in the long term. An example is the company's historical overemphasis on maintaining margins at the expense of reinvesting in the existing store base. This worked fine when the competition was weak and fragmented but as X5 improved their operations in recent years, the product offering at X5's stores far exceeded Magnit's more basic stores and led to negative traffic at Magnit. We believe that greater reinvestment in the business would have delivered better returns as fewer customers would have been lost to competitors and the additional sales revenue would have delivered greater absolute profits to Magnit even if margins were slightly lower. It has also become clear with the exit of the founder that the business has been lacking in professional management with many senior managers being responsible for multiple portfolios. Professionalising the management structure and having distinct control of functions assigned to specialist managers will help improve processes and make the company less dependent on a single individual in future. We were buyers of Magnit over the quarter and at end-March it was a 3.7% position.

The other big detractor has been Kroton, which has fully given up the gains it made after the blocking of its merger with Estácio by competition authorities in the middle of last year. Investor perception toward the private education industry in Brazil has cooled in recent quarters due to a variety of factors. Firstly, intakes have stagnated or declined as affordability has become more of an issue for students. Although the Brazilian economy has exited its deep recession of 2015 and 2016, the recovery has been very shallow, without a substantial improvement in job prospects for the workforce. Ordinarily the government student financing scheme would have helped maintain enrolment momentum, but since 2015 this scheme has been halved and made more expensive for those that qualify. The tough market has also put pressure on pricing, with many industry players offering discounts to entice students, leading to lower average fees.

While we acknowledge the merit in some of these issues, we believe there are strong counterarguments that make Kroton a very compelling investment, which is why we have been increasing the position in response to the decline in Kroton's share price. It is important to identify that the longer-term drivers of the industry remain intact – Brazil has a dire skills shortage and the return on investment for students who study certain courses is very high. The industry is very fragmented and profitability of the smaller players is minimal – many survive simply because they own the building out of which they operate and therefore don't have to pay rent. Kroton's high market share should therefore not serve as a barrier over long periods of time to continued student growth as the market will consolidate over time. Their scale and strong brands make their degrees more attractive, which raises long-term pricing power. With their solid balance sheet and high profitability, they are uniquely positioned within the industry to offer pioneering financing schemes that allow students to spread out their payments beyond the duration of their degree, which will make them more affordable to marginal students. This will help offset some of the negative impact of lower government student loans.

During the quarter we met with the CEO, CFO, CTO and various divisional heads of Kroton in Brazil. The strength and depth of management at the company places them amongst the best in emerging markets, in our view. Besides the favourable long-term prospects for their traditional business (tertiary education), Kroton are also making a concerted push into the private school market as this industry also has great economics (a student stays with you for 12 years instead of 4) and remains very fragmented despite many strong local brands. At 10x earnings we believe you are buying the current earnings stream at a substantial discount and getting all of the above optionality for free. Kroton was a 5% position at end March and is the 2nd largest position in the fund.

Members of the team continue to travel extensively to enhance our understanding of the businesses we own in the fund, their competitors and the countries in which they operate. In the quarter there were trips undertaken to Brazil, India and China. In the coming weeks the team will visit Russia, South Korea, Taiwan, Indonesia and Singapore. The weighted average upside to fair value of the fund at the end of March was c.45%.

Portfolio managers
Gavin Joubert and Suhail Suleman
as at 31 March 2018