CORONATION EQUITY FUND

Quarterly Portfolio Manager Commentary

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

The fund had a challenging quarter with a decline of 2.2%. Over longer periods, the fund has performed well against both its peer group and the quantitative benchmarks.

Our large weighting in global equities has added to performance over the past quarter and year respectively. One of the fund's largest international holdings, Airbus, has delivered very strong returns for the fund over the past quarter (+10% in rands) and year (+41%) respectively. Airbus is one of the two major original equipment manufacturers in the commercial aerospace manufacturers' duopoly (75% of revenues). It also owns a helicopter business (9% of revenues) and a defence and space (16% of revenues) business. Our investment case is predicated on:

- Global air traffic growing steadily above global GDP as the wealth effect makes air travel more affordable to the growing middle class;
- Airbus ramping up deliveries of commercial aircraft, supported by a 10-year backlog of orders;
- Profitability recovering from depressed levels (due to front-loaded project costs and foreign exchange hedging headwinds dissipating) to a normal earnings before interest and tax margin level of more than 10%.
- An upcoming decade of lower research & development and capex requirements and lower technological risks resulting in a more predictable earnings trajectory and an above-average free cash flow generation ability; and
- A genuine change in corporate governance and shift in management's subsequent priorities since 2012 (from social and national security goals to more normal commercial goals).

Airbus trades on 19.8x forward earnings (or 17.6x if one excludes its sizable cash balance) and a 2.1% dividend yield.

Domestically, things remain very tough. The local economy dipped into recession with the second-quarter GDP number of -0.7% being well below the consensus expectations of +0.6% growth. Recent reporting by domestic consumer-facing businesses reflects this harsh economic reality, with numerous companies reporting results below expectations. In September, President Cyril Ramaphosa announced a new economic stimulus package which included several supply and demand side reforms aimed at both raising productivity and public sector driven investment projects. These reforms comprise infrastructure spend projects, easing of work and travel visa requirements, employment tax incentives and market-friendly revisions to the Mining Charter 3. Sadly, the local economy has many structural challenges and improvements are likely to take time to gain traction. Nonetheless, these initiatives are a step in the right direction. Against the backdrop of a very weak economy, the South African Reserve Bank was still able to leave the repo rate unchanged at 6.5%, as the inflation outlook continues to look relatively benign.

Overall, the JSE experienced a difficult quarter, with the JSE Capped Swix All Share Index declining by 1.7% (and with it dragging down rolling 12-month period returns to a paltry 0.4%). The poor returns for the quarter were driven by a weak performance from the industrial sector (-8%). The financial sector performed strongly – mainly driven by the life and non-life sectors that were up 12% and 17% respectively. The resources sector had another good quarter and was up 5%, with platinum stocks (+26%), having a very strong three-month period on the back of a rising platinum group metals basket price.

We continue to maintain reasonable exposure to resources based on our assessment of their long-term value. Our preference for Anglo American (+6%) over BHP Billiton (+2%) – based on a more attractive commodity mix and valuation – continued to contribute to performance for the quarter. Our platinum exposure – mainly through Northam (+9%) – also added to performance during the period under review. We took advantage of market volatility and opportunistically added to our Anglo American holdings during the period.

Naspers' share price declined on the back of a pullback in the Tencent share price. Tencent's recent quarterly earnings were disappointing and short-term earnings expectations have been revised downwards due to the restructuring of certain Chinese government departments and the subsequent delays in the licensing of new online games. Chinese authorities have also proposed new regulations around protecting minors from the adverse effects of online games which has created uncertainty in the Chinese gaming sector. We believe the licensing delays will be a temporary disruption to the business. Furthermore, our interpretation of the new proposed gaming regulations is that they will favour strong, responsible incumbents like Tencent. As such, we remain optimistic on the longer-term prospects for its online gaming business and are still very encouraged by the opportunities in growing its advertising, financial services and cloud businesses. In addition, Tencent has an outstanding investment portfolio, the value of which we believe is still very underappreciated by the market. In the case of Naspers itself, we are very encouraged by its management team's actions around portfolio optimisation and the steps taken to reduce the discount to its underlying intrinsic value. In this regard, management announced they would proceed with the unbundling of Multichoice – most likely to be completed in the first quarter of 2019.

The MTN share price declined after the surprise announcements by the Central Bank of Nigeria (CBN) and Nigerian Attorney General that MTN was in violation of certain foreign exchange control regulations and it should repatriate $8 billion to the country and pay an additional $2 billion in back-taxes. These actions have created widespread uncertainty and is undermining the investment case for foreign investment in Nigeria. As the pressure of market forces has come to bear, the tone of more recent public announcements by the CBN has been less aggressive and more constructive. While these events were extremely disappointing, we believe a worst-case scenario is more than reflected in the current MTN share price (even with Nigeria at a zero value, we still see upside from current share price levels). Furthermore, we remain hopeful that rationality prevails and an amicable resolution can be found.

During the quarter we continued to build a position in Quilter following its recent unbundling from Old Mutual. Quilter is a UK- focused integrated wealth manager. The UK savings market is substantial and the need for financial advice has increased dramatically given recent pension reforms which gives individuals more control over their retirement savings. This should act as a structural tailwind for the business. Quilter is very well placed with the second largest advice force and platform in the UK. It currently trades on around 13x one-year forward earnings and about 10x our assessment of normal earnings. This is a significant discount to its listed peers and we believe particularly attractive.

The fund's UK property holdings – primarily Intu (-13%) and Hammerson (-8%) - had another disappointing quarter, mainly due to the economic uncertainty surrounding Brexit and, specifically in the case of Intu, concerns around its gearing levels. We are cognisant of the risks surrounding their investment cases, but nevertheless believe that these stocks are incredibly cheap. At quarter end, Intu was trading at a discount of more than 50% to its most recently reported NAV and offered investors a dividend yield of around 8% in pounds. Needless to say, this valuation dislocation has not gone unnoticed and after the failed offer by Hammerson for Intu earlier this year, it appears that Intu is once again in play after a consortium of investors - led by the Peel Group (Intu's largest shareholder) - confirmed that it is considering making an offer for Intu.

Some of our consumer-facing domestic holdings faced a very challenging quarter and experienced double-digit share price declines. At this point, we are asking ourselves whether the weakness is a cyclical or structural phenomenon. Has the earnings quality of food producers and retailers structurally changed? We don't believe this to be the case. In an economy with high structural inflation, it is extremely challenging for management to navigate a low volume growth environment. Only a small recovery in economic growth will significantly ease this burden. This issue has been exacerbated by the current low food inflation environment and, for producers, by additional imports on shelves because of a strong rand at the beginning of the year. As such, we believe some of these pressures will abate and continue to selectively add to the consumer stocks.

This has certainly been a testing quarter, but in this volatile and uncertain world, our objective remains on building diversified portfolios that can absorb unanticipated shocks. We will remain focused on valuation and will seek to take advantage of attractive opportunities that the market may present to us and, in so doing, generate inflation-beating returns for our investors over the long term.

Portfolio managers
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