CORONATION GLOBAL EMERGING MARKETS FLEXIBLE [ZAR] FUND

Quarterly Portfolio Manager Commentary

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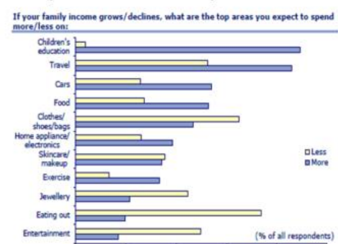
Please note that the commentary is for the retail class of the fund.

The fund had a poor quarter, returning -2.5% compared to the +1.9% of the MSCI EM index. The largest negative detractors over the period by some way were 2 of the Indian Financials, Yes Bank and Indiabulls Housing Finance, which together detracted 2.3%. Other notable detractors were JD.com (-1.0% impact), Magnit (-0.6% impact) and Naspers (-0.5% impact). Having no commodity exposure (either energy or basic materials) also detracted (-1.5% total impact) in what continued to be a good period for commodity prices. On the positive side, Tencent (which the fund doesn't own, and which declined by 18% over the quarter) was the largest contributor (+0.9%) followed by Kroton (+0.7% impact due to appreciating by 20% over the quarter after falling significantly in the first half of the year), Ping An (+0.4%) and Adidas (+0.4%). Since inception the fund has generated a return of 9.3% p.a. compared to the 8.2% p.a. return of the MSCI EM index.

With volatility at above average levels in emerging markets, we were more active than usual, having made 5 new buys during the quarter. Four of the new buys were Chinese companies (a number of Chinese stocks have experienced sharp falls recently) with the 5th being Brazilian. As a result of new buying being focused in Chinese stocks, the fund's China exposure increased from 17.6% at the end of June to 25.4% at the end of September.

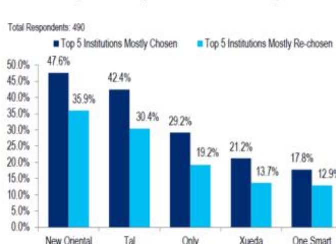
The largest new buy over the quarter was a 1.6% position in New Oriental Education, one of the leading after school tutoring businesses in China with over 1,000 learning centres, 28,000 teachers and operations in 75 cities in the country. In our view, the leading Chinese tutoring businesses are very good businesses with attractive long-term prospects. Demand is driven by the importance of getting good marks for entrance into the best high schools, local universities (the Gaokao exams) and international universities. In China, children's education is amongst the highest priorities in terms of discretionary spend. Increasing disposable incomes over time and urbanisation are additional long-term drivers, as is the recently introduced two-child policy. The businesses are reasonably defensive, very cash generative (well north of 100% free cash flow generation due to upfront payments and low capex needs) and generate high returns on capital.

Priority of children's education spend



Source: China Reality Research

Brand recognition: Top 5 institutions mainly chosen

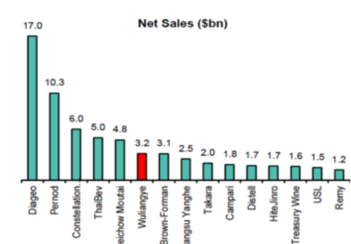


Source: Frost and Sullivan

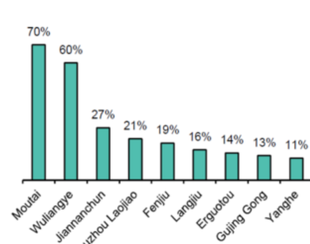
After meteoric share price increases over the past few years the Chinese education companies lost half their value over the past few months which brought New Oriental Education into buying range. The recent share price declines were driven by a number of factors. Firstly, Chinese equities have generally performed poorly over the last few months (concerns over the economy/trade wars). Secondly, their high ratings made them vulnerable to any small disappointment or change in outlook, and thirdly this indeed came in recent months in the form of increased regulation of the sector. In summary, the Chinese government is tightening up regulation of the sector which includes all operators having to obtain business and educational licences for all learnings centres, all teachers having to write qualifying exams by the end of 2018 and classrooms having to be of a certain size. In this regard, New Oriental and TAL (being the 2 largest tutoring companies) are well placed relative to the numerous smaller operators, and the increased regulation, while having a shorter-term impact in terms of new learning centre roll-out, will only increase their competitive advantage relative to the smaller operators who lack the resources to meet the new requirements. At time of writing, New Oriental trades on c. 19x forward earnings and c. 14x forward free cash flow and with over 25% of its market capitalisation in net cash. Additionally, operating margins currently (c. 11%) are almost half of where they have historically been (c. 17% three years ago and as high as 20% several years ago) due to the large number of new centres rolled out in the last few years that are yet to contribute materially to profits.

The 2nd largest new buy during the quarter was a 1.2% position in Wuliangye Yibin, the 2nd largest premium baijiu (a local Chinese white liquor) company in China.

Ranking by sales of Global spirits companies



Brand recognition (all alcohol consumers)



Source: Bernstein

The baijiu spirits market in China is a large subset of the overall market and makes up c. 90% of all spirits (whisky, brandy, white spirits, etc.) consumption in China. As can be seen in the graphs above, the baijiu market leader (Kweichow Moutai) is the 5th largest spirts company in the world by sales (even though they only operate in China), with Wuliangye being the 6th largest. On a free cash flow basis, the gap between the 2 global spirits leaders (Diageo and Pernod Ricard) and the 2 main baijiu producers (Kweichow and Wuliangye) is far smaller than the sales gap as a result of the higher margins of the baijiu companies as well as their higher free cash flow conversion. For the most recent financial year, Kweichou Moutai almost generated as much free cash flow as Diageo ($ 3.2b vs $ 3.4b) and Wuliangye almost as much free cash flow as Pernod ($ 1.4b vs $ 1.7b).

Within the baijiu market, the ultra-premium brand is Moutai (priced at c. $ 150 a bottle), followed by the regular Wuliangye brand (priced at c. $ 100 a bottle). As simple reference points to provide context, a bottle of Johnny Walker Black sells for around $ 25 globally, Macallan 12-year old single malt for $ 40 and Macallan 15-year old single malt for $ 70. The ultra-premium baijiu market in particular is very attractive, with age old heritage and very high desirability. Wuliangye's baijiu offering covers the whole market (with price points as low as $ 5 a bottle), but a shift over time to the ultra-premium and premium Wuliangye products provides both higher revenue and higher margins. Wuliangye generate a c. 20% return on capital and over the past 5 years have cumulatively converted 100% of earnings into free cash flow. After a 25% share price decline this year it now trades on c. 15x forward earnings with a strong balance sheet (c. 20% of market capitalisation in net cash). We have also done detailed work on Kweichou Moutai (which the strategy doesn't own), but prefer Wuliangye's broader mix, lower government related sales and lower starting valuation (c. 15x forward earnings vs Kweichou Moutai on c. 19x earnings).

There were smaller buys in Li Ning (0.8%), NetEase (0.8%) and Itau Unibanco/Itausa (0.6%). Li Ning is the 2nd largest domestic sportswear brand in China (after Anta Sports) and the 4th largest overall in China. Nike and Adidas are the leaders in the market with c. 20% apiece, followed by Anta with 8% market share and then Li Ning with c. 6%. The fund has owned Nike and Adidas for large parts of its history (and today still owns Adidas and only recently sold Nike) and in our view the sportswear industry is an attractive one, being the beneficiary of rising disposable incomes and the age-old wealth effect that results in the desire to own brands. More recent drivers include an increased health awareness globally (and specifically encouraged by the government in China) and of casual dressing (moving away from a more formal dress code generally). While Nike and Adidas are the clear leaders in China (and will continue to take market share over long periods of time in our view), there is also place for a 2nd tier due to affordability, and Li Ning and Anta are the 2 clear leaders in this area. Li Ning is part of the way through a hitherto successful turnaround but profitability is still well below peers (Li Ning have current EBIT margins of c. 7% compared to Anta at 23% and smaller peers all in the 13-17% range) and besides double-digit sales growth (which is already happening) we believe there is room for margins to expand from current levels, with the big drivers being more direct to consumer (DTC) sales, lower wholesaler rebates and operational gearing. Li Ning trades on c. 16x forward (below normal) earnings and has a very strong balance sheet with 22% of its market cap in cash. We have done detailed work on both Li Ning and Anta (they are after all competitors to each other) but only bought a position in Li Ning due to a number of concerns we have with Anta at this point. These concerns include a stagnant core Anta business (ex Kids) with revenue being driven by the more fashionable (and hence potentially cyclical) Fila brand, peak operating margins, a recent large international acquisition as well as concerns on the board/management structure.

NetEase is the 2nd largest online gaming company in China after Tencent (gaming is c. 70% of NetEase's revenue) and have a fast-growing e-commerce business (c. 20% of revenue). We have owned NetEase twice before in the past 10 years and the c. 40% decline in its share price this year brought it back into buying range. Unlike Tencent, who mainly licence games, NetEase develop their own in-house games with a focus on higher quality, more technical games, with the resultant intellectual property that goes with this. The founder, who remains CEO, owns a 40% stake in the business and the company has bought back shares on a number of occasions, and is doing so again. The share trades on c. 17x forward earnings and has 15% of its market capitalisation in net cash, which we believe is an attractive valuation for what is a high-quality asset.

Itau Unibanco is the largest private bank in Brazil (3rd largest bank overall behind the 2 large State banks), and the highest quality one in our view. Concerns over the Brazilian elections as well as general emerging market concerns resulted in a large share price decline to the point where we were able to buy this asset on less than 10x earnings with a 6% dividend yield. The bank is a leader in digital, is conservatively managed (Tier 1 capital of 15% and a coverage ratio of 200%) and has attractive long-term prospects in our view due to potential market share gains (State banks still make up over 50% of the banking system) and ongoing digital development (the cost/income ratio of a digital branch is 30% compared to a bricks and mortar branch of 70%).

Members of the team continue to travel extensively to enhance our understanding of the businesses we own in the strategy, their competitors and the countries in which they operate, as well to find potential new ideas. In this regard, over the past 20 months we have done detailed work (modelling, fair value and research report) on 43 new companies, 10 of which have made it into the portfolio, making up 24% of the strategy today. In the quarter there were 2 trips to China as well as trips to India and Russia. The coming months will see further China trips (2) as well as trips to India and Brazil. The weighted average upside to fair value of the strategy at the time of writing was approaching 70%, well above its long-term average of c. 50%.

Portfolio managers
Gavin Joubert and Suhail Suleman
as at 30 September 2018