CORONATION RESOURCES FUND

Quarterly Portfolio Manager Commentary

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The first quarter of 2020 was a tough one from both an absolute and a relative perspective for the fund. It returned -35.8% against a benchmark return of -25.3%. While this has hit the medium-term performance, the long-term track record of the fund remains compelling, with it performing well against both its peer group and the benchmark over most meaningful periods.

For the quarter, the fund benefited from overweight holdings in Pan African Resources and Exxaro. Being overweight platinum-group metals (PGM) shares and underweight BHP and the gold majors detracted from performance.

The dominant news for the quarter centred around the Covid-19 virus. For broader Coronation comments on this, refer to our CIO's commentary. As far as the resources sector goes, since the realities of Covid-19 became apparent until quarter-end, oil fell 60%, PGMs 15-30%, base metals around 10-20%, bulks 0-10% and gold was flat.

It is hard to know how long things will endure as they are, as well as the timing and extent of any recovery. 2020 demand is likely to be weak for most commodities. Longer-term demand is also likely to be a bit lower than we would have expected prior to the Covid-19 pandemic due to second-order effects of less consumer wealth. Offsetting this, we would expect meaningful stimulus programmes kicking in and aiding commodity demand (notably in China). What is unique with this downturn is the supply impact. Typically, producers do not cut production or do not do so aggressively enough, ensuring a painful downcycle and a protracted recovery. Government-mandated cuts in the wake of Covid-19 have meant that, in many cases, market balance is not thrown significantly out of kilter. For example, South African (SA) PGM cuts and Peruvian copper supply cuts will help market balances. This will pressure current year earnings, but should lead to a faster recovery.

Meaningful supply cuts and the possibility of vicious negative commodity price moves favour those companies with strong balance sheets. To that end, we have exited our positions in Sappi and Sasol (discussed below).

The bull case for Sasol was predicated on a few legs:

- A mid-cost oil producer with above-average reserve life;
- The share price giving little credit to the disastrous Lake Charles Chemical Project (LCCP), which was nearing completion. This would have seen a meaningful earnings and free cash flow (FCF) pick-up as it ramped up and project capex ceased; and
- A new, well-regarded CEO being installed.

While Sasol's debt was high, it was not alarmingly so, and was expected to degear quite quickly as LCCP capex stopped and free cash started being generated from the asset. Unfortunately, the combination of two leftfield events sent oil prices crashing:

1. The largest impact from Covid-19 on oil demand: Oil demand from transport is a material component of overall oil demand. This demand was decimated (and can never be recovered).

2. A ramp-up in oil supply: While initial talks between Organization of the Petroleum Exporting Countries and Russia centred around how much supply to cut and how to share the burden, talks broke down, with Russia turning around and boosting supply and the Saudi's following in short order. Each of these two events in isolation is enormous. Together, they have proved catastrophic for oil prices and producers of oil (with consumers and oil-importing countries being the key beneficiaries). Short of a reversal by the Saudi's and Russia, we would expect oil to be in a very oversupplied position over the medium term. A reversal of their position is hard to call and not guaranteed, given that they want US shale oil producers to be the players that balance the market. The lower oil prices has left Sasol in a precarious financial position. It appears likely that Sasol will need to raise capital from shareholders and sell assets. Both of these prospects have resulted in us impairing our Sasol fair value. Given the path dependency, reduced upside and very attractive upside on offer from most of the other holdings of the fund, we reduced our Sasol position to zero during the quarter, with an exit price above R80.

The sharp decline in the PGM shares is a bit surprising to us, having all declined in the region of 50% post-Covid-19. They went into 2020 facing meaningful supply/demand deficits. While we expect weak 2020 automotive demand as a result of Covid-19, in the case of PGMs there are a few mitigating factors. In past downcycles, the automotive sector has been one of the key recipients of stimulus measures to reignite demand (e.g. 2008/2009 Cash for Clunkers programme). On the supply side, SA produces 62% of primary 3E mine supply. Given the government-mandated Covid-19 shutdown, this goes a long way to softening the blow from reduced demand. Further, since scrap recycling is also impacted by shutdowns globally, scrap supply as a source is also reduced. We have also seen Norilsk terminate a project that would have contributed to longer-term supply. All-in, we expect 2020 to be a tough year from an earnings perspective given the impact of production shuts. However, our long-term view of a market in deficit remains. Most of the PGM shares trade on mid-single-digit multiples of our assessment of normal earnings. We added to our holdings post-Covid-19.

The gold shares have held up comparatively well in this environment. We do not believe the SA gold majors offer value at current levels. They are high-cost producers and have relatively short reserve lives. We expect them to use the higher gold price environment to increase capex to lengthen reserve lives, impacting FCFs that shareholders will see. Even if spot prices persist, we see limited margins of safety. While Pan African Resources lacks the geographic diversification of the majors, its assets are lower-cost, medium-lived and lower-risk (given a material component comes from reprocessing old tailings dumps). Pan African Resources is attractively prices at 4 times our assessment of normal earnings.

The diversified majors are attractive, particularly Anglo American, Exxaro and Glencore. They all have diversified, attractive commodity mixes, low-cost positions and solid balance sheets. With their share prices 20-40% lower post-Covid-19, we have added to these positions. Mondi has been used as a funding source, as it has held up well.

We believe the resources sector offers compelling value at current share prices. While the short-term performance of the fund has been disappointing, we are very encouraged by the fund's holdings and its ability to generate meaningful alpha over the long term.

Portfolio managers
Nicholas Stein and Nicholas Hops
as at 31 March 2020