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 returned -3.1% in the second quarter, lagging the 1.5% return of the benchmark MSCI Emerging Markets (Net) Total Return Index by 4.5%. This underperformance has reversed the positive start to the year, and the Fund now lags the benchmark over the last year by 4.7%. Although this short-term underperformance is disappointing, we believe some drivers are shorter-term in nature and driven by stock-specific moves, which are discussed below. Over more meaningful long-term periods, the Fund is still ahead of its benchmark; by 1.1% p.a. over three years, by 0.2% p.a. over 10 years and by 1.5% p.a. since inception in December 2007.

The biggest positive contributor to relative performance (alpha) in the quarter was Sendas Distribuidora SA (Sendas). We spoke about Sendas in our last quarterly commentary, when it had been freshly spun out of its previous holding company CBD, with shareholders receiving an equal number of Sendas shares to their CBD shareholding. This was done to better realise value by separating the cash and carry operation of CBD (which became Sendas) from the supermarket, hypermarket and convenience store formats, which remain part of CBD. The cash and carry business was run separately from the other formats, so there were no real gains from having everything under the same roof other than saving a few central costs, which were dwarfed by the poor rating applied to the company as a whole. This transaction has proven to be a spectacular success, with the individual shares - Sendas and CBD - now (as at 30 June) trading at a combined share price of R$124 compared to a share price for CBD of R$71 at the beginning of the year and R$79 just before the spinoff at the beginning of March. The biggest pickup was in the much-maligned CBD, which has almost doubled in value since the separation (in local currency terms). As a result, we sold out of CBD completely as it reached our assessment of fair value. The Sendas position we retained returned 28% (in ZAR, as with all other share price moves unless otherwise specified) in the quarter, contributing 45 basis points (bps) to relative performance.

There were a few other material positive contributors during the quarter. First of these was Kaspi, a payments, fintech and marketplace ecosystem/operator in Kazakhstan that went public last year. Kaspi was up 44% and contributed 39 bps to relative performance. Next was Momo.com, the leading Taiwanese e-commerce retailer, which almost doubled and contributed 36bps to alpha. Additionally, the 29% return from Brazilian education stock YDUQS contributed 0.3% to alpha and Chinese spirits producer Wuliangye Yibin contributed 23bps with its 9% return.

There were two equally big detractors in the quarter that each cost 1.5% of relative performance. First of these was the combined Naspers/Prosus position. We hold these stocks in preference to holding Chinese internet firm Tencent as they trade at a significant discount to their look-through value. The Fund holds a large position in Naspers and Prosus (8.6% combined position at the end of the quarter), which returned an aggregate -16%. This was slightly offset by not owning Tencent directly as it is the second-largest stock in the benchmark (over 5% weight at quarter-end). This was a direct reversal of the situation that occurred in the first quarter and was caused by the discount to which Naspers and Prosus trade relative to Tencent widening once more. Prosus, which was originally spun out of Naspers to narrow the discount, has announced a scheme to purchase Naspers shares by means of a tender offer. This tender offer is aimed at addressing the discount. Coronation is currently engaged in discussions with Naspers and Prosus in this regard.

The second equally big detractor was the Chinese after school tuition (AST) provider New Oriental Education (EDU). We added to the existing EDU position late in the March quarter after a 25% share price decline in a short period of time. Unfortunately, the regulatory news that led to the original downward move continued to develop negatively in the latest quarter, and the share declined substantially further during the period (-46%), costing the Fund 1.5%. Overall, we believe that EDU's share price already reflects a fairly dire outcome. The risk/reward is attractive in our view and thus we have kept the position around 2.3% of the Fund.

The next most significant negative contributor was Tencent Music Entertainment. This was also a stock that declined late in the previous quarter and returned a further -27% in the latest quarter. This position cost 77bps of relative performance. Operationally TME is doing well, despite a challenging base in the first quarter of 2020 when China was mostly locked down, which was good for their business. Revenue in Q1-21 was up 24% year on year, with operating profit up 12% and accompanied by great cash generation. The company even bought back roughly $200m of stock, a rarity among Chinese businesses. The reason for the share price decline is antitrust related, given that TME, like most dominant firms in China, has attracted attention from Chinese regulators.

The last material detractor was JD.com (JD), which returned -10% in the quarter and cost the Fund 0.5% alpha. JD is the second-largest e-commerce retailer in China, with 500m customers reported at the end of March compared to 387m in the comparable period a year ago, with management aiming to gain a further 100m in the year ahead. Customer growth has been driven by greater assortment and improvements in fulfilment. Their incredible logistics arm employs 200,000 people and has more than 1,000 warehouses, giving them almost complete geographical coverage of this massive country - all within their own control. More than 90% of orders are delivered either the same day or the next day. Customer loyalty is most evident when looking at purchase frequency and spend, which have increased four-fold and five-fold respectively since 2015.

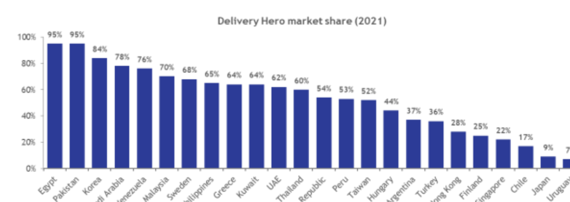
JD has been effective in incubating new business units, with the most notable being JD Logistics (described above) and JD Health (an online health platform). Both have been separately listed successfully, with the holding company retaining 64% ownership in JD Logistics and 69% ownership in JD Health. This dynamic is important to consider when thinking about the *implied* valuation for the core retail business. The entire group has a market value of $118bn but the market value of their listed stakes ($50bn), together with the most recently reported net cash ($19bn), means the market values the retail arm at only around $50bn. The core retail business should generate $135bn in revenue this year at a 4% EBIT margin. We believe this margin is well below normal, which could potentially be high single digits. If you apply a conservative 6% EBIT margin and the statutory 25% tax rate, the core retail business trades on less than 9x earnings for this year. Even at the current 4% margins, the multiple is only 12x earnings for a company growing topline at 20% p.a. This analysis ignores other balance sheet investments that they have, namely, JD Technology (fintech and cloud) and JD Property, which is increasingly housing their physical logistics assets off balance sheet by bringing in capital partners.

A final point worth considering is that the increased scrutiny of the technology sector in China could *potentially* benefit JD's retail business. They have historically been hurt by "pick one" tactics, whereby a brand that sells on multiple platforms is penalised on Alibaba's platforms. These tactics have resulted in JD having an inferior assortment for some key categories, such as fashion and beauty products. With the banning of these tactics by the regulators, merchants have been free to sell all products on all platforms, which should further improve the customer value proposition. The share is down around 25% (in US dollars) from its peak in mid-February this year and offers around 100% upside to fair value, in our view. This is extremely attractive in both absolute and relative terms, and JD is thus a 6.9% position in the Fund.

Two of the notable new buys in the Fund were Delivery Hero (1.6% of the Fund) and Anglo American (0.8% of the Fund). Anglo American (AGL) was purchased for both valuation and diversification reasons. The Fund has little commodity exposure at a time where demand is generally more than supply and prices are rising as a result of this mismatch. Unlike the 2007 period, where miners were trading at high ratings (multiples) on unsustainably high earnings, ratings today are generally quite reasonable, even if spot commodity prices are at the higher end of their normal range. In the case of AGL, the company trades at around 6.5x 12-month forward earnings and offers a 7% dividend yield. Importantly, it trades at less than 11x earnings if its key commodities were to return to our assessment of normal prices. In previous commodity booms (most notoriously in the run-up to 2007), miners blew all their profits on massive expansion projects that ultimately caused prices to tank, or they bought each other out at astronomical valuations only to see share prices fall later in tandem with commodity prices. This time around, behaviour has been more disciplined, so it is less likely this mistake will be repeated. From an environmental, social and governance perspective, AGL has no direct oil exposure and have spun out their coal assets to shareholders, leaving shareholders with platinum group metals, iron ore, diamonds and copper making up more than 90% of profits.

The other new buy mentioned above, Delivery Hero (DH), is a food delivery business. While it is listed in Germany, it derives the majority of its revenue (>80%) from emerging markets. DH has the number one market position, accounting for 95% of its Gross Merchandise Value (GMV), the best measure of the value of transactions taking place on its platform. This is important as substantial network effects between restaurants, customers and delivery drivers come with a market-leading position. On-demand delivery of food, groceries and other goods is underpenetrated in emerging markets, and substantial tailwinds are driving further growth. People place orders with DH, and these are fulfilled either by their own delivery fleet or by the restaurant's delivery personnel. With the passage of time, more and more will be moved to their own delivery fleet, which will give DH higher commission and delivery fees. The business is already profitable in its mature markets and is improving profitability in its other markets. With its recent acquisition of Woowa, South Korea is now half the business by GMV, but profitability is quite depressed there currently due to a very strong offering from competitor, Coupang Eats. DH trades at an undemanding valuation of less than 1x Enterprise Value (market capitalisation plus net debt) to GMV.

Delivery Hero has >50% market share in the majority of its markets



Source: Bernstein and Apptopia analysis

Portfolio managers
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