

corospondent

The Global Quarterly

#wearamask



CORONATION



TRUST IS EARNED™

IN THIS ISSUE

03

Kirshni on point

06

The year in review
*An extract from our
2019 Stewardship Report*

12

South African economic comment
The rubber and the road

16

South African market
Aspen Pharmacare Holdings

20

South African market
The Covid-19 crisis
*A chance to add good quality domestic
businesses to your portfolio*

23

Bond outlook
On the brink

27

Developed markets
Where form meets function

30

Global economic comment
The debt mountain

34

Frontier markets
Hotel California

CORONATION STRATEGY UPDATES

36

Global Emerging Markets Strategy

41

Active Global Equity Strategy

43

Global Managed Strategy

45

Global Frontiers Strategy

Global readers:

The information contained in the publication is not approved for the public and is only intended for recipients who would be generally classified as 'qualified', 'professional', 'accredited' or 'institutional' investors. The information is not designed for use in any jurisdiction or location where the publication or availability of the information would be contrary to local law or regulation. If you have access to the information it is your responsibility to be aware of and to observe all applicable laws and regulations of any relevant jurisdiction and it is recommended any potential investor first obtain appropriate legal, tax, investment or other professional advice prior to acting upon the information. The value of investments and any income from them can go down as well as up and investors may not get back all that they have invested. Please be advised that any return estimates or indications of past performance in this publication are for information purposes and can in no way be construed as a guarantee of future performance. Coronation Fund Managers accepts no liability of any sort resulting from reliance being placed upon outdated information contained in this publication by any user or other person. Whilst every effort is made to represent accurate financial and technical information on an ongoing basis, inadvertent errors and typographical inaccuracies may occur. Information, laws, rules and regulations may also change from time to time. Information contained in the publication is therefore made available without any express or implied representation or warranty whatsoever, and Coronation Fund Managers disclaims liability for any expenses incurred, or any damage, claims or costs sustained by users arising from the reliance being placed on the use of links, services or any information or representations contained in the publication. Coronation Asset Management (Pty) Ltd (FSP 548), Coronation Investment Management International (Pty) Ltd (FSP 45646) and Coronation Alternative Investment Managers (Pty) Ltd (FSP 49893) are authorised financial services providers. Coronation International Limited is authorised and regulated by the Financial Conduct Authority. Coronation Global Fund Managers (Ireland) Limited is authorised by the Central Bank of Ireland under the European Communities (UCITS) Regulations 2011 and the Alternative Investment Fund Managers Directive 2011, with effect from 22 July 2014. Unit trusts are generally medium to long-term investments. The value of units may go up as well as down. Past performance is not necessarily an indication of the future. Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. Unit trusts may invest in assets denominated in currencies other than their base currency and fluctuations or movements in exchange rates may have an adverse effect on the value of the underlying investments. Performance is measured on NAV prices with income distribution reinvested.

US readers:

Coronation Investment Management International (Pty) Limited is an investment adviser registered with the United States Securities and Exchange Commission ("SEC"). An investment adviser's registration with the SEC does not imply a certain level of skill or training. Additional information about Coronation Investment Management International (Pty) Limited is also available on the SEC's website at www.adviserinfo.sec.gov. The information in this document has not been approved or verified by the SEC or by any state securities authority. The opinions expressed herein are those of Coronation Investment Management International (Pty) Limited at the time of publication and no representation is made that they will be valid beyond that date. Certain information herein has been obtained from third party sources which we believe to be reliable but no representation is being made as to the accuracy of the information obtained from third parties. This newsletter contains references to targeted returns which we believe to be reasonable based on current market conditions, but no guarantees are being made the targets will be achieved or that investors will not lose money.



Kirshni on point

100 days and counting ...

By KIRSHNI TOTARAM

Kirshni is Global Head of Institutional Business. She joined Coronation in 2000.

"A truly living human being cannot remain neutral." – Author, activist and Nobel laureate, Nadine Gordimer

In April's edition of *On Point*, I wrote, "What a long year these last three months have been". Now, seven months into the Covid-19 pandemic and just past 100 days of lockdown measures in South Africa, I didn't realise how these words would grow in resonance as time marched on. Life and society have changed on so many levels in a remarkably short space of time, from politics and macroeconomics down to the personal experience of our daily tasks and interactions in this Covid-19-disrupted society. There is no doubt that this year will leave a lasting legacy – events that hold the world's attention consistently for an extended period and that alter the rhythms of our everyday life leave a mark.

Amidst the daily tally of infection rates, it was the brutal killing of an unarmed African American, George Floyd, on 25 May that shifted attention away from the pandemic and its ensuing fallout. This tragic event triggered unprecedented protests through the 'Black Lives Matter' movement in the US and across the world. Protestors, mainly young, came from a wide array of ethnic backgrounds and shone a sharp spotlight on the systemic racism and prejudice that are still prevalent in so many, no, too many, countries around the world. The roots of the problem are deep and old, and it is now clear that the pent-up anger and the incontrovertible feelings of injustice have finally found a strong voice.

This heightened attention on the racial inequality and economic bifurcation in the US shows the ways in which they are inexorably linked – both generally and in terms of vulnerability – to this pandemic. The new world that emerges post-Covid-19 simply must do much, much more to eradicate centuries-old prejudice and create equal opportunities.

LOCKDOWN REFLECTIONS ...

It's been over 100 days since we've been in some form of lockdown in South Africa. Over 100 days of working from home. After watching the initial frenzy of people bulk-buying toilet roll, I think it's safe to say that many of us have adapted and become accustomed to many 'new normal' things that we now do without question. We have learnt that we can work from anywhere, that our kids can be taught online (and that teachers truly are saints), and that physical distancing does not equal 'social' distancing with technology like Zoom, FaceTime and MS Teams at our disposal.

From a personal perspective, as a family we have spent significantly more time together and realised that there is simply no need to fill our schedules rushing from one activity or social engagement to the next – home is a good place to be. I have also enjoyed not racing through peak hour traffic to make the next meeting or appointment, or to catch another flight. And no, I don't yet miss the airports or the significant time spent on planes. These are some valuable insights I have gained and I hope to sustain the new rhythm I set for myself when things return to 'normal'.

But I do miss the interaction with my broader family, my friends, my colleagues and my clients. While we need to adhere to distancing measures for some time still, I look forward to the days when we can again share face-to-face experiences. >

Without doubt, one of the biggest irritations of this pandemic is the wearing of face masks. It is after all one of the most visible and contentious reminders of the invisible enemy we all face.

I confess, I find them uncomfortable. It seems, however, that the wearing (or not) of masks has been used as a political tool in too many places around the world.

Admittedly, science and opinion on their use is divided; everyone can find an expert view to support their preference on the matter. And one thing is undeniable – in South Africa and across the world – not everyone is wearing one. To me, this all seems counterproductive. There is still so much that we do not know about this virus, but if there is a chance that wearing a mask can reduce the rate of infection or can offer protection to the more vulnerable in society, then surely it's a small price to pay? More importantly, intellectual debates over the science often detract from society as a whole adopting the required behavioural changes needed until pharmaceutical interventions are available.

The Covid-19 disruption is real, and the world has changed. Undoubtedly taking its toll is the overt trauma of the daily tally of the sick and the dying, coupled with the extreme economic fallout that has seen unemployment skyrocket and businesses fail, exacerbating the plight of the destitute. In addition, research continues to show that women, and in particular working mothers, have shouldered a significant part of the burden during this pandemic – the true costs and impact are unknown but are likely to leave a permanent mark.

We are all navigating an uncertain road today – our approach to this moment will inform the way we lead tomorrow. What we can do in such times is to focus on how we can rise to these new challenges of the day. I'm sure I'm not alone when I say that as a mother, partner and business leader, not only have I had to come to terms with this new reality for myself, but I have had to learn a myriad of fresh skills to be there for my family, my clients, my team and my colleagues. And the life skills learning curve, much like that of the actual virus, has been exponential.

MANAGING THROUGH ADVERSITY

Those of us fortunate enough to have had the opportunity to continue working during the economic shutdown found ourselves working from home overnight as companies speedily equipped their employees for a virtual workday. It quickly became clear that this transition was not just a matter of sitting alone at your kitchen table or in

a home office for the usual eight-hour workday. It has been a time of blurred lines, as families found themselves confined 24/7, combining homeschooling, full-time jobs, limited help and restricted shopping hours.

While there are many benefits to this 'experiment', current research shows that a greater proportion of employees miss the social interaction of their working environments. The truth is that the mental health impact of the Covid-19 pandemic is significant and traumatic, even for the most emotionally resilient and mentally fit among us.

Covid-19 has accelerated unprecedented change and there is no doubt that the health of a business is visibly linked to the health of its workforce, its stakeholders, and the health of our broader society and planet.

At Coronation, as with many other leaders who run businesses and manage teams, the quick adjustment included gearing up our business to change overnight and finding appropriate ways to support our teams through this transition in a manner that is authentic and sensitive to all their new challenges. As many others have found, mental and emotional health (not just task productivity) have become an integral part of managing a team effectively.

I have found it important to understand this, and to take steps to ensure that my team remains connected and open, maintaining levels of trust and collaboration that can easily be eroded through isolation, uncertainty and anxiety. Sydney Finkelstein, professor at Tuck School of Business at Dartmouth College and author of *The Superbosses Playbook*, believes those companies that nurture talent during this time will emerge from this pandemic better and stronger.

As leaders, we are required to step up and do things differently to what we have done before. It starts with transparency, authenticity and communication that conveys action, seriousness of intent and empathy.

COVID THE AMPLIFIER

Covid-19 will change many things for the long term. Many of the trends that were already emerging prior to the pandemic have seen a decade's worth of acceleration in mere months.

But there are as many things that should stay the same. For me, a key focus has been and continues to be ensuring that our organisational culture and common purpose are sustained and in fact amplified through this time.



This is sometimes easier said than done. One of the big challenges of remote work is to ensure that our culture and values are not diluted over time as people spend less critical time in a shared space.

At Coronation, our unique culture has anchored our business since our inception in 1993.

We are all driven by a simple and common purpose to deliver superior long-term investment outcomes to you, our clients, while being responsible stewards of your capital. This purpose ensures that we put clients first – a focus that has remained steadfast and has kept us forging ahead through these uncertain and challenging times.

IN THIS EDITION

In our latest thought-leadership publication, we have once again included our strategy comments, as well as several articles about share selection and specific stocks that we hold in our portfolios. In addition, we've included an excerpt from our second annual Stewardship Report, reviewing our stewardship and responsible investment activities for the calendar year 2019. I trust you will enjoy the read and the insights that we offer you.

OUR CLIENTS REMAIN AT THE CENTRE

The challenges above notwithstanding, at the heart of our business remains our continued commitment to offering our clients a world-class experience. Through our support of our employees in ensuring they are receiving the tools and understanding they need to weather this crisis, we have also ensured that our service to you, our

client, has been uninterrupted. While 85% of our workforce continue to operate remotely, we are fully equipped and operational to offer our clients the service that is the hallmark of Coronation.

As this pandemic and its effects continue to unfold, I'd like to assure you that my team and I are always available to you to answer any questions that you may have.

As before, I wish you, your family and your colleagues strength, fortitude and good health during this trying and ever-changing time. Please keep safe and well, and I look forward to the time when we meet again in person.

And on a last note, there is much discussion at present about the virus, the hope for a vaccine so that life can return to some form of normality and even the immunology around herd immunity. In reality, we are still some time away from a true understanding of any of these challenges to meaningfully move the needle in dealing with the pandemic. Ultimately, the main variable in all the modelling and projections scientists have is ... us – our individual and collective choices. It is our behaviour in the short and medium term that will ultimately inform how much chaos ensues.



The year in review

- an excerpt from the Coronation 2019 Stewardship Report

THE QUICK TAKE

Awareness of responsible investment and sustainability practices is increasing

We believe that engagement with investee companies on ESG issues is key

The mitigation of climate change and related risks is in sharp focus globally

Good human capital management is strongly linked to long-term value creation



Kirshni is Global Head of Institutional Business. She joined Coronation in 2000.

INTRODUCTION

In 2019, we saw a strong trend of growing interest in, and awareness of environmental, social and governance (ESG) and sustainability issues from most clients and regulators. Today, we live in a more transparent and connected world. Poor practices are more easily exposed, and asset owners and their members are becoming increasingly intolerant of this.

This translated into our having more robust and holistic conversations, which helped improve and widen the ambit of our own stewardship activities and focus.

It has therefore, understandably, been a busy year within Coronation and our entire investment team has again, during this time, worked tirelessly to improve our stewardship efforts considerably.

In the early years of our stewardship journey, much of the focus was on governance issues, but our processes and analyses have evolved over time to

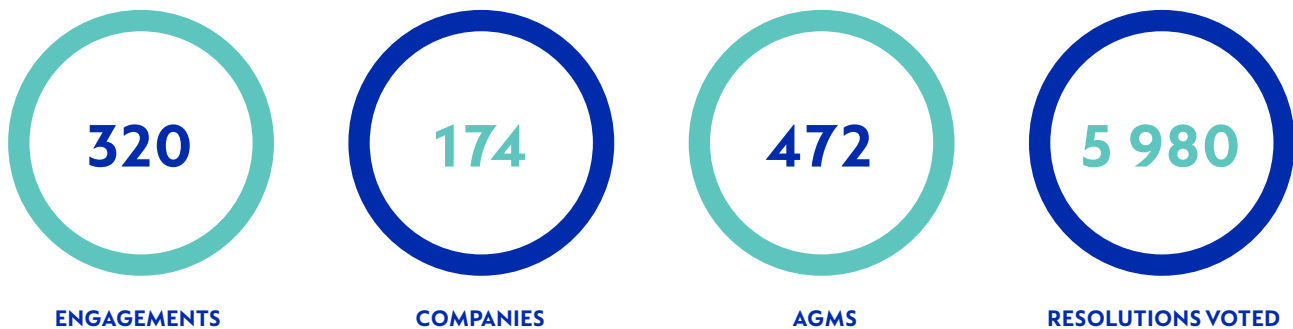
also take into consideration the growing number of social and complex environmental issues.

For all of our portfolios, material sustainability issues are fully integrated and taken into account in the investment decision-making process. But they are not the main driving factor for investments. We do apply exclusions based on issues such as cluster munitions, anti-personnel mines and any client-specified sectors. But, for the most part, our approach is about valuation and driving change through active engagement as opposed to exclusion.

Engagement with companies and voting at shareholder meetings are both powerful tools that we have considered to be an essential part of our active management offering since the very beginning of our stewardship journey. As you will see through this document, we believe that constructive dialogue with the companies in which we invest is far more effective than excluding companies from the investment universe. Only if



DURING 2019, WE PARTICIPATED IN 320 ENGAGEMENTS ACROSS 174 COMPANIES



enhanced engagement does not lead to a desired change do we consider alternative actions that may include collaboration with other shareholders to help achieve the desired outcome. If all else fails, we will look to disinvestment and exclusion.

LAUNCHED SUSTAINABILITY FUND

In 2019, we took our approach to ESG and active ownership one step further through the launch of the Coronation Global Sustainable Equity Income Fund. This is a global equity fund that is designed for investors that require a combination of superior risk-adjusted long-term returns and a dividend yield that is higher than that of the MSCI All Country World Index. Long-term sustainability is a core objective of the fund. This means that, in addition to encouraging responsible business practices through our approach to stewardship and active engagement, the fund also excludes investment in companies that derive a material part of their revenue from activities that cause, or could result in, material harm to society or to the environment. The fund excludes investment into all companies that operate in this sphere, such as tobacco companies, companies that manufacture controversial weapons, and those that operate in the thermal coal or tar sands industries.

THE PRI PEER REVIEW

This year, we achieved the highest Principles for Responsible Investing (PRI) ratings of either A or A+ in all categories. The PRI assessment is an important yardstick for us, as it helps us measure where we stand compared to the rest of the market, and also highlights the areas and competencies where we can improve. For almost all categories, we achieved a score ahead of the median of the market. We are extremely proud of this achievement, but we will not rest on our laurels and will continue to look to improve upon the work that we are doing and the impact we have made.

TACKLING THE ISSUE OF CLIMATE CHANGE

Dire warnings from scientists about the ill effects of climate change have become impossible to ignore and, in January 2020, all of the major risks identified by the World Economic Forum were related to the environment.

This was not surprising following a year characterised by floods and droughts, when fires ravaged Australia and the Amazon, and teenage climate activist Greta Thunberg was chosen as Time's Person of the Year.

Climate change is already a measurable global reality and our home country South Africa, along with other developing countries, is likely to see a more pronounced impact due to the perceived lack of financial resilience. South Africa has an energy-intensive economy and as such is a significant contributor to global carbon emissions. The impacts of climate change are potentially significant if not mitigated. These include, among others, physical, transition and disclosure risks.

As economies change from being predominantly fossil fuel dominated to a lower-carbon world, the >

Figure 1

2019 CALENDAR YEAR

Assets under management	R576 billion
No. of engagements	320
No. of companies	174
No. of themes	22
% of multi-year engagements	> 65%
Voting resolutions	5 980
Shareholder meetings	472

Source: Coronation

transition will impact all aspects of the economy and society as it has become clear that, in the long term, economic, environmental and social risks are linked.

The Paris Agreement of 2015 served notice that companies could not continue with a 'business as usual' approach. As active managers with a long history of engaging with companies to drive meaningful change, we believe that we are well positioned to be an active and meaningful change agent to influence favourable climate-related resolutions.

We have had, for example, had several discussions with fossil-intensive companies to fully understand the adequacy and appropriateness of their emission reduction plans.

Over the year, Coronation became a signatory to the Climate Action 100+, which is a large investor-led initiative focusing on systematically significant greenhouse gas (GHG) emitters. As a signatory, investors agree to engage with more than 100 of the world's largest such corporations to curb emissions, strengthen climate-related financial disclosures, and improve governance on climate change risks and opportunities.

To date, signatories of Climate Action 100+ have been important catalysts for action, alongside significant moves by policymakers and civil society. As part of this initiative, Coronation has joined as a collaborating investor on both Sasol and Eskom.

The complexity of climate change for investors is compounded by factors that include the absence of historical data, the need for an ability to forecast probabilities into the future and a lack of standardised disclosure among companies.

As such, Coronation is an official supporter of the Task Force on Climate-related Financial Disclosures (TCFD), a private-sector international task force formed to develop recommendations for mainstream financial disclosure of climate risks and opportunities across sectors.

We will use their recommendations where appropriate and in engaging with our peers and investee companies on reporting challenges. In this way, we hope to gain improved information and disclosure from companies to help better understand and value climate-related risks.

Given all of the above, it is fair to conclude that the past year has seen major advances in our ongoing goal to understand the risks and

opportunities posed by climate change. We are taking action today based on our understanding of the current situation and challenges. We constantly monitor new developments and our approach to climate change will evolve over time.

We have increased the sources from which we collate climate change-related data and have also started to measure the carbon footprint of our portfolios to give us a better idea of the starting point from which we need to launch our engagements. In addition, all our analysts have done a refresh on the ESG-related analyses of the companies for which they are responsible, identifying key risks and opportunities.

REDUCING SINGLE-USE PLASTIC IN SOUTH AFRICA

There is a growing trend of responsible consumption among consumers globally and an increased awareness of how this can positively contribute to a sustainable planet. Plastics have become a resource used in nearly every part of our modern economy, combining superior functional properties with low cost. Its use has increased twenty-fold since the 1970s and is expected to double again in the next two decades. Today, nearly everyone, everywhere, every day, encounters plastic packaging that is only used once. Tackling this issue of wasteful, single use plastic is now a major engagement theme among investors globally.

While delivering many benefits, the current use of plastic has drawbacks that are becoming increasingly apparent. Most of the plastic used escapes collection systems and is dumped – much of it ending up in the ocean, polluting the seas and endangering marine life.

Recognising the breadth and scale of the effort required to reduce pollution and, while remaining mindful of the complexity of the issue, we took the view that South African retailers could do more to reduce the impact of plastic bags on the environment. This view was also informed by the fact that many other countries around the world have already made significant progress in this area and we believed that South African retailers are well placed to make a visible impact.

Together with other asset managers, we wrote a letter to the management of large South African retailers to express our concerns regarding single-use plastics, recommending that management considers accelerating the reduction, or even total elimination, of single-use plastic shopping bags in their stores. This has started a constructive engagement process.

TACKLING THIS ISSUE OF WASTEFUL, SINGLE-USE PLASTIC IS NOW A MAJOR ENGAGEMENT THEME AMONG INVESTORS GLOBALLY.



DEMONSTRATING ACTIVE OWNERSHIP

Active ownership is a key part of our investment tenet and our value proposition to our clients. As mentioned earlier, for us, it encompasses two key areas – our engagement with investee companies and our votes executed at shareholder meetings.

GOVERNANCE MATTERS

The dangers of ignoring poor governance are well understood and are always significant. As such, governance issues have always been considered the biggest of the ESG triumvirate.

As a member of the International Corporate Governance Network (ICGN), a leading authority on global standards of corporate governance and investor stewardship, we are aligned with, committed to, and advocate for the highest standards of corporate governance. It has always been an important part of our investment process to ensure that the companies in which we are invested maintain high standards of corporate governance. As the emphasis on sustainable investing has increased, we have responded through greater engagement with companies. Coronation values the opportunity to join ICGN as a means of further improving our roles as stewards of our clients' capital.

In addition, our investment team has spent a large amount of time during this year on several matters relating to corporate governance. The most material of these include:

Board composition, functioning and independence: Investors care deeply about good corporate governance and a well-functioning board is an important part of this equation. We believe that companies should be headed by an effective board that is responsible for setting the strategy, direction and risk appetite of the company. Yet, it remains difficult to truly assess the effectiveness of a board beyond the data metrics. Standardised data reporting is an important step forward; however, it provides a very limited insight into the true functioning and effectiveness of a board. Ticking good governance boxes does not necessarily translate into good governance in practice and, hence, as investors, our aim is to try and delve deeper, beyond the basic metrics.

A key part of our assessment is thus focused on trying to gain an understanding of the genuine independence and skills of a board. Our inherent aim is to ensure that boards comprise a diverse range of competencies, knowledge, perspectives and experiences to enable them to effectively carry out their duties and responsibilities.

We believe that an independent chairperson is pivotal in creating conditions for overall board and individual director effectiveness.

Executive remuneration: we improved our principles and guidelines on voting in relation to executive remuneration. Consideration was given to important issues that centred on aspects such as enrichment versus compensation, alignment with shareholders, and whether it is sufficiently long term in nature and set against appropriate key performance indicators. Importantly, we pushed for the inclusion of malus and clawback mechanisms in all remuneration structures to ensure that shareholders are protected from fraud and/or material misrepresentations at the company in the context of being able to claw back or implement a forfeiture of executive bonuses.

Mandatory audit rotation: following a number of accounting-related scandals, we are of the belief that a regular rotation of company auditors would serve as a useful tool in safeguarding against fraud and corruption at a company. It is our belief that the audit process should be objective and independent to be effective and maintain market confidence. As such, we have become strong supporters of a mandatory audit firm rotation for all companies after a period of 10 years.

Our initial success in driving mandatory audit rotation has been high and encouraging, and we will continue in our efforts to champion this change.

SOCIAL CONSIDERATIONS

The social element within ESG considerations is often the most difficult to assess and require case-by-case consideration.

Having said that, we do have an overarching belief that a company's long-term strategy should take into account the development of its workforce. Labour rights and the treatment of human capital are an important part of an organisation's culture and are fundamental in driving good business performance. Good human capital management practices include the provision of a fair basic minimum wage, good health and safety standards, and an investment in training and development programmes. These help to ensure that the workforce is well equipped for completing its required tasks, operates under the latest and highest safety standards and regulations, and remains motivated. Good human capital management generates a culture that is demonstrably linked to more stable and productive workforces and, ultimately, long-term value creation.

A KEY PART OF OUR ASSESSMENT IS THUS FOCUSED ON TRYING TO GAIN AN UNDERSTANDING OF THE GENUINE INDEPENDENCE AND SKILLS OF A BOARD.

>

Consequently, an interrogation of these practices forms part and parcel of our ongoing investment analysis and, where warranted, of our engagement process with investee companies.

Over the last year, our investment team conducted a detailed deep dive into the mining and resource industry, looking specifically at employee safety records. Besides minimising accidents and fatalities, health and safety also interrogate broader working conditions and the prioritisation of employee well-being.

This has prompted the start of a longer and more nuanced engagement process with a number of companies, aimed at improving the safety of working environments for employees.

COVID-19

The Covid-19 crisis has highlighted, and in many ways exacerbated, some of the major social and political challenges facing the global community. As an immediate response, many of the issues that companies had to deal with had a social dimension, which included actions centred on protecting the health and welfare of individuals affected by the virus and the response.

However, the most vulnerable in society have been hardest hit by this pandemic and we understand that the longer-term social consequences are likely to be devastating, unless dealt with explicitly by governments, business and society as a collective.

TRANSPARENCY ON OUR INITIATIVES

Transparency is an important element of stewardship and is dealt with explicitly by various international codes. Transparency has also been a key part of our culture since our inception in 1993. As part of our stewardship commitment, we provide regular updates to clients on our wider stewardship activities, including our engagement activities, our voting activities and updates on ESG matters.

We communicate the results of these activities in our client interactions and, ultimately, through this document. Most of our engagement, however, takes place behind closed doors in order to preserve trust and achieve the greatest level of impact and understanding.

We also work with our clients individually to ensure that we provide them with meaningful information that they need to fulfil both their stated stewardship objectives, as well as any regulatory reporting required.

Our voting activities are disclosed, and updated on a quarterly basis, on the Coronation website, along with this annual [Stewardship Report](#).

As PRI signatories, we are required to report publicly on our responsible investment activities each year. These Transparency Reports, together with the Assessment Reports, are accessible to signatories on the PRI Data portal.

WORKING TOGETHER

Institutional investors are now, more than ever, working collaboratively to move the needle at companies, and the momentum for improving corporate practices in the long term is building.

The regulatory environment around the world has increased scrutiny of and the responsibility for long-term savings in respect of ESG incorporation into investment strategies, which is evidenced through portfolio holdings. Regulatory changes, such as the enactment of the EU Shareholder Rights Directive, the progression of global corporate governance and stewardship code requirements (PRI, UK Stewardship Code, Code for Responsible Investing in South Africa), coupled with mounting social pressures on companies and investors, will bolster the growth and adoption of more sustainable business practices.

As such, we continue to work with our clients on appropriate adjustments to their investment policy statements and their voting policies, as well as mechanisms to improve communication and reporting.

As a company, we believe in proactively engaging with the industry and policymakers to ensure that we help develop an environment that improves outcomes and protects the long-term savings industry. These discussions span a number of different topics and are conducted through various industry bodies in which we are active members and also directly with regulators, where appropriate.

SIGNATORIES TO MULTIPLE CODES

Coronation continues to be a signatory to multiple responsible investing codes, including the PRI and CRISA. In addition, we adhere to the principles denoted in the updated UK Stewardship Code which was published in the latter part of 2019.

As signatory to these codes, we work very hard to ensure that we continue to take cognisance of and champion their tenets and principles.

**GOOD HUMAN
CAPITAL
MANAGEMENT
GENERATES A
CULTURE THAT IS
DEMONSTRABLY
LINKED TO MORE
STABLE AND
PRODUCTIVE
WORKFORCES
AND, ULTIMATELY,
LONG-TERM VALUE
CREATION.**





THE ROAD AHEAD

It is encouraging that the investment industry across the globe has stepped up its overall focus on a wide range of sustainability issues over the past decade. Long-term thinking about the impacts of a business and society across E, S and G has become increasingly important aspects and indicators of investment success. While the crystallisation and awareness of stewardship concepts are improving dramatically across the industry, standardised and useful reporting is still one of the biggest challenges that we continue to grapple with. We predict that this is a critical area that the industry and regulators will work hard at improving in the next few years. We would strongly support this initiative, as it will result in investors having access to improved and more meaningful data that can better inform our investment decisions.

For our part, we will continue to put our resources into growing and developing our understanding of this complex, ever-evolving and challenging field, and we will continually review, interrogate and enhance our processes. As an active steward of our clients' capital, we believe that this will be integral to achieving our goal of delivering significant and sustainable long-term benefits, not only for our clients but for the generations to come. +

This is an extract from the Coronation Stewardship Report 2019, published June 2020. You can read the full report on our website, www.coronation.com

ECONOMIC COMMENT

The rubber and the road

We can't afford not doing better

By MARIE ANTELME

THE QUICK TAKE

South Africa's outlook is bleak, but firm action by the administration could soften the landing

A clear plan to service inexorably rising debt is crucial

National Treasury is the lead actor in how the Covid-19 drama plays out

The possibility of zero to negative growth is a stark reality



Marie is an economist with 19 years' experience in financial markets.

SOUTH AFRICA'S FISCAL position is precarious. Finance Minister Tito Mboweni tabled a Special Appropriation Budget (SAB) on 24 June. This was necessary because the financial allocations associated with the Covid-19 pandemic response exceed the amount allowed by the Public Finance Management Act in a single fiscal year. The new baseline outlined in the SAB reflects the devastating economic and fiscal damage meted out by the Covid-19 pandemic on an already very weak economy. This is how things stand:

1. GDP growth is expected to contract 7.2% in 2020 and recover by just 2.6% in 2021 (Coronation: -9.8% and 3.4%, respectively). This implies that the level of GDP will only return to 2019 figures by late-2023.
2. The associated revenue loss is expected to be R300 billion, (6.1% of GDP; Coronation: R314 billion).
3. Expenditure is expected to rise by R36 billion, adding to the redirected R100.9 billion, to complete a R145 billion support package for the economy.

4. The main budget deficit is forecast at 14.6% of GDP from -6.8% in 2019/2020, and with a rise in debt service costs expected, the primary deficit is expected to widen from -2.7% of GDP to -9.7%.
5. Gross government debt will rise from 63.5% to 81.8% in a year.

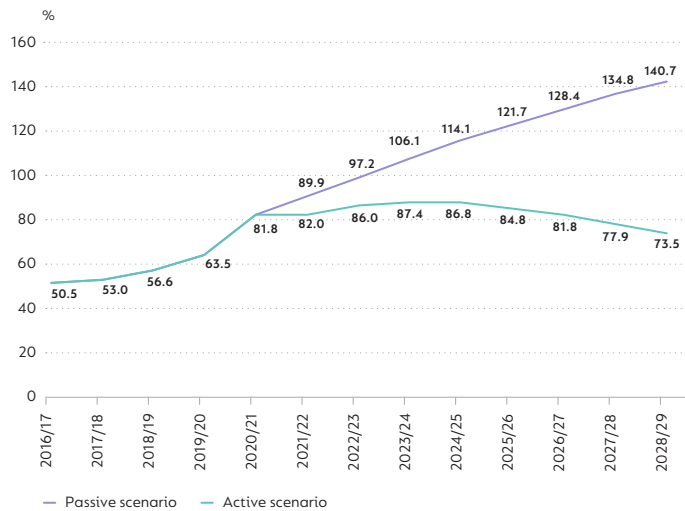
The SAB presents alternative 'active' and 'passive' approaches to managing the longer-term impact of the crisis on government finances, especially on its debt burden. The 'active' approach requires R250 billion of expenditure consolidation and revenue adjustments over the next two years, to return the fiscal balance to neutral and help stabilise the debt profile, with a peak at 87.4% in the fiscal year 2023/2024. The 'passive' approach makes no meaningful adjustment and leads to an explosion in government debt.

The National Treasury reportedly secured ministerial support for the 'active' scenario before tabling the SAB, which means government has, de facto, committed to a painful consolidation of its spending, even if the full amount seems unrealistic. Despite massive efforts by the National



Figure 1

NATIONAL TREASURY'S 'ACTIVE/PASSIVE' CHART



Sources: The National Treasury, Coronation

Figure 2

GOVERNMENT DEBT ACCUMULATION EQUATION

$$\Delta d_t = d_{t-1} * \left(\frac{i_t - g_t}{1 + g_t} \right) - pb_t$$

Source: JP Morgan

Treasury to intervene in the most effective and sustainable manner, the weak starting position (low growth, poor policy execution, maladministration of State-owned enterprises [SOEs], and ongoing costly fiscal support of these entities) and the anticipated long-term impact on the fiscal position have made financial markets understandably more wary of its commitment.

BUT IS IT SUSTAINABLE?

There is no single empirical or widely agreed upon definition of what constitutes fiscal sustainability, and there is no inviolable measure for the tipping point into crisis. But there are points of general agreement. The International Monetary Fund (IMF) defines a sustainable fiscal position as one which allows the government to meet its debt servicing obligations in the short, medium and long term without the need to make policy adjustments, which is implausible from an economic or political standpoint, without default or renegotiation given the financing costs and conditions it faces.

There are several important criteria implicit in this definition which need to be looked at more closely:

- Government needs to be able to service its debt, for which it needs to be solvent and have access to liquid financial markets.

- Servicing debt should not require a material change in behaviour – that means the government should not already have been running large deficits for a long period beforehand.
- The government's economic and fiscal strategy needs to be credible.

DEBT DYNAMICS

We have discussed debt accounting in a previous article, but it is worth highlighting again that debt dynamics are complex, and non-linear. The evolution of public debt is a function of three things: i) the existing stock of debt (a result of past policy decisions); ii) the interplay between growth and debt service costs (influenced by markets and past policy decisions) and iii) the primary balance (directly influenced by policy decisions) all captured in the simplified equation shown in Figure 2.

This equation highlights the complexities and interconnectedness of the dynamics that drive debt accumulation. For instance, for countries with a low stock of debt (d_{t-1}), the primary balance plays a large role in debt dynamics, and government decisions to run surpluses can generally stabilise debt. For countries with a big existing stock of debt, the rate of growth relative to the cost of servicing debt has a bigger influence, potentially increasingly undermined by an unfavourable starting point. Managing this relationship doesn't guarantee stabilisation without an improvement in the primary balance, but it helps buy time.

THE DYNAMICS OF DEBT

This crisis is expected to profoundly impact government debt dynamics globally. In South Africa, the pandemic impact, which hit an economy already in recession, with rising debt service costs and weakening nominal growth, will add 18.3 percentage points of GDP to the stock of government debt this year. This puts us firmly in the latter camp, where growth and interest costs are most influential, but the primary balance also has to adjust to stabilise debt dynamics.

Before the crisis, South Africa had seen its debt stock grow from 26.5% in 2008/2009 to 63.5% last year. The IMF Debt Sustainability Analysis, published in January 2020, showed that most of this deterioration was because of the large deficits run from 2010/2011 to 2018/2019 – an average of 4.9% of GDP over the period. These persisted for a variety of reasons, including the growing public sector wage bill, ongoing support for SOEs and much weaker post-Global Financial Crisis growth. In parallel, government financing needs accelerated from 2% of GDP to 12% in 2018/2019, and an estimated 15.8% in 2020/2021.

>

Mitigating factors include a very favourable maturity structure of outstanding debt. South Africa's average term to maturity of its marketable debt is 12.8 years, which means it takes a long time for a change in market interest rates to materially impact the overall rate of interest government pays on its outstanding debt.

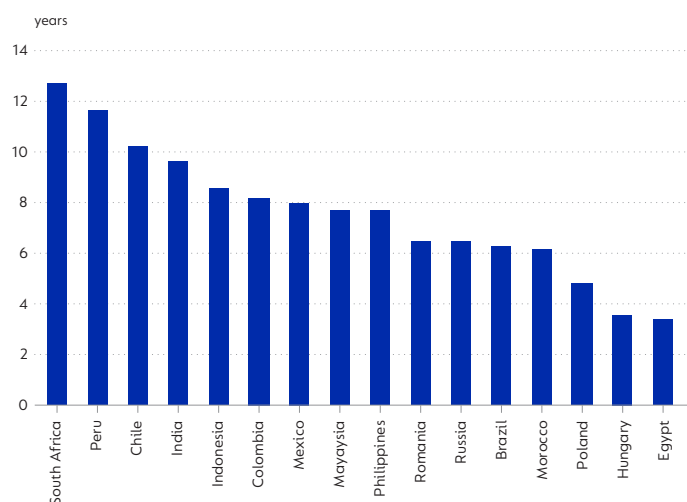
With these dynamics already at play in the accumulation of debt in South Africa, we are right to question the sustainability of government's position going forward. We believe government will be able to reduce some of its expenditure in line with the SAB commitment, but that the planned 8% of expenditure over two years will simply not be politically possible.

However, if much of the R101 billion reallocated in the current fiscal year is not back-tracked, government will be in a stronger starting position to limit spending in 2021/2022 and 2022/2023. Moreover, Finance Minister Mboweni has two powerful tools with which to impose some austerity – the reality that there simply is not additional revenue to spend (there is no money) and the real risk that ultimately South Africa may need additional financial assistance from an international organisation like the IMF, which will carry painful conditions.

We think a saving of R110 billion to R120 billion is possible through a combination of permanent reallocation of some departmental, ministerial spending and grant saving, the withdrawal of specific Covid-19-related support, and perhaps a more aggressive stance on public sector wages under a new agreement from next year. We expect taxes to rise in line with the SAB directives.

Figure 3

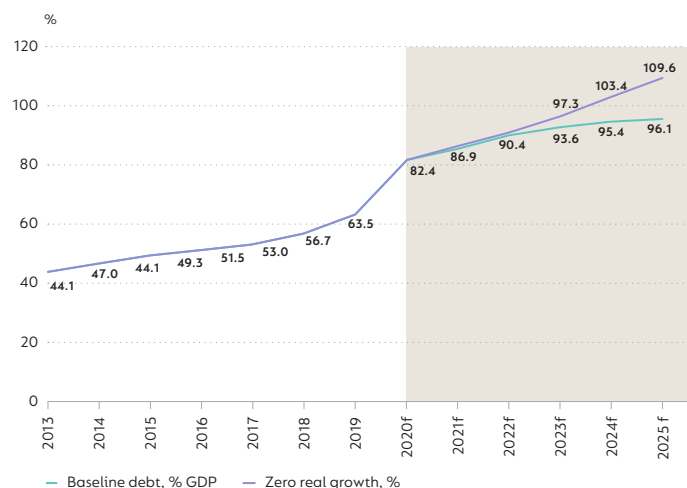
COMPARATIVE MATURITY PROFILE OF GOVERNMENT DEBT



Source: UBS

Figure 4

CORONATION'S BASELINE PLUS ZERO GROWTH



Sources: The National Treasury, Coronation

A LOW BAR

Under this baseline, we see the primary deficit narrowing from 10% of GDP in 2020/2021 to -3.2% in 2023/2024 and -1.1% in 2025/2026. While debt service costs are expected to rise only slowly given lower policy rates, changing funding strategies and the favourable debt structure, we think costs will rise. In addition, the persistently large deficits implied by the forecast will need to be funded.

This year's huge public sector borrowing requirement of almost 16% of GDP is being helped by international financing flows (the IMF and the World Bank) and a large increase in domestic issuance. Next year and the year after that will see smaller, but still-large financing needs without the support of these international flows. Local and foreign market participants will need to absorb this issuance and it is unclear to what degree they will be able to do so, and at what cost.

The alternatives are unattractive. The associated increase in debt would still see it approaching 100% of GDP over the next five years, albeit at a slowing pace. Whether or not this inexorable rise is sustainable comes down to whether the market thinks government's strategy is credible. This not only applies to its consolidation delivery, but its growth strategy too. Looking back at the IMF's definition of sustainable debt, it highlights that the policies needed to stabilise debt should not be inconsistent with past behaviour and therefore does not require a massive leap of faith from the market to believe its intentions.

Unfortunately, the government's inability to reign in deficits over the past decade, either by stimulating much-needed growth or by cutting spending



are discouraging, and the steepness of the South African yield curve is testament to this uncertainty. However, past performance is not always a perfect predictor of future outcomes. There are powerful incentives to deliver, and an even more desperate economic imperative to help stimulate growth. Failure to grow will see debt explode – and risk the loss of market access.

THE TIME IS NOW

Because debt sustainability in South Africa's case is closely linked to its growth recovery, it could be argued that allowing fiscal accommodation to remain in place for longer would help build growth momentum and give the fiscus a firmer footing in the longer term.

However, unlike emerging markets that have stronger starting positions and may have headroom and credibility to delay crisis-related consolidation in order to support growth, South Africa can no longer rely on unconditional support.

There are signposts to watch. A growth strategy, starting with the allocation of spectrum later this year and progress with energy sector transformation, which could both boost productivity, is essential. The Medium-Term Budget Policy Statement in October will give some indication of baseline spending allocations, (possibly excluding the wage agreement which may not have been concluded at the time). Any payments to SOEs outside of existing allocations will be indicative of government's commitment – and political mettle. The February Budget in 2021 should provide a transparent framework by which government is measurable and accountable to markets going forward.

It is true that the post-Covid-19 world, especially for emerging markets, is going to be a precarious place and that relative performance will count. Markets will assess government nonetheless, and experience suggests that sovereign crises happen slowly at first, and then very fast. We cannot afford to waste the opportunity to do better. +

STOCK ANALYSIS

Aspen Pharmacare Holdings

“The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price.” – Benjamin Graham, The Intelligent Investor

By **QUINTON IVAN**

THE QUICK TAKE

To reap the benefits of a long-term view, the cost is often short-term discomfort

Margin of safety is key when assessing the attractiveness of a share

A high price earnings multiple can signal a death knell for a share should earnings expectations disappoint

A focus on fundamentals is essential when investing in an unpredictable world



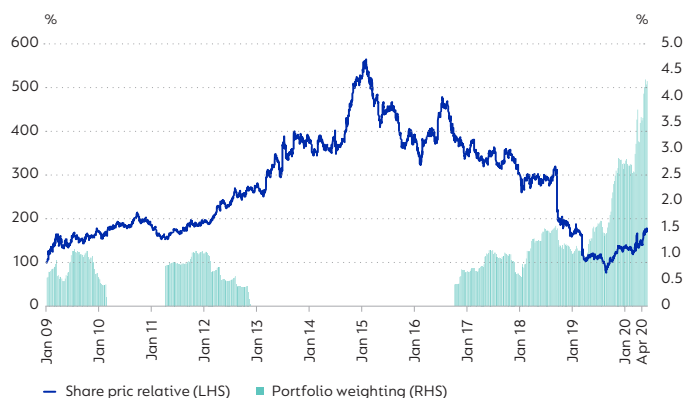
Quinton is Head of South African Equity Research and a portfolio manager.

THE DEFINING ASPECT of Coronation's investment philosophy is our long time horizon. We follow a common-sense, valuation-driven process through which we attempt to cut out the noise and buy undervalued stocks that offer a large margin of safety. Unfortunately, this usually coincides with periods when the share price is under pressure, either due to negative newsflow or the share falling out of favour with investors. Our time horizon,

which spans at least five years, often accepts short-term underperformance to deliver market-beating returns over meaningful periods. While this sounds simplistic, it is hard to implement in practice. Long-term investing requires patience and courage. One must be prepared to own shares that are out of favour and almost guaranteed to underperform in the short term. While this goes against one's natural instinct, the results are rewarding over time.

Figure 1

ASPEN'S RELATIVE PRICE PERFORMANCE AND PORTFOLIO WEIGHTING



Sources: Aspen Pharmacare Holdings Annual Reports; CFM analysis

A good example demonstrating our investment philosophy is the history of our holding in Aspen Pharmacare Holdings (Aspen). We owned Aspen early on in its golden run as the business was transformed from SA Druggists into the leading South African generics company and then into a global specialist pharmaceutical company. From a base of R5, the share outperformed for more than a decade and peaked at R440 a share. Coronation sold early, missing much of the upside in later years. This is illustrated in Figure 1, which depicts the weighting of Aspen in Coronation's Houseview Equity Strategy and its share price performance relative to the FTSE/JSE All Share Index over time.



Figure 1 above shows that post Coronation exiting its holding in Aspen in October 2012, the share continued to outperform significantly, returning more than double that of the market between 2013 and mid-2015. Aspen's share price peaked at R440, at which point it earned R12.19 per share to yield a price earnings multiple of 36 times. While the underlying fundamentals of the business remained unchanged, it continued to enjoy healthy returns and generate significant amounts of cash; this was more than discounted in its rating, with the share trading above our assessment of its fair value. In short, we believed the share price offered no margin of safety.

THE IMPACT OF GLOBALISATION

Aspen embarked in earnest on its globalisation strategy around 2009, when it concluded the first of three transformational deals with GlaxoSmithKline (GSK). Post-2009, it globalised at a rapid pace, concluding several large acquisitions with Pfizer, Merck, AstraZeneca and Nestlé. Today, the business is focused on three main therapeutic classes:

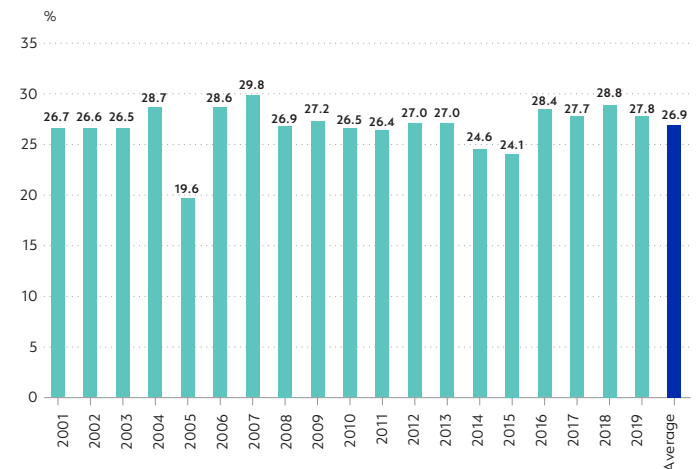
- Anticoagulants (blood thinners) – Aspen is the second-largest provider of injectable anticoagulants worldwide after Sanofi;
- Anaesthetics – Aspen has a 20% market share in anaesthetic products worldwide (ex-US); and
- High-potency and cytotoxic products, with a focus on oncology and female health.

These therapeutic classes have the following traits in common:

- They are niche and post-patent, which means that there is no pending earnings cliff. Once a patent expires, more affordable, generic products can compete and erode the profits enjoyed by the originator product. This also ensures predictability of future cash flows.
- Multinationals dispose of these products as they are regarded as non-core, which means that they are often neglected, resulting in product volumes declining over time. This presents Aspen with an opportunity to arrest the decline and eventually grow volumes. This can be achieved by placing more sales representatives behind these products and growing distribution in emerging markets where per-capita usage is lower.
- The products are complex to manufacture, which negates the competitive threat from Asian players that prefer products with long production runs (such as antibiotics) where they can drive down the cost of goods. Manufacturing is the cornerstone of Aspen's

Figure 2

NORMALISED GROUP EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION AND AMORTISATION



Sources: Aspen Pharmacare Holdings annual reports, CFM analysis

Figure 3

COMPOUND AVERAGE GROWTH RATE IN NORMALISED HEADLINE EARNINGS PER SHARE

Compound average growth	Since listing	10-year	5-year	3-year
Normalised headline earnings per share*	21.1%	14.1%	5.8%	3.8%

* Compound annual growth rate per annum

Sources: Aspen Pharmacare Holdings Annual Report, CFM analysis

business model and it leverages its scale to reduce the cost of goods through better procurement and improved production efficiency.

This is key to protecting gross margins – pharmaceutical companies are highly regulated and price increases are often controlled by government. Aspen's excellence in manufacturing has resulted in its operating margins remaining relatively stable over time, despite pricing pressure (regulatory and competitive), as shown in Figure 2.

The transformation into a global pharmaceutical company was overseen by two of South Africa's most entrepreneurial managers, Stephen Saad (CEO) and Gus Attridge (deputy CEO), who together own 16.5% of the company, aligning their interests with those of shareholders. Aspen's track record of earnings delivery is impressive.

Figure 3 shows that the company has grown earnings at just over 21% per annum since its listing. Also apparent is the significant slowdown in earnings growth over the last three and five years. The combination of a high price earnings multiple and weak earnings growth resulted in the share de-rating relative to the market over the last five years.

>

Towards the end of 2018, the share price collapsed, eventually reaching a trough of R65 due to concerns about:

- A stretched balance sheet and the short tenor of debt borrowed to fund a series of company-transforming acquisitions.
- Although most of the recent acquisitions were successful, one of the largest (the purchase of anticoagulant products from GSK) has been disappointing.
- Organic earnings delivery in developed markets, especially Europe, has disappointed.
- The impact of African swine fever on the anti-coagulants business which uses pig mucosa (in the production of heparin) as an input.

These issues have damaged the credibility of management and called into question Aspen's business model of using debt to acquire post-patent products from multinationals and growing them in emerging markets.

After not owning Aspen for many years, we started buying in late 2016 and added to this holding as the share price continued to come under pressure as investor sentiment swung from euphoria to pessimism.

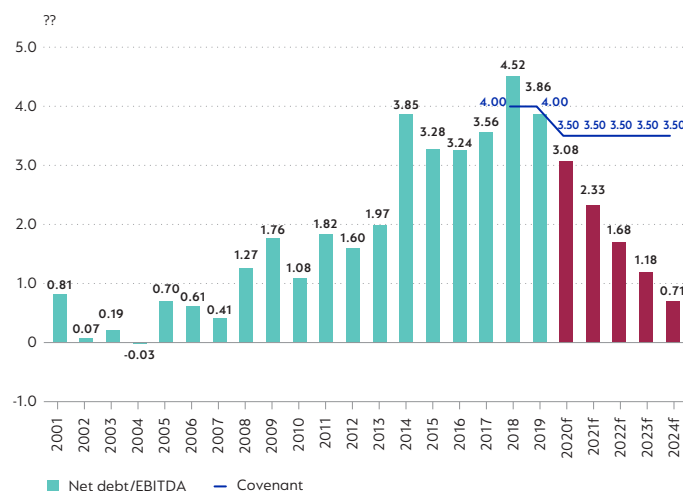
While the above concerns were real, and we believed they were adequately discounted by the market – at its low, Aspen's price earnings rating collapsed to just below five times, providing a significant margin of safety. The share now offered an attractive risk-adjusted return for the long-term investor.

While the share has recovered from its lows, we think the market has underappreciated the significant strides management has made in addressing investor concerns:

- Net debt levels have been significantly reduced following several large disposals. Aspen sold its infant milk nutritional business to French dairy group, Lactalis, for R11 billion. It also recently sold its Japanese operations to Sandoz for R5.2 billion. These disposals reduced Aspen's net borrowings from a peak of R53.5 billion to just over R33 billion as at 31 December 2019, thereby creating some covenant headroom. Furthermore, cash-flow generation in its most recent results was very strong as management focused on reducing the investment in working capital. Aspen's capital expenditure cycle reduces significantly from 2020, which

Figure 4

NET DEBT TO EARNINGS BEFORE INTEREST, TAXES, DEPRECIATION AND AMORTISATION



Sources: Aspen Pharmacare Holdings annual reports, CFM analysis

should allow debt to be paid down faster. The reduction in net debt levels removes the risk of Aspen needing to raise equity to bolster its balance sheet. This is depicted in Figure 4.

- Management has a stated target of reducing the net debt to earnings before interest, taxes, depreciation and amortisation ratio to close to two times. They believe that this will allow for sufficient financial flexibility to allow Aspen to capitalise on acquisitive opportunities. We believe this is achievable given the focus to unlock the investment in working capital and the reduction in future capital expenditure requirements.
- Aspen has built up a significant buffer in heparin stock and has nearly two years of supply. This is due to it being vertically integrated into the manufacture of its anti-coagulant products. The buffer stock protects it from short-term spikes in heparin prices caused by African swine fever and reduces the risk of stock-outs. This should allow it to either supply competitors, capitalise on high heparin prices, or gain market share in the event of competitors being unable to meet demand.
- There are plans to address the weak performance from its anticoagulants division by introducing a strategic partner into its developed European business. This will result in an initial cash injection (once a portion of this business is sold) and should result in better volume performance as the strategic partner assists in placing more sales representation behind these products.

ASPEN'S CAPITAL EXPENDITURE CYCLE REDUCES SIGNIFICANTLY FROM 2020, WHICH SHOULD ALLOW DEBT TO BE PAID DOWN FASTER.



Furthermore, emerging markets currently contribute 46% of the revenue generated by anticoagulants. Per capita anticoagulant usage is lower in emerging markets, which should support future volume growth as the contribution of emerging markets to sales increases.

- Demand for Aspen's sterile portfolio of anticoagulants and anaesthetics has increased due to the Covid-19 pandemic:
 - Blood clots are treated by administering anticoagulants, and there is increasing evidence that Covid-19 leads to blood clots in patients that may result in pulmonary embolism.
 - Anaesthetics, especially muscle relaxants, are administered to patients who require ventilation. This should support volume growth for the foreseeable future until such time that a vaccine is developed.

At the time of writing, the Aspen share price has recovered to R150, after reaching a trough of R65. It has outperformed the market by a factor of two from this low.

Despite some recovery, Aspen trades on an attractive one-year forward price earnings multiple of 9.3 times and just under nine times our assessment of normal earnings, and remains a 4.2% holding in our clients' portfolios.

Recent newsflow has also been supportive – an injectable steroid, dexamethasone, has proven to reduce Covid-19 deaths by a third in patients on ventilators and has also shown to reduce fatalities by a fifth among patients who were receiving oxygen support. Aspen is a major manufacturer of dexamethasone injections in South Africa as well as other markets such as the UK. We had no special insights into these extraordinary developments, and we simply owned Aspen as we believed that the risk-adjusted returns and resultant margin of safety were attractive.

In today's volatile financial markets where asset prices are determined by the news of the day, it's easy to miss the wood for the trees. Patience, courage and a long time horizon are required to make rational, long-term decisions. In a world where time horizons are collapsing, we remain committed to our proven philosophy of investing for the long term. +

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The portfolio positioning mentioned herein relates to Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a position's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned positions will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same positioning described herein.

SOUTH AFRICAN STOCK SELECTION

The Covid-19 crisis

A chance to add good quality domestic businesses to your portfolio

By SARAH-JANE ALEXANDER

THE QUICK TAKE

Covid-19 has reset prices and expectations across asset classes, creating investment opportunities.

The quality of the domestic stocks held in the house portfolio has meaningfully increased. We believe the market is underpricing the resilience of these businesses.

Markets rebounded off their lows rapidly, despite lingering uncertainty. We remain committed to investing where there is long-term value, regardless of current market sentiment.



Sarah-Jane is a portfolio manager with 14 years of investment experience.

WAS IT JOHN F Kennedy who said, "In a crisis, be aware of the danger, but recognize the opportunity"? For Coronation's portfolios, the Covid-19 crisis has meant an ongoing search for mispriced opportunities across asset classes. And we have found value.

At the start of 2020, many of the global asset classes were reasonably fully valued. The broad sell-off in March gave us an opportunity to rebuild offshore equity exposure across our multi-asset and house equity portfolios. The risk diversification and more resilient economic outlook of developed markets should benefit these portfolios in the years ahead.

The crisis also reset inflationary expectations very low, which enabled the multi-asset funds to buy well-priced local protection (in the form of South African inflation-linked bonds) against the medium-term risks of a rise in inflation.

The JSE did not escape the turmoil, with many domestic stocks now trading materially below their year-end levels. While the past few years have not been easy for South African companies, the

outlook has further deteriorated. Already-fragile South African consumers and businesses will not experience the financial support offered to those in more prosperous nations.

With this hard truth in mind, we have selectively added to companies whose strong business models should deliver earnings resilience in what will be an even more challenging environment than we expected as we headed into 2020. As a result, our equity portfolios currently have higher exposure to quality local stocks than previously. This is not an uncontentious statement, given the subjectivity of 'quality'.

RESETTING VALUE

Defining a quality stock requires a combination of numeric and qualitative assessment. High-quality businesses should grow over time by using their strong free cash flows to reinvest in their businesses and generate good returns on capital invested. A huge amount of judgement is involved in assessing a business's ability to grow and sustain these high levels of returns going forward.



Given that disclaimer, we think the overall quality of the equity portfolio has meaningfully increased.

Figure 1 reflects the percentage of the portfolio invested in quality stocks today. It would include the investments in high quality, international businesses listed in South Africa and which we believe continue to offer good value, such as Naspers, Quilter and Bidcorp. It also includes our increased exposure to several domestic businesses during this period of economic constraint.

Coronation may be seen to have a bias in quality. We concede that we are happy owners of a good quality business, but only where we are able to

acquire it at the right price. While quality has been a winning strategy in the past few years, many of these businesses were trading on lofty multiples at the start of the year. The Covid-19 crisis provided investors with an opportunity. It reset prices, enabling investors to increase portfolio quality at a reasonable price. This is especially true in South Africa where we believe the testing times ahead will cause a divergence in performance. Good quality businesses are best poised to navigate the choppy waters ahead.

Five years ago, we owned very few South African domestic stocks, as expectations and valuations were high. A dramatic reset in investor expectations and price means that today we can own more of these.

Figure 1

PORTFOLIO EXPOSURE TO HIGH-QUALITY STOCKS



Source: Coronation

Figure 2

HOLDINGS: JUNE 2020 VERSUS JUNE 2015

Stock	Owned as at 30 June 2015	Owned as at 30 June 2020
AVI	N	N
Capitec	N	N
Clicks	Y	N
Dischem	n/a	Y
Famous Brands	Y	Y
FirstRand	Y	Y
PSG Konsult	Y	Y
Pepkor	n/a	Y
Santam	N	Y
Sanlam	N	Y
Shoprite	Y	Y
Spar	Y	Y
Total	6/10	9/12

Source: Coronation

Figure 2 provides a comparison of quality stocks held in the house portfolio five years ago versus our holding at 30 June 2020, and shows that of the 12 best local businesses, we own 75% of these names versus 60% in 2015. Within the context of the house portfolio, our holdings of the names below have grown from 5.5% to 16%.

STOCK ANALYSIS

This is a brief overview of the characteristics that should support the resilience of our quality domestic holdings:

Shoprite

Shoprite's financial metrics over the past few years understate the true quality of the business. This is a business that has invested heavily in fixed assets (distribution centres, property and stores), expanded its working capital and consistently added new stores. All this was achieved while profitability collapsed in its African operations. Under a new CEO, we expect a reduction in capital intensity to improve free cash flow and returns. New accounting standards will partly disguise this (International Financial Reporting Standard 16 [IFRS16] is brutal for retailers with large leased-store portfolios), but, looking through this, Shoprite trades on 10.8 times our assessment of normal IFRS-adjusted earnings.

Spar

Spar has a long track record of delivering strong like-for-like growth as its franchised stores are run by entrepreneurs who are focused on delivering store-level growth. The business has a long history of generating returns on equity in excess of 30%, while delivering above-average free cash flow conversion. Spar's international expansion has been successful in Ireland where it owns a dominant convenience retailer, while the Swiss and Polish acquisitions are still a work in progress. The business trades on 10.8 times normal earnings. >

Famous Brands

The franchise business model is attractive for the high returns it generates on invested capital due to low capital intensity and good profitability. This profitability is converted to cash at a high rate, with Famous Brands boasting a long-run average free cash flow conversion ratio of 92%. This places it among the highest in our investable universe.

Famous Brands has a portfolio of recognised and trusted brands, which builds a strong moat against competitors. The quality of its offering has been further improved by backward integrating up the value chain through logistics, and manufacturing enables the company to offer franchisees world-class support and low prices, while capturing a full margin on sales to the end-consumer. Return on equity (ROE) is well above the cost of capital, averaging 31% over the past decade.

FirstRand

Within the banking sector, we have built a position in FirstRand, which has delivered high ROEs over the past decade. Its attractive customer proposition has achieved strong asset growth resulting in a dominant 'main bank' market share in the middle- to upper-income market.

FirstRand has leveraged its position of strength, diversifying its sources of non-interest revenue, reinvesting in its digital offering and driving down its cost to income ratio. These actions stand it in good stead to continue gaining market share even in a tough economy. FirstRand trades on 7.7 times our assessment of normal earnings.

Pepkor

Pepkor is a value retailer offering consumers everyday products at affordable prices. A culture of low costs and the reinvestment of excess margins ensure prices remain low. The large store base is conveniently located near transport nodes, with flexible store sizes allowing it to trade profitably in small towns where competitors typically struggle.

In a tougher economy, Pepkor's low prices should benefit from downtrading, while defensive everyday items (kidswear and babywear) represent approximately 60% of PEP and Ackerman's sales. Over the past decade, this business has delivered double-digit sales growth and currently trades on 9.7 times normal earnings.

Sanlam

Sanlam is an insurance business with an enviable track record. Management has allocated capital well over time and there is a long history of conservatively stating earnings. Earnings are underpinned by cash due to fully expensing new business costs. Operating variances are positive, reflecting the conservative assumptions underpinning profit recognition.

Santam

Santam is a short-term insurer that has consistently grown premiums above GDP. It has navigated the challenges of direct insurance on its intermediated business while successfully launching a direct insurer, MiWay. It has done this through constant reinvestment in its business while maintaining an ROE in the 20% range.

Dischem

We like the pharmacy sector where the listed pharmacy players have successfully grown their revenues by rolling out stores and taking market share for a decade. In a not uncompetitive sector, Dischem is an entrepreneurial business focused on offering consumers low prices. They continue to innovate and expand their consumer offering into primary care and via Baby City.

PSG Konsult

PSG Konsult is an advice-led financial services group focused on wealth management, short-term insurance and asset management. It has a track record of delivering good profitability with high free cash flow conversion (five-year average: 89%) and attractive returns (five-year average: ROE 23%). This, while continuing to grow in a tough economy. The wealth business boasts the largest independent advisor network in South Africa and should continue to benefit from further consolidation of the network.

LOOKING AHEAD

We believe our holdings represent quality businesses in South Africa that trade at prices that understate the relative resilience of their prospects. As a result, we expect them to deliver attractive returns in the years ahead. We remain vigilant of current market conditions and committed to our long-term valuations-based investment philosophy that helps us to look through the noise to identify the prevailing risks and opportunities. +

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.



BOND OUTLOOK

On the brink

"When the world is running down, you make the best of what's still around." – Musician and actor, Gordon Sumner (aka Sting)

By NISHAN MAHARAJ

THE QUICK TAKE

Bond yields are wildly volatile in the Covid-19 economy

South Africa is on the brink of a debt trap as the drop in tax revenue bites

Interim funding from international lenders will be a temporary plug

Firm policy action remains crucial to South Africa's recovery



Nishan is head of Fixed Interest and has 17 years of investment experience.

WE ARE ALREADY six months into 2020, a year that truly defies description, with a landscape that still presents as volatile and treacherous. At the beginning of the year, it was hard to find a pessimist in financial markets until the novel coronavirus turned into a fully-fledged pandemic. The subsequent global lockdown sent both the global and local economies into severe recession.

Global monetary and fiscal policy then unleashed a flood of money into the economy, the likes of which has never been seen before, spurring expectations for a quick recovery. Asset prices started to recover in the second quarter of the year (Q2-20) as economies across the globe started to open up from 'hard lockdowns'. However, concerns about a second wave of infections in developed markets and escalating infection rates in emerging markets threaten to derail the recovery.

THE SOUTH AFRICAN SITUATION

The local economic backdrop is concerning, but valuations were considerably cheaper by the end of the first quarter. South Africa's asset price recovery was buoyed by better risk sentiment in

global markets. The All Bond Index (ALBI) was up 9.9% in Q2-20, but its return remains flat year to date and a paltry 2.9% over the last 12 months. ALBI performance continues to be driven by the performance of bonds in the zero- to seven-year area of the curve, as cash rates have pulled down aggressively on the 275 basis points (bps) of repo rate cuts carried out by the South African Reserve Bank (SARB).

The 12-year-plus area of the curve has continued to underperform due to the deterioration in government finances and increased public sector borrowing requirements. Inflation-linked bond (ILB) performance has been dismal, with the Composite Inflation-Linked Index down 3% over the last 12 months, led again by ILBs in the seven-year plus area. Despite poor index performance, ILBs out to seven years have still generated a return more than cash (2.9%) year to date. Overall, bond yields have had a rollercoaster year and are currently only marginally higher than they were during the 'Nenegate' aftermath and considerably lower than during the March sell-off, but still embed a significant risk premium.

>

Emerging market debt crises have traditionally occurred in countries that predominantly have foreign-denominated debt; face an accelerated decline in their currency, resulting in an increased debt burden that they are unable to service; and an inflationary problem that re-enforces the downward spiral in their currency. South Africa is slightly different in that inflation will remain modest over the next two to three years.

However, due to an incapacitated State, the poor shape of State-owned enterprises, a lack of targeted structural reform and a dearth of political direction, government finances have deteriorated to such an extent that debt service costs are the fastest rising government expenditure item. In the fiscal year 2020/21, the fiscal deficit will register a whopping -15%, the debt-to-GDP ratio will exceed 80%, tax revenue will be down R300 billion and nominal growth will be down 3.5%. Many countries around the world, both developed and emerging, will face a similar reality as the fiscal taps open to soften the fallout from the Covid-19 pandemic.

Unfortunately, due to its poor starting position, the glacial pace of reform implementation and reliance on foreign portfolio flows, South Africa is teetering on the edge of a debt trap; with local public sector borrowing requirements pushing up to almost R800 billion this year, due to the drop-off in tax revenue. Over the longer term, more steps are needed to ensure that the underlying growth engine is restarted through targeted, efficient and transparent investment into the local economy by government and the private sector. In the interim, South Africa will have to rely on funding from international finance institutions (IFIs) such as the International Monetary Fund and the World Bank, and capital markets to keep the ship afloat.

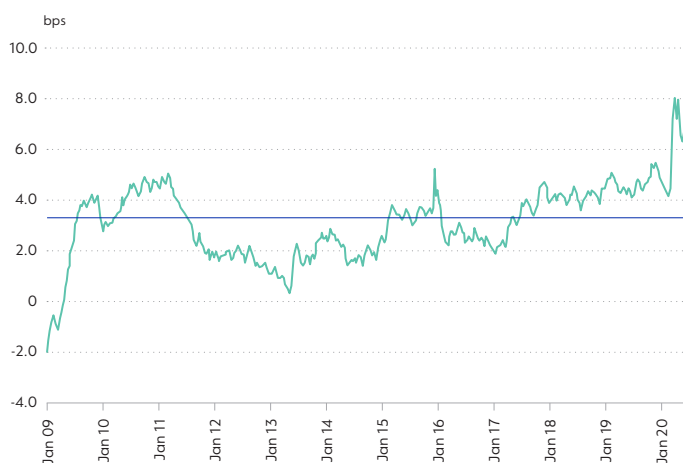
IFI funding is relatively cheap and has little conditionality but will still need to be repaid in foreign currency, while local capital market funding will have to be accompanied by a strong commitment to reel in wasteful expenditure, refocus current expenditure and implement key sector reforms (e.g. energy, labour and transport) in order to increase investor confidence and trust. South Africa has a long history of not delivering on key policies and reforms, which has resulted in the current debt nexus and erosion of investor confidence in the country.

Consumer price inflation will average 2.7% over the next year and 3.5% over the next two years. Following the cumulative 275bp rate cuts since the beginning of this year, the SARB has room to reduce rates by another 50bps over the next three to six months and is likely to keep them at

similar levels over the next 12 to 18 months to support the economic recovery. The 10-year South African Government Bond (SAGB) currently trades at 9.5%, which implies a real yield (return after inflation) of 6.6% and a breakeven to cash (the extent to which bond yield can widen before its return equals cash) of 93bps over the next year. In figures 1 and 2, one can clearly see that both the implied real yield and breakeven relative to cash remain at very extended levels relative to history and to their long-term average. This suggests that, from a local perspective, there is a significant risk premium in place due to the poor fiscal outlook.

Figure 1

10-YEAR SOUTH AFRICAN GOVERNMENT BOND IMPLIED REAL YIELD



Sources: Bloomberg, Coronation

Figure 2

10-YEAR SOUTH AFRICAN GOVERNMENT BOND BREAKEVEN RELATIVE TO CASH



Sources: Bloomberg, Coronation



THE GLOBAL OUTLOOK

Globally, bond yields and policy rates are testing their zero bounds. US 10-year yields, which are widely accepted as the proxy for global bond yields, are trading at historic lows. The Federal Reserve Board (the Fed) has injected massive amounts of stimulus through its open-ended quantitative easing programme, and policy rates and bond yields are not expected to move materially away from their current levels at any time soon.

Even if bond yields do push higher due to structural changes in employment and inflation, fair value is not materially more than 1.5% on the US 10-year bond. South African 10-year bonds trade at a spread of 9% above US 10-year bonds which,

once again, is considerably above historic levels and the long-term average. If US bonds were to gravitate towards the 1.5% level, unless this is accompanied by a massive inflation shock, the South African spread over US bonds does have a significant cushion to absorb this move, and would still trade at a historically wide spread (Figure 3). Add to this the fact that the 10-year SAGB trades at a significantly wider real yield than its emerging market peer group, and one can see that even from a global perspective, a significant risk premium remains in place (Figure 4).

A VOLATILE CURVE

The yield curve has been as volatile (if not more so) as outright bond yields. South Africa now has the steepest yield curve in the tradeable emerging market universe. The 10-year bond trades 1.7% above the 6.5-year bond, the 15-year bond trades 1.5% above the 10-year bond, and the 20-year bond trades 2% above the 10-year bond. Due to the higher yields on offer in the 10-year plus area of the curve, the inherent breakeven protection in these yields, both relative to cash and inflation, is attractive.

Our base-case assumption is that the repo rate settles at 3.25% over the next six months and stays there for at least the next 12 months. This implies a cash average of 3.35% over the next 12 months. If we assume inflation comes through more strongly and base rates rise more aggressively to average 4% over the next year, this implies a peak repo rate of close to 5% at the end of year one (250bps of hikes). We use similar assumptions over two and three years, and then run a total return analysis to understand how much the various bonds can sell off before their returns equal cash – illustrated in Figure 5 overleaf. As can be deduced from the table, the 15-year area of the curve offers the most protection. Combine this with the fact that the 15-year point is steeper than it has ever been relative to the 10-year area (1.5% above), the five-year area (4.4% above) and cash (7.3% above), and its appeal increases.

In addition, at the Special Adjustment Budget in June, Finance Minister Tito Mboweni reinforced the point that the National Treasury plans to shorten the duration of its issuance profile to seven to 10 years, suggesting less issuance and hence less supply pressure in the >10-year area of the curve. The intentions set out in the June Budget are ambitious, and the lack of the flattening of the yield curve bears testament to that. However, if the Treasury were able to get just half of its intentions through, the result would still be more positive than current market pricing and the yield curve should enjoy significant flattening. The current valuation

Figure 3

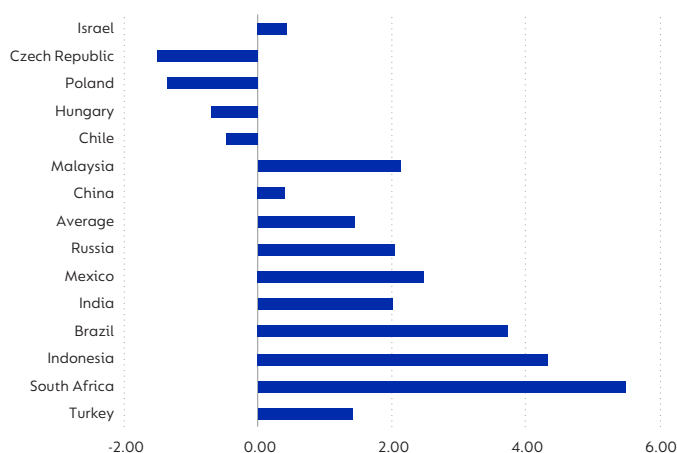
10 YEAR SPREAD: SOUTH AFRICAN GOVERNMENT BOND VERSUS US TREASURY NOTE



Sources: Bloomberg, Coronation

Figure 4

EMERGING MARKET REAL YIELD COMPARISON



Sources: Bloomberg, Coronation

of the 15-year point is quite attractive due to its inherent breakeven protection relative to cash and inflation, as well as the negativity priced into its elevated spread relative to shorter-dated bonds. We therefore view it as an attractive relative allocation on the local bond curve.

The fallout from the Covid-19 pandemic will linger for some time to come. In South Africa, the impact will be felt most in a much dimmer growth outlook, which will have a severe impact on government finances. The effects of the very hard lockdown and poor policy choices will weigh heavily on the economy going forward. As it was not well positioned going into the crisis, strong reforms are needed to return the country to a structurally better growth path, although lower interest rates will lend support to the economy through this difficult phase.

SAGBs do embed a decent risk premium, although this premium has reduced slightly post the recovery in Q2-20. As mentioned, South Africa is on the brink

Figure 5

AVERAGE BREAKEVEN RATES

Bond	Maturity	Yield	1-year breakeven (cash at 4%)	2-year breakeven (cash at 5.25%)	3-year breakeven (cash at 6.25%)
R186	21 Dec 26	7.71%	0.92%	1.50%	1.70%
R2030	31 Jan 30	9.41%	0.94%	1.65%	2.15%
R2032	31 Mar 32	10.33%	0.99%	1.77%	2.38%
R2035	28 Feb 35	10.99%	1.01%	1.83%	2.49%
R2040	31 Jan 40	11.44%	1.00%	1.81%	2.47%
R2044	31 Jan 44	11.56%	0.98%	1.78%	2.43%
Average breakeven			0.97%	1.72%	2.27%

Sources: Bloomberg, Coronation

of a debt trap and, although promises have been made to restore the country to a more sustainable debt trajectory, the implementation risks remain elevated. The valuation of SAGBs does provide some offset to this, implying that local bonds do warrant at least a neutral allocation in portfolios. +



DEVELOPED MARKETS

Where form meets function

Investment opportunities in the eyecare industry

By DANIE PRETORIUS

THE QUICK TAKE

Vertical integration and scale provide an enviable edge

A stable management team is key to unlocking value

Increased efficiencies cut costs and improve margins

Vision correction is a €113 billion market globally, and growing



Danie is an investment analyst with 12 years of investment industry experience.

THE GLOBAL MARKET for eyecare and vision correction is large and growing. According to the World Health Organization, at least 2.6 billion people worldwide suffer from myopia (near-sightedness) and a further 1.8 billion from presbyopia (age-related farsightedness). Due to a variety of environmental and demographic factors, the incidence of these conditions is expected to rise – the number of myopes is projected to grow by 28% over the next decade, and presbyopes by 17%. Asia in particular is seeing rapid deterioration in eyesight – for instance, some studies suggest that over 80% of high-school students in China are nearsighted.

Luckily, these refractive errors can be relatively easily corrected with eyeglasses or contact lenses. Similarly, regular wearing of sunglasses to protect the eyes from UV or blue light can help reduce the risk of developing cataracts or macular degeneration later in life. Against this backdrop, global eyewear sales is a €113 billion market, growing at mid-range single digits (Figure 1 overleaf).

Due to the nature of the product – part medical device, part fashion accessory – success in the eyewear industry relies not just on functionality, but equally on aesthetics, brands and distribution. While online challengers like Warby Parker are trying to disrupt the market, the need to have a physical eye exam, frames fitted and lenses aligned to the correct orientation on the wearer's face has seen e-commerce penetration grow much more slowly than in other consumer categories. As a result, industry profitability remains very healthy and is largely controlled by current incumbents.

ESSILORLUXOTTICA – FRENCH FLAIR AND ITALIAN STYLE

A typical consumer may visit a LensCrafters store where an optometrist performs an eye exam and fits a Prada frame with Varilux lenses, and pay for the experience by using insurance benefits provided by EyeMed Vision Care. On her way home, she may pop into a Sunglass Hut store and pick up a new pair of Oakley or Ray-Ban sunglasses. What she may not realise, is that every product and service was provided by one company – EssilorLuxottica. >

In a highly fragmented industry, French-Italian EssilorLuxottica is the undisputed 800-pound gorilla. The group was created through the 2018 merger of the global leader in sunglasses and frames, Luxottica, with the global leader in corrective lenses, Essilor. With operations spanning the full value chain (including the manufacturing of frames and lenses, wholesale and retail), EssilorLuxottica holds a more-than 50% market share in sunglasses, 31% in lenses and 23% in frames. Figure 2 shows that in each category it is at least three times larger than its closest competitor. Its unrivalled scale and vertically integrated model afford EssilorLuxottica a number of important and hard-to-replicate advantages over rivals, which we believe will help the group to grow ahead of the overall market.

Figure 1

EYEWEAR MARKET DEVELOPMENT BY CATEGORY (GLOBAL EYEWEAR SALES € BILLION)

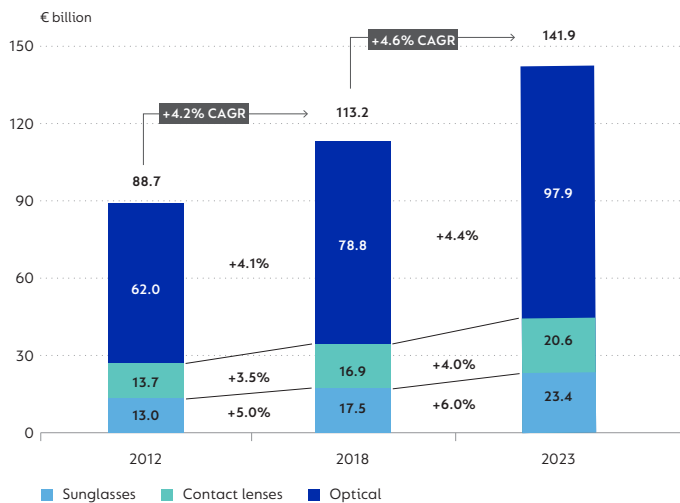
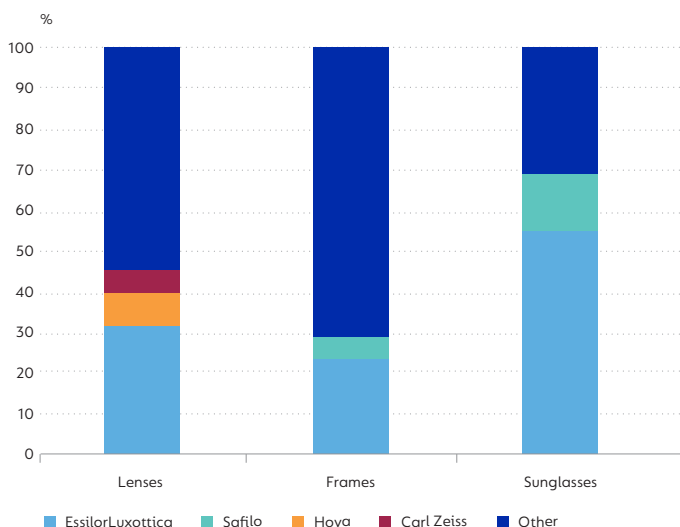


Figure 2

GLOBAL MARKET SHARE



The individual businesses are formidable in their own right. Luxottica has very successfully built the industry's most valuable brands that span frames and sunglasses, including owned brands such as Ray-Ban, Oakley and Vogue, as well as licensed brands such as Prada, Armani and Ralph Lauren. For example, when Luxottica acquired the Ray-Ban brand in 1999, it was seemingly in terminal decline. A pair of poorly constructed Aviators could be bought for \$19 from convenience stores and gas stations. Luxottica shifted production to Italy, rationalised distribution and repositioned the brand. Today, Aviators sell for \$150 – revenue from the brand has grown tenfold under Luxottica's stewardship.

In turn, Essilor has built a dominant position in lens manufacture and finishing, with manufacturing facilities around the world and control of over 70% of optical laboratories in the US.

Combined, as the only fully vertically integrated player, EssilorLuxottica is uniquely positioned to offer consumers distinctive value propositions. For instance, it is the only major player that can sell a complete pair of branded prescription glasses. In the current model, frames and lenses are typically sold separately (usually consumers choose a frame, which is then sent to an offsite laboratory to have the lenses finished and fitted). An integrated model allows for less inventory to be kept, reduces logistics costs and ensures faster turnaround times, benefiting the consumer.

In addition, by increasing the share of Essilor lenses sold through Luxottica channels and by leveraging Essilor's lens technology in developing prescription sunglasses, the group is in a position to not only capture a greater share of the revenue, but also to grow the pie through product innovation. And by rationalising overlapping functions, EssilorLuxottica can reduce its cost base and improve margins. These factors should allow EssilorLuxottica to grow ahead of the market over the next few years, despite its size.

While many large mergers are often fraught with risk and unforeseen challenges in integration, the marriage between Essilor and Luxottica has been tumultuous from the start. From the get-go, the entrepreneurial, marketing-oriented culture of Luxottica, led by its charismatic octogenarian founder Leonardo Del Vecchio, clashed with the more corporate culture of Essilor.

The relationship has at times been downright antagonistic, resulting in management departures and a formal transition agreement, by the end of which an external candidate is likely to be



appointed CEO. The full benefits of the merger are unlikely to be realised until the legacy businesses are fully integrated.

The uncertainty created by this management power struggle has weighed heavily on the stock price, which has underperformed the market by 15% since the merger. We believe this has created an opportunity to acquire the dominant franchise in an attractive industry at a very compelling valuation.

WHAT ABOUT CONTACT LENSES?

Another vision correction business we follow closely is Alcon. A recent spin-off from Swiss pharmaceutical giant Novartis, Alcon is a global leader in contact lenses, intraocular lenses and ophthalmic surgical equipment.

The contact lens market is effectively a four-player oligopoly, dominated by Johnson & Johnson, Alcon, Cooper and Bausch & Lomb. The market is growing faster than the overall vision-correction market, driven by higher penetration rates and more frequent replacement cycles (particularly as more consumers opt for daily replacement). The consumable nature of the product and low propensity for customers to switch between brands (usually they stick to the one recommended by their optometrist) means contact lenses generate stable, recurring revenues.

As is often the case with spin-off companies, the business was somewhat neglected as part of a

bigger pharmaceutical conglomerate. It had noticeably underinvested in new product development and manufacturing capacity, and as a result had lost market share. However, newly independent, the business has been re-energised. For instance, with its new PanOptix intraocular lens, a synthetic lens that is used in cataract surgery, Alcon has already captured 60% of the market for multi-focal lenses.

A more profitable product mix driven by new products and a more critical focus on costs as a stand-alone company should allow Alcon to meaningfully expand profit margins going forward and deliver double-digit earnings growth for a number of years.

COVID-19 HAS HURT, BUT IT'S TEMPORARY

Both EssilorLuxottica and Alcon will see disruption to their business from Covid-19. The closure of retail stores around the world in response to the epidemic has resulted in fewer visits to opticians and hence reduced sales. Similarly, capacity constraints in the global healthcare system (and patients' reluctance to undergo elective procedures) have meant fewer cataract and other ophthalmic surgeries. We see this as a temporary setback in a structurally attractive, long-term story with the underlying demand intact.

At some point in our life, most of us will need corrective glasses, contact lenses or surgery. Most of us will own at least one pair of sunglasses. EssilorLuxottica and Alcon will be there to meet those needs. +

This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.

ECONOMIC COMMENT

The debt mountain

"If you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has."

– Economist John Maynard Keynes

By MARIE ANTELME



THE QUICK TAKE

The level of global debt is staggering at c.\$11 trillion, up from \$8 trillion at end-April

QE measures have reached unparalleled levels, far exceeding those seen during the 2008/09 GFC

Developed markets are more resilient in terms of repayment and should stage rapid recoveries

Many emerging markets went into the Covid-19 crisis on the back foot and will struggle to bounce back



Marie is an economist with 19 years' experience in financial markets.

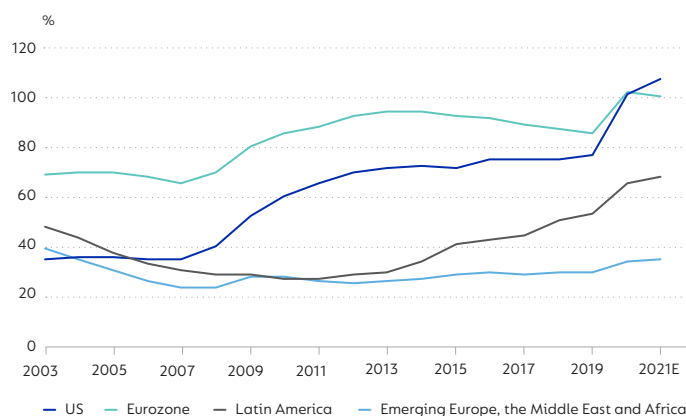
THE INTERNATIONAL MONETARY Fund (IMF) estimates that average public debt will rise by almost 20 percentage points of global GDP to above 100% in 2020. In advanced economies, this is pegged even higher at 131.2%, while in emerging markets the estimate is lower at 63.1% (Figure 1), but this is arguably more worrying given

fewer policy resources and possibly more lasting economic damage in the wake of the Covid-19 pandemic. This increase in debt raises a plethora of difficult questions about debt sustainability, mitigating policies, the challenges of funding and the risk of default.

The spreading pandemic prompted swift policy responses from governments and central banks. At the time of writing, fiscal efforts to mitigate the social and economic impacts of the pandemic have reached \$11 trillion globally, amounting to 3.8% of global GDP. This is up from \$8 trillion at the end of April 2020 (Figure 2 overleaf). About half of this (\$5.4 trillion) reflects additional expenditure and lost revenue that directly affect government budgets. The remainder is made up of various forms of liquidity support, including loans with guarantees – which may or may not fall to governments to fund in due course. These measures have certainly helped save lives, protect livelihoods and cushion businesses from the sudden loss of income, but they all have fiscal recourse. While some fiscal support programmes are intended to be self-destructing and should contribute to

Figure 1

GROSS GOVERNMENT DEBT, % GDP



Source: UBS



some consolidation in fiscal deficits, the risk is that a long, disrupted recovery will require extended fiscal support for vulnerable households, health-care and companies.

HOW WORRIED SHOULD WE BE?

This magnitude of global debt accumulation puts us in uncharted territory, and naturally raises concerns about its sustainability. There are a number of considerations here and there is no 'one size fits all', as challenges facing developed and emerging markets differ.

It's hard to know what to monitor. The ratio of government debt to GDP doesn't tell us a great deal about sustainability. It measures the stock of debt to the flow of GDP (output) and gives us a

measure and context for what ultimately must be repaid. But what matters, especially in the short to medium term, is a country's ability to service its ongoing debt obligations, and this is a function of interest and growth rates, and what then influences the stock of debt along the way.

Throughout history¹ there have been five things that have combined to reduce government debt ratios: i) economic growth; ii) substantive fiscal adjustment/austerity; iii) default or restructuring; iv) a surge in inflation; and v) a steady imposition of financial repression. The latter two are only applicable to local currency denominated debt, but historic episodes of debt liquidation have been owed to a combination of these factors.

The automatic debt dynamics (the equation² that explains how government debt is accumulated) shows that while the cost of debt is below the growth rate ($r-g$), governments can shrink their stock of debt, as long as the primary deficit isn't growing. This is because the numerator is growing more slowly than the denominator. If the differential becomes positive (interest costs rise above the rate of growth), government will add to the debt stock unless it cuts spending elsewhere (the primary balance moves into surplus), forcing the numerator to grow more slowly.

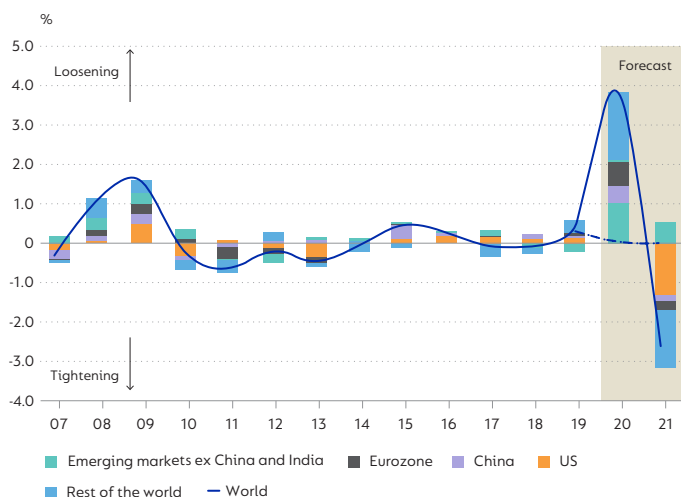
These dynamics tell us three things: i) that it is useful to look at debt service costs relative to growth rates or revenues (which is also methodologically cleaner because it measures a flow to a flow); ii) that while interest rates are below growth rates, governments can continue to service debt reasonably comfortably; and iii) that governments can reduce the stock of debt through time by reducing expenditure, with the help of lower debt service costs.

Indeed, this is what a few developed markets successfully achieved in the post-Global Financial Crisis (GFC) period. Germany saw debt stock fall from 81.1% of GDP in 2012 to 59.8% in 2019, the UK saw debt stabilise at about 80% of GDP and the US was able to slow the pace of accumulation because growth rates outstripped borrowing costs, despite persistent deficits (Figure 3). For this happy dynamic to continue after this crisis therefore requires interest rates to remain low

Figure 2

UBS FISCAL STIMULUS BY COUNTRY

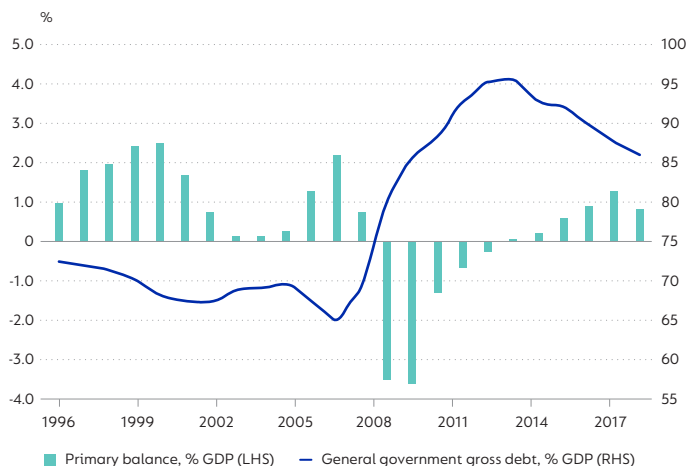
Change in cyclically adjusted primary fiscal balance as % of global GDP



Source: UBS

Figure 3

EURO AREA DEBT AND PRIMARY BALANCE, % GDP



Source: Haver

¹ Carmen M Reinhart and M. Belen Sbrancia "The Liquidation of Government Debt", IMF working paper WP/15/7.

²
$$\frac{(1+r)}{(1+g)} * d_{t-1} + \frac{(1+i^*) * (1+e)}{(1+g) * (1+\pi)} d_{t-1}^* - 1$$

where g is real GDP growth rate, r is the real weighted domestic interest rate, π is the GDP deflator, i^* is the weighted nominal interest rate on fx debt, e is the currency depreciation, d is local currency debt/GDP and d^* is fx debt/GDP.

long enough for GDP growth to recover which, in turn, will certainly require central banks to continue to play their part in repressing the cost of government borrowing.

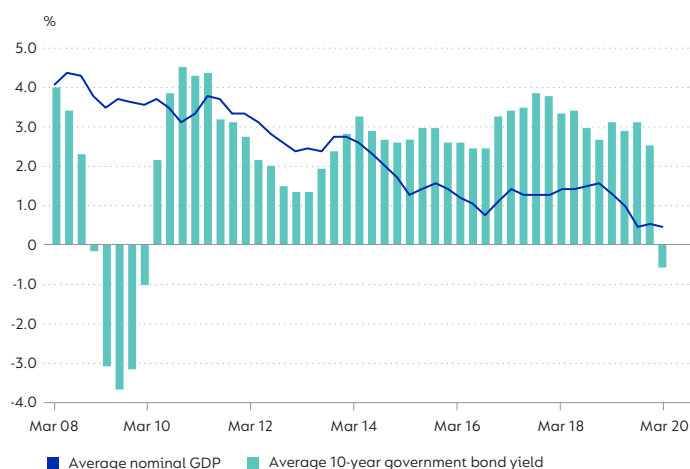
Central banks have again dusted off the toolkit and aggressively revived quantitative easing (QE) policies, especially in developed economies, and, more recently, new 'QE' ventures by emerging markets. The nature of these programmes differs but, essentially, in developed markets where policy rates are at or near zero, QE targets the expansion of the monetary base through the purchase of financial assets, mostly government bonds, but across asset classes in some economies. In the absence of inflation, the expansion of the monetary base lowers the cost of money (interest) (Figure 4). In emerging markets, the stated intent is different, and is more generally aimed at rectifying market dysfunction and providing bond market liquidity through the unsterilised purchase of government bonds. Here emerging market central banks are signaling a willingness to be buyers of last resort during periods of market stress.

Figure 5 shows that UBS estimates 15 out of 40 economies covered have announced some form of QE, with the large developed-economy central banks committing to purchase assets in amounts unimaginable just a few months ago. These programmes typically see the central bank buying fixed-income assets – mostly government bonds – in the secondary market from banks, and crediting the banks with reserve money held by the central bank. This encourages the banks to reduce unprofitable, low (or negative) interest-earning deposits at the central bank, and to either on-lend into the economy or buy more government paper. This theoretically creates a virtuous cycle of demand for government bonds, and hopefully facilitates economic growth.

There is also more to QE than just the provision of a bid for government paper. Most central bank assets are in fact owned by their governments (although this is not the case with the Federal Reserve Board or the South African Reserve Bank, but this doesn't materially change the arrangements), and central banks transfer interest payments on the debt they hold to the taxpayer (government) after expenses. This effectively means that the debt held by the central bank costs the government very little and, on balance, reduces the funding cost. Moreover, this debt is more likely to be rolled over than redeemed. Taking central bank holdings of government debt into account may be a better indication of what the ultimate cost to the taxpayer will be.

Figure 4

DEVELOPED MARKETS: AVERAGE 10-YEAR YIELDS VERSUS GDP GROWTH

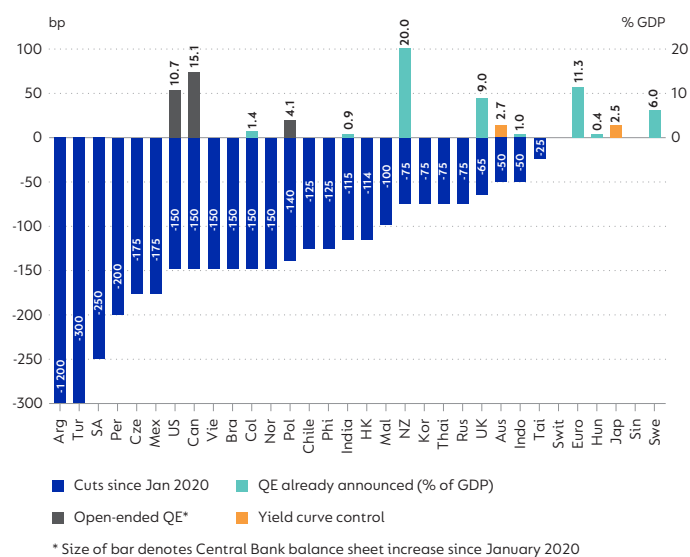


Source: Haver

Figure 5

CENTRAL BANK MONETARY STIMULUS

Monetary easing since January 2020



SO MUCH FOR THE THEORY, CAN IT WORK?

Year to date, the large developed-market central banks have, with credibility, successfully managed to help lower interest rates, and their balance sheets have expanded in line. The process has been supported by demand for less risky assets, as well as general expectations that inflation will remain low because of the combined impact of low oil prices, income loss, excess capacity and much wider output gaps. Such success is less evident in emerging markets where interest rates at the long end of the curve are generally not back at pre-crisis levels. These economies face several challenges in this regard, but perhaps the most important



factor is that, in many cases, the pandemic has hit those that were already weak and will struggle to recover (undermining efforts to reduce r-g). South Africa is a case in point, but India, Brazil, Mexico, Argentina and Turkey are all in this position to varying degrees. Also, the fiscal positions of these countries have deteriorated since the GFC and the inflation-targeting credibility of the central banks may be questionable.

Taken together, these factors may make markets uncertain about long-term efficacy of such an intervention as concerns about fiscal dominance increase. Governments will therefore either have to consolidate aggressively, with painful growth repercussions, or may risk defaulting on their debt. Market concerns about the risk of such outcomes are therefore more visible in emerging markets where, on average, long-term interest rates are well above short-term rates, and curves are steeper. Again, South Africa is a very visible example.

We have concentrated here mostly on domestic debt, but external debt stock adds to the challenge for many emerging economies and low-income poor countries (LIPCs). Here, external debt had risen ahead of the crisis, and now, for many countries, in the moment of the crisis (the IMF has granted emergency funding to 77 countries to date). While some external debt is extended on favourable terms, much carries market-related interest rates. Taken together with weaker currencies and large domestic debt obligation, external debt is another risk to developing economies servicing debt burdens and their ability to facilitate a growth recovery. With this in mind, the crisis has prompted a new discussion about emerging market debt.

From 1 May 2020, the G20 suspended repayment of official bilateral credit by the world's poorest countries. There are also growing calls for the cancellation of some external debt accumulated

by emerging markets and LIPCs, and a number of criteria have been put forward. While this discussion might end in some debt forgiveness, it's hard to see that it will be sufficient to materially change the debt dynamics for the larger emerging markets, and may carry long-term, adverse funding repercussions.

WHAT WORKS NOW MAY NOT BE A LONG-TERM SOLUTION

Finally, another risk to the global debt strategy hides in the wings. The successful monetisation of developed market government debt has been possible because inflation has remained very low. This may continue for a while, but may not last.

Given the sheer size of monetary expansion in developed markets, coupled with the combination of targeted income-related fiscal support that may remain in place until labour markets recover and central banks are actively targeting higher inflation, supply disruptions could see inflation accelerate. In emerging markets, weak growth and fragile fiscal positions, failed QE, weaker currencies, supply shortages and rising commodity prices could all contribute to higher prices.

For a while, central banks may also tolerate higher inflation, and continue funding the governments with some success. History tells us that in all periods of post-World War II, debt liquidation has been characterised by financial repression in some form, along with rising inflation¹. But this is unlikely to be the case for developed and emerging markets alike – history also suggests that such crises materially raise the risk of sovereign default. +

¹ Carmen M. Reinhart and M. Belen Sbrancia, "The Liquidation of Government Debt", IMF WP/15/7.

FRONTIER MARKETS

Hotel California

South African investor heaven or hell?

By PETER LEGER



THE QUICK TAKE

When it comes to investing in Africa, negative newsflow obscures the facts

Allocating to Africa is akin to selecting any other stock

Our Africa Frontiers Strategy has outperformed SA equities against meaningful time periods

Seldom have valuations been so attractive and many countries across Africa have superior prospects relative to South Africa



Peter is head of Global Frontiers with 21 years' investment experience.

FRONTIER MARKETS HAVE been on the bleeding edge of the listed-equity universe. A number of countries have swung from being failed states to show some promise, only to collapse back into an economic pile of questionable future. The share of news airtime has sadly been tilted in favour of high drama as opposed to the promise of high returns. Egypt's Arab Spring, Argentina's record International Monetary Fund default, Nigeria's multiple-currency default, and Zimbabwe's eternal death spiral, to name a few stories.

Having managed an African portfolio for 12 years now, it has started to feel like 'Waiting for Godot', with me telling the story of future returns to come, while these continue to remain elusive. As my colleague likes to serenade – you can check in, but you can never leave. The question is, though, is this true – has Africa been the Hotel California of investments?

FIRST SOME BACKGROUND

In 2004, then-President Thabo Mbeki granted South African pension funds the flexibility to invest 5% of their assets in Africa (ex-South Africa). Few took up his offer, and those that did, nibbled, staying well shy of the 5%. And judging from the introduction above,

if you ask anyone whether they should have held more Africa in their balanced funds, they will shout, "No!" But would they be right?

Index returns have been terrible. Since the inception of the Coronation Africa Frontiers Strategy, the FTSE/JSE All Africa (ex-South Africa) 30 Index has returned 4.2% p.a. in rand and a negative 2.1% p.a. in US dollars. However, Coronation's Strategy has returned 12% in rand and 5.2% in US dollars. Frontier markets lend themselves better to stock pickers, given the dearth of quality compounders.

'Smoke and mirrors', I hear you say when using a rand return. However, I would argue that a rand return comparison is appropriate, as an Africa allocation would have come from a portfolio manager's rand bucket, and not the precious outright US dollar allocation they have available. So, the right measure is to compare the Strategy's returns to a South African equity benchmark that balanced funds would measure against and which would be Regulation 28 compliant¹.

¹ Regulation 28 of the Pension Funds Act of South Africa.



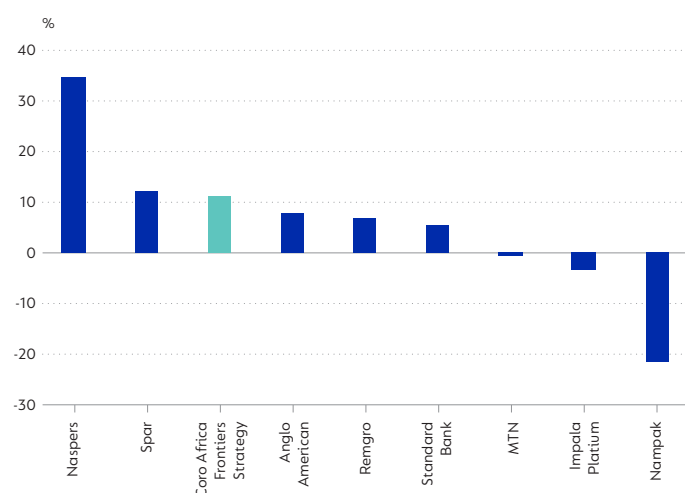
IT'S AN ALLOCATION DECISION

In fact, the decision to allocate to Africa is just like selecting a stock – not a massive off-piste investment idea. And, while any one country at any time might look challenging, when considered in a portfolio context, over time, returns are diversified and the bumps smoothed out. Yes, we have taken hits in different countries, but, these are appropriately valued at realisable values and, in my view, will add to returns over time rather than detract.

Investing often comes with a large dose of dissonance – where we think one thing is perfectly normal, yet something else is an uncomfortable departure for our senses. If, when casting an eye over the top holdings in a balanced fund, a position that is high conviction and somewhat differentiated will catch your attention, but will also be what you'd expect from a stock-picking manager – after all, that is how value is added over time. A 5% Africa allocation, however, causes more of a stir – and the question is: why should it be, relative to the comfort of our more known benchmark universe?

Figure 1

10-YEAR ANNUALISED RETURN (IN RAND) TO JUNE 2020



Source: Bloomberg

Figure 2

AFRICA FRONTIERS STRATEGY'S OUTPERFORMANCE

Returns in rand outperformed South African equities over all periods

	Year to date	1 year	3 years (p.a.)	5 years (p.a.)	10 years (p.a.)	*Since inception (p.a.)
Coronation Africa Frontiers portfolio (gross in ZAR)	(2.2%)	1.4%	3.3%	1.7%	11.0%	12.0%
SA equity benchmark**	(10.7%)	(10.8%)	(0.8%)	0.3%	9.6%	9.5%
Outperformance	8.5%	12.2%	4.1%	1.4%	1.4%	2.5%

* Since inception – October 2008 / Return as at 30 June 2020

** Performance measured against dominant benchmark in the composite index at the time (JSE Low Mining, FTSE Capped Swix from 1 May 2017)

THE PROOF OF THE PUDDING

Stripping out emotion, the past decade's returns (the timespan that is becoming a meaningful period for manager measurement) are as shown in Figure 2.

We have outperformed South African equities against every time period. Within these returns, we have marked down virtually all of Zimbabwe, conservatively valued the Nigeria naira and, wherever there is doubt, looked to value assets as realistically as we can. In short, these returns are very realisable. In the life of our Strategy, we have never had to gate² it due to liquidity constraints and have handled large inflows and outflows seamlessly.

WORTHY OF DEBATE

It does feel like investors in the asset class are at a point of capitulation. I urge investors to be aware that their fatigue is more because of the noise around the asset class as opposed to its delivered and expected returns. Seldom have I seen more attractive valuations and, relative to South Africa, many countries and companies across Africa have superior prospects. The asset class should really be afforded more debate when it comes to an allocation within a South African pension fund.

In conclusion, Hotel California hasn't been as inhospitable as one might feel, and relative to South Africa, it has delivered more. Don't let a bad story spoil the facts – it's not the dark desert highway people make it out to be. +

² A manager's right to limit or halt redemptions.

All strategy returns are quoted gross of fees. For a side-by-side comparison of gross and net performance, please refer to: www.coronation.com/us/strategy-performance. This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.

STRATEGY UPDATE

Coronation Global Emerging Markets Strategy

By GAVIN JOUBERT and SUHAIL SULEMAN



Gavin is Head of Global Emerging Markets and has 21 years of investment industry experience.



Suhail is a portfolio manager within the Global Emerging Markets team and has 18 years of investment industry experience.

THE CORONATION GLOBAL Emerging Markets Strategy returned +20.9% during the second quarter of 2020 (Q2-20), which was 2.8% ahead of the +18.1% return of the benchmark MSCI Emerging Markets Total Return Index¹. The one-year return of the Strategy is now marginally positive at +0.3%, which is 3.7% ahead of the benchmark's negative return of -3.4%. Over more meaningful longer-term periods, the Strategy has also outperformed – by 3.2% p.a. over three years, 2.2% p.a. over five years, 3.6% p.a. over 10 years and by 4.3% p.a. since inception almost 12 years ago.

For Q2-20, the largest positive contributor to performance was the second-largest premium Chinese baijiu company, Wuliangye Yibin (+1.0%), followed by the Latin American e-commerce and payments company, Mercado Libre (+1.0%), the no. 2 e-commerce retailer in China, JD.com (+0.9%), the no. 2 food retailer in Russia, Magnit (+0.8%) and the no. 1 search-engine operator in Russia, Yandex (+0.7%). In terms of detractors, there were

only two stocks that detracted by more than 0.5% – Philip Morris (-0.8%) and Tencent (-0.8%) – the latter as a result of us not owning Tencent (directly) in the Strategy. The Strategy does, however, have large positions in Naspers and Prosus (whose main asset is its 31% stake in Tencent and which trades at a substantial discount to the value of its stake), and the positive contributions from these two slightly more than offset Tencent's negative attribution. There was no specific reason for the c.9% decline in Philip Morris during the quarter and we continue to own the stock (3% position). We believe that on a c.7.5% 2021 free cash flow yield and with a 6.7% dividend yield, it is very attractive.

CORPORATE ENGAGEMENT AND OUTCOMES

We sold two stocks during the quarter: KB Financial (Korean bank) and Hero MotoCorp (Indian motorbike manufacturer). Both were small positions (1% and 0.5%, respectively) and the risks in both had increased, in our view, at the same time as other attractive opportunities where we have higher conviction were opening up. We also reduced the 58.com (the leading online classified business in China) position materially, from 5% of the Strategy to 1%. In early April, a private equity group made a bid for the company at a 20% premium to the then-share price. In our view, the offer price materially undervalued the business

¹ The volatility of the Benchmark may be materially different from that of the Strategy. In addition, the holdings in the accounts comprising the Strategy may differ significantly from the securities that comprise the Benchmark. The Benchmark has not been selected to represent an appropriate benchmark to compare the Strategy's performance, but rather is disclosed to allow for comparison of the Strategy's performance to that of a well-known and widely recognized Benchmark. Material facts in relation to the Benchmark are available here: www.msci.com/emergingmarkets.



and we also held the view that the CEO (who subsequently joined the private equity consortium) was conflicted, as he was both buyer and seller in the transaction and, as such, should not be able to vote on the transaction from a corporate governance perspective. We wrote two letters to the Board of 58.com, as well as a letter to Tencent's Board (which owns a 20% stake in 58.com) and engaged with other large shareholders who shared our view.

We also spent time in dialogue with the firm that was providing an independent valuation to the 58.com Board and explained our rationale (with extensive back-up) as to why we believed the offer significantly undervalued the company. Unfortunately, the Board of 58.com, on advice from the special committee and the valuation firm, deemed the offer fair and the CEO indicated he was going to vote his shares in favour (which legally he is entitled to do). Given his 44% voting stake, it became clear that the transaction was in all likelihood going to go through. As such, we started reducing the position and added to other existing holdings that we believed were attractive at the time, including Naspers, Alibaba, Netease, Tencent Music Entertainment and Taiwan Semiconductor.

HONG KONG EXCHANGES & CLEARING

The only new buy during the quarter was a small (0.5%) position in Hong Kong Exchanges & Clearing (HKEx), which is the monopoly stock exchange operator in Hong Kong. The HKEx is effectively a gateway to China, as 70% of the Hong Kong market is made up of Chinese businesses. Stock exchanges are generally very good businesses in our view, and the HKEx is right up there among the best, as its monopoly gives it pricing power and resultant high margins (earnings before interest and taxes [EBIT] margins are around 67%, which are among the highest margins for an exchange globally). As a result of this and its relatively low capital intensity, HKEx generates a high return on equity (north of 20%) and converts 100% of its earnings into free cash flow.

The revenue line of the HKEx has a number of positive long-term drivers, including, rising equity markets and Chinese stocks over time; increased southbound activity (mainland Chinese investing in the Hong Kong market); increased northbound activity (institutional investors accessing the Chinese mainland markets through Hong Kong, which is increasing as China A shares start being included in the MSCI and other emerging market indices); ongoing initial public offerings; the increasing rate of US-listed Chinese companies doing secondary listings in Hong Kong (JD.com

and Netease both announced secondary Hong Kong listings in the past few months); increased derivative activity (in recent months the HKEx was awarded the contract for 37 MSCI futures indices, which the Singapore Exchange had the rights to); and, lastly, increased 'velocity' (more trade in existing listed shares).

In addition to the above, the listing of China A share futures contracts looks likely to happen in the short to medium term, which will provide an additional lift to the top line. As a result of these factors, in our view, the HKEx should be able to grow its revenue by around 13% p.a. over the next few years. The cost base of an exchange is largely fixed, which results in positive operational gearing with a rising revenue line, and, thus, margins should expand, resulting in earnings growth of around 15% p.a.

Free cash flow growth will also be around 15% p.a. over the next few years due to the fact that 100% of earnings are converted into free cash flow. The HKEx trades on a c.3.5% 2021 free cash flow yield, which we think is attractive, given the quality of this asset and the free cash flow growth of c.15% p.a. over the next few years.

Covid-19 has naturally had an impact on all businesses globally. In some cases, this is likely to only be a short- to medium-term impact, but in other cases a long-term impact will be felt as well. For most businesses, the impact has been/will be negative, to varying degrees. One clear exception to this is e-commerce, where there has been a positive impact, largely as a result of increased use of e-commerce by consumers (for obvious reasons), resulting in an acceleration of e-commerce penetration. This acceleration results in higher earnings and free cash flow generation in the nearer term which, in turn, results in higher fair values for these businesses due to the time value of money (near-term free cash flow is worth more than free cash flow further out).

The Strategy has a number of investments in emerging market e-commerce assets, including 5% in Alibaba and 4.3% in JD.com (the no. 1 and no. 2 e-commerce businesses in China, respectively), and a smaller 1.3% position in Mercado Libre (the effective Amazon of Latin America) which, in our view, is a great asset and which we have owned for a number of years, but have been reducing more recently because of valuation.

Figures 1 and 2 overleaf are a good illustration of the current acceleration of e-commerce adoption, as well as the massive opportunity still ahead. Figure 1 shows the current online >

penetration rates in Mercado Libre's main markets (Argentina, Brazil, Chile, Colombia and Mexico, where Mercado Libre is either the no. 1 or no. 2 e-commerce operator). The average penetration rate in Latin America is around 6.5%, which is among the lowest in the world (developing countries are in many cases at 20% to 30% online penetration and increasing, and China, as another reference point, is currently at 23%). Figure 2 shows the year-on-year (y/y) growth in Mercado Libre's businesses by country for the two-month period of April and May 2020, with growth rates ranging from 40% to 125%. This represents a significant acceleration in orders compared to what was being seen pre-Covid-19. What is clearly happening is that existing users of e-commerce are using it more due to lockdowns but, as importantly, there are also many first-time users entering the system, which is resulting in an acceleration in overall penetration. History shows that this (online

penetration) doesn't reverse, and as such provides a significant and sustainable boost to the likes of Mercado Libre.

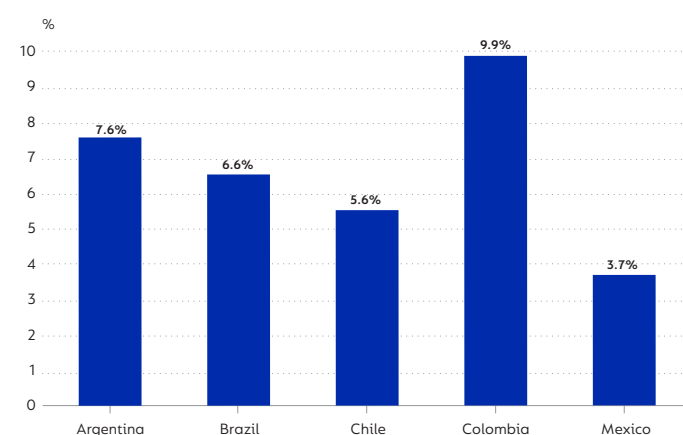
JD.com has been a top 10 holding in the Strategy for the past six years since it first listed. While there have been disappointments along the way, throughout this period we have continued to believe that this is a great asset with a very promising future. More recently, this view has started to come to fruition and JD.com's share price is up 70% this year. Since its listing in 2014, it has now given a return of 20.8% p.a. compared to the 2.2% p.a. return of the MSCI Emerging Markets Index. Even after the strong share price performance, and partly due to the dynamics described above, we believe JD.com is very attractively valued and it remains a large position in the Strategy. Figures 3 and 4 overleaf show JD.com's revenue growth over the past five years – 34% p.a. in US dollars. This business has clearly delivered, in contrast to the widely held market view that JD.com is unable to compete with Alibaba. It also shows the most recent reported quarter's growth (quarter to 31 March 2020, which coincided with the peak of Covid-19 in China). In this particular period, revenue grew by 21%. In addition to this, JD.com guided for revenue growth of 20% to 30% for Q2-20 (to end-June).

As important as the strong revenue growth is the progression of profitability (operating profit margin) over time, which is shown in Figure 4 overleaf. The top line shows the operating profit (EBIT) margin of JD.com's core retail e-commerce business, which was 0.2% in 2015 and has been slowly increasing over time to reach 2.5% by 2019. It then took a further step up to 3.2% in the first quarter of 2020. The second line shows the group EBIT margin (which comprises the core retail e-commerce assets as described above and the smaller, still loss-making, third-party logistics business). Here too there has been a continual improvement over time, with margins going from 0.1% in 2015 to 2.0% in Q2-2020. In our view, group margins are still well below being at a normal level and will increase over time to closer to 5% to 6% (compared to 2% currently).

JD.com now trades on c.30 times 2021 earnings. However, embedded in this is a 2.5% EBIT margin. If one were to put a normal 5% margin onto the 2021 revenue line, then the multiple halves to 15 times earnings. We don't believe that JD.com will get to a 5% margin next year (it will take a number of years still), and this exercise is merely to illustrate how attractive JD.com still is. In summary, current 2021 profits are still far below normal, as revenue will grow at 20%+ for a

Figure 1

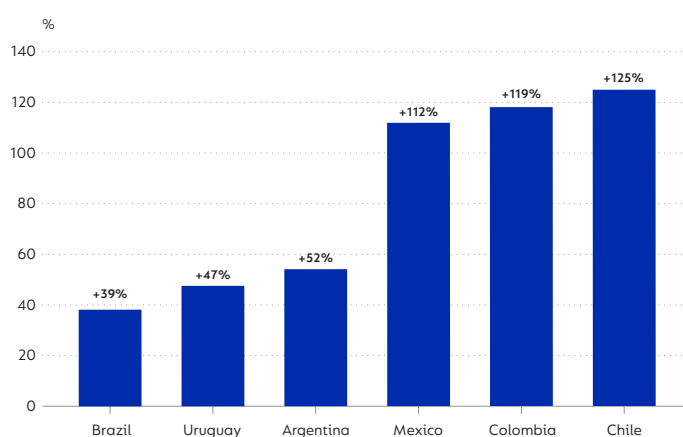
MERCADO LIBRE ANNUAL E-COMMERCE PENETRATION RATES, 2019



Source: Mercado Libre

Figure 2

MERCADO LIBRE ORDERS GROWTH RATE

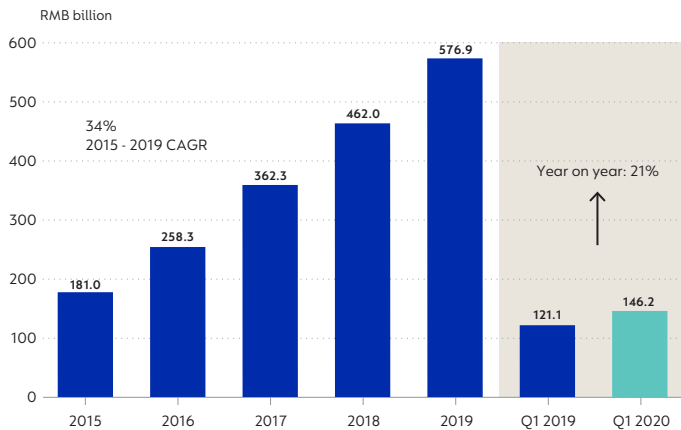


Source: Mercado Libre



Figure 3

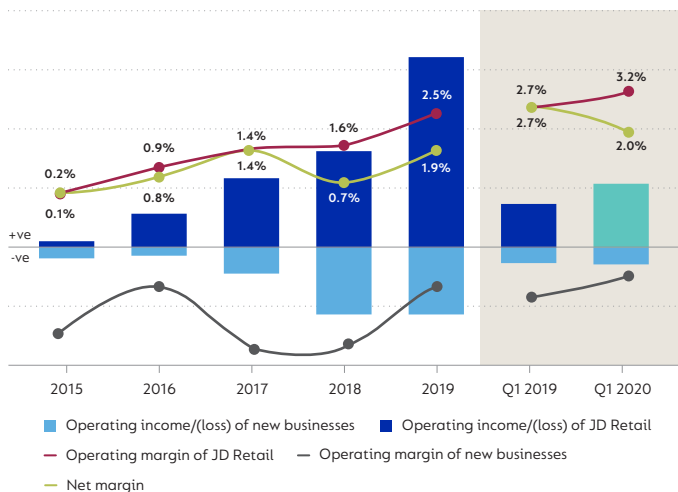
JD.COM NET REVENUES



Source: JD.com

Figure 4

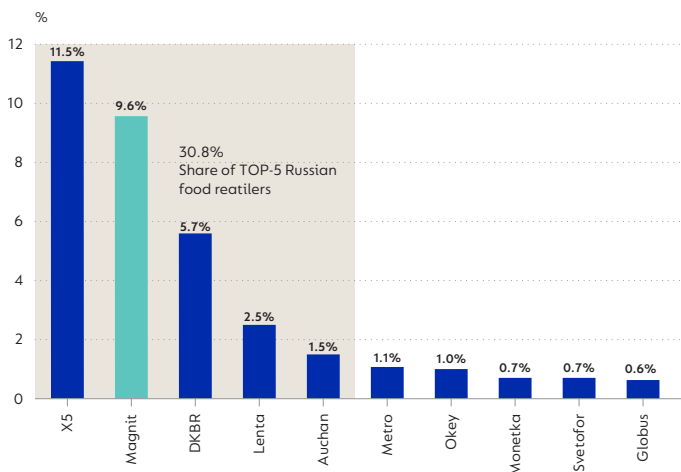
JD.COM: NON-GAAP OPERATING PROFIT AND MARGINS



Source: JD.com

Figure 5

FOOD RETAILER MARKET SHARES



Source: Magnit

number of years ahead and the margin will expand significantly over time, in our view. For this reason, looking at shorter term valuation metrics is not particularly meaningful. In conclusion, we believe that JD.com is a growth business, but at a value price, which is that rare combination that is very difficult to find.

Magnit is another long-held position (and a 3% position in the Strategy today), which has been a disappointing investment in more recent years, but where green shoots have started to come through. Magnit is the second-largest food retailer in Russia (no. 1 is X5 Retail, which is also a Strategy holding). Supermarkets have generally been beneficiaries of Covid-19 due to stockpiling ahead of lockdowns; this, however, is a one-off, short-term positive impact and should not be capitalised into perpetuity, in our view. In its most recent results (Q1-2020), Magnit finally showed a significant turnaround in like-for-like sales (which have been negative for the past few years). Like-for-like sales (in other words, sales growth in existing stores, excluding new store openings) grew by 7.8%. Even stripping out a c.2% positive impact from Covid-19 as described above (stockpiling), like-for-like sales were +5.8%, a very healthy number and an indication that store refurbishments and a better offering are starting to pay off. Total sales grew by 17.6% y/y, which was also a significant acceleration from the high single-digit sales growth shown in the past few years. Importantly, this accelerated sales growth did not come at the expense of margins; there was in fact a slight increase in margins resulting in 21% operating profit growth.

In addition to the improvement operationally shown by Magnit, the long-term opportunity in Russia for the scale operators (X5 Retail and Magnit) is still significant, in our view. As shown in Figure 5, the no. 1 operator, X5 Retail, still only has 11.5% market share (the no. 1 in developed markets typically has 20%+ market share), and the no. 2, Magnit, has 9.6% market share. The third-largest food retailer in Russia is a long way behind (with 5.7% market share) and the fifth largest has only 1.5% market share. The top five have a 30% combined market share. The share of the top five in developed markets is typically in the 50% to 70% range. In our view, the two biggest operators will continue to take market share over time, notably from the informal market and the smaller operators. With increased store roll-outs and the resultant scale come increased buying power and the ability to reinvest in price, which in turn make it harder for the smaller operators to compete. On our numbers, Magnit trades on a 5.5% free cash flow yield to December 2021 and a 6.5% dividend, which is very attractive, in our view.

E-COMMERCE POSITIONED FOR GROWTH

While the fall in markets globally in March was very quick and severe, so too has been the rebound over the past few months. The world, and emerging markets, are by no means out of the woods, even if global equity markets seem to be behaving as such. We expect difficult times ahead in a number of emerging markets, particularly those with poor country balance sheets and weak economies, such as South Africa and Brazil, and we have been very selective with stock selection in these countries. China is emerging as one of the better-off countries – partly because it was ‘first-in’ with Covid-19, partly because it locked down hard and early, and partly because the underlying economy was reasonably strong pre-Covid-19 and has attractive fundamentals. 36% of the Strategy is invested in China (41% if one includes Naspers, whose largest asset [c.80% of our Naspers valuation] is its stake in Tencent). A large part of the Chinese exposure is in internet businesses that have structural growth drivers and which have continued to grow, even through Covid-19 (Tencent [through Naspers and Prosus], Alibaba, JD.com, Netease and Tencent Music Entertainment), as well as in selected assets in other attractive industries where penetration rates are low, including premium branded spirits (Wuliangye Yibin), insurance (Ping An) and education (New Oriental Education).

India is the second-largest country exposure (9.7% of the Strategy), with 6% of this being invested in financials (Housing Development Finance Corporation [HDFC] and HDFC Bank). While India is suffering economically because of its hard lockdown, we believe that both HDFC and HDFC Bank, while also clearly being impacted, will take market share from weaker players and emerge even stronger at the other end. 2.5% of the Strategy is invested in two of the Indian IT services companies (Tata Consultancy and Infosys). Russia is the third-largest exposure by country (9.6%), with four investments: the no. 1 and no. 2 food retailers, X5 Retail and Magnit (a combined 5% position), Yandex (no. 1 in search, with various other assets, including taxi ride hailing, food delivery, e-commerce and online classified advertising; a 2.9% position) and Sberbank (1.6%). Developed market exposure is currently 15.5%, which is lower than its 12-year average exposure of 17%, due to us finding better risk-adjusted opportunities in emerging markets at the moment. The weighted-average upside to fair value in the Strategy is currently c.34%, which is below its long-term average, but as a counter, the overall quality of stocks comprising the Strategy is higher than it has been historically, in our view. The five-year internal rate of return for the Strategy (five-year forecasted earnings growth + dividend yield +/- rating change) is currently around 13%, which is attractive, in our view. +

Note: All strategy returns are quoted gross of fees. For a side-by-side comparison of gross and net performance, please refer to: www.coronation.com/us/strategy-performance. This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.



STRATEGY UPDATE

Coronation Active Global Equity Strategy

By NEIL PADOA



Neil is Head of Global Developed Markets and has 12 years of investment experience.

FOLLOWING A RAPID sell-off earlier this year, markets rebounded strongly in the second quarter (Q2-20). The stock market recovery has been very much V-shaped, with a gain of 19.2% this quarter following the first quarter's -21.4%, despite continued economic uncertainty and an unclear path to recovery. Nevertheless, this leaves global markets, as measured by the MSCI All Country World Index, still down 6.3% for the year. The Strategy returned 18.9% for the quarter, very slightly behind the benchmark.

BULLISH ON STREAMING AUDIO

Spotify, which more than doubled over the quarter, was the largest single contributor to returns. We have previously written that the global recorded music industry returned to growth in 2015 after almost two decades of decline. This growth was driven by streaming, which today accounts for the majority of industry revenue. In our view, music remains extremely under-monetised and we are still in the very early stages of streaming industry growth. There are now over 300 million paying music streamers globally. This is, however, a small portion of the 3.5 billion smartphones in the world today, while headline subscription prices have not changed in years and average revenues per user have in fact declined due to family and student discount plans. In the US, Spotify's headline price of \$9.99 per month is unchanged since its 2011 launch, while music spending per capita has

halved in real terms since 1999. As the largest audio platform outside of China, with 130 million paying subscribers and an additional 163 million ad-supported users, we believe the company is well placed for long-term growth. Spotify is significantly larger than its primary competitor (Apple Music, which has 60 million to 70 million subscribers, with no free, ad-supported tier) and continues to add more subscribers each year due a better product and ongoing innovation.

We are also bullish on Spotify's podcast strategy. Terrestrial radio remains a large advertising revenue pool globally and Spotify is trying to disrupt this, acting decisively and investing in leading podcast creation tools, studios and exclusive content from top podcasters such as Joe Rogan. We believe this strategy is a win-win for all involved, as it increases utility for users, allows podcasters to connect to the largest global audience and monetise their content, and brings significant benefits to Spotify itself, including higher user engagement and additional revenue streams.

Since 2015, Spotify has grown its revenue by 37% p.a. and we expect strong growth to continue, forecasting growth of over 20% p.a. and steadily expanding margins going forward. In the words of co-founder and CEO Daniel Ek, "Everything linear dies". As the leading player and innovator in the fast-growing audio streaming market, led by an >

exceptional management team, we believe Spotify is well positioned to capitalise on this trend.

TEMPORARY SETBACK

Philip Morris International (PMI) was the largest detractor from performance, although with a return of -2.6%, the effect was only marginally negative. PMI is a global tobacco company and the global leader in potentially reduced-risk, next-generation products through its IQOS heated tobacco franchise. IQOS is already contributing c.20% to company revenues.

PMI has invested significantly into the IQOS franchise over a sustained period and has built a significant first-mover advantage in the heated tobacco category. IQOS has been a phenomenal success in our view, ranging from truly extraordinary results in Japan to solid, steady progress across many European markets.

To date, c.11 million smokers have completely quit smoking combustible cigarettes and moved to IQOS. At the time of writing, the US Food and Drug Administration, probably the preeminent tobacco regulator globally and renowned for its science-led approach to regulation, had just authorised IQOS to be sold in the US with a reduced exposure claim – to the effect that completely switching to IQOS significantly reduces a smoker's exposure to harmful chemicals. Importantly, as IQOS grows, it is accretive to PMI's revenues and profits.

We believe there is still a long runway of growth for IQOS globally. Despite the resilience of tobacco as a consumer category, PMI has not been immune to Covid-19 lockdowns. PMI has been severely impacted by lost duty-free sales, the impact of lockdowns in emerging markets such as the Philippines and Indonesia, and temporarily slower IQOS user conversion. Q2-20 results will be significantly negatively impacted by these factors, but we expect that over the medium term, these lost sales should be recovered and that IQOS should fairly quickly resume its growth trajectory. PMI remains a top 10 holding.

LOOKING AHEAD

Last quarter, we felt that there were attractive opportunities for those investors with a long time horizon and the ability to filter companies whose prices had been dislocated with little impact to their sustainable earnings power. After a sharp rally, these opportunities are now harder to find. In addition, the need to reassess the prospects of many businesses continues as investors parse fundamental virus-induced behavioural changes from short-term noise. Fundamental changes, however, play to the strengths of fundamental investors, and we continue to find a select number of stocks with attractive long-term prospects that are reasonably priced.

Thank you for your continued support and interest in the Strategy. +

Note: All strategy returns are quoted gross of fees. For a side-by-side comparison of gross and net performance, please refer to: www.coronation.com/us/strategy-performance. This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.



STRATEGY UPDATE

Coronation Global Managed Strategy

By NEIL PADOA



Neil is Head of Global Developed Markets and has 12 years of investment experience.

FOLLOWING A RAPID sell-off earlier this year, markets rebounded strongly in the second quarter of 2020 (Q2-20). The stock market recovery has been very much V-shaped, with a gain of 19.2% this quarter following the first quarter's -21.4% decline, despite continued economic uncertainty and an unclear path to recovery. Nevertheless, this leaves global markets, as measured by the MSCI All Country World Index (ACWI), still down 6% for the year to date.

The Strategy returned 12.3% for Q2-20, in line with the benchmark return of 12.8%.

Contributions to performance were broad based, as most risk assets rallied:

- The Strategy's equity holdings returned 19.2% (in line with the ACWI).
- Property returns were also strong at 19.3%.
- Fixed interest rebounded, returning 4.5% (more than 1% ahead of the benchmark).
- Gold delivered a 10.6% return, bringing the gain over the last year to over 26%.

BULLISH ON STREAMING AUDIO

Spotify, which more than doubled over Q2-20, was the largest single contributor to returns. We have previously written that the global recorded music industry returned to growth in 2015 after almost

two decades of decline. This growth was driven by streaming, which today accounts for the majority of industry revenue. In our view, music remains extremely under-monetised and we are still in the very early stages of streaming industry growth. There are now over 300 million paying music streamers globally, but this is a small portion of the 3.5 billion smartphones in the world today, while headline subscription prices have not changed in years and average revenues per user have in fact declined due to family and student discount plans. In the US, Spotify's headline price of \$9.99 per month is unchanged since its 2011 launch, while music spending per capita has halved in real terms since 1999. As the largest audio platform outside of China, with 130 million paying subscribers and an additional 163 million ad-supported users, we believe the company is well placed for long-term growth. Spotify is significantly larger than its primary competitor (Apple Music, which has between 60 million and 70 million subscribers, with no free, ad-supported tier), and continues to add more subscribers each year due a better product and ongoing innovation.

We are also bullish on Spotify's podcast strategy. Terrestrial radio remains a large advertising revenue pool globally and Spotify is trying to disrupt this, acting decisively and investing in leading podcast creation tools, studios and >

exclusive content from top podcasters such as Joe Rogan. We believe this strategy is a win-win for all involved, as it increases utility for users, allows podcasters to connect to the largest global audience and monetise their content, and brings significant benefits to Spotify itself, including higher user engagement and additional revenue streams.

Since 2015, Spotify has grown its revenue by 37% p.a. and we expect strong growth to continue, forecasting growth of over 20% p.a., and steadily expanding margins going forward. In the words of co-founder and CEO Daniel Ek, "Everything linear dies". As the leading player and innovator in the fast-growing audio streaming market, led by an exceptional management team, we believe Spotify is well positioned to capitalise on this trend.

TEMPORARY SETBACK

Philip Morris International (PMI) was the largest detractor from performance, although with a return of -2.6%, the effect was only marginally negative. PMI is a global tobacco company and the global leader in potentially reduced-risk, next-generation products through its IQOS heated tobacco franchise. IQOS is already contributing about 20% to company revenues. PMI has invested significantly into the IQOS franchise over a sustained period and has built a significant first-mover advantage in the heated tobacco category. IQOS has been a phenomenal success in our view, ranging from truly extraordinary results in Japan to solid, steady progress across many European markets.

To date, some 11 million smokers have completely quit smoking combustible cigarettes and moved to IQOS. At the time of writing, the US Food and Drug Administration, probably the preeminent tobacco regulator globally and renowned for its science-led approach to regulation, has just authorised IQOS to be sold in the US with a reduced exposure claim – to the effect that completely switching to IQOS significantly reduces a smoker's exposure to harmful chemicals.

Importantly, as IQOS grows, it is accretive to PMI's revenues and profits. We believe there is still a long runway of growth for IQOS globally. Despite the resilience of tobacco as a consumer category, PMI

has not been immune to Covid-19 lockdowns. PMI has been severely impacted by lost duty-free sales, the impact of lockdowns in emerging markets such as the Philippines and Indonesia, and temporarily slower IQOS user conversion. Second-quarter results will be significantly negatively impacted by these factors, but we expect that, over the medium term, these lost sales should be recovered and that IQOS should fairly quickly resume its growth trajectory. PMI remains a top 10 holding.

PORTFOLIO POSITIONING

At quarter-end, the Strategy was positioned with 68% in growth, or risk assets, comprised of the following:

- 53% effective equity;
- 3% in property;
- 6% in convertible bonds;
- 3% in high-yield corporate bonds; and
- 2% in infrastructure.

The remaining 32% of the Strategy is invested in more stable, diversifying assets with limited correlation to equities:

- 7% in hedged equity;
- 5% in commodities; and
- 20% in fixed income, the bulk of which is invested in Treasury Bills (9%), inflation-protected securities (6%) and investment-grade corporate bonds (3%).

Last quarter, we felt there were attractive opportunities for those investors with a long time horizon and the ability to filter companies whose prices had been dislocated with little impact to their sustainable earnings power. After a sharp rally, these opportunities are now harder to find. In addition, the need to reassess the prospects of many businesses continues as investors parse fundamental virus-induced behavioural changes from short-term noise. Fundamental changes, however, play to the strengths of fundamental investors, and we continue to find a select number of stocks with attractive long-term prospects that are reasonably priced, while appropriately managing exposures across a range of asset classes.

Thank you for your continued support and interest in the Strategy. +

Note: All strategy returns are quoted gross of fees. For a side-by-side comparison of gross and net performance, please refer to: www.coronation.com/us/strategy-performance. This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.



STRATEGY UPDATE

Coronation Global Frontiers Strategy

By GREG LONGE



Greg is a frontier markets investment analyst with seven years of investment experience.

THE YEAR SO far has truly been unprecedented. After the Covid-19-induced bear market in March, markets shrugged off their fears in April. Aggressive fiscal and monetary support packages were announced by a number of countries around the globe. Despite widespread cuts to growth forecasts and rising job losses, equity markets had a good second quarter (Q2-20).

The Global Frontiers Strategy returned 5.3% during the period, while the MSCI Frontier Markets Index¹ was up 14.8%. Having sold off by less than the index in Q1-20, the Strategy's recovery in Q2-20 was more muted. Year to date, the Strategy is down 15.4% versus the index, which is down 15.8%. As a reminder, the Strategy performance numbers include the write-down of the in-country Zimbabwe (currently 34 basis points [bps] of the Strategy) and Nigerian assets (157bps of the Strategy), as currency challenges persist in both markets. The index continues to use the official exchange rates.

The Q2-20 performance of the major markets across the universe was largely positive, with Argentina (+45.2%), Vietnam (+26.8%) and

Slovenia (+18.8%) the top-three performing markets. The laggards were Bangladesh (-0.4%), which suspended trading for a period and implemented price floors, Oman (+2.0%), and Kenya (+3.0%).

THE LAND OF THE BLUE DRAGON

The Covid-19 pandemic has provided a harsh test for all nations and their governments' abilities to handle a crisis. Some have handled themselves with aplomb, carefully going about the necessary steps and adaptations needed to adjust to life this year. Others have seen their dysfunctional governance placed front and centre, with factionalism, cronyism, divisive politics and the simple inability to get things done, sadly dominating. Looking across the Global Frontiers investment universe, there are many examples of countries that fall in either of these two camps. However, the country that has by far scored the highest on this tragic Covid-19 'test' is Vietnam.

Despite being a country of 100 million people, sharing a border with China and extensive trade links with the rest of the world (including 250 flights per day with China and South Korea), Vietnam has only recorded 355 cases and zero deaths (Johns Hopkins data, 6 July 2020). This is a truly remarkable achievement and bears testament to the

¹ Material facts in relation to this index are available here: www.msci.com/msci-emerging-and-frontier-markets-indexes

technocratic ability of the Vietnamese government. Vietnam's success can be attributed to a number of factors, a few of which are listed below:

- **Rapid response:** schools were shut the day after the first case was confirmed in late January. The country then entered three weeks of strict social distancing.
- **Extensive testing:** testing focused on hot-spot areas and saw everyone tested, not just those showing symptoms.
- **A widespread information campaign:** the first 30 seconds of every phone call was a message from Vietnam's Ministry of Health, and a website was set up that shared the details of everyone who was infected and their contacts.
- **A responsible population:** the Vietnamese have a high sense of trust in their government, resulting in good adherence to the social distancing and mask-wearing requirements. Experience with the SARS virus in the early 2000s meant that the general population understood the seriousness of Covid-19 very early on and acted accordingly.

Today, Vietnam is largely back to business as usual. After a slowdown in economic growth to 1.8% in the first half of 2020, the economy is bouncing back quickly. The country's reliance on tourism and exports sees it remain exposed to the challenges being experienced in other parts of the world, but for the domestic economy, life is largely back to normal.

We increased our Vietnam weighting from a low of 6.5% at the end of March to 19.2% at quarter-end. Vietnam has always been a country that we would have liked to own more of in the Strategy, with arguably the best macroeconomic outlook in our investment universe and some exceptional listed businesses. Foreign ownership limits, valuation and corporate governance concerns have meant that we have never owned as much of Vietnam as we would have liked. This has changed, with Vietnam now our single largest country exposure. The increase was primarily driven by improving valuations. The March correction in the stock market presented us with some very attractive buying opportunities, as we believed that the

economic impact on the individual companies that we analysed was likely to be less than the correction in share prices.

PORTFOLIO ACTIVITY

During the quarter, we sold the bulk of our gold position (589bps) as equities looked more attractive following the March sell-down. We trimmed some of our exposure in Eastern Tobacco (161bps) as we participated in the share buyback announced by the company. Eastern remains a core holding and is the third-largest position in the Strategy. We also exited our Hemas Holdings position (145bps) on concerns around the operating environment and on news that the dynamic CEO was retiring.

The largest contributors over the quarter were Vietnam Enterprise Investment Fund (+199bps), Zimplats (+107bps) and VNV Global (+102bps), while the largest detractors were QNB Al Ahli (-72bps), Al Eqbal Tobacco (-68bps) and British American Tobacco Kenya (-55bps).

THE TEACHING VALUE

The handling of the Covid-19 pandemic thus far has provided valuable new information about how well individual country governments function. During the quarter, we incorporated this information into our extensive valuation framework. This has seen the country market multiples adjusted slightly for some markets. In the case of Vietnam, its market multiple increased. This results in a lower discount rate in our modelling, and a willingness to pay a higher price earnings multiple than before. It is important to note that the handling of the Covid-19 pandemic is just one of a number of quantitative and qualitative factors we look at when assessing individual country multiples. As the John Maynard Keynes quote goes, "When the facts change, I change my mind – what do you do, sir?"

The individual businesses in the portfolio continue to trade on incredibly attractive valuations. They are largely resilient to the impact of Covid-19 and while earnings will be impacted in 2020, the long-term outlook is incredibly promising. The pandemic has given us the opportunity to significantly increase our exposure to a number of high-quality businesses in Vietnam that we are incredibly excited about. Thank you for your continued support, particularly during these volatile times. +

All strategy returns are quoted gross of fees. For a side-by-side comparison of gross and net performance, please refer to: www.coronation.com/us/strategy-performance. This article is for informational purposes and should not be taken as a recommendation to purchase any individual securities. The companies mentioned herein are currently held in Coronation managed strategies, however, Coronation closely monitors its positions and may make changes to investment strategies at any time. If a company's underlying fundamentals or valuation measures change, Coronation will re-evaluate its position and may sell part or all of its position. There is no guarantee that, should market conditions repeat, the abovementioned companies will perform in the same way in the future. There is no guarantee that the opinions expressed herein will be valid beyond the date of this presentation. There can be no assurance that a strategy will continue to hold the same position in companies described herein.

CORONATION

TRUST IS EARNED™

Coronation Fund Managers

Telephone: +44 (0)20 7389 8840

E-mail: cib@coronation.com

www.coronation.com