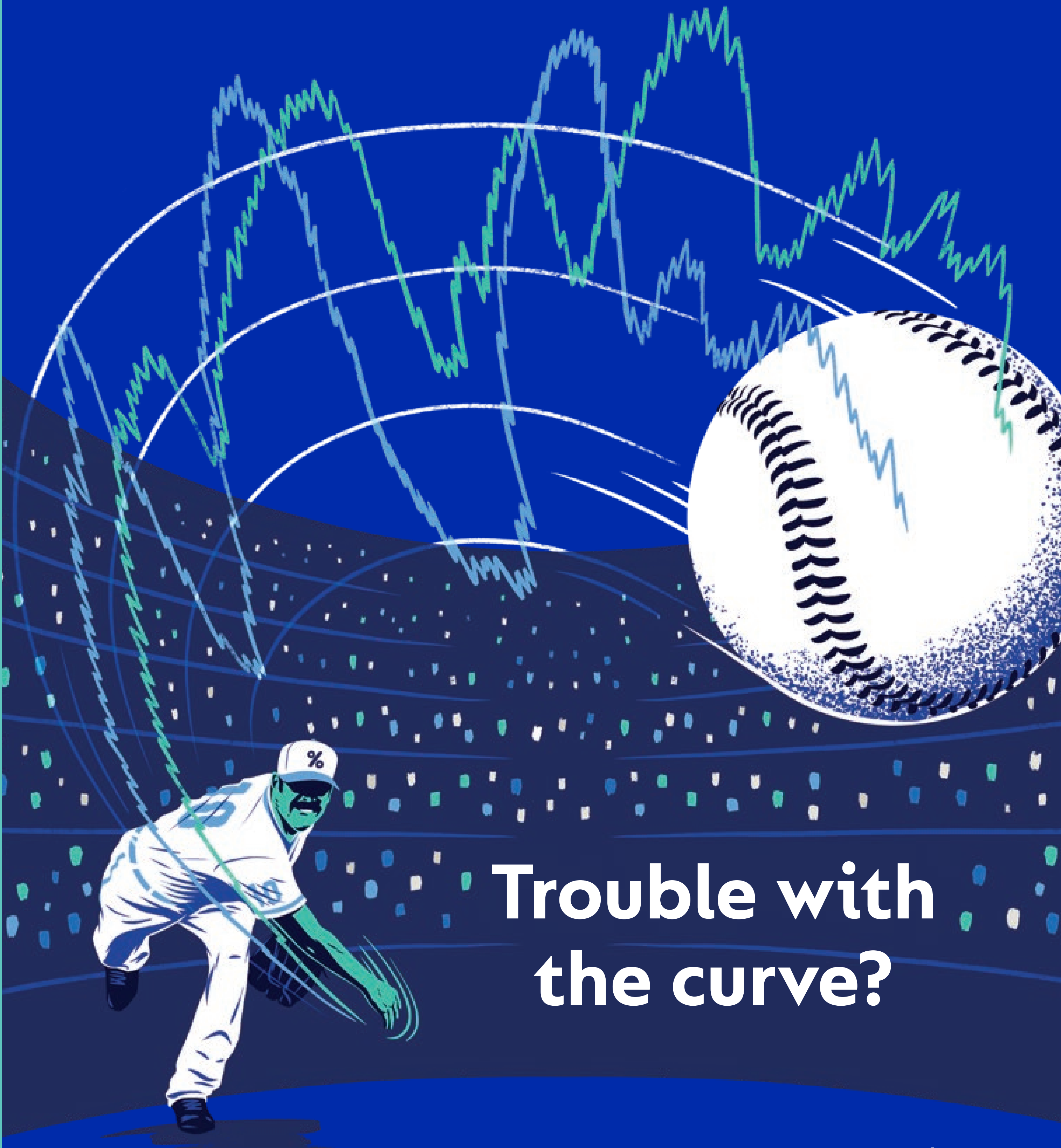
corospondent

The Global Quarterly



Trouble with the curve?

CORONATION

TRUST IS EARNED™

OCTOBER 2019

On the cover: The US 10-year Treasury bond's yield curve inversion has attracted much attention in recent months. Baseball is the quintessential US sport, and the curve ball speaks to the uncertain outcome of the brief inversion.

Kirshni on point

We're up for the challenge

By **KIRSHNI TOTARAM**

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

WELCOME to our latest *Corospondent*!

Not surprisingly, I again started this note with penning thoughts about the uncertain times we currently find ourselves in. And it dawned on me that it's been this way for some time now. As an individual and as a company, when you have navigated through years of challenging environments in the local and global markets, as well as in our industry, I think it's important to pause and reflect from time to time.

I find it valuable to look at who we are and what we continue to stand for. At Coronation, we have stayed true to our culture since starting out in 1993 – an anchor which has served us well over the past quarter of a century. Always remaining singularly focused on our purpose of building long-term wealth for our clients gives us great clarity in what we need to achieve. And, while we acknowledge that uncertain times means that we still have a lot to do, we take pride in what we have achieved over the long term. We have never wavered from our path as custodians of the savings of millions of South Africans. But more than that, we have used our resources and influence to be a leader and change agent in the South African retirement industry. To this end, assisting in the transformation of our country has been deeply important to us. This is why we have played a significant role in transforming the financial services sector to be more inclusive, in uplifting communities through our CSI initiatives and ensuring our own business reflects the demographics of our country.

During Women's Month in August, we highlighted the value and achievements of women in South Africa by hosting a number of inspiring events. I hosted our annual Women's Day events for clients and Grade 11 schoolgirls in Johannesburg and Cape Town. Renowned US space engineer Danielle Wood gave an inspirational talk on her life and how she uses space technology to create solutions for communities in need here on earth and to address the UN's Sustainable Development Goals.

This was particularly meaningful given the increased focus globally on issues of climate change and sustainability. In South Africa, dialogue about these and other environmental, social and governance (ESG) issues has certainly increased. The Financial Sector Conduct Authority released its guidance note in June, requiring pension funds to factor ESG concerns into their investment strategy and monitoring. For us, this means increased time spent understanding, articulating a belief system, and reporting on these matters – something that will become a standard part of the offering of managers around the world.

We also welcomed South African athlete and Olympic gold medallist Caster Semenya to our Cape Town office as part of our mentorship programme for employees. The story of her rise to the top of her discipline speaks to the resilience required to prosper over time. Her boldness in the face of adversity reveals deep self-acceptance and confidence. It was hugely inspirational to hear that to navigate successfully through tough times takes immense grit. She taught us that it is okay to be bold and acknowledge the awesome things you do. As she said, "I believe in everything I do". And so do we.

However, the month concluded on a sombre and dark note with cases of brutal gender-based violence holding the headlines and our hearts, with a subsequent rise in mass civilian protests. We lend our voice in support of the calls to bring about change that improves the treatment of and respect shown to women everywhere.

>

WHAT WE NEED IS LESS TALK, MORE ACTION

South Africa is in desperate need of some tangible action. For the past 18 months, we have not been short of commissions and white papers identifying the real challenges we face as a country and an economy. But to move us forward, we need to start acting. For this reason, the market welcomed Finance Minister Tito Mboweni's surprise release of the National Treasury's plans to boost growth and create a million jobs.

Adding his weight, President Cyril Ramaphosa later announced the appointment of a new economic advisory panel to help turn the ailing economy around. In addition, in a move to increase both his leadership and communication to the country, the President recently implemented a weekly newsletter titled "From the desk of Ramaphosa". While these are all good and crucial steps, some tough decisions are overdue and much needed.

A GLOBAL GEOPOLITICAL SPECTACLE

Globally, the world seems a mess. Ongoing geopolitical theatrics would certainly provide enough material for the next decade of soap operas. The Brexit deadline of 31 October is looming, while across the Atlantic, Trump's tweets have turned into marathons as he voices his disdain for his impeachment enquiry. The simmering rivalry between the US and China continues to play out with the trade wars, and increased military unrest in Syria has raised concern from humanitarian groups. Looking further east, Hong Kong is facing its first recession since the Global Financial Crisis as the negative impact of anti-extradition law protests that have escalated to violent confrontations begins to weigh.

And of course, before we get into this issue of *Corospondent*, here's a strong shout-out to our boys in green and gold. At the time of writing, they are preparing to take on Wales in the semi-finals of the Rugby World Cup. Go Bokke!

IN THIS ISSUE

Economist Marie Antelme outlines her laundry list of concerns on page 12 . With the US 10-year Treasury bond yield briefly inverting this quarter, portfolio manager Seamus Vasey provides the logic behind the widely reported and eyebrow-raising event on page 6.

Back home, portfolio manager Tumi Motlanthe outlines the investment case for Shoprite on page 26. Globally, investment analyst Chris Cheetham provides insight into the value we see in leading US cable operators on page 16. Portfolio manager Suhail Suleman weighs in on China's influence on the emerging market basket on page 33, while investment analyst Greg Longe points out why it's best to be circumspect about frontier market IPOs on page 20.

TRUST IS EARNED

At Coronation, we continue to seek opportunities amid the challenges, and convert them into value adds for our clients. I believe we are made more resilient by the demanding environment in which we manage the money entrusted to us. We remain steadfast in our purpose, with our clients' best interests at the core of what drives us.

As we head into the last quarter of this decade, I wish you all the best and share my gratitude for your ongoing support.

Thank you

Kirshni

IN THIS ISSUE

TRUST IS EARNED

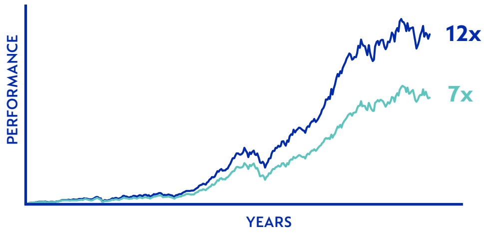
When Coronation opened its doors back in 1993 and committed wholeheartedly to the future of South Africa, the country was moving through uncertain times. As we head into the next decade, that sense of uncertainty is again palpable, both at home and globally. But navigating through challenging times takes courage, confidence and a strong sense of clarity of purpose.

We are a homegrown South African business and have become one of the leading investment managers in our country. We are privileged to manage the savings of millions of South Africans, a responsibility that we take very seriously. Our unique culture and values, instilled from inception, drive how we show up every single day to earn our clients' trust. Here are ways in which we honour our long-term commitments to clients and stakeholders:

Building our clients' wealth over the long term

We have generated long-term outperformance for our investors.

Long-term performance matters



– Coronation Houseview Equity
– JSE Capped Shareholder Weighted Index

Source: Coronation, as at 30 September 2019

Based on R100m invested in Coronation Houseview Equity Strategy on 1 Oct 1993, compounding at a real rate of 9.9% gross of fees

Note: This portfolio is only available to South African investors. It is included for illustrative purposes only.

97.5% of client assets[1] have outperformed their benchmarks since inception

[1] As at 30 September 2019; funds with a 10-year+ history

12x purchasing power after 26 years

Transforming our business from within

We are a proud South African business.

Level 2 B-BBEE contributor*

Successfully recruited, trained and retained exceptional black and female talent across our business since 1993.

56% black employees

49% female employees

78% of our board members are black

>R210bn[2] of total AUM managed by black investment professionals

[2] As at 31 August 2019

Advancing transformation in our industry

Pre-dating BEE legislation in South Africa, we pioneered corporate initiatives that have contributed to meaningful transformation and the development of skills in the financial services industry.

Established 3 independent black businesses

- African Harvest Fund Managers
- Kagiso Asset Management
- Intembeko Investment Administrators

Since 2006, we have allocated **>R300 million** in brokerage to black stockbrokers through the Coronation Business Support programme

Over the past decade, we have funded and trained

120 **black IFA practices** through the ASISA IFA Development Programme

27 **analysts** through the Vunani Securities Training Academy

*as measured by the revised Financial Sector Code

All figures are as at 30 September 2019, unless otherwise stated.

INSIGHTS

Yield curves

Inverted yield curves, negative bond yields, liquidity everywhere and not a drop to drink

By SEAMUS VASEY

THE QUICK TAKE

- An inverted US 10-year Treasury bond yield curve can not only be a predictor, but a cause
- The post-GFC central bank monetary arsenal may well prove ineffective in current conditions
- Times are unprecedented; more than 25% of the global bond market now trades at a negative yield
- It's not insane to invest in negative-yielding bonds; in current conditions it would be a pity if SA missed the bus

Seamus is a fixed income portfolio manager and analyst with 15 years of investment experience.

SMALL FORESTS HAVE been razed to the ground and squids worldwide have been sucked dry to help support the volumes that have been written about bond yield curve inversions in recent times. This reached a peak at the beginning of September when the US 10-year Treasury bond yield briefly fell below that of its short-dated counterpart, the two-year bond, for the first time since 2006. The ensuing frenzy of handwringing and woeful prognostications from market commentators has certainly been eyebrow raising. Yet are they wrong?

There are respectable justifications for taking heed when long-term interest rates in the US fall below the level of short-term rates. This is a rare occurrence and has been – without contest – the most reliable early warning signal of an impending recession. Out of the 10 instances that the curve has inverted since World War II, only once (in the mid-1960s) did the slope of the curve turn negative *without* an ensuing recession; conversely, there haven't been any modern US recessions that *weren't* preceded by an inverted yield curve (see Figure 1 on page 7).

THE ORACLE

But it's not just the success of this indicator that's attractive to market watchers; it's the extent of the forewarning the signal provides. While many other harbingers of a slump in economic activity tend to be practically contemporaneous with the slowdown itself, the yield curve is seemingly able to look over the horizon and provide several quarters' advance warning.

Just as important as the reliability and predictive strength of this indicator are its simplicity and plausibility. These latter benefits are related. The difference between a long-term interest rate (typically the 10-year bond) and a short-term interest rate (alternatively the policy rate, a T-bill rate or yield on the two-year bond) is the entire metric.

Hence, even as macroeconomic, external and regulatory conditions varied considerably at the times when the yield curve became downward sloping over the past seven decades, all these influences were arguably already incorporated into interest rates. The unconditionality of this metric shouldn't be too surprising.

After all, bond yields are really just aggregated market expectations of all the macroeconomic factors that influence growth, inflation and policy, and savings and investment decisions.

And if that weren't enough to solidify confidence in the importance of this measure, there is a causality argument. Most analysts view an inverted yield curve as being *anticipatory* of an approaching economic slump. However, there is some validity to the notion that an inverted yield curve itself can help promote a negative feedback loop within the broader real economy.

So, it's not just the collective foresight of the US bond market that – for all intents and purposes – predicts recessions each and every time, but it is the very occurrence of long-term interest rates being less than short-term rates that helps bring about the slump. This negative effect would most clearly permeate through the banking system, which relies on an upward-sloping yield curve to be profitable.

Weakness in the ability of the economy to generate credit almost inevitably harms economic growth, so it's quite conceivable that yield curve inversion may actually help bring about recessions – which would certainly bolster the metric's predictive ability!

IS THIS TIME DIFFERENT?

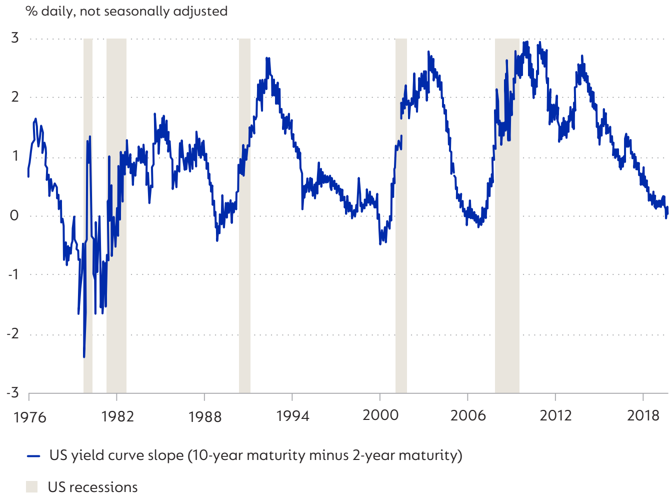
But what are the counterarguments to the implications of the 'true' US yield curve inversion that recently arose, or equivalently, to invoke the most dangerous question in economics: is this time different?

There are two key differences for the US bond market between the current era and prior decades. The first is financial repression – the extent to which policymakers have actively influenced bond yields through direct, unconventional means. The second is the substantially globalised nature of G10 sovereign debt markets and how distorted these markets have become through their own central bank involvement.

The former simply means that one can't necessarily trust the signals being provided by a market that has been deliberately distorted by the Federal Reserve Board (the Fed), principally through its quantitative easing (QE) programme. The latter implies that, even when the Fed isn't directly influencing US Treasury yields, the substitutability among G10 sovereign bonds means that central bank interference anywhere will filter through to other markets, including the US. These differences certainly lend weight in applying additional scepticism to the signals being sent by the US yield curve. So, to return to the original question: is the intense concern generated by yield curve inversion in the US justified or not? For most people, the concise answer would still be 'yes', despite the counterarguments. But for long-term investors, the original question itself is largely irrelevant.

Figure 1

HISTORIC YIELD CURVE INVERSIONS



Source: Federal Reserve Bank of St. Louis

A US RECESSION: WHEN, NOT IF

Long-term investors are always interested in what's beyond the next phase of the business cycle. It isn't controversial to suggest that the US is facing a slowdown. Exactly when it will occur and how deep the slump will be are important cyclical questions, but there are far more significant, secular uncertainties to contemplate.

IS THE INTENSE CONCERN GENERATED BY YIELD CURVE INVERSION IN THE US JUSTIFIED OR NOT?

Indeed, these structural questions are already being posed in many economies and bond markets around the world. The US will very likely face these same challenges in time, but they are immediate for most other developed markets.

Underlying these concerns are two interrelated questions: what is the effectiveness of monetary policy from this point and how (un)sustainable are negative interest rates?

THE FUTURE OF MONETARY POLICY

The key is to recognise that the current, synchronised global slowdown is substantially different to the downturn that materialised in the wake of the 2008/2009 Global Financial Crisis (GFC). Central bank optimists will highlight that this is a positive starting point: the vastly >

expanded toolboxes of the European Central Bank (ECB), the Bank of Japan, the Bank of England and the Swiss National Bank, among others, can be more quickly and assertively deployed. Previously, short-term policy rates were really the only primary tool to ease monetary conditions, but, through dire necessity, a much broader set of interventions came to fruition, along with a greater willingness to embrace unorthodox methods. The problem is whether the limits of even these unconventional interventions might already have been reached.

HAS THE GLOBAL BOND MARKET COLLECTIVELY LOST ITS MIND ... AND WILLINGLY PLUNGED DOWN THE INFAMOUS RABBIT HOLE?

The most blatant sign that monetary policy in many parts of the world may be pushing up against an effective limit can be seen in the extent of negative interest rates.

The landscape is unprecedented. Over a quarter of the global bond market (c. $15 trillion of the Bloomberg Barclays Global Aggregate Bond Index) now trades with a negative yield (see Figure 2). And with the US being the second-to-last major bond market with an all-positive yield curve (the UK is the other), this means that nearly 90% of the positive yield being generated from the global investment-grade bond market comes from America.

Furthermore, unlike previous episodes of negative-yielding debt, not only are large proportions of sovereign and investment-grade corporate bond markets trading at below-zero interest rate levels, but this has even infected some parts of 'high-yield' bond markets (subinvestment grade or junk), making a mockery of price-based risk discrimination within certain jurisdictions.

Figure 2

A PROXY FOR NEGATIVE-YIELDING DEBT IN THE GLOBAL BOND MARKET

Source: Bloomberg

NEGATIVE-YIELDING BONDS ARE OBVIOUSLY IRRATIONAL ... OR ARE THEY?

It seems absurd that literally thousands of billions of dollars' worth of bonds are trading with negative yields; has the global bond market collectively lost its mind, quaffed generously from a "Drink Me" potion and willingly plunged down the infamous rabbit hole (as suggested by the long- and very long-term yields in figures 3 and 4 on page 9)?

The answer is: maybe not. There is a variety of rationalisations for holding negative-yielding bonds. The first fallacy to displace is the overwhelmingly widespread notion that buying a negative-yielding bond *guarantees* a loss-making investment. This is patently not true for holding periods of less than maturity where capital gains outpace the losses from negative yields. It is also not necessarily true for bonds bought with a negative yield and held till maturity. Provided a bond has an initial non-negative coupon (as all bonds currently do) and reinvestment rates aren't always negative, the total return over the life of the bond may still be positive.

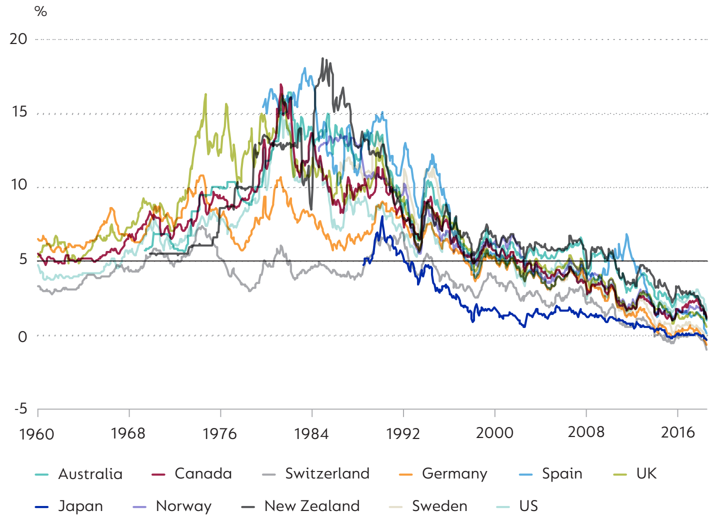
As such, if bondholders were momentum-driven investors with short-term horizons or long-term holders not overly concerned by market-to-market losses in the intervening period, a strange equilibrium could be sustained whereby views for a return to positive rates *and* even more deeply negative rates could co-exist and negative yields could be maintained.

A less far-fetched rationalisation for the sustainability of negative-yielding bonds for an extended period lies with a more entrenched fear of deflation. In the face of a potentially protracted period of negative inflation, nominal bonds are typically the superior asset class to hold. With declining price levels, any asset that can provide a sustained nominal cash payout becomes very valuable.

Another way to see this is to focus on the real yields provided by nominal, fixed-coupon bonds; these can very well be positive in a deflationary environment. And aside from the fixed cash-flow profile that nominal bonds provide, they become even more valuable relative to other asset classes, which tend to struggle in the macro-economic climate that accompanies an extended period of deflation. This is the 'Japanification' scenario whereby a similar fate that befell Japan over its lost decade strikes elsewhere, with Western Europe being highest ranking on the candidate list.

Figure 3

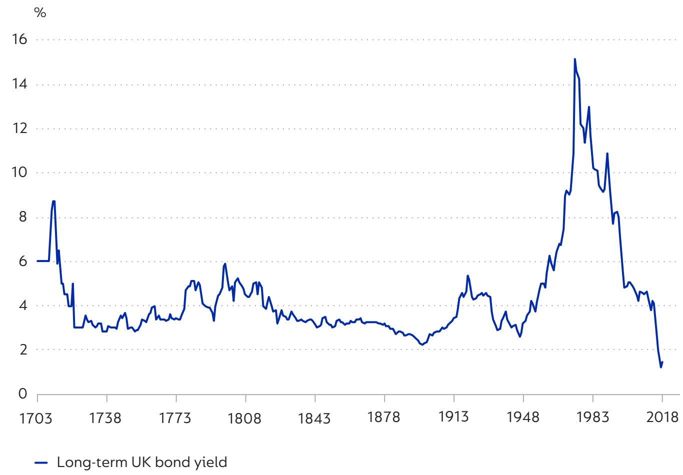
10-YEAR GOVERNMENT BOND YIELDS – HISTORICALLY COORDINATED AND DEPRESSED



Source: Federal Reserve Bank of St. Louis

Figure 4

HISTORY OF LONG-TERM UK BOND YIELDS



Source: Federal Reserve Bank of St. Louis

An even more reasonable class of justifications for the viability of negative-yielding bonds lies with investment portfolio dynamics. What many bondholders will have found reassuring in recent months is that the 'safe-haven' characteristics of bonds trading with negative yields have been sustained. This means that these are still reliable defensive assets.

So, from a portfolio construction basis, while these bonds may well be vulnerable due to exceptionally high valuations, they also continue to provide a nominal income stream and offer their traditional diversification benefits (including capital preservation and negative correlation to growth assets) within a multi-asset class context. And it is these latter characteristics that are highly sought after within any holistic investment portfolio. Indeed, they are scarce enough that investors may even be prepared to pay up for these features; a cost potentially represented by negative yields.

But perhaps the most feasible validation for seeing sustained negative global bond yields lies with market expectations. In the context that the short-end policy rates of major central banks were increasingly seen as being set around or below zero for an extended period, it would be rational to anticipate equally subdued long-term rates. Indeed, provided the equilibrium real rate of interest (or 'R-star' in economists' jargon) was believed to have reset to a very low level, the danger posed by bond yields 'normalising' to some pre-GFC long-term neutral level is effectively neutered. Hence it is the notion – increasingly more plausible to investors – that structural factors are responsible for a lower equilibrium real rate (essentially where inflation and unemployment are in balance in an economy).

In particular, globalisation; technological changes, through digitisation; demographics, through the ageing developed world; and even the wage-bargaining process, through the shift in the relative balance of power between capital and labour, have lowered inflation and altered the relationship between inflation and other economic variables. And regardless of where the balance lies in these explanations, provided belief in lower inflation is increasingly attributed to structural rather than cyclical causes, then the more justified the notion of entrenched low interest rates becomes.

NOT A REVIVAL OF THE POST-GFC CENTRAL BANK PLAYBOOK

It appears that central banks and markets have been rapidly adjusting in preparation for a rerun of the post-GFC interval that saw exceptional monetary easing over a protracted period. After all, policy rates have been cut widely, lending operations have been revived, asset purchase programmes reinvigorated and forward guidance is open-ended once again. However, there is a crucial difference this time around.

There is significantly more widespread recognition that monetary policy has reached some – if not all – of its effective limits. Perhaps the greater area of dispute now is around whether exceptional monetary easing, especially negative rates, >

is actually counterproductive to its own aims or whether these ill effects are long term enough in nature (or manageable) that aggressively loose monetary policy is still better than nothing – even if it'll do little to solve deeper productivity issues facing most economies.

This complexity was highlighted at the ECB's September policy meeting. Much of the attention was focused on the Bank's monetary policy adjustments, especially the *de facto* open-ended revival of bond purchases to the tune of €20 billion per month. However, the underlying messaging was very clear: monetary policy cannot be the only heavy lifter.

Without fiscal expansion, European growth will remain anaemic and a form of secular stagnation will likely take hold. The departing ECB President, Mario Draghi, even while reviving easing mechanisms for the Euro-area (and adding a few monetary innovations too), unequivocally emphasised that fiscal policy needs to become the main instrument to stimulate demand.

This clear and forceful endorsement from such an eminent policymaker should – in an ideal world – have significant traction in finance ministries across the Continent. Yet this is not a given. Resistance to perceived sovereign profligacy has been legendary in Northern Europe. After all, it isn't coincidental that the German word for 'debt' *(Schuld)* is the same for 'guilt'.

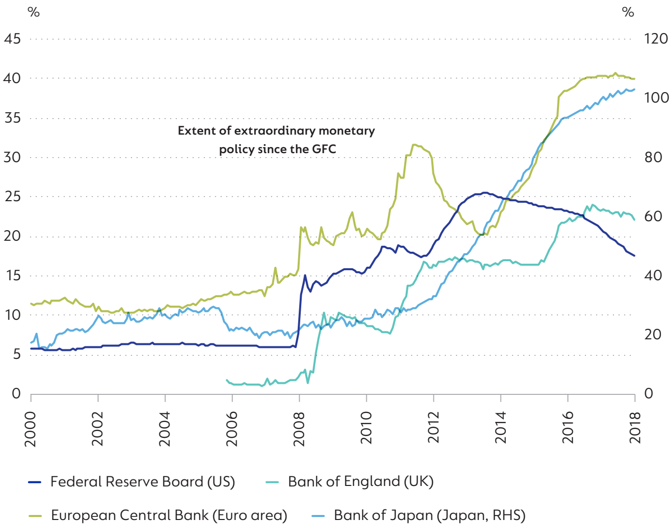
The most that can be said is that the debate has already begun to shift. But while this has been a global phenomenon, it has unfortunately been slowest to evolve in Europe – the developed world geography that most urgently needs a different policy configuration.

And so, the market's answers to the imperative questions facing bond investors reflect deep scepticism about the effectiveness of monetary policy tools, both interest rates and unconventional interventions, from this point (see Figure 5). As such, the potential for an extended period of exceptionally low interest rates is seen as quite high, as the political courage to forego extraordinarily easy monetary conditions is seen as absent.

Rates may be negative or slightly positive, but what isn't doubted by the market is that they'll remain so for a protracted extent. This itself reflects cynicism about policymakers' willingness and ability to rebalance policy interventions to favourably boost growth and raise inflation.

Figure 5

HAVE THE LIMITS OF MONETARY POLICY BEEN REACHED?



Sources: Bloomberg, US Federal Reserve Board, Bank of England, Bank of Japan, European Central Bank

THROUGH THE LOOKING GLASS – THE SOUTH AFRICAN CONTEXT

South Africa doesn't face quite the same monetary policy restraints as those seen in developed markets. Real rates are still very much positive across the curve, inflation is low but set to remain in the upper end of the target band over the foreseeable future, and fiscal expansion certainly hasn't been kept unduly restrained – in fact, quite the opposite. But it would be absolutely accurate to emphasise that South Africa's growth issues go well beyond what monetary policy can sufficiently address – just like in much of the rest of the world.

However, with the globalised nature of fixed income markets, the *direct* influence of G3 (the US, Japan and the EU) risk-free rates on domestic bond yields always needs careful consideration. As such, it is instructive to consider the counterfactual: what would South African bond yields have looked like if there hadn't been the most widespread and prolific reduction in developed market bond yields over the past three quarters or so?

Even with other countervailing forces, it is highly improbable that South African bonds that have fared particularly well in a world that was pursuing a continued de-escalation away from extraordinarily easy monetary conditions.

A higher level of global risk-free rates would have necessitated a commensurate adjustment to South African bond yields, while a reversal of capital flows from emerging markets back to a US dollar base would likely have exacerbated this process.

So, it's fair to characterise this episode of global interest rate and spread compression as both a blessing and curse for South Africa. Without the offsetting gravitational pull of lower developed market yields, South African bonds would have almost certainly struggled to overcome the intensification of domestic fiscal difficulties.

The curse is that the market signal that this would have provided may have prompted a quicker and more compelling political response to address these difficulties in a more coherent and definitive manner than has been seen to date.

If the market's prognostication for ineffective monetary policy and an extended period of very low developed-market interest rates pans out, South Africa has a window of opportunity to structurally turn around its current fiscal predicament and avoid a far more rapid and jarring correction to an unsustainable debt trajectory. It would be deeply regrettable if this passing moment of grace were to be squandered and a crisis were necessary to correct the imbalance. ✚

ECONOMIC COMMENT

My laundry list of concerns

Restoring confidence is key to growth recovery

By MARIE ANTELME

THE QUICK TAKE

- We're experiencing a perfect storm of economic headwinds to global growth
- Policy inertia continues to dog growth and confidence
- The government debt-to-expenditure ratio is of grave concern
- The world at large is in a state of upheaval; quantitative easing is back

Marie is an economist with 18 years of experience in financial markets.

TO SAY THAT we are living in uncertain times seems more than ever a gross understatement. South Africa's political landscape is in transition from a decade of maladministration towards painful stabilisation. Economic growth has suffered and the path to recovery is still unclear.

EXODUS

People are leaving and at times the political narrative is toxic. Globally, populist politics and protectionism are weakening traditional allegiances; while against a backdrop of slowing economic growth, traditional policy instruments seem stretched beyond effectiveness. This turbulent combination finds us in choppy, unchartered waters. In this note, I try to distil the issues that concern me most.

OVER THE RAINBOW

My most immediate concern is the outlook for domestic politics. Importantly, whether this administration will deliver sustainable policies that are necessary to improve domestic growth. This extends beyond the President, through an administration which has thus far failed to act decisively or think creatively when the economy needs it most.

When Cyril Ramaphosa won the ANC presidency at the ANC's 2017 National Conference at NASREC, the country was euphoric, expecting (or hoping against hope?) one man to transform a corrupt state and a growthless economy into an accountable state and a growing economy. To date, progress has been slow at best, and expectations have been disappointed. Several reasons for this sluggishness have emerged in the intervening 19 months:

1. The degree and depth of corruption in both the public and private sectors were much worse than suspected. The Zondo Commission, among others, has revealed this, and recent public statements by the President have confirmed it.

2. The President has had to opt for a strategic, reformist approach, which takes time to implement. His narrow NASREC victory, coupled with ongoing opposition from his detractors,

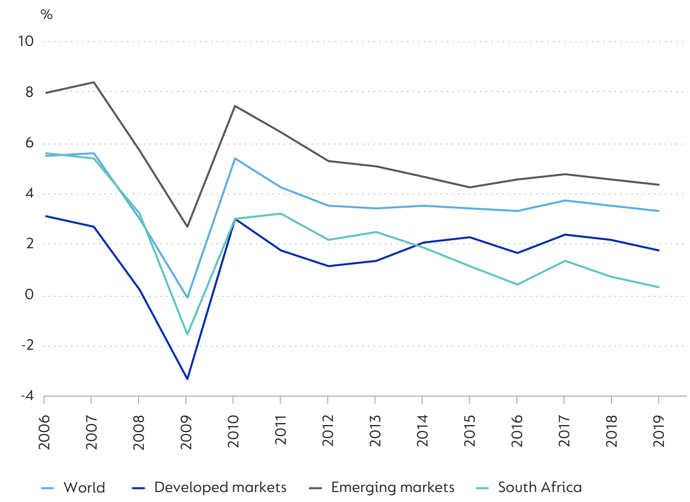
both within and from outside the ANC, means he has had to use commissions and review committees, the mechanism of the courts, and the slow attrition of opponents to reach decisions and make appointments. This has taken time.

3. Unfortunately for the President, his ability to build an economic dialogue with enough momentum has been thwarted by a number of other distractions. These constraints seem to be easing, as he recently confirmed the imminent announcement of new policies; however, we still await key decisions.

4. There have been some notable successes, including the appointment of a credible commissioner of the South African Revenue Service, a renewed and credible head of the National Prosecuting Authority, and the rehabilitation of various institutional investigative units. These are all important, positive steps to restoring institutional resilience.

Figure 1

REAL GDP GROWTH COMPARISON



Source: IMF

A STATE OF INERTIA

A decade of poor policy setting and weak implementation, exacerbated by state rent seeking, has led to a considerable depletion of domestic resources. Offshoring by local companies, and an acceleration in emigration have hollowed out the financial and skills bases. It is unclear whether the economy will be able to make a full recovery, but the result has been a protracted period of very low growth.

Low nominal growth is the next concern. Achieving better, stronger growth really is the most important economic challenge for South Africa at this critical stage. It is the means by which economies generate opportunities and government the resources by which to provide for people where economic allocations fail. It doesn't fix inequality, but it allows the state to make provision for the most vulnerable. Without growth we have no options. The South African economy has underperformed global growth, across developed and emerging markets, since the 2008/2009 Global Financial Crisis (GFC). This became (and has stayed) more pronounced in 2012 (see Figure 1).

This at least partly reflects the effects of post-GCF policy choices: at the time, government spending accelerated as revenue collapsed. This was the right thing to do in a crisis. However, the way in which government spent, hiring many people and expanding their incomes at a rate well ahead of inflation, had a permanently negative effect on government expenditure. At the time, government expected growth to return to pre-crisis rates; only it didn't. The result is that revenue has fallen much faster than expenditure has been able to adjust, and the shortfall has been met by an accelerated accumulation of debt. And, in spite of all the best efforts of the National Treasury, this continues to be the case. It means that the two fastest-growing expenditure lines in the budget are the public sector wage bill and the price of servicing government debt.

DROWNING IN DEBT

This brings me to my next biggest concern, because the two are linked – rising government debt combined with the financial and operational condition of state-owned enterprises (SOEs). In the case of the former, because growth has been so much weaker than expected, revenues have consistently underperformed budgeted amounts and the allocation to expenditure, and government has funded the shortfall by raising debt.

Government debt is expected to hit 60% of GDP in the current fiscal year, excluding the debt owed by the SOEs. Alone this is not alarming, but the trajectory is: government debt bottomed at 24.6% of GDP in the third quarter of 2008; since then, it has increased to 56.7%, a compound annual rate of 7.9%. As we stand, government debt will not stabilise, but will continue to build over the medium term (refer to figures 2 and 3 on page 14).

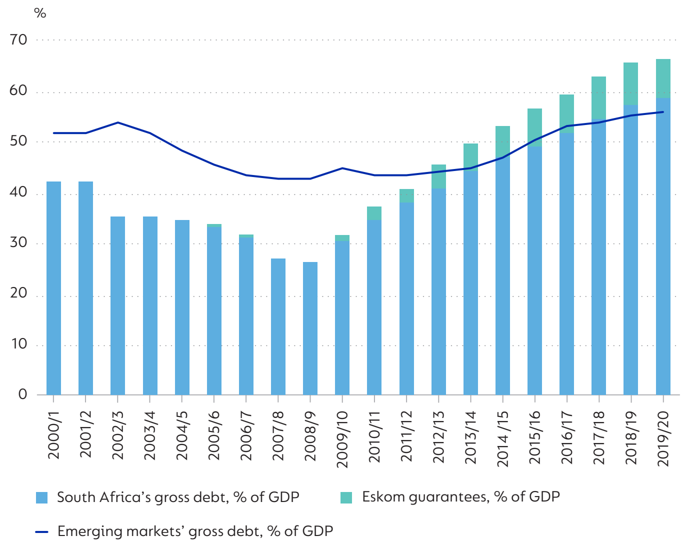
Why does it matter? The bigger the debt burden becomes, the greater the cost it exacts on the economy. Not only are financial resources directed away from productivity-promoting investment to >

finance the debt; but it must ultimately be repaid. We can already see that increased debt is weighing on the economy's ability to grow. Rising issuance puts pressure on long-term interest rates, which affect borrowing costs across the economy by raising the cost of debt and debt service.

Taken together, the increased cost of debt, coupled with a rising risk that the situation will become increasingly unsustainable, undermines any appetite for investment. Less investment now means less growth later, which means high levels of debt have a lasting impact on both realised and potential growth. As this happens, living standards fall.

Figure 2

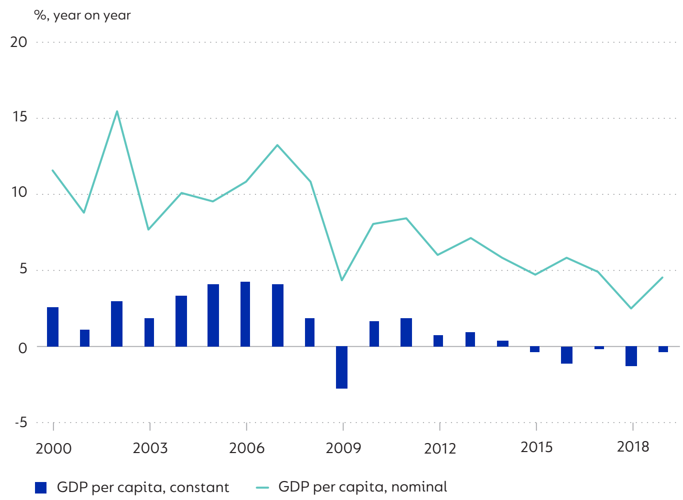
GOVERNMENT DEBT, PERCENTAGE OF GDP



Source: South African Reserve Bank

Figure 3

GDP PER CAPITA



Source: IMF

Outside of a cumbersome wage bill, the costs to the fiscus of troubled SOEs have increased enormously. Eskom remains the biggest challenge. This is the next big concern – the financial and operational viability of Eskom and the risk this poses to both sustainable growth and government finances.

DARK MATTER

In February, the National Treasury allocated an additional R23 billion per annum of taxpayers' money over the next decade to keep Eskom afloat. By March (the very next month) it became clear that this wasn't enough, and government frontloaded R13 billion of this year's annual allocation to the entity. At the end of July, Finance Minister Tito Mboweni tabled a Special Appropriation Bill, allocating an additional R26 billion transfer to Eskom in the current fiscal year, and a further R33 billion in 2020/2021. Despite promises that these transfers would be made on condition that certain reforms be met, further details have not been forthcoming.

Eskom's financial and operational fragility really emerged at the start of Ramaphosa's presidency in mid-2018. While the causes pre-date this, the situation has deteriorated visibly since, and the complex nature of Eskom's challenges has become more apparent:

1. Eskom is insolvent. Years of corruption, coupled with a failure to invest in adequate capacity, and falling revenues have resulted in a debt stock of R420 billion, and its revenues cannot meet the combined cost of servicing this debt and its operating expenses. By our estimates, without dramatic remedial intervention, Eskom will need direct financial assistance (taxpayers' transfers) for the foreseeable future.

2. The remedy requires difficult decisions. At group level, recurrent expenditure (wages and debt service) continues to rise, and there is little appetite to reduce these costs. To add to these woes, revenue is constrained by a shrinking customer base and chronic non-payment.

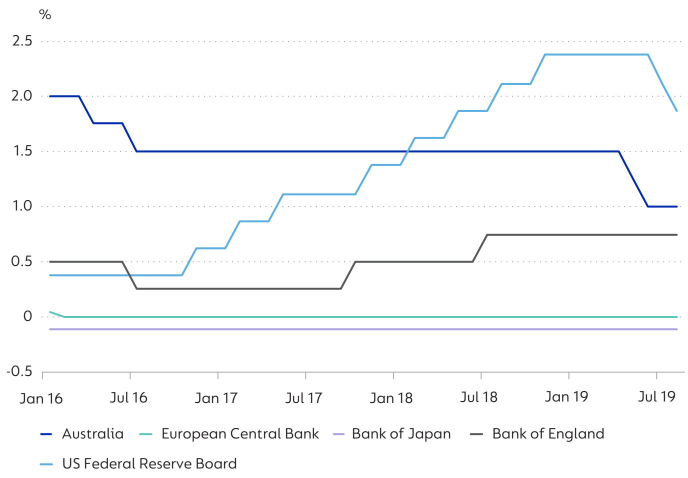
3. Eskom as an entity is an anachronism and needs to be restructured. This includes vertical disintegration, higher tariffs, and, importantly, a new way of managing its excessive debt burden.

4. Eskom is unable to meet the energy needs of a growing economy.

5. It isn't clear that decision makers realise the urgency with which this needs to be addressed.

Figure 4

GLOBAL POLICY RATES



Source: Haver

Probably the most important parallel requirements for stability are a detailed (and agreed) turnaround strategy for a disintegrated entity, and what Eskom and the government propose to do with its debt. The former is up to the Department of Public Enterprises, the President and stakeholders; the latter requires that these agree and then negotiate with the bondholders. At this late stage, while there has clearly been a lot of consultation, there seems to be little agreement. As we head into the tabling of the Medium-Term Budget Policy Statement in October, we have yet to see any evidence of real progress.

This means that there is real risk that Minister Mboweni will table a policy statement with a fiscal position considerably worse than was estimated at the time of the February National Budget (which is widely expected), but with few compensating measures. In this case, domestic debt to GDP will not only rise above 60% this year, but is also unlikely to reflect the necessary conditions for stabilisation. In this dim light, growth prospects are further diminished. And there is little relief in looking to the rest of the world to find it. This time, there is cold comfort to be found abroad.

A WORLD AT SEA

South Africa is a small, open economy operating in a very uncertain world. More than ever, political signalling is driving asset markets and economic policy in a global environment that is more disconnected than it has ever been in the post-war period. Across economies, growth has decelerated since late-2018, owing mostly to moderation in China, compounded by falling global trade volumes and the escalation in trade tensions between the US and China. At the same time, political tensions remain high. China-related protests in Hong Kong are ongoing, with little obvious source of diffusion; the Middle East remains a source of great potential unrest; and the UK's EU exit date is fast approaching, with its own fraught political uncertainty. And, US President Donald Trump continues to be a disruptor across a range of issues and geographies.

Central banks in the US, the EU, Japan and across emerging markets have increased monetary support for their economies in response to this weakness and the uncertainty it poses to domestic growth. At the September news conference of the Federal Open Market Committee, Jerome Powell, Chairman of the Federal Reserve Board, reiterated that the decision to cut the fund's rate for the second time this year, despite decent growth in the US, was due to a weaker external environment, with growing risk and inflation persistently below the 2% target.

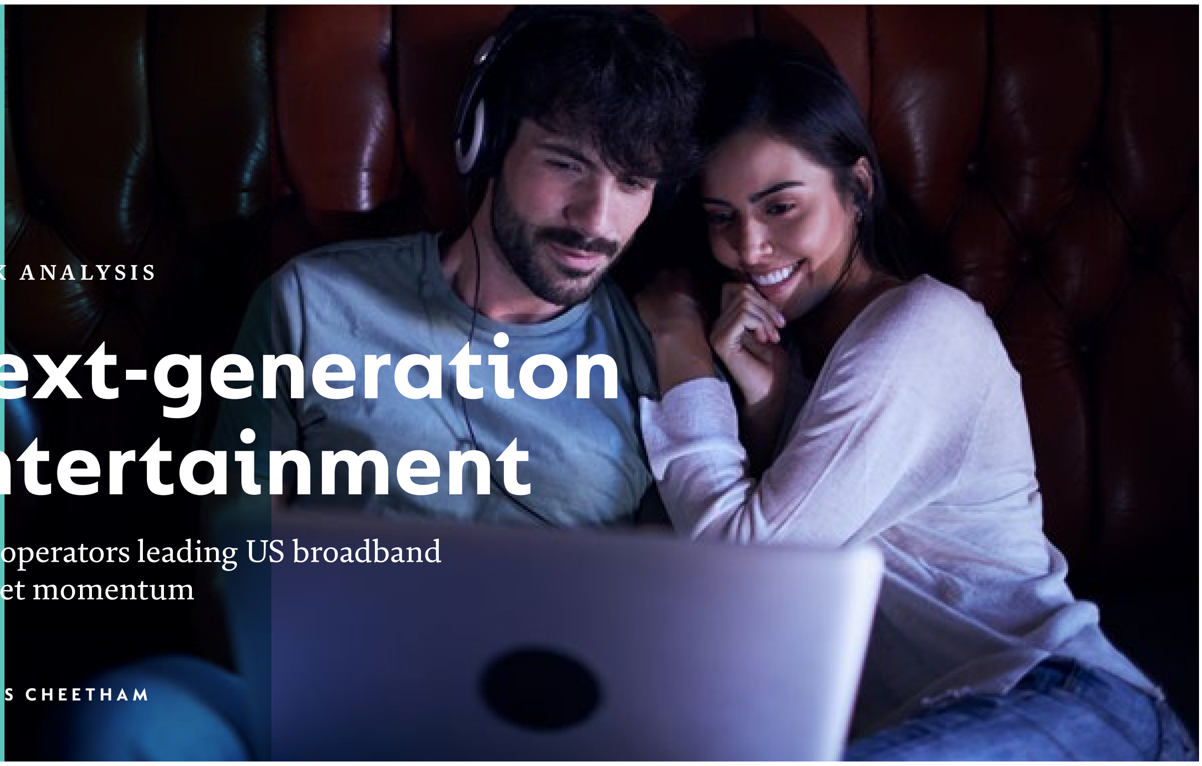
Similarly, outgoing European Central Bank President, Mario Draghi, announced not only a deposit rate reduction into deeper negative territory, but open-ended direct support for asset markets in the form of a renewed targeted longer-term refinancing operation. Japan's stance is also accommodative and "more keen to ease than before since overseas risks are heightening" (see Figure 4).

Ultimately, the outlook for global growth in coming quarters will be in the balance between supportive monetary and fiscal policies for reasonably solid domestic demand, and an ongoing deterioration and heightened escalation in uncertainty playing out in global trade.

For now, we expect global growth to stabilise at weaker levels as policy support matures, acknowledging the pronounced uncertainty.

For South Africa, there is much to be gained from clarified policy direction, despite rising global headwinds. In particular, decisive action on Eskom could go a long way to restoring confidence among businesses and consumers. Recent data from the Bureau for Economic Research confirmed that confidence among these key growth drivers hit multi-decade lows in the third quarter of 2019, inhibiting consumption and capex decisions. With few easy short-term drivers of growth available, restoring confidence is key to the start of any growth recovery. ✚

STOCK ANALYSIS



Next-generation entertainment

Cable operators leading US broadband internet momentum

By CHRIS CHEETHAM

THE QUICK TAKE

- The TV shift from linear to OTT is still nascent in the US and momentum will increase
- The average US cable household consumes over 250GB per month
- Broadband internet will be the backbone of next-generation entertainment
- Broadband is now the primary product sold by cable operators, while pay TV is less relevant

Chris is a global developed markets analyst with more than eight years of investment experience.

IN THE LAST edition of *Corospondent*, we discussed how consumer habits have evolved with respect to entertainment and how viewership continues to shift away from traditional live television to on-demand video streamed over the internet. The transition of entertainment and communication to online is still in its infancy and we expect the trend to continue. Against this backdrop, we believe cable operators are well placed as the leading providers of broadband internet in the US.

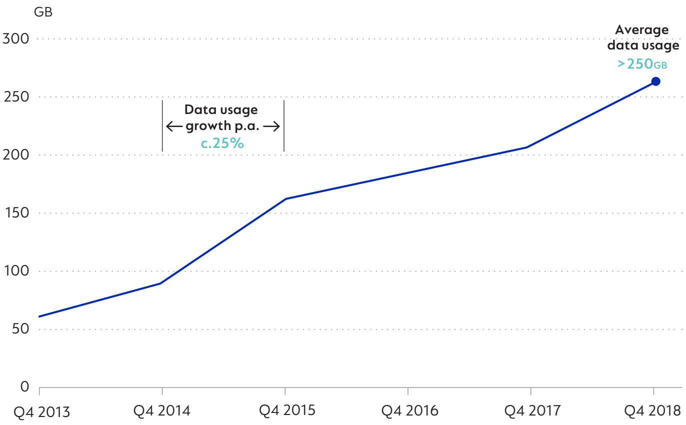
Both Charter Communications and Altice USA have materially outperformed the market year to date, up around 45% and 70%, respectively, and we continue to hold both as core positions in our active global equity portfolios. Although the market has traditionally focused on cable's declining pay-TV business, broadband internet is the primary product sold into the home. With the strong growth in its customer base, broadband now contributes almost all of the free cash flow generated by the cable operators. As consumers continue to shift to streamed video, broadband will become the backbone of next-generation entertainment, the importance of which will continue to rise, and our view is that the cable investment case is misunderstood and underappreciated by the market.

As reflected in Figure 1 on page 17, these strong structural trends have resulted in a rapid increase in data demand, with the average US cable household consuming over 250 Gigabytes (GB) of data per month, while households that don't subscribe to traditional pay TV use roughly double that.

This is a clear illustration that cord cutters consume more data as video content is streamed via the likes of Netflix and other over-the-top (OTT) providers. Data consumption is only set to increase further, with Altice USA disclosing that its most data-hungry homes (the top 10% of users) consume one Terabyte of data per month and have 15 or more connected devices. In time, it's fair to expect this to become the norm as streaming-use cases expand to include higher-quality video as well as connected home and gaming applications.

Figure 1

AVERAGE DATA USAGE PER HOUSEHOLD PER MONTH



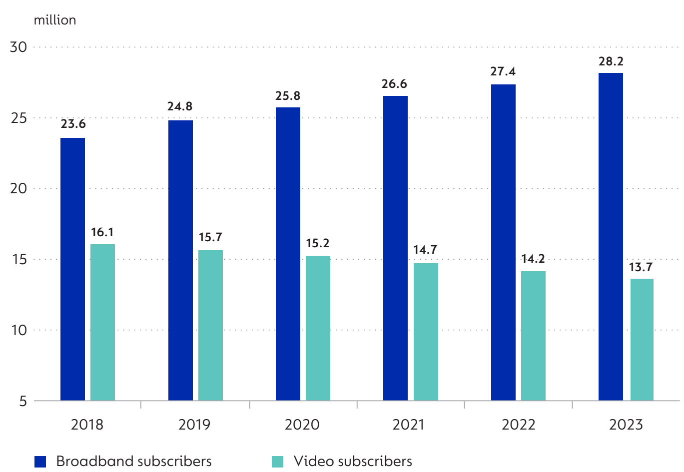
Source: Altice USA 2018 results presentation

WHAT IS CABLE?

Cable was initially conceived to bring free broadcast television to mountainous areas unable to receive adequate signal through the air via antenna systems. A cable system can be thought of as an electricity grid transmitting data from one point to another, and at its core consists of a mix of copper and fibre transmission lines. Today, most US homes and businesses have cable running past them, dug into the pavement decades before, and cable has both an advantaged infrastructure and natural monopoly in most US towns and cities. The rapid construction of cable infrastructure started in the mid-50s and was followed by decades of footprint expansion and consolidation led by players such as the legendary John Malone.

Figure 2

CHARTER: STEADY GROWTH IN BROADBAND SUBSCRIBERS IN THE US



Source: Coronation estimates

The cable-use case soon shifted from broadcast to pay TV, leading to the establishment of well-known channels such as ESPN and HBO. For many subsequent years, cable was primarily focused on selling a traditional bundle of pay-TV channels, as DSTV does today. Cable is a scale game, and years of footprint consolidation means that the three major listed US operators – Charter Communications, Comcast and Altice USA – now pass 51 million, 58 million and nine million homes or businesses, respectively!

THE SHIFT TO BROADBAND

It's no secret that traditional, 'linear' TV subscriber numbers are declining, and we expect this to continue. Cable operators have repositioned themselves with broadband as the primary focus, enabled by extensive plant upgrades that started at the turn of the century and continue to this day.

Much of the original footprint has been replaced with fibre, and networks have been digitised and upgraded, resulting in speeds of one Gigabit per second (Gbps) being readily available. Operators have already identified a realistic, low-cost path to 10Gbps.

As a result of its well-established position and advantaged infrastructure, cable has continued to take share of the US broadband market and today serves two thirds of all broadband-connected homes. Most US homes are passed by both cable and a telco line offering DSL (think Telkom); the latter offers insufficient speeds and continues to lose market share as data consumption explodes.

New competition is unlikely due to the cost of laying fibre and the questionable return on investment in doing so because of the difficulty in prying customers away from entrenched providers. Much of this cable was originally put down decades ago and it's often near impossible to overbuild this infrastructure from a town planning or regulatory perspective. Today, the provision of broadband internet is cable's primary cash generator.

WHAT ABOUT CABLE'S TRADITIONAL VIDEO BUSINESS?

Figure 2 illustrates that while broadband is now clearly the primary service being sold into the home, video still comprises a significant proportion of cable operator revenue, although video users continue to decline by 2% to 3% per year. The video backdrop is one of intense competition, with traditional distributors like cable and satellite losing out to OTT platforms. >

Furthermore, new services from deep-pocketed companies such as Disney and Apple are due to launch imminently.

This fight for eyeballs is driving content costs up, with timeless shows like *Seinfeld* and *Friends* recently costing around the $400 million to $500 million mark for new multiyear carriage deals, according to press reports, while Apple is reportedly spending over $15 million an episode on *The Morning Show* starring Jennifer Aniston and Reese Witherspoon.

IS IT VIDEO'S TURN TO DIE?

What does this challenging backdrop mean for cable operators?

Table 1 clearly shows that video's contribution to cable is smaller than the revenue headline suggests. Due to significant programming costs paid to channel and content owners, video is a very low-margin business and is estimated to contribute under 20% of total earnings before interest, tax, depreciation and amortisation (EBITDA) for the likes of Charter and Altice USA. Content costs are paid on a per-subscriber basis, and so naturally decrease in line with declines in the video subscriber base, smoothing the overall impact of video's downward trajectory.

Furthermore, video contributes only marginal free cash flow to cable operators due to the high cost of putting set-top boxes into homes. We believe that the current pace of video subscriber declines is very manageable, and that new cable initiatives, such as the launch of aggressively-priced bundled mobile plans, will bring benefits such as broadband churn reduction, filling the gap that video once filled. While video is still an important element of the cable triple-play bundle, its contribution to free cash flow and therefore company valuation must not be overestimated.

TRADITIONAL VIDEO'S LOSS IS BROADBAND'S GAIN

While content owners slug it out for eyeballs and continue to write bigger cheques for new shows, a fast and consistent internet connection remains paramount to delivering the required streaming experience. It's estimated that over 75% of internet traffic is video use, which clearly illustrates how a traditional video subscriber loss is broadband's gain.

As the traditional television bundle is replaced with skinnier online options and individual apps, a complicated experience arises for consumers used to having all their video needs met in one place. In response, cable is making the right moves to leverage its primary broadband relationship into being the aggregator of choice in the modern world of streamed video, with set-top boxes now including OTT options in an easily searchable format.

Table 1

CONTRIBUTION TO REVENUE, EBITDA AND FREE CASH FLOW

	Altice USA	Charter
Revenue contribution		
Video	42%	38%
Broadband, business services and other	58%	62%
EBITDA contribution		
Video	17%	8%
Broadband, business services and other	83%	92%
Estimated 2020 free cash flow yield	9%	7%

Sources: Published financials and Coronation estimates

WHAT ARE THE KEY RISKS TO CONSIDER?

Could technological change challenge cable's advantage in the provision of broadband internet? We continue to monitor global developments around 5G and its potential to allow mobile operators to play a larger role in home broadband. 5G is the next generation of radio network technology and should bring significant benefits to the average mobile phone user, including higher speeds and increased capacity. US telecom giants like Verizon and T-Mobile have different strategies, but both envisage using 5G technology to provide home broadband. While we are not dismissive of this threat, the amount of data consumed by the average US household and the growth thereof make it difficult for mobile technology to compete with fixed alternatives such as cable and fibre.

The average US mobile customer uses under 10GB of data per month; even a tenfold increase in mobile capacity – the upper range suggested by industry experts – will struggle to compete with the average cable household consuming over 250GB per month and growing rapidly. 5G will also allow the use of previously untapped spectrum[1] bands, and certain use cases will enable high-capacity home broadband solutions in limited circumstances. This high-frequency signal does not travel far and therefore requires more towers (connected with fibre) near to the end-

[1] Spectrum refers to a range of radio waves used by telecommunication providers for wireless communication purposes.

consumer – an effective densification of the network. In these use cases, the lines between wired and wireless will become increasingly blurred and, ultimately, cable companies are well placed due to their ownership of existing wired infrastructure.

CONCLUSION

While cable stocks have performed strongly this year, Charter and Altice USA trade on 2020 free cash flow yields of around 7% and 9%, respectively – still a significant discount to the overall market. We believe this is too cheap, considering both companies have excellent, shareholder-friendly management teams and offer the potential for explosive free cash flow growth on the back of growing earnings and declining capital intensity.

In our view, the market is still overly focused on video declines and isn't adequately rewarding cable operators for their strong, incumbent position as the leading providers of broadband internet. Broadband is a must-have, sticky product for consumers, and offers attractive margins and growing free cash flow profiles to the providers. We do not believe that this is reflected in current cable valuations. We continue to hold both Charter and Altice USA as core positions in our global portfolios. ✚

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.

GLOBAL FRONTIER MARKETS

Buyer beware

IPO learnings from frontier markets

By GREG LONGE

THE QUICK TAKE

- New listings may set hearts racing, but reason must intervene
- Companies list to the seller's advantage
- Keep in mind the industrial cycle
- Experience can unlock opportunity

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

WE HAVE ALL been there. Your heart begins to beat a little quicker, you press forward, leaning closer, the fear of missing out starts to reveal itself as you eye the 'competition'. Will you get lucky, or has the chance passed you by? Whether it's a glimpse of a celebrity or your favourite sport star, the chance to get free tickets to a show or simply waiting to catch the bouquet or garter at a wedding, we all have those moments when we get caught up in the hype and excitement of the crowd. Initial public offerings (IPOs) can evoke similar reactions in the investing public, often to their detriment.

When it comes to IPOs, investing in global frontier markets is no different to investing elsewhere. They have a way of grabbing your attention, whether you want them to or not. The phone begins to ring incessantly with 'well-meaning' bankers looking to provide updates on the latest hot listing, and diaries fill up with meeting requests from investment analysts wanting to share their views. Company management meetings become more frequent as they crisscross the world on roadshows aimed at charming investors. Post listing, it's amazing how these roadshows dry up. If the IPO is large enough, they can capture the hearts and minds of the general public. Uber drivers, distant relatives and old school friends suddenly want to talk about the new listing, while daytime TV and the Twittersphere is filled with so-called experts sharing their opinions.

At Coronation, we are typically more reserved when it comes to IPOs. Some can be good investments, but most often the risks outweigh the reward. Of the 67 capital raises above $25 million in global frontier markets over the past three years, we have participated in five.

LESSONS LEARNT

There are many reasons why the barrier to investing in an IPO should be higher than simply purchasing shares on the secondary market, but here are a few key lessons that we have learnt from 26 years of investing around the globe and, more recently, in our Global Frontiers Strategy:

- The inside edge
- Timing matters
- Understanding the industrial cycle
- The hype seldom works in your favour
- It's the length of track record that counts

THE INSIDE EDGE

IPOs involve insiders (founders/executives/private equity investors/financial institutions) selling shares to outside investors. Typically, these insiders are intimately involved in the business, either through direct management or via a seat on the board. They know the business better than anyone else ... and they are choosing to sell. To make matters worse, they get to set the price and date of the listing. Unlike purchasing shares on an exchange where both buyers and sellers have access to similar information, the price is market determined and timing is up to the buyer; with IPOs, the insiders have a clear information advantage over potential buyers. It's like playing poker with someone who has already seen all the cards in the deck.

TIMING MATTERS

Have you ever been to a Sunday afternoon show house? There are flowers everywhere, freshly baked bread in the oven and everything is neat and tidy. It is the very picture of suburban bliss. The house has been dressed up to sell.

Contrast this with surprising a friend with a visit. While it will no doubt depend on your friend, chances are that there would be dishes in the sink, the bed might not be made, muddy paw prints probably trace a line down the passage and toys might be littering the floor. It could even be the very same house, just different timing. Companies come to market when they feel that 'market conditions are favourable'. What that means is that the sellers feel that the market conditions are favourable – to them. And by inference, less favourable to the buyer.

Insiders know exactly when the IPO will occur, with many months' notice. It is unsurprising then that management teams do their very best to ensure that everything looks great by the time the IPO date arrives. In many ways the companies trading year in and year out on stock exchanges look like your friend's house, while IPOs always seem to end up feeling more like a show house.

A stock-specific example of 'favourable timing' in global frontier markets was the recent listing of an oil marketing company following two years of very strong profit growth in Morocco. While the company operates in several markets, the business was heavily reliant on its Moroccan business, which made up approximately 30% of total earnings before interest, tax, depreciation and amortisation (EBITDA). Fast forward six months and significant regulatory headwinds emerged that severely undermined the profit pool in this market, cutting the Moroccan EBITDA by over 50% as a result. The timing of the IPO was certainly favourable to the sellers. Coronation did not participate in the IPO due to valuation concerns given the regulatory risk in the business.

THE INDUSTRIAL CYCLE

The industrial cycle sees a business build a factory, steadily increase unit sales until the factory becomes capacity constrained, and then build another factory as the cycle starts again. As utilisation of the factory increases, so too will the level of profitability. This is because the company's fixed costs are spread over a larger volume of units – which is economies of scale at work. Table 1 captures this dynamic well for a fictitious factory. It shows how operating profit margins increase as the volume of units produced rise from 40% of capacity to 100%. Margins rise from 0% to 30% as utilisation increases.

Table 1

INDUSTRIAL CYCLE

Utilisation	Per unit	40%	60%	80%	100%
Volume		800	1 200	1 600	2 000
Sales	1 000	800 000	1 200 000	1 600 000	2 000 000
Variable costs	(500)	(400 000)	(600 000)	(800 000)	(1 000 000)
Contribution margin	500	400 000	600 000	800 000	1 000 000
Fixed costs		(400 000)	(400 000)	(400 000)	(400 000)
Operating profit		-	200 000	400 000	600 000
EBIT %		0.0%	16.7%	25.0%	30.0%

Source: Coronation

IPOs are often used as a way for a business to raise money to expand capacity when existing capacity starts to become constrained. Phrased differently, when businesses operate at somewhere between 80% and 100% capacity, they often look to list. This also happens to be when operating margins are at cyclical highs, when management can show a few years of improving profitability and the results look strong. This is well and good, provided the buyers of the IPO understand where the business is positioned in the industrial cycle and then value the business using a lower, through-the-cycle margin forecast. Our experience has been that this is typically not the case.

The investment bankers forecast margin expansion into perpetuity and management teams give a multitude of reasons why 'this time it's different' or why the high margins are here to stay. A few years down the line, the new factory is built and overall utilisation has fallen, margins decline (not

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because of bad management but simply due to the industrial cycle at work) and share prices come under pressure. Our experience has been that this is the time when you want to be buying the now out-of-favour, recently listed company.

A global frontiers example is a food company in Egypt that listed a few years ago. The company released three years of annual financial statements that provided margins from 2011 to 2014 (see Figure 1). They showed steady improvement as utilisation increased by close to 100%.

Post listing, 2015 and 2016 saw capacity increase by 50%. Utilisation, and with it, margins, fell significantly into 2017 before both picked up in 2018. While there were no doubt many factors at play here, the industrial cycle certainly made an impact. Coronation did not participate in the IPO, due in part to our view of the level of normal profitability we used in our valuations.

THE HYPE SELDOM WORKS IN YOUR FAVOUR

Every day, stock exchanges around the world facilitate trades in the thousands of companies listed globally. All but a handful of trades occur with little fanfare, marketing or hype.

The story of IPOs could not be more different. A string of analysts, advisers, brokers, bankers and company representatives are readily available to walk you through the investment case, five-year plans and reasons why this is too good an opportunity to be missed. The level of noise surrounding an IPO is deafening, but just because it's front of mind doesn't mean it's a good investment. Often the overlooked, unloved, boring and forgotten stocks represent the true bargains.

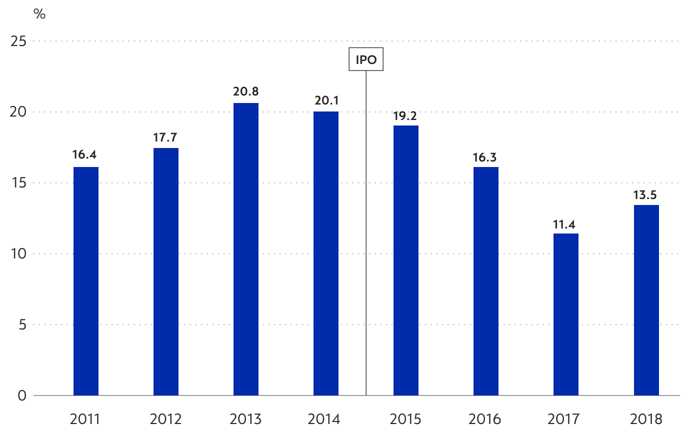
It seems that nothing captures the investing public's attention quite like the IPO of a technology stock. The hype surrounding the listings in the dotcom bubble of 2000 are legendary. In more recent history, high-profile listings like those of Facebook, Twitter, Alibaba and Uber have dominated headlines.

In our global frontier markets universe, Jumia, the so-called 'Amazon of Africa' has been the subject of similar hype. This was especially so after listing at $14.5 a share, the share price quickly moved up to almost $50 in a matter of weeks, before giving back all the gains.

Jumia now trades below its listing price. While we would have loved to have participated in the IPO (and then sold close to the peak) we did not, due to concerns around the business model and once again the margin of safety being too low.

Figure 1

EARNINGS BEFORE INTEREST AND TAX MARGINS



Source: Coronation

IT'S THE LENGTH OF TRACK RECORD THAT COUNTS

Listed companies publicly disclose financial statements each year. The longer they have been listed, the longer the history of results becomes. By reading these reports and analysing the financial statements through the years, an investor can observe how the business performs through the economic cycle; in good times and in bad. They can observe some of the culture of the business, how capital is allocated and how management teams treat shareholders and their other stakeholders. While anyone operating in financial markets knows that past performance is no guarantee of future success, the past does provide valuable insights into a business.

At Coronation, we will regularly analyse 10 or even 20 years of a company's operating history and financial performance as we evaluate investment opportunities. IPOs do not afford us the same opportunity, as historic financials for the past three years are typically all that is disclosed. Management teams are aware of this, and they know when the IPO is scheduled to take place. Optimising the financials over a fairly short period of time is not difficult – capex can be delayed, sales pushed onto distributors and discretionary expenditure postponed. As a result, it's tough to really know what you are buying when it comes to IPOs.

Take another look at the EBIT margins in Figure 1 – by providing only three years of financial history (which is actually pretty good for an IPO) the margins shown capture a very limited period in the company's life. It's difficult to know whether the 16% low in 2011 or the 21% high in 2013 are normal. Analysing the business today, over a fuller eight-year cycle, shows that the through-the-cycle average is most likely somewhere around 17%. This is well below the 21% shown at the time of the IPO.

OPPORTUNITY KNOCKS

While the issues listed here are significant, they are not insurmountable, and every so often an opportunity crosses our desk that has a sufficient margin of safety to warrant a position in our portfolios (even after adjusting for the concerns raised here). The important thing to understand is how the very nature of an IPO works against the buyer and in response, to increase the required return needed to invest. Two examples of recent listings in Egypt in which we have participated are Ibnsina Pharma and Cairo for Investment and Real Estate Development (CIRA), the latter which, despite its name, is the largest private-sector education provider in the country. Both listings came to the market at valuations that were attractive, despite the risks mentioned above.

EVERY SO OFTEN AN OPPORTUNITY CROSSES OUR DESK THAT HAS A SUFFICIENT MARGIN OF SAFETY TO WARRANT A POSITION IN OUR PORTFOLIOS.

Ibnsina Pharma is Egypt's second-largest and fastest growing pharmaceutical distribution business. The business has a very strong management team headed up by co-founders who, together with the chairman, own a collective 33% of the company. They are very much aligned with shareholders. The business has succeeded by focusing closely on the 40 000 pharmacists they serve, leveraging their country-wide distribution network, and ensuring that they were well positioned to capture the rapid growth in Egypt's pharmaceutical sector. While we participated in the IPO, we were only allocated a fraction of the shares we applied for due to the high demand the listing attracted. We subsequently doubled our position through buying in the market in the days following the IPO, despite the share increasing strongly, as the margin of safety was large. The share is up almost 100% since listing and results continue to be strong.

CIRA runs 19 schools across Egypt and a university. The company is growing strongly as existing facilities are being expanded and new schools are being added. The business model focuses on providing high-quality but affordable private schooling to the middle class by teaching a variety of international curriculums.

Despite being the largest private-sector educator, the company's market share is still only 0.1% and the business has a long growth runway ahead. Given the rate of expansion, the biggest risk is the ability of management to execute and ensure that the new schools adhere to the high standards of the existing offering. While near-term valuation multiples were not cheap, our long-term valuation methodology meant that we could value the many years of compounding ahead of the company, which, when coupled with strong cash generation and high returns, made for a compelling investment opportunity. CIRA is up almost 90% since the IPO.

We often get a client or a colleague asking whether we had participated in a particular stock's IPO, usually regarding a high-profile listing that has increased in value (think Jumia once it was in the $30 per share area). In these moments we are reminded of the wise words of Warren Buffett:

"I worry much more about the things that I do than the things that I don't do. I missed all kinds of opportunities in my life. You just want to make sure that you're on the side of the house when you bet rather than bet against the house. You don't really have to worry about, you know, what's going on in IPOs, or people making money. People win lotteries every day, but there's no reason to have that affect you at all."

IPOs are simply another investment opportunity that may or may not be attractive. The idiosyncratic risks of the listing process, though, do require a little bit of extra care and thought. ✚

IN SUMMARY

National imperatives

Transformative policy paper needs strong implementation

By MARIE ANTELME

THE QUICK TAKE

- The emphasis must be on growth-promoting policy and improving employment
- Public-private partnerships are key to unlocking growth and addressing social reform
- Not enough attention was paid to supporting small to medium enterprises
- We need political will to come to the fore for any hope of recovery

Marie is an economist with 18 years of experience in financial markets.

IN AUGUST, the National Treasury released a policy document for public comment. The document prioritises reforms that are expected to have maximum impact on growth, acknowledging that the lethal cocktail of low growth and rising unemployment is rendering South Africa's economic trajectory unsustainable.

The paper also advocates reforms that will improve economic transformation, increase employment, boost competitiveness and support the expansion of export-oriented sectors of the economy. In addition, it highlights that "any attempt to raise South Africa's potential growth rate must include progress on the fundamental building blocks of long-run sustainable growth".

Some of the preconditions to success listed, such as a stable macroeconomic framework, are already in place. However, others, including improved basic education; relaxed immigration requirements to address skills constraints; and a new social compact between government, the private sector and other social partners are not, and may pose significant political challenges to delivery. Additionally, the reforms themselves will take time to implement.

THE UPSIDE

Positively, the document addresses several critical issues:

- The most important feature of the document is its focus on growth. Without growth, South Africa will not have the resources with which to tackle social challenges, or an increasingly unsustainable fiscus.
- It strongly advocates greater engagement with and inclusion of the private sector, broadly through a social compact and specifically through several direct interventions.
- It prioritises improving the competitiveness of domestic companies through cutting red tape; reducing the cost and increasing the efficiency of business and transport services; and a commitment to identifying and addressing issues that hamper the ease of doing business in South Africa.

While most of the content is not new, synthesising existing policy documents within the National Treasury as well as independently produced research by both local and international specialists over a significant period, the paper brings a wealth of insight into key issues that South Africa has so far failed to adequately address.

THE GAPS

There are several shortcomings and omissions. For a start, the paper does not directly address labour market reform, despite this being highlighted as a considerable constraint to growth and improved employment.

It does make indirect references to the need to reduce the regulatory burden on small and medium enterprises, but they are arguably not enough. Ideas include exempting them from automatic inclusion in sectoral wage agreements and offering incentives to employ young people.

Also, while macroeconomic stability is an absolute precondition for microeconomic interventions to succeed, the paper does not address fiscal sustainability in the short term, which is not only a practical constraint to growth, but is also essential to restoring confidence.

PRESSING CONCERNS

The publication carries with it a sense of urgency, not least of which is the way in which it was published by the National Treasury. Kickstarting economic growth is paramount, not only to stabilise the fiscus, but also to provide the economic resources with which to address South Africa's crippling triad of poverty, inequality and a failed transformation agenda.

That said, it appears that this sense of urgency has not landed, and it is unclear how much political backing the recommendations will attract. If the ongoing delays in the provision of clear policy direction, notably for the failing state-owned enterprises that threaten both fiscal and growth outlooks, continue to undermine household and business confidence, the success of any new policy will be limited, and growth is likely to remain lacklustre.

We need broad consensus for this potentially transformative policy document to gain critical traction and then the momentum required for it to yield any success. Importantly, factional, ideological and perhaps even personal differences simply cannot be allowed to prevail at the expense of economic recovery. ✚

STOCK ANALYSIS

Shoprite

The price is right (or at least it feels that way)

By **TUMI MOTLANTHE**

THE QUICK TAKE

- The decision to invest in a business isn't arrived at neatly
- Despite poor GDP numbers, Shoprite SA has defended its earnings base admirably
- Shoprite Africa's fixes will take time, but we are happy to sit and wait for them
- As one of SA's best businesses, Shoprite is a great stock to own at this point in time

Tumi is an equity portfolio manager with 12 years of investment experience.

"We are not so brazen as to believe that we can perfectly calibrate valuation; determining risk and return for any investment remains an art not an exact science." – Seth Klarman, Baupost Group CEO

WHEN IT COMES to having your favourite cake or dessert, you typically choose between taking a trip to the shops or, if you're feeling a bit of *MasterChef* inspiration, you may decide to make it yourself. If it's the latter, you'll know that a quick online search will result in any number of recipes with accurate measurements for each ingredient, the order in which they should be mixed together, and the precise amount of time it should be in the oven.

Unlike baking, the decision to invest in a business isn't arrived at so neatly, and often hinges on a blend of tangible and intangible elements, the interpretation of which could easily make one person a buyer and the next person a seller. The Shoprite investment case is one such example in today's market, and we've positioned ourselves in the Buy camp within our South African portfolios.

A LOT OF BAD NEWS BAKED INTO THE PRICE

Shoprite's share price peaked on 7 March 2018, closing at R275.50 – today it trades at R122 a share. While it has more than halved over the past 18 months, this precipitous decline isn't enough to conclude that the stock will generate a market-beating return over our investment horizon.

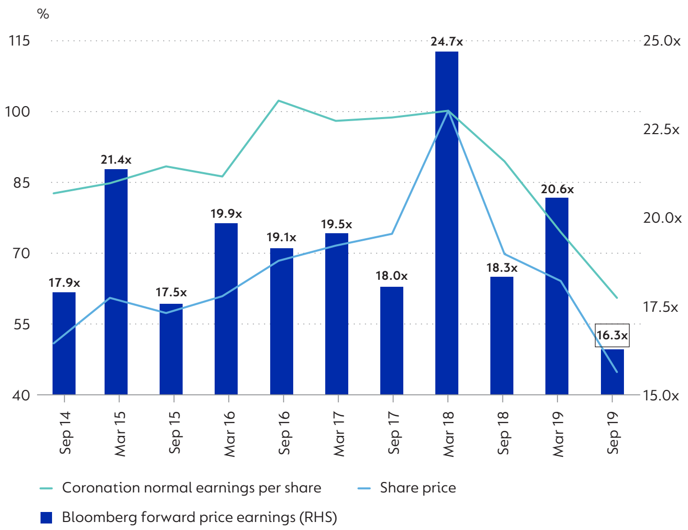
This price move must be contextualised by the underlying earnings power of the company and/or the value of the assets underpinning the operations. Figure 1 attempts to do just this.

Using 7 March 2018 as a reference point, the chart highlights how our assessment of normal earnings has since declined 40%. It also shows that the stock has de-rated significantly, with the market saying it is willing to pay a lot less (around 35% less) for R1 of earnings a year out versus at the peak.

On a price-to-earnings basis, it's only been cheaper than it is today 6% of the time over the last 10 years.

Figure 1

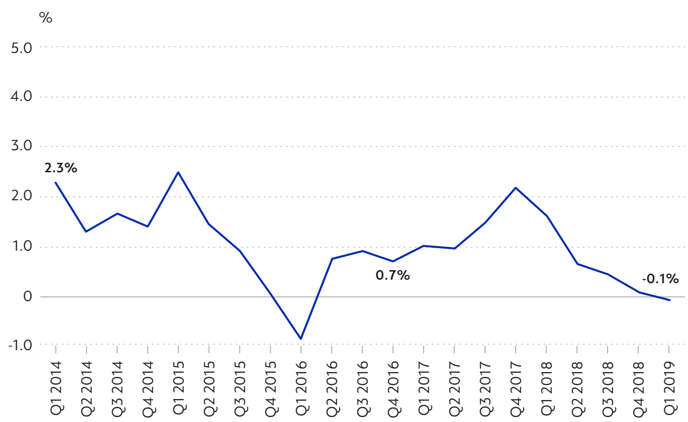
SHOPRITE RATING CHECK – LAST FIVE YEARS



Sources: Bloomberg, Coronation data and analysis

Figure 2

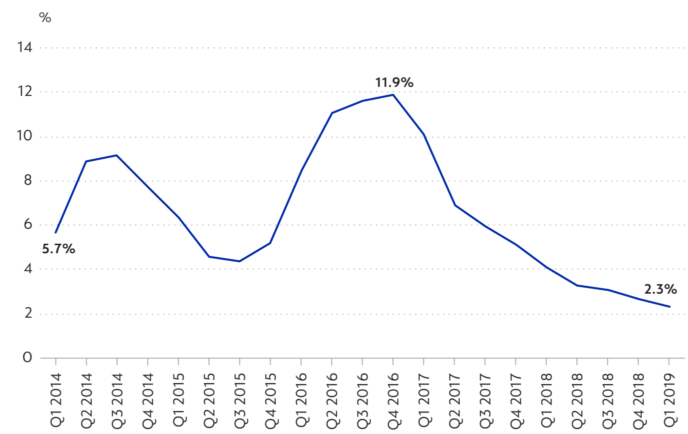
SOUTH AFRICAN REAL GDP GROWTH – LAST FIVE YEARS



Source: Statistics South Africa

Figure 3

SOUTH AFRICAN FOOD INFLATION – LAST FIVE YEARS



Source: Statistics South Africa

NOT JUST A SHOPRITE STORY, BUT A BROADER SOUTH AFRICA INC. STORY

This development of big share price declines, on the back of large earnings disappointments, is quite broad based and has presented several investment opportunities in companies with operations facing the local environment. After all, companies deliver earnings based on what they've been able to do in the real economy. And the real economy has not been supportive.

Figure 2 shows how South African GDP has failed to show meaningful growth on a sustained basis over the last five years and has actually been slowing down. At the same time, the cost of living – electricity, rates and taxes, fuel and services – has gone up a lot and income hasn't kept up. For many businesses, the ability to pass on inflationary price increases has not been there, and the food retailers in particular have seen this come off spectacularly (especially in the last three years), as shown in Figure 3.

DESPITE THIS, SHOPRITE SOUTH AFRICA HAS PROVED QUITE RESILIENT

Although group earnings have been materially reset from the highs of two years ago, the South African Supermarkets division has defended its earnings base admirably (down 15% in real terms) and achieved trading profit margins above 5%, despite real revenue in 2019 only being a percent higher than it was in 2017.

Having historically been 80% of group trading profit, South African Supermarkets were responsible for all the profit reported in the last set of results – Africa Supermarkets' earnings are down 115% and currently lossmaking (see Figure 5).

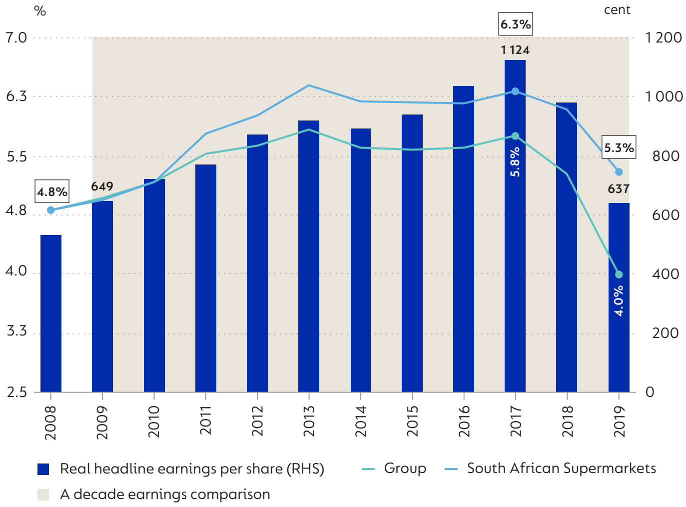
In thinking about the current tough climate, and the group's ability to defend today's earnings base going forward, we see this particular development as positive, and are of the view that there is limited downside to the last reported earnings – and good upside potential.

Given the difficulty of the last year for the group, it's easy to forget just how excellent an operation Shoprite's local business is. It owns a third of the South African food market, has the biggest footprint in three distinct brands, boasts the longest heritage and runs the most refined operation in centralised distribution, with a good management team that's been in the business for years.

These virtues don't simply disappear over a 12- to 18-month period, which, by the way, was plagued by a combination of once-off disruptions, including a troubled SAP implementation and a strike >

Figure 4

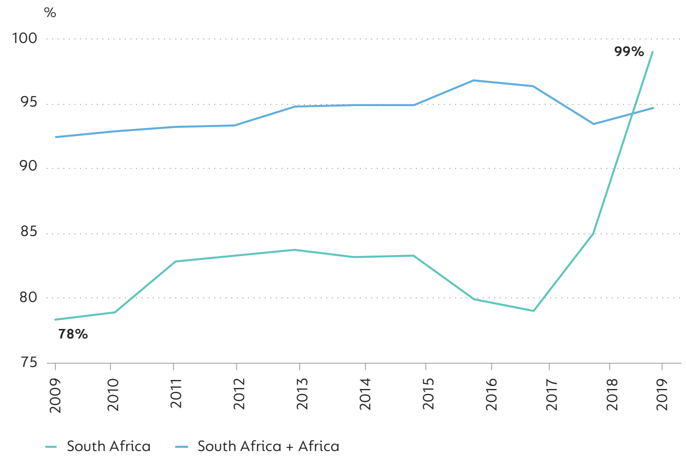
SHOPRITE: REAL HEADLINE EARNINGS PER SHARE AND EARNINGS BEFORE INTEREST AND TAX MARGINS



Sources: Shoprite financial results releases, Coronation analysis

Figure 5

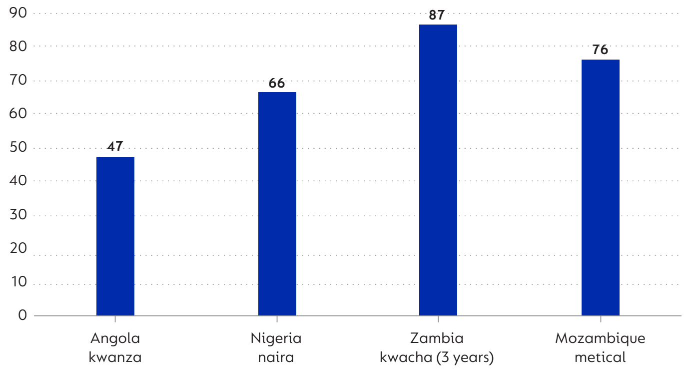
SUPERMARKETS' CONTRIBUTION TO GROUP TRADING PROFIT



Sources: Shoprite investor presentations, Coronation analysis

Figure 6

SHOPRITE AFRICA: CURRENCY DEPRECIATION – LAST FIVE YEARS 2014=100



Note: This is the 12-month average exchange rate over Shoprite's financial year, which is to end June.

Sources: Shoprite investor presentations, Thomson Reuters Eikon, Coronation analysis

at its main distribution centre (that handles more than half of Shoprite's volumes), while having higher exposure than its peers to the low-end consumer who has felt the brunt of the weak economy.

Over the last six months, Shoprite has reasserted its sales growth leadership among the three majors (Shoprite, Spar and Pick n Pay), delivering growth of nearly 10% (admittedly off a soft base), which has come with an increase in both volumes and inflation during that time. Industry players we've been speaking to confirm that they are experiencing similar trends, with the sense that demand for food staples has stabilised somewhat.

It is our view that as things like the new minimum wage start to filter through to cash-strapped consumers and the country gets a bit of policy direction (and action!) from the recently elected government, we'll start to see sales growth trends match nominal GDP growth and then accelerate ahead of it. Before any discretionary spending starts to come through, the basics have to be taken care of first.

FIXING AFRICA

After being the main, positive differentiator versus its peers over much of the last decade, Shoprite's 14-country operation has turned into a decidedly negative differentiator. The cluster generates nearly a fifth of South African Supermarkets' sales, on 40% of the South African asset base, and just made a trading loss of R265 million (from a R1.4 billion profit just two years ago). The going has been very tough.

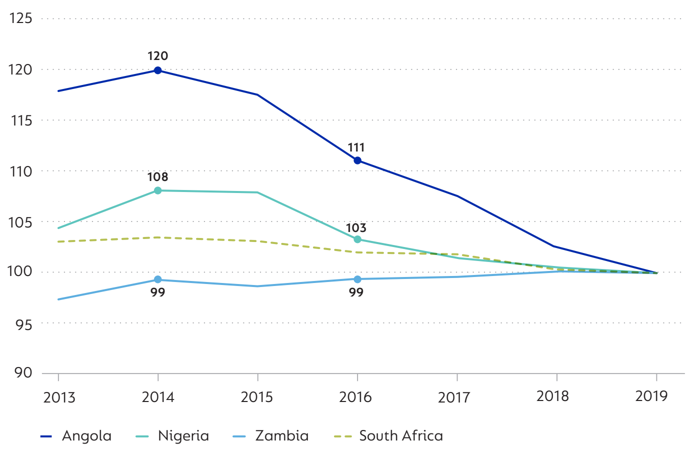
Figure 6 highlights the extent to which local currencies have depreciated against the South African rand, with the major revenue and profit contributors, Angola and Nigeria, losing half and a third of their purchasing power, respectively. This has had a material impact on the underlying economies and the ability of individuals to hold their real incomes (Figure 7).

Exacerbating the deterioration in affordability is the increased complexity of trading in these markets. Selling food in increasingly hard-to-reach places and in more challenging regulatory regimes (in response to the currency situation) has now resulted in a large amount of invested capital generating negative returns, while the cash-flow generation ability versus peers is structurally lower at the group level. But this can change, and we think it will.

The executive management team appreciates the fact that the current operating model is inefficient and needs correcting. Conversations with

Figure 7

SHOPRITE AFRICA: REAL GDP PER CAPITA, 2019 = 100



Sources: IMF, Coronation analysis

them suggest that they are scrutinising all areas of spend within the business, and that no option is off the table. This includes selling off excess real estate and limiting further new investment into the detracting countries, thereby limiting the extent to which the operations are being subsidised. There is also the possibility of exiting some markets if they see no turnaround prospects over the medium term.

However, whether or not Shoprite puts these actions into effect does not affect our base case. We have taken a harsher view on the value of the African operations – which have declined by two thirds – by reducing optimism around sustainable margins (down from 6% to 4%), cutting revenues four years out (by 35%) and lowering the fair multiple used to value the operation (by 20%).

If management executes half of the actions within its control, a lot of value will be unlocked in Africa. However, these fixes will take time, and we're happy to sit and wait for them. Encouragingly, the company has demonstrated its seriousness here by introducing return and bottom-line earnings growth hurdles (at group level) as performance criteria for incentive remuneration in its latest integrated report.

CONCLUSION

In the end, the call to invest in Shoprite on behalf of clients remains a valuation-based decision.

The share price has meaningfully retraced, and the earnings base is no longer high (and is a lot more defendable than two years ago). We have arrived at our assessment of the fair value of the business using conservative assumptions – many of which will likely need to be relaxed a year or two from now. Despite this, the share trades on 13 times what we view as the normal earnings per share for the group and offers valuation upside.

The current sentiment around the business is very negative, but this doesn't change the fact that Shoprite remains one of South Africa's best businesses. You would want to own such businesses at most points in the investment cycle, but particularly in times such as these. ✚

BOND OUTLOOK

South African bonds attractive in low-yield world

But depressed growth and further Eskom support weigh heavily on government

By NISHAN MAHARAJ

THE QUICK TAKE

- We're still far from seeing a restart of the US QE programme, given the room to move lower on policy rates
- SAGBs have a very limited margin of safety against a turn in global sentiment
- SA will likely be downgraded to subinvestment grade territory by Q3-20
- SA bonds look fantastically attractive and relatively cheap to dollar-based investors

Nishan is Head of Fixed Interest and has 16 years of investment experience.

AN ASTONISHING $15 trillion worth of global government bonds now trade at a negative yield. That's approximately 25% of the market that is trading with a yield to maturity of less than zero. This phenomenon, for now, has been confined to Europe and Japan, and in extreme cases like Switzerland, Germany and the Netherlands, the entire yield curve trades in negative territory (negative yields all the way out to 2050!).

Any intelligent person would ask the question, who in their right mind would be investing in an asset that is guaranteed to lose them money? In a world where the alternatives are overpriced risky assets, where one can suffer permanent loss of capital, or negative cash/deposit rates, suddenly assets at less negative yields and that have consistent buyers in the form of central banks (which makes short-term capital gain possible), look a whole lot better.

In a world of no yield, one would expect relatively high-yielding assets to be well supported. Since the beginning of the year, emerging market bonds returned 12.1% in US dollars. This is despite many emerging market currencies being down considerably (3%-7%) over the last quarter.

South African bonds scraped in with a positive return of 0.74% this last quarter, but over the last 12 months the All Bond Index has delivered an impressive return of 11.4% in rand, which, despite the 6.5% depreciation in the currency over the same period, still produced a positive return of approximately 5% in dollars. Over the last quarter, the South African 10-year bond has traded in the 8.50%-9% range, with the further rally in global bond yields acting as a strong anchor for local yields.

The US 10-year bond has rallied from levels of just above 2% to 1.67% over the course of the quarter, for several reasons. The escalation of tension in the US-China trade relationship has dented global confidence, which has led to a material slowdown in the global capex cycle. This has coincided with a slowing in US and global growth. Central banks have been quick to step in and engineer a softer growth landing, with the US reducing interest rates 0.5% this year and the European Central Bank moving deposit rates further into negative territory, accompanied with a restart of its bond purchase programme.

Current data emerging from Europe point to growth slowing to 1% with inflation of 1.5%, which suggests, at a bare minimum, a continuation of accommodative monetary policy in the EU. US data, more specifically the US labour market, have proved more resilient, despite recent cracks starting to appear. The reaction of the US Federal Reserve Board has not been as frantic as market pricing of interest rate cuts and has instead adopted a wait-and-see approach to further rate easing. We are still quite far away from seeing a restart of the US quantitative easing programme, given the room to move lower on policy rates. The hope is that recent measures implemented by global central banks are enough to mitigate an aggressive growth slowdown in the months to come.

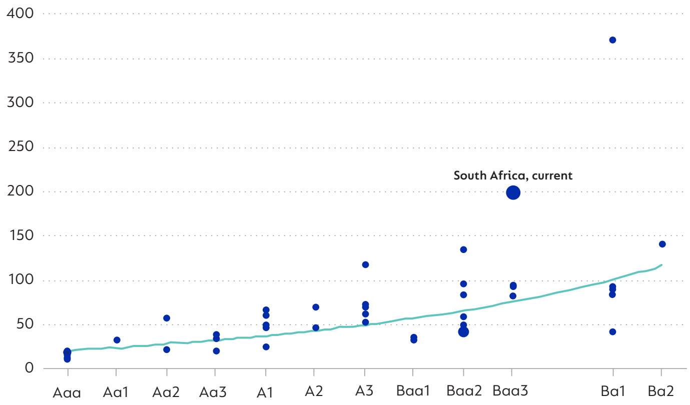
On the local front, we remain in limbo as we await the Medium-Term Budget Policy Statement at the end of October and further details on the turnaround for Eskom. Inflation continues to be well behaved and expectations are for it to average 5% over the next two to three years. Growth expectations have been continually revised down, with current expectations for a marginal pick-up to 1.5% over the next two to three years. Structural reforms have been much talked about, especially in the new National Treasury economic strategy plan released by Finance Minister Tito Mboweni towards the end of the third quarter. Unfortunately, time is running out, and what's needed now is an accelerated implementation of these initiatives to bring back confidence and investment into the local economy – read more on page 24.

Government finances continue to weigh heavily on the local outlook, with the fiscal deficit expected to breach -6% this year and debt/GDP to push above 60%. The major culprit of this deterioration has been the continued support needed by ailing state-owned entities (SOEs), most specifically Eskom. Without a credible plan to turn around the entity, more money will need to be poured in to allow it to meet its obligations. Herein lies the major risk for the local economy, and while there has been an acknowledgement of the problems by government, there has been a lack of urgency in putting a credible plan in place to halt Eskom's deterioration, let alone turn the entity around.

Moody's is still the only rating agency that rates South Africa as an investment-grade country and has provided the country with a tremendous amount of leeway over the last 12 months. Its recent statements suggest that it will continue to do so, given the reform intent of government. However, given what is currently known about the trajectory of further deterioration, if there are no substantial efforts to fix the problems the country faces, it is very likely that South Africa would be assigned a negative outlook on our investment-grade rating by November 2019 and downgraded to subinvestment grade territory by Q3-20. The deterioration in South Africa's fundamentals has been well flagged, which has allowed a risk premium to be built into South African government bonds (SAGBs), both in terms of absolute yields and the steepness of the yield curve. South Africa's credit spread (represented in Figure 1 by South Africa's credit default spread) already trades at levels that are consistent with a subinvestment peer group. In addition, 10-year >

Figure 1

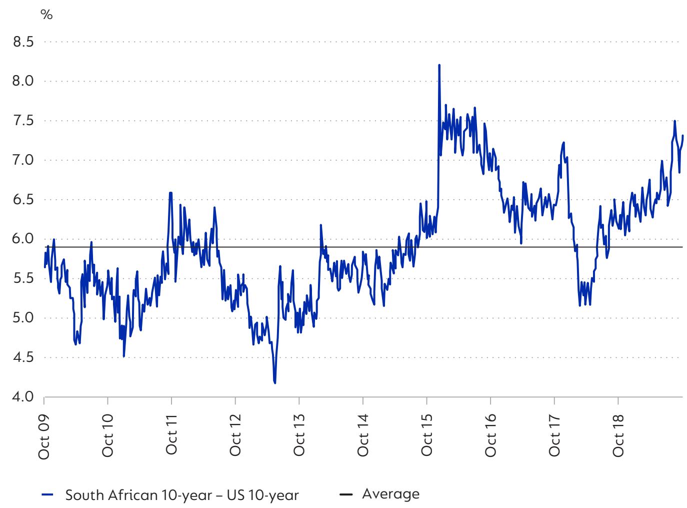
SOUTH AFRICA'S CREDIT SPREAD



Source: Bloomberg

Figure 2

SOUTH AFRICAN 10-YEAR VERSUS US 10-YEAR SPREAD



Source: Bloomberg

SAGBs trade at a spread of 7.25% over US 10-year yields, which is well above the long-term average and close to the widest levels they have been in 10 years (see Figure 2). These measures suggest a decent amount of the bad news is already being priced in by markets.

Furthermore, SAGBs look quite cheap when compared to the emerging markets universe. In Table 1, we show the nominal yields of various emerging market bonds and their implied real yields (the return one would get if we stripped out the effects of inflation over the next year). South Africa not only sits well above the emerging market average but also at the top of the ranking table when it comes to the relative cheapness of nominal and real yields. In a world of very low to zero yields, South African bonds look fantastically attractive and relatively cheap to dollar-based investors.

As a dollar-based investor, when one invests into a local currency bond market, there are two major risks that one takes. First, you take the risk that the yield at which you are investing does not offer a sufficient margin of safety in the event of further local fundamental deterioration, and secondly you are taking the risk that the currency depreciates to such an extent that it wipes all the yield from the bonds. The first risk is something that we have discussed at length in the past. We construct a fair value for 10-year SAGBs, using the expected global risk-free rate (US 10-year), expected US/South African inflation differentials and the South African credit spread. We use values of 2% (normal US 10-year rate), 3.8% (5.3%-1.5%; South African 10-year breakeven minus US 10-year breakeven) and 3.16% (South African EMBI plus sovereign spread) to arrive at a fair value of 9.03%, which is not far from current levels of 8.92%. This suggests that SAGBs trade pretty much at fair value, implying not much room in the case of further fundamental deterioration.

Dollar-based investors have the option of buying 10-year South African bonds issued in dollars, currently trading at 4.88% with no currency risk, or buying a 10-year SAGB issued in rand trading at 8.92%. If you do not expect the currency to move, then it's a no-brainer to buy the bond issued in rand due to the higher yield on offer. Over the past two decades, the rand has depreciated by an annualised rate of 4.4%. The annual depreciation would comprise inflation differentials and a risk premium. Since South Africa runs a higher inflation rate than the US, the rand has to deteriorate by a minimum of the inflation differential for purchasing power between the two countries to remain unchanged. The more unpredictable part is the risk premium that needs to be priced due to the risk of deterioration in other local factors.

Table 1

EM BOND MARKETS: NOMINAL AND IMPLIED REAL YIELDS

	Nominal yield	Implied real yield
South Africa	8.92	4.13
Indonesia	7.26	3.79
Brazil	7.05	3.23
Mexico	6.88	3.16
India	6.70	3.04
Russia	6.90	2.62
Malaysia	3.33	1.85
Average	5.15	1.30
China	3.14	0.73
Chile	2.53	(0.07)
Israel	0.89	(0.36)
Poland	1.99	(0.55)
Czech Republic	1.33	(1.09)
Turkey	13.15	(1.16)
Hungary	1.97	(1.19)

Source: Bloomberg

Over the last 20 years, the inflation differential between South Africa and the US has been 3.4% (5.6%-2.2%: actual inflation outcomes), suggesting the risk premium should be 1% (4.4%-3.4%).

Current inflation differentials sit at 3.8%, which makes the 20-year annualised depreciation of 4.4% look reasonable, as we assume a reduced risk premium going forward. This implies that a dollar-based investor can expect a return in dollars of 4.52% (8.92%-4.4%). Compared to the actual South African 10-year dollar bond, this is not that attractive, unless one has a materially positive view on the currency. It would also explain why the local South African bond market has experienced outflows this last year of approximately R8 billion. This is a big turnaround from the R20 billion of inflows we were sitting with at the end of the first quarter of this year.

South Africa inflation will remain benign and growth subdued, which would, at worse, allow policy rates to remain on hold. However, persistent low growth and the need for further support of SOEs will weigh heavily on government finances, resulting in wider budget deficits and a significant increase in the debt burden. The global environment remains supportive for emerging markets and South Africa, especially given the renewed monetary policy easing embarked on by global central banks. However, SAGBs trade at fair value at best and have a very limited margin of safety against a turn in global sentiment or a worsening in local economic conditions. Therefore, it is prudent to maintain a neutral to slightly underweight allocation to SAGBs at current levels. ✚

GLOBAL EMERGING MARKETS

China

A weighty issue?

By SUHAIL SULEMAN

THE QUICK TAKE

- Unprecedented growth has boosted China from a stagnant economy to a global heavyweight
- China's dominance of the MSCI EM Index is set to strengthen in the near future
- An index that is so dominated by one country poses a problem for passive investors
- Active management is required to price the risks associated with the degree of Chinese state-owned stocks in the EM Index

Suhail is a global emerging markets portfolio manager with 18 years of investment experience.

MUCH TIME AND effort have been devoted to understanding the recent rise of China as a major global economic power. It is, however, important to also note that China (or at least the precursor territories making up modern China) was the largest single economy in the world until the late 1800s and had been so for several hundred years. This isn't surprising, as people have lived a subsistence or agrarian existence with fairly low output per capita for most of human history. Countries with larger populations would therefore have had larger economies. This changed permanently with the advent of the industrial revolution and the advancement of technology, in particular. First the Western European nations, then a rapidly growing US, came to dominate the world economy thanks to massive gains in technology-enabled productivity.

China underwent substantial transformation during this period. Military defeats to Britain in the Opium Wars (which led to the ceding of Hong Kong to Britain) were followed by partial colonial occupation by Japan, a civil war leading to communist control of 'mainland' China and the fleeing of the nationalist government to the island of Taiwan in the aftermath of World War II. Following this period, communist mainland China stagnated economically until around 1980. At that point, China accounted for less than 5% of world GDP (despite the country making up 22% of the world population at the time) and the average person was extremely poor relative to someone living in the West (per capita GDP was a mere 1.5% of the average American). Unprecedented sustained economic growth has since transformed China into a middle-income country and, because of its large population, it is today the second-largest economy in the world; the largest if you use purchasing power parity.

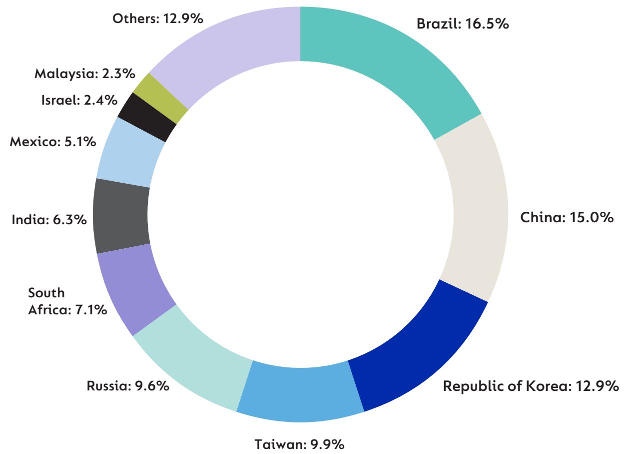
EMERGING GLOBAL FORCE

Where China was once just another emerging market at the turn of the century, today it is the most important emerging market (see figures 1 and 2), and one that can make or break the returns of any fund manager. In the run up to the Global Financial Crisis, when commodity prices were still elevated and the currencies of commodity exporters were trading at historical (relative) >

highs, Brazil was the largest weight in the MSCI Emerging Markets Index at 17%. China's weight had risen to 15% by this point, from single digits several years before. Fast forward to the time of writing, and China's weight has reached almost 32%, while Brazil's has declined to just under 8%. Such has been the scale of China's growth that the next largest country weight in the index is almost 20% behind it (Republic of Korea).

Figure 1

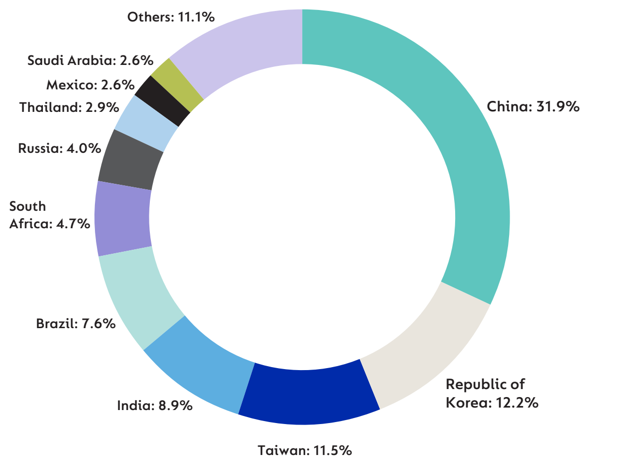
MSCI EMERGING MARKETS COUNTRY WEIGHTS – JULY 2008



Source: MSCI

Figure 2

MSCI EMERGING MARKETS COUNTRY WEIGHTS – SEPTEMBER 2019



Source: MSCI

If all index securities moved in tandem going forward, China's weight would increase further in the months and years ahead. Currently, the A shares (domestic China listings) have an 'inclusion factor' of 15%, meaning that 85% of their weight is not counted within the MSCI Emerging Markets Index. They started the year at 5% and by the end of 2019, the inclusion factor will increase to 20%. All else being equal, this will increase China's overall weight to 33%. As the inclusion factor edges up further, it could, if it reached 100%, eventually result in China being over 42% of the broader index. An index so dominated by an individual country is problematic for passive or tracking error-conscious investors, but it is a material opportunity for active managers to add (or destroy) value.

EMERGING MARKET OUTLIER

China is in many ways very different from the rest of the emerging market universe. As a start, it is the only country in the index with a weight above 5% where a very large proportion of the listed market consists of state-owned entities. Russia is another country with high levels of state ownership of large index constituents, but is only 4% of the market.

State ownership is rarely positive for minority shareholders in the long run, as the state has often shown itself to be a poor custodian of capital and has other obligations to meet besides maximising shareholder returns. Over time, a high level of exposure to state-owned businesses could likely result in poor absolute returns. A very good illustration of this is shown in Table 1, where the top 10 Chinese stocks in the MSCI Emerging Markets Index are shown at the end of the most recent month and the corresponding month 10 years ago. State-owned businesses are highlighted for ease of reference.

As one can see in Table 1 (page 35), state-owned businesses have underperformed their private sector peers by a significant margin over the last 10 years, such that five new private businesses have entered the top 10 weights (displacing state-owned businesses), and the only top 10 private sector business from 10 years ago (Tencent) is now the largest stock in the Emerging Markets Index. A passive investor in emerging markets today (like before) has significant exposure to the Chinese state via the state-owned businesses that comprise the index. Additionally, many of the private sector stocks in China face risks and regulations that are unique to China. A good example is the existence of variable interest entity structures. These allow companies in China to list overseas despite their core operations being officially closed to foreign investors. All the main internet stocks (Tencent, Alibaba, Baidu and others) use these structures. We don't believe it is likely that China would end this practice due to the impact it would have on its capital markets, but the risk is non-zero in nature and does not exist in other countries. >

China-specific regulation also impacts many other businesses, from censored search results in Baidu to foreign content restrictions in the gaming companies. The high concentration to China should play a precautionary role in both the asset allocation decision on exposure to emerging markets and the decision on whether to invest passively or actively. In our view, the very high China concentration, coupled with state ownership and regulation, materially increases the risks associated with investing passively in emerging markets.

Only an active approach can price for and navigate around these risks. There are many great businesses in China that investors should have access to at the right price and, in our view, their presence in an investor's portfolio should be valuation dependent, not determined by index weight. This observation is true for all countries, but with China's high index weight, it is particularly relevant. ✚

Table 1

TOP 10 CHINA WEIGHTS

SEPTEMBER 2009		SEPTEMBER 2019	
Name	**Weight**	**Name**	**Weight**
China Mobile	2.0%	Tencent	4.5%
China Construction Bank Corporation	1.2%	Alibaba	4.4%
ICBC	1.2%	China Construction Bank	1.4%
China Life Insurance	1.1%	Ping An Insurance Group	1.2%
Bank of China	1.0%	China Mobile	1.0%
CNOOC	0.8%	ICBC	0.8%
Petrochina	0.8%	Bank of China	0.6%
Tencent	0.5%	Baidu	0.5%
China Shenhua Energy	0.5%	CNOOC	0.5%
China Petroleum & Chemical Corporation	0.5%	JD.com	0.4%

State-owned businesses

Source: MSCI

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 INSIGHTS

2019 third quarter in review

CORONATION GLOBAL HOUSEVIEW STRATEGY

The portfolio delivered a positive return in what was a challenging quarter, mainly due to weak domestic equity markets. The portfolio has performed well since inception and against its peer group over all meaningful time periods.

Tensions place equities under pressure

Against the backdrop of a slowing global economy, an escalating trade war and a revival of central bank stimulus measures, the MSCI All Country World Index ended the quarter flat in US dollar terms. Geopolitical risk in the Middle East, with escalating US-Iran tensions and a missile strike on a Saudi oil refinery – which is responsible for almost 5% of world oil supply – added to equity market volatility during the quarter. Emerging markets continued their recent underperformance, declining 4.3% for the quarter (with returns now negative 2.0% over a rolling 12 months) relative to developed markets which were marginally positive for the quarter (+1.8% over a rolling 12 months).

GEOPOLITICAL TENSIONS IN THE MIDDLE EAST ADDED TO EQUITY MARKET VOLATILITY.

Notwithstanding this, the portfolio's exposure to emerging market equities performed exceptionally well on the back of some excellent stock picking and our overweight exposure has, in fact, contributed meaningfully to performance over the past year. We continue to maintain a relatively large exposure to global equities and believe that our emerging market equity exposure, in particular, still offers compelling value.

Quantitative easing abounds once more

The FTSE World Government Bond Index appreciated by just under 1% in US dollars for the quarter. In September, the European Central Bank announced its biggest package of rate cuts and economic stimulus in three years as President Mario Draghi warned governments that they needed to act quickly to revive flagging eurozone growth. The stimulus included cutting interest rates further into negative territory, reviving its contentious €2.6 trillion programme of buying bonds for an unlimited period and easing lending terms for eurozone banks.

Soon thereafter, the US Federal Reserve Board also cut rates by a further 25 basis points (bps), although the accompanying commentary was more hawkish than the market was expecting. Negative interest rates have led to significant distortions in asset markets. Currently roughly $15 trillion of global debt trade at negative yields, meaning you are likely to lose money if you hold these instruments to maturity. Furthermore, in Denmark – where banks have been grappling with negative interest rates longer than in any other country – they are now offering home mortgages at negative interest rates (the bank is effectively paying the borrower to take money off their hands, so they pay back less than they have been loaned). The extent to which central banks continue to distort debt markets is concerning and we remain cautious on the outlook for global bonds.

Local economy weighs on sentiment

Recent economic data served to reinforce how dire the underlying domestic economic situation really is. This has flowed through to corporate earnings and we have been bombarded with company profit warnings over the past quarter. Investor and consumer sentiment continue to remain very weak and government urgently needs to deliver on much-needed structural reform to restore consumer and corporate confidence and kickstart the economy.

MONETARY POLICY IS NOT THE SOLUTION TO SOUTH AFRICA'S POOR GROWTH.

During September, the South African Reserve Bank (SARB) held the policy rate unchanged at 6.5%, but the SARB's statement was more dovish than in July when it did actually cut rates. Although the SARB's view is that monetary policy is not the solution to South Africa's poor growth outlook, we believe that given the weak domestic economy, contained inflation and favourable global rate expectations, the SARB has room to cut rates further. Against this challenging economic backdrop, the rand weakened by almost 7% against the US dollar. The portfolio was well positioned for this move.

With local bond yields ticking up, the All Bond Index returned only 0.7% for the quarter. However, over the past year bonds have performed strongly and are up 11.4% over the rolling 12 months. Given the attractive real yields, local bonds continue to offer reasonable value and our current bond weighting is the highest it has been for a number of years. Property stocks have been battered by the weak economy, which is playing itself out through increasing vacancy levels, large rental reversions and reduced rental escalations. Much of the sector will struggle to show any distribution growth over the medium term. Our property holdings are concentrated in the A property shares, which we believe offer very attractive risk-adjusted returns and we have a small position in some of the higher-quality property stocks, whose earnings should prove to be more defensive than those of their peers.

Overall, the JSE experienced a disappointing quarter, with the JSE Capped Shareholder Weighted All Share Index declining 5.1% (and with it dragging down rolling 12-month period returns to -2.4%). The weakness was broad-based, but the financial and resource sectors fared the worst – both down over 6% for the quarter.

The industrial sector was down only 2.5%, with the large rand hedge stocks such as Naspers (flat), British American Tobacco (+14%), Anheuser-Busch InBev (+16%) and Bidcorp (+6%) holding up well. Notwithstanding the challenging market returns, our equity holdings performed well on a relative basis. We believe that our equity holdings are currently offering compelling value and have used the weakness during the quarter to add to our position. It should, however, be noted that our domestic equity holdings continue to be skewed towards the global stocks that just happen to be listed on the JSE. Although many domestic-facing businesses are starting to screen as extremely cheap, given the deteriorating macro environment, there is a high probability many of them turn out to be value traps.

On the resources front, our large exposure to the platinum-group metals (PGM) sector contributed meaningfully to portfolio performance during the quarter. Northam Platinum and Impala Platinum (Implats) were up 40% and 37% respectively. Deficits in PGMs have seen the 3E (platinum, palladium and rhodium) basket price continue to rise. Despite their strong run, we still view the PGM stocks as very attractive. Northam Platinum and Implats currently trade on between six and eight times our assessment of normal earnings and still offer material upside to our fair values.

The Sasol share price has collapsed over the past 12 months (down 54%) as further cost overruns relating to the Lake Charles Chemicals Project (LCCP) emerged and management had to announce a delay in the reporting of the company's full-year results to further investigate a breach of internal controls. Our underweight position in Sasol over this time has added to performance. We believe that the results delay is a consequence of control weaknesses identified around the LCCP budgeting process and not centred around the financial statements themselves. Although further cost overruns are unlikely, our biggest remaining concern is that the budgeted profitability for LCCP disappoints on the back of ramp-up issues or pressure on commodity prices.

Nevertheless, we expect the company to now shift to a phase of debt reduction and improved free cash flow generation. Sasol trades on four times 2021 earnings, which is calculated using what we feel are relatively conservative currency and oil price assumptions. This is very attractive for a business of its quality. We have used the share price weakness to increase our exposure but remain cognisant of the risks surrounding recent announcements and are managing the position size carefully.

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Corporate action

The quarter was also characterised by corporate actions in several stocks that the portfolio was invested in. Some of those worth mentioning include:

Prosus, the newly established corporate entity that will house Naspers' global internet portfolio, including its stake in Tencent and its interests in online classifieds, food delivery and online payments. During the quarter, Naspers listed and part unbundled 26% of Prosus to its underlying shareholders. This listing is another positive step by management in its efforts to try and narrow the discount at which Naspers trades relative to its underlying intrinsic value. A foreign listing of Prosus will assist Naspers to pursue its ambitions to become a leading global consumer internet business by giving it access to a wider pool of investors and capital.

Furthermore, going forward, the two-tier corporate structure provides Naspers with more financial flexibility and the ability to more efficiently manage the discount to its underlying intrinsic value by using capital allocation tools such as share buybacks. In this corporate action, we elected to take the full allotment of Prosus shares, given the value unlock opportunity that we expected.

In July, global food and beverage conglomerate PepsiCo announced a takeover bid for Pioneer Foods, at a more than 50% premium to the Pioneer share price at the time. The subsequent repricing of our holdings in both Pioneer and Zeder (whose largest asset is its stake in Pioneer) contributed meaningfully to performance during the quarter. We used the rerating in Pioneer to sell out of our position and redeploy the proceeds into other, more attractive investment opportunities.

Trencor recently announced that it will be unbundling its Textainer stake to its shareholders in the coming months. Coronation has been actively pushing for this unbundling over the last few years and we are extremely pleased that it is finally proceeding. The share price reacted positively – up 37% for the quarter – and this also contributed meaningfully to quarterly performance.

In this volatile and uncertain world, our objective remains to build diversified portfolios that can absorb unanticipated shocks. We will remain focused on valuation and will seek to take advantage of attractive opportunities that the market may present and in so doing generate inflation-beating returns for our investors over the long term.

GLOBAL EMERGING MARKETS

The Coronation Global Emerging Markets Strategy returned -4.6% during the third quarter of 2019, slightly behind the -4.3% return of the benchmark MSCI Global Emerging Markets Total Return Index[1]. The cumulative performance for 2019 remains very pleasing at +23.8%, which is 17.9% ahead of the index return of 5.9%. Over one year, the Strategy has returned 10.0% (12.1% alpha), and over three years, 7.2% p.a. (1.2% p.a. alpha).

Although we are very pleased with these strong short-term returns, the long-term nature of the Strategy makes longer-term returns more meaningful for assessment. In this respect, while the five-year return is slightly behind the benchmark (-0.1% p.a.), the seven-year (2.5% p.a. alpha), 10-year (2.8% p.a. alpha) and since-inception figures (4.2% p.a. alpha) are all pleasingly strongly positive.

Contributors

The largest positive relative contributor to the Strategy during the quarter was New Oriental Education. The share was up by 15.0% during the quarter after delivering positive full-year results (the company's financial year end is 31 May), reinforcing the guidance that margins will improve in the years ahead as New Oriental's heavy investment in new capacity starts to mature.

The company currently earns operating margins of 12%, well below the 18% it used to earn three years ago before it started investing heavily to grow its capacity, which has since doubled. We met with management in Beijing in August, and our positive long-term view on potential was reinforced – the margins on mature operations exceed 20% and unsuccessful sites can be fairly easily shut down if they are not meeting expectations.

Were the business to stop growing today, the ramp-up of New Oriental's already-opened learning centres (which are not fully contributing to revenues), combined with the increase in margins that accompanies this (the company is incurring the full cost of employing teachers and paying rent), could see profits double within three years.

This is in addition to the substantial organic opportunities available to New Oriental, whose market

[1] The volatility of the Benchmark represented in the growth chart above 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.

share is still in the single digits, despite being the largest operator of on-site, after-school tutoring facilities in the country. New Oriental contributed 0.50% of alpha during the quarter; however, the strong share price performance reduced the relative attractiveness of the share, and we reduced New Oriental from a 3.1% position to 2.5% as a result.

The second-largest relative contributor was Wuliangye Yibin (Wuliangye), the Chinese baijiu spirits brand. Although up by 'only' 5.8%, the minimal index weight and negative return of the index mean Wuliangye contributed alpha of 0.39% to the Strategy.

PROPERTY AND BLUE-COLLAR JOBS ARE AFFECTED BY THE BROADER MACROECONOMIC SLOWDOWN IN CHINA.

Over the quarter, one of our analysts visited the company at its headquarters in mainland China for the second time this year, a visit that reinforced the positive steps the company is taking to improve its pricing ladder and increase the share of premium baijiu within its portfolio. Over the last year, Wuliangye has returned 87.1% and has contributed 2.7% to the relative performance of the Strategy. It remains a top 10 position in the Strategy despite this strong performance, as we believe it is a unique asset, capable of compounding earnings at 20% p.a. for the next few years, and this is not yet reflected in the share price.

Other meaningful contributors during the period were British American Tobacco (+5.5% for 0.37% alpha), Brazilian education company Estácio (+14.5% for 0.31% alpha) and global brewer Anheuser-Busch InBev (+7.9% for 0.19% alpha).

Sidestepping Juul

The big news in the tobacco industry was the aborted merger attempt between Philip Morris International (PMI) and Altria. As PMI shareholders (2.5% of Strategy), we were vehemently opposed to the deal and communicated this strongly through a letter to the board immediately upon announcement of the merger talks. The market's reaction to the deal (PMI fell as much as 9% on the day of the announcement) clearly sent the same message to the affected parties. We were against the deal for a variety of reasons, not least of which is the very negative regulatory environment for combustible cigarettes in the US currently, to which PMI would have been exposed through Altria's US operations.

Furthermore, Altria's shareholding in electronic cigarette company Juul is problematic as Juul is a potential competitor to PMI's well-received Heat-Not-Burn IQOS product, which will be launched in the US shortly (by Altria, with a royalty payable to PMI). Juul has come under significant regulatory scrutiny due to the prevalence of teenage vaping, which itself has been partly driven by dubious marketing tactics and an array of flavours that give the impression that vaping is harmless. We believe IQOS has tremendous long-term potential in many markets (it has been very successful in Japan, Korea and parts of Europe already) as a means of reducing the consumption of more harmful combustible cigarettes. We did not want any exposure to Juul, so, as PMI shareholders, the failure of the merger talks was, in our view, a very positive development.

Tensions hit China

On a less positive note, the biggest detractor for the quarter was Chinese classifieds business 58.com, which fell 20.6% for a -0.80% impact. The two biggest 'verticals' within 58.com are property and jobs (blue collar), both of which are (in theory) affected by the broader macroeconomic slowdown being experienced in China. Trade war fears have intensified negative perceptions of stocks exposed to the broader economy and, with 58.com viewed in this light, it has fallen for reasons of sentiment rather than fundamentals.

Towards the end of the quarter, 58.com fell significantly after a competitor Meituan Dianping (a new Strategy holding, which we discuss in more detail lower down) moved into the blue-collar jobs market. One cannot dismiss this development, given Meituan's disruption of other internet-based platforms; however, in our view, Meituan's jobs platform is more suited to matching users of its delivery services with advertisers in the restaurant and service industry. This is a specialist niche within the broader market and, we believe, is unlikely to materially impact on 58.com's appeal for jobs postings. 58.com's earnings before interest, tax, depreciation and amortisation margins (mid-20%s) are below most peers in other countries, despite earning similar gross margins.

Over time, as the business continues to scale up and investment declines, profits should grow at a rate materially higher than revenue growth. 58.com continues to deliver operationally, with revenue up 21% and operating profit up 24% in the first half results to end-June 2019. It now trades on a 12% free cash flow yield (to enterprise value), which is very attractive in our view, and so it remains one of the largest positions in the Strategy.

Other big detractors for the quarter were the relative underweight in Taiwan Semiconductor Company, which returned 19.1% in the quarter and cost the Strategy 0.43% in relative performance. Chinese wealth manager Noah Holdings declined by 31.3% in the quarter and the 1% position (at the >

start of the quarter) therefore cost the Strategy 0.30% in relative performance. The Strategy's other baijiu holding, Jiangsu Yanghe, fell by 17.8% to also cost the Strategy 0.30% in relative performance, while the ongoing political strife in Hong Kong weighed heavily on Hong Kong-listed life insurance group AIA, which fell 12.1% and cost 0.29% in relative performance. AIA generates about 40% of new business in Hong Kong and it is estimated that half of this comes from mainland China. In addition, 30% of new business is originated directly in China. Although it was only a small detractor in the quarter (0.18% negative contribution), the Strategy's Ctrip holding was also negatively affected by China-Hong Kong developments, as travel bookings are a large part of its business, and China-to-Hong Kong travel makes up around 30% of outbound ticketing volumes processed by Ctrip.

Shopping list

There were several new buys in the Strategy, the largest of which was Meituan, mentioned above. Meituan is a platform business offering food delivery services (such as Uber Eats), hotel booking and in-store services such as restaurant bookings, movie tickets and hairdressers (to name but a few examples). Meituan has a number one or two position in its various business niches and leverages its massive scale to gain a cost advantage over weaker peers. In food delivery, it competes primarily with Alibaba-backed Ele.me, while in hotel bookings it has surpassed Ctrip in the lower end of the market (when measured by room nights, but not by revenue, since Ctrip targets mid- to higher-end hotels). Online penetration in most categories remains quite low, so there is still substantial room for the market leaders to take share from offline over time, which will further enhance their cost advantage over time.

THERE WERE NEW BUYS IN THE STRATEGY.

Another new buy was Indian online travel agency (OTA) Make My Trip. We have met this business several times over the years and believed it had significant potential, as it has many similarities to Ctrip, which has been in the Strategy for some time. The Indian market is, however, several years behind China's. India is also a far more cost-conscious market, with lower per capita incomes. The airline industry is dominated by low-cost carriers and the hotel industry is also focused mostly on lower-tier hotels. Travel is still predominantly domestic and for leisure, which is more price sensitive. With more than half of air tickets still booked offline and perhaps 80% of hotels booked offline, the runway for online to take share from offline is significant, and Make My Trip already has more than 50% market share in the online space after acquiring the second-largest OTA in India (Ibibo).

The relatively faster growth of the non-air ticketing part of the business in recent years has resulted in air ticketing revenues making up only a third of revenue, from more than 50% a few years ago. In addition to airline tickets and hotels, Make My Trip offers a variety of value-add services such as train ticket bookings (the state-run railways in India are not easy to book online), car hire, full package holidays, travel insurance and assistance with procuring visas.

As these higher value-add services grow in the mix, we believe Make My Trip's profitability will be significantly enhanced, as it is currently loss-making. Naspers was previously the largest shareholder in Make My Trip, followed by Ctrip, but a recent shareholding structure change has resulted in Ctrip becoming the largest shareholder, with Naspers becoming a material shareholder in Ctrip. We believe that Make My Trip will benefit from having a dedicated OTA as its largest shareholder, since Ctrip has been through a similar development and learning curve in China.

Another new buy in India was Axis Bank, the third-largest private bank in the country. We have previously highlighted the investment case in the private banks in that country as they take market share from the poorly run public sector banks in what is still a fast-growing market overall. Axis is a previous Strategy holding that we sold when it started to approach our assessment of fair value. Like many of its peers that grew too fast, the book quality deteriorated and some time was needed to clean up the bad debts.

A highly regarded new CEO was brought in and the share price recovered strongly. Axis is increasingly becoming a more retail-focused bank, which, in our view, is significantly more attractive than focusing on corporate loans, which are more competitive and can have a bigger negative impact on the book (as we have seen in the bank and its peers historically).

More recently, the (relative) slowdown in the Indian economy, the liquidity issues within the banking sector as a whole and the aggressive provisioning of old loans under the new CEO saw the Axis share price decline by around 20% from its second-quarter peak. At these levels, we believe Axis offered significant upside and we started to build a small position toward the end of the third quarter. As the bank is growing quite fast, it also needed to raise capital, and we were able to purchase most of the position during this capital raise at a discount to the prevailing market price. Subsequent to purchasing the position, the Indian government reduced corporate tax rates, which will be positive for shareholders of Axis and shareholders of some of the Strategy's other Indian pure domestic holdings, like HDFC and HDFC Bank.

The last new buy was a repurchase of Turkish discount retailer BIM, one of the best-performing businesses anywhere in the world over the last two decades. We had sold out of BIM in mid-2018 due to the economic crisis in Turkey and a loss of confidence in the country's government, which looked to be operating in an increasingly populist and haphazard fashion.

BIM has continued to grow its store network through all of this and has gained share by limiting price increases in an environment of very high inflation within the Turkish economy. The Turkish lira, which was one of the worst-performing currencies in 2017/2018, has stabilised, and with interest rates and inflation declining, we believe that BIM will continue to deliver high returns on capital in an improving economy in the years ahead.

Two small positions were sold to zero in the quarter – Global Mediacom in Indonesia (we still retain a small position in free-to-air TV operator Media Nusantara, which is majority owned by Global Mediacom) and bank holding company Itaúsa in Brazil.

Members of the team travelled extensively during the quarter, meeting management of over 100 companies in various locations, as well as conducting site visits to holdings in Russia, China, Hong Kong and Macau. Travel will continue in the fourth quarter, including a visit to Brazil, whose weight in the Strategy has declined to 6.3%, the lowest it has been in several years.

BY FAR THE MOST SIGNIFICANT MOVE DURING THE QUARTER WAS ARGENTINA.

FRONTIER MARKETS

Over the past three months, the Strategy's gross return was -1.8%, while the MSCI Frontier Markets Index[2] returned -1.1%. Since inception, the Strategy's return is +1.8% p.a., which compares to +0.6% p.a. for the index. Index heavyweight, Kuwait, was down -2.9% in US dollars over the past three months. Vietnam (+5.4%), Romania (+3.9%), Egypt (+3.7%) and Sri Lanka (+3.5%) all performed well, but several other frontier markets saw large declines.

Latin America

By far the most significant move during the quarter was Argentina, where the market was down a staggering -48.6% in US dollars. The presidential primary election in August saw the populist candidate, Alberto Fernández, defeat President Mauricio Macri by a far greater margin than expected. The reaction of the market was brutal. The Argentine Index lost almost half of its value in US dollar terms on the day following the announcement, bond markets immediately priced in a much higher probability of default, and the currency lost almost 25% of its value within a week.

The Argentine businesses we own in the Strategy were not spared, and together detracted -2.6% from the performance of the Strategy during the quarter. Policy uncertainty increased significantly for many businesses in the country. This means the level of conviction an investor has on the future cashflows of these companies reduced considerably. As a result, we were not tempted to buy domestic-focused businesses, despite many of them being valued at half of what they were only a few months ago.

However, there are a few Argentine businesses where a large portion of their revenues are generated outside Argentina or are denominated in US dollars. With costs largely peso-denominated, these businesses are well positioned to improve profit margins on the back of the currency weakness in Argentina. A case in point is Despegar.com, the leading online travel company in Latin America, which generates the vast majority of its transactions outside Argentina. In addition, the company has a large cash balance in US dollars. Following the share price weakness during the past quarter, Despegar.com's valuation is even more attractive, and we used the opportunity to add to this position.

India

In Bangladesh, the Dhaka Stock Exchange Broad Index was down -8.8% during the quarter. Sentiment was negatively affected by the ongoing litigation between the largest mobile operator, Grameenphone, and the telecommunications regulator. The regulator is claiming approximately $1.5 billion in fees and taxes from Grameenphone. The regulator even issued a notice requesting that the company explain why its licence should not be revoked. Three months ago, we wrote that we sold out of Grameenphone as we believed the share price did not adequately reflect the risks.

Other frontiers

In Nigeria, the Main Board Index lost -8.2% over the past three months. Banks were under pressure on the back of new minimum loan to deposit regulations. This is an attempt to force banks >

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

to lend more in order to stimulate economic growth. For the banks, this will likely result in lower net interest margins as competition to lend to high-quality clients increases. If banks are going to increase lending simply to achieve the target ratio without proper consideration of the economic fundamentals, we will likely see higher non-performing loans as a result. The Strategy owns only one Nigerian bank, Stanbic IBTC. This bank is well positioned to meet the new requirements, and we are confident that the bank will not abandon its high lending standards simply to boost its loan to deposit ratio.

The largest contributor to the Strategy's performance over the past three months was Eastern Tobacco, the monopoly tobacco company in Egypt, which added 1.0% to performance. We increased the position in Eastern Tobacco during the quarter and this business is now the second-largest position in the Strategy. The company has a new management team that is actively working to transform the company from a bloated state-owned entity to an efficient manufacturing business. The next few years should see improved profitability as the new initiatives bear fruit. What also excites us is the improvement in the board's approach to capital allocation – it is no longer looking at non-core projects and is increasingly focused on returning cash to shareholders.

AFRICA HAS BEEN A TOUGH PLACE TO BE THIS YEAR.

Other large contributors to performance during the quarter were Zimplats (+0.8%) and Dragon Capital's Vietnam Enterprise Investments Limited (VEIL) Fund (+0.9%). On the back of the strong performance of VEIL, we reduced the position during the quarter, but VEIL remains a top 10 holding in the Strategy. VEIL holds many companies that we view as attractive investment opportunities, but for which foreign ownership limits prohibit direct purchases at quoted prices. Buying VEIL allows us to access these opportunities without paying the large premiums required to attract foreign sellers.

The valuation metrics of the businesses we own in the Global Frontiers Strategy are extremely attractive at the moment, with many businesses on single digit price-to-earnings multiples and high dividend yields. If we compare our assessment of the intrinsic values of the companies in the Strategy to the current share prices, it shows that the upside to fair value for the Strategy, as a whole, is currently at one of the most attractive levels since it was launched almost five years ago. While frontier markets can be volatile in the short term, we believe the businesses we own in the Strategy offer very attractive long-term return prospects.

AFRICA FRONTIER MARKETS

As 1 October was the Strategy's birthday, it is useful to use this time to reflect on the year that was, and the road travelled thus far. Over 11 years, the Africa Frontiers Strategy has returned gross 7.3% p.a. This is well ahead of the FTSE/JSE All Africa (ex-South Africa) 30 Index[3], which has returned -1.0% p.a. and is also ahead of the MSCI Emerging Markets Index[4] (+4.7% p.a.) and the MSCI Frontier Markets Index[5] (0.4% p.a.). Given how tough things have been on the continent over this period, we feel that 7.3% p.a. is a reasonable return. After a strong year last year, the past 12 months have been very tough, with the Strategy down 12.5%. The FTSE/JSE All Africa (ex-South Africa) 30 Index is up 2.8% over the same period. The main driver of the current year's weak performance has been the change in valuation methodology to our Zimbabwe assets. The two names most affected, Econet and Delta, have been a combined detractor of 14.5% over the period. Phrased differently, the portfolio, excluding the valuation change in Zimbabwe, was up around 2%, roughly in line with the index.

Africa has been a tough place to be this year, with most indices negative in US dollars over the past 12 months. Ghana (-29.9%), Nigeria (-14.9%), Mauritius (-9.5%), Kenya (-5.7%) and Morocco (-1.3%) have all been weak. Egypt has been the only market with a positive return, up 6.7%.

Pros and cons

Zimplats, another Zimbabwe stock (although Australian-listed and thus not subject to trading and repatriation issues), has been the largest contributor this year, with Egyptian schools operator, Cairo For Investment and Real Estate Development, and Eastern Tobacco close behind. On the other hand, Nigeria has been tough. Of the five largest detractors, ex-Zimbabwe, four of them are Nigerian. While the long-term investment case remains, in the short term, share prices can be volatile.

Stocks in Nigeria have come under pressure as the Central Bank governor continues to pursue a raft of unorthodox economic policies as he looks to defend the value of the naira – at the expense of all else. His latest circular requires banks to meet certain loan-to-deposit thresholds (in practice, more like loans to total funds). This is an attempt to force banks to lend in order to stimulate economic growth.

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[3] Material facts in relation to this index are available here: www.jse.co.za/services/market-data/indices/ftse-jse-africa-index-series/all-africa

[4] Material facts in relation to the index are available here: www.msci.com/emerging-markets

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

In reality, his high interest rates, prohibitive cash reserve ratios and meddling in the currency market are more than enough to offset any potential economic growth benefit that forcing banks to lend will have. The more likely outcome is that competition for high-quality corporate borrowers increases, driving down bank net interest margins. In time, non-performing loans are likely to grow, a function of banks being forced to lend rather than being able to appropriately price risk. We are increasingly worried about the impact this is having on the Central Bank's balance sheet and the country's finances. While we will never be able to predict the event that will bring these activities to an abrupt halt, we do know that they are not sustainable in the long term.

What we bought

During the quarter, we increased our exposure to BAT Kenya, a subsidiary of British American Tobacco (BAT) and the largest tobacco company in Kenya. After several tough years, following the 2015 doubling of the excise duty on cigarettes, the market is showing signs of returning to stability. First-half earnings grew 25% year-on-year and should continue to be strong. Illicit volumes have started to decline. After peaking at 15% of the market last year, they now account for around a 12% share.

Prior to the excise hike, illicit volumes were below 5% of the market. BAT Kenya is a large exporter and is benefiting from an improved economic outlook in a number of key markets. This is translating into increased sales volumes into the East African region. Finally, the move to next-generation products is not limited to the developed markets but is also an area the company is exploring in its home market of Kenya. The potential to migrate consumers from combustibles to nicotine alternatives is significant.

We also increased our exposure to Egypt's largest private hospital group, Cleopatra Hospitals, over the period. Hospital penetration in Egypt is incredibly low, at 1.3 beds per 1 000 people (South Africa in 2005 had 2.8 beds per 1 000) and demand for private hospitals overwhelms supply. Cleopatra has six out of the top 13 private hospitals in Cairo and is well positioned to capture this demand. While organic growth continues to be very strong, Cleopatra is also able to supplement this via greenfield and brownfield acquisitions. As these hospitals are added to the group, the company can exact synergies, improve the standards of the acquired hospitals and drive margin expansion. Sustainable, long-term earnings growth is certainly possible. The big risk is execution, ensuring that the group continues to function at the highest level while growing rapidly.

The Strategy's performance over the past year has been disappointing, but we continue to believe that the write-down of the Zimbabwean exposure was prudent and protects investors in the Strategy. Any improvement in the transactability of the country should see strong improvements in our realisable values.

We remain incredibly excited about the businesses owned in the Strategy. The asymmetry between risk and reward is as attractive as we have ever seen it over our 11 years of investing in Africa. The businesses in the portfolio continue to perform well, and operational performances are increasingly divergent from share price performances. Valuations are at levels we have not seen for many years and our estimate of upside to portfolio fair value is at some of the highest levels we have seen in the Strategy's history. Thank you for your continued support. ✚

* 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

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Coronation Fund Managers
Telephone: +44 (0)20 7389 8840
E-mail: cib@coronation.com
www.coronation.com