corospondent

The Global Quarterly

The power issue

CORONATION

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APRIL 2019

IN THIS ISSUE

Kirshni on point

Feeling in the dark? Shining a light on uncertainty

By Kirshni Totaram

IT'S A COMPLICATED world out there and we have seen a continuation in uncertainty both in South Africa and globally since the beginning of 2019. In this edition of *Corospondent*, we look to unpack prevailing issues, demonstrating how the ability to 'keep your head when all about you are losing theirs"[1] pays dividends in the end.

POWER STRUGGLES IN SOUTH AFRICA

The biggest event in South Africa this year has been the sudden recurrence of load shedding. We had cautioned early this year that Eskom was the biggest, most immediate threat to growth, and that has indeed manifested.

Given the significance of the Eskom issue, we have addressed different aspects, in not one but four articles in this edition, given the severity of the threat to our economy and the urgency required to find solutions. In his article on the investment impact of Eskom on page 8, portfolio manager, Neville Chester, points out that

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[1] Rudyard Kipling, *If*

any recovery is likely to be slow. The unannounced load shedding was detrimental to the psyche of South Africans who are already under economic pressure. Economist, Marie Antelme, echoes this cautious stance in her South African economic review on page 23. She still expects consumer spending to be the biggest driver of growth, and for growth to be marginally better than 2018. But she states clearly that time is of the essence to sort out Eskom's complex issues. In his article 'South Africa's power conundrum' on page 5, portfolio manager, Mauro Longano, tells it like it is in numbers and notes that all stakeholders will have to remain focused on finding a solution and dedicated to implementing what will be intricate plans to keep the lights on.

It's also an election year and a slew of pre-election activity has already begun – political noise is likely to remain high until the National Elections on 8 May. There has been a recent increase in service delivery-related protests across the country and tensions are running high. Whatever the outcome, we expect President Cyril Ramaphosa will try to ensure that key ministries are headed by capable people. Along with interventions at key institutions, this should help to provide some stability to policy and delivery. But really, it's the way in which government manages the Eskom crisis which will give us insight into its wider capacity for reform.

AN UNSURE GLOBAL ENVIRONMENT

Keeping the world in the dark is the uncertainty over the future interconnectivity of the global economy. The outlook for global growth has been worsened by issues in several key economies. While some of these issues should ease over time, it's hard to account for the long-term cost. A perfect example is the 'Brextension' which the UK has been allowed. It pushes back the deadline for the UK to exit the EU to 31 October so that it can avoid leaving without a deal. Fair enough – but it keeps the uncertainty going for longer. Elsewhere, racial tensions have continued across the world – in Paris, the US and in the recent attack in New Zealand. Marie Antelme reviews the global economy on page 27.

STILL FINDING OPPORTUNITIES

While frontier markets are frequently viewed as the preserve of investors with a higher risk appetite, it is apparent that certain business models work far better in frontier markets than in their developed peers, allowing investors some very interesting return opportunities. Global Frontiers portfolio manager, Peter Leger, and investment analyst, Tascha Terblanche, share their insights on one such exciting opportunity, namely mobile money, in their article on page 11.

THE PERILS OF BUYING INTO 'STORY STOCKS'

It is easy for investors to get caught up in the market noise, not wanting to miss out on the 'next big thing'. Unfortunately, the market often drives up the price of favourably positioned assets way beyond their underlying intrinsic value. Deep proprietary research, which is a critical part of our investment process at Coronation, gives you the clarity to cut through this noise and leads to better investment decisions. Equity analyst, Nicholas Hops, takes us through three case studies of different commodity markets to show how detailed analysis can provide the kind of conviction needed to take an alternative view and go against the tide.

PERFORMANCE

Last year was a tough one for most of our strategies. We were truly tested on our belief in hard work and the power of investing for the long term. But we did not waver and kept our eye on the goal, which in our world means striving to ensure that the people who entrust us to manage their hard-earned savings can retire with dignity and feeling secure.

Amidst all the noise in the market this quarter, we are pleased to report that we have seen better returns across all our strategies, many of the key contributors being reversals from the painful losses experienced in the market last year.

HOUSTON, WE HAVE AN INCLUSIVITY PROBLEM

In what was almost one giant step for womankind, the first all-women spacewalk with NASA astronauts Anne McClain and Christina Koch was due to take place in March, which is US Women's History Month. Until NASA realised it had a big (or small) problem – two female astronauts, but only one space suit available in their size. So instead of McClain doing the spacewalk, a male colleague had to replace her.

It is an absurd example of how certain biases and assumptions shape our world, and how individual needs get overlooked. It talks to the lack of practical inclusivity in the workplace and one that I address in my article on inclusivity and diversity on page 18.

I look beyond the importance of achieving diversity in visible terms and highlight the importance of creating a work environment that enables people to be themselves, values their unique talents and perspectives, and makes them feel welcome. Being fully inclusive and harnessing the power of the different ways people think – cognitive diversity – is the key to truly unlocking optimal value in an organisation.

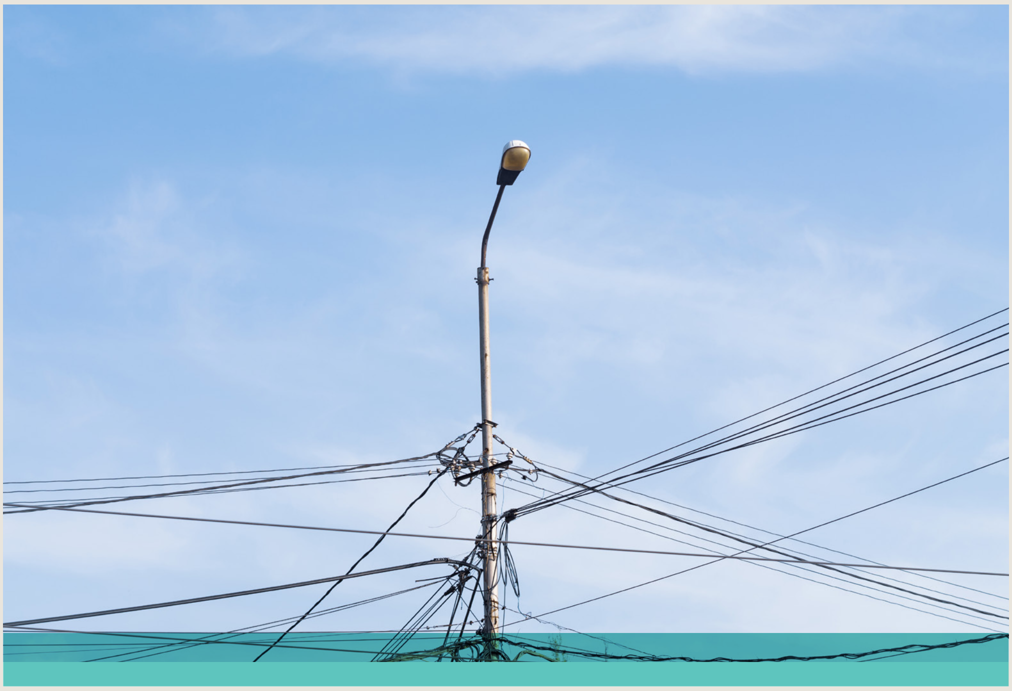
CONCLUSION

In times of uncertainty it has been our experience that staying committed to a long-term investment philosophy provides an invaluable anchor. After a more pleasing quarter for performance, and with our portfolios underpinned by compelling valuations, we remain cautiously optimistic about return opportunities going forward.

Thank you for your continued support and trust. ✚

Kirshni

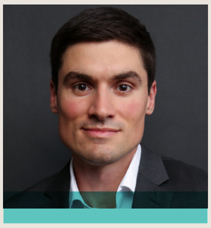
COMMENTARY AND ANALYSIS



South Africa's power conundrum

Keeping the lights on needs dedication to complicated turnaround plans

Mauro joined Coronation's Fixed Interest investment unit in 2014 and is responsible for co-managing the Strategic Cash and Medical Aid Cash strategies. In addition to this, he is involved in credit research and pricing. Mauro has eight years' investment experience.



By Mauro Longano

ESKOM IS ALWAYS a contentious topic, with the very mention of its name causing anguish and frustration for most South Africans. Since 2007, Eskom's 10 different CEOs have been unable to successfully address the issue of load shedding. And, despite the appointment of various task teams, clarity about the problems facing Eskom and the steps required to solve them remain elusive.

This is further inflamed by the alleged corruption highlighted through the likes of the Zondo Commission (as well as the R20.7 billion of reported irregular expenditure) and the failure, as yet, to hold anyone legally accountable. However, it is important that we do not let the facts be clouded by emotion and politics. The problems facing Eskom are complex, and it is important that all stakeholders remain focused on finding a solution.

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Prior to 2007, when load shedding became a ubiquitous term in South African households, government had already been notified of the impending energy crisis. They chose not to act, and this led to former President Thabo Mbeki apologising in December 2007, with the admission, "Eskom was right and government was wrong".

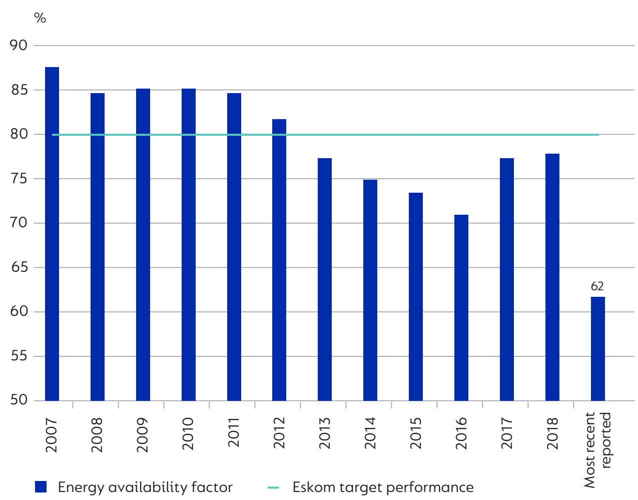
This put into motion the construction of Medupi and Kusile, the mega power stations, which together were to contribute an additional 9 600 megawatts (MW) of generation capacity to the national grid. However, what was to be Eskom's saviour has become its largest liability, as the complexity and challenges of the projects have proved too much. Time delays, cost overruns and poor contractor performance, as well as allegations of high levels of corruption, resulted in the cost estimates for Medupi alone ballooning from a reported R69.1 billion in 2007 to current incurred costs of double that, at R145 billion. The final cost to completion is still unknown, and recent reports of design flaws mean that substantial further expenditure is likely required to make the plant viable.

SUPPLY CONSTRAINTS

Ironically, growth in electricity demand is no longer an issue for Eskom, as electricity sales have fallen over the last 10 years due to consumption having become more efficient. The problem today is different: Eskom has the capacity to meet demand, but it is unable to do so because of units that are either being maintained or have stopped working after years of lack of maintenance.

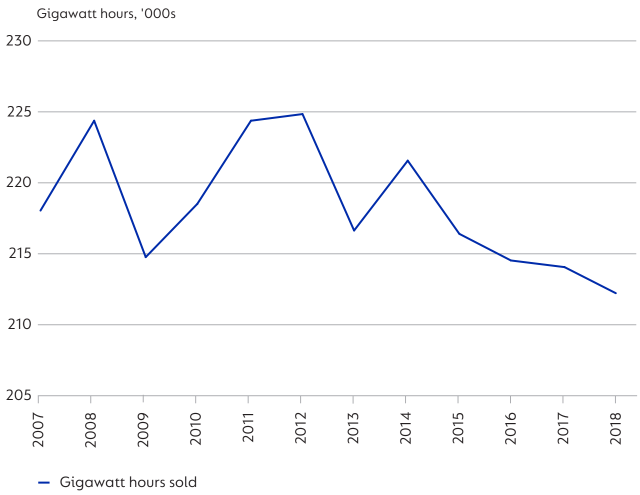
Eskom currently has 46 000 MW of installed capacity, but with the energy availability factor (a measure of the amount of time a plant is available to produce electricity) hovering around 62%, only 28 000 MW seem to be available. Unfortunately, trying to estimate when the situation will improve is a challenge, and Eskom needs time to perform the required maintenance. On this basis, our view is that load shedding will remain a reality for the foreseeable future. In fact, one could say that load shedding is needed to remedy the situation, providing it is efficiently scheduled and properly communicated.

ENERGY AVAILABILITY FACTOR



Sources: Eskom Annual Reports, Eskom Weekly System Reports

ELECTRICITY SOLD



Sources: Eskom Annual Reports, Eskom Weekly System Reports

FINANCIAL WOES

Unfortunately, Eskom's generation challenges are not being assisted by its precarious finances. The Eskom revenue model should be straightforward: it sells electricity for a price regulated by the National Energy Regulator of South Africa (NERSA), and this should be enough to cover the costs required to generate that electricity, together with a modest return. But the tariffs are granted on assumed levels of expenditure, and this is where the model has failed. Costs, particularly on energy and interest, have grown significantly faster than revenue; capital expenditure on Medupi and Kusile continues to increase above budget; and a culture of nonpayment has started to develop among some of Eskom's larger customers. To complicate matters further, the financial pressures have meant that Eskom has reduced expenditure on repairs and maintenance, a decision which has had a significant impact on the performance of its fleet of power stations. The extent to which this underinvestment extends to Eskom's other divisions, such as Transmission, is another concern which could lead to further financial stress in the future.

FUELLING THE FIRE

Eskom relies on coal as its primary fuel source. This was traditionally sourced from Eskom mines located adjacent to coal power stations in Mpumalanga. Over the years, Eskom has not invested in these mines, resulting in their productivity decreasing and additional coal having to be procured and transported from independent coal suppliers at a significantly higher cost. In times of crisis, Eskom has also resorted to using its open cycle gas turbines (OCGTs), which are exceptionally expensive due to their high consumption of diesel. During the 2014 financial year, Eskom spent R10.5 billion on diesel, and it is likely that diesel costs will be elevated while the system remains under pressure. It also bears remembering that the OCGTs were designed to be used as a temporary backup, not run 24/7, and this is likely to result in significant wear and tear on these generators as well.

In addition, Eskom's debt burden has increased to R419 billion, of which R336 billion is under government guarantee. To put this into context, this full debt balance equates to around 9% of South African GDP. The interest required to service this debt is significant, and in Eskom's most recent half-year report, the R26.6 billion of operating cash flow that it generated was quickly absorbed by interest costs of R17.7 billion and capital investments of R17 billion. The deficit was, of course, financed by more debt, and so the vicious cycle continues. Lower levels of revenue collectability are also pressuring cash flows.

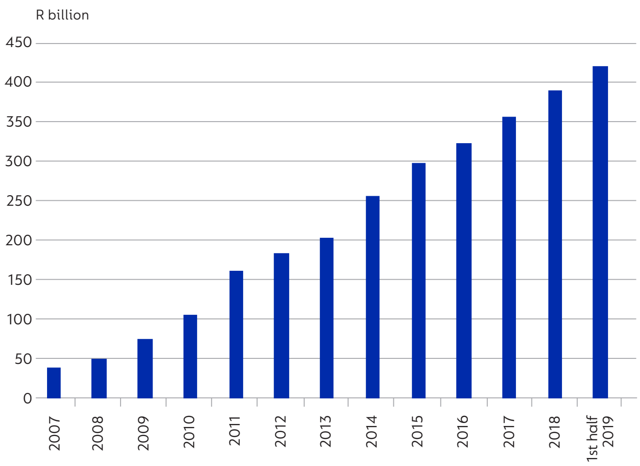
As at 30 September 2018, Eskom had invoiced municipal arrears debt of R17 billion, excluding Soweto's arrears debt – which, at R12.6 billion, is worth a separate mention. This issue is unlikely to be resolved without government support and commitment to ensure consumers pay for the electricity they use.

PER ANNUM INCREASES OVER 10 YEARS ENDING 31 MARCH 2018

Revenue	14.8%
Primary energy	**16.6%**
Employee expenses	10.0%
Finance costs	**18.6%**
Repairs and maintenance	12.5%

Sources: Eskom Annual Reports, Coronation

DEBT SECURITIES AND BORROWINGS



Sources: Eskom Annual Reports, Coronation

BAILOUT

To assist Eskom with its financial predicament, government has committed to injecting R23 billion annually into the entity for the next 10 years. In addition, NERSA recently granted the entity a 13.8%[1] tariff increase for its 2020 financial year, with 8.1% and 5.2% increases stipulated for the subsequent two years. In our view, this is unlikely to be enough, and Eskom, together with its stakeholders, will need to make difficult decisions to reduce costs going forward. The recently appointed Eskom CEO, Phakami Hadebe, and the Chairman of the Board, Jabu Mabuza, have both been shown capable of turning around struggling entities in their previous roles at the Land Bank and Telkom, respectively. However, Eskom is a political minefield with many vested interests at play, complicating any potential restructuring and turnaround plan.

SO WHERE TO FROM HERE?

As a first step, government has proposed unbundling Eskom into three separate units: generation, transmission and distribution. This concept is not new and has been proposed several times over the last two decades. More importantly, however, this model is more in line with international standards and has also been followed by other African countries. The benefits are simple: each division can focus on its own revenue and costs, thereby driving efficiencies, and improving accountability and governance. But perhaps the most important benefit for the public will be the associated improvement in price transparency and competition. While not an immediate solution to load shedding, allowing multiple participants to be involved in the broader energy market should, over time, improve the integrity and resilience of the electricity system. In our view, unbundling is certainly a step in the right direction, but achieving it will not be easy.

Creating new legal entities and transferring existing assets to them will take time and additional costs will have to be incurred. Furthermore, there is the question of what Eskom does with its enormous debt burden and how, if at all, this is allocated to the newly separated entities. Government and NERSA also need to move quickly to ensure that the legislative and regulatory frameworks are in place to allow reform to happen.

One way or another, the market will solve the electricity crisis, and the role of Eskom as the sole provider of electricity will diminish. How much more discomfort South Africans will endure before this happens, however, is a question that ultimately only government can answer. +

[1] A 9.41% tariff increase, together with a 4.4% regulatory clawback

Eskom: the investment impact

Bad news for economic recovery, business and consumer confidence, and jobs

By Neville Chester

Neville is a senior member of the investment team, with 20 years' investment experience. He joined Coronation in 2000 and manages Coronation's Aggressive Equity Strategy.

WHILE THE ANNOYANCE and frustration of dealing with load shedding has impacted our personal lives, the impact on the economy and the investment climate is of far greater concern. There was a rude awakening in December 2018 when the spectre of renewed load shedding arrived, something we all believed had been done away with in 2016. And its impact was immediately felt in the most important month in retailers' lives, the December holidays.

SENTIMENT

The unannounced arrival and high level of load shedding had a hugely detrimental impact on the psyche of a consumer who was already struggling to deal with a year that included increases in VAT, interest rates and municipal rates; numerous commissions detailing allegations of vast corruption across the country; and the continuous job shedding that was the inevitable result of these factors on our stretched economy. While South Africans are generally resilient and have dealt with many challenges over the last decade, rolling blackouts and the inability to indicate how long load shedding will continue have further undermined South African consumers' confidence in the future. The net result of this is significant curtailment of consumption expenditure and capital investment.

Whether it is being less inclined to eat out, purchase an additional item of clothing, or delaying a new car purchase or a home upgrade (except for buying solar panels and a battery), the lack of confidence derails spending. This then obviously impacts heavily on the various businesses providing these services and products, resulting in fewer sales, lower profits and potential losses. This in turn could lead to further job cuts and potential insolvencies – the classic negative reinforcement spiral downwards, which will be tough to arrest without some kind of external input.

While sentiment is not something tangible, it undoubtedly has an enormous effect on the economy.

The high levels of emigration that have become evident in 2018 are also likely to remain elevated by fears over the future of the power system in the country, further eroding the consumer and tax base in South Africa. So, while sentiment is not something tangible, it undoubtedly has an enormous effect on the economy from the consumption side. This then feeds into corporate investment, as companies that see no growth in the local environment will not invest in further capacity, since there is no investment case to be made for, or return to be generated from, this additional investment.

PHYSICAL IMPACTS

The rolling blackouts arrived suddenly and without warning but, due to our experience from earlier in the decade, we have established systems to deal with them. Individuals and corporates quickly became accustomed once again to factoring the daily schedules of load shedding into their lives. However, some businesses are able to handle the daily shedding better than others.

Generally, industrial customers who operate directly on the Eskom grid and who are advised well ahead of time as to the level of load shedding coming can adjust their processes to factor this in. They can take steps to ensure that no energy-intensive processes are scheduled for the downtime, nor in progress when the power drops, or that they have enough backup power to handle these fluctuations. This does not mean there is no negative effect, as efficiencies are impacted by having to move processing around, and the cost of overtime, backup facilities and running power off diesel as opposed to grid power is significantly higher.

This cost gets passed on to the end-consumer, or is borne by the company itself, putting its own profitability under pressure. In the difficult consumer environment that we find ourselves in, the ability to pass costs on to the consumer has been very limited, so in most cases these costs are being borne by the companies, resulting in the aforementioned cost cutting, job losses and ultimately corporate failures. Industrial customers operating on municipal grids are not so fortunate, and generally suffer the same vagaries of load shedding as the typical residential customer. In the retail environment, there is obviously less mitigation that companies can implement. If the power goes down during key sales periods like lunchtime and late afternoon, there is no way for them to capture sales from consumers who will not come back at a later time. The restaurant and quick service restaurant industry is particularly exposed here.

While many individual retailers have implemented their own backup power generation, particularly those with cold chains to protect the quality of fresh foods, the fact that the overall shopping centre is dark, or that streets are gridlocked, will still deter any potential shopper from venturing out to find the one shop that still has its lights on. This impact will clearly also be felt by the various landlords, as lower sales put pressure on rent renewal agreements, and those that do put in additional backup power sources need to fund this and attempt to collect these additional costs from their tenants.

As with the industrial sector, the mining industry is more flexible in dealing with the fluctuating power supply and, as massive customers of Eskom, generally get better line of sight into coming outages. As important drivers of the economy and large paying customers, they are also receiving better consistency of supply, although when Stage 4 load shedding hits, they also suffer rolling outages and, if this becomes the norm, it will definitely have an impact on their ability to produce at current levels.

Those companies that will feel the brunt the most are the various small to medium enterprises (SMEs) of all types of industry that do not have the balance sheet to be able to put in place alternative measures to handle power outages. Drive down the main street of any town during a power outage and you will see the multitude of small service outlets, be it hair salons, takeaways or small retailers that cannot function without power, but cannot afford to implement alternatives.

COSTS

As is evident from all the above, load shedding comes at a significant cost. Ignoring the fact that Eskom needs to pass through significant price increases over the next few years to recover the costs of the enormous debt that they have built up over the past decade, electricity consumers have to incur additional costs to deal with security of supply.

Most companies we have spoken to indicate that the cost of using diesel generation is three to four times that of current Eskom power. This ignores the significant capital outlay required to buy additional generation capacity in the first place. Energy-intensive

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industries, where power is a large part of their cost base, will obviously feel this the most. For example, for gold mining companies, which require significant ventilation and cooling deep underground, 20% of their cost base is electricity. If this grows at double digits for three to five years, it erodes margins massively in an industry already under significant pressure.

What is important to know for industry is the extent of the problem and its likely duration. Short-term load shedding, and mainly at Stage 1 or Stage 2 will require a significantly different response than multi-year Stage 3 and Stage 4 load shedding would.

While the above deals with risks posed by power generation, it is becoming increasingly evident that there are major issues looming on the transmission side. Over the years, Eskom has underinvested in this network as maintenance and re-furbishment plans were cancelled. Even when it is in a good state, the transmission network is not designed to handle the repetitive on/off fluctuations of power very well and in its reduced state we have seen numerous substation failures. In addition, in a country where cable and metal theft is rampant, having long periods where cables and equipment are not carrying live current has seen a dramatic uptick in cable theft and vandalism. The cost of this replacement is often picked up by the various municipalities and needs to be recovered by additional increases in electricity prices or overall rates charged.

CONCLUSION

Given the above, our investment stance has remained one of caution on the South African economy. Any recovery is likely to be slow. From a South African equity perspective, we are avoiding discretionary-spend retailers and businesses that are heavily reliant on the growth of the overall economy.

Our large exposures remain global businesses listed on the JSE and where we can find value in defensive South African businesses, such as nondiscretionary retailers and healthcare businesses. In addition, we remain exposed to both global and local miners where operating fundamentals are robust enough to deal with the impact of load shedding.

In South African fixed income and property, we have increased our exposure to bonds after a long period of owning very little in these asset classes. While still remaining underweight and concerned about the fiscal situation given low growth and state-owned enterprise debt, we feel that real rates of return are attractive, as we have seen 10-year bonds sell off to yields in excess of 9%, while inflation has been steady in the 4% to 5% range. South African property faces more significant risks of negative reversions and lower inflation-linked increases from tenants, while at the same time having to deal with higher costs and municipal rates, making it less attractive in this environment. ✚

The rise of mobile money in frontier markets

Where the frontiers of consumer need, technical innovation and pragmatic regulation meet

By Peter Leger and Tascha Terblanche

Peter is head of Global Frontiers with 20 years' investment experience; Tascha is a Global Frontiers investment analyst.

IT IS EASY to know what a frontier market is when you are in one, but defining it from beyond its borders proves somewhat more elusive. Frontier markets are typically economies where the usual consumer brand suspects are largely absent: large-scale, production-type multinationals such as Heineken, Anheuser-Busch InBev and British American Tobacco may have taken root, but familiar consumer brands such as Starbucks, McDonalds and KFC have yet to establish extensive footprints in the somewhat virgin market territory.

While these markets are frequently viewed as quite fragile and high risk, it is quickly becoming apparent that certain business models work far better in a frontier market than in a developed one, allowing investors some very interesting return opportunities. One such an opportunity is mobile money (MM).

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In the June 2017 edition of *Corospondent*, we wrote about the parallels between two MM businesses, bKash in Bangladesh and M-Pesa in Kenya. These businesses have done well and we continue to hold both companies in our Africa and Global frontier market portfolios.

MM businesses in frontier markets are fascinating subjects. It is an industry born from a marriage of consumer need, legacy high-cost banking infrastructure and exceptional technical innovation, and one that produces fast-growing, profitable businesses. Globally, the MM industry processed $1.3 billion a day in 2018, with the number of registered MM accounts increasing to 866 million, making MM the leading payments platform for the digital economy in several emerging and frontier markets[1].

In 2018, there were 272 MM businesses across 90 countries. Of these, 62 had more than one million active users, compared to only 13 in 2013[2]. Having investigated a number of payments businesses globally, there are a few that stand out for us: M-Pesa in Kenya and Tanzania, EcoCash in Zimbabwe, Orange Money in West Africa, MTN MoMo in Ghana and bKash in Bangladesh. These markets have a few things in common that have supported the growth of MM. The most significant in our view are the following:

1. Large unbanked populations that are in dire need of convenience and an affordable, secure way to complete very simple transactions

An inadequate legacy banking system in frontier economies renders a large percentage of the population unbanked, while mobile telephony has enjoyed huge penetration. Mobile phones play a central role in the lives of these users, creating higher levels of trust in mobile services than elsewhere.

[1 & 2] GSMA 2018 State of the Industry Report on Mobile Money

2. Pragmatic regulators with an approach that enables financial access

When paired with a supportive regulatory system, a fertile environment is created for the formation of formidable mobile financial services businesses that can grow from concept to profitability in a very short space of time. And, in so doing, these businesses aid in the financial inclusion – and consequent economic liberation – of millions of people.

MOBILE MONEY BUSINESSES AS INVESTMENTS

Some of our best investments have been when we have paid a low multiple on low earnings. For the MM businesses we like, both these metrics hold true.

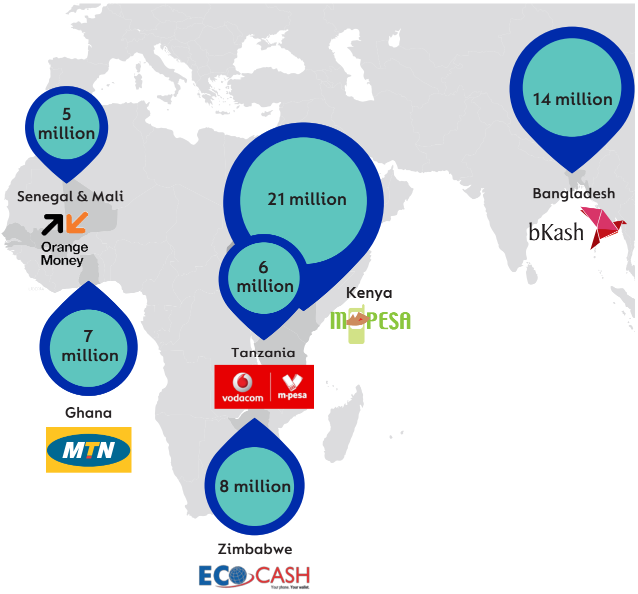
Current earnings are low

The profitability of MM businesses in the very early stages of their lifecycle is a characteristic that is often in stark contrast to what we see in developed markets. International payments businesses are often lossmaking, whereas our estimates indicate that EcoCash and M-Pesa, for example, have net profit margins in the region of 20%.

Across MM businesses, we believe there is significant potential for earnings growth driven predominantly by margin expansion. Over the long term, the true value of these businesses lies in the payment and transaction ecosystem being created. Once this ecosystem is established, there is almost no limit to the auxiliary services that can be added.

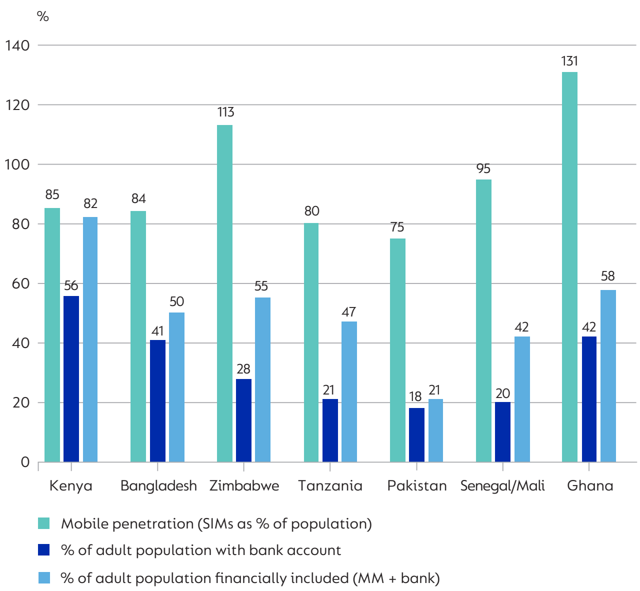
Services such as loans, insurance products, merchant payments, utility payments, salary disbursements and even asset management services can easily be added – all of which usually come with very high margins. Current levels of earnings are therefore well below what we believe to be normal.

ACTIVE USERS OF MOBILE MONEY SERVICES



Source: GSMA 2018 State of the Industry Report on Mobile Money

LARGE UNBANKED POPULATIONS WITH MOBILE PHONES



Sources: Coronation estimates, World Bank Global Findex

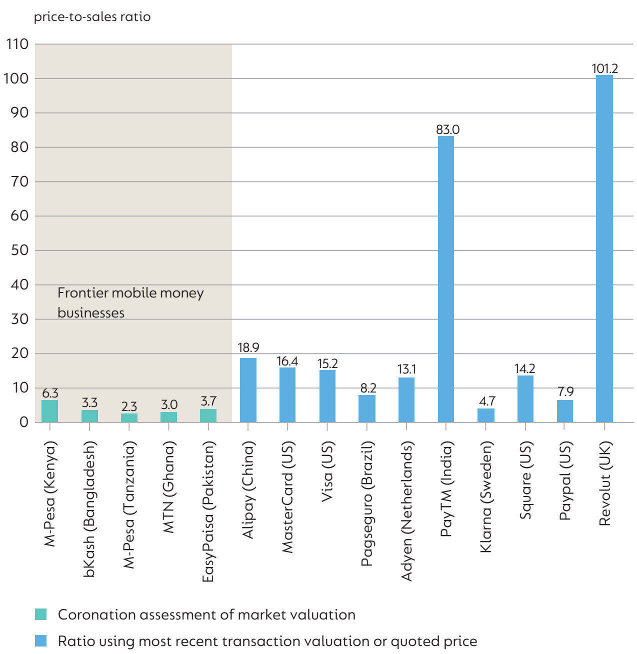
M-Pesa in Kenya serves as an example of this dynamic. In 2012, traditional person-to-person transfers accounted for 95% of revenue. By 2018, this had dropped to 74%, as M-Pesa had added loans, insurance products and an e-commerce business to its platform. Product proliferation is one of the key drivers of the significant margin expansion witnessed over the same period. M-Pesa has also packaged its capabilities into a targeted value proposition in DigiFarm, an M-Pesa platform that currently allows around one million farmers to access funding and sell their goods.

The opportunity to add to the ecosystem once it is established is remarkable. Alipay, the payments platform of billionaire Jack Ma's Alibaba, is arguably the most successful global mobile financial services provider. Over time, it has added food ordering, ride hailing, insurance and investments products to its offering, supporting its valuation of $150 billion.

Multiples are attractive

What really excites us as valuation-driven investors is that these businesses tend to trade on much lower multiples than developed and even emerging market peers – you get a whole lot more mobile bang for your buck. The graph below shows this by comparing the price-to-sales (P/S) ratios.

MOBILE MONEY BUSINESSES TRADE ON LOWER MULTIPLES THAN DEVELOPED AND EMERGING MARKET PEERS



Sources: Best estimates based on internal research, Bloomberg and publicly available media reports; most recent valuations and sales/revenue figures used

One of the reasons we believe MM businesses trade at such large discounts in frontier markets is that they are not listed separately. The only way an investor can access such a business is by owning the parent company, usually a telecommunications company or bank, which typically trade on lower multiples. Given the higher-quality income stream and the growth potential of MM businesses, we believe they should trade on higher multiples. However, the nascency of these businesses mean that they are a small part of current earnings, so often very little attention is paid to understanding the quality of these earnings.

A case in point is bKash, the largest MM business in Bangladesh, which is 51% owned by private commercial bank, BRAC Bank. In 2018, Alipay acquired a 20% stake in bKash in a deal that valued bKash at $700 million. The implied P/S ratio of this valuation is 3.3 times, well below that of peers, even those in frontier markets.

bKash currently has around 30 million subscribers; multiple times that of its closest competitor and compared to only 48 million formal accounts held by banks in Bangladesh. This scale creates a network effect that continues to attract more users and service providers to the ecosystem. The growth opportunity is extraordinary: revenue per user is still only about half of what we see in more mature markets such as Kenya and the profit margin is much lower, because bKash continues to invest in the business.

We believe the Alipay deal should be transformative for bKash. Alipay brings with it years of experience, more sophisticated technology and a new dimension to customer acquisition, which is shifting the business even further towards a revenue growth model rather than a profit-driven model.

As a comparative, when looking at the valuation of mobile network operator Safaricom in Kenya, we estimate that the market currently assigns a value to M-Pesa in the region of $4 billion. We see no reason why bKash should not be worth at least as much as M-Pesa – Bangladesh's population is more than three times that of Kenya, with only 41% of adults having a bank account, compared to 56% in Kenya.

RISKS – THE THREAT OF PAYMENT APPS

When building an investment case, we spend a lot of time investigating the risks. Regulation is the most obvious risk associated with payments businesses and, indeed, financial institutions more generally. But a risk that is perhaps less widely appreciated is disruption from messenger apps such as WeChat, WhatsApp and Facebook that are entering the mobile payments space.

Messenger apps have the same ability to leverage their existing platforms (which already capture consumer attention and enjoy an established degree of trust among users) when introducing mobile payment services. This is what KakaoTalk is doing in Korea and WhatsApp in India, and what Line is now hoping to do in Japan, Taiwan and Thailand.

The graph overleaf shows the most popular social messaging apps around the world, with a number of these either already offering payment services or likely to soon develop a payment offering (WhatsApp, Facebook, Line, WeChat and KakaoTalk).

One of the key constraints messenger apps face in frontier markets is transferring money into the user's mobile wallet. MM players use large agent networks that physically receive deposits and process cashouts – in Bangladesh, bKash now has more than

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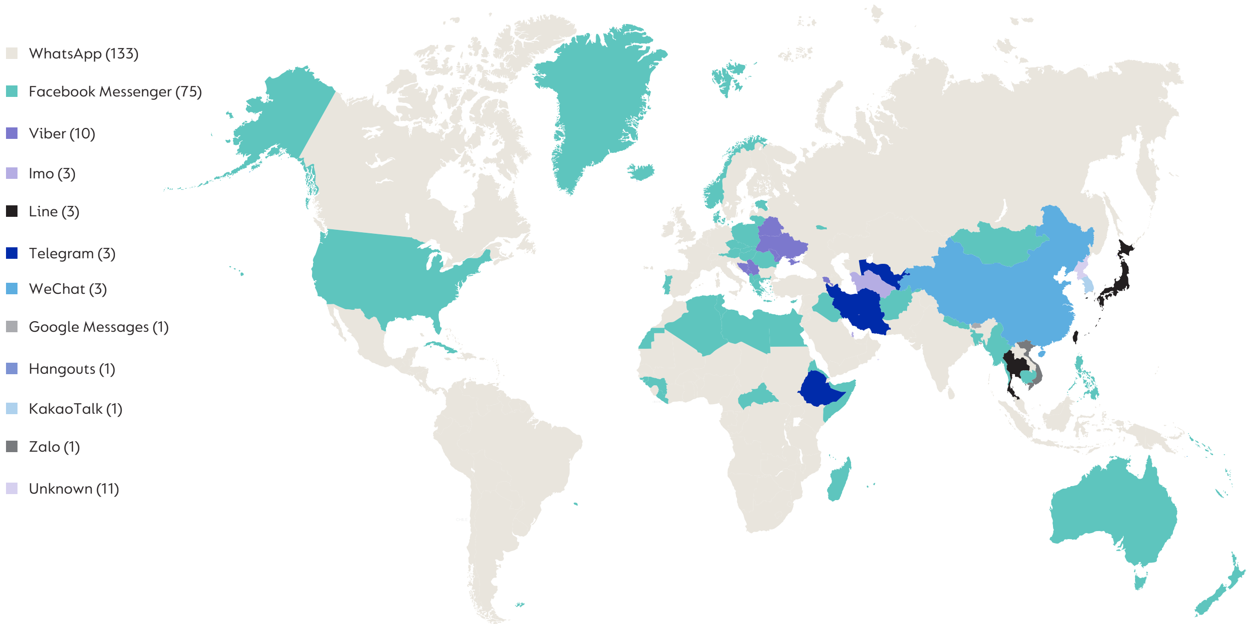
TOP SOCIAL MESSENGERS AROUND THE WORLD

The most popular messenger app by country/territory in December 2018



Note: Figures in parentheses in the legend represent the number of countries/territories in which each platform is the top-ranked messenger app.

Source: Hootsuite, January 2019; based on SimilarWeb's algorithm integrating current installs from the Google Play Store with active app users (December 2018).

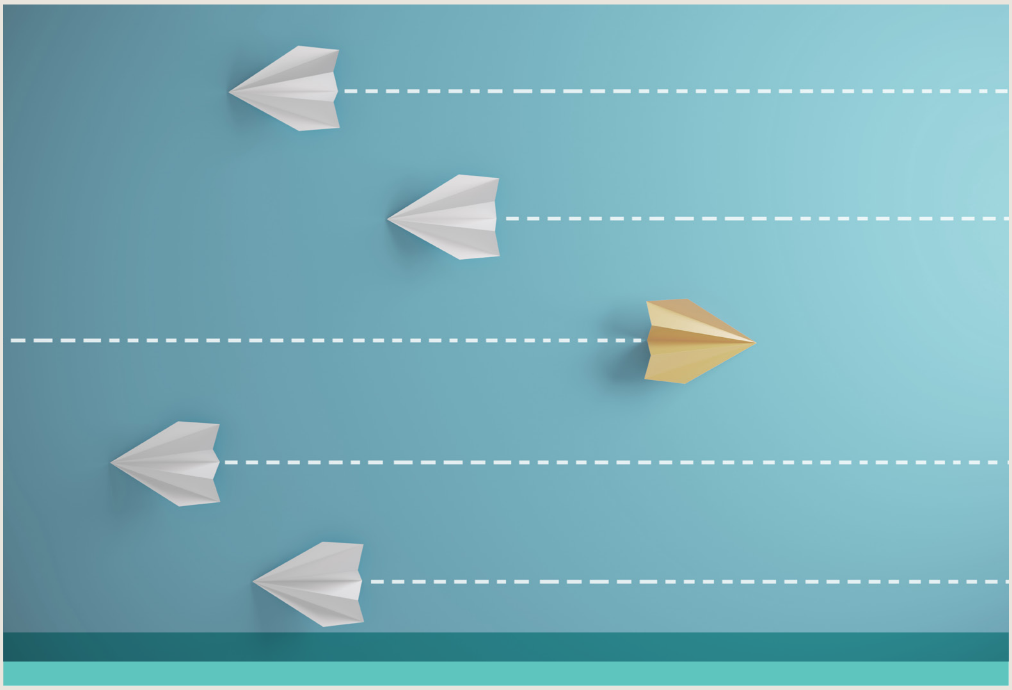
200 000 agents doing this. Messenger apps typically partner with banks when launching payment functions and require users to link their bank card – therefore requiring a bank account. This is what WhatsApp is doing in India, where 80% of the adult population has a bank account, compared to 41% in Bangladesh. The lack of bank accounts in a typical frontier market is therefore problematic for messenger apps.

The extent of smartphone penetration in frontier markets presents another barrier. While mobile phone penetration is typically high, smartphone penetration is much lower, explaining the success of MM businesses that leverage unstructured supplementary service data-based (USSD) technology for feature phones.

We have seen several case studies of collaboration rather than competition in frontier markets. In Africa, a recent partnership between WhatsApp and telecommunications network provider MTN has allowed MTN customers to recharge airtime and check their bank balances using the WhatsApp platform. We have also seen large players such as mobile and online payment platform Alipay partner with MM businesses. In addition to bKash, Alipay purchased 45% of Easypaisa, the largest MM player in Pakistan. In Kenya, Alipay has partnered with Safaricom to allow customers to use M-Pesa when paying on Alipay's online retail service, AliExpress. It targets around 100 000 traders in Kenya who source goods from China each month.

While messenger apps and large players such as Alipay pose a risk, partnering with MM businesses that have large, established ecosystems that already benefit from network effects likely makes more strategic sense than meeting them head on.

Over the past 25 years of investing, we have learnt time and time again that the combination of low earnings and low multiples can result in very rewarding investments for our clients. We believe MM businesses are already showing these same signs and will be multi-year compounders, making them among the most compelling investment opportunities in our universe. ✚



The dangers of headline investing

Only deep, proprietary research sharpens analysis, providing the necessary focus to look through the noise

By Nicholas Hops

Nicholas co-manages the Resources Strategy and is an equity analyst within the South African investment team. He joined Coronation in 2014 and is a CFA charterholder.

IT IS PERILOUSLY easy for investors to get caught up in the sentiment of the day and buy into 'story stocks'. Not wanting to miss out on the next big thing, the market often drives up the price of favourably positioned assets, far beyond their underlying intrinsic value, and pushes the perceived losers far below theirs.

At these times, there is often considerable emotion involved, and the disconnect between price and value can be extreme. At a time when headlines scream 'buy' or 'sell', almost regardless of price, only detailed analysis can give one the kind of conviction needed to take an alternative view and go against the tide. The following three commodity markets serve as useful case studies.

UNCOATED FINE PAPER

For at least a decade, paper has been written off as an attractive investment, with most observers expecting a relentless and brutal

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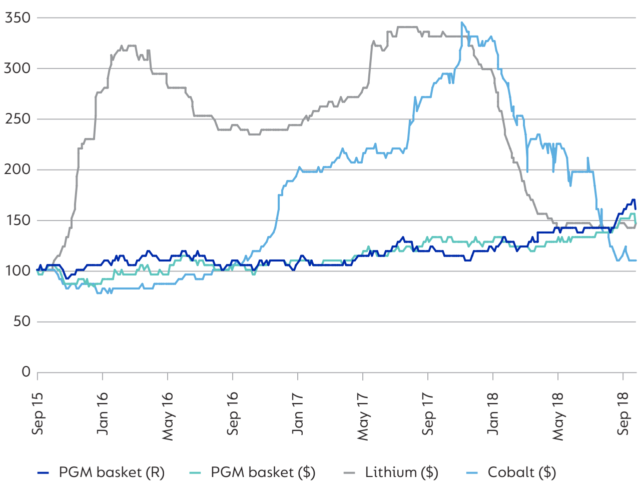
decline in demand. Despite this bleak outlook, Mondi has grown earnings before interest and taxes from its uncoated fine paper division almost threefold since 2007. This surprising outcome is due to a combination of constrained supply (a consequence of underinvestment) and demand proving to be more resilient than most expected. Mondi's low-cost assets and excellent management team have thrived through more than a decade of declining demand. The clear learning in this case is the danger of obsessing over one variable without giving due focus to the interaction between supply and demand, which is fundamental to the price discovery process in any market.

THERMAL COAL

This is another commodity market in which most observers agreed that demand would decline as renewable energy took market share. As a consequence, many investors wrote off coal assets as an investment. What this negative thematic view once again failed to consider is the intersection between supply and demand.

Although thermal coal demand will decline over time, it is likely to remain more resilient than many expect. In addition, underinvestment in supply has, and will likely continue to, lead to constrained supply. This has resulted in supply deficits and price increases (over 140% from trough to peak). We expect constrained supply to endure and would therefore not be surprised to see prices remain elevated above incentive prices in the years to come.

METAL PRICE PERFORMANCE (INDEXED TO 100)



Source: Bloomberg

ELECTRIC VEHICLE COMMODITIES

When the Volkswagen emissions scandal ('Dieselgate') broke in September 2015, it coincided with the rise of Tesla as an automaker and battery electric vehicles (BEVs) as an alternative drivetrain. Tesla's share price has risen sevenfold in the last seven years and its market capitalisation is comparable to that of traditional automakers such as General Motors (GM) and Ford, despite the fact that the company has struggled to turn a profit and produces only 3% of the vehicles that GM produces. At the time, headlines announcing the death of the internal combustion engine were everywhere.

Within six months of 'Dieselgate', the price of lithium, a key component of BEVs, went up over three times. Cobalt, another key component, started to rally a year after the scandal broke and went up threefold in the following two-and-half years. Prices of lithium and cobalt rose to multiples of their incentive prices and existing producers were enjoying super profits. In contrast, when cobalt and lithium hit their peaks in March 2018, the platinum group metals (PGM) basket price was trading well below marginal cost, and up to half of the South African industry was burning cash.

The BEV thematic was everywhere as investors chased the long-term opportunity and shunned the technologies that they stand to displace. Fast forward 12 months and the rand PGM basket is up 43% – close to lifetime highs – while lithium and cobalt prices are down 56% and 68%, respectively. As we have noted before, we are believers in BEV technology in the long term, but expect the process to be evolutionary rather than revolutionary because the hurdles to mass adoption are significant and they will likely take decades to overcome.

After an enormous amount of detailed work on the future of the drivetrain and ridesharing, we have concluded that demand for PGMs will be more resilient than most expect. We are of the view that mass adoption will take decades and that hybrid vehicles with similar, and in some cases higher, PGM content than standard cars will bridge the gap between today's cars and BEVs.

Regulatory tightening supports PGMs

In the medium term, we also expect PGM demand to surprise positively as a consequence of tightening emissions standards globally. In addition to this, 'Dieselgate' placed the auto industry under the microscope, and exposed the industry's collusion and manipulation of emissions testing.

Car manufacturers will soon have to meet far tougher standards than in the past. Vehicles in the EU and China will have to pass emissions tests that cover the first 160 000 km to 200 000 km of a car's life, as opposed to previous testing simply at the point of production; and that assess emissions in real-world driving conditions, as opposed to in a laboratory. The tightening of emissions legislation has large benefits for the broader climate as well as local air quality; PGMs are a key enabler of this while the slow mass adoption of BEVs takes place.

In addition to this, material underinvestment in mine supply over the last decade means it will take many years before supply can meet current demand. We therefore expect structural PGM market deficits to persist for at least the next decade. Although prices may appear elevated, with the rand PGM basket up 45% off 2018 lows, we estimate that prices are only now close to incentive prices, enabling PGM miners to earn no more than a fair return on their invested capital. This is in sharp contrast to the lithium and cobalt price rallies, where prices last year hit multiples of incentive prices for both commodities.

CONCLUSION

Scrutinising what is in the price is a critical consideration for making any investment decision. When the market gets overly negative on a story, an opportunity is often provided for investors who can cut through the almost deafening noise and take the long-term view.

At peak negativity in the PGM sector last year, Impala Platinum (Implats) and Royal Bafokeng Platinum both touched price-to-book lows of 0.15 times. Impala's market cap hit R11.7 billion, down 94% from peak levels and roughly equal to the cost of just one shaft at the Implats lease (compared to its 11 shafts and four additional mines). Although Implats was the extreme case in the sector and its peers traded at less depressed levels, they also offered significant opportunity (with less risk).

As a counterweight, investing where sentiment is extremely positive and prices are already high can be dangerous and often carries the risk of a permanent loss of capital. +

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.

Accessing the diversity dividend

Why being (and being allowed to be) yourself at work is valuable to your organisation

By Kirshni Totaram

Kirshni is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity portfolio. Kirshni joined Coronation in 2000.

AS SOUTH AFRICANS, our complex history has ensured that we inherently understand the deep need to nurture diversity and inclusion at every level of government, society and business.

There are essentially two kinds of diversity, and considering both is useful when it comes to understanding how they impact an organisation for the better.

Identity diversity refers to diversity of race, gender, ethnicity and age, whereas **cognitive diversity** is the diversity in people's perspectives, culture, socioeconomic circumstances and education.

In South Africa, achieving identity diversity in its employee profile is an obvious goal for any business in order to correct the inequality of the past and appropriately reflect the demographics of our country. But beyond the benefits of identity diversity in the workplace, more global companies are realising the value created by tapping into cognitive diversity.

LOOK BEYOND VISIBLE DIVERSITY

South African businesses, in particular, are very familiar with the identity diversity part of it, to a large degree driven by broad-based black economic empowerment (B-BBEE) legislation that impacts companies operating within the South African context. And, depending on who you are, the mere mention of B-BBEE incites very different feelings and responses. But I want to address and unpack the big casualty to the heavy focus on headline statistics – the concept of cognitive diversity and inclusion, i.e. creating an environment where people can be who they are, that values their unique talents and perspectives, and makes them feel like they belong. I believe the 'inclusion' component captures the zeitgeist of this complex topic and is key to unlocking the diversity dividend.

For those of us operating in the asset management industry, embracing true diversity and inclusion seems obvious. Our environment is characterised by competitiveness and uncertainty, and thriving in that context requires creative thinking. This is exactly what makes diverse collaborators better equipped to face these challenges.

Cognitive diversity means recognising what isn't always visible in people, embracing this difference, and actively including people who think differently, and have differing viewpoints and skill sets. This is the really difficult part. Our South African experience has shown that looking beyond the many superficial assumptions based on identity has been one of the biggest challenges. This, in turn, creates a barrier to digging deeper and identifying the cognitive – something that we have had to work hard at changing.

Improved cognitive diversity goes a long way to boost collective intelligence among teams

Harvard Business Review[1] has reported that teams solve problems more effectively when they are cognitively diverse. Researchers looked closely at how individuals with different perspectives or information processing styles add value in a team that is tackling new challenges. The results showed a significant correlation between high cognitive diversity and high performance, which makes intuitive sense. When we take on a new challenge, we need to balance what we know with discovering what we don't know that might also be important. So, it's valuable for everyone involved to be able to apply their unique expertise to the task at hand.

THE BARRIERS

Visibility

The problem is that cognitive diversity does not come with a well-printed label and is hard to detect at face value. A person's race, gender, culture or generation may not necessarily tell us how that person thinks and processes information. It takes effort to draw out those internal differences and harness the benefits, the 'how' of which I discuss further on.

An organisation's culture

Cognitive diversity can be restrained unintentionally by an organisation's cultural barriers. It is normal and natural for people to gravitate toward others who think and express themselves in a similar way (aka 'group think'), and so organisations often end up with like-minded teams. This is called functional bias and research globally continues to show that people have a more positive skew towards individuals who have the same qualifications and went to the same schools or universities as themselves. The result is low cognitive diversity. It's a problem because teams with little cognitive diversity have limited ability to see things differently and engage creatively and innovatively. This can become a material decision-making handicap in fast-changing and complex environments.

Organisational beliefs and setup

In addition, an organisation's beliefs about diversity creates a self-fulfilling cycle. Industries and companies that view diversity as important and actively implement it in their recruitment, capture the benefits from it. Those that don't, don't. Diversity creates positive benefits when people ***believe*** in its intrinsic value. They don't see it as an obligation or a social tax. Because when you value diversity, you encourage diverse idea exchange. Research has shown that truly diverse teams can develop more innovative ideas. When people from different contexts work together, their unique perspectives often lead to greater creativity.

Tied to this is the fact that diversity does not work without psychological safety. People only contribute unique ideas to the group when they feel comfortable enough to speak up and present a contrarian view. It is difficult and stressful for those who do not fit into an entrenched culture or identity group. Many choose to hide important parts of themselves and importantly, their ideas.

Experimental studies further support this, showing that psychological safety is key to idea generation. Increasing a team's collective intelligence is not just about having cognitive diversity but also about having equality in the distribution of conversational turn-taking to unlock it. This is essential because it is easy for differences in views to be lost within a team setting that is dominated by a few individuals who think similarly.

When there is a failure to harness the true diverse thinking of different people, everyone loses.

HOW TO ACHIEVE COGNITIVE DIVERSITY AND INCLUSIVITY

Cognitive diversity is all around us, but you have to look out for it. When you are faced with a complex business challenge, and everyone agrees with you on what to do, find someone who disagrees and ***actively*** make an effort to understand their viewpoint. I know firsthand that this is really hard – we all prefer the comfort of being surrounded by our own echo chambers. But, the evolution and robustness of your thinking improves significantly when considering different views, and the end result is far better than your initial thoughts.

At Coronation, we encourage robust debate. We know how important it is to give everyone a voice and to enable them to be

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[1] Harvard Business Review 30 March 2017

themselves. And we know that this alone is not enough. We actively promote communications or interactions where those views are truly heard and the individuals expressing minority views are celebrated for thinking differently. It makes for richer and deeper analysis, and, ultimately, better outcomes for our clients.

But to achieve this, one must take deliberate action. Start with the right tone at the top and ensure that progress is being made at every level of the organisation. Make it clear that not only diversity but also inclusion is a business necessity and not just a human resources target. It needs a long-term plan and commitment in order to become entrenched in the culture.

Mentoring talent

A good way to encourage cognitive diversity and an inclusive environment is to establish mentoring programmes within the business. Giving advice as someone with experience and expertise can help others along their own path. My mentoring programme for high school learners who receive a Coronation bursary and Coronation's Lean In initiative for employees are just two examples of how we provide a safe and supportive space for participants to learn and grow. We become stronger by leveraging our mix of capabilities, skills and personalities, and we intentionally seek to maximise our collective intelligence through cognitive diversity. In an industry where you are only as good as the people you employ, it gives you a competitive edge when you enable that group of people to collaborate seamlessly and to bring out everyone's best.

I am personally proud of our distinctive and inclusive culture, which has evolved (and continues to evolve) since our launch over 25 years ago, and it would be encouraging to see inclusivity and diversity accelerated across the industry. Anyone with the appropriate skills and qualifications should feel that they belong in asset management. No-one should avoid pursuing a career in the industry because of their background or upbringing. The outdated thinking epitomised by the age-old question, "Where did you go to school?" is out of step with our industry which, like the rest of the world, is changing fast. Companies can only survive if they inherently understand their clients, deliver on what they promise, and act to stay relevant.

Celebrating the contribution of a minority view

As mentioned earlier, an important aspect of achieving cognitive diversity is the psychological safety produced by an inclusive culture. How to get this right varies by organisation, but most often it includes the following two important elements:

1. Creating a discussion framework where people, motivated by the genuine fear of missing important perspectives, look at differing views as an opportunity for all to learn more about a situation.

2. Ensuring that the organisation's culture celebrates the person giving rise to the minority view rather than punishing or alienating them. Let's face it, human beings are social characters and we all have a profound need to be accepted. Celebrating differing views elevates the perception around this and should encourage a greater confidence among others to do the same.

Building a strategy for the future

Management consulting firm *McKinsey*'s latest study on diversity in the workplace, 'Delivering through diversity', reiterates the positive relationship between a company's level of diversity and financial outperformance, and recommends how to develop more effective Diversity and Inclusion (D&I) Strategies (whether these are stand-alone policies or part of the company's cultural vision) as a source of competitive advantage. One needs to be mindful that groups of people in companies responsible for implementing D&I policies are themselves representative of a broader grouping – otherwise you are running the risk of merely institutionalising their individual biases.

The research shows that the success factors of top-performing companies include having a strong, sustained and inclusive leadership who are committed for the long term and who ensure that the strategy reflects their own unique company ethos and business-growth drivers.

CONCLUSION

Companies can empower themselves beyond creating a demographically diverse workforce by creating a cognitively diverse and inclusive environment. A willingness to openly recognise and tackle bias is at the heart of all recommendations. When people choose to ignore bias or deny that it exists, they keep seeking out colleagues and business partners, team members and employees who share their traits, and they miss out on the quantifiable benefits of diversity. Implementing a well-planned and long-term D&I Strategy is the key.

From personal experience, I know that you do not need to conform to a stereotype to fit in. Own and celebrate your differences and the value they bring to your area of work. Both you and your organisation will reap the rewards. ✚

ROUNDUP

Navigating complexity

Highlights from 'Talking Investments with Coronation'

By Kirshni Totaram

IN FEBRUARY, I hosted our annual 'Talking Investments with Coronation' event, which brought together a team of local and global experts who shared knowledge on a diverse range of topics in key areas impacting our world.

GLOBAL THEMES

We had three global speakers join us this year – **Moshe Milevsky** (Professor of Finance, York University, Toronto), **Dr Vivienne Ming** (renowned American theoretical neuroscientist and one of America's most celebrated experts on artificial intelligence [AI]) and **Jeremy Bowen** (BBC Middle East Editor – veteran war correspondent) spoke on seemingly unrelated themes but the commonality is they all gave us a greater understanding of the world in which we operate today.

Moshe has fascinating insight into the intersection of wealth management, financial mathematics and insurance – all presented in accessible language and with humour – while Vivienne reflected on the various ways in which many aspects of tasks and work done today will eventually be programmed and executed by a computer. Bowen took us to some infamous hot spots as he shared his first-hand experience of the geopolitical state of the world, gained from a lifetime spent reporting from the frontlines.

These are some of my key takeouts after reflecting on their collective insight:

Biological age will increasingly become the focus of the retirement investment conversation

Scientific advances now enable us to measure true biological age – as opposed to our chronological age, which merely reflects the number of years that one has been alive.

When it comes to retirement planning, one of the biggest challenges is understanding the period of time during which a person needs to earn an income. This is what biological age looks to address – the longevity risk. Statistics often show that the gap between biological age and chronological age can be as large as 15 to 20 years. Longevity has economic implications for retirement financial planning and investment asset allocation. The ability to draw sufficient income in retirement is one of the biggest challenges facing the global pensions system, and concepts such as biological age can potentially lead to some interesting and innovative product designs.

The future of work is changing

Another area that is evolving quickly is AI and its impact on the future of work. At the mention of AI, most of us still flash back to visions of Skynet – the AI computer in Terminator that torched the earth. However, the reality today is that more and more routine tasks (no matter how complex) are replaceable by appropriate machine-driven algorithms.

We have seen AI used in many fields, and a wide range of industries have been disrupted as a result. In financial services, we cannot ignore the changing rhythm in the markets. How much of this is driven by the prevalence of 'algos' or quant-like strategies is difficult to determine, but the impact is certainly not inconsequential. No human can do what we are seeing happen from time to time when share prices move seconds after news alerts.

It was fascinating and scary listening to Vivienne. She reminded us that no job or task is totally safe from computerised disruption. The key is for each industry to develop and evolve people and processes such that machine + human together results in far better and more efficient outcomes.

A challenging geopolitical environment

The issues facing the world today are enormous and have an impact on the outlook of investment managers and the decisions they make in managing money. One person who understands the political and economic vulnerabilities of conflicted regions first-hand is Jeremy. As a veteran war correspondent and Middle East specialist, he has riveting anecdotes from a lifetime of reporting from the frontlines of some of the world's most fraught conflicts. To have someone like Jeremy's deep insight into some of the most complex geopolitical tensions in the world is not just interesting, it is invaluable.

When asked why he keeps doing this, the answer was very simple. He is driven by a desire to shine a light into the nasty, dark corners of the world to help people understand what is going on. The sad reality about the tensions in the Middle East is that after more than 30 years of working in the region, he hasn't seen any improvement. While there have been some positive developments

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over the years, the world today is more dangerous and confused than ever. There is more uncertainty. Part of the challenge of any investment manager is to unpack this newsflow into what is most relevant and meaningful economically. This is not always easy and in a highly uncertain world, one thing is clear – the risks are incredibly high.

SOUTH AFRICAN OUTLOOK

Complementing our global speakers were four local experts. We started the morning with views from Coronation portfolio manager, Neville Chester, and economist, Marie Antelme. With all the political and economic noise, it's often hard to see the bigger picture, but they provided insight and context as they set out the economic and investment outlook for 2019. The highlights were:

Yes, the biggest risk to the South African economy/recovery is Eskom

The continued mismanagement at Eskom was clearly highlighted as the biggest threat to growth recovery, to the fiscus and to confidence. And subsequently the threat manifested itself with the sudden recurrence of load shedding. A constructive, committed plan to deal with Eskom is needed urgently. You can read more about our views on Eskom on pages 5 to 10.

Being in an election year will keep political noise and risks high

The National Elections on 8 May will be a landmark event in South Africa. Our guest speaker was an expert political analyst and unpacked the lay of the land, outlining the various scenarios that could unfold when we go to the polls. He is of the view that once the elections are out of the way, government is likely to be less defensive, and that there will hopefully be greater attention to structural issues, and a concerted push by the governing party for economic and institutional reform. But political risks include a continued resistance to the reform agenda and potential pushback from organised labour to structural reforms, as well as an outside possibility of an outperformance by the EFF.

The outlook for long-term returns is more positive after a bruising 2018

Despite all the noise, at Coronation we are optimistic about the long-term opportunities for our clients across our portfolios, which are underpinned by compelling valuations. You can read more about our current portfolio positioning within our local and international strategies on page 34.

To end the day on a different note, social media law expert, Emma Sadleir, gave us some sobering advice on navigating the world of social media. ✚

Uncertainty is the enemy of growth

Government's management of the power crisis will be telling of its broader capacity for reform

By Marie Antelme

Marie is an economist with 18 years' experience in financial markets. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

WE STARTED THE year cautiously optimistic that a cyclical recovery, driven by some acceleration in consumer spending, was a reasonable expectation for the year ahead. However, we cautioned that anything more durable needed a commitment to accelerated policy reform and that time to deliver was short. We also cautioned that Eskom remained the biggest, most immediate threat to growth. At the end of the first quarter of 2019, we must reset these expectations. We still expect consumer spending to be the biggest driver of growth, and for growth to be marginally better than last year, but the starting point has weakened, time is even more of the essence and Eskom has indeed become the biggest threat to growth. On pages 5 to 10, we provide a detailed analysis and investment impact of the crisis at Eskom.

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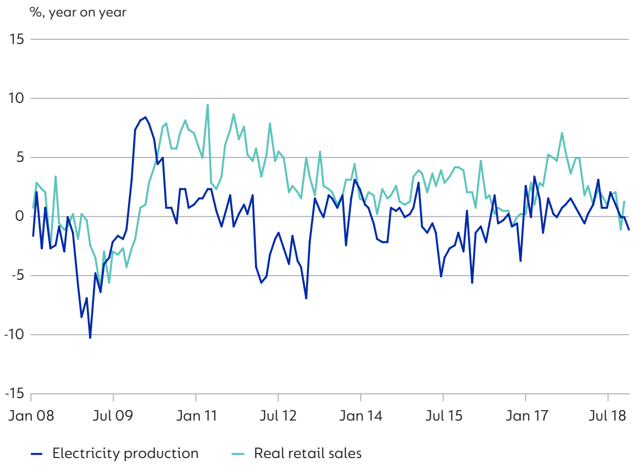
ESKOM ELEMENT 2.0

The shock escalation in load shedding in March, following a mild (although also unexpected) period in the last quarter of 2018, has materially increased downside growth risk. It is difficult to incorporate or make allowance for unprecedented uncertainty in an economic forecast, specifically the risk embodied by Eskom, which is clear and present, but unscheduled and prone to randomness.

The direct impact on numbers at this stage is limited by the relatively short period of actual Stage 4 outages. Anecdotal evidence suggests large users had the capacity to mitigate most of the impact associated with unscheduled outages and managed production accordingly. Some users could protect core operations using generators (which still cost more), while small and medium enterprises are likely to have been most affected by production downtime, stalled supply chains, a backup in inventories and weak sales. However, historic data show only a loose relationship between blackout periods and a change in retail sales volume.

ELECTRICITY PRODUCTION AND RETAIL SALES

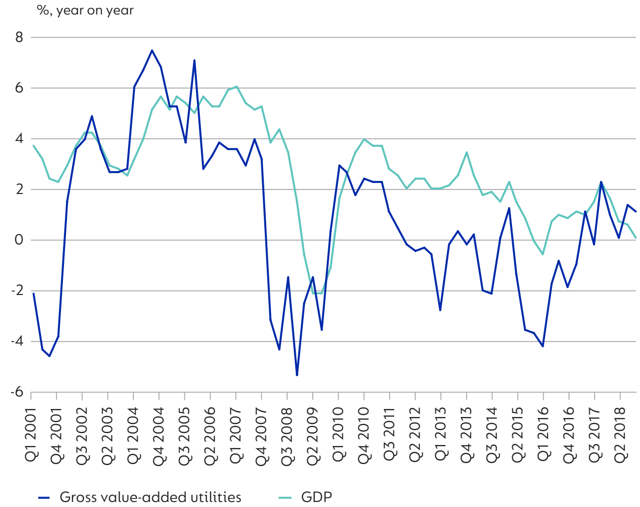


Source: Statistics South Africa

The broader impact on the fiscus, should more financial support be needed, and importantly on sentiment is harder to estimate. However, it seems reasonable to expect further delays in any planned capex, and disruptions to consumption. We remain very concerned that the escalation in March load shedding reflects a significantly more decrepit underlying generation fleet than previously assumed and that the prospects of stabilising long-term energy availability and the associated cost are all unknown. This will have a material impact on sentiment, and such aggravated uncertainty is the enemy of growth.

Past periods of failing energy production and rolling blackouts have reduced GDP by 0.2 to 0.4 of a percentage point. These periods were prolonged relative to what we have seen now, although the recent load shedding was even more severe. Experience has also improved communication between users and Eskom, with some corporates better prepared to mitigate the impact on production than before.

ELECTRICITY PRODUCTION AND GDP GROWTH



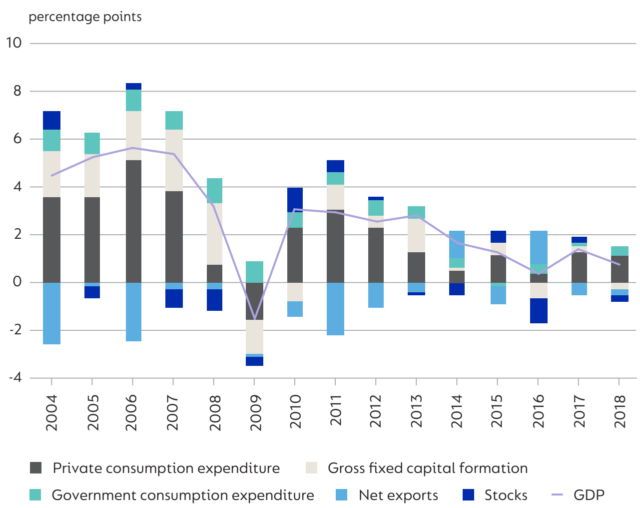
Source: Statistics South Africa

GDP REVISITED

For now, we have shaved 0.3 of a percentage point off our 2019 GDP estimate, and lowered the 2019 and 2020 estimates to 1.3% and 1.7% respectively. There is still downside risk to these numbers, but until we have better information about Eskom's future supply and actual impact from hard data, we are reluctant to extrapolate this relatively short-lived, although severe and alarming, episode.

The domestic economy grew 0.8% in 2018, in line with our expectation and the poor average GDP of the past decade. Within this, consumer spending was the biggest contributor, with real household spending up 1.8% year on year (y/y), but slower than 2017's 2.1%. Government added at the margin, but this was disappointingly offset by outright contractions in gross fixed capital formation, net exports and a large drawdown in stocks.

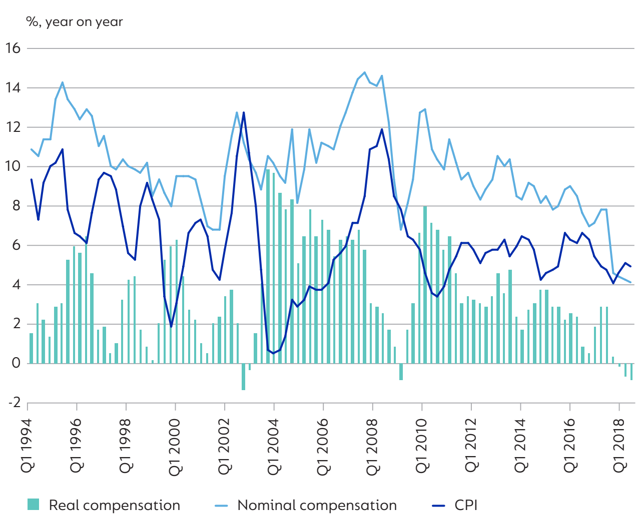
GDP CONTRIBUTIONS BY COMPONENT



Source: Statistics South Africa

The outlook for consumer spending is still critical to any improvement in activity in the year ahead. In this regard, the publication of full-year GDP data held several negative surprises. Most important was a significant revision to the underlying estimates for compensation. Compensation and employment are the biggest drivers of consumer spending, in turn 60% of GDP. In the last *Corospondent*, we flagged the downside risk to spending due to a slowing in compensation. New data show that household compensation indeed slowed – in nominal terms – to 4.1% y/y at the end of 2018. This is the lowest ever since 1994 and represents an outright inflation-adjusted contraction of 0.8% in both the third and fourth quarters of 2018. This is a deeper contraction and more prolonged than we saw in the depths of the crisis in 2009 when formal employment fell 5% from the 2008 peak.

REAL COMPENSATION AT CRISIS LEVELS



Source: Statistics South Africa

When we adjust for other income and deduct taxes and social contributions, we can derive households' disposable income – the bit left over with which households purchase all consumer goods and services. At 4.9% y/y in nominal terms, disposable income outpaced compensation, because income from investments increased sharply last year. In real terms, disposable income was flat last year (0% y/y in the fourth quarter of 2018).

This massive deterioration in spending capacity not only reflects weakness in employment, but very constrained economic circumstances – compensation data capture salaries, overtime and bonuses, and pressure on all avenues of earning ability reflects an overall exceptionally constrained economy. While this is a 'backward-looking' data point, it not only explains a considerable amount about the bleak retail environment of the past year, but also represents a considerably weaker starting point from which households are operating.

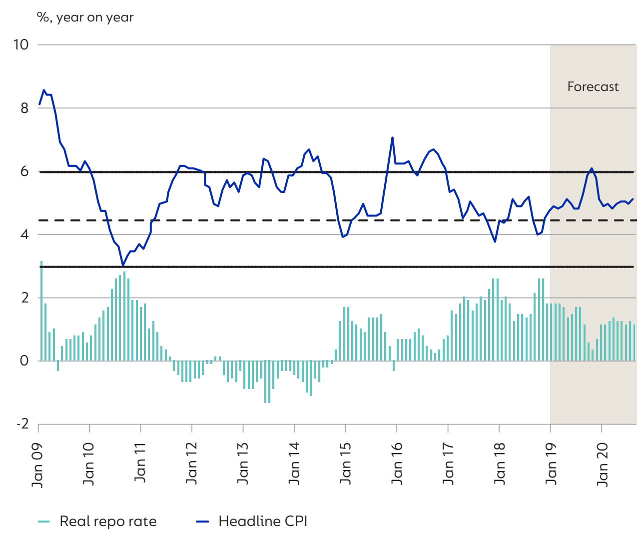
Credit extension to households has picked up, providing a boost to spending late last year. We expect this to continue and look for a stabilisation in nominal compensation growth this year. Low inflation should assist stability in real disposable incomes, although rising fuel prices and the possibility of higher food inflation are an additional risk as the year progresses, particularly if employment and compensation remain under pressure. Overall, we think household spending will grow 1.9% y/y in real terms in 2019 and accelerate to 2.5% in 2020.

We have never counted on an acceleration in capital investment over our forecast period. This is typically a late-cycle phenomenon in South Africa, and we believe there are still binding structural and cyclical constraints on investment. This remains the case, although the downside risk (off a weak base) has increased materially with Eskom's failing fleet.

INFLATION BENIGN FOR NOW

Consumer inflation remains low, printing 4.5% y/y in March, following a benign 4.1% in February and 4.0% in January. The acceleration in March mostly reflects the rise in retail fuel prices and Budget-related implementation of various taxes. However, behind the March headline acceleration was a very sharp drop in rental and owners' equivalent rent (OER) to 3.5% y/y and 2.6% y/y from 4.2% y/y and 3.5% y/y, respectively. Rentals are typically slow moving, and the sharp deceleration reflects a very constrained consumer and housing environment. With food inflation at 2.3%, this further moderation in rental (services) inflation provides a large anchor for headline CPI, which we expect to average 4.7% in 2019 and 5.3% in 2020.

CPI PLUS FORECAST



Sources: Statistics South Africa, Coronation

The March Monetary Policy Committee (MPC) meeting resulted in a unanimous vote to leave the repo rate unchanged at 6.75%, and detailed a downward-revised 2021 CPI forecast at 4.7%, from 4.8%. Within a low domestic growth and globally benign context, the MPC is in a more comfortable position than before as it assesses the outlook for inflation. A moderation in inflation expectations has helped reinforce more moderate forecasts. By mid-year, data confirming weak GDP figures for the first quarter

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of 2019 (which could be negative sequentially), low inflation and a possible compositional change within the MPC may well see some members consider cutting the policy rate at coming meetings. For now our base case remains that the repo rate will be unchanged through the end of the forecast horizon, allowing the already accommodative stance to increase as inflation rises moderately.

FISCAL POLICY – DOWNSIDE RISK OVERWHELMS UPSIDE POSSIBILITIES

The February Budget presented a worse set of fiscal data than we had expected. The fiscal deficit was revised larger, reflecting weaker revenue outcomes and greater support for Eskom than expected at the time of the Medium-Term Budget Policy Statement in October.

Provisional financing data released by the South African Revenue Service (SARS) for the end of the fiscal year showed a R14.6 billion shortfall relative to the Budget expectations and a R57 billion (1.2% of GDP) miss compared to the Budget in 2018. It also implies that the 2018/2019 consolidated deficit will widen relative to the -4.2% of GDP Budget expectations.

Looking ahead, it is uncertain whether committed support for Eskom will grow, given the unknown outlook for the entity. On the revenue side, weaker growth may well put pressure on projections, although we are hopeful that efforts to rehabilitate SARS and the permanent appointment of a new Commissioner will offset some of this risk.

Moody's, the only ratings agency with South Africa's sovereign rating within investment grade, did not review the rating in March and maintained an unchanged rating at Baa3 (stable). This provides a near-term reprieve, although downside risks for both growth and the fiscal position suggest that a ratings action in due course remains a considerable risk.

THE ELECTION AND STRUCTURAL REFORM

The 8 May election outcome may provide President Cyril Ramaphosa with a decisive win and a stronger mandate to appoint a Cabinet better equipped to change the tone and focus of economic policy. Almost regardless of the outcome, we still expect the President will try to ensure that key economically systemic ministries are headed by capable people and that this, combined with interventions at key institutions, should help provide some stability where uncertainty in the past has been deeply detrimental to growth.

A coordinated vision of the ANC's election manifesto, which aims to transform the economy through job creation, sustainable land reform and addressing anticompetitive corporate concentration, is necessary to encourage investment. While we expect Eskom's role as the country's sole energy provider to diminish over time (as we argue on page 7), the way in which government manages the crisis will give us some insight into its broader capacity for reform. A clear signal of the administration's ability to deliver a new vision for economic policy will not just be its ability to stabilise the entity in the short term, but having a clear, decisive and far-reaching vision for long-term energy supply as well as making the political decisions this entails. ✚

GLOBAL ECONOMY

An unsure world under pressure

But 'one-off event' corrections should bring some relief

By Marie Antelme

Marie is an economist with 18 years' experience in financial markets. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston

GLOBAL GROWTH SLOWED through most of 2018. But the pace of slowing accelerated meaningfully from mid-2018 into the first quarter of 2019. 'Recession indicators' started rising in the US, and growth concerns in Europe and China were reinforced by an escalation in trade tensions and ongoing deterioration in an increasingly wide set of economic data. Uncertainty about the future interconnectivity of the global economy will undoubtedly play a bigger long-term role in the global growth moderation than the direct impact of trade weakness, but the current situation has undeniably been exacerbated by idiosyncratic issues in several key economies, which should ease. The longer-term cost of heightened uncertainty is still to be counted.

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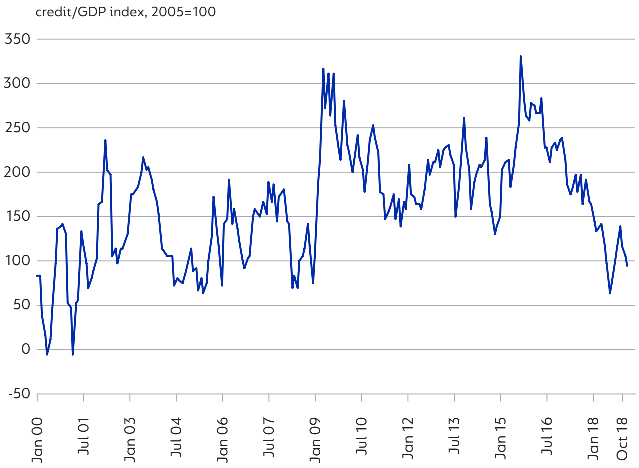
Within this context, it is instructive to try to identify the sources of economic weakness and uncertainty, and then assess how durable the effects may be. These seem to fall broadly into three buckets:

1. CHINESE ECONOMIC ACTIVITY

The internal, policy-driven moderation in Chinese economic activity started in 2017. Successive stimulus interventions have seen an unprecedented accumulation of debt relative to GDP in China, which peaked at an estimated 250% of GDP in mid-2017. Reasonable concerns about the sustainability of both the stock and the rate at which it has increased prompted policymakers to moderate credit availability from the end of 2016. The impact of credit withdrawal led to a moderation in growth momentum, which affected domestic activity and then rippled into global trade.

CHINESE CREDIT IMPULSE



Source: Emerging Advisors Group

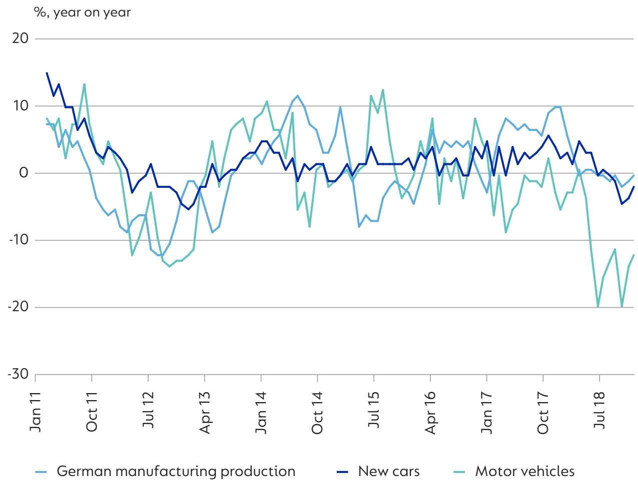
2. US-SINO TRADE TENSION

The above factors coincided with the escalation of US-Sino trade tension, which saw the US initially impose 10% tariffs on $200 billion of Chinese imports in mid-September, followed by retaliatory tariffs from China on $60 billion of US imports. While the US and China's negotiations are still ongoing, global trade indicators remain weak. The knock-on has started to affect global manufacturing and, more broadly, sentiment and business investment. The hardest hit have been large trading economies, including Germany, much of Asia and Japan.

3. INDIVIDUAL MARKET EVENTS

More randomly, there are a number of idiosyncratic events which have either materially exacerbated the impact of the above, such as the change in emissions regulations in Germany, or had the effect of weakening broader sentiment and hard data, such as a combination of US market volatility, the polar vortex and the shutdown of the Federal government in February. Elsewhere, political tension in France and the chaotic Brexit negotiations have negatively affected confidence and biased growth weaker.

GERMAN VEHICLE PRODUCTION AND MANUFACTURING OUTPUT

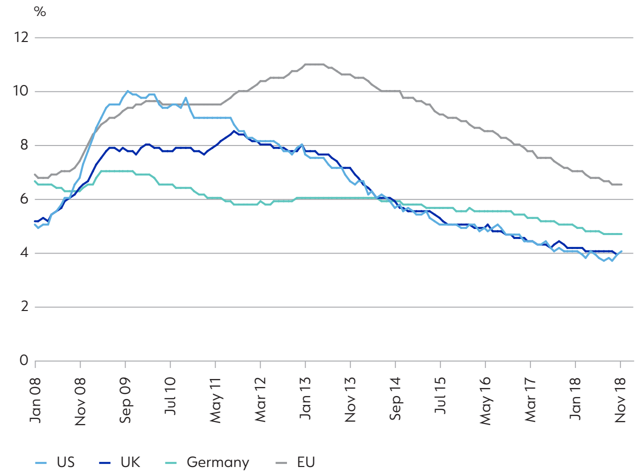


Note: 'Motor vehicles' include light, medium and heavy vehicles, and usually buses, too.
'Cars' refer to cars only, usually with a weight limit.

Source: Datastream

For all this weakness, the resilience of domestic demand in these economies has provided a relatively robust buffer. Across a broad base of developed and some emerging markets, the current economic cycle has seen unemployment fall to multi-decade lows. While there are ongoing questions about the quality of this employment growth, low levels of unemployment support wage growth – and we have seen earnings pick up in the US, UK, Japan and parts of Europe, to the extent that developed markets' income growth now rivals the last expansion. This has not been enough to mitigate all the headwinds, but it is an important source of stability.

DEVELOPED MARKET UNEMPLOYMENT RATES



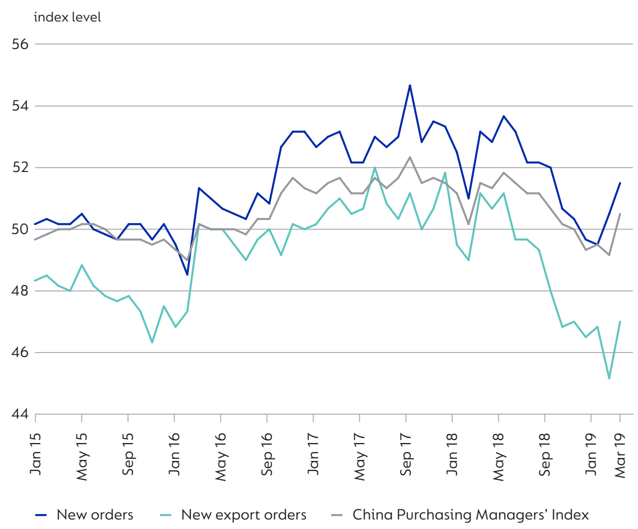
Source: Datastream

Despite all the bad news, at the time of writing, there is mounting evidence that the first quarter of 2019 may be the low point of global growth. Several 'nowcast' models (UBS and JP Morgan), which track changes in high-frequency data to monitor the state of the economy in real time, are pointing to an improvement in global growth momentum. While the activity data are still mixed, there is enough evidence to suggest that, at the minimum, disruptions in the US and parts of Europe are normalising, and policy intervention is gaining traction in China.

This base is narrow because global trade-related activity and associated indicators are still uniformly weak. Data published by Morgan Stanley suggest that global trade volumes slowed to just 0.5% year on year in March, from 1.0% in February, based on export expectations in the Ifo Institute for Economic Research survey and hard export volume data from Korea captured by their trade indicator. For better certainty of a recovery in global growth, we need a few things to go 'right':

Firstly, China's outlook is critical to the prospects and magnitude of a global recovery, given its significant contribution to the global demand weakness over the past six to nine months. The main drag on growth remains property construction and manufacturing capex. This should be countered by an improvement in consumer spending and the support from fiscal stimulus. The rise in China's Purchasing Managers' Index new orders for the second consecutive month is encouraging.

CHINA PURCHASING MANAGERS' INDEX



Source: Datastream

Secondly, some resolution to the US-Sino trade tension is needed in the form of an agreement on terms and implementation between the US and China. Not only is this key to an improvement in trade volumes; a better framework for dispute resolution is also a necessary condition to avoid a repeat of the past year's standoff or a deterioration to something more hostile. The likelihood of achieving a robust agreement with long-term solutions is questionable given the US and China's very different economic policies, but a stabilisation in tariff uncertainty should support confidence lost in the current state of flux.

Then, we need to continue to see the influence of the 'one-offs' fade, especially the disruptions to US activity and spending after February, and the lesser influence of the manufacturing disruptions in Germany. The US Federal Reserve's commitment to 'patience' should also provide a meaningful fillip by keeping global financial conditions easy for a prolonged period, although better growth could also see an uptick in inflation and ultimately put pressure on the Federal Open Market Committee to continue raising rates. Similar very dovish guidance from the European Central Bank suggests it will take a considerable change to conditions to alter its outlook, and we assume monetary policy will stay accommodative in coming months, even as activity picks up again.

Lastly, the 'red flags' raised during this period of slowing growth need to be tested. Not all of the decline in growth momentum that we have seen in the past two quarters can be fully explained by the events listed above and, in some cases, these have not been resolved.

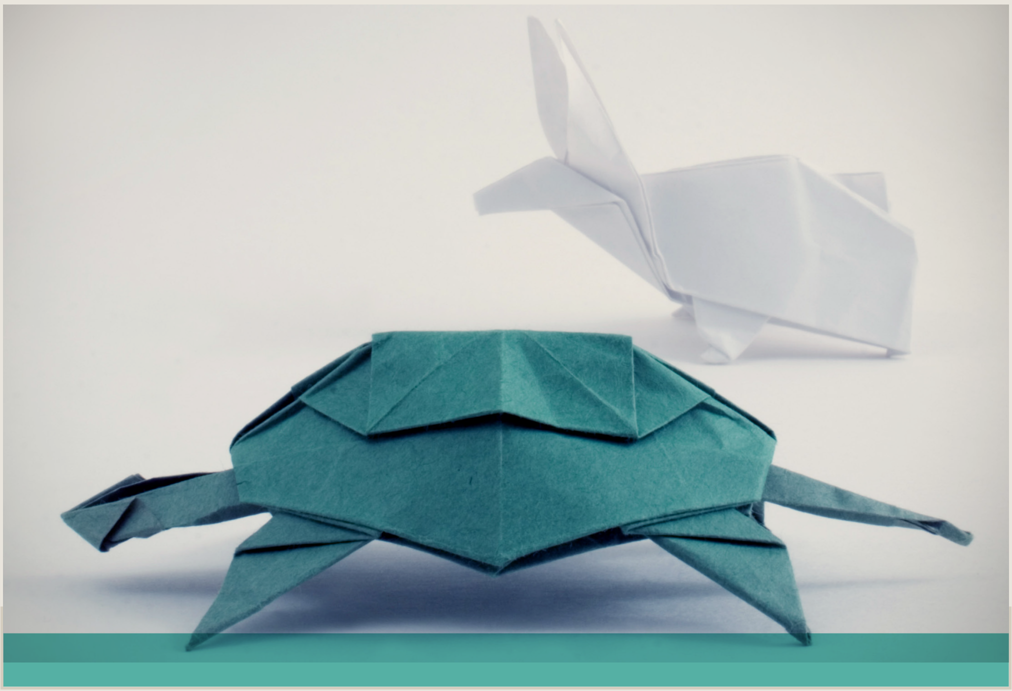
In China, we assume that much of the slowdown in growth started with tighter credit conditions, which have started to ease modestly, and that fiscal interventions will buoy activity in the second half of 2019. It is possible, however, that the impact of credit withdrawal has not yet fully played out, notably on the property market, and that we have yet to feel the full impact of the trade war with the US. Both factors are considerable uncertainties, and hard to quantify.

For the US, the combined sluggishness in the housing market – which is at odds with the very supportive macro factors, including employment and wage growth, household formation and very supportive financing conditions – and emerging weakness in business investment are traditional signs of cyclical weakness, which are important to monitor.

In Europe, the impact of protracted weakness in the external sector may have a much deeper effect on growth. Global trade is a much stronger driver of internal growth momentum than in the US or China. Political uncertainty will play in the background and is not limited to Brexit. It also includes the outcome of the European Parliamentary elections, taking into account more populist and less traditional leadership in several member countries, as well as the impact of weak growth on Italian fiscal metrics, especially under the coalition government.

The umbrella risk is that the uncertainty imposed by all these factors becomes reinforcing in a global economy that is weaker and more fragile than it was at the start of 2018. Our base case, however, is that one-offs correct – and a few things go right – aided by strong domestic demand conditions in key economies and very supportive monetary policies.

We expect global growth to slow to about 3.4%, from 3.8% in 2018, and to recover to 3.7% in 2020. Within this, growth from emerging markets should be supported by recovering economies hard hit in 2018, including Argentina and Turkey, with emerging market aggregate growth expected to be 4.7% in 2019 from 5.0% in 2018, and 5.1% by 2021. Developed economies are more likely to remain under pressure, with the growth forecast flat at 1.8% in 2019 and 2020 as momentum from 2018 is lost and the US tax boost fades. ✚



Emerging market equities – a horizon of opportunities

Potential for high growth and diversity, but over a longer-dated timeframe

By Suhail Suleman

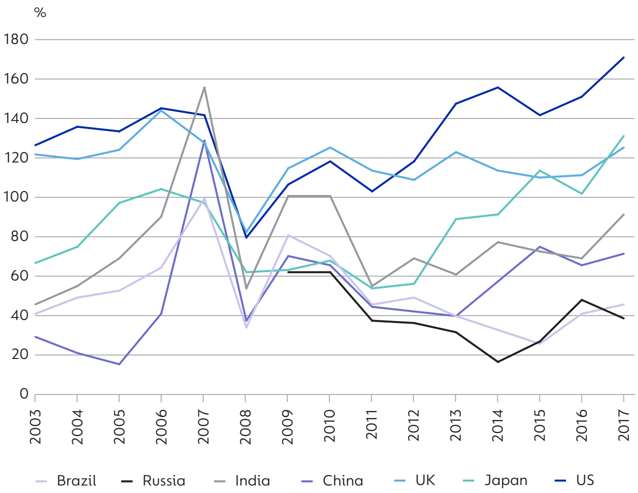
AROUND 80% OF the world's population live in the developing world, with close to half this populace from China and India alone. In terms of land mass, similar statistics prevail, with the bulk of global land located in countries yet to reach economic maturity. As a general principle, developing countries started on the path to industrialisation decades after their developed peers and remain far poorer overall. For this reason, their contribution to global economic output, at between 40% and 50% – depending on whether market or purchasing power parity (PPP) exchange rates are used – is substantially below their population share.

Financial markets in developing regions also developed much later than those in the developed world, resulting in their current share of global market capitalisation being only around 25%.

Suhail is a portfolio manager within the Global Emerging Markets investment unit. He joined Coronation in 2007 and has more than 16 years' investment experience.

Once free-float adjustments are taken into account, their share of benchmark global indices reduces to below 20%. While many large developed markets boast market capitalisation rates greater than 100% of GDP, very few emerging markets are anywhere near this level. The exception to this rule is South Africa, where financial markets developed far earlier and where many global multinationals have listings on the JSE, artificially boosting the market capitalisation ratio to 200% of GDP.

MARKET CAP TO GDP: BRIC AND SELECTED DEVELOPED MARKETS



Source: World Bank estimates

While I have touched on developing markets more generally, this piece will concentrate on emerging markets, as they make up the bulk of the investable equity universe outside developed markets.

Within the broader MSCI All Country World Index (ACWI), emerging markets have a 12% weight and frontier markets have no representation at all. Given that emerging markets are between 40% and 50% of global output and are growing between 1.5 times and 2 times faster than the developed world (in aggregate), investors in ACWI (or any other global index) are structurally underweight emerging markets and are generally missing out on the long-term opportunities they offer.

THE TORTOISE AND THE HARE

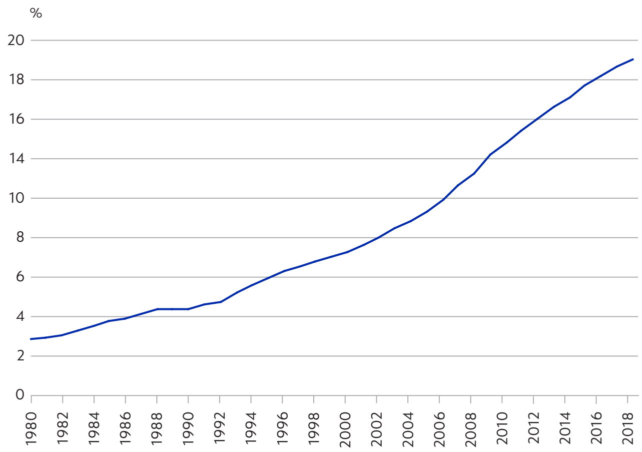
Emerging markets are growing faster than developed markets as a result of several drivers. The simplest explanation is that when installed capital and productivity levels are low – which was the case in most emerging markets 30 years ago – a dollar of capital invested yields higher incremental returns than in a country with a high base of installed capital and an already productive workforce.

China and India were both very poorly managed by their respective governments until the early 1980s and 1990s, and it is no coincidence that a loosening of regulation and an opening up of domestic markets to capital investment and competitive forces coincided with a significant increase in growth rates in these countries.

China's transformation, in particular, could rank as humanity's greatest ever poverty alleviation project. In 1980, China's GDP per capita was similar to that of Zambia and more than 85% of the population lived in extreme poverty. Since then, the country has averaged real GDP growth of close to 10% per annum, raising GDP per capita from under $200 at the time to $9 000 today – a fifty-fold increase in the space of one generation. Today, less than 10% of Chinese live in extreme poverty.

The relatively low increase in population – cumulatively only 40% over 29 years – has certainly helped to ensure that high aggregate growth translated into high per capita growth. However, even if China's population had doubled over the period, object poverty would still largely have been eliminated. The one-child policy certainly played a role in reducing population growth, but its role should not be overstated – the birth rate was already in steep decline when the population curbs were introduced and examples elsewhere in Asia suggest that the rising wealth levels would have seen it naturally decline even further. In the process, China's share of global output has moved from 2% to close to 20%, as the graph below illustrates.

CHINA'S SHARE OF WORLD GDP AT PURCHASING POWER PARITY



Source: IMF estimates

China is not alone in having raised living standards materially, although it is probably the most dramatic example of what compounded high growth can do for countries. India, the world's only other billion-person country, has also come a long way since it started opening up in the early 1990s. Despite being a democracy (with the occasional emergency rule) since independence from Britain, India traditionally had a very protected and state-dominated economy, with many key sectors (notably banking) nationalised in the years after independence from Britain, foreign investment severely curtailed and price controls distorting economic incentives.

The result was close to 50 years of economic stagnation, made worse by a fairly high birth rate that saw the population increase by 2.5 times in the 44 years after independence and until 1991 when reforms were introduced by then-Finance Minister

Manmohan Singh (who would subsequently serve as Prime Minister for 10 years from 2004). India's GDP per capita in 1991 was $300 (at market prices) and, by the end of 2018, was estimated to have grown to $2 000 – a compound growth rate of 7.3% delivered despite a 50% increase in population over the 27-year period.

THE OPPORTUNITIES IN THE STEP CHANGE

Why is the above context important when considering opportunities available to equity investors? The answer stems from the investment opportunities created when economies modernise, increase in size and see a step change in financial sophistication. Shanghai's stock exchange, for example, was re-established in late 1990 after a 41-year closure. From having no listed companies at all 30 years ago, the market capitalisation of Chinese stocks today exceeds $10 trillion.

India's market capitalisation has increased from $280 billion in 2003 to $2.5 trillion in 2018, a ninefold increase in 15 years. The table below, drawn from the World Federation of Exchanges database, shows how the market capitalisation (in current US dollars) has changed for the listed universe of several countries over the latest 14 years for which data are available for all the selected countries.

STOCK MARKET SIZE

Country	2004 $ market cap	2017 $ market cap	% change CAGR	Classification
China	448	8 711	25.6%	Emerging
Indonesia	73	521	16.3%	Emerging
Thailand	115	549	12.7%	Emerging
Korea, Rep.	428	1 772	11.5%	Emerging
Brazil	330	955	8.5%	Emerging
South Africa	443	1 231	8.2%	Emerging
Argentina	41	109	7.9%	Frontier*
Mexico	171	417	7.1%	Emerging
Nigeria	16	37	6.8%	Frontier
Turkey	98	228	6.7%	Emerging
The Netherlands	539	1 100	5.6%	Developed
Switzerland	829	1 686	5.6%	Developed
US	16 324	32 121	5.3%	Developed
Australia	776	1 508	5.2%	Developed
Germany	1 195	2 262	5.0%	Developed
France	1 559	2 749	4.5%	Developed
Portugal	70	76	0.6%	Developed
Spain	941	889	(0.4%)	Developed

* To join the Emerging Markets Index in May 2019

Source: World Federation of Exchanges

The results above speak volumes, although I would caution that they are not directly translatable into equity returns as, at the very least, they include new listings over the period and follow-up equity offerings on already-listed stocks, and they ignore dividends that have been paid. Nonetheless, the figures do highlight that the investment universe in emerging markets has expanded rapidly and therefore should be given serious consideration by investors. As markets develop, and as liquidity and trading continuously improve as they have done over the last two decades, we would expect that the weight of emerging markets within global indices would increase significantly from the 12% to 13% mentioned earlier.

It is important to highlight that emerging markets are not a homogeneous asset class where equity values in the various countries move in tandem. The returns in the various individual emerging markets can and do diverge materially, as their drivers are very different. As an example, China's market has grown with the rapid industrialisation that the country has undergone. Its market comprises oil, property, banking, industrials, consumer and internet stocks, and there remains heavy influence from the state through direct and indirect ownership and regulation of the listed universe. No single individual industry or sector dominates and, with a quasi-fixed currency, the influence of exchange rate movements for dollar-based investors is also more muted than, for example, for South Africa, which has a freely floating exchange rate (the rand) with substantial volatility.

Brazil, on the other hand, has a higher equity weighting towards oil, iron ore, agricultural commodities and regulated utilities. The Brazilian currency, like the rand and the Russian ruble, is volatile and heavily influenced by commodity prices. At times when commodity prices are high and terms of trade are in Brazil's favour, Brazil's equities tend to increase substantially in value, and the currency strength that accompanies this amplifies the movement.

The broader emerging market classification includes countries that are growing fast but are relatively poor in absolute terms, such as India, and those that are relatively wealthy and growing at rates similar to those of developed markets, such as South Korea and Taiwan. The investment opportunities between these countries therefore differ materially, since industry structures are quite divergent. Less developed countries tend to have more fragmented industries with substantial scope for consolidation, whereas wealthier emerging markets tend to have a greater degree of consolidation.

Some of the best returns in emerging markets will be available where companies increase their market share at the expense of weaker players, growing revenue at a rate substantially above nominal GDP growth. In the process, these companies will be able to raise margins as their scale relative to competitors' increases and barriers to entry for new entrants rise. A good example of this is the Russian food retail sector, where the top two players have barely 10% market share each and the formal players, as a whole, around 65%. In developed markets, it is not uncommon for the top players in food retail to have market shares above 20% and for formal retail to command 75% to 80% of total sales. The only natural limitation to market share in Russia is a 25% single-metro market share limit in terms of Russia's food retail law, and both the market leaders are some way from hitting this ceiling.

Financial services is another sector in which substantial opportunities exist due to fairly low credit penetration. In most emerging markets, access to financial services is far from universal, and penetration of products such as bank accounts, credit cards and mortgages is at a fraction of that of their developed peers. As an example, in mid-2018, the Bank for International Settlements noted that the credit-to-GDP ratio (total credit to the private nonfinancial sector divided by GDP) of India stood at 56%. Brazil was not much higher, at 67%. In comparison, the UK's ratio was 170% and that of the US 150%. Some emerging markets do have developed-level credit penetration, but this is restricted to wealthier emerging markets such as Korea, with 194%.

TAKING ACTION

Some examples will naturally answer the question most asked by investors with respect to their potential emerging markets exposure – should the investment be passive or active? Coronation has been an active manager in emerging markets for more than a quarter of a century and we believe it is the most suitable option for investors looking for long-term value uplift in returns. As a starter, a large percentage of the indices in emerging markets are dominated by many mediocre businesses that often serve as state champions. Examples of these include the Chinese state-owned banks, whose credit allocation is very opaque, and national oil companies such as Petrobras and Gazprom. This is clearly different to some developed market countries like the US where the index is dominated by some of the best businesses in the world, run primarily for the benefit of their shareholders. Examples include technology stocks such as Apple, Amazon, Alphabet and Facebook.

While the index quality has improved over the last decade, we still don't believe it represents access to the most compelling businesses and investments in emerging markets.

We believe that some of the best opportunities are in private sector-run businesses such as the Russian food retailers mentioned earlier. Another very compelling example is in Indian banking. Some 70% of the market here is still run by the state-owned banks, whose operations have underperformed their private sector peers since their monopoly ended as part of the economic reform process. As recently as 15 years ago, the private sector market share was 10%. It has since tripled in a banking market (as measured by total assets) that has also grown by 15% per annum in nominal terms over the period. The private sector banks have better balance sheets, which allow them to grow their books faster than the public sector banks. They also have better credit granting processes, so the bad debts of the well-run private sector banks are substantially lower than those of public sector banks that often have a second agenda of furthering development regardless of credit risk.

The combination of high growth, robust credit processes and long-term thinking from management will yield higher returns for investors over the long term. An index-tracking investor would have a larger allocation to public sector banks and would also have significant exposure to overvalued consumer stocks in the fast-moving consumer goods sector. Here, a scarcity premium means that Hindustan Unilever (Unilever PLC's listed subsidiary) trades on more than 50 times earnings, despite delivering earnings growth below that of HDFC Bank, the leading private sector bank that trades on 20 times earnings.

To conclude, in our view emerging markets offer a compelling long-term opportunity for investors. The most important consideration, however, is time horizon. As countries and economies are still decades behind their developed market peers on most metrics, the duration of the investment opportunity is also long dated. A focus on the long term (five years or longer) rather than the shorter term will, in our view, deliver compelling returns for investors, even if shorter-term volatility may be higher than in developed markets. ✚

2019 first quarter in review*

CORONATION GLOBAL HOUSEVIEW STRATEGY

The broad-based asset class declines experienced in 2018 reversed dramatically in the first quarter of 2019. The MSCI All Country World Index ended the quarter up 12.2% in US dollar terms, despite a deteriorating macroeconomic environment in which central banks have become meaningfully more dovish than they were late last year. Developed market equities, and in particular the US, performed strongly and recorded their best quarter in nearly 20 years. The portfolio has benefitted from its large exposure to global equities, and our overweight position in emerging market equities contributed meaningfully to performance during the quarter.

The Citigroup World Government Bond Index appreciated by 1.7% in US dollars for the quarter. Bond yields fell, with investors buying up debt as a haven amid mounting evidence of a global economic slowdown, continued political uncertainty and a more dovish outlook among global central bankers. This shift has seen the US Federal Reserve (Fed) signalling that rates will remain on hold for the rest of this year and announcing that the bank will end its balance sheet run-off programme.

In addition, the European Central Bank announced future stimulus measures and that it too will leave rates on hold until the end of 2019. At the end of March 2019, the amount of global government debt with negative yields rose above the $10 trillion mark, and European corporates such as LVMH Moët Hennessy Louis Vuitton (LVMH) and Sanofi were even raising debt at sub-zero rates (meaning you have to pay for the privilege to lend to these companies). The extent to which central banks continue to distort debt markets is concerning and we remain cautious on the outlook for global bonds.

The All Bond Index ended the quarter strongly (+3.8%) as the market started to price in potential interest rate cuts later this year. We believe the high real yields on offer are a reasonably attractive investment opportunity. Given recent global monetary policy developments and the South African Reserve Bank's benign inflation outlook, coupled with weak economic growth, we expect policy rates to remain on hold for an extended period of time. The property sector underperformed during the quarter on broad-based weakness. Distribution growth rates are increasingly at risk given negative rent reversions in certain sectors and nodes, high vacancy rates in the office sector and leveraged balance sheets. The portfolio's property exposure, which is focused on the higher-quality portfolios such as Redefine and Investec, together with our exposure to the A property shares, should weather the storm better than peers.

Overall, the JSE had a good quarter, with the FTSE/JSE Capped Shareholder Weighted All Share Index appreciating 3.9%. Resources had another very strong quarter and were up 17.8% – bringing the sector's rolling 12-month total return up to a whopping 41.6%. Platinum stocks in particular had a very strong quarter on the back of a rising platinum group metals (PGM) basket price.

During the quarter, all mining companies reported their annual or interim results for the period to end-December 2018. These results were characterised by a strong performance from the bulk metals (iron ore, coking coal, thermal coal and manganese). The theme of strong cash flow, deleveraging and capital returns to shareholders continues. Shares reacted positively to financial results announcements and a strong commodity price environment, driven by tight supply/demand balances and an abatement of China-US trade war fears. Our large exposure to Anglo American (+22%) contributed to performance.

After a long and frustrating wait, PGM shares have finally begun to rally strongly, with our holdings in Northam Platinum (+47%), Anglo American Platinum (+38%) and Impala Platinum (+66%), as well as our position in the Palladium Exchange-Traded Fund (ETF) (+12% in US dollars) all contributing meaningfully to returns for the quarter (refer to Nicholas Hops' article, 'The dangers of headline investing', on page 15 for more insight into PGMs).

After a challenging 2018, it was also particularly encouraging to see that a number of the portfolio's other high-conviction ideas recovered well. These included Naspers, British American Tobacco and Quilter.

Naspers (+19%) benefitted from a strong recovery in the Tencent share price as sentiment towards China shifted positively on the back of a reduction in trade war fears and a resumption in the licensing approval process of online games by the Chinese authorities. Naspers also surprised the market in March by announcing the offshore listing and part unbundling of its offshore internet portfolio (i.e. Tencent, Mail.ru, OLX, its food delivery businesses, et al.) in an effort to reduce the discount at which it trades relative to its underlying intrinsic value. While this is certainly no 'silver bullet' that will immediately remove the entire discount, we nevertheless view it as a marginally positive step in the evolution of the group into a global consumer internet powerhouse and will allow it access to a wider investor base.

The British American Tobacco share price (+27%) recovered strongly during the quarter on the back of reporting good results, which allayed market fears around US volume declines, its debt levels and the outlook for its next-generation products. It also appears that investor anxiety towards the regulatory headwinds faced by the US business is abating and sentiment is finally starting to turn positive on the stock. Even after this short-term price rally, British American Tobacco is still trading on only 9.5 times one-year forward earnings and a 7% dividend yield. We still believe this to be very attractive for a stock of this quality and it remains the second biggest position in the portfolio.

Quilter (+28%) performed very well over the period. Its maiden full-year results materially exceeded market expectations. Management provided medium-term guidance on their profit-before-tax-margin aspirations, and at 34%, this too exceeded expectations. The long-term outlook for integrated wealth managers with advice forces at scale remains very attractive. This positive outlook is driven by a decline in advisers following the UK's adoption of the Retail Distribution Review, 'pension freedom' boosting demand for advice and opening up the post-retirement market to wealth managers, and a shift away from defined benefit funds to defined contribution funds.

Stocks exposed to the domestic economy came under significant pressure during the quarter as the realities of operating in a 'no-growth' economic environment filtered through into corporate earnings. The quarter kicked off with a string of profit warnings from the domestic retailers, and the likes of Mr. Price (-23%), Massmart (-22%), Truworths (-18.5%) and Dischem (-16%) all ended the period materially lower. Fortunately, the portfolio had no exposure to any of these stocks. Eskom remained in the headlines as it hit Stage 4 load shedding in the middle of March. Years of underinvestment and alleged mismanagement and corruption are finally coming home to roost. Although for now we appear to have received a temporary reprieve from the worst of load shedding, it has become clear that we are only starting to understand the true extent of the power utility's problems and that its numerous issues could indeed take years to rectify.

Unfortunately, if persistent load shedding becomes the norm over the next few years, the impact on consumer sentiment, business confidence and GDP growth will be devastating. We therefore

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continue to remain cautious on stocks that are heavily exposed to the domestic economy and our preferred exposures are through high-quality domestic defensive businesses that should weather the challenging environment better than their weaker, economically sensitive peers.

To conclude

Notwithstanding the uncertainties that abound, our objective remains building diversified portfolios that can absorb unanticipated shocks. We are happy with the current portfolio positioning and excited about future return prospects. We remain focused on valuation and will seek to take advantage of attractive opportunities the market may present to us, and in so doing generate inflation-beating returns for our investors over the long term.

GLOBAL EMERGING MARKETS

The Coronation Global Emerging Markets Strategy had a very good quarter, returning +23.4% compared to the MSCI Emerging Markets Index[1] return of +9.9% and in doing so outperformed the market by 13.5%. This made it the Strategy's best quarter of outperformance since inception almost 11 years ago. Its previous best quarter was the one to end-June 2009 (12.1% outperformance), which was the period that signalled the bottom of the market post the 2008 Global Financial Crisis (GFC) decline.

During the quarter to end-March 2019 there were a number of stocks that contributed positively, with all of the 15 largest positive stock contributors appreciating by more than c. 20% in US dollars. At the top of the list was Wuliangye Yibin (+91%, 2.0% contribution), followed by New Oriental Education (+64%, 1.4% contribution), JD.com (+44%, 0.9% contribution), YES Bank (+52%, 0.8% contribution), British American Tobacco (+29%, 0.8% contribution), Ctrip (+60%, 0.7% contribution) and Philip Morris (+33%, 0.7% contribution). A number of these stocks were poor performers in 2018 (specifically in the last few months of the year) and so the Strategy's strong performance to date in 2019 is partly a reversal of a poor 2018. JD.com, YES Bank, British American Tobacco, Philip Morris and Ctrip would all fall into this category.

In addition, a few of the new buys in late 2018 were strong performers, most notably Wuliangye Yibin and New Oriental Education. Lastly, a number of long-held positions contributed positively, including Airbus (+38%, 0.6% contribution), 58.com (+21%, 0.5% contribution) and Ping An Insurance (+27%, 0.4% contribution). At the same time there were few large negative contributors with no detractors of more than 0.5%. Since inception almost 11 years ago, the Strategy has outperformed the market by 4.0% per annum and over the last 10 years has outperformed by 3.5% per annum.

There were five new buys during the quarter. The two largest new buys were that of Jiangsu Yanghe Brewery (1.8% position) and LVMH (1.9% position). The three other buys were small: a 0.7% position in NetEase (no.2 online gaming company in China after Tencent), a 0.6% position in BM&F Bovespa (Brazil's dominant vertically integrated multi-asset [equity, bonds, derivatives] exchange) and a 0.4% position in Eastern Tobacco (Egypt's monopoly cigarette manufacturer). In total, the five new buys represent 5.5% of the Strategy. There were two outright sells during the quarter: that of Baidu (no. 1 search engine in China) and Marisa (a Brazilian clothing retailer). In the case of Baidu (a 1.3% position at the start of the year), we had become increasingly worried about the core search business, as well as the uncertain future return from the numerous other areas where the group is investing significant capital.

In the case of Marisa (a small 0.3% position at the start of the year) there was still not much sign of a turnaround in the business, and we felt the funds were better invested elsewhere. In terms of other portfolio activity, we reduced the positions in New Oriental Education, Ctrip, Noah, Li-Ning and Adidas (all on strong share price performance and resultant less upside to our estimate of fair value) as well as Indiabulls (largely due to a reduction in our fair value and a less attractive risk/return profile). From a buying point of view, most of the activity was in the five aforementioned new buys, but we also added to the existing positions in HDFC Bank and Pão de Açúcar.

In good spirits

Jiangsu Yanghe Brewery is the largest *premium* brand baijiu (the dominant white spirit in China) company, in contrast to the main *ultra-premium* (very high end) baijiu companies Kweichow Moutai (not owned in the Strategy) and Wuliangye Yibin (a 3.9% position in the Strategy). We bought a position in Wuliangye Yibin late last year and subsequently continued to do additional work on the industry, including a week's trip to China solely focused on the baijiu industry, which led us to Jiangsu Yanghe.

Over the past decade, Jiangsu Yanghe has grown sales by 27% per annum, making it the fastest-growing baijiu company over this period. Both net profit and free cash flow have grown by 35% per annum over the past 10 years and today the company generates over $1 billion of free cash flow. The company is a beneficiary of the premiumisation of baijiu (their main premium brand, 'Dream Blue' series, has gone from being 2% of sales a decade ago to contributing over 20% of sales today) and we expect this to continue, together with further expansion to regions outside of its home base, Jiangsu (which today still contributes 53% of sales).

A unique feature of Jiangsu Yanghe that also attracts us is the fact that management own c. 21% of the company. Just like Kweichow Moutai and Wuliangye Yibin, the financial metrics of Jiangsu Yanghe are impressive, with operating margins of c. 45%, return on capital of c. 20% and high free cash flow conversion (over 100% of net profit in the past three years has been converted into free cash flow). The share trades on c. 18.5 times forward earnings with a 3% dividend yield, which we believe is attractive given the company's long-term prospects.

The wealth effect drives luxury goods

The other new buy of note was a 1.9% position in LVMH, which we have covered for several years and have owned in the Strategy in

[1] The volatility of the Benchmark (MSCI Daily TR Net Emerging Markets USD [NDUEEGF Index]) 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 recognised Benchmark. Material facts in relation to the Benchmark are available at: https://www.msci.com/emergingmarkets

the past. LVMH is the largest global luxury goods company and the owner of the Louis Vuitton brand (c. 50% of group profits) and many other global brands, including Moët & Chandon, Hennessy, Christian Dior, Fendi, Bulgari and Tag Heuer. Over 40% of sales come from emerging markets and the Chinese consumer alone (purchasing at home as well as while travelling) is responsible for well over 50% of incremental growth.

LVMH has an enviable track record (over the past 20 years, earnings per share has compounded at c. 12% per annum) and today is well placed to be a key beneficiary of the growing emerging market middle and upper class, and the wealth effect. The barriers to entry possessed by the true global luxury brands (Hermès, Louis Vuitton and Gucci) are among the highest in any industry in our view: in the case of Louis Vuitton, a 150-year history and investment in the brand for a start.

The resilience (of both the top-line and profitability) of the Louis Vuitton brand, in particular in tough economic periods is also unparalleled: in 2009 (post the GFC), sales of the Fashion & Leather Goods division of LVMH (with Louis Vuitton making up the lion's share of this division) grew by 2% and earnings before interest and taxes (EBIT) grew by 3%. In 2002 (post September 11), the same division experienced 16% sales growth (and this after double-digit sales growth in 2001 as well) and 5% EBIT growth. The Strategy bought LVMH on c. 20 times forward earnings and a 2% dividend yield, which we think is attractive for what we would consider to be one of the best businesses in the world.

Members of the Global Emerging Markets team continue to travel extensively to enhance our understanding of the businesses we own in the Strategy, their competitors and the countries in which they operate, as well as to find potential new ideas. In this regard, over the past two years we have done detailed work (modelling, fair value and research reports) on 51 new companies, 18 of which have made it into the portfolio over this period, representing 32% of the Strategy today. In the first quarter, there were two trips to China and two to India. The coming months will see a further trip to China, as well as one to Brazil. The Strategy's weighted average upside to fair value at the end of March was c. 40%, which we feel is compelling. We would also consider the overall quality of the stocks held in the Strategy currently to be above average when compared with other points in the Strategy's 11-year history.

FRONTIER MARKETS

Global Frontier Markets

Markets have started 2019 brightly, with the MSCI Frontier Markets Index[2] (up 6.9%) recovering nicely after a tough end to 2018. As the Strategy significantly outperformed the market in 2018, it has unsurprisingly lagged the market recovery in the first quarter of 2019 (Q1-19), with a return of 3.5%. While we are certainly never happy with relative underperformance, when viewed over a more appropriate time period, we remain satisfied with the performance. Over the one- and three-year periods to end-March 2019, the Strategy has returned -11.7% and 10.5% per annum, respectively, while the Index was down 15.0% and up 6.9% per annum over the same periods.

The quarter saw positive returns across most markets, with Egypt (+16.9%), Kenya (+13.6%), Vietnam (+9.8%) and Kazakhstan (+7.2%) all seeing strong gains. Argentina (-3.9%), Pakistan (-0.6%) and Bangladesh (+1.5%) were more muted. The Strategy's largest exposures are Egypt (18.3%) and Jordan (10.4%). As always, country weights are a function of the attractiveness of the individual companies in each market rather than being based on a macroeconomic or index view.

We added to our position in Egypt's monopoly tobacco company, Eastern Tobacco (Eastern), over Q1-19. Egypt is one of the most attractive tobacco markets globally, with high prevalence rates, growing volumes and good affordability. The company is in the process of moving from being regulated as a state-owned entity to a private company. During Q1-19, the government sold down a 4.5% stake in the business to facilitate this change, and on 1 April 2019 shareholders officially approved the move. Being regulated as a private company should result in numerous benefits for the business, and we expect vast improvements in production efficiency, marketing, investor engagement and capital allocation. Eastern remains the Strategy's largest position.

The Strategy exited its position in Citadel Capital in Q1-19. Citadel is an Egyptian investment company with interests in energy, cement, agrifoods, logistics and mining. By far the largest part of the business is their 17% stake in Egyptian Refining Company (ERC). With the commissioning of ERC expected in Q4-19, market sentiment has turned very optimistic, which has seen the share move through our estimate of fair value. We thus exited on valuation grounds.

Stock view

The largest contributors for the quarter were Vostok New Ventures and Zimplats, while the largest detractors were British American Tobacco Kenya (BAT Kenya) and Al Eqbal Tobacco. Vostok New Ventures received $540 million through the sale of its stake in Avito to Naspers. In turn, Vostok used the proceeds to buy back shares, pay a special dividend and settle some bonds. Zimplats benefitted from higher palladium prices, and a change in its mining licence (from a special mining licence to a normal one). This change resulted in a simplification of and reduction in tax payable, and gives Zimplats increased mining rights over the remaining 45-year lease.

BAT Kenya ended 2018 strongly, but declined over Q1-19 despite a strong set of results which followed two tough years. Al Eqbal Tobacco is in the process of taking a significant part of its distribution in-house, which has seen a number of nonrecurring charges causing a slowdown in growth. Management has focused on bedding down these changes and took a step back from investor engagement. While this decision is the right one, it has left the market a bit surprised by the results and its share has come under pressure. We recently met the new CEO in Dubai and toured the production facility in Ajman, and returned even more positive on the long-term opportunity despite the likely disruptions in the short term. Al Eqbal is the largest position in the Strategy.

[2] Material facts in relation to the MSCI Frontier Market Index are available at: https://www.msci.com/msci-emerging-and-frontiermarkets-indexes

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African Frontier Markets

African frontier markets also enjoyed a good start to the year, with the FTSE/JSE All Africa ex-South Africa 30 Index[3] (up 6.4%) recovering nicely after a tough end to 2018. The quarter saw positive returns in Egypt (+16.9%) and Kenya (+13.6%), while Nigeria (-0.6%) and Morocco (-5.3%) were negative. Egypt benefitted from a surprise 100 basis points (bps) rate cut and a strengthening in the currency as the government's reform strategy continues to bear fruit. In a recent meeting, the CEO of one of Egypt's most successful banks commented that the economy has seen tourism arrivals up 41%, tourism receipts up 77%, remittances increase to $26 billion, the Zohr gas field come online and Suez Canal revenues increase by 15%.

Much has changed over the past year. Egypt (at 32.9% of Strategy) remains the portfolio's largest exposure and we continue to be excited about the businesses we own in the country. As previously mentioned, country weights are a function of the attractiveness of individual companies in each market rather than a macroeconomic or index view.

We made similar additions and exits to those in the Global Frontiers Strategy during the quarter, adding to our position in Egypt's monopoly tobacco company, Eastern during the quarter, and exiting Citadel Capital.

[3] Material facts in relation to the FTSE/JSE Africa Top 30 Ex South Africa Index are available at: https://www.jse.co.za/services/marketdata/indices/ftse-jse-africa-index-series/all-africa

Stock view

The largest contributors for the quarter were Eastern and Zimplats, the reasons for which have been detailed under Global Frontier Markets above; while the largest detractors were BAT Kenya and Egyptian International Pharmaceuticals Industries (EIPICO). BAT Kenya ended 2018 strongly, but declined over Q1-19, despite a strong set of results that followed two tough years. EIPICO had enjoyed a period of cheap raw materials purchased before the floatation of the Egyptian pound. This saw margins expand significantly in 2017. Calendar 2018 saw a normalisation and margins came under pressure. Coupled with sales lagging the market, this resulted in a share price decline for EIPICO. We have since spoken to the new CEO, who communicated a number of positive initiatives, and saw the parent company increase its stake in EIPICO, both of which are positive in our view.

Conclusion

The Global Frontier Markets team travelled to Vietnam and Bangladesh as part of small investor group trips and to Dubai to attend the largest Global Frontiers conference in the world. We also met a number of African corporates at two separate conferences in Cape Town. We continue to believe that both of our strategies have a number of very attractive opportunities across countries and sectors. While these businesses are compelling in their own right, the valuations at which we can buy them make for an even more compelling investment case. Over the long term, this should result in attractive returns for our investors.

We thank you for your ongoing support. ✚

* All strategy returns are quoted gross of fees. For a side-by-side comparison of gross and net performance, please refer to: http://www.coronation.com/us/strategy-performance

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