corospondent

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Notes from my inbox

A stable investment process in unsettled times.

by **KIRSHNI TOTARAM**

__KIRSHNI TOTARAM__ 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.

It has been an explosive couple of weeks, with Brexit rocking the markets to their core. The UK's decision to leave the EU has injected even more volatility into an already uncertain environment.

We expect the markets to remain unsettled for some time. As always, our focus is on the long term and on identifying investments that are trading at a discount to their long-term business value. The market mania is creating more of these opportunities, which should over time deliver long-term outperformance. We certainly do not believe investors will achieve compelling returns by slavishly following erratic market indices.

Team-based investment

At Coronation, we are very careful about not creating specialist silos where investment decisions are made in a vacuum.

Our entire investment team of more than 60 individuals – covering the South African, Global Emerging, Global Developed and Frontier Market strategies – sit together in an open-plan office. They are constantly interacting and exchanging investment information.

Also, our analysts and fund managers are each allocated a wide range of research responsibilities, across different industries and countries. This emphasis on a generalist investment perspective and skill set, rather than a specialist one, is one of our defining advantages. Our investment professionals can price profit and risk across asset classes, sectors and geographies, and should be able to give a well-considered view on the merits of an investment in a bond against any equity that they may analyse.

We believe this broader perspective builds better investors, drives better debate and results in better investment decisions. It has also been invaluable in helping us to deliver excellent long-term outcomes in our multi-asset strategies.

Our team-based and generalist approach has contributed to the stability of our investment process. With analysts covering a wide range of companies in different sectors, there are no gaps in research coverage in the event of departures from the team. We find this provides an important source of comfort to our clients.

In this edition

This issue of *Corospondent* offers extensive analysis of how the recent political events have impacted the markets. On page 4, our economist Marie Antelme explains the larger implications of Brexit, while Neville Chester notes our investment response to the event (page 7). You will find more on the immediate repercussions in our international market review (page 12).

Pallavi Ambekar details our investment case for MTN, which is showing signs of recovery after a tough period, on page 9, while Iakovos Mekios gives our assessment of the Mexican investment landscape (page 19) following a recent visit. Also in this edition, Greg Longe discusses the prospects of Nigeria (page 22), which is suffering from chronic balance of payment problems, and Steven Barber examines the long-term prospects of a global pharmacy giant (page 16).

We hope you enjoy the read.

Brexit: The economic and political impact

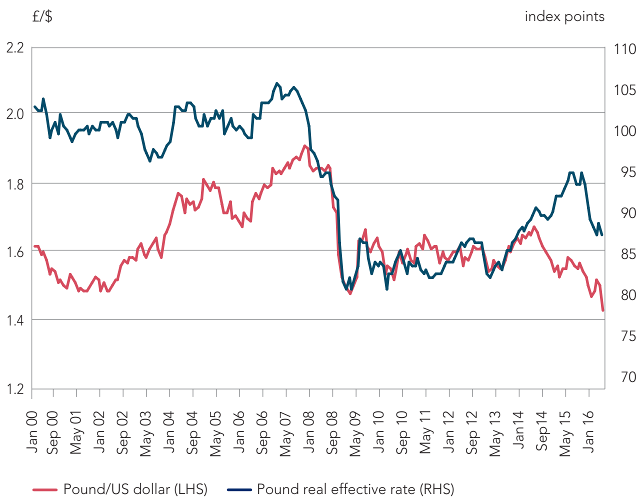
Untangling the spider's web.

by **MARIE ANTELME**

MARIE ANTELME is an economist in the fixed interest team. Marie joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

The UK referendum vote was a shock to politicians, markets and much of the populace. Poll data in the run-up to the referendum showed growing support for the leave campaign but it seemed that markets, and indeed most people, thought the rational outcome was to remain. The early repercussions of the vote were dramatic: the pound saw its largest drop ever in intraday trade, the FTSE 100 initially tumbled almost 9%, and both European and emerging market assets responded negatively.

POUND EXCHANGE RATE



Sources: Coronation, Datastream

The referendum outcome certainly raises more questions than it answers. It has injected a new measure of complexity into the current global political environment and economic outlook, which remain inextricably interlinked.

The first observation to make is that the international political environment has changed dramatically since the end of the global financial crisis (GFC). There has been growing support for political parties on the extremes of the political spectrum. In Europe, Marine Le Pen's National Front has gained ground in France, while support for both right-wing and left-wing groups in Spain has grown meaningfully, and increased polarisation was also seen during the municipal elections in Italy. Hungary voted for the conservative Fidesz in 2010 and, more recently, Poland backed the right-wing national-conservative PiS. (Donald Trump's bid to become the US president is arguably also part of this trend.)

These political parties' main platforms are less about advocating specific policy actions, and generally more focused on either a particular social philosophy, or specific groups in society. The increased attraction of this kind of politics seems to reflect a social climate of dissatisfaction, with roots in the weak economic recovery post-GFC. For many households the crisis had a material impact on incomes and wealth. The recovery in Europe has been the most uneven, and arguably remains the most fragile. Many households are still worse off than they were before, and the promises made by the moderate politicians and the policymakers, who supported and implemented moderate policies, were not met. This fuelled the appeal of parties or policies which reject the status quo. The example of the UK's leave campaign reflects this unhappy reality most clearly. Voters who chose to exit had no real understanding of what they voted for (and given the immediate resignations of the senior leave campaigners it appears they had no idea either). It was more a vote of unhappiness with the status quo than a decision that leaving will deliver specific benefits.

The popular response following the vote suggests that many simply did not fully understand the potential repercussions of their vote. The calls by other parties in the EU for referendums in their own countries could yield similar risks. A precedent has been set by citizens being able to opt out of the EU through a referendum (with the debate often fuelled by spurious claims and misinformation). This is very negative for the future of the EU. While no other moderate EU government is likely to make the mistake of calling for a similar referendum, any election will now become a proxy for this type of referendum, with the fringe parties campaigning vigorously on the exit card.

There are a number of important elections looming in other large economies – the US (8 November 2016), France (April/May 2017), Germany (October 2017) – which are now also much more uncertain, and perhaps also much more vulnerable to more extreme political outcomes than before.

While markets will take a dim view of a move towards isolation and reversing the benefits of global free trade, they hate uncertainty even more. In a fragile world, the shock of the Brexit vote result has created further uncertainty over the outlook for global growth. Yields on the ten-year US government bond fell dramatically after the Brexit result, indicating a flight to safety and a concern that global growth will remain weak as companies withhold investment and consumers withhold spending while the details of what Brexit means are finally ironed out.

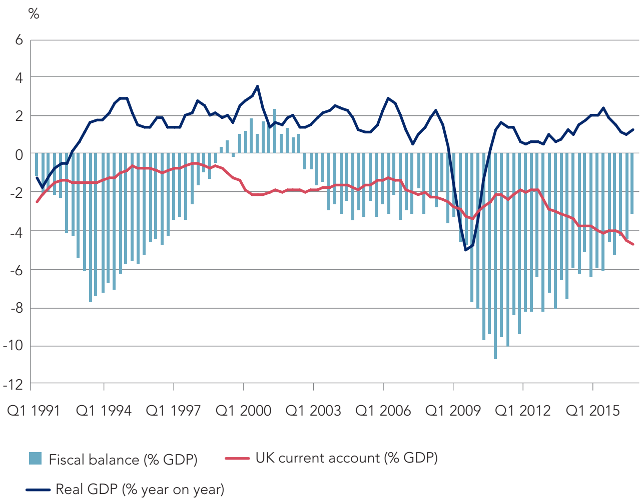
Growth in the UK is expected to slow, and may contract next year, depending on how long political uncertainty continues and how EU negotiations evolve. Growth momentum is already moderating and the UK has large twin deficits, with the fiscal balance -4.4% in 2015, and the current account -6.8% in the first quarter of 2016. General expectations are for real GDP growth of about 1.3% in 2016 and just 0.5% in 2017.

The impact on confidence and investment is expected to be more significant than the immediate impact on trade, but unemployment may also increase, and a weaker pound implies higher inflation than would have been the case otherwise. Taken together, this is not good news for UK consumers, and consumer spending is expected to be materially weaker.

European growth and policy expectations have also been affected by the referendum vote, but the most immediate risk is that the continent's fragile recovery is also derailed by uncertainty. Much will depend on whether the EU moves towards greater integration or disintegration over the longer term.

The biggest initial impact will likely be on investment, with trade less vulnerable in the short term. The European Central Bank is also expected to remain a visible and responsive support for growth and will likely extend its current quantitative easing programme beyond March 2017, if necessary.

UK TWIN DEFICITS UNDER PRESSURE



Sources: Coronation, Datastream

It is hard to disentangle the spider's web of interconnected issues and potential repercussions of the UK referendum vote, especially in a world where economic growth is fragile, and politics increasingly uncertain, and extreme. The end game for the UK and Europe may not be all bad, but a lot depends, first, on the internal political outcomes in the UK and then on the timing and manner in which negotiations between Britain and the EU evolve.

The speed with which the Conservative Party has nominated a new prime minister is the first vaguely positive sign emanating from the vacuum that followed the referendum. The political credentials of Theresa May have brought some stability to the market amid the expectation that a better result will be achieved in negotiations with the EU than if one of the exit campaigners led the country. In time, new trade relations and a greater degree of flexibility over policy setting may prove beneficial for the UK. For Europe, the stark warning of strong member dissatisfaction may spur reform from Brussels that leads to greater integration and reform which they have failed to implement in the period following the global financial crisis. If Europe fails to respond to this warning it is likely to see more discontent brewing among the weaker member states and ultimately more pressure to leave, precipitating in the break-up of the EU. This would have major economic consequences for the world, on a scale far greater than Brexit.

Brexit: The investment implications

Opportunity amid turmoil.

by **NEVILLE CHESTER**

***NEVILLE CHESTER** is a senior portfolio manager responsible for the management of aggressive equity portfolios within our South African specialist strategies.*

The consensus sentiment globally was that the UK would not vote to exit the EU, given the jump into the unknown this would represent. Therefore the world was surprised to wake on 24 June to the shock of the UK electorate doing just that. The moves in currencies and equity markets were immediate and brutal. The performance of safe haven assets such as precious commodities as well as US and Swiss government bonds was also immediately boosted as investors scurried for perceived safety in the light of this great jump into the unknown.

As referred to in the previous article, we were as surprised by the outcome of the referendum as most other market participants. This did not mean that the ensuing volatility in markets did not present a potential opportunity for clients. As always, the most important step was to remain calm and unemotional, assess the likely impact and then identify assets inevitably being mispriced in the panic that follows unexpected events.

At Coronation, we benefit from a team of over 60 investment professionals. We have detailed models on all the companies and instruments we hold, so we were able to immediately isolate all parts of the companies that would have potential exposure to the fallout from Brexit. We ran various scenarios to see what the overall impact on valuations would be. We could then compare this to the moves in the market and take opportunities to invest where there was a clear discrepancy between what the market was pricing and what the actual impact would end up being. To be clear, this is not a simple process of buying the assets that have fallen the most; the end outcome for the UK and Europe is not clear and risks in certain valuations have increased.

An example of our approach was illustrated by our holdings in two large listed property companies in the UK. Intu and Capco, which are dual-listed in SA, fell 26% and 35% respectively in the days following the referendum. We bought a lot of Intu as we are very comfortable with its forecast for expected rental income, given the defensive nature of its shopping centre portfolio, which is predominantly based in regions which will be unaffected by the Brexit vote. We also do not believe that credit markets will freeze like they did following the global financial crisis, and expect that capitalisation rates will remain fairly stable as the Bank of England is likely to cut interest rates further. With Capco we have been more circumspect. While half of its valuation is represented by the retail-focused Covent Garden (which should do even better given increased tourism from the weaker pound), the other half of its valuation is far more speculative, influenced by the demand and pricing levels for residential property in the City of London, which is likely to feel the pain of Brexit more keenly.

We have increased our holdings in two other dual-listed counters significantly following the referendum. Old Mutual fell sharply in line with many other UK insurers, despite the fact that the majority of its operations are domiciled outside the UK. The company is in the process of unbundling its core components and re-domiciling most of these assets back in SA. We do not expect the UK operations of Old Mutual to be that affected by Brexit, given that it is a UK wealth business serving predominantly UK citizens. As roughly 25% of the Old Mutual valuation is UK-based, we would have expected at most a 2.5% decline in its value with the 10% fall in the pound. Instead the share fell 14%, clearly an over-reaction.

Mondi has virtually no operations in the UK; all its operations are domiciled in Western and Eastern Europe and SA. Other than some potential spill-over from weaker European growth into demand for its packaging products there should be no impact at all from Brexit on its business. The slightly weaker euro will actually benefit Mondi's export business. Despite this, Mondi's share price fell 10% following the referendum, presenting a clear opportunity.

A number of other companies with very little or no UK exposure also fell on the day as a result of general risk sentiment. Anglo American, MTN and Steinhoff all fell between 10% and 12%, presenting good buying opportunities as these businesses' fundamental values were entirely unaffected by the Brexit decision and their share prices merely reflected investor panic.

In the flight to safety, some of our other holdings have performed extremely well amid the panic. Our holding in British American Tobacco and our platinum shares were the big beneficiaries of money moving into safe havens. To the extent that the market has priced in a lot of good news here, we reduced some of these holdings to fund new investment ideas.

Markets are full of uncertainty. Unusual events will play out time and time again, often in an unpredictable fashion. As managers of long-term capital, our key strength is having the knowledge and depth of analysis to be able to take calm and rational decisions, often against the sentiment of the day. In times like these, some of the best investment decisions are made.

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.

MTN

Darkest before the dawn.

by **PALLAVI AMBEKAR**

***PALLAVI AMBEKAR** is a portfolio manager within the SA investment team. She co-manages institutional portfolios within Coronation's aggressive equity portfolio range and analyses shares within the telecommunications, consumer goods, retail, and hotel and leisure sectors. Pallavi joined Coronation in 2003.*

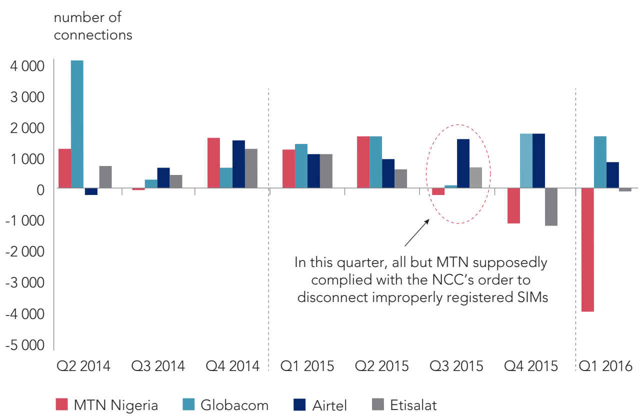
The last year has been a dramatic one for MTN. After more than a decade of growing to become the largest mobile operator in Africa and the Middle East, the company found itself facing a multitude of headwinds. The deteriorating economic environment in key markets such as SA and Nigeria started putting pressure on its organic growth. Also, the business had not invested adequately in its network and was slow to recognise the global trend in mobile usage away from voice and towards data. As a result, the company was losing market share to more agile competitors who had better network capacity. And then, in October 2015, news emerged that the company was being fined $5.2 billion for a delay in disconnecting subscribers who were improperly registered on MTN's Nigerian network.

The magnitude of the fine was extraordinary by global standards, for any industry. Previously, the largest telecommunications fine was $1.3 billion, levied on Djezzy Telecom for breaching foreign exchange regulations in Algeria in 2012. In other industries, the largest fine given by the US Justice Department to an automotive manufacturer was $1.2 billion in 2014 to Toyota after a faulty accelerator mechanism led to 37 deaths. General Motors was fined $900 million for an ignition switch defect that caused 174 deaths. Earlier this year, a BHP Billiton and Vale joint venture negotiated a settlement of $1.1 billion over 15 years for compensation and repair costs following a dam disaster in Brazil that caused 17 fatalities.

Subscriber registration has been an ongoing process in Nigeria. The requirements are onerous (akin to the biometric capturing of individual details) and obtaining complete subscriber information in the absence of a national identity database is difficult. A new, more security-conscious political regime felt it was imperative to have a quick cleanout of unregistered subscribers in an effort to tackle terrorism. Mobile operators were given seven days to comply. According to the Nigerian regulator only MTN did not meet this deadline.

This assertion was not easy to confirm or dispute at the time. However, our channel checks with competitors and ex-employees, as well as analysis of the quarterly reported subscriber numbers published by the Nigerian regulators, seemed to suggest that MTN had been singled out. The official data (shown in the bar graph below) show that, in the third quarter of 2015, only MTN showed net subscriber disconnections. Every other operator (Globacom, Airtel and Etisalat) showed net additions – despite the regulatory requirement to disconnect unregistered users.

MOBILE SUBSCRIBER CONNECTIONS AND DISCONNECTIONS IN NIGERIA



Sources: Nigerian Communications Commission (NCC) and Citi Research

In addition to the fine, the Nigerian regulator also proceeded to suspend regulatory services to MTN. The suspension of these services effectively hamstrung MTN's competitive position as it was not allowed to implement any promotions or new tariffs. This led to a direct loss of market share to competitors. The quantum of the fine and the suspension of services highlighted the extent to which the relationship between MTN and the Nigerian regulator had broken down.

The share price reaction to these events was swift and brutal. In the space of three months, the market wiped $10 billion off the market capitalisation of the company, almost twice the initial fine amount. News headlines from the Nigerian press were extremely negative, unofficial comments from the regulator were not encouraging and there was no consistency in the official communications on the fine. In December 2015, MTN was notified that the fine was reduced by 35%. Then, a day later, this was changed to 25%! Compounding the relentless newsflow was further macro pressure with poor Nigerian GDP growth and investors questioning the sustainability of a pegged exchange rate.

Although we held MTN in our portfolios when the fine was announced, it was an underweight position across most of our strategies. While there was a lot of conflicting newsflow and confusion following the fine announcement, we thought that the share price presented an interesting investment opportunity. The market's attention was focused only on Nigeria: the negative issues around the fine, the economy and the exchange rate. While it is a big market for MTN, its other key operations in Iran and Ghana were performing well and SA was staging a recovery after years of underperformance. All operations were generating good cash flow.

Also, the company was using the tough economic environment in Nigeria to deepen the moat around its business. Despite the tense regulatory relationship, MTN still managed to renew its mobile licence for a reasonable payment and received approvals to make spectrum acquisitions. With the growing demand for data services in Nigeria, this would expand MTN's network capability and entrench its market leadership.

By March 2016, regulatory services were restored, allowing MTN to once again be competitive in the market from a pricing perspective.

MTN's share price also posed very little downside from a valuation perspective. It had already more than discounted the full initial fine amount of $5.2 billion. The company had a fortress balance sheet with no net debt and was in a position to pay the full fine amount without the need to raise equity capital. Even after adjusting for the fine, the market's rating of the business looked very cheap compared to a basket of emerging market telecommunication peers.

The shock of the fine had also prompted a deep introspection within MTN and a recognition by the board that some fundamental changes to the company's culture and strategy were required. Chairman Phuthuma Nhleko stepped into the CEO role on an interim basis to implement some of these changes. The company made the decision to increase its capital expenditure programme in key markets. Fresh management and board skills were brought in to enhance governance, improve the culture and unlock efficiencies. Our previous experience has taught us that it is dangerous to underestimate the long-term benefits of a high-level change in direction, especially in a business that was not achieving its full potential.

With this long-term perspective in mind, we took the decision to increase our MTN position and moved to an overweight position in our strategies. Our discussions with competitors and regulators, as well as with board and management members, solidified our view that regardless of the final amount to be paid to resolve the fine, the company was on the path to making fundamental business changes. None of this was reflected in the market price.

Towards the end of June 2016, the fine was settled at $1.7 billion, payable in instalments over three years. The present value of this fine is much lower at around $1 billion. Subsequent to that, the Central Bank of Nigeria announced a move away from the pegged currency towards a more flexible exchange rate regime. With this implemented, dollar availability has improved in the country and businesses should be able to extract cash from Nigeria. Finally, we saw the announcement of Rob Shuter as the new MTN group CEO. Shuter will be a positive appointment for MTN as he has financial experience from his time with Vodacom as financial director, as well as operational experience as CEO of Vodafone's European cluster. We think he will bring good capital allocation skills and improved operational discipline to MTN. He is further supported by a strengthened board, which now also includes Paul Hanratty (formerly with the Old Mutual Group) and Stan Miller (from the US investment company Capital Group and executive chairman of MTS, a Russian mobile operator) among others.

It was not an easy or a comfortable decision to increase our position size in MTN. But the fear in the market granted us an opportunity to make an investment which would be to the long-term benefit of our clients. The resolution of these issues will bring about some short-term pain for the group, but the overall business fundamentals still look attractive. MTN has a market-leading footprint in key countries that is very difficult to replicate. While not immune to macro pressures, it has a relatively defensive business model. Data penetration across key markets is still at very low levels and growth will be supported by the increased availability and affordability of smartphones. Its balance sheet strength is not to be underestimated. In most markets, competitors are unable to match MTN's level of capital spend on its network. The business is able to fund elevated capital expenditure, while still supporting a decent dividend yield.

All of these factors, along with improved management and board skills, will be a powerful combination that can deliver good long-term returns to the patient long-term investor.

International outlook

Globalisation under the spotlight.

by **TONY GIBSON**

***TONY GIBSON** is a founder member of Coronation and a former CIO. He was responsible for establishing Coronation's international business in the mid-1990s, and has managed the global equity fund of funds product since inception.*

In recent months global investment markets have had much to fret about – whether it be Brexit, worries over the post-Obama leadership in the US, the migration crisis, wavering confidence in the strength of the US economy or deflationary fears in Europe. In our opinion, the clear growth of populism (best exemplified by the utterances of Donald Trump) has unsettled investors the most. Markets are no doubt alarmed that 'even' the US economy is falling prey to protectionist and populist statements. Additionally, investors are concerned that globalisation is seen to be failing in advanced Western countries. Once hailed for delivering universal benefit, it is now facing a political backlash. The reason for this, it seems, is the delayed (but inevitable) effects of financial repression.

This is the phenomenon whereby central banks aggressively intervene to lower interest rates to effectively zero, in the hope that it will stave off deflation. The consequence of this strategy has been that, while staving off deflation, savers are penalised. Additionally, while the financial position of the median worker in the US has deteriorated in real terms since 2006, a small but very visible component of the business community has made extraordinary amounts of money. This is an environment in which antimigration sentiment flourishes as it is seen to be the reason for the lack of economic progress suffered by the working class. Similar sentiments are being expressed in Europe – exacerbated by the migrant crisis.

Accordingly, critics of globalisation contend that Western countries are failing to cope with the economic shocks that inevitably result from closer integration, particularly the stagnation of real average incomes for two decades. Another shock was the global financial crisis itself, seen as a consequence of globalisation, with its permanent impact on long-term economic growth.

A stark example of antiglobalisation sentiment is the dramatic reversal of public opinion in Germany about the benefits of free global trade in general. In 2014 almost 90% of Germans were in favour of free trade, according to a poll. That has now fallen to 56%. The number of people who outright reject the Transatlantic Trade and Investment Partnership (a proposed trade agreement between the EU and the US) has risen from 25% to 33% over the same period of time. Although these numbers do not suggest that the EU will become protectionist, the fast shift in those figures is a worrying trend. In many European countries, globalisation and technical innovation have together destroyed the jobs of the working classes. Now these factors are threatening the livelihoods of the lower middle class. Accordingly, a revolt among voters is unsurprising

While workers in the West remain wealthy compared with most others around the world, their incomes and benefits have stopped improving and, more ominously, are increasingly deemed unaffordable. This has fuelled social uncertainty and the rise of anti-establishment politicians through Europe and now the US. Essentially, electorates believe there is insufficient factual evidence that countries that have reformed are performing better. The US and the UK have more liberal market structures than most of continental Europe. Yet the UK is exiting the EU and in the US the Republicans may be about to nominate an extreme populist as their presidential candidate. Politicians who advocate global market liberalisation are being forced to face up to the notion that both globalisation and European integration are increasingly seen as failures. Both were supposed to produce a situation where nobody should be worse off, while some might be better off. The key point is that if the politicians do not take action, the voters surely will.

Meanwhile, the influence of the global economy on the decisions of the US Federal Reserve (Fed) has become a topic of frontline importance in recent months. Since the start of 2016, events in foreign economies have conspired to delay the Federal Open Market Committee's intended 'normalisation' of domestic interest rates, which had apparently been set on a firmly determined path last December. But the key question now is whether weak foreign activity will continue to trump (no pun intended) domestic strength in the US. The US central bank certainly has no responsibility to take direct account of the welfare of foreigners. That said, the impact of events overseas on the dollar and the domestic US economy are too important to be entirely ignored.

Remarkably, the ten-year German Bund yield reached a record low of -0.17% in the wake of the Brexit vote. The ten-year US Treasury note is around 1.45%. These bonds are now trading below the yields during the depressionary period of the 1930s and 1940s. This does suggest a serious bubble, representing a bigger problem in government bonds around the globe than what we saw following the technology bubble during the late 1990s. As has been well signalled, the Fed seems intent on normalising rates, albeit at a slower pace than in the past. While this may be undesirable, what the Fed does (or does not do) is critically important for the market. It seems the bond market is currently expecting two to three rate increases, followed most likely by a recession.

We disagree with that. While secular headwinds will pose a formidable barrier to global growth over the medium to longer term, a cyclical rebalancing should buoy growth over the next two to three years. As mentioned, fears of an impending recession in the US have been on the rise – both because the current expansion is growing tired and because declining profits are seen as a signal for firms to cut capital spending and hiring. We believe these fears are exaggerated, for several reasons. First, economic expansions do not necessarily simply end due to the flux of time. Rather, they die of natural causes, including overinvestment imbalances, policy tightening, and other exogenous or external shocks. Secondly, although profit growth rates have declined significantly over the past year and a half, this has been from extremely high levels. Profit margins are still quite high by historical standards – well above levels normally seen as the economy nears a recession. Margins normally peak at mid-cycle, not at the end of a cycle, and they decline for a number of years as the expansion matures.

We do not currently detect any of the various potential natural causes of recessions in the US. Frequently, it is aggressive Fed tightening in response to rising inflation pressures that induces downturns, but that prospect still seems a couple of years away. Overinvestment in housing and/or business capital has also been a traditional culprit, but underinvestment has been the mode so far in this expansion. Looking at other conventional causes of a recession in the US, oil shocks have often been major contributing factors. However, the shale industry has become a buffer to potential price spikes going forward, thereby arguing against this as a cause. China may offer a new potential shock, but Chinese officials seem to have both a desire to avoid and the resources to deal with any disruptions that do arise.

The more bearish commentators will point to recession probability models that suggest that the likelihood of a downturn has increased in recent quarters. These models, and indeed the economic profession, do not have an especially good record in predicting recessions a year or two out. In our opinion, a recession is not the most likely outcome over the next two years, with current conditions certainly not favouring a severe recession any time soon. This is validated by the fact that the median US worker enjoyed a pay increase of 3.5% year-on-year in May, according to the Federal Reserve Bank of Atlanta's wage growth tracker. Wage growth has been accelerating since October, quickening to a pace not seen since January 2009. This measure of wage growth is far from the only metric suggesting that the US labour market might be close to full employment. The National Federation of Independent Business (NFIB) Small Business Optimism report for May indicated that finding quality labour remains one of employers' biggest problems. Citing anecdotal evidence, the NFIB reported that the 'failure rate' rose over the course of the month, as the share of owners who could not fill a job opening lingered at historically high levels.

What will, ultimately, cause the US economy to move into a recession will be the slow but inevitable climb back to positive real interest rates, which will also increase the cost of debt service for many countries and corporations. While companies may have locked in longer-duration debt, most countries had been short-sighted and face a surge in net interest costs. While the timing of the climb will have a significant impact on near-term capital flows and asset allocation by country and industry, the end destination is still likely to be a rise of

200 basis points to 250 basis points in the Fed funds rate (and much of the US yield curve) over the next 24 to 36 months.

The primary reason for our view is the expected ripple effect of the year-on-year rise in energy prices over the next 18 months, which may prove to be a major catalyst of rate hikes. This will increase consumer prices and therefore boost (already rising) cost-of-living wage hikes. While the media and many investors focus on tepid year-on-year inflation in the US (up only 1.1% in the year to April), less attention is paid to the measure of consumer price index (CPI) less food and energy – which has been at or more than 2% year-on-year since November 2015, despite the ripple effect of sharply lower energy prices. With year-on-year energy prices poised to rise sharply during the remainder of 2016 and into 2017, top-line CPI is likely to rise above 2%. As a result, a normalised Fed funds rate would be 2.5% or higher by 2018.

That said, while the Fed will lead the climb towards positive real interest rates, it will be followed only after a considerable lag by the Bank of Japan and the European Central Bank. As a result, money is likely to rotate towards the dollar and US financial assets again. Despite popular belief, such a modest real rate of return may actually stimulate rather than dampen economic activity.

Looking at equity markets, some perspective is called for. Seven years of the Fed's zero-interest rate policy have resulted in an increasingly over-extended search for yield. This has inflated valuations of many financial assets to historically high levels. Additionally, US equity markets have also experienced an extreme divergence since mid-2014 as the collapse in commodity prices and exceptional US dollar strength stoked fears of an industrial recession, which depressed the share prices of many value stocks and drove investors into perceived safe-haven assets, such as passive large-cap exchange traded funds (ETFs), mega-cap consumer staples and growth stocks. This equity market dynamic caused many investors to crowd into momentum stocks, inflating their valuation premiums over value stocks to levels not seen in the past 35 years, other than during the tech bubble period of 1998 to 2000.

As context, in 1998, the Asian financial crisis and collapse of Long-Term Capital Management created major macroeconomic disruptions and raised fears of systemic risk that caused equity markets to experience a sharp bifurcation. At that time, fear caused capital to leave the equity markets, while the remaining investments tended to gravitate towards large-cap stocks. The rise of passive investing (via ETFs and index funds) during the mid-1990s had already channelled large amounts of capital into large-cap and growth companies, particularly those focused on the internet, resulting in significant share price appreciation. As investors grew concerned about the macro environment, they crowded into these 'safe' investments. Value stocks, particularly small and mid-caps, became a source of cash and underperformed in late 1998.

By the end of 1998, the ten largest technology stocks, including Microsoft, Intel, Cisco, AOL and Yahoo, had gained an average of over 140%, driving the Nasdaq Index up 40% and the S&P 500 Index up 29% for the year. The S&P 500 Equal-weight Index gained only 10% in 1998, while most value managers performed well below that level. This extreme divergence reinforced itself over the next 18 months, as investors ignored fundamental analysis and rotated further from value into growth and momentum names. While the AOL-Time Warner merger in January 2000 should have rung a 'bell at the top', as it revealed the enormous gap between the prices and fundamentals of many growth companies, the actual inflection point for US equity markets came in March 2000. The ensuing collapse of the tech bubble triggered a long-overdue rotation back to value and initiated a seven-year cycle, from 2000 to 2006, during which value outperformed growth. Despite global economic growth that fell well below trend from 2000 to 2003, active value-oriented strategies outperformed the market meaningfully as the valuation differential between growth and value continued to narrow. Investors remained focused on fundamentals as the economy improved, which enabled value to outperform growth through 2006.

Equity markets experienced another significant bifurcation from mid-2014 to early 2016, with large-cap growth stocks again outperforming small- and mid-cap value stocks. Two major macro factors triggered this equity market divergence: firstly, a rapid and sustained decline in commodity prices, highlighted by a historic 70% peak-to-trough decline in the price of oil; and secondly, a similarly rapid and sustained strengthening of the US dollar, which appreciated by 25% to 40% against major developed market currencies, and by 40% to 80% against many emerging market currencies. These two disruptions caused fear among investors and pressured the earnings of US industrial and export-focused companies, prompting investors to rotate back to large-cap stocks at the expense of small- and mid-caps, and to growth and momentum at the expense of value stocks. Passive investing, already on the rise for years due to substantial capital inflows into ETFs, gained even more momentum during this period, exacerbating the bifurcation. The so-called FANG stocks (Facebook, Amazon, Netflix and Google) gained more than 80% on average in 2015, largely due to a multiple expansion in valuations, fuelling a double-digit gain in the Nasdaq 100 Index, which, without these four stocks, would have been down in 2015.

It would seem to us that the multi-year rotation away from value may be in the process of reversing after equity markets experienced their worst start to any year on record. This sell-off was broad based, but as investors once again fled to the relative 'safety' of mega-cap consumer staple and growth stocks, small- and mid-cap stocks and many value stocks were disproportionately impacted, driving valuations to near historically low levels. The bottom in February 2016 and subsequent recovery of the equity market might have coincided with another major inflection point in the dynamic from growth to value. This inflection point appears to be a function of the stabilisation of the two macroeconomic factors (oil prices and the US dollar) that drove the recent bifurcation in equity markets: oil prices have rebounded significantly from their low, and the US dollar has gradually stabilised against major currencies.

Walgreens Boots Alliance

A compelling investment opportunity.

by **STEVEN BARBER**

***STEVEN BARBER** is an analyst in the global developed markets team. He joined Coronation in 2012, prior to which he was an analyst at Element Investment Managers.*

The global pharmacy giant Walgreens Boots Alliance (WBA) recently made headlines with its plans to create the largest pharmacy chain in the US through the acquisition of its competitor Rite Aid.

We have found compelling investment value in WBA for some time, and have built a sizeable holding across some of our portfolios. Even without the Rite Aid transaction, the company offers a high-quality investment that is trading below our assessment of its intrinsic value, and which should see substantial operational gains over the long term.

Background

Following the two-stage acquisition of Alliance Boots by Walgreens, WBA was formed in December 2014.

The new group has three principal divisions:

Retail Pharmacy USA (75% of group profits): Walgreens is the second largest US retail pharmacy chain with over 8 000 locations across the US.

Retail Pharmacy International (15% of group profits): Boots, the retail pharmacy chain with 2 500 stores across the UK, is the primary contributor to this division's profits. This business is fairly mature and has attractive levels of profitability.

Pharmaceutical Wholesale (10% of group profits): Alliance Healthcare is a pan-European pharmaceutical wholesale business that operates distribution centres throughout Europe, delivering drugs to pharmacies and hospitals. This business is also mature and has the low margins typical of a wholesaler.

Management

While on paper Walgreens acquired Alliance Boots, the deal has the hallmarks of a reverse takeover. Upon consummation of the deal, the Alliance Boots management team, led by the Italian Stefano Pessina, assumed leadership of the combined entity. We rate Pessina and his team as one of the best in our investment universe. Pessina has a unique strategic vision and is a patient and disciplined dealmaker, with an incredible track record of value creation over almost 40 years through both mergers and acquisitions (M&A) and operational turnarounds. In 1977 he took over his family's small, struggling Italian pharmaceutical wholesaler. Since then he has concluded over 500 M&A deals[1], first building a pan-European pharmaceutical wholesaler, and subsequently a retail pharmacy business focused primarily on the UK and the US. Notable deals include:

- a merger with the French pharmaceutical wholesaler Santé in 1991;
- a merger with the UK pharmaceutical wholesaler Unichem in 1997;
- a merger with Boots in 2006 and the delisting of Alliance Boots in 2007 in partnership with KKR;
- a merger with Walgreens in a two-step transaction (2012, 2014); and
- the possible acquisition of Rite Aid, the third-largest US pharmacy chain (awaiting Federal Trade Commission approval).

[1] *The number could be as high as 1 500 but because many of the deals were concluded in unlisted entities it is not possible to verify the actual number.*

Today, Pessina owns a 13% stake in WBA worth $12 billion. He is self-avowedly a dealmaker: "I am not a retailer – I have never run a store, I have never understood the full details of how you can make a consumer satisfied … To build a company, to do deals, to motivate people: this is what I am able to do." He has assembled a formidable team under him, led by Alex Gourlay (head of Walgreens and Boots) and Ornella Barra (head of Alliance Healthcare). The team that is now running Walgreens is the same one that achieved phenomenal success transforming Boots in the UK. Between 2006 and 2014, in a very tough revenue environment (revenues per script declined 16% due to reimbursement[2] cuts by the NHS), profit margins increased from 7.6% to 12.4% and profits almost doubled. This is largely attributable to cost savings, and a wildly successful health and beauty strategy built around the Boots No7 brand.

The opportunity at Walgreens

We believe that the fundamental backdrop at Walgreens is favourable:

- The ageing US population – 10 000 people a day are turning 65 and becoming eligible to join Medicare[3] – should continue to drive low single-digit growth in scripts as the elderly consume significantly higher volumes of pharmaceuticals than younger generations.
- Ongoing generic conversions[4] should continue to support profitability. While some 85% of scripts dispensed in the US are already generics, the generic conversion pipeline over the next few years should provide a tailwind to pharmacy profitability. Pharmacies earn higher profits on generic drugs than they do on branded alternatives.
- Following a brief period of generic inflation over the last few years due to disruptions in the generic supply chain and a backlog of new generic approvals by the US Food and Drug Administration (FDA)[5], generics have more recently resumed their typical deflationary trend. This will support pharmacy profitability.

Offsetting these tailwinds is ongoing reimbursement pressure. There is no shortage of pharmacies in the US and as they all compete to grow script volumes, there is a general downward trend in the level of reimbursement paid to them. We believe that Walgreens is reasonably well positioned in this environment. As one of two 'at scale' pharmacy chains, they are best positioned to leverage their size to trade lower reimbursement for higher script volumes. Given the fixed-cost nature of pharmacy operations, if done correctly, this trade-off can deliver positive results as more scripts flow through the store network. The new management team is also well versed in operating in the UK's intense reimbursement environment and should be able to offset headwinds through efficiencies and cost savings.

We believe that under the leadership of Pessina there are substantial opportunities to improve the operational performance of what we believe was an undermanaged business. (Pessina is the first external CEO appointment at Walgreens in more than 100 years!) Margins are considerably lower than its closest peer, CVS. There is now a clear strategy to grow script market share, cut costs and improve the mix in the front-end of their stores.

There are early signs of success evident at Walgreens, with substantial cost savings and merger synergies already delivered. The longer-term opportunity lies in continued operating efficiency improvements and transforming the health and beauty offering at Walgreens by implementing some of the learnings from Boots. This is a longer-term opportunity that will take time to deliver results.

The pending Rite Aid acquisition

WBA is in the process of acquiring Rite Aid, the third-largest stand-alone US retail pharmacy chain with approximately 4 500 stores. We believe that the deal makes both financial and strategic sense and that WBA is acquiring Rite Aid at an attractive price. The Rite Aid store base has a complementary geographic footprint with Walgreens and will in effect 'complete' the Walgreens store base, giving it a nationwide footprint.

Rite Aid has been challenged as a stand-alone business and its margins are half those of Walgreens. Significant debt incurred prior to the 2009 financial crisis and the associated

[2] Reimbursement is the term used to refer to the amount that a pharmacy is paid for dispensing a script. In the UK, the NHS is the sole payer, whilst in the US pharmacies negotiate reimbursement with the pharmacy benefit managers.

[3] Medicare is the US government healthcare plan for those 65 and older.

[4] The process whereby a branded pharmaceutical drug loses patent protection and has to compete with generic copies of the drug, normally sold at a fraction of the price of the branded drug.

[5] The regulatory entity that oversees the pharmaceutical industry.

cash flow constraints have constrained management's ability to run the business optimally. In addition, Rite Aid's lack of scale relative to its two larger peers has rendered it less competitive when negotiating reimbursement and in pharmaceutical procurement. We believe that by combining with WBA, there are significant synergies that WBA can unlock by using its superior size to negotiate better procurement and reimbursement terms.

The deal is not without challenges. It is subject to approval from the Federal Trade Commission, which may still block the deal on anticompetitive grounds. We believe anticompetitive concerns can be assuaged through manageable store divestitures. WBA has confirmed that it is willing to dispose of up to 1 000 stores, but there remains a risk that the deal does not get approved.

Another challenge is that the Rite Aid store base is underinvested and in poorer locations than rivals Walgreens and CVS. WBA will have to invest in the store base to bring it up to acceptable standards.

While we believe the acquisition of Rite Aid offers a compelling opportunity to create sustainable value, we believe that WBA is an attractive investment with or without Rite Aid, and our investment case is not premised on the Rite Aid deal.

Mexico

A local bank is our top investment holding in a promising market.

by **IAKOVOS MEKIOS**

__IAKOVOS MEKIOS__ is an analyst in the global emerging markets team. He joined Coronation in 2013, prior to which he was an investment consultant at Willis Towers Watson in London.

Coronation investment team members recently visited Mexico where we gained an on-the-ground view of the country's prospects and a better understanding of what some of its most dynamic companies are planning. We met one-on-one with a number of key executives and visited operations in the consumer and financial sectors.

In the past, we have been fairly cautious on the Mexican market. Generally, it trades at higher-than-average multiples compared to the rest of the Global Emerging Market (GEM) universe. Also, while its economy is often touted as being close to an inflection point, Mexican growth has been a perennial disappointment. While valuations in Mexico remained stretched (its stock market is currently trading at around 18.4 times one-year forward earnings versus 12 times for the broader GEM universe), we believe that its economic fundamentals as well as various policy initiatives have at last created a more conducive environment for select medium- to long-term investment opportunities. Mexico has either already implemented, or is in the process of implementing, a series of reforms in education, energy, banking and the fiscus – arguably, the most ambitious policy reform programme in our GEM universe.

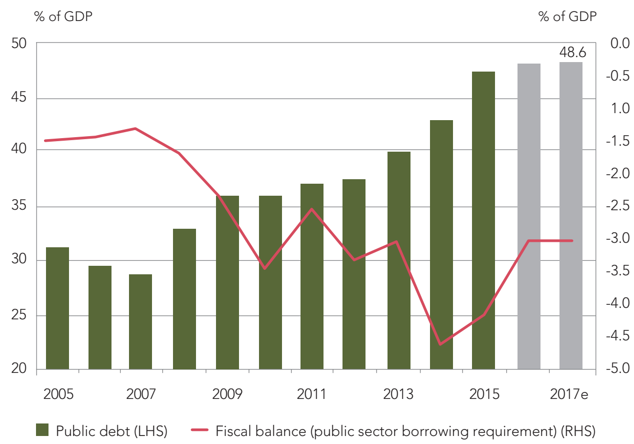
Still, we have found a clear disconnect between the respective outlooks of policymakers and company management teams. Policymakers are increasingly defensive in their policy mix. However, management teams appear optimistic about the demand outlook for their businesses, especially those facing the consumers. This is largely due to the boom that most Mexican consumers have been enjoying. Employment stands at its highest level in years (with an unemployment rate of 3.9%) and remittances (mostly from Mexicans living in the neighbouring US) have grown 28% in Mexican peso in the year to date. Although the sanguine mood of the policymakers has been tempering consumer sentiment, which remains at moderate levels, consumer spending and credit are nonetheless growing at a healthy pace. Accordingly, banks are seeing strong growth in the demand for consumer loans and the use of credit cards, and a number of retailers are enjoying robust same-store sales growth. This sector (in particular segments such as convenience stores, food retail and casual dining) is also benefiting from the shift from informal trading to formal, more sophisticated outlets. Mexico has a much larger informal sector than many other emerging countries, with strong scope for growing formalisation.

Mexico's competitiveness has improved significantly in the years since the global financial crisis. As labour productivity in China has been declining, Mexico has benefited from the decision of large manufacturing companies to resettle their activities closer to the important end-user market of the US. It has also continued to see a flow of US manufacturing capacity moving across the border to take advantage of its stronger economic growth, lower cost of labour and convenient location. More recently though, as the strong dollar and low oil price weighed on US manufacturing orders, Mexico has also seen a slowdown in its own manufacturing sector (as much of it is intricately linked to US supply chains).

The challenges that Mexican policymakers face are not negligible. In the last six months, the Mexican central bank (Banxico) has had to raise its benchmark rates by a total of 125 basis points in order to shore up support for the peso, which has seen a steady decline since the end of 2014. The currency's high liquidity and low yield make it an easy proxy for investors who want to take a short position in emerging market currencies, a popular trade the last couple of years. The authorities have adopted more stringent fiscal measures to bolster state revenues and to counter the effect of low oil prices on the external accounts. (While oil and gas are not as material for Mexico as they are for some of its Latin American peers, the country is a net exporter of oil.) The timing of liberalisation of the energy industry (previously monopolised by troubled state giant Pemex) has been unfortunate: it came amid collapsing commodity prices, resulting in lower-than-expected revenues from oil field auctions. The result has been a widening in the country's twin deficits (fiscal and current account), an additional source of vulnerability for the peso. Although foreign direct investment has continued to increase, the economy has grown more vulnerable to external crises and the currency has played the role of the shock absorber.

Of course, it should be underlined that given the linkages of the Mexican economy to its wealthy northern neighbour, it is important for the country's economic performance that US growth remains at least benign. Also, the possible election of Donald Trump (who has adopted a hostile stance towards Mexico) as US president is a risk. In addition, prospective investors need to take note of the early signs of a rise in domestic Mexican populism.

MEXICO'S PUBLIC FINANCES SHOULD STABILISE



Sources: Mexican Ministry of Finance, Barclays Research

A number of Mexican companies, particularly in the consumer sector, are on our radar. These include Femsa, a Mexican-based multinational which (among other businesses) owns the country's largest beverage bottling company, as well as the leading convenience store chain Oxxo and a 20% interest in the brewer Heineken NV. We also like Alsea, which operates fast-food and casual-dining brands in Mexico, broader Latin America and Spain. However, we believe their valuations are too demanding, and we are happy to remain patient and buy them only when the price is right. While the Coronation GEM strategy holds a small position in the US-listed railways operator Kansas City Southern for its Mexican exposure (Mexico represents more than half of the group's profits), the portfolio currently only has one Mexican-listed holding: Grupo Financiero Banorte.

Banorte

We have been investors in Banorte since November 2014. Banking represents some 70% of its earnings, while long-term savings (insurance and asset management) make up 22%, followed by brokerage (5%) and its other activities (3%). Over recent years, the group's profitability has been underwhelming due to a long period of record-low interest rates (which squeezed its net interest margins), the cost of integrating Ixe Banco (which focuses on the premium segment and had a high cost base) after its acquisition in late 2010 and low levels of leverage. A relatively new management team has embarked on initiatives to improve the utilisation of the bank's balance sheet. The team wants to achieve a return on equity (ROE) target of 20% by the end of the decade – and, importantly in our view, management is aligned to this target. Some 40% of executives' variable compensation will only be released as key ROE milestones are achieved.

We believe the ROE target will be achieved due to the following:

- The implementation of efficiency initiatives. These interventions are in the process of being adopted following an extensive consulting project, led by IBM. The initiatives include a new customer relationship management system, expanded use of online and mobile channels, and the optimisation of the bank's fee and commission structure. In the next five years, the bank's branch footprint will remain stable or grow smaller, while its assets are forecast to continue growing by double digits.
- A return of capital to shareholders. This could come in the form of larger ordinary dividends and, potentially, the payment of extraordinary dividends.

- Material improvements in the cross-selling of products to the bank's existing customers. The bank has already seen some success on this front: the number of products sold per customer has increased from 1.7 to 1.83 products since the management team set on improving this metric. It believes this can grow to more than two products.
- A key shift in its client base. The breakdown of Banorte's various customer segments is stunning: high-income customers represent 1% of its total number of customers, but provide 12% of profits, while middle-income customers are 4% of total and contribute 65% of profits! By comparison, 95% of its customers are low-income and generate 23% of profits. Management believes that 40% of the low-income customers are moving into the middle-income segment – this could present the bank with a big opportunity.
- Rising interest rates. Banorte is one of the most asset-sensitive banks in the country (meaning its assets re-price considerably faster than its liabilities) and will benefit from higher net interest income as the central bank of Mexico increases its policy rate.
- An increase in the contribution to earnings from the non-banking subsidiaries of the group, especially insurance and pension management. Both stand to benefit from structural tailwinds and are high ROE businesses.

In terms of competition, Banorte (which has the fourth-largest share of the loan market), along with other players, are taking market share off the embattled Banamex (the number two player, owned by Citigroup). While competition is robust, generally product pricing remains rational, as we understand from our conversations with a number of management teams in the sector.

While we believe Banorte offers a strong investment case, governance risk has deterred investors over the past two years. Banorte's chairman Carlos Hank González is the former CEO and majority shareholder of Grupo Financiero Interacciones. His family holds a stake of more than 70% in this Mexican financial institution, which is mostly focused on infrastructure loans. Investors were concerned that he might attempt to force a merger between the two companies, to the detriment of Banorte's minority shareholders. However, Hank González has repeatedly denied this. Last month, he backed this up with more concrete action. He suggested a change in the company's bylaws that will ensure that any acquisition proposal for a related party (e.g. Grupo Interacciones) has to be approved not only by Banorte's audit and corporate practices committee and the board, but also be put to a shareholder vote. This should allay any lingering corporate governance concerns.

VALUATIONS OF MEXICAN BANKS

Sources: MSCI Aggregates, Thomson Financials Datastream, UBS

From a valuation point of view, Mexican banks in general look rather pricey compared to their emerging market peers. However, compared to their own history, valuations are in line with the average forward price earnings multiple over the past ten years. The banks are also trading below their average price-to-book levels over the same time period. Banorte has appreciated nicely since our initial purchase. It can currently be bought for approximately 14 times one-year forward earnings or 1.8 times book value – reasonable, given the robust earnings growth we expect in the coming years. Accordingly, Banorte remains a holding of the Coronation GEM strategy.

Nigeria: Addicted to dollars

An investment response to naira uncertainty.

by **GREG LONGE**

***GREGORY LONGE** is an investment analyst in Coronation's Global Frontiers unit. Gregory is a Chartered Accountant (SA) and joined Coronation in 2013 after completing his articles at Ernst & Young.*

Addiction. A word that can conjure up a multiplicity of emotions, including euphoric highs and heart-breaking failures. Whether we care to admit it or not, in some way most of us are addicted to something: love, work, social media, alcohol, coffee, status or food. Some 'substances' may be more socially acceptable than others, and in measured doses, some of these addictions may be good for us, but there comes a point where we develop an unhealthy reliance on our vice of choice. Take that stimulant away and we slowly fall apart.

Nigeria is addicted to dollars. Over the past 18 months, the government has had to figure out how best to respond to much less of its regular hit.

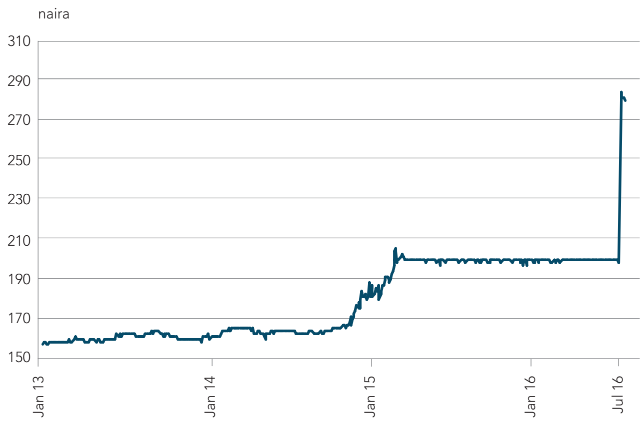
Nigeria, like other oil producers, is deeply reliant on oil revenue. Not only does oil account for more than 80% of its fiscal revenue, but with oil representing close to 90% of exports, it is effectively its only source of dollar income. These dollars are then used to pay for Nigeria's large import bill. The import bill is large because Nigeria produces very little locally. A steady stream of dollars is thus vital to ensure that the population is fed, clothed and able to move around. It is also vital to ensure that businesses can access raw materials and the equipment that they need to function. With the collapse in oil prices, and cut off from dollars, Nigeria's economy has become deeply strained. The impact of going cold turkey has been harsh: the current account fell into a deficit of -3.3% of GDP, the first deficit in 13 years; the trade balance turned negative for the first time in 30 years; and oil-related foreign direct investment collapsed.

Nigeria's economic fundamentals saw a meaningful deterioration, but unlike other oil producers that allow their currencies to weaken, Nigeria's policy response was to hold the naira painfully stable, resulting in a very overvalued currency. Government contended that fixing the currency would limit the impact of inflation on the economy and protect the poor from rising food prices. Unfortunately, it effectively led to a seizure in the foreign exchange market and many businesses were forced to buy dollars through unofficial channels, where rates were 50% to 100% higher than the official rate. This meant that inflation rose regardless. In order to hold the pegged exchange rate, the Central Bank of Nigeria (CBN) implemented an array of restrictions, including a long list of import controls. This forced even more businesses into the unofficial market. The net result has been a sharp rise in inflation and a decline in growth. Inflation was 15.6% year-on-year in May and GDP growth in the first quarter of 2016 was -0.4% year-on-year and is forecast to contract almost -2% in real terms for the year as a whole.

BRENT CRUDE OIL PRICE

Source: Bloomberg

NAIRA / DOLLAR EXCHANGE RATE



Source: Bloomberg

The cost of defending the naira finally became too much to bear and the currency was allowed to float in June. We view this as a positive development, as we believe that the level of the exchange rate is far less important than the requirement for dollars to be accessible in the market. Businesses are surprisingly resilient and are generally able to deal with a sharp rise in costs, either through passing on price increases, cutting costs or accepting lower margins. However, resilient businesses cannot survive if the raw materials or machinery they need to produce their products suddenly become unavailable. This is what happens when they cannot access dollars; businesses that rely on imported raw materials grind to a halt. Assuming the CBN allows the naira to find a rate that fully reflects its real market value in coming months, the economy is likely to go through a painful, but necessary, adjustment. The first impact will be higher inflation in an environment where prices are already rising.

We would expect the CBN to respond by increasing the monetary policy rate by some 200 to 300 basis points over the next year. At the same time, the external balance should adjust, providing some reprieve and better support for growth. A currency that is completely free-floating and that is more reflective of fundamentals should support confidence in not only the value, but also the convertibility, of the currency.

Admittedly it is still early days in the new regime, but our initial euphoria over Nigeria's move towards a freer exchange rate is waning. Liquidity has continued to be severely constrained and the rate of exchange has been stubbornly steady around N280 to the dollar. The market remains opaque, with limited visibility into its inner workings. An obvious question at the moment is whether Nigera has truly moved to a floating exchange rate or whether the CBN is managing the float, allowing for a one-off 40% devaluation, but now continuing to maintain the peg, albeit at a lower level. The risk with a 'managed float' is that the underlying problem (dollar shortages in the economy) is not addressed and the limited access to dollars will ultimately strangle the economy once again.

As the manager of an Africa-focused strategy, it is difficult to ignore a country like Nigeria, and over the medium to long term, we still believe that Nigeria is one of the most attractive markets globally. Unsurprisingly, we have seldom struggled to find high-quality companies trading at attractive valuations on the Lagos bourse. However, given the policy response of president Muhammadu Buhari's administration to the decline in oil prices, we have spent the better part of the last 18 months debating how best we should respond in our portfolios.

At this point, it is worth noting that our investment methodology is very much a long-term, bottom-up, valuation-driven one. Exchange rates and currencies are taken into account in our earnings forecasts, but are viewed admittedly as 'low-conviction' inputs. We simply have never been very good at calling short-term fluctuations in currencies. Our competitive advantage is our long-term investment horizon and our valuation-driven philosophy, not our view on a particular currency. With that caveat out of the way, how did we position ourselves?

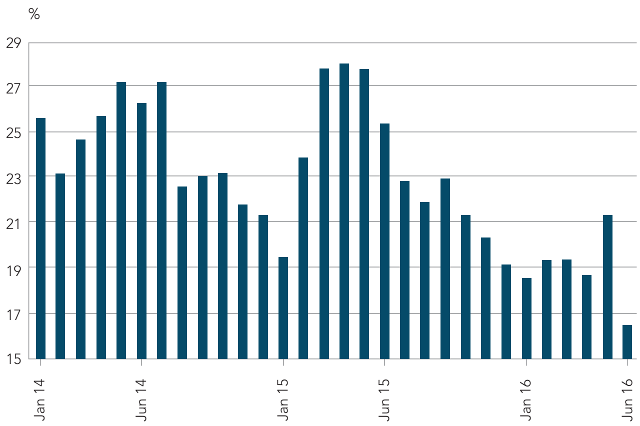
Our approach was as follows:

Reduce our position size

As the oil price started falling in the second half of 2014, equity valuations began to look stretched and our earnings forecasts started to decline. We took a decision to reduce our Nigerian exposure from a high of 27.4% of our Africa Frontiers strategy in July 2014 to 19.6% in January 2015.

Following the move to reduce our exposure to Nigeria, the market sold off significantly in the run-up to the March 2015 election. With valuations looking attractive, we added to some of our positions, increasing our Nigeria exposure, resulting in Nigeria once again representing 27% of fund. This investment allowed us to benefit from the strong market gains following the peaceful transition to the Buhari administration. The large market gains pushed some of our holdings to close to our estimate of their fair value. Accordingly, we reduced our portfolio exposure to below 20% once again. At the time, there were still enough dollars in the market to enable this withdrawal and we could repatriate our naira sales. We also increased our cash holding at this time.

CORONATION AFRICA FRONTIERS STRATEGY'S EXPOSURE TO NIGERIA



Source: Coronation

Hedge the naira

In November 2014, with oil prices continuing to fall rapidly and the naira stubbornly pegged at N168 to the dollar, we entered into a hedge for 20% of our Nigerian exposure. This allowed us to further reduce our naira position without having to physically sell the underlying shares. In hindsight, while the hedge worked very well for us, we should have hedged a far greater proportion of our exposure.

Switch exposure to foreign listings

As dollar liquidity in the market dried up in the second half of 2015 and concern grew around our ability to repatriate returns from any sales, we took an active decision to move our exposure in dual-listed companies from listings on the Lagos exchange to the equivalent listings in London or New York. This allowed us to continue to trade these shares without worrying whether the de facto capital controls in Nigeria would persist.

Avoid cash

Over the course of 2016, it became apparent that it would be very difficult to repatriate any naira into dollars. We were effectively stuck with the naira we had invested in Nigeria. While we waited for the inevitable devaluation, the very worst place to be would be in cash. Any devaluation would see the strategy take a guaranteed loss. A far better place to hide was in equities, which we expected would see a relief rally following any currency move.

Avoid companies that short dollars

The final adjustment to our portfolios was to switch out of companies that were naturally shorting dollars or were exposed to the Nigerian consumer, and buy companies that stand to benefit from a naira devaluation. This saw us sell out of a number of counters that have dollar payables or have large import bills. A company that we have been adding to in this environment is Dangote Cement. Dangote is commissioning cement plants across the continent, resulting in dollar revenues increasing as a percentage of its sales. Any naira devaluation would benefit Dangote, as the company earns 30% of its revenue from international operations, cushioning any rising import costs.

Whether Nigeria will learn from the latest oil shock and pursue more appropriate policy responses going forward is yet to be seen. The Buhari government has certainly taken a step in the right direction by allowing the naira to float and we believe that their intentions are good. However, good intentions, as any addict knows, are largely worthless. What Nigeria needs is for the currency to float freely and for a market-determined exchange rate to attract an inflow of dollars once again.

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