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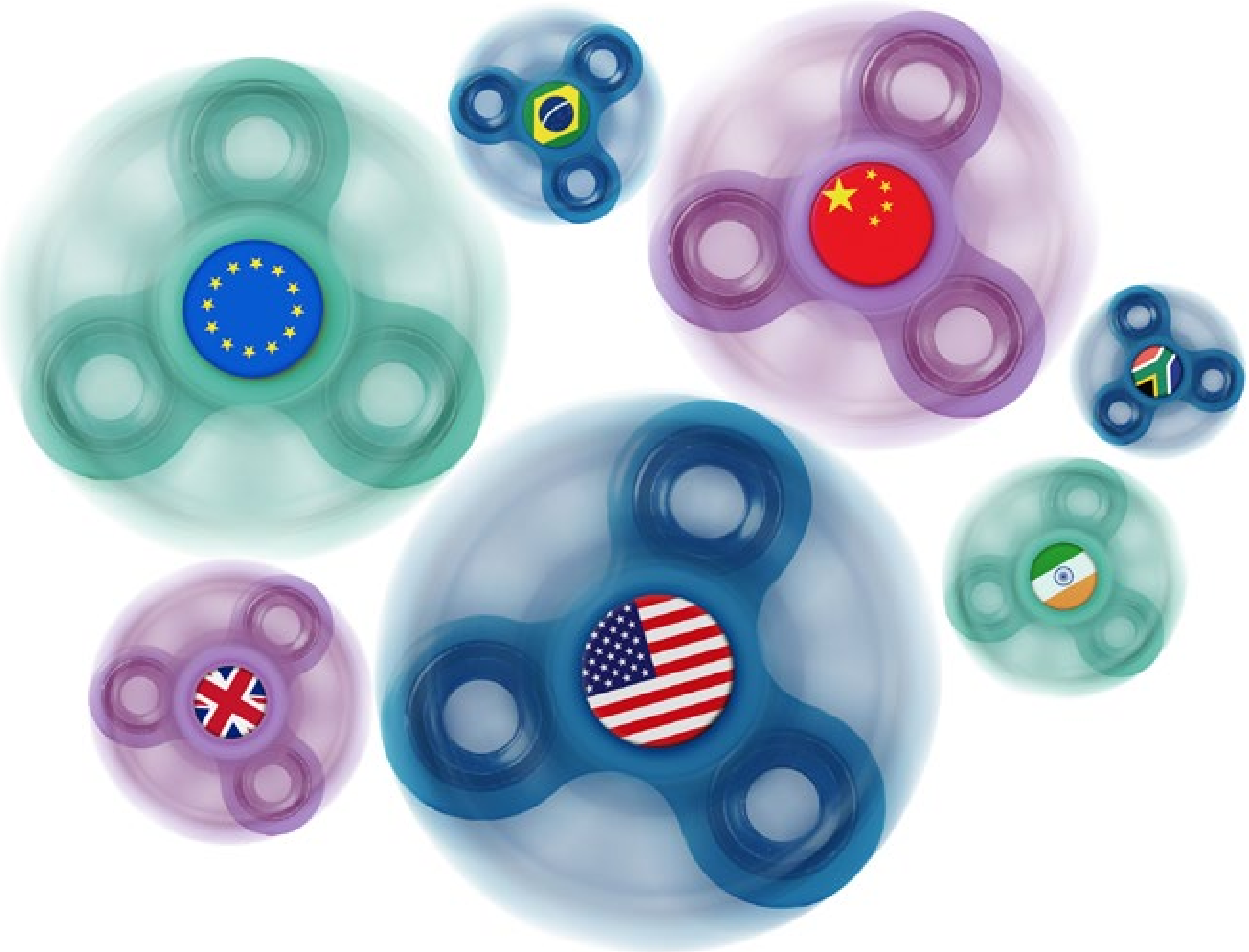

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NOTES FROM MY INBOX

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.

It is scary how quickly we have reached the halfway mark to this year, which has so far been filled with much newsflow and surprises. The UK electorate delivered another shock result at the start of the crucial Brexit negotiations, the US president's intemperate tweets are slowly shaping a new global diplomatic order and tensions are escalating in the Middle East. Global markets have been moving higher in fits and starts, but a recent sharp sell-off in global bonds, a continuous European banking crisis and a slump in the oil prices have unnerved many.

As a South African company, we have a high uncertainty threshold. There is no doubt that this threshold has been severely tested during the first six months of the year as the political climate in South Africa has deteriorated further. We have been managing money in an open emerging market for almost a quarter of a century, investing and protecting clients' savings amid ongoing currency and political shocks. This has stood us in good stead, helping us become disciplined investors who can cut through the noise and focus on the long term. It has also helped us to find value where others may only see risk, especially in emerging markets, where we understand the dynamics of formalising economies despite political turmoil.

Our experience in emerging markets has also granted us a firm understanding of the limitations of passive investing – a trend that has gained massive flows in global markets in the last few years. These shortcomings were highlighted recently after the MSCI decided to include selected China A-shares in its emerging markets' benchmark index for the first time. After extensive consultation, it decided on 222 shares (out of more than 3 000) considered suitable for the index. The decision sparked concern among passive investors who have to track the index. The Chinese market is opaque, with questions about ownership structures, shadow finance and the true extent of state involvement in each company. In addition, the selected companies are skewed towards the problematic Chinese financial sector. Above all, as a number of commentators pointed out, it demonstrated that tracking an index is not a passive investment decision at all.

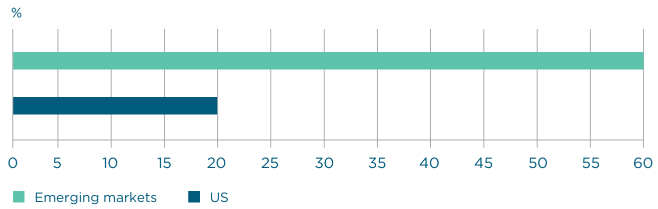
"It is a neat reminder that the style of investing they (passive investors) think they have embraced does not actually exist," as the editor of *MoneyWeek*, Merryn Somerset Webb, wrote in the *Financial Times*. "There is no such thing as passive. Someone has to decide what is an emerging market, someone has to decide which emerging markets are the most important and someone then has to decide which stocks define each emerging market." In fact, what this style of investing does is outsource the investment decision to the index providers themselves.

No matter how artfully the passive sales pitch is presented, all passive investments fundamentally require investors to make an active decision. Investors need to choose from the myriads of indices, many with increasingly complex rules and algorithms, each with a potential materially different outcome over long periods.

In addition, we have long argued that passive investing is particularly ineffective in emerging and frontier markets. Indices for these markets do not offer investors a true reflection of the investable potential and economic drivers of these markets, nor the best companies that investors could invest in (at the right price). The benchmark indices in these markets favour shares that are liquid and are usually skewed towards lower-quality companies, which have larger weightings due to their free floats. Typically, these indices have a lot of exposure to the financial sector and other highly regulated industries – and not to companies which can benefit most from fast-growing structural changes in developing markets. Often, these include businesses with large foreign parents (like Heineken, Diageo and Unilever) which have great growth prospects but a lower free float, and therefore smaller weightings in the indices.

ACTIVE OUTPERFORMS PASSIVE IN EMERGING MARKETS

Percentage of actively managed equity funds that outperformed exchange traded funds in past five years



Sources: Morningstar, Bloomberg

Tracking the index can also be hazardous in some highly concentrated markets like South Africa. While investors tracking the Standard & Poor's (S&P) 500 will end up with a portfolio where the top 10 largest stocks represent less than a fifth of their portfolio, in a concentrated market like South Africa, Naspers will represent almost 20% of your portfolio (if you are tracking the Shareholder Weighted Indices [SWIX]). One of the biggest selling points of passive investing is that you remove stock-specific risk and simply get the return of the market. In emerging markets, often investors end up with much more single-stock risk, and they do so without a skilled and experienced investment professional held accountable for the appropriateness of that weighting.

At Coronation, we construct clean-slate portfolios of our highest conviction views. We believe that this approach affords us the ability to outperform indices over meaningful periods of time.

IN THIS EDITION

We are extremely concerned about the recent events in South Africa. Simon Freemantle explains the political forces behind the current turmoil on page 8, a sobering read.

The respected emerging market analyst Jonathan Anderson has contributed an exclusive article on China's prospects (page 5). While for the foreseeable future the country should remain stable, Jon warns that investors need to be aware of risks in the Chinese economy. China may not escape its debt boom without pain.

In addition to our quarterly contributions on the markets, you will find a number of investment cases in this edition, including for the US fashion retailer L Brands (page 16), mobile money operators in Bangladesh and Kenya (page 19) and the South African hospital group Mediclinic (page 14).

We hope you enjoy the read as we prepare for the next half of this eventful year. ■

Kirshni

WHITHER CHINA?

FOUR TRENDS IN COMING MONTHS

By Jonathan Anderson

Jonathan is president of the Emerging Advisors Group. He was previously the global emerging market economist at UBS Investment Bank, as well as the IMF's resident representative in both China and Russia.

As we enter the second half of 2017, China is easily the biggest wild card in the global economic outlook. On the one hand, mainland growth has proven to be very resilient; local consumer demand is strong, corporate earnings have rebounded and buoyant import spending has provided a much-needed tailwind for its Asian neighbours as well. On the other, since the beginning of the year the government has placed renewed emphasis on deleveraging and balance sheet control, sharply curbing excessive financial flows and tightening credit.

That is not all; China also faces an unpredictable political environment, as the upcoming 19th Communist Party Congress will allow president Xi Jinping to reshuffle the top leadership ranks and consolidate his power. If successful, many feel that the removal of weaker and opposition players could lead to meaningful changes in policy direction.

Finally, markets are continually worried about financial risks. Chinese debt ratios have been rocketing this decade, and the renminbi already experienced one sudden and sizeable 'run' in 2015/2016. How does this all play out for the rest of the year and beyond?

Here are four trends investors should consider:

SLOWDOWN AHEAD

For starters, there is no question that China is tightening. Emboldened by the strong economy and the visible upturn in corporate profitability over the past few quarters, the government has encouraged financial regulators to 'go to town' in curbing the banking and credit excesses that characterised the previous two years. This included wild balance sheet expansion in the form of opaquely structured investment products, essentially hidden loans intermediated through non-bank financial institutions; dramatic growth in interbank borrowing and lending as well as wholesale funding from shadow banks; and an explosion in direct local government borrowing via bond issuance to banks.

All of these items grew rapidly in 2015 and 2016, but since the beginning of this year new issuance of all has dropped nearly to zero. The result is a sharp drop in the volume of total 'effective' credit extended; Emerging Advisors Group's own flow credit impulse measure is now approaching the lowest recorded level in the post-2009 era, which makes this a serious policy shift indeed.

What impact will this have on the overall economy? Balance sheet retrenchment particularly affects local governments and their affiliated development- and infrastructure-related corporate entities, and in the second half of the year China should see a visible slowdown in new project starts and ongoing investment activity. More important still, there will also be an effect on private property markets. The relationship between aggregate credit flows and new housing sales is one of the strongest in China, and it is hardly surprising that residential demand has already started to tail off over the past few months. As the property market continues to weaken, there will also be a gradual but steady drop in related construction activity, reducing the use of steel, cement and other basic materials.

Add to this our jaundiced view of the sustainability of the current global trade upturn – which has provided tremendous support for the Chinese recovery of the past three quarters in its own right – and by the end of this year China will have gradually moved from an economy firing on all cylinders (infrastructure, property, exports) to an economy firing on none. We are not talking about a growth collapse by any means; mainland consumer demand is relatively protected by the lack of leverage exposure in the household sector, and this lends China a strong element of stability. Nonetheless, from nearly 7% year on year currently, we would expect most private estimates of growth to fall well below 6% by the fourth quarter of 2017.

FADING SUPPORT FOR GLOBAL MARKETS

This, in turn, has big implications not only for China but for other emerging markets as well, in two ways.

The first is through weaker commodity prices. Global prices for 'China-related' ores and materials – not oil per se, but coal, iron ore, copper, aluminium and steel – have fallen about 12% on average since January peaks on the back of tightening fears, and the downturn is likely to continue through the second half of 2017 as China's real economy slows as well. Needless to say, this has big implications for exporting countries from Brazil to Indonesia to South Africa.

The impact is not limited to commodity producers. There will also be a negative effect on Asian neighbours that supply capital goods and semi-manufactured products into the Chinese industrial machine. The rest of Asia has been a big export outperformer in volume terms over the past few quarters, with almost all of the increase coming from mainland demand. China's own import trade volume data are notoriously volatile and unreliable, but available trade figures from major partner countries show a clear trend: from outright contraction in the beginning of 2016, Chinese real import spending was up by an eye-popping 20% year on year by the end of last year, making this the biggest recovery of the decade.

But of course that import recovery has been driven by a combination of strong domestic upturn in property and investment along with the cyclical improvement in global manufacturing export demand – and again, both of those trends should be fading away in the coming quarters. As a result, we expect Chinese import volume growth to fall to the low single digits by year-end, which implies a broad macro slowdown across Asia as well.

RENEWED EASING CYCLE IN 2018

That is the picture through to the end of 2017. What about next year?

The answer, for us, lies in renewed policy easing.

This may come as a bit of a surprise for those who follow the current political calendar. Remember that the Chinese Communist Party undertakes its congresses in a five-year cycle, with a spate of leadership changes across the party structure in the opening year of each congress. The upcoming 19th Congress will take place towards the end of the year, and while there is no doubt that president (and party secretary) Xi will remain in his post for a second term, there will clearly be a number of big changes directly under him at the Politburo and Politburo Standing Committee level.

The common assumption in the global press is that this mid-term leadership transition represents a major watershed for the Xi administration. Once he has sent off a number of retiring senior opponents and ensured that his handpicked supporters take their place, thus cementing his political position once and for all, the argument is that Xi will show his true colours, putting less emphasis on growth and more on reforms – even if it means potentially serious pain for the economy.

The reality is almost certainly the opposite. To begin with, there is little evidence to suggest that president Xi is a closet economic reformer. To the extent that he has weighed in on economic topics at all, he has vocally and often repeated that his main priority is for steady, relatively rapid growth, at a minimum of 6.5% per annum in order to achieve a doubling of real incomes during his tenure. Indeed, this was the driving reason behind the massive stimulus-fuelled balance sheet expansion in the first place.

Yes, Xi has been happy to give in to demands from the central bank and from regulators to carry out tightening this year … as long as the growth numbers are more than comfortable. But as the economy slows through the second half of 2017 and into 2018, leading to renewed worries about corporate health, profitability and employment, we fully expect the policy pendulum to swing back in favour of pressure on banks to lend out via all available channels to support the pace of expansion.

NO FINANCIAL CRISIS … (YET)

On a final note, what about the much-touted crisis scenarios? China has added more than the equivalent of 100% of its GDP in financial debt in the past eight years alone, an astounding figure by emerging market standards – and one that takes overall debt levels close to developed-country levels (again virtually unheard of for a low- or middle-income economy). Is this not a bubble, fraught with tremendous risks in the banking and corporate sectors?

There are risks, no question, and our own long-standing conclusion is that China will not escape this debt boom without pain. Moreover, as tightening continues this year we are likely to see some signs of financial and corporate fragility.

However, we need to stress that 2017 is *not* the year that China's financial system falls apart, in the sense of major funding crises or true Minsky shocks.

Why? Because what really matters for financial fragility is not debt itself but rather the funding structure of the debt – and here exposures are building more slowly. China will still reach an eventual crisis point if the government continues to pump credit into the economy indiscriminately, but by our estimates true systemic fragilities will only start to appear three or four years down the road, at the beginning of the next decade.

This is all the more true given that while the authorities may be pursuing a regulatory crackdown on credit and quasi-credit activity, they are not pulling liquidity wholesale from the system. In the past six months, there have been some of the strongest policy tightening rounds since 2009 in terms of new credit flows, but still one of the weakest in terms of the behaviour of short-term interest rates, which remain profoundly low as we write. Simply put, the central bank is doing everything it can to avoid any hint of illiquidity in the system, which significantly lowers the near-term risk profile.

The same analysis holds for the exchange rate. China had a sizeable renminbi scare in 2015/2016, with large, sudden capital outflows that caused the country to lose nearly $1 trillion of its $4 trillion foreign exchange reserves pile. Since then, however, the authorities have made an all-out frontal attack on outflows in the form of sharp restrictions on capital convertibility and an intensified commitment to broad stability against the trade-weighted basket. This programme will not hold off currency pressures forever – indeed, no peg/quasi-peg could possibly survive the exponential growth of domestic liquidity against the backdrop of flat or falling foreign reserves. However, once again, our analysis suggests that true flash points are still a number of years away on the exchange rate front, and until then things are likely to be relatively quiet.

In sum, investors do need to be vigilant and aware of risks in the Chinese economy. But there is no 'run for your life' moment coming any time soon. For the time being, it is all about a gradual slowdown over the year to come. ■

SOUTH AFRICAN POLITICS

A STATE OF PARALYSIS

By Simon Freemantle

Simon is the senior political economist and head of the African political economy unit at Standard Bank. He is a regular presenter on political and economic issues relating to South Africa and Africa on a variety of local and international platforms.

Paralysis is defined by the Oxford English Dictionary as "the loss of the ability to move in part or most of the body", or "the inability to act or function properly". Recent events within the ANC have reflected how deep the state of paralysis is that has set in across the party's senior structures. Though able to diagnose the crisis that it (and the broader body politic as a whole) faces, the party appears unable to move in any decisive manner to address the challenges it knows to be eroding public trust, and widening what ANC secretary general Gwede Mantashe has referred to as the ANC's "trust deficit" with the nation.

There are two examples of the ANC's current inertia which best reflect this internal dilemma.

The first is the manner in which this state of paralysis has undermined the ANC's capacity to act nimbly with regard to the destruction wrought by President Zuma on the ANC and the alliance, the economy and the country's wider institutional edifice. President Zuma no longer enjoys the majority of support in the ANC's national executive committee (NEC), nor does he hold the kind of branch-level endorsement that he was not long ago able to command. At least since his unilateral dismissal of former finance minister Nhlanhla Nene on what has been infamously dubbed '9/12' (9 December 2015) the president's base of political authority has considerably and consistently weakened. Calls for his removal as head of state have grown louder since his bold cabinet reshuffle in March this year. The president was booed at this year's May Day rally and is now unwelcome at gatherings of both of the ANC's tripartite alliance partners – the SACP and COSATU. In a March survey by TNS, just 20% of South Africans living in major metropolitan municipalities stated that they believed President Zuma was doing a good job, a drop from 58% in 2009. Many in the ANC blame the president's urban unpopularity for the party's dismal election performance in last year's municipal polls. Meanwhile, as the allegations of impropriety linked to the Gupta family continue to mount, exploding with even greater clarity into the public conscience as a result of the trove of leaked emails from within the family's business empire, President Zuma remains stoically silent and tacitly defensive of the interests he, and more directly his son, Duduzane Zuma, have in ensuring the Gupta family continues to enjoy access to state patronage.

Yet, despite the obvious liability President Zuma has become for the ANC, the party is unable to manage his exit in a manner that presents some image of internal cohesion, and reflects the capacity to 'self-correct'. The reason for this is simple: factionalism within the ANC has ripped apart its internal accountability mechanisms and undermined its central authority. There is no longer a final word on matters of party concern as all statements are deemed by opposing factions to be designed to undermine their interests and expand those of the groups they oppose. Further, the ANC's constitution is poorly equipped to manage the intensity of the animosities that now characterise the party's senior structures.

There is no real mechanism to remove a party president prior to the five-yearly national elective conference, and the decision to rescind the party's nomination for the president as head of state is not taken by a vote at the NEC level, but rather by a search for 'consensus'. When such consensus is absent (and President Zuma has enough support still in the NEC to prevent consensus from building against him), the only option is to preserve the status quo, as damaging as this may be for the party and the country it leads. President Zuma has also adopted a typical 'divide and rule' strategy as president – so much so that his removal would, in Mr Mantashe's words, "tear the ANC apart" as groups loyal to the president would mount an aggressive counter to his premature eviction from office. Fearful of this outcome, a cluster of moderate ANC leaders hope to hold the middle line and drag the party to its December elective conference in order to more formally address the crises that President Zuma has bestowed on them.

The second feature of this state of paralysis is the manner in which the ANC and the alliance appear unable to define a coherent course of action to address the country's crippling economic and social shortcomings. The party's recent national policy conference was a study in this dilemma. Indeed, driven by the political jostling which has come to define the ANC's succession battle, delegates at the conference were consumed by proxy battles around the definition of "(white) monopoly capital" and land expropriation with or without compensation (and with or without changes to the Constitution). There appeared to be little substantive engagement on the issues that should most concern the party in order to address the fundamental frustrations of the broader population: unemployment, crime, corruption and social transformation. Though on the day that the conference began, the *Daily Maverick* released a report detailing how the Guptas funnelled money from a failed and state-funded dairy farm in the Free State to pay for a lavish Sun City wedding, delegates did not (or were not able to) voice their resounding condemnation of 'state capture', the definition of which is held hostage by the same factional tensions outlined before. Indeed, such was the party's priorities at the conference that it could not even find the time in an extended six-day gathering to brief the media on its education, health, science and technology resolutions, which it only managed to do the week after the conference had closed. And while there was a focus on the National Development Plan (NDP), which minister in the presidency Jeff Radebe doggedly continues to pursue, the party was able only to concede that 'implementation' remains a crippling hurdle to the realisation of the Plan's goals – with little understanding of how such an impediment can be lifted. Broadly speaking, the ambiguous mantra of radical economic transformation, which has vastly divergent interpretations within the ANC, has replaced the NDP as a guiding force for internal policy discussions. It is worth noting that this was the ANC's last scheduled policy conference before the 2019 elections, where it will undoubtedly face its sternest national test since 1994.

While resolutions to these issues will not be straightforward, the ANC does at least have an opportunity to address the depth of internal disunity that it faces at its national elective conference in December. Here there are three broad types of outcomes, though only one of the three offers the opportunity for any form of decisive and positive change.

The **first outcome** is one in which a reformist movement secures the party reins. This movement appears most likely to be led by Deputy President Cyril Ramaphosa, but there are other ANC leaders capable of driving a similar type of sentiment (including human settlements minister Lindiwe Sisulu and, to an extent, ANC treasurer Zweli Mkhize). Under this scenario a collective of leaders with stronger moral mettle and a more moderate approach towards the tackling of the country's economic malaise would defeat those clustered around President Zuma and the 'premier league' of provincial power barons who have sustained his party power. It would be important for a 'winner-takes-all' outcome in which a reform movement secures all of the ANC's top positions and squeezes President Zuma's staunchest provincial supporters out of the party's senior leadership.

A **second outcome** is the exact opposite of the first, and would see the ANC Youth League's (ANCYL) slate of preferred leaders elected as a bloc. The group pulled together by the ANCYL is an ominous one, with Nkosazana Dlamini-Zuma as president, Mpumalanga premier David Mabuza as deputy president and Free State premier Ace Magashule as secretary general. It is the extraordinary bias of this slate, and the apparent inability to attract moderates to balance its scales, that are undermining its chances in December. But the residual branch power that the president enjoys in KwaZulu-Natal and in the more compliant 'premier league' provinces of the Free State and the North West still sustains its viability. Should this slate succeed, the consequences for the ANC and the alliance would be dire, leading to the kind of split that would almost certainly undermine the party's grip on Gauteng in 2019, and quite possibly at the national level too.

A **third outcome** is one of compromise between the warring factions in the party, which many in the ANC are seeking as the means through which to avoid the split that they fear would result from either of the above outcomes triumphing as a bloc. President Zuma has floated a compromise 'solution' as well, suggesting in his closing remarks at the recent national policy conference that the losing presidential candidate should automatically slot in as one of two party deputy presidents. It is likely that the president made this recommendation from a position of weakness, cognisant (finally) of the fact that his branch-level support is more precarious than he assumed it to be. This does suggest that Mr Ramaphosa is well positioned to lead the compromise collective, if such an outcome is pursued. A critical swing province in this regard is Mpumalanga, which will account for around 15% of voting delegates at the conference. As it stands, Mr Mabuza is hedging his bets, shifting subtly away from his previous defence of President Zuma and the 'premier league' and offering to position himself on Mr Ramaphosa's ticket in exchange for his endorsement as deputy president. Though this would fundamentally improve Mr Ramaphosa's chances of success, it would come at the cost of profoundly undermining the reformist zeal that he would seek to project as party and state leader. Though a compromise would at least prevent a more cataclysmic outcome in December in which President Zuma's allies secure even more profound control of the party reins than they currently enjoy, it would not offer the kind of momentum for reform that is required to shatter the paralysis that has set in at a party/alliance and national policy level.

The probabilities assigned to each of the aforementioned outcomes remain exceptionally fluid, and there are pervasive unknowns that will have a profound bearing on the process itself. For instance, the outcome of the ANC's Eastern Cape and Free State provincial elections, which will both be held in the coming months, and the resolution in court in August of the contested KwaZulu-Natal party leadership election of 2015, will have a potentially marked bearing on events in the lead-up to December. Above all, though, the finalisation of the ANC's contested membership audit will be all-important. There have been reports of KwaZulu-Natal branch membership having exploded, from 158 199 in 2015 to over 500 000 currently. The composition of voting delegates in December is determined by the proportionate size of each branch, and the relative share of total membership that each province contributes to the party. As such, if there are 4 000 branch delegates at the conference, and KwaZulu-Natal accounts for 25% of total ANC membership, then 1 000 of those 4 000 voters will come from the province. Mr Mantashe's task in injecting integrity into these fraught audit systems will be a towering one, and vigorous contestation within the branches seeking to superficially inflate their importance will again expose the depth of disunity that the party suffers from.

Meanwhile, as the ANC is consumed with its own internal wrangling, a new kind of national opposition collective appears to be forming. Galvanised by resistance to President Zuma and mounting evidence of Gupta-orchestrated 'state capture', a coalition of opposition parties, tripartite alliance members (the SACP primarily), ANC veterans, civil society organisations, and business and religious groupings has found common cause. It is therefore not only the ANC's waning capacity for 'self-correction' upon which the nation's hopes rest, but also on a movement that has mobilised as a result of the ruling party's paralysed reaction to the unfolding crisis of the past five years in particular.

Here the country is in marked contrast to some of its more oppressive emerging market peers, where resistance to the creeping autocracy of the state is more easily and systematically squashed. In fluid democratic systems, actors – even ones as dominant as the ANC – cannot afford to stand still for too long, and it has been in the shadows created by the state of paralysis that the ruling party has allowed to consume the broader body politic that the seeds for a new political realignment have formed. How this realignment takes shape will of course also rely on the ANC's succession outcome, which is now just five months away and presents the opportunity for the lifting (for better or worse) of our collectively paralysed state. ■

Disclaimer: The views and opinions expressed in this article are those of the author and have originally been prepared and previously shared with other financial market participants, primarily institutional clients of Standard Bank.

PERFORMANCE MANAGEMENT

THE IMPORTANCE OF STRONG BUSINESS LEADERS

By Quinton Ivan

Quinton is head of South African equity research and co-manages Coronation's Core Equity Strategy. He joined the business in 2005.

"Success leaves traces." – Sir John Templeton

Quality businesses possess certain attributes that make them long-term winners: enduring competitive advantages (such as the franchise value of brands or a store footprint that is hard to replicate), robust and adaptable business models, good cash flows and excellent returns. These characteristics often result in such businesses compounding revenue and earnings at a higher rate than expected – and the market rewarding this superior growth with a premium rating when compared to the average company. However, one attribute that is often overlooked when assessing a business's track record, is the role played by management. While most companies are heavily subject to the macroeconomic conditions of the day, good management make things happen and get on with the job of driving shareholder value.

In his excellent book, *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success*, author William Thorndike attempts to identify the key traits and methods of eight CEOs. Each is responsible for delivering exceptional shareholder returns, which ultimately results in their companies handsomely outperforming both their peers and the market. We are fortunate to have many examples of truly exceptional businesspeople in South Africa, who have created enormous value for shareholders over time. Similar to Thorndike, I consider two South African case studies in an attempt to identify what it is that makes the managers in question so special.

STEPHEN SAAD – ASPEN PHARMACARE HOLDINGS (ASPEN)

Saad is one of South Africa's great entrepreneurs. His first job in 1989 was at a startup, Quickmed, a small medical wholesale business operating mainly in townships around Durban. Quickmed later merged with Zurich, which was bought by Prempharm (now Adcock Ingram) in 1993 for R75 million. Saad, who was 29 years old at the time, made approximately R20 million on the deal. Not resting on his laurels, he teamed up with Aspen's current deputy CEO, Gus Attridge, later that year and together they bought a stake in Varsity College, which was struggling at the time. They turned the educational business around, partly through innovative marketing offering students a refund on tuition fees if they failed their courses, provided that they attended all of their lectures. Saad and Attridge sold their stake in Varsity College to Leisurenet in 1997 for R100 million – they had bought it for R1.5 million.

Aspen listed on the JSE in 1998 via a reverse listing into Medhold. Shortly after, it launched a hostile takeover of South Africa Druggists (SAD), acquiring the old Lennon drug business (a pioneer in generic medicines) as well as a manufacturing plant in Port Elizabeth.

Today, Aspen has successfully transformed from a South African generic pharmaceutical company into a global player focusing on anticoagulants, anaesthetics, high potency pharmaceuticals and cytotoxics, and infant milk formula in both developed and emerging markets.

Since listing, revenue and normalised headline earnings per share have compounded at close to 40% per annum, through a combination of acquisitive and organic growth. More recently, Saad has concluded large deals with GlaxoSmithKline (GSK), Merck and AstraZeneca, which has seen it become a significant player in the highly specialised therapeutic classes of anticoagulants and anaesthetics. This has been the culmination of years of relationship building and a focused strategy to internationalise the business and focus on niche, post-patent products that are complex to manufacture.

A few things about Saad stand out throughout Aspen's successful history:

- **A passion for the business and an unwavering ambition to globalise.** The following quote from Aspen's 1999 annual report is noteworthy: "The group recognises the advantages to the internationalisation of its business in today's global economy. The development of this strategy will be off the base of a successful and stable domestic operation."

- **Having conviction in his strategy and betting big, even in the face of market scepticism.** Noteworthy deals over the years include:
    - acquisition of SAD in 1999 for R2.4 billion – still regarded by Saad as the riskiest deal he has ever done;
    - two deals with GSK in 2008 and 2009 for R7.3 billion;
    - acquiring Sigma Pharmaceuticals in Australia in 2011 for R5.9 billion;
    - acquiring Merck's anticoagulant portfolio and manufacturing sites for R10 billion; and
    - the recent acquisition of AstraZeneca's anaesthesia portfolio for approximately $770 million.

While investors are typically wary of acquisitive growth and tend to find more comfort in lower-risk, organic growth strategies, Saad has delivered on all of these transactions. Aspen's acquired businesses are highly cash generative and the group has simplified the manufacturing process of acquired product portfolios, delivering – and in most cases exceeding – promised synergies.

- **Acting like an owner.** Saad owns 12% of Aspen and has never sold a share. Despite the enormity of recent transactions, equity has only been issued on two occasions:
    - the SAD acquisition in 1999, where the immature balance sheet was geared 4.7 times – the maximum lenders would allow; and
    - the GSK transaction in 2008 and 2009, where GSK insisted on a partial share offer as a condition of the deal (GSK ended up with a 16% stake in Aspen at the time).

As an owner, Saad understands that equity is precious and an expensive source of funding (if you believe your business is undervalued), as any issued shares need to be serviced, via dividends, in perpetuity.

- **Surrounding himself with good people.** While Saad is clearly a special individual, and Aspen will be a poorer business without him, he has ensured that each major geographic hub is run by a capable management team that is empowered to act. He also has a very strong deputy in Attridge – himself a significant owner – who deserves credit for the financial structuring and integration of these various acquisitions.

SIMON CRUTCHLEY – AVI LIMITED (AVI)

Crutchley established his reputation as a top-tier manager in his role as managing director of Consol, the glass-packaging manufacturer, from 1998 to 2002. During this time, Consol was delisted and significantly restructured – Crutchley's tenure was characterised by focused investment in plant, improved marketing efforts and rigorous cost management. The result: Consol dominated the South African glass market, and the once loss-making plastics division turned profitable. Revenue grew by 10% per annum and profits doubled over this five-year period – an admirable result in a mature, highly competitive industry.

In 2002, Crutchley became the business development director of AVI. He took over as CEO in 2005. This coincided with AVI transitioning from an industrial conglomerate to a focused branded consumer goods company. As part of the transition, AVI sold Vector Logistics, unbundled Consol and acquired Spitz and Green Cross. While much of this happened prior to Crutchley's appointment as CEO, he was instrumental in shaping the group's new strategic direction given his role as business development director.

Under Crutchley's leadership, brand portfolios were aggregated to leverage off shared services, thereby saving costs. He also invested heavily in plants, marketing and innovation efforts to grow key product categories. Productivity metrics were benchmarked against international best practice, and any shortcomings were addressed. In addition, Crutchley demonstrated good discipline on capital allocation, walking away from numerous potential deals as he was not prepared to overpay. Excess cash was returned to shareholders in the form of share buybacks and special dividends. This was in stark contrast to peers that paid up handsomely for similar assets, or to expand their footprint into Africa – a strategy that ultimately ended up costing shareholders dearly.

Crutchley's standout strengths as CEO are:

- **An extremely disciplined approach to capital allocation.** Underperforming assets that could not be fixed were disposed of (Alpesca, Denny and Sir Juice). He also walked away from numerous potential acquisitions for which vendors had unrealistic price expectations, and invested heavily in existing product categories where he believed returns could be enhanced. The result was an increase in return on equity from 13% to 27% from 2005 to 2016.
- **A razor-like focus on shareholder returns.** Crutchley ensured that AVI returned excess cash to shareholders by consistently increasing the ordinary dividend payout, share buybacks and special dividends.
- **Tight cost control.** However, this is coupled with a willingness to invest in entrenching and growing brands and product categories to enhance returns.
- **Judicious price management.** This ensures that value market share is protected and maximised.

- **Rigorous talent management.** Control is reasonably centralised and divisional managers are given scope to execute their strategies – but are quickly removed if they underperform. Between management changes, Crutchley has often stepped in to run and fix underperforming divisions.

While I have used Saad and Crutchley to identify the key attributes I believe make them special, they are by no means the only examples of exceptional business leaders in South Africa. Several others readily spring to mind:

- **Koos Bekker**, former CEO of Naspers. Bekker is a visionary and has successfully identified megatrends and shifts in technology very early on. This has allowed him to transform Naspers from a predominantly South African pay TV and print business into a globally significant company focused on its core verticals of media, e-commerce and classifieds.

- **Pat Goldrick**, former CEO of Cashbuild. Under Goldrick's stewardship, Cashbuild was repositioned from a business dependent on government's erratic infrastructural spend to one of the country's most successful discounters of building materials, servicing the neglected informal trade. What makes this achievement all the more impressive is that Goldrick had very little formal education (he had a poor Irish upbringing and never completed high school). His success came from pure determination, relentless focus on customer service and good old-fashioned hard work.

- **Adrian Gore**, current CEO of Discovery Holdings. Gore is a true entrepreneur who is not afraid to challenge the status quo. He is a major proponent of innovation and of using data analytics to disrupt well-established industries such as private healthcare funding, short- and long-term insurance and, more recently, retail banking.

- **Kevin Hedderwick**, former CEO of Famous Brands. Hedderwick created a culture of operational excellence across Famous Brands' key platforms of food services and logistics, which still endures today. This enabled the business to offer its franchisees exceptional service and value. It also allowed additional brands to be plugged into the existing supply chain infrastructure, thereby transforming what was Steers Holdings into the enviable portfolio of quick service restaurant brands it is today.

While these individuals are by no means homogenous – some are born entrepreneurs, while others are highly skilful managers – they have certain common qualities:

- **They have enormous shareholder focus.** More often than not, these people are significant owners of the businesses they run and guard the value of that equity jealously.

- **They are prepared to think big, act big and follow through on their convictions if they believe these to be correct.** They do so even when it may be unpopular with the broader investment community.

- **They are focused**. While their control is often centralised, they have an intimate knowledge of all underlying operations.

- **They are highly strategic.** But they are also prepared to roll up their sleeves and get stuck in to fix and turn around underperforming operations.

- **They are very good allocators of capital.** They are prepared to invest if it enhances shareholder returns, but will otherwise return excess cash to shareholders.

Warren Buffett is famous for saying that he prefers to buy businesses that are so wonderful that an idiot can run them because sooner or later, one will. There is some truth to this statement – after all, a business with good fundamentals and average management is preferred over a business with average fundamentals run by good management. However, there are several examples in our market that prove that exceptional people have generated outsized returns for shareholders in both good and average businesses. Once you identify these special people, back them and you will be rewarded handsomely. ■

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MEDICLINIC

SUNSHINE AFTER THE RAIN

By Sarah-Jane Alexander

Sarah-Jane joined the Coronation investment team in 2008 as an equity analyst. Her current responsibilities include co-managing the Coronation Industrial Strategy as well as researching food producers and hospital stocks among others.

Global demand for healthcare is rising. Ageing populations, technological innovation and growing incidences of lifestyle disease are among the contributing factors. People require more healthcare, at great expense to governments and individuals. As a result, funders are increasing their efforts to rein in these costs.

Demand for healthcare is difficult to constrain. Better preventative care is helpful. Medical advances mean procedures become less invasive, reducing the required lengths of hospital stay – although often increasing technology costs. Limited ability to control demand means most energy is spent on tackling the cost to supply services. Wholesale structural changes to market practice and efficiency are usually the result of regulatory interventions, while pricing is constantly interrogated. As affordability becomes even more of an issue, the continued pressure on healthcare providers will only grow stronger.

Despite these challenges, well-run hospital businesses should continue to thrive. Private hospitals deliver critical services efficiently in environments where traditional providers (often the government) are very constrained, with limited ability to fund the growing demand. If rational funders want to optimise value-for-money healthcare, the private sector has a role to play if it can deliver efficient services.

Investors in South Africa have access to three high-quality listed hospital groups: Life Healthcare, Netcare and Mediclinic International. All provide good clinical care domestically. However, it is the size and quality of their international businesses that really set them apart. Mediclinic International generates the bulk of its earnings offshore through market-leading businesses in Switzerland and the United Arab Emirates (UAE). While the outlook for its South African operations is dimmed by a government inquiry, a sluggish economy and challenged affordability, Mediclinic's international footprint offers an opportunity for growth and protection against adverse risk in a single market.

However, over the last year, Mediclinic has been hit by an almost perfect regulatory storm. In addition to South Africa's long-running market inquiry, operations in its largest Swiss hospital faced a potential punitive tax on private patients and Abu Dhabi regulators introduced a 20% co-payment fee on all nationals using private hospitals. The Swiss tax has been averted and Abu Dhabi reversed its regulation, so there is some respite over the short term. Still, we expect regulation will continue to impact hospital businesses from time to time as governments strive to maximise value for their healthcare spending.

Any pressure exerted on pricing must tread a fine line between incentivising investments in desired additional capacity without encouraging excessive investment. Underutilised assets make for an expensive healthcare system. Growing demand means additional capacity must be created in most markets we consider and prices therefore need to be sufficiently high to encourage investment. Our analysis of regional returns shows that Mediclinic does not earn excessive returns on newly deployed capital. In South Africa, adjusting its assets to replacement asset costs delivers returns in the low double digits. It is the long duration of the asset life (hospital buildings and land), rather than high upfront earnings generation ability, that delivers the returns over time. This low upfront return provides protection from excessive pricing cuts later on, with geographical diversification providing further defence.

Steady earnings and valuations, underpinned by tangible portfolios of land and buildings, mean hospital purchases can be highly geared, reducing the amount of equity needed to fund these transactions. This improves the underlying return that is achievable. These factors deliver returns to patient, long-term investors who are prepared to invest and wait for returns delivered over the asset lifetime. Mediclinic has continued to invest on this basis.

Despite threats posed by regulation, hospital groups trade on high multiples, reflecting the market's recognition of their structural growth prospects and ability to deliver steady, defendable earnings over time. Mediclinic trades on a one-year forward price earnings of 21 times. High short-term valuation multiples will unwind as earnings grow.

In the case of Mediclinic earnings, the base is low. In a reverse takeover, Mediclinic acquired the FTSE-listed Al Noor Hospitals Group last year. It has been a rocky start. Al Noor had suffered significant doctor losses as Mediclinic began to transition the group to comply with its global clinical policies. In addition, occupancies were substantially undermined when Abu Dhabi regulators introduced co-payments for state patients using private hospital facilities. First-year reported earnings for the combined regional group collapsed.

We believe that the private sector can be an efficient supplier of high-quality, critical services to the state – a position that was confirmed by Abu Dhabi's decision to reverse the co-payment regulations in April 2017. Growth in the regional structural demand remains intact and the existing hospital base has spare capacity to be filled.

Attracting more doctors is essential to lure patients back, now that regulatory obstacles have been removed. The recruitment of doctors into the UAE is a slow process as work permits, relocation and the build-up of patient bases take time – but the programme is well under way and we would expect earnings to recover strongly in coming years.

The Swiss business has its own challenges. The market has an effective regulator, which tackles areas where overinvestment and excessive profits are detected. From time to time, changes in tariffs on basic insured patients should be expected and the business will face this in the next year. While this will have a short-term impact, over time costs and investment will be adjusted to mitigate the tariff cuts. In addition, the business is investing in integration, building a strong central platform to offer efficient services to its hospitals. Over time, these investments should serve the dual purpose of making existing operations more competitive and creating a lean infrastructure. The platform investment allows for future acquisitions to be simply 'bolted on'. Mediclinic announced a small hospital acquisition in June, and more are expected.

South Africa faces a challenging time and the private hospital companies cannot escape this. A lack of growth in private sector employment means membership of medical aid schemes is sluggish. Growth in demand comes from the existing memberships, which is putting pressure on affordability. Attempts to control spiralling healthcare costs by large schemes like Discovery add to the pressure on hospital volumes. Despite this, Mediclinic is reasonably well positioned. Global learnings have been implemented and Mediclinic has focused on clinical quality and patient experience. In addition, a well-located footprint across South Africa's secondary towns makes it an important part of any medical scheme network. This will prove significant in a market where we expect competitive forces to accelerate. With this in mind, we expect South African earnings to be relatively resilient.

Hospital companies are attractive businesses with long-duration assets and the ability to deliver steady and defensive earnings over time. While the market recognises this earnings quality with high multiples, the Mediclinic multiple is likely to unwind over the coming years as its Middle Eastern business recovers and its other platforms deliver sustainable earnings. ■

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L BRANDS

BEAUTY IS IN THE EYE OF THE BEHOLDER

By Ryann Dean

Ryann joined Coronation in 2014 as a global developed markets analyst. He is a qualified chartered accountant and completed his articles in the financial services division of KPMG.

L Brands is a global retailer with a long history of success, a loyal customer base and a dominant brand in a compelling category of apparel retail. Its leading brand should be familiar to most as it is a name synonymous with lingerie globally – Victoria's Secret. Besides Victoria's Secret the company owns PINK (the younger sister brand to Victoria's Secret), Bath & Body Works, La Senza and Henri Bendel.

Les Wexner founded the company in 1963 and today is the longest serving executive in the Fortune 500 at 55 years – even longer than Warren Buffett!

When we first did detailed work on L Brands we liked the fundamentals of the company, but there was insufficient margin of safety due to its high valuation. Accordingly, we originally chose not to own any shares. A series of subsequent short-term struggles at Victoria's Secret caused the price to drop (50% from its peak at one stage), allowing us an opportunity to build a position. The fundamentals still remain attractive, but the share now trades for less than we think it is worth. We address the concerns and the investment case for L Brands in this article.

RECENT CONCERNS

We believe the struggles faced by Victoria's Secret are short term in nature and do not affect the long-term attractiveness of the company. Firstly, Victoria's Secret chose to cease selling swimwear, apparel and footwear in 2016 which, combined, accounted for $525 million (c. 7%) of revenue. These categories were deemed noncore, lower return and more seasonal, leading to increased markdown risk and pressure on margins. Freeing up store space that was used by these categories could also be utilised better with higher-return categories, for example sports and beauty.

Secondly, management decided to significantly reduce direct mail couponing and replace it with targeted category and product promotions instead. Although this has pressured near-term results, these strategic changes are beneficial to the sustainability of the brand and the long-term returns and earnings power of the company.

These changes also coincided with broad-based weakness in overall US retail sales, with multiple store closures (especially department stores) and the continued growth of online retail. The underlying narrative for any retailer with an extensive store base is not favourable and has led to further negative sentiment towards the retail sector as a whole. Having first owned shares in Amazon in 2011 we are fully aware of the threat online retail poses to traditional bricks-and-mortar shops. However, Victoria's Secret has key attributes which differentiate it from other retailers. Firstly, it is focused primarily on lingerie, a category which is more attractive than general apparel due to the emotive nature of the product which engenders high customer loyalty and repeat purchases. This results in industry-leading store productivity (on a sales per square foot basis), with 99% of stores generating positive free cash flow (after tax).

Furthermore, L Brands also enjoys significant lease protections[1] as its 'destination' stores drive traffic to malls. These protections create flexibility in what is typically a large fixed cost for most retailers. Victoria's Secret also has above-average ecommerce penetration (20% of domestic sales versus the industry average of 13%) and is therefore well placed to adapt to changing shopping habits and potentially capture market share as competitors close doors.

So while L Brands works through these headwinds (which impact near-term earnings), we believe the strengths of the business are as relevant today as when we first researched the company three years ago.

BRAND POWER

In a world where anyone can call up a product on a smartphone and where multiple brands are competing for a share of the consumer's wallet, ownership of a compelling brand is vitally important to stay relevant and grow. In fact, it is almost impossible to place an explicit numerical value

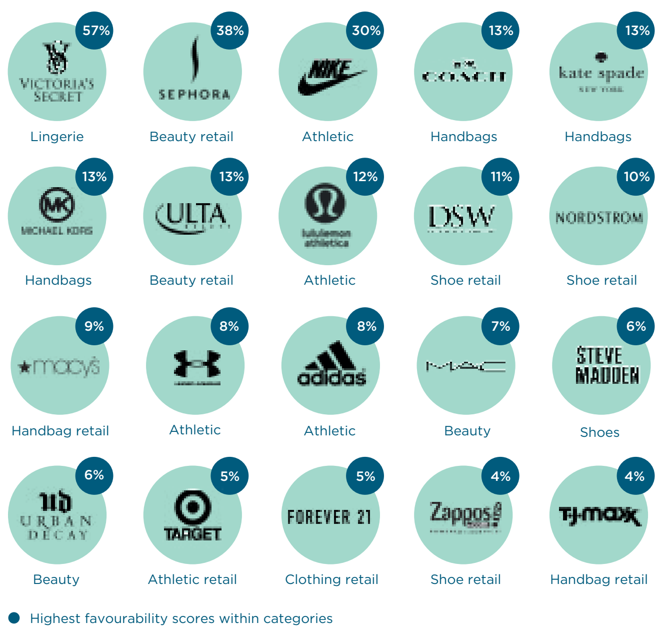
[1] *Should the occupancy of a mall fall below a certain level or anchor tenants leave, L Brands' rental costs drop and it is able to vacate on short notice with no financial penalty.*

on it. This is something management clearly understands, given the growth of Victoria's Secret into the dominant global lingerie brand over many years. The Victoria's Secret Fashion Show, a springboard for many successful international models' careers, is shown in nearly 200 countries and has generated 100 billion media impressions worldwide. It has a strong social media presence, with 27 million Facebook followers and 56 million Instagram followers, and is the market leader in the fragmented lingerie category, with market share of approximately 27% in the US.

PINK is the sister brand to Victoria's Secret aimed at university-age women. The brand was created internally to address the younger consumer and has grown to a sizeable business with industry-leading productivity metrics (over $1 000 sales per square foot). PINK also has a strong social media presence, with 13.6 million Facebook followers and 7.2 million Instagram followers.

Recently Goldman Sachs, in partnership with Condé Nast, conducted a survey which focused on millennial female shoppers' affinity for various brands. Victoria's Secret was the clear leader in the lingerie space, more than eight times more favoured than the second-placed brand. Victoria's Secret dominates its category more so than any other brand, beating Nike, lululemon, Coach and Michael Kors, to name a few. According to the survey, the millennial shopper controls over one quarter of dollars spent in fashion categories already and their spending will increase almost 40% in the coming 15 years due to rising disposable income. With its high brand affinity, Victoria's Secret is well placed to capture a fair share of this increasing spend.

BRAND AFFINITY AMONG MILLENNIALS



Source: Goldman Sachs and Condé Nast (2017 Brand Affinity Index)

INTERNATIONAL POTENTIAL

L Brands has followed an approach unlike most other retailers with regard to its international expansion. While many retailers rapidly expanded through a combination of wholesale sales, franchise agreements and their own stores, L Brands focused first on succeeding in the North American market and building its brand premium. In 2016, international revenue only accounted for 3% of total revenue.

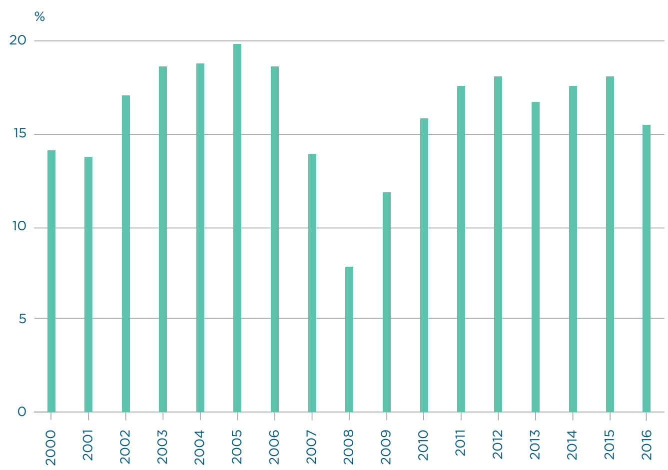
With a globally recognised brand portfolio (particularly Victoria's Secret), there is clearly a significant international growth runway remaining. Its brand and customer experience remain the highest priority for management and as such the company has approached its expansion in a steady and measured way, ensuring that every store around the world meets strict standards (unusually for a retailer, it gives final approval on all store locations for franchise partners).

International growth is focused on a few key geographies – Europe, the Middle East and most recently (and importantly) China. China is a market with massive long-term potential, highlighted by the company's decision to assume control from its former franchise partner and operate its own stores and ecommerce (in partnership with Alibaba). The opportunity is sizeable as China could be the same size as the US business in time. Victoria's Secret is already well recognised in China and management intends to have the 2017 Fashion Show in Shanghai, confirming its commitment to the country. We believe that the international potential for L Brands is incredibly attractive and will be a revenue and earnings growth theme that plays out for many years.

MARGIN POTENTIAL

L Brands has multiple avenues for future operating margin improvement from 2016 levels.

VICTORIA'S SECRET OPERATING MARGINS



Source: Company reports

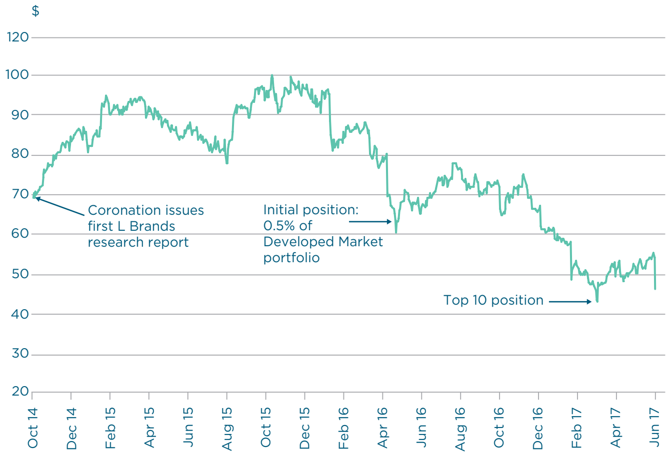
The aforementioned strategic changes have depressed merchandise margins due to the need to discount product in order to clear it quickly. The new targeted promotional strategies should also result in fewer margin-dilutive promotions. For example, in the past, direct mailers were used to offer a free pair of underwear (no corresponding purchase required) and 40% of customers simply came into store to collect their free product with no additional purchase. Clearly, giving away products for nothing is very dilutive to margins.

L BRANDS' INTERNATIONAL SEGMENT OPERATING MARGINS

Source: Company reports

L Brands' decision to enter and roll out stores in China with its own team also does not come without short-term costs. It has depressed margins in the international segment, which historically earned higher margins than the core company. However, as the Chinese business gains scale over time we expect margins to improve meaningfully from current levels.

L BRANDS SHARE PRICE



Sources: Bloomberg, Coronation

CONCLUSION

L Brands owns world-class brands, with leading market positions in attractive categories. Although cyclical, the company has tremendous potential to grow as it expands internationally.

"Long ago, Ben Graham taught me that price is what you pay; value is what you get", Warren Buffett wrote in a Berkshire Hathaway shareholder letter nearly a decade ago. "Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down." As investors, much like consumers, we are constantly on the lookout for markdowns like these. But the skill lies in determining whether the headwinds the company faces are cyclical or structural, a once-off or a permanent (value-destroying) change. In our view, the challenges L Brands faces today are mostly temporary and short term. We believe L Brands is quality merchandise that has been temporarily marked down. ■

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MOBILE MONEY IN FRONTIER MARKETS

SAFARICOM LEADS THE WAY

By Floris Steenkamp

Floris joined Coronation as an investment analyst in the Global Frontiers unit in 2014. Previously, he was an audit manager in the financial services division of PricewaterhouseCoopers.

Certain brands are not only well known, they are so renowned that they have actually become generic terms for products. People will refer to any bandage as a Band-Aid, or will call a hot tub a Jacuzzi, irrespective of whether it was actually manufactured by these companies. Other brands have become verbs: you often hear people say, "I will Uber home", and just think how frequently we use the phrase, "Let me Google it".

When you visit Kenya you will find another brand that has become a verb – M-Pesa, the leading mobile money business in the country. "Should I just M-Pesa you the money?" is commonly heard and is evidence of a business that has become completely entrenched in the Kenyan economy. M-Pesa is owned by Safaricom, the leading mobile operator in Kenya. Safaricom recently became particularly relevant for South African investors when Vodacom announced in May 2017 that it will acquire a 35% stake in the company.

We have been following Safaricom closely since we participated in its listing in 2008. We have held this company in different sizes in our portfolio for many years, and as a result our Global Frontiers team, as well as many of our South Africa-focused analysts and portfolio managers, is very familiar with this business.

Typically it is our years of experience investing in South Africa that assist us in analysing companies in frontier markets, but in some cases, like with Safaricom, it is our experience in Kenya that helps us to better analyse an investment in South Africa.

Safaricom's telecommunication business is highly cash generative and offers attractive growth due to low mobile and data penetration in Kenya. The risk of aggressive price competition is also small due to the low profitability levels among its competitors and the fact that tariffs in Kenya are already among the lowest in Africa. In addition to these factors, what really excites us is the potential of M-Pesa, a business started in 2007 as a service to transfer money using your mobile phone. M-Pesa was specifically targeted at people without a bank account, evidenced by its first advertisement campaign with the simple slogan "Send money home". The low banking penetration and supportive regulations, particularly at the time when M-Pesa was launched, resulted in a rapid uptake. M-Pesa now accounts for 27% of Safaricom's revenue and has grown to 26 million customers, 19 million of whom were active in the past 30 days. This means that two out of every five Kenyans have used M-Pesa in the last month!

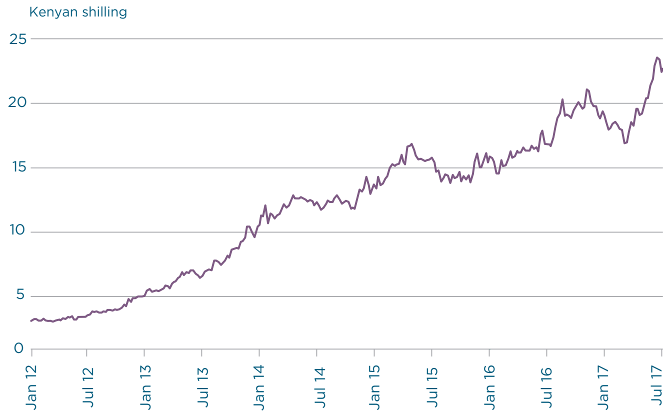
Today, M-Pesa is a phenomenal ecosystem with a strong moat of agents and satisfied customers, as well as large economies of scale. The velocity of money within M-Pesa is quite spectacular and continues to grow. In the most recent financial year alone, $18 billion was deposited into the system and $16 billion person-to-person (P2P) transfers were made using M-Pesa.

The evolution from P2P transfers to an integrated payments platform is only just beginning. Supermarkets now allow customers to use M-Pesa to pay for goods, businesses increasingly use M-Pesa for bulk payments such as wages and you can now even buy government bonds using M-Pesa. The profit margins of these new services are significantly higher than for P2P transfers where Safaricom has to pay an agent commission every time money is deposited or withdrawn from the ecosystem. There is significant potential to add more services to the platform as over 90% of transactions in the Kenyan economy are still done with physical cash. M-Pesa is increasingly looking like a payments network such as Visa or Mastercard, whose attractive economic fundamentals are well documented.

M-Pesa has already begun to disrupt the banking landscape in Kenya. We have argued for many years that the Kenyan banking industry is simply too profitable, leaving the door open for disruptive competitors such as M-Pesa. Although M-Pesa currently does not have intentions to become a fully-fledged bank, we view this as a natural progression over time. We estimate that deposits in the M-Pesa system have grown to such an extent that they eclipse the deposits of at least 26 of the 40 banks in Kenya. Currently Safaricom is not entitled to keep the interest earned on the float (the interest is paid to charities), but there is significant potential to mobilise these deposits should M-Pesa get a full banking licence. In addition, we would argue that the information it has on customer behaviour, based on their M-Pesa transaction history, means that Safaricom's ability to do credit scoring must be well ahead of many of the banks.

The following graph shows the share price performance of Safaricom over the past five years. During this period, the company often appeared to be expensive on near-term multiples, but by looking a number of years out and valuing the business based on what we believed to be a normalised earnings level, we continued to find the valuations attractive. We believe today is no different and that M-Pesa's evolution over the coming years will continue to surprise investors.

SAFARICOM'S SHARE PRICE



Source: Bloomberg

Across frontier markets there are a number of countries that offer similar opportunities. The low banking penetration in countries like Mali and Pakistan offers the ideal environment for mobile money, while in Zimbabwe the tight liquidity environment acted as a boon for mobile money adoption. However, the investment opportunity we are most excited about is bKash in Bangladesh, another example of a brand that has become a verb.

bKash has close to 80% market share of mobile money transactions in Bangladesh. The business is run by a management team with a lot of experience in mobile money and, similar to Kenya, Bangladesh has low banking penetration with supportive regulation, focused on financial inclusion in the country. We have seen that the network effect in a business like this is incredible, with the number of transactions growing exponentially as the number of users expands. This means that the strongest player usually just gets stronger and in this 'winner takes all' industry, bKash is extremely well positioned to capture the Bangladeshi mobile money market. We believe that bKash is today where M-Pesa was about four or five years ago, and if M-Pesa's growth trajectory is anything to go by, bKash has enormous growth ahead of it.

Firstly, bKash should experience strong revenue growth as the number of users and the transactions per user increase. The following table and graphs show that although Bangladesh's population is almost four times the size of Kenya, its mobile money revenue is (still) significantly lower than that of M-Pesa, clearly highlighting the potential for bKash.

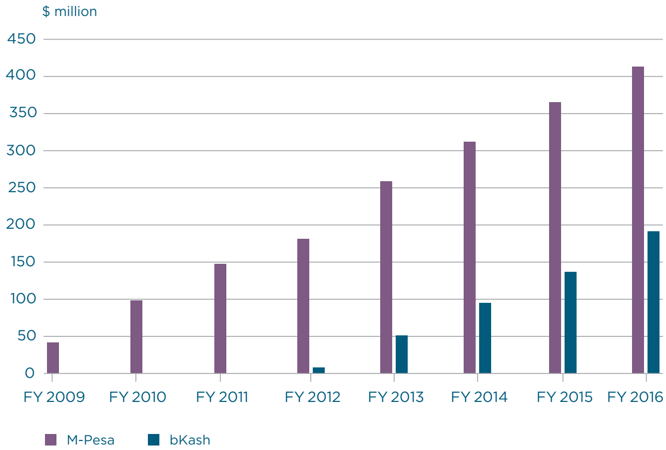
REVENUE FROM MOBILE MONEY VS POPULATION

	M-Pesa (Kenya)	bKash (Bangladesh)
Revenue from mobile money (FY 2016, converted to $ million)	415	192
Population (million)	46	162
GDP per capita ($)	1516	1411
Number of active users* (million)	19	11
Active users as % of population	41%	7%

* Active users are defined by M-Pesa as those users active within the last 30 days and by bKash as those active within the last 90 days.

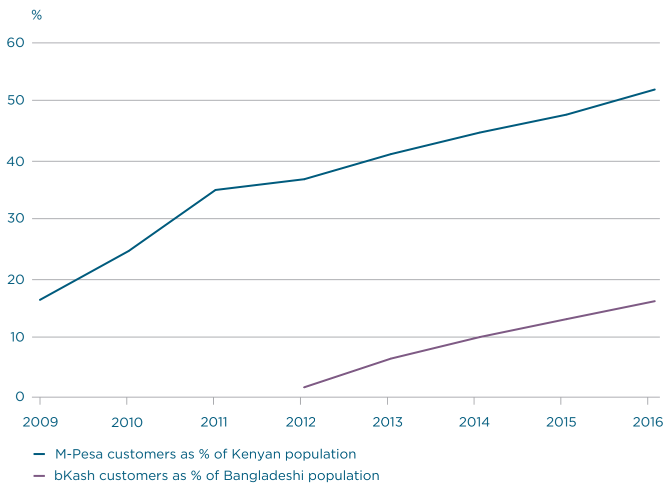
Sources: Company reports, IMF

REVENUE (CONVERTED TO US DOLLAR)



Source: Company reports

PERCENTAGE OF POPULATION WITH A MOBILE MONEY ACCOUNT



Sources: Company reports, IMF

Secondly, the profit margin of bKash is still well below where it could be once this business reaches maturity. bKash is investing heavily to build its agent network and entrench its market position. This, as well as the fact that virtually all its transactions are still the traditional lower-margin P2P transfers, both point to significant growth in margins in the future. The gross profit margin of bKash has grown to 19% in 2016, but this is well below that of M-Pesa, which we estimate to be in excess of 50%. Over time, we see no reason why bKash cannot have similar gross profit margins as the business matures and new high-margin services are added to the bKash platform.

When it comes to net profit margins, bKash should be able to achieve margins well above that of M-Pesa, given that it is entitled to the interest earned on the float balance. If M-Pesa had this benefit, its profit margin would have been more than 10 percentage points higher. Many articles have been written on the benefits of a business which generates float, usually quoting Warren Buffett's explanation that float is essentially free money which a business can use to invest. The bKash float has grown rapidly from $50 million in 2013 to over $200 million currently. The float has the potential to be a multiple of this balance in a few years' time and, similar to M-Pesa, we believe the ability of this business to gather these cheap deposits is a major threat to banks.

Currently investors can get exposure to bKash through its listed parent, BRAC Bank. We expect that bKash will be unbundled from BRAC Bank at some point in the future – firstly to give investors direct exposure to this attractive business, but also to allow bKash even more freedom to pursue new products and services which will inevitably compete with its parent. Similar to Safaricom, we believe that while the BRAC Bank valuation might look stretched on near-term multiples, the share price does not yet fully reflect the growth potential and optionality inherent in the mobile money business. We believe this offers an attractive opportunity for long-term investors. ■

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

GLOBAL ECONOMY

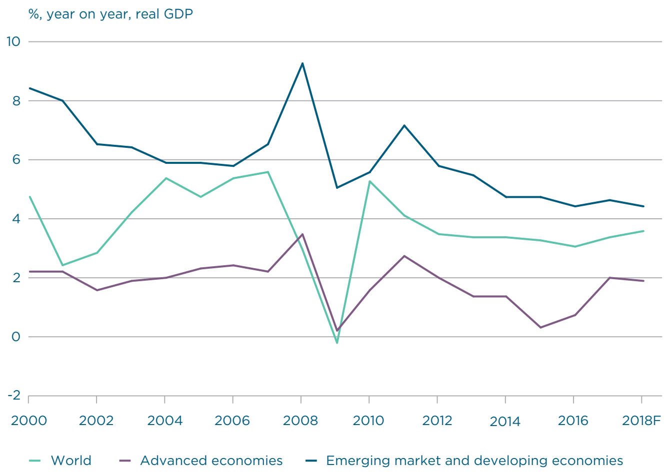
GROWTH UPTICK, BUT INFLATION MAY BE LOWER FOR LONGER

By Marie Antelme

Marie is an economist within the fixed interest investment unit. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

Taking stock at mid-year, prospects for the world economy seem reasonably bright. Growth surprises have trumped uncertain politics, and uncertain politics, at least for now, seem to have settled. Global growth is expected to accelerate from 3.1% in 2016 to 3.5% in 2017, and remain buoyant at 3.6% in 2018, according to IMF projections. The underpin has been a strong end to 2016, an acceleration in infrastructure and real estate investment in China, rising commodity prices, an improvement in global growth expectations, moderate inflation, strong financial market performance and ongoing monetary support.

GLOBAL GROWTH



Source: IMF

By country, Europe is the stand-out best economic performer this year relative to expectations. With GDP growth for the euro area set to remain strong at 1.7%, a broad base of European economies are performing well. Germany, thanks to an exceptionally strong trade performance, is expected to grow by 1.6%, with buoyant growth also anticipated from Spain (+2.6%) and France (+1.4%). Italy, which has significant financial and fiscal challenges, remains the laggard, and is expected to grow by only 0.8% this year and next year. European forward-looking activity indicators, like the Purchasing Managers' Index, have in aggregate been at cyclical highs for months, suggesting that current momentum may be sustained for a while.

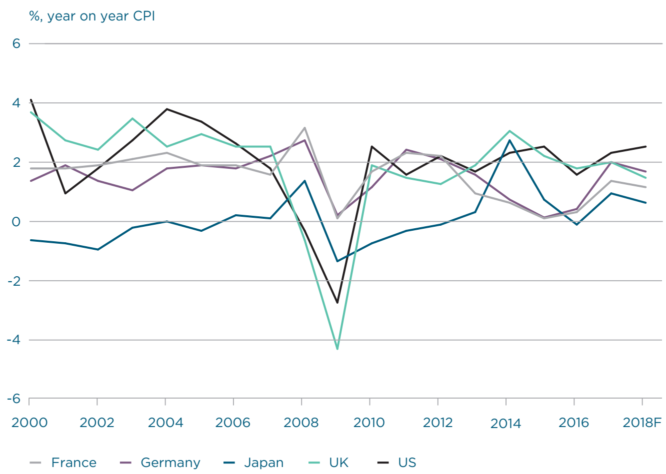
Projected growth has also been revised higher for the US, despite a weak start to the year and some moderation in expectations that promised reform would have an early, and meaningful, impact on domestic growth. GDP growth in 2017 is expected to reach 2.6% (following 1.3% in 2016), and 2.4% in 2018. There has also been an ongoing recovery in US employment, and with it, decent consumer confidence. Consumer spending has remained subdued, but may accelerate in the second half of 2017. Amid an uptick in oil prices at the start of the year, capital expenditure (capex) in oil-related industries revived at the start of the year, but there has also been a broader rise in capex intentions, and private investment in both non-residential and residential property has improved.

The outlook for the UK is less positive, with the June snap election an unexpected setback for Theresa May's Conservative Party, that has forced it into a minority government and added both to uncertainty about domestic policy going forward, and, importantly, to the pending Brexit negotiations. Amid this uncertainty, the economic backdrop has weakened: GDP growth slowed to 0.3% quarter on quarter in the first quarter from 0.7% in the fourth quarter, and 1.8% in 2016 for the year as a whole. This poses some downside risk to previous growth projections of 2.1% year on year for 2017 and 1.5% in 2018. The weaker exchange rate is also adding to pressure on import prices, and the Bank of England is likely to face an increasingly uncomfortable situation: moderating GDP growth as price pressure rises. In Japan, growth has picked up, but inflation remains elusive, despite prime minister Shinzo Abe's commitment to hold interest rates at zero for as far out as another 10 years.

Consistent with the firming of global activity, international trade volumes have improved. This is key for growth in emerging markets, and in line with the uptick in trade activity, growth prospects in a number of key emerging markets have improved.

Despite improved growth outcomes across the world, inflation remains benign. An early-year acceleration in headline inflation in developed economies, mostly related to oil prices and base effects, has faded. A great conundrum for monetary policymakers in the developed world has been the slow response of wage rates to tight labour markets. In some instances – the US, Germany, France, Japan and the UK – unemployment has fallen to rates historically consistent with considerably higher wage inflation. This confirms concerns that demand-driven inflation may emerge. There is not a simple explanation why wage inflation has so far remained weak, but a combination of higher rates of labour market participation (more people looking for work instead of dropping out of the labour force), more people who are underemployed (part-time or overqualified, but working for low wages), mechanisation, product-related compensation (online work, paid for on delivery), fading unionism and wage agreements indexed to lower inflation may be contributing.

INFLATION IN DEVELOPED ECONOMIES



Source: IMF

This is a difficult economic environment for central banks to navigate, especially because the very weak momentum in core inflation may also be the result of a complex set of circumstances. Only the US Federal Reserve has embarked on a slow, steady normalisation path – and has signalled not only that it will continue to do so, but that it will implement plans to start the long process of balance sheet normalisation in coming months. The European Central Bank faces structural constraints: high government debt levels in some member countries, the uneven growth revival, coupled with a more recent, more concerning, flirtation with deflation. Accordingly, it has a tolerance for higher inflation (for longer) than would have been the case before. Nonetheless, it has also signalled a less accommodative stance in June, and some intention to taper its active quantitative easing programme. As the Bank of England faces the difficult combination of slowing growth and rising inflation, its monetary policy committee has become more fractured, with three members voting to raise interest rates at the June meeting. The Bank of Japan has sent a clear signal that its accommodative policies will remain on hold for some time.

Emerging market growth prospects are often linked to China, either through the trade in commodities or its demand for light manufacturing. The revival of China's economy, which gained traction in 2016 to reach 6.9% year on year in the first half of 2017, has contributed to higher commodity prices, providing a fillip for commodity exporters. Since June, the People's Bank of China has been tightening liquidity conditions, particularly in the more creative lending associated with structured products in non-traditional banking sectors. Over time, this should see growth momentum in China slow, and the property market retrench some of the growth seen over the past one to two years. Slower growth in China implies – broadly – somewhat weaker industrial commodity prices, which are less favourable for emerging markets. That said, growth momentum in many key emerging markets is building off a notably weak base, and should improve this year. Looking ahead, a number of larger emerging markets face idiosyncratic challenges. In Brazil, a political crisis has delayed key legislative reform and the fiscus remains under extreme pressure. In Mexico, policy uncertainty in trade and immigration is muddying its relatively solid economic prospects. In Turkey, the April referendum heralded a change to its presidential democracy which may bring changes to historically conservative fiscal policy. In South Africa, political uncertainty weighs on a fragile economy, undermining confidence and putting long-term growth and fiscal sustainability at risk.

Despite the broad-based improvement in global growth (and, for many countries, enhanced prospects for 2018), there remain significant structural impediments that could undermine a sustained strong upturn. Policy tightening tilts the risks to growth to the downside and raises longer-term political risk. In particular, low productivity, the aforementioned weak wage growth and persistent inequality remain unaddressed challenges, especially in developed economies. ■

MERE MONETARY MORTALS

CENTRAL BANKERS DO OFTEN GET IT WRONG

By Tony Gibson

Tony is a founder member of Coronation and a former CIO. He established Coronation's international business in the mid-1990s, and has managed the Global Equity Fund of Funds strategy since inception.

TAKING STOCK

The first half of 2017 was largely characterised by momentum investing, especially rallying behind large-cap technology stocks. Passive (index-tracking) investment flows no doubt continued to play a major role in these flows. Although this trend appeared to have peaked in early June, there were impressive gains in top-tier technology stocks as they retained their leadership in the US equity market in the past six months. Stocks such as Tesla, Facebook, Amazon, Apple and Netflix were the clear winners.

By comparison, industrial, materials and energy stocks had a very tough six months. Financial stocks also materially lagged the technology sector. As has become a familiar pattern in recent years, the underperformance of the industrially sensitive stocks was essentially due to fears over the resilience of the US economy. In particular, this was sparked by signs of weakening motor vehicle demand and ongoing gridlock within US government. Additionally, pre-Brexit uncertainty in the UK did not help sentiment.

Despite these concerns, and even with increased tensions between the US and North Korea, equity market volatility remains low. Although this is a potential red flag in terms of investor complacency, it no doubt represents (for now, anyway) a prudent commitment to equity investing. This is supported by continued liquidity injections from central banks, rising earnings and a slow but steady return towards expectations for modest but synchronised global growth for 2017 and into 2018.

MARKET ROTATION

When looking at returns beyond US equity markets, it must be borne in mind that the US Dollar Index fell by 6.4% in the first half of 2017. This currency rotation towards the euro and the yen therefore exaggerated the first-half gains in many foreign equity markets when measured in US dollars. European equity markets outperformed the Standard & Poor's Index by a range of between 12% (Spain) and 6% (Sweden), measured in US dollars.

Additionally, the broad rise in global equity prices over the first half of 2017 fed strong gains in liquidity-sensitive emerging equity markets. Anticipation that Germany (to preserve the EU) will provide further support for peripheral market banks and debt exaggerated the rotation toward Greece, Italy and Spain. Also, the modest pullback in the US dollar, combined with economic resilience in the US and China, enhanced the rotation toward most emerging market equities – with the exception of oil-sensitive Russia, which fell by 12%. The top-performing emerging markets were Greece (39%), Turkey (29%) and Mexico (25%).

As already mentioned, a rotation out of the momentum-driven technology sector and towards value in emerging markets, financials and industrials began in June. By way of example, despite a further 4.7% drop in the price of West Texas Intermediate crude oil in June, the Journal of Commerce Material Price Index and the Integrated Oil & Gas Index fell only 0.7% and 0.9% respectively. Hence, fears that US equities are overpriced *may* be counterbalanced during the second half as domestic economic resilience attracts some capital back toward US financials, industrials and the energy sector.

Given that the expectation is for the cost of money to continue to rise, it is not surprising to note that bond yields have moved up during June and July. This is a change in trend from earlier in 2017 when bond yields fell due to a waning of the overexuberant expectations of stimulatory policies under US president Donald Trump. Additionally, it should be pointed out that companies with high levels of borrowings have underperformed the broad equity market so far in 2017.

RE-EMERGENCE OF INFLATION

Looking towards the remainder of 2017, the issues currently weighing on investors' minds relate to the following two questions: Has the US recovery peaked or will it remain resilient through into 2018? And have equity prices peaked or will the rally be supported into next year by strong earnings and a broader rally, possibly lifting financials and energy stocks?

We believe that conditions favour continued resilience in US consumer spending and a modest but synchronised upturn in global growth later this year and into 2018. That said, we believe that the outlook for inflation, and central bank actions, will be vital to understand the direction in the near future.

After a decade of central bank intervention aimed at preventing a deflationary contraction and restoring liquidity and solvency in the banking system, the return to market pricing for money and risk will be slow, halting and unpredictable. That said, the first steps toward normalcy have been taken and despite continued central bank bond buying in Europe and Japan (and the reinvestment of the Federal Reserve's [Fed] massive bond portfolio), interest rates have begun to rise. Since real rates remain negative in much of the northern hemisphere, the slow withdrawal of intervention over the next 18 to 24 months is not likely to affect consumer spending or private sector investment materially.

The potential re-emergence of inflation is a critical issue investors face today. This is partly because three decades of benign inflation have bred investor complacency – and that complacency has become even more entrenched in the nearly nine years since the financial crisis. As a result, investors are largely underweight assets that stand to do well in an inflationary environment, probably leaving their portfolios insufficiently insured against a significant rise in prices.

Influencing this is the fact that, during the current recovery, traditional measures of inflation have lagged significantly when compared to prior recoveries. Implied inflation measures remained extremely subdued until late 2016. The result is that most equities sell-offs over the past decade were associated with fears of deflation, not inflation. As a result, investors in recent years have gravitated toward assets that tend to do well in low-growth, low-inflation environments, and these assets did indeed provide valuable diversification.

Economists often attribute the benign inflation that prevailed since the 1980s to a number of institutional changes, including monetary policy independence and globalisation, which suppressed the cost of goods and labour. This allowed investors and consumers to anchor their inflation expectations better. The 2008 global financial crisis and its aftermath – particularly a slow recovery in business confidence and corporate spending, and overcapacity in the commodity sector – intensified these trends and increased fears about outright deflation. Historically speaking, this was highly unusual. As a recovery takes hold, inflation normally rises as debt levels and aggregate demand increases. But this recovery was a weak one and, without inflation, companies lacked pricing power. That, combined with low productivity, led to an earnings recession that lasted from 2012 until 2016. This contributed to weakness in confidence, hiring and capital spending.

However, there is reason to believe things will be different in the years ahead. Several disinflationary factors that kept prices in check over the last three decades, such as globalisation, are fading. At the same time, cyclical factors such as earnings growth, rising confidence and capital spending plans, tighter labour markets and capacity rationalisation in commodity markets are setting the stage for rising inflation. Additionally, governments' willingness to expand fiscal policy despite a low level of slack in their economies is raising inflation expectations in the US, Japan and the UK.

CENTRAL BANKER FALLIBILITY

In our opinion, too many investors like to take their cue from the utterings of central bankers – simply due to the belief that these central bankers have a great deal more insight that most. In our opinion this a dangerous and flawed approach. Central bankers can and do frequently get things wrong. Not because they are being duplicitous, but rather due to the reality that they are seemingly blind to the bubble-creating effect that their policies have had in the last 20 years or so. As we know, bursting bubbles can devastate both investment markets and the real economy.

To illustrate this point, one need look no further than quotes from former Fed chair Ben Bernanke around the time of the housing peak in 2005/2006:

"We've never had a decline in house prices on a nationwide basis. So, what I think is more likely is that house prices will slow, maybe stabilise, might slow consumption spending a bit. I don't think it's going to drive the economy too far from its full employment path, though." (Bernanke, July 2005).

"Housing markets are cooling a bit. Our expectation is that the decline in activity or the slowing in activity will be moderate, that house prices will probably continue to rise." (Bernanke, February 2006).

As it turns out, Bernanke was wrong. House prices did not continue to rise, or even stabilise. Shortly after his comments, house prices started to fall across the US, and would only begin to stabilise after a 25% decline over five years.

Recent weeks have been no different, with central bank comments and statements abound. One of the more recent comments, from Fed vice chair Stanley Fischer, referred to high asset values – specifically that "high asset values may lead to future stability risks". In essence, he is warning that central bankers are now worried that their extraordinary policies have created significant asset bubbles, and a future bear market would hurt both financial markets and the real economy. Their poor forecasting track records aside, when central bankers tell us that asset values are "somewhat rich" (Fed chair Janet Yellen) and that they are worried about future stability – whilst at the same time raising interest rates and potentially reducing their balance sheet – we as market participants should take note. Our view remains that the Fed will continue to walk a bit of a tight rope, that is, tightening policy until something 'breaks', either in the US or globally.

Of course, even if the Fed is worried that they have created a massive bubble, they will be very careful in the way they manage markets. As a result we will continue to get ridiculous comments such as when Yellen recently said she did not believe that there will be another financial crisis in our lifetime. This statement conveniently ignores the fact that, historically, every period when asset markets have become this expensive and debt this high has been followed by a financial crisis. This is of course looking backwards.

The trigger for past crises has always been falling asset values; we now have a Fed that is acknowledging high asset values and yet is still tightening policy. Logic suggests to us that the monetary policymakers are also privately worried about this, and are now trying to dig themselves out of a very deep hole with their policy tightening. What worries us is the implicit reason that many investors are remaining invested in risky assets – despite the increasing warning signs. Many investors simply believe that during the next crisis, the Fed will be very quick to slash interest rates and print money. After all, Fed governors have told us that this is what they expect to do.

CONFIDENCE VERSUS ANGST

Analysing 2017 thus far can be summed up as follows: capital flows, exaggerated by central bankers' liquidity injections (in Europe and Japan in particular) aimed at suppressing interest rates, flowed towards risk from January into early February. Capital then became overexposed to economic risk and allocations were pulled back, crowding again into the momentum of top-tier large-cap equities in the tech sector. The perceived safety of sovereign debt also attracted money flows. This rotational momentum was exaggerated as a mild northern-hemisphere winter triggered a gathering exodus from the energy sector. Simultaneously, delays in passing meaningful fiscal reforms in the US tempered expectations for the scope and timing of monetary tightening, pulling capital away from interest rate-sensitive financial equities. In our opinion, current investor worries should be balanced by our expectation of renewed confidence in the outlook for global growth as we move into 2018, triggering a rotation back toward economically sensitive stocks and sectors. Capital will again flow from safe havens and bonds toward financials, industrials, commodities and the deeply oversold energy sector.

While any investment forecast is dangerous and flawed, the current dynamics influencing the direction of global equity markets are particularly hard to predict. The primary reason for this is the relentless growth in passive investing. Passive investment products represent a very large part of flows into US equities in particular, thereby changing the demand dynamics. What is very difficult to predict is how passive investors will respond to any material market correction. ■